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FREE EBOOK

ACCOUNTING AND BUSINESS

Basics of Accounting

Debit and credit, journal, ledger, trial balance and final accounts, made simple

INSIDE THIS BOOK

- What accounting is
- Assets, liabilities, capital, income and expenses
- The accounting equation
- Debit and credit: the golden rules and the modern rules
- Journal entries: a month at a small shop
- ...and 6 more chapters, practice questions and a glossary

Beginner

Commerce students and anyone starting Tally

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Basics of Accounting

A gentle first course in accounting for commerce students and anyone about to learn Tally. Follow one small shop through a month of twenty transactions, from journal entries and ledger posting to the cash book, the trial balance, the trading and profit and loss account and the balance sheet. Depreciation and correcting errors are covered too.

WHO IT IS FOR	Commerce students and anyone starting Tally
LEVEL	Beginner
SUBJECT AREA	Accounting and business
WHAT IS INSIDE	11 chapters, practice questions with answers, and a glossary

HOW TO USE IT

Read one chapter at a time and try the examples as you go: on a computer, at your workbench or in your notebook. The boxes give tips, safety points and short activities. When you finish, test yourself with the practice questions and check your answers at the end. Words you may not know are explained in the glossary.



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What accounting is

Every business, from a tea stall in Varanasi to a big company in Mumbai, needs answers to three questions. How much did we earn? What do we own? What do we owe? Accounting gives those answers.

Accounting is the work of recording, sorting and summing up the money side of a business, so that people can understand it and make decisions. It has four steps:

1. **Recording** every money event on the day it happens.
2. **Classifying**: putting similar items together, such as all rent payments.
3. **Summarising**: making short statements, such as the profit for the year.
4. **Interpreting**: reading those statements to judge how the business is doing.

Transactions

A **transaction** is an event that involves money or money's worth and changes the position of the business. Buying goods, selling goods, paying rent and taking a loan are all transactions.

Not every event is a transaction. When a customer phones to place an order, nothing has changed hands, so nothing is recorded. Delivering and billing the goods is the transaction.

Transactions are of two kinds:

- **Cash transactions**: payment is made at once, in cash, by UPI, card or cheque.
- **Credit transactions**: payment is made later. "Credit" here means "pay later", not the credit side of an account.

Bookkeeping is only the recording part. **Accounting** includes bookkeeping and also preparing statements and explaining them. The owner reads the accounts to know the profit; a bank reads them before giving a loan; suppliers, partners and the tax department read them too.

DID YOU KNOW

Indian traders have kept accounts for centuries in long, red cloth-bound books called bahi-khata (बही खाता). Today most shops use software such as Tally, but the rules inside are the same ones you will learn here.

The business is separate from its owner

This is the **business entity** idea, and it is the most important idea in this chapter. In the books, the business and its owner are two different persons, even if one person owns the whole shop.

So when the owner brings money into the business, the business "owes" that money to the owner. This amount is called **capital**. When the owner takes money or goods out of the business for home use, it is called **drawings**.

EXAMPLE

Ravi Verma opens a small general store in Bhopal with ₹ 2,00,000 of his own savings. In the shop's books, the shop has ₹ 2,00,000 of cash, and it owes Ravi ₹ 2,00,000 as capital. If Ravi later pays his daughter's school fees from the shop's cash, that is not a shop expense. It is drawings.

Every transaction has two sides

When Ravi buys a fan for cash, the shop gets a fan and gives cash. This is the **dual aspect** idea. Recording both sides of every transaction is called **double entry**, and it is the base of all accounting.

In India, the **financial year** for accounts runs from 1 April to 31 March. Accounts for a year are usually prepared up to 31 March.

REMEMBER

Keep business money and home money apart, always.

CHAPTER 2

Assets, liabilities, capital, income and expenses

All accounting is built from five kinds of item. Learn these five well and the rest of the book becomes easy.

Assets

An **asset** is something the business owns that has value. Examples are cash, money in the bank, furniture, a computer, a delivery van, a building and goods kept for sale.

Assets come in two groups:

- **Fixed assets** are kept for long-term use in the business, not for sale. A shop's counter, shelves and computer are fixed assets.
- **Current assets** change form quickly, usually within a year. Cash, bank balance, goods in stock and money owed by customers are current assets.

A customer who has bought goods on credit and still has to pay is called a **debtor**. The money a debtor owes is an asset, because the business will receive it.

