1.2 INTRODUCTION

In this unit we will be discussing on the various concepts, meaning of accounting, about accounting principles, concepts and standard.

Accounting is the measurement, statement or provision of assurance about financial information primarily used by managers, investors, tax authorities and other decision makers to make resource allocation decisions within companies, organizations, and public agencies. The terms derive from the use of financial accounts.

Accounting is a service activity. Its function is to provide quantitative information primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions, and in making reasoned choices among alternative courses of action.

1.3 CONCEPT OF ACCOUNTING

Meaning of accounting:

Accounting is a social science. It caters to the needs of the society as well as business. A society is always changing, so also the form of business organization. For the purpose of ascertaining the amount of profit earned (or loss incurred), in the enterprise a complete and systematic record of business transactions are required to be maintained.

Accounting helps a business in having a complete and systematic record of its business transactions, reporting the results of its operation and interpreting such results for the purpose of effective control of future operations or activities.

Definitions of Accounting:

The term accounting has been defined by different authors as under:

According to R.N Anthony, “nearly every business enterprise has accounting system. It is a means of collecting, summarizing, analyzing and reporting in monetary terms, information’s about business”.

GBA S2 03

FINANCIAL ACCOUNTING

SEMESTER - 2

BUSINESS ADMINISTRATION

BLOCK - 1

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

Subject Expert

Prof. Nripendra Narayan Sarma, Maniram Dewan School of anagement.,KKHSOU

Prof. Munindra Kakati, VC, ARGUCOM

Prof. Rinalini Pathak Kakati, Dept. of Business Administration, G.U.

Course Coordinator

Dr. Smritishikha Choudhury, Assistant Professor, Management, KKHSOU

Dr. Chayanika Senapati, Assistant Professor, Managemennt, KKHSOU

SLM Preparation Team

Units	Contributors
1, 2 & 3	Prof P. K Jain Dept of Business Administration Gauhati University
4 & 6	Prof. B.B. Dam, Principal Advisor, Royal School of Commerce
5	Shweta Jalan NERIM

Editorial Team

Content : Prof. H.C Gautam, Dept of Commerce, GU

Language : Retd Prof. Robin Goswami, Cotton College, Guwahati

October, 2017

© Krishna Kanta Handiqui State Open University

This Self Learning Material (SLM) of the Krishna Kanta Handiqui State Open University is made available under a Creative Commons Attribution-Non Commercial-Share Alike 4.0 License (international): http://creativecommons.org/licenses/by-nc-sa/4.0/

Printed and published by Registrar on behalf of the Krishna Kanta Handiqui State Open University

Head Office : Patgaon, Rani Gate, Guwahati-781 017

City Office : Housefed Complex, Dispur, Guwahati-781 006; Web: www.kkhsou.in

The University acknowledges with thanks the financial support provided by the Distance Education Bureau, UGC for the preparation of this study material.

UNIT 1: FUNDAMENTALS OF ACCOUNTING

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Concept of Accounting

- 1.3.1 Difference between Accountancy and Accounting
- 1.3.2 Accounting as Science and Art
- 1.3.3 Features of Accounting

1.4 Scope and Functions of Accounting

1.5 Accounting Principles

- 1.5.1 Meaning of Accounting principles
- 1.5.2 Generally accepted Accounting
- 1.5.3 Features of Accounting principles
- 1.5.4 Need / Importance of Accounting principles
- 1.5.5 Classification of Accounting principles

1.6 Accounting Concepts

1.7 Meaning of Accounting Standard

- 1.7.1 Definition of Accounting Standard
- 1.7.2 Benefits of Accounting Standards

1.8 Recognition and Measurement of the elements of Financial Statement

1.9 Let Us Sum up

1.10 Further Reading

1.11 Answers To Check Your Progress

1.12 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- discuss the concept of Accounting
- describe the scope and functions of Accounting
- identify the accounting principles and concepts
- learn accounting standard
- learn recognition and measurement of the elements of Financial Statement

UNIT 5. Bank Reconciliation Statement

Pass book and statement of decerent; Concept of Bank Reconcilition statement; Importance of Bank Reconciliation statement; Distinctions between Bank statement and Bank Reconciliation Statement; Preparation of Bank Reconciliation Statement; Causes of differences

UNIT 6. Hire-Purchase Purchase System

Meaning and Features of Hire Purchase System; Advantages and Disadvantages of Hire Purchase System; Rights and Obligations of Hire Purchaser and Seller; Accounting for Hire Purchaser System.

COURSE INTRODUCTION:

This course is designed to provide a basic understanding of financial accounting, including introductory accounting theory, concepts, principles and procedures. Financial accounting gathers and summarizes financial data to prepare financial reports such as balance sheet and income statement for the firm's management, investors, lenders, suppliers, tax authorities, and other stakeholders.Thecourse consists of 12 units and the course is divided into two blocks :

Block 1 deals with the Fundamentals of Accounting, The Double-Entry System, Concept of Ledger, Meaning and features of Trail balance,Sectional Ledger Balancing System, Concept of Bank Reconcilition statement and the concept Hire Purchase System

Block 2 concentrates on some of the most important concepts of Installment Purchase System final Accounts, depreciation , partnership, financial statement analysis and ratio analysis.

Each unit of these blocks includes some along-side boxes to help you know some of the difficult, unseen terms. Some "EXERCISES" have been included to help you apply your own thoughts. You may find some boxes marked with: "LET US KNOW". These boxes will provide you with some additional interesting and relevant information. Again, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your progress of study. It will be helpful for you if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with "ANSWERS TO CHECK YOUR PROGRESS" given at the end of each unit. you in making your learning more active and efficient. And, at the end of each section, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with "ANSWERS TO CHECK YOUR PROGRESS" given at the end of each unit.

BLOCK INTRODUCTION:

This is the *First Block* of the course '***Financial Accounting***'. After completing this block, which consists of six units, you will be able to get a fairidea on the different concepts in financial accounting.

This block comprises the following six units :

The first unit introduces us to the Fundamentals of Accounting, Concept of Accounting, Accounting Principles, Concepts and Standards, Recognition and Measurement of the elements of Financial Statement.

The second unit gives us a broad overview of the accounting Process, Double-Entry System, Books of Accounts, and Journal.

The third unit gives us an idea on Ledger and Ledger Posting, Balancing of an Account and Procedure for Balancing of an Account, Trial Balance.

The fourth unit will help us in understanding the concept of Sectional and self balancing ledger system, its advantages, defects, procedure for self balancing ledger system, preparation of total debtors and creditors account.

The fifth unit gives us a broad overview of Bank Reconciliation Statement.

The sixth and the last unit is about Hire-purchase and installment purchase system , Meaning and Features of Hire Purchase System, Advantages and Disadvantages of Hire Purchase System, Rights and Obligations of Hire Purchaser and Seller, Accounting for Hire Purchaser System.

The structure of Block 1 is as follows :

UNIT 1 : Fundamentals of Accounting

UNIT 2 : Accounting Mechanics -I

UNIT 3 : Accounting Mechanics -II

UNIT 4 : Sectional and Self Balancing Ledger Systems

UNIT 5 : Bank Reconciliation Statement

UNIT 6 : Hire-Purchase System

BACHELOR OF BUSINESS ADMINISTRATION

FINANCIAL ACCOUNTING

BLOCK-I

DETAILED SYLLABUS

UNIT 1. Fundamentals of Accounting

Concept of Accounting : Difference between Accountancy and Accounting, Accounting as Science and Art, Features of Accounting; Scope and Functions of Accounting; Accounting Principles : Meaning of Accounting principles, Generally accepted Accounting, Features of Accounting principles, Need / Importance of Accounting principles, Classification of Accounting principles; Accounting Concepts; Meaning of Accounting Standard : Definition, Benefits of Accounting Standards; Recognition and Measurement of the elements of Financial Statement

UNIT 2. Accounting Mechanics : I

The Double-Entry System : Practical application of the Principle of Double Entry, Meaning of Account, Meaning of Debit and Credit, Classification of Accounts; Golden rules of Accounting; An Introduction to the Books of Accounts; Journal : Format of Journal, Process of Journalizing.

UNIT 3. Accounting Mechanics : II

Concept of Ledger : Meaning of Ledger, Need for Ledger and Subdivision of Ledger, Format of a Ledger Account, Distinction between Journal and Ledger; Ledger Posting : Meaning of Posting and basic Points regarding posting, Procedure for Balancing of an Account; Trial Balance : Meaning and features of Trail balance, Preparation of a Trial Balance; Methods of preparation of Trial Balance; The Suspense Account; Nature of Ledger Account Balances

UNIT 4. Sectional and Self Balancing Ledger Systems

Meaning of Sectional Ledger Balancing System; Features of Sectional Ledger Balancing System; Advantages of Sectional Ledger Balancing System; Defects of Sectional Ledger Balancing System; Procedure of Sectional Ledger Balancing System : Preparation of Total Debtors' Account, Preparation of Total Creditors' Account; Meaning and Features of Self-Balancing Ledger System; Advantages of Self- Balancing Ledger System; Procedure of Self- Balancing Ledger System : Entries to be passed under Self- Balancing Ledger System, Posting from the Sales Book when Ledgers are on Self-Balancing Ledger System, Self-Balancing of Debtors' Ledger, Self- Balancing of Creditors' Ledger, Self- Balancing of General Ledger

practice'. The word 'Principle' when applied in accounting may have different meanings in different contexts. It is not used in the sense of a fundamental accounting truth – it connotes a guiding influence or an accepted rule of action or conduct.

Accounting principles have been defined as the body of doctrine, commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternative exist.

In simple words, 'Accounting Principles' may be defined as those rules of conduct or procedure which are adopted by the accountants universally for recording and reporting of financial data.

1.5.2 Generally Accepted Accounting Principles (GAAP)

Accounting is a practical activity. Historically, the accounting professionals have not been very much concerned about the theoretical base of their profession. But gradually their job has been regarded as supplier of financial information for use by the economic decision makers. With the growth in business and financial activities, this job of an accountant is being put under scrutiny. They have to satisfy all the users of their financial statements. They have to apply certain concepts, conventions and postulates while preparing and presenting accounting information for the assistance of decision makers. Persons engaged in the accounting profession frequently face problems in the matters relating to:

a. which economic resources and obligations should be recorded as assets and liabilities in financial accounting,
b. which changes in assets and liabilities should be recorded,
c. when these changes should be recorded,
d. how the assets and liabilities and changes in them should be measured,

According to Smith and Ashburne, "accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the result thereof".

In whatever way the term accounting is defined, its universally accepted objective is to record all the transactions in monetary units and to report them to its users in useful manner in the form of financial statements. These financial statements provide accounting information which is used by various interested parties for decision making. We will discuss on financial statement in the sec 1.8

1.3.1 Differences between Accountancy and Accounting

The term 'Accountancy' and 'Accounting' are often considered as synonymous. However, there are some fundamental differences between the two.

'Accountancy' is profession while 'Accounting' is the methodology. The term 'Accountancy' refers to a systematic knowledge of accounting with the principles and techniques of application in accounting. It provides rules, principles, methods, concepts and conventions for recording, classifying and summarizing of financial transactions and accounting information in a systematic manner. Accountancy also tells us the methods, procedures and ways how to communicate with the interested parties.

According to Eric L. Kohler "Accountancy is the theory and practice of accounting: its responsibilities, standards, conventions and activities."

According to F.W. Pixley, "Accountancy is the science which deals with recording of monetary transactions of every description".

Thus, accountancy is regarded both as a science and as an art; this will be discussed in the following sec i.e. Sec 1.3.2. It is the subject which speaks about the principles and practices of Accountancy. Again, accounting is the art of recording, classifying

and summarizing the financial transaction in a systematic manner and interpreting the results to achieve predetermined objectives. Accounting is based on the rules, principles and technique of application formulated by the subject, accountancy.

1.3.2 Accounting as Science and Art?

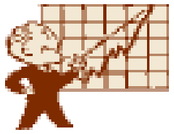
A question arises, whether Accounting is a science or an art? Before deciding whether it is a science or an art or both, it is better to go through the meaning of the two terms – science and art.

Science may be defined as a systematized body of knowledge based on certain principles which have universal application. It establishes the relationship of cause and effect about any occurrence or happening. Scientific knowledge is based on observation, experiments and testing of facts.

On the other hand, art is the application of knowledge comprising of some accepted theories, principles, rules, concepts and conventions. It helps to achieve the goals and tells us the manner in which we may attain our objectives in the best possible way. The more an art is practiced, the more expert one becomes in it.

Accounting is considered as science because recording, classifying and summarizing of business transactions is done on the basis of certain principles such as principle of double entry system which has universal application. However, in accounting, the relationship of cause and effect is not studied which is a basic feature of pure sciences. It may, therefore, be said that accounting is a science but not a pure science.

Since accounting is applied in different organizations belonging to different industries, it has not been possible to develop principles which have universal applicability. Accounting is based on certain concepts and conventions called Generally Accepted



CHECK YOUR PROGRESS

Q1. What do you mean by Accounting

.....

.....

.....

.....

Q2. Write down the features of Accounting

.....

.....

.....

.....

Q3. Write down the functions of Accounting

.....

.....

.....

.....

Q4. Fill in the blanks:

a) The financial position of the business is ascertained by preparing a statement called .....

b) The main objective of accounting is to keep a complete record of ..... of the entity.

c) Each and every transaction is recorded in the books of account in terms of .....

d) According to F.W. Pixley, “Accountancy is the science which deals with ..... transactions of every description”.

1.5 ACCOUNTING PRINCIPLES

1.5.1 Meaning of Accounting Principle

Principle means a general law or rule adopted or professed as a guide to action ‘a settled ground or a basis of conduct or

(a) To keep systematic record of business transactions: The main objective of accounting is to keep a complete record of business transactions of the entity. This record is required to be maintained according to specified principles and rules. Keeping of compel record of business transactions helps to avoid the possibility of omission and fraud. For this purpose, all the business transactions are recorded first in Journal or Special Purpose Books and then posted into Ledger.

(b) To ascertain the result of operation: Another objective of accounting is to ascertain the result of operation carried on by the business during an accounting period. The result of operation may be either profit earned or loss suffered. A Trading and Profit & Loss Account of the business is prepared at the end of each accounting period to ascertain profit or loss. In the profit and loss Account, the revenue of the business is matched with the expenses incurred.

(c) To ascertain the financial position of the business : The financial position of the business is ascertained by preparing a statement called Balance Sheet. In this statement, the values of all the assets and liabilities of the business are shown. For a businessman, merely ascertaining the profit or loss of the business in not enough, he must also know the financial health of the business. For this purpose, after preparing the Profit & Loss Account a statement called 'Balance Sheet' is prepared which shows the assets and their values on the one hand and the liabilities and capital on the other.

(d) To provide information to various parties : Another main objective of accounting is to communicate the accounting information to various interested parties like owners, investors, creditors, banks, employees and government authorities etc. This information helps them in taking sound and judicious decisions about the business entity.

Accounting Principles, (which will be discussed in sec 1.5.2), and are subject to some limitations. It may be influenced by bias and personal judgment of the accountant. The more a person is involved in accounting work, the more proficient he becomes in it. From this point of view, accounting is still an art. It tells us the manner in which some special objectives such as ascertaining the trading results of an entity for a particular period and the financial position of the entity on a particular date can be ascertained.

From the above discussion, it may be concluded that accounting is both a science and an art.

1.3.3 Features of Accounting

An analysis of the definitions of accounting brings out the following as features of accounting:

(i) Accounting is an art: Accounting is considered as an art because it requires the application of some special knowledge comprising of some accepted theories and principles.

(ii) Identification of financial events: In course of daily activities, a number of events take place. Accounting is concerned with only those events which are of financial nature. These events are termed as economic activities. In other words, only those events which can be measured in terms of money, called business transactions, are identified for the purpose of recording.

(iii) Recording of financial transactions: Only the financial transactions are recorded according to some specified rules in the books of accounts. Books of accounts to be maintained depend on the nature and size of the business. Only those transactions and events which are of a financial character are recorded in accounting. There are a number

of events in the business which are very important for business but which cannot be measured and, expressed in terms of money and hence such transactions will not be recorded.

For example, the quarrel between the Production Manager and the Sales Manager, resignation by an able and experienced manager, strike by employees and starting of a new business by the other competitor etc. Though these events affect the earnings of the business adversely but as not one can measure the effect of such events in terms of money, these will not be recorded in the books of the business.

(iv) Classifying the business transactions: Classification is the process of grouping the transactions or entries of the same type or similar nature in one place. This is done by opening accounts in the ledger. In the ledger, the transaction involving a particular account is recorded in that account only.

(v) Summarizing the information: Summarizing involves the preparation of reports and statements from the classified data (ledger) in a manner understandable to the user of accounting information. This involves the balancing of ledger accounts and the preparation of Trial Balance with the help of such balances. Final Accounts, which include Trading the Profit & Loss Account and a Balance Sheet, are prepared with the help of Trial Balance.

(vi) Recording in terms of money: Each and every transaction is recorded in the books of account in terms of money only. For example, if a businessman purchases 30 Chairs and 5 Tables, their values in terms of money will be recorded in the books. Similarly, if a business possesses Rs. 5,000 in Cash; Land measuring 1,000 Square Meters; 2 Machines; 5 ton of raw materials; 30 Chairs; 5 Tables, and so on, then in the absence of money measurement these different

types of assets cannot be added up and hence cannot give any useful information. Bit if they are expressed in terms of money, they will immediately provide useful information such as, Cash Rs. 5,000; Land Rs. 80,000; Trucks Rs. 2,00,000; Machines Rs. 60,000; Goods Rs. 40,000; Furniture Rs. 20,000 (30 chairs and 5 tables together).

(vii) Interpretation of the results: In Accounting, the results of the business are presented in such a manner (i.e., by preparing Trading and Profit & Loss Account and Balance Sheet) that the various parties interested in the business such as proprietors, managers, employees, bank, creditors, etc. can have full information about the profitability and the financial position of the business.

1.4 SCOPE AND FUNCTIONS OF ACCOUNTING

SCOPE OF ACCOUNTING : The scope of modern accounting is indeed very wide, it is not merely concerned with record-keeping, but is also concerned with a whole range of activities involving:

a. Planning
b. Control
c. Decision making
d. Problem-solving
e. Performance measurement
f. Co-ordination and directing
g. Auditing
h. Tax-determination and planning
i. Cost accounting
j. Management accounting
k. Financial Accounting.
l. Stock broking

FUNCTIONS OF ACCOUNTING : The following are the main objectives or functions or utilities of accounting:

1.7.2 Benefits of Accounting Standards

Accounting standards are now a days regarded as a major component in the framework of accounting and reporting practices. They help the accountants to apply these practices as the most suitable for some given circumstance. Following are the benefits:

1. **Credibility of Financial Statements:** Standards when used in accounting make the financial statements fair to all the groups of users. They imply that among the various alternatives, the most suitable one has been adopted in a given situation. Standards make the statements conform to a particular model for the sake of comparability. Thus they improve the credibility and reliability of financial statements.
2. **Benefits to Accountants and Auditors:** Standards provide guidelines for accounts and auditors in the performance of their duties. They can resort to these standards as a shield against any prosecution for alleged lapse of duties such as discovered frauds, etc. Moreover, they are used as controlling techniques by the chartered institutes for the functioning of their members.
3. **Measuring Managerial Accountability:** Standards facilitate in determining specific corporate accountability and regulation of the company. They measure managerial skill and improve the profitability of a company. They ensure consistency and comparability of financial statements. They reduce the manipulation of accounts.
4. **Reforming Accounting Theory and Practice:** Standards help in the development of accounting theories and in the improvement of existing practices by rectifying their defects where there is any. They make us aware of alternative possibilities for defining and measuring financial performance.

e. what information should be disclosed;

f. how it should be disclosed; and

g. which financial statement should be prepared.

An effort has been made to solve these problems by applying Generally Accepted Accounting Principles (GAAP) which help to bring about uniformity in the reporting of financial events of the entities.

Generally Accepted Accounting Principles (GAAP) is a guide to the accounting profession in the choice of accounting techniques for the purpose of recording, preparing and presenting the financial statements.

1.5.3 Features of Accounting Principles

The features of Accounting Principles are as follows :

a. Accounting principles are made and developed by men (accountants) and, as such, they do not have the authoritativeness of universal principles, like other natural sciences, viz. Physics, Chemistry, Mathematics etc. It is an empirical science i.e. based on what is experienced or seen.

b. The general acceptance of an accounting principle usually depends on how well it satisfies three criteria: Relevance, Objectivity and Feasibility. The word ‘relevant’ implies that the information will be useful to the users. The word ‘objectivity’ implies that the recorded data are reliable and verifiable. The word ‘feasibility’ implies that the implementation of the principle in practice will be without much complexity and cost.

c. Accounting principles cannot be validated /proved by reference to natural laws, as in the case of physical sciences. They are the best possible suggestions based

on practical experiences, reasons and observations which have been developed by the persons/authorities engaged in the accounting profession over the years.

d. Accounting principles are developed for common usage to ensure uniformity and understandability.

e. Accounting principles are in the process of evolution, i.e., are not in their finished form. On the other hand, they are fast developing.

f. They are not rigid.

1.5.4 Need / Importance of Accounting Principles

(a) Uniformity of Accounting: Accounting is considered as the language of business. Accounting as a language, should be understandable to all, must follow certain principles uniformly all over the world. Therefore, accounting principles bring about the uniformity in accounting practices.

(b) Comparability of accounting information: Accounting principles, if consistently followed, will make the accounting information comparable over a number of periods. Therefore, accounting information must satisfy the criteria of comparability so that it can be useful to the users.

(c) Reliability of Accounting Information: Financial statements show operational results and financial position for the users. Therefore, this information must be uniform and reliable for any decision making purposes. Accounting principles make the financial statements more reliable and non-biased.

(d) Neutrality in Accounts: Financial information is required by different classes of users having conflicting interests. Accounting principle help to maintain neutrality in presenting the financial information and leave little scope for statements becoming biased to a particular class of users.

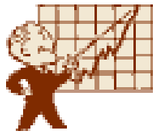
1.7.1 Definition of Accounting Standard

The term 'Accounting Standards' may be defined as written statements issued from time to time by the institutions of accounting profession.

Littleton defines Standards as follows: "A Standard is an agreed upon criteria of what is proper practice in a given situation; a basis for comparison and judgment; a point of departure when variation is justifiable by the circumstances and reported as such. Standards are not designed to confine practice within the rigid limits but rather to serve as guide-posts to truth, honesty and fair dealing. Again they are not accidental but intentional in origin; they are expected to be expressive of the deliberately chosen policies of the highest types of business and the most experienced accountants. They direct a high but attainable level of performance, without precluding justifiable departures and variations in the procedures employed."

