



ACCOUNTING PROCESS



UNIT 1 : BASIC ACCOUNTING PROCEDURES - JOURNAL ENTRIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand meaning and significance of Double Entry System.
- ◆ Familiarize with the term 'account' and understand the classification of accounts into personal, real and nominal.
- ◆ Note the utility of such classification and sub-classifications.
- ◆ Understand how debits and credits are determined from transactions and events.
- ◆ Observe the points to be taken care of while recording a transaction in the journal .

UNIT OVERVIEW



Source Documents

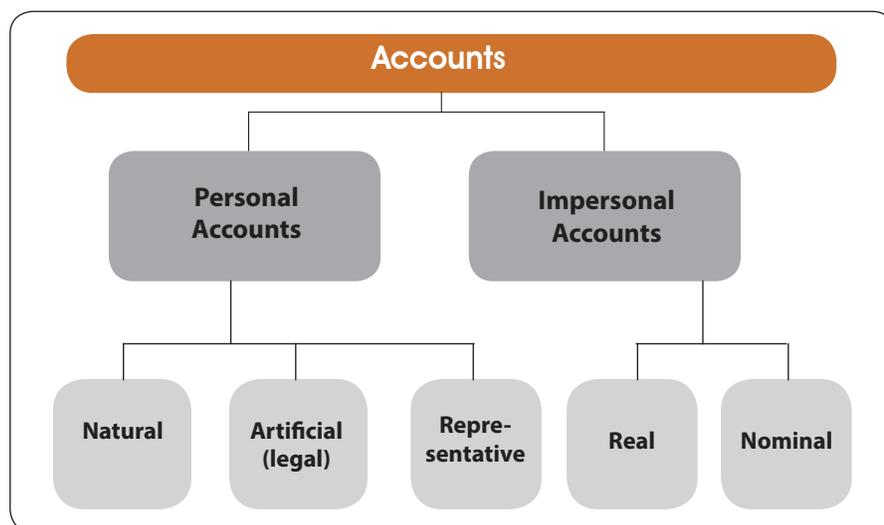
- All documents in books which contain financial records and act as evidence of transactions.

Books of original entry and Ledger Accounts

- Purchase day book, Cash book, Sales day book and Purchases return book
- Accounts where information relating to a particular asset/ liability, capital , income and expenses are recorded.

Trial Balance

- It contains the totals from various ledger accounts and act as preliminary check on accounts before producing final accounts.



1.1 DOUBLE ENTRY SYSTEM

Double entry system of accounting is more than 500 years old. "Luca Pacioli" an Italian friar & mathematician published *Summa de Arithmetica, Geometria, Proportioni, et Proportionalita* ("Everything about Arithmetic Geometry and proportions"). The first book that described a double entry accounting system. Double entry system of book-keeping has emerged in the process of evolution of various accounting techniques. It is the only scientific system of accounting. According to it, every transaction has two-fold aspects—debit and credit and both the aspects are to be recorded in the books of accounts. Therefore, in every transaction at least two accounts are effected.

For example, on purchase of furniture either the cash balance will be reduced or a liability to the supplier will arise. and new asset furniture is acquired. This has been made clear already, the Double Entry System records both the aspects. It may be defined as the system which recognises and records both the aspects of transactions. This system has proved to be systematic and has been found of great use for recording the financial affairs for all institutions requiring use of money.

1.2 ADVANTAGES OF DOUBLE ENTRY SYSTEM

This system affords the under mentioned advantages:

- (i) By the use of this system the accuracy of the accounting work can be established, through the device of the trial balance.
- (ii) The profit earned or loss suffered during a period can be ascertained together with details.
- (iii) The financial position of the firm or the institution concerned can be ascertained at the end of each period, through preparation of the balance sheet.
- (iv) The system permits accounts to be kept in as much details as necessary and, therefore affords significant information for the purposes of control etc.
- (v) Result of one year may be compared with those of previous years and reasons for the change may be ascertained.

It is because of these advantages that the system has been used extensively in all countries.

1.3 ACCOUNT

We have seen how the accounting equation becomes true in all cases. A person starts his business with say, ₹ 10,00,000; capital and cash are both ₹ 10,00,000. Transactions entered into by the firm will alter the cash balance in two ways, one will increase the cash balance and other will reduce it. Payment for goods purchased, for salaries and rent, etc., will reduce it; sales of goods for cash and collection from customers will increase it.

We can change the cash balance with every transaction but this will be cumbersome. Instead it would be better if all the transactions that lead to an increase are recorded in one column and those that reduce the cash balance in another column; then the net result can be ascertained. If we add all increases to the opening balance of cash and then deduct the total of all decreases we shall know the closing balance. In this manner, significant information will be available relating to cash.

The two columns which we referred above are put usually in the form of an account, called the 'T' form. This is illustrated below by taking imaginary figures:

Cash

| | Increase (Receipt) ₹ | | Decrease (Payment) ₹ |
|---------------------|----------------------------|------------------------|----------------------------|
| Opening Balance (1) | 10,00,000 | (7) | 1,00,000 |
| (2) | 2,50,000 | (8) | 3,00,000 |
| (3) | 2,00,000 | (9) | 2,00,000 |
| (4) | 5,00,000 | (10) | 5,00,000 |
| (5) | 1,35,000 | | |
| (6) | 4,00,000 | (11) | 12,00,000 |
| | | New or Closing Balance | 1,85,000 |
| | 24,85,000 | | 24,85,000 |

Since, each T-account shows only amounts and not transaction descriptions, we key each transaction in some way, such as by numbering used in this illustration. However, one can use date also for this purpose.

What we have done is to put the increase of cash on the left hand side and the decrease on the right hand side; the closing balance has been ascertained by deducting the total of payments, ₹ 23,00,000 from the total of the left - hand side. Such a treatment of receipts and payments of cash is very convenient.

Here we talked about only one account namely cash, now let us see how to make T-accounts when asset as well as liabilities are effected from a particular transaction.

Now, let us take some more examples:-

Transaction 1 :

Initial investment by owners ₹ 25,00,000 in cash.

This will effect two accounts namely cash and capital. The asset cash increases and the stock holders' equity paid up capital also increases.

CASH

| | Increase | | Decrease |
|-----|-----------|--|----------|
| (1) | 25,00,000 | | |

CAPITAL

| | Decrease | | Increase |
|--|----------|-----|-----------|
| | | (1) | 25,00,000 |

Transaction 2:-

Paid cash to the creditors ₹ 14,00,000

This will effect cash account which will decrease and creditors account which is a liability will also decrease.

CASH

| | Increase | | Decrease |
|--|----------|-----|-----------|
| | | (2) | 14,00,000 |

CREDITORS

| | Decrease | | Increase |
|-----|-----------|--|----------|
| (2) | 14,00,000 | | |

The proper form of an account is as follows:

Account

| Date | Particulars | Ref. | Amount | Date | Particulars | Ref. | Amount |
|------|-------------|------|--------|------|-------------|------|--------|
| | | | | | | | |

The columns are self-explanatory except that the column for reference (Ref.) is meant to indicate the sources where information about the entry is available.

**1.4 DEBIT AND CREDIT**

We have seen that in T-accounts increase and decrease entries are made on the left and right side of the accounts for assets respectively and vice-versa for liabilities. But, formally accountants use the term Debit (Dr.) to denote an entry on the left side of any account and Credit (Cr.) to denote an entry on the right side of any account.

We know that by deducting the total of liabilities from the total of assets the amount of capital is ascertained, as is indicated by the accounting equation.