Liabilities

A **liability** is an amount the business owes to outsiders. A **creditor** is a person or firm to whom the business owes money, often a supplier who sold goods on credit. A bank loan is a liability. So is a salary that is due but not yet paid.

Capital

Capital is what the business owes its owner. It goes up when the owner brings in more money and when the business makes a profit. It goes down when the owner takes drawings and when the business makes a loss.

Income

Income is what the business earns. The main income of a shop is from sales. Other incomes include commission, interest and discount received.

Expenses

An **expense** is money spent to run the business and earn income. Rent, salaries, electricity, phone bills, transport and repairs are expenses. A **loss** is money lost with nothing gained, such as goods stolen or damaged by rain.

"Goods" has a special meaning

In accounting, **goods** means the things a business buys in order to sell them. For a stationery shop, notebooks and pens are goods. For a furniture dealer, chairs are goods. But when a stationery shop buys a chair to use at its own counter, that chair is a fixed asset, not goods. Buying goods is recorded as **purchases**; selling goods is recorded as **sales**.

Item	What kind of item it is
Delivery van	Asset (fixed)
Goods in stock	Asset (current)

Item	What kind of item it is
Amount due from a customer	Asset (debtor)
Loan from a bank	Liability
Amount due to a supplier	Liability (creditor)
Owner's investment	Capital
Commission received	Income
Shop rent	Expense

TRY THIS

Decide the kind of item for each: (a) a cash register, (b) salary paid, (c) interest received, (d) money owed to a wholesaler, (e) money in a savings account of the business. Answers: (a) asset, (b) expense, (c) income, (d) liability, (e) asset.

CHAPTER 3

The accounting equation

Everything a business owns has come from one of two sources: the owner or outsiders. So:

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

This is the **accounting equation**. It stays true after every transaction, because both sides always change in a way that keeps them equal.

A worked example

Anjali opens a tailoring shop in Nagpur. Watch the equation after each of her transactions.

1. She starts with ! 50,000 cash.
2. She buys a sewing machine for ! 15,000 in cash.
3. She buys cloth for ! 10,000 on credit from Rajan Textiles.
4. She stitches clothes for customers and receives ! 8,000 in cash.
5. She pays shop rent of ! 3,000.
6. She pays ! 6,000 to Rajan Textiles.
7. She takes ! 2,000 cash for home use.

No.	Cash	Machine	Cloth	Creditors	Capital
1	50,000	0	0	0	50,000
2	35,000	15,000	0	0	50,000
3	35,000	15,000	10,000	10,000	50,000
4	43,000	15,000	10,000	10,000	58,000
5	40,000	15,000	10,000	10,000	55,000
6	34,000	15,000	10,000	4,000	55,000
7	32,000	15,000	10,000	4,000	53,000

The first three money columns are assets. The last two are liabilities and capital. Check the last row: assets are $32,000 + 15,000 + 10,000 = ₹ 57,000$. Liabilities and capital are $4,000 + 53,000 = ₹ 57,000$. The equation holds.

In step 2, one asset went down and another went up, so total assets did not change. In step 4, the income of ₹ 8,000 increased cash and also capital, because profit belongs to the owner. The rent in step 5 and the drawings in step 7 reduced both cash and capital.

The equation with income and expenses

Since income adds to capital and expenses reduce it, we can write a longer form:

$$\text{Assets} = \text{Liabilities} + \text{Capital} + \text{Income} - \text{Expenses} - \text{Drawings}$$

REMEMBER

Every transaction changes at least two items. If you change only one, the equation breaks. This is why every entry in accounting has two sides.

TRY THIS

Mehul's business has assets of ₹ 4,80,000 and liabilities of ₹ 1,30,000. What is his capital?
Answer: $4,80,000 - 1,30,000 = ₹ 3,50,000$.

Debit and credit: the golden rules and the modern rules

Each item in the books has its own record, called an **account** (A/c). Every account has two sides: the left is the **debit** side (Dr) and the right is the **credit** side (Cr). These are just names for left and right, not good or bad.

In every transaction, at least one account is debited and one credited, for the same total. There are two ways to decide which is which. Both give the same answer, so use the one you find easier.

Types of accounts

The traditional method sorts accounts into three types.

