Accounting Equation

An accounting **transaction** is a business activity or event that causes a measurable change in the accounting equation. An exchange of cash for merchandise is a transaction. Merely placing an order for goods is not a recordable transaction because no exchange has taken place. In the coming sections, you will learn more about the different kinds of financial statements accountants generate for businesses.

In the previous section we described specific types of accounts that business activities fall into, namely:

1. Assets (what it owns)

2. Liabilities (what it owes to others)

3. Equity (the difference between assets and liabilities or what it owes to the owners)

These are the building blocks of the **basic accounting equation**. The accounting equation is:

ASSETS = LIABILITIES + EQUITY

For Example: A sole proprietorship business owes $12,000 and you, the owner personally invested $100,000 of your own cash into the business. The assets owned by the business will then be calculated as: $12,000 (what it owes) + $100,000 (what you invested) = $112,000 (what the company has in assets)

Assets	=	Liabilities	+ Equity
112,000	=	12,000	100,000

In a sole-proprietorship, equity is actually Owner's Equity. If the business in question is a corporation, equity will be held by stockholders, which uses stockholder's equity but the basic equation is the same:

ASSETS = LIABILITIES + EQUITY

For Example:
A business owes $35,000 and stockholders (investors) have invested $115,000 by buying stock in the 9 company. The assets owned by the business will then be calculated as: $35, 000 (what it owes) + $115,000 (what stockholders invested) = $150,000 (what the company has in assets)

Assets	=	Liabilities	+ Equity
150,000	=	35,000	115,000

Since each transaction affecting a business entity must be recorded in the accounting records based on a detailed account (remember, file folders and the chart of accounts from the previous section), analyzing a transaction before actually recording it is an important part of financial accounting. An error in transaction analysis could result in incorrect financial statements.

To further illustrate the analysis of transactions and their effects on the basic accounting equation, we will analyze the activities of Metro Courier, Inc., a fictitious corporation. Refer to the chart of accounts illustrated in the previous section.

1. Owners invested cash

Metro Courier, Inc., was organized as a corporation on January 1, the company issued shares (10,000 shares at $3 each) of common stock for $30,000 cash to Ron Chaney, his wife, and their son. The $30,000 cash was deposited in the new business account.

Transaction analysis:

- The new corporation received $30,000 cash in exchange for ownership in common stock (10,000 shares at $3 each).
- We want to increase the asset Cash and increase the equity Common Stock.

	Assets	Equity
Transaction	Cash	Common Stock
1. Owner invested cash	+ 30,000	+ 30,000

Let's check the accounting equation: Assets $30,000 = Liabilities $0 + Equity $30,000

2. Purchased equipment for cash

Metro paid $ 5,500 cash for equipment (two computers).

Transaction analysis:

- The new corporation purchased new asset (equipment) for $5,500 and paid cash.
- We want to increase the asset Equipment and decrease the asset Cash since we paid cash.

	Assets		Equity
Transaction	Cash	Equipment	Common Stock
1. Owner invested cash	+ 30,000		+ 30,000
2. Purchased equipment for cash	– 5,500	+5,500	
Balance:	24,500	5,500	30,000

Let's check the accounting equation: Assets $30,000 (Cash $24,500 + Equipment $5,500) = Liabilities $0 + Equity $30,000

3. Purchased truck for cash

Metro paid $ 8,500 cash for a truck.

Transaction analysis:

- The new corporation purchased new asset (truck) for $8,500 and paid cash.
- We want to increase the asset Truck and decrease the asset cash for $8,500.

	Assets			Equity
Transaction	Cash	Equipment	Truck	Common Stock
1. Owner invested cash	+ 30,000			+ 30,000
2. Purchased equipment for cash	– 5,500	+5,500		
3. Purchased truck for cash	– 8,500		+8,500	
Balance:	16,000	5,500		30,000

Let's check the accounting equation: Assets $30,000 (Cash $16,000 + Equipment $5,500 + Truck $8,500) = Liabilities $0 + Equity $30,000

4. Purchased supplies on account.

Metro purchased supplies on account from Office Lux for $500.

Transaction analysis:

- The new corporation purchased new asset (supplies) for $500 but will pay for them later.
- We want to increase the asset Supplies and increase what we owe with the liability Accounts Payable.

	Assets=				Liabilities+	Equity
Transaction	Cash	Supplies	Equipment	Truck	Accounts Payable	Common Stock
1. Owner invested cash	+ 30,000					+ 30,000
2. Purchased equipment for cash	– 5,500		+5,500			
3. Purchased truck for cash	– 8,500			+8,500		
4. Purchased supplies on Account.		+500			+500	
Balance:	16,000	500	5,500	8,500	500	30,000

Let's check the accounting equation: Assets $30,500 (Cash $16,000+ Supplies $500 + Equipment $5,500 + Truck $8,500) = Liabilities $500 + Equity $30,000

5. Making a payment to creditor.

Metro issued a check to Office Lux for $300 previously purchased supplies on account.

Transaction analysis:

- The corporation paid $300 in cash and reduced what they owe to Office Lux.
- We want to decrease the liability Accounts Payable and decrease the asset cash since we are not buying new supplies but paying for a previous purchase.

	Assets=				Liabilities+	Equity
Transaction	Cash	Supplies	Equipment	Truck		
1. Owner invested cash	+ 30,000					+ 30,000
2. Purchased equipment for cash	– 5,500		+5,500			
3. Purchased truck for cash	– 8,500			+8,500		
4. Purchased supplies on Account.		+500			+500	
5. Making a payment to creditor	-300				-300	
Balance:	15,700	500	5,500	8,500	200	30,000

Let's check the accounting equation: Assets $30,200 (Cash $15,700 + Supplies $500 + Equipment $5,500 + Truck $8,500) = Liabilities $200 + Equity $30,000

6. Making a payment in advance.

Metro issued a check to Rent Commerce, Inc. for $1,800 to pay for office rent in advance for the months of February and March.

Transaction analysis (to save space we will look at the effects of each of the remaining transactions only):

- The corporation prepaid the rent for next two months making an advanced payment of $1,800 cash.
- We will increase an asset account called Prepaid Rent (since we are paying in advance of using the rent) and decrease the asset cash.