According to Bromwich, accounting standards are uniform rules for financial reporting. The standard sellers seek to prescribe a preferred accounting treatment from the available set of methods for treating one or more accounting problems. They deal with financial measurements and disclosures used in financial statements. They draw the boundaries within which acceptable conduct lies. They reflect society's changing corporate behaviour. They are vehicles in social and political monitoring and control of the enterprise. They provide flexible and realistic working guidelines for accounting practitioners.

Thus Accounting Standard (AS) is standardized accounting practices formulated by a recognized professional body such as Accounting Standard Board (ASB) in India. These standards are observed by the accountants in order to harmonize the operating results and to bring about uniformity in accounting practices.



CHECK YOUR PROGRESS

Q5. Write down the meaning of Accounting Principle

.....

.....

.....

.....

Q6. What do you mean by GAAP

.....

.....

.....

.....

Q7. What are the two types of Accounting principles

.....

.....

.....

.....

Q8. Write the different Accounting Concepts

.....

.....

.....

.....

1.7 MEANING OF ACCOUNTING STANDARD

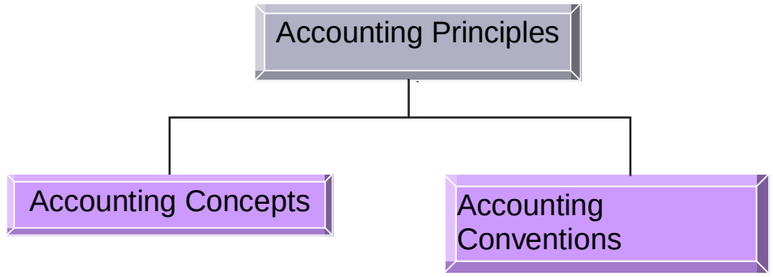
The word ‘standard’ in accounting literature is of a recent origin. Standard is generally known as principle till 1969. At the end of 1969, the British introduced the term ‘Standard’ when they set up their ‘Accounting Standard Streering Committee’ and the Americans adopted the same term ‘Standard’ in 1973 by creating ‘Financial Accounting Standards Board.’ In India, the term became popular when the Institute of Chartered Accountants of India formed ‘Accounting Standard Board’ (ASB) in April, 1977.

(e) Guidelines to Accountants: Accounting principles provides guidelines to the accountants in preparing and presenting financial statements in different situations. Thus the scope of personal choice is reduced to the minimum.

1.5.5 Classification of Accounting Principles

Traditionally, accounting principles were classified into two categories:

The International Accounting Standards (IAS – I) has classified the accounting principles into (A) Fundamental Accounting assumptions (Concepts), and (B) Accounting Policies (Conventions).



1.6 ACCOUNTING CONCEPTS

Accounting is the language of business. The affairs of a business unit are communicated to others as well as to owners, managers, etc. through accounting information which has to be suitably recorded, classified, summarized and presented. If the language is to be understood by all, it must contain certain concepts which are universally understandable. So, the accountants have agreed upon a number of concepts which they try to follow in accounting. These are explained in short as below:

1. **Business Entity Concept:** Accountants treat a business as a distinct entity, separate from the persons who own it. Thus, it becomes possible to record the transactions of the business with

the proprietor also. If the businessman introduces cash into the business, he becomes a creditor of the business, and his contribution is recorded as capital. Thus, business affairs are not mixed up with the private affairs.

2. **Money Measurement Concept:** Accounting records only those transactions which are expressed in monetary terms. Non-monetary events are ignored, even if they are otherwise important, thus, the purchase of furniture will be recorded in the books of accounts while the death of a very efficient manager will be ignored though it may greatly affect the business.

3. **Cost Concept:** Transactions are recorded in the books of account at the amounts actually involved. No **arbitrary** values, put on transactions, are considered. Thus, if a plot of land in Guwahati is purchased for Rs.10, 000 though it is word Rs.1,00,000 will be recorded in the books. However, in some cases estimated values are taken into consideration, e.g. depreciation, etc.

arbitrary : having any value or form.

4. **Going Concern Concept:** It is assumed that the business will exist for a long time and transactions will be recorded with that end in view. This concept classifies expenditure into capital and revenue. Expenditure that will render benefit over a long period is called capital expenditure while the expenditure which will be exhausted quickly, say, within a year, is termed as revenue expenditure. The purchase of a building is a capital expenditure because it will render benefit over a long period while purchase of stationery is revenue expenditure because stationery will be consumed in a short period, say, in a year. This concept is also very important from the point of view of profit measurement.

5. **Dual Aspect Concept:** Each transaction has two aspects. If a business has acquired an asset, it must have resulted in any one of the following:

   (a) Some other asset has been given up; or

   (b) Obligation to pay for it has arisen; or

   (c) There has been a profit, which the business owes to the proprietor; or

   (d) The proprietor has contributed for the acquisition of the asset.

The reverse is also true. So the equation is—

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

Or

$$\text{Capital} = \text{Assets} - \text{Liabilities}.$$

The above equation is called the accounting equation which is explained later on.

6. **Realization Concept:** Accounting is a historical record of transactions. It records what has happened but does not record anticipated events. It means legal transfer of goods and services either in cash or on credit creating a legal obligation to pay in future. However, adverse effects of events that have already occurred are usually recorded. Thus, cash realized or a legal obligation to pay is recorded in the books.

7. **Accrual Concept:** If an event has occurred, its consequence will follow. If a transaction is not settled in cash, nevertheless it is proper to record the event in the books. Thus expected future cash receipts and payments are considered in accounting. As for example; unpaid salaries and wages, prepaid rent etc. are taken into account.

8. **Matching Concept:** Though the business is a continuous affair, its continuity is artificially split into several accounting years for determining the periodical results. Thus, expenses of a particular period are compared with the revenues of that period to determine the net operational results of that accounting period. As for example; rent for twelve months whether paid or not is matched against the revenues earned during these twelve months.

   In addition to these, legal position of transactions should be considered while recording such transactions e.g. Hire Purchase transactions.

receivable from various parties, or the amount payable to the suppliers of goods from the records. He can also ascertain the result of the business and the financial position of his business at the end of a given period. Besides, he can use such information as needed to get finance from the banks. From memory it is not possible to do all these unless proper records are maintained. Accounting takes care of all these functions.

In this unit we are going to learn on the double entry system, how to make journal, accounting process

2.3 THE DOUBLE ENTRY SYSTEM

Double entry system states that each transaction has two fold aspects and the effects of these two fold aspects are opposite in nature. If one aspect, receives a benefit, there must be another aspect to impart that benefit. The system of book-keeping under which both the aspects of every transaction is recorded in the books of account is known as “Double entry system of Book-keeping”.

Under this system, every transaction is recorded in an accounting format having two sides namely left hand side and right hand side. For a transaction, the account which receives the benefit is called a debtor and it is recorded on the left hand side of the format which, in book-keeping, is known as debit side. At the same time, the other account of the transaction, which imparts the benefit is known as a creditor and is recorded on the right hand side of the accounting format which, in book-keeping, is known as credit side. Thus, every transaction is recorded in its two-fold aspects. That is why this system is known as Double entry system. Under this system of book keeping for each transaction the debit amount must be equal to the credit amount.

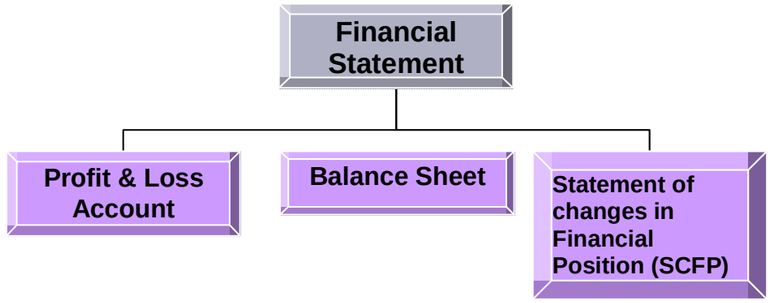
LET US KNOW



Double Entry System was first propounded in 1340, in Genoa, in Italy, and was used by stewards for rendering accounts in the state; but is was developed in proper form in Venice at the end of 15th century by Fra Luca Pacioli, a Franciscan monk of Italy. He is considered as the father of modern accountancy.

1.8 RECOGNITION AND MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENT

The end product of the financial accounting process is set reports that are called ‘financial statements’. The following generally constitute the financial statements:



(1) Profit and Loss A/c.

(2) Balance Sheet.

(3) Statement of changes in Financial Position (SCFP)

Profit and Loss A/c : Profit and Loss account, also known as income statement, presents the results of operation of a business enterprise for a period of time. This statement shows net profit or net income of an entity for a period of time. Net profit or income is the difference between revenue and expenses. The profit and loss account indicates how successful a business enterprise has been in achieving its profit goal for a given time span. It also gives the sources and amounts of revenue earned and the different types and amounts of expenses. Net profit indicates an enterprise’s accomplishments (expenses) in pursuing its operating activities. When expenses exceed revenue for a period, a business enterprise incurs a net loss.

Balance Sheet : Balance Sheet shows the financial position of a business on a certain date. For this reason, it is often called the ‘statement of financial position’. Balance sheet indicates the inventing and financial activities of a business enterprise at a point of time and shows a firm’s assets, liabilities, and equity capital usually at the close of the last day of a month or a year. Assets are economic resources

and provide future benefits to a firm such as cash, inventories, debtors, building, plant, patents, goodwill etc. Liabilities are creditors or outsider's claims on the assets of a business enterprise such as creditors, accounts payable, salaries payable, income tax payable, debentures. Liabilities include shareholder's equity as well which are in the form of ordinary shares, preference shares, and retained earnings. Shareholder's equity is the shareholder's or owner's claim on the asset of a firm. The shareholders have claims against the assets of a company only after all creditors' claims have been met.

Statement of Changes in Financial Position : A statement of changes in financial position (SCFP) shows where the financial resources (funds) have come from (sources) and where they have gone (uses). SCFP is generally prepared on working capital basis and cash basis. Working capital – based SCFP explains increase or decrease in working capital for a specified period of time. It reports:

(a) Amount of changes in working capital associated with the operating activities of a firm.

(b) Long term financing or other sources that cause an increase in the working capital

(c) Long term investment activities or other uses that causes a reduction in the working capital.

The cash basis SCFP is popularly known as the 'Cash Flow Statement'. Cash is considered as the business lubricant. This statement summarizes the flow of cash in and out of the firm over a period of time. It focuses on various items which bring out changes in the cash balance between two balance sheet dates. A cash flow statement covers all items which increase or decrease the cash of a business enterprise. In USA, a statement of cash flows is legally required to be prepared by US companies along with Income Statement and Balance Sheet.

Among the above statements, balance sheet is considered a status or

UNIT 2: ACCOUNTING MECHANICS: 1

UNIT STRUCTURE

2.1 Learning Objectives
2.2 Introduction
2.3 Double-Entry System
2.3.1 Practical application of the Principle of Double Entry
2.3.2 Meaning of Account
2.3.3 Meaning of Debit and Credit
2.3.4 Classification of Accounts
2.4 Golden rules of Accounting
2.5 Introduction to the Books of Accounts
2.6 Journal
2.6.1 Format of Journal
2.6.2 Process of Journalizing
2.7 Let Us Sum up
2.8 Further Reading
2.9 Answers To Check Your Progress
2.10 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- describe the meaning of account, debit, credit
- discuss the concept of books of accounts
- outline the format and process of journalizing

2.2 INTRODUCTION

In the earlier unit, we got an idea about the concept of accounting, its scope and functions, the various accounting principles and financial statement. Business activities usually increase with their growth in size and volume. As they grow it becomes impossible for a businessman to keep in memory all such activities for a long period of time. Hence, the recording of these activities is necessary. If you are a businessman, keeping accurate and organised records is vital to the success of your business. From such records, the businessman can ascertain the amount

Ans. to Q.5.: 'Accounting Principles' may be defined as those rules of conduct or procedure which are adopted by the accountants universally for recording and reporting of financial data.

Ans. to Q.6.: Generally Accepted Accounting Principles (GAAP) is a guide to the accounting profession in the choice of accounting techniques for the purpose of recording, preparing and presenting the financial statements.

Ans. to Q.7.: (a) Accounting Concepts; and (b) Accounting Conventions

Ans. to Q.8.: a) Entity Concept Money b) Measurement Concept c) Cost Concept d) Going Concern Concept e) Dual Aspect Concept f) Realization Concept g) Accrual Concept h) Matching Concept



1.12 MODEL QUESTIONS

Q1. Define Accounting and the scope of accounting.

Q2. Briefly explain the functions of Accounting.

Q3. What do you mean by 'Accounting Concepts'?

Q4. What are accounting conventions? Explain them?

Q5. Explain briefly the underlying principles:-

a) A business unit is normally considered as having an indefinite life. Discuss.

b) Recognize all losses, anticipate no gain.

Q6. Mention the advantages and disadvantages of Money-Measurement Concept.

Q7. What are the golden rules of accounting?

Q8. Explain in details as how recognition and measurement of the elements of Financial Statements take place.

stock report and the other two statements – Income Statements and Statement of changes in Financial Position – are known as flow reports. Balance sheets, as shock reports, show the information about the resources of an organization at a specified moment of time. The income statement and statement of changes in financial position (working capital and cash basis) as the flow reports, show the activities of the enterprises for a period of time, say for a year, half-year, or a quarter summarizes

Fig 1.1: Information provided by the Financial Statements

PROFIT AND LOSS ACCOUNT	⇨	PROFITABILITY
BALANCE SHEET	⇨	SOLVENCY
STATEMENT OF CHANGES IN FINANCIAL POSTION	⇨	SOURCES AND USES OF FUNDS

rm of

- Accounting is both science and art
- The characteristics of accounting are:
  - ➢ Identification of financial events
  - ➢ Recording of business transactions
  - ➢ Classifying the business transactions

- Summarizing the information
- Recording in term of money
- Interpretation of result

- The functions of accounting are
  - To keep systematic record of business transactions
  - To ascertain the result of operation
  - To provide information to various parties
  - To ascertain the financial position of the business
- Accounting Principles are those rules of conduct or procedure which are adopted by the accountants universally for recording and reporting of financial data.
- Generally Accepted Accounting Principles (GAAP) is a guide to the accounting profession in the choice of accounting techniques for the purpose of recording, preparing and presenting the financial statements.
- Accounting principles were classified into two categories:
  (1) Accounting concept
  (2) Accounting Conventions
- The following are the various concept of accounting :
  - Entity Concept
  - Money Measurement Concept
  - Cost Concept
  - Going Concern Concept
  - Dual Aspect Concept
  - Realization Concept
  - Accrual Concept
  - Matching Concept
- Financial statements generally constitute the following :
  (1) Profit & Loss account
  (2) Balance Sheet
  (3) Statement of Changes in Financial position



1.10 FURTHER READING

1. Ashis Bhattacharya,(2006), *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari,(2014), "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*", Capital Publishing Company, Guwahati
4. R. L. Gupta and M. Radhaswamy, (2017), "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.
5. S.C. Jain & K.L. Narang,(2006), "*Accounting Theory and Management Accounting*", Kalayani Publishers.



1.11ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q.1.: Accounting is the measurement, statement or provision of assurance about financial information primarily used by managers, investors, tax authorities and other decision makers to make resource allocation decisions within companies, organizations, and public agencies.

Ans. to Q.2.: a) Accounting is an art b) Identification of financial events b) Recording of business transactions c) Classifying the business transactions d) Summarizing the information e) Recording in terms of money f) Interpretation of the results

Ans. to Q.3.: a) To keep systematic record of business transactions b) To ascertain the result of operation c) To ascertain the financial position of the business d) To provide information to various parties

Ans. to Q.4.: a) Balance Sheet b) Business transactions c) money d) recording of money.

4. Plant and machinery is an example of ……..account.
5. Capital account is an example of ……...account.
6. Commission received will be classified under ……. account.

2.5 INTRODUCTION TO THE BOOKS OF ACCOUNTS

Recording of transaction is a process of entering the transactions in the proper books of accounts in a systematic manner. It means putting into black and white the transactions that take place in course of business activities. Normally transactions are first recorded in a book of original entry, called Journal.

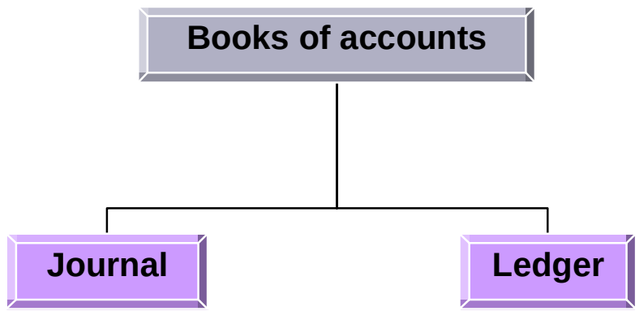
Books of accounts are specially printed and ruled books where the accounts of a firm are kept or written up. The two main books of accounts of a business entity are Journal and Ledger.

Different classes of books of accounts:

There are two different classes of books of accounts which are maintained by a business entity. They are:

(a) Books of original entry or Primary book (Journal); and

(b) Principal book or book of Final entry (Ledger).



2.3.1 Practical application of the Principle of Double Entry

All business transactions involve the transfer of value in the form of money, goods or services from one party to another. So, it involves two parties. One party gives some benefit while another party receives the benefit of an equivalent value. For the purpose of recording, the transactions are analyzed further to ascertain the two aspects affected by each transaction.

Most important point to be kept in mind at this stage is that for the purpose of recording, a transaction is required to be analyzed from the point of view of the party in whose books of accounts the recording is to be made. This analysis is required in order to ascertain the accounts affected by the transaction.

For example, Mr. A paid Rs.500 to Mr. B. Most important point to be considered is – in whose books of account the recording is to be made? If the recording is to be made in the books of A, from his point of view, we find the Cash has gone out and 'B' has received the same. Therefore, the two-fold aspects are Cash and 'B'. Since an account is maintained for each type of asset and the person to receive the benefit is 'B', the accounts affected are Cash Account and the Account of B. Under Double entry system recording will be made in both Cash Account and in the account of B.

Thus, every transaction has two aspects, viz.

(i) The receiving of value on the one hand; and

(ii) The giving of the same value on the other hand.

Both the receiving and giving aspects take place between the 'two account heads' of each party involved in the transactions.

2.3.2 Meaning of Account

An account is a summarized record of all transactions of similar

nature relating to a particular person, an asset, an item of income or an item of expense. A businessman should classify and summarize all the business transaction of similar nature or with the same person under respective groups. Each such group or head is known as an 'Account' or 'Account heads'. For example, all dealings with 'Sourav' will be recorded under the heading 'Account of Sourav'. Account is abbreviated as 'A/c'.

Definition of Account:

According to R.N. Carter, "An account is a ledger record, in summarized form, of all the transactions that have taken place with the particular person and the value specified".

Format of Account:

The account is generally prepared in 'T' form having two sides namely, left hand side and right hand side. A specimen form of an account is given below:

Cash Account

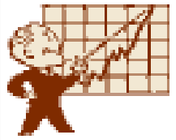
Dr. Cr.

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

All accounts are divided into two sides. The left hand side of the account is called 'debit side'. It is indicated by 'Dr.' (abbreviation for debit) on the top corner of the left hand side. Right hand side of the account is called 'credit side.' It is indicated by 'Cr.' (abbreviation for credit) on the top corner of the right hand side of the account. The name of the account is written at the top in the centre. The word 'Account' or its abbreviation 'A/c' is added to the name of the account. For example, Building A/c, Furniture A/c, Salary A/c.

(ii) American Approach or Modern Approach:

S.No.	Class of Account	When to Debit	When to Credit
1	Asset Account	Increase	Decrease
2	Liabilities Account	Decrease	Increase
3	Capital Account	Decrease	Increase
4	Revenue(Income) Account	Decrease	Increase
5	Expense Account	Increase	Decrease
6	Drawings Account	Increase	Decrease



CHECK YOUR PROGRESS

Q1. Classify the following items into Personal, Real and Nominal Accounts:

1. Capital 2. Sales 3. Drawings
4. Outstanding salary 5. Cash 6. Rent 7. Interest paid
8. Indian Bank 9. Discount received 10. Building

Q2. Choose the correct answer:

1. The receiving aspect in a transaction is called as:
   a) debit aspect b) credit aspect c) neither of the two
2. The giving aspect in a transaction is called as
   a) debit aspect b) credit aspect c) neither of the two
3. Ram's account is an example of:
   a) personal A/c b) real A/c c) nominal A/c

Q3. Fill in the blanks:

1. Every business transaction reveals…….. aspects.
2. The incoming aspect of a transaction is called …….. and the outgoing aspect of a transaction is called ……..
3. Impersonal accounts are classified into …….. types.

(d) Revenue Accounts: Revenue Accounts are the accounts of incomes and gains. For example, sales, discount received, interest received, Commission received etc. These accounts are taken into account for preparation of Trading & Profit and Loss Account.

(e) Expense Accounts: Expense Accounts are the accounts of expenses incurred and losses suffered by an entity. For examples; purchases, wages paid, depreciation, rent paid, rates and taxes, etc. like Revenue Account, expense accounts are also taken into account for preparation of Trading & Profit and Loss Account.

However, in case of sole proprietorship/ partnership form of business, another account called 'Drawings Account' is also maintained in order to record the transactions relating to withdrawals of cash or goods made by the proprietor / partners for their personal use.

2.4 GOLDEN RULES OF ACCOUNTING

The rules of debit and credit under English Approach or Traditional Approach are termed as 'Golden Rules of Debit and Credit'. These rules are as under:

(i) English Approach or Traditional Approach:

S.No.	Name of Account	Debit Aspect	Credit Aspect
1	Personal	The receiver of benefit	The giver of benefit
2	Real	What Comes in	What Goes out
3	Nominal	All Expenses and Losses	All income and gains

2.3.3 Meaning of Debit and Credit

In accountancy, to debit an account means to record the transactions on the left hand side on an account which receives the benefit. Left hand side of the account is called the debit side. It is abbreviated as 'Dr.' the word 'debit' originated from the Latin word 'Debitum'. It means what is due.