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

or

$$\text{Assets} - \text{Liabilities} = \text{Capital}$$

To understand the equation better, let us expand it:-

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$



$$\text{Assets} = \text{Liabilities} + (\text{contributed capital} + \text{beginning retained earnings} + \text{revenue} - \text{expense} - \text{dividends})$$

Here,

| | | |
|-----------------------------|---|---|
| Contributed capital | = | the original capital introduced by the owner. |
| Beginning retained earnings | = | previous earnings not distributed to the shareholders. |
| Revenue | = | generated from the ongoing activities of the business |
| Expenses | = | cost incurred for the operations of the company. |
| Dividends | = | earnings distributed to the shareholders of the company |

We have also seen that if there is any change on one side of the equation, there is bound to be similar change on the other side of the equation or amongst items covered by it or an opposite change on the same side of the equation. This is illustrated below:

| Transactions | Total Assets ₹ | = Liabilities ₹ | + Owner's Capital ₹ |
|---|-------------------|--------------------|------------------------|
| (1) Started business with cash ₹ 10,00,000 | 10,00,000 | | 10,00,000 |
| (2) Borrowed ₹ 5,00,000 | + 5,00,000 | + 5,00,000 | |
| (3) Withdrew cash from business ₹ 2,00,000 | - 2,00,000 | | - 2,00,000 |
| (4) Loan repaid to the extent of ₹ 1,00,000 | - 1,00,000 | - 1,00,000 | |
| Balance | 12,00,000 | = 4,00,000 | + 8,00,000 |

As has been seen previously, what has been given above is suitable only if the number of transactions is small. But if the number is large, a different procedure of putting increases and decreases in different columns will be useful and this will also yield significant information. The transactions given above are being shown below according to this method.

| Total Assets | | = Liabilities | | + Owner's Capital | |
|--------------------------|-----------------|-----------------|-----------------|-------------------|-------------------|
| | Decrease ₹ | Decrease ₹ | Increase ₹ | Decrease ₹ | Increase ₹ |
| (1) 10,00,000 | | | | | 10,00,000 |
| (2) 5,00,000 | | | 5,00,000 | | |
| (3) | 2,00,000 | | | 2,00,000 | |
| (4) | 1,00,000 | 1,00,000 | | | |
| Total 15,00,000 | 3,00,000 | 1,00,000 | 5,00,000 | 2,00,000 | 10,00,000 |
| Balance 12,00,000 | | | 4,00,000 | | + 8,00,000 |

It is a tradition that:

- (i) increases in assets are recorded on the left-hand side and decreases in them on the right-hand side; and
- (ii) in the case of liabilities and capital, increases are recorded on the right-hand side and decreases on the left-hand side.

When two sides are put together in T form, the left-hand side is called the 'debit side' and the right hand side is 'credit side'. When in an account a record is made on the debit or left-hand side, one says that one has debited that account; similarly to record an amount on the right-hand side is to credit it.

From the above, the following rules can be obtained:

- (i) When there is an increase in the amount of an asset, its account is debited; the account will be credited if there is a reduction in the amount of the asset concerned : Suppose a firm purchases furniture for ₹ 8,00,000 the furniture account will be debited by ₹ 8,00,000 since the asset has increased by this amount. Suppose later the firm sells furniture to the extent of ₹ 3,00,000 the reduction will be recorded by crediting the furniture account by ₹ 3,00,000.

FURNITURE

| | Increase | | Decrease |
|-----|-----------------|---------|-----------------|
| (1) | 8,00,000 | (2) | 3,00,000 |
| | | Balance | 5,00,000 |

- ii) If the amount of a liability increases, the increase will be entered on the credit side of the liability account, i.e. the account will be credited: similarly, a liability account will be debited if there is a reduction in the amount of the liability. Suppose a firm borrows ₹ 5,00,000 from Mohan; Mohan's account will be credited since ₹ 5,00,000 is now owing to him. If, later, the loan is repaid, Mohan's account will be debited since the liability no longer exists.

MOHAN

| | Decrease | | Increase |
|-----|-----------------|-----|-----------------|
| (2) | 5,00,000 | (1) | 5,00,000 |

- (iii) An increase in the owner's capital is recorded by crediting the capital account: Suppose the proprietor introduces additional capital, the capital account will be credited. If the owner withdraws some money, i.e., makes a drawing, the capital account will be debited.
- (iv) Profit leads to an increase in the capital and a loss to reduction: According to the rule mentioned in (iii) above, profit & incomes may be directly credited to the capital account and losses & expenses may be similarly debited.

However, it is more useful to record all incomes, gains, expenses and losses separately. By doing so, very useful information will be available regarding the factors which have contributed to the year's profits and losses. Later the net result of all these is ascertained and adjusted in the capital account.

- (v) Expenses are debited and Incomes are credited: Since incomes and gains increase capital, the rule is to credit all gains and incomes in the accounts concerned and since expenses and losses decrease capital, the rule is to debit all expenses and losses. Of course, if there is a reduction in any income or gain, the account concerned will be debited; similarly, for any reduction in an expenses or loss the concerned account will be credited.

The rules given above are summarised below:

- (i) Increases in assets are debits; decreases are credits;
- (ii) Increases in liabilities are credits; decreases are debits;
- (iii) Increases in owner's capital are credits; decreases are debits;
- (iv) Increases in expenses are debits; decreases are credits; and
- (v) Increases in revenue or incomes are credits; decreases are debits.

The terms debit and credit should not be taken to mean, respectively, favourable and unfavourable things. They merely describe the two sides of accounts.

ILLUSTRATION 1

Following are the transactions entered into by R after he started his business. Show how various accounts will be affected by these transactions:

| 2017 April | | (₹ in 000) |
|---------------|----------------------------|------------|
| 1. | R started business with | 5,000 |
| 2. | He purchased furniture for | 1,200 |
| 3. | Paid salary to his clerk | 1,100 |
| 4. | Paid rent | 1,150 |
| 5. | Received interest | 2,000 |

SOLUTION

| 2017 April | Explanation | Accounts Involved | Nature of Accounts | How affected | Debit (₹ in 000) | Credit (₹ in 000) |
|---------------|-------------------------------------|----------------------|--------------------|------------------------|---------------------|----------------------|
| 1. | ₹ 5,000 cash invested in business | Bank and R's Capital | Asset Capital | Increased Increased | 5,000 | 5,000 |
| 2. | Purchased furniture for ₹ 1,200 | Furniture and Bank | Asset Asset | Increased Decreased | 1,200 | 1,200 |
| 3. | Paid ₹ 1,100 to employee for salary | Salary & Bank | Expense Asset | Increased Decreased | 1,100 | 1,100 |
| 4. | Paid Rent ₹ 1,150 | Rent & Bank | Expense Asset | Increased Decreased | 1,150 | 1,150 |
| 5. | Received interest ₹ 2,000 | Cash & Interest | Asset Income | Increased Increased | 2,000 | 2,000 |

1.5 TRANSACTIONS

In the system of book-keeping, students can notice that transactions are recorded in the books of accounts. A transaction is a type of event, which is generally external in nature and can be determined in terms of money. In an accounting period, every business has huge number of transactions which are analysed in financial terms and then recorded individually, followed by classification and summarisation process, to know their impact on the financial statements. A transaction is a two way process in which value is transferred from one party to another. In it either a party receives a value in terms of goods etc. and passes the value in terms of money or vice versa. Therefore, one can easily make out that in a transaction, a party receives as well as passes the value to other party. For recording transaction it is very important that they are supported by a substantial document like purchasing invoices, bills, pay-slips, cash-memos, passbook etc.

Transactions analysed in terms of money and supported by proper documents are recorded in the books of accounts under double entry system. To analyse the dual aspect of each transaction, two approaches can be followed:

- (1) Accounting Equation Approach.
- (2) Traditional Approach.

