

## Chapter - 1

### Basics of Financial Accounting

| Sr. No | Course outline – Topics                                     |
|--------|-------------------------------------------------------------|
| 1      | Definition of Accounting & Financial Information            |
| 2      | Sources of Financial Information                            |
| 3      | Money Measurement & Financial Position                      |
| 4      | Functions of Financial Accounting                           |
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| 6      | Entity and Separate Entity Concept                          |
| 7      | User of Financial Information                               |
| 8      | Underlying Assumption – Going Concern                       |
| 9      | Recognition of the elements of financial statements         |
| 10     | Measurement of the elements of financial statements         |
| 11     | Qualitative characteristics of useful financial information |

**Video number 1-11 are mandatory part of this module.**

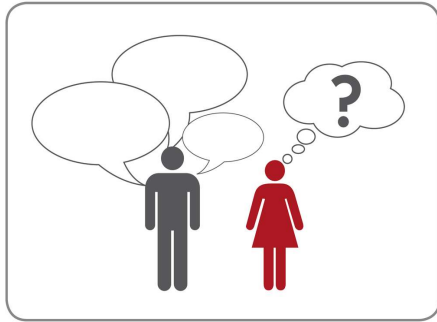
## Definition of Accounting

**Accounting** is a language that is used to communicate and understand the financial ideas, financial expressions, financial thoughts and financial information.



## Language

Language is a medium that is used to **communicate** and **understand** some ideas, feelings, expressions or information.



**Financial information**

Any information that is measurable in terms of money and causes a **change in financial position** of an entity is known as financial information.

## Sources of Financial Information

There are three sources of financial information, which are also known as accounting phenomena.

### i) Transactions

Transactions are the outcome of dealings made.

### ii) Events

Events are the outcome of incidents happened.

### iii) Conditions

Conditions are the adjustments in recorded information.



## Transaction (source of financial information)

Transaction occurs when two persons deal with each other.



**Social motives dealings** ➡ Social transaction

For example; a person receiving birthday gift from his friend is a social transaction.



**Economic benefits dealing** ➡ Accounting transaction

Accounting transaction is a monetary dealing between the entity (business / non business) and other person. An accounting transaction causes **change in financial position** (financial status) of the entity.



Dealing between entity and other person includes:

1. Dealing of entity (first party) with owner/s (Second party)
2. Dealing of entity (first party) with any person other than the owner/s (third parties).



From this details we can extract two *criteria* to identify accounting transaction:

1. Measurability in terms of money, and
2. Dealing of the entity with other person.



**Practice 1.1**

**Keeping in view the criteria, identify which of the following information is accounting transaction:**

1. Payment of staff salaries made by cheque.
2. Appointing a production manager on contract.
3. Having a conversation with foreign supplier for import of raw material.
4. Placing an order for purchase of production machine.
5. Purchasing motor vehicle and paying cash for the price.

**Answer: (1, 5)**

Explanation;

1. This is a dealing between **entity** and **employee** that is measurable in money.
2. Activity has no effect on financial position – there is no money measurement.
3. Activity has no effect on financial position – there is no money measurement.
4. Activity has no effect on financial position – there is no money measurement.
5. This is a dealing between **entity** and **car showroom** that is measurable in money.

Practice 1.2

**Identify accounting transactions:**

1. Up-keeping expenses of building paid by cheque.
2. Collection of dues from customers.
3. Negotiating with bank for taking loan.
4. Receiving cash against loan from bank.
5. Payment of personal expenses of the owner in cash.

**Answer:** (1, 2, 4, 5)

Explanation:

1. This is a dealing between **entity** and **repairer** that is measurable in money.
2. This is a dealing between **entity** and **customer** that is measurable in money.
3. Activity has no effect on financial position – there is no money measurement.
4. This is a dealing between **entity** and **bank** that is measurable in money
5. This is a dealing between **entity** and **owner** that is measurable in money

### Event (source of financial information)

Event means anything that happens. There are two types of events, **Monetary** and **Non-Monetary** events.

#### Monetary Event

It is an outcome of happening or occurrence of incident that can be measured in terms of money and can cause a change in financial position (financial status) of an entity.

Examples include:

##### Loss by fire.



##### Loss by accident.



##### Foreign exchange (gain/loss)



#### Non-Monetary Event

It is an outcome of happening or occurrence of incident that cannot be measured in terms of money and cannot cause a change in financial position (status) of an entity.

Examples include:

##### Winning or losing a game that does not carry financial impacts



**Condition (source of financial information)**

Condition is the third source of financial information. It requires certain adjustments to be made in already recorded transactions and events.

Examples include:

- **Fixed Assets to be depreciated according to their expected useful life**
- **Provision to be created against expected doubtful recovery from customer**



### Practice 1.3

Which of the the following information is Transaction, Event or Condition.

1. Stock in godown lost by fire
2. Giving away gifts to employees of the entity
3. Training to employees through external trainers
4. Organizing a dinner for entity's valued customers
5. Recognizing depreciation of machinery
6. Insurance claim recovered from insurance company against stock lost by fire
7. Cash paid as charity to a hospital

**Answer:** 1. Event – 2. Transaction – 3. Transaction – 4. Transaction – 5. Condition – 6. Transaction – 7. Transaction

Explanation:

1. Fire accident is **not a dealing** between two persons, value of loss of stock due to fire is an outcome of fire accident that is measurable in terms of money. Therefore it is an event.
2. It's a dealing between **entity** and **employees** and also measurable in terms of money. Therefore, it is a transaction.
3. It's a monetary dealing between **entity** and **external trainers**. Therefore, it is transaction
4. It's a dealing between **entity** and **restaurant** that is measurable in terms of money. Therefore, it is a transaction.
5. It is an adjustment in the value of already purchased machinery in order to show money measurement of the benefits obtained from that machinery during the reporting period. Therefore, it is termed as condition.
6. It's a dealing between **entity** and **insurance company**. It is measurable in terms of money. Therefore, it is a transaction.
7. It's a dealing between **entity** and **charitable institute**. It is measurable in terms of money. Therefore, it is a transaction.

## Money measurement

Money measurement is often misunderstood as receipt or payment of cash. Whereas, money measurement means to assign a value in reporting currency to the information, regardless the cash is still payable or receivable.

To better understand the concept of money measurement let us understand the idea of other measurements.

In order to measure a table; different parameters may be used for its measurement such as:

|                      |          |
|----------------------|----------|
| Measuring its weight | 10.0 Kg  |
| Measuring its length | 3.0 Feet |
| Measuring its width  | 1.5 Feet |
| Measuring its height | 2.0 Feet |

Whereas, money value assigned to this table, Rs. 15,000 will be its *money measurement*.



**Practice 1.4**

Which of the following information is carrying money measurement?

1. Bought 30 numbers of computers.
2. Bought 10 fans @ Rs. 1,500 each, cash paid immediately.
3. Scrap dumped, weighted 150 Kg.
4. 5 workers are working on the plant in double shift.
5. Bought raw material worth Rs. 50,000, cash is not yet paid.

**Answers: (2 & 5)**

Explanation:

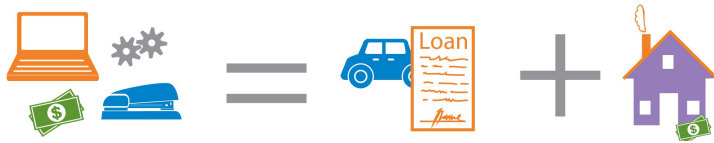
1. Only quantity is given, no currency value is known.
2. Quantity and currency value are given. Money value is measurable (10 fans x Rs.1,500 = Rs. 15,000)
3. Only quantity is given, no currency value is known.
4. Only quantity is given, no currency value is known.
5. Money value of raw material is available in the information.

## Financial position

Financial position means; an entity's status of Resources & Sources. **Resources** are the assets that an entity holds in its control and **Sources** are the means of finances through which the entity makes such assets. Means of finances include; liability and owners' equity.

*Concept of Asset, Liability and Owners' Equity will be discussed in detail in the upcoming topics.*

$$\text{Assets} = \text{Liability} + \text{Equity}$$



| ASSETS       |               | LIABILITIES     |               |
|--------------|---------------|-----------------|---------------|
|              | Rs.           |                 | Rs.           |
| Furniture    | 80,000        | Bank loan       | 35,000        |
| Computers    | 10,000        | Other payable   | 15,000        |
|              |               | EQUITY          |               |
|              |               | Owner's Capital | 40,000        |
| <b>TOTAL</b> | <b>90,000</b> | <b>TOTAL</b>    | <b>90,000</b> |

### Functions of financial accounting (Accounting cycle)

Financial accounting is a subject that is about financial information. It is said that where-ever there is financial information; there would be a need of financial accounting.

Financial accounting is used to:

1. Classify,
2. Record,
3. Summarize,
4. Report, and
5. Analyze



the financial information of an entity by using different accounting tools.

So, there are five functions of Financial Accounting.

1. **Classifying.** All types of financial information are classified into five main heads:
  - i. Assets
  - ii. Liabilities
  - iii. Incomes
  - iv. Expenses
  - v. Owners Equity.

These **main heads** are further sub-classified into **accounting heads**, which are then used for recording accounting transactions in the books of accounts.

| Main Heads       | Assets       | Expenses      | Owners' Equity | Liabilities    | Incomes    |
|------------------|--------------|---------------|----------------|----------------|------------|
| Accounting Heads | Land         | Purchases     | Capital        | Bank loan      | Sales      |
|                  | Building     | Salaries      | Drawings       | Bank overdraft | ServiceFee |
|                  | Machinery    | Electricity   | Profits        | Creditors      | Commission |
|                  | Furniture    | Repair        | etc.           | Payable        | etc.       |
|                  | Motor Van    | Advertisement |                | etc.           |            |
|                  | Computer     | Telephone     |                |                |            |
|                  | Stocks       | Traveling     |                |                |            |
|                  | Receivables  | Freight       |                |                |            |
|                  | Cash Balance | Rent          |                |                |            |
|                  | Bank Balance | Stationery    |                |                |            |
|                  | etc.         | etc.          |                |                |            |

2. **Recording.** Financial information are recorded in the books of accounts according to the prescribed rules
3. **Summarizing.** Recorded financial information is summarized in another book of account. These summaries are prepared for each accounting head that are named as ledger accounts
4. **Reporting.** The results of summaries of each accounting head are reported to the users of financial information by preparing financial statements
5. **Analyzing.** Finally the facts reported are analyzed for certain decision making purposes

## Elements of Financial Statements

All financial information of a business entity are divided into five main heads of accounts. These are also known as elements of financial statements, according to the conceptual framework of financial reporting by IFRS.

### Assets:

Assets are the resources in control of entity as a result of past event for which there is a probability that there will be an inflow of economic benefits to the entity in future.



### Liabilities:

Liabilities are the present obligations of entity arising from past events for which there is a probability that there will be outflow of resources embodying economic benefits for the entity in future.



### Income:

Incomes are earnings of the entity through **Revenue** or **Gains**. Income simultaneously causes increase in economic benefits during the reporting period in the form of inflows or enhancements of assets or decrease of liabilities that result in increase in equity, other than those relating to contributions from equity participants. Sources of revenue are; sales of goods or services and return on investments. Sources of gains are; profit on disposal of assets and discounts on settlement of liabilities.



### Expense:

Expenses are the costs that expire during the reporting period of entity. Expenses simultaneously cause decrease in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity, other than those relating to distributions to equity participants. These must match with current year's revenue. It includes **losses** sustained during the reporting period.



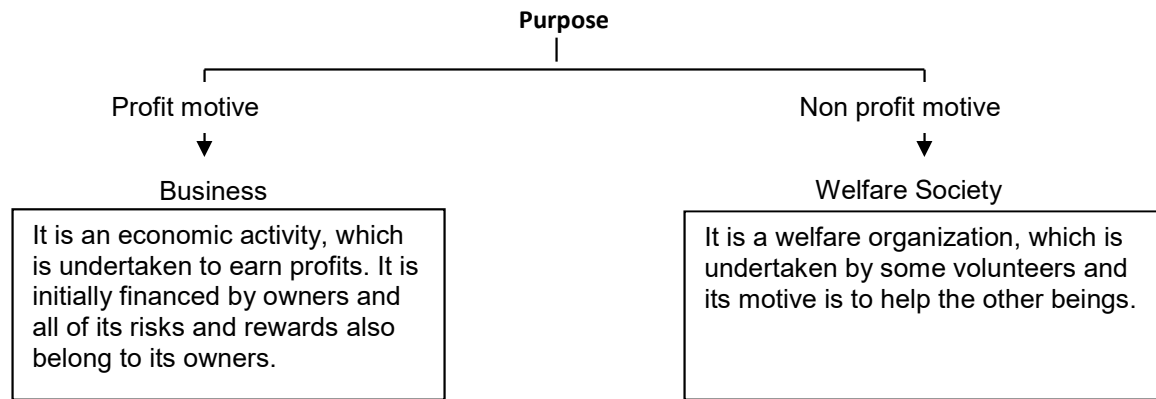
### Owners' Equity:

Owners' equity is the source of finance that represents owners' stake in the entity. Equity is the residual interest in the assets of the entity after deducting all its liabilities. Components of owners' equity are; introduction of resources by owner into the business (capital); profits generated by the entity (net profit); distributions of profits to the owners for personal use (drawings/dividends).



## Entity

It is an activity that is undertaken by individuals or group of people for some **purpose** (profit or non profit).



Financial information is involved in both profit motive and non profit motive entities. Therefore, financial accounting is a need for a business as well as a welfare society.



## Separate Entity Concept

A business entity and its owner are two different persons. For accounting purposes, business has separate entity/identity apart from its owner.

As a student of accounting, while analysing the transactions, you must focus on the accounting information considering yourself as an accountant of the business for which you are analysing the transactions. Do not consider yourself as an owner of that business.

Owner's personal expenses like food, medicines, clothing, house rent etc., which are paid by the owner from his/her owned resources are not financial information belonging to the business unless those are paid from business cash resources on behalf of the owner.



### Practice 1.5

Based on the business entity concept, which of the following information would be accounted for in the accounting books of an entity/business?

1. Cash invested as capital of the business by the owner.
2. Owner bought motor car for his personal use out of his personal bank account.
3. Owner used a part of his residential building for the business godown for which he was paid rent out of business bank account.
4. Owner took loan for his daughters' marriage from a friend.
5. Goods bought by business for trading were consumed by the owner for his personal consumption.

**Answers (1, 3, 5)**

Explanation:

1. It will affect cash asset and owner equity of the business.
2. There will be no effect of this transaction on business.
3. It will affect the business bank account.
4. There will be no effect of this transaction on business.
5. This transaction will decrease the stock balance of the business.

## Users of Financial Information

According to the Conceptual Framework for Financial Reporting, "The objective of financial statements is to provide information about the financial position, financial performance and changes in financial position of an entity that is useful to a wide range of users in making accounting decisions."

A business must report its financial information because there are various groups of people who want or need to know it. Following groups are likely to be interested in financial information of an entity.

**(a) Investor/Shareholders/owners**

To assess how well the management is performing. How profitable are the operations? How much profit they can easily withdraw from the business for their own use.



**(b) Trade contacts**

Suppliers and customers are two main trade contacts. Suppliers want to know about the entity's ability to pay its debts against supplies on credit terms, customers need to know that the entity is a secured source of supply and is in no danger of having to close down.



**(c) Lenders**

Providers of finance are lenders to entity might include a bank. The bank wants to ensure that the entity is able to keep up interest payments, and eventually to repay the amounts advanced.



**(d) Taxation authorities**

Interested to know about profits in order to assess the tax payable by the entity, including sales taxes etc.



**(e) Manager and Employees**

Need information about the entity's financial situation, because their future careers and the size of their wages and salaries depend on it. To enable them to manage the business efficiently and to make effective decisions



**(f) Financial consultants and advisers**

Need information for their clients or audience.

For example, stockbrokers need information to advise investors, credit agencies want information to advise potential suppliers of goods to the concern; and journalists need information for their reading public.



**(g) Government**

Interested in the allocation of resources. They also require information in order to provide a basis for national statistics.



**(h) Public**

Entity affects members of the public in a variety of ways. For example, entity may make a substantial contribution to a local economy by providing employment and using local suppliers. Another important factor is the effect of an entity on environment, for example, as regards pollution.



**Practice 1.6**

State following statements are true or false:

1. Debt burden of the company is the information mostly require by income tax authorities.
2. Dividend declaration is the information needed by shareholders.
3. Financial ratios are most likely require by financial consultants
4. Bonus to employee's is the information that is needed by Government.
5. Cost of sales information is usable for managers.
6. Welfare society is always interested in green policies cost of company.

Answers: (1-false 2-true 3-true 4-False 5-true 6-True)

Explanation:

1. This information is required by lenders, investors and shareholders
2. True
3. True
4. Such information is required by income tax authorities and managers
5. True
6. True

## **Underlying Assumption**

### **Going concern**

Assumption that a business unit will remain in existence for the foreseeable future

The IFRS Conceptual Framework states that the going concern assumption is an underlying assumption, it is assumed that the entity will realize its assets and settle its obligations in the normal course of the business. Thus, the financial statements presume that an entity will continue in operation indefinitely or, if that presumption is not valid, disclosure and a different basis of reporting are required.

Examples include:

- Significant trading losses being incurred for several years. Profitability of a company is essential for its survival in the long term.
- Deteriorating liquidity position of a company not backed by sufficient financing arrangements.
- High financial risk arising from increased debts level causing the company to delays in payment of interest and loan.
- Aggressive growth strategy not backed by sufficient finance which ultimately leads to over trading.
- Increasing level of short term borrowing and overdraft not supported by increase in business.
- Serious litigations faced by a company which does not have the financial strength to pay the possible settlement.
- Inability of a company to develop a new range of commercially successful products.
- Bankruptcy of a major customer of the company.

## Recognition of the elements of financial statements

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- The item's cost or value can be measured with reliability.

Based on these general criteria:

- **An asset** is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
- **A liability** is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
- **Income** is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).
- **Expenses** are recognised when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).

## **Measurement of the elements of financial statements**

Measurement involves assigning monetary amounts at which the elements of the financial statements are to be recognised and reported.

The IFRS Framework acknowledges that a variety of measurement bases are used today to different degrees and in varying combinations in financial statements, including:

- Historical cost
- Current cost
- Fair Value ( realizable value / settlement value)
- Present value (discounted cash flows)

Historical cost is the measurement basis most commonly used today, but it is usually combined with other measurement bases. The IFRS Framework does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. However, individual standards and interpretations do provide this guidance.

## Qualitative characteristics of useful financial information

### Fundamental qualitative characteristics

#### Relevance

Relevance refers to whether the information makes a difference to the decision maker in order to make predictions about the outcome of past, present and future events or to confirm and correct prior expectations, e.g., report of bank balance that is essential to determine how much to borrow.

To be relevant, information must have confirmatory value, predictive value or both.

**Confirmatory** value is the exchange value, i.e., the value of one thing in terms of another at any place or time, e.g., the expected selling price of a non-current asset less costs to sell.

**Predictive** value is the ability of accounting numbers to provide information that is useful in predicting future accounting numbers, e.g., present value of expected future cash flows (known as value in use).

The confirmatory value and predictive value of financial information are interrelated. Information that has predictive value often also has confirmatory value.

#### Materiality (entity specific aspect of relevance)

Materiality is the basis for recognising a transaction in the financial reporting process. It is the extent to which financial information is material. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.

Therefore, information is considered material if its omission could influence the decision making of the users.

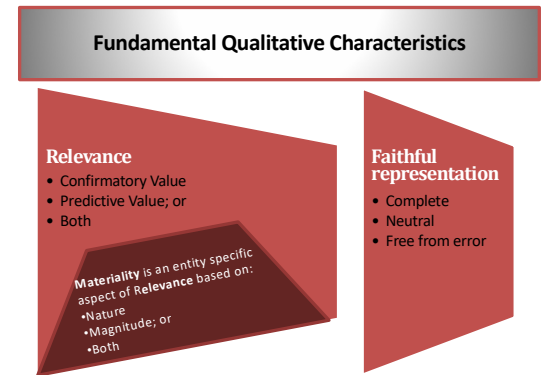
#### Faithful representation

Faithful representation is the correspondence between accounting figures and descriptions and the resources or events that these figures and descriptions represent. Information must faithfully represent the effects of transactions and other events.

To be a perfectly faithful representation, a depiction would have the following three characteristics:

- **Complete** A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.
- **Neutral** A neutral depiction is without bias in the selection or presentation of financial information, which does not mean information with no purpose or no influence on behavior.
- **Free from error** It means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

A faithful representation, by itself does not necessarily result in useful information, e.g., reporting an asset acquired through a government grant at nominal value.



#### Example – Getting prepared for facing loss because of doubtful recovery from customers (economic phenomena)

The information about this economic phenomenon should be useful (relevant & faithful) (comparable, verifiable, timely & understandable)

## Enhancing qualitative characteristics

The qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented are:

### Comparability

It requires consistent accounting treatments of items in the financial statements of different entities at the same point of time so as to enable valid comparison. Two sets of financial statements would have comparability if they had been prepared on the same basis and include similar type of value.

### Verifiability

It means that the measurement made by one measurer will be confirmed by another. It exists when there is a high degree of consensus among independent measurers, i.e., independent accountants using the same measurement process arrived substantially at same results. Verification can be:

- *direct* (verifying an amount or other representation through direct observation; (e.g., by counting cash); or
- *indirect* (checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology, (e.g., using FIFO method)

### Timeliness

It is necessary to balance the relative merits of timely reporting, and the provision of reliable information. If reporting is delayed until all aspects are known, the information may be reliable, but of little use to those who have had to make decisions in the interim.

### Understandability

Information should be presented in a way that is readily understandable by users who have a reasonable knowledge of business, economic activities and accounting and who are willing to study the information diligently. Disclosures make the information understandable.

## Enhancing Qualitative Characteristics

### Comparability

- Consistency

### Verifiability

- Direct
- Indirect

### Timeliness

- Timely Report
- Reliable Information

### Understandability

- Reasonable Knowledge
- Disclosures

## Assignment Questions

Q. 1

The underlying assumption in preparing financial statements is 'Going Concern'. State which ONE of the following best explains this concept.

- a) An entity has no intention to liquidate but can curtail major operations if management decides
- b) The financial statements of an entity should be user friendly
- c) **An entity should continue in operation for the foreseeable future**
- d) Transactions and events of an entity should be recorded for the foreseeable future

Q. 2

Which of the following is the best description of fair presentation in accordance with IAS 1 Presentation of Financial Statements?

- a) The financial statements are accurate
- b) The financial statements are as accurate as possible given the accounting systems of the organization
- c) The directors of the company have stated that the financial statements are accurate and correctly prepared
- d) **The financial statements are reliable in that they reflect the effects of transactions, other events and conditions**

Q. 3

For the purpose of fair presentation, the requirement of IAS 1 can be stated as which of the following?

- i. Selection and application of accounting policies
  - ii. Presentation of information in a manner which provides relevant, reliable, comparable and understandable information
  - iii. Additional disclosures where required
- a) (i) and (ii) only
  - b) (ii) and (iii) only
  - c) (i) and (iii) only
  - d) **(i), (ii) and (iii)**

## **Examination Questions**

**Q. 1**

**Briefly describe the fundamental and enhancing characteristics of useful financial information (marks 3)**

**Q. 2**

**Enumerate different users of financial statements (marks 3)**

**Q. 3**

**What are the two recognition criteria for Assets?**

## **Chapter – 2**

### **Recording Financial Information Double Entry Bookkeeping System – Accounting Equation**

| <b>Sr.<br/>No</b> | <b>Course outline – Topics</b>                       |
|-------------------|------------------------------------------------------|
| 1                 | Types of Transactions - Cash and Credit Transactions |
| 2                 | Identifying Debtors and Creditors                    |
| 3                 | Accounting Equation - Concepts                       |
| 4                 | Accounting Equation - Worked Example                 |
| 5                 | Accounting Equation - Practice                       |

**Video number 12-16 are mandatory part of this module.**

## Sources of financial information

As discussed earlier Financial information means the information that can be measured in terms of money



There are three sources of financial information:

1. Transactions
2. Events
3. Conditions

We shall put special concentration to identify and analyze “**transactions**” for recording purposes in the books of accounts.

## Types of transactions

There are two types of transactions:

1. Cash Transactions



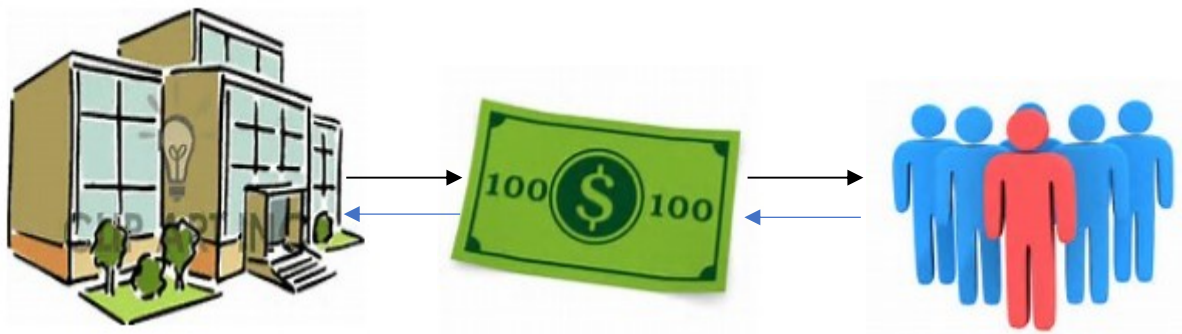
2. Credit Transactions



## Cash transaction

Cash transaction means the transaction in which cash/cheque is either paid or received at the same time while entering into the transaction. Examples include:

1. Cash received from customers/debtors/accounts receivables.
2. Cash paid to supplier/creditors/accounts payables.
3. Staff salaries paid through cheques.
4. Service fee received in cash.
5. Any type of payments made by cash/cheques/standing order/direct debit/debit card/demand draft etc.
6. Any type of collections received in cash/cheques / credit transfer in the bank etc.



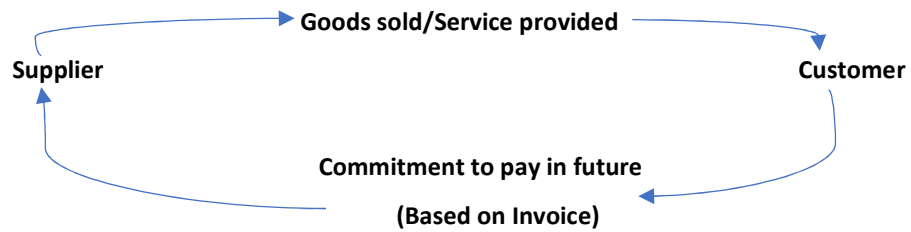
## Credit transaction

Credit transaction means a transaction in which payment or receipt in terms of cash or any other financial instrument is deferred for some future period. Means payment will be made or collection will be received sometime in future.

Examples include:

1. Sales of goods on credit by issuing sales invoice.
2. Purchase of goods on credit by receiving purchase invoice.
3. Return of goods from customers and issuing credit note.
4. Return of goods to suppliers and receiving credit note.

(A credit transaction creates Accounts Receivable - DEBTOR for supplier & Accounts Payable - CREDITOR for Customer)



## Identifying Debtors and Creditors

- Each **cash transaction** causes an increase or decrease in the cash balance / bank balance



- Each **credit transaction** either creates accounts receivable also known as **debtor**, or accounts payable also known as **creditor**. These personal accounts represent the transactions with Customers and Suppliers

### For Example:

An entity (customer) buys goods from supplier without making cash payment. This transaction creates a commitment on customer for supplier which is recorded as a liability and is recognized as Account Payable (Creditor) in the books of customer.

OR

An entity (supplier) sells goods to its customer without receiving cash. This transaction creates a commitment to receive cash from its customer which is recorded as an asset and is recognized as Account Receivable (Debtor) in the books of supplier.

|                            |   |             |
|----------------------------|---|-------------|
| Goods moving from Supplier | ➡ | to Customer |
| Cash moving from Customer  | ➡ | to Supplier |



### Debtors (Accounts Receivables) – ASSETS

These are the customers to whom goods/services are sold on credit terms based on a commitment that they will pay money in future. In other words, Debtors owe money to the business therefore, they are treated as accounts receivables.

*Examples include:*

- ⇒ Goods sold to **Yasmin** on credit terms. (credit transaction)
- ⇒ Cash received from **Yasmin** after 1 month of sales. (cash transaction)

Here, **Yasmin** (in the above two examples) is accounts receivable (debtor) for the entity.

- In the first transaction entity sold goods to **Yasmin** on credit, this creates a commitment for collection of money in future from **Yasmin**.
- In the second transaction entity is collecting cash from **Yasmin**, who is fulfilling the past commitment.



### Creditors (Accounts Payable) – LIABILITIES

These are the suppliers from whom the goods/services are purchased on credit term based on a commitment that they will be paid in future, in other words business owes money to the Creditors therefore, they are treated as accounts payables.

*Examples include;*

- ⇒ Goods purchased from **Maryam**. (credit transaction)
- ⇒ Paid cash to **Maryam** After one month of purchase. (cash transaction)

Here, **Maryam** (In the above two examples) is accounts payable (creditor) for the entity.

- In the first transaction entity bought goods from **Maryam** on credit, this creates a commitment for payment of money in future to **Maryam**.
- In the second transaction entity is paying cash to **Maryam** in order to fulfill the past commitment.



### Practice 2.1

Identify which of the followings is a cash or credit transaction, **also** identify the personal account as Debtor or Creditor from the following transactions.