	Assets	
Transaction	Cash	Prepaid Rent
Previous Balance	$15,700	
6. Making a payment in advance.	-1800	+1800
Balance:	13,900	1,800

The only account balances that changed from transaction 5 are Cash and Prepaid Rent. All other account balances remain unchanged. The new accounting equation would be: Assets $30,200 (Cash $13,900 + Supplies $500 + Prepaid Rent $1,800 + Equipment $5,500 + Truck $8,500) = Liabilities $200 + Equity $30,000

7. Selling services for cash.

During the month of February, Metro Corporation earned a total of $50,000 in revenue from clients who paid cash.

Transaction analysis:

- The corporation received $50,000 in cash for services provided to clients.
- We want to increase the asset Cash and increase the revenue account Service Revenue

	Assets	Revenues
Transaction	Cash	Service Revenue
Previous Balance	$13,900	
7. Saving service for cash	-50,000	+50,000
Balance:	$63,900	$50,000

Wait a minute…the accounting equation is ASSETS = LIABILITIES + EQUITY and it does not have revenue or expenses…where do they fit in? Revenue – Expenses equals **net income.** Net Income is added to Equity at the end of the period. Assets $80,200 (Cash $63,900 + Supplies $500 + Prepaid Rent $1,800 + Equipment $5,500 + Truck $8,500)= Liabilities $200)+ Equity $80,000 (Common Stock $30,000 + Net Income $50,000). Note: This does not mean revenue and expenses are equity accounts!

8. Selling services on credit.

Metro Corporation earned a total of $10,000 in service revenue from clients who will pay in 30 days.

Transaction analysis:

- Metro performed work and will receive the money in the future.
- We record this as an increase to the asset account Accounts Receivable and an increase to service revenue.

	Assets	Revenues
Transaction	Accounts Receivable	Service Revenue
Previous Balance		$50,000
8. Selling service on credit	+10,000	+10,000
Balance:	$10,000	$60,000

Remember, all other account balances remain the same. The only changes are the addition of Accounts Receivable and an increase in Revenue. Assets $90,200 (Cash $63,900 + Accounts Receivable $10,000 + Supplies $500 + Prepaid Rent $1,800 + Equipment $5,500 + Truck $8,500)= Liabilities $200 + Equity $90,000 (Common Stock $30,000 + Net Income $60,000).

9. Collecting accounts receivable.

Metro Corporation collected a total of $5,000 on account from clients who owned money for services previously billed.

Transaction analysis:

- Metro received $5,000 from customers for work we have already billed (not any new work).

- We want to increase the asset Cash and decrease (what we will receive later from customers) the asset Accounts Receivable.

	Assets	
Transaction	Cash	Accounts Receivable
Previous Balance	$63,900	$10,000
9. Collecting accounts receivable	+5,000	-5,000
Balance:	$68,900	$5,000

Assets $90,200 (Cash $68,900 + Accounts Receivable $5,000 + Supplies $500 + Prepaid Rent $1,800 + Equipment $5,500 + Truck $8,500)= Liabilities $200 + Equity $90,000 (Common Stock $30,000 + Net Income $60,000).

10. Paying office salaries.

Metro Corporation paid a total of $900 for office salaries.

Transaction analysis:

- The corporation paid $900 to its employees.
- We will increase the expense account Salaries Expense and decrease the asset account Cash.

	Assets	Expenses
Transaction	Cash	Salary Expense
Previous Balance	$68,900	
10. Paying office Salaries	-900	+900
Balance:	$68,900	$5,000

Remember, net income is calculated as Revenue – Expenses and is added to Equity. The new accounting equation would show: Assets $89,300 (Cash $68,000 + Accounts Receivable $5,000 + Supplies $500 + Prepaid Rent $1,800 + Equipment $5,500 + Truck $8,500)= Liabilities $200 + Equity $89,100 (Common Stock $30,000 + Net Income $59,100 from revenue of $60,000 – expenses $900).

11. Paying utility bill.

Metro Corporation paid a total of $1,200 for utility bill.

Transaction analysis:

- The corporation paid $1,200 in cash for utilities.
- We will increase the expense account Utility Expense and decrease the asset Cash.

	Assets	Expenses
Transaction	Cash	Utilies Expense
Previous Balance	$68,900	
11. Paying utility bill	-1,200	+1,200
Balance:	$66,800	$1,200

The final accounting equation would be: Assets $88,100 (Cash $66,800 + Accounts Receivable $5,000 + Supplies $500 + Prepaid Rent $1,800 + Equipment $5,500 + Truck $8,500) = Liabilities $200 + Equity $87, 900 (Common Stock $30,000 + Net Income $57,900 from revenue of $60,000 – salary expense $900 – utility expense $1,200).

Accounting Procedures

A. Basic Accounting Procedures and Concepts

1. Accounting Process

Accounting is the process of recording, measuring, summarizing, analyzing, and interpreting financial information and communicating it for decision-making purposes.

a. An **Accounting Entity** is any business, individual, or not-for-profit organization whose financial information is separate from any other.

b. Accountants are concerned with these **Types of Business Entities.**

i) A sole proprietorship is owned by one individual; it is a separate accounting entity from the individual, but not a separate legal entity.

ii) A partnership has two or more owners that operate together and share the profits/losses as agreed. It is a separate accounting entity, but not separate legally.

iii) A corporation is a separate legal entity created by law; it has the same legal rights as individuals. A charter must be obtained from the state where it is formed and then shares of stock are issued in exchange for assets. These shareholders/stockholders are the owners.

c. **Financial Information Is Recorded** when the transaction takes place.

i) A common monetary unit is used for recording; this is known as the money management or monetary unit principle.

ii) Historical cost is used to determine the value of assets; that means the original cost is the basis.

iii) The stable dollar concept assumes that a dollar today is worth the same amount as the dollar used to buy the asset in the past.

d. **Financial Information is Classified** relative to the areas that are affected.

e. **Financial Information is Summarized** into reports to make it more useful in decision making.

f. Accounting information is **Used by Different Groups of People.**

i) Internal users include managers in the organization.

ii) External users are separate from the organization; specific and general reports may be generated for this group.

2. Reporting Accounting Information

a. External Reports that serve general purposes are known as financial statements; they include the balance sheet, income statement, statement of retained earnings, and statement of cash flows.