- 1. Personal accounts** are accounts of persons: natural persons (Mohan Lal), artificial persons (a bank, a company, a school), or accounts that stand for a person, such as "Salary Outstanding" (salary owed to staff). Capital and Drawings are the owner's personal accounts.
- 2. Real accounts** are accounts of things, whether you can touch them (cash, furniture) or not (a trademark).
- 3. Nominal accounts** are accounts of expenses, losses, incomes and gains, such as Rent, Salary, Commission Received and Discount Received.

The golden rules

Type of account	Debit	Credit
Personal	The receiver	The giver
Real	What comes in	What goes out
Nominal	All expenses and losses	All incomes and gains

Using the golden rules in three steps

- 1.** Find the two accounts involved.
- 2.** Decide the type of each.
- 3.** Apply the rule for that type.

EXAMPLE

Ravi pays shop rent of ₹ 6,000 in cash. The accounts are Rent and Cash. Rent is nominal and an expense, so debit Rent. Cash is real and it goes out, so credit Cash.

EXAMPLE

Ravi sells goods on credit to Mohan Lal for ₹ 18,000. Mohan Lal is a person who receives the goods, so debit Mohan Lal. Sales are goods going out, so credit Sales.

Goods accounts (Purchases, Sales and their returns) are treated as real accounts by many teachers: goods come in when you buy and go out when you sell. Some books call them nominal. The entry is the same either way.

The modern rules

The modern method uses five types, which match the five items of the last chapter.

Type of account	Increase	Decrease
Asset	Debit	Credit
Expense or loss	Debit	Credit
Liability	Credit	Debit
Capital	Credit	Debit
Income or gain	Credit	Debit

A simple way to remember: assets and expenses increase on the debit side; liabilities, capital and income increase on the credit side. Drawings reduce capital, so drawings are debited.

EXAMPLE

Ravi takes a loan of ₹ 50,000 from a bank, paid into the shop's bank account. The bank balance (an asset) increases, so debit Bank. The loan (a liability) increases, so credit Bank Loan.

TIP

When you are stuck, ask two questions. What did the business get? What did it give? What it got is usually the debit. What it gave is usually the credit.

Journal entries: a month at a small shop

The **journal** is the book where every transaction is first written, in date order. It is called the **book of original entry**. Writing a transaction in the journal is called **journalising**.

The journal format

Date	Particulars	L.F.	Debit !	Credit !
1 Apr	Cash A/c Dr		2,00,000	
	To Capital A/c			2,00,000
	(Being business started with cash)			

- The account to be debited comes first, with "Dr" at the end of the line.
- The account to be credited comes on the next line, set in a little, starting with "To".
- The **narration** is a short note in brackets that explains the entry. It usually starts with "Being".
- **L.F.** means ledger folio: the page number of the ledger where the entry is posted. You fill it in when you post.

Twenty transactions at Ravi's store

Ravi Verma opens his general store in Bhopal in April. To keep the examples simple, GST is left out. Read each transaction, decide the entry yourself, then check the table.

No.	Transaction	Debit	Credit
1	1 Apr: Ravi starts the business with cash ! 2,00,000	Cash A/c	Capital A/c
2	2 Apr: Deposits ! 1,20,000 cash in a bank account	Bank A/c	Cash A/c
3	3 Apr: Buys shelves and a counter for ! 30,000 by cheque	Furniture A/c	Bank A/c
4	4 Apr: Buys goods for cash ! 40,000	Purchases A/c	Cash A/c
5	5 Apr: Buys goods on credit from Gupta Traders ! 50,000	Purchases A/c	Gupta Traders A/c

