2. FINANCIAL ACCOUNTING

We will cover the following topics in this chapter:

- Rules of Journal
- Posting in Ledger Accounts
- Subsidiary Ledgers and Control Account
- Bank Reconciliation
- Trial Balance
- Final Accounts
- Owner's Equity
- Current Assets
- Current Liabilities

Journal

"The process of recording a transaction in a journal is called journalizing the transactions."

--Meigs and Meigs and Johnson

Journal is a book that is maintained on a daily basis for recording all the financial entries of the day. Passing the entries is called journal entry. Journal entries are passed according to rules of debit and credit of double entry system.

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
1	2	3	4	5
Xxxx	****************A/c Dr. To ************A/c (Narration****************)	xx xx	xxxx	Xxxx

Column 1: It represents the date of transaction.

Column 2: Line 1 (******) represents the name of account to be debited.

Line 2 (******) represents the name of account to be credited.

Line 3 for narration of transaction.

Column 3:   Ledger Folio (L.F.) represents the page number of ledger account on which we post these entries.

Column 4 : Amount(s) to be debited.

Column 5 : Amount(s) to be credited.

Notes:

1. If there are multiple transactions in a day, the total amount of all the transaction through a single journal entry may pass with total amount.

2. If debit or credit entry is same and the corresponding entry is different, we may post a combined entry for the same. It is called **'compound entry'** regardless of how many debit or credit entries are contained in compound journal entry. For example,

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
1	2	3	4	5
Xxxx	*****************A/c Dr. *****************A/c Dr. To ***********A/c (Narration*****************)	xx xx xx	xx xx	 Xxxx

Analysis and Treatment of Transactions

Let us go through the nature of transactions and their treatment in our books of accounts. The following accounting entries are commonly used in every business and they come under the category of routine journal entries.

S.No.	Nature of Transaction	Analysis and treatment
1.	Capital	Capital account is personal account. Whenever the owner introduces capital in the form of cash, goods or assets, the entry will be as hereunder: Cash/Goods/Asset A/c Dr. XX To Capital A/c XX (Being cash/goods/assets introduced as capital)
2	Drawing Account	Drawing account is also a capital account. Whenever the owner of the business withdraws money for his personal use, it is called drawing. The balance of Drawing account is transferred to the capital account at the end of the accounting year. Drawing A/c Dr. XX

		To cash A/c XX (Being withdrawal of cash for personal use)

Notes:
1. Introduction of capital as well as withdrawal of capital may occur any time during the accounting year.

2. In addition to cash, there may be other expenses of the owner/proprietor which may pay directly on his behalf debating his account. For example, payment of his insurance, taxes, rent, electricity or personal phone bills.

3. Business account and personal account of proprietor are different as owner of the business and business, both are separate entities.

3	Trade Discount	Trade discount is allowed by seller to buyer directly on their sales invoice. Buyer in this case are usually whole-sellers, traders or manufacturers, who further sell this material to their customers or use the material in their manufacturing process. Rate of discount may vary from customer to customer. **Treatment**: No need to pass any journal entry in this case. The sale is booked on the net of trade discount. Similarly, if we get trade discount from our supplier, we book our purchase at the net of trade discount.

4	Cash Discount	Cash discount is also allowed by seller to his buyer; still it does not come in the category of trade discount. Cash discount is a sort of scheme to inspire their debtors to release their due payment in time. For example, a seller may allow 5% cash discount, if he gets payment within a week against the time limit of 45 days.
		
		Treatment: If A allowed a discount of 5% to B, then
		
		In the books of A
		  Cash A/c Dr. xx
		  Discount A/c Dr. xx
		  To B A/c xxxx
		
		(Being 5% discount allowed to B on payment of Rs........)
		
		In the books of B
		  A A/c Dr. xxxx
		    To Cash A/c xx
		    To Discount A/c xx
		(Being payment of Rs........ made to A and getting a discount of 5%)
		Note: In the above case, discount is a loss to A and income to B.

