320en04

4

ACCOUNTING FOR BUSINESS TRANSACTIONS

You visit the shop of a person known to you and observe the activities he/she is doing. He/she is selling goods for cash and on credit, collecting payments, making payments to suppliers, instructing the worker to deliver the goods in time, making payments for telephone, carriage, etc. These are all business activities, but cash is not involved in all of them at the time of making transactions. Activities which are in cash terms are called business transactions. You will also find that for every transaction, he/she makes use of a document like bills, cash memos, receipts, etc. These are termed as vouchers. In this lesson, you will learn about business transactions, accounting vouchers, accounting equation and the basic mechanism of accounting.

OBJECTIVES

After studying this lesson, you will be able to

- explain the meaning of source documents and accounting vouchers;
- explain the preparation of accounting vouchers;
- explain the meaning of accounting equation;
- explain the effect of business transactions on the accounting equation;
- explain the rules of accounting;
- explain the bases of accounting and
- explain the double entry mechanism.

4.1 SOURCE DOCUMENTS AND ACCOUNTING VOUCHERS

Accounting process begins with the origin of business transactions and it is followed by analysis of such transactions. A business transaction is a transaction, which involves exchange of values between two parties. Every transaction involves Give and Take aspect. The debit represents Take aspect and credit represents the Give aspect in a transaction. For example, when a computer is purchased for office use for cash, then the delivery of computer represents Take aspect and payment of cash represents Give aspect. Thus , business transactions are exchange of goods or services between two parties and effects of these transactions are recorded in two accounts.

Source Documents and vouchers

All business transactions are based on documentary evidence. A Cash memo showing cash sale, an invoice showing sale of goods on credit, the receipt made out by the payee against cash payment, are all examples of source documents. A document which provides evidence of the transactions is called the Source Document or a voucher. It is the primary evidence in support of a business transaction. A source document is the first record prepared for a business transaction and is the basis for entries in the books of accounts. There are certain items, which have no documentary proof, such as petty expenses. In such case necessary voucher is prepared showing the necessary details. All such documents are kept in a separate file in chronological order and are serially numbered. All recording in books of accounts is done on the basis of accounting vouchers. A Voucher is documentary evidence in support of a transaction. It is a document to record the accounting transaction. A transaction with one debit and one credit is a simple transaction and voucher prepared for such transaction is known as transaction voucher. The format of transaction voucher is as follows:

Transaction Voucher

Firm Name

Voucher No.
Date:
Debit account:
Credit account:
Amount (₹) :
Narration :
Authorised By : Prepared By:

Specimen of transaction voucher

Preparation of Accounting Vouchers

Accounting vouchers are the written documents containing the analysis of business transactions for accounting and recording purpose. These are prepared by the accountant and countersigned by authorised person. Features of Accounting vouchers are as :

- It is a written document.
- It is prepared on the basis of evidence of the transaction.

Notes

- It contains an analysis of a transaction i.e. which account has to be debited and which has to be credited.
- It is prepared by an accountant and countersigned by the authorised signatory.

Accounting voucher may be classified as Cash voucher i.e., debit voucher, credit voucher, and non-cash voucher i.e., transfer voucher.

Types of Accounting Voucher

- Cash Voucher
  - Debit voucher
    - [For Cash Payments]
  - Credit voucher
    - [For Cash Receipts]
- Non-Cash Voucher
  - (Transfer voucher)
    - [For Non-cash Transaction]

Debit Vouchers

These vouchers are prepared for recording of transactions involving cash payments only. Cash payments in the business are made on account of :

- Expenses
- Purchases of Goods
- Purchases of Assets
- Payment to creditors
- Repayment of loans
- Drawings and advances etc.

In all cash payments, one aspect is cash and the other is either the party to whom the payment is made, or an expense or an item of property for which the payment is made. A format of debit voucher is as follows:

Firm's Name

Debit Voucher

Voucher No. : Date:

Debit Account:

Amount:

Credit Account			
S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*
Authorised By:		Prepared By:	

Specimen of Debit voucher

Illustration 1

On September 21, 2014 M/s Mohit Chemicals paid ₹40,000 in Cash and balance amount of ₹1,60,000 by Banker's Cheque to HT Chemicals Ltd., Prepare Debit Voucher.

Solution:

Mohit Chemicals

Debit Voucher

Voucher No.: 22 Date: 21.9.2014

Debit Account: HT Chemicals Ltd

Amount : ₹ 200000.

Credit Accounts

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*
1. 2.	Cash Bank	40,000 1,60,000	Paid Part payment in cash and balance by bank draft.
Authorised By:		Prepared By:	

Credit Vouchers

These vouchers are prepared for recording of transactions involving cash-receipts only. Cash receipts in the business are accepted on account of:

- Cash sales of goods
- cash sales of assets

Notes

- revenue income like interest, rent, etc. received in cash
- Cash receipts from debtors.
- Loan taken
- Cash withdrawn from bank
- receipts of advances, etc.

In all cash receipts, one aspect is cash and the other is either person or party from whom cash is received or revenue on account of which cash is received or the property on sale of which cash is received. A format of credit voucher is as follows:

Credit Voucher

Firm Name

Voucher No. : Date:

Debit Account:

Amount:

Credit Account

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*

Authorised By: Prepared By:

Fig. 4.3 Specimen of Credit voucher

Illustration 2

₹25000 Office furniture is purchased from Modern Furniture on July 4, 2014 and ₹15000 are paid by cash immediately and ₹10000 is still payable. Prepare Credit Voucher.

