



**DR. BABASAHEB AMBEDKAR
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DBA

DIPLOMA IN BUSSINESS ADMINISTRATION



DBAR-102

Basics of Accounting

BASICS OF ACCOUNTING



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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self- instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual- skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self- instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)



PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect. All the best for your studies from our team!



BASICS OF ACCOUNTING

Contents

BLOCK-1: BASICS OF ACCOUNTING

UNIT-1 ACCOUNTANCY MEANING AND SCOPE

Introduction, Definitions of Accounting, Origin and Growth of Accounting, Need for Accounting, Functions of Accounting, Users of Accounting Information, Book Keeping, Definition of Book-Keeping, The objectives of Book-Keeping, Accounting Mechanics, The Double Entry System, Terminology of Financial Accounting, Accounting Documents, Accountant's Responsibility, Accounting Measurement, Basis of Accounting, Accounting Principles, The book-keeping and accounting process, Type of Accounts, Rules for Debit (Dr.) and Credit (Cr.)

UNIT-2 JOURNAL AND LEDGER

Introduction, The Journal, Advantages of using a Journal, Types of Entries, Ruling of a Journal, The Ledger, Sub-division of Ledger, Ledger Format, Ledger Posting, Balancing Ledger Accounts, Difference between Journal and Ledger

UNIT-3 SUBSIDIARY BOOKS

Introduction, Cash Book, Features of Cash Book, Types of Cash Book, Single Column Cash Book, Double Column Cash Book, Three Column Cash Book, Petty Cash Book, Sales Book, Purchase Book, Sales Return Book, Purchase Return Book, Bills Receivable Book, Bills Payable Book, Journal Proper.

BLOCK-2: TRIAL BALANCE, BANK RECONCILIATION STATEMENT, CAPITAL AND REVENUE TRANSACTION AND ACCOUNTING FOR BAD DEBTS

UNIT-1 TRIAL BALANCE

Introduction, Objectives of Trial Balance, Limitations of Trial Balance, Errors disclosed by a Trial Balance, Errors that are not disclosed by a Trial Balance, Methods of preparing Trial Balance, Methods of Locating Errors, Suspense Account

UNIT-2 BANK RECONCILIATION STATEMENT

Introduction, Causes of Difference, Need for Bank Reconciliation Statement, Method of preparation (Without Adjustment).

UNIT-3 CAPITAL AND REVENUE TRANSACTION

Introduction, Capital Expenditure, Revenue Expenditure, Deferred Revenue Expenditures, Difference Between Capital Expenditure, Revenue Expenditure and Deferred Revenue Expenditure, Difference between Capital Expenditure and Revenue Expenditure, Difference between Capital Expenditure and Deferred Revenue Expenditure, Capital Receipt, Revenue Receipt, Capital and Revenue Profits, Capital and Revenue Losses.

UNIT-4 ACCOUNTING FOR BAD DEBTS

Introduction, Sundry Debtors, Bad Debts, Provision Reserve for Bad Debts, Methods of Accounting, Provision for Discount on Debtors, Provision for Discount on Creditors, Bad Debts Recovery

BLOCK-3 : DEPRECIATION ACCOUNTING, FINAL ACCOUNTS (WITHOUT ADJUSTMENTS) & FINAL ACCOUNTS (WITH ADJUSTMENTS)

UNIT-1 DEPRECIATION ACCOUNTING

Introduction, Meaning of Depreciation, Characteristics of Depreciation, Causes of Depreciation, Objectives of providing Depreciation, Computation of Depreciation, Methods of charging Depreciation, Change of Method of Charging Depreciation, Salient Features of AS-6: Depreciation Accounting, Illustrations

UNIT-2 FINAL ACCOUNTS (WITHOUT ADJUSTMENTS)

Introduction, Trading Account: Format of a Trading Account, Trading Account Items (Dr.Side), Trading Account Items (Cr.Side), Balancing of Trading Account, Profit and Loss Account: Profit and Loss Account Items (Dr.Side), Profit and Loss Account Items (Cr. Side), Balancing Profit and Loss Account, Adjustments, Difference between Trading A/c and Profit and Loss A/c, Balance Sheet: Preparation and Presentation of Balance Sheet, Difference between Trial Balance and a Balance Sheet, Explanation and Clarification of certain Items, Limitations of balance Sheet, Illustrations

UNIT-3 FINAL ACCOUNTS (WITH ADJUSTMENTS)

Introduction, Objectives or need of adjustment, Types of adjustments, Various Illustrations

BLOCK-4: RECTIFICATION OF ERRORS, BILLS OF EXCHANGE, ACCOUNTS FOR HIRE PURCHASE & ELEMENTS OF COST

UNIT-1 RECTIFICATION OF ERRORS

Introduction, Errors which do not affect trial balance, Errors which affect trial balance, Errors detected before preparation of final accounts

UNIT-2 BILLS OF EXCHANGE

Introduction, Bill of exchange, Specimen to Bill of exchange, Bills receivables and Bills payable, Terms of bill, Due date, Days of grace, Disposal or uses of a bill, Dishonor of a bill, Promissory note, Characteristics, Parties to promissory note, Difference between Bills of exchange and Promissory note

UNIT-3 ACCOUNTS FOR HIRE PURCHASE

Introduction, Meaning, Difference between Hire Purchase and Instalment system, Ascertaining the interest rate, Accounting records under Hire Purchase system

UNIT-4 ELEMENTS OF COST

Introduction, Meaning of Cost, Various elements of cost, Classification of cost



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BBAR-102/DBAR-102

BASICS OF ACCOUNTING

BLOCK-1 BASICS OF ACCOUNTING

UNIT 1

ACCOUNTANCY MEANING AND SCOPE

UNIT 2

JOURNAL AND LEDGER

UNIT 3

SUBSIDIARY BOOKS

BLOCK 1 : BASICS OF ACCOUNTING

Block Introduction

In the field of management and commerce, accounting is considered to be one of the most important subjects. As study of management and commerce involves finance and revenue and for this purpose the role of accounting becomes further more important and this is the reason behind inclusion of this.

In this block you are provided detailed information on the basics of accounting i.e. in this block you are given an introduction, definition of accounting. You are given information as to what gave rise to accounting. The objects of accounting are explained in detail. The mechanics of accounting is also explained to you in this section. The basics are explained in this section to you even the rules of debit and credit are explained to you in a very simple language. The second unit covers the topics of journal and ledger in detail. You are given explanation on both of the important aspects in a very simple and understandable language. In the first unit detailed about the various subsidiary books such as cash book, the various types of cash books is explained to the students. The students are also briefed about the sales, purchase, sales return, purchase return, bills receivable and bills payable book.

In this block an introduction of accounting, discussing its functions, detailing the various types of users of accounting information, Apart from this discussed the various principles of accounting with different books needed for the recording of the transactions are also discussed.

Block Objective

After learning this block you will be able to understand:

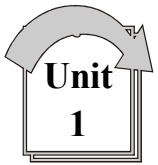
- Introduction and role to Accounting
- Various users of Accounting Information
- Accounting principles
- Indian and international accounting standards
- Importance of journal and its techniques
- Process of posting entries into journal
- Transfer the entries into different types of subsidiary books
- Understanding the need and importance of every subsidiary book.

Block Structure

Unit1: Accountancy Meaning and Scope

Unit2: Journal and ledger

Unit3: Subsidiary Books



ACCOUNTANCY MEANING AND SCOPE

UNIT STRUCTURE :

1.0 Learning Objectives

1.1 Introduction

1.2 Definition of Accounting

1.3 Origin and Growth of Accounting

1.4 Need for Accounting

1.5 Functions of Accounting

1.6 Users of Accounting Information

1.7 Bookkeeping

1.7.1 Definition of Book keeping

1.7.2 The Objectives of Book keeping

1.8 Accounting Mechanics

1.8.1 The Double Entry System

1.8.2 Terminology of Financial Accounting

1.8.3 Accounting Documents

1.8.4 Accountantes Responsibility

1.8.5 Accounting Measurement

1.9 Basis of Accounting

1.9.1 Accounting Principles

1.9.2 The Bookkeeping and Accounting Process

1.10 Types of Accounts

1.11 Rules for Debit (Dr.) and Credit (Cr.)

1.12 Let Us Sum Up

1.13 Answers for Check Your Progress

1.14 Glossary

1.15 Assignment

1.16 Activities

1.17 Case Study

1.18 Further Readings

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Need, Origin and Growth of Accounting.
- Functions of Accounting.
- Users of Accounting Information.
- Various Principles of Accounting and Book Keeping.
- Types of Accounts and Golden Rules of Accounting.

- Various Basis of Accounting.

1.1 Introduction

Accounting is a prerequisite of finance. Finance is a vast subject of education and knowledge of accounting serves as a ground for it. Knowledge and use of accounting information is key factor in any business undertaking. Just as there are various terminologies in medicine, which one has to know to become a doctor, similarly in the field of finance various terminologies are used such as revenue, net profits, cost, expense, operating margin and cash flow. This terminologies have clearly defined meaning and often used in business organisation.

Accounting is not an end but means to an end. The result of accounting information is the decision that is made after analysis and interpretation of this accounting information. Such information is vital to the owners, management, creditors, governmental regulatory bodies, labour unions or the many other groups that have stake in the financial performance of the company. Accounting is extensively used to illustrate all types of business activity hence it can be suitably called as language of business.

The main objective of accounting is to ascertain profit or loss during a specific period and to determine financial position of a business enterprise on a particular date. Accounting is defined as “the art of recording, classifying and summarising financial transactions and interpreting results to meet the objectives”. Besides, it provides necessary business information to the interested parties. Thus, accounting includes following activities:

- Recording of business transactions either in journal or subsidiary books
- Classifying business transactions by posting them to ledger accounts
- Closing ledger accounts and preparation of summary of all ledger accounts called trail balance
- Preparation of final accounts viz. trading, profit and loss accounts and balance sheet

During the nineteenth century, the quantum of business transactions increased to great extent and it became clear that the journal was inadequate as the sole book of original entry. In order to save time and efforts and avoid inconvenience of classifying transactions for posting purposes, similar types of transactions are recorded in special journals called subsidiary books. This would facilitate not only the division of journal but it would also make easier the job of posting in the ledger as the postings are done in the form of totals, since they are transactions of similar nature. Various subsidiary books are cash-book, sales book, purchase book, sales returns book, purchases returns book, bills receivable book, bills payable book, journal proper, etc.

1.2 Definition of Accounting

From the above discussion, it is clear that over a period of time the concept of accounting and the role of accountants have undergone a revolutionary change. There is no unison regarding exact definition of accounting. Different definitions are drawn by various researchers. However, the central idea of all definitions has been almost the same except the fact that their emphasis has been shifting from one aspect to other.

The American Institute of Certified Public Accountant (AICPA) in 1941, laid the definition of accounting as “Significantly classifying in monetary terms the recording, classifying and summarising money, transactions and events and interpreting the results, they should be at least partly of financial character.”

According to The American Accounting Association (AAA), “Accounting is the method in which identifying, measuring and communicating economic information is done to allow the users to judge and take decisions.”

The Accounting Principles Board (APB) of AICPA in 1970 said that accounting provides financial information about economies to take decisions of economic nature.

Thus, accounting may be defined as the process of recording, classifying, summarising, analysing, interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

Check your progress 1

1. “Accounting is the method in which identifying, measuring and communicating economic information is done to allow the users to judge and take decisions “ is given by

a. AAA	c. ABB
b. APB	d. ABP

1.3 Origin and Growth of Accounting

Many people have the opinion that accounting has been developed in recent years. However, from the puranas we see that Chitrugupta maintains accounts for qualities and vices. In earlier days, there was financial minister in each kingdom, who would look after financial matters like cash transactions, taxes payable by people to king, etc.

The chapter, “The Business of Keeping of Accounts in the Office of Accounts” from Arthashastra written by Kautilya, Minister of king Chandragupta, shows that accountancy was practiced in India twenty-three centuries back. However, the current accounting is based on the principles of double entry system which was given to us by Luco Pacioli and Franciscan Monk who got it published first in 1494 at Venice in Italy. The work was translated and published in English by H. O. Castle in 1543. In the 1553, James Pule published his work on How to Keep a Perfect Account of Debtors and Creditors.

After various other publications, the most important publication was that of Edward Jones (1795) who created the concept of two column journal. This was followed by many other innovations, which were introduced later from time to time.

The present system of accounting occupies a vital position in today’s business. With the help of accounting, managers or owners can take countless important decisions and make right decisions at right time, which is the key to success. Owners can know whether they have made profitable investment. The cost accountant can know how to control the cost of production. Government can get date for tax and license purpose. Therefore, accounts will provide information to every person regarding the particular concern.

Check your progress 2

1. The current accounting is based on the principles of double entry system which was given to us by.
 - a. Luco Pacioli and Franciscan Monk
 - b. Kautilya
 - c. Chandragupta
 - d. Edward Jones

1.4 Need for Accounting

Accounting is often called the speech of business. It serves as means of communication. The information regarding the results of business operations to interested parties in the business viz., the proprietor, creditors, government and other agencies are to be communicated in the form of accounting data. In order to provide correct information it is necessary for the business organisation to record its transactions in clear and systematic manner. A clear and systematic record will serve twin purposes like

- Ascertaining transactions of business to determine profits or loss made during any accounting period.
- Showcase of impact of business transactions on the net worth of the business unit i.e. financial position of the business in terms of assets and liabilities of business as a whole.

Since resources are scarce, it is wiser to maintain a check on them constantly, to know whether there has been any generation of income or squeezing or shrinking of resources. It is of primary importance and is considered an indispensable tool of measuring operating efficiency of any profit making or non-profit making entity.

Accounting information differs largely on the types of organisation. However, viewed broadly, the information needs of most organisations are similar. This information need of an organisation is depicted as follows:

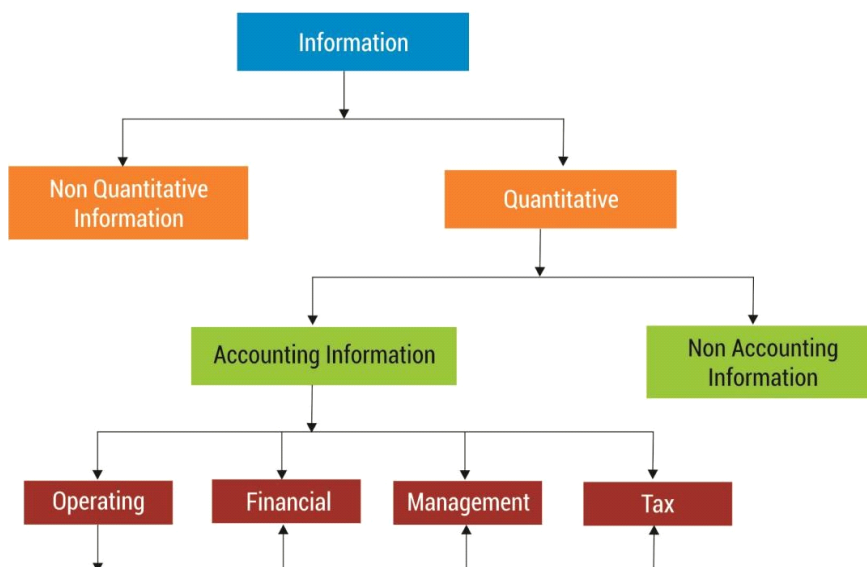


Fig 1.1 Information need of an organization

Considerable amount of operating information is required to conduct an organisation's day-to-day activities, which consist of information about inventory, production, sales cash balance etc. Operating information provides much of the basic data for management accounting, financial accounting and tax accounting.

Financial accounting information is intended by different stakeholders of the business, such as management, employees, financiers, government authorities, shareholders etc. In other words, financial accounting is the process of summarising financial data taken from an organisation's accounting records and publishing in the form of annual reports for the benefit of people outside the organisation.

Management Accounting: The accounting information specifically prepared to aid managers is known as Management Accounting. This information is used in three managerial functions namely, planning, implementation and control. An important form of planning is budgeting. Budgeting is the process of planning the overall activities of an organisation for a specified period of time, usually a year.

Tax accounting information is required to comply with various legal requirements. Hence, it is useful for tax authorities, auditors and the management.

Check your progress 3

1. The accounting information specifically prepared to aid managers is known as
 - a. Management Accounting
 - b. Cost Accounting
 - c. Financial accounting
 - d. None of above

1.5 Functions of Accounting

Following are the main functions of accounting:

1. **Maintaining systematic records:** The basic function of accounting is to maintain proper records of transactions that take place in chronological order. These records provide a base analysis and decision-making. It consists of recording in the original/subsidiary books of entry, posting to ledger, preparation of trial balance and final accounts.
2. **Meeting legal requirements:** Under the provision of law, a business person has to file various statements e.g. income tax returns, returns for sales tax purpose etc. Accounting system aims at fulfilling the requirements of law. Accounting is a base, with the help of which various returns, documents, statements etc are prepared.
3. **Protecting and safeguarding business assets:** Records always serve as an evidence in case of any dispute relating to ownership title of any property or assets of the business. Accounting helps in this regard to a very great extent it protects the property of business from unjustified and unwanted use. The accounts manager thus has to design such a system of accounting, which protects its assets from an unjustified and unwanted use.
4. **Accounting helps to very great extent in decision-making:** The accounting facilitates the right decision-making process. Most of the

managerial decisions are based on the figures. An effective price policy, satisfied wage structure, inventory policy, advertisement and sales promotion policy are a result of proper accounting structure. Accounting provides necessary data on which managerial decision-making process is based.

5. **Communicating and reporting:** Accounting can be said to be the language of business. All the transactions of business are communicated through accounting. All the interested parties such as entrepreneur, creditors, governments, and employees and so on, who are interested directly or indirectly in knowing the results of the firm are provided information through accounting. Accounting communicates the results to interested parties. Accountant prepares report based on accounting information to show financial position of firm to interested parties. Thus, accounting shows a true and fair financial position of firm.

Check your progress 4

1. The basic function of accounting is to maintain proper records of transactions that take place in .
 - a. Chronological order
 - b. Money order
 - c. Value order
 - d. Order

1.6 Users of Accounting Information

Accounting information is of prime importance to its interested parties to understand the financial position of firm and its future prospects. The interested parties or users of accounting can be divided into two main categories namely, external and internal users.

External User Include Following

1. **Creditors:** People who have extended credit to the company are termed as creditors. They are eager to know the financial position of firm to determine whether the enterprise will be able to meet its obligations in time. The statement of accounts helps to determine a liquidity position on which creditors can rely upon and check their credit policy or supply decisions.
2. **Investors:** These individuals put their money in any business with the aim of making more money. Any investor before making investments considers three important factors i.e. safety of his principle amount, rate of return on his investment in the form of dividend/interest and regular and consistent rate of return. Detailed study of the financial statements of firm enables investors in taking correct investment decision.
3. **Government:** The government is not interested in making money or investments. It is concerned with accounting information of company for purpose of taxation, labour and corporate law. Thus, it is interested in allocation of resources, taxation policies and statistical interests.
4. **Bankers:** Banks and financial institutions who lend money to business want to know the financial stability of the company in terms of the companies ability to pay interest and principle amount. They want to know whether this company can turn into a defaulter if so banks would

not want to lend to such company. Thus before lending money, banks want to be sure of the financial status of the company through its financial statements.

5. **Competitors:** Competitors of the company are interested in its financial to improve its own financial strategies, policies and systems. Comparison of one company with another can provide valuable clues about the financial health of the organisation. It helps to benchmark its own financial results.
6. **Others:** In addition to the above, other users of accounting information are researchers, consumers, stock exchange, brokers, underwriters, economists, press and public in general. However, their interests and goals altogether being different in nature, yet require accounting information for serving their own interests.

Internal Users Include Following

1. **Owners:** Owners include shareholders, partners and proprietors of the firm. They are the backbone of the business in the sense that they provide necessary funds for its smooth running, growth and development. Company's profitability and financial security are, therefore of prime importance to these people who have stake in the business. Such information can be obtained through published accounts, annual report and other supplementary statements.
2. **Management:** Accounting provides necessary information for managerial decision-making. The managerial tools, such as production budget, sales budget and cash budget, capital budget, etc., are the result of efficient accounting system. Various functions of management such as planning, organising, coordination, motivation and control can be implemented effectively through proper accounting system.
3. **Employees:** Healthy industrial relations between employer and employee are important to growth and development of firm. Accounting information helps to settle industrial disputes, prevent strike or likewise situation arising from demand for wage hike, bonus, higher compensation, etc. It helps employees to determine whether they are paid fair wages or not. Sometimes employees are given shares of the company in which they work. Thus, accounting information becomes vital for them too.

Check your progress 5

1. are eager to know the financial position of firm to determine whether the enterprise will be able to meet its obligations in time.
 - a. Creditors
 - b. Investors
 - c. Shareholders
 - d. a & b both

1.7 Book keeping

The process of recording financial transactions in the books of accounts is called as bookkeeping. These transactions include sales, purchases, income and payments by an individual or organisation. Bookkeeping should not be confused with accounting. Accounting is the process of recording, classifying, summarising, analysing, interpreting financial transactions and communicating the results thereof to the persons interested in such information.

Bookkeeping is just recording of transactions. Bookkeeping is the base of accounting. The accountant analyses the books of accounts and prepares reports from the financial transactions recorded by the book keeper. Normally business organisations are using two types of bookkeeping systems: single-entry system and the double-entry system of bookkeeping. In case single-entry only income and expense accounts are recorded primarily in a revenue and expense journal and this system is generally suitable for almost all of the small businesses. On the other side the double entry bookkeeping requires posting (recording) of each transaction twice in two different accounts, using debits and credits.

1.7.1 Definition of Book keeping

“Book-Keeping is a science and art of maintaining transactions of money transfers entered in the books of accounts. It may also be defined as the art of recording mercantile transactions in a regular and systematic manner, the art of keeping accounts in such a manner that a man may know the true state of his business and property by an inspection of his books”- Carter.

1.7.2 The Objectives of Book keeping:

The object of bookkeeping may be stated as under:

1. To have a permanent record of each transaction of the business and to show its financial effect to the business.
2. To find the collective effect of all the transactions made during an accounting period (usually a year) upon the financial position of the business.
3. To meet the legal requirements.
4. One of the main objectives of bookkeeping is to determine the sales, find the actual position of stock estimate the cash position of the business at a given point of time or for a particular period.

Check your progress 6

1. is just recording of transactions.
 - a. Book keeping
 - b. Accounting
 - c. Balance sheet
 - d. Journal Voucher

1.8 Accounting Mechanics

Accountancy is the science of recording, classifying and summarising transactions. Generally, a business entity has multiple transactions every day during an accounting period and unless and until these transactions are analysed and recorded individually, it is very tough to determine the result of each transaction in the above two basic statements. The business transactions may be recorded in various ways. However, the double entry system is the most suitable for this purpose.

1.8.1 The Double Entry System

The origins of double-entry system can trace as far back as from the 12th century. According to sources Giovanni di Bicci de Medici first gave this method for the Medici bank.

The modern double-entry system is of Amatiino Manucci, a Florentine merchant who lived in 14th century. This system was used by the merchant adventurer by the end of the 15th century. Luca Pacioli, a monk and collabora-

tor of Leonardo da Vinci was the first to codify the system in a mathematics textbook in 1494. Pacioli was the first to publish a detailed description of double-entry system thus was called the „father of accountinge. His publishing the double entry system enabled many to study and use it.

Under this system of double-entry bookkeeping, each and every transaction is split into two aspects and both these aspects are recorded without any exception, whatsoever, any change in the concern. Whenever there is any action, there must be opposite and equal reaction. Thus, if furniture is purchased with cash, cash is depleted as against furniture, which increases. If furniture is purchased on credit, furniture increases as against increase in liability.

Each and every transaction is entered in the documents providing all the required information of the transaction. The most regular documents that are used are as under:

1. **Payment Voucher:** This is usually on a printed standard form and it is a record of payment. Whenever we pay for an expense, then mostly a bill is prepared which records full particulars of the claim by the person receiving payment. The accounts department prepares a voucher for every payment to be made.
2. **Money Receipt:** Money receipt is a document, which is issued whenever cash / cheque are received. This document is an evidence that a sum of money has been received from a person or organisation.
3. **Journal Voucher:** The journal voucher records all other residuary transactions. Any internal transaction or a transactions not involving any cash payment or cash receipt is posted in the journal voucher.
Now payment and receipt are done through NEFT and RTGS, i.e. internet banking also.

1.8.2 Terminology of Financial Accounting

1. **Event:** It a process or part of process that occurs at a particular moment and has a definite place of occurrence. Events are the cause of external transactions.
2. **Transaction:** It refers to any act of the business that changes the financial position of the business unit.
3. **Debit:** It is the aspect of a financial transaction where we receive benefit.
4. **Credit:** It is the aspect of a financial transaction where we give benefit.
5. **Entry:** It is the process where we record the transaction in the books of accounts.
6. **Assets:** Anything of value owned by a business is known as „asete.
7. **Liability:** Anything owed, a debt, a claim of an outsider against the business is called a ‘liability’.
8. **Accounts:** An account is a summarised record and systematic arrangement of transactions for a period affecting a person, entity, expense, income, asset and liability.
9. **Turnover:** The total sales during a period, cash sales as well credit sales is called turnover.

10. **Business:** Any economic activity, which is legal and done with the intention of earning profit, is called business.
11. **Capital:** Capital represents the amount of funds invested by the owner in the business. It may be in the form of cash, goods or any other asset. Capital is always equal to the difference between total assets and liabilities.

1.8.3 Accounting Documents

The various types of documents which have been put to use for recording the occurrence of various business transactions are as under:

1. **Official receipts:** These receipts are received whenever any payment is made over the counter to the cashier
2. **Cash bills:** This is proof of cash transaction which can be receipt or payment.
3. **Bills:** These documents are received and issued when payment is made or payment is received by a specified date. As for illustration: electricity, water, rent and assessment services, cash sales etc.
4. **Invoices:** These documents are issued when physical goods are purchased. It functions same as bills and the recipients have to pay dues within the dates mentioned. Invoice can be for sales also.
5. **Delivery Orders:** This refers to the quantity of goods that has been ordered. The order concerns the quantity and description of the goods that are ordered and is different from invoice These are the two documents that are received while purchasing goods or services. These documents are also issued to the clients during sale transactions.

Purchase invoicee and „Supplier invoicee are documents that clients receive. The company that supplies the goods prepares the Sales invoicee.

The other types of documents used in business are:

1. **Purchase Orders:** To place orders for raw material or any assets as per specifications and quantity through proper documentation is called Purchase Order.
2. **Clients Orders:** Order received from clients is called Clientse orders.
3. **Credit Notes:** These are documents issued to clients mentioning the credits incurred by the client, the reason for crediting from the account is also mentioned generally it is issued for sales return.
4. **Debit Notes:** These are documents issued to clients mentioning the debits incurred by the client, the reason for debiting from the account is also mentioned. It is issued for purchase return.
5. **Payment Vouchers:** It is document of payments made, maintained in a chronological manner.
6. **Petty Cash Vouchers:** It is a record of payments made, maintained in a chronological manner in daily cash transactions
7. **Goods Received Notes:** Is a record of receipts of goods purchased. A logbook is maintained regarding goods received

- 8. Stock Cards and Stock Ledger:** Physical movement of stocks is maintained through Stock Cards and Stock Ledger. They are maintained by storekeepers. Quantities of stocks, stock codes and description of stocks are made. Here unit price is not mentioned. Updating according to stock in and stock out is done. Some business houses maintain stock ledger in addition to stock cards

1.8.4 Accountant's Responsibility

The primary responsibility of the accountant is to present the financial information to the owners at the end of financial year. The role and responsibility is multifold due to the introduction and practice of cost accounting, management accounting and financial management. Thus the expectation from the accountant in present era is very high.

The modern function of accounting has grown enormously and they can be grouped under the following broad categories:

- 1 Finance function
- 2 Control function
- 3 Planning function

1 Finance Function

Finance is the major requirement in front of any business and many of the business also face the problem of raising and using funds.

A finance accountantes major responsibility is to ensure:-

1. Obtaining hassle free funds at low cost
2. To make maximum use of funds and derive maximum benefit. The problems faced by accountants are as follows:-

What type of expenses the firm should undertake i.e. in which type of projects the firm should invest the fundse What is the amount of funds which should be allocated towards that every project. What sources should be used to raise the funds for a particular project. How to attain maximum funds What should be the repayment terms and duration of borrowed funds. The decision on all issues is taken as per the policy and objectives of the enterprise.

2 Control Function

Here the accountant has the responsibility to communicate the management's goals to individuals in respective fields.

1. To assist managers and unit/department heads to achieve their goals efficiently
2. To optimize results, the accountant has to coordinate the activities across the organization
3. Based on the goals set for each centre they have to measure the performance of the unit or department head. This helps to assess the efficiency
4. Identify problem areas and take decision to find a solution to enhance the efficiency and performance

3 Planning Function

Planning function which is the next function involves long term decision and short term actions.

In the short term decision has the following are to be done:

1. Making the best choice out of selected alternatives
2. Should priority be given to maximizing profit or minimizing loss

To address the problems encountered in planning function the accountant has to take an overall view such as accounting information and outside information. Planning for continuity and development of the firm comes under long term planning.

1.8.5 Accounting Measurement

Quantification of accounting information in the form of money or other units. Transactions are recorded in the accounts in terms of money (e.g. dollar, rupee yen etc.) based on historical cost. Some accounting measurements have to be expressed in volume such as direct labor hours used to apply overhead in a cost accounting system.

The accountant should check the correctness of accounting policies which has been employed by the management. Detailed description of the company's accounting policies should be presented to their users in a separate section preceding the footnotes to the financial statements or as the first footnote. The disclosure of accounting policies should always include Accounting Principles and should also include the methods of application that involve

1. Selection from generally accepted alternatives
2. Peculiar to the industry
3. Unusual or different applications of Generally Accepted Accounting Principles (GAAP) for example depreciation method and inventory pricing. Disclosure of accounting policies helps readers in better interpreting a company's financial statements. Thus, it results in fair presentation of the financial statements.

Check your progress 7

1. was the first to publish a detailed description of double-entry system thus was called the „father of accountinge.
 - a. Luca Pacioli
 - b. Amatino Manucci

1.9 Basis of Accounting

1.9.1 Accounting Principles

Accounting principles are in general decision rules derived from accounting concepts. According to AICPA (US), a principle means “a general law or rule adopted or professed as guide to action: a settled ground or basis of conduct or practice”.

Accounting principles are man made. Accounting principles do not suggest exactly how each transaction will be recorded. This is the reason that accounting practice differs from enterprise to another.

There are various principles of accounting according to GAAP (US):

1. **Historical Cost principle:** says that companies should record and report the cost of assets on the basis of cost incurred in it rather than fair market value of assets and liabilities. This principle states that the information that is reliable (removing opportunity to provide subjective and potentially biased market values) but not very relevant. Thus, there

is a tendency to use fair values. Most debts and securities are now reported at market values.

2. **Revenue principle:** As per this principle the companies should record the revenue when either has been (1) realised or is realisable or when (2) it is earned and not when cash is received. This method of accounting is also known as „accrual basis accounting“.
3. **Matching principle:** As per this principle the expenses have to be matched with revenues so long it is logical to do so. Expenses should be identified not when the work has been done or when a product is produced but when the work or the product actually makes its part to revenue.
4. **Disclosure principle:** In short this principle is based on the principle that each and every such information should be disclosed to the users of such information which may affect their willingness to continue their relationship with the company, as per this principle the quantum and kinds of information to be disclosed should be based on trade-off analysis as a larger amount of information costs more to prepare and use. While also keeping costs reasonable.
5. **Objectivity principle:** The financial statements that have been prepared by the accountant of the company should be based on objective evidence. Disclosure of information should have quality of objectivity
6. **Materiality principle:** As per this principle all information on materials should be disclosed to its users. The importance of an item should be considered when it is reported. Information is considered important when it may affect the willingness and decision of a reasonable individual.
7. **Consistency principle:** It means that the company should use the same accounting rules and principles and methods over the year.
8. **Prudence principle:** As per this principle there are two alternatives before us, where one will be least likely to overstate assets and income should be chosen.

Accounting Postulates:

Accounting postulates are basic assumptions which are generally accepted as self-evident truth in accounting. Postulates are established or general truth which do not require any evidence to prove them. They are the propositions taken for granted these postulates are as follows:

1. **Entity postulates:** The entity postulates assumes that the financial statements and other accounting information are for the specific business enterprise which is distinct from its owners. In brief from accounting theory business and owners of business are separate entity.
2. **Going concern postulates:** According to this postulates, time period of business units is not predetermined a business entity is viewed as continuing in operation in the absence of evidence to the contrary. Because of the relative permanence of enterprise, financial accounting is formulated assuming that the business will continue to operate for an indefinitely long period in the future.

3. **Accounting period postulates:** The creation or happening of this postulates is due to going concern postulates. This postulate is developed for measurement of economic activities of the business. The time period is identified in the financial statements. The time periods are usually of twelve months. This is useful for comparative performance evaluation.
4. **Money Measurement Postulates:** A unit of exchange and measurement is necessary to account for the transactions of business enterprises in a uniform manner. The common denominator chosen in accounting is the monetary unit. Money is the common denominator in the terms of goods and services including labour, natural resources and capital are measured. Money measurement concepts holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms.

1.9.2 The Book keeping and Accounting Process

The bookkeeping process refers primarily to recording the financial effects of financial transactions only into accounts. The difference between manual and any electronic accounting system is the time delay between the recording of the financial transaction and posting it in the concerned account. This delay is absent in electronic accounting systems due to instantaneous posting into relevant accounts, is not replicated in manual systems.

Generally in a business, a document has to be produced each time a transaction occurs. Similarly in case sales and purchases they have invoices or receipts. In the same way deposit slips are produced whenever deposits are made in a bank account. The bookkeeping involves recording the details of all such source documents into multi-column journals. As for illustration, all credit sales are recorded in the sales journal; all cash payments are recorded in the cash payments journal.

By using the rules of double entry system, the journal entries posted into the journal there after they are transferred to their respective accounts in the ledger, or book of accounts and this process of transferring summaries or individual transactions to the ledger is called posting. Once we are finished with the posting process we go for balancing, which is simply a process to arrive at the balance of the account.

In order to ensure that posting process was performed correctly, a working document called an unadjusted trial balance is created. In the simplest form, this is a three-column list. The first column contains the names of those accounts in the ledger, which have non-zero balance. If an account has a debit balance, the balance amount is copied into column two (the debit column). If an account has a credit balance, then the amount is written on credit side. Thereafter the totaling is done of both the sides as for example i.e. both debit and credit side is totaled. The two totals must agree and if the two totals do not agree it means an error has been made either in the journal or during the posting process. Therefore the error must be located and rectified and the totals of debit column and credit column re-calculated to check for agreement before any further processing can take place.

Once there are no errors, the accountant produces a number of adjustments and changes the balance amount of some of the accounts. As for example the

„inventory account and „office supplies asset accounts are changed to bring them in line with the actual numbers counted during a stock take. At the same time, the expense accounts associated with usage of inventory and with the usage of office supplies, are adjusted. It is the accounts in this list and their corresponding debit or credit balances that are used to prepare the financial statements.

Finally, financial statements are drawn from the trial balance, which may include:

- The income statement, also known as a statement of financial results, profit and loss statement, or simply P&L
- The balance sheet
- The cash flow statement
- The statement of retained earnings

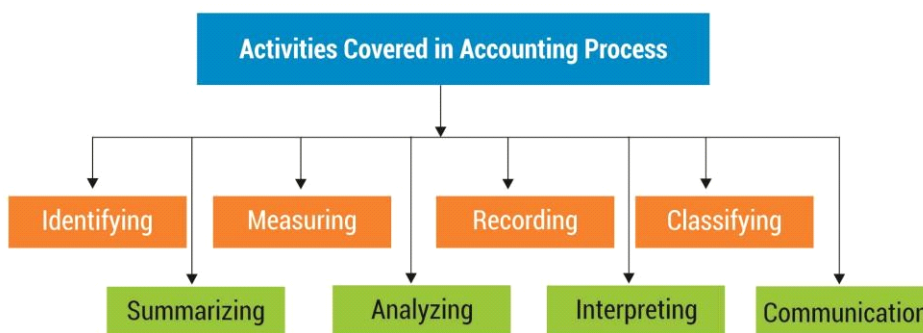


Fig 1.2 Activities in Accounting Process

Check your progress 8

1. Only such information should be made available to its users which are relevant and helpful for achieving its objectives.
 - a. Convention of Relevance
 - b. Convention of Objectivity
 - c. Convention of Feasibility

1.10 Types of Accounts

An account can be explained as a summary record of all transactions related to a particular type of item. It may be an asset, a liability, income, expenses, etc. These accounts are then classified in different types. Broadly, the accounts are divided into two types as follows:

1. **Personal Account:** Personal accounts include the accounts of persons with whom the business deals. These accounts show the transactions with the clients, suppliers, money lenders, bank, etc. The main purpose of preparing personal accounts is to ascertain the balances due to or due from persons or organisation.
2. **Impersonal Accounts:** The accounts other than personal accounts are termed as impersonal accounts and divided into two parts, real and nominal.
 - a. **Real Accounts:** Accounts of each property or assets acquired by the firm named real accounts. These accounts are both tangible and intan-

gible. Tangible real accounts relate to the real properties, which we can see, touch, or feel, such as building furniture, etc. Intangible real accounts consists of such things, which cannot be touched but may be measured in terms of money, such as Goodwill, trademarks, patents, etc.

- b. Nominal Accounts:** These are the accounts of incomes, expenses, gains and losses. The business has to incur certain expenses to earn certain income or to meet the requirements or certain business transaction. As for illustration these accounts are rent, wages or salary paid, telephone expenses, purchase, sale, etc.

Table Types of Accounts

Type	Represent	As for illustrations
Real	Tangible things which are available physically in the real world and certain intangible things not existing physically	Tangibles - Plant and Machinery, Furniture and Fixtures, Computers and Information Processing Equipment etc., Intangibles - Goodwill, Patents and Copyrights
Personal	Legal and Business Entities (Natural and artificial persons)	Individuals, Partnership Firms, Corporate entities, Non-Profit organisations, any local or statutory bodies including local, state and national governments
Nominal	To recognise the implications of financial transactions during each fiscal year till finalisation of accounts at the end, Income and Expenditure Accounts are Temporary accounts.	Sales, Purchases, Electricity Charges, Commission, Rent, Interest.

As for illustration 1: Classify the following accounts:

- (i) Capital A/c, (ii) Drawings A/c, (iii) Goodwill A/c, (iv) Bank A/c, (v) Rent paid A/c, (vi) Interest A/c, (vii) Building A/c, (viii) Stock A/c, (ix) A& Co. A/c, (x) Salaries A/c, (xi) Purchase A/c, (xii) Sales A/c, (xiii) Outstanding Wages A/c, (xiv) Prepaid Salary A/c.

Solution:

- (i) Capital A/c = Personal A/c
- (ii) Drawings A/c = Personal A/c
- (iii) Goodwill A/c = Real A/c
- (iv) Bank A/c = Personal A/c
- (v) Rent paid A/c = Nominal A/c
- (vi) Interest A/c = Nominal A/c

- (vii) Building A/c = Real A/c
 (viii) Stock A/c = Real A/c
 (ix) A & Co. A/c = Personal A/c
 (x) Salaries A/c = Nominal A/c
 (xi) Purchase A/c = Nominal A/c
 (xii) Sales A/c = Nominal A/c
 (xiii) Outstanding Wages A/c = Personal A/c
 (xiv) Prepaid Salary A/c = Personal A/c

Check your progress 9

1. Include the accounts of persons with whom the business deals
 - a. Personal account
 - b. Real account
 - c. Nominal account
 - d. None of above

1.11 Rules of Debit (Dr.) and Credit (Cr.)

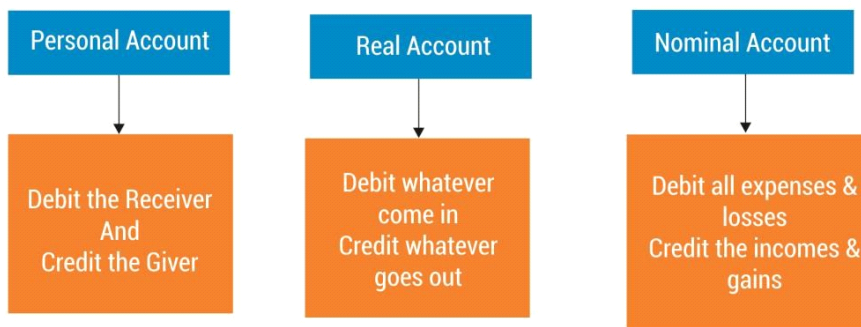


Fig 1.3 Debit and Credit Rules

The complete process of accounting is driven by

- Concept of separate or dual entity
- Nature of accounts
- Debit and Credit rules (also called Golden rules of Accounting)

There are rules for every type of account whether it is credit or debit. Let us study those rules in detail now.

Real Account:

As for example let us take the following transaction: Bought furniture from M/s Classic Wood on credit

The two accounts that have been affected here by the transaction are

1. Furniture A/c (Real Account)
2. M/s Classic Wood A/c (Personal A/c)

As furniture has been bought, we can say that it is coming in to us.

Thus, we say that furniture A/c is to be debited based on the principle “debit what comes in”. classic wood a/c will be credited, based on principle “credit the giver.”

Credit what goes out Consider the following transaction: Sold goods to Mr. Gaurav on credit. The two elements that have been affected here by the transaction are

1. Goods A/c (Real Account)
2. Mr. Gaurav A/c (Personal A/c)

As we are selling goods, we can say that it is going out from us.

Thus, we say that goods A/c is to be credited based on the principle „Credit what goes out. Mr. Gavrav A/c will be debited based on principle “debit the receiver.”

To make a decision whether a particular Real a/c (element) affected by an accounting transaction is to be debited or credited; we need to simply identify whether the element is coming into the organisation or going out of the organisation.

Personal Accounts

Debit the benefited person i.e. the receiver

Let us take the following transaction: Paid cash to Mr. Singh.

The two accounts that have been affected here by the transaction are

1. Cash A/c (Real Account)
2. Mr. Singh A/c (Personal A/c)

As the cash is being paid, we can say that Mr. Singh is the receiver of cash i.e the person receiving the benefit from the organisation. Thus, we say that Mr. Singh A/c is will debited based on the principle „Debit the benefit receive. On the other hand cash is being paid that means that cash is going out form us so it has been credited. Cash A/c will be credited based on principle “credit whatever goes out.”

Credit the benefited person i.e. the giver

Let us Consider the following transaction: Purchased goods on credit from M/s Singh &Co..

The two accounts that have been affected here by the transaction are:

1. Goods A/c (Real Account)
2. M/s Singh &Co.. A/c (Personal A/c)

As the goods are being purchased on credit, that goods are coming to us so being a real account going by its rule “debit what comes in” we will debit the goods account on the other handM/s Singh & Co. is giving (benefit) to the organisation. So, we can say that M/s Singh & Co. a/c is to be credited based on the principle “Credit the benefit giver”.

Therefore in order to make a journal entry make decision whether a particular Personal a/c affected by a transaction is to be debited or credited; we should first of all identify whether the element is giving the benefit to the particular organisation or it is taking the benefit from the organisation.

Nominal Accounts

While making journal entries where nominal accounts are involved, in most of the cases we come across the situations where the transaction is either related to an expenditure/loss or income/gain to the organisation.

Going as per the rules of nominal account

Debit all Expenses and Losses

Let us take the following transaction for illustration: Paid Salary to staff The two accounts that have been affected here by the transaction are

1. Cash A/c (Real Account)

2. Salaries A/c (Nominal A/c)

Since salaries are being paid, it amounts to expenditure for the organisation. Thus, we say that salaries a/c is to be debited based on the principle “Debit all expenses and losses”. Cash being a real account is moving out of the organisation so it will be credited.

Credit all Incomes and Gains

Let us consider the following transaction: Received Commission from M/s Garima Enterprises by cheque

The two accounts that have been affected here by the transaction are

1. Bank A/c (Personal Account) and
2. M/s Commission A/c (Nominal A/c)

Here commission has been received, which is an income for the organisation. Thus, the Commission a/c is to be credited based on the rule of nominal account “Credit all incomes and gains”. Bank account will be debited based on principle “Debit the receiver.”

In order to make a journal entry decision and whether a particular Nominal a/c (element) affected by an accounting transaction is to be debited or credited; we simply need to identify whether it is an expenditure (or loss) or an income (or gain) to the organisation.

Check your progress 10

1. In Cash paid to Ram, should cash be
 - a. Credited
 - b. debited

1.12 Let Us Sum Up

In this unit we have studied the basics of the subject accounting. We learnt that accounting is not an end, but a means to an end. The end result of accounting information is the decision that is made after analysis and interpretation of this accounting information. Such information is vital to the owners, management, creditors, governmental regulatory bodies, labour unions, or the many other groups that have vested interest in the financial performance of the company.

The study of this unit is important for the readers to understand this subject, as this subject has made the basics very clear in the minds of the readers.