5	Bad Debts	Part of credit sale which is unrecovered from debtors due to some reason like insolvency, dishonesty, etc. are called bad debts of the company. Bad debts are loss to the company.

		Treatment:
		(1) To book bad debts
		    Bad Debts A/c Dr. xx
		         To Debtor A/c xx
		(Being loss on account of bad debts)
		
		(2) To recover bad debts
		      Cash A/c Dr. xx
		         To bad debts recovery A/c xx
		(Being recovery of bad debts)

6	Expenses on purchase of Goods	There are a few types of expenses incurred on the purchases of goods like inward freight, octroi, cartage, unloading charges, etc. **Treatment**: Inward freight/Cartage/Octroi A/c Dr. xx To Cash A/c xx (Being freight charges paid on purchase of goods)
7	Expenses on Sale of Goods	Expenses are also incurred while selling products to customers such as freight outward, insurance charges, etc. **Treatment**: Freight outward/Insurance Expenses A/c. Dr. xx To Cash A/c xx (Being freight charges paid on sale of goods)
8	Expenses on Purchase of Assets	Sometimes we need to pay expenses on the purchase of fixed assets like transportation charges, installation charges, etc. **Treatment**: Expenses incurred on purchases of fixed asset are added in the value of fixed assets and could not be treated like expenses on purchases of goods: Fixed Asset A/c Dr. XX To Cash A/c XX (Expenses incurred on purchase of asset)
9	Payment of Expenses	**Treatment**: Expenses A/c Dr. XX To Cash A/c XX (Being expenses incurred)
		Sometimes expenses remain outstanding at the end of the financial year, but due to the accrual basis of accounting,

10	Outstanding Expenses	we need to book those expenses which are due for payment and to be paid in the next accounting year. For example, the salary due on the last day of the accounting year to be paid in the next year. **Treatment**: Salary A/c Dr. XX To salary outstanding A/c XX (Being salary for the month of ....due)
11	Prepaid Expenses	Sometimes we pay expenses in advance such as insurance paid three months before the closing of the accounting year. Since insurance is usually paid for the whole year, in this case, the insurance for nine months is treated as prepaid insurance. Similarly, rent for the first month of next accounting year may be paid in advance. **Treatment**: Prepaid expenses A/c Dr. XX To Expenses/ Cash A/c XX (Being prepaid expenses for month paid) **Note:** Expenses account is replaced with the respective head of expense account.
12	Income Received	**Treatment**: Cash/Debtor A/c Dr. XX To Income A/c XX (Being Income received in cash) **Note**: Income account will be replaced with the respective head of Income account
13	Banking Transactions	**(1) Cheque deposited in bank** Cheque received from party is deposited in bank, Cheque direct deposit by party in our bank account, payment made by party through NEFT or RTGS, or cash directly deposited by party in our bank account. The entry remains same in all the above cases. Bank A/c Dr. XX To Debtor A/c XX (Being payment received from..... and deposited in bank) **(2) Payment made to party through cheque** Cheque issued to party or directly deposited in his bank account, or payment made through either by NEFT, RTGS, or cash directly deposited in his bank account. Entry remains same in all the above cases except in the case of cash deposited in his bank account.

		Debtor A/c Dr. XX
		    To Bank A/c XX
		(Being payment made through .....)
		
		If we deposit cash in his bank account, entry will be as follows:
		
		Debtor A/c Dr. XX
		    To Cash A/c XX
		(Being payment made through .....)
		
		(3) Cash withdrawn for office Expenses
		Cash A/c Dr XX
		    To Bank A/c XX
		
		(Being cash withdrawn from bank for office use)
		
		(4) Cash deposited with Bank
		Bank A/c Dr XX
		To Cash A/c XX
		
		(Being cash withdrawn from bank for office use)
		
		Note: The above entries No. 3 & 4 are called **'contra'** entries.
		
		(5) Bank charge debited by bank
		Sometimes banks debit from our account against some charges for service provided by them. For example, cheque book issuing charges, demand draft issuing charges, Bank interest, etc.
		