Solution:

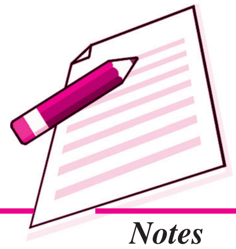
Credit Voucher

Modern Furniture

Voucher No. : 125 Date: July 4,2014

Debit Account: Furniture

Amount: ₹25000.



Notes

Credit Account

S.No.	Account Name	Amount (₹)	Narration (i.e. Explanation)
1.	Cash	15,000	Purchase of Office furniture from Modern Furniture. Cash paid. ₹15,000, for the Balance Liability created as per terms of purchase.
2.	Modern Furniture	10,000	

Authorised By: Prepared By:

Transfer Vouchers

With the expansion of business, the role of credit transactions is increasing at a fast pace. For recording of these credit transactions, a voucher is prepared known as transfer voucher. These transfer vouchers are prepared to record non-cash transactions of the business involving:

- Credit purchases
- Credit sales
- Return of goods sold
- Return of goods purchased on credit
- Depreciation on Assets
- Bad Debts etc.

These vouchers are prepared both in debit and credit forms simultaneously.

Firm Name

Transfer Voucher

Voucher No. : Date:

Amount:

Debit Account

S.No.	Account Name	Amount (₹)	Narration (i.e. Explanation)

Notes

Credit account			
S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*
Authorised By:		Prepared By:	

Fig. 4.4 Specimen of Transfer voucher

Illustration 3

Stationery Mart furnishes the following information:

April 1,2014

Opening Balances:

(i)	Cash	₹13000
(ii)	Bank	₹5000
(iii)	Furniture	₹22000
(iv)	Land and Building	₹125000
(v)	Trade Debtors :	
	Puneet	₹16000
	Mohan	₹14000
(vii)	Secured Bank Loan	₹70000
(viii)	Trade creditors:	
	Gopi	₹18000
	Sumit	₹24000
	Vipin	₹8000

Prepare transfer Voucher.

Solution :

Stationery Mart

Transfer Voucher

Voucher No. **Date: April 1,2014**

Amount:

Debit Account

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*
1	Cash	13000	Opening Balance
2	Bank	5000	Opening Balance
3	Furniture	22000	Opening Balance
4	Land and Building	125000	Opening Balance
5	Trade debtors:	30000	Opening Balance
	Puneet	16000	
	Mohan	14000	

Credit Account

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*
1.	Secured Bank Loan		70000 Opening Balance
2	Trade creditors:		
	Gopi	18000	
	Sumit	24000	
	Vipin	8000	50000 Opening Balance
3	Capital	120000	Balancing Figure (i.e.240000-120000)

Authorised By: Prepared By:

Notes

INTEXT QUESTIONS 4.1

I. Classify the following into Business and Non-business Transactions:

i. Manav commences business with cash ₹200000.

ii. He deposited cash into bank ₹160000.

iii. He purchased goods for cash ₹25000.

Notes

iv. He took out cash from the shop and handed over to his wife for purchasing household goods ₹3000.

v. He attended a family function and got a gift worth ₹1500.

vi. He paid monthly salary to his business employees ₹3,000.

II. Fill in the blanks with suitable word or words:

i. The accounting vouchers are based on ....

ii. Invoice/bill is a .... document.

iii. Both debit and Credit aspects of a transaction are shown by .... Vouchers.

iv. A Credit voucher is prepared for .... receipts.

v. A debit voucher is prepared for .... payments.

4.2 ACCOUNTING EQUATION AND EFFECTS OF TRANSACTIONS ON IT

The recording of business transactions in the books of account is based on a fundamental equation called Accounting Equation. Whatever business possesses in the form of assets is financed by proprietor or by outsiders. This equation expresses the equality of assets on the one side and equity on the other side *i.e.,* the claims of outsider [liabilities] and owners or proprietors funds on the other side. In mathematical form,

Assets = Equity

Equity = Liabilities + Capital

As an asset is introduced in the business, a corresponding liability also emerges.

Effect of business transactions on accounting equation

These transactions increase or decrease the assets, liabilities, or capital. Every business has some assets. For example, Sunil started business with cash ₹3,00,000 as Capital. In this transaction, asset in the form of cash is created for the business. Hence,

Cash (Asset)		Capital (Equity)
₹3,00,000	=	₹3,00,000

Sunil purchased Machinery for ₹40,000 and Furniture for ₹20,000. Thus, the position of the assets and capital is as:

Cash	+	Machinery	+	Furniture	=	Capital
2,40,000	+	40,000	+	20,000	=	3,00,000

The above transaction shows that

Assets = Capital

Or

Capital = Assets

Notes

Increase or decrease in capital will result in the corresponding increase or decrease in assets. For example Sunil withdrew cash for personal use ₹5,000. Thus, the position of the assets and capital is as under :

Cash	+	Machinery	+	Furniture	=	Capital
2,40,000	+	40,000	+	20,000	=	3,00,000
[–5,000]	+	0	+	0	=	[–5,000]
2,35,000	+	40,000	+	20,000	=	2.95.000