1. Generally Accepted Accounting Principles (GAAP) are set by the Financial Accounting Standards Board. The rules are necessary because the information is provided to external users.
2. Audits are performed by CPAs to judge the fairness of reports; the independent review determines if the GAAP have been followed.

b. **Internal Reports** are used by managers and do not have to follow generally accepted accounting principles

3. Basic Concepts and principles used in accounting include the following:

a. **Going Concern** states that the accountant assumes that the entity will continue operations indefinitely.

b. **Relevance** means the accounting information must make a difference in the decisions made using it.

c. **Periodicity** divides the life of an accounting entity into time intervals for reporting purposes. An accounting period consisting of 12 consecutive months is called a fiscal year; it may or may not follow the calendar.

d. **Estimation** is used to determine amounts for the financial reports because the life of a entity is divided into arbitrary time intervals.

e. **Consistency** requires that the same accounting or reporting method be used form one period to another. If a change must be made, it must also be disclosed in the financial statements.

f. **Conservatism** requires that the valuation method of an asset that is least likely to overstate the income for financial position be used.

g. **Full Disclosure** requires that all information relevant to decision makers be disclosed through financial statements.

h. **Materiality** refers of the relative importance of an item or event to the decisions that users will be making.

B. Summarizing Financial Data

1. Accounts are used to collect and summarize data; they can also be called ledger accounts.

a. **Recording Information in Accounts** can be done in different formats.

i) Computerized systems store data on magnetic tape or disks.

ii) Manual systems use a three- column account format.

b. **T-Accounts** are used as teaching tools; they resemble a capital T.

c. **Recording debits** (left side) and Credits (right side) add and subtract from an account's balance.

d. **Recording entries** summarize transactions.

e. **Calculating Account Balances** means taking the difference between debits and credits; the balance is recorded on the side with the larger balance.

f. The **Ledger** is a record of accounts.

2. Classification of Permanent Accounts

a. **Assets** are economic resources from which the owner can expect to benefit.

i. Increases are debits, decreases are credits, and the normal account balance is on the debit side.

ii. Assets are recorded at cost because that can be verified.

b. i) **Liabilities** are obligations or debts that are owed to others.

ii) Increases are credits, decreases are debits, and the normal account balance is on the credit side.

c. Owner's Equity represents the resources invested by the owners; however, the liabilities must come first and the owners get what is left.

i) In a sole proprietorship, the owner's equity is recorded in the owner's capital account.

ii) In a partnership, each owner has his or her own capital account.

iii) In a corporation, owner's equity is divided into contributed capital and earnings of the company.

iv) Decreases in owners' may come from investments made by owners or retained earnings of the business.

v) Decreases in owners' equity may come from distribution of cash or assets to owners or losses incurred through business operations.

vi) Increases to owners equity are recorded as credits decreases are debits, and the normal account balance is on the credit side.

d. Balance sheet accounts are also called permanent accounts because they remain on the company's books permanently.

3. The Accounting Equation: Assets= Liabilities +Owner's Equity

a. **Equality** must always be represented between assets and associated right/claims.

b. **Source of Assets** is another way to look at liabilities: all of the resources used to obtain assets are provided through creditors holdings or owners investments.

c. **Continual Changes in Composition** of assets, Liabilities, and capital are normal: however, the equity of the basic equation must always be maintained.

d. **Residual Aspect of Owner's Equity** allows the equation to be rewritten as Assets-Liabilities=Owner's Equity.

e. **Double –Entry Accounting** states the debits must equal credits for every entry that is recorded.

4. Classification of Temporary Accounts

a. i) **Revenues** are earnings based on business operations.

ii) Increases are credits, decreases are debits, and the normal balance is credit.

b. i) **Expenses** are costs of goods and services used as a result of earning revenue.

ii) **Increases** are debits, decreases are credits, and the normal balance is debit.

c. Net Income = Revenue-Expenses

i) Net income is reported periodically (when it is earned).

ii) Accrual concept matches revenue with its associated expenses; they are reported when they are accrued rather than when they are paid.

iii) The matching principle states that expenses incurred in earning revenues should be matched with that revenue to calculate that net income.

iv) Increases to owner's equity come from reporting a net income; decreases come from a net loss.

v) Revenue and expense accounts are closed to income summary.

d. **Investments by Owners**

i) The investment is not revenue it is recorded as assets and increases owners equity.

ii) If a corporation sells shares of stock, the cash is not revenue. It is recorded as an increase to cash and an increase to capital stock.

e. **Withdrawals and Dividends**

i) Withdrawals of assets from a business are not expenses; they decrease owner's equity and the assets.

ii) Dividends represent a distribution of assets to stockholders; that is not an expense.

5. The Accounting Cycle includes all procedures performed during each accounting period.

a. Analyze and Record transactions while preparing the source document.

b. **Post journal Entries** to ledger accounts, both the debits and credits.

c. **Prepare a Trial Balance** to check debits/credits.

i) The trial balance proves the equality of debits and credits; however, it does not ensure there are no errors in the previous steps.

ii) A trial balance can be prepared at any time.

d. **Complete Worksheet** to make the end-of-period processes easier, like adjusting entries, closing entries, and financial statements.

i) Complete each set of columns on the worksheet.

ii) Make the end-of-period adjustments.

iii) Journalize and post the entries.

e. **Prepare Financial Statements** using the worksheet information.

f. **Prepare a Post-closing Trial Balance** is the final step in the accounting cycle; it includes only the permanent accounts.

g. **The next Accounting Cycle begins** on the first day of the next accounting period.

C. Preparing Journal Entries

1. Recording Accounting Transactions

a. Journalizing is done chronologically; it is the first recording of each transaction.

i) A <u>source document</u> provides information for recording journal entries; examples include checks, sales invoices purchase orders, and receipts.

ii) A general journal most common type of journal; if a business uses just one type, then it is general.

b. Posting is a process that transfers journal entries to the ledger.

i). Post debit entry first; the journal page number is recorded in the reference column.

ii). The ledger account number is the reference recorded in the journal.

iii). The same procedure is followed for the credit side of the journal entry.

c. Review the typical accounting transactions that are analyzed in this section to reinforce the concepts that have been presented so far.

d. Review the typical accounting transactions, including revenue and expenses, to reinforce the concepts that have been presented so far.