1.6 ACCOUNTING EQUATION APPROACH

The relationship of assets with that of liabilities and owners' equity in the equation form is known as 'Accounting Equation'. Basic accounting equation comes into picture when sum total of capital and liabilities equalises assets, where assets are what the business owns and capital and liabilities are what the business owes. Under double entry system, every business transaction has two-fold effect on the business enterprise where each transaction affects changes in assets, liabilities or capital in such a way that an accounting equation is completed and equated. This accounting equation holds good at all points of time and for any number of transactions and events except when there are errors in accounting process.

Let us suppose that an individual started business by contributing ₹ 50,00,000 and taking loan of ₹10,00,000 from a bank to be repayable, after 5 years. He purchased furniture costing ₹ 10,00,000, and merchandise worth ₹ 50,00,000. For purchasing the merchandise he paid ₹ 40,00,000 to the suppliers and agreed to pay balance after 3 months. Assume that all these transactions and events occurred at to, base point of time.

The contribution by the owner is termed as capital; the borrowings are termed as loans or liabilities. Whenever the loan is repayable in the short-run, say within one year, it is called short-term loan or liability. On the other hand, if the loan is repayable within say 4 or 5 years or more, it would be termed as long term loan or liability.

Some other short-term liabilities relating to credit purchase of merchandise are popularly called as trade payables, and for other purchases and services received on credit as expense payables. These short-term liabilities are also termed as current liabilities.

On the other hand, money raised has been invested in two types of assets—fixed assets and current assets. Furniture is a fixed asset, if it lasts long, say more than one year, and has utility to the business, while inventory and cash balance will not remain fixed for long as soon as the business starts to roll—these are current assets.

Often the owner's claim or fund in the business is called equity. Owner's claim implies capital invested plus any profit earned minus any loss sustained.

Now at to we have an equation:

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

or, $\text{Equity} + \text{Long-Term Liabilities} = \text{Fixed Assets} + \text{Current Assets} - \text{Current Liabilities}$

Check: L.H.S.

(₹ in '000)

| | |
|-----------------------|---------|
| Equity | ₹ 5,000 |
| Long-term Liabilities | ₹ 1,000 |
| Current Liabilities | ₹ 1,000 |
| | ₹ 7,000 |
| R.H.S. | |
| Fixed Assets: | |
| Furniture | ₹ 1,000 |
| Current Assets: | |
| Inventory | ₹ 5,000 |
| Cash | ₹ 1,000 |
| | ₹ 7,000 |

$$\begin{aligned}\text{Cash} &= \text{Capital} + \text{Loan} - \text{Furniture} - \text{Payment to Trade payables (₹'000)} \\ &= ₹ 5,000 + ₹ 1,000 - ₹ 1,000 - ₹ 4,000 = ₹ 1,000\end{aligned}$$

Let us use E_0 , L_0 and A_0 to mean Equity, Liabilities and Assets respectively at t_0 . Thus the basic accounting equation becomes

$$\begin{aligned}E_0 + L_0 &= A_0 \\ \text{or } E_0 &= A_0 - L_0 \dots (\text{Eq. 1})\end{aligned}$$

(₹'000)

Now, let us suppose that at the end of period inventory valuing ₹ 2,500 is in hand, cash ₹ 2,000; trade payables ₹ 500; bank loan ₹ 1,000 (interest was properly paid); furniture ₹ 800 (₹ 200 is taken as loss of value due to use). So at t_1 -

| Assets: | (₹'000) |
|---------------------------|----------------|
| Fixed assets/ Furniture | ₹ 800 |
| Current assets/ inventory | ₹ 2,500 |
| Cash | ₹ 2,000 |
| (A_1) | ₹ 5,300 |
| Liabilities: | |
| Long-term Liabilities | ₹ 1,000 |
| Current Liabilities | ₹ 500 |
| (L_1) | ₹ 1,500 |
| Equity ($A_1 - L_1$) | ₹ 3,800 |

Equity = Assets - Liabilities

$$\text{i.e., } E_1 = A_1 - L_1$$

$$\text{or } E_1 + L_1 = A_1 \dots (\text{Eq. 2})$$

Let us compare E_1 with E_0 . Equity is reduced by ₹ 12,00,000 (50,00,000 - 38,00,000). Reduction in equity is termed as loss.

Since the business sustained loss during the period, E_1 becomes less than E_0 .

$$E_1 < E_0 \text{ implies loss during } t_{01}$$

Similarly, $E_2 < E_1$ implies loss during t_{12} and so on.

On the other hand, $E_1 > E_0$ implies profit earned by business during t_{01} , $E_2 > E_1$ implies profit earned during t_{12} and so on.

So if $E_n > E_{n-1}$, in general terms, equity has increased, while $E_n < E_{n-1}$ implies that equity has declined. Increase in equity is termed as profit while decrease in equity is termed as loss.

 **ILLUSTRATION 2**

Develop the accounting equation from following information available at the beginning of accounting period:

| Particulars | (₹ in 000) |
|-------------------|------------|
| Capital | 51,000 |
| Loan | 11,500 |
| Trade payables | 5,700 |
| Fixed Assets | 12,800 |
| Inventory | 22,600 |
| Trade receivables | 17,500 |
| Cash and Bank | 15,300 |

At the end of the accounting period the balances appear as follows:

| | (₹ in 000) |
|-------------------|------------|
| Capital | ? |
| Loan | 11,500 |
| Trade payables | 5,800 |
| Fixed Assets | 12,720 |
| Inventory | 22,900 |
| Trade receivables | 17,500 |
| Cash at Bank | 15,600 |

- (a) Reset the equation and find out profit.
 (b) Prepare Balance Sheet at the end of the accounting period.

 **SOLUTION**

(All the figures in solution are in ₹ 000)

- (a) Accounting equation is given by
 Equity + Liabilities = Assets

Let us use E_0 , L_0 and A_0 to mean equity, liabilities and assets respectively at the beginning of the accounting period.

$$E_0 = ₹ 51,000$$

$$\begin{aligned} L_0 &= \text{Loan} + \text{Trade payables} \\ &= ₹ 11,500 + ₹ 5,700 \\ &= ₹ 17,200 \end{aligned}$$

$$\begin{aligned} A_0 &= \text{Fixed Assets} + \text{Inventories} + \text{Trade receivables} + \text{Cash at Bank} \\ &= ₹ 12,800 + ₹ 22,600 + ₹ 17,500 + ₹ 15,300 \\ &= ₹ 68,200 \end{aligned}$$

So, at the beginning of accounting period

$$\begin{aligned} E_0 + L_0 &= A_0 \\ \text{i.e., } ₹ 51,000 + ₹ 17,200 &= ₹ 68,200 \end{aligned}$$

Let us use E_1 , L_1 , A_1 to mean equity, liabilities and assets respectively at the end of the accounting period.

$$\begin{aligned} L_1 &= \text{Loan} + \text{Trade payables} \\ &= ₹ 11,500 + ₹ 5,800 \\ &= ₹ 17,300 \end{aligned}$$

$$\begin{aligned} A_1 &= \text{Fixed Assets} + \text{Inventories} + \text{Trade receivables} + \text{Cash at Bank} \\ &= ₹ 12,720 + ₹ 22,900 + ₹ 17,500 + ₹ 15,600 \\ &= ₹ 68,720 \end{aligned}$$

$$E_1 = A_1 - L_1 = ₹ 68,720 - ₹ 17,300 = ₹ 51,420$$

$$\text{Profit} = E_1 - E_0 = ₹ 51,420 - ₹ 51,000 = ₹ 420$$

(b)