Business enterprise borrows money in the form of loan from outsiders to carry on its activities. In other words, every business concern owes money from outsiders. Money borrowed from outsiders is called as liability. For example, ₹1,50,000 were borrowed from Shipra. Thus, the position of the assets and capital will be as under

Cash	+	Machinery	+	Furniture	=	Liabilities	+	Capital
2,35,000	+	40,000	+	20,000	=	0		2,95,000
+1,50,000	+	0	+	0	=	1,50,000	+	0
3,85.000	+	40,000	+	20,000	=	1,50,000	+	2,95.000

The fact that business receives funds from proprietors and creditors and retains all of them in the form of assets, can be presented in the terms of an accounting equation as under

Assets	=	Liabilities	+	Capital	or	A= L+ C
			OR			
Liabilities	=	Assets	–	Capital	or	L= A – C
			OR			
Capital	=	Assets	–	Liabilities	or	C = A – L

Expenses and Revenue also affect the accounting equation. Their effect is always on the capital.

A business concern has to meet some expenses in its normal course of operations such as payment of salary, rent, insurance premium, postage, wages, repairs etc. Payment of these expenses reduces the cash. These expenses reduce the net income of the business. All the income is the income of proprietor, which is added in the capital account, so all these expenses are deducted from the capital. Similarly, business concern receives some revenues during normal course of operations, such as rent received, commission received, etc. Revenue is added to the cash balance as it is received in terms of cash. Revenue increases the net income of the business and hence, it is added to the capital. Now, the accounting equation is represented by

Assets	**=**	**Liabilities**	**+**	**Capital**
+ Revenue [Cash]	**=**		**+**	**Revenue**
– Expenses [Cash]	**=**		**–**	**Expenses**

Accounting equation is thus, affected by every business transaction. Any increase or decrease in assets, liabilities, and capital can be identified by preparing accounting equation. It shows that every business transaction satisfies the dual aspect concept of accounting. It also serves as the basis for preparing the Balance Sheet.

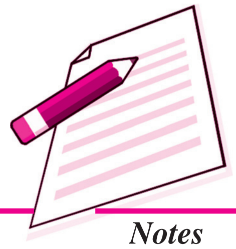
Effect of Transactions on the Accounting Equation

You have learnt that assets, liabilities and capital are the three basic elements of every business transaction, and their relationship is expressed in the form of accounting equation which always remains equal. At any point of time, there can be a change in the individual asset, liability or capital, but the two sides of the accounting equation always remain equal. Let us verify this fact by taking up some transactions and see how these transactions affect the accounting equation :

1. Namita started business with cash ₹3,50,000 introduced as capital. Thus the equation is as:

Assets	=	Liabilities	+	Capital
3,50,000	=	0	+	3,50,000

   This transaction shows that ₹3,50,000 have been introduced by Namita in terms of cash, which is the capital for the business concern. Hence on one hand, the asset [cash] has been created to the extent of ₹3,50,000.



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2. She purchased goods for cash ₹90,000.

   Thus the accounting equation is as :

	Assets			=	Liabilities	+	Capital
	Cash	**+**	**Goods**				
old equation	3,50,000			=	0	+	3,50,000
Effect of Transaction	–90,000	+	90,000	=	0	+	0
New equation	2,60,000	+	90,000	=	0	+	3,50,000

   Goods purchased is an asset and cash paid is also an asset. Hence in this transaction, there is an increase in one asset [Goods] and decrease in the other asset [cash]. There is no change in capital and liabilities. i.e. the other side of the accounting equation.

3. She purchased goods from Mohit for ₹60,000 on credit

   Thus the equation is as:

	Assets			=	Liabilities	+	Capital
	Cash	+	Goods				
Old equation	2,60,000	+	90,000	=	0	+	3,50,000
Effect of Transaction	0	+	60,000	=	60,000	+	0
New equation	2,60,000	+	1,50,000	=	60,000	+	3,50,000

   In this transaction goods have been purchased on credit from Mohit , hence there is an increase in the assets [goods] by ₹60,000 and also an increase in the liabilities by ₹60,000 as the business concern now owes money to Mohit.

4. She sold goods to Anish for ₹40,000 (Cost ₹25,000) and received Cash ₹10,000 and balance after one month. Thus the accounting equation is as:

	Assets					=	Liabilities	+	Capital
	Cash	+	Goods	+	Debtors				
Old equation	2,60,000	+	1,50,000	+	0	=	60,000	+	3,50,000
Effect of Transaction	10,000	+	[–25,000]	+	30,000	=	0	+	15,000
New equation	2,70,000	+	1,25,000	+	30,000	=	60,000	+	3,65,000

Notes

In this transaction goods have been sold on credit and some on cash to Anish, so there is a decrease in the assets [goods] by ₹25,000, and increase in the assets (Anish) by ₹30,000 and [Cash] by ₹10,000. In this process the proprietor has gained an amount of ₹15,000 which is added to his capital.

