CHAPTER

2 Accounting Process

Unit-1: Cash Book

CASH BOOK – A PRINCIPLE BOOK AND A SUBSIDIARY BOOK

Cash (incl. Bank & cash Discount) transactions are promptly **documented in the Cash Book**, and **from this record, ledger** accounts **are generated**. Consequently, the Cash Book functions as a subsidiary book. However, it also functions as both the cash account and the bank account, with their balances directly included in the trial balance. This dual role classifies the Cash Book as an integral part of the ledger. As a result, it should be considered a principal book. In summary, the **Cash Book serves as both a subsidiary book and a principal book**..

TYPES OF CASH BOOK

Cash Book is of the three types:

(i) Simple Cash Book;

(ii) Two-column Cash Book;

(iii) Three-column Cash Book.

Apart from the primary Cash Book, **firms** typically also **prepare a petty cash book, which** exclusively **serves** as a **subsidiary book.**

SIMPLE CASH BOOK

This type of cash book resembles a **regular account format,** featuring a single column for amounts on each side. On the **left-hand side**, it records **cash receipts**, while on the **right-hand side**, it documents **cash payments.**

Balancing – The cash book is balanced in a manner **similar to regular accounts.** The sum of the receipts column consistently exceeds the total of the payments column. This discrepancy is recorded on the credit side as 'By balance c/d.' Subsequently, the sums are inserted in corresponding columns, and on the debit side, the balance is designated as "To Balance b/d" to indicate the opening cash balance for the next accounting period.

DOUBLE-COLUMN CASH BOOK

When a supplementary **column labeled 'Amount'** is **used to document cash inflows and outflows**, and **additional columns** are **introduced on each side to capture cash discounts**

given or received, or a **separate column** on the debit side is designated for bank deposits while another column on the credit side is reserved for bank withdrawals, this results in the creation of a double-column cash book.

Since cash discounts are granted exclusively for cash payments, it is **practical to include a 'Discount Allowed'** column on the cash receipt side of the cash book and a 'Discount Received' column on the cash payment side of the cash book.

Balancing- It is **important to note** that the **discount columns do not require balancing;** they are merely subject to totaling. The total of the discount column on the receipts side represents the overall discounts granted to customers and is **recorded as a debit in the Discount Account & vice-versa.**

Cash columns are balanced. Similarly, the Bank columns **are also balanced**, and the resultant figure is referred to as the 'bank balance.'

In summary, a double-column cash book should contain **two columns on each side**, which can consist of **either cash and discount** transactions **or cash and bank** transactions.

In summary:

(i) The discount columns in the cash book are subjected to totaling.

(ii) These columns do not require balancing.

(iii) The cumulative totals are subsequently recorded in the ledger under the 'Discount Received/Paid' account.

THREE-COLUMN CASH BOOK

A **typical practice** for businesses is to **maintain** the **majority of their funds in bank accounts,** providing the flexibility to deposit and withdraw funds as needed. **Transactions involving banks often outnumber** strictly **cash transactions.**

The distinction between cash on hand and funds in the bank is relatively minor. Therefore, it is advantageous to include an additional column on both sides of the cash book for recording cash deposits into the bank (on the receipt side) and bank withdrawals (on the payment side).

When documenting entries in a three-column cash book, consider the following key points:

1. When starting a new business, record the amount in the cash column if cash is introduced, and in the bank column if it is directly deposited in the bank with the notation 'To Capital Account.' For an existing business starting a new cash book, opening balances are recorded as 'To Balance b/d.'
2. All incoming payments are listed on the receipt side, with cash payments in the cash column and check payments in the bank column. If any discounts are granted to the paying party, they are recorded in the discount column. The particulars column should include the name of the account for which the payment is received.
3. All outgoing payments are documented on the payment side, with cash payments in the cash column and check payments in the bank column. If any discounts are received from the receiving party, they are entered in the discount column.

4. **Contra Entries:** In some cases, cash is withdrawn from the bank for office use. In such instances, the amount is recorded in the bank column on the payment side and also in the cash column on the receipt side. Conversely, when **cash is deposited** into the bank, the amount is recorded in the bank column on the receipt side and in the cash column on the payment side. For these entries, the letter "C" should be noted in the L.F column to signify that these are contra transactions, requiring no further posting

Note: When checks received are initially recorded in the cash column and subsequently deposited into the bank, the entry is treated as if cash has been transferred to the bank.

We can record contra entries, by following these rules:

(a)	Receiver A/c	Dr.
	Giver A/c	Cr.
(b)	what comes in	Dr.
	what goes out	Cr.

In cases where a Cash Book includes distinct columns designated for bank transactions.

(a) When cash is deposited into the Bank Account, the Bank assumes the role of the recipient, resulting in a debit entry. Meanwhile, since cash is being disbursed, a credit entry is made to the cash account.

(b) In the event of cash withdrawal from the Bank Account, the Bank takes on the role of the provider, leading to a credit entry. Conversely, as cash is entering the picture, a debit entry is recorded for the cash account.

5. If a check sent to the bank cannot be collected, meaning it is dishonored, it is recorded in the bank column on the credit side, along with the name of the concerned party in the particulars column.
6. If a check issued by the firm is not honored upon presentation, it is noted in the Bank column on the debit side, along with the name of the party to whom the check was issued.
7. In a less common scenario, a received check may be endorsed to another party. Initially, it is recorded in the bank column on the debit side upon receipt, and when endorsed, the amount will be registered in the bank column on the credit side.
8. The benefits of such a Cash Book are as follows:
   (a) Simultaneous Preparation: The Cash Account and the Bank Account are prepared concurrently in this format, completing the double-entry process within the Cash Book itself. This simplifies cross-checking of contra entries between the Cash column on one side and the Bank column on the other side of the Cash Book, thereby reducing the likelihood of errors.

   (b) Quick Access to Cash and Bank Balance: Obtaining information about the Cash on Hand and Bank Balance is expedited and simplified since there is no requirement to maintain a separate Ledger for the Bank Account.

9. When managing multiple Bank Accounts, individual columns can be added for each Bank Account. This facilitates the recording and reconciliation of transactions among these accounts with minimal effort.
10. For example, if there are two Bank Accounts, namely ICICI Current Account and HDFC-Cash Credit Account, and a check is issued from the ICICI account to the HDFC account, the recipient, i.e., the HDFC account, will be debited, and the sender, i.e., the ICICI account, will be credited.

    Balancing: The discount columns are subject to totaling, yet they do not require balancing. The cash columns are balanced in the same way as outlined for a simple cash book. A similar process is applied when balancing the bank columns. However, it is possible for the bank to permit the firm to withdraw more than the amount initially deposited, resulting in an overdraft. In such a scenario, the total of the bank column on the credit side exceeds the one on the debit side. The disparity is recorded on the debit side as "To Balance c/d." Subsequently, the totals are entered on opposite sides, and the balance is recorded on the credit side as "By Balance b/d."

    Yet, in typical situations, the inflow of funds into the bank surpasses the withdrawals or disbursements from the bank. In such instances, the bank columns are balanced in the same manner as the cash columns.

PETTY CASH BOOK

Within the organization, **numerous minor expenses,** such as those **related to**

- telegrams,
- taxi fares,
- cartage, etc.,

must be settled. **If each of these payments is documented in the cash book,** it would make the cash book bulky. Additionally, it would place **excessive demands on the main cashier.**

As a result, it's a **common** practice for businesses to designate a**n individual as the 'Petty Cashier' and delegate the** responsibility of handling small disburse**ments, typically below Rs 400,** to this individual. Naturally, the **Petty Cashier will be reimbursed for the expenses incurred.** Subsequently, after a thorough review, the respective accounts may be charged to reflect the transactions.

IMPREST SYSTEM OF PETTY CASH

It is practical to **allocate a fixed amount of funds to the petty cashier at the commencement of a specific period, with reimbursement scheduled at the period's end**. This ensures that the petty cashier always begins each new period with the same predetermined amount. This approach is referred to as the imprest system of petty cash.

The imprest system becomes exceptionally valuable when an analytical Petty Cash Book is employed. This specialized book features a column for recording cash receipts (typically solely from the main cashier) and additional columns for documenting various types of expenditures. The cumulative figures in these various columns help identify the reasons behind the disbursements, which in turn allows for the appropriate accounts to be debited.

(i) The fixed petty cash amount should be adequate to cover anticipated minor expenses over a relatively short period, such as a week or a fortnight.

(ii) Reimbursement should only be made when the petty cashier presents a statement supported by vouchers, offering documentary evidence, and the reimbursement should not exceed the actual disbursements.

(iii) Properly organized filing of vouchers is essential.

(iv) No disbursements should be made without proper authorization, and payments above a specified limit should be handled exclusively by the main cashier.

(v) The **petty cashier should not be permitted to accept cash, except for reimbursement.**

In the petty cash book, the **leftmost column records cash receipts**. The **right-hand** side of the book **displays the money column, which summarizes payments** for various purposes. Typically, there is a **column dedicated to "sundries" to record infrequent expenses,** and this column is subject to analysis. At the conclusion of the week or fortnight, the petty cash book is balanced using the same method as employed for a simple cash book.