No.	Transaction	Debit	Credit
6	6 Apr: Sells goods for cash ! 25,000	Cash A/c	Sales A/c
7	8 Apr: Sells goods on credit to Mohan Lal ! 18,000	Mohan Lal A/c	Sales A/c
8	10 Apr: Pays shop rent ! 6,000 in cash	Rent A/c	Cash A/c
9	11 Apr: Returns goods worth ! 2,000 to Gupta Traders	Gupta Traders A/c	Purchase Returns A/c
10	12 Apr: Mohan Lal returns goods worth ! 1,000	Sales Returns A/c	Mohan Lal A/c
11	14 Apr: Receives ! 12,000 in cash from Mohan Lal	Cash A/c	Mohan Lal A/c
12	15 Apr: Pays Gupta Traders ! 29,500 by cheque in full settlement of ! 30,000	Gupta Traders A/c ! 30,000	Bank A/c ! 29,500 and Discount Received A/c ! 500
13	17 Apr: Withdraws ! 5,000 cash for home use	Drawings A/c	Cash A/c
14	18 Apr: Pays electricity bill ! 1,800 in cash	Electricity A/c	Cash A/c
15	20 Apr: Sells goods for ! 22,000, paid by customers through UPI into the bank	Bank A/c	Sales A/c
16	22 Apr: Pays helper's salary ! 7,000 by bank transfer	Salary A/c	Bank A/c
17	24 Apr: Takes goods costing ! 1,500 for home use	Drawings A/c	Purchases A/c
18	26 Apr: Buys a computer for the shop on credit from Sai Computers ! 28,000	Computer A/c	Sai Computers A/c
19	28 Apr: Receives commission ! 1,200 in cash	Cash A/c	Commission Received A/c
20	29 Apr: Takes a bank loan of ! 50,000, paid into the bank account	Bank A/c	Bank Loan A/c

Why some entries look the way they do

- **Entry 2** moves money from cash to bank, both of which belong to the business. This is called a **contra entry**.
- **Entries 9 and 10** use separate returns accounts, so the books show clearly how much was returned.
- **Entry 12** has one debit and two credits. An entry with more than two accounts is a **compound entry**. Ravi cleared a debt of ₹ 30,000 by paying only ₹ 29,500. The ₹ 500 he saved is a gain, so it is credited to Discount Received.
- **Entry 17** credits Purchases, because those goods will never be sold. They have left the business as drawings.
- **Entry 18** debits Computer, not Purchases. Ravi does not deal in computers; he will use this one in the shop, so it is a fixed asset.

REMEMBER

The total of the debits in an entry must always equal the total of the credits. In entry 12, ₹ 30,000 = ₹ 29,500 + ₹ 500.

TRY THIS

Write the journal entry, with narration, for entry 13. Answer: Drawings A/c Dr ₹ 5,000, To Cash A/c ₹ 5,000 (Being cash withdrawn for personal use).

CHAPTER 6

Posting to the ledger and balancing

The journal lists entries by date, so it cannot tell Ravi quickly how much Mohan Lal still owes. For that, all the entries for one account are gathered in one place. The book that holds all the accounts is the **ledger**, and copying entries into it is called **posting**.

The ledger format

Each account has a debit side on the left and a credit side on the right. Because it looks like a letter T, it is often called a **T-account**.

The posting rule

For each journal entry:

1. Go to the account that was **debited**. On its debit side, write the date, "To" and the name of the **other** account, and the amount.
2. Go to the account that was **credited**. On its credit side, write the date, "By" and the name of the **other** account, and the amount.

So entry 5 (Purchases A/c Dr, To Gupta Traders A/c, ₹ 50,000) is posted twice:

- In Purchases A/c, debit side: "To Gupta Traders 50,000".
- In Gupta Traders A/c, credit side: "By Purchases 50,000".

Balancing an account

At the end of the month, each account is **balanced**, so we know what it stands at.

1. Add both sides.
2. Find the difference between the two totals.
3. Write the difference on the **lighter** side as "Balance c/d" (carried down), so that both sides total the same.
4. Write the equal totals on both sides.
5. On the first day of the next month, write the same difference on the **other** side as "Balance b/d" (brought down).

If the debit side was heavier, the account has a **debit balance**. If the credit side was heavier, it has a **credit balance**.

Three of Ravi's accounts

Gupta Traders A/c

Debit side	!	Credit side	!
11 Apr To Purchase Returns	2,000	5 Apr By Purchases	50,000
15 Apr To Bank	29,500		
15 Apr To Discount Received	500		
30 Apr To Balance c/d	18,000		
Total	50,000	Total	50,000
		1 May By Balance b/d	18,000

Ravi still owes Gupta Traders ! 18,000. A credit balance on a person's account means the business owes that person.

Mohan Lal A/c

Debit side	!	Credit side	!
8 Apr To Sales	18,000	12 Apr By Sales Returns	1,000
		14 Apr By Cash	12,000
		30 Apr By Balance c/d	5,000
Total	18,000	Total	18,000
1 May To Balance b/d	5,000		

Mohan Lal still owes ! 5,000. He is a debtor. In the same way, the Purchases account ends with a debit balance of ! 88,500: ! 90,000 of goods bought, less the ! 1,500 taken home.