- (a) Purchased goods from Hanan on credit.
  - Credit transaction
  - Cash transaction
  - Hanan is Debtor – Accounts Receivable
  - Hanan is Creditor – Accounts Payable
- (b) Paid cash to Maria on account.
  - Cash transaction,
  - Credit transaction,
  - Maria is Debtor – Accounts Receivable,
  - Maria is Creditor – Accounts Payable
- (c) Received cash from Star Brothers on account.
  - Cash transaction,
  - Credit transaction,
  - Star Brothers is Debtor – Accounts Receivable,
  - Star Brothers is Creditor – Accounts Payable
- (d) Paid cash to Donald on account.
  - Cash transaction,
  - Credit transaction,
  - Donald is Debtor – Accounts Receivable,
  - Donald is Creditor – Accounts Payable
- (e) Sold goods to John Smith on credit.
  - Cash transaction,
  - Credit transaction,
  - Smith is Debtor – Accounts Receivable,
  - Smith is Creditor – Accounts Payable
- (f) Purchased goods from Michael & Co.
  - Cash transaction,
  - Credit transaction,
  - Michael & Co is Debtor – Accounts Receivable,
  - Michael & Co is Creditor – Accounts Payable

#### Answer

- a. Credit transaction – Creditor
- b. Cash transaction – Creditor
- c. Cash transaction – Debtor
- d. Cash transaction – Creditor
- e. Credit transaction – Debtor
- f. Credit transaction – Creditor

Explanation to the correct answer:

- a. The person from whom goods are purchased on credit is “creditor – accounts payable”.
- b. Cash payment is made on account against credit purchase in previous dates
- c. Cash is received on account from customer against credit sale to customer in previous dates
- d. The person to whom money is paid on account is “creditor”
- e. The person to whom goods are sold on credit is “debtor”
- f. The person from whom goods are purchased on credit is “creditor”.

### Practice 2. 2

Identify which of the followings is a cash or credit transaction, **also** identify personal account as a Debtor or Creditor in the following transactions.

1. Bought motor car for cash.
2. Paid creditor Donald by cash.
3. Paid cash to Meera on account.
4. Sold motor car for cash to Dawood.
5. Bought furniture on credit from Henry.
6. Received cash from Star Brothers on account.
7. Owner Hamesh introduced further cash into the business.
8. Loan in cash received from Jasmin.
9. Paid Richard by cheque on account.
10. Sold goods on credit to Nelson.
11. Received Loan from Commercial Bank

### Answer

1. Cash transaction – No Debtor or Creditor
2. Cash transaction – Donald is creditor
3. Cash transaction – Meera is creditor
4. Cash transaction – No Debtor or Creditor
5. Credit transaction – Henry is creditor
6. Cash transaction – Star Brothers is debtor
7. Cash transaction – No Debtor or Creditor
8. Cash transaction – No Debtor or Creditor
9. Cash transaction – Richard is creditor
10. Credit transaction – Nelson is debtor
11. Cash transaction – No Debtor or Creditor

### Explanation:

1. Cash is paid against asset-motor car
2. The person to whom money is paid on account is “creditor”
3. The person to whom money is paid on account is “creditor”
4. Cash is received from selling an asset
5. The person from whom assets or goods are purchased on credit is “creditor”
6. The person from whom money is received on account is “debtor” because we have had sold goods or asset to him on credit in the past
7. Cash is received from owner, Hamesh is not a creditor
8. Cash received as loan, any person who provides loan is not a creditor but will be recognized as liability.
9. The person to whom money is paid on account is “creditor”
10. The person to whom goods are sold on credit is called “debtor”
11. Cash received as loan, provider of loan is not a creditor but will be recognized as liability.

*When cash is received as loan, that provider does not become creditor although that person is treated as a liability.*  
**Creditors** are the suppliers of goods or services on credit terms.

## ACCOUNTING EQUATION

The concept of double entry accounting system is based on an equation that is initially "**0 = 0**", subsequently each financial information causes a change in this equation, which results into following effects in terms of **+** or **-** :

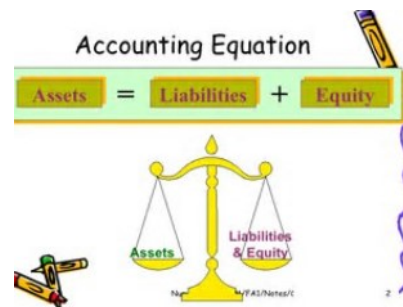
- i. increase in left side and also increase in right side (**+ = +**) or
- ii. decrease in both sides (**- = -**) or
- iii. increase in one side and decrease in the same side (**± = 0**) or (**0 = ±**)

With the help of accounting equation it becomes easy to understand that each financial information has two fold effects. Basic accounting equation is: **(Resources = Sources)**.

When a business is started, initially it needs **resources**; such resources are taken from its Owners and can also be borrowed from Lenders as a **sources** of finance.

In accounting the resources *controlled* by a business are **assets** and sources of such inputs are **owner's equity** and **liabilities**. So, we can amend the above equation as:

$$\text{(Assets = Owner's Equity + Liabilities)}$$



From the above equation it is understood that both sides will always give equal sum. This happens because we are treating the same transaction from two aspects i.e.

1. What are the resources (assets), and



2. What are the sources of such resources (Owners Equity and Liabilities)



Recalling the previous knowledge; we have discussed five main heads of accounts, among those three heads are appearing in the equation. Whereas, two heads i.e., expenses and incomes are missing. These two heads constitute profit of the entity

**Incomes – Expenses = Profit**

Profit also contributes as a source of acquiring assets in the business.



**Resources** appearing at left side of the equation are financed by **external sources** as well as **internal sources** that appear at the right side of the equation.

External sources are provided by Owners and Lenders, whereas internal sources are generated by the business itself by way of earning profits.

$$\text{Profit} = \text{Incomes} - \text{Expenses}$$



Profits earned by the business are included in Owners' Equity, which are paid to the owners for personal use (known as drawings/dividends).

Following equation makes this concept clear:

$$\text{Owner's Equity} = \text{Capital} + \text{Profit} (- \text{loss}) - \text{Drawings}$$

In the following section we shall learn through a detailed worked example that how different transactions affect the accounting equation.

You will find it very interesting because of its mathematical wizard; that both sides of equation shall remain equal.

### Worked example

**Transaction 1:** Henry started business, Micro Logics, by introducing capital Rs. 45,000 in cash.

The effect of this transaction is to increase the asset-cash (on left side of the equation) by Rs. 45,000, in order to balance the equation; the owner's equity (on right side of the equation) is increased by the same amount. The owner's equity is referred by using the "owner's name" and "capital", such as "Henry's capital". The effect of this transaction on Micro Logics accounting equation is below.

### Assets

### Owner's Equity

### Liabilities

| Sr # | Cash   | Furniture | Computer | Stock | Debtors | = | Henry Capital | Profit | Bills payable | Creditors |
|------|--------|-----------|----------|-------|---------|---|---------------|--------|---------------|-----------|
| 1    | 45,000 |           |          |       |         |   | 45,000        |        |               |           |

Henry is the sole owner of the business, Micro Logics is a sole proprietorship business.

Above accounting equation relates only to the business "Micro Logics". Under the business entity concept, Henry's personal assets such as a home or personal bank account, and personal liabilities are excluded from the equation.



**Transaction 2:** Micro-Logics purchased **furniture** by paying **cash** Rs. 20,000.

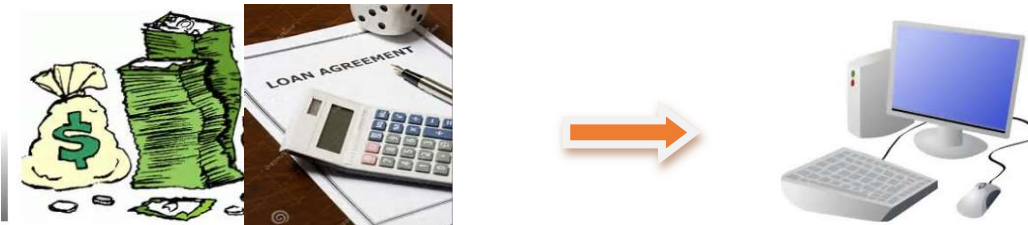
The purchase of furniture changes make up of the assets, but does not change the total amount of assets. Its effects in the equation are below:



| Assets |               |               |          |       |         |   | Owner's Equity  |        | Liabilities   |           |
|--------|---------------|---------------|----------|-------|---------|---|-----------------|--------|---------------|-----------|
| Sr #   | Cash          | Furniture     | Computer | Stock | Debtors | = | Henry's Capital | Profit | Bills payable | Creditors |
| 1.     | 45,000        |               |          |       |         |   | 45,000          |        |               |           |
| 2.     | -20,000       | 20,000        |          |       |         |   |                 |        |               |           |
|        | <u>25,000</u> | <u>20,000</u> |          |       |         |   | <u>45,000</u>   |        |               |           |

**Transaction 3:** Micro Logics purchased a **computer** for Rs. 28,000 by paying Rs. 8,000 in **cash** and signing a **promissory note** agreement with with supplier for Rs. 20,000.

This transaction changes the assets and also adds a liability at right side of the equation. See below for its effects in the equation.



| Assets |                   |                   |                   |       |         |   | Owner's Equity    |        | Liabilities       |           |
|--------|-------------------|-------------------|-------------------|-------|---------|---|-------------------|--------|-------------------|-----------|
| Sr #   | Cash              | Furniture         | Computer          | Stock | Debtors | = | Henry's Capital   | Profit | Bills payable     | Creditors |
| 1.     | 45,000            |                   |                   |       |         |   | 45,000            |        |                   |           |
| 2.     | -20,000           | 20,000            |                   |       |         |   |                   |        |                   |           |
| 3.     | -8,000            |                   | 28,000            |       |         |   |                   |        | 20,000            |           |
|        | <del>17,000</del> | <del>20,000</del> | <del>28,000</del> |       |         |   | <del>45,000</del> |        | <del>20,000</del> |           |

**Transaction 4:** Micro Logics entered into a transaction of buying stocks/inventory of Rs. 1,350 and agreed **to pay the supplier in near future**.

In this transaction, the liability created is known as creditor and the Items such as stock/inventory that will be used for the business in future is asset. The effect of this transaction is to increase assets and liabilities by Rs. 1,350 as shown here;



| Assets |               |               |               |              |         | Owner's Equity |                 | Liabilities |               |              |
|--------|---------------|---------------|---------------|--------------|---------|----------------|-----------------|-------------|---------------|--------------|
| Sr #   | Cash          | Furniture     | Computer      | Stock        | Debtors | =              | Henry's Capital | Profit      | Bills payable | Creditors    |
| 1.     | 45,000        |               |               |              |         |                | 45,000          |             |               |              |
| 2.     | -20,000       | 20,000        |               |              |         |                |                 |             |               |              |
| 3.     | -8,000        |               | 28,000        |              |         |                |                 |             | 20,000        |              |
| 4.     |               |               |               | 1,350        |         |                |                 |             |               | 1,350        |
|        | <u>17,000</u> | <u>20,000</u> | <u>28,000</u> | <u>1,350</u> |         |                | <u>45,000</u>   |             | <u>20,000</u> | <u>1,350</u> |

**Transaction 5:** During its first month of operations, Micro Logics provided **services** to customers, earning fee of Rs. 7,500 and receiving the amount in **cash**.

The receipt of cash increases assets and also increases Henry's equity by Rs. 7,500, as shown in the equation.



| Assets |               |               |               |              |         |   | Owner's Equity  |              | Liabilities   |              |
|--------|---------------|---------------|---------------|--------------|---------|---|-----------------|--------------|---------------|--------------|
| Sr #   | Cash          | Furniture     | Computer      | Stock        | Debtors | = | Henry's Capital | Profit       | Bills payable | Creditors    |
| 1.     | 45,000        | 20,000        | 28,000        | 1,350        |         |   | 45,000          | 7,500        | 20,000        | 1,350        |
| 2.     | -20,000       |               |               |              |         |   |                 |              |               |              |
| 3.     | -8,000        |               |               |              |         |   |                 |              |               |              |
| 4.     |               |               |               |              |         |   |                 |              |               |              |
| 5.     | 7,500         |               |               |              |         |   |                 |              |               |              |
|        | <u>24,500</u> | <u>20,000</u> | <u>28,000</u> | <u>1,350</u> |         |   | <u>45,000</u>   | <u>7,500</u> | <u>20,000</u> | <u>1,350</u> |

**Transaction 6:** For Micro Logics, the expenses paid during the month were as follows:

Wages               Rs. 2,125  
 Rent                 Rs. 800  
 Utilities            Rs. 450  
 Miscellaneous     Rs. 275

Miscellaneous expense includes petty amounts paid for items like; postage, coffee, and magazine etc.

Effect of this group of transactions is opposite to the effect of revenues. These transactions reduce cash and owner's equity, as shown here:



| Assets |               |               |               |              |          | Owner's Equity |                 |                                         | Liabilities   |              |
|--------|---------------|---------------|---------------|--------------|----------|----------------|-----------------|-----------------------------------------|---------------|--------------|
| Sr #   | Cash          | Furniture     | Computer      | Stock        | Debtors. | =              | Henry's Capital | Profit                                  | Bills payable | Creditors    |
| 1.     | 45,000        | 20,000        | 28,000        | 1,350        |          |                | 45,000          | 7,500<br>-2,125<br>-800<br>-450<br>-275 | 20,000        | 1,350        |
| 2.     | -20,000       |               |               |              |          |                |                 |                                         |               |              |
| 3.     | -8,000        |               |               |              |          |                |                 |                                         |               |              |
| 4.     |               |               |               |              |          |                |                 |                                         |               |              |
| 5.     | 7,500         |               |               |              |          |                |                 |                                         |               |              |
| 6.     | -3,650        |               |               |              |          |                |                 |                                         |               |              |
|        | <u>20,850</u> | <u>20,000</u> | <u>28,000</u> | <u>1,350</u> |          |                | <u>45,000</u>   | <u>3,850</u>                            | <u>20,000</u> | <u>1,350</u> |

**Transaction 7:** Micro Logics **paid** Rs. 950 to its **creditors** during the month.

It reduces both assets and liabilities, as shown here:



| Assets |               |               |               |              |              |   | Owner's Equity  |              | Liabilities   |            |
|--------|---------------|---------------|---------------|--------------|--------------|---|-----------------|--------------|---------------|------------|
| Sr #   | Cash          | Furniture     | Computer      | Stock        | Debtors      | = | Henry's Capital | Profit       | Bills payable | Creditors  |
| 1      | 45,000        |               |               |              |              |   | 45,000          |              |               |            |
| 2      | -20,000       | 20,000        |               |              |              |   |                 |              |               |            |
| 3      | -8,000        |               | 28,000        |              |              |   |                 |              | 20,000        |            |
| 4      |               |               |               | 1,350        |              |   |                 |              |               | 1,350      |
| 5      | 7,500         |               |               |              |              |   |                 | 7,500        |               |            |
| 6      | -3,650        |               |               |              |              |   |                 | -2,125       |               |            |
|        |               |               |               |              |              |   |                 | -800         |               |            |
|        |               |               |               |              |              |   |                 | -450         |               |            |
|        |               |               |               |              |              |   |                 | -275         |               |            |
| 7      | -950          |               |               |              |              |   |                 |              |               | -950       |
|        | <u>19,900</u> | <u>20,000</u> | <u>28,000</u> | <u>1,350</u> | <u>1,200</u> |   | <u>45,000</u>   | <u>3,850</u> | <u>20,000</u> | <u>400</u> |

**Transaction 8:** During the month Micro Logics **sold** out **stock costing** Rs. 800 for Rs. 1,200 on credit terms, earning a **profit** of Rs. 400.

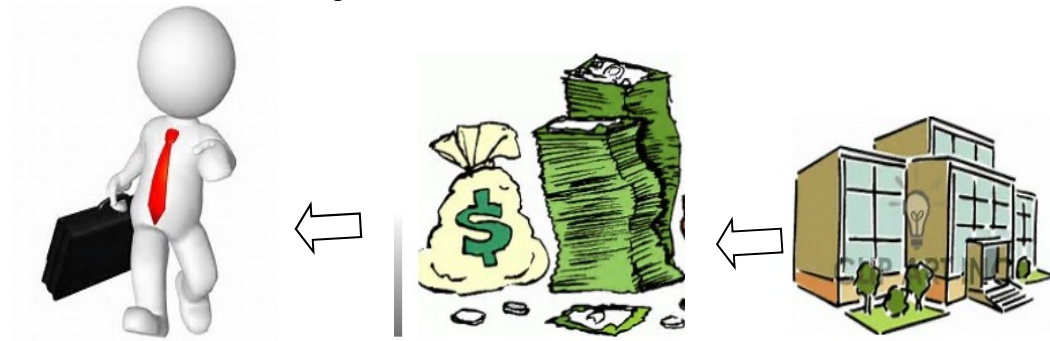
Sale on credit creates Debtors as asset, whereas in the asset side there is a decrease in stock for Rs. 800. Profit resulting from this transaction will cause an increase in owner's equity with Rs. 400. As shown here;



| Assets |         |           |          |       |         |   | Owner's Equity  |        | Liabilities   |           |
|--------|---------|-----------|----------|-------|---------|---|-----------------|--------|---------------|-----------|
| Sr. #  | Cash    | Furniture | Computer | Stock | Debtors | = | Henry's Capital | Profit | Bills payable | Creditors |
| 1.     | 45,000  |           |          |       |         |   | 45,000          |        |               |           |
| 2.     | -20,000 | 20,000    |          |       |         |   |                 |        |               |           |
| 3.     | -8,000  |           | 28,000   |       |         |   |                 |        | 20,000        |           |
| 4.     |         |           |          | 1,350 |         |   |                 |        |               | 1,350     |
| 5.     | 7,500   |           |          |       |         |   |                 | 7,500  |               |           |
| 6.     | -3,650  |           |          |       |         |   |                 | -2,125 |               |           |
|        |         |           |          |       |         |   |                 | -800   |               |           |
|        |         |           |          |       |         |   |                 | -450   |               |           |
|        |         |           |          |       |         |   |                 | -275   |               |           |
| 7.     | -950    |           |          |       |         |   |                 |        |               | -950      |
| 8.     |         |           |          | -800  | 1,200   |   |                 | 400    |               |           |
|        | 19,900  | 20,000    | 28,000   | 550   | 1,200   |   | 45,000          | 4,250  | 20,000        | 400       |

**Transaction 9:** At the end of month, Henry withdrew Rs. 2,000 cash from the business for personal use.

This transaction is exactly opposite to the capital introduced in business by the owner. Cash and owner's equity, both decrease because of cash drawings. As shown here:



| Assets |               |               |               |            |              |   | Owner's Equity  |              | Liabilities   |            |
|--------|---------------|---------------|---------------|------------|--------------|---|-----------------|--------------|---------------|------------|
| Sr. #  | Cash          | Furniture     | Computer      | Stock      | Debtors      | = | Henry's Capital | Profit       | Bills payable | Creditors  |
| 1.     | 45,000        |               |               |            |              |   | 45,000          |              |               |            |
| 2.     | -20,000       | 20,000        |               |            |              |   |                 |              |               |            |
| 3.     | -8,000        |               | 28,000        |            |              |   |                 |              | 20,000        |            |
| 4.     |               |               |               | 1,350      |              |   |                 |              |               | 1,350      |
| 5.     | 7,500         |               |               |            |              |   |                 | 7,500        |               |            |
| 6.     | -3,650        |               |               |            |              |   |                 | -2,125       |               |            |
|        |               |               |               |            |              |   |                 | -800         |               |            |
|        |               |               |               |            |              |   |                 | -450         |               |            |
|        |               |               |               |            |              |   |                 | -275         |               |            |
| 7.     | 950           |               |               |            |              |   |                 |              |               | -950       |
| 8.     |               |               |               | -800       | 1,200        |   |                 | 400          |               |            |
| 9.     | -2,000        |               |               |            |              |   |                 | -2,000*      |               |            |
|        | <u>17,900</u> | <u>20,000</u> | <u>28,000</u> | <u>550</u> | <u>1,200</u> |   | <u>45,000</u>   | <u>2,250</u> | <u>20,000</u> | <u>400</u> |

\*Solved example presented two columns for owner equity head i.e., capital and profit. Drawing is not the expense and it should not be treated to reduce the income because drawing is not a contra account of income/revenue. Drawing is basically treated as appropriation/distribution of profit and reduces the amount of profit. Profit becomes the part of owners' equity; ultimately the drawing indirectly reduces the owner equity. You can directly reduce the amount of drawing from owner's equity/capital if use one column of capital to solve the questions of accounting equation. Please note that Drawings account is a contra account of capital.

End of Accounting Equation – Worked Example

## Exercise Questions

Choose the possible effects of following transactions on accounting equation.

1. Goods purchased on credit
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity
2. Paid utility bills
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity
3. Sold goods on profit of Rs.200
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity
4. Paid to supplier of good on account
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity
5. Cash invested by owner
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity
6. Owner buys a new car from personal resources (No Effect)
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity
7. Goods lost in fire
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity
8. Goods taken by owner for personal use
  - ☐ increase asset,
  - ☐ decrease asset,
  - ☐ increase liability,
  - ☐ decrease liability,
  - ☐ increase equity,
  - ☐ decrease equity

9. Loan taken from commercial bank

- increase asset,
- decrease asset,
- increase liability,
- decrease liability,
- increase equity,
- decrease equity

10. Received commission

- increase asset,
- decrease asset,
- increase liability,
- decrease liability,
- increase equity,
- decrease equity

Correct answers:

1. Increase asset, increase liability
2. Decrease asset, decrease equity
3. Decrease asset, increase asset ,increase equity
4. Decrease asset, decrease liability
5. Increase asset, increase equity
6. No effect
7. Decrease asset, decrease equity
8. Decrease asset, decrease equity
9. Increase asset, increase liability
10. Increase asset, increase equity

Explanation:

1. Increase asset-stock of goods, increase liability creditors
2. Decrease asset-cash , decrease equity because of expense of utility bills
3. Decrease asset-stock at cost, increase asset cash with sale price ,increase equity with profit
4. Decrease asset-cash, decrease liability creditor
5. Increase asset-cash, increase equity by capital amount invested by owner
6. No effect-its owner personal transaction
7. Decrease asset-stock, decrease equity with loss amount
8. Decrease asset-stock, decrease equity by drawings made by owner
9. Increase asset-cash, increase liability-loan from bank
10. Increase asset-cash, increase equity-for income

## Examination Questions

1. The owner puts \$10,000 into a separate bank account for the business:
2. The business buys a shop for \$2,000 paid in cash
3. The business buys goods for resale (in cash) for \$1,000
4. The business buys more goods for resale (on credit) for \$2,000
5. The business buys a car for \$3,000 (cash)
6. The business sells half of the goods for \$2,400 (cash)

Correct answers:

1. Increase asset, increase equity
2. Increase asset, decrease asset
3. Increase asset, decrease asset
4. Increase asset, increase liability
5. Increase asset, decrease asset
6. Decrease asset, increase asset, increase equity

## Chapter – 3

### Rules of Debit and Credit

#### Preparation of voucher with supporting documents

| <b>Sr. No</b> | <b>Course outline Topics</b>                        |
|---------------|-----------------------------------------------------|
| 1             | Concept of Debit and Credit (Dr. and Cr.)           |
| 2             | Types of Account - Elements of Financial Statements |
| 3             | Analyzing Dr. & Cr.                                 |
| 4             | Concept of Main Head and Accounting Head - Practice |
| 5             | Double entry accounting system - Practice           |
| 6             | Double entry accounting system - Practice           |
| 7             | Concept of Voucher                                  |
| 8             | Concept of Source Documents                         |
| 9             | Different types of books of accounts                |
| 10            | Accounting systems - Cash Basis Vs. Accrual Basis   |
| 11            | Single entry accounting Vs Double entry accounting  |

**Video number 17-27 are mandatory part of this module.**



## Rules of Debit & Credit

### Concept of Debit and Credit – (Dr. and Cr.)

Each language has unique alphabets which are used to create words and to give sense to the ideas or information. In the same way, Accounting as a language also carries unique alphabets that are used to give sense to the financial information, these are two in count.

1. **Debit – Debere in Latin – denoted by Dr.**
2. **Credit – Credere in Latin – denoted by Cr.**



Here one should not ignore that alphabets of all the languages (inclusive of Accounting) do not carry any meaning but the alphabets are used to compose words for expressing an ideas or information. In accounting language “Dr.” and “Cr.” are the alphabets that are used to record financial information in the books of accounts. Dr. and Cr. are also termed as tools of accounting.

For the purpose of developing rules for Dr. and Cr., elements of financial statements are further distinguished into two groups. This division is done based on their nature.

1. **Debit Group**
2. **Credit Group**

#### Debit Group consists of

1. Assets
2. Expenses



**Assets**



**Expenses**

#### Credit Group consists of

1. Owner's Equity
2. Liabilities
3. Incomes



**O. Equity**



**Liabilities**



**Incomes**

Characteristically; the members of Dr. Group carry same nature i.e., derivation of these two heads materializes when resources have been expended in the past or will be expended in future.

Whereas, derivation of the three heads in Cr. Group happens when resources have been received in the past or will be received in future.

## Types of Account

Before discussing the rules of Dr. and Cr., it is important to understand different types of “account”. This is because, while recording financial information we have to identify the correct “account” to be recognized as Dr. or Cr.

“Account” is a terminology that is used for an individual record of similar transactions in a summarized form, belonging to any of the five main heads i.e., asset, liability, income, expense and owner’s equity.

An account is a further division of the elements of financial statements (main heads) so that the financial statements are understood in elaborated way. For example; *cash* is an account under the main head of asset, *creditor* is an account under the main head of liability.

This division of the elements of financial statements (main heads) is known as modern approach of identifying types of accounts. According to the modern approach of accounting, there are five types of accounts; asset, liability, income, expense, owner’s equity.

Conventionally accounts were divided into three types; personal, real, nominal.

### 1. Personal Account

Accounts which are related to persons or institutions dealing with the entity, for example; debtors, creditors or banks.



### 2. Real account

Accounts which are related to properties or possessions related to the entity, for example; furniture, buildings, cash.



### 3. Nominal Account

Accounts which are related to expenses, income, losses and gains of the entity, for example; sales, purchases, salary, utility bills etc.



## Important Note:

In this course we shall follow the modern approach to learn the rules of Dr. and Cr.

## Analyzing “Debit and Credit”

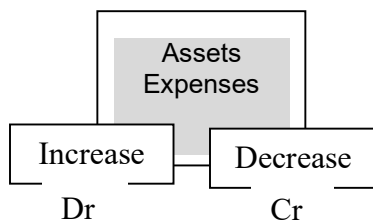
Remember the algebraic rule of addition and subtraction; increase in a figure is brought-in through the same sign whether negative (-ve) or positive (+ve) whereas; decrease in a figure is brought-in through the opposite sign whether negative (-ve) or positive (+ve).

Hence, in the same way:

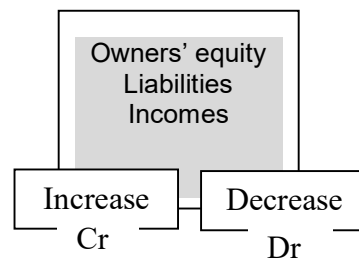
|                                                  |                      |                     |
|--------------------------------------------------|----------------------|---------------------|
| <b>Increase (+) in the items of Debit group</b>  | <b>is brought in</b> | <b>through “Dr”</b> |
| <b>Decrease (-) in the items of Debit group</b>  | <b>is brought in</b> | <b>through “Cr”</b> |
| <b>Increase (+) in the items of Credit group</b> | <b>is brought in</b> | <b>through “Cr”</b> |
| <b>Decrease (-) in the items of Credit group</b> | <b>is brought in</b> | <b>through “Dr”</b> |

|                                          |     |
|------------------------------------------|-----|
| Increase in Assets & Expenses            | Dr. |
| Decrease in Assets & Expenses            | Cr. |
| Increase in Equity, Liabilities & Income | Cr. |
| Decrease in Equity, Liabilities & Income | Dr. |

### Debit Group



### Credit Group



| Main Heads     | Nature | Increase | Decrease |
|----------------|--------|----------|----------|
| Assets         | Dr     | Dr       | Cr       |
| Expenses       | Dr     | Dr       | Cr       |
| Owners' Equity | Cr     | Cr       | Dr       |
| Liabilities    | Cr     | Cr       | Dr       |
| Incomes        | Cr     | Cr       | Dr       |

| Debit         | Credit        |
|---------------|---------------|
| ↑ Assets      | ↓ Assets      |
| ↑ Expenses    | ↓ Expenses    |
| ↓ O Equity    | ↑ O Equity    |
| ↓ Liabilities | ↑ Liabilities |
| ↓ Incomes     | ↑ Incomes     |

## Important Tips To Remember (ITTRs)

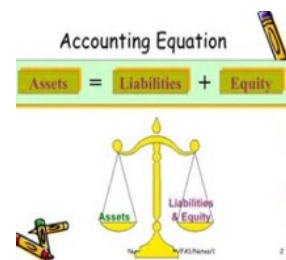
- ⇒ Each financial information causes a monetary change (increase or decrease) in the five **main heads of accounts**. Such change is recorded (translated) into accounting language using its alphabets “Dr” & “Cr”.
- ⇒ “Dr” or “Cr” does not carry literal meanings, just like alphabets of other languages.
- ⇒ Each transaction causes a change in two **accounting heads**, one change (increase or decrease) is analyzed as *Dr* and second change (increase or decrease) is analyzed as *Cr*. Both changes carry equal weight in terms of monetary effects. That’s why accounting is said to be based on double entry concept.
- ⇒ Often the beginners of accounting studies confuse the terms **Main Heads** with **Accounting Heads**. In order to resolve this ambiguity, go through the following table:



| Main Heads       | Assets       | Expenses      | Owners' Equity | Liabilities      | Incomes    |
|------------------|--------------|---------------|----------------|------------------|------------|
| Accounting Heads | Land         | Purchases     | Capital        | Bank Loan        | Sales      |
|                  | Building     | Salaries      | Drawings       | Bank Overdraft   | Interest   |
|                  | Machinery    | Electric Bill | Profits        | Creditors        | Commission |
|                  | Furniture    | Repair        | etc.           | Accounts Payable | etc.       |
|                  | Motor Van    | Advertisement |                | etc.             |            |
|                  | Computer     | Commission    |                |                  |            |
|                  | Stocks       | Traveling     |                |                  |            |
|                  | Debtors      | Freight       |                |                  |            |
|                  | Cash Balance | Rent          |                |                  |            |
|                  | Bank Balance | Stationery    |                |                  |            |
|                  | etc.         | etc.          |                |                  |            |

## ⇒ Important Accounting equations

- (i)  $\Sigma \text{Dr} = \Sigma \text{Cr}$
- (ii) Resources = Sources
- (iii) Assets = Owners' Equity + Liabilities
- (iv) Owners' Equity = Capital + Profit – Loss – Drawings
- (v) Profit/Loss = Incomes – Expense



**Practice 3.1**

Identify two accounting heads from each transaction and place it under the appropriate main head.