1.13 Answers for Check Your Progress

Accountancy Meaning and Scope

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-a)

Check your progress 7

Answers: (1-a)

Check your progress 8

Answers: (1-a)

Check your progress 9

Answers: (1-a)

Check your progress 10

Answers: (1-a)

1.14 Glossary

1. **Accounting** - The process of identifying, measuring and communicating economic information to users of information to permit informed judgments and decisions by the users.
2. **Creditors** - A list of suppliers to whom the business owes money, due to credit purchase.
3. **Debtors** - A list of customers, to whom goods is sold on credit.
4. **Drawing** - The money taken out of a business by its owner(s) for personal use in the form of cash or assets is known as drawings.
5. **Principles (GAAP)** - These are the uniform minimum standards for financial accounting and reporting. They govern the form and content of the financial statements of an entity is known as generally accepted accounting principles.

1.15 Assignment

Study the Accounting Standards in India and compare it with International Accounting Standards.

1.16 Activities

State which item is part of what type of account.

- a) Copyrights account
- b) Non-Profit Organisation account
- c) Fixed assets account
- d) Goodwill account
- e) Salaries account
- f) Commission account
- g) Prepaid rent account
- h) Municipal Corporation account
- i) Mr. Mikees account

1.17 Case Study

Discuss the concept of “Accounting Measurement”

1.18 Further Readings

1. Advanced Accounting: Financial Accounting, Dr Ashok Sehgal, Dr Deepak Sehgal, Taxmann Allied Services Pvt. Ltd. , 2008
2. Modern Accountancy Volume I, Mukherjee, Tata Mcgraw Hill, 2008
3. Accounting theory and practice, Jawaharlal, Himalaya Publishing house pvt ltd, 2011



: UNIT STRUCTURE :

- 2.0 Learning Objectives**
- 2.1 Introduction**
- 2.2 The Journal**
- 2.3 Advantages of Using A Journal**
- 2.4 Types of Entries**
- 2.5 Ruling of A Journal**
- 2.6 The Ledger**
- 2.7 Sub-Division of Ledger**
- 2.8 Ledger Format**
- 2.9 Ledger Posting**
- 2.10 Balancing Ledger Accounts**
- 2.11 Difference between Journal and Ledger**
- 2.12 Let Us Sum Up**
- 2.13 Answers for Check Your Progress**
- 2.14 Glossary**
- 2.15 Assignment**
- 2.16 Activities**
- 2.17 Case Study**
- 2.18 Further Readings**

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Techniques of Journalising transactions.
- Importance of Journal.
- Posting journal entries to Ledger.
- Techniques of Ledger posting.
- Sub-division of ledger.
- Format of Journal and Ledger.

2.1 Introduction

The total sequence of accounting procedures, which are required to be followed in same order during each accounting period, is known as accounting cycle. It includes:

- **Recording:** In the first step, all the transactions should be recorded in the journal or books of original entry known as subsidiary books as and when they take place.
- **Classifying:** Thereafter, in the next step all entries in the journal of books of original entry are posted to the appropriate ledger accounts

to find out the total effect of all such transactions in a particular account.

- **Summarising:** This is the last stage, here efforts are made to prepare the trial balance and final accounts with a view to find out the profit or loss made during a trading period and to know the financial position of the business on a particular date.

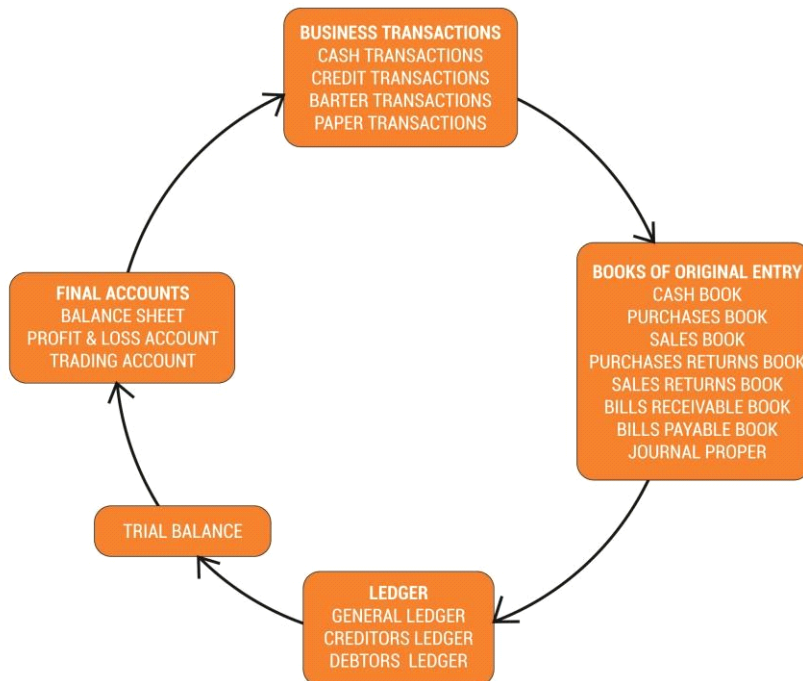


Fig 2.1 Accounting Cycle

In this unit, the recording and classifying process of accounting cycle i.e. meaning and importance of journal and ledger has been explained.

2.2 The Journal

The word „journale has been taken from a French word “jour” which means a day. Thus journal means daily as the daily transactions are recorded in journal and hence it has been named so. It is a book of original entry to record chronologically (i.e. in order of date), as here transactions are recorded daily that is why it is also known as „day booke. It is also called as book of prime entry. The process of recording transactions in a journal is called journalising and the entries are called journal entries. As all the transactions are first entered in the journals, which are then posted into ledger. Journal is the beginning of the process of accounting. For accounting convenience, journal is divided into different subsidiary books like purchase book, sales book, purchase return book, sales return book, bills receivable book, bills payable book, cashbook and journal proper.

Characteristics of Journal:

Journal is said to be the first step of the double entry system. A transaction is first of all recorded in the journal. Therefore, the journal is the book of original entry.

1. A transaction is recorded on the same day it takes place. Therefore, journal is called ‘Day Book’.

2. All the monetary transactions relating to business are recorded chronologically hence the journal is called chronological book.
3. For each and every transaction the names of the two concerned accounts indicating which is debited and which is credited, are clearly written in two consecutive lines. This makes ledger posting easy. That is why journal is called Assistant to Ledger or subsidiary book.
4. Narration is written below each entry.
The amount is written in the last two columns - debit amount in debit column and credit amount in credit column.
5. There are five columns in journal entry- (1) Date (2) Particulars (3) L.F. no. (4) Debit amount (5) Credit amount.

Check your progress 1

1. The _____ is the book of original entry.
 - a. Journal
 - b. Ledger

2.3 Advantages of Using a Journal

The advantages of a journal can be studied through the following points:

1. Every transaction is recorded as it takes place. Therefore, there is almost no possibility of omission of any transaction from the books of account.
2. As the transactions are recorded in the journal chronologically with narration the reason behind why a transaction has taken place can ascertained easily.
3. For each and every transaction the two concerned accounts that will be debited and credited are clearly written in the journal. Therefore, there is least possibility of committing any mistake in writing the ledger.
4. As all the debits of transaction are recorded in journal so there is no need to repeat them in ledger. So the ledger is always kept tidy and brief.
5. The Journal shows the complete story of every transaction in one entry.
6. Any mistake in ledger can be easily detected through the journal.

Check your progress 2

1. The _____ shows the complete story of every transaction in one entry
 - a. Journal
 - b. Ledger

2.4 Types of Entries

There are two types of entries, which are recorded in the journal: simple entry and compound entry. A simple entry involves two accounts only, one affecting the debit side and other affecting the credit side with an equal amount. Sometimes a journal entry may have more than one debit or more than one credit entry. This type of journal entry is called compound journal entry. Regardless of how many debits or credits are contained in a compound journal entry, all the debits are entered before any credits are entered. The aggregate amount of debits should be equal to the aggregate amount of credits.

As for illustration 2

JOURNAL AND LEDGER

Sr	As for illustrations of Simple Entry	As for illustration of Compound Entry
1	<p>Started business and introduced Rs.10,000 as capital</p> <p>Cash a/c Dr10000 To Capital a/c 10000 (Being capital introduced in the business in the form of cash)</p>	<p>Started business and introduced Rs.10,000 cash and stock worth Rs.10,000 as capital</p> <p>Cash a/c Dr 10000 Stock a/c Dr 10000 To Capital a/c 20000 (Being capital brought in, in the form of cash & stock)</p>
2	<p>Purchased Machinery from Kulkarni & Co. for Rs.10,000 cash</p> <p>Machinery a/c Dr.10000 To cash a/c 10000 (Being machinery purchased for cash)</p>	<p>Purchased Machinery from Kulkarni & Co. for Rs.25,000 and paid cash Rs.10,000</p> <p>Machinery a/c Dr.25000 To cash a/c 10000 To Mr Kulkalrni's a/c 15000 (Being machinery purchased from Mr. Kulkarni partly in cash)</p>

Check your progress 3

1. Sometimes a journal entry may have more than one debit or more than one credit entry. This type of journal entry is called .
 - a. compound journal entry
 - b. simple entry

2.5 Format of a Journal

A journal is generally kept on a columnar basis. There are five columns in the journal, which are as under:

Date	Particulars	Ledger Folio	Amount (Dr)	Amount(Cr)

1. **Date:** Recording Date and Year of transaction.
2. **Particulars:** This is meant for recording the titles, description of transaction and passing entries. Here the name of the Account to be debited is written along with „Dr on the first line and the name of the Account to be credited is written along with a prefix „To on the second line. Finally, a short explanation of the transaction known as narration begins on the line immediately below the account credited. The narration always appears within parentheses and is begun with the word, Beinge – which means, what it is.

3. **L.F No:** Recording ledger folio number, which helps in identifying where the transaction is recorded in ledger.
4. **Debit Amount:** Recording amount debited.
5. **Credit Amount:** Recording amount credited.

As for illustration 3

Record journal entries in the books of J. Smith & Co. from the following transaction:

Transactions during January, 2020

- 1 Started business with a cash of ₹ 50,000 and Building valued ₹ 5, 00,000 and stock of ₹ 50,000.
- 6 Paid into bank ₹ 30,000.
- 8 Cash Sales of ₹ 10,000.
- 10 Purchased goods of ₹ 4,000.
- 17 Goods sold to Ramakant of ₹ 2,800 and cash received of ₹ 2,750/-
- 25 Paid telephone Bill of ₹ 300
- 26 Paid wages to workers ₹ 5000
- 28 Withdrawn from Bank for personal use ₹ 5000
- 31 Purchased computer and paid by cheque ₹ 22,000

Solution:

Date (2020 Jan.)	Particulars	L.F	Dr. Amount	Cr. Amount
1	Cash A/c Dr. Building A/c Dr. Stock A/c Dr. To Capital A/c (Being business started with cash, building and stock)		50,000 5,00,000 50,000 -	- - - 6,00,000
6	Bank A/c Dr. To Cash A/c (Being the cash paid to bank)		30,000 -	- 30,000
8	Cash A/c Dr. To Sales A/c (Being cash sales made)		10,000 -	- 10,000
10	Purchases A/c Dr. To Cash A/c (Being goods purchased for cash)		4,000 -	- 4,000
17	Cash A/c Dr. Discount Allowed A/c Dr. To Sales A/c (Being good sold and allowed discount)		2,750 50 -	- - 2,800

25	Telephone Expenses A/c To cash A/c	Dr.	300 -	- 300
26	Wages A/c To Cash A/c (Being wages paid to the workers)	Dr.	5,000 -	- 5,000
28	Drawings A/c To Bank A/c (Being the amount withdrawn for personal use)	Dr.	5,000 -	- 5,000
31	Computer A/c To Bank A/c (Being the computer purchased)	Dr.	22,000 -	- 22,000

Check your progress 4

1. The numbers of columns in journal are .
 - a. four
 - b. five

2.6 The Ledger

Once the transactions have been entered in the journal the next step is to classify or categorise them according to the accounts affected. All similar transactions are brought together through the ledger. For instance, all transactions relating to cash are brought to one place in the cash ledger or cash book. In the same way all transactions with a clients or a supplier are also written at one place. The book in which this classification is done is called the ledger.

The Ledger is also called the king of all books of accounts because all entries from the books of original entry are posted to the various accounts in the ledger. It should always be kept in mind that journal contains a chronological record while a ledger contains a classified record of all transactions.

The features of a ledger can be studied through the following points:

1. Two identical sides - The left hand side is called debit side and right hand side is called credit side.
2. The debit aspects of every transactions is recorded on the debit side, while credit aspect on credit side according to date.
3. The difference of the two sides represents the balance. The excess of debit side over credit side indicates debit balance, while excess of credit side over debit side indicates credit balance. If the two sides are equal there will be no balance.
4. Normally balance is drawn at the year-end and recorded on the deficit side to make the two sides equal. This balance is known as closing balance.

The closing balance of the current year will become the opening balance of the next year.

Check your progress 5

1. The _____ is also called the king of all books of accounts.
 - a. Ledger
 - b. journal

2.7 Sub-Division of Ledger

When the size of organisation is very large and number of accounts is abundant, it is necessary to maintain a separate ledger for different accounts. Generally, the following three kinds of ledger are maintained by organisations:

- Debtors Ledger
- Creditors Ledger
- General Ledger
- **Debtor's Ledger:** Debtors are the clients (customers) of the business to whom goods are sold on credit. Debtors ledger contains all the details of transactions with debtors. Entries in this ledger are made mostly from sales daybooks, sales returns book and cashbook. Therefore, it is also called as Sales ledger.
- **Creditor's Ledger:** Creditors are suppliers of the material to business from whom goods are purchased on credit. Purchase daybooks, purchase return book are one of the main sources of entries for this ledger. Therefore, it is also known as Purchase Ledger.
- **General Ledger:** This ledger contains all residual accounts – mainly real and nominal accounts. This ledger is also called nominal ledger.

Check your progress 6

1. _____ are the clients of the business to whom goods are sold on credit
 - a. Debtors
 - b. Creditors

2.8 Ledger Format

Ledger accounts are represented in "T" format. This consists of two sides, the left side represents the debit side and the right side represents credit side. Each side divided into four columns of varying sizes for the following:

- Date – used for date of transaction
- Particulars – Recording the name of the accounts debited or credited
- Journal Folio (J.F) – used to mark the page number of the journal for which the transaction is being recorded.
- Amount – Recording the amount debited or credited It may be kept in (i) Bound ledger or (ii) Loose leaf form

Ledger Format

JOURNAL AND LEDGER

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount

Check your progress 7

1. accounts are represented in “T” format
 - a. Ledger
 - b. Journal

2.9 Ledger Posting

Ledger posting can be understood as the system of transferring of the debits and credits from the journal to the ledger accounts. It should be kept in the mind that the exact names of accounts used in the Journal should be carried to the Ledger. Posting may be done at any time but should be completed before the financial statements are prepared. It is advisable to keep more active accounts posted to date.

As we know under double entry system, each transaction is transferred in two different ledger accounts, affecting the debit side of one and credit side of the other one. The following procedure is followed for posting:

1. Open separate ledger account for posting transactions relating to different accounts.
2. Consider each transaction separately for posting purposes.
3. Locate the transaction in Journals, to be posted in the ledger.
4. Locate in the ledger the first account named in the journal.
5. Enter the date of the transaction in the date column as per the dates of journal entry.
6. In the particular column of the ledger bookse debit side, enter the name of the account credited in the journal entry with a prefix „Toe.
7. In the Folio column of ledger book, enter the journal page number of which the posting is being made.
8. Locate in the ledger the second account named in the journal.
9. Repeat step 5.
10. Enter in the credit side of the ledger in particular column, the name of the account debited with a prefix „Bye.
11. Repeat step 7.

Check your progress 8

1. can be understood as the system of transferring of the debits and credits from the journal to the ledger accounts.
 - a. Ledger posting
 - b. Journal posting

2.10 Balancing Ledger Accounts

All the accounts in the ledger are balanced periodically to ascertain the collective effect of entries on the accounts. The balance at the end of tallying the account is the difference between the two sides of an account. In the event the total of the debit side exceeds the total of the credit side, then that every account is said to have a debit balance. On the contrary when, when the total of the credit side exceeds the total of the debit side, then that account is said to have a credit balance.

The following steps should be followed for the purpose of balancing or closing of ledger accounts:

1. On a rough paper, total both the debit amount column and credit amount column separately.
2. Find out the difference between the two sides if there is no difference; close the account by showing the totals of both the sides which are equal.
3. If the debit side total is more, put the difference on the credit side amount column, by writing the words in particulars column „By Balance c/d to make the totals of both sides equal. Conversely, if there is an excess of credit side total, the same must be put to debit side as „To Balance c/d.
4. Carry forward the balance c/d to the opposite side of the account as To Balance b/d or „By Balance b/d as applicable, in the beginning of the accounting year.

As for illustration 4

Pass necessary journal entries for the following transactions and post them in the appropriate ledger Accounts of P. Bhavsar.

2020

Jan. 1 Started business with ₹ 2,00,000 in the Bank and ₹ 40,000 cash.

- 1 Bought shop fittings ₹ 40,000 and a van ₹ 60,000 both paid by cheque.
- 2 Paid rent by cheque ₹ 5,000.
- 3 Bought goods for resale on credit from Zakir & co. ₹ 50,000.
- 5 Cash sales ₹ 5,000.
- 8 Paid wages of assistant in cash ₹ 1,000.
- 10 Paid insurance by cheque ₹ 500.
- 12 Cash sales ₹ 8,000.
- 15 Paid wages of assistant in cash ₹ 1000; Goods returned to Zakir & co ₹ 6,000.
- 17 Paid Zakir & Co. ₹ 30,000 by cheque.
- 19 Bought goods for resale on credit from Rao & Co ₹ 25,000.
- 19 Cash sales ₹ 7,000.
- 22 Paid wages of assistant in cash ₹ 1,000.
- 24 Bought stationery, paid in cash ₹ 500.
- 25 Cash sales ₹ 15,000.
- 27 Paid Rao & Co ₹ 14,000 by cheque.
- 29 Paid wages of assistant in cash ₹ 1,000.
- 31 Paid ₹ 20,000 into the bank.

Solution

**JOURNAL AND
LEDGER**

In the books of P.Bhavsar				
Dr. Date	Journal Particulars	L.F.	Rs.	Cr. Rs.
2020 Jan 1				
1	Bank A/c Dr Cash A/c Dr To Capital A/c (Being capital invested)		2, 00,000 40,000 -	- - 2, 40,000
1	Furniture & Fittings A/c Dr Van A/c To Bank A/c (Being the purchase of fittings and van for the business)		40,000 60,000 -	- - 1, 00,000
2	Rent A/c Dr To Bank A/c (Being rent paid by cheque)		5,000 -	- 5,000

BASICS OF
ACCOUNTING

3	Purchases A/c To Zakir & Co. A/c (Being goods purchased on credit)	Dr	50,000	50,000
5	Cash A/c To Sales A/c (Being goods sold for cash)	Dr	5,000	5,000
8	Wages To cash A/c (Being wages paid to assistant)	Dr	1,000	1,000
10	Insurance A/c To Bank A/c (Being insurance paid by cheque)	Dr	500	500
12	Cash A/c To Sales A/c (Being goods sold for cash)	Dr	8,000	8,000
15	Wages A/c To Cash A/c (Being wages paid in cash)	Dr	1,000	1,000
15	Zakir & Co A/c To Returns Outwards A/c (Being goods returned)	Dr	6,000	6,000
17	Zakir & Co A/c To Bank A/c (Being paid Zakir by cheque)	Dr	30,000	30,000
19	Purchases A/c To Rao & Co A/c (Being goods purchased on credit)	Dr	25,000	25,000

JOURNAL AND
LEDGER

19	Cash A/c	Dr	7,000	
	To Sales A/c			7,000
	(Being goods sold for cash)			
22	Wages A/c	Dr.	1,000	
	To Cash A/c			1,000
	(Being wages paid to assistant)			
24	Stationery A/c	Dr	500	
	To Cash A/c			500
	(Being purchase of stationery)			
25	Cash A/c	Dr	15,000	
	To Sales A/c			15,000
	(Being goods sold for cash)			
27	Rao & Co A/c	Dr	14,000	
	To Bank A/c			14,000
	(Being paid by cheque)			
29	Wages A/c	Dr	1,000	
	To Cash A/c			1,000
	(Being wages to assistant paid in cash)			
31	Bank A/c	Dr	20,000	
	To Cash A/c			20,000
	(Being Cash paid into Bank)			
	Grand Total		5, 30,000	5, 30,000

Ledger Postings

Dr. Bank Account Cr.

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
1.1.20	To Capital		2,00,000	1.1.20	By Furniture & Fittings		40,000
31.1.20	To Cash		20,000	1.1. 20	By Van		60,000
				2.1. 20	By Rent		5,000
				10.1. 20	By Insurance		500
				17.1. 20	By Zakir		30,000
				27.1. 20	By Rao		14,000
				31.1. 20	By Balance c/f		70,500
			2,20,000				2,20,000
1.2. 20	To Balance b/d		70,500				

Dr. Cash Account Cr.

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
1.1. 20	To Capital		40,000	8.1. 20d	By Wages		1,000
5.1. 20	To Sales		5,000	15.1. 20	By Wages		1,000
12.1. 20	To Sales		8,000	22.1. 20	By Wages		1,000
19.1. 20	To Sales		7,000	24.1. 20	By Stationery		500
25.1. 20	To Sales		15,000	29.1. 20	By Wages		1,000
				31.1. 20	By Bank		20,000
				31.1. 20	By balance c/f		50,500
	Total		75,000	Total			75,000
1.2. 20	To balance b/d		50,500				

Dr.**Capital Account****Cr.****JOURNAL AND
LEDGER**

Date	Particulars	J F	Amt.	Date	Particulars	J F	Amt
31.1.20	To Balance c/f		2,40,000	1.1.20	By Bank		2,00,000
							40,000
	Total		2,40,000		Total		2,40,000
				1.2.20	By balance c/f		2,40,000

Dr.**Furniture Account****Cr.**

Date	Particulars	J F	Amt	Date	Particulars	J F	Amt
1.1.20	To Bank		40,000	31.1.20	By Balance c/f		40,000
	Total		40,000		Total		40,000
1.2.20	By balance b/f		40,000				

Dr.**Van Account****Cr.**

Date	Particulars	J F	Amt	Date	Particulars	J F	Amt
1.1.20	To Bank		60,000	31.1.20	By Balance c/f		60,000
	Total		60,000		Total		60,000
1.2.20	By balanc e b/f		60,000				

Dr. Rent Account Cr.

Date	Particulars	J F	Amt	Date	Particulars	J F	Amt
2.1.20	To Bank		5,000	31.1.20	By Balance c/f		5,000
	Total		5,000		Total		5,000
1.2.20	By balance b/f		5,000				

Dr. Zakir?s Account Cr.

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
15.1.20	To Return outward		6,000	3.1.20	By Purchases		50,000
17.1.20	To Bank		30,000				
31.1.20	To Balance c/f		14,000				
	Total		50,000		Total		50,000
				1.2.20	By balance b/f		14,000

Dr Sales Account Cr.

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
31.1.20	To Balance c/f		35,000	5.1.20	By Cash		5,000
				12.1.20	By Cash		8,000
				19.1.20	By Cash		7,000
				25.1.20	By Cash		15,000
	Total		35,000		Total		35,000
	Sales account						
				1.2.20	By Balance b/d		35,000

Dr.**Wages Account****Cr.****JOURNAL AND
LEDGER**

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
8.1.20	To cash		1,000	31.1.20	By Balance c/f		4,000
15.1.20	To cash		1,000				
22.1.20	To cash		1,000				
29.1.20	To cash		1,000				
	Total		4,000		Total		4,000
1.2.20	By Balance b/d/		4,000				

Dr.**Insurance Account****Cr.**

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
10.1.20	To Bank		500	31.1.20	By Balance c/f		500
	Total		500		Total		500
	Insurance a/c						
1.2.20	By balance		500				
	b/f						

Dr.**Rao's Account****Cr.**

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
27.1.20	To Bank		14,000	19.1.20	By Purchases		25,000
31.1.20	To Balance c/f		11,000				
	Total		25,000		Total		25,000
				1.2.20	By Balance b/d		11,000

Dr. Purchases Account Cr.

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
3.1.20	To Zakir		50,000	31.1.20	By Balance c/f		75,000
19.1.20	To Rao		25,000				
	Total		75,000		Total		75,000
1.2.20	To balance b/d		75,000				

Dr. Return Outward Account Cr.

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
31.1.20	To Balance c/f		6,000	15.1.20	By Zakir		6,000
	Total		6,000		Total		6,000
				1.2.20	By Balance b/d		6,000

Dr. Stationery Account Cr.

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
24.1.20	To Cash		500	31.1.20	By balance c/f		500
	Total		500		Total		500
1.2.20	By Balance b/d		500				

Check your progress 9

1. In the event the total of the debit side exceeds the total of the credit side, then that very account is said to have a balance.
 - a. Debit
 - b. Credit

2.11 Difference between Journal and Ledger

The differences between the Journal and the Ledger can be studied through the following table:

JOURNAL AND LEDGER

Journal	Ledger
1. Journal is book of primary entry.	1. Ledger is book of final entry.
2. As soon as a transaction originates it is recorded into the journal.	2. Transactions come into the ledger from the journal.
3. All the transactions are recorded in chronological order.	3. The transactions are categorised into the accounts.
4. In journal narration is required and written in each and every entry.	4. No narration.
5. Here the ledger folio number is written	5. The Folio number of the journal or sub-journal is written.
6. The Relevant information cannot be ascertained readily.	6. As the transactions of particular nature are grouped at one place therefore the relevant information can be ascertained easily.
7. The ledgers are prepared from the journal and final accounts cannot be prepared directly from a journal.	7. Through Ledger trial balance is prepared which is the basis of preparing the final accounts.
8. The accuracy of the accounts books can't be tested through journal.	8. The accuracy of the books is tested by Trail balance which is prepared after closing of ledgers.
9. Debit and credit amounts are recorded in adjacent columns.	9. The Debit and credit are recorded in two different sides of different accounts.
10. In case of journal no balancing is done.	10. In ledger is balancing is done periodically.

Check your progress 10

1. In narration is required and written in each and every entry.
 - a. Journal
 - b. ledger

2.12 Let Us Sum Up

In this unit we have studied the about journal, ledger in very detail. We learnt how to post the entries into the journal and how to transfer those entries to their respective ledgers. Illustrations are given to explain this topic. Sub ledger is also discussed in detail.

The study of this unit will help the students to learn about accounting cycle, the various types of accounts and entries and how to post entries in journal and ledger.

2.13 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-a)

Check your progress 7

Answers: (1-a)

Check your progress 8

Answers: (1-a)

Check your progress 9

Answers: (1-a)

Check your progress 10

Answers: (1-a)

2.14 Glossary

1. **Bad Debts** - The amount of un-recoverable debts from customers.
 2. **Book Value** - It is an accounting term which usually refers to a business historical cost of assets and liabilities.
 3. **Capital** - An amount of money put into the business by the owner
 4. **Closing Balance** - Balance of an account at the end (or close), of an accounting period. This figure is then carried forward to the next accounting period.
 5. **Closing Stock** - Closing stock is the stock of inventory available with the business at the end of the accounting period.
 6. **Cost** - The value of money that has been used up to produce something, and hence is not available for use any more.
-

2.15 Assignment

1. Distinguish between journal and ledger.
 2. Define ledger. Explain posting and balancing of ledger accounts
-

2.16 Activities Journals And Ledger

Practical Questions

Journalise the following transactions in the books of Mahesh trading co.

1. Jan 1 Started business with cash ₹ 2, 00,000, Building ₹ 15, 00,000, Furniture ₹ 50,000.

2. Jan 2 Purchased goods from Mane on credit ₹ 50,000.
3. Jan 3 Purchase stationery ₹ 500.
4. Jan 12 Open a current bank account for the business and deposited ₹ 150000 in the same.
5. Jan14 sold good to Raman ₹ 30000.
6. Jan 20 purchased good from Rajeev ₹ 80,000
7. Jan 22 sold good for cash ₹ 25000 and offer a cash discount of 2%.
8. Jan 25 sold goods to Rohit, of ₹ 35000 and offered him a trade discount of 1%.

Journalize the following transactions & post them into ledger in the books of Swami Traders, for March 2007.

1. 1/3 Commenced business with cash ₹ 27000, bank ₹ 20000, Stock ₹ 20000, Furniture ₹ 50000 Building ₹ 1500000.
2. 2/3 Purchased goods from Nitin of ₹ 25000, he offered trade discount of 1%.
3. 5/3 Purchased stationery ₹ 1200
4. 6/3 sold goods for cash ₹ 15000 and offered a cash discount of 2%.
5. 10/3 Sold goods to Navin Rs 20000.
6. 15/3 Paid cartage ₹ 500.
7. 16/3 Paid wages ₹ 4500.

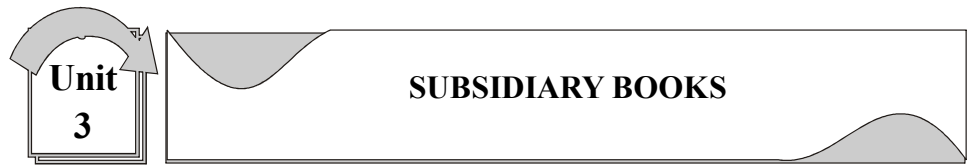
2.17 Case Study

Write a short note on

- a. Types of entries in journal
- b. Sub-division of ledger
- c. Advantages of ledger
- d. Accounting process
- e. Format of Journal

2.18 Further Readings

1. Advanced Accounts, M. C. Shukla & T. S. Grewal, S. Chand Publisher, 1997.
2. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 1978.
3. Financial Accounting, Paul S K, New Central Book Agency, 2001.
4. Modern Accountancy Volume I, Mukherjee, Tata McGraw Hill 2008.



: UNIT STRUCTURE :

3.0 Learning Objectives

3.1 Introduction

3.2 Cash book

3.2.1 Features of Cash book

3.2.2 Types of Cash Book

3.2.3 Single Column Cash book

3.2.4 Double Column Cash book

3.2.4.1 Double column cash book with discount and cash columns.

3.2.4.2 Double column cash book with bank and cash columns.

3.2.5 Three Column Cash book

3.3 Petty Cash Book

3.4 Sales Book

3.5 Purchase Book

3.6 Sales Return Book

3.7 Purchase Return Book

3.8 Bills Receivable Book

3.9 Bills Payable Book

3.10 Journal Proper

3.11 Let Us Sum Up

3.12 Answers for Check Your Progress

3.13 Glossary

3.14 Assignment

3.15 Activities

3.16 Case Study

3.17 Further Readings

3.0 Learning Objectives

After learning this unit, you will be able to understand:

- Various Subsidiary Books. like:
- Concept of Cash Book.
- Application and Operations of Petty cashbook.
- Purchase and Sales book.
- Various types of Return Books.
- Bills Receivable.
- Bills Payable.
- Journal proper.

3.1 Introduction

During the nineteenth century, the quantum of transactions of almost all the business houses rose enormously and it became clear that the journal was inadequate as the sole book of original entry. In order to save time, efforts and avoid inconvenience of classifying transactions for posting purposes, similar types of transactions are recorded in special journals called subsidiary books. The various subsidiary books are as follows:

1) Cashbook 2) Sales Book 3) Purchase Book 4) Sales Returns Book
5) Purchases Returns Book 6) Bills Receivable Book 7) Bills Payable Book
8) Journal Proper.

3.2 Cash Book

Cash book is a book of original entry. It records transactions involving receipts or payment of cash. Since the number of cash transactions is usually large, it is a difficult task to classify and post them to their respective ledger accounts. Though cashbook is a book of primary entry yet it serves as a ledger account. Cashbook is called as journalised ledger since cash transactions are primarily entered in cashbook and it shows the closing cash balance at the end of the particular period.

3.2.1 Features of Cash Book

1. Only cash transactions find its place in cash book
2. Each and every cash receipts are posted on the debit side whereas every cash payments are posted on the credit side of the cash book.
3. Only one aspect of a transaction is recorded in the cash book, i.e. cash.
4. All cash transactions are recorded chronologically in the cashbook.
5. It performs functions of both journal and ledger at the same time.
6. In case of cashbook at the end of accounting period either both the sides will have same total hence no balance will be there or total of debit side will be higher than credit side and difference will be shown as closing balance.

3.2.2 Types of Cash Book

Cash book can be of following four types

1. Single column cashbook – with cash column only
2. Two column cashbook – with cash and bank column
3. Three column cashbook – with cash, bank and discount column
4. Petty cashbook for petty expenses

3.2.3 Single Column Cash Book

It records only cash receipts and payments. It has only one amount column on each of the debit and credit sides of the cashbook and all the cash receipts and cash payments are entered on the debit side and the credit side respectively. Cash book, serves purpose of cash account and cash is a real account so rule of debit what comes in and credit what goes out shall be applicable.

Points to be kept in mind while writing single column cash book:

1. The pages of the cashbook are vertically divided into two equal parts. The left hand side is for recording receipts and the right hand side is for recording payments.

Solution:

Dr. Cash Book for April 2020 Cr.

Date	Receipts	L F	Amount	Date	Payments	L F	Amount
1.1.20	To balance b/d		4000	7.1.20	By purchases a/c		2600
4.1.20	To Sales a/c		3000	10.1.20	By Bank a/c		1000
5.1.20	To Anand a/c		1400	15.1.20	By Stationery a/c		1000
9.1.20	To Sales a/c		1400	24.1.20	By Purchases a/c		9000
12.1.20	To sales a/c		1400	25.1.20	By Kishan a/c		600
20.1.20	To Bank a/c		6000	30.1.20	By Salary a/c		1600
30.1.20	To Sales a/c		1800	30.1.20	By Rent a/c		300
				31.1.20	By Balance c/f		2900
	Total		19000				19000

3.2.4 Double Column Cash Book

3.2.4.1 Double column cash book with discount and cash columns.

Double column cash book which is also known as the two column cash book consists of two separate columns on the debit side and credit side for recording cash and discount. In many organisation trader allow or to receive small allowance off or against the dues. These allowances are provided for prompt settlement of accounts. In some of the business almost all receipts or payments are accompanied by such discounts and in order to avoid unnecessary postings separate columns in the cash book are introduced in order to record the discounts received or allowed. These discount columns are only memorandum columns and they should never be considered as the discount account. The discount column on the debit side of the cash book will record discounts allowed (ie. expense for business) and that on the credit side discounts received (i.e. income for business).

The process of posting entries in the cash columns is in the same way as single column cash book. But as far as discount column is concerned, each item of discount allowed (Dr. side of the cash book) will be posted on the credit side of the concerned personal accounts. On the other hand any discount received will be posted to the debit of the concerned personal account. The total of the discount column on the debit side of the cash book will be posted to the debit side of the discount account in the ledger and the total of discount column on the credit side of the cash book on the credit side of the discount account. It should always be remembered that we never do balancing of discount column as we do in cash column.

**Dr. Format of the Double Column Cash Book
With Discount and Cashbook**

Cr.

Date	Receipts	V.N.	L.F.	Discount	Cash	Date	Payments	V.N.	L.F.	Discount	Cash

Illustration 5

Prepare two columner cash book (cash and discount) of Pankaj from the following transactions.

2020 March

1. Opening cash balance ₹ 8000.
4. Goods of ₹ 6000 purchased at 10% trade discount.
7. Goods of ₹ 3000 sold to Prakash for cash at 5% cash discount.
10. Goods of ₹ 4000 sold for cash at 10% trade discount and at 5% cash discount.
12. Furniture of ₹ 5000 purchased from Nitu furniture mart.
15. ₹ 1000 paid to Vishwas for settelment of ₹ 1020.
16. ₹ 900 paid for commission.
18. ₹ 1500 received from Kamlesh towards fall settlement of ₹ 1560.
20. Paid ₹ 2000 for salary and ₹ 400 for wages.
23. Goods of ₹ 2000 purchased from Vishwan for cash at 10% cash discount.
26. Cash of ₹ 4000 introduced in the business.
28. Machine of ₹ 8000 is purchased from Mehta equipment for which ₹ 5000 is paid and balance amount is agreed to pay after one months.

Dr. Cash Book of Shri Pankaj (Discount and Cash Column) Cr.

Date	Receipts	Voucher No.	L F No.	Discount	Cash	Date	Payments	Voucher No.	L F No.	Discount	Cash
2020 March-1	To Balance b/d (Opening balance)	-	-	-	8000	2020 March -4	By Purchase A/c	-	-	-	5000
7	To Sales A/c	-	-	150	2850	15	By Vishwas A/c	-	-	20	1000
10	To Sales A/c	-	-	180	3420	16	By Commission A/c	-	-	-	900
18	To Kamlesh A/c	-	-	60	1500	20	By Salary A/c	-	-	-	2000
26	To Capital A/c	-	-	-	4000	20	By Wages A/c	-	-	-	400
						23	By Purchase A/c	-	-	180	1620
						28	By Machinery A/c	-	-	-	5000
						31	By Balance c/d (Closing balance)	-	-	-	3450
Total				390	19770					200	19770
April - 1	To Balance b/d				3450						

3.2.4.2 Double Column Cashbook With Bank and Cash column :-

In this type of cash book, an additional column (bank) is inserted on both the sides of simple cash book. This column is kept to record the transactions with the bank. Bank account is treated as 'personal account' hence 'debit the receiver' and 'credit the giver' rule of personal account shall be applicable. Such cash book has bank account and cash book. In this case, cash account is treated as an asset and so the rule of 'real account' shall be applied.

When (1) cash is deposited (2) cheque is deposited (3) Draft is deposited (4) amount deposited by debtors directly in bank account (5) any amount like

interest, dividend collected by the bank will be recorded at debited side of bank column.

When (1) cash is withdrawn from bank (2) amount is paid by cheque (3) any charges like commission, bank. In this transaction bank is giver, Hence bank account will be recorded at credit side of bank column.

Formate of two colummer cash book (with bank and cash column)

Date	Receipts	V. No.	L F No.	Cash (₹)	Bank (₹)	Date	Payments	V. No.	L F No.	Cash (₹)	Bank (₹)

Illustration 6

Record the following transaction in a suitable cash book of Mr. P. Basu and show the closing balances of cash and Bank

Jan 2020

		₹
1	Cash in hand	50,000
2	Opened a Bank Account	30,000
2	Received from Mr. T. Bose	4,000
3	Paid to Mr. N. Gopal by Cheque	500
3	Purchase made in cash	1,000
3	Paid rent	250
3	Withdrawn from Bank	3,000
4	Cash Sales	5,000
4	Received a cheque from Sunil Ranjan	10,000
4	Paid wages	200
4	Purchased furniture and paid by cheque	4,000
4	Cash Purchases	3,000
5	Withdrawn from Bank for personal use	3,000
5	Paid electricity Bill	52
5	Paid rates and taxes	100
5	Purchase made in cash	7,000
5	Cash Sales	12,000
5	Sold to Sree Nagrajan	5,000
5	Purchased from Mr. Nema Bose	2,000
7	Received a cheque from Sree Nagarjan and sent to Bank	3,000
7	Paid railway fright	250
7	Purchased stamps and Stationery	25
7	Deposited in Bank Account	300

Solution:

SUBSIDIARY
BOOKS

Dr. Two columnar Cash Book for Jan 2020 Cr.

Dat e 2020	Receipts	L F	Cash	Bank	Dat e 2020	Payments	L F	Cash	Bank
1.1	To bal. b/d		50,000		1.1	By Bank a/c		30,000	
1.1	To Cash a/c			30,000	3.1	By N. Gopal a/c			500
2.1	To Bose a/c		4,000		3.1	By Purchase a/c		1,000	
3.1	To Bank a/c		3,000		3.1	By Rent a/c		250	
4.1	To Sales a/c		5,000		3.1	By Cash a/c			3,000
4.1	To Rajan a/c			10,000	4.1	By Wages a/c		200	
5.1	To Sales a/c		12,000		4.1	By Furniture a/c			4,000
7.1	To Nagrajan a/c			3,000	4.1	By Purchases a/c		3,000	
7.1	To Cash a/c			300	5.1	By Drawing a/c			3,000
					5.1	By Elce. Chg a/c		52	
					5.1	By Rates, taxes a/c		110	
					5.1	By Purchases a/c		7,000	
					5.1	By Freight a/c		250	
					7.1	By Stationery a/c		25	
					7.1	By Bank a/c		300	
						By balance c/f		31,813	32,800
	Total		74,000	43,300		Total		74,000	43,300

Note: Credit transactions will not be recorded in cashbook only cash and bank related transactions are recorded.

3.2.5 Three Column Cash Book

A three column cashbook or triple column cashbook is one in which there are three columns on each side of the cash book i.e. on both the debit and credit side. First one is used to record cash transactions; the second is used to record bank transactions and third is used to record discount received and paid.

When a trader maintains a bank account, it becomes necessary for him to record the amounts deposited into bank and withdrawals from it. Because of this reason, one additional column is added on each side of the cashbook. The three column cash book reveals the cash as well as bank deposits at a glance.

Process of writing a Three Column cashbook:

The first step is write the opening balance of cash in hand and cash at bank on the debit side in the cashbook and bank columns. If the opening balance is credit balance (overdraft) then it will be put in the credit side of the cashbook in the bank column. i.e. opening bank balance would appear at debit side of cashbook as a opening balance in bank column and and bank over draft at credit side.

Cheque/ Chequeor Cash Received

When a cheque is received from any person and is paid into the bank on the same date it will appear on the debit side of the cashbook. The amount will be shown in the bank column. However if the cheque received could not be deposited into the bank on the same date then the amount will appear in the cash column. Cash received will be recorded in the usual manner in the cash column.

Payment by Cheque/Chequeor Cash

Whenever we make payment by way of cheque, these will appear on the credit side and the amount in the bank column. However if the payment is made in cash, it will be recorded in usual manner in the cash column.

Contra entries

If an amount is entered on the debit side of the cashbook and the exact the same amount is again entered on the credit side of the same account, it is called 'contra entry'. In the same way If an amount is entered on the credit side of an account also may have a contra entry on the debit side of the same account.

Contra entries are passed when:

Cash is deposited into bank by us: This is a payment from cash and a receipt in bank. Therefore, enter on credit side, cash column and on debit side bank column. The reason for making two entries is to follow the principle of double entry, which in such transactions is completed and therefore, no posting of these items is necessary. Such entries are marked in the cashbook with the letter 'C' in the folio column.

Cheque is drawn for office use: It is cash withdrawal from our bank account i.e. payment from our bank and receipt in cash. Therefore enter on the debit side, cash column 'To Bank' and on credit side, bank column 'By Cash'.

Bank Charges and Bank Interest Allowed

Bank charges paid appears on the credit side of bank column because on credit side of bank account shows all payment under the head 'Bank Charges'. Bank interest allowed appears on the debit side, bank column 'To Interest'.

Posting

The method of posting three-column cashbook into the ledger is as follows:

1. The opening balance of cash in hand and cash at bank are not posted.
2. Contra entries are marked with 'C' are not posted.
3. All other items on the debit side will be posted to the credit of respective accounts in the ledger and all other items on the credit side will be posted to the debit of the respective accounts.
4. The total of the discount allowed will be posted to the debit of the discount account in the ledger and total of the discount received to the credit side of the discount account.

Format of Three-Column cashbook

SUBSIDIARY
BOOKS

Dr.

Cr.

Date	Rec eipts	V.N.	L.F.	Dis	cash	Bank	Date	Pay men ts	V.N.	L.F.	Dis	Cash	Bank

Illustration 7

From the following particulars you have to prepare a Three Column cashbook. For the month of Jan 2020.

Jan 1 Cash in hand ₹ 25,000 and at bank ₹ 40,000.

- 1 Bought goods from Rajan for cash ₹ 10,000 and ₹ 10,000 on credit.
- 2 Bought good for ₹ 8,000 paid by cheque, discount allowed is 2%.
- 3 Sold goods for cash ₹ 15,000, with a cash discount of 1%.
- 4 Sold good to Rajesh of ₹ 25,000.
- 5 Cash deposited into bank ₹ 10,000.
- 6 Paid Rajan by cheque, he allowed discount of ₹ 200.
- 7 Rajesh paid us by cheque ₹ 25,000.
- 8 Paid Ramsharn by cheque ₹ 9,800 in full settlement of his dues of ₹ 10,000.
- 9 Sold goods to Mohan for cash ₹ 22,0 00.
- 10 Cash deposited into bank ₹ 25,000.

Solution:

Three Columnar cashbook for Jan 2008

Dr.

Cr.

Date 2020	Receipts	L F	d/c	cash	bank	Date 2020	payments	L F	d/c	cash	bank
1	To bal b/d			25,000	40,000	2	By Purchases			10,000	
4	To Sales		150	14,850		3	By Purchases		160		7,840
6	To cash	c			10,000	6	By Bank	c		10,000	
8	To Rajesh				25,000	7	By Rajan		200		9,800
10	To Sales			22,000		9	By Ramsharn		200		9,800
11	To Cash	c			25,000	11	By Bank	C		25,000	
						11	By balance c/f			16,850	72560
	Total		150	61,850	1,00,000				560	61,850	1,00,000

Check your progress 1

1. Though is a book of primary entry yet it serves as a ledger account.
 - a. Cashbook
 - b. Ledger
 - c. Journal

3.3 Petty Cash Book

In every business, whether large or small there are numerous small expenses incurred regularly, e.g. stationery, cartage, newspaper and magazine, refreshments etc. Generally, major payments are made by cheque for better control over cash. In spite of this advantage, payment by cheque in the above cases is impractical. As a solution, head cashiers transfer a small amount of cash to a person who is designated to be responsible for it – the petty cashier. The petty cashier will record all the petty transactions in an separate multi column book called petty cashbook. Amount received from the head cashier is debited in the petty cashbook. All payments are entered on the credit side. The petty cashbook is treated as book of original entry.