TIP

Assets, expenses and drawings usually end with a debit balance. Liabilities, capital and incomes usually end with a credit balance. If an account ends on the "wrong" side, look again: there may be a posting mistake.

CHAPTER 7

The cash book

A shop handles cash many times a day, and writing each payment in the journal and then the ledger is slow. So most businesses keep a **cash book**. It records all cash receipts and payments in date order, like a journal, and also works as the Cash account in the ledger.

Kinds of cash book

- **Single column cash book:** one money column on each side, for cash only.
- **Double column cash book:** two money columns on each side, one for cash and one for bank.
- **Three column cash book:** adds a discount column on each side to note discounts allowed and received.

Receipts go on the debit side (money comes in). Payments go on the credit side (money goes out).

Ravi's double column cash book for April

The two sides are shown one after the other.

Receipts (debit side)

Date	Particulars	Cash !	Bank !
1 Apr	To Capital	2,00,000	
2 Apr	To Cash (C)		1,20,000
6 Apr	To Sales	25,000	
14 Apr	To Mohan Lal	12,000	
20 Apr	To Sales		22,000
28 Apr	To Commission Received	1,200	
29 Apr	To Bank Loan		50,000
	Total	2,38,200	1,92,000
1 May	To Balance b/d	65,400	1,25,500

Payments (credit side)

Date	Particulars	Cash !	Bank !
2 Apr	By Bank (C)	1,20,000	
3 Apr	By Furniture		30,000
4 Apr	By Purchases	40,000	
10 Apr	By Rent	6,000	
15 Apr	By Gupta Traders		29,500
17 Apr	By Drawings	5,000	
18 Apr	By Electricity	1,800	
22 Apr	By Salary		7,000
30 Apr	By Balance c/d	65,400	1,25,500

Date	Particulars	Cash !	Bank !
	Total	2,38,200	1,92,000

Points to notice

- The letter **(C)** marks a contra entry. Both its sides are inside the cash book, so it is not posted anywhere else.
- Only ! 29,500 appears for Gupta Traders, because only that much left the bank. The ! 500 discount goes through the journal, or in the discount column of a three column cash book.
- Transactions with no cash or bank movement, such as credit sales and credit purchases, never appear in the cash book.
- The cash column can never have a credit balance, because you cannot pay out more cash than you have. The bank column can, if the bank allows an **overdraft** (spending more than the balance, as a short loan).

TIP

Count the cash in the drawer at the end of every day and compare it with the cash book balance. A difference found today is easy to trace. A difference found after a month is very hard.

CHAPTER 8

The trial balance

Once every account is balanced, we list all the balances in one statement. This is the **trial balance**. Accounts with debit balances go in the debit column, and accounts with credit balances go in the credit column. If the double entry was done correctly, the two totals are equal.

Which side does each balance go on?

Debit column	Credit column
Assets (cash, bank, furniture, debtors)	Liabilities (creditors, loans)
Expenses and losses	Capital
Purchases, sales returns	Sales, purchase returns

Debit column	Credit column
Drawings	Incomes and gains

Ravi's trial balance as on 30 April

Account	Debit !	Credit !
Cash	65,400	
Bank	1,25,500	
Furniture	30,000	
Computer	28,000	
Mohan Lal (debtor)	5,000	
Drawings	6,500	
Purchases	88,500	
Sales Returns	1,000	
Rent	6,000	
Electricity	1,800	
Salary	7,000	
Capital		2,00,000
Gupta Traders (creditor)		18,000
Sai Computers (creditor)		28,000
Bank Loan		50,000
Sales		65,000
Purchase Returns		2,000
Discount Received		500
Commission Received		1,200
Total	3,64,700	3,64,700

Drawings is ! 6,500 because it holds both entry 13 (! 5,000 cash) and entry 17 (! 1,500 goods).

What the trial balance proves, and what it does not

When the totals agree, it shows that every debit had an equal credit. It does **not** prove that the books are free of mistakes. An entry left out completely, or posted to the wrong person's account, still leaves the totals equal. You will meet these errors in the last chapter.

When the totals do not agree

1. Add both columns again.
2. Check that every balance is copied correctly and on the correct side.
3. Halve the difference and look for that amount. A balance written on the wrong side makes the difference double its size.
4. If the difference divides exactly by 9, look for two digits swapped, such as ! 5,400 written as ! 4,500. The difference, 900, is 9×100 .