- Transaction 1: Bought a building for cash.  
a) Bought b) Building c) Cash d) Expense
- Transaction 2: Paid salaries to staff in cash.  
a) Paid b) Staff c) Cash d) Salary
- Transaction 3: Goods sold on credit to Dar Brothers.  
a) Creditor b) Sales c) Cash d) Debtor
- Transaction 4: Cash introduced by the owner as a capital.  
a) Investment b) Cash c) Capital d) Owner
- Transaction 5: Commission received in cash  
a) Receiving b) Cash c) Equity d) Commission
- Transaction 6: Purchase goods for cash.  
a) Stock b) Cash c) Purchases d) goods
- Transaction 7: Cash withdrew by the owner for personal use.  
a) Drawings b) Cash c) Owner d) Goods
- Transaction 8: Rent paid by cheque.  
a) Rent b) Cash c) Bank d) Goods  
(Greens are correct)

**Answer:**

| Transaction | Assets                 | Expenses     | Owner's Equity | Liabilities | Incomes       |
|-------------|------------------------|--------------|----------------|-------------|---------------|
| 1           | b) Building<br>c) Cash |              |                |             |               |
| 2           | c) Cash                | d) Salary    |                |             |               |
| 3           | d) Debtors             |              |                |             | b) Sales      |
| 4           | b) Cash                |              | c) Capital     |             |               |
| 5           | b) Cash                |              |                |             | d) Commission |
| 6           | b) Cash                | c) Purchases |                |             |               |
| 7           | b) Cash                |              | a) Drawings    |             |               |
| 8           | c) Bank                | a) Rent      |                |             |               |

## Double Entry Accounting System

- » Evolved during the Renaissance.
- » Described by Fra Luca Pacioli, Italy, 1494.

As discussed earlier, each transaction causes increase or decrease in two accounting heads. While doing bookkeeping (recording transaction in the books of accounts) we have to show these two effects on each of the two relevant accounting heads. Increase or decrease caused by a transaction in two accounting heads is recorded in terms of *Dr* and *Cr*. The core concept of double entry bookkeeping is that each transaction is recorded twice.

**Practice 3.2**

From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the **main heads** to make decision for Dr and Cr effects.

1. Capital introduced in the business Rs.10,000.
2. Purchase furniture for cash Rs.4,000.
3. Purchase goods for cash Rs. 2,000.
4. Sold goods for cash Rs.3,000.
5. Rent paid in cash Rs.2,000.
6. Owner withdrew cash for personal use Rs.500.
7. Salaries paid in cash Rs.200.
8. Bought goods from John Smith on credit Rs.6,000.
9. Sold goods on credit to Henry for Rs.8,000.
10. Received cash from Donald Rs.2,500.

**Answer:**

| No. | Accounting Head                     | Main Head             | Group      | Increase/decrease | Dr./Cr. Effect |
|-----|-------------------------------------|-----------------------|------------|-------------------|----------------|
| 1   | Cash<br>Capital                     | Asset<br>Own. Equity  | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 2   | Cash<br>Furniture                   | Asset<br>Asset        | Dr.<br>Dr. | Dec.<br>Inc.      | Cr.<br>Dr.     |
| 3   | Purchases<br>Cash                   | Expense<br>Asset      | Dr.<br>Dr. | Inc.<br>Dec.      | Dr.<br>Cr.     |
| 4   | Cash<br>Sales                       | Asset<br>Income       | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 5   | Rent<br>Cash                        | Expense<br>Assets     | Dr.<br>Dr. | Inc.<br>Dec.      | Dr.<br>Cr.     |
| 6   | Drawings<br>Cash                    | Own. Equity<br>Assets | Cr.<br>Dr. | Dec.<br>Dec.      | Dr.<br>Cr.     |
| 7   | Cash<br>Salaries                    | Asset<br>Expense      | Dr.<br>Dr. | Dec.<br>Inc.      | Cr.<br>Dr.     |
| 8   | Purchases<br>Creditors (John Smith) | Expense<br>Liability  | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 9   | Sales<br>Debtor (Henry)             | Income<br>Asset       | Cr.<br>Dr. | Inc.<br>Inc.      | Cr.<br>Dr.     |
| 10  | Cash<br>Debtor (Donald)             | Asset<br>Asset        | Dr.<br>Dr. | Inc.<br>Dec.      | Dr.<br>Cr.     |

### Important Tips To Remember (ITTRs)

⇒ For purchase of goods--- use "Purchases" as Dr. accounting head (never use goods as accounting head).

|   |                   |
|---|-------------------|
| ✓ | Purchases Account |
| X | Goods Account     |

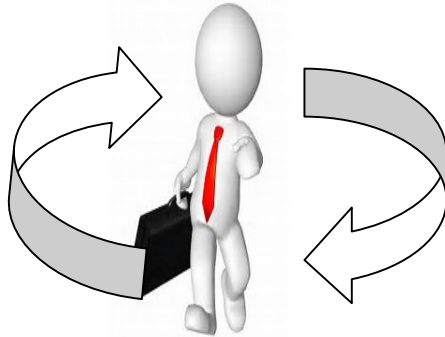


⇒ For sale of goods--- use "Sales" as Cr. accounting head (never use goods as accounting head).



|   |               |
|---|---------------|
| ✓ | Sales account |
| X | Goods account |

⇒ For personal use of owner--- accounting head "Drawings" is used.



⇒ For goods or cash withdrawn for personal needs --- use "Drawings" as Dr. accounting head

⇒ For investments introduced by owner into the business--- use "Capital" as Cr. accounting head.

**Practice 3.3**

From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the main heads and then make decision for Dr and Cr effects.

1. Started business with Rs. 10,000 in the bank.
2. Bought goods from Maria & Co. Rs. 3,000.
3. Paid the month's wages by cash Rs.500.
4. Paid insurance by cheque Rs.600.
5. Owner withdrew goods for personal use Rs. 2,000.
6. Sold goods on credit to Stars Bros. Rs. 3000.
7. Bought stationery Rs.300, paying in cash.
8. Owner took cash for himself Rs.200.
9. Cash received from Stars Bros. Rs.3000.

**Answer:**

| Sr. No. | Accounting Head                     | Main Head              | Group      | Increase/decrease | Dr./Cr. Effect |
|---------|-------------------------------------|------------------------|------------|-------------------|----------------|
| 1       | Bank<br>Capital                     | Asset<br>Own. Equity   | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 2       | Purchases<br>Creditor (Maria & Co.) | Expense<br>Liability   | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 3       | Cash<br>Wages                       | Asset<br>Expense       | Dr.<br>Dr. | Dec.<br>Inc.      | Cr.<br>Dr.     |
| 4       | Bank<br>Insurance                   | Asset<br>Expense       | Dr.<br>Dr. | Dec.<br>Inc.      | Cr.<br>Dr.     |
| 5       | Drawings<br>Purchases               | Own. Equity<br>Expense | Cr.<br>Dr. | Dec.<br>Dec.      | Dr.<br>Cr.     |
| 6       | Sales<br>Debtor (Stars Bros.)       | Income<br>Asset        | Cr.<br>Dr. | Inc.<br>Inc.      | Cr.<br>Dr.     |
| 7       | Cash<br>Stationery                  | Asset<br>Expense       | Dr.<br>Dr. | Dec.<br>Inc.      | Cr.<br>Dr.     |
| 8       | Drawings<br>Cash                    | Own. Equity<br>Asset   | Cr.<br>Dr. | Dec.<br>Dec.      | Dr.<br>Cr.     |
| 9       | Cash<br>Debtor (Stars Bros.)        | Asset<br>Asset         | Dr.<br>Dr. | Inc.<br>Dec.      | Dr.<br>Cr.     |

### **Important Tips To Remember (ITTRS)**

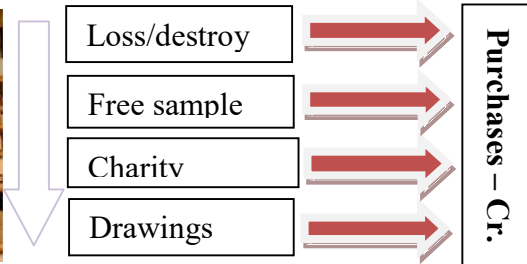
- ⇒ For payments through cheque use “Bank” as credit accounting head because it decreases bank balance.



Payment by cheque:  
✓ Bank account  
✗ Cash account

- ⇒ Whenever there is a decrease in purchased goods, other than because of sales and purchases return, always use “Purchases” as credit accounting head.

#### **Decrease in stocks**



**Practice 3.4**

From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the main heads and then make decision for Dr and Cr effects.

- Machinery purchased from Maria & Co. on credit Rs.2,000.
- Loan taken from friend Rs.200 in cash.
- Machinery returned to Maria & Co. Rs. 2,000.
- Bought goods on credit from Kashmiri Rs. 600.
- Sold goods on credit to Harris Rs.800.
- Goods returned to Kashmiri Rs.100.
- Goods returned by Harris Rs. 200.
- Charity paid in cash Rs. 200.
- Free sampling of goods Rs. 50.
- Friend's loan was repaid Rs. 200.

**Answer:**

| Sr. No. | Accounting Head                         | Main Head            | Group      | Increase/decrease | Dr./Cr. Effect |
|---------|-----------------------------------------|----------------------|------------|-------------------|----------------|
| 1       | Machinery<br>Creditors (Maria & Co.)    | Asset<br>Liability   | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 2       | Cash<br>Loan from friend                | Asset<br>Liability   | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 3       | Machinery<br>Creditor (Maria & Co.)     | Asset<br>Liability   | Dr.<br>Cr. | Dec.<br>Dec.      | Cr.<br>Dr.     |
| 4       | Purchases<br>Creditor (Kashmiri)        | Expense<br>Liability | Dr.<br>Cr. | Inc.<br>Inc.      | Dr.<br>Cr.     |
| 5       | Sales<br>Debtor (Harris)                | Income<br>Asset      | Cr.<br>Dr. | Inc.<br>Inc.      | Cr.<br>Dr.     |
| 6       | Purchases Return<br>Creditor (Kashmiri) | Expense<br>Liability | Dr.<br>Cr. | Dec.<br>Dec.      | Cr.<br>Dr.     |
| 7       | Sales Return<br>Debtor (Harris)         | Income<br>Asset      | Cr.<br>Dr. | Dec.<br>Dec.      | Dr.<br>Cr.     |
| 8       | Cash<br>Charity                         | Asset<br>Expense     | Dr.<br>Dr. | Dec.<br>Inc.      | Cr.<br>Dr.     |
| 9       | Free Sampling<br>Purchases              | Expense<br>Expense   | Dr.<br>Dr. | Inc.<br>Dec.      | Dr.<br>Cr.     |
| 10      | Cash<br>Loan from friend                | Asset<br>Liability   | Dr.<br>Cr. | Dec.<br>Dec.      | Cr.<br>Dr.     |

### **Important tips to remember (ITTRs)**

- ⇒ For faulty goods returned to suppliers (Creditors), use “Purchases Return” as Cr. accounting head.  
Purchases return may occur because of multiple reasons like; defects in goods, quality is not matching with the requirement ordered by the entity, the entity does not need the stock in excess.



- ⇒ For faulty goods returned by customers (Debtors) use “Sales Return” as Dr. accounting head.  
Sales return may occur because of multiple of reasons like; defects in goods, quality is not matching the order received from the customer, the customer does not need the stock in excess, etc.

custome



## Concept of Voucher and Supporting Documents

## Voucher

Voucher is used to recognize two accounting heads along with their values. Voucher is an internal document that is prepared to witness that the transaction is complete and verified, it is supported by needful documents and authorized by appropriate signatories.

Bookkeeper requires documentary evidence with proper approval of the transaction and authorization of the source documents from a concerned authority. For this purpose, all descriptions of the transaction are written on the voucher and supporting documents are attached along with evidences of approvals and authorizations. Such voucher is then processed by the bookkeeper for its recording in the proper book of original entries.

[illegible]

## Types of vouchers

There are different types of vouchers that a bookkeeper prepares depending upon the nature of transactions, other events or conditions.

- **Journal Vouchers**

A written authorization prepared for each non-cash financial information, or for every transaction that meets defined requirements.

- **Petty Cash Receipt Voucher**

A statement of spending from petty cash fund for which bill/invoice was not received. Petty cash fund is maintained to provide fast access to small amounts of cash for non-routine expenses. Petty cash vouchers are used to maintain financial control of petty cash account, preventing abuse or mismanagement of the funds.

[illegible]

**Petty Cash Receipt**

Date \_\_\_\_\_ No. \_\_\_\_\_

| Amount \$ _____ |  |
|-----------------|--|
| Description     |  |
| Charged to      |  |
| Received by     |  |
| Approved by     |  |

- **Cash Payment Voucher**

A document, which is used as proof that a cash payment transaction has occurred between two parties. In business, a payment voucher can be used for a variety of purposes, sometimes taking the place of cash in a transaction, acting as a receipt, or indicating that an invoice has been approved for payment.

[illegible]

- **Bank Receipt & Payment Voucher**

A bank receipt voucher contains detailed information about transactions involving bank deposits, collection from customers who make payments on account, credit card based sales and other similar types of transactions. Bank payment voucher is a document that is used as a proof of payments made through cheques, pay order, direct debits, standing instructions etc.

**BANK VOUCHER**

DATE: \_\_\_\_\_

AMOUNT: \_\_\_\_\_

To the credit of \_\_\_\_\_

For \_\_\_\_\_

Signed by \_\_\_\_\_

- **Gift Voucher**

Gift voucher is used to give rights to the customers for buying goods for free or to avail discount as a special offer

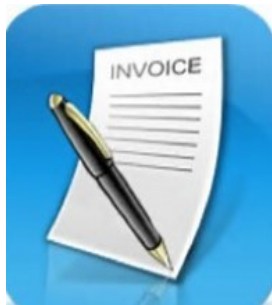


### Practice - 3.8

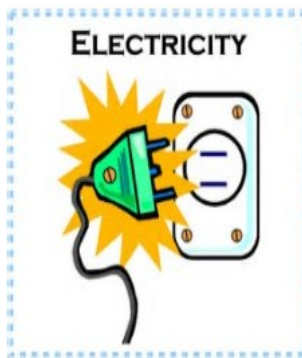
1. Who is responsible to prepare journal voucher?  
a) supplier b) manager c) bookkeeper d) accountant
2. Journal voucher is used to record transaction in?  
a) general journal b) general ledger c) trial balance d) balance sheet
3. Which voucher is used as proof that a significant cash transaction has occurred between two persons?  
a) petty cash voucher b) cash payment voucher c) journal voucher d) gift voucher
4. Which voucher is given by seller to customer that gives right of free shopping or discounts?  
a) petty cash voucher b) gift voucher c) cash payment voucher d) bank payment voucher
5. Which voucher is prepared in support to transaction of collecting money in the bank from customer?  
a) bank receipt voucher b) bank payment voucher c) deposit slip d) bank statement



| Source Documents |                      |                                                                               |
|------------------|----------------------|-------------------------------------------------------------------------------|
| Sr. No.          | Transaction          | Source Documents                                                              |
| 1                | Sales                | Invoice (issued) against sales of goods or services on account                |
| 2                | Purchases            | Invoice (received) against purchases of goods or services on account          |
| 3                | Sales Return         | Credit Note (issued) upon accepting the goods returned by customer            |
| 4                | Purchases Return     | Debit Note (issued) / Credit Note (received) upon returning goods to supplier |
| 5                | Cash received        | Cash Memo/receipt (issued) upon receiving cash                                |
| 6                | Cash paid            | Cash Memo/receipt (received) upon making cash payment                         |
| 7                | Leases (Rental etc.) | Agreements signed by the parties to a lease or any other contract             |
| 8                | Staff Salaries       | Payrolls sheet upon transferring salaries and wages to the staff              |
| 9                | Utility Bills        | Metered Bills/Invoices against obtaining economic benefits of the utilities   |

[illegible]

|                                    |  |                     |  |
|------------------------------------|--|---------------------|--|
| Name of the Firm Issuing the Note  |  | Address of the Firm |  |
| No.                                |  | Date of Issue       |  |
| <b>DEBIT NOTE</b>                  |  |                     |  |
| Against : Supplier's Name          |  |                     |  |
| Goods returned as per Delivery     |  | Amount (Rs.)        |  |
| Challan No.                        |  |                     |  |
| (Details of goods returned)        |  |                     |  |
| (Rupees ..... Only)                |  |                     |  |
| Signature of the Manager with date |  |                     |  |



MEMO

To:

From:

Date:

Re:

Message:



## Invoice

An invoice is a document that is prepared by seller and sent to the buyer, it specifies description and amount of products or services provided by the seller.



An invoice describes the amount due on the buyer according to the settlement terms agreed with the seller. Settlement terms usually specify the period of time during which buyer has to pay to the seller for the goods or services purchased.

## Sample invoice

| Your Company Name                     |  | INVOICE                             |   |
|---------------------------------------|--|-------------------------------------|---|
| Your Company Slogan                   |  |                                     |   |
| Street Address                        |  | DATE: August 22, 2011               |   |
| City, ST, ZIP Code                    |  | INVOICE # 10                        |   |
| Phone: 405.555.0190 Fax: 405.555.0191 |  | FOR: Product or service description |   |
| Bill To:                              |  |                                     |   |
| Name                                  |  |                                     |   |
| Company Name                          |  |                                     |   |
| Street Address                        |  |                                     |   |
| City, ST, ZIP Code                    |  |                                     |   |
| Phone                                 |  |                                     |   |
| DESCRIPTION                           |  | AMOUNT                              |   |
|                                       |  |                                     |   |
| TOTAL                                 |  | \$                                  | - |

Make all checks payable to Your Company Name  
If you have any questions concerning this invoice, contact Name, Phone Number, Email

THANK YOU FOR YOUR BUSINESS

### Credit Note

Credit note is a document that is prepared by a seller and sent to the buyer to correct mistake in the original invoice or to reduce the balance due on the buyer for any other reason including the return of goods by buyer to seller.



Credit note describes the reason because of which the buyer's balance payable to seller is reducing.

### Sample credit note

|                                  |             |                    |            |                     |   |
|----------------------------------|-------------|--------------------|------------|---------------------|---|
| <b>Your Service Company Name</b> |             | <b>CREDIT NOTE</b> |            |                     |   |
| Street Address                   |             | DATE:              |            |                     |   |
| City, ST ZIP Code                |             | CREDIT NOTE #:     |            |                     |   |
| Phone Number Web Address, etc.   |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
| Bill To:                         |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
| P.O. #                           |             | Sales Rep. Name    |            |                     |   |
|                                  |             |                    |            |                     |   |
| Product ID                       | Description | Quantity           | Unit Price | Line Total          |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
|                                  |             |                    |            |                     |   |
| Notes:                           |             |                    |            |                     |   |
|                                  |             |                    |            | SUBTOTAL            | - |
|                                  |             |                    |            | PST 8.00%           | - |
|                                  |             |                    |            | GST 6.00%           | - |
|                                  |             |                    |            | SHIPPING & HANDLING | - |
|                                  |             |                    |            | TOTAL               | - |

THANK YOU FOR YOUR BUSINESS!

## Recording in the books of accounts

Approved vouchers are recorded in the books of original entries (journals and cashbook), such recorded information is known as “accounting entry”. These accounting entries are then posted into the books of secondary entries (ledgers).

Mostly integrated computer software is used for recording and posting transactions. However, an understanding of books of accounts is necessary either transactions are recorded manually or electronically.

There are two types of books of accounts that are used to keep records of financial information of a business entity:

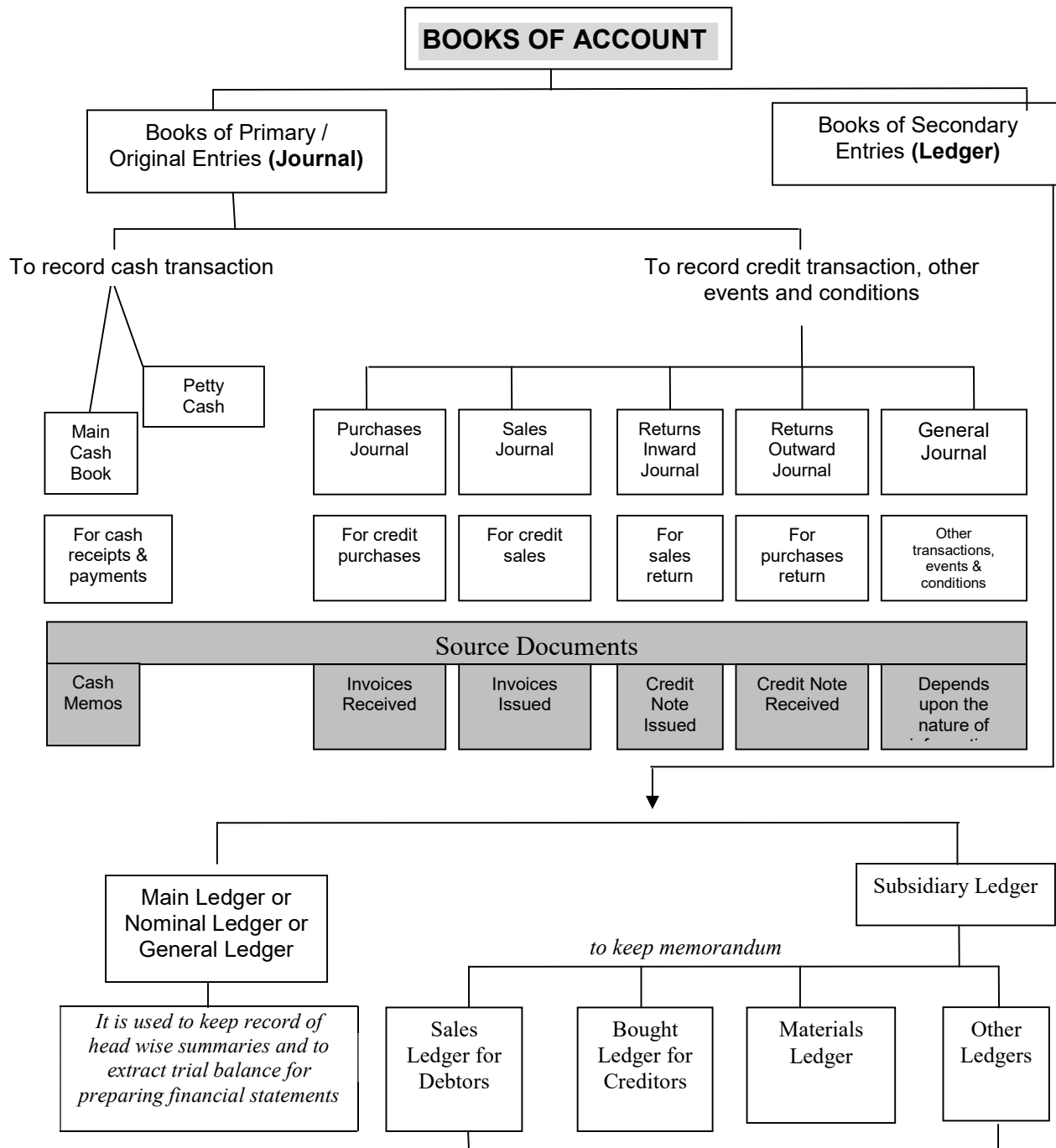
1. Books of original entries.



2. Books of secondary entries.



These books of accounts are further subdivided according to the needs of the business and/or complexity of the transactions. Following diagram best describes the different books of accounts that are used in a business entity.



## Systems of Accounting/Reporting

There are two accounting systems being practiced:

- **Cash Based Accounting/Reporting System**

It is a system in which transactions are recorded only when cash is received or paid. The system which reports income when received and expenses when paid.

- **Accrual Based Accounting/Reporting System**

It is a system in which transactions are recorded on the basis of amount becoming due for payment or receipt, regardless the condition that settlement in terms of cash has happened or not. The only point of concern is, whether the expense or income belongs to the reporting period. If that belongs to the reporting period then payment or collection in terms of cash becomes irrelevant.

It is the most commonly used accounting method, which reports income when earned and expenses when incurred, as opposed to cash basis accounting, which reports income when received and expenses when paid.

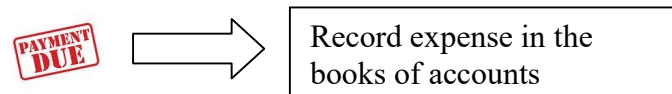
Under the accrual method, companies do have some discretion as to when income and expenses are recognized, but there are rules governing the recognition.

**Example – 1**

- i. Electricity bill for the last quarter (October – December) was not paid until the end of reporting period 31<sup>st</sup> December 20X9. **Under the cash-based accounting;** such unpaid utility bill will not be recognized as expense in the accounting year 20X9. It will be expense for the year 20Y0 upon payment.



- ii. Electricity bill for the last quarter (October – December) was not paid until the end of reporting period 31<sup>st</sup> December 20X9. **Under the accrual-based accounting;** such unpaid utility expense will be recognized as expense in the accounting year 20X9 along with a liability that will be paid in 20Y0.



**Accounting treatment for accrued expense and accrued income:**

Expense belongs to the reporting period but its payment will be made in the next year.

Expense head      Dr.      (being economic benefit has been enjoyed during the reporting period)

Liability head      Cr.      (being the amount in terms of cash is still payable)

Income belongs to the reporting period but its receipt will be collected in the next year.

Asset head      Dr.      (being the amount in terms of cash is still receivable)

Income head      Cr.      (being income has been earned by selling goods or rendering services)

**Example – 2**

Insurance paid in advance for the year 20X9 on 1<sup>st</sup> November 20X8

**Under the accrual-based accounting**

The payment of insurance will be recorded in the year 20X8 as “prepayment or paid in advance” which shall be recognized as asset and then in the year 20X9 it will be recorded as expense, to which it belongs to.

**Under the cash-based accounting**

Payment will be recorded as expense as soon as cash is paid to insurance company on 1<sup>st</sup> November 20X8



## Single Entry Bookkeeping Approach

**Single entry bookkeeping** is a simplest form of **bookkeeping** in which single effect of each financial information is **entered** in the books of accounts.

## Single Entry Bookkeeping -Vs- Double Entry Bookkeeping

The single entry bookkeeping approach contrasts with double entry bookkeeping approach. Each financial information brings at least *two* equal and offsetting entries in the double entry bookkeeping approach. One is debit (Dr) and the other one is credit (Cr). As a result:

- Entities using the double entry approach report financial results with an accrual accounting/reporting system.
- Entities using single entry approach are effectively limited to reporting on a cash basis only.

On the positive side, single-entry bookkeeping is simpler and much easier to use than the double entry approach. And, the single-entry approach does not require background or training in accounting. Nevertheless, the overwhelming majority of firms, worldwide, follow double entry not the single-entry approach.

### **Adequacy of single entry accounting system**

Single entry accounting can be adequate for a small business practicing cash based accounting. Small firms may in fact prefer single entry accounting over a double-entry system when all or most of the following conditions apply:

- Entity uses cash based accounting, not accrual accounting.
- There are few financial transactions per day.
- Entity does not sell on its own credit. Customers must pay at the time of the sale either in cash or, by bank transfer, 3rd-party debit card, 3rd-party credit card, or by writing a cheque. The entity does not deliver goods or services and then invoice customers for payment later.
- There are very few employees.
- Entity is privately held or operates as a sole proprietorship or partnership. As a result, the firm does not publish an income statement, balance sheet, or other financial statements that are mandatory for public companies.



### Example- single entry system

The single-entry approach is very similar to the cash book that individuals use to keep track of receipts and payments. In both cases, users simply record the date, amount, and name of each transaction. Example below shows how the single-entry record might look for a few days transactions for a very small business.

Example: Five column single entry record

| Date                   | Transaction                    | Receipts<br>Rs. | Payments<br>Rs. | Balance<br>Rs.  |
|------------------------|--------------------------------|-----------------|-----------------|-----------------|
| 1 December 20X7        | Starting balance for the month |                 |                 | 4,520.00        |
| 2 December 20X7        | Utility bills paid             |                 | (Rs.43.00)      | 4 477.00        |
| 2 December 20X7        | furniture purchased            |                 | (Rs.624.15)     | 3,852.85        |
| 3 December 20X7        | Sales                          | Rs.1,040.25     |                 | 4,893.10        |
| 4 December 20X7        | tax paid                       |                 | (Rs.83.22)      | 4,809.88        |
| 4 December 20X7        | Commission                     | Rs.592.25       |                 | 5,402.13        |
| 5 December 20X7        | Bank interest received         | Rs.180.83       |                 | 5,582.96        |
| 8 December 20X7        | Salaries paid                  |                 | (Rs.42.95)      | 5,540.01        |
| <b>8 December 20X7</b> | <b>Ending balance for week</b> |                 |                 | <b>5,540.01</b> |

**Exercise Question 1**

From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the main heads and then make decision for Dr and Cr effects.