5. She paid salaries to employees for ₹16,000.

	Assets					=	Liabilities	+	Capital
	Cash	+	Goods	+	Debtors				
Old equation	2,70,000	+	1,25,000	+	30,000	=	60,000	+	3,65,000
Effect of Transaction	[-16,000]	+	0	+	0	=	0	+	[–16,000]
New equation	2,54,000	+	1,25,000	+	30,000	=	60,000	+	3,49,000

In this transaction, salaries paid to employees are expenses for the business concern. Salaries are paid in terms of cash, hence cash as an asset is reduced by ₹16,000 and as all expenses reduce the capital, so capital is also reduced by ₹16,000.

From the above transactions, it is obvious that how every transaction has its effect on the accounting equation without disturbing the equality of the two sides of the equation.

Illustration 4

Prepare accounting equation from the following Transactions:

		₹
1.	Hemant started business with cash	3,00,000
2.	Purchased goods for cash	80,000
3.	Sold goods[costing ₹30,000] for	45,000
4.	Purchased goods from Monika	70,000
5.	Salary paid	7,000
6.	Commission received	5,000
7.	Paid Cash to Monika in full settlement	69,000
8.	Goods sold to Rahul {Costing ₹20,000} for	25,000

Notes

Solution

S.	Transaction	Assets					=	Equity			
No.		Cash	+	Goods	+	Debtors	Total	Liabilities	+	Capital	Total
1.	Started business with cash	3,00,000	+	0	+	0	3,00,000	0	+	3,00,000	3,00,000
2.	Purchased goods for cash	-80,000	+	80,000	+	0		0	+	0	
	New Equation	2,20,000	+	80,000	+	0	3,00,000	0	+	3,00,000	3,00,000
3.	Sold goods for cash	45,000	+	-30,000	+	0		0	+	15,000	
	New Equation	2,65,000	+	50,000	+	0	3,15,000	0	+	3,15,000	3,15,000
4.	Purchased goods from Monika	0	+	70,000	+	0		70,000	+	0	
	New Equation	2,65,000	+	1,20,000	+	0	3,85,000	70,000	+	3,15,000	3,85,000
5.	Salary paid	-7,000	+	0	+	0		0	+	-7,000	
	New Equation	2,58,000	+	1,20.000	+	0	3,78,000	70,000	+	3,08,000	3,78,000
6.	Commission received	5,000	+	0	+	0		0	+	5,000	
	New Equation	2,63,000	+	1,20,000	+	0	3,83,000	70,000	+	3,13,000	3,83,000
7.	Paid Cash to Monika in full settlement	-69,000	+	0	+	0		–70,000	+	1,000	
	New Equation	1,94,000	+	1,20.000	+	0	3,14,000	0	+	3,14,000	3,14,000
8.	Goods sold to Rahul	0	+	-20,000	+	25,000		0	+	5,000	
	New Equation	1,94,000	+	1,00,000	+	25,000	3,19,000	0	+	3,19,000	3,19,000

Notes

Illustration 5

Prepare accounting equation from the following Transactions:

	₹
1. Nutan started business with cash	4,00,000
2. Purchased goods from Rohit	60,000
3. Sold goods[costing ₹25,000] for cash	22,000
4. Purchased goods for cash	50,000
5. Salary outstanding	3,000
6. Rent received	6,000
7. Paid Cash to Rohit on account	35,000
8. Goods sold to Bharti {Costing ₹30,000} for	40,000

INTEXT QUESTIONS 4.2

Fill in the blanks with suitable word/words:

i. Accounting equation satisfies the .... concept of accounting.

ii. Assets = ... + Liabilities

iii. Capital = Assets – ....

iv. Accounting Equation serves as a basis for preparing ....

v. Liabilities = ... – Capital

4.3 RULES OF ACCOUNTING

Using Debit and Credit

In Double Entry accounting both the aspects of the transaction are recorded. Every transaction has two aspects and according to this system, both the aspects are recorded. If the business acquires something, it must have been acquired by giving something. While recording each transaction, the total amount debited must be equal to the total amount credited. The terms 'Debit' and 'Credit' indicate whether the transaction is to be recorded on the left hand side or right hand side of the account. In its simplest form, an account looks like the English Language Letter 'T'. Because of its shape, this simple form of account is called T-account (refer figure 4.5) . Have you observed that

Notes

Solution : (Illustration 5)

S.No	Transaction	Assets					=	Equity			
		Cash		Goods		Debtors	Total	Liabilities		Capital	Total
1.	Started business with cash	4,00,000	+	0	+	0	4,00,000	0	+	4,00,000	4,00,000
2.	Purchased goods from Rohit	0	+	60,000	+	0		60,000	+	0	
	New Equation	4,00,000	+	60,000	+	0	4,60,000	60,000	+	4,00,000	4,60,000
3.	Sold goods for cash	22,000	+	[-25,000]	+	0		0	+	[-3,000]	
	New Equation	4,22,000	+	35,000	+	0	4,57,000	60,000	+	3,97,000	4,57,000
4.	Purchased goods for cash	[-50,000]	+	50,000	+	0		0	+	0	
	New Equation	3,72,000	+	85,000	+	0	4,57,000	60,000	+	3,97,000	4,57,000
5.	Salary outstanding	0	+	0	+	0		3,000	+	[-3,000]	
	New Equation	3,72,000	+	85,000	+	0	4,57,000	63,000	+	394,000	4,57,000
6.	Rent received	6,000	+	0	+	0		0	+	6,000	
	New Equation	3,78,000	+	85,000	+	0	4,63,000	63,000	+	4,00,000	4,63,000
7.	Paid Cash to Rohit on account	[-35,000]	+	0	+	0		[-35,000]	+	0	
	New Equation	3,43,000	+	85,000	+	0	4,28,000	28,000	+	4,00,000	4,28,000
8.	Goods sold to Bharti	0	+	[–30000]	+	40,000		0	+	10,000	
	New Equation	3,43,000	+	55,000	+	40,000	4,38,000	28,000	+	4,10,000	4,38,000