REMEMBER

A trial balance that agrees is a good sign, not a guarantee.

CHAPTER 9

Final accounts: trading account, profit and loss account and balance sheet

The owner wants to know two things: did the shop make a profit, and where does it stand? The **final accounts** answer both. Real businesses prepare them for the whole financial year; here we do it for Ravi's first month.

Closing stock

At the end of April, Ravi counts the goods still on his shelves. They cost ! 45,000. This is **closing stock**. Unsold goods are not an expense of this month, so they are taken out of the cost. Closing stock is usually valued at cost, or at a lower amount if the goods are now worth less than they cost.

The trading account

The **trading account** finds the **gross profit**: the profit on buying and selling goods, before running expenses.

Debit side	!	Credit side	!
Purchases 88,500 less Returns 2,000	86,500	Sales 65,000 less Returns 1,000	64,000
Gross profit (to P&L account)	22,500	Closing stock	45,000
Total	1,09,000	Total	1,09,000

A business that already had goods at the start would show **opening stock** on the debit side too. **Direct expenses**, such as carriage on purchases, or wages paid to unload goods, also go on the debit side of the trading account.

The profit and loss account

The **profit and loss account** starts with the gross profit, adds other incomes and takes away the running expenses, called **indirect expenses**. What is left is the **net profit**.

Debit side	!	Credit side	!
Rent	6,000	Gross profit	22,500
Electricity	1,800	Discount received	500
Salary	7,000	Commission received	1,200
Net profit (to capital)	9,400		
Total	24,200	Total	24,200

Ravi's shop made a net profit of ₹ 9,400 in April.

The balance sheet

The **balance sheet** is a statement of assets and liabilities on one date. It is not an account, so it has no debit and credit; it simply lists liabilities on one side and assets on the other.

Liabilities	!	Assets	!
Capital 2,00,000		Furniture	30,000
add Net profit 9,400		Computer	28,000
less Drawings 6,500	2,02,900	Closing stock	45,000
Bank loan	50,000	Debtor: Mohan Lal	5,000
Creditor: Gupta Traders	18,000	Bank	1,25,500

Liabilities	!	Assets	!
Creditor: Sai Computers	28,000	Cash	65,400
Total	2,98,900	Total	2,98,900

Both sides total ! 2,98,900. This is the accounting equation once again: assets equal liabilities plus capital.

REMEMBER

Each trial balance item is used once: goods, incomes and expenses in the trading and profit and loss account; assets, liabilities and capital in the balance sheet. Closing stock appears in both.

DID YOU KNOW

Companies in India must use a vertical balance sheet form laid down by company law. Small traders often use the two-sided form shown here. Only the layout differs.

CHAPTER 10

Depreciation: the straight line method

Ravi's computer will not last for ever. Every year it gets older, slower and closer to being replaced. The fall in the value of a fixed asset because of use, age or new technology is called **depreciation**.

Why charge depreciation?

The computer helps Ravi earn income for several years, so its cost should be spread over those years. Charging depreciation each year gives a fair profit for each year and shows the asset at a sensible value in the balance sheet.

The straight line method

In the **straight line method**, the same amount is charged every year.

Yearly depreciation = (Cost – Scrap value) ÷ Useful life in years

Scrap value (also called residual value) is the amount the asset is expected to fetch when it is finally sold off. **Useful life** is the number of years the owner expects to use it.

EXAMPLE

Ravi's computer cost ₹ 28,000. He expects to use it for 4 years and then sell it for ₹ 4,000.
Yearly depreciation = $(28,000 - 4,000) \div 4 = ₹ 6,000$.

Year	Value at start !	Depreciation !	Value at end !
1	28,000	6,000	22,000
2	22,000	6,000	16,000
3	16,000	6,000	10,000
4	10,000	6,000	4,000

The value after depreciation is called the **book value**. At the end of year 4, the book value equals the scrap value, as planned. If you draw these values as a graph, they fall in a straight line, which is how the method got its name.

When the asset is bought during the year

Charge depreciation only for the months the asset was used. Suppose a shelf costing ₹ 12,000, with a life of 10 years and no scrap value, is bought on 1 October, and the books close on 31 March. The yearly charge is ₹ 1,200. It was used for 6 months, so this year's charge is $1,200 \times 6 \div 12 = ₹ 600$.