1. Machinery purchased from Maria & Co. on credit Rs.2,000.
2. Loan taken from friend Rs.200 in cash.
3. Machinery returned to Maria & Co. Rs. 2,000.
4. Bought goods on credit from Kashmiri Rs. 600.
5. Sold goods on credit to Harris Rs.800.
6. Goods returned to Kashmiri Rs.100.
7. Goods returned by Harris Rs. 200.
8. Charity paid in cash Rs. 200.
9. Free sampling of goods Rs. 50.
10. Friend's loan was repaid Rs. 200.

**Answer:**

| Sr. No. | Accounting Head         | Main Head | Group | Increase/decrease | Dr./Cr. Effect |
|---------|-------------------------|-----------|-------|-------------------|----------------|
| 1       | Machinery               | Asset     | Dr.   | Inc.              | Dr.            |
|         | Creditors (Maria & Co.) | Liability | Cr.   | Inc.              | Cr.            |
| 2       | Cash                    | Asset     | Dr.   | Inc.              | Dr.            |
|         | Loan from friend        | Liability | Cr.   | Inc.              | Cr.            |
| 3       | Machinery               | Asset     | Dr.   | Dec.              | Cr.            |
|         | Creditor (Maria & Co.)  | Liability | Cr.   | Dec.              | Dr.            |
| 4       | Purchases               | Expense   | Dr.   | Inc.              | Dr.            |
|         | Creditor (Kashmiri)     | Liability | Cr.   | Inc.              | Cr.            |
| 5       | Sales                   | Income    | Cr.   | Inc.              | Cr.            |
|         | Debtor (Harris)         | Asset     | Dr.   | Inc.              | Dr.            |
| 6       | Purchases Return        | Expense   | Dr.   | Dec.              | Cr.            |
|         | Creditor (Kashmiri)     | Liability | Cr.   | Dec.              | Dr.            |
| 7       | Sales Return            | Income    | Cr.   | Dec.              | Dr.            |
|         | Debtor (Harris)         | Asset     | Dr.   | Dec.              | Cr.            |
| 8       | Cash                    | Asset     | Dr.   | Dec.              | Cr.            |
|         | Charity                 | Expense   | Dr.   | Inc.              | Dr.            |
| 9       | Free Sampling           | Expense   | Dr.   | Inc.              | Dr.            |
|         | Purchases               | Expense   | Dr.   | Dec.              | Cr.            |
| 10      | Cash                    | Asset     | Dr.   | Dec.              | Cr.            |
|         | Loan from friend        | Liability | Cr.   | Dec.              | Dr.            |

### Exercise Question 2

Choose correct answer

1. Goods purchased from John smith
  - a. - cash + stock
  - b. + stock + cash
  - c. + creditors + stock
  - d. b & c both
2. Commission paid to agent Jordan
  - a. - commission - cash
  - b. + commission - cash
  - c. + Jordan Account - cash
  - d. + capital - cash
3. Goods sold for Rs.5,000 that cost 4500
  - a. + cash 5,000 + sales 5,000
  - b. - cash 4,500 - stock 4,500
  - c. + cash 5,000 - stock 5,000
  - d. +cash 4,500 - sales 4,500
4. Goods returned from credit customer
  - a. - debtors + sales return
  - b. - creditors + stock
  - c. + debtors - owner's equity
  - d. none of the above
5. Cash received from debtor Rs.4,800
  - a. + cash 5,000 + sales 5,000
  - b. + cash 4,800 + capital 4,800
  - c. + cash 4,800 - debtor 4,800
  - d. + cash 4,800 - drawings 4,800
6. Loan repaid to Hassan brothers
  - a. - owner's equity + cash
  - b. - liability - cash
  - c. + cash - liability
  - d. + Hassan brothers - cash
7. Cash withdraw by owner
  - a. + owners' equity - cash
  - b. - owners' equity + cash
  - c. - owners' equity - cash
  - d. - owners' equity - stock
8. Machinery purchased from Caterpillar on credit
  - a. + machinery - cash
  - b. + machinery + cash
  - c. + machinery + Liability
  - d. - machinery + cash

Answer: (1-c, 2-b, 3-a, 4-a, 5-c, 6-b, 7-c, 8-c)

**Examination Question 1**

From the following transactions identity two accounting heads and also make decision for Dr and Cr effects.

- Jan 1:** Capital introduced in the business by owner Rs. 100,000.  
**Jan 2:** Deposited cash into the bank Rs.50,000.  
**Jan 3:** Bought goods on credit from Harris Rs.10,000.  
**Jan 4:** Bought goods from John Smith by paying him cash Rs.5,000.  
**Jan 5:** Stationery paid in cash Rs.500.  
**Jan 6:** Sold goods on credit to Stars bros. Rs.12,000.  
**Jan 8:** Rent expense paid by cheque Rs.2,000.  
**Jan 9:** Furniture and fixture purchased on credit from Charlie Rs.5,000.  
**Jan 10:** Paid salaries Rs.1,000 in cash.  
**Jan 14:** Returned goods to Harris Rs.2,000.  
**Jan 15:** Rent received by subletting the buildings Rs. 6,000.  
**Jan 16:** Received cash from Stars bros. Rs.12,000.  
**Jan 20:** Cash paid to Harris Rs.8,000.  
**Jan 25:** Bought motor car for Rs.30,000 by cheque.  
**Jan 30:** Insurance paid in cash Rs.200.

**Answer:**

| Date   | Accounting Head      | Dr./Cr. Effect | Amounts |
|--------|----------------------|----------------|---------|
| Jan 1  | Cash                 | Dr.            | 100,000 |
|        | Capital              | Cr.            | 100,000 |
| Jan 2  | Bank                 | Dr.            | 50,000  |
|        | Cash                 | Cr.            | 50,000  |
| Jan 3  | Purchases            | Dr.            | 10,000  |
|        | Creditor (Harris)    | Cr.            | 10,000  |
| Jan 4  | Purchases            | Dr.            | 5,000   |
|        | Cash                 | Cr.            | 5,000   |
| Jan 5  | Stationery           | Dr.            | 500     |
|        | Cash                 | Cr.            | 500     |
| Jan 6  | Debtor (Stars bros.) | Dr.            | 12,000  |
|        | Sales                | Cr.            | 12,000  |
| Jan 8  | Rent                 | Dr.            | 2,000   |
|        | Bank                 | Cr.            | 2,000   |
| Jan 9  | Furniture & Fixtures | Dr.            | 5,000   |
|        | Creditor (Charlie)   | Cr.            | 5,000   |
| Jan 10 | Salaries             | Dr.            | 1,000   |
|        | Cash                 | Cr.            | 1,000   |
| Jan 14 | Creditor (Harris)    | Dr.            | 2,000   |
|        | Purchases (Returns)  | Cr.            | 2,000   |
| Jan 15 | Cash                 | Dr.            | 6,000   |
|        | Rent (Income)        | Cr.            | 6,000   |
| Jan 16 | Cash                 | Dr.            | 12,000  |
|        | Debtor (Stars bros.) | Cr.            | 12,000  |
| Jan 20 | Creditor (Harris)    | Dr.            | 8,000   |
|        | Cash                 | Cr.            | 8,000   |
| Jan 25 | Motor Car            | Dr.            | 30,000  |
|        | Bank                 | Cr.            | 30,000  |
| Jan 30 | Insurance            | Dr.            | 200     |
|        | Cash                 | Cr.            | 200     |

### Examination Question 2

State whether the following statements are true or false

1. Owner introduced fresh capital during the year will be credited to capital account.
2. Goods given away as charity will be credited to gifts account.
3. Goods Lost by fire will be credited to Purchases account.
4. Cash taken by Proprietor for personal use will be debited to owner's personal account.
5. Loan taken from bank will be credited to creditor account.
6. Salary paid to Mr. John will be debited to Mr. John account

**Answer:** (1-True, 2-False, 3-True, 4-False, 5-False, and 6-False)

**Explanation:**

**2**-Goods given away as charity means inventory of goods decreased other than sale, therefore purchases account will be credited

**4**-when goods or cash taken by owner for personal use than drawings account will be debited his personal account or name will never be used in books of account

**5**-loan account will be credited as liability, creditors account is used when goods are purchased on credit

**6**-For expenses, name of expense will be used instead of the person to whom we pay. Debit will be "salary account"



## Chapter – 4

### Journalizing – Books of Original Entries

| Sr. No | Course outline Topic - Chapter 4                           |
|--------|------------------------------------------------------------|
| 1      | Journalizing Transactions                                  |
| 2      | Journal entry - Practice                                   |
| 3      | Compound entry - Practice                                  |
| 4      | General Journal - Practice                                 |
| 5      | Discounts                                                  |
| 6      | Journalizing settlement discounts                          |
| 7      | General Journal - Practice with complex accounting entries |
| 8      | General Journal - Practice with complex accounting entries |
| 9      | Subdivision of Journal                                     |
| 10     | Sales Journal                                              |
| 11     | Purchase Journal                                           |
| 12     | Sales Return Journal                                       |
| 13     | Purchase Return Journal                                    |
| 14     | Comprehensive practice - subdivision of journal            |
| 15     | Cash Book                                                  |
| 16     | Single Column Cash Book                                    |
| 17     | Two Column Cash Book                                       |
| 18     | Three Column Cash Book                                     |
| 19     | Petty Cash Book                                            |

Topic Videos 28-46 are mandatory part of this module

## Journal / Book of Primary Entry / Book of Original Entry

Journal is the first book in accounting cycle, which is used primarily to record all financial information of the entity. Since the journal is first book of account, therefore, it is also known as book of primary entry or book of original entry.

Financial information comprises of; transactions, events and conditions also known and accounting phenomena. These accounting phenomena are recorded in a chronological (date) sequence. Both accounting effects of a financial information, i.e., Debit & Credit, are analyzed in a voucher and then recorded in journal by following a systematic manner.



Systematic manner of maintaining journal includes proper format and certain rules to be followed. Information recorded by following such rules and in a proper format of journal is known as *journal entry* or *accounting entry*. Simply it can also be named as *entry*. Just like parts of speech in English language, there are six parts of *entry* in Accounting language; 1) Date, 2) Particulars, 3) Post reference, 4) Debit amount 5) Credit amount, and 6) narration.

The process of maintaining journal is a part of bookkeeping. The person responsible for maintaining journal is known as bookkeeper, who has all the expertise to analyze financial information and to maintain journal.

## Recapitulation – Analyzing Dr & Cr

- |                   |                                    |
|-------------------|------------------------------------|
| 1. Assets         | (increase debit & decrease credit) |
| 2. Expenses       | (increase debit & decrease credit) |
| 3. Liabilities    | (increase credit & decrease debit) |
| 4. Incomes        | (increase credit & decrease debit) |
| 5. Owners' Equity | (increase credit & decrease debit) |

| Main Heads     | Nature | Increase | Decrease |
|----------------|--------|----------|----------|
| Assets         | Dr     | Dr       | Cr       |
| Expenses       | Dr     | Dr       | Cr       |
| Owners' Equity | Cr     | Cr       | Dr       |
| Liabilities    | Cr     | Cr       | Dr       |
| Incomes        | Cr     | Cr       | Dr       |

## Format of Journal & Journal Entry

For a small entity, which is having very few transactions, events and conditions, a *general-purpose journal* is quite sufficient for recording purposes. Format of a general journal and rules to record journal entry are illustrated below:

### Sample Transaction

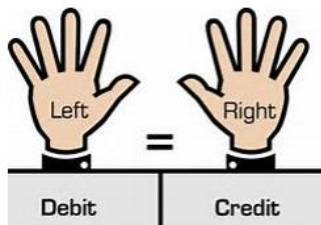
10 Jan 20X9      Cash paid for staff salaries Rs.50,000



| Date<br>20X9 | Particulars/Description           | Post<br>Ref. | Debit<br>(Rs) | Credit<br>(Rs) |
|--------------|-----------------------------------|--------------|---------------|----------------|
| Jan. 10      | Salaries Account ( <i>Debit</i> ) | 39           | 50,000        |                |
|              | Cash Account ( <i>Credit</i> )    | 10           |               | 50,000         |
|              | (Staff salaries paid in cash)     |              |               |                |



- ⇒ From the above illustration we can understand that on 10<sup>th</sup> January 20X9, business paid cash Rs.50,000 as staff salaries.
- ⇒ As a rule; it is customary that the accounting head analyzed as *debit* is written firstly in the Particulars/Description column and its amount is written in the debit column whereas the accounting head analyzed as *credit* is written under the debit accounting head but after indenting some space from the left side, its amount is written in the credit column.
- ⇒ The post reference column shows page numbers of the “**Ledger**” in which salaries and cash accounts are posted.
- ⇒ The column of post reference cannot be very well understood without having knowledge of “**Ledger**” that will be learned in the next chapter.
- ⇒ Short explanation of transaction written within the parenthesis in particulars/description column is known as “**Narration**”. It is an integral part of a journal entry. Narration explains accounting treatments to a layman.
- ⇒ Conventionally Debit effects are recorded at left-hand side and Credit effects are recorded at right-hand side.



**Practice 4.1**

Pass journal entries for the following transactions

**20X9**

**Jan. 2:** Goods bought for cash Rs.20,000.



**Jan. 5:** Goods sold for cash Rs.35,000.



**Jan. 10:** Loan taken from friends in cash Rs.50,000.



**Answer:**

| Date<br>20X9 | Particulars/Description                                                                                                                                                                                                                                                                                    | Post<br>Ref. | Debit<br>(Rs) | Credit<br>(Rs) |
|--------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|---------------|----------------|
| Jan. 2       | Purchases Account ( <i>Debit</i> )<br>Cash Account ( <i>Credit</i> )<br>(Bought goods for cash).<br><b>Explanation:</b><br>This transaction increased expenses on purchase of goods, therefore debit is given to purchases account and cash-asset decreased therefore credit is given to the cash account. | ?<br>?       | 20,000        | 20,000         |
| Jan. 5       | Cash Account ( <i>Debit</i> )<br>Sales Account ( <i>Credit</i> )<br>(Sold goods for cash)<br><b>Explanation:</b><br>This transaction increased the cash-asset therefore cash account is debited and it increased the sales-income, therefore credit sales account.                                         | ?<br>?       | 35,000        | 35,000         |
| Jan. 10      | Cash Account ( <i>Debit</i> )<br>Loan from friend ( <i>Credit</i> )<br>(Loan taken in cash from friend).<br><b>Explanation:</b><br>This transaction increased the cash-asset therefore cash account is debited and it increased loan-liability Loan from Friend is credited.                               | ?<br>?       | 50,000        | 50,000         |

## Compound Accounting Entry

A business makes multiple transactions in a day in which same accounting head is involved. The single journal entry, which combines multiple journal entries in which same accounting head is repeating, is known as compound entry. For example;

**5 Jan 20X9: Cash Rs.7,000 was paid for salaries and cash Rs.1,000 was paid for purchase of stationery.**

In this transaction, cash account is to be credited against both, salaries and stationery. If we record these transactions separately, this would be:

| Date<br>20X9 | Particulars/Description                                                                                                                                     | Post<br>Ref. | Debit<br>(Rs) | Credit<br>(Rs) |
|--------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|---------------|----------------|
| Jan. 5       | Salaries account<br>Cash account<br>(Salaries paid in cash)<br>           | ?<br>?       | 7,000         | 7,000          |
| Jan. 5       | Stationery account<br>Cash account<br>(Stationery purchased for cash.)<br> | ?<br>?       | 1,000         | 1,000          |

In order to avoid double working, we can combine these two entries in one, which is known as compound entry:

| Date<br>20X9 | Particulars/Description                                                                                    | Post<br>Ref. | Debit<br>(Rs)  | Credit<br>(Rs) |
|--------------|------------------------------------------------------------------------------------------------------------|--------------|----------------|----------------|
| Jan. 5       | Salaries account<br>Stationery account<br>Cash account<br>(Salaries paid & Stationery purchased for cash). | ?<br>?       | 7,000<br>1,000 | 8,000          |

## Practice 4.2

Prepare a journal for the following transactions during January 20X9.

**Jan 1:** Capital introduced in the business Rs.10,000 in cash and Rs.20,000 as machinery.



**Jan 2:** Purchase land for cash Rs.4,000.

**Jan 3:** Purchase goods for cash Rs.2,000 and on credit from Giant Store Rs.7,000.

**Jan 4:** Sold goods for cash Rs.3,000.

**Jan 5:** Rent paid in cash Rs.2,000.

**Jan 6:** Owner withdrew cash for personal use Rs.500 **OR** Paid Rs.500 to owner for his personal use.

**Jan 7:** Salaries paid in cash Rs.200.

**Jan 8:** Bought goods from Moon Light on credit Rs.6,000.

**Jan 9:** Sold goods on credit to Falcons for Rs.8,000 and for cash Rs.4,000.

**Jan10:** Received cash from Falcons 2,500 on his account.

| Date<br>20X9 | Particulars                                                                                                                                                                                                                                                                                                                                                                                        | Post<br>Ref. | Debit<br>(Rs)    | Credit<br>(Rs) |
|--------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|------------------|----------------|
| Jan. 1       | Cash Account<br>Machinery Account<br>Capital Account<br>(Cash & machinery introduced as capital).<br><u>Explanation</u><br>Two assets- cash & machinery increased therefore debited and equity is increased therefore capital account is credited.                                                                                                                                                 | ?<br>?       | 10,000<br>20,000 | 30,000         |
| Jan. 2       | Land Account<br>Cash Account<br>(Purchased land for cash).<br><u>Explanation</u><br>asset- land increased therefore debited and cash-asset is decreased therefore cash account is credited.                                                                                                                                                                                                        | ?<br>?       | 4,000            | 4,000          |
| Jan. 3       | Purchases Account<br>Cash Account<br>Creditor (Giant Store)<br>(Goods purchased for cash & on credit from Giant Store).<br><u>Explanation</u><br>Expense for purchase of goods increased therefore debited purchases account and cash-asset is decreased therefore cash account is credited, also worth 7,000 goods are on credit which increase the liability therefore creditor is also credited | ?<br>?       | 9,000            | 2,000<br>7,000 |
| Jan. 4       | Cash Account<br>Sales Account<br>(Sold goods for cash).<br><u>Explanation</u><br>Cash-Asset increased therefore cash account is debited and sales income increased therefore credit sales account                                                                                                                                                                                                  | ?<br>?       | 3,000            | 3,000          |
| Jan. 5       | Rent Account<br>Cash Account<br>(Rent paid in cash).<br><u>Explanation</u><br>Increase in expense is always debit therefore rent account is debited and cash-asset is decreased therefore cash account is credited.                                                                                                                                                                                | ?<br>?       | 2,000            | 2,000          |

|         |                                                                                                                                                                                                                                                                                                                                                                                                   |                            |                           |        |
|---------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------|---------------------------|--------|
| Jan. 6  | <p>Drawings Account<br/>Cash Account<br/>(Cash withdrew by the owner for personal use).</p> <p><u>Explanation</u><br/>Whenever owner withdraws cash for personal use drawing account is debited and cash-asset is decreased therefore cash account is credited.</p>                                                                                                                               | <p>?</p> <p>?</p>          | 500                       | 500    |
| Jan. 7  | <p>Salaries Account<br/>Cash Account<br/>(Salaries paid in cash).</p> <p><u>Explanation</u><br/>Increase in expense is always debit therefore salaries account is debited and cash-asset is decreased therefore cash account is credited.</p>                                                                                                                                                     | <p>?</p> <p>?</p>          | 200                       | 200    |
| Jan. 8  | <p>Purchased Account<br/>Creditors (Moon Light) Account<br/>(Purchase goods on credit from Moon Light).</p> <p><u>Explanation</u><br/>Expense against purchase of goods increased therefore debited purchases account, this purchase is on credit which increases the liability therefore creditor account is credited.</p>                                                                       | <p>?</p> <p>?</p>          | 6,000                     | 6,000  |
| Jan. 9  | <p>Debtors (Falcons) Account<br/>Cash Account<br/>Sales Account<br/>(Sold goods on credit to Falcons and goods sold for cash)</p> <p><u>Explanation</u><br/>Cash-Asset increased therefore cash account is debited, goods worth Rs. 8,000 are sold on credit, this increases debtor-asset. Both cash and credit sales are increasing sales income therefore credit sales account with 12,000.</p> | <p>?</p> <p>?</p> <p>?</p> | <p>8,000</p> <p>4,000</p> | 12,000 |
| Jan. 10 | <p>Cash Account<br/>Debtors (Falcons) Account<br/>(Received cash from Falcons on account).</p> <p><u>Explanation</u><br/>Asset-cash increased therefore debited cash account. Cash paid by debtors therefore decrease the asset-debtors therefore credit debtors account.</p>                                                                                                                     | <p>?</p> <p>?</p>          | 2,500                     | 2,500  |

### Accounting entries for “Discounts”



#### Types of discounts

A trader often allows its customers two types of discounts

- Trade discount
- Settlement discount

#### Trade Discount

It is the discount offered by a seller to its customers before entering into transaction with them. Trade discount is always offered based on some policy. *Examples include:*

1. Bulk purchase discounts.
2. Regular customer discounts.
3. Season end discounts.



#### Note:

- ⇒ Trade discounts are never recorded in the books of either party (Seller or Buyer). The amount after subtracting trade discount is recorded in the books of account.

**For example,** list price of a product is Rs.220 and retailer seller offers 10% discount to its customers. The amount after subtracting trade discount for the purpose of recording transaction in the books is:

$$220 - (220 \times 10\%) = 220 - 22 = \text{Rs.198}$$

**Purchases Account (debit)**

**Rs.198**

**Cash Account (credit)**

**Rs.198**

## Settlement Discount



**5% CASH  
DISCOUNT**

It is the discount offered by a seller to its customers based on cash settlement terms for early payment of the invoice.

*Example:* Goods sold for Rs.2,000 on settlement terms (5/10, n/30). Rs. 100 shall be the amount of settlement discount ( $2,000 \times 5\%$ ) = Rs.100. This discount is also known as cash discount.

⇒ Settlement discount is recorded in the books of both parties (Seller and Buyer).

⇒ Settlement discount for seller is known as “*discount allowed*”; and for buyer is known as “*discount received*”.

### Accounting Entries:

#### Scenario (i)

Cash received from debtor Rs.11,400 in full settlement of his account of Rs.12,000.

*By analyzing this transaction, we find that there is a decrease in debtors' balance because of discount allowed to them based on settlement terms for Rs.600 and because of cash received from them Rs.11,400, therefore, the double entry would be:*

|    |                          | Rs.    | Rs.    |
|----|--------------------------|--------|--------|
| I  | Cash Account             | 11,400 |        |
|    | Debtor Account           |        | 11,400 |
| II | Discount Allowed Account | 600    |        |
|    | Debtor Account           |        | 600    |

By combining these two journal entries, we shall have a compound entry as

|          |                          |        |        |
|----------|--------------------------|--------|--------|
| (I + II) | Cash account             | 11,400 |        |
|          | Discount Allowed Account | 600    |        |
|          | Debtors Account          |        | 12,000 |

#### Scenario (ii)

Cash paid to creditors Rs.9, 500 after deducting a discount of Rs.500.

*By analyzing this transaction, we find that there is a decrease in creditors because of discount received from them based on settlement terms Rs.500 and because of cash paid to them for Rs.9,500. Therefore, the double entries would be:*

|    |                           | Rs.   | Rs.   |
|----|---------------------------|-------|-------|
| I  | Creditor Account          | 9,500 |       |
|    | Cash Account              |       | 9,500 |
| II | Creditor Account          | 500   |       |
|    | Discount Received Account |       | 500   |

By combining these two journal entries we can have a compound entry as

|          |                           |        |      |
|----------|---------------------------|--------|------|
| (I + II) | Creditors Account         | 10,000 |      |
|          | Cash Account              |        | 9500 |
|          | Discount Received Account |        | 500  |

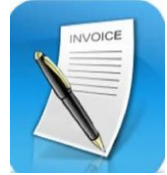
#### Scenario (iii)

Cash paid to Creditor in full settlement of his account Rs.9,500, after subtracting discount Rs.500.

|  |                           | Rs.   | Rs.   |
|--|---------------------------|-------|-------|
|  | Creditor's Account        | 9,500 |       |
|  | Cash Account              |       | 9,000 |
|  | Discount Received Account |       | 500   |

## Understanding the concept of settlement terms through invoice

Invoice is a document that is issued by a seller to its customer at the time of sales. An invoice states trade discount as a deduction from the list price and also states settlement terms for calculation of settlement discount in future. Following sample of invoice will explain the concept of trade discount and settlement terms:



### Sample Invoice

| Invoice #<br>Date:<br>December<br>19, 20X9 | Business Name and Address <b>John Smith Traders</b> |          |             |               |
|--------------------------------------------|-----------------------------------------------------|----------|-------------|---------------|
|                                            | Customer's Name and Address <b>Star Traders</b>     |          |             |               |
| Serial No                                  | Description                                         | Quantity | Rate<br>Rs. | Amount<br>Rs. |
| 1                                          | Fans                                                | 5        | 2,000       | 10,000        |
| 2                                          | Air conditioner                                     | 2        | 25,000      | 50,000        |
| 3                                          | Room Coolers                                        | 3        | 10,000      | 30,000        |
|                                            | Sub Total                                           |          |             | <b>90,000</b> |
|                                            | Trade discount 10%                                  |          |             | (9,000)       |
|                                            | Net amount of invoice                               |          |             | <b>81,000</b> |
|                                            | <b>Settlement term: 2/10, n/30</b>                  |          |             |               |

### Describing the above invoice

As per the above invoice Rs.9,000 is the amount of trade discount that is subtracted from the total amount of invoice. Net of trade discount invoice price is Rs.81,000 that is payable to the supplier on December 19, 20X9. If the invoice will be paid within 10 days i.e. by December 29, 20X9, the supplier will offer further 2% discount that is known as settlement discount (as per settlement terms given at the bottom of the invoice). Amount of settlement discount would be Rs.1,620 = (81,000 x 2%).

### Accounting Entries

#### In the Books of Seller (John Smith Traders)

|                          |                       | Rs.    | Rs.    |
|--------------------------|-----------------------|--------|--------|
| Dec. 19                  | Debtors A/c.          | 81,000 |        |
|                          | Sales A/c.            |        | 81,000 |
| <u>If settled before</u> |                       |        |        |
| Dec. 29                  | Cash A/c.             | 79,380 |        |
|                          | Discount allowed A/c. | 1,620  |        |
|                          | Debtors A/c.          |        | 81,000 |
| <u>If settled after</u>  |                       |        |        |
| Dec. 29                  | Cash A/c.             | 81,000 |        |
|                          | Debtors A/c.          |        | 81,000 |

#### In the Books of Buyer/Customer (Star Traders)

|                          |                        |        |        |
|--------------------------|------------------------|--------|--------|
| Dec. 19                  | Purchases A/c.         | 81,000 |        |
|                          | Creditors A/c.         |        | 81,000 |
| <u>If settled before</u> |                        |        |        |
| Dec. 29                  | Creditors A/c.         | 81,000 |        |
|                          | Cash A/c.              |        | 79,380 |
|                          | Discount received A/c. |        | 1,620  |
| <u>If settled after</u>  |                        |        |        |
| Dec. 29                  | Creditors A/c.         | 81,000 |        |
|                          | Cash A/c.              |        | 81,000 |

**Practice 4.4**

Pass journal entries in a journal for the following transactions during the month of December 20X9.

