

Chapter 5: Accounting Records

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Introduction

- ❑ Accounting concepts provide theoretical and practical basis
- ❑ Structure and format for accumulation of information is derived from the basic balance sheet equation
- ❑ The basic information formats used for accumulation of material, measurable information relating to the entity is an *account*
- ❑ Depending on information needs, the information may be classified and accumulated in many separate accounts
- ❑ Only technical consideration to be kept in mind is that once summarized it should maintain the balance sheet equality intact
- ❑ This requirement dictates the form, contents and rules of preparing *accounting records*

Balance Sheet Equation and Accounts

- Expanded accounting equality could be written as: $A = L + C + R - (E + D)$

Where, A = assets; L= liabilities; C = capital; R = revenue; E = expenses; and D = dividends

- Rearranging gives: $A + E + D = L + C + R$
- This transposed equality is the basic accounting equality
- Quantities on the LHS are normally referred to as '**debit**' or 'Dr. in short
- Quantities on the RHS are known as '**credit**', or 'Cr.' in short

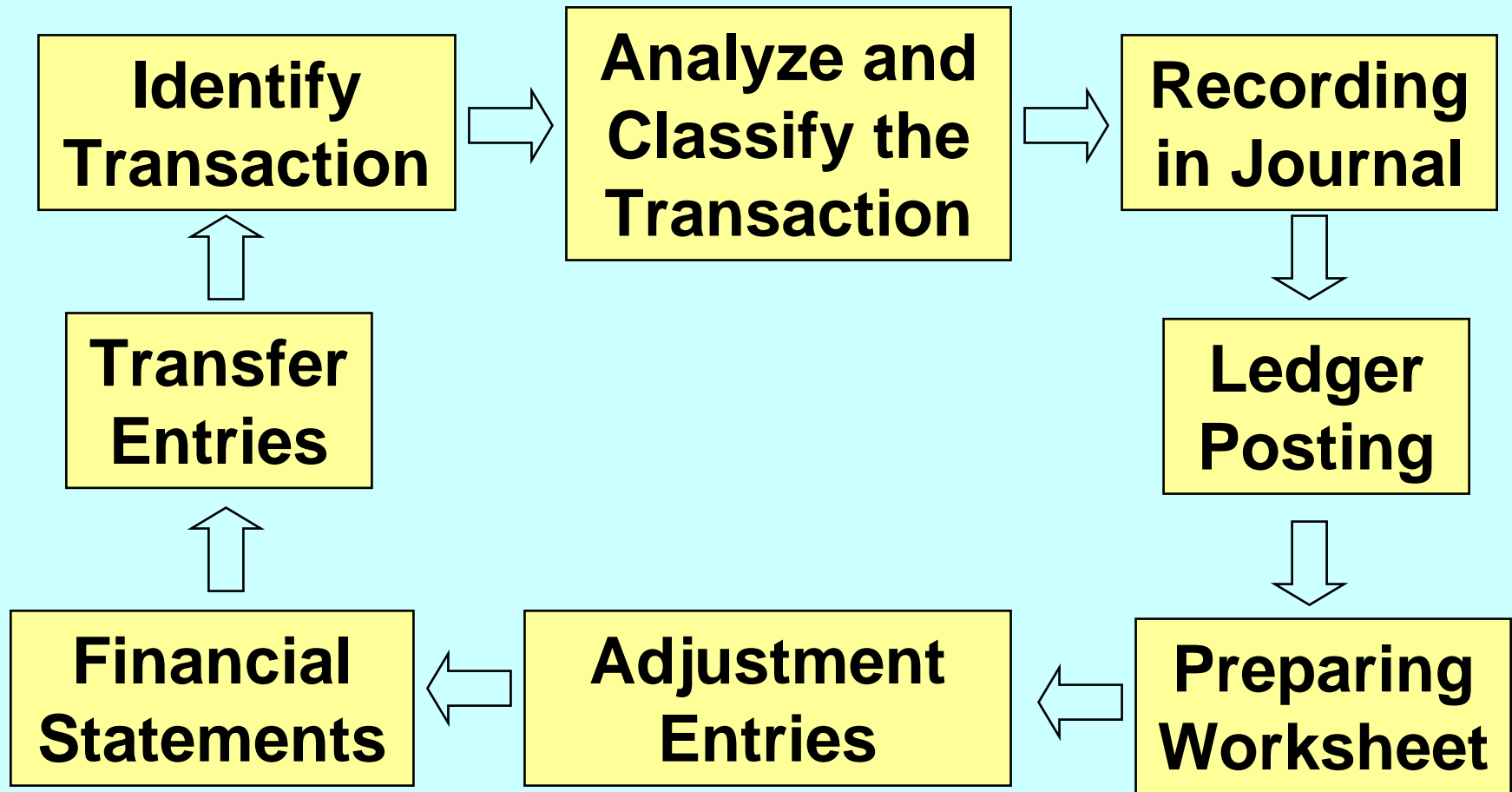
Balance Sheet Equation and Accounts

- Accounts belonging to LHS terms, namely, Assets, Expenses, and Dividends, their basic accounting character being 'debit' have ***debit balances***
- For these accounts: **Debits - Credits \geq 0**
- Similarly, in the case of accounts relating to terms on the RHS of the equality: Liabilities, Capital, and Revenues, normally have ***credit balances***
- For these accounts: **Credits - Debits \geq 0**
- In any case, equal to zero implies no balance