There are two systems of petty cash.

1. Simple system of petty cash: Under this method, petty cashier is given any specific amount to be spent on petty expenses. After spending the whole amount, he submits the petty cashbook to the head cashier for necessary verification. He also asks for more money to carry out further transactions.
2. Imprest system of petty cash: A fixed amount of money for a fixed period which may be a week or a month and it is allocated towards meeting the petty small daily expenses. At the end of the period the accounts are checked, verified and again cash equivalent to expenses incurred is reimbursed to the petty cashier. It means the opening and closing balance of the petty cashbook remains the same i.e. balance held by petty cashier in the beginning and the end does not change.

Illustration 8

SUBSIDIARY BOOKS

You are required to enter the following transactions in the columnar petty cashbook of Mr. Medhansh, the accountant who was given ₹ 100 on 1st

April 2020	Particulars	
2	Paid for postage	8
2	Paid for book	10
3	Paid for Photocopy	4
3	Paid for postage stamps	6
8	Paid for paper	1
12	Paid for cartage	6
18	Paid for trips to office peons	2
23	Paid for ink and nibs	4
25	Paid for Tiffin to office peons	6
26	Paid for train fair	5
28	Paid for bus fair	4
29	Envelops and letter heads	6
30	Printing address on above	4
31	Taxi fare to manager	10

Solution:

Amount Received	Date	Particulars	V.N.	Total	Postage	Printing and Stationary	Cartage	Traveling Expenses	Misc.
Rs. 100	2020 March 1	To Cash							
	" 2	By Postage		8	8		4		
	" 2	By Stationary		10		10			
	" 3	By photocopy		4					
	" 3	By Postage		6	6				2
	" 3	By Paper		1		1	6		
	" 12	By Cartage		6				5	6
	" 18	By Tip to peon		2				4	
	" 23	By Ink & nibs		4		4			
	" 25	By Tiffin to		6					
	" 26	Peon		5				10	
	" 28	By train fair		4					
	" 29	By bus fair		6		6			
	" 30	By Envelops et.		4		4			
	" 31	By printing		10					
	" 31	By Taxi fair		24					
100		By balance c/d		100	14	25	10	19	8
24									
76									

Check your progress 2

1. Amount received from the head cashier is in the petty cashbook
 - a. Debited
 - b. credited

3.4 Sales Book

In this book, all transaction related to credit sales are recorded. Generally sale of assets on credits banks are recorded through journal. Only the credits sale of goods in which you are dealing for trading purpose are recorded in sales book. This book is also known as „sales journal or „sales day booke. It should be remembered that sales daybook, records only those goods which are sold on credit and the goods in which the business enterprise deals in. It should be also noted that the goods any forward sale the delivery of which is to be made in future will not find place in the daybook. However, the entries are made with the net amount after allowing for trade discount.

Specimen of sales book

Date	Name of the customer	Invoice No.	L F No.	Amount (₹)

It is to be noted that the sales book is a book of original entry and hence periodic posting must be completed to ledger accounts concerned.

Illustration 9

From the following transactions write – up the sales day book of M/s X & Co.:

- Jan. 1 Sold to Premier Traders 100 bags of sugar @ ₹ 650 per bag, less trade discount @5 %.
- Jan. 10 Sold to R & Co. 10 bags of milk powder @ ₹ 500 per bag, less trade discount @ 10%.

Solution:

In the books of M/s X & Co.

Sales Book

Date	Name of the customer	Invoice No.	L F No.	Amount (₹)
Jan - 1	Premier Traders. 100 × ₹650 = ₹65000 – 5% T.D	–	–	61750
Jan - 10	R & Co. 10 × ₹500 = ₹5000 – 10% T.D	–	–	4500
	Total	–	–	66250

Check your progress 3

1. In book, all transaction related to credit sales are recorded.
 - a. Sales book
 - b. Cash book
 - c. Journal
 - d. Ledger

3.5 Purchase Book

All transactions related to credit purchases of goods are primarily recorded in this book. It is also known as „purchase day booke, „bought day booke, or purchase journale. On receiving the goods and the invoice, the receiving department compare both with the copy of the order placed by purchase department. If everything is found in order, the goods are sent to the stores. Based on the invoice received from the supplier, necessary entry is passed in the Purchase Book.

Specimen of Purchase Book

Date	Name of the supplier	Invoice No.	L F No.	Amount

Illustration 10

(Only purchase book no ledger entry)

Enter the following transactions in Purchases Book of m/sc X & Co.

Jan.1 Purchased on credit from Ambani & Co. 100 shirts @ 125 each less 5 % trade discount.

3 Purchased from Behri Brothers 60 shirts @ ₹ 200 each, trade discount allowed by them 10 %

10 Purchased a type writer from Big Brothers for ₹ 5,000

12 Purchased 300 shirts @ ₹ 175 each from Rehman & Co.

Solution :

Purchase Book

Date	Name of the Supplier	Invoice No.	L F No.	Amount (₹)
Jan. 1	Ambani & Co. 100 shirts @ ₹125 = ₹ 12500 – 5% T.D.	-	-	11875
Jan. 3	Behri Bros 60 shirts @ ₹200 = ₹12000 – 10% T.D.	-	-	10800
Jan. 12	Rehman & Co. 300 shirts @ ₹175 = 52500	-	-	52500
	Total	-	-	75175

Check your progress 4

- All transactions related to credit purchases of goods are primarily recorded in book.
 - Purchase Book
 - Sales Book

3.6 Sales Return Book

Goods may be returned by the customers for a variety of reasons such as wrong quantity and/or quality. All goods returned by the customers are primarily recorded in this. This book is also known as „return inward booke. It only records the transaction of those goods returned by credit customers. When goods are returned by the customer following procedure is followed:

1. Preparation of „credit note: When credit customers return goods, the company prepares a credit note in the customer's name. This note mentions that the account of the customer has been credited with the amount stated there in. The original being sent to the customer and the duplicate is preserved in the file, which provides basis for recording entries in the sales return book.
2. Posting from the sales return book: The total values of the goods returned by customers are posted to various ledger accounts concerned periodically

Specimen of Sales Return Book

Date	Name of the Customer	Credit note No.	L F	Amount (Rs.)

Illustration 11

Enter the following sales returns in the books of Shyamlal.

Date	Invoice No.	Particulars
06.10.20	8256	M/s Navin traders returned Samrat groundnut oil 900 ml, 15 packs @110.
12.11.20	8362	M/s Prabhat traders returned Bornvita 500 gm., 25 packs @125
18.12.20	8528	M/s Kanchan traders returned Samrat Sunflower oil 900 ml, 15 packs @100.

Solution : In the books of Shyamlal

Sales Return Book

Date	Name of the Supplier	Invoice No.	L F No.	Amount (₹)
6-10-20	M/s Navin traders 15 × ₹110	8256	-	1650
12-11-20	M/s prabhat traders 25 × ₹125	8362	-	3125
18-12-20	M/s Kanchan traders 15 × ₹100	8528	-	1500
	Total	-	-	6275

Check your progress 5

1. All goods returned by the customers are primarily recorded in
 - a. Sales return book
 - b. Purchase return book

3.7 Purchase Return Book

Goods may be returned by the company to the sellers for a variety of reasons such as wrong quantity and or quality. All goods returned by the company are primarily recorded in this. This book is also known as „Return Outwards Booke. It only records the transaction of those goods returned to the debit sellers. When goods are returned to the sellers following procedure is followed:

1. Preparation of „Debit Note: When the goods are returned to the suppliers, intimation is sent to them through what is known as a debit note. These debit notes serve as vouchers for these entries. A debit note is a statement sent by a businessman to another person, showing the amount debited to the account of the latter. Debit notes are usually serially numbered and are prepared in the same form as that of the invoice.
2. Posting from the Sales Return Book: The total of the purchases returns or returns outwards book is credited to returns outward account or purchases return account (being the goods sent out). Individual suppliers to whom goods are returned are debited (because they receive the goods).

Specimen of Purchase Return Book

Date	Name of the supplier	Debit Note No.	L F No.	Amount

Entries in the purchase return book are made on the basis of original Credit Note received from the supplier.

Illustration 11

Enter the following purchases returns in the books of Vikaram.

Date	Invoice No.	Particulars
12/5/20	78125	Returned to Gupta Traders, 5 sets of Dining tables @ 8,000
28/06/20	78256	Returned to Godrej & co 3 Wardrobes, Costing Rs. 15,000, 18,500, 26,000 respectively.
8/09/20	78345	Returned to Croma Furnitures 2 sofa-sets costing Rs.25,000 &18,900 respectively

Solution: In the books of Vikaram

Purchase Return Book

Date	Name of the Supplier	Invoice No.	L F No.	Amount (₹)
12-5-20	Gupta traders 5 × ₹8000	-	-	40000
28-6-20	Godrej & Co. ₹15000 + ₹18500 + ₹26000	-	-	59500
8-9-20	Croma Furnitures ₹25000 + ₹18900	-	-	43900
	Total	-	-	143400

Check your progress 6

1. All goods returned by the company are primarily recorded in
 - a. Purchase return book
 - b. Sales return book

3.8 Bills Receivable Book

When goods are sold on credit, the funds are blocked in the form of debtors and can be materialised in near future. Sometimes the seller wants a written undertaking from the credit customer, to pay after a specific period. Such document, containing an undertaking to pay with the details of payments is termed as bills of exchange. When the bill is drawn by the seller and accepted by the buyer it is termed as bills receivable from seller's point of view. All such bills receivables are recorded in the books of accounts through a subsidiary book called as bills receivable book.

Specimen of Bills receivable Book

No. of bill	Date of receipt	Date of bill	From whom received	Name of the acceptor	L F	Due date of bill	Amount	Remark

The total of the bills receivable book indicates the total value of bills receivable drawn during the period. Information about bill discounting, dishonour, encashment etc is noted in the remark column. Entries of endorsement, dishonour of bills are recorded through journal proper. Bill encashment and discounting is passed through cashbook.

Check your progress 7

1. The total of the book indicates the total value of bills receivable drawn during the period.
 - a. bills receivable
 - b. bill payable

3.9 Bills Payable Book

When the business unit purchases goods on credit, the creditor may want an undertaking from the unit, for the payment in future on or before a specific date, such written promise to pay the specific amount on specific date, is termed as bills of exchange. For the person or the organisation that promises, the bill is bills payable and for the one whom it is promised, it is bills receivable. Bills payable book is maintained for the bills accepted by the drawee.

Specimen of Bills payable Book

No. of bill	Date of receipt	Date of bill	Name of the drawer	LF	Due date of bill	Amount	Remark

Check your progress 8

1. book is maintained for the bills accepted by the drawee.
 - a. Bills payable
 - b. Bill receivable

3.10 Journal Proper

Journal proper is used for making the original record of those transactions, which do not find a place in any of the previously mentioned books of original entry. The journal proper is used to record the following types of entries:

1. **Opening entries:** Opening entries are used at the beginning of the financial year to open the books by recording the assets, liabilities and capital, appearing in the Balance Sheet of the previous year. The rule to be applied is:
 Assets Account Dr
 To Liabilities Account
 To Capital Account
2. **Closing entries:** Closing entries are passed at the end of each year whereby the revenue items (expenses and incomes losses and profits) are transferred to revenue account (i.e. trading and profit and loss account). Balances in capital items (as assets, liabilities, and proprietary balances etc) do not change and then these are transferred to balance sheet. The closing entries are often avoided now and instead, in the ledger itself the destination of the balances is indicated as: transfer to trading account, transfer to profit and loss account etc.
3. **Adjustment entries:** Adjustment entries are passed at the time of finalisation. These entries are needed to bring into books outstanding expenses, accrued incomes, depreciation, provision for bad and doubtful debt, provision for discounts etc.
4. **Rectification entries:** Rectification entries are required to rectify different types of errors located, as errors of omission, commission, principle etc. (for details refer unit – V)
5. **Transfer entries:** These are needed for transfer of any amount from one account to another account.
6. **Share Issue entries:** Share issue entries are needed for issue of share and making calls etc in case of companies.

Illustration 12

Pass necessary Journal entries:

(1) Opening Balance:

	Rs.		Rs.
Plant	80,000	Cash	5,000
Creditors	40,000	Debtors	40,000
Stock	10,000		

(2) Closing figures as per Trial Balance include:

	Rs.
Purchases	70,000
Sales	1,00,000
Expenses	12,000

(3) Closing Stock Rs 5,000

(4) Transfer Rs. 1,000 from credit of A to credit of B.

- (5) Rs. 1,000 repairs to Furniture debited to Furniture Account by mistake.
(6) Provide 10 % depreciation on assets of Rs. 60,000.

Journal

Date	Particular	L F No.	Debit	Credit
1	Plant A/c Dr.	-	80000	-
	Cash A/c Dr.	-	5000	-
	Debtors A/c Dr.	-	40000	-
	Stock A/c Dr.	-	10000	-
	To Creditors A/c	-	-	40000
	To Reserve A/c	-	-	15000
	To Capital A/c	-	-	80000
(Being opening balances are recorded)				
2	Trading A/c Dr.	-	80000	-
	To purchase A/c	-	-	70000
	To opening stock A/c	-	-	10000
(Being purchase and opening stock transfer to trading A/c)				
3	Sales A/c Dr.	-	100000	-
	To trading A/c	-	-	100000
(Being closing stock transfer to trading A/c)				
4	Closing stock A/c Dr.	-	5000	-
	To trading A/c	-	-	5000
(Being closing stock transfer to trading A/c)				
5	Trading A/c Dr.	-	25000	-
	To P & L A/c	-	-	25000
(Being gross profit transferred to P & L)				
6	Profit and loss A/c Dr.	-	12000	-
	To expense A/c	-	-	12000
(Being expense transferred to P & L A/c)				
7	Profit and loss A/c Dr.	-	13000	-
	To capital A/c	-	-	13000
(Being net profit transferred to capital A/c)				
8	Repair A/c Dr.	-	1000	-
	To furniture A/c	-	-	1000
(Being repairs wrongly debited to furniture A/c is rectified)				
9	Depreciation A/c Dr.	-	6000	-
	To assets A/c	-	-	6000
(Being depreciation charged on fixed assets)				
Total			377000	377000

Note : (1)	Purchase	70,000	Sales	10,000	SUBSIDIARY BOOKS
	Opening	<u>10,000</u>	Closing	5,000	
		80,000			
	Gross profit	<u>25000</u>			
		<u>1,05,000</u>		<u>1,05,000</u>	
(2)	To Expense	12000	Gross profit	25000	
	Net Profit	<u>13000</u>			
		<u>25000</u>		<u>25000</u>	

Check your progress 9

1. is used for making the original record of those transactions, which do not find a place in any of the previously mentioned books of original entry.
 - a. Journal proper
 - b. Ledger
 - c. Journal

3.11 Let Us Sum Up

In this unit we have studied about various subsidiary books. In very details we have discussed the various types of subsidiary books. The purpose of these subsidiary book is different and they are of many types, almost all of them have been discussed in detail.

In order to save time, efforts and avoid inconvenience of classifying transactions for posting purposes, similar types of transactions are recorded in special journals called subsidiary books. The various subsidiary books are cash-book, sales book, purchase book, sales returns book, purchases returns book bills, receivable book bills, payable book, journal proper.

3.12 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-a)

Check your progress 7

Answers: (1-a)

Check your progress 8

Answers: (1-a)

Check your progress 9

Answers: (1-a)

3.13 Glossary

1. Double-entry book-keeping - A system that accounts for every aspect of a transaction – where it came from and where it went to. This from and to aspect of a transaction (called crediting and debiting) is what the term double-entry means.

3.14 Assignment

What are the books of original entry explain in detail

3.15 Activities

Explain the Following:

- a. Three Column cashbook
- b. Transfer entries
- c. Bills Payable Book
- d. Purchase Return Book

3.16 Case Study

What do you mean by “Subsidiary Books”e Describe in brief each of these subsidiary books.

3.17 Further Readings

1. Advanced Accounting - Financial Accounting, Dr Ashok Sehgal, Dr Deepak Sehgal, Taxmann Allied Services Pvt. Ltd., 2008.
2. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 1978.
3. Advanced Accounts, M. C. Shukla& T. S. Grewal, S. Chand Publisher, 1997.
4. Financial Accounting, Paul S K, New Central Book Agency, 2001.
5. Financial Accounting, J C Varshney, Wisdom Publication, 2006.
6. Modern Accountancy VolumeI, Mukherjee, Tata McGraw Hill 2008.

Block Summary

In this block best efforts have been made to provide the basics of accounting to the students in easy language. In the starting unit we discussed the very basic topics of accounting, the basic terminologies of accounting. We discussed the various rule and principles of accounting. Through knowledge of these principle is a must as they are the foundation of modern accounting. These principles have been discussed with sufficient illustrations and examples. In the second unit of this block we studied in very detail about journal, ledger and how to post entries into the ledger. In this portion we have covered and explained in detail how to post entries into the ledger, how to transfer entries from journal to ledger and how to close the ledger account. In the third unit we have studied about the subsidiary books, all the books of subsidiary nature were discussed in detail

It has covered almost all the basic things in detail to the students and all the required information has been included in this block which was essential for the students to understand this subject.

Block Assignment

Short Answer Questions

1. Discuss the various forms of ledger.
2. Discuss the characteristics of Journal.
3. Write short notes on.
 - a. Bookkeeping
 - b. Type of accounts
 - c. Evolution of accounting
 - d. Origin and growth of accounting
 - e. Accounting mechanics
 - f. Rules for debit
4. Debit balance as per cash book.
5. Debit balance as per pass book.
6. Items to be added and subtracted when overdraft balance as per cash book is given.
7. Items to be added and subtracted when credit balance as per pass book is given.

Long Answer Questions

1. Discuss the documents used in recording accounting transactions of business.
2. What is a journal? Explain its features and advantages.
3. Define accounting. Explain the functions of accounting. Also, state the users of accounting information.
4. What are the types of accounts? Explain the rules of debit and credit for various types of accounts.
5. Explain the principles of accounting.
6. Discuss the procedure of preparing sales return book.

Enrolment No

1. How many hours did you need for studying the units

Unit No	1	2	3
Nos. of Hrs			

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Language and Style	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Illustration used (Diagram, tables etc)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Conceptual Clarity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Check your progress Quest	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Feed back to CYP Question	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____

3. Any Other Comments

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**Dr. Babasaheb
Ambedkar
OpenUniversity**

BBAR-102/DBAR-102

BASIC OF ACCOUNTING

**BLOCK 2 : TRIAL BALANCE, BANK RECONCILIATION
STATEMENT, CAPITAL AND REVENUE
TRANSACTION AND ACCOUNTING FOR BAD
DEBTS**

UNIT 1

TRIAL BALANCE

UNIT 2

BANK RECONCILIATION STATEMENT

UNIT 3

CAPITAL AND REVENUE TRANSACTION

UNIT 4

ACCOUNTING FOR BAD DEBTS

BLOCK 2 : TRIAL BALANCE, BANK RECONCILIATION STATEMENT, CAPITAL AND REVENUE TRANSACTION AND ACCOUNTING FOR BAD DEBTS

Block Introduction

Accounts is considered to be one of the most important subject for the students of commerce and management and keeping in view this book has been made to make the subject very simple and understandable for the student.

This block will be coverings topics of trial balance, bank reconciliation statement, Capital & revenue transactions and Bad debts. All these topics are considered to be one of the most important topics in accounting. In the first unit the students will be told about the trial balance. The purpose and objectives of trial balance will also be informed to the students. They will also be explained how to prepare the trial balance. In the second unit the students will also be told about the bank reconciliation. They will be told about the purpose and uses of a bank reconciliation statement and why is it necessary in accounts. They will also explained in detail the process of preparing bank reconciliation statement.

In the third unit we shall study in detail about the capital and revenue nature of expenses. We will be discussing in detail the difference between the capital and revenue expenditure. We will also be studying the deferred revenue expenditure and how they are different from revenue and capital expenditure. In this block we will be studying about capital and revenue receipts and capital and revenue losses. This block will also cover a unit on bad debts, where we shall be studying what are bad debts and what is the procedure of its role in accounting. We will also be studying in this topic the provision for bad debts, provision for discount on debtors and creditors and the accounting treatment on recovery of bad debts.

The study of this block is very useful to the students as it will help them in understanding the basic concepts of final accounts and knowledge of these topics is very essential for the preparation of books of accounts.

Block Objective

After reading this block, you will be able to understand :

- Trial balance and its limitations.
- Errors disclosed by trial balance.
- Methods of preparing Trial Balance.
- What is Suspense account?
- Purpose of preparing Bank reconciliation.
- Capital and Revenue expenses and receipts.
- Bad debts and their accounting provisions.

Block Structure

Unit 1: Trial Balance

Unit 2: Bank Reconciliation Statement

Unit 3: Capital and Revenue Transaction

Unit 4: Accounting for Bad debts



: UNIT STRUCTURE :

- 1.0 Learning Objectives**
- 1.1 Introduction**
- 1.2 Objectives of Trial Balance**
- 1.3 Limitations of Trial Balance**
- 1.4 Errors Disclosed by a Trial balance**
- 1.5 Errors that are not Disclosed by a Trial Balance**
- 1.6 Methods of Preparing Trial Balance**
- 1.7 Methods of Locating Errors**
- 1.8 Suspense Account**
- 1.9 Let Us Sum Up**
- 1.10 Answers for Check Your Progress**
- 1.11 Glossary**
- 1.12 Assignment**
- 1.13 Activities**
- 1.14 Case Study**
- 1.15 Further Readings**

1.0 Learning Objectives

After learning this unit, you will be able to understand :

- Meaning and Objectives of preparing a Trial Balance.
- Limitations of Trial Balance.
- Various types of disclosed as well as undisclosed errors by Trial Balance.
- Concept of Suspense account.
- Methods of locating errors.

1.1 Introduction

A trial balance is a detailed list of all the nominal ledger (general ledger) accounts contained in the ledger of a business. It contains the name of the nominal ledger account and the value of that nominal ledger account. The value of the nominal ledger hold either a debit balance value or a credit value balance. The debit balances are shown in the debit column of the trial balance and the credit balances are shown in the credit column. The financial statements i.e. profit and loss account and balance sheet are prepared by using the trial balance.

The name of Trial balance comes from its purpose i.e. the purpose of a trial balance, the purpose of trial balance has been to prove that the value of all the debit balances are equal the total of all the credit balances.

Normally trial balance is prepared by a bookkeeper or accountant who has used day books to record financial transactions and then post them to the nominal ledgers and personal ledger accounts. The trial balance is a part of the double-entry bookkeeping system and uses the classic 'T' account format for presenting values.

1.2 Objectives of Trial Balance

Trial Balance serves the following objectives :

1. It makes sure that all transactions have been recorded with identical debit and credit amounts and the balance of each account has been computed correctly.
2. It provides for the test of arithmetical accuracy of various ledger accounts.
3. As the Trial Balance contains the ledger balance on a particular date, thus the entire ledger is summarised in the form of a Trial Balance. Hence, it is a summarised ledger.
4. It provide base for preparing final accounts.

Check your progress 1

1. provides for the test of arithmetical accuracy of various ledger accounts
 - a. Journal
 - b. Ledger
 - c. Trial balance

1.3 Limitations of Trial Balance

An agreed Trial Balance does not prove that :

1. All transactions have been correctly analysed and recorded in the proper accounts. For instance, if the wages paid for the installation of plant had been erroneously recorded by debiting the wages account as opposed to the plant account, the trial balance would still agree.
2. All transactions have been recorded in the books of original entry. If, for example, a sales invoice were to be completely omitted from being recorded in the sales day book, the error would not be disclosed in the trial balance.

To conclude, we can say that a trial balance should not therefore, be regarded as conclusive proof of the correctness of the books of accounts.

Check your progress 2

1. should not therefore, be regarded as conclusive proof of the correctness of the books of accounts.
 - a. Trial balance
 - b. Journal
 - c. Errors

1.4 Errors Disclosed by a Trial Balance

In order to understand the types of errors and their rectification we have to classify them into Errors disclosed and Errors not disclosed by trial balance. Following are the errors in the books of accounts which are disclosed by a Trial Balance :

1. **Omission error** : Both the sides of a trial balance will not agree when a transaction has not been correctly posted in the books of accounts.i.e. There will be differencein both debit and credit side of the trial balance.
2. **Debit or Credit entries are not posted at all or posted twice** : If only one side of the transaction i.e. If only one aspect has been recorded or it has been recorded twice, the trial balance will not agree.
3. **Debits are wrongly posted as credits and vice versa** : A trial balance will always be in disagreement when a transaction is recorded on the wrong side of an account.
4. **Wrong totalling of subsidiary books** : If the total of any subsidiary book is wrongly cast, it will result in disagreement of the trial balance.
5. **Difference in amount between the entries** : If different amounts are posted in two different accounts, the trial balance will never agree.
6. **Error in computation of an account balance** : If the balance of an account is not correctly computed, the balance of the ledger will not show the true position and will cause disagreement of the trial balance.
7. **Omission of Account Balance** : If the balance of an account is not listed in the trial balance at all, it would fail to agree.
8. **Balance of an account wrongly recorded in the trial balance** : If the balance of an account is wrongly recorded in the trial balance, there will be some disagreement.
9. **Errors in extraction of the trial balance** : The trial balance will not tally if any or both the columns are wrongly totalled up.

Check your progress 3

1. The trial balance will not tally if any or both the columns are wrongly totalled up
 - a. Errors in extraction of the trial balance
 - b. Ommission error
 - c. totalling error

1.5 Errors that are not disclosed by a Trial Balance

1. **Errors of omission** : If a particular transaction omitted altogether from the books of original entry.
2. **Errors of principal** : These errors results because of an incorrect application of the principles of accounting, e.g. failure to differentiate between capital and revenue expenditure.
3. **Compensating errors** : These area group of errors and the total effect of which is not reflected in the trial balance. These errors are of a neutralizing nature. One error is compensated by errors of an opposite nature.
4. **Recording wrong amount in the books of original entry** : If a transaction is wrongly recorded in the books of original entry and there after carried through the ledger it will not cause disagreement in the trial balance.

- 5. Recording a transaction more than once :** The trial balance will agree if a transaction is recorded correctly more than once.

Check your progress 4

1. Errors disclosed by trial balance
 - a. Wrong totalling of subsidiary books
 - b. Compensating error

1.6 Methods of Preparing Trial Balance

A Trial Balance may be prepared based on the following methods :

1. Total method
 2. Balance method
 3. Total-cum-balance or compound method
- 1. Total Method :** In this method, the totals of credit and the totals of debits are transferred to the trial balance without finding out the difference of the two sides. The excess of debit side over credit side or vice versa is automatically adjusted and both the sides tally. This method is not so popular.

Illustration : 13

**M/S Swaraj Traders
Trial Balance as on 31/03/20**

Name of accounts	Total of debit side of A/c	Total of credit side of A/c
Capital Account	-	90000
Drawings Account	20000	-
Param's Account	3000	9500
Karam's Account	4000	6000
Ashmita's Account	8000	2000
Khushbhu's Account	10000	3000
Sheth & Bros Account	9000	2000
Cash Account	57000	49500
Bank Account	30000	8000
Furniture Account	20000	-
Purchase Account	25000	-
Sales Account	-	28000
Salary Account	5000	-
Wages Account	6000	-
Stationery Account	1000	-
Discount Account	2000	-
Purchase return Account	-	2000
Total	200000	200000

2. Balance Method : In this method the differences of two sides i.e. debit and credit for each ledger account is taken to the trial balance. The excess of debit total over credit is put to the debit column and vice versa.

Illustration : 14TRIAL
BALANCE**Trial Balance as on 31/03/20**

Account Head	Debit	Credit
	Amount	Amount
Capital	-	8,00,000
Drawing	50,000	-
Plant and Machinery	4,00,000	-
Building	6,00,000	-
Furniture	50,000	-
Stationary	3,000	-
Salary	28,000	-
Wages	18,000	-
Loan	-	4,00,000
Bank OD	-	1,20,000
Cash	18,000	-
Purchases	2,80,000	-
Sales	-	3,20,000
Debtors	80,000	-
Sales return	8,000	-
Creditors	30,000	-
Purchase Return	-	6,000
Investments	1,41,000	-
Total	16,76,000	16,76,000

3. Compound Method: In this system, a trial balance is prepared with both the balances along with total of the various accounts. It is a combination of both the two of the methods discussed above.

Check your progress 5

1. A Trial Balance may be prepared based on the following methods
 - a. Total method
 - b. difference method

1.7 Methods of Locating Errors

Method or the procedure to be followed for detection and rectification of errors varies according to the nature of the error. Some errors can be detected and rectified while preparing the trial balance, whereas some errors remained undetected and hence uncertified in preparation of trial balance. In order to maintain maximum accuracy, some steps to be followed to avoid the omissions and errors. These steps areas follows :

After balancing of ledger, the ledger balances should be confirmed with the outside parties like debtors, creditors, lenders or financiers, bankers, etc. And reconciliation of the accounts to be made if the difference in the account. This

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

would help in detection and rectification of errors and omissions.

In the event of disagreement of trial balance, the following procedure should be followed very carefully :

- First of all, check the extraction and listing of the ledger account balances one by one very carefully
- Check the totalling of both the columns of debit and credit of the Trial Balance and find the difference if any.
- Now ,divide the exact difference by 9. If the difference is completely divisible by 9, this means that there is a possibility of either a transposition error or a side error. A transposition error is committed when the digit of an amount is misplaced. For example, Machine account has a balance of Rs.4,860, but it has been written as 4,680 in the trial balance. The resulting error is Rs.90, which is divisible by 9. A slide error is committed when the decimal point is placed incorrectly. For example, Rs 4250 is copied as Rs.42.50. The resulting error is 4207.5 is completely divisible by 9.
- Divide the differences by 2 and scan the columns to see whether the said figure appears on the correct side i.e. Dr. or Cr.
- The next step is to check the additions of the subsidiary books.
- Now try to re-compute the balances of the ledger accounts.
- Check the posting from the subsidiary books to the ledger.

Illustration : 15

The Following is the Trial Balance of R. & Co. showing debit total of Rs. 3,18,200 and credit total of Rs. 3,76,200

You are required to ascertain the correct total of Trial Balance after pointing out the causing the disagreement.

Trial Balance as on 31 / 12/ 2020

	Debit Rs.	Credit Rs.
Capital	–	1,00,000
Cash in hand	1,200	–
Bills Payable	22,000	–
Bills Receivable	–	20,000
Purchases	1,20,000	–
Opening Stock	35,000	–
Creditors	24,000	–
Sales	–	2,00,200
Debtors	1000	–
Plant & Machinery	60,000	–
Furniture	15,000	–

Rent & Taxes	5,000	–
Drawings	5,000	–
Wages	10,000	–
Income –tax	–	6,000
Salaries	20,000	–
	3,18,200	3,76,200

TRIAL
BALANCE

Solution :

The above Trial Balance can be redrafted under any of the following ways :

Method 1

Trial Balanceas at 31st December 2020

Heads of Accounts	Debit Rs.	Credit Rs.
Capital A/c	–	1,00,000
Cash A/ C	1,200	–
Bills ReceivableA/c	–	22,000
Bills ReceivableA/c	20,000	–
Purchases A/c	1,20,000	–
Opening Stock	35,000	–
Creditors A/c	–	24,000
Sales A/c	–	2,00,200
Bad Debts ReserveA/c	–	1,000
Debtors A/c	50,000	–
Plant and Machinery A/c	60,000	–
FurnitureA/c	15,000	–
Rent & Taxes A/c	5,000	–
Drawings A/c	5,000	–
Wages A/c	10,000	–
Income – Tax A/c	6,000	–
Salaries A/c	20,000	–
	3,47,200	3,47,200

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Method II

(Note: Under this method, only the wrong postings should be Correction of Trial Balance)

	Debit Rs.	Credit Rs.
Total as per Trial Balance	3,18,200	3,76,200
Bills payable being credit Balance but shown as debit balance	-22,000	+22,000
Bills Receivable being debit balance but shown as credit balance	2,96,200	3,98,200
Creditors being credit balance but shown as debit balance	+20,000	-20,000
Bad debts Reserve being a credit balance but shown as debit balance	3,16,200	3,78,200
Debit being debtors balance but shown as credit balance	-24,000	+24,000
Income tax being debit balance but shown as credit balance	2,92,200	4,02,200
	-1,000	+1,000
	2,91,200	4,03,200
	+ 50,000	- 50,000
	3,41,200	3,53,200
	+ 6,000	- 6,000
	3,47,200	3,47,200

Check your progress 6

1. Some errors can be detected and rectified while preparing the .
 - a. trial balance
 - b. ledger
 - c. journal

1.8 Suspense Account

In accountancy, a suspense account is an account used temporarily to carry doubtful receipts and disbursements or discrepancies pending their analysis and permanent classification.

If it is not possible to locate the errors in spite of the above steps, the difference of the trial balance is transferred temporarily to an account known as "Suspense Account". After transferring the difference, the trial balance can thus be totalled up and balanced. This account will be automatically closed when the error or errors in trial balance are subsequently discovered or rectified. Entries in this account are made temporarily and when the correct accounts are found the amounts are transfer by transfer entries to the correct accounts.

Check your progress 7

1. A is temporarily used to carry doubtful receipts and
 - a. suspense account
 - b. Ledger
 - c. Journal
 - d. Trial balance

1.9 Let Us Sum Up

In this block we have studied about the trial balance and suspense account. We have studied about what are trial balance and its purpose. We have even learnt the various methods of preparing it. Suspense account is a temporary account which is created in order to tally our trial balance in case of difference; this topic too was discussed in detail in this unit.

Trial Balance is the proof of accuracy of the books of account. If the trial balance does not tally, it means there are certain errors. But certain errors may not affect agreement of Trial Balance as the erroneous entries may not violate the dual aspect concept. It means even if trial balance agrees, steps should be taken to ensure that the records are free from errors. A suspense account is an account used temporarily to carry doubtful receipts and disbursements or discrepancies pending their analysis and permanent classification. If it is not possible to locate the errors, their analysis and permanent pending disbursements or discrepancies classification. the difference of the trial balance is transferred temporarily to an account known as “Suspense Account”.

1.10 Answers for Check Your Progress

Check your progress 1

Answers: (1–c)

Check your progress 2

Answers: (1–a)

Check your progress 3

Answers: (1–a)

Check your progress 4

Answers: (1–b)

Check your progress 5

Answers: (1–a)

Check your progress 6

Answers: (1–a)

Check your progress 7

Answers: (1–a)

1.11 Glossary

1. **Trial Balance :** A statement showing all the accounts used in a business and their balances.
2. **SuspenseAccount :** A temporary account used to force a trial balance to balance if there is only a small discrepancy (or if an account’s balance is simply wrong and one do not know why).

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

1.12 Assignment

1. Correct the following trial Balance (all figures in rupee)

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
Return Outward	16,000	Debtors	15,000
Opening Stock	34,200	Carriage Outward	5,000
Salaries	12,000	Capital	55,200
Creditors	28,000	Machinery	18,000
Bank	45,000	Return Inward	3,000
Carriage Inward	6,000	Discount Received	4,000
Rent Received	3,000	Trade Expenses	6,000
Discount Allowed	2,000	Sales	1,40,000
Purchases	1,00,000	Building	20,000
Bills Payable	20,000		
	2,66,200		2,66,200

1. Correct the following trial Balance (All figures in rupee)

Account Head	Debit Amount	Credit Amount
Purchases		1,50,000
Sales	3,45,000	
Purchases Return		14,500
Sales Return		11,300
Salary & Wags	25,000	
Cash	38,000	
Bank	69,500	
Bills Receivable		28,000
Bills Payable	39,500	
Creditors		41,000
Debtors	68,000	
Stock	1,08,000	
Loan		1,20,000
Capital		4,50,000
Drawings		22,000
Building	2,40,200	
Investments	2,50,000	
	11,83,200	8,36,800

(Trial Balance Total 10, 10,000)

2. A Book-Keeper has submitted the following Trial Balance for your observation and suggestions and to correct the mistakes to make the Trial Balance agree.

TRIAL
BALANCE

Particulars	Amount Rs.	Particulars	Amount Rs.
Land	60,000	Drawings	4,000
Plant & Machinery	80,000	Insurance premium	800
Office furniture	4,000	S. Creditors	31,000
Office Computer	8,000	Sales	2,20,000
Debtors	36,000	Capital	80,000
Purchases	1,00,000	Carriage outward	900
Loan on Mortgage	40,000	Discount allowed	400
Cash in Hand	600	Stock (Opening)	16,300
Cash at Bank	34,000	Rent and Rates	2,400
Bad debts	1,700	Purchases return	1,600
Trade expenses	900	Wages	15,000
Interest on loan	1600	Salaries	3,000
Factory power	3,600	Discount received	600
	3,70,400		3,76,000

Ans. Trial Balance Totals Rs. 3, 73, 200

1.13 Activities

1. Explain the errors which are disclosed by the trial balance.
2. What do you mean by a trial Balance? Discuss the main objectives.

1.14 Case Study

Explain the steps for locating errors through the trial balance.

1.15 Further Readings

1. Modern Accountancy Volume I, Mukherjee, Tata McGraw Hill 2008.
2. Financial Accounting, Paul S K, New Central Book Agency, 2001.
3. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 1978.
4. Advanced Accounts, M. C. Shukla & T. S. Grewal, S. Chand Publisher, 1997.



: UNIT STRUCTURE :

- 2.0 Learning Objectives**
- 2.1 Introduction**
- 2.2 Causes of Difference**
- 2.3 Need for Bank Reconciliation Statement**
- 2.4 Method of Preparation (Without Adjustment)**
- 2.5 Let Us Sum Up**
- 2.6 Answers for Check Your Progress**
- 2.7 Glossary**
- 2.8 Assignment**
- 2.9 Activities**
- 2.10 Case Study**
- 2.11 Further Readings**

2.0 Learning Objectives

After learning this unit, you will be able to understand :

- The meaning and Objectives of Preparing a Bank Reconciliation Statement.
- The various Causes of Difference.
- The methods of Preparing Bank Reconciliation Statement.

2.1 Introduction

For any business firm its cash balance is a very important element of its financial conditions. For exercising greater control over cash, most of the business concerns prefer to operate a Bank Account. The banker acts as a custodian of the funds to be spent by business. Since the banker is the trustee of the customer, the bank provides to its customer a Pass Book or Bank Statement (at regular intervals), which summarizes payments as well as deposits and other charges for the period. To know the bank balance a firm has two sources of information:

1. Bank column of the cash book; and
2. Bank Statement

On principal, two balances should be equal and opposite on a stated date. But usually these two balances do not agree due to various reasons. In view of the above mentioned explanation, it becomes necessary to reconcile the balances. Therefore a reconciliation statement is prepared that tells us the reason behind non agreement of cash balance per book and cash balance as per bank. Usually these statements are prepared on monthly basis because the bank also provides the statement on monthly basis.

Check your progress 2

1. Cheques issued but not presented for payment is one of the reasons for non agreement between and pass books.
 - a. cash book
 - b. Ledger
 - c. Journal

2.3 Need for Bank Reconciliation Statement

1. It reflects the actual bank balance position.
2. It helps to detect any mistake in the cashbook and in the passbook.
3. It prevents frauds in recording the banking transactions.
4. It explains any delay in the collection of cheques.

Check your progress 3

1. Helps to detect any mistake in the cashbook and in the passbook.
 - a. Bank reconciliation statement
 - b. Ledger
 - c. Journal

2.4 Method of Preparation (Without Adjustment)

Basically there are two methods of preparing bank reconciliation statement, namely,

1. Bank Reconciliation Statement without any adjustment.
2. Bank Reconciliation Statement with adjustment.

Whenever a bank reconciliation statement is prepared without making the necessary adjustments for omissions, errors in the cashbook the Bank Reconciliation Statement is called as Bank Reconciliation Statement without adjustment.

However, whenever a bank reconciliation statement is prepared after making such necessary adjustments for omissions, errors in the cashbook, it is called as Bank Reconciliation Statement with adjustment i.e. the bank balance is adjusted for the errors in the cash book.

Bank Reconciliation Statement without adjustment

The bank balance of a business enterprise may either be favourable or unfavourable. When the cashbook shows a debit balance of the bank or a pass book shows a credit balance it is known as favourable balance, wherein the deposits are comparatively more than the withdrawals. On the other hand when the cashbook has a credit balance or the pass book has a debit balance then it is termed as unfavourable balance. Finding the balance as per cash book or as per passbook is the first step in bank reconciliation, it is the starting point of reconciliation process. So there are four different points for preparing bank reconciliation statement :

1. Debit balance as per cashbook (favourable).
2. Credit balance as per passbook (favourable).
3. Credit balance as per cashbook, (unfavourable).
4. Debit balance as per passbook (unfavourable).

BANK
RECONCILIATION
STATEMENT

Table: 3.1 The Cause and Effect relations in BRS

When Reconciliation is started with →	Balance as per			
	Cash book = CB, Pass Book = PB, Overdraft = OD			
	CB +ve	CB - OD	PB +ve	PB - OD
Cheque issued but not presented in the bank for payment	Add	Less	Less	Add
Cheque Deposited but not credited by the bank	Less	Add	Add	Less
Income directly collected & credited by bank	Add	Less	Less	Add
Expenses directly paid & debited by bank	Less	Add	Add	Less
Bills discounted & dishonoured	Less	Add	Add	Less
Bank charges debited by bank not entered in cash book	Less	Add	Add	Less
Interest credited by bank not entered in cash book	Add	Less	Less	Add

The items which will increase the passbook balance more than the cash book.

1. Interest credited by bank not presented for payment.
2. Debtors directly deposited into bank, not entered in cash Book.
3. Cheque issued but not presented for payment.
4. Dividend collected by bank not recorded in cash book.
5. Bank Charges recorded twice in cash book, etc.

The items which will decrease the passbook balance more than the cash book.

1. Debit side of the cash book was overcast.
2. Cheque deposited but not presented for payment.
3. Dishonoured cheque appeared in the passbook but not entered in the cash book.
4. The Direct payment by bank as per standing order has been left in the Cash Book, etc.
5. Credit side of the cash book was under coats.
6. The Bank Charges are not recorded in the cash book.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Illustration : 16

From the following particulars, prepare Bank reconciliation Statement from Shri. S. Banerjeas at 31 March, 2020.

	Rs.
(a) Bank balance as per Cash book	7,000
(b) Cheques issued but not presented for payment upto after 31st March	1,000
(c) Three cheques were issued for Rs. 500 Rs. 1,000 and Respectively, but the cheque for 1,000 was not presented for payment at all	-
(d) Cheques issued for payment but forgot to enter in Cash Book	750
(e) Cheques deposited into the bank but credit was Given after 31 st March,	250
(f) 3 cheques of Rs. 1,000 Rs. 1,200 and Rs. 1,600, were deposited but the cheque for Rs. 1,600 was credited on 2nd April	
(g) Cheques deposited into Bank no entry was made in Cash Book	1,000
(h) Receipt side of the cash Book was overcastted or over shown by	500
(i) The payment side of the Cash Book was under shown by	800
(j) Bank Interest received Rs. 150 and bank charges paid Rs. 50 Not recorded in Cash Book.	
(k) Dividend collected directly by bank.	1,000
(i) A debtor directly made the payment into bank.	500
(m) Rs. 1,500 in respect of dishonoured cheque appeared in the Pass book but No entry was done in the Cash Book	
(n) Bank paid a Bill Payable of the firm for Rs. 1,500 on 30th March, under advice to the firm on 2 nd April.	
(o) Bank s Charges (postal) for a cheque book issue charges by Shri. S. Banerjee Rs. 5, was entered twice in the Cash Book.	29
(p) A cheque for Rs. 50 drawn by Mr. Aadvik had been charged to Shri. S. Banerjee account in error in March 2020.	

Solution :

In the books of Shri. S. Banerjee
Bank Reconciliation Statement
As at 31st March 2014

BANK
RECONCILIATION
STATEMENT

Particular	Rs.	Rs.
Bank Balance as per Cash book	7,000	
Add: Cheques issued but not presented	1,000	
Cheques issued but not presented	1,000	
Cheques deposited into bank, but not recorded in cash book	1,000	
Interest credited by Bank not recorded in Cash Book	150	
Dividend collected by Bank not recorded in Cash Book	1000	
Dividend directly deposited into Bank, but not recorded in cash book	500	
Bank's Charges (Postal) recorded twice in cash book	5	4,655
		11,655
Less: Cheques issued but not recorded in Cash Book	750	
Cheques deposited but not credited by the Bank	250	
Cheques deposited but not credited by the Bank	1,600	
Debit side of the Cash Book was overcast	500	
Credit side of the Cash Book was undercuts	800	
Bank Charges debited by Bank not recorded in Cash Book	50	
Dishonoured cheques appeared in Pass Book but not entered in Cash Book	1,500	
Contd. Bank met a Bill Payable, but not recorded in Cash Book	1,500	
A Cheque drawn by Mr. Advik wrongly debited by Bank to Shri. S. Banerjee A/c	50	7,000
Bank Balance as Per Pass Book		4,655

(ii) When Balance as per Pass Book (favourable) is given :

When pass book balance is given and we have to find out the balance as per cash book. In this case we have to find the impact of each item causing difference, in the cash book favourable balance. To put in different words, we will have to see whether a particular item increases or decreases the favourable balance of the cash book.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Add : The items, which will increase the cash book balance more than the pass book.