ADVANTAGES OF PETTY CASH BOOK

The primary benefits include:

(i) **Reduction in the chief cashier's workload**, resulting in time savings.

(ii) Diminished labor requirements for maintaining the cash book and entering data into the ledger.

(iii) **Enhanced oversight and control** over minor disbursements.

POSTING THE PETTY CASH BOOK

(i) **In the ledger, a petty cash account is maintained**. When an **amount is disbursed to the petty cashier**, the **petty cash account is debited**. On a **weekly or bi-weekly basis**, the **total of** the **payments** made is **credited to this account. Consequently**, the petty cash account **reflects the balance held by** the **cashier, which should be readily available for inspection** upon request. At the end of the accounting period or year, the **remaining balance appears in the balance sheet** as part of the overall cash balance.

(ii) **To ensure proper accounting**, the **payments must also be debited to their respective accounts** as indicated in the petty cash book. Two methods can be employed for this purpose:

   (i) The **total of the various columns in the petty cash book** may be **directly debited to the relevant accounts.**

   (ii) **Alternatively, a journal entry** may be **first prepared based on the petty cash book.** This entry debits the accounts specified in the analysis columns and credits the total of the payments from the petty cash accounts.

ENTRIES FOR SALE THROUGH CREDIT/DEBIT CARDS

In contemporary times, various banks in India offer Credit/Debit Card services either directly or through collaborations with other agencies. Popular card options include HSBC Card, SBI Card, BOB Card, ICICI Bank Card, HDFC Card, and Andhra Bank Card.

The process for issuing Credit/Debit Cards unfolds as follows:

(i) The bank provides a small plastic card, known as a Credit Card, to a potential customer upon assessing their creditworthiness, typically gauged by their income sources. Debit Cards are issued to customers who maintain accounts with the bank. Nowadays, ATM Cards issued by the bank can also function as Debit Cards. These cards feature an embossed 16-digit number and the cardholder's name.

(ii) Credit cardholders are generally subject to annual subscription fees imposed by the bank. Debit Cards, on the other hand, are typically fee-free, although some banks may levy a nominal charge on Debit Cards.

(iii) When a cardholder intends to make purchases using a Credit or Debit Card, the seller inserts the customer's card into a card machine, inputs the transaction amount, and then returns the card to the customer for entering their password (i.e., Personal Identification Number – PIN) to authorize the transaction. The seller provides one copy of the transaction receipt to the customer and retains another for record-keeping.

(iv) The seller aggregates the various transaction amounts and usually submits these forms to their bank on a daily basis. The bank credits the amount to the seller's account and debits the account of the bank or company responsible for issuing the Credit/Debit Card.

(v) The bank issuing the card levies a commission for each transaction, typically ranging from 1% to 4%, which is promptly debited from the seller's bank account.

(vi) The bank sends a monthly statement to the cardholder. In the case of a Debit Card, the account is instantly debited for the cardholder, while for a Credit Card, the cardholder must settle the amount in full or in part. Failure to pay in full may result in the assessment of interest charges.

ACCOUNTING FOR CREDIT/DEBIT CARD SALE

From the seller's perspective, this kind of transaction is akin to a cash sale. The commission imposed by the bank is categorized as a selling expense. The seller will record the following journal entries in their accounting records.

1. Bank A/c   Dr.
     To Sales A/c
   (Sales made through Debit/Credit Card)
2. Commission A/c   Dr.
     To Bank A/c
   (Commission charged by bank)

TEST YOUR KNOWLEDGE

TRUE AND FALSE

1. Cash book is a subsidiary book as well as a principal book. **(ICAI Study Material)**

Sol. True: As the balance is transferred directly from the cash book to the trial balance, it serves a dual role, functioning both as a subsidiary book and as a principal book

2. Two column cash book consists of two columns: cash column & bank column or cash column & Discount column **(Modified ICAI Study Material)**

Sol. True: A two-column cash book includes a pair of columns, which can be a combination of the cash column and the discount column or the cash column and the bank column

3. Discount column of the cash book is never balanced. **(ICAI Study Material)**

Sol. True: The total from the discount column is summed up and subsequently posted to the discount allowed or discount received account

4. Contra entry is passed in a two column cash book. **(ICAI Study Material)**

Sol. False: A contra entry is recorded within a three-column cash book that features both bank and cash columns.

Note: If in Two Column Cash Book if Cash & Bank Column is maintained then contra entry will als be shown in Two Column cash book

5. If the bank column is showing the opening balance on the credit side, it is an overdraft. **(ICAI Study Material)**

Sol. True: The debit side of the opening balance indicates a favorable balance, while the credit balance is considered unfavorable and is treated as an overdraft

6. A cash book records cash transactions as well as credit transactions. **(ICAI Study Material)**

Sol. False: A cash book records cash transactions only

7. Discount column of the cash book records the trade discount. **(ICAI Study Material)**

Sol. False: The discount column in the cash book documents cash discounts, while trade discounts are not included in the accounting records

MULTIPLE CHOICE QUESTIONS

1. The total of discounts column on the debit side of the cash book, recording cash discount deducted by customers when paying their accounts, is posted to the___________________ **(ICAI Study Material)**

   (a) Credit of the discount allowed account.

   (b) Debit of the discount allowed account

   (c) Credit of the discount received account.

   (d) None of the above

Sol. (b) Debit of the discount allowed account

2. Cash book is a type of ________ but treated as a of accounts. **(ICAI Study Material)**
   (a) Subsidiary book, principal book
   (b) Principal book, subsidiary book
   (c) Subsidiary book, subsidiary book
   (d) None of the above

Sol. (a) Subsidiary book, principal book (Refer Para 1)

3. Which of the following is not a column of a three-column cash book? **(ICAI Study Material)**
   (a) Cash column (b) Bank column
   (c) Petty cash column (d) None of the above

Sol. (c) Petty cash column

4. Contra entries are passed only when ________________ **(ICAI Study Material)**
   (a) Double-column cash book is prepared (Cash & Discount Column)
   (b) Three-column cash book is prepared
   (c) Simple cash book is prepared
   (d) None of the above

Sol. (b) Three-column cash book is prepared

5. The Cash Book records ________________ **(ICAI Study Material)**
   (a) All cash receipts (b) All cash payments
   (c) All cash receipts and payments (d) None of the above

Sol. (c) All cash receipts and payments

6. The balance in the petty cash book is ________________ **(ICAI Study Material)**
   (a) An expense (b) A profit
   (c) An asset (d) None of the above

Sol. (c) An Asset

7. If Ram has sold goods for cash, the entry will be recorded ________________ **(ICAI Study Material)**
   (a) In the Cash Book (b) In the Sales Book
   (c) In the Journal (d) None of the above

Sol. (a) In the Cash Book

THEORY QUESTIONS

1. Is a cash book a subsidiary book or a principal book? Explain. **(ICAI Study Material)**

Sol. Cash transactions are directly recorded in the Cash Book, and ledger accounts are subsequently created based on this record. Consequently, the Cash Book functions as a subsidiary book. However, it also assumes the roles of the cash account and the bank account (if a bank column is included), with the balances being entered directly into the trial balance. This dual nature makes the Cash Book a part of the ledger, thus designating it as a principal book. Consequently, the Cash Book is both a subsidiary book and a principal book

2. What are the various kinds of cash book? **(ICAI Study Material)**

Sol. The primary Cash Book can be categorized into three main types:

- Simple Cash Book
- Two-column Cash Book
- Three-column Cash Book

Aside from the primary Cash Book, companies often keep a petty cash book, but it primarily serves as a subsidiary book

3. What are the advantages of a three column cash book? **(ICAI Study Material)**

Sol. The three-column Cash Book offers several advantages:

(a) **Simultaneous Preparation:** Both the Cash Account and the Bank Account are created concurrently, completing the double-entry process within the Cash Book. This simplifies the cross-verification of contra entries, as the Cash column on one side can be cross-checked with the Bank column on the other side of the Cash Book, leading to a reduction in the likelihood of errors.

(b) **Swift Access to Cash and Bank Balances:** Information about Cash on Hand and Bank Balances can be readily and promptly obtained without the necessity of preparing separate Ledgers for the Cash and Bank Accounts.

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Unit-2: Subsidiary Books

INTRODUCTION

In business, **various transactions occur, such as cash receipts and payments, sale and purchase of goods. To organize these transactions, separate registers are maintained**.

Each class of transaction **has its own register**, including one for cash receipts and payments, one for purchase of goods, and one for the sale of goods. **These registers are referred to as books of original entry or prime entry. Transactions recorded in** these **books do not require journal entries. This method of recording** transactions **in specialized books, from which ledger** accounts are **prepared**, is **known as** the **Practical** System of Bookkeeping **or** the **English System**.

It is important to note that **this system closely follows the rules of the double-entry system**.

These books of original or prime entry are also **known as subsidiary books because ledger accounts are created based** on them. **Without** the subsequent process of **ledger posting**, a **trial balance cannot be generated**.