Information Accumulation Process

- ❑ In all accounts representing LHS terms, all increases of those items are debited and all decreases are credited in the same account
- ❑ In case of accounts representing RHS, increase with respect to an item is credited and decreases are debited to that account
- ❑ Actual balances as of a point in time would be shown by the net difference
- ❑ The terms 'debit' and 'credit' in accounting has no more practical significance than 'left' and 'right' of an account

Steps in Formation of Accounting Records



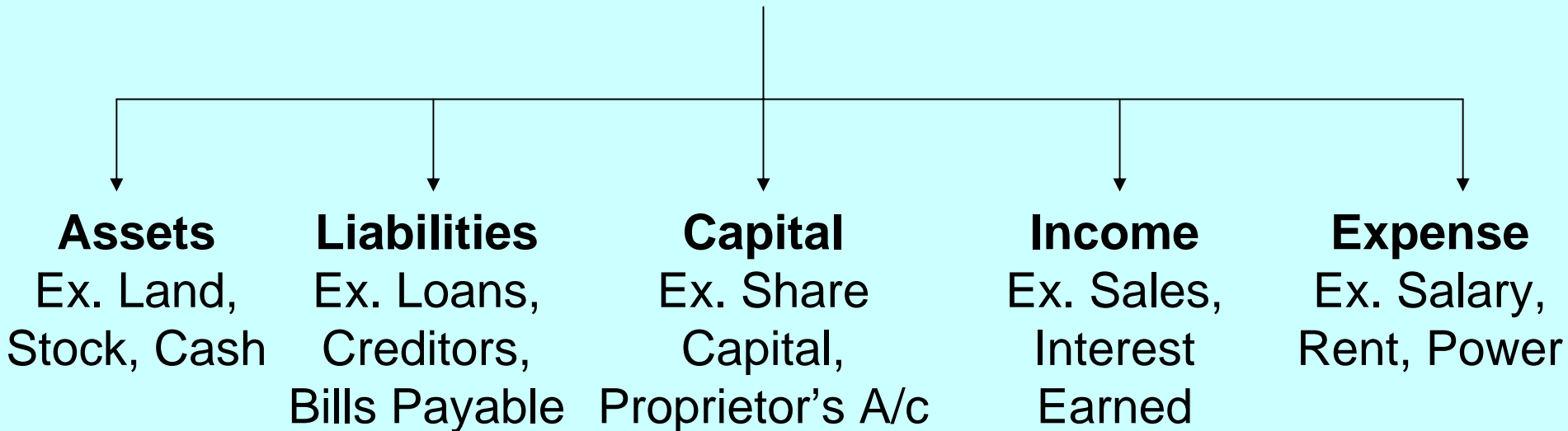
Account

- ❑ An account is a comprehensive and classified record of transactions affecting one person, one kind of property or one class of gains or losses arising out of expenses or incomes.
- ❑ Since the transactions can either increase or decrease these items an account is structured into two parts like a capital T, denoted by Debit on the LHS and Credit on the RHS
- ❑ Accounts are titled denoting the nature of information accumulated in them viz. "cash account" or "receivable account" and so on

| | | |
|--------------|---------------------|---------------|
| Debit | Cash Account | Credit |
|--------------|---------------------|---------------|

Classification of Accounts

Accounts Classified



Classification of Accounts

- ❑ The basic accounting equation reminds us that the accounts can be divided into the following five broad categories:
- ❑ **Assets** or the **resources** which a firm is enjoying
- ❑ **Liabilities** or the **obligations** of the firm towards outsiders
- ❑ **Capital** or the amount **invested** by the owners, the increase in such capital and the decreases in it.
- ❑ **Income** or **expenses** of the business affect the increase and decrease in capital. Therefore, two more forms of account
- ❑ **Incomes** or the amounts **earned** by the business
- ❑ **Expenses** or the amounts **expended** by the business

Example – Cash Account

- ❑ All transactions involving cash will be recorded in the '*cash account*'
- ❑ All increase or receipts of cash will be debited to and all decreases or payments will be credited to the cash account
- ❑ At the time of summarizing, balance in an account will be the difference
- ❑ Since it is not possible to make payments in excess of receipts, the balance in the account will have to be *debit balance*
- ❑ If the payments are equal to receipts, then, there is no balance of cash

Rules for Debit and Credit

| | | | | |
|-----------------------------|---|-----------------------------|---|-----------------------------|
| Assets | = | Liabilities | + | Common Stock |
| Debit for increase + | | Debit for Decrease - | | Debit for Decrease - |
| Credit for Decrease - | | Credit for Increase + | | Credit for Increase + |
| | | | | Retained Earnings |
| | | | | Debit for Decrease - |
| | | | | Credit for Increase + |
| | | | | Dividends |
| | | | | Debit for Increase + |
| | | | | Credit for Decrease - |
| | | | | Revenues |
| | | | | Debit for Decrease - |
| | | | | Credit for Increase + |
| | | | | Expenses |
| | | | | Debit for Increase + |
| | | | | Credit for Decrease - |

Accounting Equation

Assets = Liabilities + Shareholders Equity

Or

Assets = Liabilities + (Contributed Capital + Retained Earnings – Dividends + Revenue – Expenses)