Balance Sheet

| Liabilities | ₹ | ₹ | Assets | ₹ |
|----------------|--------|--------|-------------------|--------|
| Capital | | | Fixed Assets | 12,720 |
| Balance | 51,000 | | Inventories | 22,900 |
| Add: Profit | 420 | 51,420 | Trade receivables | 17,500 |
| Loan | | 11,500 | Cash at Bank | 15,600 |
| Trade payables | | 5,800 | | |
| | | 68,720 | | 68,720 |



ILLUSTRATION 3

Mr. David. has provided following details related to his financials. Find out the missing figures:

| Particulars | (₹ in'000) |
|--|------------|
| Profits carved during the year | 5,000 |
| Assets at the beginning of year | A |
| Liabilities at the beginning of year | 12,000 |
| Assets at the end of the year | B |
| Liabilities at the end of the year | C |
| Closing capital | 35,000 |
| Total liabilities including capital at the end of the year | 50,000 |



SOLUTION

Computing opening capital: (All figure in ₹' 000)

Closing capital - profits earned during the year

$$= 35,000 - 5,000$$

$$= 30,000$$

We also know:

Assets = liabilities + capital

$$\text{Therefore, opening assets (A)} = 12,000 + 30,000$$

$$= 42,000$$

Computation of liabilities at the end of the year:

| | | |
|--|---|--|
| Total liabilities including capital | = | 50,000 |
| Less: closing capital | = | (35,000) |
| Liabilities at the end of the year (C) | = | <u>15,000</u> |
| Also assets at the end of the year (B) | = | closing capital + liabilities at the end of the year |
| | = | 35,000 + 15,000 |
| | = | 50,000 |

1.7 TRADITIONAL APPROACH

Under traditional approach of recording transactions one should first understand the term debit and credit and their rules. The term debit and credit have already been explained in para 1.4 of this Unit.

Transactions in the journal are recorded on the basis of the rules of debit and credit only. For the purpose of recording, these transactions are classified in three groups:

- (i) Personal transactions.
- (ii) Transactions related to assets and properties.
- (iii) Transactions related to expenses, losses, income and gains.

1.7.1 Classification of Accounts

- (i) **Personal Accounts:** Personal accounts relate to persons, trade receivables or trade payables. Example would be the account of Ram & Co., a credit customer or the account of Jhaveri & Co., a supplier of goods. The capital account is the account of the proprietor and, therefore, it is also personal but adjustment on account of profits and losses are made in it. This account is further classified into three categories:
 - (a) **Natural personal accounts:** It relates to transactions of human beings like Ram, Rita, etc.
 - (b) **Artificial (legal) personal accounts:** For business purpose, business entities are treated to have separate entity. They are recognised as persons in the eye of law for dealing with other persons. For example: Government, Companies (private or limited), Clubs, Co-operative societies etc.
 - (c) **Representative personal accounts:** These are not in the name of any person or organisation but are represented as personal accounts. For example: outstanding liability account or prepaid account, capital account, drawings account.
- (ii) **Impersonal Accounts:** Accounts which are not personal such as machinery account, cash account, rent account etc. These can be further sub-divided as follows:
 - (a) **Real Accounts:** Accounts which relate to assets of the firm but not debt. For example, accounts regarding land, building, investment, fixed deposits etc., are real accounts. Cash in hand and Cash at the bank accounts are also real.
 - (b) **Nominal Accounts:** Accounts which relate to expenses, losses, gains, revenue, etc. like salary account, interest paid account, commission received account. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are, therefore, temporary.

1.7.2 Golden Rules of Accounting

All the above classified accounts have two rules each, one related to Debit and one related to Credit for recording the transactions which are termed as golden rules of accounting, as transactions are recorded on the basis of double entry system.

| Types of Account | Account to be Debited | Account to be Credited |
|------------------|-----------------------|------------------------|
| Personal Account | Receiver | Giver |
| Real Account | What comes in | What goes out |
| Nominal Account | Expense and losses | Income and gains |

Example:-

From the following information, state the nature of account and state which account will be debited and which will be credited.

1. Started business with a capital of ₹ 50,00,000.
2. Wages and salaries paid ₹ 50,000
3. Rent received ₹ 2,00,000
4. Purchased goods on credit ₹ 9,00,000
5. Sold goods for ₹ 8,16,000 and received payment in cheque.



SOLUTION

| Transaction | ACCOUNTS INVOLVED | NATURE | DEBIT OR CREDIT | Journal Entry |
|--|---------------------------------|----------------------|-------------------------------------|--------------------------------------|
| Started business with capital of ₹ 50,00,000 | Bank account Capital account | Personal Personal | Debit (Receiver) Credit (giver) | Bank A/c Dr. To Capital A/c |
| Wages and salaries paid | Wages/salaries Bank | Nominal Personal | Debit (expense) Credit (giver) | Wages/ Salaries Dr. To Bank A/c |
| Rent received | Bank Rent | Personal Nominal | Debit (Receiver) Credit (income) | Bank A/c Dr. To Rent A/c |
| Purchases made on credit | Purchases Creditor | Nominal Personal | Debit (expense) Credit (giver) | Purchases A/c Dr. To Creditor A/c |
| Goods sold and payment received in cheque | Bank Sales | Personal Nominal | Debit (Receiver) Credit (gains) | Bank A/c Dr. To Sales A/c |

1.8 MODERN CLASSIFICATION OF ACCOUNTS

Real, nominal and personal accounts is the traditional classification of accounts. Now, let us see the modern and more acceptable classification of accounts:-

| Types of account | Normal balance of account | Account to be debited when there is: | Account to be credited when there is: |
|---------------------|---------------------------|--------------------------------------|---------------------------------------|
| Asset account | Debit | Increase | Decrease |
| Liabilities account | Credit | Decrease | Increase |
| Capital account | Credit | Decrease | Increase |
| Revenue account | Credit | Decrease | Increase |
| Expenditure account | Debit | Increase | Decrease |
| Drawing account | Debit | Increase | Decrease |

Let us solve the same example with the modern approach now:-

| Accounts involved | Nature | Debit/Credit | Reason |
|-------------------|-----------|--------------|----------|
| Bank | Asset | Debit | Increase |
| Capital | Liability | Credit | Increase |
| Wages/salaries | Expense | Debit | Increase |
| Bank | Asset | Credit | Decrease |
| Bank | Asset | Debit | Increase |
| Rent | Revenue | Credit | Increase |
| Purchase | Expense | Debit | Increase |
| Creditor | Liability | Credit | Increase |
| Bank | Asset | Debit | Increase |
| Sales | Revenue | Credit | Increase |

1.9 JOURNAL

Transactions are first entered in this book to show which accounts should be debited and which credited. Journal is also called subsidiary book. Recording of transactions in journal is termed as journalizing the entries. It is the book of original entry in which transactions are entered on a daily basis in a chronological order.

1.9.1 Journalising Process

All transactions may be first recorded in the journal as and when they occur; the record is chronological; otherwise it would be difficult to maintain the records in an orderly manner. Debits and credits are listed along with the appropriate explanations. There are basically two types of journals:-

1. General journal
2. Specialized journal

The latter is used when there are many repetitive transactions of the same nature. The form of the journal is given below:

JOURNAL

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

The columns have been numbered only to make clear the following but otherwise they are not numbered. The following points should be noted:

- (i) In the first column the date of the transaction is entered-the year is written at the top, then the month and in the narrow part of the column the particular date is entered.
- (ii) In the second column, the names of the accounts involved are written; first the account to be debited, with the word "Dr" written towards the end of the column. In the next line, after leaving a little space, the name of the account to be credited is written preceded by the word "To" (the modern practice shows inclination towards omitting "Dr." and "To"). Then in the next line the explanation for the entry together with necessary details is given-this is called narration.
- (iii) In the third column the number of the page in the ledger on which the account is written up is entered.
- (iv) In the fourth column the amounts to be debited to the various accounts concerned are entered.
- (v) In the fifth column, the amount to be credited to various accounts is entered.