Following are the **subsidiary books are utilized in a business**:

(i) **Cash book:** Records cash receipts and payments, including bank transactions.

(ii) **Purchases book:** Records credit purchases of goods or materials required by the business.

(iii) **Purchase Returns book:** Records the return of goods or materials previously purchased.

(iv) **Sales book:** Records the credit sale of goods by the business.

(v) **Sales Returns book:** Records returns made by customers.

(vi) **Bills Receivable book:** Records the receipts of promissory notes or hundies from various parties.

(vii) **Bills Payable book:** Records the issuance of promissory notes or hundies to other parties.

(viii) **Journal (proper):** Records transactions that cannot be recorded in any of the above mentioned seven books.

ADVANTAGES OF SUBSIDIARY BOOKS

The utilization of subsidiary books offers the following advantages:

(i) **Work division:** By employing multiple subsidiary books instead of a single journal, the accounting tasks can be divided among several clerks, allowing for efficient work distribution.

(ii) **Specialization and efficiency:** Assigning specific tasks to individuals over a period of time enables them to acquire in-depth knowledge and expertise, leading to increased efficiency in handling those tasks. Consequently, accounting work is performed more proficiently.

(iii) **Time savings:** The use of multiple books enables simultaneous execution of various accounting processes, resulting in quicker completion of work.

(iv) **Information accessibility:** Maintaining separate registers or books for each class of transactions ensures that relevant information pertaining to each transaction is consolidated in one place, facilitating easy access and retrieval.

(v) **Enhanced checking capabilities:** The presence of distinct books aids in locating errors or discrepancies when the trial balance does not align. Additionally, the use of various subsidiary books helps detect errors and fraudulent activities, thereby promoting effective checks and controls.

DISTINCTION BETWEEN SUBSIDIARY BOOKS AND PRINCIPAL BOOKS

The Subsidiary books are the initial records where transactions are recorded to facilitate further processing. Among these books, the ledger and cash book hold significant importance as they provide essential information for preparing the trial balance and financial statements. To better comprehend the distinction between Subsidiary Books and Principal Books, refer to the table below:

Comparison between Subsidiary Books and Principal Books

Subsidiary Books	Principal Books
Transactions are first recorded here.	These books rely on subsidiary books for information.
Serve as the primary source of transaction data.	Utilized to prepare the trial balance and financial statements.
Examples include cash book, purchases book, sales book, etc.	Examples include ledger and cash book.
Essential for maintaining organized and accurate records.	Crucial for generating financial reports and analysis

PURCHASES BOOK

Businesses typically maintain a separate register, known as the **Purchases Book or Purchases Journal, to document credit purchases** of goods or materials used in the factory. This register is specifically dedicated to recording such transactions and is commonly employed by firms for this purpose.

Date	Particulars	L.F	Details ₹	Amount ₹

It is **important** to keep in mind that:

(i) **Cash purchases** are **not recorded in** the **Purchases Book**, as they are entered in the cash book.

(ii) **Credit purchases** of items **other than goods or materials**, such as office furniture or typewriters, are journalized and **not included in** the **Purchases Book**.

The "Particulars" column in the Purchases Book is intended to capture the supplier's name, the articles purchased, and their respective quantities. The individual amount for each article is entered in the "Details" column. After totaling the amounts for a specific purchase, additional charges like packing or other fees are added, while any trade discounts are deducted. The resulting net amount is recorded in the right-hand column. The total of this column represents the overall purchases made during a specific period.

POSTING THE PURCHASES BOOK

In the **Purchases Book,** the **names** of the **suppliers from whom goods were purchased on credit** are recorded. **These suppliers** are **considered as trade payable**s, **and their respective accounts** need to be **credited** with the amounts stated in the Purchases Book. The **total of the amounts column represents the overall purchases** made during a specific period. To indicate the receipt of goods, the corresponding amount is **debited to** the **Purchase Account.**

SALES BOOK

The Sales Book serves as a dedicated register to **document credit sales of goods** conducted by the firm. It is important to note that **cash sales are not recorded in the Sales Book** but instead entered in the Cash Book. Additionally, **credit sales of items other than the goods** dealt in by the firm are **not included in the Sales Book**; they are **recorded through journal entries**. The format and rules for recording entries in the Sales Book are similar to those of the Purchases Book.

Entries in the Sales Book follow a similar approach as in the Purchases Book. The "Particulars" column captures the customer's name, along with the details and quantities of the goods sold. The amount for each item is entered in the "Details" column. After summing up the amounts for a single sale, additional charges for packing, etc., are added, while any trade discounts are subtracted. The resulting net amount is recorded in the outer column. The total of this column represents the overall credit sales made during a specific period.

POSTING THE SALES BOOK

The **Sales Book contains** the **names of the parties** who have received the goods as recorded credit sales. To account for these transactions, the **respective parties' accounts need to be debited** with the corresponding amounts. The total indicated in the Sales Book represents the overall credit sales made during the specific period. This total amount is credited to the Sales Account for proper recording and tracking purposes.

SALES RETURNS BOOK OR RETURNS INWARD BOOK

In cases where **customers frequently return the goods they have purchased**, it is **beneficial to maintain a separate book** specifically designated for recording these returns. This book is commonly referred to as the Sales Returns Book or Returns Inward Book. The format and structure of this book follow a similar ruling as that of the Purchases Book or Sales Book, and the entries are made in a similar manner.

Illustration is given below:

Returns Inward Book

Date	Particulars	Details	L.F.	Amount

2021				
May 20	Kailash & Co.			
	5 registers			
	Accountancy book for class 12 @ ₹7	500.00		
	Less: Trade Discount 10%	(50)		450
	Ramesh & Co.			
	1 Accountancy book class 11			300
		Total		750

PURCHASE RETURNS OR RETURNS OUTWARD BOOK

To efficiently document the return of purchased goods or materials to the suppliers, a book specifically dedicated to this purpose is maintained. However, **if** such **returns are infrequent, it may be adequate to record the transactions in the journal.** The format and layout of the Purchase Returns or Returns Outward Book follow a similar ruling as that of the Purchase Book, and the entries are made in a similar manner. The provided illustration below demonstrates this process:

Returns Outward Book

Date 2020	Particulars	₹	Amount ₹
June 2	Tarun systems.		
	1 cooler		1700
	Ketan Electronics & Co.		
" 28	5 small fans		
	Less: Discount Total	700	
		(70)	630
			2330

POSTING OF THE RETURN BOOKS

The **Sales Return Book** provides a comprehensive **record of the total returns** made by customers. Typically, these returns are deducted from the sales. Ideally, **the amount should be debited to the Sales Account**. **However**, it is **common practice to open** a **separate account called a Returns Inward Account and debit the total of the sales returns to this account**. The **customers who have returned** the goods are then **credited** with the respective amounts.

It is **important to highlight** that when **goods** are **received** and accepted **back from customers**, a **credit note** is **issued to** the concerned **customers**, indicating the amount to be credited to their accounts.

Similarly, **when goods are returned to suppliers (i.e. Purchase Return)**, supplier's they issue a credit note, **while the firm returning the goods issues a debit note to the supplier**, stating the amount for which the supplier is liable due to the return.

The **total** displayed **in** the **Returns Outwards Book reflects** the **overall returns** made. **Although**

the amount can be credited to the Purchase Account, it is **common practice to credit it to** a **separate account known as the Purchase Returns or Returns Outward Account**. Since the suppliers mentioned in the book have received the goods, their accounts must be debited accordingly.

BILLS RECEIVABLE BOOKS AND BILLS PAYABLE BOOKS

In situations where the firm regularly receives a significant number of promissory notes or hundies, it is advantageous to document these transactions in a dedicated book known as the Bills Receivable Book. Similarly, if the firm frequently issues promissory notes or hundies, the Bills Payable Book serves as a convenient record.

IMPORTANCE OF JOURNAL

Students are already acquainted with the journal and its purpose. They understand that:

(i) Cash transactions are recorded in the cash book.

(ii) Credit purchases of goods or materials are documented in the purchases book.

(iii) Credit sales of goods are recorded in the sales book.

(iv) Returns from customers are documented in the sale returns book.

(v) Returns to suppliers are entered in the purchase returns book.

For bill transactions, they are entered in either the bills receivable book or the bills payable book if such records are maintained. Aside from the aforementioned transactions, there are additional entries that need to be recorded. In such cases, the appropriate place for recording them is the journal (proper).

The journal serves the following purposes:

(i) **Opening entries:** When commencing a new accounting year, the opening balances of assets and liabilities are recorded through journal entries.

(ii) **Closing entries:** At the end of the year, the profit and loss account needs to be prepared. To accomplish this, the nominal accounts are transferred to this account using closing entries.

(iii) **Rectification entries:** If an error has been made, it is corrected through a journal entry.

(iv) **Transfer entries:** When an amount needs to be transferred from one account to another, a journal entry is made to facilitate the transfer.