The Journal

- ❑ A chronological record of all transactions showing the debit and credit of the accounts affected by the transaction
- ❑ Primary record for a transaction – “book of prime entry”
- ❑ Narrative Description
- ❑ Sub-divided on the basis or type of transaction into subsidiary books

| <u>JOURNAL</u> | | | | |
|-----------------------|-------------|------|-------|--------|
| Date | Explanation | Ref. | Debit | Credit |
| | | | | |

Illustration - Journalizing

- There is purchase of furniture for cash on January 1, 20X1 as per Bill No. 001 from Modern Furniture for Rs. 1000

| Journal Entries in the books of M/s... | | | | |
|---|--|-----------------|---------------------|----------------------|
| Date | Explanation | Ref. | Debit Amount | Credit Amount |
| Jan. 1, 20X1 | Furniture account (Debit) Cash Account (Credit) (Being purchase of furniture for cash from Modern Furniture as per Bill No.001.) | Invoice no: 001 | 1,000 | 1,000 |

Illustration

The following information relates to Shyam's Enterprise for a month

| Date | Transaction | Rs. |
|-------------|---|------------|
| January 1 | Starts business with | 1000 |
| January 8 | Buys merchandise and stores them | 800 |
| January 10 | Receive order for half the merchandise from A | |
| January 15 | Delivered the merchandise, customer invoiced | 500 |
| January 17 | Received order for other half of merchandise | |
| January 31 | Customer A pays | 500 |

Understanding the transactions

| Date | Transaction | Accounts affected |
|--------|---|-------------------|
| Jan 1 | Starts business with | |
| Jan 8 | Buys merchandise and stores them | |
| Jan 10 | Receive order for half the merchandise from A | |

Understanding the transactions

| Date | Transaction | Accounts affected |
|--------|--|-------------------|
| Jan 15 | Delivered the merchandise, customer invoiced | |
| Jan 17 | Received order for other half of merchandise | |
| Jan 31 | Customer A pays. | |

Process of recording...

- Starts business with Rs.1,000 – affects two accounts:
 - Cash increase - entry on the debit side of the account
 - Capital increases - entry on the credit side of the account
- Purchases merchandise and stores them
 - Merchandise inventory increase - entry on the debit side of the account
 - Cash decrease - entry on the credit side of the account.
- Receipt of order for half the merchandise
 - Receipt of order does not warrant any record. We consider realization of revenue only when goods are delivered

Process of recording...

- Delivered goods and customer invoiced
 - Cash is not collected simultaneously, it represents a credit transaction. Increase in claims against 'A' accounts receivable account created and debited
 - Revenue earned: sales account credited.
- Cost of goods sold should also be considered:
 - We part with merchandise inventory worth Rs.400. Debit cost of goods sold account with increase in expense or expiration of cost
 - Credit the merchandise inventory account to show the reduction in inventory

Process of recording...

- Receivables collected
 - Cash increase recorded by debit in cash account and a credit to receivables (A) account
 - Credit to receivables account shows the liquidation of our claim (asset). In practice this amounts to repayment of the debt by A

Recording in T accounts

| Dr. | | Cash Account | | | | Cr. |
|--------|---------------------|--------------|---------------|-----------------------|------------|-----|
| Date | Explanation | Amount | Date | Explanation | Amount | |
| Jan 1 | Capital | 1,000 | Jan 8 | Merchandize inventory | 800 | |
| Jan 31 | Accounts receivable | 500 | <i>Jan 31</i> | <i>Balance</i> | <i>700</i> | |

| Dr. | | Capital Account | | | | Cr. |
|---------------|----------------|-----------------|-------|-------------|--------|-----|
| Date | Explanation | Amount | Date | Explanation | Amount | |
| <i>Jan 31</i> | <i>Balance</i> | <i>1,000</i> | Jan 1 | Cash | 1,000 | |

| Dr | | Cost of Goods Sold Account | | | | Cr. |
|--------|-----------------------|----------------------------|---------------|----------------|------------|-----|
| Date | Explanation | Amount | Date | Explanation | Amount | |
| Jan 15 | Merchandize Inventory | 400 | <i>Jan 31</i> | <i>Balance</i> | <i>400</i> | |

Recording in T accounts

| Dr. | | Merchandise Inventory Account | | | | Cr. |
|-------|-------------|-------------------------------|---------------|--------------------|------------|-----|
| Date | Explanation | Amount | Date | Explanation | Amount | |
| Jan 8 | Cash | 800 | Jan 15 | Cost of goods sold | 400 | |
| | | | <i>Jan 31</i> | <i>Balance</i> | <i>400</i> | |

| Dr | | Account Receivable | | | | Cr. |
|---------------|----------------|--------------------|--------|-------------|--------|-----|
| Date | Explanation | Amount | Date | Explanation | Amount | |
| Jan 15 | Sales Revenue | 500 | Jan 31 | Cash | 500 | |
| <i>Jan 31</i> | <i>Balance</i> | <i>0</i> | | | | |

| Dr. | | Sales Revenue | | | | Cr. |
|---------------|----------------|---------------|--------|--------------------|--------|-----|
| Date | Explanation | Amount | Date | Explanation | Amount | |
| <i>Jan 31</i> | <i>Balance</i> | <i>500</i> | Jan 15 | Account Receivable | 500 | |

Financial Statements

| Dr. | | Income Summary | | Cr. | |
|--------------------|--------|----------------|--------|-----|-----|
| Explanation | Amount | Explanation | Amount | | |
| Cost of goods sold | 400 | Sales revenue | | | 500 |
| Profit | 100 | | | | |

| Balance Sheet on Jan. 31 | | | |
|--------------------------|--------|---------------------------------|--------|
| Assets | Amount | Liabilities and Owner(s) Equity | Amount |
| Cash | 700 | Capital | 1,000 |
| Merchandise inventory | 400 | Profit retained | 100 |
| | 1,100 | | 1,100 |

Exercise to cross check: Use accounting equation(s) to give effect to above transactions of Shyam.