2. Adjusting Entries are necessary to bring accounts up to date that have incorrect balances at the end of the accounting period. Review the sample entries throughout this section.

a. **Estimates** are one reason for adjusting entries.

i) Depreciation expense is adjusted to properly reflect the asset's value and depreciation expense for the accounting period.

ii) Allowance for uncollectible accounts is adjusted to correspond with the current accounting period.

b. **Prepaid/Unearned Accounts** are another area where adjusting entries are recorded.

i). Expenses that are originally recorded as assets are adjusted for the current accounting period. Some expenses that are adjusted include insurance expense and supplies expense. Adjustments are also made for expenses that are originally recorded as expenses like supplies and insurance.

ii). Revenues that are originally recorded as liabilities represent deferred revenue; the adjustment updates the account for the revenue that has been received, like rent revenue. The revenue may also have been first recorded as revenue, and an adjusting entry would update that.

d. Accruals

i). Accrued expenses are adjusted to display the expenses that have actually been incurred, like salaries and interest.

ii). Accrued revenues are also updated for the revenue earned in the current period; interest is a good example.

iii). Interest revenue is earned with the passage of time on most notes receivable held by a company, but interest revenue is not normally recorded until it is received.

iv). The **Worksheet** is used to show the unadjusted trial balance, adjustments, adjusted trial balance, income statement, and balance sheet information.

Other adjustments are shown in examples.

3. Closing Entries are recorded to close the temporary accounts at the end of each accounting period to prepare for the next. They are done in the following order:

a. Close revenue and gain accounts to income summary.

b. Close expense and loss accounts to income summary.

c. Close the income summary account.

d. Close withdrawal and dividend accounts.

e. Journalize and post closing entries.

Prepare the post-closing trial balance and everything is ready for the next accounting period.

Source Documents and Preparation of Vouchers

The concept of Source Documents or Vouchers

Any document based upon which a financial transaction is recorded in the books of accounting is known as 'source documents.' Among these, the documents which show the amount and nature of a business transaction are known as 'vouchers'.

Once a business sells its products, certain invoices are prepared for sending their goods out of the workplace, cash memos for cash sales and bills for denoting credit sales. While the original copy is sent or handed over to the buyer, a duplicate copy is set aside for recording it in the books of accounts. It is these duplicate copies which are known as source documents and are further used for recording it in the books of accountancy. Similarly, the original copy which a company receives while purchasing a good from some other company is also termed as source documents.

Vouchers are the cash memos, bills, receipts, traveling allowance bills, wage bills, salary bills, registration deeds, counterfoils of cheques, etc. These vouchers can be any form of written document which validates that a financial transaction has happened so that it can be considered as provable documents of that transaction.

Source documents are significant in everyday life too. For example- while paying house rent to a landlord, a receipt for the received rent is received. Electricity Supply companies, Insurance companies, Water Works issue a receipt for the received rent to their customers. Employees of a company affix their signature on salary bills and wages bills when they receive their payments in the form of salaries and wages. This depicts that monetary receipts are received for every form of payments in all sectors of life.

Thus, in the case of accountancy, the first step is identifying the foundation of a financial transaction. This is based on a documentary proof known as source documents.

Source Documents

Meaning

Accountancy is a subject which deals with facts which take place and are further proved by written evidence which is termed as source documents. These documents act as evidence that a financial transaction has taken place. All entries in the books of accounting are based on the information which has been derived from these documents. It is a must that in the case of accountancy a financial transaction has to be supported by source documents which are known as vouchers.

Types of source documents

1. Cash Memo

It is a source document which indicates the details, amount and date of cash sales and cash purchases of a company. It specifies the cash memos which have been issued by that company on cash sales and the cash memos received on purchases. It is based on this, that cash payment, cash sales and cash purchases are recorded in the accounting books.

2. Cheques

Cheques can be issued for various payments, either self-withdrawal or payments. For recording in the books of accounting, it is either the notes on the chequebook or the counterfoil of cheques which are taken into consideration. The received cheques are deposited through Pay-in-Slip into the book.

3. Invoices and Bills

Invoices and bills are documents which are used for credit sales and credit purchases. For credit sale, invoices and bills are received indicating the amount, date and details of the sale. In the case of credit purchases; invoices and bills are received with the details of the credit purchase.

These invoices get prepared in three copies. While the first is sent to the buyer, the second is send along with the goods and third is used for books of accountancy in the form of a source document.

4. Credit Note

Credit Notes are issued to customers in the event of sales return. Here, the customer's account is credited with the sales return amount. These credit notes are further used as a source document.

Name of the Firm Issuing the Note
Address of the Firm
Date of Issue
No.

DEBIT NOTE

Against : Supplier's Name
Goods returned as per Delivery Challan No. Amount (Rs.)
(Details of goods returned)
(Rupees .... Only)
Signature of the Manager with date

5. Debit Note

Debit Notes are issued to sellers in case of return of goods which were purchased on credit. The seller's account is debited with the amount of purchase return. Further, this debit note is used as a source document for recording about the purchase return in books of accounting.

Name of the Firm Issuing the Note

Address of the Firm

Date of Issue

No.

CREDIT NOTE

Against : Customer's Name

Goods returned by the customer Amount (Rs.)

Challan No.

(Details of goods received)

(Rupees .... Only)

Signature of the Manager with date

6. Pay-in-Slip

Pay-in-slip is filled up while depositing cheques and cash in the bank. While the main body of pay-in-slip is kept with the bank, the duly stamped and signed counterfoil is given to the consumer. This is further used for recording it in the accounting book.

7. Receipt

Whenever an amount is received or paid, the receiver issues a receipt to his payer. This indicates the date, amount and other details like the purpose of payment, payee details, etc. This receipt is used as a source document for the amount received or paid for recording it in the books of accounting.

8. Miscellaneous

Other than the ones listed above, there are various other source documents like registration deeds, bills like electricity, salaries, wages, water, telephones, tickets, counterfoils which are also used and termed as source documents.