(v) **Adjusting entries:** Towards the end of the year, adjustments may be required for expenses or income relating to amounts received in advance or amounts not yet settled in cash. Such adjustments are made through journal entries. Typically, these entries pertain to the following:

- **(a) Outstanding expenses:** Expenses that have been incurred but not yet paid.
- **(b) Prepaid expenses:** Expenses paid in advance for a future period.
- **(c) Interest on capital:** Interest accrued on the owner's investment in the business.
- **(d) Depreciation:** The decline in the value of assets due to wear and tear. Journal entries are necessary for recording depreciation.

(vi) **Entries for dishonored bills:** If a person who accepted a promissory note (or bill) fails to make the payment on the due date, a journal entry is required to record the non-payment or dishonor.

(vii) **Miscellaneous entries:** Certain entries also need to be recorded in the journal, including:

(a) Credit purchases of items other than goods or materials used in production, such as furniture or machinery.

(b) Allowances or charges to customers after the issuance of an invoice.

(c) Receipt or issuance of promissory notes when separate bill books are not maintained.

(d) Recording an amount as irrecoverable, such as in the case of a customer becoming insolvent.

(e) Effects of accidents, such as loss of property due to fire.

(f) Transfer of net profit to the capital account.

In all these cases, journal entries are necessary to accurately record the transactions.

TEST YOUR KNOWLEDGE

True and False

1. The purchases recorded in the purchase book specifically pertain to credit transactions for the acquisition of goods.

Sol. **True:** As cash purchases are documented in the cash book, the purchases book exclusively captures credit transactions.

2. The purchase book is utilized to record transactions related to the acquisition of fixed assets.

Sol. **False,** The purchase book exclusively records credit purchases of goods and does not include transactions related to the purchase of fixed assets

3. Sales made in cash are shown in the sales book.

Sol. **False:** The sales book is used to record credit sales transactions

4. The purchase book is where the acquisition of second-hand machinery is recorded.

Sol. **False,** The purchase book does not include entries for the purchase of second-hand machinery.

5. The total amount from the sales return book is debited to the sales account.

Sol. **True:** As sales returns result in a reduction of the total sales value, they are debited in the sales account.

6. When sales occur regularly, they are recorded in the sales book to maintain a comprehensive record of the transactions.

Sol. **True:** In cases of high transaction volumes, subsidiary books such as the sales book are used to record the transactions.

MULTIPLE CHOICE QUESTIONS

1. In Purchases Book the record is in respect of

(a) Cash purchases.
(b) Credit purchases.
(c) All purchases.
(d) None of the above

Sol. (b) Credit purchases.

2. The Sales Returns Book records

(a) Sales return of goods.
(b) Returns of anything (goods/assets).
(c) Return of purchased goods.
(d) None of the above

Sol. (a) Sales return of goods.

3. The sales book forms an integral component of

(a) Journal.
(b) Ledger.
(c) Both (a) and (b)
(d) None of the above

Sol. (a) Journal.

4. The cumulative total of the Purchase Book for a specific week or month is transferred to

(a) Debit side of the Purchases Account.
(b) Debit side of the Sales Account.
(c) Credit side of the Purchases Account.
(d) None of the above

Sol. (a) Debit side of the Purchases Account.

5. Second hand machine purchased on credit will be recorded in the–

(a) Journal Proper
(b) Cash Book
(c) Purchase Book
(d) None of the above

Sol. (a) Journal Proper

THEORY QUESTIONS

1. In a business, what are the commonly used subsidiary books include?

Sol. In a typical business, the following subsidiary books are commonly utilized:

(i) Cash Book – to document cash receipts and payments, including bank transactions.

(ii) Purchases Book – to record credit purchases of goods or materials required for the business operations.

(iii) Purchase Returns Book – to note the returns of previously purchased goods or materials.

(iv) Sales Book – to record the sales of goods offered by the business.

(v) Sales Returns Book – to document returns made by customers.

(vi) Bills Receivable Book – to record the receipt of promissory notes or hundies from various parties.

(vii) Bills Payable Book – to record the issuance of promissory notes or hundies to other parties.

(viii) Journal (proper) - to record transactions that cannot be accommodated in the above-mentioned books.

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Unit-3: Journal Entries

DOUBLE ENTRY SYSTEM

The **double entry system of accounting has a rich history** dating back over 500 years, **with its origins attributed to Luca Pacioli;** Over time, the double entry system evolved from various accounting techniques, becoming the sole scientific approach to accounting.

This system revolves around the **principle** that every **financial transaction has dual implications** – a debit and a credit.

Both aspects must be recorded in the books of accounts, **resulting in at least two accounts being affected for each transaction.**

This systematic approach has helped in accurately documenting the financial affairs of various institutions that handle monetary transactions.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

This system offers several notable benefits:

1. It enables the **verification of accounting accuracy by use a trial balance,** ensuring precision in financial records.
2. It allows for the **determination of profits or losses** during a specific timeframe, accompanied by a breakdown of the relevant details.
3. The system facilitates the **assessment of the financial position (i.e. Networth)** of the firm or institution at the conclusion of each accounting period by preparing a balance sheet.
4. **Providing valuable data for managerial control** and other purposes as data can be maintained in detail
5. **Comparative analysis of yearly results** is possible, helping identify reasons for any fluctuations, and it is due to these advantages that this system has gained widespread adoption across all nations.

ACCOUNT

We have observed how the **accounting equation (i.e. Asset = Liability + Capital)** consistently holds true.

However, by maintaining Account (i.e. One Column on the left and One Column on the right) **we will get valuable insights**

Example:

Payments made for goods, salaries, and rent decrease the cash balance, while amount received from sales and customer payments increase it.

While it's **possible to adjust the cash balance with each** transaction, this approach can be unwieldy. A more efficient method involves categorizing all **transactions that increase the cash balance into one column and those that reduce into another.**

This allows us to calculate the net impact (i.e. closing balance) By summing up all the increases to the initial cash balance and then **subtracting the total of all decreases.** The two columns mentioned earlier are typically organized in what is commonly known as a 'T' account format.

To illustrate this concept, let's use hypothetical numbers as an example:

CASH

	Increase (Receipt) ₹		Decrease (Payment) ₹
Opening Balance (1)	5,00,000	(7)	50,000
(2)	1,25,000	(8)	1,50,000
(3)	1,00,000	(9)	1,00,000
(4)	2,50,000	(10)	2,50,000
(5)	67,500		
(6)	2,00,000	(11)	6,00,000
		New or Closing Balance	92,500
	12,42,500		12,42,500

As each T-account exclusively displays monetary amounts without transaction descriptions, we employ a method to uniquely identify each transaction, typically by assigning a numerical reference, as demonstrated in this example. However, one can also employ dates for this purpose.

In our approach, we record cash inflows on the left-hand side and outflows on the right-hand side of the T-account. To calculate the closing balance, we subtract the total of payments (amounting to 11,50,000) from the total on the left-hand side. This method of handling cash receipts and payments proves to be highly practical.

In our previous discussion, we focused solely on a single account, namely cash. Now, let's delve into the process of creating T-accounts when a transaction affects both assets and liabilities.

DEBIT AND CREDIT

In T-accounts, we've observed that entries signifying increases and decreases for assets are positioned on the left and right sides, respectively. Conversely, for liabilities, the arrangement is reversed. However, **accountants employ the terms "Debit" (Dr.) to signify an entry on the left side of any account and "Credit" (Cr.) to indicate an entry on the right side** of any account. It's important to note that the total assets minus the total liabilities yields the amount of capital, as indicated by the accounting equation.

Assets = Liabilities + Capital or

Assets – Liabilities = Capital

Alternatively we can say:

Assets = Liabilities + stockholders' Equity

Assets = Liabilities + (capital introduced + opening retained earnings + revenue – expense)

Here,

Capital Introduced	=	Capital introduced by the owner in the business.
Opening retained earnings	=	Accumulated earnings which were distributed to the owners of business.
Revenue	=	Money earned from business activities

Expenses = Money incurred for the business activities.

Furthermore, we've observed that any alteration on one side of the equation invariably results in a corresponding adjustment on the opposite side of the equation or among the elements encompassed by it, leading to a contrasting alteration on the same side of the equation. This principle is exemplified below:

Transactions	Total Assets ₹	= Liabilities ₹	+ Owner's Capital ₹
(1) Started business with cash 5,00,000	5,00,000		5,00,000
(2) Borrowed 2,50,000	+ 2,50,000	+ 2,50,000	
(3) Withdrew cash from business 1,00,000	– 1,00,000		– 1,00,000
(4) Loan repaid to the extent of 50,000	-50,000	– 50,000	
(5) Bought furniture worth ₹ 150,000 with	+1,50,000		
Cash	– 1,50,000		
Balance	**6,00,000**	**= 2,00,000**	**+ 4,00,000**

As mentioned earlier, the method described above is appropriate when dealing with a small number of transactions. However, when dealing with a large volume of transactions, it is beneficial to employ an alternative approach of segregating increases and decreases into distinct columns. This method also provides valuable insights. The transactions listed previously will now be presented below using this alternative method.