Recording of Transactions

- Possible for us to record each and every transaction of an entity in a balance sheet
 - However not practically feasible
- Thus, we accumulate the transactions in separate accounts relating to revenue, expenses, assets and liabilities
- All transactions are reduced to statements of facts. These facts are then specified as a set of relationships
- Each item on a balance sheet can be changed only in one of the two possible ways by a transaction:
 - they can increase it, or
 - they can decrease it

Recording of Transactions

- By recording of transaction in accounts we are just accumulating increases and decreases of various items of the balance sheet during a period to be summarized and presented as the balance sheet at the end of the period
- The record of changes in the particular item is referred to as an *'account'*
- It is summed up at the end of an account period and the result of this summing up is the balance that would appear in the profit & loss account or balance sheet as the case may be

Alternate Account Classification

- **Personal Accounts** or the accounts that are related to persons i.e., specific parties dealing with
- **Real Accounts** or the account of tangible nature; items that can be physically possessed
- **Nominal Accounts** or the intangible items are the items that are not visible or which cannot be touched
 - Temporary in nature

In a nutshell...

Rules of Debit and Credit

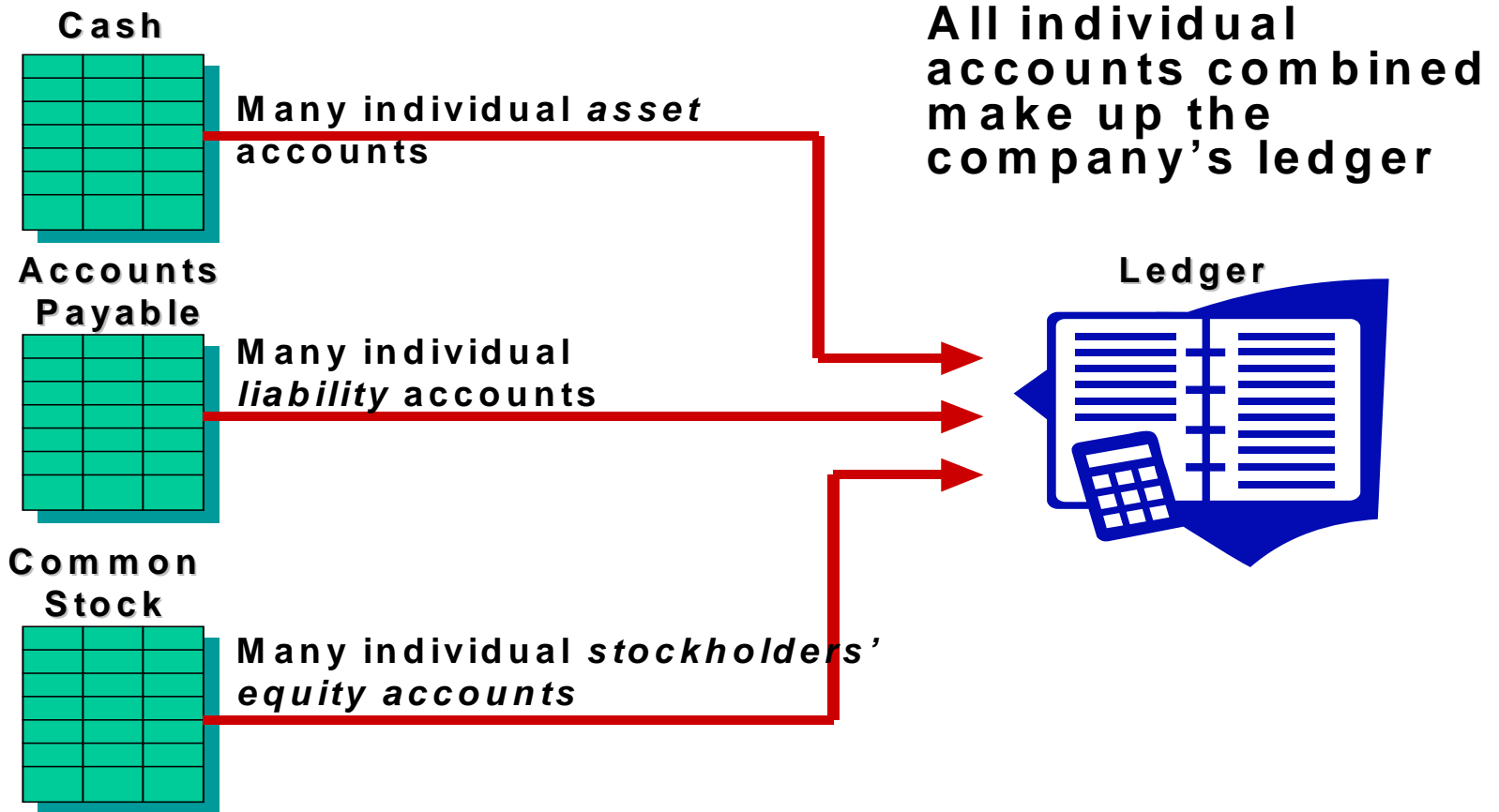
Personal Account : Debit the Receiver, Credit the giver.