- (i) The Cheque deposited but not credited;
- (ii) The Bank Charges but not recorded in the cash book;
- (iii) The Dishonoured cheque appeared in the pass book but not in the cash book;
- (iv) The Debit side of the cash book was overcast;
- (v) The Direct payment by bank as per standing order not recorded in the Cash Book, Etc.

Less : The items which will decrease the cash book balance more than the pass book.

- (i) The Cheque issued but not presented for payment;
- (ii) The Interest credited by bank not presented for payment;
- (iii) The Dividend collected by bank but not recorded in cash book;
- (iv) The Debtors directly deposited into bank, but not entered in cash Book;
- (v) The Bank Charges recorded in cash book, etc.

Illustration : 17

From the following Particulars, Prepare a Bank Reconciliation Statement showing the Balance as Per Cash Book on 31st March 2020:

	Rs.
(a) Balance as per Pass Book	8,000
(b) Cheques deposited but not credited by the Bank	1,000
(c) Cheques issued but not Presented for Payment	500
(d) Cheques deposited into Bank without recording in Cash Book	600
(e) Cheques issued to creditors but not recorded in Cash Book	700
(f) Dividend collected by Bank, not recorded in Cash Book	100
(g) Debtors directly deposited into Bank not recorded in Cash Book	2,000
(h) Debit side of the Cash Book was under cast by	1,000
(i) Bank charges debited in Pass Book, not recorded in cash Book	50
(j) Bank met a Bill Payable for Rs. 1,000 on 30 / 3 / 2020 under advice to the firm on 2/4/2020	–
(k) A bill for Rs. 2,000 discounted for Rs. 1,900 returned dishonoured by Bank noting Charge being	10
(l) A Bill for Rs. 1,000 discounted with the Bank is entered in the Cash Book without recording the discount charges	100

Solution :

In the Books of

Bank Reconciliation Statement

As at 31 st March 2020

BANK
RECONCILIATION
STATEMENT

	Rs.	Rs.
Bank Balance as per Book	8,000	
Add: Cheques deposited but not credited by the Bank	1,000	
Cheques issued to creditors but not recorded in Cash Book	700	
Bank charges debited in the Pass Book, not entered in Cash Book	50	
Bank met a Bill Payable, not recorded in Cash Book	1000	
Bills discounted and dishonoured, not entered in Cash Book	2,010	
A bill discounted by the Bank without recording the discounting charges	100	
		4,860
		12,860
Less: Cheques issued but not presented for payment	500	
The Cheques deposited into Bank without recording in		
The Cash book	600	
The Dividend collected by Bank, not recorded in Cash Book	100	
The Debtors directly deposited into Bank not recorded in the Cash Book	2,000	
The Debit side of the Cash Book was	1,000	
Undercast		4,200
The Bank Balance as per the Cash Book		8,660

(iii) When Bank Overdraft as per the Cash Book is given :

If we start Reconciliation Statement with bank overdraft as per the Cash Book, then we are to ascertain the impact of each item (causing difference) on pass book overdraft. In other words, we will have to see whether a particular item increases the overdraft as per the pass book or decreases as per the pass book.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Add: The items, which will increase the, pass book overdraft more than the cash book overdraft.

- (i) Cheques paid/deposited into bank but not credited;
- (ii) Bank met a pay order as per standing instruction;
- (iii) Bank charges debited in the pass book, not in cash book;
- (iv) Deposited cheque dishonoured, not entered in the cash;
- (v) Interest charged on overdraft, not entered in the cash book; etc.

Less : The items, which will decrease the, pass book overdraft more than the cash book overdraft.

- (i) Cheque issued but not presented for payment;
- (ii) Direct deposit by debtor, not recorded in the cash book;
- (iii) Interest on overdraft recorded in cash book, not in pass book;
- (iv) Credit side of the cash book is overcast;
- (v) Bank collected any income not entered in the cash book, etc.

Illustration : 18

From the following particulars prepare a Bank Reconciliation Statement for Sri S. Sarkar as at 31 st Dec. 2020 :

- (a) Bank Balance as per Cash Book (Cr.) Rs. 610.
- (b) Cheques issued but not presented Rs. 3,000
- (c) Cheques deposited but not credited by bank Rs. 2,500.
- (d) A cheque drawn for Rs. 100 had been incorrectly entered as Rs. 10 in the Cash Book.
- (e) A debtor directly deposited into Sarkar s Bank Account, but not recorded in Cash Book Rs. 1,000
- (f) Credit side of the Cash Book (Bank Column) was under cast by Rs. 500
- (g) A cheque for Rs. 5,000 drawn by Mr. Banerjee had been charged to Sri Sarkar s Account in error.
- (h) Bank paid a Bill payable for Rs. 1,450 but it was recorded in Cash Book as Rs. 1540.
- (i) The receipt column of the Cash Book has been overcasted or overshown by Rs. 1,000
- (j) The Discount allowed Rs. 410 has been entered through mistake with the cheque in the Bank Column of the Cash Book.
- (k) After the instruction dated 30 the Dec. 2020, asking the Banker to transfer Rs. 10,000 to Fixed deposit Account an entry for this was made in the Cash Book but the Bank acted on Jan. 2021.
- (i) The Bank also debited the account for Rs. 500 being the amount of a cheque received from a customer and returned it dishonoured but not entered in Cash Book.
- (m) The Cheques amounting to Rs. 300 though actually banked were not entered in Cash Book.

Solution :

BANK
RECONCILIATION
STATEMENT

In the Books of Sri. S. Sarkar
Bank Reconciliation Statement As at 31st Dec. 2020.

Particular	Rs.	Rs.
Bank Balance as per Cash Book (Cr.)		610
Add: Cheques deposited but not credited by the Bank	2,500	
Cheques drawn for Rs. 100 but recorded only Rs. 10 in the Cash Book	90	
Credit side of the Cash Book was under cast	500	
Bank wrongly debited Sarkar s Account	5,000	
Bank column of the Cash Book overcast	1,000	
Discount Allowed Rs. 410 has been entered through mistake with the cheque in the Bank column of the Cash Book	410	
Bank debited for a dishonoured cheque , not entered in Cash Book	500	
		10,000
		10,610
Less: Cheques issued but not presented	3,000	
A debtor directly deposited into Bank but not recorded in Cash Book	1,000	
		1,000
Transfer to Fixed Deposit Account not recorded in Pass Book	90	
Transfer to Fixed Deposit Account not recorded in Pass Book	10,000	
Cheques deposited but not recorded in Cash Book	300	
		14,390
Bank Balance as per Pass Book (Cr.)		3,780

(iv) When Bank Overdraft as per Pass Book is given :

If we start Reconciliation Statement with bank overdraft as per the Pass Book, then we are to ascertain the impact of each item (causing difference) on cash book overdraft. In other words, we will have to see whether a particular item increases the overdraft as per the cash book or decreases as per the cash book.

Add : The items, which will increase the cash book overdraft more than the pass book overdraft.

- (i) Cheque issued but not presented for payment;

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

- (ii) Direct deposit by debtor, not recorded in the cash book;
- (iii) Interest on overdraft recorded in cash book, not in pass book;
- (iv) Credit side of the cash book is overcast;
- (v) Bank collected any income not entered in the cash book; etc.

Less : The items, which will decrease the cash book overdraft more than the, pass book overdraft.

- (i) Cheques paid/deposited into bank but not credited;
- (ii) Bank met a pay order as per standing instruction;
- (iii) Bank charges debited in the pass book, not in cash book;
- (iv) Deposited cheque dishonoured, not entered in the cash book;
- (v) Interest charged on overdraft, not entered in the cash book; etc.

Illustration : 18

Prepare a Bank Reconciliation Statement from the following data as on 30/11/2020

- (i) Balance as per Pass Book on 30/11/2020 overdrawn Rs. 9,204.
- (ii) Cheques drawn on 30/11/2020 but not cleared till Dec. 2020, Rs. 3,225; Rs. 745 and Rs. 926.
- (iii) Bank Overdraft interest charged on 28/11/2020 not entered in Cash Book Rs. 1,610
- (iv) Cheques received on 29/11/2020 entered in Cash Book but not deposited to Bank till 3rd December, 2020 Rs. 11,322 and Rs. 1,730.re
- (v) Cheque reviewed amounting to Rs. 35 entered in the Cash book twice.
- (vi) Bills Receivable due on 29 / 11 / 20 was sent to Bank for collection on 28/11/20 and was entered in Cash Book forth with but the proceeds were not credited in Bank Pass Book till 3rd Dec. 2020 Rs. 2,980
- (vii) Cheque Deposited on 30th Nov. 2020 dishonoured but the entry there of Rs. 1890 was not made in the Cash Book.

Solution : **In the books of.....**

Bank Reconciliation Statement

Particular	Rs.	Rs.
Overdraft Balance as per Pass Book		9,204
Add : Cheques drawn but not cleared (Rs. 3,225 + Rs. 745 + Rs. 926)	4,896	4,896
		14,100
Less :		
Interest on bank Overdraft not entered in Cash Book	1,610	
Cheques received and entered in the Cash Book as		

BANK
RECONCILIATION
STATEMENT

Deposited into Bank but actually not deposited till 3 rd Dec. 1988 (Rs. 11,322 + Rs. 1,730 0	13,052	
Cheque received and entered in the Cash Book		
twice 35 bills sent to Bank for collection but not credited till 3rd Dec	35	
	2,980	
Cheques deposited and dishonoured but not entered in Cash Book	1,890	
		19,567
Bank Balance as per Cash (Dr.)		5,467

Illustration 19

Prepare a bank reconciliation statement as on 31st Dec. 2020, in the books of Manish traders.

Balance as per cash book (Debit balance) Rs 28,000.

1. A cheque deposited into bank Rs.25,000 but not credited by bank till 31/12/20.
2. Two cheques of Rs. 15,000 and 4,800 issued were not presented in the bank for payment.
3. The Bank collected dividend Rs.10,000, not accounted in the cash book.
4. The Bank paid insurance premium Rs. 7,500 and a loan EMI Rs.10,000 as per the standing instructions, entries for the same are not recorded in cash book.
5. A cheque deposited in the bank of Rs.5,000 was dishonoured and hence not credited by bank, the intimation of dishonour was not received till Dec 20.

Solution :

M/S Manish Traders

Bank Reconciliation Statement

Particular	Rs.	Rs.
Balance as per cash book		28,000
Add :		
Cheque issued but not presented before bank	15,000	
Cheque issued but not presented before bank	4,800	
Dividend collected by bank, not accounted in cash Book.	10,000	
	29,800	29,800
		57800
Less :		

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Cheque deposited but not credited by bank	25,000	
Insurance premium paid by bank not recorded in Cash book	7,500	
Loan EMI paid by bank not recorded in cash book	5,000	47,500
Cheque deposited was dishonoured	47,500	10,300

Illustration 20

Take the illustration where the bank balance, as per cash book as an overdraft balance & prepare the bank reconciliation statement with the information given in the illustration 19

Solution :

M/S Manish Traders

Bank Reconciliation Statement

Particular	Rs.	Rs.
Balance as per cash book(Overdraft)		28,000
Add :		
The Cheque deposited but not credited by bank	25,000	
The Insurance premium paid by bank not recorded in Cash book	7,500	
The Loan EMI paid by bank not recorded in cash book	10,000	
The Cheque deposited was dishonoured	5,000	
		47,500
		75,500
Less :		
Cheque issued but not presented before bank	15,000	
Cheque issued but not presented before bank	4,800	
Dividend collected by bank, not accounted in cash Book.	10,000	
		29,800
Balance as per pass book (overdraft)		45,700

Illustration 21

Prepare a bank reconciliation statement as on 31st March.2020, in the books of ABC co.

Balance as per Pass book (credit balance) Rs 30,000.

1. A cheque deposited into bank Rs.12,000 but not credited by bank till 31/3/20.
2. Two cheques of Rs. 18000 and 14800 issued but one of these of Rs

BANK
RECONCILIATION
STATEMENT

- 14,800 was not presented to bank for payment.
3. Bank collected interest on investment of Rs.12,500, not accounted in the cash book.
 4. Bank paid Rent Rs. 7,500 and an Electricity bill Rs.4,000 as per the standing instructions, entries for the same are not recorded in cash book.
 5. A cheque deposited in the bank of Rs.12,000 was dishonoured and hence not credited by bank, the intimation of dishonour was not received till March 20.

Solution :

Bank Reconciliation Statement
M/S ABC co.

Particular	Rs.	Rs.
Balance as per pass book		30,000
Add :		
Cheque deposited but not credited by bank		
Rent paid by bank not recorded in cash book	12,000	
Electricity bill paid by bank not recorded in cash book	7,500	
	4,000	
Cheque deposited was dishonoured		35,500
	12,000	
Continued from last page	35,500	65,500
Less :		
Cheque issued but not presented before bank		
Interest on investment collected by bank, not accounted in cash book		
	14,800	27,300
	12,500	
Balance as per cash book		38,200

Considering the bank balance, as per pass book as an overdraft balance and prepare the bank reconciliation statement with the information given in the illustration 21.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Solution :

Bank Reconciliation Statement

M/S ABC co.

Particulars	Rs.	Rs.
Balance as per pass book (overdraft)		30,000
Add :		
Cheque issued but not presented before bank		
Interest on investment collected by bank, not accounted in cash book	14,800	
	12,500	27,300
		57,300
Less :		
Cheque deposited but not credited by bank	12000	
Rent paid by bank not recorded in cash book	7500	
Electricity bill paid by bank not recorded in cash book	4000	
Cheque deposited was dishonoured	12000	
		21,800
Balance as per cash book		

Illustration 23

The bank column of the cash book showed an overdraft of Rs 5000 on 31-03-2020, where as as per bank statement the overdraft is Rs 4,200. The following differences were noticed between the two records :

1. Cheques of Rs 2,400 issued but not encashed by customers
2. Cheques deposited but not cleared Rs 1,200
3. Collection charges debited by bank not recorded in CB Rs 100
4. Bank interest charged by the bank not recorded in CB Rs 300
5. Cheques dishonoured debited by bank not in CB Rs 400
6. Interest directly received by bank not entered in CB Rs 400 Prepare bank reconciliation statement

Solution :

Bank Reconciliation Statement

Particulars	Rs.	Rs.
Balance as per cash book (Overdraft)		5,000
Add :		
A Cheque deposited but not credited by bank	1,200	
The Collection charges debited by bank not entered in the Cash book	100	

BANK
RECONCILIATION
STATEMENT

The Bank interest charged by bank but not entered in cash book	300	
Cheque dishonoured not entered in cash book	400	2,000
		7000
Less :		
Cheque issued but not presented for payment Interest directly received by bank not entered in Cash book.	2,400	
	400	2,800
Balance as per pass book (overdraft)		4200

Check your progress 4

1. Which of the following statements states the balance is favorable
 - (a) Cashbook shows debit balance of bank
 - (b) Passbook shows credit balance
 - (c) Both

2.5 Let Us Sum Up

In this particular unit bank reconciliation statement has been discussed in very detail. Usually it happens that at the end of a period that there is a difference between the balance as per pass book and cash book. In this chapter the reasons behind such difference has been mentioned in detail and how to prepare a bank reconciliation statement has been illustrated with sufficient examples. The purpose of preparing a bank reconciliation statement is that it brings into agreement the bank balance per cash book and cash balance per bank. It is normally prepared on monthly basis because the bank provides the depositor a bank statement at the end of every month

So after studying this chapter readers would have got the idea of what actually is bank reconciliation. It also prevents frauds in recording the banking transactions and explains any delay in the collection of cheques.

2.6 Answers for Check Your Progress

Check your progress 1

Answers: (1-b)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-c)

2.7 Glossary

1. **Dishonour of cheque** – when a cheque received is deposited in our bank account and it is rejected and no payment is received against that cheque.
-

2.8 Assignment

1. Prepare Bank Reconciliation Statement as on 31.12.20 from the following information and show the bank balance, as on that date, as per the Cash Book :
- 1) Bank overdraft, as on 31/12/20 as per the Pass Book Rs. 7,891.50.
 - 2) Cheques issued before, but presented for payment after 1st January, 1921 Rs. 532.25
 - 3) Cheques deposited with the bank on or before 30th December, but collected after 1st January, 1921 Rs. 631.75
 - 4) Rs. 786 was repaid by debtors on 30/12/20 by depositing the money directly into the bank. The information was received from the bank on 2/1/21
 - 5) There was a wrong entry in the Bank column on the debit side of the Cash book amounting to Rs. 300.00
 - 6) Dividend received Rs. 125.00 though credited in the pass book prior to 30/12/20 was recorded in the Cash Book on 3/1/21
 - 7) From the following particulars, calculate the Cash Book balance of a merchant as on 31st December, 1920 by means of Bank Reconciliation Statement:
 - 8) Balance as per the Pass Book (Dr.) Rs. 4,475.70
 - 9) A Cheque for Rs. 399.50 was deposited on 24th December but the same was returned by the bank on 29th, for which no entry was made in the Cash Book.
 - 10) A bill for Rs. 1,020 received from a debtor previously discounted for Rs. 1,000 was dishonoured and the bank debited the account of the merchant, but the same was not recorded in the Cash Book.
 - 11) Two cheques issued on 27th December, but not encashed before 5th January, next: Rs. 650.40 and Rs. 498.30
 - 12) A cheque for Rs. 300 was debited twice in the Cash Book.
 - 13) Interest on overdraft for Rs. 56 and the bank charges for Rs. 17 were not passed through the Cash Book.
 - 14) Dividend of Rs. 200 collected by the bank on behalf of the merchant but the matter was not recorded in the Cash Book.
2. From the following particulars, find out the adjusted bank Balance as per the Cash Book and prepare there after, the Bank Reconciliation Statement as on 31-12-2020

**BANK
RECONCILIATION
STATEMENT**

- 1) Bank overdraft as per the Cash Book 80,000
- 2) Cheques deposited as per bank the statement but not entered in the Cash Book 3,000
- 3) Cheques recorded for collection but not sent to the bank 10,000
- 4) Credit side of the Bank Column cast short 1,000
- 5) Premium on proprietor's LIP paid on standing advice 5,000
- 6) Bank charges recorded twice in the Cash Book 100
- 7) Customer's cheque returned as per Bank Statement only 4,000
- 8) Cheques issued but dishonoured on technical grounds 3,000
- 9) Bills collected by the Bank directly 20,000
- 10) Cheque for Rs. 50,000 deposited but collection as per
- 11) Bank Statement 49,980
- 12) Cheque received entered twice in the Cash Book 500

2.9 Activities

What do you mean by Bank Reconciliation Statement? Why it is required?

2.10 Case Study

What are the different causes for discrepancy between the balance as per the cash book and the Pass book.

2.11 Further Readings

1. Accounting For Management, Jawahar Lal , HIMALAYA PUBLISHING HOUSE.
2. Financial Accounting For Management : An Analytical Perspective, Ambrish Gupta, Prentice Hall, 2008.
3. Financial Accounting For Business Managers, Phi Learning Pvt Ltd, 2009.
4. Accounting theory, Porwal L.S, TataMcGraw Hill Publishing company, 2001.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS



CAPITAL AND REVENUE TRANSACTION

: UNIT STRUCTURE :

- 3.0 Learning Objectives**
- 3.1 Introduction**
- 3.2 Capital Expenditure**
- 3.3 Revenue Expenditure**
- 3.4 Deferred Revenue Expenditures**
- 3.5 Difference between Capital Expenditure, Revenue Expenditure and Deferred Revenue Expenditure**
 - 3.5.1 Difference between Capital Expenditure and Revenue Expenditure**
 - 3.5.2 Difference between Capital Expenditure and Deferred Revenue Expenditure**
- 3.6 Capital Receipt**
- 3.7 Revenue Receipt**
- 3.8 Capital and Revenue Profits**
- 3.9 Capital and Revenue Losses**
- 3.10 Let Us Sum Up**
- 3.11 Answers for Check Your Progress**
- 3.12 Glossary**
- 3.13 Assignment**
- 3.14 Activities**
- 3.15 Case Study**
- 3.16 Further Readings**

3.0 Learning Objectives

After learning this unit, you will be able to understand :

- The Need for classification of accounts as capital and revenue.
- The Meaning of Capital & Revenue Expenditure.
- The Deferred Revenue Expenditure.
- The Difference between Capital, Revenue and Deferred Revenue Expenditure.
- The Meaning of Capital & Revenue Receipt.
- The Meaning of Capital & Revenue Loss and Profits.

3.1 Introduction

One of the most important objectives of financial accounting is to find out correct amount of profit or loss and to ascertain the financial position of the business enterprise on a particular date. The concepts of capital and revenue are of fundamental importance to the correct determination of accounting profit for a period and recognition of business assets at the end of that period. The distinction affects the measurement of profit in a number of accounting periods. Transaction of a business enterprise may be classified into: (1) Capital Transactions and (2) Revenue Transactions.

1. **Capital Transactions :** The transactions which provide benefits or supply services to the business unit for more than one year or one operating cycle of the business are known as capital transactions.
2. **Revenue Transactions :** The transactions which provide benefits or supply services to the business unit for only one accounting year, are known as Revenue transactions.

3.2 Capital Expenditure

Under this category comes those expenditure which are incurred for the following purposes :

Purchase of building, land, plant and machinery, furniture and fitting and vehicles that are called fixed assets. The assets that are purchased should be done with the intention of using them for business purpose and not with the intention of making profit through resale. All expenditure incurred on the particular asset to prepare it for using in the enterprise forms the cost of the fixed asset.

Capital expenditure also includes extensions and additions on the fixed asset purchased such as additions to buildings, plant, machinery since it contributes to enhancing productivity during future use. It also includes expenses that would reduce production cost, administrative costs and distribution costs such as expense of shifting business premises, compensation to retrenched employee, etc.

Capital expenditure represents an asset or a liability and is reflected in the balance sheet.

Items listed under capital expenditure are given below :

Goodwill, freehold land and building, legal charges, lease, expenses incurred on machineries, plants, tools, fixtures, etc. The expenses incurred on trademarks, patents, copyrights, designs are also examples of capital expenditure. Expenses incurred on erection of plant and machinery also comes under capital expenditure.

Check your progress 1

1. expenditure also includes extensions and additions on the fixed asset.
 - a. Capital
 - b. revenue

3.3 Revenue Expenditure

All the expenses are treated as revenue expenditures if it is incurred for the following purposes :

Expenditure made on the purchase of assets meant for resale at a profit or for being converted into saleable goods, such as the cost of goods, raw materials and stores. Apart from this all those expenses which are incurred on the

maintenance of assets in proper working order e.g., repairs to plant and machinery, building furniture and fittings etc. also comes under revenue expenditure. Even day to day recurring expenses also comes under revenue expenditure for example expenses of carrying on a business e.g., salaries, rent, rates, taxes, stationery, postage, etc.

All revenue expenditures which are incurred to get revenue income are taken to the profit and loss account.

List of Revenue Expenditures – (Examples of Revenue Expenditures) :

The following is a list of the usual items of revenue expenditures :

1. All Expenses which are incurred for the ordinary administration and carrying on the business.
2. All the Expenses incurred on the repairs, renewals and replacement of permanent assets.
3. All the cost of goods for resale is treated as revenue expenditure.
4. All the Cost of raw materials and stores acquired for use in the production process.
5. All the wages paid for production of goods for sale.
6. All the expenses which are incurred on the production and distribution of the final product.
7. All the Loss arising from normal wear and tear and obsolescence of assets.
8. All the Depreciation of lease.
9. Any type of Interest on loans borrowed for the purpose of business.
10. Any type of loss arising from sale of fixed assets.
11. Any type of Fees paid for renewal of patent rights, etc.
12. Any type of expenses incurred on the vehicle.
13. Any expenses incurred on the fan and lights etc.
14. Any loss arising due to assets discarded or totally damaged or destroyed by fire or other reasons.

Check your progress 2

1. Expenditure made on the purchase of assets meant for resale at a profit is a expenditure.
 - a. Capital
 - b. revenue

3.4 Deferred Revenue Expenditure

When a large sum of revenue expenditure is incurred in any particular year, the benefit of such expenditure may carry on to several years; such expenditure is called 'Deferred Revenue' Expenditure. The utilized portion of expenditure is charged to Profit and Loss Account and the balance is carried forward and are written off in future accounting periods and shown in assets side of the Balance Sheet of the current year. Following are the main characteristics of deferred revenue expenditure :

1. Such expenses are of revenue nature
2. These expenses are relatively of very large amount
3. The benefit of such expenses is extended beyond the accounting year or several accounting year.

Deferred Revenue Expenditure is comprises of the following :

Expenditures wholly paid in advance: These are the expenses which are usually paid in advance in full during the accounting year.

Expenditures partly paid in advance: such expenses include insurance premium which is payable partly for the current year and partly for the next year. The expired period expenditure is charged to profit & loss A/c and the unexpired portion is taken into the side of balance sheet that has assets column.

Abnormal Losses : Loss incurred due to uninsured risk such as loss due to fire, loss in transit due to accident or confiscation of property in a foreign country. Such losses are spread over two to three years. This amount is written off and is charged to profit and loss account and balance is shown to assets side of the balance sheet.

Check your progress 3

1. When a large sum of revenue expenditure is incurred in any particular year, the benefit of such expenditure may carry on to several years ?
 - a. revenue
 - b. capital
 - c. deferred

3.5 Difference between Capital Expenditure, Revenue Expenditure and Deferred Revenue Expenditure

3.5.1 Difference between Capital Expenditure and Revenue Expenditure

Point	Capital Expenditure	Revenue Expenditure
1) Incurred on business.	Acquisition, extension, modification of fixed asset e.g. purchase of a plant, modification of machinery.	Day to day activities of E.g. Administrative, maintenance expenditure.
2) Effect on Earning Capacity	These expenditures increase the earning capacity of the business e.g. purchases of new, modern machine would increase the speed, accuracy of performance.	These expenditures maintain the earning capacity of business, expenses on regular maintenance would help to avoid stoppage in performance.
3) Not recognized on the basis of amount spent	Expenditure is not capital in nature only because the amount involved is quite huge.	Expenditure is not revenue in nature only because the amount involved is small.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

4) Add value to existing asset	This type of expenditure adds value to an existing asset, when modification, extension to existing asset is done.	This type of expenditure does not add any value to an existing asset.
5) Benefit derived	Benefits more than one accounting period or several periods.	Normally benefits one accounting period.
6) Where recorded	Recorded in Balance Sheet subject to depreciation.	Recorded in Income Statement subject to prepaid and outstanding expenses.

3.5.2 Difference between Capital Expenditure and Deferred Revenue Expenditure

1) Incurred on	Acquisition, extension, modification of fixed asset e.g. purchase of a plant, modification of machinery.	An item the benefits of which would be derived for 2 to 5 years in near future, An abnormal expense like loss by fire and the amount is huge that cannot be justifiably accounted in a single period. An expense which provide part benefit in current period and part in next period.
2) Effect on Earning Capacity	These expenditures increase the earning capacity of the business e.g. purchases of new, modern machine would increase the speed, accuracy of performance.	No effect on earning capacity, but some of these expenditures may help in maintaining the capacity as like revenue expenditures.
3) Not recognized on the basis of amount spent	Expenditure is not capital in nature only because the amount involved is quite huge.	Recognition is also based on the amount spent e.g. loss by fire if it is small to be treated as revenue and written of during the period but if heavy then deferred over a period of time.

4) Add value to existing asset	This type of expenditure adds value to an existing asset, when modification, extension to existing asset is done.	Does not add value to an asset.
5) Benefit derived	Benefits more than one accounting period or several periods.	Benefits may be derived for more than one accounting period, but for near future.
6) Where recorded	Recorded in Balance Sheet subject to depreciation.	The part of the amount to be written off during current period is recorded in Income Statement and the rest of the amount is recorded in Balance Sheet

Check your progress 4

1. Generally expenses which are incurred to meet daily expenses are known as
 - a. Revenue expenses
 - b. Capital expenses
 - c. Deferred revenue expenses

3.6 Capital Receipt

A receipt is the inflow of money into the business which indicates the money received by a business enterprise. A receipt of money is considered as capital receipt when a contribution is made by the proprietor, partners or shareholders towards the capital of the business or a contribution of capital by someone outside the business. As such capital receipt creates a liability for the business. Capital receipts do not have any effect on profit or losses of the business enterprise. Capital receipts can take one or more of the following forms :

Additional capital introduced by the proprietor or partners or shareholders by issuing fresh shares.

When a loan or a mortgage on property is arranged. By selling assets, previously not intended for resale.

Check your progress 5

1. A receipt of money is considered as receipt when it is received from customers for goods supplied.
 - a. Revenue
 - b. Capital

3.7 Revenue Receipts

A receipt of money is considered as revenue receipt when it is received from customers for goods supplied, or fees received for services rendered in the ordinary course of business, which is result of the firm's activity in the current period. Revenue receipts increases the profits and reduce the losses of the firm

and as such credited to trading, profit & loss account or income statement.

Examples of Revenue Receipts :

1. Sale proceeds of goods in which the firm deals.
2. Discount received.
3. Commission received.
4. Interest received.
5. Dividend received on investment.
6. Subscriptions received.
7. Rent received etc.

Check your progress 6

1. A receipt of money is considered as receipt when a contribution is made by the proprietor, partners or shareholders towards the capital
 - a. Capital
 - b. Revenue
 - c. Deferred revenue

3.8 Capital and Revenue Profits

There is a lot of difference between the capital and revenue profit. Capital profit is the profit gained due to sale of a fixed asset. For example a building which was earlier purchased for Rs. 2, 20,000 is sold for Rs.3,25,000 the profit Rs.1,05,000 thus made is capital profit.

Revenue profit is a profit made by its normal business activities e.g., profit made through sale of goods, income from investments, commission earned, etc.

Capital profit earned should be transferred to the capital account of the proprietor or credited to capital reserve account and this appears as a earned profit on the balance sheet. Capital profit is never transferred in the profit and loss account as this contains items that are earned as revenue profit. Whenever there is a transaction of revenue profit is done only receipts and payments are entered in the P&L account and under no circumstances are capital profit transactions are entered.

Check your progress 7

1. profit is a profit made by its normal business activities
 - a. Revenue
 - b. capital

3.9 Capital and Revenue Losses

Capital loss is opposite of capital profit. It is a loss arising due to sale of fixed asset or loss due to raising funds for business purpose. It is better to write off capital loss in the balance sheet instead of even showing it as liability since the asset is fictitious.

Revenue loss is loss occurred in normal business operations such as loss incurred while selling goods. Unlike capital loss revenue losses are charged to profit and loss account of the year in which they occur.

Illustration 24

Give reasons for the items given below that are to be considered as capital and as Revenue :

CAPITAL AND REVENUE TRANSACTION

1. Rs. 20,000 is the expense incurred for remodelling the factory and the enhancement value is Rs. 15,000.
2. Rs. 2000 on Expenses on Wages paid for machine installation & carriage Rs. 500.
3. Cost of old plant is Rs. 3,000 (or W. D. V. Rs. 1,800) and it was sold for Rs. 1,000.
4. Rs. 1000 is the cost incurred on stock removal from old factory to the new one.
5. Rs. 4000 for white washing factory building.
6. Rs. 4000 for purchase of patent rights and Rs. 400 renewal fee for the next year.
7. Rs. 800 expenses for repainting the factory building.
8. Rs. 2,000 as compensation paid to a retrenched employee for loss of employment.
9. Rs. 2,000 for buying new tyres for an old car.
10. Rs. 20,000 for buying goods which was confiscated by customs authorities for non – disclosure of material facts.
11. Rs. 1,000 as lawyer fees for an immovable property.
12. Rs. 10,000 expenses incurred on research work for a particular product that ultimately did not give fruitful result.
13. Rs. 20,000 for cost of conversion of gas plant to oil fuel plant for the generation of electricity.
14. Rs. 8,000 book value for plant, Rs. 4,000 for stock that were destroyed by fire and Rs. 10,000 and Rs. 5,000 recovered from insurance company respectively.
15. Rs. 4,000 for re-decorating a cinema hall and Rs. 12,000 for enhancing sitting accommodation.
16. Rs. 1,200 paid for premium for Fire insurance on 30th Nov. for one year. The accounting date is 31st December.
17. Rs. 1,60,000 paid for purchase of plot by a firm and construction of quarter for officers. The rest of the plot is for building houses to be sold to public.
18. Rs. 2,000 spent on a machine of which Rs. 400 is for replacement of worn out parts and Rs. 1,600 for additions to new devices which doubles the output.
19. Expenses incurred on the foreign visit of sales manager to U.K. was Rs. 20,000 for promoting export sales. Visit was quite successful.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Solution :

1. Rs. 15,000 (by which the value of factory is enhanced for remodelling is capital expenditure as it increases the earning capacity of the firm) and Rs. 5,000 (i.e. 20,000 – Rs. 15,000) that has also been used for remodelling is revenue expenditure since it does not increase earning capacity.
2. Rs. 2,000 paid for installing a machine and Rs. 500 paid for carriage are capital expenditure since they are incidental to the acquisition of fixed assets and its installation. They help in increasing earning capacity.
3. The loss on sale of old machine amounting to Rs. 800 (i.e. Rs. 1,800 – Rs. 1,000) is revenue loss since it represents under provision for depreciation already made in the earlier years and the selling price amounting to Rs. 1,000 is a capital receipt as it reveals the proceeds of a sale of fixed assets.
4. The cost of removal of Stock amounting to Rs. 1,000 is a revenue expenditure of special nature which may be written off against the revenue of a number of years i.e. like deferred revenue expenditure and does not increase the efficiency of the assets or earning capacity.
5. Rs. 4,000 is the expense for white washing the factory building is regular expenditure in order to maintain the factory hence should be treated as revenue expenditure.
6. The cost of patent rights amounting to Rs. 4,000 is a capital expenditure as it is fixed asset and helps in earning revenue over a period of few years. But the renewal fee 400 is revenue expenditure since it is designed to supply benefit only for the current financial year.
7. Cost of repainting the factory building amounting to Rs. 800 may be considered as a regular expenditure in order to maintain the building and as such, it must be treated as revenue expenditure. In case this is done at an interval of a few years, the expense of such painting may be spread over the period when benefit is actually taken.
8. Rs. 2,000 paid as compensation to a retrenched employee is treated as revenue expenditure of special type and of non – recurring nature and then written off against Profit and loss Account over a number of certain periods considering as deferred revenue expenditure. This is because; compensation for loss of service is generally paid against the salary payable to the employee for the period of notice before retrenchment.
9. Purchase of a new tyre for an old card amounting to Rs. 2,000 is a capital expenditure since it is nothing but a cost of replacement of a part of an existing fixed asset.
10. Imported goods amounting to Rs. 20,000 which were confiscated by customs authorities for non – disclosure of material facts is an abnormal revenue loss and non – recurring in nature which are incurred in the regular course of the business. As such it is better to treat the same as deferred revenue expenditure which may be written off against the period of few years.

11. Rs. 1,000 paid to a lawyer for drafting agreement of lease is a capital expenditure as it is incidental as it is part of fixed asset.
12. Expenditure on any type of scientific research if fruitful may be treated as capital expenditure. But if the product is unsuccessful then it should be treated as an expenditure of special nature which again should be written off against the profit and loss Account.
13. In this case, the purpose of conversion is not known to us. It may be happened for two purposes viz.(i) the said conversion may increase the efficiency of the plant, or (ii) the said conversion may arise since three is non – availability of gas supply in the locality for any other purpose. Needless to say, the former is a capital expenditure whereas the latter is a revenue expenditure which is written off against the revenue over a number of years by charging profit and loss account.
14. The excess amounts which are realized from insurance company over the book value of plant amounting to Rs. 2,000 (i.e. Rs. 10,000 – Rs. 8,000) is a capital Profit since plant is an item of fixed assets while the excess amounts which are realized from the Insurance company over the value of stock amounting to Rs. 1,000 (i.e. Rs. 5,000 – Rs. 4,000) is a revenue profit since stock is an item of current assets and which are meant for re–sale.
15. Redecoration of a cinema hall amounting to Rs. 4,000 is revenue expenditure as it does not enhance the earning capacity. But if it is a substantiality large amount, the same may be treated as deferred revenue expenditure and may be spread over two or three years. But enhancement of sitting accommodation increases the earning capacity. As such, it should be capitalized.
16. Fire insurance premium it usually paid in advance and such, Rs. 12,000 would have been paid for the following period. As premium is paid on 30th Nov. and current year closes on 31st Dec. hence, one month premium amounting to Rs. 100 (i. e. Rs. 1,200 / 12 x 1) would be charged to revenue and the balance Rs. 1,100 (Rs. 1,200 – Rs. 100) would be carried forward as deferred revenue expenditure as “Prepaid insurance Premium in the assets side of the Balance sheet.
17. Rs 40,000 (i.e. 1, 60,000 x 1/4) which is incurred by the builders while erecting officers for own use should be capitalized and the balance i.e. 1,20,000 (i.e. Rs. 1,60,000 – Rs. 40,000) which is spent for constructing the building sold out to the public is a revenue expenditure.
18. Rs. 400 which is incurred for replacing worn out parts is a revenue charge since it's a routine expenditure for maintaining the existing earning capacity of the firm and Rs. 1,600 which is incurred for additions to the new device is a capital expenditure since it results in an increase in the earning capacity.
19. Visit of sales manager to U. K. for promoting export sales is

expenditure in the nature of advertisement campaign. As the visit is found to be quite successful it is likely to render benefit for enhancing export sales over a number of years and as such, it should be treated as deferred revenue expenditure and should be written off against Profit and Loss account spread over the related number of years.

Check your progress 8

1. is a loss arising due to sale of fixed asset or loss due to raising funds for business purpose.
 - a. Capital
 - b. revenue

3.10 Let Us Sum Up

In this block we have studied in very detail about the revenue and capital expenses and receipts. The nature of both revenue and capital has been very well explained by the writer.

After study of this block you will be able to know about the capital and revenue transactions. Which of those are classified under revenue and which of them will be treated as capital? We studied that the transactions which provide benefits or supply services to the business unit for more than one year or one operating cycle of the business are known as capital transactions. We even studied that the transactions which provide benefits or supply services to the business unit for one accounting year only, are known as Revenue transactions. On the other hand capital expenditure is the expenditure incurred to acquire an asset or service that will benefit the business more than one accounting period. Capital expenditures are those expenditure which are incurred on expenditures that either increases the number of fixed asset units or have the effect of increasing production capacity or efficiency, capital expenditure even increases the span of life or economy of operation of an existing fixed asset whereas revenue expenditure consists of expenditure the benefit of which is not carried over to the several accounting periods. It is the outward movement of funds which are incurred to meet the running expenses of a business and it will be of benefit for the current period only.

3.11 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-c)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1–a)

Check your progress 7

Answers: (1–a)

Check your progress 8

Answers: (1–a)

3.12 Glossary

1. **Fixed Assets :** It consist of any asset which a business owns or buys for use within the business and which is retained at for a number of years and put to production. The major items include land, buildings, equipment and vehicles but can include smaller items like tools.
-

3.13 Assignment

1. Explain with reasons whether following items are Capital or Revenue :
- Debenture issue expenses Rs. 2,000.
 - Legal expenses in connection with infringement of trade mark Rs. 5,000
 - Purchase of second–hand machinery Rs. 12,000, installation charge Rs. 2,000 and repairs of the second–hand machine Rs. 1,000 before installation.
 - Legal expenses incurred for protecting trade mark Rs. 1,000.
 - Freight charge of Rs. 500 on acquiring a computer and a fax machine for office.

(Ans. i) Capital ii) Capital iii) Capital iv) Revenue v) Capital

2. State whether following is Capital or Revenue
- Confiscation of imported goods worth Rs. 50,000 for non–disclosure of material facts.
 - Fixing a new device in the plane to reduce power consumption at a cost of Rs. 20,000 Capital and Revenue.
 - Rs. 95,000 spent on publicity and advertisement in connection with introduction of a new product.
 - Spent Rs. 10,000 for providing temporary huts to workers, during the construction of factory building.
 - Special repairs necessitated by accidental damage Rs. 1,750.

Ans. (i) Deferred Revenue (ii) Capital (iii) Deferred Revenue (iv) Capital (v) Capital

3. State with reason which of the items would be charged to Capital and which Revenue.
- Cost of dismantling, removing and re–installing plant to more suitable place Rs. 30,000.
 - Paid Rs. 1,300 for removal of stock to new site.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

- iii. A sum of Rs. 1,000 spent on alteration of existing plant incorporating there by new device which could affect substantial reduction in power consumption.
- iv. Imported goods worth Rs. 25,000 confiscated by custom by authority for non-disclosure of material facts.

Ans. (i) Deferred Revenue (ii) Revenue (iii) Capital (IV) Deferred Revenue.

4. State which of the following Expenditure capital is and which is deferred revenue expenditure or revenue?

- i. Demolition of an old building of book value Rs. 10,000 and construction of new building on its site costing Rs. 1,50,000.
- ii. Replacement of vital part cost Rs. 99,000 for the one damaged in transit of a newly purchased machine.
- iii. Visit of a sale manager abroad total cost Rs. 16,000 for promoting export sale. Visit is quite successful.
- iv. Purchase of new tyres for an old van. Rs. 2,000
- v. Cost of repairing factory building Rs. 5,000

Ans. (i) Deferred Revenue (ii) Capital (iii) Deferred Revenue (iv) Revenue (v) Revenue

3.14 Activities

Define Capital Expenditure, Revenue expenditure and Deferred Revenue Expenditure.

3.15 Case Study

Distinguish between Capital Expenditure, Revenue Expenditure and Deferred Revenue expenditure.

3.16 Further Readings

- 1. Accounting For Management, JawaharLal , HIMALAYA PUBLISHING HOUSE.
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- 4. Advanced Accounts, M. C. Shukla & T. S. Grewal, S. Chand Publisher, 1997.
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ACCOUNTING FOR BAD DEBTS

UNIT STRUCTURE :

- 4.0 Learning Objectives**
- 4.1 Introduction**
- 4.2 Sundry Debtors**
- 4.3 Bad Debts**
- 4.4 Provision Reserve for Bad Debts**
- 4.5 Methods of Accounting**
- 4.6 Provision for Discount on Debtors**
- 4.7 Provision for Discount on Creditors**
- 4.8 Bad Debts Recovery**
- 4.9 Let Us Sum Up**
- 4.10 Answers for Check Your Progress**
- 4.11 Glossary**
- 4.12 Assignment**
- 4.13 Activities**
- 4.14 Case Study**
- 4.15 Further Readings**

4.0 Learning Objectives

After learning this unit, you will be able to understand :

- The Concept of Bad Debts, the Provision for Bad Debts, the Sundry Debtors, Provision for Discount on Debtors, Provision for Discount on Creditors.
- Types of Debtors.
- Various Accounting Methods for Calculating and Recording Provision for Bad Debts.
- Recording of Transactions related to Provision for Discount Allowed and Received.
- Concept and Accounting Treatment of Bad Debt Recovery.
- Provision for Discount on Creditors.

4.1 Introduction

In today's competitive world, many methods are used to attract and maintain customers. Offering credit to customers is a one such trend. Customer satisfaction and customer care are buzz words in this modern age. Formulating attractive credit policy that will boost up the sales is the prime necessity of any marketing division. This in turn gives prime importance to the management of receivables.

- (ii) For actual bad debts (if there is an existing provision i.e., old reserve)

Provision for Bad Debts A/c Dr. (Actual amount)

To Bad Debts A/c

Thus, for Final Accounts:

Bad Debts –

- (iii) If given in the Trial Balance: To be debited to Profit & Loss A/c

- (iv) If outside the Trial Balance: To be debited to Profit & Loss A/c

(i.e., in the adjustment) And, to be deducted from Sundry Debtors in the Balance Sheet

Check your progress 2

1. is an amount which is written off by the business as a loss to the business and considered as an expense because the debtors of the business have turned to be bad.

- a. Bad debts b. loss

4.4 Provision Reserve for Bad Debts

Doubtful debts are those debtors from whom the chances of getting the payment are very low. There may be many reasons for non-payment that may be able to include disputes over supply, delivery, and conditions of goods, the appearance of financial stress within customers operation. In the business whenever such a dispute occurs it is very sensible to add this debt or portion thereof to the doubtful debt reserve. This is based on the principle of conservatism and this is done to avoid over-stating the assets of the business as trade debtors is reported net of Doubtful debt.

Accounting Steps

To sum up, the following entries are required to be passed for Bad Debts and Provision for Bad Debt –

- (a) Whenever provision is made for the 1st time (at the end of the first year)

- (i) Bad Debts –

Profit & Loss A/c Dr. (With the actual amount)

To Provision / Reserve for Bad Debts A/c

- (ii) For creating provision for Bad debts –

Profit & Loss A/c Dr.

To Provision / Reserve for Bad Debts A/c (With the amount of further provision)

- (b) At the end of subsequent year –

- (i) For Bad Debts –

Provision / Reserve for Bad debts Dr. (With the actual amount)

To Bad Debts A/c

- (ii) Then the next year's provision is estimated which is carried forward and

the extra or excess provisions are adjusted (against the old provision) which is transferred to Profit & Loss Account, that is, the entry will be –

Profit and Loss A/c	Dr.
To Provision / Reserve for Bad Debts A/c (With the amount of further provision)	

If any reserve for bad debt is in excess will be credited to P&L A/c

Check your progress 3

1. are those debtors from whom the chances of getting the payment are very low.
 - a. Doubtful debts
 - b. Bad debts

4.5 Methods of Accounting

Basically there are two methods used for recording for bad and doubtful debts.