The entries

1. To charge depreciation: Depreciation A/c Dr, To Computer A/c.
2. To close it at the year end: Profit and Loss A/c Dr, To Depreciation A/c.

In the balance sheet, the asset is shown at cost less depreciation, for example "Computer 28,000 less depreciation 6,000 = 22,000".

DID YOU KNOW

Another common method is the **written down value** method. It takes a fixed percentage of the book value each year, so the charge is large at first and smaller later.

REMEMBER

The depreciation rates allowed for income tax, and those laid down for companies, are set by law and can change. This book uses only the owner's own estimate of life and scrap value.

Errors and how to correct them

Everyone makes mistakes. Good accountants find them and correct them with a proper entry. This is called **rectification**.

Kinds of errors

Kind of error	Example	Does the trial balance still agree?
Error of omission (complete)	A rent payment not recorded at all	Yes
Error of commission	A sale to Rina posted to Rita's account	Yes
Error of principle	Buying furniture recorded as Purchases	Yes
Compensating errors	Purchases debited ! 100 too much and Sales credited ! 100 too much	Yes
One-sided error	Sales total added short by ! 1,000	No

Correcting errors with an entry

The method is the same every time:

1. Write down the entry that **was** made.
2. Write down the entry that **should have been** made.
3. Pass an entry that turns the first into the second.

EXAMPLE

Goods sold on credit to Rina for ! 4,000 were debited to Rita's account. Rita has been debited wrongly, and Rina has not been debited at all. Correction: Rina A/c Dr ! 4,000, To Rita A/c ! 4,000.

EXAMPLE

Furniture bought for ! 10,000 was debited to Purchases. Purchases is too high and Furniture is missing. Correction: Furniture A/c Dr ! 10,000, To Purchases A/c ! 10,000.

EXAMPLE

A rent payment of ₹ 3,000 in cash was not recorded at all. Correction: simply pass the missing entry. Rent A/c Dr ₹ 3,000, To Cash A/c ₹ 3,000.

EXAMPLE

A salary payment of ₹ 5,000 was recorded as ₹ 500 on both sides. Both accounts are short by ₹ 4,500. Correction: Salary A/c Dr ₹ 4,500, To Cash A/c ₹ 4,500.

The suspense account

When the trial balance does not agree and the error cannot be found at once, the difference is put in a temporary **suspense account** so that work can go on. When the error is found, it is corrected through the suspense account, which then closes.

Suppose the sales total was added short by ₹ 1,000. The credit column is ₹ 1,000 short, so ₹ 1,000 is put in suspense on the credit side. Once the error is found, the correction is: Suspense A/c Dr ₹ 1,000, To Sales A/c ₹ 1,000. Suspense is now zero.

NOTE

Never rub out, overwrite or tear a page from account books. A clean correcting entry shows honesty. Altered figures look like cheating, even when they are not.

TIP

Most errors come from rushing. Write the narration for every entry, add totals twice, and tick each posting as you make it.

CHECK YOURSELF

Practice questions

1. Write the four steps of accounting.
2. Is receiving a customer's order on the phone a transaction? Give a reason.
3. What is the business entity idea?
4. Prakash brings ₹ 75,000 into his business, and later takes ₹ 4,000 for household use. Name each of these two amounts.

5. Classify as asset, liability, capital, income or expense: (a) bank loan, (b) commission received, (c) delivery van, (d) wages paid, (e) amount due from a customer.
6. A business has assets of ₹ 6,20,000 and capital of ₹ 4,50,000. Find its liabilities.
7. Write the three golden rules of accounting.
8. Write the journal entry: goods bought on credit from Kiran Stores, ₹ 12,000.
9. Write the journal entry: cash withdrawn from the bank for office use, ₹ 8,000. What is such an entry called?
10. Write the journal entry: paid ₹ 9,800 by cheque to Kiran Stores in full settlement of ₹ 10,000.
11. Why is a computer bought for shop use not debited to Purchases?
12. Write the journal entry: goods costing ₹ 2,000 taken by the owner for home use.
13. What does "Balance c/d" mean, and on which side of an account is it written?
14. Gupta Traders' account ends with a credit balance of ₹ 18,000. What does this tell Ravi?
15. Why can the cash column of a cash book never show a credit balance?
16. Name two errors that do not affect the agreement of the trial balance.
17. Opening stock ₹ 20,000, purchases ₹ 1,00,000, sales ₹ 1,50,000, closing stock ₹ 30,000. Find the gross profit.
18. A machine costs ₹ 60,000, has a life of 5 years and a scrap value of ₹ 10,000. Find the yearly depreciation by the straight line method.
19. In question 18, what is the book value at the end of year 2?
20. Machinery bought for ₹ 15,000 was debited to Purchases. Write the correcting entry.