Notes

the 'T' format has a left side and a right side for recording increases and decreases in the item? This helps in ascertaining the ultimate position of each item at the end of an accounting period. For example, if it is an account of a supplier all goods/materials supplied shall appear on the right (Credit) side of the Supplier's account and all payments made on the left (debit) side.

In a 'T' account, the left side is called debit (usually abbreviated as Dr.) and the right side is known as credit (as usually abbreviated Cr.).

Account Title

(Left Side) (Right Side)

Fig.4.5: Specimen of T-account.

Rules of Accounting

All accounts are divided into five categories for the purpose of recording of the business transactions:

(i) Assets, (ii) Liability, (iii) Capital,

(iv) Expenses/Losses, and (v) Revenues/Gains.

Two Fundamental Rules are followed to record the changes in these accounts:

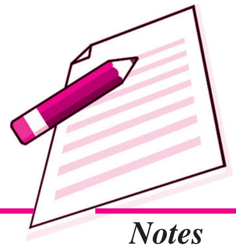
1. For recording changes in Assets/Expenses/Losses

> "Increase in Asset is debited, and decrease in Asset is credited."
>
> "Increase in Expenses/Losses is debited, and decrease in Expenses/Losses is credited."

2. For recording changes in Liabilities and Capital/Revenue/Gains

> "Increase in Liabilities is credited and decrease in Liabilities is debited."
>
> "Increase in Capital is credited and decrease in Capital is debited."
>
> "Increase in revenue/gains is credited and decrease in revenue/gain is debited".

The rules applicable to the five kinds of accounts are summarised in the following chart:



Notes

Rules of Accounting

Assets

(Increase)	(Decrease)
+	–
Debit	Credit

Liabilities

(Decrease)	(Increase)
–	+
Debit	Credit

Capital

(Decrease)	(Increase)
–	+
Debit	Credit

Expenses/Losses

(Increase)	(Decrease)
+	–
Debit	Credit

Revenue/Gains

(Decrease)	(Increase)
–	+
Debit	Credit

I. Analysis of Rule Applied to Assets Accounts

Rohan Purchased Furniture for ₹80,000.

Analysis of Transaction : In this transaction, the affected accounts are Cash account and Furniture account. Cash account is an assets account and has decreased. As per rule if asset decreases the affected account is credited, so cash account credited. Furniture is also an asset and it has increased. As per rule asset if increases the affected account is debited thus, furniture account is debited.

Cash

	Decrease
	80,000
	[–] Credit

Furniture

Increase	
80,000	
[+] Debit	

II. Analysis of Rule Applied to Liabilities Accounts:

Purchased Machinery for ₹60,000 on credit from M/s Indian Machinery Mart.

Analysis of Transaction: In this transaction, the two accounts affected are machinery and M/s Indian Machinery Mart. Machinery is an asset, an asset has increased, therefore machinery account is debited. M/s Indian Machinery Mart is the creditor on account of supply of machinery and constitutes, the liability for the buying firm which

Notes

has increased. Rule is that on increase of liability the concerned account is credited and vice-versa. Thus, M/s Indian Machinery Mart A/c is credited.

M/s Indian Machinery Mart [Liability]		Machinery (Assets)	
	Increase	Increase	
	60,000	60,000	
	[+] Credit	[+] Debit	

III. Analysis of Rule Applied to Capital Accounts:

Cash of ₹50,000 introduced in business as Capital by Rakesh.

Analysis of Transaction: In this transaction, the two account affected are Cash account and Rakesh [Capital account] . Cash is an asset and Rakesh invested capital. Rule for Capital is that if it increases the account is credited and vice-versa. So, here capital account is credited.

Capital [Rakesh] Account		Cash (Assets)	
	Increase	Increase	
	50,000	50,000	
	[+] Credit	[+] Debit	

IV. Analysis of Rule Applied to Expenses/Losses Accounts:

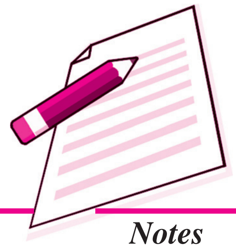
Paid ₹6000 to the employees as Salary.

Analysis of Transaction: In this transaction, the two accounts affected are salary account and Cash account. Salary account is an expense and has increased. Cash is an asset and has decreased. Rule regarding expenses/losses is that if it increases the account is debited.

Salary Account [Expenses]		Cash (Assets)	
Increase			Decrease
6,000			6,000
[+] Debit			Credit [-]

V. Analysis of Rule Applied to Revenue/Profit Accounts:

Received interest for the month ₹4000.