1.9.2 Points to be taken into care while recording a Transaction in the Journal

1. Journal entries can be 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 cases, it is important to check that the total of both debits and credits are equal.
2. If journal entries are recorded in several pages then both the amount column of each page should be totalled and the balance should be written at the end of that page and also that the same total should be carried forward at the beginning of the next page.

An entry in the journal may appear as follows:

| | | | | |
|-------|--|-----|-----------|-----------|
| | | | ₹ | ₹ |
| May 5 | Bank Account | Dr. | 14,50,000 | |
| | To Mohan | | | 14,50,000 |
| | (Being the amount received from Mohan in payment of the amount due from him) | | | |

We will now consider some individual transactions.

- (i) Mohan commences business with ₹ 50,00,000 in his bank account. This means that the firm has ₹ 50,00,000 in bank. According to the rules given above, the increase in an asset has to be debited to it. The firm also now owes ₹ 50,00,000 to the proprietor, Mohan as capital. The rule given above also shows that the increase in capital should be credited to it. Therefore, the journal entry will be:

| | | | |
|--|-----|-------------|-------------|
| Bank Account | Dr. | ₹ 50,00,000 | |
| To Capital Account | | | ₹ 50,00,000 |
| (Being capital introduced by Shri Mohan) | | | |

- (ii) Out of the above, ₹ 25,000 is withdrawn from the bank. By this transaction the bank balance is reduced by ₹ 25,000 and another asset, cash account, comes into existence. Since increase in assets is debited and decrease is credited, the journal entry will be:

| | | | |
|-------------------------------|-----|----------|----------|
| Cash Account | Dr. | ₹ 25,000 | |
| To Bank Account | | | ₹ 25,000 |
| (Being cash withdraw in Bank) | | | |

- (iii) Furniture is purchased for ₹ 12,00,000. Applying the same reasoning as above the entry will be:

| | | | |
|--|-----|-------------|-------------|
| Furniture Account | Dr. | ₹ 12,00,000 | |
| To Bank Account | | | ₹ 12,00,000 |
| (Being Furniture purchased vide CM No....) | | | |

- (iv) Purchased goods for cash ₹ 4,00,000. The student can see that the required entry is:

| | | | |
|--|-----|------------|------------|
| Purchases Account | Dr. | ₹ 4,00,000 | |
| To Bank Account | | | ₹ 4,00,000 |
| (Being goods purchased vide CM No....) | | | |

- (v) Purchased goods for ₹ 10,00,000 on credit from M/s Ram Narain Bros. Purchase of merchandise is an expense item so it is to be debited. ₹ 10,00,000 is now owing to the supplier; his account should therefore be credited, since the amount of liabilities has increased. The entry will be:

| | | | |
|--|-----|-------------|-------------|
| Purchases Account | Dr. | ₹ 10,00,000 | |
| To M/s Ram Narain Bros. | | | ₹ 10,00,000 |
| (Being goods purchased vide Bill No....) | | | |

- (vi) Sold goods to M/s Ram & Co. for ₹ 6,00,000. Amount is received in cheque. The amount of bank increases and therefore, the bank amount should be debited; sale of merchandise is revenue item so it is to be credited. The entry will be:

| | | | |
|-----------------------------------|-----|------------|------------|
| Bank Account | Dr. | ₹ 6,00,000 | |
| To Sales Account | | | ₹ 6,00,000 |
| (Being goods sold vide CM No....) | | | |

- (vii) Sold goods to Ramesh on credit for ₹ 13,00,000. The Inventories of goods has decreased and therefore, the goods account has to be credited. Ramesh now owes ₹ 13,00,000; that is an asset and therefore, Ramesh should be debited. The entry is:

| | | | |
|-------------------------------------|-----|-------------|-------------|
| Ramesh | Dr. | ₹ 13,00,000 | |
| To Sales Account | | | ₹ 13,00,000 |
| (Being goods sold vide Bill No....) | | | |

Note: There are two views on classification of "Purchase Account" and "Sales Account". One view is that they represent "flow of goods", so they should be classified as 'Real A/c'. However, others are of the opinion that only nominal a/cs are closed by transferring to 'Trading or Profit and Loss A/c'. Therefore, purchases and sales shall be classified as Nominal A/cs. However, in both the views, there will be debit balance of Purchase A/c and credit balance of Sales A/c.

(viii) Received cheque from Ramesh ₹ 13,00,000. The amount of bank increased therefore the bank account has to be debited. Ramesh's liability towards firm has decreased in fact in this case he no longer owes any amount to the firm, i.e., this particular form of assets has disappeared; therefore, the account of Ramesh should be credited. The entry is:

| | | | |
|---|-----|-------------|-------------|
| Bank Account | Dr. | ₹ 13,00,000 | |
| To Ramesh | | | ₹ 13,00,000 |
| (Being cheque received against Bill No....) | | | |

(x) Paid rent ₹ 1,00,000. The bank balance has decreased and therefore, the bank account should be credited. No asset has come into existence because the payment is for services enjoyed and is an expense. Expenses are debited. Therefore, the entry should be:

| | | | |
|--|-----|------------|------------|
| Rent Account | Dr. | ₹ 1,00,000 | |
| To Bank Account | | | ₹ 1,00,000 |
| (Being rent paid for the month of) | | | |

(xi) Paid ₹ 22,000 to the clerk as salary. Applying the reasons given in (x) above, the required entry is:

| | | | |
|--|-----|----------|----------|
| Salary Account | Dr. | ₹ 22,000 | |
| To Bank Account | | | ₹ 22,000 |
| (Being salary paid to Mr.... for the month of) | | | |

(xii) Received ₹ 2,20,000 interest. The bank account should be debited since there is an increase in the bank balance. There is no increase in any liability; since the amount is not returnable to any one, the amount is an income, incomes are credited. The entry is :

| | | | |
|--|-----|------------|------------|
| Bank Account | Dr. | ₹ 2,20,000 | |
| To Interest Account | | | ₹ 2,20,000 |
| (Being interest received from..... for the period) | | | |

When transactions of similar nature take place on the same date, they may be combined while they are journalised. For example, entries (x) and (xi) may be combined as follows:

| | | | |
|--|-----|------------|------------|
| Rent Account | Dr. | ₹ 1,00,000 | |
| Salary Account | Dr. | ₹ 22,000 | |
| To Bank Account | | | ₹ 1,22,000 |
| (Being expenses done as per detail attached) | | | |

When journal entry for two or more transactions are combined, it is called composite journal entry. Usually, the transactions in a firm are so numerous that to record the transactions for a month will require many pages in the journal. At the bottom of one page the totals of the two columns are written together with the words "Carried forward" in the particulars column. The next page is started with the respective totals in the two columns with the words "Brought forward" in the particulars column.

ILLUSTRATION 4

Analyse transactions of M/s Sahil & Co. for the month of March, 2017 on the basis of double entry system by adopting the following approaches:

- (A) Accounting Equation Approach.
 (B) Traditional Approach.

Transactions for the month of March, 2017 were as follows (figures are in '000):

- Sahil introduced capital through bank of ₹ 4,000.
- Cash withdrawn from the City Bank ₹ 200.
- Loan of ₹ 500 taken from Mr. Y.
- Salaries paid for the month of March, 2017, ₹ 300 and ₹ 100 is still payable for the month of March, 2017.
- Furniture purchased ₹ 500.

Required

What conclusion one can draw from the above analysis?