Total Assets		= Liabilities		+ Owner's Capital	
	Decrease	**Decrease**	**Increase**	**Decrease**	**Increase**
(1) 5,00,000					5,00,000
(2) 2,50,000			2,50,000		
(3)	1,00,000			1,00,000	
(4)	50,000	50,000			
Total 7,50,000	1,50,000	50,000	2,50,000	1,00,000	5,00,000
Balance 6,00,000			2,00,000		+ 4,00,000

It's a conventional practice that:

(i) Increments to assets are registered on the left-hand side, while reductions in assets are documented on the right-hand side.

(ii) In the context of liabilities and capital, expansions are recorded on the right-hand side, whereas contractions are noted on the left-hand side.

When both sides are organized into a T-shaped format, the left-hand side is commonly referred to as the 'debit side,' and the right-hand side is known as the 'credit side.' If a transaction is recorded on the debit or left-hand side of an account, it is said to be "debited," and similarly, recording an amount on the right-hand side is termed "credited."

The principles outlined above can be condensed as follows:

(i) Increase in assets are recorded as debits, while reductions are recorded as credits.

(ii) Increase in liabilities are recorded as credits, while reductions are recorded as debits.

(iii) Increase in owner's capital are recorded as credits, and reductions are recorded as debits.

(iv) Increase in expenses are recorded as debits, while reductions are recorded as credits.

(v) Increase in revenue or income are recorded as credits, and reductions are recorded as debits.

It's important to clarify that the terms "debit" and "credit" do not signify, respectively, positive or negative connotations. Instead, they solely represent the two sides of an account.

TRANSACTIONS

In the field of bookkeeping (i.e.recording), it is evident that transactions are meticulously **documented in financial records.** These transactions typically represent external events with quantifiable monetary values. Throughout an accounting period, **businesses encounter multiple transactions, which are evaluated in financial terms, and then individually recorded. Following Accounting, there is a process of classification and summarization to assess their impact on financial statements.**

A transaction is essentially a bilateral exchange where value is transferred from one party to another. In such exchanges, one party either receives value in the form of goods, services, or other items, and **reciprocally transfers value in the form of money or vice versa.** Thus, it is **evident that in transaction, one party both acquires and conveys value to another.**

To capture the dual aspects of each transaction, two distinct approaches can be employed:

(1) Accounting Equation Approach.

(2) Traditional Approach.

ACCOUNTING EQUATION APPROACH

The connection between a company's assets, liabilities, and owner's equity, as expressed in equation form, is referred to as the 'Accounting Equation.' The fundamental accounting equation becomes relevant when the combined total of capital and liabilities equals the value of assets. In this context, assets represent what the business possesses, while capital and liabilities denote the obligations and claims against the business.

Within the framework of the double-entry system, every business transaction has a dual impact on the enterprise. Each transaction induces changes in assets, liabilities, or capital in such a manner that the accounting equation remains balanced and in equilibrium. This accounting equation remains applicable at all times, regardless of the number of transactions and events, except in instances involving errors in the accounting process.

TRADITIONAL APPROACH

In the conventional method of documenting transactions, it is essential to grasp the concepts of debit and credit along with their associated principles. Transactions entered into the journal are registered solely according to the rules of debit and credit. To facilitate recording, these transactions are categorized into three groups:

(i) Personal transactions.

(ii) Transactions pertaining to assets and properties.

(iii) Transactions associated with expenses, losses, income, and gains.

CLASSIFICATION OF ACCOUNTS

(i) **Personal Accounts:** Personal accounts pertain to individuals, trade receivables, or trade payables. Examples include the account of Ram & Co., a credit customer, or the account of Jhaveri & Co., a supplier of goods. While the capital account is considered a personal account as it represents the proprietor, adjustments for profits and losses are made within it. Personal accounts can be further categorized into three types:

(a) **Natural personal accounts:** Transactions involving human beings like Ram, Rita, etc.

(b) **Artificial (legal) personal accounts:** Business entities are treated as separate entities for business purposes, recognized as legal persons for transactions. Examples include the Government, Companies (private or limited), Clubs, Co-operative societies, etc.

(c) **Representative personal accounts:** These are not named after specific individuals or organizations but are represented as personal accounts. Examples include outstanding liability accounts, prepaid accounts, capital accounts, and drawings accounts.

(ii) **Impersonal Accounts:** These accounts are not personal and include machinery accounts, cash accounts, rent accounts, etc. They can be further subdivided into:

(a) **Real Accounts:** Accounts related to the firm's assets but not debts, such as land, building, investments, fixed deposits, cash in hand, and cash at the bank.

(b) **Nominal Accounts:** Accounts related to expenses, losses, gains, revenue, etc., such as salary accounts, interest paid accounts, and commission received accounts. The net result of all nominal accounts is reflected as profit or loss, which is then transferred to the capital account. Nominal accounts are considered temporary

GOLDEN RULES OF ACCOUNTING

Each of the aforementioned categorized accounts is governed by two rules— one associated with Debit and one with Credit— for recording transactions. These rules, known as the golden rules of accounting, form the basis for recording transactions under the double-entry system.

Types of A/c	Account to be Debited	Account to be Credited
Personal A/c	The Receiver	The Giver
Real A/c	Whatever comes in	Whatever goes out
Nominal A/c	Expense and losses	Income and gains

MODERN CLASSIFICATION OF ACCOUNTS

(This is actually used widely also Accounting Standards are based on Modern Approach w.r.t Accounting Treatment)

The traditional classification of accounts includes real, nominal, and personal accounts. Now, let's explore the contemporary and widely accepted classification of accounts:

Types of account	Normal balance of a/c	A/c to be debited when there is:	A/c to be credited when there is:
Asset a/c	Dr	Increase	Decrease
Liabilities a/c	Cr	Decrease	Increase
Capital a/c	Cr	Decrease	Increase
Revenue a/c	Cr	Decrease	Increase
Expenditure a/c	Dr	Increase	Decrease
Withdraw a/c	Dr	Increase	Decrease

JOURNAL

Entries indicating which accounts should be debited and credited are initially recorded in this book.

The journal, also referred to as a subsidiary book, serves as the book of original entry where transactions are journaled daily in chronological order.

The process of recording transactions in the journal is known as journalizing the entries.

Journalising Process

Every transaction can be initially documented in the journal as it unfolds, ensuring a chronological record to maintain orderly and systematic records. Debits and credits, accompanied by relevant explanations, are outlined. There are primarily two types of journals:

1. General journal
2. Specialized journal

The latter is employed when numerous repetitive transactions of the same nature occur. The journal takes a specific form, as illustrated below:

JOURNAL

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

The columns have been marked with numbers solely for clarity in the following explanation, but they are not numbered otherwise. It's important to note the following points:

(i) The first column is designated for entering the date of the transaction, with the year at the top, followed by the month, and the specific date in the narrower part of the column.

(ii) The second column is utilized for listing the names of the accounts involved. Initially, the account to be debited is written, with the term "Dr" placed towards the end of the column. Subsequently, on the next line, leaving a small space, the name of the account to be credited is written, preceded by the term "To" (although modern practice often omits "Dr." and "To"). The subsequent line is dedicated to providing an explanation for the entry, along with necessary details—referred to as narration.

(iii) The third column is reserved for entering the page number in the ledger where the account is recorded.

(iv) In the fourth column, the amounts to be debited to the relevant accounts are recorded.

(v) The fifth column is used for entering the amounts to be credited to various accounts.

Considerations to be Taken Into Account When Recording a Transaction in the Journal

Journal entries can be either single entry (i.e., one debit and one credit) or compound entry (i.e., one debit and two or more credits, or two or more debits and one credit, or two or more debits and credits). In such instances, it is crucial to ensure that the total of both debits and credits is balanced.

When journal entries span multiple pages, it is necessary to calculate the total of each page's amount column. The balance should be noted at the end of that page, and the same total should be carried forward to the beginning of the next page.

A journal appears as follows:

			₹	₹
May 10	Bank Account	Dr.	29,00,000	
	To Mohan (Being the amount received from Mehak in payment of the amount due from him)			29,00,000

We will now consider some individual transactions.

Mehak starts the business with a deposit of 25,00,000 into the bank account. This indicates that the firm now holds 25,00,000 in the bank. Following the rules outlined earlier, the augmentation of an asset necessitates a debit entry. Concurrently, the firm now owes ₹ 25,00,000 to the proprietor, Mohan, as capital. As per the aforementioned rule, the escalation in capital should be credited. Hence, the journal entry will be:

Bank Account	Dr.	₹ 25,00,000	
To Capital Account (Being capital introduced by Shri Mehak)			₹ 25,00,000

From the aforementioned, 12,500 is extracted from the bank. Through this transaction, the bank balance is diminished by 12,500, and another asset, the cash account, is established. Following the principle of debiting for an increase in assets and crediting for a decrease, the journal entry will be:

Cash Account	Dr.	₹ 12,500	
To Bank Account			₹ 12,500
(Being cash deposited in Bank)			

(ii) Furniture is purchased for ₹ 6,00,000. Applying the same reasoning as above the entry will be:

Furniture Account	Dr.	₹ 6,00,000	
To Bank Account			₹ 6,00,000
(Being Furniture purchased vide CM No.)			