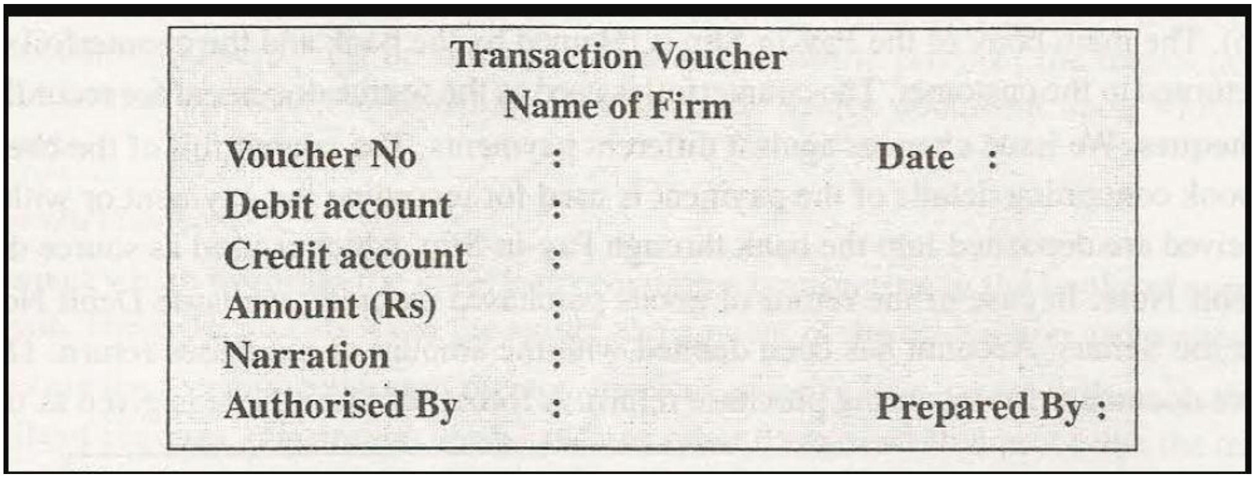
Vouchers:

Definition

Ronald A. Irish believes that a voucher can be an invoice, a written requisition slip, a receipt, agreement or any written proof which validates a financial transaction.

1. R. Batliboi has defined voucher as a form of documentary evidence which is in support of an entry which has appeared in the books of accountancy.

A voucher looks like-



Transaction Voucher

Name of Firm

Voucher No : Date :

Debit account :

Credit account :

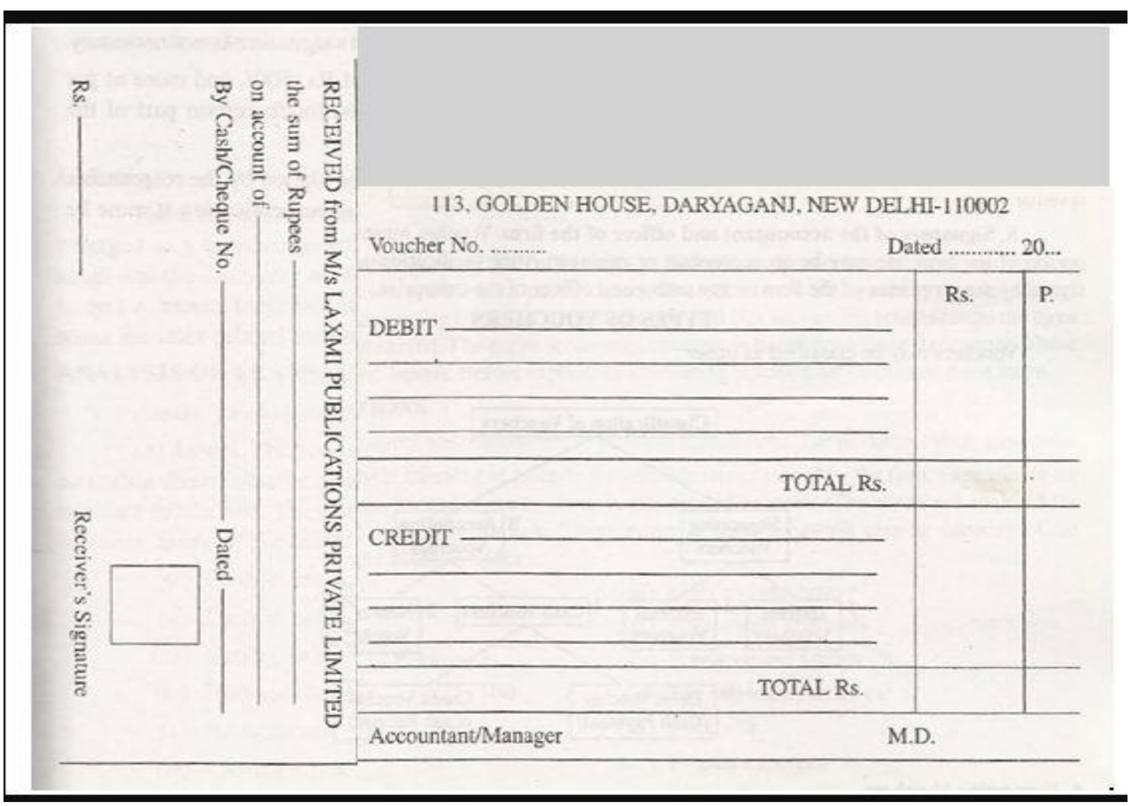
Amount (Rs) :

Narration :

Authorised By : Prepared By :

Features of Vouchers

- These are written documents.
- These are a form of written evidence of any financial transaction.
- Vouchers validate an entry in the books of accounting.
- These authenticate that an entry in the books of accountancy is valid.
- These contain the full details of a monetary transaction like the date, amount and other financial details.



RECEIVED from M/s LAXMI PUBLICATIONS PRIVATE LIMITED

the sum of Rupees

on account of

By Cash/Cheque No. Dated

Rs.

Receiver's Signature

113, GOLDEN HOUSE, DARYAGANJ, NEW DELHI-110002

Voucher No. .... Dated .... 20...

	Rs.	P.
DEBIT		
TOTAL Rs.		
CREDIT		
TOTAL Rs.		

Accountant/Manager M.D.

Examples of Vouchers

1. Cash Payment- Vouchers like wage sheets, cash memos, correspondence, salary register copies of contracts, etc. are types of cash payments.
2. Cash Receipts- Carbon copies, counterfoils of issued receipts, carbon copies of completed contracts, correspondence, etc. are various forms of cash receipts.
3. Purchase Return- Letter of credit, goods outward book, correspondence, are examples of purchase return vouchers.
4. Purchases- Vouchers regarding purchases are – copies of sent order, invoices, goods inward book, correspondence, etc.
5. Sales- Vouchers like record of supplied goods, copies of received orders, correspondence, good outward book, etc. are sales vouchers.

Journal-and-Ledger

What is a Ledger in Accounting?

A ledger is a book containing accounts in which the classified and summarized information from the journals is posted as debits and credits. It is also called the second book of entry.