SOLUTION

(A) Analysis of Business Transaction: Accounting Equation Approach

The accounting equation is
 Assets = Liabilities + Capital

(₹ in '000)

| ASSETS | | | | | | = | CAPITAL | + | LIABILITIES |
|----------------|------------|----------|--------------|----------|------------|----------|--------------|----------|-------------|
| | CASH | + | BANK | + | FURNITURE | = | CAPITAL | + | LIABILITIES |
| (a) | - | + | 4,000 | + | - | = | 4,000 | + | - |
| (b) | +200 | + | -200 | + | - | = | - | + | - |
| (c) | - | + | 500 | + | - | = | - | + | 500 |
| (d) | - | + | -300 | + | - | = | -400 | + | 100 |
| (e) | - | + | -500 | + | 500 | = | - | + | - |
| Balance | 200 | + | 3,500 | + | 500 | = | 3,600 | + | 600 |
| | | | 4,200 | | | | 4,200 | | |

(B) Analysis of Business Transactions: Traditional Approach

| Transaction | Analysis | Account Affected and Nature of Account | Rule | Entry |
|--|---|--|---|------------------------------|
| Introduction of ₹ 4,000 through bank by the proprietor | Bank has received the money; Owner has given Bank balance | Bank–Personal Capital–Personal | Debit the receiver Credit the giver | Debit Bank Credit Capital |
| Cash Withdrawn from Bank ₹ 200 | Cash comes into business; Bank gives out cash | Cash–Real Bank–Personal | Debit what comes in Credit the giver | Debit Cash Credit Bank |

| | | | | |
|---|--|---|--|--|
| Loan from Y ₹ 500 | Bank receives the amount :Y pays through bank | Bank–Personal Y’s Loan–Personal | Debit the receiver Credit the giver | Debit Bank Credit Y’s Loan |
| Salary paid ₹ 300 and still payable ₹ 100 | Cost of services used ₹ 400; Bank gives out ₹300; Still payable or outstanding for services received ₹ 100 | Salary Nominal Bank–Personal Salary Outstanding Personal | Debit all expenses Credit the giver Credit the giver | Debit Salary (₹ 400) Credit Bank (₹3,00) Credit Salary outstanding (₹ 100) |
| Furniture purchased ₹ 500 | Furniture is purchased; Bank gives out money | Furniture Real Bank–Personal | Debit what comes in Credit the giver | Debit Furniture Credit Bank |

Conclusion:

It is evident from above analysis that procedure for analysis of transactions, classification of accounts and rules for recording business transactions under accounting equation approach and traditional approach are different. But the accounts affected and entries in affected accounts remain same under both approaches. Thus, the recording of transactions in affected accounts on the basis of double entry system is independent of the method of analysis followed by a business enterprise. In other words, accounts to be debited and credited to record the dual aspect remain same under both the approaches.

 **ILLUSTRATION 5**

Journalise the following transactions. Also state the nature of each account involved in the Journal entry.

Following figures are given in ('00)

1. December 1, 2016, Ajit started business with capital ₹ 4,00,000
2. December 3, he withdrew cash for business from the Bank ₹ 2,000.
3. December 5, he purchased goods making payment through bank ₹ 15,000.
4. December 8, he sold goods ₹ 16,000 and received payment through bank.
5. December 10, he purchased furniture and paid by cheque ₹ 2,500.
6. December 12, he sold goods to Arvind ₹ 2,400.
7. December 14, he purchased goods from Amrit ₹ 10,000.
8. December 15, he returned goods to Amrit ₹ 500.
9. December 16, he received from Arvind ₹ 2,300 in full settlement.
10. December 18, he withdrew goods for personal use ₹ 1,000.
11. December 20, he withdrew cash from business for personal use ₹ 2,000.
12. December 24, he paid telephone charges ₹ 110.
13. December 26, amount paid to Amrit in full settlement ₹ 9,450.

14. December 31, paid for stationery ₹ 200, rent ₹5,000 and salaries to staff ₹ 2,000.

15. December 31, goods distributed by way of free samples ₹ 2,000.

 **SOLUTION**

| JOURNAL | | | | | | (₹ in '00) | |
|---------|---------|---|----------------------------------|------|-----------|------------|--|
| Sl. No | Date | Particulars | Nature of Account | L.F. | Dr. | Cr. | |
| | | | | | Debit (₹) | Credit (₹) | |
| 1. | Dec. 1 | Bank Account To Capital Account (Being commencement of business) | Dr. Personal A/c Personal A/c | | 4,00,000 | 4,00,000 | |
| 2. | Dec. 3 | Cash Account To Bank Account (Being cash withdrawn from the Bank) | Dr. Real A/c Personal A/c | | 2,000 | 2,000 | |
| 3. | Dec. 5 | Purchases Account To Bank Account (Being purchase of goods for cash) | Dr. Real A/c Personal A/c | | 15,000 | 15,000 | |
| 4. | Dec. 8 | Bank Account To Sales Account (Being goods sold for cash) | Dr. Personal A/c Real A/c | | 16,000 | 16,000 | |
| 5. | Dec. 10 | Furniture Account To Bank Account (Being purchase of furniture, paid by cheque) | Dr. Real A/c Personal A/c | | 2,500 | 2,500 | |
| 6. | Dec. 12 | Arvind To Sales Account (Being sale of goods) | Dr. Personal A/c Real A/c | | 2,400 | 2,400 | |
| 7. | Dec. 14 | Purchases Account To Amrit (Being purchase of goods from Amrit) | Dr. Real A/c Personal A/c | | 10,000 | 10,000 | |
| 8. | Dec. 15 | Amrit To Purchases Returns Account (Being goods returned to Amrit) | Dr. Personal A/c Real A/c | | 500 | 500 | |

| | | | | | | |
|-----|---------|---|-------------------|---|-----------------------|-------------|
| 9. | Dec. 16 | Bank Account Discount Account To Arvind (Being cash received from Arvind in full settlement and allowed him ₹ 100 as discount) | Dr. Dr. | Personal A/c Nominal A/c Personal A/c | 2,300 100 | 2,400 |
| 10. | Dec. 18 | Drawings Account To Purchases Account (Being withdrawal of goods for personal use) | Dr. | Personal A/c Real A/c | 1,000 | 1,000 |
| 11. | Dec. 20 | Drawings Account To Cash Account (Being cash withdrawal from the business for personal use) | Dr. | Personal A/c Real A/c | 2,000 | 2,000 |
| 12. | Dec. 24 | Telephone Expenses Account To Bank Account (Being telephone expenses paid) | Dr. | Nominal A/c Personal A/c | 110 | 110 |
| 13. | Dec 26 | Amrit To Bank Account To Discount Account (Being cash paid to Amrit and he allowed ₹ 50 as discount) | Dr. | Personal A/c Personal A/c Nominal A/c | 9,500 | 9,450 50 |
| 14. | Dec. 31 | Stationery Expenses Rent Account Salaries Account To Bank Account (Being expenses paid) | Dr. Dr. Dr. | Nominal A/c Nominal A/c Nominal A/c Personal A/c | 200 5,000 2,000 | 7,200 |
| 15. | Dec. 31 | Advertisement Expenses Account To Purchases Account (Being distribution of goods by way of free samples) | Dr. | Nominal A/c Real A/c | 2,000 | 2,000 |

 **ILLUSTRATION 6**

Show the classification of the following Accounts under traditional and accounting equation approach:

(a) Building; (b) Purchases; (c) Sales; (d) Bank Fixed Deposit; (e) Rent; (f) Rent Outstanding; (g) Cash; (h) Adjusted Purchases; (i) Closing Inventory; (j) Investments; (k) Trade receivables; (l) Sales Tax Payable, (m) Discount Allowed; (n) Bad Debts; (o) Capital; (p) Drawings; (q) Interest Receivable account; (r) Rent received in advance account; (s) Prepaid salary account; (t) Bad debts recovered account; (u) Depreciation account, (v) Personal income-tax account.