Tangible Accounts : Debit what comes in, Credit what goes out.

Intangible Accounts : Debit all the expenses and losses, Credit all the gains and profits.

Ledger Accounts

- ❑ Book of final entry in which a record of debits and credits to various accounts are kept
- ❑ Nothing but a **group of accounts**
- ❑ The ledger will contain at least as many separate accounts as there are items on the balance sheet and income statement
- ❑ The number of accounts is governed by
 - Management's need for information
 - Statutory requirements if any
 - Cost of keeping it



Posting of Transactions

- ❑ Process of recording the transactions in the ledger from the books of original entry is termed as '*posting*'
- ❑ Dual aspect principle ensures that each transaction finds a place in at least two accounts
- ❑ Total amount of debits as a result of a transaction will be equal to the credits

Journal Entry & Posting to the Ledger

Journal Entry :

| <u>Particulars</u> | <u>Debit</u> | <u>Credit</u> |
|--|--------------|---------------|
| Cash A/c.....Dr. | 50,000 | |
| To Common Stock A/c (Issued Common stock to Owners) | | 50,000 |

Posting to the Ledger :

Cash A/c

| | |
|--------|--|
| 50,000 | |
|--------|--|

Common Stock A/c

| | |
|--|--------|
| | 50,000 |
|--|--------|

Illustration

| | | |
|--------|--------------------|----------|
| Jan. 1 | Sales for Cash | Rs.3,000 |
| Jan. 1 | Purchases for Cash | 1,000 |
| Jan. 3 | Rent paid in Cash | 500 |

| <u>JOURNAL</u> | | | | |
|-----------------------|--|--------------------------------|------------|------------|
| Date | Explanation | Ref | Dr. | Cr. |
| Jan 1, 20X1 | Cash (Debit) Sales (Credit) (Being cash sales) | Sales Invoice no: 001 | 3,000 | 3,000 |
| Jan 1, 20X1 | Purchases (Debit) Cash (Credit) (Being cash purchases) | Purchase Invoice no: 101 | 1,000 | 1,000 |
| Jan 3, 20X1 | Rent expense (Debit) Cash (Credit) (Being rent paid in cash) | Payment Voucher no: 011 | 500 | 500 |

Ledger Posting in T Accounts

| Dr. | | | | Sales Account | | | | Cr. | | | |
|------|-------------|------|--------|---------------|-------------|-----|--------|-----|--|--|--|
| Date | Explanation | Ref. | Amount | Date | Explanation | Ref | Amount | | | | |
| | | | | Jan 1 | Cash | | 3,000 | | | | |

| Dr. | | | | Cash Account | | | | Cr. | | | |
|-------|-------------|------|--------|--------------|--------------|-----|--------|-----|--|--|--|
| Date | Explanation | Ref. | Amount | Date | Explanation | Ref | Amount | | | | |
| Jan 1 | Sales | | 3,000 | Jan 1 | Purchases | | 1,000 | | | | |
| | | | | Jan 2 | Rent expense | | 500 | | | | |

| Dr. | | | | Purchases Account | | | | Cr. | | | |
|-------|-------------|------|--------|-------------------|-------------|-----|--------|-----|--|--|--|
| Date | Explanation | Ref. | Amount | Date | Explanation | Ref | Amount | | | | |
| Jan 1 | Cash | | 1,000 | | | | | | | | |

| Dr. | | | | Rent Account | | | | Cr. | | | |
|-------|-------------|------|--------|--------------|-------------|-----|--------|-----|--|--|--|
| Date | Explanation | Ref. | Amount | Date | Explanation | Ref | Amount | | | | |
| Jan 3 | Cash | | 500 | | | | | | | | |

Journal vs. Ledger

| Points | Journal | Ledger |
|------------------|---|---|
| Nature | Book of prime entry | Book of final entry |
| Style | Chronological record | Analytical Record |
| Process | Recording here is known as 'journalizing' | Recording here is known as 'posting' |
| Unit | Unit of classification of data is transaction | Unit of classification of data is account |
| Objective | Final Accounts cannot be prepared from this alone | Final Accounts maybe compiled with this |

Subsidiary Books – Divisions of Journal

- When volume of transactions of a business is large it is highly advantageous to classify them into groups of similar transactions
- All those transactions repeatedly affecting one aspect of an account are grouped together and recorded in a subsidiary book, Ex. Sales journal, Cash receipts journal, etc.
- All transactions not passed through the subsidiary books will be passed through the **general journal**

Some subsidiary books

- ❑ **Sale Journal** – Recording all credit sales
- ❑ **Purchase Journal** – Recording all credit purchases
- ❑ **Cash Receipts Journal** records all cash receipts
- ❑ **Cash Payments Journal** records all cash payments
- ❑ The cash receipts and payments book can be combined (like an account) there by combining the primary and secondary record in one place

Types of Cash Book

- ❑ Entries in the cash book can be passed directly, based on which the ledger accounts are prepared
- ❑ For this, there can be three types of cash book
- ❑ Simple cash book → single column cash book
- ❑ Two column cash book → having cash-bank, cash-discount, or bank-discount columns
- ❑ Three column cash book → having all three columns i.e., cash, bank and discount

Illustration

- M/s Subham & Co. purchases furniture for Rs. 10,000 on which he gets a discount of 10%. He also sells goods to M/s Sohan for Rs. 15,000. It is known that M/s Sohan also makes the full payment after availing a discount of 10%. The opening cash balance is Rs. 5,000. Prepare Cash Book.