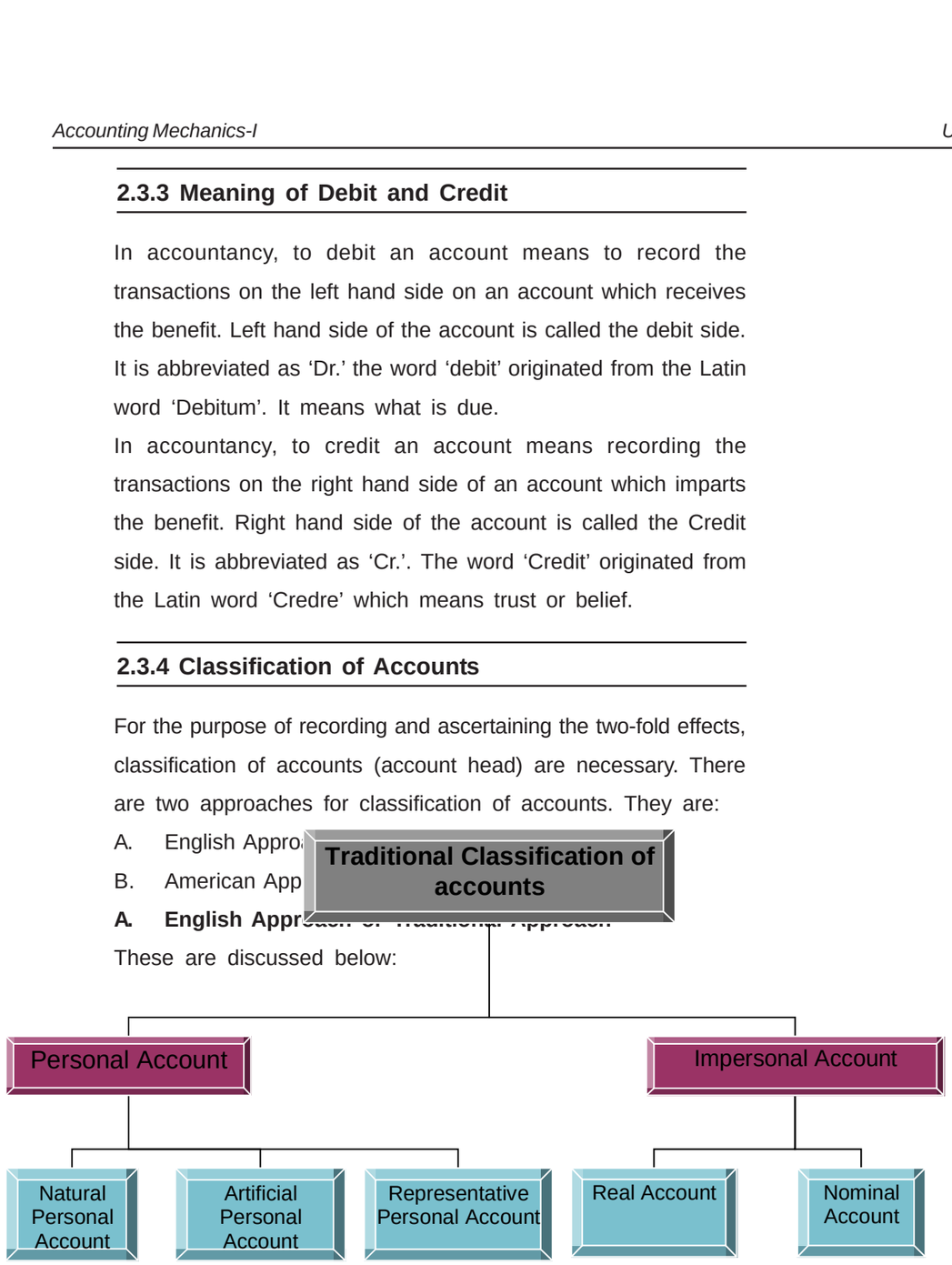
In accountancy, to credit an account means recording the transactions on the right hand side of an account which imparts the benefit. Right hand side of the account is called the Credit side. It is abbreviated as 'Cr.'. The word 'Credit' originated from the Latin word 'Credre' which means trust or belief.

2.3.4 Classification of Accounts

For the purpose of recording and ascertaining the two-fold effects, classification of accounts (account head) are necessary. There are two approaches for classification of accounts. They are:

A. English Appro
B. American App
A. English Appr

These are discussed below:



1. **Personal Account:** The element or account which represents person or organizations.

   (i) **Accounts of Natural persons:** Account heads recording the transactions of individual human beings fall into the category of natural persons. For example, accounts of Ram, Jadu, Suresh, Jayanta, Raja etc.

   (ii) **Accounts of Artificial persons:** Accounts recording the transactions concerning a firm, company, institution, association, organization etc. fall into this category. For example, Gauhati Commerce College A/c, J.B. College A/c, M/s. Baruah Brothers A/c, Assam Tea Company A/c, N.F. Railway A/c.

   (iii) **Representative Personal Accounts:** These are the accounts which represent a certain person or a group of persons although the names of the concerned person or persons are not mentioned in the account head. Such type of account head occurs in cases of outstanding expenses, prepaid expenses, income receivable and income received in advance. For example Wages outstanding. For example; Outstanding Salary, Salary Repaid, Unexpired Insurance or Insurance paid in Advance, Commission Received in Advance etc.

2. **Impersonal Accounts:** All those accounts which are not personal accounts. This is further divided into two type's viz. real and nominal accounts.

   (i) **Real Accounts :** The 'account heads' recording transactions relating to tangible things (which can be seen, touched or physically exchanged such as goods, cash, land, building, machinery, etc. are classified as real accounts).

There are some intangible items which do not have a physical shape and which cannot be seen or touched but the presence can be felt and can be bought and sold. For example; goodwill, patents, trademarks, copyrights, etc. They also fall within the category of real accounts.

(ii) **Nominal Accounts:** The accounts recording transactions relating to losses, expenses, incomes and gains are classified as nominal accounts. For example; Salaries, Wages, Rent paid, Discount allowed, Discount Received, Commission paid, Commission Received, Interest paid, interest received etc.



LET US KNOW

When any 'Prefix' or 'Suffix' is used before / after any nominal account head, such account is classified as Representative Personal Account under Traditional approach.

B. American Approach or Modern Approach:

According to the American approach or Modern approach, accounts are classified into five categories as under:

(a) **Assets Account :** Assets account are the accounts of assets and properties such as land, building, plant, machinery, patents, cash in hand, cash at bank, investments, inventory, etc. held by an entity. This category also includes the accounts of debtors.

(b) **Liabilities Account:** Liabilities accounts are the accounts pertaining to the liabilities of the entity to lenders, creditors for goods, creditors for assets, creditors for expenses, etc.

(c) **Capital Account:** Capital is the amount with which the business is started. It is the account of the owner who invests money in the business as capital.

Dec 31: Goods distributed by way of free samples Rs 1000

Solution:

In the books of Mr A. Bora Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
Dec 1	Cash A/C Dr. To Capital A/c (*Being Comencement of the business)*		40000	40000
Dec 3	Bank A/C Dr. To Cash A/c (*Being Cash deposited in the bank)*		2000	2000
Dec 5	Purchases A/C Dr. To Capital A/c (*Being purchase of goods for cash)*		15000	15000
Dec 8	Cash A/c Dr. To Sales A/c (*Being goods sold for cash)*		6000	6000
Dec 10	Furniture A/c Dr. To Bank A/c (*Being purchase of furnirure, paid by cheque)*		5000	5000
Dec 12	Arvind Dr To Sales A/c (*Being sale of goods)*		4000	4000
Dec 14	Purchases A/c Dr To Rahul (*Being purchase of goods From Rahul)*		10000	10000
Dec 15	Rahul Dr. To Purchases Returns A/c (*Being goods returned to Rahul)*		5000	5000
Dec 16	Cash A/c Discount A/c To Arvind (*Being cash received from Arvind in full settlement and allowed him Rs 40 as discount)*	Dr.	3960 40	4000

2.6 JOURNAL

Books of original entry means the books of accounts where the transactions are recorded as and when they take place. The first book of original entry is called 'Journal'.

Journal is a book of original entry in which transactions are originally recorded in chronological order (in order of date) from source documents showing the accounts to be debited and credited in a systematic manner. Thus, the Journal provides a date-wise record of all the transactions with details of the accounts and amounts debited and credited for each transaction with a short explanation.

The word 'Journal' has been derived from the French word **'JOUR'** means daily records. Journal is a book of primary entry for daily records.

2.6.1 Format of Journal

The following is the format of journal:

Format of Journal

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
(i)	(ii)	(iii)	(iv)	(iv)

The format of journal is sub-divided into five columns. These five columns are (i) Date, (ii) Particulars, (iii) Ledger Folio (L/F), (iv) Amount (Debit) and (Credit). In these columns following information is recorded:

(i) **Date:** In this column, the date of the transaction with its month and year is recorded. The year is not repeated against every entry because the year is almost the same. The sequence of the dates and months should be strictly

maintained i.e., transaction taking place on January 2, 2005 and so on will be recorded. For example, transactions took place in a business on 3rd January 2005, 10th January 2005, 5th February 2005, and 9th February 2005.

The date of the above transactions will be recorded as under:

Date
2005
Jan. 3
" 10
Feb. 5
" 9

(ii) Particulars: In this column, both the debit aspect and credit aspect of each transaction is recorded. The name of account to be debited followed by the word 'Dr.' against that account is written in the first line. In the second line, the account to be credited is written. However, the word 'Cr.' Is not written against this account. In the next line, an explanation to the entry called 'narration' is given to explain the transaction. For example, Machinery has been purchased in cash. This transaction will be recorded in the particulars column of the journal as under:

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
(i)	(ii) Machinery A/c Dr. To Cash A/c (Being Machinery purchased)	(iii)	(iv)	

(iii) Ledger Folio (L.F.): Journal is the original record of the business transactions. All entries from the journal are posted

Purchase A/c is an expense A/c. so it is to be credited as the expense decreases.

7. Apr.28: The two account heads involved are 'Loss by Fire A/c' and 'Purchase A/c'.

Loss by Fire A/c is an expense A/c. So, it is to be debited as the expense increases. Purchases A/c is an expense A/c. So it is to be credited as the expense decreases.

Exercise: 2.2

Journalize the following transatcions for the month of Dec. 2016. Also stse the nature of each account invoved in the journal entry.

Dec 1: Ajay Started business with Cash 40,000.

Dec 3: He paid into the Bank 2000.

Dec 5: He purchased goods for cash 15,000.

Dec 8: He sold goods for Cash 6,000

Dec10: He purchased furniture and paid by cheque 5,000

Dec 12: He sold goods to Arvind 4000

Dec 14: He purchased goods from Rahul 10,000

Dec 15: He returned goods to Rahul 5000

Dec 16: He recevied from Arvind 3960 in full settlement.

Dec 18: He withdrew goods for personal use Rs 1000

Dec 20: He withdrew cash from business for personal use Rs. 2000.

Dec 24: He paid telephone charges Rs 1000

Dec 26: Cash paid to Rahul in full settlement Rs 4900

Dec 31: Paid for stationary Rs 200 , rent Rs 500 and salaries Rs 2000

Explanation:

1. **Apr. 2:** The two account heads involved are 'Cash A/c' and '10% Bank loan A/c.' is an asset account. Cash A/c is to be debited as the asset increases. '10% Bank A/c' is a liability A/c. '10% Bank Loan A/c' is to be credited as the liability increase.

2. **Apr.20:** The two account heads involved are '12% Loan to Madhu A/c' and 'Cash A/c'. 12% Loan to Madhu A/c is an asset account. 12% loan to Madhu is a loan or advance given by the business to Madhu and it will be receivable in future from Madhu. Such advance is treated as an asset. Therefore, it is to be debited as the asset increases. Cash A/c is an asset account. Cash A/c is to be credited as the asset decreases.

3. **Apr.21:** The two account heads involved are 'Charity' A/c and 'Purchase A/c' Charity A/c is an expense Account. Charity A/c is to be debited as the expense increases.

4. **Apr.22:** The two account heads involved are 'Free Sample A/c' or 'Advertisement A/c' and 'Purchases A/c'

   Free Sample/Advertisement is an expense account. It is to be debited as the expense increases. Purchase A/c is an expense account. Purchase A/c is to be credited as the expense decreases.

5. **Apr.23:** The two account heads involved are 'Loss by theft A/c' and 'Cash A/c'. Loss by Theft A/c is an expense account. It is to be debited as the expense increases. Cash A/c is an asset account. So it is to be credited as the asset decreases.

6. **Apr.25:** The two account heads involved are 'Loss by Theft A/c' and 'Purchases A/c'. Loss by Theft A/c is an expense account. It is to be debited as the expense increases.

in the ledger accounts. The page number and folio number of the ledger account where the posting has been made from the journal is recorded in the L.F. column of the Journal. For example, if posting is made in Machinery Account appearing at page number 15 of the ledger and Cash A/c appearing at Page 6 of the ledger, 15 will be entered in the L.F. column in the journal against Machinery A/c and 6 will be entered against Cash A/c in the ledger folio column in the journal.

(iv) Amount (Debit) and (Credit) : Every transaction has got debit and its corresponding credit for the same amount. The amount of the account debited is written at the debit column of the amount column and the amount of the account credited is written at the credit column meant for writing the amount.

(v) Narration: After every journal entry, a brief explanation of the transaction for which the entry has been passed is given. It enables the persons going through the journal entry to have an idea about the transaction. This explanation is known as 'narration'. Narration is preceded by the words 'Being' / 'For'. After the narration, a horizontal line is drawn in the particulars column only to separate one journal entry from the other.

2.6.2 Process of Journalizing

The process of journalizing means the steps to be followed for ascertaining the account heads to be debited / credited for a particular transaction. There are three steps involved in the process of journalizing a transaction.

Step 1: Identification of accounts or 'account heads' affected by the transaction.

Step 2: Classification of accounts or account heads.

Step 3: Application of Rules for Debit and Credit.

A. Types of Journal entries:

Entries recorded in the journal may be of two types:

a) Simple Journal Entry; and

b) Compound Journal Entry.

a) Simple Journal Entry: When a transaction affects only one aspect/ account in the debit and on aspect / account in the credit, it is known as Simple Journal Entry.

b) Compound Journal Entry: When a transaction affects more than two accounts at a time – one or more accounts being debited/ one or more accounts being credited, such entry is known as Compound Journal Entry.

Exercise: 2.1



Journalize the following transactions in the books of Mr. A. Bora.

2005 April		Amount (Rs)
2	Took a Bank Loan at 10% interest	20,000
20	Advanced a Loan at 12% to Madhu	10,000
21	Goods distributed as charity	300
22	Goods distributed as free samples	500
23	Loss of cash by theft	1800
25	Loss of goods by theft	2000
28	Loss of goods by fire	7000

Solution: **Journal**

In the books of Mr A. Bora Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2005 Aug. 2	To Cash A/C Dr. To 10% Bank Loan A/c (Being Bank Loan taken at 10% interest p.a.)		20,000	20,000
April 20	12% Loan to MadhuA/c Dr. To Cash A/c (Being loan advanced to Madhu at 12% Interest p.a.)		10,000	10,000
April 21	Charity A/c Dr. To Purchase A/c (Being goods distributed as charity)		300	300
April 22	Free Samples/Advertise A/c Dr. To purchase A/c (being goods distributed as free samples)		500	500
April 23	Loss by Theft A/c Dr. To cash A/c (being the loss of cash be theft)		1,800	1,800
April 25	Loss by Theft A/c Dr. To Purchases A/c (being the loss of goods by fire)		2,000	2,000
April 28	Loss by Fire A/c Dr. To Purchases A/c (Being the loss of goods by fire)		7,000	7,000

(ii) General Ledger: The general ledger, sometimes known as the nominal ledger, is the main accounting record of a business which uses double-entry bookkeeping. It will usually include accounts for such items as current assets, fixed assets, liabilities, revenue and expense items, gains and losses.

General ledger may be subdivided into:-

(a) Impersonal Ledger: Impersonal Ledger contains the accounts relating to Assets, Expenses, Incomes, Cash Book and Petty Cash Book.

(b) Private Ledger: It contains the accounts of confidential nature like Capital, Drawing and Profit and Loss Accounts.

3.3.3 Format of a Ledger Account

There are two types of forms for writing up Ledger Accounts namely:

(a) Horizontal form; and (b) Vertical or T shaped form.

These are discussed below:

(a) A Horizontal Ledger Account is ruled out as follows:

"AB & Co" Account

Date	Particulars	J.F.	Debit Amount (Rs.)	Credit Amount (Rs.)	Debit or Credit	Balance (Rs.)

In this form of ledger, balance is ascertained after every transaction. This method is generally used in bank. Where the accounts are maintained in computers through the use of accounting software like Tally, accounts are also prepared in this form.

Dec 18	Drawings A/c Dr. To Purchases *(Being withdrawal of goods for personal use)*		1000	 1000
Dec 20	Drawings A/c Dr. To Cash A/c *(Being cash withdrawal from the business for personal use)*		2000	
Dec 24	Telphone Expenses A/c Dr. To Cash A/c *(Being Telephone expenses paid)*		1000	 1000
Dec 26	Rahul Dr. To Cash A/c To Discount A/c *(Being cash paid to Rahul and he allowed Rs 100 as discount)*		5000	 4900 100
Dec 31	Stationary Expenses Dr. Rent A/c Dr. Salaries A/c Dr. To Cash A/c *(Being expenses paid)*		200 500 2000	 2700
Dec 31	Advertisement Expenses A/c Dr. To Purchases A/c *(Being distribution of goods by way of free samples)*		1000	 1000



LET US KNOW

Under modern method of Classification of 'account heads' and 'rules for Debit and Credit', losses are also considered as 'Expense'.

2.7 LET US SUM UP

- The system of book-keeping under which both the aspects of every transaction is recorded in the books of account is known as "Double entry system of Book-keeping".
- Tvery transaction has two aspects:
  1. The receiving of value on the one hand; and
  2. The giving of the same value on the other hand
- An account is a summarized record of all transactions of similar nature relating to a particular person, an asset, an item of income or an item of expense.
- There are two approaches for classification of accounts. They are:
  a. English Approach or Traditional Approach; and
  b. American Approach or Modern Approach.
- There are two different classes of books of accounts which are maintained by a business entity. They are:
  a. Books of original entry or Primary book (Journal); and
  b. Principal book or book of Final entry (Ledger).
- Journal is a book of original entry in which transactions are originally recorded in chronological order (in order of date) from source documents showing the accounts to be debited and credited in a systematic manner.



2.8 FURTHER READING

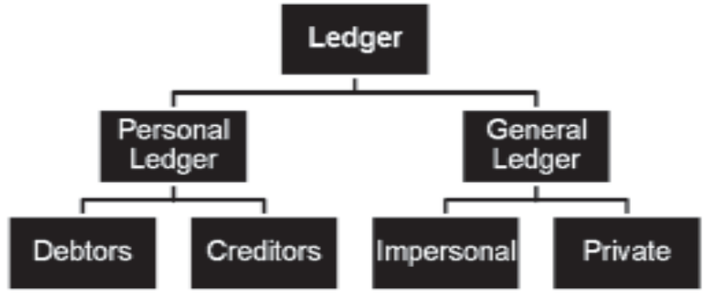
1. Ashis Bhattacharya, *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.

regarding any account which is available from Ledger is called the king of all books.

B. Sub Division of Ledger:

Ledger can be primarily subdivided into two:

(i) Personal Ledger; and
(ii) General Ledger.



(i) Personal Ledger: The Ledger which contains the accounts of persons or organizations is called Personal Ledger. These Accounts are relating to persons or organizations whom goods are bought or to whom goods are sold on credit. The Personal Ledger is again subdivided into (a) Debtors Ledger and (b) Creditors Ledger.

(a) Debtors Ledger: It contains the accounts of debtors to whom goods are sold on credit. It is also called Sales or Sold Ledger. The name "Debtors Ledger" is more appropriate than Sales or Sold Ledger as it contains Debtors' Accounts and not the Sales Accounts.

(b) Creditors Ledger: It contains the accounts of creditors from whom goods are bought on credit. It is also called Purchases or Bought Ledger. The name "Creditors Ledger" is more appropriate as it contains the Creditors' Accounts, Purchases Account.

unit we are going to learn the concept of and formatting a ledger account. Again, we will get a fair idea on the difference between journal and ledger.

At the end of this unit you will be able to discuss procedure for balancing an account and the concept of trail balance and preparation of trial balance.

3.3 CONCEPT OF LEDGER

3.3.1 Meaning of ledger

According to V.G. Vickery, "Ledger is a book of account which contains in a suitably classified form, the final and permanent record of trader's transactions". It is essentially a collection of five types of accounts – Assets, Liabilities, Capital, Revenue and Expenses.

According to William Pickles – "A Ledger is a most important book of account and is the destination of the entries made in the subsidiary books."

Thus, Ledger is a book which contains records of all transactions permanently in a summarized and classified form. It is the book of final entry and is the principal book of accounts.

3.3.2 Need and Sub division of ledger

A. Need for Ledger:

A Journal fails to give complete information regarding an account at a glance at a particular point of time because of the scattered entries of the transactions in different pages. This defect gives birth to ledger. The ledger brings together these dispersed entries regarding an account from the Journal to a place in a condensed and summarized form and gives a complete picture including its final position at a glance. The necessity of obtaining summarized and condensed information in respect of each class of transactions at a particular point in the need of a ledger. All information

2. S. N. Maheshwari, "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*", Capital Publishing Company, Guwahati
4. R. L. Gupta and M. Radhaswamy, "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.
5. Jain & Narang,"*Accounting Theory and Management Accounting*", Kalayani Publishers.

2.9 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q.1. 1) Personal a/c 2) Nominal a/c 3) Personal a/c 4) Personal a/c 5) Real a/c 6) Nominal a/c 7) Nominal a/c 8) Personal a/c 9) Nominal a/c 10) Real a/c

Ans. to Q.2. 1) (a) 2) (b) 3) (a)

Ans. to Q.3. 1) Two 2) Debit, credit 3) two 4) Real a/c 5) personal a/c 6) Nominal a/c

2.10 MODEL QUESTIONS

1. Explain the meaning of Double Entry System and Define Double Entry System.
2. What do you mean by Accounts? How are accounts classified?
3. Write notes on personal accounts.
4. Write notes on real accounts.
5. Explain nominal accounts.
6. What are the golden rules of Accounting?
7. What is the function of Suspense Account?
8. Classify the following items into real, personal and nominal accounts

   a. Capital
   b. Purchases
   e. State Bank of India
   f. Electricity Charges

c. Goodwill
d. Copyright
g. Dividend
h. Ramesh
i. Outstanding rent

9. Journalize the following transaction:

2017

Jan.1 Naresh started business with a capital of Rs. 50,000
Jan 5 Purchased Goods for Cash Rs. 12,000/-
Jan. 7 Sold goods to Madhu Rs. 3,200/-
Jan 10 Received cash from Madhu Rs. 700/-
Jan 12 Cash sales to Nayan Rs. 800/-
Jan 15 Goods returned by Madhu Rs. 150/-
Jan 18 Purchased Furniture Rs. 3,000/-
Jan 23 Purchased goods from Bhuban on credit Rs. 4,000/-
Jan 25 Paid to Bhuban Rs. 1,600/-
Jan 27 Goods returned to Bhuban Rs. 600/-
Jan 28 Purchased goods from Babla on cash Rs. 6,800/-
Jan 29 Sold goods Rs. 3,500/-, Sales Tax charged 10%
Jan 30 Withdrew goods for personal Rs. 500/-
Jan 31 Used goods worth Rs. 2,000/- for making furniture.