**Dec 1:** Business started with cash Rs.100,000 and furniture worth Rs.35,000 as capital.

**Dec 2:** Machinery purchased from Jordan on credit Rs.2,000.

**Dec 4:** Loan taken from bank Rs.200,000 in cash.

**Dec 6:** Machinery returned to Jordan Rs.2,000.

**Dec 8:** Bought goods on credit from Pearl Traders Rs.6,000.

**Dec 10:** Bought goods on credit from Giant Store for Rs.10,000 subject to a 5% trade discount.

**Dec 11:** Goods sold for Rs.2,000 to Falcons on settlement terms 5/10, n/30.

**Dec 12:** Sold goods on credit to John Smith for Rs.8,000.

**Dec 16:** Goods returned to Pearl Traders Rs.1,000.

**Dec 17:** Falcons settled his account in full.

**Dec 18:** Cash paid to Pearl Traders Rs.4,800 in full settlement of his account.

**Dec 20:** Goods returned by John Smith Rs.2,000.

**Dec 22:** Charity paid in cash Rs.200.

**Dec 23:** Goods worth Rs.350, Cash Rs.1,000 were taken away by the proprietor for personal use.

**Dec 26:** Goods distributed as free sample Rs.1,000 and given away as charity worth Rs.500.

**Dec 28:** Bank loan paid Rs.200,000.

| Date<br>20X9 | Particulars/Descriptions                                                                                                                                                                                                                                                                                                  | Post<br>Ref. | Debit<br>(Rs.)    | Credit<br>(Rs.) |
|--------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|-------------------|-----------------|
| <b>Dec 1</b> | Cash Account<br>Furniture Account<br>Capital Account<br>(Cash and Furniture introduced as capital)<br><u>Explanation</u><br>Two assets - cash & furniture increased therefore debited and equity is increased therefore capital account is credited.                                                                      | ?<br>?<br>?  | 100,000<br>35,000 | 135,000         |
| <b>Dec 2</b> | Machinery Account<br>Creditors (Jordan) Account<br>(Machinery purchased on credit from Jordan).<br><u>Explanation</u><br>Asset - machinery increased therefore debited, and no payment is made against the purchase therefore liability is created hence creditor account is credited.                                    | ?<br>?       | 2,000             | 2,000           |
| <b>Dec 4</b> | Cash Account<br>Bank Loan Account<br>(Loan taken in cash from Bank).<br><u>Explanation</u><br>Asset - cash increased therefore debited, and the cash is repayable in future therefore liability is created called loan from bank.                                                                                         | ?<br>?       | 200,000           | 200,000         |
| <b>Dec 6</b> | Creditors (Jordan) Account<br>Machinery Account<br>(Machinery returned to Jordan).<br><u>Explanation</u><br>Asset - machinery decreased therefore credited, and liability is cancelled as machinery has been returned therefore liability - creditors is debited. this entry is reversal of entry on Dec. 2nd             | ?<br>?       | 2,000             | 2,000           |
| <b>Dec 8</b> | Purchase Account<br>Creditors (Pearl Traders) Account<br>(Bought goods on credit from Pearl Traders).<br><u>Explanation</u><br>Expense against purchase of goods increased therefore debited purchases account and payment is not made at time of purchase therefore liability is created by crediting creditors account. | ?<br>?       | 6,000             | 6,000           |

|               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |             |               |              |
|---------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|---------------|--------------|
| <b>Dec 10</b> | Purchases Account<br>Creditors (Giant Store) Account<br>(Goods purchased on trade discount of 5%)<br>(10,000 X 95% = 9,500)<br><br><u>Explanation</u><br>Expense against purchase of goods increased therefore debited purchases account and cash-asset is decreased therefore cash account is credited. Amount will be net off of trade discount, because trade discount is not recorded.                                                                                                                                                              | ?<br>?      | 9,500         | 9,500        |
| <b>Dec 11</b> | Debtor (Falcons) Account<br>Sales Account<br>(Goods sold on credit on settlement term 5/10, n/30)<br><u>Explanation</u><br>The transaction creates debtor-Asset therefore debtor account is debited and sales income increases because of sales of goods, therefore credit sales account.<br>Discount policy is mentioned in the transaction but has no effect on sale entry. it will be accounted for at the time of receiving cash from debtor.                                                                                                       | ?<br>?      | 2,000         | 2,000        |
| <b>Dec 12</b> | Debtors (John Smith) Account<br>Sales Account<br>(Sold goods on credit to John Smith).<br><u>Explanation</u><br>This transaction creates debtor-Asset therefore debtor account is debited and sales income increases because of sales of goods, therefore credit sales account                                                                                                                                                                                                                                                                          | ?<br>?      | 8,000         | 8,000        |
| <b>Dec 16</b> | Creditors (Pearl Traders) Account<br>Purchases Return Account<br>(Goods returned to Pearl Traders).<br><u>Explanation</u><br>The transaction will decrease the liability payable to Pearl Traders therefore creditors account will be debited and at the same time the purchases expense is also decreasing because of goods returned to supplier therefore credit Purchase return account                                                                                                                                                              | ?<br>?      | 1,000         | 1,000        |
| <b>Dec 17</b> | Cash Account<br>Discount Account<br>Debtor (Falcons) Account<br>(Cash received & discount allowed)<br>2,000 X 5% = 100*<br><u>Explanation</u><br>This transaction decreases the debtor-Asset balance; therefore, debtor account is credited and cash-asset increases therefore cash account is debited. Falcon became debtor on 11 <sup>th</sup> Dec. with settlement terms 5/10, n/30. Account is settled in full on 7 <sup>th</sup> day on 17 <sup>th</sup> Dec. Cash discount of 5% will be given because payment is made within 10 days of invoice. | ?<br>?<br>? | 1,900<br>100* | 2,000        |
| <b>Dec 18</b> | Creditor (Pearl Trader) Account<br>Cash Account<br>Discount Received<br>(Final settlement to Pearl Trader 6,000-1,000=5,000)                                                                                                                                                                                                                                                                                                                                                                                                                            | ?<br>?<br>? | 5,000         | 4,800<br>200 |
| <b>Dec 20</b> | Sales return Account<br>Debtors (John Smith) Account<br>(Goods returned by John Smith).<br><u>Explanation</u><br>The debtor-Asset balance decreases therefore debtor account is credited and sales income is reducing therefore debited sales return account.                                                                                                                                                                                                                                                                                           | ?<br>?      | 2,000         | 2,000        |

|               |                                                                                                                                                                                                                                                                                                                                                     |             |              |              |
|---------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|--------------|--------------|
| <b>Dec 22</b> | Charity Account<br>Cash Account<br>(Charity paid in cash).<br><u>Explanation</u><br>Charity increases expenses therefore charity account is debited and cash-asset is decreased therefore cash account is credited.                                                                                                                                 | ?<br>?      | 200          | 200          |
| <b>Dec 23</b> | Drawings Account<br>Cash Account<br>Purchases Account<br>(Owner withdrew cash & goods for personal use).<br><u>Explanation</u><br>Whenever owner withdraws cash or goods for personal use drawing account is debited and cash-asset & stock of goods decreased therefore cash & purchases accounts are credited.                                    | ?<br>?<br>? | 1,350        | 1,000<br>350 |
| <b>Dec 26</b> | Free Sampling Account<br>Charity Account<br>Purchases Account<br>(Goods distributed as free sampling & given away as charity).<br><u>Explanation</u><br>Free sampling as well as charity increases expenses therefore charity and free sampling accounts are debited and stock of goods-asset is decreased therefore purchases account is credited. | ?<br>?<br>? | 1,000<br>500 | 1,500        |
| <b>Dec 28</b> | Bank Loan Account<br>Cash Account<br>(Bank Loan paid in cash)<br><u>Explanation</u><br>Liability of loan is decreased therefore debited bank loan account and cash-asset is decreased therefore cash account is credited                                                                                                                            | ?<br>?      | 200,000      | 200,000      |

**Practice 4.5**

Pass journal entries in a journal for the following transactions during the month of December 20X9.

**Dec 1:** Business started with cash Rs.200,000 out of which deposited cash into bank Rs.100,000.

**Dec 2:** Machinery purchased from Jordan on credit Rs.40,000

**Dec 4:** Machinery lost in fire accident Rs.20,000

**Dec 6:** Paid charity Rs.550

**Dec 8:** Cash withdrawal from bank Rs.5,000 for office use

**Dec 10:** Cash stolen from Business Rs.3,000

**Dec 11:** Owner sold his saving bonds of value Rs.3,000 and invested that money in business

**Dec 12:** Profit earned on Bank Deposits Rs.1,350

**Dec 16:** Received commission from a client Rs.1,000

**Dec 17:** Rent paid to Real Estate by cheque Rs.2,000.

| Date<br>20X9 | Particulars/Descriptions                                                                                                                                                                                                                                                   | Post<br>Ref. | Debit<br>(Rs) | Credit<br>(Rs) |
|--------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|---------------|----------------|
| <b>Dec 1</b> | Cash Account<br>Capital Account<br>(Cash introduced as capital)<br><u>Explanation</u><br>Asset- cash increased therefore debited and equity is increased<br>therefore capital account is credited.                                                                         | ?<br>?       | 200,000       | 200,000        |
| <b>Dec 1</b> | Bank Account<br>Cash Account<br>(Cash deposited into bank account)<br><u>Explanation</u><br>Asset- bank balance increased therefore debited bank account<br>and asset-cash is decreased therefore cash account is credited.                                                | ?<br>?       | 100,000       | 100,000        |
| <b>Dec 2</b> | Machinery Account<br>Creditors (Jordan)Account<br>(Machinery purchased on credit from Jordan).<br><u>Explanation</u><br>Asset- machinery increased therefore debited and as payment<br>has not been made so liability increased therefore creditor<br>account is credited. | ?<br>?       | 40,000        | 40,000         |
| <b>Dec 4</b> | Loss by Fire Account<br>Machinery Account<br>(Machinery lost in fire)<br><u>Explanation</u><br>Business losses are expenses, increase in expense is debit.<br>Machinery-asset is decreased; therefore, machinery account is<br>credited.                                   | ?<br>?       | 20,000        | 20,000         |
| <b>Dec 6</b> | Charity Account<br>Cash Account<br>(Cash paid as charity)<br><u>Explanation</u><br>Charity increases business expenses and is debited and cash-asset<br>is decreased therefore cash account is credited.                                                                   | ?<br>?       | 550           | 550            |
| <b>Dec 8</b> | Cash Account<br>Bank Account<br>(Cash withdrawn from bank).<br><u>Explanation</u><br>Asset- cash balance increased therefore debited cash account and<br>asset-bank balance is decreased therefore bank account is<br>credited.                                            | ?<br>?       | 5,000         | 5,000          |

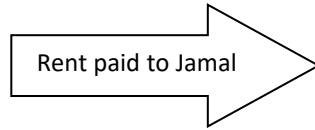
|               |                                                                                                                                                                                                                                                 |        |       |       |
|---------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------|-------|-------|
| <b>Dec 10</b> | Loss by theft Account<br>Cash Account<br>(cash stolen)<br><u>Explanation</u><br>Debited loss account as an expense and asset-cash decreased<br>therefore cash account is credited.                                                              | ?<br>? | 3,000 | 3000  |
| <b>Dec 11</b> | Cash Account<br>Capital Account<br>(Fresh capital introduced by owner)<br><u>Explanation</u><br>Asset- cash increased therefore debited and equity is increased<br>therefore capital account is credited.                                       | ?<br>? | 3,000 | 3,000 |
| <b>Dec 12</b> | Bank Account<br>Profit on bank Account<br>(profit earned on bank deposits).<br><u>Explanation</u><br>Asset- bank increased therefore debited and profit on bank<br>deposits belongs to Incomes that is increasing therefore, it is<br>credited. | ?<br>? | 350   | 350   |
| <b>Dec 16</b> | Cash Account<br>Commission Account<br>(Commission received).<br><u>Explanation</u><br>Asset- cash increased therefore debited and commission is<br>increasing incomes of the business; therefore, commission<br>account is credited.            | ?<br>? | 1000  | 1000  |
| <b>Dec 17</b> | Rent Account<br>Bank Account<br>(Rent paid by cheque).<br><u>Explanation</u><br>Rent is increasing expenses of the business, debit the rent<br>account and bank-asset is decreased therefore bank account is<br>credited.                       | ?<br>? | 2,000 | 2,000 |

### Important Tips To Remember (ITTRs)

While analyzing expenses & incomes for recognizing accounting head as Dr or Cr, never use “*personal account*” like name of the person to whom expense is being paid or from whom income is being received, use “*nominal accounts*” as Dr or Cr.

For example:

1. Salaries paid to John, Steve and Zara; here personal account “*the names*” shall not be debited rather salaries as an expense account will be debited.
2. Received commission from David, Nasar, and Rajab; here personal account “*the names*” shall not be credited rather commission as an income account will be credited.



Debit “Rent expense”



Debit “Jamal”



## Subdivision of Journal

Journal is sub-divided because of complexity of the transactions or large size of business. Subdivision of journal is required when:

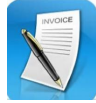
- There are increased number of cash transactions in a day.
- There are large number of transactions for credit purchases and credit sales.

Large number of transactions create a mess in bookkeeping office; therefore, separate bookkeepers are assigned responsibilities for separate types of transactions along with separate journals. For example:

- For sales transactions there is a ***sales journal*** in which only and only credit transaction for sales are recorded.
- For purchases transactions there is a ***purchase journal*** in which only and only credit transactions for purchases are recorded.
- If there are a large number of returns then separate ***journals for sales return and purchases return*** are also maintained.
- For cash transactions there is a separate book in which only cash transactions are analyzed and recorded it is named as ***cash book or cash journal or cash register***.
- All remaining transactions and events like sale and purchase of fixed assets on credit, loss by fire etc. are recorded in ***general journal***. General journal is also used to record *rectifying entries, adjusting entries and closing entries*.

**Need for Sales Journal**

In small business entities there are very less number of transactions for credit sales. As we can have an example of a barber's shop, a tailor, a retailer etc. they mostly sell their services or goods on cash. But as business expands, its sales also grow in terms of cash as well as in terms of credit. The cash sales are then recorded in the cash book as a receipt, and the credit sales are recorded in a separate journal named as sales journal (sales day book). In sales journal, no other transactions are recorded except the transactions for sales on **credit terms**.



|   |              |
|---|--------------|
| ✓ | Credit sales |
| ✗ | Cash sales   |

**Recording transactions in Sales Journal**

In case of credit sales, the business is always interested in the names and addresses of its credit customers (Debtors), therefore, sales journal is designed accordingly in order to cover following information:

|                               |                                                |
|-------------------------------|------------------------------------------------|
| <b>Date</b> -----             | Date of invoice                                |
| <b>Name of Debtor</b> -----   | Mentioned in the invoice                       |
| <b>Invoice number</b> -----   | It helps to trace the other details of invoice |
| <b>Post reference</b> -----   | Page number of subsidiary ledger               |
| <b>Amount of invoice</b> ---- | Net of trade discount                          |

**Format of Sales Journal**

| Date | Name of Debtors | Invoice No. | Post. Ref. | Amount Rs. |
|------|-----------------|-------------|------------|------------|
|      |                 |             |            |            |

In the sales journal, there is only one column for amount because all transactions are of same nature (credit sales) and the purpose of maintaining sales journal is to avoid over working for recording the debits and credits for each transaction again & again. After specific intervals (a week or a month), sum of sales journal is posted to the debit of "*total debtors account*" and credit of "*sales account*" in general ledger (details will be discussed later).

**Practice 4.5**

Record following transactions in a Sales Journal.

- Feb 1:** Credit sales to Nelson Rs.3,875  
**Feb 3:** Credit sales to John Smith Rs.1,667  
**Feb 6:** Credit sales to Moon Light Rs.1,285  
**Feb 10:** Credit sales to Super Mart Rs.550  
**Feb 17:** Credit sales to Moon Light Rs.9,280  
**Feb 19:** Credit sales to Popular Traders Rs.2,880  
**Feb 27:** Credit sales to Pearl Traders Rs.8,250  
**Feb 28:** Credit sales to Royal Club Rs.4,244

**Sales Journal**

| <b>Date<br/>20X9</b> | <b>Name of Debtors</b> | <b>Invoice<br/>No.</b> | <b>Post.<br/>Ref.</b> | <b>Amount<br/>Rs.</b> |
|----------------------|------------------------|------------------------|-----------------------|-----------------------|
| <b>Feb 1:</b>        | Nelson                 |                        |                       | 3,875                 |
| <b>Feb 3:</b>        | John Smith             |                        |                       | 1,667                 |
| <b>Feb 6:</b>        | Moon Light             |                        |                       | 1,285                 |
| <b>Feb 10:</b>       | Super Mart             |                        |                       | 550                   |
| <b>Feb 17:</b>       | Moon Light             |                        |                       | 9,280                 |
| <b>Feb 19:</b>       | Popular traders        |                        |                       | 2,880                 |
| <b>Feb 27:</b>       | Pearl Traders          |                        |                       | 8,250                 |
| <b>Feb 28:</b>       | Royal club             |                        |                       | 4,244                 |
| <b>Feb 28:</b>       | <b>Total</b>           |                        |                       | <b>32,031</b>         |

## PURCHASE JOURNAL

### Need for Purchase Journal

After knowing the need of sales journal (as discussed in previous section) it is now very easy to understand that for large business entities, which use to deal with so many transactions for credit purchases on daily basis, it becomes necessary to maintain a separate book for recording transactions of purchases on credit terms. This book is named as purchase journal. Obviously, same like a sales journal, no cash transaction for purchase shall be recorded in this book.



### Recording transactions in Purchase Journal

The basic content of a purchase journal is exactly the same as in the case of a sales journal with the exception of Name of Creditors instead of Debtors.

#### Format of Purchases Journal

| Date | Name of Creditors | Invoice No. | Post. Ref. | Amount Rs |
|------|-------------------|-------------|------------|-----------|
|      |                   |             |            |           |

Purchase journal shows a list of all credit purchases in a stipulated time period. Credit purchases recorded in purchase journal, during a period, are summed up and their debit effect is given to "*purchases account*" and credit effect is given to "*total creditors account*" in general ledger (details will be discussed later).

**Practice 4.6**

Record following transactions in a Purchase Journal.

- Feb 1:** Purchase on credit from Shahla Rs.2,875  
**Feb 3:** Purchase on credit from Samrana Rs.667  
**Feb 6:** Purchase on credit from Amara Rs.285  
**Feb 10:** Purchase on credit from Fareeha Rs.550  
**Feb 17:** Purchase on credit from Saima Rs.8,280  
**Feb 19:** Purchase on credit from Arooj Rs.1,880  
**Feb 27:** Purchase on credit from Naila Rs.7,250  
**Feb 28:** Purchase on credit from Shumaila Rs.3,244

| Date<br>20X9   | Name of Creditor | Invoice<br>No. | Post.<br>Ref. | Amount<br>Rs. |
|----------------|------------------|----------------|---------------|---------------|
| <b>Feb 1:</b>  | Shahla           |                |               | 2,875         |
| <b>Feb 3:</b>  | Samrana          |                |               | 667           |
| <b>Feb 6:</b>  | Amara            |                |               | 285           |
| <b>Feb 10:</b> | Fareeha          |                |               | 550           |
| <b>Feb 17:</b> | Saima            |                |               | 8,280         |
| <b>Feb 19:</b> | Arooj            |                |               | 1,880         |
| <b>Feb 27:</b> | Naila            |                |               | 7,250         |
| <b>Feb 28:</b> | Shumaila         |                |               | 3,244         |
| <b>Feb 28:</b> | <b>Total</b>     |                |               | <b>25,031</b> |

## SALES RETURN JOURNAL (*RETURN INWARDS JOURNAL*)

### Need for Sales Return Journal

As the business expands the number of complaints and return inwards also increases. Such return inwards can be recorded in the sales journal as a negative entry if these are very few in number. But because of its contra nature it is recommended to maintain a separate journal for sales return. However, in sales return journal only the returns against credit sales (from Debtors) are recorded. Returns of cash sales are not recorded in this journal.



Goods sold on credit - returned by customers

### Recording transaction in sales return Journal

Same like sales journal a sales return journal also contains the same content. It is used to record credit transactions of return inwards during a stipulated time period. At the closing date of the period sum of the sales return journal is debited to the “*sales return account*” and credited to the “*debtors account*”.

#### Practice 4.7

Enter the following transactions in a sales return journal.

- Feb. 1:** Goods returned by Madinah Stores Rs.200
- Feb. 9:** Goods returned by John SmithRs.100
- Feb. 10:** Goods returned by Giant Store Rs.300
- Feb. 11:** Goods returned by Falcons Rs.400
- Feb. 16:** Goods returned by Pearl Traders Rs.50
- Feb. 19:** Goods returned by Nelson Rs.150
- Feb. 23:** Goods returned by Mega Mart Rs.500
- Feb. 28:** Return inwards by Giant store Rs.600

| Date           | Name of Debtors | Credit<br>Note No. | Post<br>Ref. | Amount<br>Rs. |
|----------------|-----------------|--------------------|--------------|---------------|
| <b>Feb. 1</b>  | Madinah Stores  |                    |              | 200           |
| <b>Feb. 9</b>  | John Smith      |                    |              | 100           |
| <b>Feb. 10</b> | Giant Store     |                    |              | 300           |
| <b>Feb. 11</b> | Falcons         |                    |              | 400           |
| <b>Feb. 16</b> | Pearl Traders   |                    |              | 50            |
| <b>Feb. 19</b> | Nelson          |                    |              | 150           |
| <b>Feb. 23</b> | Mega Mart       |                    |              | 500           |
| <b>Feb. 28</b> | Giant Store     |                    |              | 600           |
|                | <b>Total</b>    |                    |              | <b>2,300</b>  |

## PURCHASES RETURN JOURNAL (*RETURN OUTWARDS JOURNAL*)

### Need for Purchases Return Journal

Although purchases return can be recorded in the purchase journal as negative entry but same like sales return journal it is required to maintain a separate journal for purchases return because of its contra in nature to the purchases. Purchases return journal is maintained to record credit transactions for purchases return.



Goods purchased on credit - returned to suppliers

### Recording transactions in Purchases Return Journal

All transactions for purchases return are recorded chronologically in the purchases return journal. The sum of purchases return journal is debited to the "*creditors account*" and credited to the "*purchases return account*".

#### Practice 4.8

Enter the following transactions in a Purchases Return Journal

- Feb. 1:** Goods returned to Mega Mart Rs.200  
**Feb. 3:** Goods returned to Royal club Rs.600  
**Feb. 7:** Goods returned to Super Mart Rs.120  
**Feb. 9:** Goods returned to Moon Light Rs.300  
**Feb. 11:** Goods returned to Star Gold Rs.500  
**Feb. 15:** Goods returned to Hills Bros. Rs.550  
**Feb. 19:** Goods returned to Dunhill mart Rs.600  
**Feb. 23:** Return outwards to Falcons Rs.800

| Date<br>20X9 | Name of Creditors | Credit<br>Note No. | Post<br>Ref. | Amount<br>Rs. |
|--------------|-------------------|--------------------|--------------|---------------|
| Feb. 1       | Mega Mart         |                    |              | 200           |
| Feb.3        | Royal Club        |                    |              | 600           |
| Feb. 7       | Super Mart        |                    |              | 120           |
| Feb. 9       | Moon Light        |                    |              | 300           |
| Feb. 11      | Star Gold         |                    |              | 500           |
| Feb. 15      | Hills Bros.       |                    |              | 550           |
| Feb. 19      | Dunhill mart      |                    |              | 600           |
| Feb. 23      | Falcons           |                    |              | 800           |
| Feb. 28      | <b>Total</b>      |                    |              | <b>3,670</b>  |

**Practice 4.9**

Record following transactions in the appropriate journals.

- Dec 2:** Credit sales to Nelson Rs.600, John smithRs.200, Hills Bros. Rs.500  
**Dec 4:** Credit purchases from Giant store Rs.450, Star Gold Rs.300, Moon Light Rs.250  
**Dec 5:** Credit sales to Madinah Stores Rs.630, John smithRs.500, Falcons Rs.420  
**Dec 6:** Credit purchase from Falcons Rs.1,000  
**Dec 10:** Goods returned by Nelson Rs.100, John smithRs.50  
**Dec 12:** Goods returned to Star Gold Rs.80, Giant store Rs.30  
**Dec 18:** Credit sales to Super Mart Rs.650  
**Dec 24:** Return outwards to Falcons Rs.200  
**Dec 28:** Return inwards from Super Mart Rs.150

**Sales Journal**

| Date<br>2003 | Name of Debtors | Invoice<br>No. | Post.<br>Ref. | Amount<br>Rs. |
|--------------|-----------------|----------------|---------------|---------------|
| Dec 2        | Nelson          |                |               | 600           |
|              | John Smith      |                |               | 200           |
|              | Hills Bros.     |                |               | 500           |
| Dec 5        | Madinah stores  |                |               | 630           |
|              | John Smith      |                |               | 500           |
|              | Falcons         |                |               | 420           |
| Dec 18       | Super Mart      |                |               | 650           |

**Purchases Journal**

| Date<br>2003 | Name of Creditors | Invoice<br>No. | Post.<br>Ref. | Amount<br>Rs. |
|--------------|-------------------|----------------|---------------|---------------|
| Dec 4        | Giant Store       |                |               | 450           |
|              | Star Gold         |                |               | 300           |
|              | Moon Light        |                |               | 250           |
| Dec 6        | Falcons           |                |               | 1,000         |



### Sales Return Journal

| Date    | Name of Debtors | Credit Note No. | Post Ref. | Amount Rs. |
|---------|-----------------|-----------------|-----------|------------|
| Dec. 10 | Nelson          |                 |           | 100        |
|         | John Smith      |                 |           | 50         |
| Dec. 28 | Super Mart      |                 |           | 150        |



from Customers



### Purchase Return Journal

| Date    | Name of Creditors | Credit Note No. | Post Ref. | Amount Rs. |
|---------|-------------------|-----------------|-----------|------------|
| Dec. 12 | Star Gold         |                 |           | 80         |
|         | Giant store       |                 |           | 30         |
| Dec. 24 | Falcons           |                 |           | 200        |



To Suppliers



## CASH BOOK

## Need for Cash Book

Cash book is a book of original entries in which only cash transactions are recorded in a chronological sequence. The journal (book of original entry) is subdivided for two types of transactions i.e. credit transactions and cash transactions. All credit transactions are recorded in various relevant journals, as discussed above, whereas the cash transactions are recorded in a separate book named as cash book.

## Recording transactions in Cash Book

A cash book is divided into two sections, one for cash receipts and the other for cash payments. Each section is formatted for *date*, *particulars*, *post reference* and *amount*.

As a matter of fact; within a cash book, we maintain two cash journals; 1) *cash receipt journal* and 2) *cash payment journal*. Cash book is formatted like a ledger account (T shaped). Thus, it also serves as a book of secondary entry (details will be discussed later).

## Types of Cash Book

1. Single column cash-book (with cash column only)
2. Two column cash-book (with cash and bank columns) OR (with cash and discount columns) OR (with bank and discount columns)
3. Three column cash-book (with cash, bank and discount columns)
4. Petty cash book (multi columnar cash book for recording insignificant nature of expenses)

### Cash Book (Single Column)

| Date | RECEIPTS<br>Particulars | Post<br>Ref. | Amount<br>Rs. | Date | PAYMENTS<br>Particulars | Post<br>Ref. | Amount<br>Rs. |
|------|-------------------------|--------------|---------------|------|-------------------------|--------------|---------------|
|      |                         |              |               |      |                         |              |               |
|      |                         |              |               |      |                         |              |               |
|      |                         |              |               |      |                         |              |               |

### Cash Book (Two Columns)

[illegible]

### Cash Book (Three Columns)

[illegible]

## Petty Cash Book

[illegible]

**Practice 4.10**

Record following transactions into a cash book with single cash column and find closing balance to carry forward.

|                 |                                                       | <b>Rs.</b> |
|-----------------|-------------------------------------------------------|------------|
| <b>Mar. 1:</b>  | Balance brought forward (b/f)                         | 4,000      |
| <b>Mar. 3:</b>  | Sold goods for cash                                   | 40,000     |
| <b>Mar. 7:</b>  | Sold goods on credit to Alpha (credit transaction)    | 75,000     |
| <b>Mar. 10:</b> | Bought goods for cash                                 | 28,000     |
| <b>Mar. 15:</b> | Bought goods on credit from Beta (credit transaction) | 42,000     |
| <b>Mar. 18:</b> | Received cash from Debtor (Alpha)                     | 75,000     |
| <b>Mar. 19:</b> | Made part payment in cash to Creditor (Beta)          | 15,000     |
| <b>Mar. 20:</b> | Paid staff salaries                                   | 20,000     |
| <b>Mar. 26:</b> | Bought furniture for cash                             | 25,000     |
| <b>Mar. 30:</b> | Paid Electricity bill                                 | 5,000      |

**Cash Book**

| <b>Date<br/>20X9</b> | <b>RECEIPTS<br/>Particulars</b> | <b>Post<br/>Ref.</b> | <b>Rs.</b>     | <b>Date<br/>20X9</b> | <b>PAYMENTS<br/>Particulars</b> | <b>Post<br/>Ref.</b> | <b>Rs.</b>     |
|----------------------|---------------------------------|----------------------|----------------|----------------------|---------------------------------|----------------------|----------------|
| March 1              | Balance b/f                     |                      | 4,000          | March 10             | Purchases                       |                      | 28,000         |
| 3                    | Sales                           |                      | 40,000         | 19                   | Creditor (Beta)                 |                      | 15,000         |
| 18                   | Debtor (Alpha)                  |                      | 75,000         | 20                   | Staff salaries                  |                      | 20,000         |
|                      |                                 |                      |                | 26                   | Furniture                       |                      | 25,000         |
|                      |                                 |                      |                | 30                   | Electricity bill                |                      | 5,000          |
|                      |                                 |                      |                | 31                   | Balance c/f                     |                      | 26,000         |
|                      |                                 |                      | <u>119,000</u> |                      |                                 |                      | <u>119,000</u> |

**Practice 4.11**

Record following transactions into a cash book with cash and bank columns, also find closing balance for both columns to carry forward.

**20X9**

- Mar. 1:** Balances brought forward cash Rs.7,000; bank Rs.25,000  
**Mar. 2:** Sold goods for cash Rs.40,000, the amount was deposited into bank on the same date.  
**Mar. 5:** Bought stationary for cash Rs.2,000  
**Mar. 9** Bought furniture, payment made by cheque Rs.10,000  
**Mar. 15:** Received Rs.15,000 in cash from Debtor Sagheer  
**Mar. 16:** Received a cheque of Rs.20,000 from Debtor Kabeer and deposited into bank  
**Mar. 20:** Made payment to a creditor Abeer through cheque Rs.18,000  
**Mar. 22:** Cash withdrawn from bank for office use Rs.25,000  
**Mar. 25:** Cash withdrawn from Bank from owner's personal use Rs.8,000  
**Mar. 28:** Cash received from sale of old machine Rs.60,000  
**Mar. 30** Cash deposited into bank Rs.75,000 and paid salaries in cash Rs.20,000

**Cash book**

| Date<br>20X9 | Receipts<br>Particulars | Post<br>Ref. | Cash<br>Rs.    | Bank<br>Rs.    | Date<br>20X9 | Payments<br>Particulars | Post<br>Ref. | Cash<br>Rs.    | Bank<br>Rs.    |
|--------------|-------------------------|--------------|----------------|----------------|--------------|-------------------------|--------------|----------------|----------------|
| Mar. 1       | Balance b/f             |              | 7,000          | 25,000         | Mar. 05      | Stationery              |              | 2,000          |                |
| 2            | Sales                   |              |                | 40,000         | 09           | Furniture               |              |                | 10,000         |
| 15           | Debtor -<br>Sagheer     |              | 15,000         |                | 20           | Creditor -<br>Abeer     |              |                | 18,000         |
| 16           | Debtor -<br>Kabeer      |              |                | 20,000         | 22           | Cash                    | C            |                | 25,000         |
| 22           | Bank                    | C            | 25,000         |                | 25           | Drawings                |              |                | 8,000          |
| 28           | Machine<br>(Disposal)   |              | 60,000         |                | 30           | Bank                    | C            | 75,000         |                |
| 30           | Cash                    | C            |                | 75,000         | 30           | Salaries                |              | 20,000         |                |
|              |                         |              |                |                | 31           | Balance c/f             |              | 10,000         | 99,000         |
|              |                         |              | <u>107,000</u> | <u>160,000</u> |              |                         |              | <u>107,000</u> | <u>160,000</u> |

**Practice 4.12**

Record following transactions into three column cash-book; with cash, bank, and discount columns, also find closing balances to carry forward.