The ledger contains the information that is required to prepare financial statements. It includes accounts for assets, liabilities, owners' equity, revenues and expenses. This complete list of accounts is known as the chart of accounts. The ledger represents every active account on the list.

What Is a Ledger Account?

The accounting ledger contains a listing of all general accounts in the accounting system's chart of accounts.
Here are the primary general ledger accounts:

- Asset accounts include fixed assets, prepaid expenses, accounts receivable and cash
- Liability accounts which include notes payable, lines of credit, accounts payable and debt
- Stockholders' equity accounts
- Revenue accounts
- Expense accounts
- Revenue and loss accounts such as interest, investment, disposal of an asset

These transactions are recorded throughout the year by debiting and crediting these accounts. The transactions are caused by normal business activities such as billing customers or through adjusting entries.

The ledger account may be in the form of a written record if accounting is done by hand or in the form of electronic records when accounting software packages are used.

How Do You Write a Ledger?

Businesses that use the double-entry bookkeeping method of recording transactions make the accounting ledger. Each transaction is recorded into at least two ledger accounts. The entries have debit as well as credit transactions and are posted in two columns.

A general ledger is used by businesses that employ the double-entry bookkeeping method, which means that each financial transaction affects at least two general ledger accounts and each entry has a debit and a credit transaction. Double-entry transactions are posted in two columns, with debit postings on the left and credit entries on the right, and the total of all debit and credit entries must balance.

Ledgers break up the financial information from the journals into specific accounts such as Cash, Accounts Receivable and Sales, on their own sheets. This allows you to see the details of all your transactions.

1. Make a ledger for each account. For example, a cash account ledger will contain all the cash transactions of your business. For unusual or odd expenses, make a general ledger account.

2. Make columns on the far left of the page for the date, journal number and description.
3. Make columns on the left side for debit, credit, and balance. Debit refers to the money you receive while credit refers to the money that you paid or owe. Balance is the difference between the debit and credit.
4. Enter the information from the journals into related accounts. Place related debits and credits side by side. Calculate the balance you've earned or owe.
5. Record and make changes to the transactions as they occur. If you've made a journal entry, post it to the ledger immediately.
6. Combine the different accounts to make a full ledger. The front page includes the chart of accounts, listing each account in the ledger and its number.

The next step in the accounting cycle is to create a trial balance. The information in the ledger accounts is summed up into account level totals in the trial balance report. The trial balance totals are matched and used to compile financial statements.

What's the Difference Between a Journal and a Ledger?

The journal and ledger both play an important role in the accounting process. The business transactions are primarily recorded in the journal and thereafter posted into the ledger under respective heads. While many financial transactions are posted in both the journal and ledger, there are significant differences in the purpose and function of each of these accounting books.

Meaning

The financial transactions are summarized and recorded as per the double entry system in a journal. It's also known as the primary book of accounting or the book of original entry.

The ledger, on the other hand, is known as the principal book of accounting. It records the information from the journal in the "T" format. It is used to create the trial balance which is also the source of the financial statements such as the income statement and the balance sheet.

Recording Transactions

The process of recording transactions in a journal is called journalizing while the process of transferring the entries from the journal to the ledger is known as posting.

The transactions in a journal are recorded in a chronological order making it easy t identify the transactions are associated with a given business day, week, or another billing period. By contrast, the arrangement of entries within a ledger has more to do with grouping like transactions together into specific accounts for purposes of assessing the data for internal financial and accounting purposes.

Format

The format of a journal is simple. It includes the transaction date, particulars of the transaction, folio number, debit amount and credit amount. There is no scope for balancing in a journal.
The format of a journal:

Date	Particulars	L.F.	Debit	Credit
Transaction date	Account title and	Ledger folio	Amt.	Amt.

	details	number		

The ledger uses the "T" format where the date, particulars, and amount is recorded in each side.

The format of a ledger:

Date	Particulars	Folio Number	Amount	Date	Particulars	Folio Number	Amount
Transaction date	Account name		Transaction amount	Transaction date	Account name		Transaction amount

Unlike a journal, some ledger accounts start with an opening balance that is the closing balance of the previous year. Also, in the end, the ledger amounts should be balanced.

Preparing a ledger is important as it serves as a master document for all your financial transactions. Since it reports revenue and expenses in real time, it can help you stay on top of your spending. The general ledger also helps you compile a trial balance, spot unusual transactions and aids in the creation of financial statements.

Journal

Date (1)	Particulars (2)	L.F. (3)	Debit ₹ (4)	Credit ₹ (5)

- **Date:** Date of the transaction is entered in the first column. This date is entered only once unless and until there is change in the date of transaction. It should be entered in a proper sequence.
- **Particulars:** Each business transaction has two accounts- debit and credit. In the first line of the particular column, name of the debit account is written along with word "Dr." at the end. In the second line, start with the word "To" and after some space from the margin, the name of the credit account is written.
- **Narration:** Explanation of the transaction is provided within the brackets after each journal entry is called narration.
- **Ledger Folio:** All journal entries are posted later into the ledger accounts. The page number or folio number of the ledger is recorded in the L.F. column of the journal. Till then, the column remains blank.
- **Debit:** The amount of the account being debited is written in this column.
- **Credit:** The amount of the account being credited is written in this column.

Limitations:

- As the numbers of transactions in a business are large, journal becomes bulky and voluminous and therefore is not suitable in case of such large volume of transactions.
- It is considered as a difficult process as recording of journal entries requires proper identification of accounts and correct compliance of the accounting concepts and conventions.

- Cash transactions are usually recorded in a separate book called 'cash book'. Those transactions are not recorded in journal.
- After recording journal entries, separate ledger account is required to be prepared for individual account balances. Therefore, a Journal can never be used as a substitute to ledger.

Important Considerations in Journalising Transactions

Understanding the steps in Journalising, Casting, Carry Forward and some important Considerations:

- **Steps in Journalising:** The process of analysing all the business transactions of debit and credit and recording them in the journal is called Journalising. Following are the steps to be followed in Journalising the transactions:
- Determine the two accounts involved in the transaction.
- Classify the accounts into assets, liabilities, capital, expenses and incomes.
- Apply the rules of debit and credits for the above two accounts and identify which account is to be debited and credited.
- Record the date of transaction, particulars of transaction and mention the respective debit and credit amounts against each item.
- Write a brief description of the transaction recorded within brackets in the next line in the particulars column. Such description is termed as narration.
- Draw a line across the particulars column to divide one journal entry from the other.