UNIT 3: ACCOUNTING MECHANICS- II

UNIT STRUCTURE

3.1 Learning Objectives
3.2 Introduction
3.3 Concept of Ledger
3.3.1 Meaning of Ledger
3.3.2 Need and Subdivision of Ledger
3.3.3 Format of a Ledger Account
3.3.4 Distinction between Journal and Ledger
3.4 Ledger Posting.
3.4.1 Meaning of Posting
3.4.2 Procedure for Balancing an Account
3.5 Trial Balance
3.5.1 Meaning and Features of Trail balance
3.5.2 Preparation of a Trial Balance
3.6 Methods of preparation of Trial Balance
3.7 The Suspense Account
3.8 Nature of Ledger Account Balances
3.9 Let Us Sum up
3.10 Further Reading
3.11 Answers To Check Your Progress
3.12 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- learn then concept ledger
- discuss the format of ledger account
- discuss the difference between Journal and Ledger
- describe ledger posting and the procedure for balancing an account
- discuss trial balance, preparation of trail balance

3.2 INTRODUCTION

In the earlier unit we had discussed the concepts like double entry system, journal, format journal and process journalizing. Now, in this

Interest Paid Account

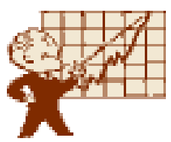
Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	5	6	7	8
2005 Jan.31	To Cash account		2,000	2005 Jan.31	By Balance c/d		2,000
			2,000				2,000
Feb.1	By Balance b/d		2,000				

Commission Paid Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	5	6	7	8
2005 Jan.31	To Cash account		1,000	2005 Jan.31	By Balance c/d		1,000
			1,000				1,000
Feb.1	By Balance b/d		1,000				



CHECK YOUR PROGRESS

Q1. The two main books of accounts are:

a) .....

b) .....

Q2. Write down the two types of journal entries.

a) .....

b) .....

Q3 What do you mean by Ledger

.....

.....

.....

(b) A Vertical or T shaped form is ruled as under:-

"AB & Co" Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	1	2	3	4

3.3.4 Distinction between Journal and Ledger

Following are the distinctions between a journal and a ledger.

Sl. No.	Points of Distinction	Journal	Ledger
(i)	Nature	Journal is a book of primary entry	Ledger is a book of final entry.
(ii)	Basis of Recording	In Journal, transactions are recorded on the basis of voucher	Here transaction are recorded from the journal
(iii)	Manner of Recording	Here transactions are recorded in order to happening i.e. date wise	Here transactions are recorded on the basis of 'account heads'
(iv)	Narration	Every entry in the journal is followed by a narration	Posting in the Ledger is not followed by any narration
(v)	Form of Information	It provides information in scattered form	It provides information in a summarised and classified form

3.4 LEDGER POSTING

In the following sections we are going to discuss the concept of ledger posting, its meaning, and the procedure for balancing of an account.

3.4.1 Meaning of Posting

Posting is a process of transferring debit and credit aspects of the entries appearing in the journal and other books of original entry to the debit and credit sides of the relevant accounts in the ledger. Postings are made using the word 'To' and 'By' as a prefix on the debit side and credit side respectively. The aim of posting is to make a classified and summarized record of all business transactions under appropriate account heads.

Basic Points Regarding Posting:

Basic points to be kept in mind before posing are:

(1) Opening of separate accounts: Separate accounts should be opened for different 'account heads' in the ledger for posting the different transactions recorded in the journal. For Example; Cash A/c, Salary A/c, Purchases A/c etc.

(2) One account for each kind of transactions: One account should be opened for each kind of transaction. Transactions taking place during an accounting period relating to that particular account should be posted to that account only. If more than one account is opened for one kind of transactions, the object of summarization of transactions of similar nature will not be achieved. For example, it may be found that in the journal, Cash A/c has been debited during a week, say on six different dates and the same account has been credited on four different dates. For recording in Cash A/c, only one Cash A/c will be opened for transactions taking place on all the days and posting of all entry relating to Cash A/c will be made in that account only.

(3) Accounting period: All recording in the Journal and post in the ledger is done for a particular 'Accounting Period'. For every accounting period separate set of books should be

Purchase Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	5	6	7	8
2005				2005			
Jan.31	To Cash A/c		5,000	Jan.31	By Balance c/d		5,000
			5,000				5,000
Feb.1	By Balance b/d		5,000				

Commission Received Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	5	6	7	8
2005				2005			
Jan.31	To Balance c/d		500	Jan.31	By Cash Account		500
			500				500
				Feb.1	By Balance c/d		500

Interest Received Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	5	6	7	8
2005				2005			
Jan.31	To Balance c/d		4,000	Jan.30	By Cash Account		4,000
			4,000				4,000
				Feb.1	By Balance c/d		4,000

Cash Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	5	6	7	8
2005				2005			
Jan.30	To Sales A/c		8,000	Jan.31	By Purchase A/c		5,000
	To Interest received A/c		4,000		By Interest Paid A/c		2,000
	To Commission Received A/c		500		By Commission paid A/c		1,000
					By Balance c/d		4,500
			12,500				12,500
Feb.1	To Balance b/d		4,500				

Sales Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1	2	3	4	5	6	7	8
2005				2005			
Jan.31	To Balance c/d		8,000	Jan.30	By Cash A/c		8,000
			8,000				8,000
				Feb.1	By Balance b/d		8,000

maintained. Posting of all transactions taking place in a particular accounting period must be made in one set of books.

(4) Same account heads in both the books: Posting in the ledger should be made in the same account heads as appearing in the journal. No change in the name of the 'account head' should be made.

(5) Postings made conveniently: Posting may be done at any time but it should be completed before the end of the accounting period. For example the accounts upto date, posting should be made immediately after recording the transactions in the journal.

3.4.2 Procedure for Balancing an Account

Balancing of an account implies the process of ascertaining the net difference of an account after totaling of both sides – viz. debit side and credit side.

In simple words, balancing means the insertion (writing) of the difference between the total of amount columns of the two sides in the smaller (smaller total) side, so that the (grand) totals of the two sides becomes equal.

Balancing is done periodically, i.e., weekly, monthly, quarterly, half-yearly or yearly, depending on the requirements of the business.

The 'balance' is a term used in accounting which means the difference between the two sides of any account, or the total of the account containing only debits and only credits.

A computerized system will usually print the balance of the account after each transaction, but in a manual system we must calculate the balance. The balance of an account shows the position of an account on the particular day.

Procedure for Balancing an Account:

The following procedure is to be followed for balancing of an account

(i) **Totaling the amount columns outside:** On a rough sheet of paper, the total of the amount column of two sides of the account concerned are to be ascertained.

(ii) **Determining the balance:** The difference of the total of two sides, called balance is then found out.

(iii) **Entering the balance on the smaller side:** If the total of the debit side is more, the difference is to be put in the amount column on the credit side, by writing the words 'By Balance c/d' in particulars column. If the total of the credit side is more, the difference is to be put in the amount column on the debit side by writing the words 'To Balance c/d' in particulars column. This will be done on the date of balancing and the date will be entered in the date column.

(iv) **Totaling both the columns:** After putting the difference in the appropriate side of the account, both sides of the account is to be totaled. The total of both the sides will be equal. A thin line above the total and two parallel lines below the total are to be drawn.

(v) **Taking the balance on the opposite side:** Lastly, on the next day of the balancing, the debit balance will be written on the debit side by writing the words 'To Balance b/d' in the particulars column. Similarly, the credit balance will be brought down on the credit side by writing the words 'By Balance b/d' in the particulars column.

If the Balance b/d (brought down) appears on the debit side, it indicates that the account has a Debit Balance. On the other hand, if the balance b/d (brought down) appears on the credit side, it indicates that the account has Credit Balance.

Exercise: 3.1

Journalize the following transactions in the books of Mr. A. Bora.

2005

Jan. 30. Received cash on account of Sales Rs. 8000;
Commission received Rs. 500, Interest received Rs. 4,000.

Jan. 31 Paid cash on account of Purchase Rs. 5,000;
Commission paid Rs. 1,000, Interest paid Rs. 2,000.

Pass Journal entries and post them in the ledger, also balance them on January 31, 2005

Solution:

Journal

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2005				
Jan 30	Cash A/c Dr.		12,000	
	To Sales A/c			8,000
	To Commission received A/c			500
	To Interest Received A/c			4,000
	(Being the receipt of cash on account of sales, commission and interest)			
	Purchases A/c Dr.			
Jan 31	Commission Allowed A/c Dr.		5,000	
	Interest Allowed A/c Dr.		1,000	
	To Cash A/c		2,000	
	(Being cash paid on account of purchases, commission and interest)			8,000

Profit from Branches
Profit on Consignment
Sundry / Miscellaneous Receipts Account
Subsidies Account
Discount Received Account
Bad Debts Recovered Account
Interest on drawings Account

4. Expenses and Losses show Debit balance:

Purchase Account
Carriage Inward Account
Wages Account
Salaries Account
Insurance Premium Account
Commission Account
Rent (Paid) Account
Traveling Expenses Account
Printing and Stationery Accounts
Bad Debts Accounts
Depreciation Account
Fire Loss Account (not covered by insurance)
Sundry Expenses
Interest on Capital
Capital Account shows a Credit balance
Drawings Account show Debit balances
Reserve and fund Accounts show Credit balance

5. Miscellaneous Accounts

Returns Inward shows a Debit balance
Returns Outward shows a Credit balance
Preliminary Expenses show Debit balance
Deferred Expenses show Debit balances

Q4 Ledgers are primarily divided into:

a) .....

b) .....

3.5 TRIAL BALANCE

3.5.1 Meaning and Features of Trial Balance

Definition of Trial Balance:

According to Cropper , “A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made”.

It is neither a Journal nor a Ledger Account. It is merely a statement of Ledger Account Balances including the Cash Book balance prepared in a separate sheet of paper with an intention to give a trial to book-keeping process. Thus, it is not a part of book-keeping; but a mere technique of testing the arithmetical accuracy of the books.

Special Features of Trial Balance:

A Trial balance has the following special features:

1) A Trial Balance is prepared on a specific date as indicated by the words ‘Trial Balance as on’;
2) It contains the list of balances of all the ledger accounts including the balances of cash.
3) It can be prepared with the balances or totals of ledger accounts.
4) The totals of the debit and of the credit columns must be equal.
5) Equality of the totals of the debit and the credit columns proves the observance of the principles of Double Entry System.

6) Non-agreement of the totals of the debit and the credit columns indicates the commission of mistakes some where.

7) Agreement of the totals of the debit and the credit sides does not prove the absence of errors in accounting.

3.5.2 Preparation of a Trial Balance

A Trial Balance can be prepared at any given date. However, it is usually prepared at the end of an accounting period.

Form: There are two forms (a) journal form and (b) ledger form and can be prepared in either of the forms.

(a) Journal form : A Trial Balance is prepared generally in a Journal form as given below:

Trial Balance as at…….

Name of accounts	L.F.	Debit Rs.	Credit Rs.

In the column 'Name of Accounts', the name of each account is to be written with its Folio No. in the 'LF' column. Debit amount or Credit amount of respective account is to be written in the Debit or the Credit column.

(b) Ledger form: However, a Trial Balance can be prepared in the Ledger from also as given below:

Trial balance as at …….

Name of A/c	L.F.	Rs.	Name of A/c	L.F.	Rs.

Land and Building Account

Machinery Account

Furniture Account

Patent Account

TradeMark Account

Live stock Account

Vehicles Account

Loose Tools, Spare Parts Account.

Sundry Debtors Account

Bills Receivable Account

Cash (in hand) Account

Bank (Cash at bank) Account

Loans and advances (granted to others) Account

Prepaid Expenses Account

Accrued Interest Account

Stock of Stationery (in hand) Account

2. Liabilities Accounts:

Liabilities Accounts shows Credit Balances. Therefore, the following Accounts being Liabilities Accounts will show Credit balances.

Sundry Creditors Account

Bills Payable Account

Loans and Advances Taken Account

Debenture Account

Outstanding Expenses Account

Income Received in Advance and

Interest Payable Outstanding

3. Revenue Accounts Show Credit Balances.

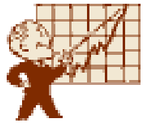
Sales Account

Interest Received Account

Rent Received Account

Dividend Received Account

Royalties Received Accounts



CHECK YOUR PROGRESS

Q5: What do you mean by Trial Balnace?

.....

.....

Q6: State True or False:

a. Trial Balance is prepared on a specific date .(T/F)

b. The totals of the debit and of the credit columns may not be equal.(T/F)

c. Trial Balance is a ledger account.(T/F)

d. Trial balance is a technique of testing the arithmetical .. accuracy of the books.(T/F)

3.6 METHODS OF PREPARATION OF TRIAL BALANCE

A Trial Balance can be prepared in any of three methods:

1. Total or Gross Trial Balance

2. Net or Balance Trial Balance and

3. Total cum Balance Trial Balance.

1. Total or Gross Trial Balance: Under this method, a Trial Balance is prepared with the debit totals and the credit totals of all ledger accounts including the Cash Book. Under this method, the two sides of each ledger account are totaled first. These totals are taken to a sheet of paper, preferably drawn in a form similar to Journal, the debit totals being in the Debit column and the credit totals, in the Credit column. The name of the accounts and the ledger folios (LF) are to be inserted in the respective columns. The accounts have only one side total namely, Expenses and Revenue Accounts will be inserted in one of the columns only. An illustration is given below:

This method is hardly in use because it is cumbersome.

3.7 THE SUSPENSE ACCOUNT

Sometimes, the two sides of the Trial balance may not tally for some reasons. The accountant is required to find out the cause of difference. If the Accountant fails to locate the cause of difference and if he is in a hurry to close the Book of accounts in order to prepare the Final Accounts, he may open an account known as 'Suspense Account' or 'Difference in Trial Balance Account' with the difference in the Trial balance.

If the credit side of the Trial Balance is heavier, then the Suspense Account is debited with the amount of difference and the amount is placed in the Debit column of the Trial balance under the heading 'Suspense Account'. Conversely, if Debit side is heavier, then the Suspense Account is credited and is placed in the Credit column of the Trial Balance. In the next accounting year, when errors are located, rectification entries are required to be passed to close the Suspense Account. Suspense Account is a temporary Account to accommodate the difference in Trial Balance. It is to be suede only in an extreme case and not by way of normal practice, because the existence of a Suspense Account creates doubt about the authenticity of the Books of Accounts and shows a departure from the strict principle of Double Entry.

3.8 NATURE OF LEDGER ACCOUNT BALANCES

While preparing a Trial Balance, we are to ascertain the nature of balances of Ledger Accounts. The rules of ascertaining Ledger Account Balance are given below:

1. Asset Account:

Asset Accounts shows debit balances. Therefore the following accounts being assets Accounts will show debit balances:

Goodwill Account

Trial balance as on 31-12-2004

Name of accounts	L.F.	Debit Rs.	Credit Rs.
Capital Account		-	20,000
Purchases		40,000	-
Sales		-	60,000
Wages		5,000	-
Salary		6,000	-
Furniture		10,000	2,000
Rent		6,000	-
Remesh		10,000	6,000
Paresh		8,000	14,000
Cash		15,000	12,000
Bank		24,000	10,000
Total		1,24,000	1,24,000

This method is not generally followed because it is a laborious and time-consuming method and balances cannot be easily obtained which are necessary for the preparation of Final Accounts.

2. **Net or Balance Trial Balance:** Under this method, a Trial Balance is prepared with the balances of ledger accounts including the Cash Book. Each ledger account is balanced at the end of a given period before passing the closing entry. The balance is written either on a rough sheet or in the particulars column on the heavier side, preferably with wooden pencil. These balances are taken to a sheet of paper drawn in a form similar to Journal; Debit balances being inserted in the Debit column while Credit balances in the Credit Column.

   This is the most popular method and is generally followed. It shows the balances of all ledger accounts at a glance and facilitates the preparation of Final Accounts. Moreover, it can be easily and quickly prepared and such a Trial Balance becomes less bulky. An illustration is given below:

Trial balance as on …….

Name of accounts	L.F.	Debit Rs.	Credit Rs.
Capital Account		-	20,000
Purchases		40,000	-
Sales		-	60,000
Wages		5,000	-
Salary		6,000	-
Furniture		8,000	-
Rent		6,000	-
Remesh		4,000	-
Paresh		-	6,000
Cash		3,000	-
Bank		14,000	-
Total		86,000	86,000

3. **Total cum. Balance Trial Balance:** Under this method, a Trial Balance is prepared with the Debit and the Credit Totals of both the sides of each account and its balance shown side by side. It is combination of the above two methods.

   An illustration is given below:

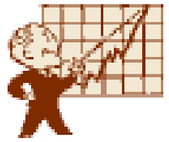
   Total Balance as on ……..

Name of accounts	L.F.	Debit Rs.	Credit Rs.	Debit Rs.	Credit Rs.
Capital Account		-	20,000	-	20,000
Purchases		40,000	-	40,000	-
Sales		-	60,000	-	60,000
Wages		5,000	-	5,000	-
Salary		6,000	-	6,000	-
Furniture		10,000	2,000	8,000	
Rent		6,000	-	6,000	-
Remesh		10,000	6,000	4,000	-
Paresh		8,000	14,000	-	6,000
Cash		15,000	12,000	3,000	-
Bank		24,000	10,000	14,000	-
Total		1,24,000	1,24,000	86,000	86,000

4.4 FEATURES OF SECTIONAL LEDGER BALANCING SYSTEM

The following are the features of Sectional Balancing System.

- It facilitates Sub-division of ledger into (a) General ledger (b) Debtors' ledger and (c) Creditors' ledger
- Under this system only one section of the ledger i.e. general ledger is self balanced and the other two ledgers are not self balanced
- This system presupposes the preparation of two control Accounts – Total Debtors Account & Total Creditors Account in the General Ledger (G.L.)
- Under this system, trial balance of the business as a whole can be prepared at periodical intervals from the balances of the Accounts in the General Ledger including the Control Accounts.



CHECK YOUR PROGRESS

Q.1: What is Sectional Balancing System?

.....

.....

.....

.....

Q.2: Mention two features of Sectional Balancing System.

i) .....

ii) .....

4.5 ADVANCTAGES OF SECTIONAL LEDGER BALANCING SYSTEM

The following are the advantages of Sectional ledger balancing system.

- Under this system more than one ledger keeper can be employed, which facilitates the division of work among the book-keepers.
- The ledger clerks are not allowed to have access to the Total Accounts prepared from Debtors and Creditors Ledger. The Total Accounts are kept under the control of a responsible official and, these can act as a valuable part of Internal Check system.

Exercise:3. 2

Prepare Trial Balance from the following items of ledger balances as on 31st December.

2007	Amount (Rs.)
Capital of Sri Bora	20,000
Furniture	10,000
Prepaid insurance	500
Purchases	50,000
Sales	80,000
Unpaid Salaries	1,500
Interest on Investment Accrued	2,000
10% Investments	20,000
Commission Received	2,000
Carriage	1,000
Printing & Stationary	3,000
Salaries and Wages	9,000
Cash in hand and at bank	7,000
Depreciation	1,000

Solution :

Particulars	L.F.	Debit Rs.	Credit Rs.
Capital Account		-	20,000
Furniture		10,000	-
Prepaid insurance		500	-
Purchases		5,000	
Sales		-	80,000
Unpaid Salaries		-	15,000
Interest on Investment accrued		2,000	-
10% Investments		20,000	-
Commission received		-	2,000
Carriage		1,000	-
Printing and stationery		3,000	-
Salaries and wages		9,000	-
Cash in hand and at Bank		7,000	-
Depreciation		1,000	
		1,03,500	1,03,500

3.9 LET US SUM UP

- There are two different classes of books of accounts which are maintained by a business entity. They are:
  a. Books of original entry or Primary book (Journal); and
  b. Principal book or book of Final entry (Ledger).
- Journal is a book of original entry in which transactions are originally recorded in chronological order (in order of date) from source documents showing the accounts to be debited and credited in a systematic manner. Ledger is a book which contains records of all transactions permanently in a summarized and classified form.
- A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made.
- A suspense account is an account used temporarily to carry doubtful receipts and disbursements or discrepancies pending their analysis and permanent classification.



3.10 FURTHER READING

1. Ashis Bhattacharya,(2006), *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari,(2014), "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*", Capital Publishing Company, Guwahati
4. R. L. Gupta and M. Radhaswamy, (2017), "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.
5. S.C. Jain & K.L. Narang,(2006), "*Accounting Theory and Management Accounting*", Kalayani Publishers.

location of arithmetical errors at the time of preparation of trial balance in case of business having large number of transactions and involving multiple ledgers, the following systems of Ledger Balancing has been developed:

(i) Sectional Ledger Balancing; and

(ii) Self Balancing Ledger system.

Sectional Ledger Balancing : Sectional Balancing System is the system of multiple ledgers designed to make only the general ledger complete. There are generally three types of ledgers.

(a) Debtors' ledger/ Sales ledger : The accounts of all the Debtors (trade debtors for goods sold in the ordinary course of business) are maintained in this ledger. Posting is made from Sales Day Book, Returns Inward Book, Cash Book, Bills Receivable Book and Journal Proper for the transactions affecting the accounts of Debtors.

(b) Creditors' Ledger/ Bought Ledger : The accounts of all the Creditors (trade creditors for goods purchased in the ordinary course of business) are maintained in this ledger.

(c) General Ledger : This ledger contains all accounts other than the accounts of Debtors and Creditors as described above. All accounts relating to nominal accounts, real accounts, capital and liabilities excluding trade debtors and trade creditors are maintained in this ledger.

Sectional Balancing System balances only a section of the total ledger system comprising of main, debtors' and creditors' ledger. Hence, the end-product of this system is a balanced general ledger and unbalanced debtor and creditor ledger. In other words, in this system only one section of the ledgers is self balanced. Here only the General ledger (out of the three ledgers viz. Debtors ledger, Creditors ledger and General ledger) is 'self balanced'. 'Self balanced' means that an independent trial balance can be prepared from that ledger.

- describe the features and advantages of Self Balancing Ledger system
- explain the procedure of Self Balancing Ledger system

4.2 INTRODUCTION

In this unit we will discuss the ledger balancing systems employed by business enterprises. Perhaps you remember the various types of books of accounts maintained by the business enterprises. However let us recapitulate the meaning and types of ledger. “A Ledger is a book of account which contains, in a suitably classified form, the final and permanent record of trader’s transactions.” It is the permanent store house of all the transactions and is maintained in the form of a bound register having special ruling in each page.