First Method

In the first method Provision for Bad and Doubtful Debts is created by debiting the Profit and Loss Account. Any bad debts arising in the subsequent years are adjusted against this Provision for Bad and Doubtful Debts.

Journal Entries in the First Year

1. When a provision is created for the first time.

Profit & Loss A/c	Dr.
To Provision for Bad and Doubtful Debts A/c	
2. For bad debts after Trial Balance:

Bad Debts A/c	Dr.
To Sundry Debtors A/c	
3. For writing-off bad debts in the Profit & Loss Account

Profit & Loss A/c	Dr.
To Bad Debts A/c (Trial Balance figure & Bad Debts after Trial Balance)	

Journal Entries in the Second and Subsequent Years

1. For bad debts after Trial Balance :

Bad Debts A/c	Dr.
To Sundry Debtors A/c	
2. For writing-off bad debts in the Profit & Loss Account:

Provision for Bad and doubtful Debts A/c	Dr.
To Bad Debts A/c	
3. For creating necessary provision at the year end:

Profit & Loss A/c	Dr.
To Provision for Bad and Doubtful Debts A/c The amount of provision to be created is calculated as under:	

Illustration 25

Mr. Vishal. A small business man, had incurred a loss of Rs. 3,000 as bad

debt during the year 2013, and thereafter decided to create a Provision in this regard at 5% on good debtors amounting to Rs.50,000 on 31st December 2013. During the year ended 31st December, 2013, the bad debt loss was Rs.2,000 on 31st December, 2014; his good debtors amounted to Rs.65,000 and decided to maintain the Provision at 4% for Bad and Doubtful Debts.

Solution :

	Rs.
Closing Provision required (65000*4%)	2,600
Add : Bad Debt	2,000
	4,600
Less: Opening balance (50000*5%)	2,500
To be provided from P & L A/c	2,100

Second Method

Here bad debt is directly charged to Profit and Loss Account in the 1st year and in subsequent years as well. Provision to be created depends on the amount of provision at the beginning of the year.

Journal Entries in the First Year

1. For the bad debts of the period for which no entry has been made

Bad Debts A/c	Dr.
To Sundry Debtors A/c	
2. For writing–off bad debts in the Profit and Loss Account

Profit & Loss A/c	Dr.
To Bad Debts A/c	
3. When provision is created for the first time

Profit & Loss A/c	Dr.
To Provision for Bad & Doubtful Debts A/c	

Journal Entries in the Second and Subsequent Years

1. For the bad debts of the period for which no entry has been made

Bad Debts A/c	Dr.
To Sundry Debtors A/c	
2. For writing–off bad debts in the Profit & Loss Account:

Profit & Loss A/c	Dr.
To Bad Debts A/c	
(Bad Debts during the year and after the Trial Balance)	
3. For creating provision at the year end :
 - (a) (Closing provision > Opening provision)

Profit & Loss A/c	Dr.
To Provision for Bad and Doubtful Debts A/c	
 - (b) (Closing provision < Opening provision)

Provision for Bad and Doubtful Debts A/c	Dr.
To Profit & Loss A/c	

This method differs from the first method in the manner that it shows bad debts and provision for Bad and doubtful Debts is maintained in the Profit and Loss Account. This is done as bad debts are not adjusted against the Provision for bad & Doubtful Debts Account.

Illustration 26

Prepare provision for bad and doubtful debts account and show it in financial statements of respective accounting years given below:

Year I Debtors at the end	25000
Year II Debtors at the end	15000
Bad debts written off	500
Bad debts not recorded	800
Year III Debtors at the end	10000
Bad debts written off	800

Maintain provision for bad and doubtful debts @ 10%

Solution :

Provision for Bad and Doubtful debts Account

Dr.			Cr.		
Yr 1	To Balance c/f	2500	Yr 1	By Profit and loss	2500
Yr.2	To Bad debts A/c	500	Yr 2	By Balance b/d	2500
	To Bad debts A/c	800		By P&LA/c	220
	To Balance c/f	**1420		(Balancing fig.)	
Yr.2	Total	2720	Yr.2	Total	2720
Yr.3	To Bad debts A/c	800	Yr.3	By bal b/d	1420
	To Balance c/f	***1000		By P&LA/c	380
		1800		(Balancing fig.)	1800

** $15000 - 800 = 14200 \times 10\% = 1420$ *** $10000 \times 10\% = 1000$

Check your progress 4

- Provision for Bad and Doubtful Debts is created by debiting the .
 - Profit and Loss Account
 - Trading account

4.6 Provision for Discount on Debtors

In almost all the business there is always an effort to collect our payments from the debtors quickly so in order to promote quick payments from the debtors we offer they discount for all the early payment. Here all those debtors who clear their dues before their due dates are given some discount. It is advisable to charge this expenditure i.e. discount to debtors to the period in which sales has been made, so a provision is created in the same manner, as in case of provision for doubtful debts

No discount should be allowed on debts which have turned bad. Here the provision is created only on good debtors. So the amount of provision for discount should be calculated after deducting the provision for bad debts from sundry debtors.

4.10 Answers for Check Your Progress

Check your progress 1

Answers: (1–a)

Check your progress 2

Answers: (1–a)

Check your progress 3

Answers: (1–a)

Check your progress 4

Answers: (1–a)

Check your progress 5

Answers: (1–a)

Check your progress 6

Answers: (1–a)

Check your progress 7

Answers: (1–a)

4.11 Glossary

1. **Creditors** : A list of suppliers to whom the business owes money.
 2. **Debtors** : A list of customers who owe money to the business.
-

4.12 Assignment

1. The figure of Sundry Debtors in a Trial Balance is Rs. 70,000. You are asked to write off Rs.500 as Bad Debts and make Provision for Doubtful Debts @ 10% on Sundry Debtors. Pass the necessary journal entries.
 2. From the following particulars, prepare the necessary accounts:
 3. Certain Balances in a company's ledger at 30th June 1999 were:
On 30th June, 2000 stock of coke was valued at Rs.750, and provision for bad debts was adjusted equally to 5% of the Debtors. On 6th August, 2000 the company paid its electricity account of Rs.1, 010 for the quarter ended 31st July, 2000. Show the debtors and provision for bad debts accounts in the company's Ledger for the year ended 30th June 2000.
-

4.13 Activities

1. What do you mean by Provision for Bad and Doubtful Debts? Justify its creation
 2. Explain the concept of sundry debtors and different types of sundry
-

4.14 Case Study

Explain in detail the accounting procedure of bad debts

4.15 Further Readings

1. Modern Accountancy Volume I, Mukherjee, Tata Mgraw Hill 2008.
2. Financial Accounting, Paul S K, New Central Book Agency, 2001.
3. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 1978.
4. Advanced Accounts, M. C. Shukla & T. S. Grewal, S. Chand Publisher, 1997.

TRIAL BALANCE,
BANK
RECONCILIATION
STATEMENT, CAPITAL
AND REVENUE
TRANSACTION AND
ACCOUNTING FOR
BAD DEBTS

Block Summary

In this block we have studied in very detail about the trial balance, bank reconciliation statement, Capital and revenue transactions and Accounting for Bad debts. Unit one covered the topic trial balance, this topic is considered to be one of the most important topic as trial balance is the key statement through which final accounts are prepared, these final accounts are the report card of the business it shows the performace of the business during a particular period of time. In trial balance we even studied about the suspense account, which is required in a situation when there is non agreement between the trial balance in that situation this trial balance is used to tally the differences. Second unit covered the topic bank reconciliation statement which was even discussed with sufficient examples and illustrations.

Through the study of this block the reader will get a detailed insight of the next unit of capital and revenue transactions. He will also get a detailed knowledge of how to make distinction between the revenue and capital expenditure. Not only expenditure but the readers will get a detailed knowledge about capital and revenue receipts and I am sure enough that after going through this block the readers could easily distinguish between the expenses and revenue of both capital and revenue nature. In the fourth unit we studied about the bad debts in very detail and its accounting treatment too was studied in detail.

All these topics were of great importance to the students undergoing the courses of commerce or management. These topics were discussed very throngly with illustrations.

Block Assignment

Short Answer Questions

1. Methods of preparing Trial Balance.
2. Errors not disclosed by Trial Balance
3. Limitations of Trial Balance
4. Suspense account
5. Method of locating errors
6. Provision for Discount on creditors
7. Bad debts recovery
8. Discount on Debtors
9. Misconceptions about depreciation
10. Bad debts
11. Capital Profit and Capital Loss
12. Capital Receipts and examples of capital receipts.
13. Revenue transactions.
14. Capital Transactions.
15. Revenue receipts

Long Answer Questions

1. Explain Bank Reconciliation Statement and also explain its importance.
2. What are the different reasons for discrepancy between the balance as per the cash book and the Pass book.
3. Explain the errors which are not disclosed by the trial balance.
4. Explain in detail why there is a difference in treatment of capital and revenue expenditure?
5. Why should provision for Bad debts be maintained?

TRIAL BALANCE,
 BANK
 RECONCILIATION
 STATEMENT, CAPITAL
 AND REVENUE
 TRANSACTION AND
 ACCOUNTING FOR
 BAD DEBTS

Enrolment No. :

1. How many hours did you need for studying the units?

Unit No 1 2 3 4

Nos of Hrs

2. Please give your reactions to the following items based on your reading of the block :

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Language and Style	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Illustration used (Diagram, tables etc)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Conceptual Clarity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Check your progress Quest	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Feed back to CYP Question	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____

3. Any Other Comments



**Dr. Babasaheb
Ambedkar
Open University**

BBAR-102/DBAR-102

BASIC OF ACCOUNTING

**BLOCK-3 DEPRECIATION ACCOUNTING, FINAL
ACCOUNTS (WITHOUT ADJUSTMENTS), FINAL
ACCOUNTS (WITH ADJUSTMENT)**

UNIT 1

DEPRECIATION ACCOUNTING

UNIT 2

FINAL ACCOUNTS (WITHOUT ADJUSTMENT)

UNIT 3

FINAL ACCOUNTS (WITH ADJUSTMENT)

**BLOCK 3: DEPRECIATION ACCOUNTING, FINAL ACCOUNTS
(WITHOUT ADJUSTMENTS), FINAL ACCOUNTS (WITH
ADJUSTMENT)**

Block Introduction

Accounting is considered to be one of the most important subjects in the field of commerce or management and therefore this subject has been introduced here in this course.

This block covers one of the most important topics of accounting. It covers important topics such as depreciation accounting, final accounts both with and without adjustments. In the depreciation accounting students have been explained the basic concept of depreciation, various methods which are used to calculate the depreciation, sufficient numerical illustrations have been provided to help the students in understanding this topic. In the next unit the topic final accounts have been covered and special emphasis has been given on this topic to make students understand this topic, sufficient illustrations and problems have been given to help them in understanding this topic in depth.

The readers will get a through insight of accounting through this block. They will get good knowledge about depreciation, final accounts, how are final accounts made.

Block Objective

After learning this block, you will be able to understand:

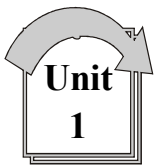
- Meaning of Depreciation.
- The Accounting Cycle.
- Objectives of Preparing Final Accounts.
- Profit and loss account and balance sheet.
- The differences between trading and profit and loss account, balance sheet and trial balance.

Block Structure

Unit1: Depreciation Accounting

Unit2: FinalAccounts (without adjustments)

Unit3: Final Accounts (without adjustments)



DEPRECIATION ACCOUNTING

: UNIT STRUCTURE :

- 1.0 Learning Objectives**
- 1.1 Introduction**
- 1.2 Meaning of Depreciation**
- 1.3 Characteristics of Depreciation**
- 1.4 Causes of Depreciation**
- 1.5 Objectives of Providing Depreciation**
- 1.6 Computation of Depreciation**
- 1.7 Methods of Charging Depreciation**
- 1.8 Change of Method of Charging Depreciation**
- 1.9 Salient Features of AS-6: Depreciation Accounting**
- 1.10 Illustrations**
- 1.11 Let Us Sum Up**
- 1.12 Answers for Check Your Progress**
- 1.13 Glossary**
- 1.14 Assignment**
- 1.15 Activities**
- 1.16 Case Study**
- 1.17 Further Readings**

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- The Concept of Depreciation
- Various Methods of Recording Depreciation
- Cause of Depreciation
- The Features of AS-6
- Objectives of depreciation
- Calculation of Depreciation
- Change of method of charging depreciation

1.1 Introduction

Fixed assets are acquired to be utilized in the process of providing goods and services to the customers. They are one time investment and needs only maintenance. Value of a fixed asset diminishes with passage of time and its utilization over the period. This decrease in value of the fixed asset is taken care of in accounting system by way of charging depreciation to the asset.

The value of a fixed asset is spread over its life time and a proportionate amount is deducted from the assets' value in the form of depreciation at the end of each period. Thus Depreciation is the portion of cost of a fixed asset allocated to a particular period.

Except for land, most fixed assets, such as building, plant, machinery, office equipment, etc. have a limited useful life. Depreciation denotes decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. Depreciation is one of the most important components of income determination. In order to ascertain the true profit for the business, it is necessary that depreciation is charged on the fixed assets of the business.

1.2 Meaning of Depreciation

Depreciation means the gradual decrease or loss in the value of asset due to its usage, passage of time and normal wear and tear. This gradual decrease in the value of the asset is of permanent nature, which cannot be made good by normal repair and maintenance.

Accounting Standards issued by Institute of Chartered Accountants of India defines depreciation as follows:

“Depreciation is a measure of wearing out consumption or loss in value of assets that are depreciable due to use, time period or obsolescence due to new technology and market changes. Depreciation is allocated in order to charge a some amount of money as depreciation amount in each accounting period during the expected useful life of the assets.”

Whereas International Accounting Standard Committee defines, “Depreciation is the allocation of the depreciable amount of an asset over its estimated life.”

We can summarize that depreciation as a „process of allocation of the cost of depreciable assets? over it suse full if einarational and systematic manner.

Check your progress 1

1. Means the gradual decrease or loss in the value of asset due to its usage.
 - a. Depreciation
 - b. Asset
 - c. demolition

1.3 Characteristics of Depreciation

The important characteristics of depreciation are noted below:

- Depreciation is charged on fixed and tangible assets only.
- Depreciation refers to a permanent / gradual and continuous decrease in the utility value of a fixed asset and it continues till the end of the useful life of the asset.
- Depreciation is a charge against profit for a particular accounting period.

- Depreciation is always computed in a systematic and rational manner since it is not a sudden loss.
- Depreciation is a process of allocation of expired cost and not of valuation of fixed assets.
- Depreciation represents only an estimate and not the exact amount.
- Depreciation may be physical and functional.
- Total depreciation cannot exceed the cost of the depreciable asset.
- It is non-cash charge and hence does not involve outflow of cash.
- The basis of charging depreciation is economic life of the asset and the cost thereof. Market value has no relevance for calculating depreciation.
- Depreciation is different and distinct from Amortization, Depletion Obsolescence, Dilapidation and Fluctuation.

Check your progress 2

1. Depreciation is charge don assets only.
 - a. Fixed and tangible asset
 - b. Current asset
 - c. Intangible asset

1.4 Causes of Depreciation

The depreciation may broadly be divided into two:-

- Internal causes
- External causes.

In detail :

1. **Internal causes:** Depreciation that is a result of certain inherent normal causes is known as internal depreciation. The causes of internal depreciation are:
 - a. **Wear and Tear:** The life of an asset reduces due to its continued use as for e.g. the life of building, plant, machinery, etc. such decline and the quantum depends of use of an asset and in the event of double- shift depreciation on plant and machinery will be doubled. It is very obvious that such loss is unavoidable. A time will come when the asset will become unfit for repairs, when it will no longer be suitable.
 - b. **Depletion:** Some assets decline in value proportionate to the quantum of production or use as for example mines, quarry, etc. As we extract coal, etc. from coal mine, the total deposit in the mine reduces gradually and after some time it will be fully exhausted. Then its value will be nil.
2. **External:** Whenever depreciation is caused by some external factors then it is called external depreciation.
 - a. **Obsolescence:** Some of the assets, though still new and still hav-

ing their life left that too in proper condition can result in becoming obsolete. For example with the advent of new technology and modern machinery, an old machine can become obsolete unable to bear the brunt of invasion of new technologies. This is also possible because new and modern machinery bring in higher productivity, better quality and lower cost of production. Thus it becomes necessary to install new machinery in a competitive environment.

- b. Passage of time:** Certain assets which have not been used also lose their value in course of time, for example lease hold property, patent rights, copy rights, etc.
- c. Accidents:** Disasters such as floods, earthquakes cause major destruction of assets reducing its usage. In such cases the assets are described as loss and new asset can be purchased.

Check your progress 3

1. Some assets decline in value proportionate to the quantum of production or use as for example mines, quarry, etc. It is known as .
 - a. Depletion
 - b. Wear and tear
 - c. Obsolescence

1.5 Objectives of Providing Depreciation

Following are the objectives of providing depreciation in any business:

1. In order to keep the owners capital intact the recovery of cost incurred on fixed assets is made over their useful life.
2. In the event of retirement of original assets the cope up with the replacement cost.
3. To determine the actual cost of production by considering depreciation as also one of the component of cost.
4. To determine the actual profit for the year.
5. To find out the actual financial position through balance sheet.

Check your progress 4

1. To determine the actual profit for the year is one of the objective of
 - a. Depreciation
 - b. Trading account
 - c. Balance sheet

1.6 Computation of Depreciation

Calculation of depreciation is a complex process. Several factors are to be kept in mind while calculating depreciation. These factors are as under:

1. Cost of the depreciable asset

Cost of the asset plays is the most important factor in determining depreciation. Here, cost implies to historical cost of the assets. This idea is also sup-

ported by cost concept which maintains that the fixed assets should be recorded at cost and not market price. Thus, Cost includes price (less discount if any), freight or handling charges, legal charges, installation charges or transfer charges, sales tax, insurance in transit, etc. which assist in acquisition and putting the asset onto working condition. When a used asset is bought, the preliminary cost of putting the asset in working condition such as expenditure for new parts, repairs/renovation, etc. are added to the cost of assets.

It is to be remembered that the interest on loan to purchase an asset does not form part of cost of asset. Instead interest paid on a loan during construction period will be treated part of cost of an asset.

2. Useful life of the Depreciable asset

As per accounting standard 6(7) the useful life of an asset that is depreciating is less than its physical life and is:

- (i) Is calculated much earlier before commencing the usage based on legal and contractual limits like the expiry date of the lease periods.
- (ii) Very often it is governed by consumption and extraction.
- (iii) The usage and physical deterioration due to wear and tear and operational entities such as how long it has been used in different shifts, repair and maintenance and the policy of the company determines the depreciation.
- (iv) Obsolescence can be due to the following:-
 - (a) Change in Technology
 - (b) Any change in production process
 - (c) Change in market demand of product or service
 - (d) Legal or other restrictions

3. Residual value

The amount that is likely to receive when asset is sold as scrap or asset is discarded. Nevertheless, the amount of expenses incurred on sale or disposal is to be deducted from the sale proceeds of asset discarded. According to AS-6, computation of residual value of an asset is generally considered a difficult task.. In such cases the value is considered as nil as it is termed irrelevant. In case the residual value is important then the calculation of the value is made at the time of purchase or instalment during revaluation of the asset. The residual value of the asset is calculated by its realizable value of the asset which is similar in nature and is completely used completing its useful life and has been operated similarly as the asset.

Therefore, calculation of depreciation consists of three variables – the cost of asset, useful or economic life of the depreciating asset and the residual value thereof.

Check your progress 5

1. The cost of includes price freight or handling charges, legal charges, installation charges or transfer charges, sales tax, insurance in transit, etc.
 - a. Asset
 - b. Depreciation

1.7 Methods of Charging Depreciation

The difference in the nature of fixed assets is so wide that the same method of depreciation cannot be applied to each other. Let us discuss few of the widely used methods of depreciation.

1. Straight line also known as Original cost method or fixed instalment method.
2. Written down value method or Diminishing Balance Method also known as Reducing Instalment method.
3. Annuity Method.
4. Sinking fund amortization fund method or Depreciation fund method.
5. Insurance policy method.
6. Revaluation method.

1) Straight line method: Straight line method or fixed instalment method which is also known as or original cost method. In this method the expected life of the asset is the calculated. The total cost of the asset i.e. cost incurred in bringing the asset to its working condition is taken and scrap value at the end of its expected life is deducted from it and then the balance amount is divided by the number of years of its expected life, the result we get is the amount of depreciation that would be charged per year. Here the amount of depreciation remains same from year to year. This method is known as straight line method because if a graph of annual depreciation is drawn, it would be a straight line.

The formula or equation used to calculate depreciation under Straight line method is as follows

Annual Depreciation = [(Cost of Assets - Scrap Value)/Estimated Life of assets.

The journal entries under this method are very simple. The journal entries will be as under:

Depreciation account A/c	Dr.
To Asset account	
(Being the depreciation charged)	
Profit and loss account A/c	Dr.
To Depreciation account	
(Being the amount of depreciation transferred to P& L a/c)	

The above entries are passed at the end of each year as long as the asset is with us in working condition and in the last year, the scrap will be sold and with the amount that realised by the sale the following entry will be passed:

Cash account
 To Asset account
 (Being the cash realised on the sale of scrap.)

Advantages:

1. Straight line method of depreciation is the most simple and easy method to work out.
2. Under this method the book value of the asset can even be reduced to zero.

Disadvantages:

1. In spite being the simplest method, it is not a popular method here the approach is not very logical to charge depreciation each year's in equal amount, the charge for repairs and renewals goes on increasing as the asset becomes older.
2. Some of the methods of depreciation consider the interest payment on money which is locked up in purchase of assets but unlike the other methods this method does not consider the interest factor.
3. In straight line method there is no provision made for the replacement of the asset.
4. Sometimes even a little difficulty is faced in calculation of depreciation on account of additions during the year.

So, from the above discussion it is clear that straight line method is more suitable for assets having small investments and on whom there is no repair and renewals expenses for example copyright, patents, short leases, etc.

Illustration 27

Mr. Aadvik purchased machinery on 1st January 1991 for Rs.21, 000. The life of machinery was estimated to be 10 years. At the end of its life it would sold for Rs. 1,000 only. You are required to calculate the amount of annual depreciation according to Straight line method and prepare the machinery account for the first three years.

Solution :

$$\begin{aligned}
 \text{Annual depreciation} &= \frac{\text{Cost of assets - Scrap value}}{\text{Estimated Life of assets}} \\
 &= \frac{21000 - 1000}{10} \\
 &= \text{Rs. 2000}
 \end{aligned}$$

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Dr.			Machinery Account			Cr.		
Date	Particular	Amount (Rs.)	Date	Particular	Amount (Rs.)			
2018 Jan - 1	To Bank A/c	21000	2018 Dec - 31	By Depreciation A/c	2000			
			2018 Dec - 31	By Balance c/d	19000			
		21000			21000			
2019 Jan - 1	To Balance b/d	19000	2019 Dec - 31	By Depreciation A/c	2000			
			2019 Dec - 31	By Balance c/d	17000			
		19000			19000			
2020 Jan - 1	To Balance b/d	17000	2020 Dec - 31	By Depreciation A/c	2000			
			2020 Dec - 31	By Balance c/d	15000			
		17000			17000			

- 2) **Written down value method:** Written down value method is also known as diminishing balance method or reducing installment method. Under this method the value of asset is depreciated or reduced at fixed percentage which is calculated on the closing balance of the asset every year which is diminished year after year on account of depreciation. Unlike the straight line method here the rate of depreciation remains the same but the amount of depreciation varies every year.

Here the journal entries will follow the straight line method and is similar to those that are discussed. The amount of depreciation is the only difference.

Advantages:

1. It is the most popular method adopted as the total burden of profit and loss due to depreciation and repairs remains almost equal year after year because the amount of depreciation goes on decreasing and with the passage of time the amount on repairs goes on increasing.
2. Separate calculations for additions and extensions of new assets are not required.

Disadvantages:

1. Like the first method even this method ignores the interest on capital investment and the replacement of the asset.
2. This method does not reduce the book value to zero as is in the case of the straight line method.
3. To write an asset value to residual value takes a long time therefore high depreciation rate is required.

Generally this is one of the most popular method which has been adopted in our country even our Income tax act prefers this method. This method is considered to be most suitable for plant and machinery where additions and extensions take place quite often. However this method does not suit the case of lease, whose value has to be reduced to zero.

Illustration 28

Mr. Medhansh purchased, a merchant purchased plant and machinery costing Rs.25,000 1st January, 2018. It has been decided to depreciate it at the rate of 20 percent p.a. on the written down value method. Show the plant and machinery account in the first three years.

Plant and Machinery Account

Date	Particular	Amount (Rs.)	Date	Particular	Amount (Rs.)
2018 Jan - 1	To Bank A/c	25000	2018 Dec - 31	By Depreciation A/c	5000
			2018 Dec - 31	By Balance c/d	20000
		25000			25000
2019 Jan - 1	To Balance b/d	20000	2019 Dec - 31	By Depreciation A/c	4000
			2019 Dec - 31	By Balance c/d	16000
		20000			20000
2020 Jan - 1	To Balance b/d	16000	2020 Dec - 31	By Depreciation A/c	3200
			2020 Dec - 31	By Balance c/d	12800
		16000			16000

Formula or equation for the above calculation may be written as follows:

*First year: $25,000 \times 20\% = 5000$

**Second Year: $(25000 - 5000) \times 20\% = 4,000$

***Third Year: $[25000 - (5,000 + 4,000)] \times 20\% = 3,200$

3) Annuity method: Under this method, the asset in question is considered as an investment of capital, earning interest at certain rate. Thus the cost of the asset and also interest there on are written down annually by equal installments unless and until the book value of the asset comes to nil. With the help of annuity table the annual charge of depreciation is found out. In the books of accounts the annual charge for depreciation will be credited to asset account and debited to depreciation account, while the interest will be debited to asset account and credited to interest account.

In this method the journal entries are a little different. The entries are to be made in respect of interest and depreciation. As far as calculation of interest is concerned it is to be calculated on the debit balance of the

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

asset account at the commencement of the period, at the given rate.

The journal entry will be:

Particular Asset account Dr.

To Interest account

(Being interest on capital sunk in asset)

After finding the depreciation amount from the depreciation annuity table, the following entry is passed:

Depreciation account Dr.

To Particular Asset account

(Being the depreciation of asset)

It should also be kept in mind that the interest is charged on the diminishing balance of the asset account, the amount of interest goes on declining year after year. But the amount of depreciation remains the same during the life time of the asset.

Illustration 29

Ms Asmita Steels purchased a 5 years' lease for Rs.40, 000 on first January. The company decides to write off depreciation on the annuity method. Presuming the rate of interest to be 5% per annum.

Show the lease account for the first 3 years. Calculations are to be made to the nearest rupee

Annuity Table

Years	3%	3.5%	4%	4.5%	5%
3	0.353530	0.359634	0.360349	0.363773	0.367209
4	0.269027	0.272251	0.275490	0.278744	0.282012
5	0.218355	0.221418	0.224627	0.227792	0.230975
6	0.184598	0.187668	0.190762	0.193878	0.197017
7	0.160506	0.163544	0.166610	0.169701	0.172820
8	0.142456	0.145477	0.148528	0.151610	0.154722

Solution:

According to the annuity table given above, the annual charge for depreciation reckoning interest at 5 percent p.a. for 5 years would be:

$$230975 \times 40,000 = \text{Rs.}9,239$$

Lease Account

DEPRECIATION ACCOUNTING

Dr

Cr.

Date	Particular	Rs.	Date	Particular	Rs.
1st Year			1st Year		
Jan. 1	To Cash	40,000	Dec. 31	By Depreciation	9,239
Dec. 31	To Interest	2,000		By Balance c/d	32,761
		42,000			42,000
2nd Year			2nd Year		
Jan. 1	To Balance b/d	32,761	Dec. 31	By Depreciation	9,239
Dec. 31	To Interest	1,638		By Balance c/d	25,160
		34,399			34,399
3rd Year					
Jan. 1	To Balance b/d	25,160	Dec. 31	By Depreciation	9,239
Dec. 31	To Interest	1,258		By Balance c/d	17,179
		26,418			26,418
3rd Year					
Jan. 1	To Balance b/d	17,179			

Advantages:

1. This method is technically more sound and scientific as it takes interest on capital invested in the asset into consideration.
2. Of the several method of depreciation it is regarded as one of the most exact and precise from the point of view of calculations and so considered to be most scientific.

Disadvantages:

1. This system is one of the most complicated.

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

2. With the passage of time there is a consistent increase in profit and loss account with the charge on depreciation remaining constant and there is a diminishing rate of interest every year. Hence the net profit and loss becomes heavier each year.

3. When the asset requires frequent additions and extensions, the calculation have to be changed frequently, which is very inconvenient.

This method is suitable for those assets that require considerable investment and where there are no frequent additions e.g., long lease.

4. Sinking fund method: Sinking fund method is also known as depreciation fund method or amortization fund method. In this method, a fund known as sinking fund is created and every year the profit and loss account is debited and the fund account credited with

A certain sum, which is so calculated that the annual sum credited to the fund account and accumulating throughout the life of the asset may be equal to the amount which would be required to replace the old asset. The main logic behind this method is to ensure the availability of the funds at the time of replacement of the asset. For this purpose an amount equal to that credited to the fund account is invested outside the business, generally in some securities. The asset appears in the balance sheet year after year at its original cost while depreciation fund account appears on the liability side.

The following entries are necessary to record the depreciation and replacement of an asset by this method.

(a) First year (at the end)

(1) Profit and loss account Dr.

To depreciation fund account

(With the amount of the annual depreciation charge).

(2) Depreciation fund investment account Dr.

To cash account

(With an equal amount.)

(b) In subsequent years.

(1) Cash / Bank Account Dr.

To depreciation fund account

(With the amount of interest earned and reinvested.)

(2) Profit and loss account Dr.

To depreciation fund account

(With the annual depreciation instalment.)

(3) Depreciation fund investment account Dr.

To cash account

(Provision + Interest will be invested.)

(c) Last year.

(i) and (ii) entry remain same as in (b) but amount is not invested.

- (1) On sale of investment.
 Bank Account Dr.
 Dep. Fund Account Dr. (In case of loss)
 To Dep. Fund investment Account
 To Dep. Fund investment Account (In case of profit)
- (2) On sale of Asset.
 Bank Account Dr.
 To Asset Account
- (3) Close dep.fund Account and transfer to asset Account
 Dep.Fund Account Dr.
 To Asset Account.
- (4) Close Asset Account and Transfer to P&L Account.
 (i) In case of Debit balance of Asset Account
 P&L Account Dr.
 To asset Account.
- (ii) In case of Credit balance of Asset Account
 Asset Account Dr.
 To P&L Account.

The amount of annual depreciation to be provided for by the depreciation fund method is ascertained from sinking fund table.

Sinking Fund Table

Annual sinking fund installment to provide Rs.1.

Years	3%	3.5%	4%	4.5%	5%
3	0.323540	0.321934	0.320349	0.318773	0.317208
4	0.239027	0.237251	0.235490	0.233741	0.232012
5	0.188350	0.186481	0.184627	0.182792	0.180975
6	0.154598	0.152668	0.150762	0.148878	0.147017
7	0.130506	0.128544	0.126610	0.124701	0.122820
8	0.112446	0.110477	0.108528	0.106610	0.104722

Illustration 30

Mr. Anjan Mazumdar on 1st January, 2017 purchased a four years lease for Rs.20,000 and was decided to make provision for the replacement of the lease by means of a depreciation fund, the investment yielding 4 percent per annum interest. Show the necessary ledger account.

Solution:

To get Re.1 at the end of 4 years at 4 percent an annual investment of Rs.235490 is necessary. Therefore, for Rs. 20,000 an annual investment of Rs.4,709.80 (i.e., $2,35,490 \times 20,000$) will be necessary.

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Dr. Depreciation Fund account Cr.

Date	Particular	Amount (Rs.)	Date	Particular	Amount (Rs.)		
2017 Dec - 31	To Balance c/d	4710	2017 Dec - 31	By P&L A/c	4710		
		4710			4710		
2018 Dec - 31	To Balance c/d	9608	2017 Dec - 31	By Balance b/d	4710		
					Dec - 31	By Bank A/c	188
					Dec - 31	By P&L A/c	4710
		9608			9608		
2019 Dec - 31	To Balance c/d	14702	2019 Jan - 1	By Balance b/d	9608		
					Dec - 31	By Bank A/c	384
					Dec - 31	By P&L A/c	4710
		14702			14702		
2020 Dec - 31	To Lease A/c	20000	2020 Jan - 1	By Balance b/d	14702		
					Dec - 31	By Bank A/c	588
					Dec - 31	By P&L A/c	4710
		20000			20000		

Depreciation Fund account

Date	Particular	Amount (Rs.)	Date	Particular	Amount (Rs.)
2017 Dec - 31	To Bank A/c	4710	2017 Dec - 31	By Balance c/d	4710
		4710			4710
2018 Jan - 1	To Balance b/d	4710	2018 Dec - 31	By Balance c/d	9608
Dec - 31	To Bank A/c	4898			
		9608			9608
2019 Jan - 1	To Balance b/d	9608	2019 Dec - 31	By Balance c/d	14702
Dec - 31	To Bank A/c	5094			
		14702			14702
2020 Jan - 1	To Balance b/d	14702	2020 Dec - 31	By Bank A/c	20000
Dec - 31	To Bank A/c	5298			
		20000			20000

Lease Account

Date	Particular	Amount (Rs.)	Date	Particular	Amount (Rs.)
2017 Dec - 31	To Bank A/c	20000	2017 Dec - 31	By Balance c/d	20000
		20000			20000
2018 Jan - 1	To Balance b/d	20000	2018 Dec - 31	By Balance c/d	20000
Dec - 31	To Balance b/d	20000			
		20000			20000
2019 Jan - 1	To Balance b/d	20000	2019 Dec - 31	By Balance c/d	20000
Dec - 31	To Balance b/d	20000			
		20000			20000
2020 Jan - 1	To Balance b/d	20000	2020 Dec - 31	By Depreciation fund A/c	20000
Dec - 31	To Balance b/d	20000			
		20000			20000

Note : The cash installment at the end of the final year is not invested as there is no need of buying the investment and selling them on the same date.

Advantages

1. The most important advantages of this method are that it helps in making the money available at the time when the replacement of the asset is needed. In the absence of such a provision the sum required to purchase a new asset will have to be withdrawn from the business which might affect its financial position adversely.

Disadvantages:

1. As the year passes by the burden on profit and loss account goes on increasing because the amount of depreciation every year remains same but the amount spent on repairs goes on increasing with the age of the asset.
2. This is a little difficult method because the work of investing money is complicated one.
3. Loss may be suffered because the prices of securities may fall at the time when they are to be realized.
4. This method is suitable wherever it is desired to replace the asset as happens in the case of plant and machinery and other wasting assets.
5. **Revaluation Method:** Here in this method as the name suggests under revaluation method, the valuation of assets done at the end of each period so as to calculate the difference between the old value and the new value and this difference is the actual depreciation which is charged to the profit and loss account. This method is most accepted method in case of assets like bottles, horses, packages, loose tools, casks etc. Sometimes rarely during the process of revaluing the asset is increased it will be temporary and will not be taken into account.

There are many objections on the method and they are :

1. There is no clarity on the value that the experts will consider for estimation at the end of each year. It is our assumption that this is the market value. If so, to assess depreciation with reference to market value is against the basic principles and theory of depreciation. A fixed asset has nothing to do with market value.
2. The amount charged to profit and loss account on account of depreciation will vary every year although the asset renders the same service throughout of its life time.

3. This is one of the most unscientific because there are great chances of manipulations.

Check your progress 6

1. Annuity Method is one of the method of calculating
 - a. Cost of asset
 - b. Depreciation

1.8 Change of Method of Charging Depreciation

It should be kept in mind that once a method of depreciation has been adopted then it should be applied consistently to ensure comparison over the years. Accounting standard AS-6 says that “to provide comparisons from time to time of the enterprise a consistency is maintained to the method of applying depreciation. If an alternate method of calculating depreciation is applied, it should be done as per the statute or compliance of the accounting standards. This is adopted only if it is seen that it is more appropriate in preparing financial statements of the enterprise. When such change in the method of depreciation is made, the un-amortized depreciable amount of the asset is charged to revenue over the remaining useful life by applying the new method”.

Hence it quite clear that a business enterprise may change the method either:

1. To comply with statutory requirements or
2. To enhance or improve quality of preparation or presentation of financial statements.

There are two ways to change the method of the depreciation:

- A Change made effective from the current year only – When a change is made effective from the current year only, the unexpired cost of the asset should be charged to Profit & Loss account over the remaining useful life of the asset by applying the new method of depreciation. Such a change is treated as a change in accounting policy and as such it is disclosed in the financial statements.
- A change in method with retrospective effect – When a change in method of depreciation is made with retrospective effect then following steps must be taken.
 - ❖ Find out the book value / cost of the assets in the beginning of year, from that date change is to be made effective. For example if on 31st March 2021 it is decided to change the method with effect from 1st April 2018, then the book value of the assets on 1st April 2018 has to be worked out. And similarly if the change is to be made from the date of acquiring of such assets then cost of the assets has to be found out.
 - ❖ Find out total depreciation charged on the assets till date on the basis of old rate i.e. depreciation already provided.
 - ❖ Calculate the depreciation on the basis of new method with retrospective effect up to the end of previous year.

- ❖ Find out the difference between (ii) and (iii) above.
- ❖ Debit or Credit the asset account by adjusting the difference. If there is excess of old accumulated depreciation over the total depreciation calculated in accordance with the new rate, assets account will be debited with the difference. And if it is otherwise, asset account will be credited with the differential figure.
- ❖ Charge depreciation according to new method for the current year.

Check your progress 7

1. Asper to provide comparisons from time to time of the enterprise a consistency is maintained to the method of applying depreciation
 - a. AS6
 - b. AS7
 - c. AS 5

1.9 Salient features of AS-6: Depreciation Accounting

Following is the synopsis of Depreciation policy as per accounting standards:

- Standard does not apply to depreciation in respect of forests, plantations and similar regenerative natural resources, wasting assets including expenditure on exploration and extraction of minerals, oils, natural gas and similar non-regenerative resources, expenditure on research and development, goodwill and livestock. Special considerations apply to these assets.
- Allocate depreciable amount of a depreciable asset on systematic basis to each accounting year over useful life of asset.
- Useful life may be reviewed periodically after taking into consideration the expected physical wear and tear, obsolescence and legal or other limits on the use of the asset.
- Basis for providing depreciation must be consistently followed and disclosed. Any change to be quantified and disclosed.
- A change in method of depreciation should be made only in that case where it is required by statute, for any kind of compliance with an accounting standard or for any of the appropriate presentation of the financial statements and such a revision in method of depreciation should be made from date of use. Such a change in method of depreciation should be considered a change in accounting policy and it should be quantified and disclosed to users of accounting information.
- If there is any addition or extension which becomes an important part of the existing asset depreciation to be provided on adjusted figure prospectively over the residual useful life or at the rate that is applicable.
- If there is a change in cost due to fluctuation in exchange rate or price adjustment, etc. then the depreciation on the revised unamortized amount should be given for the balance useful life of the asset.

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

- On revaluation of asset depreciation should be based on re-valued amount over balance useful life. Material impact on depreciation should be disclosed.
- Deficiency or surplus in case of disposal, destruction, and demolition etc. be disclosed separately, if material.
- Historical cost, amount substituted for historical cost, depreciation for the year and accumulated depreciation should be disclosed.

Depreciation method used should be disclosed. If rates applied are different from the rates specified in the governing statute then the rates and the useful life are also disclosed.

Check your progress 8

1. As per AS 6 Basis for providing must be consistently followed and disclosed. Any change to be quantified and disclosed. a. Depreciation
b. Standard
c. depletion

1.10 Illustrations

1. Medhansh Ltd. Purchased a computer for Rs. 90,000 including printer on 01-04-2018. It purchased another computer on 01-10-2018 costing Rs.60,000 and on 01-07-2019 costing Rs.30,000. On 01-01-2020 the printer of the computer purchased on 01-07-2019 costing Rs.30,000 became ineffective and was sold for Rs.10,000.
 - a. You are required to prepare Computer A/c in the Books of Medhansh Ltd Ltd. whose accounting year is the calendar year and charges depreciation @10% p.a. on Straight Line Method.
 - b. Year ending is on 31st December

Solution:

Dr.		Computer A/c		Cr.	
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount
2018 Apr 1	To Bank A/c	90,000	Dec. 31	By Depreciation A/c (6750+1500)	8,250
Oct. 1	To Bank A/c	60,000	Dec. 31	By Balance c/d	1,41,750
-	-	1,50,000	-	-	1,50,000
Jan. 2019 ¹	To Balance b/d	1,41,750	Dec. 31	By Depreciation A/c (9000+6000+1500)	16,500
July 1	To Bank A/c	30,000	Dec. 31	By c/d balance	1,55,250
-	-	1,71,750	-	-	1,71,750
Jan. 1 2020	To Balance b/d	1,55,250	Jan. 1	By Bank A/c	10,000
Jan. 1	By Profit & Loss A/c	18 500	Dec. 31	By Depreciation A/c (9000+6000)	15,000
			Dec. 31	By balance c/d	148750
-	-	173 750	-	-	173750

2. On 1-1-2018 the machinery account of a company had a balance of Rs.1,40,000. on 1-7-2018 a part of the above Machinery whose book

value on 1-1-2018 was Rs.28,000 was surrendered to the vendor at an agreed price of Rs.11,200 in part exchange for a new machinery costing Rs.23,800. The net invoice of Rs.12,600 was passed through the Purchase Book. At the same time Rs.1,400 incurred on installation of new machine wrongly debited to wages account. Record Journal Entries and prepare Machinery Account for the year ended 31st December 2018. Depreciation is charged @ 10% p.a. on Diminishing Balance.

Solution:

Journal Entries

Date	Particular	L.F.	Debit (Rs.)	Credit (Rs.)
2018	Vendor A/c Dr.		11200	-
July	Depreciation A/c Dr.		1400	-
1.	P & L A/c (Loss) Dr.		15400	-
	To Machinery A/c		-	28000
	(Being part of old machine transferred to vendor)			
July	Machinery A/c Dr.		23800	-
1.	To Vendor A/c		-	11200
	To Bank A/c		-	12600
	(Being new machine received against exchange of old machine)			
July	Machinery A/c Dr.		1400	-
1.	To wages A/c		-	1400
	(Being installation expense debited to wages is corrected)			
Dec	Deprecation A/c Dr.		12460	-
31.	To Machinery A/c		-	12460
	(Being Deprecation of current year is charged)			

Dr.

Machinery account

Cr.

Date	Particular	Amount (Rs.)	Date	Particular	Amount (Rs.)
2018 Jan 1	To Balance b/d	140000	2018 July 1	By Vendor A/c	11200
July 1	To Vendor A/c	11200	July 1	By Depreciation A/c (Machine sold)	1400
July 1	To Bank A/c	12600	July 1	By P & L A/c	15400
July 1	To Wages A/c	1400	Dec 31	By depreciation A/c	12460
			Dec 31	By Balance c/d	124740
		165200			165200

Working Note : 43

(1) Part sold :-	2800	
less : Depreciation@		
10% for 6 months	1400	
	<u>26600</u>	
less Exchanges	11200	
loss to P & L A/c	<u>15400</u>	
(2) Depreciation		
(a) Opening Balance :	140000	
Exchanged	<u>28000</u>	
	112000	@10% 11200
(b) New Machine	23800	
+ installation	<u>1400</u>	
	25200	@10% for 6 months
		<u>1260</u>
		12460

1.11 Let Us Sum Up

In this block we studied about depreciation in very detail. We studied that Depreciation refers to gradual decrease or loss in the value of asset due to usage, passage of time and normal wear and tear. Whereas International Accounting Standard Committee defines, “Depreciation is the allocation of the depreciable amount of an asset over its estimated life.” There are host of Internal and External factors causing depreciation such as usage, time span, obsolescence, depletion, accident, etc. All the fixed assets differ from each other in their nature that the same depreciation methods cannot be applied to each and every asset. The methods of depreciation are Straight line, Written down value method, Annuity Method, Depreciation fund method, Insurance and Revaluation method.

Through this chapter the readers will get very detailed information about depreciation. Sufficient illustrations and examples have been provided to make the topic easily understandable

1.12 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-a) 46

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-b)

Check your progress 7

Answers: (1-a)

Check your progress 8

Answers: (1-a)

1.13 Glossary

1. **Accumulated Depreciation** - Cumulative charges against the fixed assets of a company for wear and tear or obsolescence.
2. **Assets** - Assets represents the ownership of enterprise already existing or its purchase in due course of time. Examples are the equipment, vehicles, buildings, creditors, money in the bank, cash.
3. **Book Value** - It is an accounting term which usually refers to a business historical cost of assets less liabilities.

4. **Depreciation** - With time there is a decrease in value of assets. Depreciation is the percentage of decrease in value.
5. **Fixed Assets** - This could be anything which is owned by the enterprise for business purpose and has a value even at the end of the year. They are land, buildings, equipment and vehicles but can include smaller items like tools. Fixed assets are part of non current assets.

1.14 Assignment

Practical Questions

1. On 1/7/2018 Emerald Corporation purchased a second-hand machinery for Rs.80, 000 and spent Rs.12, 000 on reconditioning and installing it. On 1/1/2019 another machine was purchased worth Rs.48, 000. On 30/6/2000 the machine purchased on 1/1/2019 was sold for Rs.32, 000. On 1/7/2020 a new plant was purchased for Rs.60, 000.