M/s. Subham & Co.
Cash Book

| Date | Particulars | LF | Dis. | Amount | Date | Particulars | LF | Dis. | Amount |
|------|-------------|----|-------|--------|------|---------------|----|-------|--------|
| | To, Bal B/d | | 1,500 | 5,000 | | By, Furniture | | 1,000 | 9,000 |
| | To Sales | | | 13,500 | | By, Bal C/d | | | 9,500 |
| | | | 1,500 | 18,500 | | | | 1,000 | 18,500 |

Taken to the discount account in the ledger

Posting from Subsidiary Books

- Possible to post the transactions periodically

Following are the transactions of credit purchases on different dates

| | | |
|--------|------------------|----------|
| Jan. 1 | Roy and Co. | Rs.2,000 |
| Jan. 2 | Sen and Co. | 3,000 |
| Jan. 3 | Carmaker and Co. | 1,500 |
| Jan. 4 | Mondal and Co. | 6,000 |
| Jan. 5 | Naskar and Co. | 3,500 |

Purchase Journal...

| PURCHASES JOURNAL | | |
|--------------------------|---------------------------|---------------|
| Date | Credit Account of: | Amount |
| Jan. 1 | Roy and Co. | Rs.2,000 |
| Jan. 2 | Sen and Co. | 3,000 |
| Jan. 3 | Carmaker and Co. | 1,500 |
| Jan. 4 | Mondal and Co. | 6,000 |
| Jan. 5 | Naskar and Co. | 3,500 |
| Jan. 5 | Purchase Account - Debit | Rs 16,000 |

Respective 'T' Accounts

| Dr. | | | | Purchases Account | | | | Cr. | | | |
|-------|-----------------|------|--------|-------------------|-------------|-----|--------|-----|--|--|--|
| Date | Explanation | Ref. | Amount | Date | Explanation | Ref | Amount | | | | |
| Jan 5 | Sundries | | 16,000 | | | | | | | | |
| | | | | | | | | | | | |

| Dr. | | | | Roy and Co Account | | | | Cr. | | | |
|------|-------------|------|--------|--------------------|----------------------|-----|--------|-----|--|--|--|
| Date | Explanation | Ref. | Amount | Date | Explanation | Ref | Amount | | | | |
| | | | | Jan 1 | Purchases A/c | | 2,000 | | | | |
| | | | | | | | | | | | |

| Dr. | | | | Sen and Co Account | | | | Cr. | | | |
|------|-------------|------|--------|--------------------|----------------------|-----|--------|-----|--|--|--|
| Date | Explanation | Ref. | Amount | Date | Explanation | Ref | Amount | | | | |
| | | | | Jan 2 | Purchases A/c | | 3,000 | | | | |
| | | | | | | | | | | | |

Respective 'T' Accounts

| Dr. | | | | Carmaker and Co. Account | | | | Cr. | | | |
|------|-------------|-----|-----|--------------------------|----------------------|-----|-------|-----|--|--|--|
| Date | Explanation | Ref | Rs. | Date | Explanation | Ref | Rs. | | | | |
| | | | | Jan 3 | Purchases A/c | | 1,500 | | | | |
| | | | | | | | | | | | |

| Dr. | | | | Mondal and Co. Account | | | | Cr. | | | |
|------|-------------|-----|-----|------------------------|----------------------|-----|-------|-----|--|--|--|
| Date | Explanation | Ref | Rs. | Date | Explanation | Ref | Rs. | | | | |
| | | | | Jan 4 | Purchases A/c | | 6,000 | | | | |
| | | | | | | | | | | | |

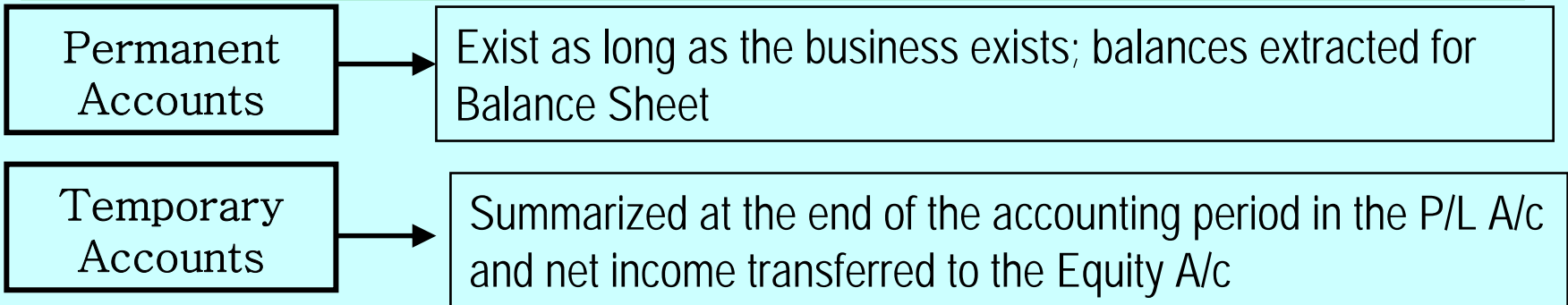
| Dr. | | | | Naskar and Co. Account | | | | Cr. | | | |
|------|-------------|-----|-----|------------------------|----------------------|-----|-------|-----|--|--|--|
| Date | Explanation | Ref | Rs. | Date | Explanation | Ref | Rs. | | | | |
| | | | | Jan 5 | Purchases A/c | | 3,500 | | | | |
| | | | | | | | | | | | |