Notes

Analysis of Transaction: In this transaction, the two accounts affected are Interest and Cash. Interest is an item of Income and Cash an item of asset. Rule regarding Revenue/profit is, increase in revenue is credited. Cash is an asset and rule for assets is increase in assets is debited.

Interest Account [Revenue]		Cash (Assets)	
	Increase	Increase	
	4,000	4,000	
	[+] Credit	[+] Debit	

Illustration 6

From the following transactions, state the titles of the accounts to be affected, types of the accounts and the account to be debited and the account to be credited:

		₹
1.	Ankur started business with cash	600000
2	Purchased goods for cash	80000
3.	Paid salaries	10000
4.	Sold goods to Rohit on credit	60000
5	Office machine purchased for cash	12000
6	He took loan from Bank	30,000
7	He received commission	4,000
8.	Postage paid	500
9.	Paid rent	6,000
10	Received cash from Rohit	60000

Solution

Trans-action No	*Names of accounts*		*Type of accounts*		*Rules applicable to A/cs in Debit/Credit items of Increase/Decrease*	
	(1)	*(2)*	*(1)*	*(2)*	*(1)*	*(2)*
1	Cash	Capital	Asset	Capital	Cash (Increase)	Capital (Increase)
2	Purchases	Cash	Expense	Asset	Purchase (”)	Cash (decrease)

3	Salaries	Cash	Expense	Asset	Salaries (")	Cash (decrease)
4	Rohit	Sales	Asset Debtor	Revenue	Rohit (")	Sales (Increase)
5	Office machine	Cash	Asset	Asset	Office (") machine	Cash (decrease)
6	Cash	Bank laon	Asset	Liability	Cash (Increase)	Bank loan (Increase)
7	Cash	Commi-ssion	Asset	Revenue	Cash (Increase)	Commission (Increase)
8	Postage	Cash	Expense	Asset	Printing and Stationery (Increase)	Cash (decrease)
9	Rent	Cash	Expense	Asset	Rent (Increase)	Cash (decrease)
10	Cash	Rohit	Asset	Asset	Cash (Increase)	Rohit (decrease

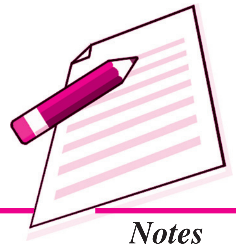
INTEXT QUESTIONS 4.3

A list of the accounts is given below. Tick the category to which each of the account belongs:

Type of Account

	Name of Account	*Asset*	*Liability*	*Capital*	*Revenue*	*Expense*
i.	Wages					
ii.	Building					
iii.	Office Machine					
iv.	Cash					
v.	Mohan (Supplier)					
vi.	Krishan (Owner)					
vii.	Radha (Customer)					
viii.	Interest received					
ix.	Bank Overdraft					
x.	Commission Earned					
xi.	Discount allowed					

4.4 BASIS OF ACCOUNTING



As we are aware that one of the most significant functions of accounting is to make us know true and fair amount of profit earned by the business entity in a particular period. This Profit or income figure can be ascertained by following

(i) Cash Basis of accounting

(ii) Accrual Basis of accounting

(iii) Hybrid Basis of accounting

I. Cash Basis of accounting

This is a system in which accounting entries are recorded only when cash is received or paid. Revenue is recognized only on receipt of cash. Similarly, expenses are recorded as incurred when they are paid. The difference between the total revenues and total expenses represents profit or loss of an enterprise for a particular accounting period. Outstanding and prepaid expenses and income received in advance or accrued incomes are not considered.

Advantages

Following are the advantages of adopting cash basis of accounting:

- It is very simple as no adjustment entries are required.
- It appears more objective as very few estimates and personal judgments are required.
- It is more suitable to those entities which have most of the transactions on cash basis.

Disadvantages

Following are the disadvantages of adopting cash basis of accounting:

- It does not give a true and fair view of profit and loss and the financial position of the business unit as it ignores outstanding and prepaid expenses.
- It does not follow the matching concept of accounting.

Illustration 7

During the financial year 2013-14, Mela Ram had cash sales of ₹580000 and credit sales of ₹265000. His expenses for the year were ₹.460000 out of which ₹60000 are still to be paid. Find out Mela Ram’s Income for the year 2013-14 following the cash basis of accounting.

Notes

Solution:

	Amount (₹)
Revenue (in terms of Cash Inflows)	580000
Less: Expenses (Outflow of cash) (i.e. ₹ 460000- 60000)	400000
Net Income	180000

Note : Credit Sales and Outstanding Expenses are not to be considered under cash basis of accounting.

II. Accrual Basis of accounting

Revenue and expense are taken into consideration for the purpose of income determination on the basis of accounting period to which they relate. The accrual basis makes a distinction between actual receipts of cash and the right to receive cash for revenues and the actual payment of cash and the legal obligation to pay expenses. It means the income accrued in the current year becomes the income of the current year whether the cash for that item is received in the current year or it was received in the previous year or it will be received in the next year. The same is true of expense items. Expense item is recorded if it becomes payable in the current year whether it is paid in the current year or it was paid in the previous year or it will be paid in the next year. For example, credit sales are included in the total sales of the period irrespective of the fact when cash on account is received. Similarly, in case the firm has taken benefit of a certain service, but has not paid within that period, the expense will relate to the period in which the service has been utilized and not the period in which the payment for it is made.