Depreciation is charged @10% on original cost. The books of Accounts are closed on 31st March each year. Prepare Plant & machinery A/c for three years ending 31st March 2021.

2. On 1/04/2019 M/s Eastern Manufacturing Co. Ltd. purchased 6 machines of Rs.30, 000 each. On 1/4/2020 one machine became defective and was sold for Rs.25, 000, and a gain on 1/4/2021 a second machine was also sold for Rs.25, 000. On 1/10/2020 a new machine of higher technical reliability was acquired for Rs.56, 000. Depreciation is charged @10% on initial cost and debited profit & Loss A/c and Credited to Provision for Depreciation Account on 31st March each year.

Prepare necessary accounts in the Books of the Company.

3. New Age Corporation had a balance of Rs.1,62,000 to the debit of Plant & Machinery A/c on 1/1/2020. During the year 2020 Part of the plant purchased on 1/1/2018 for Rs.20, 000 was sold for Rs.12, 500 on 1/7/2020 and a new machinery at a cost of Rs.23,500 was purchased and installed at the same date, the installation charges being Rs.1,500.

The Corporation charges depreciation @10% on diminishing balance. It was decided to change the method of charging depreciation to straight Line Method retrospectively w.e.f. 1/1/2018. The rate of depreciation remains same as earlier.

Prepare the Plant & Machinery A/c

4. Thompson Bros. A firm, purchased a machinery by cheque for Rs.1,00,000 on 1st January, 2020. The estimated scrap value of the machinery is Rs.20,000. At the end of each year depreciation is provided at eh rate of 10% p.a. by the diminishing balance method. Show Machinery Account and Balance Sheet (extracted) for the first two financial years, which is ending on December, 31st every year.

(When no Provision for depreciation account is maintained; and (b) When Provision for Depreciation Account is maintained.

1.15 Activities

What is depreciation? What are the various methods of calculating depreciation?

1.16 Case Study

Explain the nature and need for depreciation.

1.17 Further Readings

1. Financial Accounting : A Simplified Approach, Naseem Ahmed, Atlantic Publishers & Distributors (p) Ltd. , 2005
2. Modern Accountancy Volume I, Mukherjee, Tata Mgraw Hill 2008
3. Financial Accounting, Paul S K, New Central Book Agency, 2001
4. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 1978
5. Advanced Accounts, M. C. Shukla & T. S. Grewal, S. Chand Publisher, 1997



FINAL ACCOUNTS (Without Adjustment)

UNIT STRUCTURE :

2.0 Learning Objectives

2.1 Introduction

2.2 Trading Account

2.2.1 Format of a Trading Account

2.2.2 Trading Account Items (Dr. Side)

2.2.3 Trading Account Items (Cr. Side)

2.2.4 Balancing of Trading Account

2.3 Profit and Loss Account

2.3.1 Profit and Loss Account Items (Dr. Side)

2.3.2 Profit and Loss Account Items (Cr. Side)

2.3.3 Balancing Profit and Loss Account

2.4 Difference between Trading A/c and Profit & Loss A/c

2.5 Balance Sheet

2.5.1 Preparation and Presentation of Balance Sheet

2.5.2 Difference between Trial Balance and a Balance Sheet

2.5.3 Explanation and Clarification of certain Items

2.5.4 Limitations of Balance Sheet

2.6 Illustrations

2.7 Let Us Sum Up

2.8 Answers for Check Your Progress

2.9 Glossary

2.10 Assignment

2.11 Activities

2.12 Case Study

2.13 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Stages of the Accounting Cycle.
- Various Statements / Accounts which Comprise Final Accounts of Business Entity.
- Treatment of different items in Preparation of the Final Accounts.
- Preparation of Trading, Profit & Loss Account and Balance Sheet.
- Limitations of Balance Sheet.

- Difference between Trial Balance & Balance Sheet.
- Difference between Trading and Profit and loss A/c.

2.1 Introduction

The objective of accounting is to estimate the profit and loss of a business during the accounting period. This helps in ascertaining the financial position at a given time. This can be done by financial statements.

Preparation of Final Accounts comprises:

- Preparation of a Trading Account;
- Preparation of a Profit and Loss Account; and
- Preparation of a balance Sheet.

Trading and Profit and Loss account are prepared in order to determine income received or loss incurred during the accounting period. Balance Sheet indicates the financial position of the enterprise. Thus, preparation of final account is the end of accounting process which provides accurate and concise information of the firm for beneficiaries of accounting information of that firm.

2.2 Trading Account

It is prepared to know the result of trading operation. The main objective of this Account is to ascertain gross profit or gross loss of a business during an accounting period –i.e.usually a year. It measures the overall performance of the business during a particular period. In accounting terminology, gross profit means overall profit. It is the difference between sale proceeds of a particular period and the cost of the goods actually sold. Thus in order to arrive at the gross profit there is no deduction made, i.e. any sort of deduction like general, administrative or selling and distribution expenses are deducted. Gross Profit is said to be made when the sale proceeds exceed the cost of goods sold. On the other hand, when cost of goods sold exceeds sale proceeds, gross loss is incurred.

2.2.1 Format of Trading Account

The format of a Trading Account and the usually appearing entries there in are shown below:

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Opening Stock		***	By Sales	***	
To Purchase	***		Less: Returns	***	***
Less: Returns	***	***	Inwards		
Outwards			By Abnormal	***	
To Direct Expenses	***		Losses	***	
Freight & Carriage	***		Loss by fire	***	***
Customs & Insurance	***		Loss by		***
Wages	***		Accident		
Packing	***		Loss by theft		
(essential) Gas	***		By Closing		
& Water Fuel &	***	***	Stock		
power		***	By Gross Loss		
			c/d		
Factory expenses			(Balancing		
Royalty on			figure)		
production Dock					
Dues					
To Gross Profit c/d					
(Balancing figure					
		***			***

2.2.2 Trading Account Items (Dr. Side)

1. **Opening Stock:** During the beginning of any accounting period, the closing balances of all assets, liabilities and capital of last financial year are brought forward by passing of the opening entry and entering the balance in respective account and stock is one of such account. The amount of stock recorded in the beginning of the accounting period remained unchanged during the period and appears in the trial balance as stock or opening stock. This account is closed at the end of the period by transferring the same to trading accounts:

Trading account Dr.

To Opening Stock a/c

2. **Purchases:** This denotes the value of goods purchased either for cash

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

or on credit for the purpose of resale. The balance of the purchase account, which appears in the Trial Balance, shows the total purchases made during a particular accounting period. In respect of purchases the following points must be noted:

- The purchase of any type capital asset should not be added with the normal purchases of the business. Because the nature of both the purchases are different. If it is already included in purchases, it should be deducted from there.
- If any type of personal goods have been purchased should be excluded from the purchases. This type of purchases should be treated as drawings.
- If some of the goods purchased are still in transit at the year-end i.e. it is not yet received by us then in that case it is always better to debit Stock-in-transit Account and pass reverse entry.
- If the purchases include goods which have been received on consignment, or on approval basis or on hire purchase, these should even be excluded from purchases they are not the part of purchases.
- This account is closed at the end of the period by transferring the same to trading accounts:

Trading account Dr.

To Purchases a/c

3. **Purchases Returns / Returns Outwards:** Purchase return is the return of goods or raw material to the supplier for any reason such as damages, goods not as per description, wrong items and not as per order etc. in such case the supplier's account is debited and the Purchase return account is credited. Thus a purchase return account shows a credit balance and appears on credit side of trial balance. This Purchase return account appears to the debit side of trading account as a deduction from purchases. Purchase return is often termed as Return Outward.

This account is closed at the end of the period by transferring the same to trading account as:

Purchase Return A/c Dr.

To Trading A/c

4. **Direct Expenses:** In case of trading concern direct expenses consists of all expenses incurred on purchase of goods and bringing them in saleable condition. Whereas in case of manufacturing concern this constitutes all expenses incurred on manufacture of those goods in which the firm deals in.

Direct expenses are debited to trading account as:

Trading account Dr.

To wages a/c

To Carriage inward a/c

To factory lighting, heating a/catch.

FINAL ACCOUNTS
(WITHOUT
ADJUSTMENT)

- Wages incurred on manufacture or merchandise is called direct wages. These wages are to be recorded on trading account debit side. While indirect wages are to be debited to profit and loss account. When there is no prefix like direct or indirect, wages are to be treated as direct and debited to trading account. Moreover when the phrase „wages and salary? issued and no explanation of the same is given, in such case the account is to be transferred to trading account debit side. Whereas when the term salary and wages? is used the account is to be transferred to profit and loss account. All the wages incurred on installation of machinery or on construction or repairs of building do not form part of wages. All such expenses which are incurred on machinery to bring it in working condition shall be considered as cost of that very machine and therefore capitalized. Thus payments to the workers for manufacture or merchandise only are considered as part of wages and thus debited to trading account.
- Carriage inward, freight, insurance, etc. incurred on purchases are also to be debited to trading account. As they are considered as the cost of the purchases hence part of that purchase. It should always be kept in mind that all these expenses such as carriage inward, freight, insurance should be considered as cost of purchase as these have been incurred to bring the goods to our store are considered as the cost of purchases, however all those expenses which have been incurred on the Carriage outward, freight outward etc., are not debited to trading account because those have been incurred on sales so they will not be considered as direct cost but will be considered as indirect cost. Trading account contains on direct expenses thus they will not be considered as indirect cost and be taken to P&L account. Thus the transportation expenses incurred on purchase of raw material or merchandise are to be debited to trading account. The phrase inward or in indicates the expenses are related to purchases, whereas the phrase outward out indicate the expenses are related to sales.
- Factory lighting, heating, power and fuel etc. are to be debited to trading account as all the expenses that have been done in the factory are treated as direct expenses the reason being that production takes place in factory and all the expenses relating to factory are considered as direct cost of production. Sometimes separate manufacturing account is opened and all expenses related to manufacturing are transferred to manufacturing account first and then to trading account in the form of cost of production.
- Custom duty: Whenever the goods or raw is bought from a vendor in abroad, then in that case the tax or duty paid on import of goods is called custom duty. This is an expense and thus debited to trading account.
- Royalty: This is the amount paid by a lessee to the owner of an asset for the use of that asset. E.g. royalty paid for extracting coal from a coalmine, royalty paid to the author of a book, etc. Royalty based

on the raw material extracted e.g. coal, iron ore, etc. is charged to trading account as direct expenses. Whereas the royalty which is based on sale e.g. royalty paid to the author of a book on the basis of number of copies sold is to be charged to profit and loss account.

- Other expenses: The expenses like repairs of plant, depreciation of plant, factory building, etc. are considered as expenses related to manufacturing activity and hence debited to trading account.

2.2.3 Trading Account Items (Cr. Side)

1. **Sales:** It refers to the sale of goods in which the business deals in and includes both cash and credit sales. It does not include sale of old, obsolete or depreciated assets, which were acquired for use in business. However goods sent to customers on approval basis, free samples and GST, if any, included in the sales figure should be excluded. GST sometimes included in the total sales revenue, should also be deducted as it is the tax collected and to be deposited with tax authorities. Sales account is a revenue account (nominal account), which denotes income earned from the main business activity or activities. The income is earned when goods or services are sold to customers. As per the accrual concept, income should be recognized as soon as it is accrued and not necessarily only when the cash is paid for. Revenue should be recognized only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer. For example, if an invoice is made for sale of goods and the term of sale is door delivery; then sale can be recognized only on getting the proof of delivery of goods at the door of customer. If such proof is pending at the end of accounting period, then this transaction cannot be taken as sales, but will be treated as unearned income. Sales account in trail balance constitutes gross sales made during the accounting period and it is to be transferred to trading accounts:

Sales A/c Dr.

To Trading A/c

2. **Sales Returns / Returns Inward:** Whenever goods are returned by the buyers to the sellers for some reasons, in the books of account “Returns Inwards Account or “Sales Returns Account” is debited and that particular buyer is credited. In the Trial Balance such trial balance appears on the debit side. There are two ways in which such return may be reflected **in** the trading account. It can be shown as deduction from sales in Trading Account or as sales returns on the debit side of the Trading Account. It is transferred to trading account by passing an entry as:

Trading account Dr.

To Sales Return a/c

3. **Abnormal Loss:** Any loss in excess of normal loss is considered as abnormal loss of stock due to fire, theft or accident. Since Trading Ac-

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Particular	Amount	Particular	Amount
To Trading A/c	**	By Trading A/c	**
To Office and administrative Expenses:	**	By Interest received	**
To Salaries for Office Staff	**	By Dividend Received	**
To Office Rent, Rates & Taxes	**	By Rent Received	**
To Printing and Stationery		By Discount Received	**
To Books and Periodicals Postage and Telephones	** ** **	By Profit on sale of fixed assets	**
To Insurance Premium for office	**	By Profit on sale of investments	**
To Audit Fees	**	By Dividend from shares Insurance Claims	**
To Repairs & Maintenance	**	By Duty Drawbacks	**
To Audit Fees	**	By Apprenticeship	**
To Legal Expenses		By Premium	**
To Office Lighting		By Miscellaneous Receipts Bad Debt recovered	**
To Depreciation of Office Assets	**		
To Other office expenses	**		
To Selling and Distribution Expenses:	**		
To Salesmen's Salaries	**		
To Selling Commission	**		
To Traveling Expenses	**		
To Brokerage	**		
To Trade Expenses	**		

FINAL ACCOUNTS
(WITHOUT
ADJUSTMENT)

To Advertisement & Publicity	**		
To Sales Promotion Expenses	**		
To Carriage Outward	**		
To Godown rent	**		
To Bad debts	**		
To Provision for Bad debts	**		
To Repairs of Vehicles	**		
To Godown Insurance	**		
To Delivery Van Expenses	**		
To Packing Expenses	**		
To Rebate to Customer			
To Royalty (based on units sold)	**		
To Financial Expenses:	**		
To Discount Allowed			
To Interest on Loan paid			
To Interest on Capital			
To Discount on Bills			
To Bank Charges			
To Abnormal Losses:			
To Loss on Sale of machinery			
To Loss on sale of Investment			
To Loss by fire			
To Misc. Expenses	**		
To Net Profit transferred to Capital A/c (Balancing figure)	**		
	**		**

2.3.1 Profit And Loss Account Items (Dr. Side)

Let us discuss those items that will appear in the debit side of a Profit and Loss Account:

- **Management Expenses:** For meeting day to day business expenses these type of expenses are met, they generally include office salaries, office rent and lighting, printing and stationery and telegrams, telephone charges, etc.

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

- **Selling and Distribution Expenses:** These are incurred to meet all the expenses which are incurred in order to make our sales and all the expenses which are incidental to its distribution. Without meeting all these expenses the sales of a trading concern will not take place. These expenses are necessary to effect and continue our sales and distribution into the market.
- **Maintenance Expenses:** These expenses are necessary for maintaining the fixed assets of the administrative office in a good and working condition. They include repairs and renewals, etc.
- **Financial Expenses:** These expenses have to be incurred for arranging finance which is necessary for running the business because finance is the most required thing in any business. So this includes all the expenses which have been incurred in order to arrange finance forth organization. These include interest on loans, discount on bills, brokerage and legal expenses for raising loan, etc.
- **Abnormal Losses:** Abnormal expenses and losses are those losses which occur over and above the normal loss. In every type of business there are certain losses which are incidental to the nature of the business. The normal losses generally occurs if such a business is conducted .They are generally pre estimated that these will take place but any loss that arises over and above the normal losses or which was not pre estimated or calculated then it will be treated as abnormal loss. These type of losses may or may not occur during an accounting year. All types of abnormal losses are treated as extra ordinary expenses and debited to Profit and Loss Account. Examples are stock lost by fire and not covered by insurance, loss on sale of machinery, cash defalcation, etc.
- **Expenses –** Whether salary are paid or unpaid these are considered while preparing the profit and loss account and in the same way rent, electricity, telephone expenses are to be taken into consideration whether paid or outstanding during the accounting period. To ascertain the amount of expenses to be debited to the Profit and Loss Account, four types of event are needed to be considered and the cash payment made in connection with these events. They are as under:
 - **Expenses incurred and paid out in that year:** If expenditure has been incurred during a year and also paid in the same year, the same will be debited to the Profit and Loss Account.
 - **Expenses incurred but not paid out, partly or fully during the current year:** There are a few expenses, although which have been incurred in the current accounting period, but not paid or paid partly or they are fully unpaid, by the end of the period, they are termed as “Outstanding Expenses”. Liabilities are the unpaid expenses, which are calculated at the end of accounting year. In fact, on the date of the final accounts, outstanding expenses, both an expenses and a liability exists without having been recorded in the books of account. For recording it, the following entry is to be passed:

Expenses A/c Dr. (will be shown in the P & L A/c)
To Outstanding Expenses A/c (will appear in the liabilities side of
Balance Sheet)

- **Expenses paid for during the current year, but not yet incurred, partly or fully:** Sometimes in business, it happens that few of the expenses are paid during the current year, but they have not yet been incurred, these are known as “Prepaid Expenses”. Prepaid expense is an asset to the business and will be shown in the Balance Sheet. The journals entry to be passed”.

Prepaid Expenses A/c Dr. (to be shown as asset in the Balance Sheet)

To Expenses A/c (balance of this account is to be deducted from Expenses remaining amount is debited to P&L A/c)

- **There may be expenses of the current year which may arise in subsequent period:** Sometimes in business an expense or a loss may arise in the future which is the result of with current year’s business. In all the cases, we make a provision of that future anticipated loss and a charge is created against the profit for the current period. This is called contingent liability. In a balance sheet it is seen as deduction from some other asset such as provision for bad debts.

2.3.2 Profit And Loss Account Items (Cr. Side)

Below mentioned are the items included in the debit side of profit and loss account:

1. **Gross Profit:** It is transferred from trading account and it is the first item of profit and loss account.
2. **Non-trading Income:** They are those income which are income apart from our business activities example of such income are interest received from bank, dividend and interest incomes received from outside investments like share and debenture are known as non-trading incomes.
3. **Other incomes:** All those incomes are those incomes which arise apart from income from sale of goods. As for example discounts or commission received.

2.3.3 Balancing Profit And Loss Account

Once the balances of all the accounts have been transferred from trial balance to P&L account, gross profit/loss transferred from trading account and adjustments are take care of, the next step in preparation of P&L which is balancing of the account. Here the total of debit and credit side is computed and difference of these totals is either the net profit or net loss. If the total of credit side exceeds that of debit side then it is net profit and vice versa. Net profit is the last item to be entered in the debit side and vice versa. After computing net profit/loss the totals of two sides of P & L match.

vehicles purchased and used on a daily basis. Net fixed assets refer to the value obtained from actual value of purchase minus the depreciated value.

Current liabilities refer to those debts that would be settled within one year of the preparation of balance sheet. Non current liabilities refer to long-term debts and mortgages of the organization. Equity includes the equity of stock holders, preferred stocks, treasury stock, retained earnings and paid-in capital.

2.5.1 Preparation and Presentation of Balance Sheet

The Process of preparation and presentation of Balance Sheet involves two steps:

- Grouping and
- Marshalling

The first step refers to proper grouping of the various items, which are to be shown in the Balance Sheet as assets and liabilities. For this purpose items of similar nature are grouped under one head so that the Balance Sheet could convey true message to its users. For example, stock, debtors, Bills receivables, Bank, Cash in Hand etc. are ground under the heading „Current Assets? and Land and Building, Plant and Machinery, Furniture and Fixtures, Tools and Equipments under “Fixed assets”. Similarly „Sundry creditors? for goods must be shown separately and distinguished from money owing other than due to credit sales of goods.

The second step involves marshalling of assets and liabilities. It means orderly arrangement in which various assets and liabilities are presented or shown in the Balance Sheet. There are two methods of presentation:

- In the order of liquidity
- In the order of permanence

Under liquidity order, assets are shown on the basis of liquidity or reliability. These are rearranged in an order of most liquid, more liquid, and liquid, least liquid and not liquid (Fixed) assets. Similarly, liabilities are arranged in the order in which these are to be paid or discharged.

Under the “Order of permanence” the assets are arranged on the basis of their useful life. The assets, which are to serve business for the longest period of time, are shown first. In other words, this method puts the first method in the reserve gear. Similarly, in case of liabilities, after capital, the liabilities are arranged as long term, medium term, short term and current liabilities. New format is given in companies Act, 2013

Following are the respective formats of Balance Sheets to bring out the clarity of concept

I. Liquidity Order

BALANCE SHEET OFas on.

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Liabilities	Amt (Rs.)	Assets	Amt (Rs.)
Current Liabilities		Current Assets	
Bank Overdraft		Cash in hand	
Outs trading Expenses		Cash at bank	
Bills Payable		Marketable Securities	
Sundry Creditors		Short term Investment	
Income Received in Advance		Bills Receivables	
		Sundry Debtors	
		Prepaid Expenses	
Long Term Liabilities			
Mortgaged Loan Loan from Bank		Accrued Income Long term Investment	
Capital Add Profit Less Loss Less Drawings		Fixed assets Furniture & Fixtures Motor Vehicles Tools & Equipments Plant & Machinery Land & Building Intangible Assets Patents Copyrights Trademarks Goodwill	

II. Order of Permanence (As per companies Act, 2013)

BALANCE SHEET OFas on.

Liabilities	Amt (Rs.)	Assets	Amt (Rs.)
Capital Add Profit or (Less Loss) Less Drawings		Non Current Assets :	
Long Term Liabilities		Fixed assets	
Mortgage Loan		Goodwill	
Loan from Bank		Land and Building Plant & Machinery Tools & Equipments Motor Vehicles Furniture & Fixtures Patents Trademarks	
Current Liabilities		Investments (Long Term)	
Income Received in Advance		Current Assets Stock	
Sundry Creditors Bills Payable Outstanding Expenses Bank Overdraft		Accrued Income Prepaid Expenses Sundry Debtors Bills Receivables Short term Investments Marketable Securities Cash and Bank Balance Fictitious Assets Advertisement Profit and Loss Account Miscellaneous Expenses	

2.5.2 Difference between Trial Balance and Balance Sheet

The following are the points of distinction/difference between trial balance and balance sheet:

Trial Balance		Balance Sheet	
1	It is a list of balance extracted from the ledger accounts	1	It is a statement of assets and liabilities
2	It contains the balance of all accounts - real, nominal and personal.	2	It contains the balance of only those accounts which represents assets and liabilities.
3	It is prepared before the preparation of trading and profit and loss account.	3	It is prepared after the preparation of trading and profit and loss account.
4	Generally it does not contain the value of the closing stock of goods.	4	It contains the value of closing stock, which appears on the assets side.
5	Expenses due but not paid and incomes due but not received do not appear in the trial balance	5	Expenses due but not paid appear on the liability side and income due but not received appear on the asset side of the balance sheet.

2.5.3 Explanation and Clarification of Certain Items

For a better understanding of how various items should be placed, it is important to know the type and nature of assets and liabilities that are to be classified and arranged in either of two orderly manners discussed earlier. For the purpose of presentation of assets in the Balance Sheet, assets are classified as under:

- Fixed Assets
- Intangible Assets
- Current Assets
- Fictitious Assets
- Wasting Assets
- Contingent Assets
- **Fixed assets:** Fixed assets are those assets, which are acquired for the purpose of producing goods or rendering services. These are not held for resale in the normal course of business. Fixed assets are used for the purpose of earning revenue and hence these are held for a longer duration. These are also treated as Gross Block? and Net Block? (Fixed assets after depreciation). Investment in the seassetsisknownas Sunk Cost ? Examples of fixed as set sare Land & Building, Plant and Machinery, Furnitureand Fixtures, Tools and Equipment, Motor vehicles, etc. All fixed assets are tangible by nature.

- **Intangible assets:** Intangible assets are those capital assets, which do not have any physical existence. Although these assets cannot be seen or touched, they are long lasting and prove to be profitable to owner by virtue of the right conferred upon them by mere possession. They also help the owner to generate income. Goodwill trademarks, copyrights and patents are the examples of intangible assets. Fixed assets and intangible assets are subheads of non current assets.
- **Current assets:** Current assets include cash and other assets, which are converted or realized into cash within a normal operating cycle or say, within a year. These are acquired for resale, assisting and helping the process of production, rendering service or supplying of goods. These assets constantly keep on changing their form and contribute to routine transactions and operations of business. Examples are Cash, Bank, Bills Receivables, Debtors, Stock, Prepaid expenses etc. Current assets are also known as Floating Assets or Circulating Assets.
- **Liquid or quick assets:** Those current assets, which can be converted into cash at a very short notice or immediately, without incurring much loss or exposure to high risk, are quick assets. Quick assets can be worked out by deducting Stock (raw materials, work-in-progress or finished goods) and prepaid expenses out of total current assets.
- **Fictitious assets:** These are the non-existent worthless items which represent unwritten-off losses or costs incurred in the past, which cannot be recovered in future or realized in cash. Examples of such assets are preliminary expenses (formation expenses), Advertisement suspense, Underwriting commission, Discount on issue of shares and debentures, Loss on issue of debentures and Debit balance of Profit & Loss Account. These fictitious assets are written off or wiped out by debiting them to Profit & Loss Account.
- **Wasting assets:** An asset that has a limited life and therefore dwindles in value over time is a wasting asset. This type of asset has a limited useful life by nature and depletes over a limited duration. These assets become worthless once their utility is over or exhausts fully. During the life of productive usage, assets of this type produce revenue, but eventually reach a state where the worth of the assets begins to diminish. Such assets are natural resources like timber and coal, oil, mineral deposits, etc.
- **Contingent assets:** Contingent assets are probable assets, which may or may not become assets, as that depends upon occurrence or non-occurrence of a specified event or performance or non-performance of a specified act. For example, a suit is pending in the court of law against ownership title of a disputed property. Subsequently, if the verdict goes in favor of the business concern, it becomes the asset of the concern. However, if the business firm does not win the lawsuit, it will not have ownership rights of the property; it will be of no use to it. Thus, it remains a contingent asset as long as the judgment is not pronounced by court. Such assets are shown by means of footnotes and hence do not form part of assets shown in the Balance Sheet. Besides this, hire-

purchase contract, uncalled share capital, etc. are the other examples of contingent assets.

Classification of Liabilities

- **Long-term liabilities:** These are the obligations that the business enterprise is expected to meet after a relatively long period. Such liabilities do not become due for payment in the ordinary course of business operation or within normal operating cycle. Debentures, long-term loans from banks or financial institutions are the examples of long-term liabilities.
- **Current liabilities:** Current liabilities are those liabilities that are payable within normal operating cycle, i.e. within a given accounting year. These may arise out of realization from current assets or by creating fresh, current liability (obligation). Trade creditors, Bills payable, Bank overdraft, outstanding expenses, short-term loan (payable within twelve months or within the accounting year) are examples of current liabilities.
- **Contingent liabilities:** These liabilities may or may not be sustained by an entity depending on the outcome of a future event such as a court case. These liabilities are recorded in a company's accounts and displayed in the Balance Sheet when both probable and reasonably estimable. It is not an actual liability but an anticipated (probable) liability, which may or may not become payable. It depends upon the occurrence of certain events or performance of certain acts. An element of uncertainty is always attached to a contingent liability; it is a potential liability that may or may not become a sure liability. Contingent liabilities are exemplified in the liability for bills discounted, liability for acting as surety, liability arising on a suit for damages pending in the court to fail, liability for calls on partly paid shares etc. If a parent guarantees a daughter's first car loan, the parent has a contingent liability. If the daughter makes her car payments and pays off the loan, the parent will have no liability. If the daughter fails to make the payments, the parent will have a liability. Contingent liabilities are shown as footnotes under the Balance Sheet.

In accounting, a contingent liability and related contingent loss are recorded with a journal entry only if the contingency is probable as well as estimable. If a contingent liability is only possible (not probable) or if the amount cannot be estimated, a journal entry is not required. However, a disclosure is required. When a contingent liability is remote (such as a nuisance suit), neither a journal nor a disclosure is required.

2.5.4 Limitations of Balance Sheet

Balance Sheet is prepared by company to reveal its financial position.

Following are the limitations of balance sheet:

1. Fixed assets are shown in the Balance Sheet at historical cost less depreciation up to date. A conventional Balance Sheet cannot reflect the

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

true value of these assets. Again, Intangible assets are shown in the Balance Sheet at book values, which may bear no relationship to market values.

2. Sometimes, Balance Sheet contains some assets which command no market value such as preliminary expenses, debenture discount, etc. The inclusion of these fictitious assets unduly inflates the total value of assets.
3. The Balance Sheet cannot reflect the value of certain factors such as skill and loyalty of staff.
4. A conventional Balance Sheet may mislead untrained readers in inflationary situations.

The value of majority number of current assets depends upon some estimates, so it cannot reflect the true financial position of the business.

Check your progress 4

1. The word _____ refers to a period which is one year from the date of preparation of balance sheet or lesser.
 - a. current
 - b. Fixed
 - c. fluctuating

2.6 Illustrations

1) From the under noted Trial Balance of a Trader as on 31.12.2020 prepare a trading and Profit and Loss Account for the year ended 31.12.2020 and a Balance Sheet as on that date.

Particulars	Rs.	Particulars	Rs.
Cash in hand	1,200	Capital	80,000
Purchases	1,20,000	Bank Loan	20,000
Opening Stock	35,000	Bills Payable	22,000
Sundry Debtors	50,000	Sundry Creditors	24,000
Plant & Machinery	60,000	Sales	2,00,000
Furniture	15,000	Bad debts Reserve	1,200
Bills Receivable	20,000		
Rent and Taxes	10,000		
Wages	16,000		
Salaries	20,000		
	3,47,200		3,47,200

Additional Information supplied: I) Closing Stock Rs. 40,000

Solution:

Trading and Profit & Loss Account for the year ended on 31st December 2020

FINAL ACCOUNTS
(WITHOUT
ADJUSTMENT)

Dr.

Cr.

Particular	Amount	Particular	Amount
To Opening Stock	35000	By Sales	200000
To Purchases	120000	By Closing Stock	40000
To Wages	16000		
To Gross Profit	69000		
	240000		240000
To Rent and Taxes	10000	By Gross Profit b/d	69000
To Salaries	20000	By BDR A/c	1200
To Net Profit	40200		
Total	70200	Total	70200

Balance Sheet as on 31st December, 2020

Liabilities	Rs.	Assets	Rs.
Capital : Opening Balance	80000	Plant and Machinery	60000
Add : Net Profit	40200	Furniture	15000
	120200	Bills Receivable	20000
Bank loan	20000	Closing stock	40000
Bills Payable	22000	Sundry Debtors	50000
Sundry Creditors	24000	Cash on Hand	1200
Total	186200	Total	186200

- 2) The Trial Balance of M/s R.S. Corporation as on December 31, 2020 was as under:

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Particulars	Rs.	Rs.
Rajeev's capital A/c		80,000
Suresh's Capital A/c		1,00,000
Stock as on 1.1.1990		
Raw materials	2,500	
Finished goods	6,500	
Purchases	64,500	
Sales		1,19,000
Sales returns	2,000	
Wages	16,000	
Manufacturing expenses	12,000	
Salaries	8,000	
Insurance	1,500	
Postage	100	
Advertisement	1,000	
Bad debts	300	
Bills Payable		12,000
Discount		500
Land and Building	90,000	
Plant and Machinery	70,000	
Furniture	1,000	
Sundry Debtors	25,400	
Sundry Creditors		42,000
Drawings		
Rajeev	1,800	
Suresh	1,400	
Cash in Hand	500	
Cash at Bank	49,000	
Total	3,53,500	3,53,500

Rajeev and Suresh share profit and Loss equally. Prepare Trading, Profit & Loss Account for the year ended on 31st December 2020, and also the balance Sheet as on that date after taking into consideration the following adjustments:

1. Stock on 31st December, 2020: Raw materials Rs. 4,000; Finished goods Rs.12 ,000

Solution**M/s R.S. Corporation**FINAL ACCOUNTS
(WITHOUT
ADJUSTMENT)Trading and Profit & Loss Account for the year ended on 31st December
2020**Dr.****Cr.**

Particulars	Rs.	Particulars	Rs.
To Opening Stock	2,500	By Sales	1,19,000
Raw materials	6,500	Less: Sales	2,000
Finished goods	9,000	Returns	1,17,000
To Purchases	64,500	By Closing Stock	
		Raw Materials	4,000
To Wages	16,000	Finished Goods	28,000
To Manufacturing expenses	12,000		
To Gross Profit	31,500		
Total	1,33,000	Total	1,33,000
To Salaries	8,000	By Gross Profit b/d	31,500
To Insurance	1,500	By Discount Received	500
To Postage	100		
To advertisement	1,000		
To Bad Debt	300		
To Net Profit (transferred to partner Capital A/c)			
Rajeev	10,550		
Suresh	10,550		
	21,100		
Total	32,000	Total	32,000

Balance Sheet of M/s R S Corporation as on 31stDecember 2020

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Accounts:			Fixed assets		
Rajeev	80,000		Land and Building		90,000
Add: Share of Profit	10,550		Plant and machinery		70,000
Less: Drawings	<u>1,800</u>	88750			
Suresh	1,00,000				
Add: Share of Profit	10,550				
Less: Drawings	<u>1,400</u>	1,09,150			
Sundry Creditors		42,000	Furniture		1000
Bills Payable		12,000	Current Assets		
			Closing Stock: Raw	4,000	
			Materials Finished	12,000	16,000
			goods		
			Sundry Debtors		25,400
			Cash in hand		500
			Cash at bank		49,000
Total		2,51,900	Total		2,51,900

Check Your Progress 5

Sales return is to be mentioned at _____.

- (a) Subtracting it from sales
- (b) Posting on debit side of trading a/c
- (c) Both

2.7 Let Us Sum Up

In this unit we have studied about final accounts and through this study we came understood that after the preparation of Trial Balance, the next step in accounting is “Preparation of Final Accounts”. Final Accounts are also called “Financial Statement”. It involves preparation of Trading Account and Profit and Loss Account; and Preparation of a balance Sheet. Trading Account is prepared to ascertain gross profit or gross loss of a business during an accounting period – usually a year. Debit side of trading account includes Opening Stock, Purchases, Purchases Returns / Returns Outwards and all Direct Expenses whereas credit side includes Sales, Sales Returns / Returns Inward, Abnormal Loss, and Closing Stock. Along with trading account P&L account is prepared to as certain net profit or loss as the case may be. We the readers

even learn that the Process of preparation and presentation of Balance Sheet involves two steps namely, Grouping and Marshalling. The first step refers to proper grouping of the various items, and has to be shown as asset and liabilities on the balance sheet. It means orderly arrangement in which various assets and liabilities are presented or shown in the Balance Sheet.

Through the study of this subject the students will get detailed information about how to make the final books of accounts. Sufficient illustrations have been provided to explain the topic effectively.

2.8 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers :(1-a)

Check your progress 3

Answers :(1-a)

Check your progress 4

Answers :(1-a) Final Accounts

Check your progress 5

Answers :(1-c)

2.9 Glossary

1. **Fixed Assets** - Assets that the business owns or buys for use within the business and which still retains a value at year end. They are major items like land, buildings, equipment and vehicles but can include smaller items like tools. Fixed assets are subhead of non current assets.
2. **Goodwill** - This is an extra value placed on a business, if the owner of a business decides it is worth more than the value of its assets. Fixed it is intangible assets and subhead of non current assets.
3. **Gross loss** - The balance of the trading account, assuming it has a debit balance.
4. **Gross profit** - The balance of the trading account, assuming it has a credit balance.

2.10 Assignment

1. Given below is the detail of Krishna stores for year ending on 31st March 2020. The value of closing stock is Rs 3,00,000.

Opening stock	2,00,000	Purchase return	60,000
Purchases	10,00,000	Sales return	1,00,000
Sales	25, 00,000	Carriage on purchase	40,000

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Octopi and freight	32,500	Carriage on sales	50,000
Wages	1, 50,000	Factory rent	60,000
Factory lightning	54,000	Office rent	37, 500
Coal, gas and water	11, 000	Import duty	1, 60,000

2.11 Activities

What are Final Accounts? What purpose do they serve?

2.12 Case Study

What is meant by Grouping and Marshalling of Assets and Liabilities?

2.13 Further Readings

1. Financial Accounting : A Simplified Approach, Naseem Ahmed, Atlantic Publishers & Distributors (p) Ltd. ,2005.
2. Modern Accountancy Volume I, Mukherjee, Tata Mgraw Hill 2008.
3. Financial Accounting, Paul S K, New Central Book Agency, 2001.
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FINAL ACCOUNTS (With Adjustment)

: UNIT STRUCTURE :

- 3.0 Learning objectives**
- 3.1 Introduction**
- 3.2 Objectives or need of adjustment**
- 3.3 Types of adjustments**
- 3.5 Illustrations**
- 3.5 Let us sum up**
- 3.6 Answers for Check Your Progress**
- 3.7 Glossary**
- 3.8 Assignment**
- 3.9 Activities**
- 3.10 Case Study**
- 3.11 Further Readings**

3.0 Learning objectives

After learning this unit, you will be able to understand:

- The concept of adjustment and its objectives
- Procedure to Pass Appropriate Adjustment Entries
- Illustrations to understand the practical view of the adjustments

3.1 Introduction

In order to calculate True Profit & Loss of a business for a particular year, it is mandatory that all possible incomes and expenses relating to that year are taken into consideration. For example, if we want to calculate the net profit of the year ended on 31st March and the salary for the month of March has not been paid yet, it would be suitable to include such expense along with other expenses of the year. Similarly, it often happens that incomes such as interest, dividend, commission etc are earned but not received during the year. Adjustments for such incomes must be made in the current year so that the P&L account may disclose the correct amount of Net Profit or Net Loss. With P&L, balance sheet may present the correct financial position of the business.

In simple words we can say that if there are transactions which are detected while making the final accounts which are either omitted in the books or which have been wrongly recorded or whose only one aspect has been recorded, then the entries could be passed to correct it and hence such are known as adjustments.

Check your progress 1

Adjustments are transactions which are either _____

- (a) Omitted (b) Wrongly recorded (c) Both

3.2 Objectives or Need of Adjustments

1. To calculate the true Net Profit or Loss
2. To ascertain the correct financial position of the business.
3. To make a record of transactions omitted from the books
4. To rectify the errors
5. To record the expenses which have been accrued but have not been paid
6. To make a record of the incomes which have been accrued but yet not received.

Check your progress 2

Adjustments are needed to rectify the errors done or missed

- (a) True (b) False

3.3 Types of Adjustments

1. **Outstanding Expenses :** Expense that has not been paid during a particular accounting period and has been taken up for the following new accounting year is called outstanding or unpaid expenses. However it is necessary that all expenses – paid and unpaid be accounted in that accounting year. For e.g. if salaries for the last month are not paid, no entry will appear in books of accounts unless these are paid. So profit and loss account with regard to salaries will thus be seen indicating more profit. Hence it's recording is essential. It is liability.
2. **Prepaid Expenses :** Some of the expense of the next accounting year which has already been paid in the present accounting year thus resulting in the benefit for the next accounting year is called prepaid expense. These expenses are also entered in the books of accounts of that period to which they do not relate. Hence the result seen in the final accounts of a particular period will not be correct because such expenses relate to future periods. Prepaid expenses must be adjusted in the books of accounts to arrive at true profit. Generally insurance, taxes, telephone subscriptions, rent, etc. are paid in advance, thus requiring adjustment e.g. Rent paid by X for one year on 1.7.20 when his accounting year is calendar year; thus rent for 6 months will remain un exhausted and will be c/f to the next year. It is an assets.
3. **Accrued Income:** Incomes earned during the year but not yet received till the end of the accounting year is called accrued income. Some examples are Income like interest on investments; rent and commission etc. earned by a trader during a particular accounting period but actually not received in that period. Such income items have to be adjusted

before the preparation of final accounts. They have to be credited to that particular income account. This income so –earned but not received is an asset because the amount is still to be received.

Check Your Progress 3

Outstanding salaries are to be _____ to the concerned expense in the Profit & Loss account

- (a) Added
- (b) Subtracted
- (c) No effect in P & L account

4. **Income Received in Advance:** Incomes that are received in the accounting period but is meant for the next accounting period even without sending the goods for which this payment is made is called Income received in advance. Though it is entered in the P&L balance sheet, it is recorded as liability. It is liability
5. **Closing Stock:** This is the stock that has remained unsold till the end of the year. In the balance sheet it is carried forward to the next year. For the next accounting year it is seen as the opening stock and is in the debit side of trading account and hence closed.
6. **Depreciation:** Gradual decline in the value of fixed stock being used in business is called depreciation. Even though the value declines on a daily basis it is recorded and computed only at the end of the accounting period. The entry is seen as depreciation account to particulars asset.
7. **Interest on Capital:** The proprietor loses interest on the money when he invests in the firm. In such cases he would like to know the profit he will get from his business. Interest that is charged on the business is an expense to the business and income to the proprietor. This is seen in the balance sheet as - Interest on capital a/e To Capital a/c Interest on capital being an expense is debited to profit and loss account and same amount of interest on capital is added to capital.
8. **Interest on Drawings:** Just as interest is charged on capital, a certain amount of money as interest is charged on drawings as well. This is an income for business and expense for the proprietor. Following adjusting entry is passed at the end of accounting period: Capital a/e Dr. to Interest on drawings a/e the interest on drawings being an income is credited to profit and loss account is shown as a deduction from the capital.
9. **Bad Debt to be written off:** Sometimes customers don't pay back money taken from the business or don't pay for the goods purchased in the accounting year. When they are not recoverable they have to be written off. These are recorded as follows: Bad debts a/c To Sundry Debtors a/c It results in the reduction of customers debit balance and addition to the loss i.e. Bad debts. At the end of the year when the trial balance is drawn, these two accounts show debit balances. The balance on sundry debtors account is the net balance, after deduction of any

bad debts recorded during the year. But after the trial balance is prepared and before the final accounts are drawn trader may find that there are additional bad debts. Such bad debts must be recorded with the same adjusting entry and giving it following effect in ledger and final accounts.

- 10. Provision for Bad Debts:** Even as the irrecoverable bad debts are written off there are certain customers who would not have paid the amount due in that particular accounting period but may do so in future. There has to be a provision for such debts. This entry allows sundry debtors to come down to a realizable value. For this a reserve is created. This adjustment is entered at the end of the accounting year.

Profit and Loss A/c Dr.

To Provision for bad debts A/c

Check Your Progress 4

Closing stock is always a part of adjustment?

- (a) Yes
- (b) No
- (c) It's a wrong question

- 11. Provision for discount on Debtors:** In trade customers are offered discounts to allow prompt payment. In some cases goods are sold on credit in one accounting period and payment is received in the next accounting period. It is a policy that the expenditure be put in the accounting period where the sale is made hence a provision is made on debtors. But if these doubtful debts turn bad then no discount is offered. Hence the provision for discount will be calculated after deducting the provision for bad debts from sundry debtors.
- 12. Provision for discount on creditors:** If the business man is a prompt payer then he or she is entitled for discount. The accountants consider the accounting year when the purchase was made as the income receipt period. Hence if some amount is to be paid to the creditors then a provision should be for probable income. The adjusting entry is passed for it: Provision for discount on creditors a/c Dr. to Profit and loss account.
- 13. Losses by Accidents:** Losses incurred due to accidents or disasters leading to destruction of property then the asset account is credited and the profit and loss account is debited.

If goods (stock-in-trade) are lost by accident the value of closing stock will be lower than what it would have been. This reduces the amount of gross profit. Hence, the cost of goods lost by accident is debited from purchase and debited to the profit and loss account. The increase in gross profit will be neutralized by the debit to the profit loss account and thus the net profit will not be affected. The entries to be passed are as follows: Loss by accident a/c to Goods lost by accident a/c.

14. Commission to manager payable on profits: Sometimes the manager is entitled to a commission on profits. Such commission maybe:

- Fixed percentage on net profits before charging such commission.
- Fixed percentage on net profits- after charging such commission. Such commission being an expense is debited to commission account.

Till the time the payment is made it is shown as liability in the balance sheet.

Calculation of Commission: The trading account is prepared in usual manner, then transferring of the gross profit or loss, all expenses and incomes should be debited or credited except the commission which is still to be calculated.

15. Goods used form business: Sometimes goods purchased for resale are used in business for charitable purpose or distributing them as free samples. In such cases purchases account is credited with an amount equal to the cost of goods used in business and the same amount is debited to charity or advertisement expenses account.

Check your Progress 5

Adjustments for Bad debts and provision for doubtful debts is same

(a) True (b) False

3.4 Illustrations

From the under noted Trial Balance of a Trader as on 31.12.2020 prepare a trading and Profit and Loss Account for the year ended 31.12.2020 and a Balance Sheet as on that date.

Trial balance

Particulars	Rs.	Particulars	Rs.
Cash in hand	1,200	Capital	80,000
Purchases	1,20,000	4% Bank Loan	20,000
Opening Stock	35,000	Bills Payable	22,000
Sundry Debtors	50,000	Sundry Creditors	24,000
Plant & Machinery	60,000	Sales	2,00,000
Furniture	15,000	Bad debts Reserve	1,200
Bills Receivable	20,000		
Rent and Taxes	10,000		
Wages	16,000		
Salaries	20,000		
	3,47,200		3,47,200

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Additional Information supplied: i) Closing Stock Rs. 40,000; (ii) Provide outstanding liabilities: Rent and Taxes Rs. 2,000; Wages Rs. 3,000; Salaries Rs. 4,000; (iii) Depreciation: On Plant and Machinery @ 5%; On Furniture @ 10%;, (iv) Write-off Rs 500 bad debts; (v) Create bad debts reserve @ 2.5 on Sundry debtors.