**20X9**

**Mar. 1:** Balance brought forward: Cash Rs.3,000; Bank overdraft Rs.10,000

**Mar. 5:** Cash received from debtor Burhan in full settlement of his account balance Rs.50,000, after subtracting 8% cash discount.

**Mar. 10:** Received a cheque of Rs.70,000 from debtor Affan in full settlement of his account after subtracting cash discount Rs.5,000.

**Mar. 15:** Goods sold on credit to debtor Aman worth Rs.80,000 subject to settlement terms 5/10, n/30 and a trade discount of Rs.4,000. (credit transaction – no effect in cash book)

**Mar. 20:** Paid Rs.40,000 through cheque to creditor Arslan after subtracting cash discount Rs.4,000.

**Mar. 25:** Paid to Salman his account balance due Rs.25,000 in cash after subtracting cash discount Rs.2,000.

**Mar. 30:** Received cheque from debtor Aman against sales made on **March 15<sup>th</sup>** and deposited into bank.

**Mar. 31** Cash in excess of Rs.6,000 is to be deposited into bank. (Rs.6,000 should remain in cash balance c/f)

**Cash book**

| Date<br>20X9 | Receipts<br>Particulars | P-<br>Ref | Cash<br>Rs.   | Bank<br>Rs.    | Disc.<br>Allowed<br>Rs. | Date<br>20X9 | Payments<br>Particulars | P-<br>Ref | Cash<br>Rs.   | Bank<br>Rs.    | Disc.<br>Received<br>Rs. |
|--------------|-------------------------|-----------|---------------|----------------|-------------------------|--------------|-------------------------|-----------|---------------|----------------|--------------------------|
| Mar.<br>1    | Balance<br>b/f          |           | 3,000         |                |                         | Mar.<br>01   | Balance<br>b/f          |           |               | 10,000         |                          |
| 5            | Debtor –<br>Burhan      |           | 46,000        |                | 4,000                   | 20           | Creditor -<br>Arslan    |           |               | 40,000         | 4,000                    |
| 10           | Debtor -<br>Affan       |           |               | 70,000         | 5,000                   | 25           | Creditor -<br>Salman    |           | 23,000        |                | 2,000                    |
| 30           | Debtor -<br>Aman        |           |               | 76,000         |                         | 31           | Bank                    | C         | 20,000        |                |                          |
| 31           | Cash                    | C         |               | 20,000         |                         | 31           | Balance<br>c/f          |           | 6,000         | 116,000        |                          |
|              |                         |           | <u>49,000</u> | <u>166,000</u> | <u>9,000</u>            |              |                         |           | <u>49,000</u> | <u>166,000</u> | <u>6,000</u>             |

## Petty Cash Book

Transactions that are recorded in petty cash book are insignificant (petty) in nature and amount for which substantial documentation is not required. For example; photocopy, entertainment, postage, local travelling, cleaning material, etc.

Accountants do separately recognize *cash at bank*, *cash in hand* and *petty cash* that can be distinguish as:

1. Main Cash (for significant receipts and payments)
2. Petty Cash (for insignificant payments)

## Mechanism to maintain Petty Cash Book

Normally an existing staff member, in addition to his/her regular duties, is delegated with additional responsibility of *petty cashier* to handle petty cash transactions. Some amount of money, depending upon the need of the organization, is transferred from main cash to petty cash from which the petty cashier meets petty expenses. There are two systems existing for transfer of money from main cash to petty cash:

1. Petty Cash System
2. Imprest System

### *Petty Cash System*

Under the petty cash system, a fixed sum of money is transferred to petty cash on a regular interval to meet petty expenses in that period. In a way a petty cashier receives a fixed amount at the start of each week to meet petty expenses during that week.

For example; In the first week of business setup the petty cashier receives Rs.1,000 and spends Rs.970 for different petty expenses and left with a balance of Rs.30 in petty cash box. In the start of second week; the petty cashier once again receives Rs.1,000 from the main cash and keeps it in the petty cash box that increases the balance of petty cash box, on that day, to Rs.1,030. During the second week the petty cashier spends Rs.990. Now the balance in petty cash box, at the end of second week, is Rs.40. In the start of third week the petty cashier once again receives Rs.1,000 from the main cash book and keeps it in the petty cash box that increases the balance in petty cash box to Rs.1,040.

### *Imprest System*

Under the imprest system, maximum need of cash for petty expenses in a specific time period is fixed. Funds are transferred to petty cashier for making payment of petty expenses during the period. The balance left in the petty cash box at the end of that period is then *topped-up* to reach at the pre-determined maximum limit. In a way the amount topped-up is exactly equal to the amount spent during the previous period for petty expenses. This is considered to be a very standard way of controlling petty expenses.

For example; a petty cashier receives Rs.1,000 at the start of first week to meet petty expenses during that week on imprest system. The petty cashier spends Rs.970 for different petty expenses and left with a balance of Rs.30 in petty cash box. In the start of second week; the petty cashier receives Rs.970 from the main cash in order to top-up petty cash box balance up to Rs.1,000. During the second week the petty cashier spends Rs.990. Now the balance in petty cash box, at the end of second week, is Rs.10 and the amount for top-up is Rs.990 to make the balance in petty cash box equal to Rs.1,000.

**Practice 4.13**

Record following transactions in petty cash book for the week at imprest system. Maximum limit is Rs.1,000.

| Date   | Transactions                                        | Rs.   |
|--------|-----------------------------------------------------|-------|
| Jan 01 | Funds transferred from main cash for petty expenses | 1,000 |
| Jan 01 | Paid for tea bags                                   | 150   |
| Jan 02 | Paid for cycle repair                               | 200   |
| Jan 03 | Paid for photocopies                                | 50    |
| Jan 03 | Paid for cycle stand at bank                        | 10    |
| Jan 03 | Paid for postage                                    | 60    |
| Jan 05 | Paid for sugar and tea biscuits                     | 220   |
| Jan 06 | Paid for stove repair                               | 180   |
| Jan 07 | Paid for stationery                                 | 120   |

**Petty Cash Book**

| Date   | Receipt<br>Rs. | Particulars          | Total<br>Payment<br>Rs. | Enter-<br>tainment<br>Rs. | Photo<br>copy<br>Rs. | Repair<br>Rs. | Travelling<br>Rs. | Postage<br>Rs. | Stationery<br>Rs. |
|--------|----------------|----------------------|-------------------------|---------------------------|----------------------|---------------|-------------------|----------------|-------------------|
| Jan 01 | 1,000          | Imprest<br>Main Cash |                         |                           |                      |               |                   |                |                   |
| Jan 01 |                | Tea bags             | 150                     | 150                       |                      |               |                   |                |                   |
| Jan 02 |                | Cycle repair         | 200                     |                           |                      | 200           |                   |                |                   |
| Jan 03 |                | Photocopy            | 50                      |                           | 50                   |               |                   |                |                   |
| Jan 03 |                | Cycle stand          | 10                      |                           |                      |               | 10                |                |                   |
| Jan 03 |                | Postage              | 60                      |                           |                      |               |                   | 60             |                   |
| Jan 05 |                | Sugar etc.           | 220                     | 220                       |                      |               |                   |                |                   |
| Jan 06 |                | Stove repair         | 180                     |                           |                      | 180           |                   |                |                   |
| Jan 07 |                | Stationery           | 120                     |                           |                      |               |                   |                | 120               |
|        |                |                      |                         |                           |                      |               |                   |                |                   |
|        |                | Balance c/f          | 10                      |                           |                      |               |                   |                |                   |
|        | <b>1,000</b>   | <b>Total</b>         | <b>1,000</b>            | <b>370</b>                | <b>50</b>            | <b>380</b>    | <b>10</b>         | <b>60</b>      | <b>120</b>        |
| Jan 08 | 10             | Balance b/f          |                         |                           |                      |               |                   |                |                   |
| Jan 08 | 990            | Imprest<br>Main Cash |                         |                           |                      |               |                   |                |                   |

### Exercise Questions

Choose correct answer

1. Goods purchased from John smith Rs.500 are debited to \_\_\_\_\_
- John smith account
  - Goods Account
  - Cash Account
  - Purchases Account**

Explanation: whenever goods are purchased, business expenses for purchasing increases. Therefore, purchases account will be debited.

2. Commission paid to agent Jordan Rs.1,000 will be debited to \_\_\_\_\_
- Commission account**
  - Cash Account
  - Jordan Account
  - None of above

Explanation: Payment for commission to agent increases business expenses. Therefore, commission account will be debited.

3. Goods purchased for Rs.5,000 subject to 10% trade discount, amount to be debited to purchases account will be \_\_\_\_\_
- 5,000
  - 5,500
  - 4,500**
  - None of the above

Explanation: Trade discount is subtracted from the total amount of purchases and then the transaction is recorded with net off the discount amount.  $5000 \times 10\% = 500$  therefore, purchases account will be  $5,000 - 500 = 4,500$

4. Goods returned from debtors will be recorded in which book of account?
- Return inward journal**
  - Return outward journal
  - Purchase journal
  - General journal

Explanation: Goods returned from debtor will be recorded in return inward journal (also called sales return journal)

5. Payment received from Star Brothers Rs.4,800 in full settlement of Rs.5,000 will be debited to \_\_\_\_\_
- Cash Account
  - Discount allowed Account
  - Star Brothers Account
  - Both a. and b.**

Explanation: Increase in cash-asset Rs.4,800 is debited to Cash Account and loss Rs.200 in terms of settlement discount will be debited to Discount Allowed Account.

6. Loan repaid to Hassan Brothers will be debited to \_\_\_\_\_
- Hassan Brothers
  - Hassan Brothers' Loan Account**
  - Cash Account
  - None of above

Explanation: Repayment means the loan taken in the past is being returned now. This transaction causes a decrease in existing liability therefore debited Hassan Brothers' Loan account. Debiting simply Hassan Brothers will create a confusion as if loan is being advanced to Hassan Brothers.

7. Goods purchased for cash will be recorded in which book of account?
- Purchase journal
  - Cash book**
  - General journal
  - a and b both

Explanation: All cash transactions are recorded in cash book. Purchase journal is used to maintain record of credit purchases only.

8. Machinery purchased from on credit from Caterpillar will be recorded in which book of account?

- a. Assets journal
- b. Purchases journal
- c. **General journal**
- d. Machinery journal

Explanation: Purchase journal is maintained for regular purchases of trading goods and raw material that has second effect on trade creditors. Purchase of fixed assets is not a regular purchase therefore shall not be recorded in purchase journal. General journal is the book in which this transaction is recorded.

9. Stock lost in fire will be credited to \_\_\_\_\_
- a. Stock account
  - b. Goods Account
  - c. **purchases Account**
  - d. Loss by fire Account

Explanation: Whenever purchased goods are decreased other than because of sales or purchases return; purchases account will be credited.

10. Short explanation written below the accounting entry is called \_\_\_\_\_
- a. Explanation
  - b. **Narration**
  - c. Compound entry
  - d. None of above

Explanation: Narration is a terminology that is used for the explanatory statement written beneath the accounting entry and becomes integral part of it.

**Answer: (1-d, 2-a, 3-c, 4-a, 5-d, 6-b, 7-b, 8-c, 9-c, 10-b)**

### Examination Questions

#### **Q.1**

The correct double entry to record goods returned from a credit customer is

- | <b>Dr</b>                 | <b>Cr</b>          |
|---------------------------|--------------------|
| a) Returns outwards       | Receivables        |
| b) Receivables            | Returns outwards   |
| c) Receivables            | Returns inwards    |
| <b>d) Returns inwards</b> | <b>Receivables</b> |

#### **Q.2**

Which of the following is correct?

- | <b>Dr balances include:</b> | <b>Cr balances include:</b> |
|-----------------------------|-----------------------------|
| <b>a) Returns inwards</b>   | <b>Capital</b>              |
| <b>Discounts allowed</b>    | <b>Sales</b>                |
| <b>Carriage inwards</b>     | <b>Bank overdraft</b>       |
| b) Returns outwards         | Capital                     |
| Discounts allowed           | Sales                       |
| Carriage outwards           | Bank loan                   |
| c) Returns inwards          | Sales                       |
| Discounts received          | Returns outwards            |
| Purchases                   | Accrued income              |
| b) Returns outwards         | Capital                     |
| Cash                        | Returns inwards             |
| Land and buildings          | Accrued income              |

#### **Q.3**

Ali's business has a bank overdraft balance of Rs.190

What is the balance on Ali's Bank column of in three column cash-book after the following transactions?

- Ali paid off his account balance of Rs.600 to a supplier after taking advantage of 3% settlement discount.
  - Rs.780 was received from a customer. They had already subtracted 2.5% cash discount.
- a) Rs.388 Dr  
**b) Rs.8 Dr**  
c) Rs.11.50 Dr  
d) Rs.368.50 Dr

#### **Explanation to Q.3**

|                           |                   |
|---------------------------|-------------------|
| Cr. Balance Overdraft     | Rs. 190           |
| Cr. Payment to Supplier   | Rs. 582 (600x97%) |
| Dr. Receipt from Customer | Rs. 780           |
| <b>Dr. Balance</b>        | <b>Rs. 8</b>      |

## **Chapter – 5**

### **Main Ledger / General Ledger / Nominal Ledger (Book of secondary entries) and Trial Balance**

| <b>Sr. No</b> | <b>Course outline Topics</b>                             |
|---------------|----------------------------------------------------------|
| 1             | Need for ledger                                          |
| 2             | Chart of Accounts                                        |
| 3             | Format of ledger account                                 |
| 4             | Posting from General Journal into Main Ledger - Practice |
| 5             | Posting of Compound Entries into Main Ledger             |
| 6             | Practice – Posting Process                               |
| 7             | Balancing the ledger accounts                            |
| 8             | Balancing the ledger accounts - Practice                 |
| 9             | Trial Balance                                            |
| 10            | Posting from subdivided journal into main ledger         |
| 11            | Posting from cash book into main ledger                  |

**Topic videos 47-57 are mandatory part of this module**

## MAIN LEDGER / GENERAL LEDGER / NOMINAL LEDGER

### Need for a Ledger

A journal in itself is a chronological record of all the financial information (economic phenomena) but this doesn't reflect the information that is required for preparation of reports. In order to generate reports, for example; Balance Sheet, we need balance (total amount) of Assets, Liabilities, and Owners' Equity.

| Example Company<br>Balance Sheet<br>December 31, 2016 |            |                                          |            |
|-------------------------------------------------------|------------|------------------------------------------|------------|
| ASSETS                                                |            | LIABILITIES                              |            |
| Current assets                                        |            | Current liabilities                      |            |
| Cash                                                  | \$ 2,100   | Notes payable                            | \$ 5,000   |
| Petty cash                                            | 100        | Accounts payable                         | 35,900     |
| Temporary investments                                 | 10,000     | Wages payable                            | 8,500      |
| Accounts receivable - net                             | 40,500     | Interest payable                         | 2,900      |
| Inventory                                             | 31,000     | Taxes payable                            | 6,100      |
| Supplies                                              | 3,800      | Warranty liability                       | 1,100      |
| Prepaid insurance                                     | 1,500      | Unearned revenues                        | 1,500      |
| Total current assets                                  | 89,000     | Total current liabilities                | 61,000     |
| Investments                                           | 36,000     | Long-term liabilities                    |            |
| Property, plant & equipment                           |            | Notes payable                            | 20,000     |
| Land                                                  | 5,500      | Bonds payable                            | 400,000    |
| Land improvements                                     | 6,500      | Total long-term liabilities              | 420,000    |
| Buildings                                             | 180,000    |                                          |            |
| Equipment                                             | 201,000    | Total liabilities                        | 481,000    |
| Less: accum depreciation                              | (56,000)   |                                          |            |
| Prop. plant & equip - net                             | 337,000    |                                          |            |
| Intangible assets                                     |            | STOCKHOLDERS' EQUITY                     |            |
| Goodwill                                              | 105,000    | Common stock                             | 110,000    |
| Trade names                                           | 200,000    | Retained earnings                        | 220,000    |
| Total intangible assets                               | 305,000    | Accum other comprehensive income         | 9,000      |
| Other assets                                          | 3,000      | Less: Treasury stock                     | (50,000)   |
| Total assets                                          | \$ 770,000 | Total stockholders' equity               | 289,000    |
|                                                       |            | Total liabilities & stockholders' equity | \$ 770,000 |

Journals or books of original entries do not produce final balances of all accounting heads, for this purpose we need to prepare summary of each accounting head in a systematic way with the help of records maintained in journals. Such summaries are known as *ledger accounts* and the book in which these are prepared is known as a *Main Ledger or General Ledger or Nominal Ledger*.

**Journal**  **Ledger**



### Chart of accounts

**Chart of accounts** is a list of the names of **accounts** that business accountant identifies from the journal and prepares for recording transactions in its general ledger. A company has the flexibility to tailor its **chart of accounts** to best suit to its needs, including adding **accounts** as needed.

### Preparation of Chart of Accounts

There are number of accounting heads recognized as debit (Dr) and credit (Cr) in journal. In order to prepare a summary of all these accounting heads, the first step is to extract a list of all the accounting heads existing in a journal. Such list of accounting heads is known as chart of accounts. In a chart of accounts, a unique number is allocated to each accounting head which helps a bookkeeper, as well as user of financial information, to identify the accounting heads.

### Chart of Accounts – Example 1

| Chart of Accounts |                              |              |                     |
|-------------------|------------------------------|--------------|---------------------|
| Number            | Description                  | Account Type | Financial Statement |
| 1-001             | Cash                         | Asset        | Balance Sheet       |
| 1-010             | Accounts Receivable          | Asset        | Balance Sheet       |
| 1-020             | Prepaid Expenses             | Asset        | Balance Sheet       |
| 1-030             | Inventory                    | Asset        | Balance Sheet       |
| 1-040             | Fixed Assets                 | Asset        | Balance Sheet       |
| 1-050             | Accumulated Depreciation     | Asset        | Balance Sheet       |
| 1-060             | Other Assets                 | Asset        | Balance Sheet       |
| 2-001             | Accounts Payable             | Liability    | Balance Sheet       |
| 2-010             | Accrued Liabilities          | Liability    | Balance Sheet       |
| 2-020             | Taxes Payable                | Liability    | Balance Sheet       |
| 2-030             | Payroll Payable              | Liability    | Balance Sheet       |
| 2-040             | Notes Payable                | Liability    | Balance Sheet       |
| 3-001             | Common Stock                 | Equity       | Balance Sheet       |
| 3-010             | Retained Earnings            | Equity       | Balance Sheet       |
| 3-020             | Additional Paid in Capital   | Equity       | Balance Sheet       |
| 4-001             | Revenue                      | Revenue      | Income Statement    |
| 4-010             | Sales returns and allowances | Revenue      | Income Statement    |
| 5-001             | Cost of Goods Sold           | Expense      | Income Statement    |
| 5-010             | Advertising Expense          | Expense      | Income Statement    |
| 5-020             | Bank Fees                    | Expense      | Income Statement    |
| 5-030             | Depreciation Expense         | Expense      | Income Statement    |
| 5-040             | Payroll Tax Expense          | Expense      | Income Statement    |
| 5-050             | Rent Expense                 | Expense      | Income Statement    |
| 5-060             | Supplies Expense             | Expense      | Income Statement    |
| 5-070             | Utilities Expense            | Expense      | Income Statement    |

## Chart of Account – Example 2

### 1. Assets

- 11 Cash
- 12 Accounts Receivable
- 14 Stocks
- 15 Prepaid Insurance
- 17 Land
- 18 Office Equipment



### 2. Liabilities

- 21 Accounts payable
- 23 Rent Payable (accrued)

### 3. Owner's equity

- 31 Owner's capital
- 32 Owner's drawings

### 4. Incomes

- 41 Sales
- 42 Sales return

### 5. Expenses

- 51 Wages
- 52 Rent
- 54 Utilities
- 55 Stationery
- 59 Office maintenance



## Format of ledger accounts

A ledger account, in its simplest form, has three parts

- *First*, each account has a title, which is the name of accounting head.
- *Second*, each account has a debit side, which is its left-hand side.
- *Third*, each account has a credit side, which is its right-hand side.

The account format presented below is called **T account** because it resembles the letter T of English language alphabets.

| Title                     |                             |
|---------------------------|-----------------------------|
| Left side<br><i>debit</i> | Right side<br><i>credit</i> |

Amounts entered on the left side of an account are called **debits** to the account. When amounts are entered in the debit side of an account, the account is said to be debited (or charged) with a specific amount.

Amounts entered on the right side of an account are called **credits** to the account, the account is said to be credited with a specific amount when amounts are entered in the credit of an account.

## Comprehensive format of a ledger account

A ledger account with full details is prepared in two styles:

- a) T account style (traditional approach)
- b) Running balance style (modern approach)

### (a) T account style

| Date | Particulars | Post Ref. | Rs. | Date | Particulars | Post Ref. | Rs. |
|------|-------------|-----------|-----|------|-------------|-----------|-----|
|      |             |           |     |      |             |           |     |
|      |             |           |     |      |             |           |     |
|      |             |           |     |      |             |           |     |
|      |             |           |     |      |             |           |     |

### (b) Running balance style

| Date | Particulars | Post Ref. | Debit Rs. | Credit Rs. | Dr/Cr | Balance Rs. |
|------|-------------|-----------|-----------|------------|-------|-------------|
|      |             |           |           |            |       |             |
|      |             |           |           |            |       |             |
|      |             |           |           |            |       |             |
|      |             |           |           |            |       |             |

The T account style ledger accounts are balanced off on closing date of the accounting period.



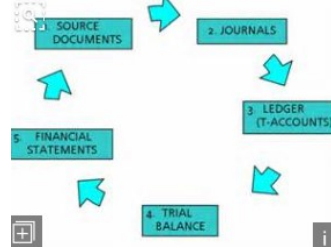
31

Whereas, the running balance style ledger accounts produce balances continuously throughout the accounting period i.e. after each Dr/Cr posting.

## Posting from General Journal

The process of picking up amount from journal and placing into the debit or credit side of relevant ledger account in ledger is known as *posting*. This process of posting is executed very technically by following the principles of double entry book keeping.

Following section will illustrate the process of posting from journal into ledger.



## Entry A

On January 1, 2009 owner introduced cash Rs.25,000 as capital into the business.

| Journal      |                                                                                 | Page 01     |        |        |
|--------------|---------------------------------------------------------------------------------|-------------|--------|--------|
| Date<br>2009 | Particulars                                                                     | Post<br>Ref | Rs.    | Rs.    |
| Jan.1        | Cash account<br>Capital account<br>(Cash introduced as capital in the business) | L61<br>L08  | 25,000 | 25,000 |

To start posting process of the above journal entry, we have to prepare two ledger accounts in the ledger i.e. *cash* account and *owner's capital* account.

The effect of this transaction is shown in the ledger accounts by transferring the amount and date of the journal entry to the left (debit) side of the *cash* and to the right (credit) side of *owner's capital*. It is shown as:

| Cash Account |                 |              |        | Page 61      |             |              |    |
|--------------|-----------------|--------------|--------|--------------|-------------|--------------|----|
| Date<br>20X9 | Particulars     | Post<br>Ref. | Rs     | Date<br>2009 | Particulars | Post<br>Ref. | Rs |
| Jan 1        | Capital account | J01          | 25,000 |              |             |              |    |
|              |                 |              |        |              |             |              |    |

| Owner's Capital Account |             |              |    | Page 08      |              |              |        |
|-------------------------|-------------|--------------|----|--------------|--------------|--------------|--------|
| Date<br>2009            | Particulars | Post<br>Ref. | Rs | Date<br>2009 | Particulars  | Post<br>Ref. | Rs     |
|                         |             |              |    | Jan 1        | Cash account | J01          | 25,000 |
|                         |             |              |    |              |              |              |        |

## Important Tips to Remember (ITTRs)

- Accounting head in journal entry opposite to the ledger accounts shall be written as a *reason* in the particulars column. In the debit side of cash account, the reason is written as *capital account* and in the credit side of the capital account the reason is written as *cash account* (as shown above).
- We can interpret this posting by reading the two ledger accounts as: On Jan.1, 2009 cash account is debited with Rs.25,000 because of the capital account and capital account is credited with Rs.25,000 because of the cash account.



**Entry B**

On January 5, the owner bought Computer for Rs.8,000, paying cash.

| Journal      |                                                                      | Page 2       |       |       |
|--------------|----------------------------------------------------------------------|--------------|-------|-------|
| Date<br>20X9 | Particulars                                                          | Post<br>Ref. | Rs.   | Rs.   |
| Jan.5        | Computer account<br>Cash account<br>(Purchase computer for business) | L10<br>L61   | 8,000 | 8,000 |

The posting of this entry is shown in relevant ledgers accounts as follows:

| Cash Account |             |              |    | Page 61      |                  |              |       |
|--------------|-------------|--------------|----|--------------|------------------|--------------|-------|
| Date         | Particulars | Post<br>Ref. | Rs | Date<br>20X9 | Particulars      | Post<br>Ref. | Rs    |
|              |             |              |    | Jan 5        | Computer account | J02          | 8,000 |
|              |             |              |    |              |                  |              |       |

| Computer Account |              |              |       | Page 10 |             |              |    |
|------------------|--------------|--------------|-------|---------|-------------|--------------|----|
| Date<br>20X9     | Particulars  | Post<br>Ref. | Rs    | Date    | Particulars | Post<br>Ref. | Rs |
| Jan5             | Cash account | J02          | 8,000 |         |             |              |    |
|                  |              |              |       |         |             |              |    |

### Entry C

On January 10, the owner purchased goods on credit from Pasha worth Rs.1,500.

| Journal      |                                                                              | Page 03      |       |       |
|--------------|------------------------------------------------------------------------------|--------------|-------|-------|
| Date<br>20X9 | Particulars                                                                  | Post<br>Ref. | Rs.   | Rs.   |
| Jan.10       | Purchases account<br>Creditor (Pasha) account<br>(Purchased goods on credit) | L13<br>L42   | 1,500 | 1,500 |

The posting of this entry is shown in the relevant ledger account as follows:

| Purchases Account |                   |              |       | Page 13 |             |              |    |
|-------------------|-------------------|--------------|-------|---------|-------------|--------------|----|
| Date              | Particulars       | Post<br>Ref. | Rs    | Date    | Particulars | Post<br>Ref. | Rs |
| Jan 10            | Creditors account | J03          | 1,500 |         |             |              |    |
|                   |                   |              |       |         |             |              |    |

| Creditors (Pasha) Account |             |              |    |        |                   |              |       |
|---------------------------|-------------|--------------|----|--------|-------------------|--------------|-------|
| Date                      | Particulars | Post<br>Ref. | Rs | Date   | Particulars       | Post<br>Ref. | Rs    |
|                           |             |              |    | Jan 10 | Purchases account | J03          | 1,500 |
|                           |             |              |    |        |                   |              |       |

**Entry D**

On January 18, received cash of Rs.2,500 from customers for sale of goods.

**Page 04**

| Date<br>20X9 | Particulars                                            | Post<br>Ref. | Rs.   | Rs.   |
|--------------|--------------------------------------------------------|--------------|-------|-------|
| Jan.18       | Cash account<br>Sales account<br>(sold goods for cash) | L61<br>L24   | 2,500 | 2,500 |

**Cash Account****Page 61**

| Date<br>20X9 | Particulars   | Post<br>Ref. | Rs    | Date | Particulars | Post<br>Ref. | Rs |
|--------------|---------------|--------------|-------|------|-------------|--------------|----|
| Jan 18       | Sales account | J04          | 2,500 |      |             |              |    |
|              |               |              |       |      |             |              |    |

**Sales Account****Page 24**

| Date | Particulars | Post<br>Ref. | Rs | Date<br>20X9 | Particulars  | Post<br>Ref. | Rs    |
|------|-------------|--------------|----|--------------|--------------|--------------|-------|
|      |             |              |    | Jan 18       | Cash account | J04          | 2,500 |
|      |             |              |    |              |              |              |       |

**Entry E**

On January 30, the owner paid creditors on account, Rs.1,000.