Under traditional system of recording transactions, all the accounts of a concern are maintained in one ledger. The system of maintaining one ledger works well when the size of the business is small or the number of accounts to be opened in the ledger is within manageable limits of one ledger keeper because only one ledger can be handled by one ledger-keeper at a time. For example, if a ledger keeper can post 50 transactions daily into the ledger and if the number of daily transactions are, say, 100, it will take two days for a ledger keeper to post the transactions of one day. Similarly, it will take two years to post the transactions of one particular year. In such a case the system of single ledger will have some disadvantages. In order to do away these disadvantages, multiple ledgers can be kept to maintain these accounts. When multiple ledgers are maintained, more than one ledger-keeper can be engaged to do the work of maintaining the ledger. As a result, the posting in the ledger can be kept up to date.

4.3 MEANING OF SECTIONAL LEDGER BALANCING SYSTEM

In order to test the arithmetical accuracy of books of accounts at periodical intervals e.g. daily, weekly or monthly and to facilitate the

3.11 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q.1.: a) Journal b) Ledger

Ans. to Q.2.: a) Simple Journal entries b) Compound Journal entries

Ans. to Q.3.: Ledger is a book which contains records of all transactions permanently in a summarized and classified form

Ans. to Q.4.: a) Personal Ledger b) General Ledger

Ans. to Q.5.: A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made

Ans. to Q.6.: a. True b. False c. False d. True

3.12 MODEL QUESTIONS

1. What do you mean by ledger?
2. Discuss the need for ledger.
3. Distinguish between journal and ledger.
4. What do you mean by trial balance and discuss its features?
5. What is the function of Suspense Account?
6. Classify the following items into real, personal and nominal accounts

   a. Capital
   b. Purchases
   c. Goodwill
   d. Copyright
   e. State Bank of India
   f. Electricity Charges
   g. Dividend
   h. Ramesh
   i. Outstanding rent

9. A book keeper has prepared the following Trial Balance which is wrong. Prepare a correct Trial Balance from the following:

Sl. No.	Particulars	L.F.	Rs.	Rs.
1.	Capital		-	15,000
2.	Drawing		3250	-
3.	Stock (Jan. 1)		17,445	-
4.	Returns Inward		-	554
5.	Carriage Inward		1,240	-
6.	Deposit with Ananda Gupta		-	1,375
7.	Returns outward		-	840
8.	Carriage Outward		-	725
9.	Loan to Ashok @ 5% given on 1st January		-	1,000
10.	Interest on the above		-	25
11.	Rent		820	-
12.	Rent outstanding		130	-
13.	Stock (Dec.31)		-	18,792
14.	Purchases		12,970	-
15.	Debtors		4,000	-
16.	Goodwill		1,730	-
17.	Creditors		-	3,000
18.	Advertisement expenses		954	-
19.	Provisions for Doubtful Debts		-	200
20.	Bad debts		400	-
21.	Patents and Patterns		500	-
22.	Cash		62	-
23.	Sales		-	27914
24.	Discount Allowed		-	330
25.	Wages		754	-
			45,095	69,915

UNIT 4: SECTIONAL AND SELF BALANCING LEDGER SYSTEMS

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Meaning of Sectional Ledger Balancing System

4.4 Features of Sectional Ledger Balancing System

4.5 Advantages of Sectional Ledger Balancing System

4.6 Defects of Sectional Ledger Balancing System

4.7 Procedure of Sectional Ledger Balancing System

4.7.1 Preparation of Total Debtors' Account

4.7.2 Preparation of Total Creditors' Account

4.8 Meaning and Features of Self- Balancing Ledger System

4.9 Advantages of Self- Balancing Ledger System

4.10 Procedure of Self- Balancing Ledger System

4.10.1 Entries to be passed under Self- Balancing Ledger System

4.10.2 Posting from the Sales Book when Ledgers are on Self-Balancing Ledger System

4.10.3 Self- Balancing of Debtors' Ledger

4.10.4 Self- Balancing of Creditors' Ledger

4.10.5 Self- Balancing of General Ledger

4.11 Let Us Sum up

4.12 Further Reading

4.13 Answers To Check Your Progress

4.14 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- explain the meaning of Sectional Ledger Balancing and Self Balancing Ledger systems
- discuss the meaning of Debtors' Ledger; Creditors' Ledger and General Ledger;
- explain the procedure of Sectional Ledger Balancing system

4.8 MEANING AND FEATURES OF SELF-BALANCING LEDGER SYSTEM

In the preceding sections we have found that where the ledgers are kept under Sectional Balancing system, double entry is not completed in Debtors ledger and Creditors Ledger. Consequently, no trial balance can be prepared independently from these ledgers. In order to do away with the above defects of Sectional Ledger Balancing system, a system called Self Balancing Ledger system is employed. A Self Balancing Ledger means that a complete and independent trial balance can be prepared on balancing of the ledger. In other words, Self Balancing Ledger system is a system of maintaining ledgers in such a way that an independent Trial balance can be prepared from each ledger without the help of any other ledger.

According to Roger N. Carter, "A Self-Balancing ledger is one whose balances, when extracted, form a complete trial balance''

Under this system, an Account called ''Adjustment Account" is opened in the back side of each ledger for the purpose of completing double entry of each of the transactions relating to each ledger within the ledger itself.

It helps the preparation of the trial balance and the ledger is made self balancing. If the trial balance prepared from each ledger does not agree independently, it may be assumed that error exists in that particular ledger. Thus, the work of location of error becomes easier.

Features of Self- Balancing Ledger system

The essential features of Self Balancing System are as under:

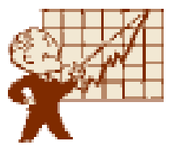
- Opening of Control or Adjustment Accounts,
- Self balancing of each ledger,
- Contra entries between two Adjustment Accounts,
- Specially designed subsidiary books,
- Periodicity of posting in the Adjustment Accounts,

- The preparation of Total Debtors Account and Total Creditors Account in the General Ledger facilitates the ascertainment of balances of Total Debtors and Total Creditors at the end of the specified period.
- Where interim Profit and Loss Account and Balance sheet are required to be prepared, the balances of Total Accounts– Total Debtors A/c and Total Creditors Accounts can be advantageously used. Thus the laborious method of extracting schedules of Debtors and Creditors can be avoided.
- Since the balances of Total Debtors and Total Creditors Account must be equal to the balances of Debtors' and Creditors' Ledgers, respectively, any difference arising between the balances of the Total Accounts and the Ledgers to which they relate help to locate the errors in the particular ledger or ledgers in which they exist. Hence, under this system, errors can be located easily and without much wastage of time.

4.6 DEFECTS OF SECTIONAL LEDGER BALANCING SYSTEM

Following are the defects of sectional ledger balancing system:

- Self-balancing of one ledger;
- Arithmetical accuracy of one ledger only;
- Limited application of internal check;
- Non-adherence to double entry principles;
- Lack of effective supervision.



CHECK YOUR PROGRESS

Q.3: Mention two advantages of Sectional Balancing System.

i) .....

ii) .....

Q.4: Mention two defects of Sectional Balancing System.

i) .....

ii) .....

4.7 PROCEDURE OF SECTIONAL LEDGER BALANCING SYSTEM

Where multiple ledgers are kept, the General Ledger contains the double aspects of the transactions relating to cash transactions. Double aspects of all transactions relating to credit purchase and credit sale of goods are not completed in the General Ledger itself. When the goods are sold on credit, the account of the individual debtors is posted in the Debtors' Ledger and the Sales Account is credited in the General Ledger. For example, credit sale of goods to Hari will be posted in the Debtors Ledger and General Ledger. Hari A/c will be debited in the Debtors Ledger and Sales A/c will be credited in the General Ledger. Now, if a trial balance is prepared from the General Ledger, the trial balance will not agree because the aspect relating to the Debtors' personal account is missing from the General Ledger. Again, if a trial balance is prepared from the Debtors Ledger, it will not agree because the aspect relating to sales is missing from the Debtors Ledger.

Now, in order to enable the preparation of trial balance from the General Ledger, two Control Accounts -viz- Total Debtors A/c and Total Creditors Accounts are required to be prepared in the General Ledger. The Total Debtors Account is used to complete the Double Entry relating to Debtors Ledger and Total Creditors Accounts, to complete the Double Entry relating to Creditors Ledger.

At the end of a specified period say— a week or a month, the periodical total of transactions affecting the Debtors and the Creditors are collected from the relevant subsidiary books.

4.7.1 Preparation of Total Debtor's Account

For the preparation of Total Debtor's Account, the following information stated in the 'transaction column' will be ascertained on total basis at periodical intervals from the subsidiary books stated in the 'source of information' column.

Purchase Return	3,500
Cash paid to creditors	12,000
Discounts received	470
Allowances received	320
Bills Payable Accepted	8,000
Closing balance of creditors (Cr.)	2,910

Solution :

IN GENERAL LEDGER

TOTAL CREDITORS ACCOUNT

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
31st March, 2017. To Purchase Return	3,500	1st March, 2017. By Balance b/d	5,700
31st March, 2017. To Cash	12,000	31st March, 2017. By Purchases A/c (Credit)	22,000
31st March, 2017. To Discount (received)	470		
31st March, 2017. To Allowances (Received)	320		
31st March, 2017. To Bills Payable (Accepted)	8,000		
31st March, 2017. To Balance c/d	3,410		
	27,700		**27,700**
		31st March, 2017. By Balance b/d	3,410

Solution :

IN GENERAL LEDGER

TOTAL DEBTORS ACCOUNT

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
1st April, 2017 To Balance b/d	19,000	31 Mar 2017 By Bills Receivable	10,000
31 Mar 2017 To Sales (credit)	70,000	31 Mar 2017 By Cash (received)	65,400
31 Mar 2017 To Bills Receivable (Dishonoured)	2,200	31 Mar 2015 By Allowances	2,400
31 Mar 2017 To Interest charged	1,560	31 Mar 2017 By Sales Return	450
31 Mar 2017 To Bank (B/R discounted and dishonoured)	500		
		31 Mar 2017 By Balance c/d	15,010
	93,260		**93,260**
April1 2015 To Balance b/d	15,010		



Exercise: 4.2

From the following particulars extracted from the books of the N.E. Ltd. for the month of March, 2017, prepare Total Creditors Account as on 31st March, 2017.

	(Rs.)
Creditors on 1st March, 2017.	5,700
Credit Purchases	22,000

Transactions	Sources of Information – Subsidiary Books
Credit Sales	Sales Day Book
Collection from Debtors – Cash and cheques	Cash Book
Discount Allowed to Debtors	Cash Book
Cheque Dishonoured	Cash Book
Returns Inward (goods returned by Debtors)	Returns Inward Book
Discount previously allowed now written off on account of dishonour of Cheques	Cash Book
Bill Receivable Received	Bill Receivable Book
Bills Receivable dishonoured	Bills Receivable Book
Interest charged on overdue accounts	Journal Proper
Bad debts written off	Journal Proper
Expenses charged to customers	Journal Proper
Transfers	Journal Proper

4.7.2 Preparation of Total Creditor's Account

For the preparation of Total Creditor's Account, the following information stated in the 'transaction column' will be ascertained on total basis at periodical intervals from the subsidiary books stated in the 'source of information' column.

Transactions	Sources of Information – Subsidiary Books
Credit Purchases	Purchases Day Book
Payment to Creditors Cash and cheques	Cash Book
Discount received from Creditors	Cash Book
Cheque Dishonoured	Cash Book
Returns Outward – goods returned to Creditors	Returns Outward Book
Discount previously received now written off on account of Dishonour of Cheques	Cash Book
Bill Payable forwarded	Bill Payable Book
Bills Payable Dishonoured	Bills Payable Book
Interest Charged by suppliers on overdue accounts	Journal Proper
Rebate Allowed by suppliers	Journal Proper
Expenses charged by suppliers	Journal Proper
Transfers	Journal Proper

On the basis of the above information, Total Creditors Account is prepared in the General ledger. If the balance of the Total Creditors A/c in the General ledger is equal to the total of balances of Individual Accounts in the Creditors ledger, then it can be assumed that there is no arithmetical error in the Creditors ledger.

Now, if a trial balance is prepared from the balances of the General Ledger and if it does not tally it indicates that there is error not in the Debtors Ledger and Creditors Ledger, but in the General Ledger itself. Therefore, location of error becomes easier.

Proforma of Total Creditors Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d (Opening Dr. balance, if any)		By Balance b/d (Opening Cr. balance)	
To Cash A/c (Cash paid to Creditors)		By Purchases A/c (Credit Purchases)	
To Bank (Cheque issued)		By Bills Payable A/c (Bills Payable Dishonoured)	
To Discount Received A/c		By Bank	
To Returns Outward A/c		By Interest A/c (Interest charged by Creditors)	
To Bills Payable A/c		By Expenses (Expenses charged by Creditors)	
To Allowances A/c		By Cash A/c (Refund from Creditors)	
To Bank A/c (Cheque dishoured)		By Balance c/d (Closing debit balance, if any)	
To Transfer			
To Balance c/d (Closing credit balance)			

Exercise: 4.1

From the following information, prepare a Total Debtors Account as on 31st March, 2017:

	(Rs.)
Debtors on 1st April, 2017	19,000
Bills Receivable	10,000
Sales	70,000
Cash received	65,400
Allowances to customers	2,400
Returns from customers	450
Bills Receivable dishonoured	2,200
Interest charged on dishonoured bills	1560
Bills Receivable met on maturity	800
Bills Receivable discounted	1800
Bills Receivable discounted and dishonoured	500

IN THE DEBTORS' LEDGER

GENERAL LEDGER ADJUSTMENT ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2017				2017			
Jan.31	To Debtors Ledger			Jan.31	By Debtors L.edger		
	Adjustment A/c:				Adjustment A/c:		
	(in D.L.)				(in D.L.)		
	Cash		15,600		Opening Balance		32,000
	Discount		400		Sales		19,600
	Bills Receivable		6,000		Bills Receivable		
	Returns Inward		1,750		dishonoured		750
	Rebates		550				
	Bad Debts		900				
Jan.31	By Balance c/d		27,150				
			52,350				52,350
				Feb.1			27,150

4.10.4 Self- Balancing of Creditors' Ledger

We know that the purpose of preparing Creditors Ledger is to show the Accounts of the suppliers or Creditors from whom goods have been bought on credit. From the last year's Books of Account, the balances of the entire Creditors' Accounts will be entered on the credit side of the relevant Accounts in the Creditors Ledger of the current year. The credit purchases during the year are posted in detail to the credit of the individual Creditor's Account.

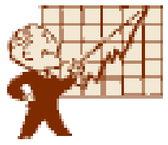
Creditors Ledger, through individual Creditors accounts, **gets Credit** on account of the following:

- Location of errors,
- Fixation of employee responsibility,
- Internal check becomes easier,
- Effective supervision is possible
- Timely preparation of trial balance and interim accounts

4.9 ADVANTAGES OF SELF- BALANCING LEDGER SYSTEM

The following are the advantages of Self-Balancing Ledger system:

- Proof of arithmetical accuracy of ledgers;
- Early detection of errors;
- Fixation of responsibility;
- Provides internal check;
- Division of Labour;
- Early preparation of Final Accounts;
- Facilitates effective supervision;
- Facilitates maintenance of secrecy of Private Ledger;
- Reduction of burden of the General Ledger;
- Reduction of Auditor's works.



CHECK YOUR PROGRESS

Q.5: Mention two features of Self- Balancing Ledger System.

i) .....

ii) .....

Q.6: Mention two advantages of Self- Balancing Ledger System.

i) .....

ii) .....



Auditor — An accountant who is appointed and authorised to examine the accounts and verify the expenditures of an organisation.

4.10 PROCEDURE OF SELF- BALANCING LEDGER SYSTEM

When the ledgers are maintained under self balancing system, the following accounts will appear in the respective ledger:

(A) Debtors Ledger

(i) Individual Accounts (Personal Accounts) of Trade Debtors. i.e. credit customers.

(ii) General Ledger Adjustment Account.

Note: (a) Accounts under (i) above appears because of posting made from Book-keeping entries; and

(b) Account under (ii) above i.e. General Ledger Adjustment Account appears because of posting made from Self Balancing entries.

(B) Creditors Ledger

(i) Individual Accounts (Personal Accounts) of Trade Creditors. i.e. the Accounts of suppliers from whom goods were bought on credit.

(ii) General Ledger Adjustment Account.

Note: (a) Accounts under (i) above appears because of posting made from Book-keeping entries; and

(b) Account under (ii) above i.e. General Ledger Adjustment Account appears because of posting made from Self Balancing entries

(C) General Ledger

(i) All personal accounts other than the personal accounts of Trade Debtors and Trade Creditors

(ii) All Individual Nominal Accounts such as Salary A/c, Rent A/c etc.

(iii) All Individual Real Accounts such as Building A/c, Furniture A/c etc.

Received Bills Receivable	6,000
Returns Inward	1,750
Rebates allowed to Debtors	550
Bad Debts	900
Bills Receivable dishonoured	750

Solution :

IN GENERAL LEDGER

DEBTORS' LEDGER ADJUSTMENT ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2017 Jan 31	To General Ledger Adjustment A/c: (in D.L.)			2017 Jan.31	By General Ledger Adjustment A/c: (in D.L.)		
	Opening Balance		32,000		Cash		15,600
	Sales		19,600		Discount		400
	Bills Receivable dishonoured		750		Bills Receivable		6,000
					Returns Inward		1,750
					Rebates		550
					Bad Debts		900
				Jan.31	By Balance c/d		27,150
			52,350				52,350
Feb.1			27,150				

(a) For items such as credit sales, cheques or bills receivable dishonoured, interest and charges levied on debtors etc. which have the effect of increasing the balance of debtors account:

Debtors Ledger Adjustment Account (in General Ledger) Dr.

To General Ledger Adjustment Account (in Debtors Ledger)

(b) For items such as cash/cheques/bills received, discount allowed, bad debts written off etc. which have the effect of decreasing the balance of debtors account:

General Ledger Adjustment Account (in Debtors Ledger) Dr.

To Debtors Ledger Adjustment Account (in General Ledger)

After passing the above entries, Debtors ledger will have accounts of individual debtors, which will generally show debit balances and another account named "General Ledger Adjustment Account'' which will show credit balance. Now a trial balance can be prepared from the Debtors ledger itself.

The entry for self balancing will be passed with the periodical totals of each item, information for which will be collected from relevant subsidiary books.

Exercise: 4.3

Bhaben & Co. decides to maintain their ledgers under Self-Balancing System. From the following particulars, prepare the Adjustment Accounts as they would appear in the Debtors' Ledger and the General Ledger of the firm.

	(Rs.)
Balance of Sundry Debtors – January 1, 2017	32,000
Transactions for the month of January, 2017	
Credit Sales	19,600
Received Cash from Debtors	15,600
Allowed them discount	400

(iv) 'Debtors Ledger Adjustment Account' in effect 'Total Debtors Account'

(v) 'Creditors Ledger Adjustment Account' in effect 'Total Creditors Account'

Note: (a) Accounts under (i), (ii) and (iii) above appear because of posting made from Book-keeping entries; and

(b) Accounts under (iv) and (v) above i.e. 'Debtors Ledger Adjustment Account' and 'Creditors Ledger Adjustment Account' appear because of posting made from Self Balancing entries

4.10.1 Entries to be passed under Self- Balancing Ledger System

When the ledgers are kept under Self Balancing system, the following two sets of entries are required to be passed

(i) Book-keeping Entries

Book-keeping entries are those entries which are passed in the books of account for recording the transactions following the Double Entry principles.

Individual personal accounts are posted in the relevant personal ledgers i.e. Debtors Ledger and Creditors ledger on daily basis whereas total of subsidiary books are posted in the relevant accounts in the 'General Ledger' on periodical basis which may be weekly, monthly or quarterly depending on policy decision of the management.

(ii) Self- Balancing Entries

At the end of each period for which self-balancing is to be done, self-balancing entries are passed with the periodical total of the different subsidiary books. For the purpose of maintaining the ledgers under self-balancing system, additional accounts– termed as 'Adjustment Accounts' are prepared, the entry will be passed

by debiting/crediting one Adjustment Account and crediting/debiting the other Adjustment Account following the Double Entry principle– depending on the ledger to be self balanced.

4.10.2 Posting from the Sales Book when Ledgers are on Self-Balancing Ledger System

When ledger are kept on self-balancing system there are four postings from the sales book - two usual posting and two posting to Adjustment Accounts. These are as follows:

Usual postings

(i) Individual items are posted to debtors accounts opened in debtors ledger;

(ii) Total of the month is posted to sales account in general ledger.

Self-balancing posting

(iii) Total of the sales book for the month is posted to general ledger adjustment account (in debtors' ledger). Amount is posted on the credit side of adjustment account because debtors are debited.

(iv) Total of the sales book for the month is posted to debtors ledgers adjustment account (in general ledger). The adjustment account is debited because sales account is credited.

4.10.3 Self-Balancing of Debtors' Ledger

When credit sales are made, the accounts of the debtors are maintained. Maintenance of such account is called Sales Ledger or Debtors' Ledger. The function of the Sales Ledger is to show the Accounts of the customers or Debtors to whom goods are sold on credit. From the last year's Books of Account, the balances of the entire Debtors' Accounts will be entered on the

debit side of the relevant Accounts in the Debtors Ledger of the current year. The credit sales during the year are posted in detail to the debit of the individual Debtor's Account.

Debtors Ledger, through individual Debtors accounts, **gets Debit** on account of the following:

- Opening debit balances of Debtors' Accounts
- Total credit sales during the period.
- Cheques and Bills of customers dishonoured.
- Discount, previously allowed, but subsequently disallowed.
- Interest charged on overdue accounts
- Any other charges debited to customers' accounts
- Transfers from any other Ledger (generally the Bought Ledger).

Debtors Ledger, through individual Debtors accounts, **gets Credit** on account of the following:

- Opening credit balance, if any.
- Cash (including cheques) received during the year.
- Discount allowed to Debtors.
- Bills Receivable accepted by the Debtors
- Bad Debts written off during the year.
- Sales Returns from the customers.
- Transfers.

For the purpose of self balancing of Debtors Ledger, the following **Adjustments or Control Accounts** are opened:

(i) General Ledger Adjustment Account in Debtors Ledger.

(ii) Debtors Ledger Adjustment Account in General Ledger.

Now, for the purpose of self balancing of Debtors Ledger, the following journal entry will be passed by debiting/crediting General Ledger Adjustment Account and crediting/debiting the Debtors Ledger Adjustment Account.

the books of bank, which the customer get at the time of opening the account. Occasionally, some differences arises between the bank balances shown by the cash book and the pass book. These differences are set aside by preparing the bank reconciliation statement.

The steps involved in the preparation of BRS will be discussed.Then we will cover the importance of BRS. The distinctions between BRS and Bank statement will also to discussed. Towards the end of this unit we will discuss the causes of differences between two balances of cash book and pass book and the causes of such differences will also be discussed.