Casting (Totalling) and Carry Forward:

- The process of totaling the amounts in the debit and credit columns on each page of a journal is termed as Casting or Totalling.
- This is required when the transactions of a business are voluminous and requires a number of pages of Journal.
- After totalling the amounts on each page, in the particulars column, against the total, the words 'Total c/f' (carried forward) are written. This shows the amount that has been carried forward to the next page. On the next page, in the particulars column, against the amount brought forward, the words 'Total b/f' (brought forward) are written. This shows the amount that has been brought forward from the previous page.

Points to determine Cash and Credit Transactions:

- If the name of the seller or purchaser is mentioned in a transaction stating that cash is transacted, then it is accounted as a cash transaction.
- If the name of the seller or purchaser is mentioned in a transaction without stating that cash is transacted, it is accounted as a credit transaction.
- If the transaction relates to sales or purchases and the name of the seller or purchaser is not given, it is accounted as a cash transaction.
- In case of expenses, even if the name of the party receiving or making payment is given, it is accounted as expense incurred in cash and personal account of the person receiving the amount is not debited.

- Any amount introduced as capital in the business by the proprietor is credited to his/her Capital Account whereas withdrawal of cash or goods for his/her personal use is debited to Drawings Account.

Understanding Purchase and Sale of Goods:

- It is important to understand the meaning of goods before understanding the purchase and sale of goods. Goods are those items that are purchased for manufacture or for the purposes of resale and not for the purpose of using it in the business. The items that are purchased to use in the various business activities for a longer period of time are assets and not goods.
- It is necessary to have an idea of the accounts associated with purchase and sale of goods as follows:

i. Purchase Account: This account is debited when the goods are purchased by following rule for Expenses Account i.e., Increase in expense is debited and decrease in expense is credited'.

ii. Sales Account: This account is credited when the goods are sold by following rule for Revenue Account i.e., Increase in revenue is credited and decrease is debited.

iii. Purchases Return Account: It is credited when the goods purchased are returned by the firm. In the event of finalising the accounts, such purchase return account is deducted from the Purchase Account to show the purchases at net amount.

iv. Sales Return Account: It is debited when the goods sold are returned to the firm. In the event of finalising the accounts, such Sales Return Account is deducted from the Sales Account to show the sales at net amount.

v. Closing Stock Account: It shows the value of the unsold stock. It is the net balance of Opening Stock + Net Purchases – Net Sales which is valued at Cost or Net Realisable Value (Market Value), whichever is less.

Understanding Discount and Rebate

Meaning, Advantages and Accounting for Discount and Rebate:

- Discount: It is the amount of reduction in the price of goods and/or services or a reduction in the total amount payable for such goods or services. Such discount is further classified as Trade Discount and Cash Discount:

  - **Trade Discount:**

- **Meaning:** It is a reduction in the prices of the goods allowed by the seller to the buyer for buying goods of certain quantity or value (bulk purchase discount). When such discount is allowed, Purchases and Sales are recorded in the books at their net value i.e., Purchases – Trade Discount and Sales – Trade Discount respectively. Such trade discount is allowed on sale of goods, therefore, it is allowed on both cash and credit sales. GST is applied at the net value of sale.

- **Advantages:**

i. It improves sales by encouraging the purchaser to buy larger quantities.

ii. It reduces the purchase cost of the purchaser and therefore, can be used as a tool to face competition.

iii. It increases the profit margin for the retailers and helps them earn more profits by making sales at list price.

iv. Differential pricing may be followed by reseller as it enables them to sell at different prices without even reprinting the catalogues or changing the price given in the articles.

- ○ **Cash Discount:**

- **Meaning:** It is allowed for timely payment of the amount. Such amount is recorded in the books for which it is treated as an expense by the party allowing such discount and income for the party receiving such discount.

- **Advantages:**

i. It helps the seller of the goods realise the payment promptly as it encourages the debtors to make the payment within a specified period.

ii. It reduces the bad debts and improves cash inflow of the business.

iii. It enables sale of goods at lower prices by way of better cash discount.

- ○ **Accounting:** Following journal entries are required to be passed for cash discount:

i. On receiving cash discount:

Creditor's A/c ...Dr.

To cash or bank A/c

To discount received A/c

ii. On allowing cash discount;

Cash or bank A/c ...Dr.

Discount Allowed A/c ...Dr.

To debtors A/c

- **Rebate:**

- ○ **Meaning**: It is a reduction in the price of the goods after the goods have been sold for Reasons other than that for allowing trade discounts (goods sold when delivered turned to be of lower quality). It is offered and allowed on sales completed in the past.

- **Accounting:**

  At the time of purchase of goods, Input GST is debited. Therefore, at the time of receipt of rebate on such purchase of goods, Input GST earlier debited will be reversed by crediting the respective GST Account.
- At the time of sale of goods, Output GST is credited. Therefore, at the time of allowance of rebate on such sale of goods, Output GST earlier credited will be reversed by debiting the respective GST Account.

Entries for some Specific Transactions

1. Bad Debts:

The amount that was receivable but could not be realized (partially or fully), such amount that is not recovered is a loss to the business and recorded as Bad Debt.

i. If amount is not recoverable:

Bad Debts A/c …Dr. (amount not received)

    To Debtor's Personal A/c

(Being the amount not recoverable written off as bad debt)

ii. If some part of debt is not recoverable:

Cash or Bank A/c …Dr. (amount received)

Bad Debts A/c …Dr. (amount not recovered)

    To Debtor's Personal A/c (total amount of debtor)

(Being the amount received and balance written off as bad debts not recoverable)

Bad Debts Recovered: The amount of bad debts recovered is a gain for the business because the amount was earlier written off as a loss (i.e., bad debts). Such amount of bad debts recovered is firstly credited to Bad Debts Recovered Account and later transferred to Profit and Loss Account.

Cash or Bank A/c …Dr.

    To Bad Debts Recovered A/c

(Being the amount earlier written off as bad debt, now recovered)

2. Cash for Personal Use: Such amount is termed as Drawing by the proprietor.

Drawings A/c …Dr.

    To Cash A/c

(Being cash withdrawn for personal use)

3. Goods for Personal Use: Such goods for personal use are also termed as Drawing by the proprietor. Since GST (input GST) was paid at the time of purchase of such goods, it is now to be reversed as it is not available to set off against the output GST.

Drawings A/c …Dr.