(iii) Purchased goods for cash ₹ 2,00,000. The student can see that the required entry is:

Purchases Account	Dr.	₹ 2,00,000	
To Bank Account			₹ 2,00,000
(Being goods purchased vide CM No.)			

(iv) Acquired goods on credit from M/s Raman Bros for 5,00,000. The acquisition of merchandise is considered an expense, necessitating a debit entry. A liability of 5,00,000 is now owed to the supplier; thus, their account should be credited to reflect the increase in liabilities. The journal entry will be:

Purchases Account	Dr.	₹ 5,00,000	
To M/s Raman.			₹ 5,00,000
(Being goods purchased vide Bill No.)			

(v) Sold goods to M/s Raja & Co. for ₹ 3,00,000. Payment received by cheque is recorded. The bank's balance increases, necessitating a debit entry, while the sale of merchandise is a revenue item and should be credited. The journal entry will be:

Bank Account	Dr.	₹ 3,00,000	
To Sales Account			₹ 3,00,000
(Being goods sold vide CM No.)			

(vi) Goods sold to Ramesh on credit for 6,50,000 are recorded. The inventory of goods decreases, requiring a credit entry to the goods account. Since Ramesh now owes 6,50,000, which is an asset, Ramesh should be debited. The journal entry is:

Ramesh	Dr.	₹ 6,50,000	
To Sales Account			₹ 6,50,000
(Being goods sold vide Bill No.)			

Note: Two perspectives exist regarding the classification of "Purchase Account" and "Sales Account." One viewpoint argues that they depict the "flow of goods," suggesting they should be categorized as 'Real Accounts.' Conversely, some assert that only nominal accounts are closed by transferring to the 'Trading or Profit and Loss Account.' Consequently, purchases and sales are deemed Nominal Accounts. Despite these perspectives, in both scenarios, Purchase Account holds a debit balance, while Sales Account maintains a credit balance.

(vii) Received cheque from Ramesh ₹ 6,50,000. The bank account should be debited since the bank balance has increased. In this case, Ramesh's liability to the firm has decreased, and he no longer owes any amount to the firm. This specific form of assets has vanished; consequently, the account of Ramesh needs to be credited. The entry is:

Bank Account	Dr.	₹ 6,50,000	
To Ramesh			₹ 6,50,000
(Being cash received against Bill No)			

(viii) Paid rent ₹ 50,000. The bank balance has diminished, so the bank account should be credited. As no new asset has been acquired, and the payment is for services enjoyed, which is an expense, the expense account should be debited. Hence, the entry should be:

Rent Account	Dr.	₹ 50,000	
To Bank Account			₹ 50,000
(Being rent paid for the month of)			

(ix) Paid ₹ 11,000 to the clerk as salary. Applying the reasons given in (x) above, the required entry is:

Salary Account	Dr.	₹ 11,000	
To Bank Account			₹ 11,000
(Being salary paid to Mr..... for the month of)			

(x) Received ₹ 1,10,000 interest. The bank account should be debited as there is a rise in the bank balance. Since there is no increase in any liability, and the amount is considered income, incomes are credited. The entry is:

Bank Account	Dr.	₹ 1,10,000	
To Interest Account			₹ 1,10,000
(Being interest received from…for the period)			

When transactions of a similar nature occur on the same date, they can be consolidated during the journalization process. For instance, entries (x) and (xi) may be merged as follows:

Rent Account	Dr.	₹ 50,000	
Salary Account	Dr.	₹ 11,000	
To Bank Account (Being expenses done as per detail attached)			₹ 61,000

When the journal entries for two or more transactions are consolidated, it is termed as a composite journal entry. In practice, business transactions are often so numerous that recording them for a month would occupy multiple pages in the journal. To streamline this process, at the end of one page, the totals of both columns are calculated and recorded with the phrase "Carried forward" in the particulars column. The subsequent page then commences with these respective totals, accompanied by the notation "Brought forward" in the particulars column.

ADVANTAGES OF JOURNAL

In the journal, transactions recorded using the double-entry system offer the following advantages:

1. The chronological order of recording transactions in the journal provides a comprehensive overview of business activities over time.
2. Each entry in the journal is accompanied by a narration, a concise explanation of the transaction. This narration ensures clarity and allows for the verification of entry accuracy.
3. The journal serves as the foundation for transferring entries to the ledger. This streamlined process simplifies the work of accountants and minimizes the likelihood of errors.

TEST YOUR KNOWLEDGE

True and False

1. In the accounting equation approach, capital + Long-term liabilities = fixed asset + current assets – current liabilities. **(ICAI Study Material)**

Sol. True – According to the contemporary accounting equation approach, it represents the fundamental formula in the accounting process.

2. In the traditional approach a debtor becomes receiver. **(ICAI Study Material)**

Sol. False – In the traditional approach, a debtor is considered a giver

3. *The rule of nominal account states that all expenses & losses are recorded on the credit side.* **(ICAI Study Material)**

Sol. False – *The rule for nominal accounts dictates that all expenses and losses are recorded on the debit side.*

4. *Journal proper is also called a subsidiary book.* **(ICAI Study Material)**

Sol. True – *It is a book where transactions not entered in other books are recorded.*

5. *Capital account has a debit balance.* **(ICAI Study Material)**

Sol. False: *Capital a/c has a Cr. balance*

6. *Purchase account is a nominal account.* **(ICAI Study Material)**

Sol. True – *It is considered an expense.*

7. *All the personal & real account are recorded in P&L A/c.* **(ICAI Study Material)**

Sol. False – *Only personal accounts are recorded in the balance sheet.*

8. *Asset side of the balance sheet contains all the personal & nominal accounts.* **(ICAI Study Material)**

Sol. False – *Asset side of the balance sheet contains real and personal accounts, not nominal accounts.*

9. *Capital account is a personal account.* **(ICAI Study Material)**

Sol. True: As it is in the name of the proprietor who is contributing capital to the business.

10. *Journal is also known as the book of original entry.* **(ICAI Study Material)**

Sol. True: As this book serves as the initial record where transactions are first entered.

MULTIPLE CHOICE QUESTION

1. The rent paid to landlord is credited to **(Modified ICAI Study Material)**
   (a) Landlord's account.
   (b) Rent account.
   (c) Bank account.
   (d) None of the above

Sol. (c) Bank account

2. In case of a debt becoming bad, the amount should be credited to **(ICAI Study Material)**
   (a) Trade receivables account.
   (b) Bad debts account.
   (c) Cash account.
   (d) None of the above

Sol. (a) Trade receivables account.

3. A Ltd. has a ₹ 35,000 account receivable from Mohan. On January 20, Mohan makes a partial payment of ₹ 21,000 to A Ltd. The journal entry made on January 20 by A Ltd. to record this transaction includes: **(ICAI Study Material)**

(a) A credit to the cash received account of ₹ 21,000.

(b) A credit to the Accounts receivable account of ₹ 21,000.

(c) A debit to the cash account of ₹ 14,000.

(d) None of the above

Sol. *(b) A credit to the Accounts receivable account of ₹ 21,000.*

4. *Which financial statement represents the accounting equation – Assets = Liabilities + Owner's equity:* **(ICAI Study Material)**

(a) Income Statement

(b) Statement of Cash flows

(c) Balance Sheet.

(d) None of the above

Sol. *(c) Balance Sheet.*

5. *Which account is the odd one out?* **(ICAI Study Material)**

(a) Office furniture & Equipment.

(b) Freehold land and Buildings.

(c) Inventory of materials.

(d) None of the above

Sol. *(c) Inventory of materials.*

6. *The debts written off as bad, if recovered subsequently are* **(ICAI Study Material)**

(a) Credited to Bad Debts Recovered Account

(b) Credited to Trade receivables Account.

(c) Debited to Profit and Loss Account.

(d) None of the above

Sol. *(a) Credited to Bad Debts Recovered Account*

7. *In Double Entry System of Book-keeping every business transaction affects:* **(Modified ICAI Study Material)**

(a) Minimum Two accounts

(b) Two sides of the same account.

(c) The same account on two different dates.

(d) Only Two Accounts

Sol. *(a) Two accounts*

8. *A sale of goods to Ram for cash should be debited to:* **(ICAI Study Material)**

(a) Ram

(b) Cash

(c) Sales

(d) None of the above

Sol. *(b) Cash*

THEORY QUESTIONS

1. Write a short note on classification of accounts. **(ICAI Study Material)**

Sol. Accounts are broadly categorized into assets, liabilities, and capital, as outlined in the basic accounting equation. The key classifications are as follows:

(i) Assets: These encompass resources controlled by the enterprise resulting from past events, expected to yield future economic benefits. Examples include cash, inventory, land, buildings, and machinery.

(ii) Liabilities: These denote financial obligations of the enterprise, excluding owner's equity, such as long-term loans, creditors, and outstanding expenses.