ANSWER KEY

Answers

- | | |
|--|---|
| <ol style="list-style-type: none"> 1. Recording, classifying, summarising and interpreting. 2. No. Nothing has changed hands yet. It becomes a transaction when the goods are supplied and billed. | <ol style="list-style-type: none"> 3. The business is treated as separate from its owner, so the owner's personal money is kept out of the business books. 4. ₹ 75,000 is capital. ₹ 4,000 is drawings. |
|--|---|

5. (a) Liability, (b) income, (c) asset, (d) expense, (e) asset (a debtor).
6. $\text{Liabilities} = \text{Assets} - \text{Capital} = 6,20,000 - 4,50,000 = ₹ 1,70,000$.
7. Personal account: debit the receiver, credit the giver. Real account: debit what comes in, credit what goes out. Nominal account: debit all expenses and losses, credit all incomes and gains.
8. Purchases A/c Dr ₹ 12,000, To Kiran Stores A/c ₹ 12,000 (Being goods bought on credit).
9. Cash A/c Dr ₹ 8,000, To Bank A/c ₹ 8,000 (Being cash withdrawn for office use). It is a contra entry, because both accounts belong to the business.
10. Kiran Stores A/c Dr ₹ 10,000, To Bank A/c ₹ 9,800, To Discount Received A/c ₹ 200. It is a compound entry.
11. Purchases is only for goods bought to sell. A computer used in the shop is a fixed asset, so it is debited to Computer A/c.
12. Drawings A/c Dr ₹ 2,000, To Purchases A/c ₹ 2,000 (Being goods taken for personal use).
13. "Balance carried down": the difference between the two sides, written on the lighter side so that both totals agree.
14. Ravi still owes Gupta Traders ₹ 18,000. Gupta Traders is a creditor.
15. A business cannot pay out more cash than it has, so cash payments can never be more than cash receipts plus the opening cash.
16. Any two of: error of omission, error of commission, error of principle, compensating errors.
17. $\text{Gross profit} = \text{Sales} + \text{Closing stock} - \text{Opening stock} - \text{Purchases} = 1,50,000 + 30,000 - 20,000 - 1,00,000 = ₹ 60,000$.
18. $(60,000 - 10,000) \div 5 = ₹ 10,000$ a year.
19. $60,000 - 10,000 - 10,000 = ₹ 40,000$.
20. Machinery A/c Dr ₹ 15,000, To Purchases A/c ₹ 15,000 (Being machinery wrongly debited to Purchases, now corrected).

WORD LIST

Glossary

Account (A/c)

the record of one item, such as Cash or Rent, with a debit side and a credit side.

Accounting equation

$\text{Assets} = \text{Liabilities} + \text{Capital}$, which stays true after every transaction.

Asset

something the business owns that has value, such as cash, furniture or stock.

Balance sheet

a statement of the assets, liabilities and capital of a business on one date.

Capital

the amount the business owes its owner, including profits kept in the business.

Cash book

a book that records all cash and bank receipts and payments, and also works as the Cash account.

Closing stock

goods still unsold at the end of the period.

Contra entry

an entry between cash and bank, marked (C) in the cash book.

Credit and debit

the right-hand (Cr) and left-hand (Dr) sides of an account.

Creditor

a person or firm to whom the business owes money.

Debtor

a person or firm who owes money to the business.

Depreciation

the fall in value of a fixed asset through use, age or new technology.

Drawings

money or goods taken out of the business by the owner for personal use.

Gross profit

sales minus the cost of the goods sold, found in the trading account.

Journal

the book in which transactions are first recorded, in date order.

Ledger

the book that holds all the accounts of a business.

Liability

an amount the business owes to outsiders.

Net profit

what is left after all expenses are taken from gross profit and other incomes.

Rectification

correcting an error in the books with a proper entry.

Suspense account

a temporary account that holds a trial balance difference until the error is found.

Trial balance

a list of all ledger balances, used to check that total debits equal total credits.



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