**Page 05**

| Date<br>20X9 | Particulars                                      | Post<br>Ref. | Rs.   | Rs.   |
|--------------|--------------------------------------------------|--------------|-------|-------|
| Jan.30       | Creditors<br>Cash<br>(Paid creditors on account) | L42<br>L61   | 1,000 | 1,000 |

The posting of this entry is shown in the relevant ledger account as follows:

**Cash Account**

**Page 61**

| Date | Particulars | Post<br>Ref. | Rs | Date<br>2009 | Particulars | Post<br>Ref. | Rs    |
|------|-------------|--------------|----|--------------|-------------|--------------|-------|
|      |             |              |    | Jan 30       | Creditors   | J05          | 1,000 |
|      |             |              |    |              |             |              |       |
|      |             |              |    |              |             |              |       |

**Creditors Account**

**Page 42**

| Date<br>2009 | Particulars  | Post<br>Ref. | Rs    | Date | Particulars | Post<br>Ref. | Rs |
|--------------|--------------|--------------|-------|------|-------------|--------------|----|
| Jan 30       | Cash account | J05          | 1,000 |      |             |              |    |
|              |              |              |       |      |             |              |    |

**Important Tips to Remember (ITTRs)**

*Each journal entry is posted twice in the ledger. One, in the debit side of the ledger account and second in the credit side of another ledger account with the same amount. This is because of double entry book keeping system.*



**Entry F (Compound entry)**

On January 1, 20X9 owner introduced cash Rs.25,000 and a computer worth Rs.10,000 into the business as capital.

**Journal****Page 01**

| Date<br>20x9 | Particulars                                                                                                      | Post<br>Ref       | Rs.              | Rs.    |
|--------------|------------------------------------------------------------------------------------------------------------------|-------------------|------------------|--------|
| Jan.1        | Cash account<br>Computer account<br>Capital account<br>(Cash and computer introduced as capital in the business) | L61<br>L12<br>L08 | 25,000<br>10,000 | 35,000 |

**Cash Account****Page 61**

| Date<br>20X9 | Particulars     | Post<br>Ref. | Rs.    | Date | Particulars | Post<br>Ref. | Rs. |
|--------------|-----------------|--------------|--------|------|-------------|--------------|-----|
| Jan 1        | Capital account | J01          | 25,000 |      |             |              |     |
|              |                 |              |        |      |             |              |     |
|              |                 |              |        |      |             |              |     |

**Computer Account****Page 12**

| Date<br>20X9 | Particulars     | Post<br>Ref. | Rs.    | Date | Particulars | Post<br>Ref. | Rs. |
|--------------|-----------------|--------------|--------|------|-------------|--------------|-----|
| Jan 1        | Capital account | J01          | 10,000 |      |             |              |     |
|              |                 |              |        |      |             |              |     |
|              |                 |              |        |      |             |              |     |

**Owners Capital Account****Page 08**

| Date | Particulars | Post<br>Ref. | Rs. | Date<br>20X9 | Particulars      | Post<br>Ref. | Rs.    |
|------|-------------|--------------|-----|--------------|------------------|--------------|--------|
|      |             |              |     | Jan 1        | Cash account     | J01          | 25,000 |
|      |             |              |     | Jan 1        | Computer account | J01          | 10,000 |

## Post Reference

In journal the post reference column is also named as ‘ledger folio (LF)’ and in ledger the post reference column is also named as ‘journal folio (JF)’.

| Journal      |                                                 |             |        |  |        |  |
|--------------|-------------------------------------------------|-------------|--------|--|--------|--|
| Date<br>2009 | Particulars                                     | Post<br>Ref | Rs.    |  | Rs.    |  |
| Jan.1        | Cash account                                    | L61         | 25,000 |  |        |  |
|              | Capital account                                 | L08         |        |  | 25,000 |  |
|              | (Cash introduced as capital in the<br>business) |             |        |  |        |  |

| Cash Account |                 |              |        |              |             |              |
|--------------|-----------------|--------------|--------|--------------|-------------|--------------|
| Date<br>20X9 | Particulars     | Post<br>Ref. | Rs     | Date<br>2009 | Particulars | Post<br>Ref. |
| Jan 1        | Capital account | J01          | 25,000 |              |             |              |
|              |                 |              |        |              |             |              |

| Owner's Capital Account |             |              |    |              |              |              |
|-------------------------|-------------|--------------|----|--------------|--------------|--------------|
| Date<br>2009            | Particulars | Post<br>Ref. | Rs | Date<br>2009 | Particulars  | Post<br>Ref. |
|                         |             |              |    | Jan 1        | Cash account | J01          |
|                         |             |              |    |              |              |              |

**Practice 5.1**

- Jan 1** Started business with Rs.200,000 in the bank and Rs.40,000 in cash  
**Jan 1** Bought shop fittings Rs.40,000 and a van Rs.60,000. Both paid by cheque.  
**Jan 2** Paid rent expense by cheque Rs.5,000.  
**Jan 3** Bought goods, for reselling, on credit from Jordan & Co. Rs.50,000  
**Jan 5** Cash sales Rs.5,000.  
**Jan 8** Paid wages of assistant in cash Rs.1,000.  
**Jan 10** Paid insurance expense by cheque Rs.500.  
**Jan 12** Cash sales Rs.8,000.  
**Jan 15** Paid wages of assistant in cash Rs.1,000.  
**Jan 17** Paid Jordan & Co. Rs.30,000 by cheque and goods returned to Jordan & Co. Rs.6,000.  
**Jan 19** Bought goods, for reselling, on credit from Dunhill & Co. Rs.25,000.  
**Jan 19** Cash sales Rs.7,000.  
**Jan 22** Paid wages of assistant in cash Rs.1,000.  
**Jan 24** Bought stationery and paid in cash Rs.500.  
**Jan 25** Cash sales Rs.15,000.  
**Jan 27** Paid Dunhill & Co. Rs.14,000 by cheque.  
**Jan 29** Paid wages of an assistant in cash Rs.1,000.  
**Jan 31** Deposited cash Rs.20,000 into the bank.

**Required:** Journalize the above transactions and prepare ledger accounts

| Date<br>20X9 | Particulars                                                                                                                 | Post<br>Ref.   | Debit<br>(Rs)             | Credit<br>(Rs) |
|--------------|-----------------------------------------------------------------------------------------------------------------------------|----------------|---------------------------|----------------|
| Jan. 1       | Bank Account<br>Cash Account<br>Capital Account<br>(Capital introduced by the owner).                                       | ?<br>?<br><br> | 200,000<br>40,000<br><br> | 240,000        |
| Jan. 1       | Furniture & Fittings Account<br>Van Account<br>Bank Account<br>(Purchase of furniture & fittings and van for the business). | ?<br>?<br><br> | 40,000<br>60,000<br><br>  | 100,000        |
| Jan. 2       | Rent Account<br>Bank Account<br>(Rent paid by cheque).                                                                      | ?<br>?<br><br> | 5,000<br><br><br>         | 5,000          |
| Jan. 3       | Purchases Account<br>Creditors (Jordan & co.)<br>(Purchase goods on credit).                                                | ?<br>?<br><br> | 50,000<br><br><br>        | 50,000         |
| Jan. 5       | Cash Account<br>Sales Account<br>(Goods sold for cash).                                                                     | ?<br>?<br><br> | 5,000<br><br><br>         | 5,000          |
| Jan. 8       | Wages Account<br>Cash Account<br>(Wages paid in cash).                                                                      | ?<br>?<br><br> | 1,000<br><br><br>         | 1,000          |
| Jan. 10      | Insurance Account<br>Bank Account<br>(Insurance paid by cheque).                                                            | ?<br>?<br><br> | 500<br><br><br>           | 500            |
| Jan. 12      | Cash Account<br>Sales Account<br>(Goods sold for cash).                                                                     | ?<br>?<br><br> | 8,000<br><br><br>         | 8,000          |

|         |                                                                                         |        |        |        |
|---------|-----------------------------------------------------------------------------------------|--------|--------|--------|
| Jan. 15 | Wages Account<br>Cash Account<br>(Wages paid in cash).                                  | ?<br>? | 1,000  | 1,000  |
| Jan. 17 | Creditor (Jordan & co.)<br>Return outwards Account<br>(Goods returned to Jordan & co.). | ?<br>? | 6,000  | 6,000  |
| Jan. 17 | Creditor (Jordan & co.) Account<br>Bank Account<br>(Paid Jordan & co. by cheque).       |        | 30,000 | 30,000 |
| Jan. 19 | Purchases Account<br>Creditor (Dunhill) Account<br>(Bought goods on credit).            | ?<br>? | 25,000 | 25,000 |
| Jan. 19 | Cash Account<br>Sales Account<br>(Sold goods for cash).                                 | ?<br>? | 7,000  | 7,000  |
| Jan. 22 | Wages Account<br>Cash Account<br>(Paid wages for cash).                                 | ?<br>? | 1,000  | 1,000  |
| Jan. 24 | Stationery Account<br>Cash Account<br>(Stationery purchased for cash).                  | ?<br>? | 500    | 500    |
| Jan. 25 | Cash Account<br>Sales Account<br>(Goods sold for cash).                                 | ?<br>? | 15,000 | 15,000 |
| Jan. 27 | Creditor (Dunhill & Co) Account<br>Bank Account<br>(Paid to creditors by cheque).       | ?<br>? | 14,000 | 14,000 |
| Jan. 29 | Wages Account<br>Cash Account<br>(Wages paid in cash).                                  | ?<br>? | 1,000  | 1,000  |
| Jan. 31 | Bank Account<br>Cash Account<br>(Cash paid into bank).                                  | ?<br>? | 20,000 | 20,000 |

### Chart of Accounts

Following is the chart of accounts for above journal;

1. Capital account
2. Cash account
3. Bank account
4. Furniture & fittings account
5. Van account
6. Rent account
7. Purchases account
8. Creditor (Dunhill & Co) account
9. Creditor (Jordan & Co) account
10. Sales account
11. Wages account
12. Insurance account
13. Purchases Return account
14. Stationery account

#### Bank Account

| Date<br>2009 | Particulars     | Post<br>Ref. | Rs      | Date<br>2009 | Particulars              | Post<br>Ref. | Rs     |
|--------------|-----------------|--------------|---------|--------------|--------------------------|--------------|--------|
| Jan 1        | Capital Account |              | 200,000 | Jan 1        | Furniture & Fittings A/c |              | 40,000 |
| Jan 31       | Cash Account    |              | 20,000  | Jan 1        | Van Account              |              | 60,000 |
|              |                 |              |         | Jan 2        | Rent Account             |              | 5,000  |
|              |                 |              |         | Jan 10       | Insurance Account        |              | 500    |
|              |                 |              |         | Jan 17       | Jordan & co. Account     |              | 30,000 |
|              |                 |              |         | Jan 27       | Dunhill & Co. Account    |              | 14,000 |

#### Cash Account

| Date   | Particulars     | Post<br>Ref. | Rs     | Date   | Particulars        | Post<br>Ref. | Rs     |
|--------|-----------------|--------------|--------|--------|--------------------|--------------|--------|
| Jan.1  | Capital Account |              | 40,000 | Jan.8  | Wages Account      |              | 1,000  |
| Jan.5  | Sales Account   |              | 5,000  | Jan.15 | Wages Account      |              | 1,000  |
| Jan.12 | Sales Account   |              | 8,000  | Jan.22 | Wages Account      |              | 1,000  |
| Jan.19 | Sales Account   |              | 7,000  | Jan.24 | Stationery Account |              | 500    |
| Jan.25 | Sales Account   |              | 15,000 | Jan.29 | Wages Account      |              | 1,000  |
|        |                 |              |        | Jan.31 | Bank Account       |              | 20,000 |

#### Capital Account

| Date | Particulars | Post<br>Ref. | Rs | Date   | Particulars  | Post<br>Ref. | Rs      |
|------|-------------|--------------|----|--------|--------------|--------------|---------|
|      |             |              |    | Jan. 1 | Bank Account |              | 200,000 |
|      |             |              |    | Jan. 1 | Cash Account |              | 40,000  |

#### Furniture & Fittings Account

| Date  | Particulars  | Post<br>Ref. | Rs     | Date | Particulars | Post<br>Ref. | Rs |
|-------|--------------|--------------|--------|------|-------------|--------------|----|
| Jan 1 | Bank Account |              | 40,000 |      |             |              |    |
|       |              |              |        |      |             |              |    |

**Van Account**

| Date  | Particulars  | Post Ref. | Rs     | Date | Particulars | Post Ref. | Rs |
|-------|--------------|-----------|--------|------|-------------|-----------|----|
| Jan 1 | Bank Account |           | 60,000 |      |             |           |    |
|       |              |           |        |      |             |           |    |

**Rent Account**

| Date  | Particulars   | Post Ref. | Rs    | Date | Particulars | Post Ref. | Rs |
|-------|---------------|-----------|-------|------|-------------|-----------|----|
| Jan 2 | Bank Accounts |           | 5,000 |      |             |           |    |
|       |               |           |       |      |             |           |    |

**Purchases Account**

| Date    | Particulars           | Post Ref. | Rs     | Date | Particulars | Post Ref. | Rs |
|---------|-----------------------|-----------|--------|------|-------------|-----------|----|
| Jan 3   | Jordan & co. Account  |           | 50,000 |      |             |           |    |
| Jan. 19 | Dunhill & Co. Account |           | 25,000 |      |             |           |    |

**Creditor (Jordan & Co) Account**

| Date   | Particulars          | Post Ref. | Rs     | Date   | Particulars   | Post Ref. | Rs     |
|--------|----------------------|-----------|--------|--------|---------------|-----------|--------|
| Jan 17 | Purchases Return A/c |           | 6,000  | Jan 31 | Purchases A/c |           | 50,000 |
| Jan 17 | Bank Account         |           | 30,000 |        |               |           |        |
|        |                      |           |        |        |               |           |        |

**Sales Account**

| Date | Particulars | Post Ref. | Rs | Date   | Particulars  | Post Ref. | Rs     |
|------|-------------|-----------|----|--------|--------------|-----------|--------|
|      |             |           |    | Jan 5  | Cash Account |           | 5,000  |
|      |             |           |    | Jan 12 | Cash Account |           | 8,000  |
|      |             |           |    | Jan 19 | Cash Account |           | 7,000  |
|      |             |           |    | Jan 25 | Cash Account |           | 15,000 |
|      |             |           |    |        |              |           |        |

**Wages Account**

| Date   | Particulars  | Post Ref. | Rs    | Date | Particulars | Post Ref. | Rs |
|--------|--------------|-----------|-------|------|-------------|-----------|----|
| Jan 8  | Cash Account |           | 1,000 |      |             |           |    |
| Jan 15 | Cash Account |           | 1,000 |      |             |           |    |
| Jan 22 | Cash Account |           | 1,000 |      |             |           |    |
| Jan 29 | Cash Account |           | 1,000 |      |             |           |    |
|        |              |           |       |      |             |           |    |

**Insurance Account**

| Date   | Particulars  | Post Ref. | Rs  | Date | Particulars | Post Ref. | Rs |
|--------|--------------|-----------|-----|------|-------------|-----------|----|
| Jan 10 | Bank Account |           | 500 |      |             |           |    |
|        |              |           |     |      |             |           |    |

**Purchases Return Account**

| Date | Particulars | Post Ref. | Rs | Date   | Particulars      | Post Ref. | Rs    |
|------|-------------|-----------|----|--------|------------------|-----------|-------|
|      |             |           |    | Jan 17 | Jordan & co. A/c |           | 6,000 |
|      |             |           |    |        |                  |           |       |

**Creditor (Dunhill & Co) Account**

| Date   | Particulars  | Post Ref. | Rs     | Date   | Particulars   | Post Ref. | Rs     |
|--------|--------------|-----------|--------|--------|---------------|-----------|--------|
| Jan 27 | Bank Account |           | 14,000 | Jan 19 | Purchases A/c |           | 25,000 |
|        |              |           |        |        |               |           |        |

**Stationery Account**

| Date   | Particulars  | Post Ref. | Rs  | Date | Particulars | Post Ref. | Rs |
|--------|--------------|-----------|-----|------|-------------|-----------|----|
| Jan 18 | Cash Account |           | 500 |      |             |           |    |
|        |              |           |     |      |             |           |    |

## Balancing the ledger accounts

Ledger accounts are used to summarize all financial information about one accounting head in one place and these are also prepared to extract the final balance of that summary/account.

In the above **practice 5.1**, the ledger accounts are not producing final balances (which can be reported in the financial statements), rather we are having so many amounts posted in the debit side and so many amounts posted in the credit side of a ledger account. *So, now we need to balance each ledger account.*



Balancing figure is an amount that equalizes both sides of a ledger account. Supposedly, sum of the debit side of a ledger account is Rs.15,000 and sum of the credit side of the same ledger account is Rs.9,000 then its balancing figure would be Rs.6,000 and will be written in the credit side to equalize both; debit & credit sides.

### Sample Account

| Date         | Particulars  | Post Ref. | Rs            | Date         | Particulars             | Post Ref. | Rs            |
|--------------|--------------|-----------|---------------|--------------|-------------------------|-----------|---------------|
| Jan 18       | Cash Account |           | 5,000         | Jan 25       | Cash                    |           | 9,000         |
| Jan 20       | Cash Account |           | 7,000         |              |                         |           |               |
| Jan 30       | Cash Account |           | 3,000         |              | <b>Balancing figure</b> | <b>B</b>  | <b>6,000</b>  |
|              |              |           |               |              |                         |           |               |
| <b>Total</b> |              |           | <b>15,000</b> | <b>Total</b> |                         |           | <b>15,000</b> |

**Debit Total**                      **Credit Total**                      **Debit Balance**  
**Rs.15,000**                      **Rs.9,000**                      **Rs.6,000**

Let's find out the balance of "Bank account" prepared in the **practice 5.1**;

Step 1. Total of Debit side Rs.220,000.

Step 2. Total of Credit side Rs.149,500.

Step 3. Deduct the sum of lower side out of the sum of higher side; the Balance is Rs.70,500.

The balance either Debit/Credit, depends on the heavier side. In this case total sum of debit side is greater than the total sum of credit side. Therefore, Rs.70,500 will be called as debit balance.



### Bank Account

| Date   | Particulars     | Post Ref. | Rs             | Date         | Particulars              | Post Ref. | Rs             |
|--------|-----------------|-----------|----------------|--------------|--------------------------|-----------|----------------|
| 1997   |                 |           |                |              |                          |           |                |
| Jan 1  | Capital Account |           | 200,000        | Jan 1        | Furniture & Fittings A/c |           | 40,000         |
| Jan 31 | Cash Account    |           | 20,000         | Jan1         | Van Account              |           | 60,000         |
|        |                 |           |                | Jan2         | Rent Account             |           | 5,000          |
|        |                 |           |                | Jan 10       | Insurance Account        |           | 500            |
|        |                 |           |                | Jan 17       | Jordan & co. Account     |           | 30,000         |
|        |                 |           |                | Jan 27       | Dunhill & Co. Account    |           | 14,000         |
|        |                 |           |                | Jan 31       | <b>Balance</b>           | <b>B</b>  | <b>70,500</b>  |
|        | <b>Total</b>    |           | <b>220,000</b> | <b>Total</b> |                          |           | <b>220,000</b> |

## Identifying the Balance

A balancing figure appearing in the credit side of a ledger account is known as a *Debit Balance* and a balancing figure appearing in the debit side of a ledger account is known as *Credit Balance*.

## Mechanism of Balancing Ledger Account

The accounting head, which is required to be balanced should be linked with its group's nature, that will be either Dr/Cr, the side of its group's nature is its '*natural side*' and it would always produce greater sum, the sum of other side (means the lower side) is then subtracted from the sum of natural side to ascertain balancing figure.

For example, cash account is an accounting head of ASSET and its group is Dr therefore its debit side is its natural side and would usually be greater in total than its Cr side.

In order to balance a ledger account following steps should be followed precisely:

1. Identify "natural side" of the accounting head.
2. Make total of the "natural side" (being greater).
3. Place this sum at the bottom of both sides (Dr. and Cr.) of the ledger account.
4. Deduct, one by one, the amounts of lower side (opposite to the natural side) from the total of the "natural side" (that has already been placed at the bottom).
5. Place the balancing figure in the lower side, so that the sum of both sides remains same.

*There is an exception to the above criterion, that's for contra nature of accounts e.g. sales return account and purchases return account etc. This happens because the natural side (greater side) of contra accounts would always be opposite to the group's nature.*



## Contra Accounts



Contra accounts are the accounting heads, which are presented in financial reports as deduction from the original accounting heads. For example;

| Original Accounts | Contra Accounts                                               | Main Head/Group |
|-------------------|---------------------------------------------------------------|-----------------|
| Purchases         | Purchases returns                                             | Expense         |
| Sales             | Sales return                                                  | Income          |
| Capital           | Drawings                                                      | Owner's Equity  |
| Fixed Asset       | Provision for depreciation ( <i>will be discussed later</i> ) | Asset           |
| Debtors           | Provision for bad debts ( <i>will be discussed later</i> )    | Asset           |

Although the main head of contra account remains the same as to its original accounting head but the contra account behaves oppositely, therefore, its balance is always opposite to the balance of its original accounts.

**Practice 5.2**

Work out balances of the above ledger accounts prepared in **practice 5.1**

**Bank Account**

| Date<br>1997 | Particulars     | Post<br>Ref. | Rs             | Date   | Particulars              | Post<br>Ref. | Rs             |
|--------------|-----------------|--------------|----------------|--------|--------------------------|--------------|----------------|
| Jan 1        | Capital Account |              | 200,000        | Jan 1  | Furniture & Fittings A/c |              | 40,000         |
| Jan 31       | Cash Account    |              | 20,000         | Jan 1  | Van Account              |              | 60,000         |
|              |                 |              |                | Jan 2  | Rent Account             |              | 5,000          |
|              |                 |              |                | Jan 10 | Insurance Account        |              | 500            |
|              |                 |              |                | Jan 17 | Jordan & co. Account     |              | 30,000         |
|              |                 |              |                | Jan 27 | Dunhill & Co. Account    |              | 14,000         |
|              |                 |              |                | Jan 31 | <i>Balance</i>           | <b>B</b>     | 70,500         |
|              |                 |              | <b>220,000</b> |        |                          |              | <b>220,000</b> |

**Cash Account**

| Date   | Particulars     | Post<br>Ref. | Rs            | Date   | Particulars        | Post<br>Ref. | Rs            |
|--------|-----------------|--------------|---------------|--------|--------------------|--------------|---------------|
| Jan 1  | Capital Account |              | 40,000        | Jan 8  | Wages Account      |              | 1,000         |
| Jan 5  | Sales Account   |              | 5,000         | Jan 15 | Wages Account      |              | 1,000         |
| Jan 12 | Sales Account   |              | 8,000         | Jan 22 | Wages Account      |              | 1,000         |
| Jan 19 | Sales Account   |              | 7,000         | Jan 24 | Stationery Account |              | 500           |
| Jan 25 | Sales Account   |              | 15,000        | Jan 29 | Wages Account      |              | 1,000         |
|        |                 |              |               | Jan 31 | Bank Account       |              | 20,000        |
|        |                 |              |               | Jan 31 | <i>Balance</i>     | <b>B</b>     | 50,500        |
|        |                 |              | <b>75,000</b> |        |                    |              | <b>75,000</b> |

**Capital Account**

| Date   | Particulars    | Post<br>Ref. | Rs             | Date  | Particulars  | Post<br>Ref. | Rs             |
|--------|----------------|--------------|----------------|-------|--------------|--------------|----------------|
| Jan 18 | <i>Balance</i> | <b>B</b>     | 240,000        | Jan 1 | Bank Account |              | 200,000        |
|        |                |              |                | Jan 1 | Cash Account |              | 40,000         |
|        |                |              | <b>240,000</b> |       |              |              | <b>240,000</b> |

**Furniture & Fittings Account**

| Date  | Particulars  | Post<br>Ref. | Rs            | Date   | Particulars    | Post<br>Ref. | Rs            |
|-------|--------------|--------------|---------------|--------|----------------|--------------|---------------|
| Jan 1 | Bank Account |              | 40,000        | Jan 31 | <i>Balance</i> | <b>B</b>     | 40,000        |
|       |              |              | <b>40,000</b> |        |                |              | <b>40,000</b> |

**Van Account**

| Date  | Particulars  | Post<br>Ref. | Rs            | Date | Particulars    | Post<br>Ref. | Rs            |
|-------|--------------|--------------|---------------|------|----------------|--------------|---------------|
| Jan 1 | Bank Account |              | 60,000        |      | <i>Balance</i> | <b>B</b>     | 60,000        |
|       |              |              | <b>60,000</b> |      |                |              | <b>60,000</b> |

### Rent Account

| Date  | Particulars   | Post Ref. | Rs           | Date   | Particulars    | Post Ref. | Rs           |
|-------|---------------|-----------|--------------|--------|----------------|-----------|--------------|
| Jan 2 | Bank Accounts |           | 5,000        | Jan 31 | <i>Balance</i> | <b>B</b>  | 5,000        |
|       |               |           | <b>5,000</b> |        |                |           | <b>5,000</b> |

### Purchases Account

| Date   | Particulars       | Post Ref. | Rs            | Date   | Particulars    | Post Ref. | Rs            |
|--------|-------------------|-----------|---------------|--------|----------------|-----------|---------------|
| Jan 3  | Jordan & co. A/c  |           | 50,000        | Jan 31 | <i>Balance</i> | <b>B</b>  | 75,000        |
| Jan 19 | Dunhill & Co. A/c |           | 25,000        |        |                |           |               |
|        |                   |           | <b>75,000</b> |        |                |           | <b>75,000</b> |

### Creditor (Jordan & Co.) Account

| Date   | Particulars          | Post Ref. | Rs            | Date   | Particulars   | Post Ref. | Rs            |
|--------|----------------------|-----------|---------------|--------|---------------|-----------|---------------|
| Jan 17 | Purchases Return A/c |           | 6,000         | Jan 31 | Purchases A/c |           | 50,000        |
| Jan 17 | Bank Account         |           | 30,000        |        |               |           |               |
| Jan 31 | <i>Balance</i>       | <b>B</b>  | 14,000        |        |               |           |               |
|        |                      |           | <b>50,000</b> |        |               |           | <b>50,000</b> |

### Sales Account

| Date   | Particulars    | Post Ref. | Rs            | Date   | Particulars  | Post Ref. | Rs            |
|--------|----------------|-----------|---------------|--------|--------------|-----------|---------------|
| Jan 31 | <i>Balance</i> | <b>B</b>  | 35,000        | Jan 5  | Cash Account |           | 5,000         |
|        |                |           |               | Jan 12 | Cash Account |           | 8,000         |
|        |                |           |               | Jan 19 | Cash Account |           | 7,000         |
|        |                |           |               | Jan 25 | Cash Account |           | 15,000        |
|        |                |           | <b>35,000</b> |        |              |           | <b>35,000</b> |

### Wages Account

| Date   | Particulars  | Post Ref. | Rs           | Date   | Particulars    | Post Ref. | Rs           |
|--------|--------------|-----------|--------------|--------|----------------|-----------|--------------|
| Jan 8  | Cash Account |           | 1,000        | Jan 31 | <i>Balance</i> | <b>B</b>  | 4,000        |
| Jan 15 | Cash Account |           | 1,000        |        |                |           |              |
| Jan 22 | Cash Account |           | 1,000        |        |                |           |              |
| Jan 29 | Cash Account |           | 1,000        |        |                |           |              |
|        |              |           | <b>4,000</b> |        |                |           | <b>4,000</b> |

### Insurance Account

| Date   | Particulars  | Post Ref. | Rs         | Date   | Particulars    | Post Ref. | Rs         |
|--------|--------------|-----------|------------|--------|----------------|-----------|------------|
| Jan 10 | Bank Account |           | 500        | Jan 31 | <i>Balance</i> | <b>B</b>  | 500        |
|        |              |           | <b>500</b> |        |                |           | <b>500</b> |

**Purchases Return Account**

| Date   | Particulars    | Post Ref. | Rs           | Date   | Particulars      | Post Ref. | Rs           |
|--------|----------------|-----------|--------------|--------|------------------|-----------|--------------|
| Jan 31 | <i>Balance</i> | <b>B</b>  | 6,000        | Jan 17 | Jordan & Co. A/c |           | 6,000        |
|        |                |           | <b>6,000</b> |        |                  |           | <b>6,000</b> |

**Creditor (Dunhill & Co.) Account**

| Date   | Particulars    | Post Ref. | Rs            | Date   | Particulars   | Post Ref. | Rs            |
|--------|----------------|-----------|---------------|--------|---------------|-----------|---------------|
| Jan 27 | Bank Account   |           | 14,000        | Jan 19 | Purchases A/c |           | 25,000        |
| Jan 31 | <i>Balance</i> | <b>B</b>  | 11,000        |        |               |           |               |
|        |                |           | <b>25,000</b> |        |               |           | <b>25,000</b> |

**Stationery Account**

| Date   | Particulars  | Post Ref. | Rs         | Date   | Particulars    | Post Ref. | Rs         |
|--------|--------------|-----------|------------|--------|----------------|-----------|------------|
| Jan 18 | Cash Account |           | 500        | Jan 31 | <i>Balance</i> | <b>B</b>  | 500        |
|        |              |           | <b>500</b> |        |                |           | <b>500</b> |

## Trial Balance

Trial balance is merely a list of balances extracted from the ledger containing final balance of each ledger account. In a trial balance; all accounting heads having debit balances are plotted at the left-hand side (Dr-side) and likewise all accounting heads having credit balances are plotted at the right-hand side (Cr-side).