(iii) Capital: This generally refers to the amounts invested in the enterprise by its owner(s), inclusive of accretions or reductions. Due to the impact of expenses and incomes of a revenue nature on capital, two additional categories, expenses, and incomes, are recognized.

- Expenses: Representing amounts spent or lost in carrying out operations.
- Incomes: Reflecting revenue amounts earned by the enterprise.

In the traditional classification, accounts are categorized as follows:

(i) Personal Accounts: Associated with individuals, institutions, debtors, or creditors.

(ii) Impersonal Accounts: Accounts not of a personal nature, further divided into:

- Real Accounts: Relating to assets of the firm, excluding debts (e.g., accounts for land, buildings, and cash in hand).
- Nominal Accounts: Pertaining to expenses, losses, gains, revenues, etc.

2. Distinguish between Real account and nominal account. **(ICAI Study Material)**

Sol. A real account pertains to properties and assets, excluding personal accounts of the firm. Illustrations include land, buildings, machinery, cash, and investments. In contrast, nominal accounts are associated with expenses, losses, incomes, and gains, such as wages, salaries, rent, and depreciation. The cumulative outcome of all nominal accounts manifests as profit or loss, subsequently transferred to the capital account. Unlike nominal accounts, which are temporary, real accounts, including personal accounts, are presented in the balance sheet.

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Unit-4: Ledger Posting

INTRODUCTION

Once transactions are recorded in the journal, the recorded entries are organized and grouped by preparing accounts. The ledger, which comprises all the different types of accounts (such as personal, real, and nominal accounts), serves as the primary book of accounts. It is where the balance of each account is determined.

SPECIMEN OF LEDGER ACCOUNTS

A ledger account consists of two sides: the debit side (left part of the account) and the credit side (right part of the account). Each side is divided into four columns, namely: (i) Date, (ii) Description/Particulars, (iii) Journal folio (referring to the page number of the journal where the entries are recorded), and (iv) Amount.

Dr.			Account				Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount

POSTING

Posting is the term used to describe the process of transferring the debit and credit entries from the journal to their respective accounts in the ledger.

RULES REGARDING POSTING OF ENTRIES IN THE LEDGER

1. A separate account is created in the ledger book for each account, and entries from the ledger are posted to their respective accounts accordingly.
2. It is customary to use the words 'To' and 'By' when posting transactions in the ledger. The word 'To' is used in the particular column for accounts on the debit side, while 'By' is used for accounts on the credit side. These terms are used to indicate the account being debited or credited.
3. The account that is debited in the journal should also be debited in the ledger, with reference to the corresponding credit account.

4. BALANCING AN ACCOUNT

At the end of each month, year, or a specific day, it may be necessary to determine the balance in an account. This can be done by totaling the debit and credit sides and calculating the difference, which represents the balance. If the credit side is larger than the debit side, it indicates a credit balance. Conversely, if the debit side is larger, it indicates a debit balance.

TEST YOUR KNOWLEDGE

True and False

1. Furniture account has a debit balance.

Sol. True, Furniture is an asset and it shows a debit balance.

2. Posting involves the transfer of account information from the ledger to the journal.

Sol. False: Posting is the process of transferring the recorded transactions from the journal to their respective accounts in the ledger.

3. At the end of the accounting year, the balances of all the nominal accounts in the ledger book are carried forward to next year.

Sol. False, At the end of the accounting year, the balances of all the nominal accounts in the ledger book are calculated and transferred to the Trading A/c or Profit & Loss Account.

4. The ledger organizes the transactions in a sequential manner, capturing the chronological sequence of events.

Sol. False, The ledger arranges the transactions in an analytical order, providing a structured representation of financial information. In contrast, the journal records the transactions in a chronological order, capturing the sequential occurrence of events.

MULTIPLE CHOICE QUESTIONS

1. The process of transferring the debit and credit items from a Journal to their respective accounts in the ledger is known as

(a) Posting (b) Purchase

(c) Balancing of an account (d) None of the above

Sol. (a) Posting

2. The process of determining the net balance of an account by considering the total debits and credits recorded in the account is referred to as

(a) Posting (b) Purchase

(c) Balancing of an account (d) None of the above

Sol. (c) Balancing of an account

3. The commonly used term for the ledger is

(a) Secondary book of accounts (b) Principal book of accounts

(c) Subsidiary book of accounts (d) None of the above

Sol. (b) Principal book of accounts

4. A positive balance in a personal account indicates

(a) Amount payable (b) Amount Receivable

(c) Cash balance (d) None of the above

Sol. (b) Amount Receivable

5. When the sum of debits in an account exceeds the sum of credits, it is referred to as

(a) Debit balance
(b) Expenses
(c) Credit balances
(d) Income

Sol. (a) Debit Balance

6. A Debit balance of nominal account indicates:
(a) Income
(b) Expenditure
(c) Profit
(d) Liability

Sol. (b) Expenditure

7. Which of the following accounts consistently exhibits a credit balance?
(a) Carriage inward
(b) Carriage outward
(c) Sales Return
(d) Purchase Return

Sol. (d) Purchase Return

8. Received ₹44,950 from Gauri in full settlement of ₹45,000. Posting of ₹50 will be made to the:
(a) Dr side of Discount A/c
(b) Cr side of discount A/c
(c) Dr side of Gauri A/c
(d) Cr side of Gauri A/c

Sol. (a) Dr side of Discount A/c

9. The closing balance of a ledger account is known as:
(a) Balance brought down
(b) Balance carried down
(c) Balance carry forward
(d) None of the above

Sol. (b) Balance carried down (i.e. Bal. c/d)

10. _____ helps in preparing Trial balance.
(a) Journal
(b) Ledger
(c) Cash flow statement
(d) None of the above

Sol. (b) Ledger

11. The balance of Rent account (at the end of financial year) will be transferred to:
(a) Balance sheet
(b) Profit and loss account
(c) Bank Account
(d) Trading account

Sol. (b) Profit and loss account

12. The proprietor of the business withdrew goods from the business for personal use. This transaction will be recorded in the _____
(a) Credit of drawings A/c
(b) Debit of Purchases A/c
(c) Credit of purchases A/c
(d) None of the above

Sol. (c) Credit of purchases A/c

THEORETICAL QUESTIONS

1. What is the definition of "principal books of accounts"?

Sol. The ledger is commonly referred to as the primary accounting record that comprehensively captures and organizes all transaction details related to individual accounts. It serves as a comprehensive repository for various types of accounts, including personal, real, and nominal accounts, providing a complete record of financial activities.

2. What guidelines should be followed when posting journal entries to the Ledger?

Sol. a. Each account is allocated a separate section in the ledger book, and entries from the journal are posted to their respective accounts accordingly.

b. When posting transactions in the ledger, it is customary to use the terms 'To' and 'By'. 'To' is used in the specific column for accounts on the debit side, while 'By' is used for accounts on the credit side. These terms, although without intrinsic meaning, indicate the account being debited or credited.

c. The account that is debited in the journal should also be debited in the ledger, but with reference to the corresponding credit account.

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Unit-5: Trial Balance

INTRODUCTION

The **creation of a trial balance marks the third step in the accounting process.** After ledger entries have been recorded, a statement is generated to display the debit and credit balances separately. This statement is known as the trial balance. It can be compiled by either listing each individual account and recording the totals of the debit and credit sides in separate columns or by simply displaying the totals of both sides.

Regardless of the method used, the key is for the totals of the two columns to match. This balance indicates the accuracy of the arithmetic calculations in the accounting work. If the two sides don't align, it suggests the presence of arithmetic errors.

This arises from the fundamental principle of the Double Entry System, where the amount on the debit side of one account always equals the amount on the credit side of another account, and vice versa. As a result, the total of debit side entries should equal the total of credit side entries, and the sum of debit balances should match the sum of credit balances.

Although such an **agreement provides a reasonable degree of confidence that the accounting work is devoid of clerical errors, it doesn't guarantee 100% accuracy, as certain errors of principle or compensating errors may still exist.** Typically, to verify the arithmetic accuracy of accounts, a trial balance is compiled at regular intervals, such as monthly. Nevertheless, **because of the double entry system's nature, a trial balance can be created at any time.**

Despite the flexibility in its preparation timing, it is advisable to prepare a trial balance at the end of the reporting period, which could be the end of a month, quarter, or year. This ensures that all accounts are arithmetically accurate before the financial statements are prepared. It's important to note that a trial balance is a statement, not an account.

OBJECTIVES OF PREPARING THE TRIAL BALANCE

The preparation of a trial balance serves several key purposes:

(i) **Verification of Accuracy:** The trial balance plays a crucial role in confirming that posting and other accounting procedures have been executed without making arithmetic errors. Essentially, it serves as a tool for establishing the mathematical precision of the accounting records.

(ii) **Basis for Financial Statements:** Financial statements are typically crafted based on a reconciled trial balance. Without a balanced trial balance, the resulting financial statements may not accurately represent the true and equitable state of financial transactions.

