COMMUNICATING WITH FINANCIAL DATA

Record the Expenses and Income (Sole Proprietorship)

Module 2 • Professional Study Notes

7. Recording the Transactions – Journal Entries and Ledger Accounts

Introduction to Recording Transactions

Every business performs financial activities daily. These activities, known as **business transactions**, are the starting point of accounting. Examples include:

- Purchasing goods and raw materials.
- Selling products to customers.
- Paying salaries to staff.
- Receiving cash from debtors.
- Paying rent for office space.
- Borrowing money from a bank.

For proper financial management, all transactions must be recorded systematically, classified properly, and stored permanently. Accounting provides a structured method via the **Journal** and the **Ledger**.

Business Transaction

Meaning: A business transaction is an exchange of money, goods, or services that affects the financial position of a business.

Features of Business Transactions:

- Must involve monetary value.
- Must affect the financial position (Assets, Liabilities, or Equity).
- Must be measurable in quantitative terms.
- Must relate strictly to business activities.

> **Examples:**
> • Purchased furniture for ₹10,000
> • Paid salary ₹5,000
> • Sold goods for cash ₹8,000
> • Received commission ₹2,000

Journal

Meaning: A journal is the primary book of accounting where transactions are recorded for the first time in chronological order. It is often called the **Book of Original Entry** or **Book of Prime Entry**.

Objectives:

- Record transactions systematically as they occur.
- Provide complete details of each transaction.
- Maintain chronological order.
- Reduce the possibility of accounting errors.

Features:

- Transactions are recorded date-wise.
- Uses the **Double-Entry System**.
- Includes a "Narration" (short explanation).
- Acts as the primary base for ledger posting.

Double Entry System

Meaning: Every transaction affects at least two accounts—one is debited and another is credited. The fundamental rule is: **Total Debit = Total Credit**.

Advantages: Accuracy in recording, easier detection of errors, a complete financial picture, and a scientific basis for the accounting system.

Types of Accounts

Accounting classifies accounts into three categories with specific rules:

Account Type	Meaning	The Golden Rule
Personal Account	Related to persons, firms, or companies.	**Debit the Receiver, Credit the Giver**
Real Account	Related to assets and properties.	**Debit what comes in, Credit what goes out**
Nominal Account	Related to expenses, losses, and incomes.	**Debit all expenses/losses, Credit all incomes/gains**

Format of Journal Entry

A standard journal entry includes the Date, Particulars (Accounts affected), L.F. (Ledger Folio), and the Debit/Credit amounts.

Steps in Journalizing

1. **Identify the Transaction:** Understand exactly what happened.
2. **Determine Accounts Affected:** Find which accounts are involved.
3. **Classify Accounts:** Identify if they are Personal, Real, or Nominal.
4. **Apply Rules:** Determine which account is debited and which is credited.
5. **Pass Entry:** Record the transaction in the journal format.

Examples of Journal Entries:
• **Capital Introduced:** Cash A/c Dr ₹50,000 / To Capital A/c ₹50,000
• **Goods Purchased:** Purchases A/c Dr ₹10,000 / To Cash A/c ₹10,000
• **Goods Sold:** Cash A/c Dr ₹15,000 / To Sales A/c ₹15,000
• **Rent Paid:** Rent A/c Dr ₹3,000 / To Cash A/c ₹3,000
• **Salary Paid:** Salary A/c Dr ₹5,000 / To Cash A/c ₹5,000

Ledger

Meaning: A ledger is a book where journal entries are classified and summarized into separate accounts. It is known as the **Principal Book of Accounts**.

Importance: Helps in knowing account balances, preparing the trial balance, providing summaries, and assisting in financial statement preparation.

Posting: The process of transferring entries from the journal to the ledger. This involves identifying the account, entering the date, writing particulars, recording the amount, and balancing.

Balancing of Ledger: The process of finding the difference between the debit and credit totals. **Debit Balance** occurs when the debit side exceeds the credit side; **Credit Balance** is the opposite.