5.3 PASS BOOK AND STATEMENT OF ACCOUNT

Pass Book : Pass Book is a copy of the customer's account in the books of a bank. It is given to a customer to keep him informed of the entries made in his account in the books of the bank and he should check periodically the entries of his cash book with entries of his Pass Book or Statement of Account to find out his exact position, thus ensuring the accuracy of the recording of the entries in both the books. A Pass Book is periodically sent by the customer to the bank for making its records up to date.

Specimen of Pass Book

United Bank of India, Guwahati

Pass Book

Date	Particulars	Withdrawal Dr.	Deposit Cr.	Dr. or Cr. Balance

- Opening credit balances of Creditors' Accounts
- Total credit purchases during the period.
- Cheques and Bills dishonoured.
- Discount, previously allowed, but subsequently disallowed.
- Interest charged by suppliers on overdue accounts
- Any other charges charged by suppliers
- Transfers from any other Ledger (generally the Sold Ledger).

Creditors Ledger, through individual Creditors accounts, **gets Debit** on account of the following:

- Opening debit balance, if any.
- Cash paid during the year.
- Cheques issued to creditors.
- Discount allowed by creditors.
- Acceptance given to creditors.
- Purchases returns to the creditors.
- Transfers.

For the purpose of self balancing of Creditors Ledger, the following **Adjustments or Control Accounts** are opened:

(a) General Ledger Adjustment Account **in Creditors Ledger.**
(b) Creditors Ledger Adjustment Account **in General Ledger.**

4.10.5 Self-Balancing of General Ledger

The function of the Sales Ledger is to show the accounts of the customers or Debtors and the purpose of preparing the Creditors Ledger is to show the accounts of the suppliers or Creditors from whom goods have been bought on credit. For other transactions a separate ledger is maintained. Under multiple ledger system, this is the main ledger, popularly known as General ledger or Nominal ledger. This ledger is used for the following purpose:

(a) To record all accounts falling within the category of real accounts such as Land, Building, Machinery, Cash etc.

(b) To record all accounts falling within the category of nominal accounts such as Salary, Rent, Interest etc.

(c) To record all accounts falling within the category of personal accounts such as Capital, Drawings, Loan etc. and personal accounts of other debtors and creditors excluding the accounts of Trade Debtors and Trade Creditors.

When an asset is bought on credit, the creditor is termed as 'Creditor for Asset'. Similarly when an asset is sold on credit, such debtor is termed as 'Debtor for Asset'. Accounts of such debtors and creditors do not fall within the category of Trade Debtors and Trade Creditors. Accounts of Trade Debtors and Trade Creditors appear in the Debtors Ledger and Creditors Ledger whereas the accounts of Debtors and Creditors for asset appear in the General Ledger.

(iv) To record all accounts of Sales, Sales Returns, Bills Receivable, Discount Allowed, Purchases, Purchases Return, Bills Payable, Discount Received etc. which have direct bearing with Trade Debtors and Trade Creditors (Credit Sale and Credit Purchase).

In case of accounts falling under category (i) to (iii) above and for Cash Sales and Cash Purchases, the double entry for the transactions are completed within the General Ledger itself. For example, Purchased Machinery for cash Rs. 10,000/-. In this case, one aspect is Machinery account and the other aspect is Cash account. Both these accounts will appear in the General Ledger and thereby completing the double entry of the transaction within the ledger itself. Again, for example, Sold goods for Cash Rs. 3,000/-. In this case, one aspect is Cash account and the other aspect is Sales account. Both these accounts will appear in the General Ledger and thereby completing the double entry of the transaction within the ledger itself.

UNIT 5: BANK RECONCILIATION STATEMENT

UNIT STRUCTURE

5.1 Learning Objectives
5.2 Introduction
5.3 Pass book and Statement of Account
5.4 Concept of Bank Reconcilition statement
5.5 Importance of Bank Reconciliation Statement
5.6 Distinctions between Bank Statement and Bank Reconciliation Statement
5.7 Preparation of Bank Reconciliation Statement
5.8 Causes of differences
5.9 Let Us Sum up
5.10 Further Reading
5.11 Answers To Check Your Progress
5.12 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- know the concept and meaning of Bank Reconciliation Statement(BRS)
- describe the steps in preparation of BRS
- learn the importance of BRS
- distinguish between Bank Statement and BRS
- identify the causes of differences and disagreement between passbook and cash book.

5.2 INTRODUCTION

In this unit, we are going to learn the concept of Bank Reconciliation statement.In bank column of the cash book we record the bank transactions like, depositing cheque into bank, withdrawing cash from bank etc. These transactions are also recorded in the books of accounts of the bank and the customer gets informations about the transactions through pass book. Pass book is the copy of customer's accounts in

5. What do you understand by the term ‘‘Sectional ledger balancing system?’’ What are its advantages?
6. What advantages are derived by a trader by keeping the Ledgers under Self-balancing System?
7. Briefly describe the procedure for self balancing of Debtors Ledger.
8. Briefly describe the procedure for self balancing of Creditors Ledger.

———————

In case of accounts falling under category (iv) above, for example, for Credit Sales to Ram Rs.2, 000, one aspect is Ram Account and the other aspect is Sales account. Ram’s account will appear in the Debtors Ledger and Sales account will appear in General Ledger. In other words, the double entry relating to such type of transactions will not be completed within the General Ledger itself. Now, if a trial balance of the General Ledger is taken out, it will not agree because of non-availability of other aspect of the transaction.

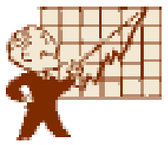
In order to make the General Ledger self balanced, the following **Adjustments or Control Accounts** are opened in the General Ledger:

(i) Debtors Ledger Adjustment Account.

(ii) Creditors Ledger Adjustment Account.

For the purpose of self balancing of General Ledger, no further journal entries are required. From entries passed for self balancing of Creditors Ledger and Debtors Ledger, the above two accounts will be opened in the General Ledger:

General ledger contains all accounts of individual Assets, Liabilities, Incomes, expenses etc. except those of individual Trade Debtors and Creditors. The accounts of Trade Debtors and Creditors will be incorporated in ‘‘Debtors Ledger Adjustment Account’’ and ‘‘Creditors’ Ledger Adjustment Account’’ stated above on total basis. Now a trial balance can be prepared from the General ledger itself.



CHECK YOUR PROGRESS

Q.7: What are the two sets of entries required to be passed when the ledgers are kept under Self-Balancing system?

i) .....

ii) .....

4.11 LET US SUM UP

In this unit, the following points have been discussed-

- Sectional Ledger Balancing System is the system of multiple ledgers containing Debtors' ledger, Creditors' Ledger and General Ledger.
- Under Sectional Ledger Balancing System only one section of the ledger i.e. general ledger is self balanced and the other two ledgers are not self balanced
- Sectional Ledger Balancing System differs from certain defects, like limited application of internal check, non adherence to double-entry principles etc.
- Under Self- Balancing Ledger system, an Adjustment account is prepared to completing double entry of each of the transactions relating to each ledger within the ledger itself.
- Self- Balancing Ledger system helps in early detection of errors and facilitates effective supervision.
- Under Self- Balancing Ledger system, two sets of entries – Book-Keeping and Self- Balancing entries are required to be passed.



4.12 FURTHER READINGS

1. Ashis Bhattacharya, *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari, "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*", Capital Publishing Company, Guwahati.



4.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q.1: Sectional Balancing System is the system of multiple ledgers designed to make only the general ledger complete.

Ans to Q.2: i) Sectional Balancing System facilitates sub-divisionof ledger into (a) General ledger (b) Debtors ledger and (c)Creditors ledger

ii) Under this system, trial balance of the business as a whole can be prepared at periodical Intervals.

Ans to Q.3: i) Under this system more than one ledger keeper can be employed, which facilitates the division of work among the book-keepers.

ii) The preparation of Total Debtors Account and Total Creditors Account in the General Ledger facilitates the ascertainment of balances of Total Debtors and Total Creditors at the end of the specified period.

Ans to Q.4: i) Arithmetical accuracy of one ledger only

ii) Lack of effective supervision

Ans to Q.5: i) Periodical posting in the Adjustment Accounts

ii) Fixation of employee responsibility

Ans to Q.6: i) Early detection of errors

ii) Early preparation of Final Accounts

Ans to Q.7: (i) Book-keeping Entries and

(ii) Self Balancing Entries.



4.14 MODEL QUESTIONS

1. What do you understand by Sectional ledger balancing system?
2. What do you understand by Self-balancing system?
3. Mention four Features of Sectional Balancing.
4. Mention five advantages of Self Ledger Balancing System.

1. **Uncredited cheques:** It includes (a) Cheques deposited into bank but not credited, and (b) Cheques deposited into bank but returned dishonored.

a) *Cheques deposited but not credited:* When cheques received from customer are deposited into the bank for collection, an entry is made on the debit side of the cash book in the bank column and thereby the bank balance as per Cash Book increases the amount whereas the bank credits the customer's account only after collecting the proceeds of the cheques. After the credit entry is made by the bank the balance as per Pass book will also increase and thus both the balances will agree. The process of collection of cheque requires time and due to this gap, some cheques deposited into the bank may remain uncredited by the bank. Hence the balances of both the books disagree.

b) *Cheques deposited but returned dishonored:* When cheques are deposited but returned dishonored due to some reasons, their will arise a difference in balances of both the books because the amount of the cheque is recorded in the bank column on the debit side of the cash book at the time of deposit but there is no corresponding entry in the bank's book as the bank has not received the proceeds of the cheques.

2. **Unpresented and unpaid cheques:** It includes (a) Cheques issued but not presented for payment to the bank, and (b) Cheques issued but returned dishonored.

a) *Cheques issued but not presented for the payment to the bank:* When the cheques are issued for payment an entry is made on the credit side of the cash book in the bank column but the bank debit's the customer's account only when it is presented and paid by the bank. Due to this time gap between the date of issue and presentation of the cheque, when on a particular date, both the books are checked, it may be found that some cheques may remain unpresented to the bank for encashment and as a result divergence arises.

Current Account of Mr. Ramesh……..

Statement of Account

A statement of Account is similar to a Pass Book but it is prepared on loose sheets by the bank. It is also a copy of Customer's Account in the books of the Bank. It is periodically prepared by the bank and is sent to the customer for his examination and comparison with his own

Points	Pass Book	Bank Statement of Account
1. Form	It is a small bound book.	It is a loose leaf typed or handwritten statement in the form of Pass Book
2.Manner of recording	A pass book is made up to date by recording therein each transaction after its occurrence.	All transactions are recorded in the Bank Statement after a definite period.
3.Purpose	It keeps the customers informed of the position of his bank account after each transaction.	It keeps the customer informed about the position of his bank account after a period.
4. Utility	It enables the customer to resolve any discrepancy between the cash book & pass book immediately.	It enables the customer to resolve any discrepancy between the cash book & pass book only after a definite period.

Cash Book. However, there are some differences between the pass book and the statement of account which may be stated as under

5.4 CONCEPT OF BANK RECONCILIATION STATEMENT

A Bank Reconciliation Statement is a statement prepared periodically by a customer to explain the divergence (difference) between the bank balance as per cash book and the bank balance as per Pass Book. It clearly shows the two differing balances and the outstanding items which causes the balances to disagree.

The objective of preparing such a statement is to know the causes of differences between the two balances and pass necessary correcting or adjusting entries in the books of the firm. But it is to be noted that some differences are automatically adjusted. For example - A cheque that has been sent for collection, but not yet collected, causes a difference between the balance as shown by the pass book and the balance as shown by the cash book, but no adjusting entry is required in the cash book for such a difference because, the bank will credit the firm's account as soon as the cheque is collected

Your are aware that on account has two sides namely, the debit side and the credit side. But there is nothing like debit side and credit side in case of a Bank Reconciliation Statement. So, it is not a ledger account, it is mere a statement prepared outside the purview of Double Entry system of Book- Keeping and therefore is not a part of book keeping. It is prepared by a customer of a bank and not by a bank.

5.5 IMPORTANCE OF BANK RECONCILIATION STATEMENT

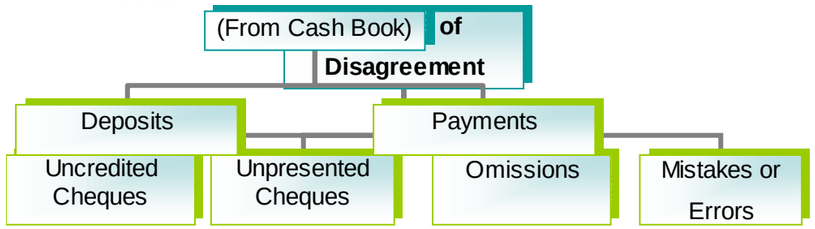
The importance of bank reconciliation statement may be discussed as under–

1. It highlights the causes of differencs between the bank balance as per cash book and the bank balance as per pass book. Necessary adjustments or corrections can therefore be carried out at the earliest.
2. It reduces the chances of fraud by the accounts staff handling cash. It may be possible that the cashier may not deposit the money in the bank in time though he might have passed the entry in the bank column of the cash book. The Bank Reconciliation Statement will project such discrepancies. There is a moral check on the staff of the organization to keep the cash records always up-to-date.
3. The reconciliation process helps in bringing out the errors committed either in Cash Book or Pass Book.

		by the bank but not recorded in the cash book.		
More	Less	Errors and Mistakes. (a)Cheques recorded in the cash book for sending the same into the bank but actually it was not sent		
Less	More	(b) Debit to a wrong account by the bank		

2. **Transactions:** Some differences arise from the bank's action that has not been intimated to the customer. For example, interest credited by bank or bank charges debited by the bank. The customer comes to know about these transactions only when it receives the Bank Statement.

3. **Errors:** Some differences arises owing to errors committed by the bank or by the persons responsible for preparing the cash book.



Effects on balance of		Causes of Discrepancy	Adjustment in statement to Opening balance of	
Cash book	Pass book		Cash book	Pass book
		Uncredited cheques:		
More	Less	(a) Cheques deposited into bank but not cleared	Deduct	Add
More	Less	(b) Cheques deposited into bank but returned dishonored	Add	Add
		Unpresented and unpaid cheques:		
Less	More	(a) Cheques issued but not presented to bank	Add	Deduct
Less	More	(b) Cheques issued but dishonored.	Add	Deduct
		Omission of Deposits	Add	Deduct
Less	More	(a) Interest, Dividend etc, collected and credited by the bank.	Add	Deduct
Less	More	(b) Interest on bank deposit allowed by a bank.	Add	Deduct
Less	More	(c) Direct payment into the bank by customer	Add	Deduct
Less	More	(d) Collection of bills by the bank on behalf of the customers.	Add	Deduct
Less	More	(e) Cheques deposited into bank but omitted to be recorded in the cash book.	Add	Deduct
		Omission of Payments		
More	Less	(a) Interest on overdraft and bank charges debited by the bank.	Deduct	Add
More	Less	(b) Direct payment by the bank.	Deduct	Add
More	Less	(c) Bills Receivable discounted and dishonored.	Deduct	Add
More	Less	(d) Cheques issued and paid	Deduct	Add

4. Bank reconciliation statement may also show any undue delay in the clearance of cheques.

5.6 DISTINCTIONS BETWEEN BANK STATEMENT AND BANK RECONCILIATION STATEMENT

Points	Bank Statement	Bank Reconciliation Statement
1.Content	It shows the transaction of a customer with the bank for a definite period as recorded in the bank Pass Book.	It shows the causes of discrepancies between the cash book and pass book.
2.Maker	It is prepared by a bank.	It is prepared by a customer of a bank.
3.Object	It object is to inform the customer of a bank about his transactions with the bank at the end of a period.	Its object is to reconcile the discrepancies between the cash book balance and the pass book balance on a given date.
4. Basis of preparation	It is prepared by the bank on the basis of the transactions recorded in the ledger account maintained in the name of the customer.	It is prepared on the basis of the transactions recorded in the cash book and the pass book.
5.Period	It is a statement for a period	It is a statement as on a particular date.
6.Starting Point	It starts with the bank balance of the customer as in the bank's ledger	It can be started with either the cash book balance or the pass book balance.

Let us have a book on the distictions between bank statement and bank reconcibition statement –

5.7 PREPARATION OF A BANK RECONCILIATION STATEMENT

In this section use will discuss the steps invelned in the preparation of a bank reconciliation stetement. The steps are–

1. **Identification of the balance:** It is prepared from either the cash book or pass book balance.
2. **Identification of plus or minus balance:** Plus balance means that the firm has deposited more in the bank than it has withdrawn whereas minus balance means more amount has been withdrawn from the bank than the amount deposited i.e. overdraft.
3. **Determining the effect of the transactions:** *If the statement is prepared from the cash book balance:* Add those items which cause an increase in the balance as per pass book and deduct those items which cause a decrease in the balance of the pass book.

   If the statement is prepared from the pass book balance: Add those items which cause an increase in the cash book balance and deduct those items which cause a decrease in the cash book balance.
4. **Considering the date of preparing the statement:** Transaction recorded before the date of reconciliation is considered for BRS
5. **Balancing the Statement:** If it is started with the cash book balance, we shall find the balance of the pass book and the vice- versa.

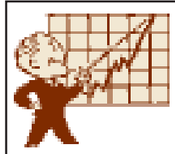
   A Bank reconciliation statement is prepared usually at the end of a period. A quarter, a half year or a year, as may be found convenient and necessary by the firm, taking into account the number of transaction involved. The following factors should be taken into account while preparing bank reconciliation statement –

1. The cash book should be completed and the balances as per the bank column on a particular date should be arrived at for the period for which the Bank Reconciliation Statement has to be prepared.
2. The pass book should be make up to date.
3. The balances as shown either the cash book or the bank pass book should be taken as a base.
4. The effect of that particular cause of difference should be studied on the balances shown by the either book.
5. In case, the cause has resulted in an increase in the balance shown by the other book, the amount of such an increase should be added

to the balance shown in the former book which has been taken as the base.

6. In case, the cause has resulted in a decrease in the balance shown by the other book, the amount of such a decrease should be deducted from the balance shown in the former book which has been taken as the base.

A Bank Reconciliation Statement is given below:



CHECK YOUR PROGRESS

Q1. What do you mean by a Pass Book

.....

.....

.....

.....

Q2. What are the steps in preparation of BRS

.....

.....

.....

.....

.....

5.8 CAUSES OF DIFFERENCES

The differences in the two balances arise from the following three causes:

1. **Timing:** There may be a time gap in between recording transactions in the customer's book and bank book. For example, when a cheque is issued to a party, it is recorded immediately in the cast book but the bank will record it only when it makes payment against that cheque. Similarly, when a cheque is deposited, it is recorded in the cash book immediately, but the bank will record it only when it collects money in respect of that cheque.

c. Determining the effect of the transactions

d. Considering the date of preparing the statement

e. Balancing the Statement

- The differences in the two balances arise from the following three causes:

  a) Timing

  b) Transactions

  c) Errors

- Causes of Disagreement can be explained as:



5.10 FURTHER READING

1. Ashis Bhattacharya, *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.

2. S. N. Maheshwari, "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.

3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*", Capital Publishing Company, Guwahati.

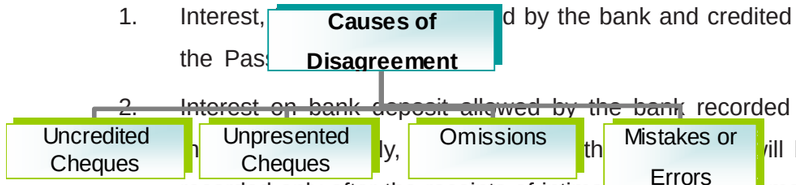
4. R. L. Gupta and M. Radhaswamy, "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.

5. Jain & Narang,"*Accounting Theory and Management Accounting*", Kalayani Publishers.

b) Cheques issued but returned dishonored: In such a case no cash goes out from the bank, hence no entry is passed in the customer's account by the bank. But an entry is made in the bank column on the credit side of the cash book when the cheque is issued, so a difference arises in the balances of both the books.

3. Omissions: It includes the transactions recorded in the customer's account in the bank's books without corresponding entries in the cash book. Entries for such transactions are passed in the cash book on receipt of the Bank Statement. However, there is a time gap in the date of entries and so when both the books are compared the balances differ. This difference will be removed by passing entries in the cash book for such omitted items. Omissions are of two types namely (a) Omission of deposits and (b) Omission of payments.

a) Omission of deposits: It includes:



1. Interest, d by the bank and credited to the Pas

2. Interest on bank deposit allowed by the bank recorded in ly, th ill be recorded only after the receipts of intimation of the statement of account.

3. Direct payment into bank by a customer may not be recorded immediately in the cash book and as a result balances may differ.

4. Collection of bills by the bank on behalf of the customer, it may not be recorded in the Cash Book and when the bank collects the bill money and credits the same to the customer's account, a difference will arise.

5. Cheque deposited into bank but omitted to be recorded in the Cash Book.

b) Omission of payments: It includes:

1. Interest on overdraft and bank charges: When customer's account is overdrawn it is overdraft, and the bank charges interest on such an overdraft which is debited to the customer's account. And the bank also debits customer's account for incidental charges called 'Bank Charges'.

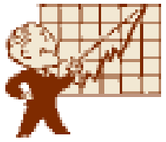
   As the entries in the cash book are passed only on the receipt of intimation from the bank, there will be a difference between the two balances.

2. Direct payment by the bank: Sometimes the bank makes the payment like insurance premium, bills payable, etc. and debits the customer's account whereas no corresponding entry is made in the cash book.

3. Bills receivable discounted and dishonored: The bank debits the customer's account with the amount of the bills and the noting charges, if any, but no entry is passed in the cash book till the intimation is received.

4. Cheques issued and paid by the bank but not recorded in the cash book.

Errors and Mistakes: Errors may be committed either in the cash book or in the bank books. As a result, it will cause a disagreement between the two balances. Such error may arise in casting, totalling, balancing, in writing amounts etc.



CHECK YOUR PROGRESS

Q3. What are the causes of differences between the two balances.

.....

.....

.....

.....

.....



ACTIVITY

Bank Reconciliation Statement as on 31st December

From the following particulars prepare the bank reconciliation statement:

1. Bank overdraft as per Cash Book. Rs.16,200
2. A cheque deposited as per Bank Statement but not recorded in the cash book Rs.700
3. Debit side of the Bank Column cast short Rs.100
4. A cheque for Rs. 500 deposited but collection as per Bank Statement Rs. 4996
5. A party's cheque retuned dishonored as per the Bank Statement only Rs. 530
6. Bills collected directly by the bank Rs. 3500
7. Bank charges recorded twice in the cash book Rs. 25
8. A bill for Rs. 8000 discounted for Rs.7960 returned dishonored by the bank, noting charges being Rs.15
9. Cheques deposited but not yet collected by the bank Rs. 2320
10. Cheques issued but not presented for encashment Rs.1250.