(iii) **Ledger Summary:** The trial balance acts as a concise summary of the information stored in the ledger. This means that one may only need to consult the ledger for specific details concerning an account when necessary, as the trial balance provides a high-level overview of the ledger's contents.

The format of the trial balance is given below:

Trial Balance

S.No	Account Name	Dr. (Amt)	Cr. (Amt)
		₹	₹

Please take note of the following aspects:

(i) **Trial Balance Date:** A trial balance is compiled with reference to a specific date, and this date should be clearly indicated at the top.

(ii) **Account Name Entry:** The name of the account is recorded in the second column.

(iii) **Debit Side Total:** The total of the debit side of the respective account, or any debit balance, is placed in the third column.

(iv) **Credit Side Total:** In the fourth column, the total of the credit side or the credit balance is documented.

(v) **Column Totals:** The sums in the third and fourth columns are calculated and summarized at the end.

LIMITATIONS OF TRIAL BALANCE

It's essential to understand that the concurrence of a Trial Balance does not provide absolute confirmation of accuracy. Put differently, even if the trial balance aligns, certain errors may persist. These errors can fall into the following categories:

1. **Omission of a Transaction:** Some transactions may not have been recorded in the journal at all.
2. **Incorrect Amount Entry:** Errors may occur where incorrect amounts have been recorded in both the debit and credit columns of the journal.
3. **Wrong Account Identification:** In some cases, an incorrect account may have been specified in the journal.
4. **Missed Ledger Posting:** An entry might not have been posted to the ledger at all.
5. **Duplicate Ledger Posting:** On occasion, an entry may have been mistakenly posted twice in the ledger.

Nevertheless, despite these potential errors, the creation of a trial balance remains highly valuable. Without it, the process of preparing financial statements would become significantly more challenging.

METHODS OF PREPARATION OF TRIAL BALANCE

1. TOTAL METHOD

In this approach, **every ledger account is summed up,** and the **combined total,** encompassing **both the debit and credit sides, is transferred to the trial balance.**

The **advantage** of this method is that the **trial balance can be prepared as soon as the ledger account is tallied. This expedites the process, saving time** that would otherwise be spent balancing the ledger accounts separately. The discrepancy between the totals of each ledger account represents the balance of that specific account.

However, it's important to note that **this method is not widely employed** <u>because the preparation of financial statements typically requires only the net balance</u> of the ledger account. Consequently, the trial balance generated using this method cannot be directly utilized for crafting financial statements.

BALANCE METHOD (This is widely Followed)

In this method, **each ledger account is reconciled, and only the resulting (net) balances are transferred to the trial balance.** This approach is frequently employed by accountants and serves as a crucial step in preparing financial statements. The balances of the ledger accounts form the basis for crafting these financial statements.

TOTAL AND BALANCE METHOD

In this approach, we amalgamate the two methods described earlier. To illustrate this hybrid method, we'll provide an example below-

Trial Balance of X as at 31.03.2022

S.No.	Account	Dr Balance (₹)	Cr Balance (₹)	Dr Total (₹)	Cr Total (₹)
1.	Cash A/c	15,000		71,000	56,000
2.	Furniture A/c	6,000		6,000	
3.	Salaries A/c	5,000		5,000	
4.	Shyam's A/c		7,000	43,000	50,000
5.	Purchase A/c	13,000		52,000	
6.	Purchase Returns A/c		1,000		1,000
7.	Ram's A/c	9,800		60,000	50,200
8.	Sales A/c		61,000		61,000
9.	Sale Returns A/c	200			
10.	Capital		19,000	1,000	20,000
	Total	**88,000**	**88,000**	**2,38,2000**	**2,38,200**

ADJUSTED TRIAL BALANCE (THROUGH SUSPENSE ACCOUNT)

In cases where the trial balance fails to reconcile, even after transferring the balances of all ledger accounts, including cash and bank balances, and when errors remain undiscovered within a reasonable timeframe, the difference between the debit and credit sides is shifted to a designated account called the "suspense account." This serves as a temporary account established to facilitate further processing and ensure the timely preparation of financial statements.

RULES OF PREPARING THE TRIAL BALANCE

When constructing the trial balance using the provided ledger balances, it's important to adhere to the following guidelines:

1. Debit Column:
    - Place the balances of all (i) asset accounts, (ii) expenses accounts, (iii) losses, and (iv) drawings in the debit column of the trial balance.
2. Credit Column:
    - Position the balances of all (i) liabilities accounts, (ii) income accounts, (iii) gains, and (iv) capital in the credit column of the trial balance.

TEST YOUR KNOWLEDGE

True and False

1. Preparing trial balance is the third phase of the accounting process **(ICAI Study Material)**

Sol. True: The creation of a trial balance represents the third step in the accounting process and serves as the foundation upon which the final accounts are prepared.

2. Trial balance forms a base for the preparation of a Financial statement. **(ICAI Study Material)**

Sol. True: We can prepare financial statements solely relying on the trial balance.

3. Agreement of trial balance is a conclusive proof of accuracy. **(ICAI Study Material)**

Sol. False: The alignment of the trial balance signifies solely mathematical precision; however, errors may persist in its compilation.

4. A trial balance will tally in case of compensating errors. **(ICAI Study Material)**

Sol. True: The reason why the trial balance balances is that compensating errors, characterized by their offsetting monetary values, effectively neutralize each other.

5. A trial balance can find the missing entry from the journal. **(ICAI Study Material)**

Sol. False: A trial balance is incapable of detecting a journal entry that has been omitted or left out.

6. Suspense account opened in a trial balance is a permanent account. **(ICAI Study Material)**

Sol. False: The suspense account created within a trial balance is a provisional or temporary account.

7. The balance of the purchase returns account has a credit balance.**(ICAI Study Material)**

Sol. True: When purchases are recorded as debits, returns are entered with credits (treated inversely

MULTIPLE CHOICE QUESTIONS

1. A trial balance will not balance if __________ **(ICAI Study Material)**

   (a) Correct journal entry is posted twice.

   (b) The purchase on credit basis is debited to purchases and credited to cash.

   (c) Rs.500 cash payment to creditor is debited to Trade payables for Rs.50 and credited to cash as Rs.500.

   (d) None of the above.

Sol. (c) Rs.500 cash payment to creditor is debited to Trade payables for ₹50 and credited to cash as Rs.500.

2. ₹1,500 received from the sub-tenant for rent and entered correctly in the cash book is posted to the debit of the rent account. In the trial balance ________ **(ICAI Study Material)**

   (a) The debit total will be greater by ₹3,000 than the credit total.

   (b) The debit total will be greater by ₹1,500 than the credit total.

   (c) Subject to other entries being correct the total will agree.

   (d) None of the above

Sol. **(a) The debit total will be greater by ₹3,000 than the credit total.**

3. After the preparation of ledgers, the next step is the preparation of **(ICAI Study Material)**

   (a) Trading accounts (b) Trial balance

   (c) Profit and loss account (d) None of the above

Sol. (b) Trial balance

4. After preparing the trial balance the accountant finds that the total of debit side is short by Rs.1,500. This difference will be **(ICAI Study Material)**

   (a) Credited to suspense account

   (b) Debited to suspense account

   (c) Adjusted to any of the debit balance account

   (d) None of the above

Sol. (b) Debited to suspense account

THEORETICAL QUESTIONS

1. What is the trial balance? And how is it prepared? **(ICAI Study Material)**

Sol. The creation of a trial balance represents the third stage in the accounting process. Following the ledger entries, a statement is generated to distinctly display the debit and credit balances, known as the trial balance. This trial balance compiles multiple ledger balances as of a specific date and serves as the groundwork for constructing financial statements, including the profit and loss account and balance sheet. If it reconciles, it signifies that the accounts are arithmetically precise; however, some errors might remain undiscovered. Hence, it is of utmost importance to meticulously record and post entries, adhering to the principles of accounting.

2. Explain objectives of preparation of trial balance. **(ICAI Study Material)**

Sol. The process of preparing a trial balance serves several key purposes:

Validation of Arithmetic Accuracy: The trial balance aids in confirming that posting and other accounting procedures have been executed without any arithmetic errors, essentially establishing the mathematical precision of the accounting records.

Foundation for Financial Statements: Financial statements are typically created using an agreed-upon trial balance as their basis.

Ledger Summary: The trial balance functions as a concise summary of the contents within the ledgers, providing a high-level overview of the financial records.

3. Even if the trial balance agrees, some errors may remain. Do you agree? Explain.

(ICAI Study Material)

Sol. Even though the trial balance may reconcile, certain errors could still persist. These errors may fall into the following categories:

1. **Omission of a Transaction:** Some transactions may not have been recorded in the journal at all.
2. **Incorrect Amount Entry:** Errors may occur when incorrect amounts are recorded in both the debit and credit columns of the journal.
3. **Incorrect Account Identification:** In some cases, an incorrect account may have been specified in the journal.
4. **Missed Ledger Posting:** An entry might not have been posted to the ledger at all.
5. **Duplicate Ledger Posting:** Occasionally, an entry may have been mistakenly posted twice in the ledger.

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