 **SOLUTION**
Nature of Account

| Sl. No. | Title of Account | Traditional Approach | Accounting Equation Approach |
|---------|--------------------------|----------------------|------------------------------|
| (a) | Building | Real | Asset |
| (b) | Purchases | Real | Asset |
| (c) | Sales | Real | Revenue |
| (d) | Bank Fixed Deposit | Personal | Asset |
| (e) | Rent | Nominal (Expense) | Expense |
| (f) | Rent Outstanding | Personal | Liability |
| (g) | Cash | Real | Asset |
| (h) | Adjusted Purchases | Nominal (Expense) | Expense |
| (i) | Closing Inventory | Real | Asset |
| (j) | Investment | Real | Asset |
| (k) | Trade receivables | Personal | Asset |
| (l) | Sales Tax Payable | Personal | Liability |
| (m) | Discount Allowed | Nominal (Expense) | Temporary Capital (Expense) |
| (n) | Bad Debts | Nominal (Expense) | Temporary Capital (Expense) |
| (o) | Capital | Personal | Capital |
| (p) | Drawings | Personal | Temporary Capital (Drawings) |
| (q) | Interest receivable | Personal | Asset |
| (r) | Rent received in advance | Personal | Liability |
| (s) | Prepaid salary | Personal | Asset |
| (t) | Bad debts recovered | Nominal (Gain) | Temporary Capital (Gain) |
| (u) | Depreciation | Nominal (Expense) | Temporary Capital (Expense) |
| (v) | Personal Income Tax | Personal (Drawing) | Temporary Capital (Drawings) |

 **ILLUSTRATION 7**

Transactions of Ramesh for April are given below. Journalise them.

| 2017 | | | ₹ |
|-------|----|-----------------------------------|-----------|
| April | 1 | Ramesh started business with | 10,00,000 |
| " | 3 | Bought goods for cash | 50,000 |
| " | 5 | Drew cash from bank | 10,000 |
| " | 13 | Sold to Krishna- goods on credit | 1,50,000 |
| " | 20 | Bought from Shyam goods on credit | 2,25,000 |
| " | 24 | Received from Krishna | 1,45,000 |
| " | | Allowed him discount | 5,000 |
| " | 28 | Paid Shyam cash | 2,15,000 |
| " | | Discount allowed | 10,000 |
| " | 30 | Cash sales for the month | 8,00,000 |
| | | Paid Rent | 50,000 |
| | | Paid Salary | 1,00,000 |

 **SOLUTION**
JOURNAL

| Date 2017 | Particulars | | L.F. | Dr. | Cr. |
|--------------|--|------------|--------------|-------------------|-----------|
| | | | | Amount | Amount |
| April 1 | Bank Account To Capital Account (Being the amount invested by Ramesh in the business as capital) | Dr. | 1 4 | 10,00,000 | 10,00,000 |
| " 3 | Purchases Account To Bank Account (Being goods purchased for cash) | Dr. | 7 1 | 50,000 | 50,000 |
| " 5 | Cash Account To Bank Account (Being cash withdrawn from bank) | Dr. | 5 1 | 10,000 | 10,000 |
| " 13 | Krishna To Sales Account (Being goods sold to Krishna on credit) | Dr. | 9 11 | 1,50,000 | 1,50,000 |
| " 20 | Purchases Account To Shyam (Being goods bought from Shyam on credit) | Dr. | 7 10 | 2,25,000 | 2,25,000 |
| " 24 | Bank Account Discount Account To Krishna (Being cash received from Krishna and discount allowed to him) | Dr. Dr. | 1 12 9 | 1,45,000 5,000 | 1,50,000 |

| | | | | | |
|------|---|-----|----|-----------|-----------|
| " 28 | Shyam | Dr. | 10 | 2,25,000 | |
| | To Bank Account | | 1 | | 2,15,000 |
| | To Discount Account (Being cash paid to Shyam and discount allowed by him) | | 12 | | 10,000 |
| " 30 | Bank Account | Dr. | 1 | 8,00,000 | |
| | To Sales Account (Being goods sold for cash) | | 11 | | 8,00,000 |
| " 30 | Rent Account | Dr. | 15 | 50,000 | |
| | Salaries Account | Dr. | 14 | 1,00,000 | |
| | To Bank Account (Being the amount paid for rent and salary) | | 1 | | 1,50,000 |
| | Total (Ledger Folio imaginary) | | | 27,60,000 | 27,60,000 |

1.10 ADVANTAGES OF JOURNAL

In journal, transactions recorded on the basis of double entry system, fetch following advantages:

1. As transactions are recorded on chronological order, one can get complete information about the business transactions on time basis.
2. Entries recorded in the journal are supported by a note termed as narration, which is a precise explanation of the transaction for the proper understanding of the entry. One can know the correctness of the entry through these narrations.
3. Journal forms the basis for posting the entries in the ledger. This eases the accountant in their work and reduces the chances of error.



SUMMARY

- The accounting process starts with the recording of transactions in the form of journal entries.
- The recording is based on double entry system. This book or register called journal is the book of first or original entry.
- Next step is to post the entries in the ledger covered in the next unit.

TEST YOUR KNOWLEDGE

Multiple Choice Question

1. The rent paid to landlord is credited to
 - (a) Landlord's account.
 - (b) Rent account.
 - (c) Cash account.
2. In case of a debt becoming bad, the amount should be credited to
 - (a) Trade receivables account.
 - (b) Bad debts account.
 - (c) Cash 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:
 - (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.
4. Which financial statement represents the accounting equation - Assets = Liabilities + Owner's equity:
 - (a) Income Statement
 - (b) Statement of Cash flows
 - (c) Balance Sheet.
5. Which account is the odd one out?
 - (a) Office furniture & Equipment.
 - (b) Freehold land and Buildings.
 - (c) Inventory of materials.
6. The debts written off as bad, if recovered subsequently are
 - (a) Credited to Bad Debts Recovered Account
 - (b) Credited to Trade receivables Account.
 - (c) Debited to Profit and Loss Account.
7. In Double Entry System of Book-keeping every business transaction affects:
 - (a) Two accounts
 - (b) Two sides of the same account.
 - (c) The same account on two different dates.
8. A sale of goods to Ram for cash should be debited to:
 - (a) Ram
 - (b) Cash
 - (c) Sales

Theory Questions

1. Write short note on classification of accounts.
2. Distinguish between Real account and nominal account.

Practical Questions

1. Show the classification of the following Accounts under traditional and accounting equation approach:

| | | | |
|---|--------------------|---|-------------------|
| a | Rent outstanding | g | Capital |
| b | Closing Inventory | h | Sales Tax Payable |
| c | Sales | i | Trade receivables |
| d | Bank Fixed Deposit | j | Depreciation |
| e | Cash | k | Drawings |
| f | Bad Debts | | |

2. Pass Journal Entries for the following transactions in the books of Gamma Bros.
- Employees had taken inventory worth ₹ 1,00,000 (Cost price ₹ 75,000) on the eve of Deepawali and the same was deducted from their salaries in the subsequent month.
 - Wages paid for erection of Machinery ₹ 18,000.
 - Income tax liability of proprietor ₹ 1,17,000 was paid out of petty cash.
 - Purchase of goods from Naveen of the list price of ₹ 2,00,000. He allowed 10% trade discount, ₹ 5,000 cash discount was also allowed for quick payment.
3. Calculate the missing amount for the following.

| | Assets | Liabilities | Capital |
|-----|---------------|--------------------|----------------|
| (a) | 15,00,000 | 2,50,000 | ? |
| (b) | ? | 1,50,000 | 75,000 |
| (c) | 14,50,000 | ? | 13,75,000 |
| (d) | 57,00,000 | - 2,80,000 | ? |

4. Show the effect of increase = (+), decrease = (-) and no change=(0) on the assets of the following transactions:
- Purchased office furniture, payment to be made next month.
 - Collected cash for repair services
 - Goods sold on credit.
 - Withdrawal of cash by the owner for personal use.
 - Hired an employee as sales manager of the north wing.
 - Returned goods worth ₹ 50,000.
 - One of our debtor agreed to pay his dues to Mr. C who is a creditor of the company with the same amount being due to him.
 - Entered into an agreement with Mehta & Co. to purchase all raw materials from their company from next year.