Outstanding Expenses are those expenses which have become due during the accounting period but which have yet not been paid off. Prepaid Expenses are those expenses which have been paid in advance. Accrued Income means income which has been earned by the business during the accounting period but has not yet become due for payment and therefore has not yet been received. Income received in advance means income which has been received by the business before being earned. Costs incurred during a particular period should be set out against the revenue of the period to ascertain profit or loss.

Following are the advantages :

- It is based on all business transactions of the year and discloses correct profit or loss.
- This method is used in all types of of business units.
- It is more scientific and rational in application.

Following are the disadvantages :

- It is not simple one and requires the use of estimates and personal judgment.
- It fails to disclose the actual cash flows.

Illustration 8

Taking the data given in the Illustration 7, find out the net income of Mela Ram as per accrual basis of accounting.

Solution

	Amount (₹)
Total Sales:	
Cash Sales (₹ 580000) + Credit Sales (₹ 265000)	845000
Less: Total Expenses for the year 2013-14	460000
Net Income	385000

Note: Outstanding Expenses of ₹60,000 relate to this accounting year and hence are to be charged to the revenues of current year. Similarly, credit sales of ₹2,65,000 are considered for this year as the transaction took place during this current year.

Difference between accrual basis of accounting and cash basis of accounting

Basis of Difference	*Accrual Basis of accounting*	*Cash Basis of accounting*
1. Prepaid, Outstanding and received in advance items	There may be outstanding expense, prepaid expenses, accrued income and income received in advance in the Balance sheet.	There is no outstanding expense, prepaid expenses, accrued income and income received in advance in the Balance Sheet
2. Effect on income of prepaid expenses and accrued income	Income statement will show relatively higher income if there are items of prepaid expenses and accrued income.	Income statement will show relatively lower income if there are items of prepaid expenses and accrued income
3. Effect of outstanding expenses and unearned income	Income statement will show a lower income if there are items of outstanding expenses and unearned income	Income statement will show a higher income if there are items of outstanding expenses and unearned income
4. Legal Position	Companies Act 1956 recognizes this basis of accounting.	Companies Act 1956 does not recognize this basis of accounting.

Notes

5. Option regarding valuation of inventories and methods of depreciation	The business unit has the option to value the inventories at cost or market, whichever is less of depreciation.	No such option is available in regard to inventory valuation and method of depreciation.
6. Reliable	It is a reliable basis of accounting as it records all cash as well credit transactions. It ascertains true profit or loss.	It is not a reliable basis of accounting as only cash transactions are recorded. It fails to ascertain true profit or loss.
7. Users	A business unit with a profit motive ascertains its profit or loss as per accrual basis.	Professional people, small ventures of temporary nature, some Not- for-Profit Organizations ascertain their profit or loss as per cash basis.

III. Hybrid Basis of Accounting

Both cash basis of accounting and accural basis of accounting have their own advantages and limitations. Cash Basis of Accounting can be used only in units which deal exclusively in cash and are very small in size. These days the number of transactions undertaken by an enterprise are very large and are for cash as well as on credit. Hence, an accounting system which is the combination of both cash as well as accural basis is in use. This system is called hybrid basis of accounting. It has advantages of both the systems and is able to eliminate disadvantages of the both the system.

4.5 DOUBLE ENTRY MECHANISM

Double Entry Mechanism entails recording of transactions keeping in mind the debit and credit aspect of the transaction. To record every transaction, one account is debited and the other is credited. This is based on the principle 'every debit has a credit'. The Double entry Book-Keeping seeks to record every transaction in money or money's worth in its dual aspect. The advantages of double entry mechanism are :

- Systematic Record: It records, classifies, and synthesizes the business transaction in a systematic manner. It provides reliable information for sound decision making. It meets the needs of users of accounting information.
- Complete Record: It maintains complete record of a business transaction. It records both the aspects of the transaction with narration.
- Accurate records: By Preparing a Summarised Statement of Account the arithmetical accuracy of the records can be checked.

- Operational Results: By preparing Income Statement (Profit and Loss Account) the business can know profit or loss due to its operations during an accounting period.
- Financial Position: By preparing Position Statement (Balance Sheet) the business can know what it owns and what it owes to others. What are its assets and what are its Liabilities and Capital.
- Possibility of Fraud: Possibility of Frauds is minimized as complete information is recorded under this system.

INTEXT QUESTIONS 4.4

I. Answer the following with reference to cash basis of accounting

i. How it is simple?

As ____

ii. How it is more objective?

As ____

iii. To which business with it is more suitable?

Which ____

iv. Which is the concept of accounting it does not follow?

The ____

v. Credit sales of ₹10000 taken into account for calculating profit.

II. State whether the following statements are True or False :

i. Creditors are the internal users of accounting information.

ii. Management are the internal users of accounting information.

iii. Hybrid basis of accounting has advantages of both the systems (Cash & Accural) of accounting.

III. Answer the following question referring to double entry mechanism:

i. How possibility of frauds are minimised.

ii. How can arithmetical accuracy of the records can be checked?

iii. Name the concept on which to record every transaction one account is debited and other is credited is based.

WHAT YOU HAVE LEARNT

- **Business Transaction :** A business transaction is a transaction, which involves exchange of values between two parties. Every transaction involves Give and Take aspect.