Solution :

Trading and Profit & Loss Account for the year ended on 31st December 2020 Dr. Cr.

Particulars	Rs.	Rs.	Particulars	Rs.
To Opening Stock		35,000	By Sales	2,00,000
To Purchases		1,20,000	By Closing Stock	40,000
To Wages	16,000			
Add: Outstanding	3,000			
		19,000		
To Gross Profit c/d		66,000		2,40,000
		<u>240,000</u>		
To Rent and Taxes	10,000		By Gross Profit b/d	66,000
Add: Outstanding	2,000	12,000		
To Salaries	20,000			
Add: Outstanding	4,000			
		24,000		
To Bad debts		500		
To Reserve for Bad debts (note 1):				
New Less: Old	1,238			
	1,200	38		
To Interest on Bank Loan @ 4% on Rs 20,000		800		
	3,000			
	1,500			
To Depreciation:				
On plant and Machinery		4,500		
On Furniture				
To Net Profit		24,162		
Total		66,000	Total	66,000

Balance Sheet as on 31st December, 2020

FINAL ACCOUNTS
(WITH ADJUSTMENT)

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital: Opening Balance	80,000		Plant and Machinery	60,000	
Add: Net Profit	24,162	1,04,162	Less: Depreciation	-3,000	57,000
4% Bank Loan	20,000		Furniture	15,000	
Add: Accrued Interest	800	20,800	Less: Depreciation	-1,500	13,500
Bills Payable		22,000	Bills Receivable		20,000
Sundry Creditors		24,000	Closing Stock		40,000
Outstanding Liabilities:			Sundry Debtors	50,000	
Rent and Taxes	2,000		Less: Bad debts	-500	
Wages	3,000		Less: Reserve for bad debts	-1,238	48,262
Salaries	4,000	9,000			
			Cash on hand		1,200
Total		1,79,962			1,79,962

Working note: (i) New provision for bad debts = 2.5% of (Rs.50, 000) = Rs. 1,238. Additional provision required Rs. 1,238 – Rs. 1,200 = Rs.38.

OR

Bad debts Rs. 500 + New BDR 2.5% on 49500, Rs. 1238 = Rs. 1738 - Old BDR 1200 = Rs. 538 to be Provided.

2) The Trial Balance of M/s R.S. Corporation as on December 31, 2020 was as under:

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Particular	Dr. Rs.	Cr. Rs.
Rajeev's capital A/c		80,000
Suresh's Capital A/c		1,00,000
Stock as on 1.1.2020	2,500	
Raw materials		
Finished goods	6,500	
Purchases	64,500	
Sales		1,19,000
Sales returns	2,000	
Wages	16,000	
Manufacturing expenses	12,000	
Salaries	8,000	
Insurance	1,500	
Postage	100	
Advertisement	1,000	
Bad debts	300	
Bills Payable		12,000
Discount		500
Land and Building	90,000	
Plant and Machinery	70,000	
Furniture	1,000	
Sundry Debtors	25,400	
Sundry Creditors		42,000
Drawings Rajeev	1,800	
Suresh	1,400	
Cash in Hand	500	
Cash at Bank	49,000	
Total	3,53,500	3,53,500

Rajeev and Suresh share profit and Loss equally. Prepare Trading. Profit & Loss Account for the year ended on 31st December 2020, and also the balance Sheet as on that date after taking into consideration the following adjustments:

1. Stock on 31st December, 2020: Raw materials Rs. 4,000; Finished goods Rs.12,000

2. Provide depreciation on land and building @ 5%; on furniture @10%; and on plant & machinery@5%.
3. Outstanding expenses: Salaries Rs. 1,500; wages Rs.2,100.
4. Insurance paid for 15 months up to March 2021.
5. Write-off bad debts of Rs.400
6. Reserve for doubtful debts @5% ofDebtors.
7. Goods withdrawn by Rajeev for personal use Rs.2,000.

Solution

M/s R.S. Corporation

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock			By Sales	1,19,000	
Raw materials	2,500		Less: Sales Returns		
Finished goods	6,500	9,000		2,000	1,17,000
To Purchases	64,500		By Closing Stock		
Less: Goods taken for personal use	2,000	62,500	Raw Materials	4,000	
To Wages	16,000		Finished Goods	12,000	16,000
Add: Outstanding	2,100	18,100			
To Manufacturing expenses		12,000			
To Gross Profit c/d		31,400			
Total		1,33,000	Total		1,33,000
To Salaries	8,000		By Gross Profit b/d		31,400
Add: Outstanding	1,500	9,500			
To Insurance	1,500		By Discount received		500
Less: Prepaid	300	1,200			
To Postage		100			
To advertisement		1,000			
To Bad Debt	300				

Trading and Profit & Loss Account for the year ended on 31stDecember 2020

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Dr.

Cr

Add: Further Bad debts	400	700			
To Provision for Doubtful debts		1,250			
To Depreciation:					
On Land & Building @ 5%	4,500				
On Furniture @ 10%	100				
On Plant & machinery @5%	3,500	8,100			
To Net Profit (transferred to partner Capital A/c)					
Rajeev	5,025				
Suresh	5,025	10,050			
Total		31,900	Total		31,900

Balance Sheet of M/s R S Corporation as on 31st December 2020

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Accounts:			Fixed assets		
Rajeev	80,000		Land and Building	90,000	
Add: Share of Profit			Less: Depreciation	4,500	85,500
Less: Drawings (Rs 1,800 + Rs. 2,000)	5,025		Plant and machinery	70,000	
Suresh	3,800	81,225	Less:	3,500	66,500
Add: Share of Profit	1,00,000				
Profit	5,025				
Less : Drawings	1,400	1,03,625			

Profit			Depreciation			
Less: Drawings						
Sundry Creditors		42,000	Furniture	1,000		
			Less: Depreciation	100	900	
Bills Payable		12,000	Current Assets			
Outstanding Expenses:			Closing Stock: Raw			
Salaries	1,500		Materials Finished	4,000		
Wages	2,100		goods	12,000	16,000	
		3600	Sundry Debtors	25,400		
			Less: Bad debts	400		
				25000		
			Less: Provision for bad debts @ 5%	1,250	23,750	
			Cash in hand		500	
			Cash at bank		49,000	
			Prepaid Insurance		300	
Total		2,42,450	Total		2,42,450	

FINAL ACCOUNTS
(WITH ADJUSTMENT)

- 3) Prepare final accounts from the following Trial Balance as on 31-03-2020 of pankaj

Trial Balance of Pankaj as on 31-03-2020

Name Of Account	Debit (Rs.)	Credit (Rs.)
Drawings - Capital	24000	300000
Purchase - Sales	296000	800000
Goods Returns	80000	20000
Provident – Contribution to provident fund	10000	100000
Provident fund investment – Int. on provident fund investment	100000	8000
Debtors - Creditors	200000	150000
Discount	46000	14000
Bad Debts & Bad debts reserve	30000	45000
Bills Receivables – Bills payable	15000	25000
Goods Stock (1-04-2019)	80000	-
Demurrage	3000	-
Tolai	1000	-
Custom duty	18000	-
Trade Expenses	90000	-
Cash balance	16000	-
Bank balance	25000	-
Fixed Assets (cost price 500000)	400000	-
Advertisement Expenses	28000	-
	1462000	1462000

Adjustments :

- Stock as on 31-03-2020 is 2,00,000 out of which market value of 30% stock is 20 % more. Market value of 50 % stock is less by 10 %. Whereas remaining stock need to repairs expenses of 2000.
- Good of 5000 given as advertisement.
- Credit sales of 10,000 wrongly recorded as credit purchase.
- Write off 20,000 as bad debts from debtors and provide 10 % Bad debt reserve.
- Calculate 10 % interest on Capital and 5 % interest on Drawings.
- Calculate depreciation at 10 % on fixed assets as per straight line method.

Solution :

Trading Account of Pankaj for the year ending on 31-03-2020

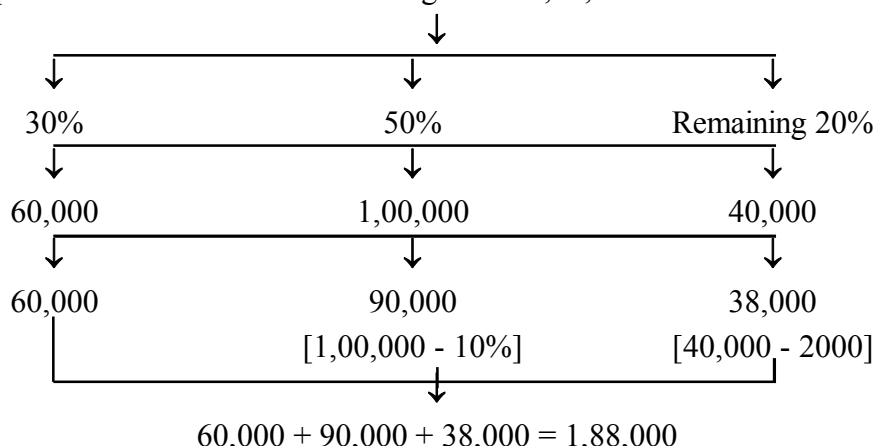
Particular	Amount (Rs.)	Particular	Amount (Rs.)
To Opening stock	80000	By Sales	800000
To purchase	296000	+ Unrecorded sales	10000
			810000
- Wrongly Recorded	10000		
	286000	- Sales return	80000
			730000
- Goods given for advertisement	5000		
- Purchase return	20000		
	261000		
To demurrage	3000		
To Tolai	1000		
To Gross profit	555000	By Closing Stock	188000
	918000		918000

Particular	Amount (Rs.)	Particular	Amount (Rs.)
Administrative Expenses :		By Gross Profit	555000
To Contribution to provi. Fund	10000	By Discount Received (Transferred from trading A/c)	14000
To Trade expenses	90000	By Interest on Drawings	1200
Sales-distribution expenses :			
To Discount given	46000		
To Advertisement exp. 28000			
+ Goods given as adv. 5000	33000		
Financial Expenses :			
To Interest on Capital	30000		
Other expenses and Losses :			
Bad debt reserve account :			
Bad Debts (Trial Bal.) 30000			
+ Bad Debts (Adj.) 20000			
+ Bad Debts Reserve (Adj.) 19000	69000		
- Bad Debts Res. (Trial Balance) 45000	24000		
To Depreciation on fixed assets	50000		
To Net Profit A/c	287200		
	570200		570200

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital :		Non Current Assets :	
Capital 300000		Fixed Assets 400000	
+ Int. on capital 30000		- Depreciation 50000	350000
+ Net Profit 287200		(Cost Price 500000 × 10%)	
(From P & L A/c) 617200		Investment :	
- Drawing 24000		Provident Fund Investments	100000
+ Int. on drawings 1200 25200	592000	Current Assets :	
Non – Current Liabilities :		Debtors 200000	
Current Liabilities :		+ Unrecorded Sales 10000	
Provident Fund 100000		210000	
+ Int. on PF 8000	108000	- Bad Debts 20000	
Investment 25000		190000	
Bills Payable 150000		+ Bad Debt Res.(10%) 19000	171000
Creditors 10000	140000	Bills receivables	15000
- Wrongly recorded		Cash Balance 16000	
		Bank Balance 25000	
		Closing Stock 188000	
	865000		865000

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Explanation : Note no. 1 : Closing Stock 2,00,000



Market value of 30 % stock is more, hence cost value will be considered.
 Market value of 50 % stock is less, hence market value will be considered.
 20 % stock has required repairing therefore repairing cost will be deducted from stock value.

4) Prepare final accounts of Nirmi Traders from the following Trial Balance as on 31-03-2020 and adjustments.

Trial Balance of Nirmi Traders as on 31-03-2020

Name of Account	Debit (Rs.)	Credit (Rs.)
Capital	-	300000
Drawings	18000	-
Land & Building	200000	-
Machinery	140000	-
Furniture and fixtures	25000	-
Leasehold Building (Dt. 1-04-2019 for five years)	50000	-
Sales	-	500000
Purchase Returns	-	12000
Debtors	90000	-
12 % Loan from Sajan (Dt. 1-10-2019)	-	30000
Purchase	200000	-
Sales returns	10000	-
Freight - Octroi	15000	-
Sundry expenses	1000	-
Stationery – printing	2500	-
Insurance premium	14200	-
Bad-Debts	15000	-
Bad-Debts Reserve	-	14000
Discount Reserve on Debtors	-	500
Commission received	-	8000
Goods Stock (Dt. 1-04-2019)	11000	-
Salary and wages	54000	-
Creditors	-	30000
Dead Stock	5000	-
Bank Overdraft	-	21000
Cash Balance	40800	-
Carriage Inward	11000	-
Carriage Outward	4000	-
Bills	18000	10000
Discount allowed	1000	-
	925500	925500

FINAL ACCOUNTS
(WITH ADJUSTMENT)

Adjustments :

- (1) Closing stock as on 31-03-20 was valued at 41,000.
- (2) Fire occurred in business as on 31-01-20 due to which goods of 10,000 were destroyed and the insurance company accepted a claim of 7000.
- (3) Out of debtors 5000 are not recoverable so they are to be written off. Provide Bad debt reserve 10 % and discount reserve 2 % on debtors.
- (4) Nirmi withdrew goods of 1000 for personal use which are not recorded in the books of accounts.
- (5) Credit purchases of 5000 were not recorded.
- (6) Calculate depreciation, at 10 % on land and building, at 20 % on machinery and at 5 % on furniture and fixtures.
- (7) Insurance premium included 1200 for the next year.
- (8) Commission of 1000 is receivable.

Solution

Trading Account of Nirmi Traders for the year ending on 31-03-2020

Particular	Amount (Rs.)	Particular	Amount (Rs.)
To Opening Stock	11000	By Sales	500000
To Purchase	200000	- Sales Return	10000
+ Unrecorded purchase	5000		
	205000		490000
- Purchase return	12000		
	193000		
- Goods burnt by fire	10000		
Withdraw for personal use	1000		
	11000		
To Freight - Octroi	15000		
To Carriage Inward	11000		
To Gross Profit (Transferred to P & L A/c)	312000	By Closing Stock	41000
	531000		531000

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Profit & Loss Account of Nirmi Traders for the year ending on 31-03-2020

Particular		Amount (Rs.)	Particular		Amount (Rs.)
Administrative Expenses :			By Gross Profit		321000
To Sundry expenses		1000	(Transferred from Trading A/c)		
To Stationery – premium		2500	By commission	8000	
To Insurance Premium	14200		+ Receivables	<u>1000</u>	9000
- Prepaid	<u>1200</u>	13000			
To Salary - Wages		54000			
Sales – Distribution Expenses :					
To Carriage Outward		4000			
Financial Expenses :					
To Interest on loan		1800			
Other Expenses and Losses :					
To Written off		10000			
Leasehold building					
Bad Debts (Trial Bal.)	15000				
+ Bad Debts (Adj.)	5000				
+ Bad Debts Res. (Adj.)	<u>8500</u>				
	28500				
+ Bad Debts Res.	<u>14000</u>	14500			
(Trial Balance)					
Dis. Reserve on debtors A/c :					
Discount given	1000				
+ Disc. Res. On Debtors	<u>1530</u>				
(Adjustment)	2530				
+ Disc. res. On Debtors	<u>500</u>	2030			
(Trial Balance)					
To Loss due to fire		3000			
Depreciation :					
Land - Building	20000				
+ Machinery	28000				
+ Furniture - Fixture	<u>1250</u>	49250			
To Net Profit		165920			
(Transfer to Capital A/c)					
		<u>321000</u>			<u>321000</u>

Balance Sheet of Nirmi Traders as on 31-03-2020

Liabilities		Amount	Assets		Amount
Capital :			Non Current Assets		
Capital	300000		Fixed Assets :		
+ Net Profit	165920		Land & Building	200000	180000
(Transferred from P&L A/c)	465920		- Depreciation (10%)	20000	
- Drawings	18000		Machinery	140000	
+Goods	1000		- Depreciation (20%)	28000	112000
Withdraw for Personal use	19000	446920	Furniture and Fixtures	25000	
Non Current Liabilities :			- Deprecation (5%)	1250	23750
12% Sajan Loan	30000		Leasehold Building	50000	
+ Int. on loan	1800	31800	- Written off (1/5)	10000	40000
Current Liabilities :			Dead Stock		5000
Creditors	30000		Current Assets :		
+ Unrecorded Credit Purchase	5000	35000	Debtors	90000	
Bank Overdraft		21000	- Bad Debts	5000	
Bills Payables		10000		85000	
			- Bad Debt Res. (10%)	8500	
				76500	
			- Discount Reserve on Debtors (2%)	1530	74970
			Cash Balance		40800
			Bills Receivables		18000
			Closing Stock		41000
			Insurance Company account		7000
			Prepaid Insurance Premium		1200
			Commission Receivables		1000
		544720			544720

Explanation : (l) Outstanding interest on Sajan's Loan.

Loan was taken from Sajan as on 1-10-2019

Final Account date : 31-03-2020

Unpaid interest on loan duration = 6 months

Interest = 30,000 X 12 % × 6/12 = 1800

Outstanding Interest = 1800

3.5 Let Us SumUp

In the last unit we learnt how to make final accounts in the books of sole proprietorship which includes Trading account, Profit and loss account and balance sheet for the business. These financial statement helps us to understand the profitability of the business and the financial position as well.

This unit is focused on adjustments which tend to happen in final accounts. Adjustments are entries which have been missed during the recording of transactions hence dual effect of these transactions are to be given in final accounts. Different types of transactions are explained if adjustments are to be done in the final accounts. Through the study of this subject the students will get a detailed information about how to make the final books of accounts. Sufficient illustrations have been provided to explain the topic effectively.

3.6 Answers for Check Your Progress

Check your progress 1

Answers:(1-c)

Check your progress 2

Answers:(1-a)

Check your progress 3

Answers:(1-a)

Check your progress 4

Answers:(1-b)

Check your progress 5

Answers:(1-b)

3.7 Glossary

1. **Commission** - A commission is a fee that a business pays to a salesperson in exchange for his or her services in either facilitating, supervising, or completing a sale.
2. **Financial Position** - Financial position is the current balances of the recorded assets, liabilities, and equity of an organization. This information is recorded in the balance sheet, which is one of the financial statements.
3. **Net loss** - The balance of the profit and loss account, assuming it has a debit balance.
4. **Net profit** - The balance of the profit and loss account, assuming it has a credit balance.

3.8 Assignment

- 1) From the following figures extracted from the books of Shri Govind, you are required to prepare a Trading and Profit & Loss Account for the year ended 31st March, 2020 and a Balance Sheet as on that date after making the necessary adjustments.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)	FINAL ACCOUNTS (WITH ADJUSTMENT)
Shri Govind's Capital	2,28,800	Stock 1.4.2019	38,500	
Shri Govind's Drawings	13,200	Wages	35,200	
Plant & Machinery	99,000	Sundry Creditors	44,000	
Freehold Property	66,000	Postage and Telegrams	1,540	
Purchases	1,10,000	Insurance	1,760	
Returns Outwards	1,100	Gas and Fuel	2,970	
Salaries	13,200	Bad debts	660	
Office Expenses	2,750	Office Rent	2,860	
Office Furniture	5,500	Freight	9,900	
Discounts A/c (Dr.)	1,320	Loose Tools	2,200	
Sundry Debtors	29,260	Factory Lighting	1,100	
Loan to Shri Krishna @ 10% p.a. – balance as on 1.4.2019	44,000	Provision of D/D	880	
Cash at Bank	29,260	Interest on loan to Shri Krishna	1,100	
Bills Payable	5,500	Cash in Hand	2,640	
		Sales	2,31,440	

Adjustments :

1. Stock on 31st March, 2020 was valued at Rs.72,600
2. A new machine was installed during the year costing Rs.15,400, but it was not recorded in the books as no payment was made for it. Wages Rs.1,100 paid for its erection have been debited to wages account.
3. Depreciate:
Plant and Machinery by % Furniture 10%
Freehold Property by 5%
4. Loose tools were valued at Rs.1,760 on 31.03.2020
5. Of the Sundry Debtors Rs.600 are bad and should be written off.
6. Maintain a provision of 5% on Sundry Debtors for doubtful debts

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

7. The manager is entitled to a commission of 10% of the net profits after charging such commission.

[Ans: Gross Profit: Rs.1,08,570, Net Profit: Rs.40,800, Balance Sheet total:Rs.3,25,380.]

2) The following is the Schedule of balances as on 31.03.2020 extracted from the books of Shri. Borkhede, who carries on business under the name and style of Messrs Borkhede Joshi & Co., at Pune.

Particulars	Dr. Amount (Rs.)	Cr. Amount (Rs.)
Cash in Hand	1,400	
Cash at Bank	2,600	
Sundry Debtors	86,000	
Stock as on 1.4.2019	62,000	
Furniture and Fixture	21,400	
Office Equipment	16,000	

Buildings	60,000	
Motor Car	20,000	
Sundry Creditors		43,000
Loan from Joshi		30,000
Reserve for Bad debts		3,000
Purchases	1,40,000	
Purchase Returns		2,600
Sales		222600
Sales Returns	4,200	
Salaries	11,000	
Rent for Godown	5,500	
Interest on loan form Joshi	2,700	
Rates and Taxes	2,100	
Discount received from Creditors		1,600
Freight on purchase	1,200	
Carriage Outward	2,000	
Drawings	12,000	
Printing and Stationery	1,800	
Electric Charges	2,200	
Insurance Premium	5,500	
General Office Expenses	3,000	
Bad debts	2,000	
Bank Charges	1,600	
Motor Car Expenses	3,600	
Capital Account		1,62,000
	469800	469800

FINAL ACCOUNTS
(WITH ADJUSTMENT)

Prepare Trading and Profit and Loss Account for the year ended on 31st March 2020 and the Balance Sheet as at that date after making provision for the following:

- a. Depreciate Building by 5%
- b. Furniture and Fixtures by 10%: one steel table purchased during the year for Rs.1,400 was sold for same price but the wrongly credited to sales account.
- c. Office Equipment by 15%: Purchases of a typewriter during the year for Rs.4,000 has been wrongly debited to purchases account.
- d. Motor Car by 20%
 1. Value of Stock at the close of the year was Rs.44,000
 2. One month rent for godown is outstanding.
 3. One month salary is outstanding.
 4. Interest on Loan from Joshi is payable @12% p.a.

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

5. Reserve for Bad debts is to be maintained at 5% on Sundry Debtors
6. Insurance premium includes Rs.4,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 1.4.2019 to 30.6.2020
7. Half of the building is used for residential purposes of Shri Borkhede.

3.9 Activities

How is final accounts for Companies is different from final accounts of sole proprietorship?

3.10 Case Study

What is meant by hidden adjustments?

3.11 Further Readings

1. Advanced Accountancy Vol-II, S N Maheshwari & V L Maheshwari, Vikas Publishing co, 2010
2. Modern Accountancy Volume I, Mukherjee, Tata McGraw Hill 2008.
3. Financial Accounting, Paul S K, New Central Book Agency, 2001.
4. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 1978.
5. Advanced Accounts, M. C. Shukla & T. S. Grewal, S. Chand Publisher, 1997.

Block Summary

In this block we have understood in detail about the Depreciation. We have also studied in detail about the final accounts with and without adjustments. The topics have been discussed in detail with proper illustrations. Through the study of this block the reader will get a detailed insight of the topic depreciation. He will also get a detailed knowledge of how to make distinction between the different parts of final accounts. Not only one part of final accounts but the readers will get a detailed knowledge about Trading and P&L account and I am sure enough that after going through this block the readers could easily distinguish between them and the balance sheet. In the third unit we have also studied the different transactions which have an impact on Final accounts known as adjustments.

Block Assignment

Short Answer Questions

Write Short Notes

1. Misconceptions about depreciation
2. Methods of depreciation
3. Provision for Discount on creditors
4. Bad debts recovery
5. Discount on Debtors

Long Answer Questions

1. Explain different adjustment entries to be done in final accounts of sole proprietorship

DEPRECIATION
ACCOUNTING, FINAL
ACCOUNTS AND
ELEMENTS OF COST

Enrolment No.:

1. How many hours did you need for studying the units?

Unit No.	1	2	3
Nos of Hrs			

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Language and Style	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Illustration used (Diagram, tables etc)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Conceptual Clarity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Check your progress Quest	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Feed back to CYP Question	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____

3. Any Other Comments

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**Dr. Babasaheb
Ambedkar
Open University**

BBAR-102/DBAR-102

BASIC OF ACCOUNTING

**BLOCK-4 RECTIFICATION OF ERRORS, BILLS OF
EXCHANGE, ACCOUNTING FOR HIRE PURCHASE
& ELEMENTS OF COST**

UNIT 1

RECTIFICATION OF ERRORS

UNIT 2

BILLS OF EXCHANGE

UNIT 3

ACCOUNTING FOR HIRE PURCHASE

UNIT 4

ELEMENTS OF COST

**BLOCK 4 : RECTIFICATION OF ERRORS, BILLS OF EXCHANGE,
ACCOUNTING FOR HIRE PURCHASE AND ELEMENTS
OF COST**

Block Introduction

Accounting is considered to be one of the most important subjects in the field of commerce or management and therefore this subject has been introduced here in this course.

This block covers one of the most important topics of accounting. It covers important topics such as rectification of errors, bills of exchange, accounting for hire purchase elements of cost. In first unit students will be able to understand the types of errors which happen while making final accounts and how to rectify them. The second unit i.e. Bills of exchange explains how the credit section of the financial market is handled by different instruments with its features. Third unit focuses on the account system being created and managed in case of Hire Purchase transactions. The last unit covers the topic of elements of cost. Though this topic is small but very important each and every aspect has been made clear to the students in understanding this topic.

The readers will get a through insight of accounting through this block. They will get good knowledge about rectification of errors, bills of exchange, how are accounts of hire purchase made, apart from this the readers will also get a complete knowledge about elements of cost.

Block Objective

After learning this block, you will be able to understand :

- Rectification of errors
- Different stages of rectification of errors
- Bills of exchange– types and properties
- Promissory and its features
- Concept of hire purchase with its accounting treatment
- Meaning, element and classification of cost.

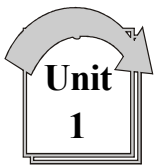
Block Structure

Unit 1 : Rectification of errors

Unit 2 : Bills of exchange

Unit 3 : Accounts for Hire Purchase

Unit 4 : Elements of Cost



RECTIFICATION OF ERRORS

: UNIT STRUCTURE :

- 1.0 Learning objectives
- 1.1 Introduction
- 1.2 Errors which do not affect trial balance
- 1.3 Errors which affect trial balance
- 1.4 Errors detected before the preparation of final accounts
- 1.5 Let us sum up
- 1.6 Answers for check your progress
- 1.7 Glossary
- 1.8 Assignment
- 1.9 Activities
- 1.10 Case study
- 1.11 Further reading

1.0 Learning objectives

After learning this unit you will be able to understand :

Errors in financial accounting

Types of errors

Errors not affecting trial balance and their rectification

Errors affecting trial balance and their rectification

Accounting treatment of all the errors

1.1 Introduction

The motive of preparing Trial balance in financial accounts is to check the accuracy and correctness of recording the transaction in Journal, later on posting it in ledgers and closing or balancing those ledgers (accounts). If the trial balance balances on both the sides then it is understood that recording, posting and balancing has been done accurately. But agreement of trial balance need not always be the accurate way to decide if the recording has been appropriately done. Even if trial balance matches, there could be few errors which might have been spotted in accounting records. Hence the errors which affect the trial balance and few of those which don't must be spotted and rectified?

For e.g. Non recording of credit sales transaction in sales book will not affect the agreement of trial balance as both the effects of this transaction are not recorded in this case. Hence such transaction need to be identified and placed accordingly.

This process of correcting the errors committed and to set the accounting records right is called rectification of errors. Accounting errors can be classified into two parts, based on whether they affect the trial balance or not.

- (i) Errors which do not affect trial balance
- (ii) Errors which affect trial balance

Check your Progress 1

1. Rectification of errors are allowed in the process of accounting regardless of them affecting the trial balance.
 - a. True
 - b. False

1.2 Errors which do not affect trial balance

A trial balance is basically prepared to understand if the records or transactions recorded are arithmetically correct or not. But as discussed above trial balance cannot be considered as a base for the perfect accounting treatment. Even in this scenario errors would have been occurred which, does not affect the trial balance. These errors are difficult to be detected. These could be caught by comparing the receipts from customer and payments from traders, vouchers of purchase and sales and many other transactions by auditing the accounts.

To mark these errors in the books of accounts, rectified entries are to be passed in the journal proper. The types in this category are:

1. **Error of Omission :** This error happens when a transaction is totally absent to be recorded in books or journal or ledger, such an error is known as Error of Omission. In such errors the trial balance gets tally even though the error continues to be, as posting on both debit and credit side is left.

- (a) A transaction is totally omitted can be recorded in journal or subsidiary books or ledger in the form of entry. E.g. – Cash sales of Rs 2000 is not recorded. So by writing the correct entry the above error can be rectified.

Cash a/c _____ Dr
 To Sales a/c

- (b) A transaction is recorded in the journal or subsidiary book or ledger but posting of both accounts has not been done. E.g. – Machinery purchased on credit from Ram Electricals of Rs 50,000 is recorded in journal but their effect in accounts of machinery and Ram electrical has not been given. This could be rectified by debiting the machinery account and crediting ram electrical account in ledger.

2. **Error of Principle :** When an error occurs because it's not according to the accounting principles it is an error of principle. This means that errors do not affect the trial balance because they have been entered in the books of accounts but instead of one account any other account is given the effect. E.g. – Rs 40,000 worth furniture purchased is debited to purchase account. This entry can be changed by:

Correct entry :

Furniture a/c _____ Dr
 To cash a/c

Error committed :

Purchase a/c _____ Dr
 To Cash a/c

Entry for rectification :

Furniture a/c _____ Dr
 To Purchase a/c

Check your progress 2

1. When a transaction is left unrecorded in primary books, the error is known as _____.
 - (a) Error of omission
 - (b) Error of principle
 - (c) Error of compensatory

3. **Error of Commission :** In this transactions in primary books are recorded not at original amount but either more or less than it. It could also be possible that the entries might be recorded in wrong subsidiary books.

- (a) Transaction recorded in correct book by wrong amount. E.g. – Goods of Rs 5000 sold to Anand is recorded as Rs 500. This error will be rectified by :

Error entry :

Anand a/c _____ Dr 500
 To Sales a/c 500

Correct entry should have been

Anand a/c _____ Dr 5000
 To sales a/c 5000

Rectification done by

Anand a/c _____ Dr 4500
 To Sales a/c 4500

- (b) Transaction recorded in wrong subsidiary book: E.g. – Goods of Rs 6000 sold to Ankit has been recorded in Purchase book which is a wrong subsidiary book.

Error entry :

Purchase a/c _____ Dr 6000
 To Ankit a/c 6000

Correct entry should have been

Ankit a/c _____ Dr 6000
 To sales a/c 6000

Rectification done by

Ankit a/c _____ Dr 12000
 To Sales a/c 6000
 To Purchase a/c 6000

1.4 Errors detected before the preparation of final accounts

1. Errors of Posting

- (a) Omission of posting in any account: It is a type of omission. In this goods worth Rs 8000 were sold to Akshay. This transaction is correctly recorded in the sales book but the posting in akshay's account is not done. Credit sales of Akshay is yet not recorded in his ledger, so the error will be rectified by posting the amount on debit side of Akshay's account.
- (b) Twice posting in an account: In this error the same transaction is posted twice. E.g. Salary paid Rs 30,000 is aptly recorded in cash book but by mistake it has been recorded twice in salary account. Hence it will be rectified by crediting the salary account by the same amount.
- (c) Posting of a wrong account in an account: As the name suggests the entry seems perfect but the amount recorded is wrong. For e.g. – The building is purchased of Rs 50, 00,000 is recorded in building a/c as 5, 00,000. So to balance it out with the correct amount the building a/c is debited with Rs 45, 00,000.

Check your progress 4

- 1. An error arises when the same transaction is posted twice happens
 - (a) Before the preparation of trial balance
 - (b) After the preparation of trial balance
 - (d) Posting on the wrong side of the account: easy to understand that in this kind of error the posting has been done in the wrong side of the account. For e.g.– Paid salaries of Rs 5000. While recording or posting the salaries a/c is credited by Rs 5000, while according to accounting rules it must be debited in salaries a/c. To rectify it, proper treatment is to be done by debiting the salaries a/c by Rs 10,000. So that credit effect of Rs 5000 will be nullified and the original entry of Rs 5000 is recorded.
 - (e) Posting wrong amount to the wrong side of account: In this transaction are recorded correctly in the subsidiary book but it is recorded on the wrong side with wrong amount. E.g.– Paid rent of Rs 5000 is recorded correctly in the cashbook but is recorded on the credit side of rent a/c by the amount of Rs 500. To rectify it two errors need to be sorted that is debiting the rent a/c by 5500. As it will nullify the effect of credit transaction of that amount and with that the original effect will be given.
- 2. Errors regarding balance of an account**
- (a) Error in finding the balance of an account: If the balance of any account is found either more or less the trial balance does not tally. If after the calculation one gets to know that the balance is less on debit side, then put the deficit amount on the debit side and if it's less on the credit side then put the deficit amount accordingly.

E.g. After calculation one spotted that the purchase account is worked out as Rs 5000 instead of Rs 20000 on the debit side. Then write Rs 15000 which is debited less on the debit side of the account to rectify the error.

- (b) Error in writing the balance of an account: In this error the balance of an account has been recorded at wrong amount. E.g. – the opening balance of machinery a/c is Rs 1, 00,000 but it has been recorded as Rs 10,000. So the balance decreases by Rs 90,000. To rectify this error the account is to be debited with additional amount of Rs 90,000.
- (c) Balance of an account is omitted: It's a general error in which opening balance of an account is totally omitted– which means not recorded at all. So a new original entry can be done in the ledger with proper effect and amount.
- (d) Amount is written on the wrong side of account: Balance of Rs 500 of Ankit (a debtor's) account is written on the credit side. Error can be rectified by writing double the amount i.e. $500 + 500 = 1000$ on debit side of the account.
- (e) Balance written as wrong amount and wrong side: Let's take the above example of Ankit (a debtor's) account with balance of Rs 500. So the error is committed is that account has been credited with Rs 50. So to balance this error out Ankit's account will be debited with Rs 550.

Check your progress 5

1. If the balance of an account has been recorded with wrong amount which is lesser than the actual amount, the error can be rectified by
 - (a) Giving the same effect with the difference amount
 - (b) Giving the opposite effect with difference amount
3. **Errors in totaling the subsidiary books :** As discussed before the trial balance will not tally if an error is committed while doing the total of subsidiary books like in purchase, sales, goods return or cash book. This error can be rectified by writing necessary notes in their resp account. A journal entry is not necessary to rectify this type of error.
4. **Errors committed while preparing trial balance :** the possibility of errors happening in preparing a trial balance is like the error in totaling of trial balance, balance of an account is omitted, recorded twice, wrong amount recorded, wrong side recorded or wrong amount recorded at wrong side. After these errors are rectified new trial balance is to be prepared.

1.5 Errors detected after the preparation of final accounts

Normally in the accounting process if the trial balance gets tallied and final accounts are prepared it means no error has been done while recording or posting or at any step. But as seen above if error has occurred before making of final accounts it could be rectified in different ways. Another set of error can occur while making or after the making of final accounts. So while making trial balance if errors are detected, it can delay the process of making final accounts. In such situations the difference of trial balance is transferred to suspense a/c and later on final accounts are prepared.

As explained if trial balance does not get tally the balance is amount is shifted to suspense account as it leads to making of final accounts. If the difference arises on the debit side of trial balance, it is created as a debit balance in suspense account and shown on the asset side of balance sheet. And if the difference arises on the credit side of trial balance, it is created as a credit balance in suspense account and shown on the capital–liabilities side of balance sheet.

Check your progress 6

1. When trial balance does not tally, it is tallied temporarily with help of _____ account
- (a) Trading a/c (b) Profit and loss a/c
(c) Suspense a/c (d) Balance sheet

1.6 Let us sum up

“To err is human”. It is imperative for us not to commit mistakes when it comes to accounts—while making it or analyzing it. This unit makes us understand that while recording the transactions in the books of accounts, posting them to ledger or preparing a trial balance it is very likely to commit errors. Hence the next step comes is rectifying the errors, because if the errors aren’t rectified then the Profit and Loss account might not show or disclose the true profit or loss of the business.

There are different methods of rectification or errors but it all depends on the stage at which the errors are rectified. As mentioned in the unit the errors are classified into two types i.e. errors which do not affect trial balance and errors which affect the trial balance. Another set of type is errors detected before making the trial balance and the ones detected after the making of trial balance.

1.7 Answers for Check your progress**Check your progress 1**

1-a

Check your progress 2

1-a

Check your progress 3

1-c

Check your progress 4

1-a

Check your progress 5

1-a

Check your progress 6

1-c

1.8 Glossary

1. **Transaction** : An agreement between buyer and seller to exchange goods, services or financial instruments.
2. **Rectification** : It is the act of changing something wrong to make it correct or satisfactory.
3. **Deficit** : It is the amount by which something, especially an amount of money, is smaller than it should be.
4. **Arithmetical** : It is a branch of mathematics that consists studying of numbers, especially the properties of traditional operations on them such as addition, subtraction, multiplication and division.

1.9 Assignment

Study the concept of Suspense account and its uses in the accounting.

1.10 Activities

Make rectification entries to rectify the following errors detected while making the final accounts as on 31-3-2019

1. Purchase of machinery Rs 10,000 is left to be recorded.
 2. Goods sold to Neelam of Rs 600 is recorded in purchase book by mistake.
 3. Rs 3800 paid to Rutu is mistakenly recorded in Prakash's account.
 4. Salary paid Rs 20000 is debited twice to salary account.
 5. Opening balance of cash account Rs 2000 is brought forward as Rs 200.
-

1.11 Case study

Understand the effects of rectification on Profit and Loss account

1.12 Further Readings

1. Introduction to accounting, T S Grewal, S.Chand & Co, 2010
 2. Financial Accounting, Dr V K Goyal, Excel Books, 2007
 3. Financial Accounting, S N Maheshwari, Vikas Publishing House, 2018
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: UNIT STRUCTURE :

- 2.0 Learning objectives**
- 2.1 Introduction**
- 2.2 Bill of exchange**
- 2.3 Specimen to Bill of exchange**
- 2.4 Bills receivables and Bills payable**
- 2.5 Terms of Bill, Due Date and Days of Grace**
- 2.6 Disposal or uses of a bill**
- 2.7 Dishonor of a bill**
- 2.8 Promissory Note**
- 2.9 Characteristics**
- 2.10 Parties to promissory Note**
- 2.11 Difference between Bills of exchange and Promissory Note**
- 2.12 Let us Sum up**
- 2.13 Answers for check your progress**
- 2.14 Glossary**
- 2.15 Assignment**
- 2.16 Activities**
- 2.17 Case Study**
- 2.18 Further Reading**

2.0 Learning Objectives

After reading this unit you will be able to understand :

- Meaning of bills of exchange and promissory note
- Characteristics and different parties to bills
- Specimen of bill and note
- Difference between bill of exchange and promissory note
- Terms of bill, due date and days of grace
- Disposal or uses of a bill

2.1 Introduction

Under accounting system the transactions are usually categorized into two sections i.e. Cash and Credit. Cash transactions as we all know are those in which immediate transfer of payment (cash) is done. On the other hand credit transactions are those where cash is not paid immediately but it is payable after a specific period subject to whatever conditions were agreed at the time of transaction. The time period decided for the future payment in credit transaction depends on

type of business, current situation, mutual understanding, amount of the transaction and conditions of opposite party.

In present times the frequency of credit transactions has increased hence its importance is rising day-by-day. But if the payments of goods or services given on credit is not received on time, many businessmen have to face financial problems. Hence they always expect to get their payment on time. To maintain liquidity and to overcome this situation, these businessmen use a document through which, the person from whom an amount is receivable, accepts his debt in writing and states the time of payment of amount or accepts to pay at the time stated in the document. If the debtor fails to pay this document can be kept as a proof for the dues.

These documents can be written in two ways: (1) Bills of exchange (2) Promissory note

Check your progress 1

Credit transactions are now a major part of businesses these days

- (a) True
- (b) False

2.2 Bills of exchange

Indian Negotiable Instrument Act, 1881 defines Bill of exchange as, “A bill of exchange is an instrument in writing containing an unconditional order, signed by the drawer, directing a certain person to pay a certain sum of money only at a specified time to a certain person or according to his order or to the holder of the instrument.”

It is also known as letter of exchange.

The acceptance of any bill is very situational but it could be considered as a bill through following features :

1. It must be in writing. Any oral order cannot be considered as a bill.
2. It is an unconditional order to pay. Which means it shouldn't be to any condition and must not be a request.
3. The order to pay should be in the form of Indian currency not for a product or anything in consideration of money.
4. The bill must be addressed to a particular person.
5. The amount mentioned in the bill must be clear.
6. The duration i.e. date mentioned on the bill should be certain and clear.
7. The bill must be signed by the person who is writing the bill.
8. The payment of the bill is done on the demand by the drawer or after the specified period.

Check your progress 2

Bill of exchange is a/an _____ order to pay money.

- (a) Conditional
- (b) Unconditional

There are different parties' w.r.t this instrument. The three parties in bill of exchange are :

1. **Drawer** : He is the creditor or is the one who is selling (seller). He is the person who makes and draws the bill. He is entitled to receive money from the debtor.
2. **Drawee** : He is the debtor or the one who has purchased the goods. The person upon whom the bill is drawn. He is the acceptor of the bill, the one who has to pay.
3. **Payee** : Usually he is the drawer of bill or the person who is going to receive the money or the one who holds it.

Check your Progress 3

_____ is the party to the bill of exchange who accepts the bill.

- (a) Drawer
- (b) Drawee
- (c) Payee

2.3 Specimen of Bill of exchange

Revenue

	Shilp Society,
Rs 10,000	Navrangpura, Ahmedabad
	Date: 25/09/2019

For the value received by you, pay Rupees Ten thousand only to Mitesh or as per his order after three months from today.

To, Shri Soham	(Soham)	(Hitesh)
Sanidhya Flats,	Signature of acceptor	Signature of
Drawer		
Jodhpur, Ahmedabad		

From the above specimen of Bill of exchange, the contents of the bill are as under :

1. **Date** : The date at which the bill is drawn should be written on top right corner. This is important as to determine the maturity of bill.
2. **Amount** : the amount of the bill should be mentioned in figures as well as in words. It should be clear and same at both the places.
3. **Definite person** : in each bill each party must be definite individuals. All the names of parties as well as their addresses must be mentioned.
4. **Period** : this is the term or tenure of the bill which runs from the date of issue of such bills. The period should be clearly mentioned after which the amount is payable.
5. **Signature** : it must contain the signature of two persons. The drawer and the drawee.

6. **Stamp :** In order to recognize a bill legally, it is mandatory to fix a revenue stamp in the proportion of the amount of the bill.

Check Your Progress 4

A ___ stamp is required to make any bill of exchange a legal document.

- (a) Postal (b) Cash
- (c) Revenue

2.4 Bills Receivable and Bills Payable

A bill can mainly be of two types namely Bills Receivable and Bills Payable. A person or trader who has to receive money from other person, he/she draws a bill on that person. The person on whom the bill is drawn is the acceptor. So in this situation where we have two parties, it is a bill receivable for the person who draws the bill and for the acceptor it is bills payable. For e.g. Kashish has to receive Rs 40000 from Ganesh. So in this case kashish would draw a bill on Ganesh for Rs 40000 and Ganesh would accept the same. Hence this bill becomes Bills receivable for kashish and becomes bills payable for Ganesh.

As we know a bill receivable is an asset for the drawer while liability for the acceptor. Both the items are placed under current assets and current liability.

2.5 Terms of Bill, Due Date and Days of Grace

As read above date is one of the important components to be mentioned on the bill of exchange. The date which is mentioned on the bill of exchange is called as Date of drawing of the bill. The similar period is allowed for the payment by the bills drawer to the bill acceptor is termed as Terms of the bill which could be two months, three months. As the bill acceptor has to pay back to the bill drawer whichever amount mentioned on the bill. Hence by the adding the period to the date of the bill on which the bill was drawn becomes the Due date or the Maturity date of the bill.

For e.g. the date on the bill is 21-1-2019 and the period is three months. The due date can be decided as :

Date of drawing of the bill :	21-1-2019
Period of bill :	3 months
Due date of the bill :	21-4-2019

In order to facilitate the payment of money there is some extra period given to the acceptor to pay his due which as known as Grace period of Three days. It means time period of three more days is added to the due date of the bill. So if a bill is dated of 5th march is payable after 3 months, it falls due on 5th June but if we add grace days which are 3 days then the maturity date with days of grace would be 8th June.

There are few conditions to be understood that if maturity date falls on a Sunday or public holiday then the day preceding to the date of maturity of the bill is to be considered. And if the payment of the bill cannot be made on the maturity date due to abnormal circumstances like natural calamities, curfew, riots, close down etc. then the next working day after the maturity date will be considered as the new maturity date.