Also give reasons for your answers.

5. Following is the information provided by Mr. Gopi pertaining to year ended 31st March 2017. Find the unknowns, showing computation to support your answer:

| Particulars | ₹ | Particulars | ₹ |
|-------------------------------------|-----------|------------------------------------|-----------|
| Machinery | 12,00,000 | Trade Receivables | B |
| Accounts Payable | 1,00,000 | Loans | C |
| Inventory | 60,000 | Closing Capital | D |
| Total Liabilities including capital | 14,15,000 | Opening Capital | 10,00,000 |
| Cash | A | Loss incurred during the year | 35,000 |
| Bank | 80,000 | Capital Introduced during the year | 1,00,000 |

Additional Information: During the year sales of ₹ 15,55,000 was made of which Rs. 15,00,000 have been received.

ANSWERS/HINTS

MCQs

1. (c) 2. (a) 3. (b) 4. (c) 5. (c) 6. (a) 7. (a) 8. (c)

Theoretical Questions

- 1 a. Accounts are broadly classified into assets, liabilities and capital. The basic accounting equation specifies broad categories, which are as follows:
- (i) **Assets:** These are resources controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise, namely cash, stock of goods, land, buildings, machinery etc.
 - (ii) **Liabilities:** These are financial obligations of an enterprise other than owner's equity namely long term loans, creditors, outstanding expenses etc.
 - (iii) **Capital:** It generally refer to the amounts invested in an enterprise by its owner(s), the accretion to it or a reduction in it. Since capital is affected by expenses and incomes of revenue nature, there are two more categories of accounts, namely expenses and incomes. The difference between incomes and expenses are taken into capital account.
 - **Expenses:** These represents those accounts which show the amount spent or even lost in carrying on operations.
 - **Incomes:** These represent those accounts which show the revenue amounts earned by the enterprise.
- However, traditionally accounts are classified as follows:**
- (i) **Personal Accounts:** These accounts relate to persons, institutions, debtors or creditors.
 - (ii) **Impersonal Accounts:** These represent accounts which are not personal. These can be further sub-divided as follows:
 - **Real Accounts:** These accounts relate to assets of the firm but not debt e.g. accounts relating to land, buildings, cash in hand etc.
 - **Nominal accounts:** These accounts relate to expenses, losses, gains, revenues etc.
2. A real account is an account relating to properties and assets, other than personal accounts of the firm. Examples are land, buildings, machinery, cash, investments etc. Nominal accounts relate to expenses or losses, incomes and gains. Examples are: wages, salaries, rent, depreciation etc. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are therefore, temporary. The real accounts are shown in the balance sheet along with personal accounts.

Practical Problems

Answer 1

Nature of Account

| Sl. No. | Title of Account | Traditional Approach | Accounting Approach | Equation |
|---------|--------------------|----------------------|------------------------------|----------|
| a | Rent Outstanding | Personal | Liability | |
| b | Closing Inventory | Real | Asset | |
| c | Sales | Nominal | Revenue | |
| d | Bank Fixed Deposit | Personal | Asset | |
| e | Cash | Real | Asset | |
| f | Bad Debts | Nominal (Expense) | Temporary Capital (Expense) | |
| g | Capital | Personal | Capital | |
| h | Sales Tax Payable | Personal | Liability | |
| i | Trade receivables | Personal | Asset | |
| j | Depreciation | Nominal (Expense) | Temporary Capital (Expense) | |
| k | Drawings | Personal | Temporary Capital (Drawings) | |

Answer 2

Journal Entries in the books of Gamma Bros.

| | Particulars | | Dr. Amount ₹ | Cr. Amount ₹ |
|-------|---|-----|--------------------|--------------------|
| (i) | Salaries A/c To Purchase A/c (Being entry made for inventory taken by employees) | Dr. | 75,000 | 75,000 |
| (ii) | Machinery A/c To Cash A/c (Being wages paid for erection of machinery) | Dr. | 18,000 | 18,000 |
| (iii) | Drawings A/c To Petty Cash A/c (Being the income tax of proprietor paid out of business money) | Dr. | 1,17,000 | 1,17,000 |
| (iv) | Purchase A/c To Cash A/c To Discount Received A/c (Being the goods purchased from Naveen for ₹ 2,00,000 @ 10% trade discount and cash discount of ₹ 5,000) | Dr. | 1,80,000 | 1,75,000 5,000 |

Note:

- i. Here wages paid on erection of machinery have been capitalised therefore machinery account has been debited directly instead of wages being recorded as an expenditure.
- ii. The students may also note that trade discount is allowed on the list price of goods. It is deducted to find out the invoice amount of the goods to be recorded in the books. Cash discount is a discount allowed in case of early payments to the seller. The entry is made in the books of accounts for cash discount.

Answer 3

- (a) 12,50,000
- (b) 2,25,000
- (c) 75,000
- (d) 59,80,000

These have been solved using the Accounting Equation:

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

Answer 4

| S.No. | Increase (+) / Decrease (-) / No Change (0) in Assets | Reasons |
|-------|---|--|
| (a) | + | Furniture has been purchased making it an increase in assets and also it being purchased on credit it increases liability and there is no outflow of assets like cash or bank. |
| (b) | + | Cash has flowed in for services provided making it an increase in assets. |
| (c) | + | Here with goods sold there is a decrease in inventory (assets) but given there is an increase in debtors there will be a net increase in assets. Though if goods are sold at cost it will result in no change whereas sale at below cost will result in decrease in assets. |
| (d) | - | Here cash has been withdrawn from business resulting in decrease in assets and capital. |
| (e) | 0 | Only hiring of employee has been done resulting in no change in assets. |
| (f) | - | Outflow of goods has resulted in decrease in assets while money owed to creditors reduce on the liability side. |
| (g) | - | Here both assets and liabilities reduce by same amounts meaning a decrease in assets. |
| (h) | 0 | Only a purchase agreement has been entered into with no transaction taking place yet. |

Answer 5

$$\begin{aligned}
 \text{Trade Receivable Balance (B)} &= \text{Sales- Amount received during the year} \\
 &= ₹ (15,55,000 - 15,00,000) \\
 &= ₹ 55,000.
 \end{aligned}$$

Since, we know Assets = Capital + Liabilities

Therefore, balance of assets is also ₹ 14,15,000

So, total assets:

| Particulars | ₹ |
|-------------------|-------------|
| Total Assets | 14,15,000 |
| Less: Machinery | (12,00,000) |
| Less: Inventory | (60,000) |
| Less: Bank | (80,000) |
| Less: Receivables | (55,000) |
| Cash (A) | 20,000 |

Computation of Closing Capital (D):

| Particulars | ₹ |
|-------------------------------------|-----------|
| Opening Capital | 10,00,000 |
| Add: Introduced during the year | 1,00,000 |
| Less: Loss incurred during the year | (35,000) |
| Closing Capital | 10,65,000 |

So, Loan amount (C) = Total Liabilities and capital - Closing Capital - Trade Payables

$$= ₹ (14,15,000 - 10,65,000 - 1,00,000)$$

$$= ₹ 2,50,000$$