5.9 LET US SUM UP

In this unit we have discussed the following

- Pass Book is a copy of the customer's account in the books of a bank.
- A statement of account is similar to a Pass Book but it is prepared on loose sheets by the bank.
- A Bank Reconciliation Statement is a statement prepared periodically by a customer to explain the divergence (difference) between the bank balance as per cash book and the bank balance as per Pass Book.
- Following are the steps in preparation of BRS:
  a. Identification of the balance
  b. Identification of plus or minus balance

Exercise: 5.3

Prepare a Bank Reconciliation Statement of Mr. Subodh Kumar on 31st December with the following particulars:

1. Cash Book showed a debit balance of Rs. 5000 as on 31st December.
2. Cheques amounting to Rs. 3, 000 were issued to creditors but were not presented to the bank for encashment before 31st December.
3. Cheques of Rs. 2, 500 were deposited into bank but were not collected by the bank before 31st December.
4. Interest on deposit credited by the bank but not recorded in the cash book was Rs. 100
5. Bank charges debited by the bank but not recorded in the cash book before 31st December was Rs.30
6. A customer directly deposited in our bank A/c Rs.5,00 on 28th December but informed us of the matter on 2nd January next.

Solution :

Particulars	Rs	Rs
Bank balance as per Cash Book (Deposit)		5,000
Add: Cheques issued but not presented	3,000	
Interest on deposit credited by the bank	100	
Direct deposit by a customer	500	3600
		8600
Less: Cheques deposited but not credited by the bank	2500	
Bank charges debited by the bank		
Bank Balance as per Pass Book (Deposit)	30	
		2530
		6070

Exercise: 5.1

Prepare a Bank Reconciliation Statement as on 31st December 2015 from the following particulars:

a. Bank Balance as per cash book on 31st December, 2015 was Rs. 30,000

b. Cheques of Rs. 2,000 issued in December have not been presented for payment till the close of the year.

c. A cheque of Rs. 300 was directly deposited by a customer into the Bank Account and there was no corresponding entry in the Cash Book.

d. Cheques deposited into bank on 30th December 2015 have not been collected by the bank Rs. 3,000

Solution : 1

Bank Reconciliation Statement as on 31st December, 2015

Particulars	Rs.	Rs.
Bank balance as per Cash Book		30000
Add: Cheques issued for payment but not presented to Bank	2000	
A cheque directly deposited into bank but not recorded in the cash book	300	2300
		32300
Less: Cheques deposited into bank but not yet collected by the bank		3000
Bank Balance as per Pass Book		29300

Exercise: 5.2



Prepare a Bank Reconciliation Statement of Mr. S Dutta on 31st December, 2016 from the following particulars:

a. Bank balance as per Pass Book as on 31st December, 2015 was Rs. 6,500.

b. A cheque of Rs. 500 issued on 28th December, 2015 was enchased after 31st December.

c. Cheques paid into bank before 31st December, 2015 and credited after 31st December were Rs. 2, 500.

d. A cheque of Rs. 600 deposited to and credited by the bank before 31st December , 2015 was omitted to be recorded in the cash book.

e. A customer directly deposited Rs.1, 000 in our bank account but the same was omitted to be recorded in the cash book.

f. A bank interest of Rs.150 credited by the bank and a bank commission of Rs. 70 debited by the bank were not recorded in the cash book.

g. Bank paid our bill for Rs.1, 000 but it was not recorded in the cash book.

Solution 2:

Bank Reconciliation Statement as on 31st December, 2016

Particulars	Rs	Rs
Bank balance as per Pass Book (Deposit)		6500
Add: Cheques deposited but not credited by the bank	2500	
Bank commission debited by the bank but not recorded in the cash book	70	
Direct payment of a bill by the bank not yet recorded in the cash book	1000	3570
Less: Cheques issued but not presented	500	10070
Cheque deposited and credited by the bank but not recorded in the cash book	600	
Direct deposit by a customer into the bank only	1000	
Bank interest credited by the bank but not recorded in the cash book	150	
Bank Balance as per Pass Book (Deposit)		2250
		7820

- **Extra income in the form of interest:** The hire vendor can earn extra income in the form of interest which he charges from the hire purchaser and thereby gets compensation for fund blocked for long time.

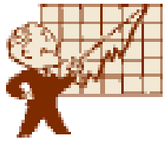
DISADVANTAGES OF HIRE PURCHASE SYSTEM

From the point of view of the Hire Purchaser

- **High price:** The levy of interest by the hire vendor increases the total cost of the goods sold under hire purchase system, thereby making the goods costlier.
- **No right of ownership:** As the buyer does not enjoy the right of ownership, he can neither sell nor mortgage the asset until the payment of the last installment.
- **Risk of financial strain on the buyer:** It associates financial strain on the income of the buyer since he is to pay the periodical installments in time out of his income to avoid the risk of repossession by the seller.

From the point of view of the Hire Vendor

- **Requirement of huge capital:** Hire purchase form of trade requires huge capital investment which is not affordable to all traders.
- **Risk of bad debt*:*** Since the goods sold under hire purchase system are expensive, the hire vendor runs the risk of bad debt if the hire purchaser makes default in payment of installments where the market value of the goods sold has decreased in the meantime.



CHECK YOUR PROGRESS

Q.1) Mention two features of hire- purchase system.

i) .....

ii) .....



5.11 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q.1.: Pass Book is a copy of the customer's account in the books of a bank.

Ans. to Q.2.: Following are the steps in preparation of BRS:

a. Identification of the balance
b. Identification of plus or minus balance
c. Determining the effect of the transactions
d. Considering the date of preparing the statement
e. Balancing the Statement

Ans. to Q.3.: The differences in the two balances arise from the following three causes:

a. Timing
b. Transactions
c. Errors



5.12 MODEL QUESTIONS

Q1. What is meant by a Bank Reconciliation Statement?

Q2. What is the need of preparing a Bank Reconciliation Statement?

Q3. Compare Bank Statement and Bank Reconciliation Statement.

Q4. Give reasons for differences between the cash book and pass book balances.

Q5. Distinguish between Bank Pass Book and Bank Statement.

Q6. Bank balance as per cash book of a trader as on 31st Dec. was Rs.10000. On the scrutiny of the pass book and cash book the following discrepancies were found–

A cheque of Rs. 2000 issued on Dec 25th was not presented to bank.

A cheque of Rs. 3000 was deposited into bank on 20th Dec and was credited in the pass book on January 2nd next.

Bank debited Rs. 20 for bank charges and credited Rs. 500 for dividend but the same were not recorded in the cash book.

Bank paid insurance premium Rs. 350 and collected rent Rs. 500 but no entries were passed for them in the cash book.

Prepare a bank reconciliation statement.

Q7. On 31st Dec. the Pass Book shows a credit balance of Rs. 5000. Before that date cheques amounting to Rs. 2000 was issued but were not presented for payment. A cheque of Rs. 500 paid into the bank was not credited. On 31st Dec, a cheque of Rs. 100 which though entered in the cash book was omitted to be paid into the bank; besides there was an entry of Rs. 75 for interest.

Prepare a bank reconciliation statement showing the adjustments.

Q8. From the following particulars ascertain the bank balance as per pass book of Mr. Raju as at 31ts March:

1. Credit balance as per cash book on31st March was Rs1500.
2. Interest charged by bank upto31st March Rs50 was recorded in the pass book.
3. Bank charges made by the bank Rs12.50 were also recorded only in the pass book.
4. Cheques paid into bank Rs2500 but cheques of Rs1875 only were cleared and credited by the bankers.
5. Two cheques of Rs750 and Rs1500 were issued but out of them only one cheque of Rs750 was presented for payment upto 31st march.
6. Dividend on shares Rs450 was collected by the bankers directly for which Raju did not have any information.

Q9. Prepare a bank reconciliation statement from the following particulars:

1. Bank balance as per Pass bookRs10,000

6.4 ADVANTAGES AND DISADVANTAGES OF HIRE-PURCHASE SYSTEM

After discussing the features of hire- purchase system, now we will discuss the advantages and disadvantages of this system from the point of view of both hire purchaser and the hire vendor.

ADVANTAGES OF HIRE-PURCHASE SYSTEM

From the point of view of the Hire Purchaser

- **Immediate possession:** As the hire purchaser gets the immediate possession of the goods he can enjoy the goods before the full payment is made.
- **Ownership out of income:** The buyer can use the goods productively and the fund generated can be utilised in payment of installments and consequently he can obtain the ownership of the goods.
- **Opportunity to test the quality:** The hire-purchaser has an opportunity to use the goods and to test the quality through actual use, and if the goods are found to be quality deficient, he has the option of returning them.
- **Opportunity to return the goods:** The purchaser has the option to return the goods if such goods fail to meet the changing needs of his business in future.

From the point of view of the Hire Vendor

- **Right of lien:** The seller has a right of lien on the goods i.e. he may take back the goods if the buyer fails to pay any installment. Thus, the seller has a security against the inability of the hire purchaser to clear his debts.
- **Opportunity to increase the turnover:** This system proves helpful to the sellers as it provides opportunity to increase their volume of turnover and consequently to increase profit.

the seller, known as Hire Vendor and the buyer, known as Hire-Purchaser or Hirer.

Features of hire-purchase system

The following are the important features of hire-purchase system:

- **Agreement:** Hire-purchase agreements are agreements to sell goods. It is not a contract of sale although it resembles a sale. The sale takes place at a future date on the fulfillment of certain conditions.
- **Possession of the goods*:*** Possession of goods sold under hire purchase system is transferred from the seller to the buyer on signing the agreement.
- **Ownership of goods:** Although the possession of goods sold under hire purchase system remains with the buyer, the ownership of such goods remain with the seller till the payment of the last installment.
- **Mode of payment:** The buyer agrees to pay cash price of the goods along with interest in periodical installments which may be monthly, quarterly, half-yearly or yearly.
- **Hire charge:** Installments paid by the hire-purchaser are treated as hire charges till the payment of the last installment.
- **Right of repossession:** The hire-vendor has the right to repossess the goods if the hire-purchaser makes default in the payment of any installment.
- **Effect of repossession:** If the hire-vendor repossesses the goods, because of non-payment of any installment, the amount paid by the hire-purchaser, if any, will be treated as hire charges and the same will not be refunded by the hire-vendor on repossession.
- **Hirer's right to terminate the agreement:** The hire purchaser has a right to terminate the agreement, after giving at least fourteen day's notice in writing, and thereby return the goods bought under hire purchase system.

2. Cheque deposited into the bank but no entry was passed in the cash book Rs500
3. Cheque received but not sent to bank Rs1200
4. Credit side of the Bank column cast short Rs200
5. Insurance premium paid directly by the bank under standing advice Rs600
6. Bank charges entered twice in twice cash book Rs20
7. Cheque issued but not presented to the bank for payment Rs500
8. Cheque received entered twice in the Cash Book.Rs1000
9. Bills discounted dishonored not recorded in the Cash Book Rs5000

———————

UNIT 6: HIRE-PURCHASE SYSTEM

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning and Features of Hire Purchase System

6.4 Advantages and Disadvantages of Hire Purchase System

6.5 Rights and Obligations of Hire Purchaser and Seller

6.6 Accounting treatment for Hire Purchaser System

6.7 Let Us Sum up

6.8 Further Reading

6.9 Answers To Check Your Progress

6.10 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- explain the meaning and features of hire- purchase system
- discuss the advantages and disadvantages of hire- purchase system
- explain the accounting system for hire- purchase sale
- states different methods for calculation of interest

6.2 INTRODUCTION

We are aware of the fact that goods can be purchased either in cash or on credit including capital goods. In many situations, capital goods are purchased neither in cash nor on credit, but by paying the price of the capital gods in installments. Perhaps you have noticed this important feature of modern day payment system for purchase of consumer durables, viz. car, two-wheeler, fridge, etc. This is installment payment system. There are two systems for paying the installments. They are:

(i) Hire Purchase System;

(ii) Installment Purchase System.

Such systems of purchases enable the purchaser to eventually secure ownership of the new asset. Payment patterns can be tailored to suit individual needs, generally involving a deposit followed by a series of

monthly or quarterly installments. The cost can be spread over its useful life and paid for out of revenue. In this unit, we will discuss both the hire- purchase system of selling goods. We will also discuss the advantages as well as disadvantages of these systems. Moreover, the accounting entries for the systems will also be covered in this unit.

Hire purchase system system serve the same purpose i.e., enables the customers to purchase costly goods by making payment in easy installments

You will find this unit interesting as it will help you in identifying the one out of the two modern systems of purchasing goods. It will give you a clear picture regarding the maintenance of accounts by the hire-purchase companies.

6.3 MEANING AND FEATURES OF HIRE PURCHASE SYSTEM

Hire-purchase system refers to that system under which the buyer agrees to pay the price of the goods bought in periodical installments (yearly, half-yearly, quarterly or monthly). It includes both a portion of the cost of goods and interest for deferred payment to acquire the immediate possession of the asset for use. But the ownership of such goods passes to the buyer (hire-purchaser) only on the payment of the last installment.

Thus, hire purchase is a type of installment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last installment is paid. The hire purchase system is regulated by the Hire Purchase Act, 1972. This Act defines a hire purchase as “an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement. In a hire-purchase transaction, there are two parties –

Total amount payable at the end of second year (2nd Installment)

= Rs. 20,000 + Interest

= Rs. 20,000 + Rs. 8,000 = Rs. 28,000

(3) The balance outstanding at the beginning of third (last) year

= (Rs. 40,000 – Rs. 20,000) = Rs. 20,000

Interest payable at the end of first year

= (20% of Rs. 20,000) = Rs. 4,000

Total amount payable at the end of third year (3rd Installment)

= Rs. 20,000 + Interest

= Rs. 20,000 + Rs. 4,000 = Rs. 24,000

Thus total payments are as follows:

(i) Down Payment: Rs. 10,000

(ii) Installment Cash Price = Rs. 60,000

(Rs.20, 000 + Rs. 20,000 + Rs. 20,000)

(iii) Interest: Rs. 24,000

Total: (i) + (ii) + (iii) = Rs. 94,000

Of this Rs. 70,000 is for Principal (capital nature) and Rs. 24,000 for Interest (revenue nature).

The Installment payments may be classified as follows:

1st Installment: Rs. 32,000

Cash Installment of Rs. 20,000 is **capital nature;**

Interest of Rs. 12,000 is **revenue nature**

2nd Installment: Rs. 28,000

Cash Installment of Rs. 20,000 is **capital nature;**

Interest of Rs. 8,000 is **revenue nature**

3rd Installment: Rs. 24,000

Cash Installment of Rs. 20,000 is **capital nature;**

Interest of Rs. 4,000 is **revenue nature**

Q.2) Fill in the blanks:

a. Under the hire-purchase system, the hire purchaser acquires the immediate…….. Of the goods on signing the agreement.

b. The amount to be paid by the buyer under hire- purchase system is called ……..

c. The hire purchaser can return the goods before the ……is paid.

6.5 RIGHTS AND OBLIGATIONS OF HIRE PURCHASER AND SELLER

Rights of Hire Purchaser : The Rights and obligations of Hire Purchaser are incorporated in Chapter IV of the Hire-Purchase Act, 1972. The rights conferred on the hire purchaser are briefly summarised below.

- **Right of hirer to purchase at any time with rebate:** The hirer may, at any time during the continuance of the hire-purchase agreement and after giving the hire vendor not less than fourteen days notice in writing of his intention to purchase the goods, complete the purchase of the goods by paying or tendering to the hire vendor the hire-purchase price or the balance thereof as reduced by the rebate calculated in the manner provided in the Act in Sec. 9.
- **Right to hirer to terminate agreement at any time:** The hirer may, at any time before the final payment under the hirer-purchase agreement falls due, and after giving the hire vendor not less than fourteen days notice in writing of his intentions to terminate the agreement and re-delivering the goods to the hire vendor, terminate the hire-purchase agreement by payment or tender to the owner of the amounts which have accrued towards the hire-purchase price and not been paid by him, including the sum, if any, which he is liable to pay under Sec. 10 of the Act.

- **Right of assignment and transmission:** The hirer may assign his right, title and interest under the hire-purchase agreement with the consent of the hire vendor, or if his consent is unreasonably withheld or not accorded, without his consent. The hire vendor cannot ask for any payment or other consideration for giving his consent to an assignment. If an owner asks for any payment or consideration, the consent shall be deemed to be unreasonably withheld. (Sec. 12)

- **Rights of hirer in case of seizure of goods by hire vendor:** Where the owner seizes under clause (c) of section 19 the goods let under a hire-purchase agreement, the hirer may recover from the owner the amount, if any, by which the hirer-purchase price falls short of the aggregate of the following amount, namely: - the amounts paid in respect of the hire-purchase price up to the date of seizure.

Obligations of hirer

- **Obligations of hirer to comply with agreement:** Subject to the provisions of the Hire Purchase Act, a hirer shall be bound to pay the hire vendor in accordance with the agreement, and otherwise to comply with the terms of the agreement.

- **Obligation of hirer in respect of care to be taken of goods:** A hirer in the absence of a contract to the contrary shall be bound to take as much care of the goods to which the hire-purchase agreement relates as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quality and value shall not be responsible for the loss, destruction or deterioration of the goods, if he has taken the amount of care thereof described in clause (i).

  The hirer shall be liable to make compensation to the owner for any damage caused by failure to take care of the goods in accordance with the provisions of sub-section (1).

Hire-purchase price
=
Total Installments (including any down payment)
=
Cash Price + Interest

Suppose you intended to purchase a bike on hire purchase basis the cost of which is Rs 70,000. The amount to be paid on the signing the Hire-purchase agreement is Rs. 10,000. The balance is to be paid on annual installments of Rs 20,000. The rate of interest to be paid is 20% pa on the reduced balance. Now,

Cash Price = Rs. 70,000

Down Payment = Rs.10, 000.

Number of Installments = 3

Amount of each Installment = Rs. 20,000 (excluding interest)

Amount of each installment is also called Cash Price Installment.

The balance at the beginning = Rs. 70,000

Amount of Down Payment = Rs.10,000.

(1) The balance outstanding at the beginning of first year

= (Rs. 70,000 – Rs. 10,000) = Rs. 60,000

Interest payable at the end of first year

= (20% of Rs. 60,000) = Rs. 12,000

Total amount payable at the end of first year (1st Installment)

= Rs. 20,000 + Interest

= Rs. 20,000 + Rs. 12,000 = Rs. 32,000

(Cash Installment = Rs. 20,000, Interest = Rs. 12,000)

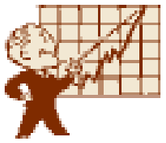
(2) The balance outstanding at the beginning of second year

= (Rs. 60,000 – Rs. 20,000) = Rs. 40,000

Interest payable at the end of second year

= (20% of Rs. 40,000) = Rs. 8,000

Nothing in clauses shall be construed as affecting the right of a third party to enforce against the owner or hirer or against both the owner and the hirer any charge or encumbrance to which the goods covered by the hire-purchase agreement are subject.



CHECK YOUR PROGRESS

Q.3: Mention two rights of hire vendor.

.....

.....

.....

.....

Q.4: Mention two obligations of hire purchaser.

.....

.....

.....

.....

6.6 ACCOUNTING TREATMENT FOR HIRE PURCHASER SYSTEM

Cash Price, Hire-purchase Price and Interest:

Before we discuss the accounting treatment of hire purchase transactions, it will be worthwhile to explain Cash Price, Hire-purchase Price and Interest. Cash price is the price or total amount to be paid on purchase of goods in cash. The other option is to buy the goods on Hire purchase basis. When goods are purchased on Hire purchase basis the buyer has to pay the Hire-purchase price. Hire purchase price is the total amount payable by the hire purchaser as per hire purchase agreement in order to complete the transaction relating to hire purchase of the goods. It is the total of down payment, if any, and all the installments including interest paid by the hire-purchaser to the hire vendor.

The cash price does not include any interest or hire charges but Hire-purchase price include any interest or hire charges on such purchase.

- **Obligation of hirer in respect of use of goods:** If the hirer makes any use of the goods to which the hire-purchase agreement relates which is not according to the conditions of the agreement, the hirer shall be liable to make compensation to the owner for any damage arising to the goods from or during such use.

- **Obligation of the hirer to give information as to whereabouts of goods:** Where by virtue of a hire-purchase agreement a hirer is under a duty to keep in his possession or control the goods to which the agreement relates, the hirer shall, on receipt of a request in writing from the owner, inform the owner where the goods are at the time of a request in writing from the owner, inform the owner where the goods are at the time when the information is given or, if it is sent by post, at the time of posting.

  If the hirer fails without reasonable cause to give said information within fourteen days of the receipt of the notice, he shall be punishable with fine which may extend to two hundred rupees.

Rights of Hire Vendor:

Now, we will discuss the rights and obligations of hire-vendor as given in the Act.

- **Right to get full payment :** The hire vendor has the right to receive the full payment of the agreed amount for the goods sold under hire purchase through installment payments on due dates as stipulated in the hire purchase agreement.

- **Right of owner to terminate hire-purchase agreement [Sec.18(1)] :** The hire vendor has a right to terminate the hire purchase agreement for default in payment of hire or unauthorized act or breach of express conditions contained in the hire purchase agreement by the hirer. Where a hirer makes more than one default in the payment of hire as provided in the hire-purchase agreement then, subject to the provisions of Sec.21 and after giving the notice in writing of not less than– (i) one week, in a

case where the hire is payable at weekly or lesser intervals; and two weeks in any other case, the owner shall be entitled to terminate the agreement by giving the hirer notice of termination in writing.

- **Right of owner on termination (Sec.19):** Where a hire-purchase agreement is terminated under this Act, the owner shall be entitled to retain the hire i.e. the installment money already been paid by the hire purchaser and to recover the arrears of hire due and when such good are seized by the owner, the retention of hire and recovery of the arrears of hire due shall be subject to the provisions of Sec.17.
- **Right to forfeit the initial deposit (Sec.19):** On termination of hire purchase agreement and subject to the provision in the hire purchase agreement, the hire vendor has the right to forfeit the initial deposit made by the hire purchaser.
- **Right to seize the goods (Sec.19):** On termination of hire purchase agreement and subject to the provision in the hire purchase agreement, the hire vendor has the right to enter the premises of the hire purchaser and seize the goods sold on hire purchase.
- **Right to recover possession of the goods (Sec.19):** On termination of hire purchase agreement, the hire vendor has the right to recover possession of the goods sold on hire purchase.
- **Right to claim damage for non-delivery of the goods (Sec.19):** The hire vendor has the right to claim damage for non-delivery of the goods, from the date on which termination of hire purchase agreement is effective, to the date on which goods are delivered to or seized by the owner.
- **Right to charge fee for statement of account:** The hire vendor has a right to charge a fee Re.1 from the hire purchaser for expenses for a statement of account showing the amount paid,

has become due and has not become due under the agreement.