Balancing & closing of accounts

- Financial statements can only be produced when accounts are closed
- Each account is balanced at the end of the accounting period to verify the accuracy of the records
 - Debit and credit balances match
 - Done usually at the end of the accounting period
- Each account will show a balance depending on which side of the account is heavier viz. debit or credit

Nature of Balance

| Nature of the ledger accounts | Nature of balance |
|-------------------------------|-------------------|
| Asset accounts | Debit balance |
| Liability accounts | |
| Capital and equity accounts | |
| Revenue accounts | Credit balance |
| Expense accounts | |



Posting of Closing Entries

| Closing Revenue and Expenses | Dr. | Cr. |
|--|------------|------------|
| All revenue accounts (Debit) Profit & loss A/c or Income summary (Credit) (being transfer of the balance in the revenue accounts to the profit & loss account) | | |
| Profit & loss account or Income summary (Debit) All expense accounts (Credit) (being transfer of the balance in the expense accounts to the profit & loss account) | | |

Posting of Closing Entries

| Closing Asset, Liability, and Equity | Dr. | Cr. |
|--|------------|------------|
| Asset account of next accounting period (Debit) Asset account of current accounting period (Credit) (being transfer of the balance in the account to the next accounting period) | | |
| | | |
| Liability account of current accounting period (Debit) Equity account of next accounting period (Credit) (being transfer of the balance in the account to the next period) | | |
| | | |
| Equity account of current accounting period (Debit) Equity account of next accounting period (Credit) (being transfer of the balance in the account to the next period) | | |

Adjustments

- Needed so as to recognize the effects of known facts as of the closing date, which was not known earlier
- There may also be implicit accounting transactions which need to be recognized in the records
- Typically three types of adjusting entries
 - **Deferrals** – An adjustment of an asset or a liability for which the business paid or received cash in advance
 - **Depreciation** – The systematic allocation of the cost of a plant asset to expense over the asset's useful life
 - **Accrual** – The process of recording of an expense or revenue before paying or receiving cash.

Events Often Requiring Adjustments

| Adjustment Required | Debit A/c | Credit A/c |
|--|------------------------------|------------------------------------|
| Asset increase as a result of revenue recognition not previously recorded. Example – Interest receivable. | Income or revenue receivable | Particular income or revenue a/c |
| Expenses and liabilities not recorded. Example – Rent expense due but not paid | Respective expense account | Unpaid expense account |
| Asset decreases and expenses not previously recognized. Example – Depreciation on fixed assets. | Respective expense account | Respective asset account decreases |
| Asset and liabilities not recorded. Usually arises in case of transactions around closing period, which could not be formally recorded due to non-receipt of documents etc. The accounting record takes the form of normal transaction only. | | |

Trial Balance and Work Sheet

□ **Process of preparation:**

- Balances of both debit and credit accounts of all the ledger accounts are first transferred to a *worksheet* called 'original trial balance' or 'unadjusted trial balance'
- Adjustments are worked out giving rise to an 'Adjusted trial balance'
- Finally, based on the type of the account it is, the balances of individual accounts are then taken to either of the two final financial statements

| Various Ledger Items ▼ | Original Trial Balance | | Adjustments | | Adjusted Trial Balance | | Income Summary | | Balance Sheet | |
|--|------------------------|--------|-------------|--------|------------------------|--------|----------------|--------|---------------|------------------------|
| | Debit | Credit | Debit | Credit | Debit | Credit | Debit | Credit | Assets | Liabilities and Equity |
| List all asset ledger accounts as per their liquidity order | | | | | | | | | | |
| List all liability and equity ledger accounts as per their liquidity order | | | | | | | | | | |
| List all revenue accounts | | | | | | | | | | |
| List all expense accounts | | | | | | | | | | |

Worksheet ...

- Helps in systematically finalizing an entities financial statement from its ledger account balances
- Serves two purposes:
 - Checks for arithmetical errors
 - Results in clear allocation of individual accounts to either of the two financial statements viz., Balance Sheet or Profit & Loss Account

Difference in Trial Balance

- ❑ Indication that the accounts have not been made or posted properly
- ❑ If not rectified, balance sheet will also not tally and there will always be a difference between the total of the assets side and the liabilities side
- ❑ The trial balance is **not a conclusive proof of accuracy** that no errors have been committed
- ❑ It is only a **prima facie** evidence that the accounts are in order
- ❑ Possible errors even when trial balance matches includes issues such as (a) wrong posting; (b) wrong entry; (c) error of principle; (d) compensating errors (in a series)

Steps for Locating Differences

- ❑ Check the total on both the side of a trial balance.
- ❑ Check whether all the balances have been taken to the trial balance
- ❑ Check the balancing of individual accounts properly
- ❑ For very large differences, compare the figures with those of the previous year
- ❑ If error is yet undetected, check the posting of subsidiary books first and then, the other accounts are to be checked in detail