- **Source Documents and vouchers :** All business transactions are based on documentary evidence. A Cash memo showing cash sale, an invoice showing sale of goods on credit, the receipt made out by the payee against cash payment, are all examples of source documents. A Voucher is documentary evidence in support of a transaction.

- **Types of Accounting Vouchers :** Accounting vouchers are the written documents, containing the analysis of business transactions for accounting and recording purpose.

Types of Accounting Vouchers

- Cash Voucher
  - Debit vouchers
    - [For Cash Payments]
  - Credit vouchers
    - [For Cash Receipts]
- Non-Cash Voucher
  - [Transfer vouchers]
    - [For Non-cash Transaction]

- **Accounting Equation :** The recording of business transaction in the books of account is based on a fundamental equation called Accounting Equation.

Assets = liabilities + Capital

- **Rules of Accounting**

Using Debit and Credit

Two Fundamental Rules are followed to record the changes in these accounts:

For recording changes in Assets/Expenses/Losses

"Increase in Asset is debited, and decrease in Asset is credited."

"Increase in Expenses/Losses is debited, and decrease in Expenses/Losses is credited."

For recording changes in Liabilities and Capital/Revenue/Gains

"Increase in Liabilities is credited and decrease in Liabilities is debited."

"Increase in Capital is credited and decrease in Capital is debited."

"Increase in revenue/gains is credited and decrease in revenue/gain is debited".

- There can be three basis of Accounting (i) Cash basis (ii) Accrual basis and (iii) Hybrid Basis

  In cash basis accounting entries are recorded only when cash is received or paid.

  In accrual basis of accounting revenue and expense are taken into consideration for the purpose of income determination on the basis of accounting period to which they relate.

- **Hybrid Basis :** This is an accounting system which is the combination of both cash as well as on credit.

  Double Entry Book Keeping Mechanism: Double Entry Book Keeping Mechanism entails recording of transactions keeping in mind the debit and credit aspect of the transaction.

TERMINAL EXERCISE

1. State the meaning of business transaction.
2. What is meant by accounting voucher ? Explain in brief different types of accounting vouchers.
3. State the fundamental rules followed to record the changes in various accounts.
4. Explain in brief cash basis of accounting and differentiate it with accrual basis of accounting.
5. What is meant by double entry mechanism? Give its advantages.
6. "Accounting equation remains intact under all circumstances" Justify the statement with the help of examples.
7. Prepare accounting equation on the basis of the following :

   (i) Anup started business with cash ₹ 2,50,000

   (ii) Purchased goods for cash ₹ 35,000

   (iii) Purchased office furniture for cash ₹ 12,000

   (iv) Paid rent ₹ 7,000

(v) Sold goods (costing ₹ 30,000) for ₹ 50,000 for cash

8. Show the accounting equation on the basis of the following transactions :

		₹
(i)	Manu started business	
	Cash	6,00,000
	Goods	1,00,000
(ii)	Purchased office machine for cash	90,000
(iii)	Sold goods (costing ₹ 60000) for credit to Asha	70,000
(iv)	Purchased building for cash	1,30,000
(v)	Cash received from Ashu	80,000
(vi)	Purchased goods on credit from M/S Ashok Traders	70,000
(vii)	Salaries paid	6,000
(viii)	Insurance prepaid	10,000
(ix)	Cash paid to M/s Ashok Traders in full settlement	68,000

9. Prepare necessary accounting vouchers from the following transactions:

(i) Building purchased for ₹ 6,00,000

(ii) Goods sold on credit to M/s Reema Trader ₹ 1,10,000

(iii) Salary paid to ₹ 1,00,000

(iv) Withdrew cash for personal use ₹ 6,000

(v) Cash receipts from debtors M/s Ankit Bros ₹ 22,000

Notes

ANSWERS TO INTEXT QUESTIONS

4.1 I.

Business transactions	**Non-business transactions**
(i), (ii), (iii)	(vi), (iv), (v)

II. (i) supporting document (ii) source (iii) Transfer
(iv) Cash (v) Cash

4.2 (i) Dual (ii) Capital (iii) Liabilities
(iv) Balance sheet (v) Assets

4.3

	Asset	Liability	Capital	Revenue	Expense
(i)					√
(ii)	√				
(iii)	√				
(iv)	√				
(v)		√			
(vi)			√		
(vii)	√				
(viii)				√	
(ix)			√		
(x)				√	
(xi)					√

4.4 I. (i) No adjustment entries are required
(ii) Very few estimates and personal judgement are required.
(iii) Have most of the transactions on cash basis
(iv) Matching concept
(v) Should not

II. (i) False (ii) True (iii) True

III. (i) As complete information is recorded under this system
(ii) By preparing summarised statement of account.
(iii) Every debit has a credit.

ANSWERS TO TERMINAL EXERCISE

7. Assets Cash ₹ 2,46,000 + Goods ₹ 5,000 + Office furniture ₹ 12,000 = Capital ₹ 2,63,000

8. Assets cash ₹ 3,76,000 + Goods ₹ 1,10,000, Office machine ₹ 90,000 + Building ₹ 1,30,000 + Prepaid insurance ₹ 10,000 = liabilities ₹ 7,16,000