Following is the trial balance of the ledger accounts prepared in preceding **practice 5.2**

| Sr. No. | Particulars                    | Debit Rs.      | Credit Rs.     |
|---------|--------------------------------|----------------|----------------|
| 1       | Bank account                   | 70,500         |                |
| 2       | Cash account                   | 50,500         |                |
| 3       | Capital account                |                | 240,000        |
| 4       | Furniture & fittings account   | 40,000         |                |
| 5       | Van account                    | 60,000         |                |
| 6       | Rent account                   | 5,000          |                |
| 7       | Purchases account              | 75,000         |                |
| 8       | Creditor Jordan & Co. account  |                | 14,000         |
| 9       | Sales account                  |                | 35,000         |
| 10      | Wages account                  | 4,000          |                |
| 11      | Insurance account              | 500            |                |
| 12      | Return outwards account        |                | 6,000          |
| 13      | Creditor Dunhill & Co. account |                | 11,000         |
| 14      | Stationery account             | 500            |                |
|         | <b>Total</b>                   | <b>306,000</b> | <b>306,000</b> |

The sole purpose of preparing a trial balance is to know all ledger balances in one sheet. It is also said that trial balance is a check of arithmetic accuracy of bookkeeping. The sum of debit balances appearing in the trial balance should always be equal to the sum of credit balances appearing in it. If there is some arithmetic error (transposition of figure or wrong casting of figures etc.), the trial balance will show a difference. It is true that trial balance is an indicator of arithmetic accuracy not the accuracy of bookkeeping.

A trial balance cannot indicate errors of the book-keeping. For example; i) omission of a complete transaction for recording, ii) giving Dr or Cr effect to wrong accounting head, iii) passing correct journal entry with wrong amount etc. Types of errors and their rectification will be discussed in a separate chapter.

### Posting from sub-divided journals

Journals are sub-divided when a business enters into number of credit transactions relating to purchases & sales and also when a separate cash book is required to record large number of cash transactions. The mechanism of posting process from subdivided journals into the relevant ledger accounts is somewhat different from the posting process discussed earlier (i.e. from general journal into ledger).

#### Posting from purchase journal into main ledger

Credit transactions of purchases are recorded in purchases journal. In the presence of a purchase journal all credit transactions of purchases are not recorded in the general journal therefore, these would have remained un-posted in the ledger had we ignored posting from purchase journal.

The posting process from a purchase journal is very simple and easy. As the purchase journal is totaled periodically, (weekly, fortnightly or monthly) only its periodic balance is posted into the relevant ledger accounts. The sum of purchases journal is posted into the debit (Left) side of the “*Purchases Account*” and into the credit (Right) side of the “*Sundry/Total Creditors Account*”.

#### Practice 5.3

#### PURCHASE JOURNAL

| Date<br>2009 | Name of Creditor | Inv.<br>No. | Post.<br>Ref. | Amount<br>Rs. |
|--------------|------------------|-------------|---------------|---------------|
| Feb 1        | Mian             |             |               | 2,875         |
| Feb 3        | Malik            |             |               | 667           |
| Feb 6        | Butt             |             |               | 285           |
| Feb 10       | Jutt             |             |               | 550           |
| Feb 17       | Buttar           |             |               | 8,280         |
| Feb 19       | Mughal           |             |               | 1,880         |
| Feb 27       | Kashmiri         |             |               | 7,250         |
| Feb 28       | Meer             |             |               | 3,244         |
| Feb 28       | Total            |             |               | 25,031        |

#### Sundry/Total Creditors Account

| Date   | Particulars | Post<br>Ref. | Rs. | Date   | Particulars       | Post<br>Ref. | Rs.    |
|--------|-------------|--------------|-----|--------|-------------------|--------------|--------|
| Feb 28 |             |              |     | Feb 28 | Purchases Account |              | 25,031 |

#### Purchases Account

| Date   | Particulars       | Post<br>Ref. | Rs.    | Date   | Particulars | Post<br>Ref. | Rs. |
|--------|-------------------|--------------|--------|--------|-------------|--------------|-----|
| Feb 28 | Creditors Account |              | 25,031 | Feb 28 |             |              |     |

### Posting from sales journal into main ledger

The process of posting from sales journal is similar to the process we discussed for posting from purchase journal. Here in the case of sales journal the two accounting heads are: 1) sales account and 2) sundry/total debtors account. All transactions recorded in the sales journal are of similar nature therefore, only the sum of sales journal is posted in the credit side of “*Sales Account*” and the debit side of “*Sundry/Total Debtors Account*”.

#### Practice 5.4

#### SALES JOURNAL

| Date<br>2009 | Name of Debtors | Invoice<br>No. | Post.<br>Ref. | Amount<br>Rs. |
|--------------|-----------------|----------------|---------------|---------------|
| Mar2         | Tiwana          |                |               | 5,425         |
| Mar6         | Kumboh          |                |               | 928           |
| Mar10        | Dar             |                |               | 728           |
| Mar14        | Tiwana          |                |               | 1,872         |
| Mar18        | Bhatti          |                |               | 5,427         |
| Mar22        | Kumboh          |                |               | 271           |
| Mar28        | Sial            |                |               | 9,494         |
| Mar30        | Rajpoot         |                |               | 899           |
| Mar31        | Total           |                |               | 25,044        |

#### Sales Account

| Date | Particulars | Post<br>Ref. | Rs. | Date   | Particulars     | Post<br>Ref. | Rs.    |
|------|-------------|--------------|-----|--------|-----------------|--------------|--------|
|      |             |              |     | Mar 31 | Debtors Account |              | 25,044 |

#### Sundry/Total Debtors Account

| Date | Particulars   | Post<br>Ref. | Rs.    | Date | Particulars | Post<br>Ref. | Rs. |
|------|---------------|--------------|--------|------|-------------|--------------|-----|
|      | Sales Account |              | 25,044 |      |             |              |     |

## Posting from cash book into main ledger

Posting of second effects of receipts and payments into the other relevant ledger accounts is done as follows:

### Practice 5.5

#### Cash Book

| Date | Receipts       | Post Ref. | Rs.    | Date | Payments       | Post Ref. | Rs.    |
|------|----------------|-----------|--------|------|----------------|-----------|--------|
|      | Capital A/c    |           | 20,000 |      | Rent A/c       |           | 500    |
|      | Debtors A/c    |           | 5,000  |      | Creditors A/c  |           | 4,000  |
|      | Commission A/c |           | 2,000  |      | Stationery A/c |           | 1,000  |
|      | Sales A/c      |           | 10,000 |      | Purchases a/c  |           | 8,000  |
|      |                |           |        |      | Balance        | B         | 23,500 |
|      |                |           | 37,000 |      |                |           | 37,000 |

#### Capital Account

| Date | Particulars | Post Ref. | Rs.    | Date | Particulars | Post Ref. | Rs.    |
|------|-------------|-----------|--------|------|-------------|-----------|--------|
|      | Balance     | B         | 20,000 |      | Cash A/c    |           | 20,000 |

#### Sundry Debtors Account

| Date | Particulars   | Post Ref. | Rs.    | Date | Particulars | Post Ref. | Rs.    |
|------|---------------|-----------|--------|------|-------------|-----------|--------|
|      | Sales journal |           | 25,044 |      | Cash A/c    |           | 5,000  |
|      |               |           |        |      | Balance     | B         | 20,044 |

#### Commission Account

| Date | Particulars | Post Ref. | Rs.   | Date | Particulars | Post Ref. | Rs.   |
|------|-------------|-----------|-------|------|-------------|-----------|-------|
|      | Balance     | B         | 2,000 |      | Cash A/c    |           | 2,000 |

#### Sales Account

| Date | Particulars | Post Ref. | Rs.    | Date | Particulars   | Post Ref. | Rs.    |
|------|-------------|-----------|--------|------|---------------|-----------|--------|
|      |             |           |        |      | Cash A/c      |           | 10,000 |
|      | Balance     | B         | 35,044 |      | Sales journal |           | 25,044 |

#### Rent Account

| Date | Particulars | Post Ref. | Rs. | Date | Particulars | Post Ref. | Rs. |
|------|-------------|-----------|-----|------|-------------|-----------|-----|
|      | Cash A/c    |           | 500 |      | Balance     | B         | 500 |

#### Sundry Creditors Account

| Date | Particulars | Post Ref. | Rs.    | Date | Particulars      | Post Ref. | Rs.    |
|------|-------------|-----------|--------|------|------------------|-----------|--------|
|      | Cash A/c    |           | 4,000  |      | Purchase journal |           | 25,031 |
|      | Balance     | B         | 21,031 |      |                  |           |        |

#### Stationery Account

| Date | Particulars | Post Ref. | Rs.   | Date | Particulars | Post Ref. | Rs.   |
|------|-------------|-----------|-------|------|-------------|-----------|-------|
|      | Cash A/c    |           | 1,000 |      | Balance     | B         | 1,000 |

#### Purchases Account

| Date | Particulars      | Post Ref. | Rs.    | Date | Particulars | Post Ref. | Rs.    |
|------|------------------|-----------|--------|------|-------------|-----------|--------|
|      | Cash A/c         |           | 8,000  |      |             |           |        |
|      | Purchase journal |           | 25,031 |      | Balance     | B         | 33,031 |

**Trial Balance**

| <b>Heads of Accounts</b>       | <b>Debit<br/>Rs.</b> | <b>Credit<br/>Rs.</b> |
|--------------------------------|----------------------|-----------------------|
| Cash account                   | 23,500               |                       |
| Capital account                |                      | 20,000                |
| Sundry/total debtors account   | 20,044               |                       |
| Commission account             |                      | 2,000                 |
| Sales account                  |                      | 35,044                |
| Rent account                   | 500                  |                       |
| Sundry/total creditors account |                      | 21,013                |
| Stationary account             | 1,000                |                       |
| Purchases account              | 33,031               |                       |
|                                | <u>78,075</u>        | <u>78,075</u>         |

### **Important Tips To Remember (ITTRs)**

1. Although cash book is not a part of main ledger but its balance is put into the trial balance.
2. If cash book is maintained then cash account is not prepared in main ledger.
3. Balance appearing in Dr. side of a ledger account is known as Cr. balance and balance appearing in Cr. side of a ledger account is known as Dr. balance.
4. All Dr. Balances are placed in debit side of Trial Balance and all Cr. Balances are placed in credit side of Trial Balance.
5. In order to balance a ledger account; firstly, make total of the heavier side and then subtract the amounts appearing in lower side of the ledger account.
6. The side matching with nature of the relevant ledger account would always be heavier. e.g. Cr. Side of creditors account would always be heavier than its Dr. side and should be totaled first.
7. Never put c/d or c/f (carry down/forward) with balances of the revenue/nominal nature of accounts (income and expense) because balances of these accounts are closed into the Income Statement of current reporting period and are never ever carried forward in next reporting period.
8. Trial balance is not a part of Financial Statements. It is merely a list of balances that shows arithmetical accuracy of book-keeping. It is prepared only and only to make oneself satisfied that all Dr. entries have been reciprocated with equal amount of Cr. entries.
9. In this chapter we discussed postings into the main ledger for the purpose of preparing trial balance. Detailed postings from sales and purchases journals into the individual ledger accounts (subsidiary ledger) will be discussed in the upcoming chapter i.e. control accounts.

### **Exercise Question**

State whether each of following statements is True or False

1. Ledger keeps transactions in chronological order.
2. Posting is done in Ledger.
3. Ledger is a source for preparation of Trial Balance.
4. An account will show a debit balance if its credit side is greater than its debit side.
5. First of all, the transactions are recorded in ledger.
6. Cash Account always shows a debit balance.
7. Debit side of expenses is always greater than its credit side.
8. While posting from general journal to ledger; the opposite account will be used to show as reference in particulars column of ledger account.

**Answer: 1-False, 2-True, 3-True, 4-False, 5-False, 6-True, 7-True, 8-True**

### **Explanation:**

1. In journal, entries are recorded in chronological order.
2. True
3. True
4. When credit side is greater than the debit side; balance will be called as credit balance.
5. Transactions are recorded in journal first.
6. True
7. True
8. True

**Exercise Question****Q. 1**

The following are the transactions of Kiran's business during her first month of trading.

**Record each transaction in T-accounts.**

1. Kiran starts a business and pays in Rs.5,000 as capital
2. The business buys a car for Rs.1,000 cash
3. They buy goods for resale for Rs.500 cash
4. They buy more goods for resale for Rs.600 on credit from Mr Ali
5. They pay rent of Rs.200 cash
6. They sell half the goods for Rs.800 cash
7. They sell the remaining goods on credit for Rs.900 to Miss Zara
8. They pay Rs.400 cash on account of the amount owing to Mr Ali
9. They receive Rs.500 from Miss Zara
10. Kiran withdraws Rs.100 cash from the business

**Answer to Q. 1**

| <b>Capital a/c</b>   |                 | <b>Receivables a/c</b> |               |
|----------------------|-----------------|------------------------|---------------|
|                      | Cash 5,000      | Sales 900              | Cash 500      |
|                      |                 |                        | Balance 400   |
|                      |                 | 900                    | 900           |
|                      |                 | Balance 400            |               |
| <b>Sales a/c</b>     |                 | <b>Payables a/c</b>    |               |
|                      | Cash 800        | Cash 400               | Purchases 600 |
|                      | Receivables 900 |                        |               |
| Balance 1,700        |                 | Balance 200            |               |
| 1,700                | 1,700           | 600                    | 600           |
|                      | Balance 1,700   | Balance 200            |               |
| <b>Purchases a/c</b> |                 | <b>Car a/c</b>         |               |
| Cash 500             |                 | Cash 1,000             |               |
| Payables 600         |                 |                        |               |
|                      | Balance 1,100   |                        |               |
| 1,100                | 1,100           |                        |               |
| Balance 1,100        |                 |                        |               |

| <i>Rent a/c</i> |              | <i>Withdrawals a/c</i> |              |
|-----------------|--------------|------------------------|--------------|
| Cash            | 200          | Cash                   | 100          |
|                 |              |                        |              |
| <i>Cash a/c</i> |              |                        |              |
| Capital         | 5,000        | Car                    | 1,000        |
| Sales           | 800          | Purchases              | 500          |
| Receivables     | 500          | Rent                   | 200          |
|                 |              | Payables               | 400          |
|                 |              | Withdrawals            | 100          |
|                 |              | Balance                | 4,100        |
|                 | <u>6,300</u> |                        | <u>6,300</u> |
| Balance         | 4,100        |                        |              |

## **CHAPTER – 6**

### **Preparation of Financial Statements**

| <b>Sr.<br/>No</b> | <b>Course Outline Topics</b>                                |
|-------------------|-------------------------------------------------------------|
| 1                 | Components of Financial Statements and Accounting Equations |
| 2                 | Proper format of Income Statement                           |
| 3                 | Proper format of Balance Sheet                              |
| 4                 | Practice                                                    |

**Topic videos 58-61 are mandatory part of this module**

## Components of financial statements

Although a trial balance reveals the amounts of final balances of each accounting head (chart of accounts) appearing in the main ledger, but one cannot construct an opinion about the profitability or financial strength of the entity with the help of trial balance alone. To achieve this objective an accountant has to prepare some financial statements that include:

1. Income statement (Statement of profit or loss and other comprehensive income)
2. Balance sheet (Statement of financial position)

(According to International Accounting Standard (IAS) 1, there are five components of financial statements; 1) Statement of Financial Position 2) Statement of Profit or Loss and Other Comprehensive Income 3) Statement of Cash Flows 4) Statement of Changes in equity and 5) Notes to the Financial Statements, but at initial stage only two components i.e. Statement of Profit or Loss and Other Comprehensive Income (commonly known as Income Statement) and Statement of Financial Position (commonly known as Balance Sheet) are discussed, rest of the components will be discussed later.

Income statement (Statement of Profit or Loss and Other Comprehensive Income) is prepared to know the financial performance of an entity. Financial performance refers to the profitability (profit or loss) of entity during the year. This is prepared with the help of all balances relating to incomes & expenses appearing in the trial balance. Income statement is prepared for a specific period for which starting and ending dates are defined, normally a year, that is known as reporting period.

|                                |                                    |                     |
|--------------------------------|------------------------------------|---------------------|
| <b>Remember this equation:</b> | <b>Incomes – Expenses = Profit</b> | <b>Equation 6.1</b> |
|--------------------------------|------------------------------------|---------------------|

Balance sheet (Statement of Financial Position) is prepared to know the financial position of an entity. Financial position refers to the financial strength of entity on a specific date. Normally it is prepared as on closing date of the accounting year, which is known as reporting date of the reporting period. Financial strength of the entity is known through the sum of total asset (resources) of the entity and the sum of total financial sources required to finance these assets i.e. owners' equity and liabilities (sources).

|                                |                                             |                     |
|--------------------------------|---------------------------------------------|---------------------|
| <b>Remember this equation:</b> | <b>Assets = Owners equity + Liabilities</b> | <b>Equation 6.2</b> |
|--------------------------------|---------------------------------------------|---------------------|

Equations 6.1 & 6.2 provide the basic ideology of income statement and balance sheet respectively. In actual practice the income statement and balance sheet are not prepared in equation style. The detailed formal format of these statements will be discussed later. For now, we shall do a little practice to identify the items to be shown in the income statement and balance sheet.

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**Practice 6.1**

Prepare income statement and balance sheet with the help of following trail balance.

| Accounting heads   | Debit<br>Rs.  | Credit<br>Rs. |
|--------------------|---------------|---------------|
| Bad debts          | 305           |               |
| Advertisement      | 1,506         |               |
| Telephone Bill     | 1,615         |               |
| Stationery         | 500           |               |
| Repairs            | 600           |               |
| Sales Revenue      |               | 40,600        |
| Purchases Expense  | 28,500        |               |
| Salaries and wages | 4,850         |               |
| Machinery          | 12,500        |               |
| Creditor           |               | 5,250         |
| Debtors            | 7,810         |               |
| Furniture          | 5,600         |               |
| Land               | 28,000        |               |
| Drawings           | 7,218         |               |
| Rent Income        |               | 1,000         |
| Capital            |               | 52,154        |
| <b>Total</b>       | <b>99,004</b> | <b>99,004</b> |

Closing stock valued at Rs. 9,960

**Income Statement for the reporting period...**

| Income               | - | Expense                      | = | Net Profit    |
|----------------------|---|------------------------------|---|---------------|
| Sales Revenue 40,600 |   | Purchases Expense 28,500     |   |               |
| Rent income 1,000    |   | Less: closing Stock* (9,960) |   |               |
|                      |   | Cost of goods sold 18,540    |   |               |
|                      |   | Bad debts 305                |   |               |
|                      |   | Advertisement 1,506          |   |               |
|                      |   | Telephone bill 1,615         |   |               |
|                      |   | Stationery 500               |   |               |
|                      |   | Repairs 600                  |   |               |
|                      |   | Salaries & wages 4,850       |   |               |
| <b>41,600</b>        | - | <b>27,916</b>                | = | <b>13,684</b> |

**Balance Sheet as on the reporting date...**

| Assets               | = | Owner's equity        | + | liabilities     |
|----------------------|---|-----------------------|---|-----------------|
| Debtor 7,810         |   | Capital 52,154        |   | Creditors 5,250 |
| Stock closing* 9,960 |   | Add Net profit 13,684 |   |                 |
| Furniture 5,600      |   | Less Drawings (7,218) |   |                 |
| Machinery 12,500     |   |                       |   |                 |
| Land 28,000          |   |                       |   |                 |
|                      |   | 58,620                | + | 5,250           |
| <b>63,870</b>        | = |                       |   | <b>63,870</b>   |

\*The cost that expires during the reporting year is reported as expense. Cost of closing stock is un-expired cost and its economic benefit shall flow to the entity in future. Closing stock represents the unsold purchased goods. Therefore, this is subtracted from the purchases (expenses) and included in the list of assets.

## Proper Format of Income Statement and Balance Sheet

### Entity's Name Income Statement For the year ended 31 December 20X9

|                                      | Rs.   | Rs.   |
|--------------------------------------|-------|-------|
| Sales Revenue                        |       | ***   |
| Cost of Goods Sold ( <i>Note 1</i> ) |       |       |
| Opening stock                        | ***   |       |
| Purchases                            | ***   |       |
| Closing stock                        | (***) | (***) |
| Gross Profit ( <i>Note 2</i> )       |       | ***   |
| Operating Expenses ( <i>Note 3</i> ) |       | (***) |
| Operating Profit                     |       | ***   |
| Other Income ( <i>Note 4</i> )       |       | ***   |
| Net Profit ( <i>Note 5</i> )         |       | ***   |

### Entity's Name Balance Sheet As at 31 December 20X9

|                                        | Rs.   | Rs. |
|----------------------------------------|-------|-----|
| <b>Assets</b>                          |       |     |
| Fixed Assets ( <i>Note 6</i> )         |       |     |
| Land                                   | ***   |     |
| Building                               | ***   |     |
| Machinery                              | ***   |     |
| Furniture                              | ***   | *** |
| Current Assets ( <i>Note 7</i> )       |       |     |
| Stock / Inventory                      | ***   |     |
| Debtors                                | ***   |     |
| Bank balance                           | ***   |     |
| Cash in hand                           | ***   | *** |
| <b>Owner's Equity (<i>Note 8</i>)</b>  |       |     |
| Capital                                | ***   |     |
| Add: Net profit                        | ***   |     |
| Less: Drawings                         | (***) | *** |
| <b>Liabilities:</b>                    |       |     |
| Long term loans ( <i>Note 9</i> )      |       |     |
| Loan from bank                         | ***   |     |
| Finance lease liability                | ***   | *** |
| Current liabilities ( <i>Note 10</i> ) |       |     |
| Creditors                              | ***   |     |
| Bank overdraft                         | ***   |     |
| Short term loans                       | ***   | *** |

## Notes:

### 1 Cost of Goods Sold

Although the purchases account is an accounting head that belongs to the main head EXPENSES and should be straightaway subtracted from sales account to ascertain gross profit of the entity, but all the goods purchased are rarely sold out in the year of purchase. Some of the goods purchased might remain unsold on the closing date of the reporting period, therefore such unsold goods (closing stock) is deducted from the purchases to calculate the figure of cost of those goods that have been sold during the period (cost of goods sold). In-fact it is the cost which has expired during the period to earn sales income and the portion not yet expired is closing stock which shall be shown in the balance sheet as an ASSET.

The closing stock of the previous reporting period becomes opening stock for the current reporting period and its sales become part of current reporting period's income, therefore the opening stock is included in the current reporting period's cost of goods sold as an EXPENSE.

### 2 Gross Profit

Income statement is divided into two portions, first portion ends at Gross Profit. Gross profit shows potential of the entity to meet operating expenses during the period. That the goods were sold at a reasonable margin and this margin (gross profit) is available to meet operating expenses i.e. administrative, selling and distribution expenses of the same reporting period.

### 3 Operating Expenses

These are the expenses which are incurred to run/operate the entity. These include;

1. Administrative expenses
2. Selling, distribution and marketing expenses

A business cannot even think to sell its goods or services without incurring operating expenses. These operating expenses are deducted from the gross profit to ascertain operating profit of the business.

#### 3.1 Administration Expenses

These are routine expenses of the entity that are incurred to run the administrative affairs. These include but not restricted to; staff salaries, building rent, repairs, insurance, electricity bill, water & gas bill, telephone bill, stationery, entertainment etc.

#### 3.2 Selling, Distribution and Marketing Expenses

It is clear from its name that these expenses are incurred to promote the sales, these include but not restricted to; sales staff wages and commission, advertisement, free sampling, carriage outwards, discount allowed, bad debts etc.

### 4 Other Incomes

These are the non-operating incomes. These are the earnings, which are not generated through the principal activities of the entity, rather these are the earnings through the sources other than sales of goods or services. These include but not restricted to; rent income, interest income, commission income, discount received etc.

### 5 Net Profit

As discussed earlier, the income statement is split into two portions; the first portion shows gross profit and the second portion shows net profit. In-fact, it is the profit that management of the entity wants to know through income statement in order to take certain economic decisions.

### 6 Fixed Assets

These are the assets that are held; for use in production of goods/services or delivery of goods/services, for renting to others and for administration purpose. These normally provide economic benefits to the entity for more than one accounting year.

### 7 Current Assets

These are the assets that are held for trading purposes (means stock for selling purpose) and/or are expected to be recovered in cash in next twelve months (debtor), and/or are cash in hand and cash at bank.

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**8 Owners' Equity**

It is the wealth of owners held by the entity. It includes the amount of capital (personal resources of the owners invested into the entity) and also the net profit earned/generated by the entity by utilizing owner's capital. The amount of drawings is subtracted from it as these were the entity's resources distributed to the owners against the expected profit of the entity.

**9 Long-Term Loan**

It is an obligation on the entity that is expected to be settled after more than one accounting year. It is the source of finance that is obtained from lenders (financial institutions).

**10 Current Liabilities**

These are obligations on the entity that are payable within next twelve months. These include but not restricted to; creditors, bank overdraft and current portion of the long-term loans payable within next twelve months.

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**Practice 6.1 – Answer**

**Entity's Name**  
**Income Statement**  
**For the year ended 31<sup>st</sup> December 20X9**

|                                      | Rs.            | Rs.                  |
|--------------------------------------|----------------|----------------------|
| Sale                                 |                | 40,600               |
| Cost of Goods Sold ( <b>Note 1</b> ) |                |                      |
| Opening stock                        | -              |                      |
| Purchases                            | 28,500         |                      |
| Closing stock                        | <u>(9,960)</u> | <u>(18,540)</u>      |
| Gross Profit                         |                | 22,060               |
| <u>Operating Expenses:</u>           |                |                      |
| Bad Debts                            | 305            |                      |
| Advertisement                        | 1,506          |                      |
| Telephone Bill                       | 1,615          |                      |
| Stationary                           | 500            |                      |
| Repairs                              | 600            |                      |
| Salaries & Wages                     | <u>4,850</u>   | <u>9,376</u>         |
| Operating Profit/Income              |                | 12,684               |
| <u>Other Income</u>                  |                |                      |
| Add: Rent Income                     |                | <u>1,000</u>         |
| <b>Net Profit/Income</b>             |                | <b><u>13,684</u></b> |

**Entity's Name**  
**Balance Sheet**  
**As at 31 December 20X9**

|                            | Rs.            | Rs.                  |
|----------------------------|----------------|----------------------|
| <b>Assets</b>              |                |                      |
| <u>Fixed Assets</u>        |                |                      |
| Land                       | 28,000         |                      |
| Machinery                  | 12,500         |                      |
| Furniture                  | <u>5,600</u>   | 46,100               |
| <u>Current Assets</u>      |                |                      |
| Stock                      | 9,960          |                      |
| Debtors                    | <u>7,810</u>   | <u>17,770</u>        |
|                            |                | <b><u>63,870</u></b> |
| <b>Owner's Equity</b>      |                |                      |
| Capital                    | 52,154         |                      |
| Add: Net Profit            | 13,684         |                      |
| Loss: Drawings             | <u>(7,218)</u> | 58,620               |
| <b>Liabilities</b>         |                |                      |
| <u>Current liabilities</u> |                |                      |
| Creditors                  |                | <u>5,250</u>         |
|                            |                | <b><u>63,870</u></b> |

Q.1

Esme took Rs.100 per week from the business to cover living expenses (drawings), other than for 2 weeks in August when she took \$500 per week.

Rs.

Prepare Balance Sheet of Esme and calculate profit or loss made during the year.

[illegible]

**\*Net Loss is a Balancing Figure**

**Q. 2**

A business has opening inventory of Rs.7,200 and closing inventory of Rs.8,100. Purchases for the year were Rs.76,500, carriage inward was Rs.50 and carriage outward was Rs.180.

What is the amount of cost of sales?

- a) Rs.75,550
- b) Rs.75,650**
- c) Rs.75,830
- d) Rs.77,450

**Answer**

Opening inventory  
Add Purchases  
Add Carriage inwards  
Less Closing inventory

**Q. 3**

Javed had the following assets and liabilities at the beginning and end of his financial year:

|                              | Beginning of the year | End of year |
|------------------------------|-----------------------|-------------|
|                              | Rs.                   | Rs.         |
| Trade payables               | 18,000                | 22,000      |
| Inventories                  | 24,000                | 27,500      |
| Long-term borrowings         | 15,000                | 10,000      |
| Property plant and equipment | 82,000                | 86,500      |
| Cash and cash equivalents    | 2,500                 | 1,500       |

During the year, Javed withdrew Rs.11,500 in drawings and no capital was introduced.

**How much profit did Javed make for the year?**

\$

**Hint: prepare opening and closing balance sheets to calculate owner's equity balances and then prepare equation "Op OE + Profit – Drawings = Cl OE"**

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## Examination Questions

1. Alia sold some items of inventory for Rs.1,950 in cash, which she had purchased for Rs.2,622. How are her assets and owner's equity affected by this transaction of sale?

| Assets                   | Owner's Equity        |
|--------------------------|-----------------------|
| A. reduced by Rs.672     | reduced by Rs.672     |
| B. reduced by Rs.2,622   | reduced by Rs.672     |
| C. increased by Rs.672   | increased by Rs.2,622 |
| D. increased by Rs.1,950 | reduced by Rs.672     |

**Explanation:** It's a loss-making transaction that is reducing inventory by Rs. 2,622 and increasing cash asset by Rs. 1,950

2. The profit earned by a business in 20X7 was Rs.72,500. The proprietor brought in new capital of Rs.8,000 during the year and withdrew goods for his private use, which had cost Rs.2,200.

If owner's equity at the beginning of the period were Rs.101,700, what was the closing owner's equity?

- A. Rs.35,000  
B. Rs.39,400  
C. Rs.168,400  
D. **Rs.180,000**

**Explanation:** Opening OE 101,700 + Fresh Cap 8,000 + Profit 72,500 – Drawings 2,200 = 180,000

3. Hala has set up a new business. The following balances are recorded in her books:

|                |           |
|----------------|-----------|
| Owner's equity | Rs.5,000  |
| Bank overdraft | Rs.10,000 |
| Motor car      | Rs.6,000  |

Her only other asset is office furniture. She has no other liabilities.

**What is book value of her office furniture?**

\$

**Explanation:** Owners equity 5,000 + Bank OD 10,000 – Motor car 6,000 = Office furniture 9,000

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