To Purchases A/c (cost of goods)

To Input CGST A/c (CGST on goods)

To Input SGST A/c (SGST on goods) or

To Input IGST A/c (IGST on goods)

(Being the goods withdrawn for personal use and GST thereon reversed)

4. Goods given as charity: It reduces the purchases as the goods are not sold.

Charity/Donation A/c …Dr. (purchase cost + GST Paid)

To Purchases A/c (purchase cost)

To Input CGST A/ c (CGST on goods)

To Input SGST A/c (SGST on goods)

To Input IGST A/c (IGST on goods)

5. Goods given as free Samples: Such distribution of goods encourages sales but is not the actual sales and therefore debited to the Advertisement Account. Also, since such distribution reduces the stock of goods, it is reduced from the purchases along with the input GST thereon.

Advertisement A/c …Dr.

To Purchases A/c (purchase cost)

To Input CGST A/ c (CGST on goods)

To Input SGST A/c (SGST on goods)

To Input IGST A/c (IGST on goods)

6. Loss of Stock by theft or damage or fire: This is a loss to the business which increases the expenses and therefore debited in the books:

Loss of Stock by theft or damage or fire A/c …Dr.

To Purchases A/c (purchase cost)

To Input CGST A/ c (CGST on goods)

To Input SGST A/c (SGST on goods)

To Input IGST A/c (IGST on goods)

If the goods/stock is insured entry passed is as follows:

Insurance Co. …Dr.

To Purchases A/c

To Input CGST A/ c (CGST on goods)

To Input SGST A/c (SGST on goods)

To Input IGST A/c (IGST on goods)

If full amount of claim is received from the Insurance Company:

Bank A/c ...Dr.

To Insurance Co.

If Insurance Company does not pay full claim amount:

Bank A/c ...Dr. (Claim amount received)

Loss of Stock by theft or damage or fire A/c (claim not admitted recorded as loss in books)

To Insurance Co. (Total Claim)

7. Purchase and Sale of fixed assets:

Purchase of fixed asset:

Fixed Asset A/c ...Dr. (purchase cost)

Input CGST A/c ...Dr. (CGST on asset)

Input SGST A/c ...Dr. (SGST on asset)

Input IGST A/c ...Dr. (IGST on asset)

To Cash/Bank A/c (if purchased by making immediate payment)

To Supplier's A/c (if purchased on credit)

Sale of fixed asset:

Cash/Bank A/c ...Dr. (If sold for cash/cheque)

Purchaser's A/c ...Dr. (if sold on credit)

Loss on Sale of Asset ...Dr. (Book Value – Sale Value)

To Fixed Asset A/c (Book Value)

To Gain on Sale of Asset (Sale Value – Book Value)

To Output CGST A/c (CGST on sale)

To Output SGST A/c (SGST on sale)

To Output IGST A/c (IGST on sale)

8. Outstanding Expenses: It is that expense which related to current year but have not been paid till the end of the year.

Expense A/c ...Dr.

To Outstanding Expense A/c

9. Prepaid Expenses: It is that expense which is paid during the current year but relate to the following accounting year.

Prepaid Expense A/c ...Dr.

To Expense A/c

10. Sundry Expenses: These are the petty expenses that involve small amounts and therefore, are not material in nature. All such petty amounts are together recorded as Sundry Expenses: Sundry or Miscellaneous Expenses A/c …Dr.

To Cash A/c

11. Accrued Income: It is the income which has been earned but has not been received or has not become due.

Accrued Income A/c …Dr.

To Income A/c

12. Advance Income: It is the income received but not earned.

Income A/c … Dr.

To Income received in Advance A/c

13. Depreciation: It is the fall in the value of fixed assets which decreases the asset value in the books every year.

Depreciation A/c …Dr.

To Assets A/c

14. Banking Transactions:

i. **Cash Deposited for opening an account:**

Bank A/c …Dr.

To Cash A/c

ii. Withdrawn of cash for office use:

Cash A/c …Dr.

To Bank A/c

iii. Withdrawal of cash for personal use:

Drawings A/c …Dr.

To Bank A/c

iv. Cheque payment to a creditor:

Creditor's A/c …Dr.

To Bank A/c

v. Cheque issued dishonoured:

Bank A/c …Dr.

To Creditor's A/c

vi. Cheque received from Debtor and deposited on the same day:

Bank A/c …Dr.

To Debtor's A/c

vii. Cheque received from Debtor and not deposited on the same day:

Cheque-in-hand A/c …Dr.

To Debtor's A/c,

Later at the time of deposit,

Bank A/c …. Dr.

To Cheque-in-hand A/c

viii. Cheque deposited dishonoured:

Debtor's A/c …Dr.

To Bank A/c

ix. Payment to creditor by draft:

Creditor's A/c …Dr.

Bank Charges A/c …Dr.

To Bank A/c

x. Payment of expenses:

Expenses A/c …Dr.

To Bank A/c

xi. Bank charges paid:

Bank Charges A/c …Dr.

To Bank A/c

xii. Bank interest charged:

Interest A/c …Dr.

To Bank A/c

xiii. Bank interest allowed:

Bank A/c …Dr.

To Interest Received A/c

xiv. Payment (insurance premium) made by bank on firm's behalf:

Insurance Premium A/c …Dr.

To Bank A/c

xv. Collection (dividend) by bank on firm's behalf:

Bank A/c …Dr.

To Dividend A/c

xvi. Bank loan repaid in cash:

Bank Loan A/c …Dr.

To Cash A/c

xvii. Bank loan repaid in cheque:

Bank Loan A/c …Dr.

To Bank A/c

xviii. Transfer of funds from one bank to another bank:

One Bank A/c …Dr.

To Another Bank A/c

15. Opening Entry:

- All the enterprises close their books of accounts on at the end of every year.
- In this process, all the nominal accounts are closed by transferring them to the Profit and Loss Account and all personal and real account balances are carried to the next year known as closing balances of the respective accounts.
- Such closing balances become the opening balances for the next year and therefore, an opening journal entry is passed at the beginning of the year.
- At the time of passing an opening entry, all Assets are debited individually whereas Capital and Liabilities are individually credited as shown below:

Assets A/c (individually) …Dr.

To Liabilities (individually) A/c

To Capital A/c

(Being balances of assets, liabilities and capital brought forward)

In order to compute the amount of Capital, following equation can also be used:

Capital = Assets Liabilities