Advantages of Journal and Ledger: Provides a permanent financial record, allows better transaction tracking, simplifies error identification, and serves as the basis for auditing and final accounts.

8. Preparations (Simple Problems)

Simple accounting problems test the practical application of journal entries, ledger posting, and accounting rules. Students must understand the logical flow of accounting records.

Steps in Solving Simple Problems

1. Read the transaction carefully to understand its nature.

2. Identify the accounts affected.
3. Apply the rules of debit and credit.
4. Record the journal entry and then post it to the respective ledger accounts.

ILLUSTRATION 1

Transaction: Started business with cash ₹1,00,000.

Journal Entry: Cash A/c Dr ₹1,00,000 to Capital A/c ₹1,00,000.

ILLUSTRATION 2

Transaction: Purchased goods for cash ₹20,000.

Journal Entry: Purchases A/c Dr ₹20,000 to Cash A/c ₹20,000.

ILLUSTRATION 3

Transaction: Paid salary ₹4,000.

Journal Entry: Salary A/c Dr ₹4,000 to Cash A/c ₹4,000.

Common Errors: Wrong debit or credit placement, incorrect account classification, posting mistakes, and simple calculation errors.

9. Preparation of Trial Balance (Simple Problems)

Meaning: A trial balance is a statement prepared to verify the arithmetic accuracy of ledger accounts. It contains all debit and credit balances, and the total of both columns must be equal.

Objectives: Check arithmetic accuracy, detect errors, summarize balances, and facilitate the preparation of final accounts.

Features: Prepared after balancing ledgers; it is not a part of final accounts but acts as the basis for them.

Steps in Preparing Trial Balance

1. Balance all ledger accounts.
2. Separate accounts into debit and credit balances.
3. Enter them in the trial balance format.
4. Calculate totals and verify equality.

Example of Trial Balance

Account Name	Debit Amount (₹)	Credit Amount (₹)
Cash A/c	30,000	
Purchases A/c	10,000	
Capital A/c		40,000
TOTAL	**40,000**	**40,000**

> **Limitations:** Some errors are not detected, such as Error of Omission (forgetting an entry), Error of Principle (wrong rule used), and Compensating Errors (mistakes that cancel each other out).

10. Depreciation, Provisions and Reserves (Simple Problems)

Depreciation

Meaning: Depreciation is the gradual and permanent decrease in the value of fixed assets over time due to wear and tear, usage, obsolescence, or the passage of time.

Need: Shows the true value of assets, helps calculate correct profit, matches cost with revenue, and helps in replacement planning.

Characteristics: It is a continuous process and a non-cash expense applicable to fixed assets.

Methods of Depreciation

1. **Straight Line Method (SLM):** Equal depreciation is charged every year.

   Annual Depreciation = (Cost of Asset - Scrap Value) / Useful Life

   Example: Machine Cost ₹50,000; Scrap Value ₹5,000; Life 5 years. Depreciation = (50,000 - 5,000) / 5 = ₹9,000 per year.

2. **Written Down Value Method (WDV):** Depreciation is charged on the reducing (book) balance every year.

Provisions

Meaning: A provision is an amount set aside from profits to meet expected future losses or liabilities where the amount is uncertain (e.g., Provision for Bad Debts, Provision for Tax).

Features: Created before profit distribution, mandatory in most cases, and meant for known liabilities.

Reserves

Meaning: A reserve is a portion of profit retained in the business to strengthen the financial position or meet future contingencies.

Types: General Reserve (general needs), Specific Reserve (particular purpose), Capital Reserve (from capital profits), and Revenue Reserve (from normal profits).

Provision vs. Reserve

Basis	Provision	Reserve
Purpose	To meet a specific liability.	To strengthen the business.
Necessity	Mandatory.	Optional.
Created From	Profit before distribution.	Profit after distribution.
Nature	Charge against profit (Expense).	Appropriation of profit.

> **Importance:** Proper profit calculation, better financial planning, and increased business stability against future losses.

End of Module 2 • Communicating with Financial Data