		Bank commission/Charges A/c Dr. XX
		    To Bank A/c XX
		
		(Bank charges/commission/interest debited by bank)

14	Interest on Capital	Interest on capital, introduced by sole proprietor or partners of the firm: This entry is passed on the last date of the accounting year as follows: Interest on capital A/c Dr. XX To Capital A/c (Being interest @..... on capital provide)
16	Payment on behalf of others	Some expenses may be on behalf of our debtors or creditors. Debtors/creditors A/c Dr. XX To Cash / Expenses A/c XX (Being expenses debited to party, paid on his behalf)

17	Advance received against supply of goods/services	Sometimes the customers pay an advance amount for the supply of goods/services, which need to be adjusted later: Bank /Cash A/c Dr. XX To Advance from Customers A/c XX (Being advance received from xxxxxxxx)
18	Advance paid against supply of goods/services	As above, we may also pay an advance amount to our supplier against supply of goods/services: Advance against supply of goods A/c Dr. XX To Cash/Bank A/c XX (Being advance paid against supply of goods/services)

Posting in a Ledger

Now let us try to understand how a journal works. With the help of journal entries, we book each and every financial transaction of the organization chronically without considering how many times the same type of entry has been repeated in that particular accounting year or period.

Journal entries in any organization may vary from hundreds to millions depending upon the size and structure of the organization. With the help of a journal, each of the transactions might be recorded; however, we can conclude nothing from a journal. Let us consider the following cases. Suppose we want to know:

- the total sale value or purchase value
- the total of any particular income or expenses
- the total of amount payable to any particular creditor or receivable from a debtor

In such cases, it might be a tedious job for any bookkeeper or accountant. Hence, the next step is ledger accounts.

The ledger helps us in summarizing journal entries of same nature at single place. For example, if we pass 100 times a journal entry for sale, we can create a sales account only once and post all the sales transaction in that ledger account date-wise. Hence, an unlimited number of journal entries can be summarized in a few ledger accounts. Transferring journal entries into a ledger account is called 'posting'.

Ruling of Account in Ledger Account

Let us see various formats of ledger accounts:

Format-1

<table>
<tr><td colspan="8">In the books of M/s. ABC Company</td></tr>
<tr><td colspan="8">Ledger account of M/s XYZ LTD.</td></tr>
<tr><td colspan="4">Dr.</td><td colspan="4">Cr.</td></tr>
<tr><td>Date</td><td>Particulars</td><td>F</td><td>Amount (Rs.)</td><td>Date</td><td>Particulars</td><td>F</td><td>Amount (Rs.)</td></tr>
<tr><td>xxxx</td><td>To Balance b/d</td><td></td><td>xxx</td><td>Xxxx</td><td>By Balance b/d</td><td></td><td>xxx</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>xxxx</td><td>To Name of the debit account</td><td></td><td>xxx</td><td>Xxxx</td><td>By Name of Credit account</td><td></td><td>xxx</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>xxxx</td><td>To Balance c/d</td><td></td><td>xx</td><td>xxxx</td><td>By Balance c/d</td><td></td><td>xx</td></tr>
<tr><td></td><td>Total Rs.</td><td></td><td>xxxx</td><td></td><td>Total Rs.</td><td></td><td>xxxx</td></tr>
</table>

Format-2

Nowadays, the handwritten books are being replaced by computerized accounts. The companies majorly use a six-column format to maintain ledger accounts of their customers. It looks as follows:

<table>
<tr><td colspan="7">In the books of M/s. ABC Bank Ltd.</td></tr>
<tr><td colspan="7">Ledger account of M/s XYZ Ltd.</td></tr>
<tr><td rowspan="2">Date</td><td rowspan="2">Particulars</td><td rowspan="2">LF</td><td rowspan="2">Debit Amount (Rs.)</td><td rowspan="2">Credit Amount (Rs.)</td><td colspan="2">Balance</td></tr>
<tr><td>Dr. or Cr.</td><td>Amount</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
</table>

Format-1 is used for academic purpose. Hence, this format is useful to learn the basics and principles of accounting.