Rectification of errors

- Once errors are located, correct entry is required to be passed
- Two types of errors
 - Errors that do not effect the trial balance
 - Errors that effect the trial balance

Errors not effecting Trial Balance

- ❑ Exists in spite of balances both the sides of a trial balance matching
- ❑ Example: If the cash received from Ram Rs. 1,000 is wrongly posted as received from Rahim, the trial balance will agree but both the accounts of Ram and Rahim will have a wrong figure. So in order to rectify such errors the following entry is passed:

| | | | |
|---------------|----------|-------|-------|
| Rahim Account | (Debit) | 1,000 | |
| Ram Account | (Credit) | | 1,000 |

(Being amount received from Ram wrongly posted to Rahim account, now rectified)

Errors effecting Trial Balance

- ❑ Placing the right figure on the right side rectifies it
- ❑ Journal entry is not required to be passed because one account out of two has been accounted for properly
- ❑ Example: Goods purchased (as raw material) from M/s Prabhu for Rs. 5,000 were taken to the purchases account with the same amount but M/s Prabhu account was credited with Rs. 500 only
- ❑ We need to credit M/s Prabhu account with another Rs. 4,500 saying "by mistake on date....rectified"

Suspense Account

- ❑ An account maintained till the trial balance is not matched
- ❑ A residual account to facilitate in the process of making the books accurate and upholding the duality principle of accounting transactions
- ❑ Amounts relating to all the errors that affect the trial balance are transferred to this account
- ❑ As and when the errors are located, a corrective entry is passed in the respective account with a corresponding entry to the suspense account
- ❑ When all the errors are located and rectified, the balance in the suspense account becomes nil

Accounting for Receivables

- ❑ Selling and buying in most of the businesses is on credit and leads to the creation of *accounts receivable* or *sundry debtors*
- ❑ We also state that in most situations these accounts are unsecured and have only the personal security of the customer
- ❑ Collection losses occur when debtors fail to pay called, *bad debts*
- ❑ Based on past experience and familiarity of market conditions, it is possible to estimate the future loss and make a provision for it

Accounting for Bad Debts

- Such provisions are used to reduce the gross accounts receivable to their estimated realizable value
- The estimated collection loss is known as 'provision for bad debts' or 'reserve for doubtful debts', etc.
- Two ways of accounting for bad or doubtful debts:
 - writing them off
 - creating a provision for bad and doubtful debts

Writing the bad debts off

- The amount of debt which is irrecoverable is treated as a loss and is transferred as bad debts expense
- For example, Chandu, a trade debtor in the books of M/s Nandu with an outstanding of Rs. 50,000, files a petition for bankruptcy. The accountant of M/s Nandu make the following entry:

| | | |
|--------------------------|----------|--------|
| Bad Debt Expense (Debit) | 50,000 | |
| Chandu Account | (Credit) | 50,000 |

(Being the amount receivable from Chandu transferred to the bad debts account)

As a result of the above entry, the profit for the period is reduced by Rs. 50,000

Bad Debt Recovery

Suppose, Chandu come back from the crisis and pays Rs. 15,000 in the next year then the following journal entries are to be passed:

| | | | |
|---------------------|-----------------------------|----------|--------|
| Cash / Bank Account | (Debit) | 15,000 | |
| | Bad Debts Recovered Account | (Credit) | 15,000 |

(Being the amount recovered from Chandu)

This amount will off course go to the Profit & Loss Account and increase the firms profit

| | | | |
|-----------------------------|-------------------------|----------|--------|
| Bad Debts Recovered Account | (Debit) | 15,000 | |
| | Profit and Loss Account | (Credit) | 15,000 |

(Being the amount of bad debt recovered transferred to the profit & loss account for the period)

Creating a Provision

- ❑ Implies setting aside some amount, out of the Profit and Loss account for the period
- ❑ Done when the exact amount of bad debt to be written off is unknown
- ❑ A percentage (or absolute figure) of the total amount can be ascertained based upon the facts and circumstances of each case and a provision can be created
- ❑ Any amount required to be written off in the coming year is met out of this provision

Illustration – Provision

Suppose, on 31st March 20X5, the following amounts were doubtful of recovery: Dinesh 3,000; Mahesh 2,000; Somesh 5,000; Ramesh 10,000

The following entry is passed for the total amount of doubtful recovery as follows:

| | | | |
|-------------------|--|--------|--------|
| Bad Debts Expense | (Debit) | 20,000 | |
| | Provision for Bad & Doubtful Debt (Credit) | | 20,000 |

(Being the amount of provision made for the accounts of Dinesh, Mahesh, Somesh and Ramesh)

Contd...

Let us further assume that the amount due on account of Dinesh and Mahesh were paid while Ramesh and Somesh were declared insolvent in the financial year ending 31-03-20X6. Also, an amount of Rs 8,000 due from Harish was considered doubtful.

Provision for Bad & Doubtful Debt (Debit) 15,000

 Accounts Receivable Account (Credit) 15,000

(Being amount outstanding from Ramesh & Somesh written off as bad debt on becoming insolvent)

Bad Debts Expense (Debit) 3,000

 Provision for Bad & Doubtful Debt (Credit) 3,000

(Being the amount of provision for the year)

Thank You