If the terms of bill is given in days instead of months then number of days should be considered to decide maturity date. E.g. date of drawing the bills is 21–6–2019 and period of bill is 90 days.

Date of drawing of the bill :	21–6–2019
Period of bill :	90 days
Due date of the bill :	21–9–2019

Check your progress 5

The maturity period mentioned on the bill could be in _____

- (a) Months (b) Days
(c) Both

2.6 Disposal or Uses of a Bill

As discussed above there are three parties in a bill– Drawer, drawee and payee. Mostly the drawer and receiver of the money both are the same. The possession of the bill remains with the drawer of the bill or holder of the bill. The following alternatives are possible to the person possessing the bill for the disposal or use of the bill :

- 1. Keep the bill with oneself up to maturity :** this is general or normal condition in which the drawer of the bill keeps the bill as he doesn't need the money earlier or the duration of maturity is of short duration and hence can collect the money on maturity date.
- 2. Discount the bill with bank or Shroff before maturity :** sometimes the drawer needs the money before the maturity date then the bill can be discounted with a bank or a Shroff before the maturity date and the money can be received. For this the holder of the bill must have a good credit in the market. The bank or Shroff doesn't pay the entire amount of the bill but they do deduct a small amount of discount from the total amount. That amount is called discount of bills. This is an income for the bank or Shroff but expense for holder of the bill.
- 3. Endorse the bill before maturity date :** A bill is a document and it can be transferred easily under the negotiable instrument act 1881. This process is endorsing a bill receivable in favor of his debt. The bill can be endorsed by the drawer by putting his signatures at the back of the bill along with the name of the party to whom it is transferred. The act of signing and transferring the bill is called endorsement.
- 4. Send a bill for collection to a bank or Shroff :** usually the holder of the bill or businessmen are busy, hence in order to save time they assign this task to a bank or a Shroff. The bill is sent to the bank or Shroff before its maturity date. This bill doesn't get discounted, but the bank collects the money on the maturity date on behalf of the trader and gets that amount credited to his account or pays it to them.

Check your progress 6

Before the date of maturity of bill, from whom is it discounted by the drawer of a bill ?

- (a) Debtor (b) State government
(c) Central government (d) Bank

2.7 Dishonor of a bill

Under normal situations the acceptor of the bill has to pay the money on its maturity but on the maturity date if the acceptor is not in a position to pay the money or does not want to pay or does not pay the money due to any other reason it can be called as dishonor of a bill.

Due to dishonor of the bill, drawer or other parties might face problems for the collection of money. Usually when a bill is dishonored then it is required to be noted.

2.8 Promissory Note

Along with Bills of exchange there is another instrument also mentioned in Negotiable Instrument Act 1881 termed as Promissory Note. In promissory note the person who has to pay the money to another person, he gives a written promise to pay the amount. The debtor writes a note which is a promise to pay to the creditor.

Negotiable instrument act 1881 defines promissory note as, “An instrument in writing containing an unconditional undertaking, signed by the drawer to pay a certain sum of money only at a specified time to a certain person or according to his order or to the holder of the instrument”.

Check your progress 7

Bill of exchange and Promissory note are two different kinds of negotiable instruments.

- (a) True (b) False

2.9 Characteristics

1. A promissory note must be in writing and not an oral promise.
2. The note must contain a promise to pay certain amount
3. The amount mentioned in the note must be definite and clear
4. The promise mentioned in the note must be the payment of money only, not a product or consideration of money.
5. The promise to pay money should be unconditional.
6. The duration of promissory note and the date of making of the note must be clearly stated.
7. The promissory note must be drawn by a definite person and the drawer must sign it.
8. A revenue stamp of the prescribed amount must be affixed on the promissory note.

2.10 Parties to promissory Note

1. Drawer (maker): Usually he is the debtor.
2. Payee (receiver of money): He is the creditor or the holder of the note.

Specimen of Promissory Note

Rs 12,000

Luv Khush Society,
Navrangpura, Ahmedabad

Date : 30/09/2019

BILLS OF
EXCHANGE

I promise to pay Rupees Twelve thousand only to Kulin Bhai shah or as per his order after two months from today, for the value received.

To,

Kulin bhai shah

Jodhpur, Ahmedabad

Kalpesh Patel

Revenue

Stamp

From the following specimen we could understand the following details of a promissory note :

- 1. Definite person :** Maker i.e. drawer of the promissory note and the receiver of the amount must be definite person in the note. In the above specimen Kulin and Kalpesh are two definite person.
- 2. Date :** The date mentioned on the promissory note while making it is the same date for the issue of the promissory note.
- 3. Period :** The period after which the amount is to be returned must be clearly stated in the note.
- 4. Amount :** The amount payable by the maker must be clearly mentioned in promissory note
- 5. Signature :** it is mandatory that the promissory note must be signed by its maker in order to make a note legally valid document.
- 6. Revenue stamp :** In order to recognize the note legally in the system, it is necessary to affix the revenue stamp depending on the amount of the note. A note without the stamp cannot be considered legal.

2.11 Difference between bill of exchange and promissory note

No.	Basis of difference	Bill of exchange	Promissory note
1	Order or promise	A bill is an unconditional order to pay money	A note is an unconditional promise to pay money.
2	Who draws on whom	It is drawn by a creditor on debtor	A note is made by a debtor and sent to his creditor
3	Parties	There are three parties to a bill– drawer, drawee and payee	There are two parties to a note. Maker of the note and receiver
4	Need for acceptance	It is compulsory for the acceptor to accept the bill on whom it is drawn.	There is no need for any acceptance as it is made by the debtor himself.

RECTIFICATION OF
 ERRORS, BILLS OF
 EXCHANGE,
 ACCOUNTING FOR
 HIRE PURCHASE &
 ELEMENTS OF COST

5	Responsibility of payment	The acceptor is responsible for the payment	The responsibility of payment in the note lies with the drawer.
6	Days of Grace	Three days of grace period is allowed after the period of bill to pay the amount.	No days of grace are allowed in case of promissory note
7	Dishonor	When the acceptor of a bill fails to pay the money on maturity date it is known as dishonor of bill. Notice is to be issued.	No notice is to be issued in case of dishonor
8	Condition	Any common person or trader can draw a bill with condition “Payment to bearer on demand”. Only RBI can issue a promissory note with the condition “Payment to bearer on demand”.	

2.12 Let us sum up

There are different ways to deal in business world, payments of goods and services can be made in variety of ways. One such way is Bill of exchange. It is a written agreement to pay a certain amount to the party at a predetermined date or on demand. There are different entities which are a part of this agreement. There are different dates which are important while dealing with bill of exchange. Another such credit instrument is Promissory note which is different from BOE. Both the instruments help in credit transaction and hence are important to be studied in accountancy.

2.13 Answers for check your progress

Check your progress 1

1-a

Check your progress 2

2-b

Check your progress 3

1-b

Check your progress 4

1-c

Check your progress 5

1-c

Check your progress 6

1–d

Check your progress 7

1–a

2.14 Glossary

1. **Negotiable** : It is a term used for any financial instrument when it is capable of being transferred.
 2. **Unconditional**: anything without conditions or restrictions.
 3. **Liability** : It is an obligation to, or something that one owes to somebody.
 4. **Revenue stamp** : Stamping of receipts or main documents evidencing giving or taking money also need such revenue stamp as an affix in proof. A properly stamped receipt or note gets a priority as an acceptable legal proof over a plain receipt paper.
-

2.15 Assignment

Study the concept of Accommodation Bill and the different features of it being part of bills of exchange

2.16 Activities

A bill dated February 1, 2018 payable 30 days after sight is accepted on February 7, 2018. Please calculate the due date and the due date with days of grace

2.17 Case study

Understand the journal entries in the books of drawer and acceptor of the bills.

2.18 Further readings

1. Financial Accounting, Mukherjee and Hanif, McGraw Hill Education, 2018
 2. Introduction to accounting, T S Grewal, S.Chand & Co, 2010
 3. An Introduction to accounting, S N Maheshwari, Suneel K Maheshwari, Sharad K Maheshwari, Vikas Publishing House, 2013
 4. Financial Accounting, S N Maheshwari, Vikas Publishing House, 2018
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: UNIT STRUCTURE :

- 3.0 Learning Objectives**
- 3.1 Introduction**
- 3.2 Meaning**
- 3.3 Difference between Hire Purchase and Instalment system**
- 3.4 Ascertaining the interest rate**
- 3.5 Accounting records under Hire Purchase System**
- 3.6 Let us sum up**
- 3.7 Answers for check your progress**
- 3.8 Glossary**
- 3.9 Assignment**
- 3.10 Activities**
- 3.11 Case Study**
- 3.12 Further Reading**

3.0 Learning Objectives

After learning this unit you will be able to understand :

Concept and terminology of Hire Purchase

Difference between Hire Purchase agreement and Instalment system

Calculation of interest rate with different information sources

Journal entries in the books of Hirer and vendor

Ledger making in the books of Hirer and vendor

3.1 Introduction

When the goods are sold the purchaser may either make the full payment at one time or may defer the payment. When the payment is delayed, the amount may be paid in monthly, quarterly or yearly instalments. When the price of an article is paid by instalments, the total amount paid is higher than the actual cash price of the article. The excess price is the charge for interest and the risk involved. This arrangement of making the payment in instalments is beneficial to both the seller and the buyer. The seller is able to sell more goods and the buyer can buy expensive items with his limited resources. There are two systems of deferred payments, namely, (i) Hire Purchase System, and (ii) Instalment Payment System. In this unit we will learn in detail about the Hire Purchase System.

3.2 Meaning

A hire purchase agreement is one under which the buyer takes delivery of goods, promising to pay the price in certain number of instalments and until full payment is made, to treat the payment as hire charges for using the said goods. In fact, a hire purchase agreement stipulates that

- (i) The delivery of goods will be given by the owner of goods to the hire purchaser,
- (ii) Payment will be made in instalments,
- (iii) Each instalment will be treated as hire charge so that if default in respect of payment of even the last instalment is made, the seller will be entitled to take away the goods without compensating, the hire purchaser in any form, and
- (iv) If all instalments are paid and the other conditions are fulfilled, the ownership of the goods will pass to the buyer.

Check Your Progress 1

The ownership of goods in Hire purchase system is transferred right after the payment of ____ instalment.

- (a) First (b) Second
- (c) Last

Therefore in case of hire purchase, the seller i.e., the hire vendor gives only the possession of the goods and retains the ownership with him until the last instalment is paid. In other words, the hire purchase is the user of the goods and not the owner. In case he fails to pay any of the instalments the vendor will take his goods back. Apart from that the vendor will not pay back the amount received from the purchaser. Such an amount will be treated as hire charge for the goods. Therefore till the last instalment is paid the hire purchaser has got an option, whether to purchase that particular article or not.

As mentioned earlier, the payment made by the hire purchaser under this system is always more than what he pays if he decided to go in for cash purchase. The reason is that, apart from the cash price, the hire purchase price includes

- i) interest for payment being made over a period of time,
- ii) the payment of the risk taken by the seller,
- iii) Expenditure on the registration, insurance and delivery of goods, etc.

Check Your Progress 2

The Hire purchase price includes

- (a) Down payment (b) Interest
- (c) Both

3.3 Difference between Hire Purchase and Instalment system

Points of Difference	Hire Purchase System	Instalment System
Nature of contract	It is a hiring goods agreement.	It is an agreement of sale.
Ownership	Ownership of goods is transferred after the payment of final instalment.	Ownership of the goods passes to the buyer just signing the agreement.

RECTIFICATION OF ERRORS, BILLS OF EXCHANGE, ACCOUNTING FOR HIRE PURCHASE & ELEMENTS OF COST

Rights	The buyer cannot sell, destroy or transfer the goods.	The buyer can sell, destroy or mortgage or transfer as his/her wish.
Risk	All the risks are borne by the vendor before the payment of final instalment.	All the risks are to be borne by the buyer from the date of agreement.
Risk of return	The buyer can return the goods before making the final instalment.	The buyer cannot return the goods to the seller.
Repair and maintenance	The liability of repair and maintenance lies with the seller provided that the buyer takes the utmost good care.	The buyer is responsible for repair and maintenance.
Forfeiture of instalment paid	In case of default in payment of instalment, paid instalment will be forfeited and treated as hire charges.	The act of forfeiture cannot be activated

Check Your Progress 3

Depreciation is calculated by the Buyer in ____ system.

- (a) Hire purchase
- (b) Instalment
- (c) Both

3.4 Ascertaining the interest rate

As mentioned earlier, when the goods are sold on hire purchase, the price so charged by the vendor is always higher than the cash price. The excess price, the difference between the hire purchase price and the cash price, includes the interest charges and the compensation for risk. However for accounting purposes the difference between the two prices is treated as the payment for interest. Thus there are basically four figures to be remembered which are as follows :

1. Cash Price: It is a capital expenditure for purchase of an asset.
2. Interest
3. Down Payment
4. Instalments

Thus one can say that Hire Purchase price = Cash Price + Interest

Check Your Progress 4

Hire Purchase Price and Cash Price is the same concept when it comes to Hire purchase

- (a) True
- (b) False
- (c) Depends on the situation

While calculating interest we may be faced with the following two situations.

- a) When rate of interest, total cash price and instalments are given
- b) When total cash price and instalments are given but the rate of interest is not given.

In both the above mentioned cases, the interest has to be calculated. Let us now take them one by one

(a) When Rate of Interest, Total Cash Price and Instalments are given.

In this situation, before calculating the element of interest included in each instalment, it will be helpful to ascertain the total amount of interest involved.

This will be ascertained by subtracting the Total Cash Price from the hire purchase price. Then the following steps should be followed for calculating the amount of interest on ' each instalment

- I) Calculate the outstanding cash price at the time of first instalment by subtracting down payment from the total cash price.
- II) Calculate interest on the first instalment. This is to be calculated on the outstanding cash price at the time of first instalment by applying the given rate of interest, in this connection, you should keep in view the mode of instalment I.e., whether the instalment is annual, half-yearly or quarterly. usually, in case of purchases for heavy equipment the instalment is annual,
- III) Calculate the amount of cash price included in the first instalment by subtracting the amount of interest as calculated in step (ii) from the amount of the first instalment.
- IV) Calculate the outstanding cash price at the time of second instalment by subtracting the amount of cash price of the first instalment from the outstanding cash price at the time of first instalment i.e., (i) – (iii).
- V) Calculate, interest on the second instalment by applying the rate of interest to the outstanding cash price at the time of second instalment.

Illustration 1 will help you to calculate the interest with the help of the above mentioned procedure.

Illustration–1

A ltd purchased a machine on Hire Purchase from B ltd on 1st April, 2008 the cash price being Rs 66,000, Rs 20,000 is payable on signing the agreement and the balance in three annual instalments of Rs 20,000 each. The vendor company charges interest @ 15% on the unpaid amount. Let us calculate interest included in various instalments.

Solution :

The cash price is Rs 66000 but the total amount payable is 80,000. Hence the amount of interest is Rs 14000 (80000–66000). This amount of interest is spread over three years as follows:

RECTIFICATION OF
 ERRORS, BILLS OF
 EXCHANGE,
 ACCOUNTING FOR
 HIRE PURCHASE &
 ELEMENTS OF COST

Cash price of machine	66000
Less: down payment	-20000
Amount outstanding	46000
Add: Interest on 46000 @15% for one year	+6900
Amount outstanding	52900
Less: first annual instalment paid	-20000
Amount outstanding	32900
Add: interest on 32900 @15% for one year	+4935
Amount outstanding	37835
Less: second instalment paid	-20000
Amount outstanding	17835
Add: Interest (difference)	+2165
Final instalment	20000

(b) When Total Cash Price and Instalments are given, but rate of interest is not given

When the total cash price, down payment and the amount of each instalment is given, but the rate of interest is not given, the interest will be calculated by procedure mentioned below.

- i) Calculate the total interest by subtracting the total cash price from the total hire purchase price.
- ii) Calculate the amounts of hire purchase outstanding at the beginning of each year after subtracting the down payment.
- iii) Find out the ratio of outstanding amounts calculated in step (ii). If the amount of each instalment is equal, the ascertainment of ratio is simple. For example, if there are four instalments of equal amounts the ratio will be 4 : 3 : 2 : 1 and if there are three instalments of equal amounts, it will be 3 : 2 : 1.
- iv) Apply this ratio to the total interest and calculate the interest on each instalment.

Let us now take an example and clarify the calculation of interest included in each instalment.

Illustration –2

X co ltd purchased a machine on hire purchase from Y co ltd. the cash price Rs 80,000. Rs 20000 is payable on signing the agreement and the balance in three annual instalments of Rs 24000 each. Calculate the amount of interest to be paid by X co ltd.

Solution :

Here the cash price is Rs 80000

$$\begin{aligned}
 &\text{Total contract price} \\
 &= \text{payment on signing the contract} + \text{total amount of instalments} \\
 &= 20000 + 24000 \times 3 \\
 &= 20000 + 72000 \\
 &= 92000
 \end{aligned}$$

Now find out the balance of contract price (amount outstanding) when each instalment becomes due

Contract price	92000
Less: Down payment	20000
Amount o/s on first instalment	72000
Less: First instalment	24000
Amount o/s on second instalment	48000
Less: Second instalment	24000
Amount o/s on third instalment	24000
Less: final instalment	_____

The above mentioned calculations show that the amount outstanding when instalment becomes due is Rs 72000, Rs 48000 and Rs 24000 resp. As such the interest will be in proportion of $72 : 48 : 24 = 3 : 2 : 1$

Interest will be calculated as follows :

Total Payment	92000
Less: cash price	80000

Total interest	12000
Interest for 1st instalment = $12000 \times \frac{3}{6}$	6000
Interest for 2nd instalment = $12000 \times \frac{2}{6}$	4000
Interest for 3rd instalment = $12000 \times \frac{1}{6}$	2000

Apart from these two there are other different calculations also which are to be studied. They are mentioned below :

Calculation of interest when interest is not included in the amount of instalment

There may be certain cases where interest would not be given in the amount of instalment. In such a case instalment given is the amount payable towards cash price of the asset only. Interest must be separately calculated. It can understood from given illustration.

Illustration-3

Bob & Co purchased a machine on hire purchase on 1st April 2012. The terms of the agreement are :

The cash price of machine was Rs 5000

Rs 2000 were to be paid as down payment

The rest of the balance was to be paid in annual instalments of Rs 1000 plus interest.

Interest charged on outstanding balance was 6% per annum.

Depreciation @10% was calculated as per Straight line method

RECTIFICATION OF ERRORS, BILLS OF EXCHANGE, ACCOUNTING FOR HIRE PURCHASE & ELEMENTS OF COST

Solution :

Date	Cash Price (1)	Inst. Including interest (2) (4 + 3)	Interest @6% (3) (1 x 6%)	Inst. Paid towards cash price (4) (1 - 4)	Balance of cash price (5)
1-4-2012	5000	2000	–	2000	3000
31-3-2013	3000	1180	180	1000	2000
31-3-2014	2000	1120	120	1000	1000
31-3-2015	1000	1060	60	1000	–
		5360	360	5000	

So here one can say that the cash price of the machine was Rs 5000 but interest charged on instalment was Rs 360 and due to it the hire purchase price of the machine turns out to be Rs 5360.

Calculation of interest when cash price is not given

Sometimes the cash price of the asset purchased is not given in the example but the rate of interest and amount of instalment is mentioned. In such cases cash price is to be found out. In such examples the calculations are to be made beginning with the last instalment.

Illustration-4

Shri Rajesh Kapoor purchased a machine from Rakesh Khanna & Co on 1-4-2010 on hire purchase system. The balance amount payable in four annual instalment at 10% interest as follows :

31-3-2010	Rs 10900
31-3-2011	Rs 9100
31-3-2012	Rs 7400
31-3-2013	Rs 8800

The down payment paid was Rs 10000. Find out the cash price of the machine.

Solution :

Rate of interest is 10% and so interest at 10/110 will be included in each instalment.

(1) Last instalment (4th) = Rs 8800 $\frac{10}{110}$

Rs 800 is the interest

So the cash price would be Rs 8800 – Rs 800 = Rs 8000. This amount will be added to the 3rd instalment.

(2) Third instalment = Rs 7400 + 8000 = 15400

Interest = 15400 $\frac{10}{100}$

Rs 1400 is the interest

So the cash price would be Rs 15400 – Rs 1400 = Rs 14000. This amount will be added to the 2nd instalment.

(3) Second instalment = Rs 9100 + 14000 = 23100

Interest = 23100 \times 10/100

Rs 2100 is the interest

So the cash price would be Rs 23100 – Rs 2100 = Rs 21000. This amount will be added to the 1st instalment.

(4) First instalment = Rs 10900 + 21000 = 31900

Interest = 31900 \times 10/100

Rs 2900 is the interest

So the cash price would be Rs 31900 – Rs 2900 = Rs 29000 which is the balance of cash price outstanding will be added to the down payment of Rs 10000 to get cash price.

Cash price = Rs 10000 + Rs 29000 = Rs 39000

Total amount paid = Rs 46200 – cash price Rs 39000 = Rs 7200 is the interest.

Calculation of interest when cash price and rate of interest are not given

When neither interest rate is given nor cash price but only amount of instalments are given it may be presumed that equal amount is paid towards cash price in all the instalments. Naturally the amount of interest will go on decreasing along with each instalment.

We may assume that Rs X is the amount paid towards cash price and Rs Y is the amount of interest paid with the last instalment. If amount is paid in three instalments the interest would be 3Y along with the first instalment, Rs 2Y with second instalment and Rs Y with third instalment. Thus,

1st instalment = Rs X + Rs 3Y

2nd instalment = Rs X + Rs 2Y

3rd instalment = Rs X + Rs Y

Check Your Progress 5

If the cash price of machine is Rs 80,000. The down payment made is Rs 20,000 and the hire purchase price is Rs 1,20,000. What will be the interest?

- | | |
|---------------|---------------|
| (a) Rs 40,000 | (b) Rs 20,000 |
| (c) Rs 60,000 | (d) Rs 80,000 |

3.5 Accounting records under Hire Purchase System

There are two parties to a hire purchase agreement, i.e., the Vendor (Seller) and Hirer (Purchaser). Both these parties have to maintain books of account and record all the transactions relating to that particular hire purchase.

Before explaining the accounting records let us first see what information is required for recording the hire purchase transaction in the books of account. The list of items required for accounting records is as follows:

1. Date of Purchase and down payment
2. Date at which the instalments become due
3. Date of closure of accounts

RECTIFICATION OF
ERRORS, BILLS OF
EXCHANGE,
ACCOUNTING FOR
HIRE PURCHASE &
ELEMENTS OF COST

4. Cash Price
5. Hire Purchase Price
6. Number, Amount and Mode of each instalment
7. Rate of Interest VU –
8. Rate of depreciation
9. Method of Depreciation

Let us now see how accounting records are maintained in the books of the purchase. There are two methods by which the purchaser can record the hire purchase transaction in the books of account.

FIRST METHOD

You know that in case of hire purchase, the ownership of the goods passes to the hire purchaser after the last instalment has been paid. Since the goods do not become the property of the purchaser, he does not have any right to debit the asset at its full price. Hence, no entry is passed when the asset is purchased unless it involves down payment. The entries are passed as and when the instalments become due and the amount is paid towards the price of the article. The journal entries are as follows :

(Books of HIRER)

1. When the asset is purchased
No entry
2. When the down payments is made
Asset A/c Dr
 To Bank A/c
3. When the instalment becomes due
Asset A/c Dr (cash price part of instalment)
Interest A/c Dr (interest on instalment)
 To Hire Vendor
4. When instalment is paid
Hire Vendor Dr
 To Bank A/c
5. When Depreciation is charged
Depreciation A/c Dr
 To Asset A/c
6. When Interest and depreciation accounts are closed by transfer to Profit & Loss A/c Profit & Loss A/c Dr
 To Interest A/c
 To Depreciation A/c

(Books of VENDOR)

ACCOUNTING
FOR HIRE PURCHASE

1. sale of goods under hire purchase
Hire Purchaser Dr (with full cash price)
 To Sales A/c
2. On receiving cash down payment
Bank A/c Dr
 To Hire Purchaser
3. On instalment becoming due
Hire Purchaser Dr
 To Interest A/c
4. On getting payment on the due instalment
Bank A/c Dr
 To Hire Purchaser

Thereafter entries nos 3 to 6 would be made on payment of each instalment at the end of the year.

SECOND METHOD

In this method when the asset is purchased on hire purchase, it is assumed that the purchaser has full intention of paying all the instalments. It is believed that hire purchase is just B method of financing fixed assets. Under this method, on purchase of plant and machinery, the Plant & Machinery Account (Fixed Asset) is debited with the total amount of Cash Price, and the corresponding credit is given to Hire Vendor's Account. Interest is recognised and accounted for at the time of instalments becomes due by debiting the Interest Account and crediting the Hire Vendor's Account. For the purpose of accounting for initial cash down payment and annual instalments, the Hire Vendor's A/c is debited on the relevant date, and the credit is given to Bank Account. The following journal entries are passed in the books of the purchaser.

1. When the asset is purchased on hire purchase
Asset A/c Dr
 To Hire Vendor
 (With total cash price)
2. For cash down payment –
Hire Vendor Dr
 To Bank A/c
3. When the first instalment becomes due
Interest A/c Dr
 To Hire Vendor a/c
4. When the first instalment is paid
Hire Vendor a/c Dr
 To Bank A/c

ACCOUNTING
FOR HIRE PURCHASE

	Depreciation A/c	Dr	9500	
	To Asset A/c			9500
	Profit & Loss A/c	Dr	10875	
	To Depreciation A/c			9500
	To Interest A/c			1375
31-3-2010	Machinery A/c	Dr	9056	
	Interest A/c	Dr	944	
	To ABC co ltd a/c			10000
	ABC co Ltd	Dr	10000	
	To Bank A/c			10000
	Depreciation A/c	Dr	9500	
	To Asset A/c			9500
	Profit & Loss A/c	Dr	10444	
	To Depreciation A/c			9500
	To Interest A/c			944
31-3-2011	Machinery A/c	Dr	9819	
	Interest A/c	Dr	490	
	To ABC co ltd a/c			10309
	ABC co Ltd	Dr	10309	
	To Bank A/c			10309
	Depreciation A/c	Dr	9500	
	To Asset A/c			9500
	Profit & Loss A/c	Dr	9900	
	To Depreciation A/c			9500
	To Interest A/c			490
Entries in the books of ABC co ltd (Seller-vendor)				
1-4-2008	Ajmer Mfg co ltd	Dr	47500	
	To sales A/c			47500
	Bank A/c	Dr	20000	
	To Ajmer Mfg co ltd a/c			20000
31-3-2009	Ajmer Mfg co ltd	Dr	1375	
	To Interest a/c			1375
	Bank A/c	Dr	10000	
	To Ajmer Mfg co ltd a/c			10000
	Interest a/c	Dr	1375	
	To Profit and loss a/c			1375
31-3-2010	Ajmer Mfg co ltd	Dr	944	
	To Interest a/c			944

RECTIFICATION OF ERRORS, BILLS OF EXCHANGE, ACCOUNTING FOR HIRE PURCHASE & ELEMENTS OF COST	Bank A/c	Dr	10000	
	To Ajmer Mfg co ltd a/c			10000
	Interest a/c	Dr	944	
	To Profit and loss a/c			944
31-3-2009	Ajmer Mfg co ltd	Dr	490	
	To Interest a/c			490
	Bank A/c	Dr	10309	
	To Ajmer Mfg co ltd a/c			10309
	Interest a/c	Dr	490	
	To Profit and loss a/c			490

Ledgers in the books of Ajmer Mfg Co ltd (Hirer)

Machinery Account

		Rs			Rs
1-4-08	To bank a/c	20000	31-3-09	By depreciation	9500
31-3-09	To Abc co ltd	8625	“	By Bal c/d	19125
		28625			28625
1-4-09	To bank a/c	19125	31-3-10	By depreciation	9500
31-3-10	To Abc co ltd	9056	“	By Bal c/d	18681
		28181			28181
1-4-10	To bank a/c	18681	31-3-11	By depreciation	9500
31-3-11	To Abc co ltd	9819	“	By Bal c/d	19000
		28500			28500

ABC co Ltd a/c

		Rs			Rs
31-3-09	To bank a/c	10000	31-3-09	By machinery	8625
				By Interest	1375
31-3-10	To bank a/c	10000	31-3-10	By machinery	9056
				By interest	944
31-3-11	To bank a/c	10309	31-3-11	By machinery	9819
				By interest	490

Interest A/c

		Rs			Rs
31-3-09	To ABC co ltd	1375	31-3-09	By P &L a/c	1375
31-3-10	To ABC co ltd	944	31-3-10	By P &L a/c	944
31-3-11	To ABC co ltd	490	31-3-11	By P &L a/c	490

Depreciation A/c

		Rs			Rs
31-3-09	To Machinery a/c	9500	31-3-09	By P &L a/c	9500
31-3-10	To Machinery a/c	9500	31-3-10	By P &L a/c	9500
31-3-11	To Machinery a/c	9500	31-3-11	By P &L a/c	9500

3.6 Let us sum up

Hire Purchase is one of the most commonly used methods of financing for various acquired assets. It helps by spreading the huge costs of an asset over a longer period of time. Hence it frees capital to be utilised in other options of investment.

It is an agreement between Hirer and Vendor to buy and sell the goods with an initial payment. But in this agreement the ownership is transferred after the last instalment. Interest is charged by the vendor for the future payments or instalments.

The accounting treatment is also to be understood in the books of both Hirer and vendor with necessary ledgers.

3.7 Answers to check your Progress

Check your progress 1

1-c

Check your progress 2

1-c

Check your progress 3

1-a

Check your progress 4

1-b

Check your progress 5

1-a

3.8 Glossary

1. **Instalment** : It is a sum of money paid in small parts over a fixed period of time. It is usually a part of staged payment plan of a loan.
2. **Down payment** : It is an initial payment paid after something is bought on credit.
3. **Hirer** : Hirer is defined as a person who has taken the goods on hire purchase in the agreement. He is also known as buyer.
4. **Vendor** : Vendor is defined as a person who has sold the goods on hire purchase to hirer. Also known as seller.

3.9 Assignment

Under the formal and legal procedure of Hire Purchase agreement with proper required documentation.

3.10 Activities

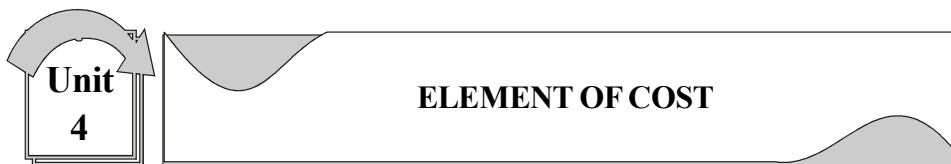
On 1st April, 2018, Punjab Collieries obtained a machine on the hire purchase system, the total amount payable being Rs 5, 00,000. Payment was to be made Rs 1, 00,000 down and the balance in four annual instalments of Rs 1, 00,000 each. Interest charged was at the rate of 15 per cent. At what value should the machine be capitalized?

3.11 Case study

Choose any three items which are normally available on hire purchase or rental items. Find out the cost of buying by cash, hire purchase or leasing for a year. Prepare a table find out findings. Explain the advantages and disadvantages for three of them.

3.12 Further readings

1. Financial Accounting, Mukherjee and Hanif, McGraw Hill Education, 2018
 2. Introduction to accounting, T S Grewal, S.Chand & Co, 2010
 3. Financial Accounting, Dr V K Goyal, Excel Books, 2007
 4. Financial Accounting, S N Maheshwari, Vikas Publishing House, 2018
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: UNIT STRUCTURE :

4.0 Learning Objectives

4.1 Introduction

4.2 Meaning of Cost

4.3 Various Elements of Cost

4.4 Classification of Cost

4.5 Let Us Sum Up

4.6 Answers for Check Your Progress

4.7 Glossary

4.8 Assignment

4.9 Activities

4.10 Case Study

4.11 Further Readings

4.0 Learning Objectives

After learning this unit, you will be able to understand :

- Meaning of Cost
- Elements of Cost
- Classification of Cost

4.1 Introduction

In previous units we discussed about the various aspects of Financial Accounting starting with the identification and recording of transactions till the preparation of final accounts to know the profit or loss of the business. However, financial accounting deals with historical data, reveals only the overall business result rather than department or group wise, and doesn't classify the cost with its various sub classification. Cost accounting has been developed as a means of overcoming the limitations of financial accounting and also to provide detailed Depreciation Accounting, Final Accounts and Elements of information regarding the classification of cost and cost ascertainment. In this unit, you will learn about the various elements of cost and its classification.

4.2 Meaning of Cost

The dictionary meaning of cost is „a loss or sacrifice , or „an amount paid or required in payment for a purchase or for the production or up keep of something, often measured in terms of effort or time expended . C I M A Terminology defines cost as „resources sacrificed or forgone to achieve a specific objective . Cost is generally measured in monetary terms. Cost is the amount of expenditure (actual or notional) incurred on or attributable to, a specified thing or activity. Thus, material cost of a product will mean the expenses incurred in

procuring, storing and using materials in the product. Similarly, labour cost will represent that part of payment made to the workmen for time spent on the product during its manufacture.

Check your progress 1

1. _____ is resources sacrificed or forgone to achieve a specific objective.
 - a. cost
 - b. price
 - c. money

4.3 Various Elements of Cost

The various components of cost can be broadly classified into three categories.

1. **Material :** It is the cost of raw materials purchased by the firm.
2. **Labour :** It is the amount of remuneration paid to the employees in the form of wages, salaries, bonus, commission, etc.
3. **Expenses :** It is the cost of various services availed by the firm e.g., electricity, rent, stationery, etc.

The above classification of cost is broad based and general. For cost accounting purposes, these cost need to be further sub classified. These costs are explained below.

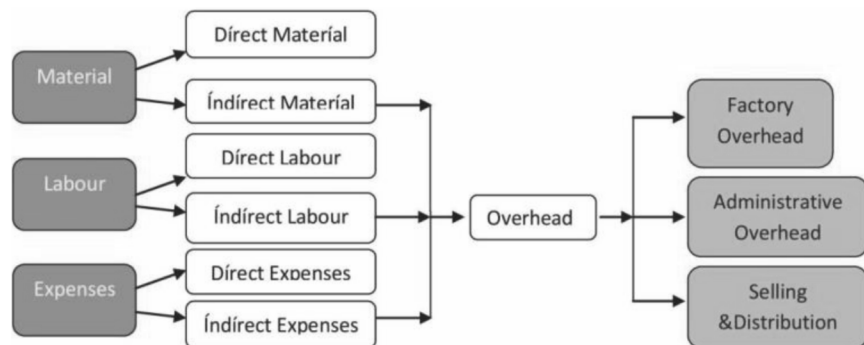


Fig. 3.1 : Elements of Cost

1. Materials :

The original product from which the final product is manufactured is the material. It may be in raw or semi manufactured state. Material may be Direct and Indirect.

Direct material is material identified with or allocated to cost centers and cost units. It is the raw or semi finished material out of which a product is manufactured. For example, leather shoes are produced out of leather, butter is produced out of milk, and steel utensils are produced out of stainless steel and so on. Thus, leather, milk and stainless steel are the direct materials for the manufacture of shoes, butter and steel utensils respectively.

Unlike direct material, another kind of material may be required for manufacturing. For example, machines used for production require lubricants, jute and cotton wastes etc. which are indirect materials.

Direct material is a component of prime cost and indirect material is a component of factory overhead. Direct material directly varies with the output whereas indirect material does not.

2. Labour :

To convert the raw materials into finished goods, human effort is required which is called labour. Labour can be Direct and Indirect.

Direct wages are the wages which are allocated to cost centres and cost units. They are wages paid to the workers who produce goods. In manual work, the worker is the one who produces goods. When work is done by a machine, the person who collects input and output and in whose Depreciation Accounting, Final Accounts and Elements of Cost account the output is credited for the purpose of payment of wages is direct worker.

Other workers help direct workers in supplying materials, power, supervision and maintenance. These are indirect workers and wages of indirect workers at different stages of production are indirect wages. Direct wage is a part of prime cost while indirect wage is a part of factory overhead. The former directly varies with the output whereas the latter may not vary so.

3. Expenses : Cost incurred on items apart from materials and labour is grouped under the heading of expenses.

Apart from direct material and direct labour, there are expenses that might be necessary for a particular production. This expense is called direct expense and can be easily identified with or allocated to cost centres or cost units. For example, when an order is received, a manufacturer will have to prepare a mould exclusively for this purpose. The cost of the mould will be direct expense of the production. Similarly, the charge for hiring a special plant for production is also direct expense and it can be and allocated to cost centres or cost units. The cost of preparing blue print for a production is another example of direct expense.

The expenses which cannot be related with indirect material or indirect labour are called indirect expenses. These are expenses which cannot be identified or linked with a particular cost centre or cost unit. For example rent, rates, depreciation on fixed assets, insurance, etc. overhead is the indirect expense incurred at different levels of activities of an enterprise. These expenses cannot be conveniently identified with or allocated to cost centres or cost units. For a manufacturing concern, overheads can be grouped under three categories.

a. Factory overheads : Factory or works overhead refers to all indirect expenses of a factory. It includes the following :

- Wages of all factory staff excluding those of direct workers
- Indirect material
- Rent
- Rates
- Taxes of factory
- Depreciation of factory assets
- Excise duty

RECTIFICATION OF
ERRORS, BILLS OF
EXCHANGE,
ACCOUNTING FOR
HIRE PURCHASE &
ELEMENTS OF COST

- Canteen expenses
- Labour welfare expenses
- b. Office and administrative overheads :** All expenses related to general administration. In administrative building, following things are included:
 - Salary of administrative staff
 - Rent
 - Rates
 - Taxes of administrative accommodation
 - Postage
 - Telegram and telephone
 - Stationery
 - Lighting of administrative building
 - Depreciation of office appliances
 - Depreciation of office appliances, etc. is included in administration overhead.
- c. Selling overhead :** All expenses related to sales. In selling overhead, following things are included:
 - Salary of sales staff
 - Traveller s commission
 - Advertisement
 - Rent
 - Rates
 - Taxes of sales office
 - Depreciation of sales office appliances
 - Cost of participation in industrial fares and exhibitions
 - Cost of free gifts
 - Cost of free after sales service
 - Normal bad debt
- d. Distribution Overhead :** All expenses related to the delivery of a product after the sale is done. In distribution overhead, following things are included:
 - Delivery van expenses
 - Fright and insurance
 - Packing for delivery loading and unloading
 - Salary of the delivery men
 - Customs duty

Check your progress 3

1. material is material identified with or allocated to cost centres and cost units.
 - a. Direct
 - b. indirect

4.4 Classification of Cost

The different costs can be grouped according to their common characteristics. They are :

1. Nature/Elements
2. Functions
3. Behaviour
4. Controllability
5. Normality
6. Time
7. Capital/Revenue

1. Nature/Elements : On the basis of nature or elements, costs can be classified into three categories i.e. materials, labour and expenses. These costs are further sub classified as direct and indirect. This classification of cost has already been discussed in the earlier paragraphs.

2. Functions : In an organization which manufacture and sell goods, four main costs are incurred i.e. manufacturing, office and administration, selling and distribution and research and development. The first three types of cost have already been discussed. Research and development cost is explained below.

Research and development cost : Research cost is the cost incurred for the improvement of the existing product or development of new product of methods of new application of materials. Development cost involves the cost of putting the research results on commercial basis.

3. Behaviour : Due to change in the volume of production, there are changes in the level of cost. Such costs can be classified as fixed cost, variable cost and semi variable cost. Fixed costs are the ones which have to be paid for any level of production. Example, rent of the factory building. Variable costs vary with the change in the production level. Example direct material cost. Semi variable costs are the ones which partly vary and partly remain fixed with the changes in the volume of production. For example, electricity bill. If the volume of production is increased the use of electricity will also increase which would result in the increased electricity bill. If the volume of production decreases the use of electricity will also decrease which would result in the reduced electricity bill. If there is zero production, still a fixed amount of electricity rental has to be paid. Thus, the rent portion of the electricity bill is fixed cost and the usage of the power is a variable cost.

4. Controllability : Costs can be either controllable or uncontrollable. Controllable cost is affected by the actions of the people associated with it. Such costs are within the control of management. The management can decide how much is to be spent on the particular cost. Examples are direct material, direct labour and direct expenses. Uncontrollable costs are beyond the control of management. Most of the fixed costs are uncontrollable in nature. For example the rent of the factory premises is fixed and has to be paid whether there is production or not.

5. **Normality** : Costs which are normally incurred to produce a certain level of output is referred to as the normal cost. However, in abnormal situation where cost need to be incurred even if there is no production, is referred to as the abnormal cost. For example, payment of wages to workers even when they have gone on strike. Abnormal cost is not included in cost of production, but recorded in the costing profit and loss account.
6. **Time** : Costs can be historical or predetermined. Historical cost is the one, which is ascertained after its occurrence. Example, after purchasing the raw materials, the cost of materials consumed is ascertained. Predetermined or estimated costs are the ones which are computed in advance. They can also be referred to as the forecasted cost.
7. **Capital and revenue** : Any cost incurred for buying an asset is referred to as the capital cost. Example cost of heavy machinery purchased to produce goods. Capital cost is incurred to increase the earning capacity of the business. In order to maintain the machinery certain costs need to be incurred like repairs, renewals and overhauling. These costs are referred to as the revenue cost.

Check your progress 5

1. cost is affected by the actions of the people associated with it. Such costs are within the control of management.
 - a. controllable
 - b. uncontrollable

4.5 Let Us Sum Up

In this unit we studied about the elements of cost. We learnt the dictionary meaning of cost is „a loss or sacrifice , or „an amount paid or required in payment for a purchase or for the production or upkeep of something, often measured in terms of effort or time expended . Cost is generally measured in monetary terms. Cost is the amount of expenditure (actual or notional) incurred on or attributable to, a specified thing or activity. We even came to know about the various elements of cost which can be broadly categorised into three which are as under.

Material, Labour, Expenses

Best efforts have been made to explain these topics to the readers. The readers will get a detailed insight about the cost and its elements. There are so many types of cost, each of these cost have been explained in the detail with example.

4.6 Answers for Check Your Progress

Answers: (1-a)

Answers: (1-c)

Answers: (1-a)

Answers: (1-b)

Answers: (1-a)

4.7 Glossary

1. **Suspense Account** : A temporary account used to force a trial balance to balance if there is only a small discrepancy (or if an account's balance is simply wrong and one do not know why).
2. **Trading Account** : An account, which shows the gross profit or loss of a manufacturing or retail business, i.e. sales less the cost of sales.
3. **Trial Balance** : A statement showing all the accounts used in a business and their balances.

4.8 Assignment

Explain the elements of cost in context to Car as a Product.

4.9 Activities

Distinguish between fixed, variable and semi-variable cost.

Check your progress 1

Check your progress 4

Check your progress 5

Check your progress 2

Check your progress 3

4.10 Case Study

Distinguish between capital and revenue cost.

Check your progress 2

1. Rent is a _____ type of expense.
 - (a) Material
 - (b) Labour
 - (c) Administrative
 - (d) Selling & Distribution

Check your progress 4

1. _____ costs are to be paid for any level of production
 - (a) Production
 - (b) Fixed
 - (c) variable

4.11 Further Readings

1. Prof. P. R. Bhonde and Dr. Shirish Limaye: Cost and Works Accounting.
2. Fundamentals Of Cost Accounting, Maheshwari Sn, Sultan Chand & Sons, 2007.
3. Cost Accounting, Jain S P, Narang K L, Kalyani, 2007.
4. Cost Accounting, Jawaharlal, McGraw Hill education, 2008

Block Summary

After reading this block the readers would have got a detailed insight of topics such as rectification of errors, bills of exchange, accounts for hire purchase and elements of cost. All these topics have been explained by the writers in their best possible way.

After reading this block the best efforts were made by the writer to make the students understand the basic concepts of all these topics. Sufficient theory along with suitable illustrations, numerical were given to make the students understand the topics. Apart from this the student were made to understand about the various topic such as rectification of errors, bills of exchange, accounts for hire purchase and elements of cost.

Each topic focuses on individual aspect of accounting such as rectification talks about the changes to be done in the errors made while making the accounts. Bills of exchange talk about the different instruments needed today to make any credit transactions and how they turn out to be beneficial for the business. Hire purchase throws some light on the different method used by business to purchase goods while the payment is done in the instalments with certain conditions for the buyer as well as seller. And lastly the elements of cost help understand students the different kinds of costs and on which basis they are differentiated in the business.

Block Assignment

Short Answer Questions

1. Discuss entries passed for Hirer and Vendor
2. What is Hire Purchase
3. Define Promissory Note
4. Days of grace
5. Down payment
6. Fixed and variable cost

Long Answer Questions

1. Discuss the errors affecting trial balance
2. Explain the dishonor of a bill
3. Differentiate between Hire Purchase and Instalment system
4. Discuss the types of cost along with examples.
5. Difference between promissory note and bills of exchange

RECTIFICATION OF
 ERRORS, BILLS OF
 EXCHANGE,
 ACCOUNTING FOR
 HIRE PURCHASE &
 ELEMENTS OF COST

Enrolment No :

1. How many hours did you need for studying the units?

Unit No	1	2	3	4
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block :

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Language and Style	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Illustration used (Diagram, tables etc)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Conceptual Clarity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Check your progress Quest	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Feed back to CYP Question	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____

3. Any Other Comments

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