Format-2 is used by banking and financial organization as well as well as by most of the business organizations.

Important Points Regarding Ledger

- Each side of a journal entry is posted in the same side of the ledger. It means the debit entry of a journal is posted in the debit side and vice-a-versa.

- Balance c/d refers to the balance carried down and balance b/d refers to the balance brought down.

- After posting in ledger, balancing of ledger is done. In the column named Total, the figure comes on the basis of '**whichever is higher'.** Means, if the total of debit side is Rs 10,000 and the total of credit is Rs 5,000, we write Rs 10,000 in the column named Total of both, the debit and the credit side.

- The difference of both sides (in this case, it is Rs 5,000) is written in the last row of the credit side as '**balance c/d'**. This balance is called the debit balance of account or vice-a-versa.

- All expenses and assets represent debit balance.

- All the income and liabilities represent credit balance including capital account.

- Debit balance of personal account represents '**Amount Receivable'.** This comes under the category of assets. For example debtors.

- Credit balance of personal accounts signifies '**Amount Payable'.** This comes under liabilities side and represents that we need to pay this amount which is credited due to goods, service, loan, or advance received.

- Debit side of real account means stock in hand or any kind of assets. Credit balance of Real account is not possible.

- Debit balance of nominal account means expenses of organization.

- Credit balance of nominal accounts means income earned.

- Debit balance of cash book means cash in hand.

- Debit side of Bank book means balance at bank.

- Credit balance of Bank book indicates '**Bank Overdraft'.**

- Debit and credit balances of nominal account (Expenses and income will be nil, because these balances get transferred to trading, and profit & loss account to arrive at profit and loss of the company.

- Balances of real and personal account appear in balance sheet of the company and to be carried forward to next accounting years.

Illustration:

Journalize the following transactions and post them in to ledger account:

S.No.	Transctions	Amount
1	Commenced business and introduced cash	400,000.00
2	Goods purchased for cash	50,000.00
3	Goods purchaed from Mr. Abdul	135,000.00
4	Freight charges paid on purchases	1,500.00
5	Computer purchased- cash	35,000.00
6	Freight charges paid on purchases of computer	500.00
7	Sale made to Mr. Ram	200,000.00
8	Rent paid	12,000.00
9	salary paid	15,000.00
10	Cash received from Mr. Ram	150,000.00
11	Cash deposited in bank	75,000.00
12	Office Expenses paid	25,000.00

Journal Entries

S.No.	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
1.	Cash A/c Dr. To Capital A/c (Being capital introduced)	**	4,00,000	4,00,000
2.	Purchase A/c Dr. To Cash A/c (Being cash purchase made)	**	5,00,000	5,00,000
3.	Purchase A/c Dr. To Abdhul A/c (Being goods purchase from Abdhul)	**	135,000	1,35,000
4.	Inward Freight Charges A/c Dr.	**	1,500	

	To Cash A/c				
	(Being freight charges Paid)				1,500
5	Computer A/c Dr.	**	35,000		
	To Cash A/c				
	(Being computer purchased on cash)				35,000
6.	Computer A/c Dr.	**	500		
	To Cash A/c				
	(Being freight charges on computer paid)				500
7.	Ram A/c Dr.	**	2,00,000		
	To Sale A/c				
	(Being sold to Mr. Ram)				2,00,000
8	Rent A/c Dr.	**	12,000		
	To Cash A/c				
	(Being rent paid)				12,000
9.	Salary A/c Dr.	**	15,000		
	To Cash A/c				
	(Being salary paid)				15,000
10.	Cash A/c Dr.	**	1,50,000		
	To Ram A/c				
	(Being cash Received from Mr. Ram)				1,50,000
11.	Bank A/c Dr.	**	75,000		
	To Cash A/c				
	(Being cash deposited in Bank)				75,000
12.	Office Expenses A/c Dr.	**	25,000		
	To Cash A/c				
	(Being office expenses paid)				25,000