Obligation of owner to supply copies and information

(a) It shall be the duty of the owner to supply, free of cost, a true copy of the hire-purchase agreement, signed by owner to the hirer, immediately after execution of the agreement, and where there is a contact of guarantee to the surety, on demand made at any time before the final payment has been made under the agreement.

(b) It shall also be the duty of the owner, at any time before the final payment has been made under the hire-purchase agreement, to supply to the hirer, within fourteen days after the owner receives a request in writing from the hirer in this behalf and the hirer tenders to the owner the sum of one rupees of expenses, statement signed by the owner or his agent showing.- the amount paid by or on behalf of the hirer, the amount which has become due under the agreement but remains unpaid, and the date upon which each unpaid instalment became due and the amount of each such instalment, and the amount which is to become payable under the agreement, and the date or the mode of determining the date upon which each future instalment is to become payable, and the amount of each such instalment.

Where there is failure without reasonable cause to carry out the duties imposed under the Act , while the default continues,- The owner shall not be entitled to enforce the agreement against the hirer or to enforce any contract of guarantee relating to the agreement, or to enforce any right to recover the goods from the hirer, and no security given by the hirer in respect of money payable under the agreement or given by a surety in respect of money payable under such a contract of guarantee as aforesaid shall be enforceable against the hirer or the surety by the holder thereof.

And, if the default continues for a period of two months, the owner shall be punishable with fine which may extend to two hundred rupees.

(B) **Asset Accrual Method:** Asset Accrual method of recording hire purchase transactions in the books of the hire purchaser recognises the fact that the hire purchaser does not become the owner of the asset till he makes payment of the last installment. Hence, no entry is passed on signing the hire purchase agreement or on taking the delivery of the asset. Entries are passed at the time of making down payment, on each installment becoming due and on payment of each installment. The entries to be passed in the books of the hire purchaser may be grouped as under:

(a) Entries on the date of agreement / taking delivery of the asset.

(b) Entries on the due dates of periodical installments

(c) Entries on annual closing of account.

(a) **Entries on the date of agreement/taking delivery of the asset:** For the purpose of purchase of asset under hire purchase system, an agreement is usually entered into between the hire purchaser and hire vendor. As per the agreement, the asset is delivered to the hire purchaser who may or may not make any down payment. Therefore, on the date of agreement, the following entries will be passed under asset accrual method:

(i) On getting delivery of the asset on the date of agreement:

No Entry

(ii) For down payment, if any, due on the date of agreement:

Asset (by name of the asset) Dr. [With the amount of down payment]

To Hire Vendor Account (By name)

(iii) For down payment made, if any, on the date of agreement:

Hire Vendor Account (By name) Dr. [With the amount of down payment]

To Bank/Cash Account

(Above entries will be passed only once for the purchase of each asset under Hire purchase system.)

In the earlier sections we have discussed the theoretical concept of hire purchase. Now we will discuss the accounting treatment of hire-purchase transactions.We have found that in a hire-purchase transaction, the price paid in installments includes two elements – the element of Cash price and the element of hire-charges or interest. For accounting purpose, the element of cash price and interest included in the installment, is required to be apportioned because the former is a payment of capital nature and the later, the hire-charges or interest, is a payment of revenue nature.

Again, under this system although the possession of the goods is transferred to the buyer by the seller, the ownership of the goods is not transferred to the buyer until the payment of the last installment. Therefore, the question arises is whether the seller can legally treat such transaction as sale and whether the hire-purchaser can treat such goods as his asset and show them in the Balance sheet until the payment of the last installment? Because of the application of modifying principle of accounting – 'Substance Over Legal Form' i.e. 'reality overriding the legality' in accounting practices, the hire vendor can treat such transactions as sales and hire-purchaser can record the goods bought under hire purchase as his asset as if he is the owner.

Calculation of Interest:

For the purpose of calculation of interest, depending upon the nature and extent of information supplied in the questions, there may be following situations:

(a) When the Rate of Interest, total Cash Price and the installments are given.

(b) When total Cash Price and the installments are given but the Rate of Interest is not given.

(c) When the installments and the Rate of Interest is given but the total Cash Price is not given.

(d) When only installments are given but neither the cash price nor the rate of Interest is given.

(e) Where a reference to the Annuity Table is made to find out (i) the cash price, or (ii) the amount of each installment

The calculation of interest and principal amount under different circumstances has been explained at appropriate places in this book.

Accounting entries

For recording hire purchase transactions the accounting entries are required to be passed in the books of both the Hire Purchaser and the Hire Vendor. These are explained below:

Books of hire purchaser

There are two methods of recording the hire purchase transactions in the books of the hire purchaser:

(A) **Credit Purchase Method (also called Full Cash Price Method)**

(B) **Asset Accrual Method.**

(A) **Credit Purchase Method or Full Cash Price Method:** Under this method, hire purchase transactions are recorded like ordinary credit purchase of assets. It is assumed that the hire purchaser has agreed to purchase the asset and for all practical purposes he becomes the owner of the asset (although not legally and technically). Therefore, the hire purchaser debits the asset account at its full cash price on the date of taking delivery. The entry for interest is passed on the dates on which the interest becomes due. The entries for payment of installments are passed on the dates on which the installments are paid. The entries to be passed in the books of the hire purchaser are:

(a) Entries on the date of agreement / taking delivery of the asset.

(b) Entries on the due dates of periodical installments

(c) Entries on annual closing of account.

(a) (i) On getting delivery of the asset on the date of agreement:

JAISWAL MOTOR CO. ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2013 Jan.1	To Bank A/c		12,000	2013 Jan.31	By Machinery A/c		60,000
Mar. 31	To Bank A/c		8,600	Mar. 31	By Interest A/c		600
June 30	To Bank A/c		8,500	June 30	By Interest A/c		500
Sep. 30	To Bank A/c		8,400	Sep. 30	By Interest A/c		400
Dec. 30	To Bank A/c		8,300	Dec. 30	By Interest A/c		300
Dec. 31	To Balance c/d		16,000				
			61,800				**61,800**
2014 Mar. 31	To Bank A/c		8,200	2014 Jan. 1	By Balance b/d		16,000
June 30	To Bank A/c		8,100	Mar. 31	By Interest A/c		200
				June 30	By Interest A/c		100
			16,300				**16,300**

ACTIVITY



On 1st April 2014, Assam Sugar Mills Ltd. purchased some plants from Bharat Industries Ltd. on hire purchase basis paying Rs. 5,000 immediately and undertaking to pay further sum of Rs. 5.000 each on 31st March, 2015 and 2016 and a further sum of Rs. 6,602 on March 2017.The cash price of the plant was taken at Rs. 20,000. Interest at 5% p.a. is charged by the supplier and 15% depreciation on cash price on reducing installment method is written off each year. Show the entries in the books of Assam Sugar Mills Ltd. and ledger accounts.

[Hints :Interest for 1st annual instalment Rs. 750, 2nd annual instalment Rs. 538, 3rd instalment Rs.314. Depreciation for 1st year Rs. 3,000, 2nd year Rs. 2,550, for 3rd year Rs. 2,168]

Calculation of depreciation:

	Cash price of the machine on 1.1.2013	60,000
Less :	Depreciation @ 10% for 1 year	6,000
	Value on 1.1.2014	54,000
Less :	Depreciation @ 10% for 1 year	5,400
	Value on 1.1.2015	48,600

IN THE BOOKS OF ARADHANA MOTORS

MACHINERY ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2013 Jan.1	To Jaiswal Motor Co. A/c		60,000	2013 Dec.31	By Depreciation A/c By Balance c/d		6,000 54,000
			60,000				60,000
2014 Jan. 1	To Jaiswal Motor Co. A/c		54,000	2014 Dec. 31	By Depreciation A/c By Balance c/d		5,400 48,600
			54,000				54,000
2015 Jan. 1	To Jaiswal Motor Co. A/c		48,600				

Asset (by name of the asset) Dr. [With the full cash price of the asset]

To Hire Vendor Account (by name)

(ii) For down payment made, if any, on the date of agreement:

Hire Vendor Account (By name) Dr. [With the amount of down payment]

To Bank/Cash Account

(The above entries will be passed only once for the purchase of each asset under Hire purchase system).

(b) (i) When the interest to be paid is due:

Interest Account Dr. [With the amount of interest becoming due]

To Hire Vendor (by name)

(ii) On making payment of the periodical installment:

Hire Vendor (by name) Dr. [With the amount of installment paid]

To Bank/Cash account

This entry will be passed on the actual date of making the payment.

(The above entries will be repeated in subsequent years).

(c) (i) For charging depreciation on the asset :

Depreciation Account Dr. [With the amount of depreciation]

To Asset Account

(ii) For transfer of interest and depreciation to Profit & Loss Account:

Profit and Loss Account Dr. [Amount of depreciation and Interest]

To Interest Account [Amount of interest for the year]

To Depreciation Account [Amount of depreciation]

(The above entries will be repeated in subsequent years).

Consequent to the passing of above entries, the following accounts are opened in the ledger of the Hire purchaser to record Hire purchase transactions:

(i) Hire Vendor Account (By name)

(ii) Asset Account (By name)

(iii) Interest Account

(iv) Depreciation Account

(v) Profit & Loss Account

(In examination problems, when you are asked to prepare necessary accounts in the books of the Hire purchaser, you should prepare the above accounts).

Exercise: 6.1



Aradhana Motors purchased machinery from Jaiswal Motor Co. on hire purchase system on 1st January, 2013. The cash price of the machinery on the date of purchase was Rs. 60,000. As per the agreement, Rs. 12,000 was paid on the date of purchase and the balance was paid equally in 6 quarterly installments together with interest. Jaiswal Motor Co. charged interest @ 5% p.a.

Prepare Machinery Account and Jaiswal Motor Co. Account in the books of Aradhana Motors under Cash Price Method providing depreciation on machinery @ 10% p.a. on reducing balance method. Accounts are closed on 31st December each year.

Solution : 6.1

calculation of interest and capital amount			
Particulars		Interest Rs.	Capital Value Rs.
Cash price of the machine on 1.1.2013	60,000		
Less: Down Payment	12,000		12,000
Balance	48,000		
Add: Interest for 1st quarter upto 31.3.13	600	600	
Total Payable	48,600		
Less: 1st installment (8,000 + 600)	8,600		8,000
Balance	40,000		
Add: Interest for 2nd quarter upto 30.6.13	500	500	
Total Payable	40,500		
Less: 2nd installment (8,000 + 500)	8,500		8,000
Balance	32,000		
Add: Interest for 3rd quarter upto 30.9.13	400	400	
Total Payable	32,000		
Less: 3rd instalment (8,000 + 400)	8,400		8,000
Balance	24,000		
Add: Interest for 4th quarter upto 31.12.13	300	300	
Total Payable	24,300		
Less: 4th instalment (8,000 + 300)	8,300		8,000
Balance	16,000		
Add: Interest for 5th quarter upto 31.3.14	200	200	
Total Payable	16,200		
Less: 5th instalment (8,000 + 200)	8,200		8,000
Balance	8,000		
Add: Interest for 6th quarter upto 30.6.14	100	100	
Total Payable	8,100		
Less: 6th instalment (8,000 + 100)	8,100		8,000
Balance	Nil		

(i) For closing the balance of Sales Account:

Sales Account Dr. [With the balance of Sales Account]

To Trading Account

(ii) For transfer of Interest to Profit and Loss Account:

Interest Account Dr. [With the total interest for the year]

To Profit and Loss Account

(*Above entries will be repeated in subsequent years*)

Consequent to the passing of above entries in the books of the Hire Vendor to record the hire purchase transactions, the following accounts are opened in the ledger of the hire vendor:

(i) Hire Purchaser's Account (By name)

(ii) Interest Account; and

(iii) Profit & Loss Account

(When you are asked to prepare necessary accounts in the books of the Hire vendor, you have to prepare the above accounts)

Exercise: 6.2

On 1st April 2016, Barua & Co. purchased a machine from Motors Ltd. on hire purchase basis. The cash price of the machine was Rs. 25,000. The payment was to be made Rs. 5,000 on the date of contract and the balance in 4 annual instalments of Rs. 5,000 plus interest at 5 per cent per annum payable on 31st December each year, the first instalment being payable on 31.12.16.

Show Journal entries and Motors limited account in the books of Barua & Co. assuming accounts are closed on 31st December and depreciation at 10% p.a. is written off on the original cost.

(b) **Entries on the due dates of periodical installments:** Under Asset Accrual method, whenever periodical installments (which may be monthly, quarterly, half-yearly or yearly) become due, it is divided into two parts – one part represents the amount paid for the asset (portion of cash price) and the other part represents hire charges or interest on the unpaid balance. The amount due for the asset is debited to the asset account and the other part representing hire charges or interest is debited to Hire Charges or Interest account and the total amount is credited to Hire Vendor account. In this book, it has been debited to Interest account. Therefore, the following two entries will be passed on the due dates of periodical installments:

(i) *On periodical installments becoming due:*

Asset Account Dr. [With the portion of cash price of the asset]

Interest Account Dr. [With the amount of interest becoming due]

To Hire Vendor (By name) [With the amount of installment due]

(ii) On making payment of the periodical installment:

Hire Vendor (By name) Dr. [With the amount of installment paid]

To Bank/Cash Account

(This entry will be passed on the date of making the payment)

(Above entries will be repeated for making each installment due and for payment of the installment)

(c) **Entries on annual closing of account:** At the end of every financial year entries will have to be passed for charging depreciation on the asset and then entry will have to be passed for transfer of interest and depreciation to Profit & Loss Account. Therefore, the following entries will have to be passed on annual closing of account:

(i) For charging depreciation on the asset:

Depreciation Account Dr. [With the amount of depreciation]

To Asset Account (By name)

(ii) For transfer of interest and depreciation to Profit & Loss Account:

Profit and Loss Account Dr. [With the amount of depreciation and interest]

To Interest Account [With the total interest for the year]

To Depreciation Account [With the amount of depreciation]

(Above entries will be repeated in subsequent years)

BOOKS OF THE HIRE VENDOR:

Hire purchase transactions are recorded like ordinary credit sale of assets by the Hire Vendor. Therefore, the hire vendor debits the hire purchaser's account and credits sales account with its full cash price on the date of delivery of the asset *irrespective of the method of recording followed by the hire purchaser.* The entry for interest is passed on the dates on which the interest becomes due. Interest becomes due when the installments become due. The *hire vendor will not pass any entry for depreciation*. The entries to be passed in the books of the hire vendor may be divided as under:

(a) Entries on the date of agreement/delivery of the asset.
(b) Entries on the due dates of periodical installments
(c) Entries on annual closing of account.

(a) Entries on the date of agreement/ delivery of the asset*:* For the purpose of sale of asset under hire purchase system, an agreement is usually entered into between the hire purchaser and hire vendor. As per the agreement, the asset is delivered to the hire purchaser who may or may not make any down payment. Therefore, on the date of agreement, the following entries will be passed:

(i) *On delivery of the asset to the Hire Purchaser on the date of agreement:*

Hire Purchaser Account (By name) Dr. [With the full cash price of the asset]

To Sales account

(ii) For down payment received, if any, on the date of agreement:

Bank/Cash Account Dr. [With the amount of down payment received]

To Hire Purchaser Account (By name)

(Above entries will be passed only once for sale of each asset under Hire purchase system)

(b) **Entries on the due dates of periodical installments**: As per the agreement, at periodical intervals, the interest on unpaid balance will become due and the periodical installments will be received by the vendor. Therefore, the following two entries will be passed on the due dates of periodical installments:

(i) On interest becoming due:

Hire Purchaser Account (By name) Dr.

To Interest Account [With the amount of interest becoming due]

(ii) On receiving payment of periodical installments*:*

Bank/Cash Account Dr. [With the amount of installment received]

To Hire Purchaser Account (By name)

(Above entries will be repeated in subsequent years)

(c) **Entries on annual closing of account:** At the end of every financial year entries will have to be passed for transfer of Interest to Profit & Loss Account. The hire vendor will not pass any entry for depreciation. Therefore, the following entries will be passed on annual closing of account:



CES

1. Ashis Bhattacharya,(2006), *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari,(2014), "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*", Capital Publishing Company, Guwahati.
4. R. L. Gupta and M. Radhaswamy,(2017), "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.
5. Jain & Narang,(2006),"*Accounting Theory and Management Accounting*", Kalayani Publishers.
6. T.S. Grewal,(2016), "*Introduction to Accountancy",* S. Chand & Co Ltd, India.
7. R.S.N. Pillai, Bagavathi, S. Uma,(2010), *"Practical Accounting (Problems and Solutions to fundamentals of Advanced Accounting) volume I"*, S. Chand & Co Ltd, India.

Solution : 6.2

Calculation of interest :

Particulars	Rs.	Interest Rs.	Capital Value Rs.
Cash Price 1-4-2016	25,000		
Less: Down payment	5,000		5,000
	20,000		
Add :Interest for 9 months up to 31-12-16	750	750	
	20,750		
Less : Instalment Rs. (5,000+750)	5,750		5,000
	15,000		
Add: Interest for 1 year up to 31-12-17	750	750	5,000
	15,750		
Less: Instalment Rs. (5,000+750)	5,750		
	10,000		
Add: Interest for 1 year up to 31-12-18	500		
	10,500		
Less: Instalment Rs. (5,000+500)	5,500		
	5,000		
Add: Interest for 1 year up to 31-12-19	250		
	5,250		
Less: Instalment Rs. (5,000+250)	5,250	250	5,000
	Nil	2,250	25,000

Calculation of Depreciation:

Since depreciation is to be charged @ 10 % p.a on the original cost, Depreciation for the 1st year will be Rs.25,000x10/100x9/12 = Rs. 1,875 and for subsequent years will be 10% of Rs. 25,000 i.e. Rs. 2,500.

In the Books of Barua & Co.

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
2016 April 1	Machinery Account Dr. To Motors Ltd. Account (Being cash price of machinery purchased on hire purchase system.)		25,000	 25,000
2016 April	Motors Ltd. Account To Bank Account (Being the down payment made)		5,000	 5,000
2016 Dec. 31	Interest Account Dr To Motors Ltd. Account (Being interest due to the vendor for 9 months)		750	 750
2016 Dec. 31	Motors Ltd. Account To Bank Account (Being first Installment paid)		5,750	 5,750
2016 Dec. 31	Depreciation Account To Machinery Account (Being Depreciation on the Machinery for 9 months)		1,875	 1,875
2016 Dec. 31	Profit & loss Account Dr. To Interest Account To Depreciation Account (Being Interest & Depreciation Trans. to P/L A/c)		2,625	 750 1,875



6.10 MODEL QUESTIONS

1. What is hire-purchase system? Discuss the feature of hire-purchase system.
2. What is installment purchase system? Discuss the features of installment purchase system.
3. Discuss the differences between hire- purchase and installment purchase systems.
4. On 1st January, 2017, Tata Company purchased a machine worth Rs. 45,000 on hire purchase system. An amount of Rs. 6,000 is paid on delivery and balance in five annual installments of Rs. 9,000 each payable annually on 1st January each year. Any difference in the fifth year's amount should be suitably adjusted. Vendor Company charged 5% interest per annum on yearly balance. Prepare Ledger accounts in the books of the Tata Company for five years providing depreciation at the rate of 20% on diminishing balance and also draw the Balance sheet as on 31st Dec. 1988 showing the relevant items.

[**Hints**: Interest for 1st installment Rs.1, 950, 2nd installment Rs.1, 598, 3rd installment Rs.1, 227, 4th installment 839, 5th installment Rs. 386. Depreciation for 1st year Rs.9, 000, 2nd year Rs.7, 200, 3rd year Rs.5, 760, 4th year Rs.4, 608, 5th year Rs.3,686]

———————

- Different right of the hire purchaser like, right to purchase at any time with rebate, right of the hire purchaser to terminate the agreement after giving due notice to the hire vendor.
- Different obligations of the hire purchaser like, obligation to comply with the agreement, obligation in respect of use of goods etc.
- Rights of hire vendor like, right to get full payment, right to terminate hire- purchase agreement for default in payment of hire by the hire purchaser etc.
- Obligations of the hire vendor regarding supply of a true copy of hire purchase agreement to the hire purchaser.
- Accounting methods for hire- purchase system i.e. (i) credit purchase method and (ii) asset accrual method.



6.8 FURTHER READING

1. Ashis Bhattacharya, *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari, "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.



6.9 ANSWERS TO CHECK YOUR PROGRESS

Q.1) i) Possession of goods ii) Ownership of goods

Q.2) a. Possession

b. Hire purchase price

c. Last installment

Q.3) i) Right to get full payment

ii) Right to seize the goods

Q.4) i) Obligation to comply with the hire purchase agreement.

ii) Obligations to take proper care of the goods.

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
2017 Dec. 31	Interest Account Dr. To Motors Ltd. Account (Being interest due to the vendor for the year)		750	 750
2017 Dec. 31	Motors Ltd. Account To Bank Account (being 2nd Installment paid)		5,750	 5,750
2017 Dec. 31	Depreciation Account To Machinery Account (Being Depreciation on the Machinery for the year)		2,500	 2,500
2017 Dec. 31	Profit & loss Account Dr. To Interest Account To Depreciation Account (Being Interest & Depreciation Trans. to P/L A/c)		3,250	 750 2,500
2018 Dec. 31	Interest Account Dr To Motors Ltd. Account (Being interest due to the vendor for the year)		500	 500
2018 Dec. 31	Motors Ltd. Account To Bank Account (being 2nd Instalment paid)		5,500	 5,500

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
2018 Dec. 31	Depreciation Account To Machinery Account (Being Depreciation on the Machinery for 9 months)		2,500	2,500
2018 Dec. 31	Profit & loss Account Dr. To Interest Account To Depreciation Account (Being Interest & Depreciation Trans. to P/L A/c)		3,000	500 2,500
2019 Dec. 31	Interest Account Dr To Motors Ltd. Account (Being interest due to the vendor for the year)		250	250
2019 Dec. 31	Motors Ltd. Account To Bank Account (being 2nd Instalment paid)		5,250	5,250
2019 Dec. 31	Depreciation Account To Machinery Account (Being Depreciation on the Machinery for 9 months)		2,500	2,500
2019 Dec. 31	Profit & loss Account Dr. To Interest Account To Depreciation Account (Being Interest & Depreciation Trans. to P/L A/c)		2,750	250 2,500

MOTORS LTD ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2016				2013			
Apr 1	To Cash		5,000	Apr. 1	By Machinery A/c		25,000
Dec.31	To Cash		5,750		By Interest A/c		750
Dec.31	To Balance c/d		15,000				
			25,750				25,750
2017				2014			
Dec.31	To Cash A/c		5,750	Jan 1	By Balance b/d		15,000
Dec.31	To Balance c/d		10,000	Dec.31	By Interest A/c		750
			15,750				15,750
2018				2015			
Dec.31	To Cash A/c		5,500	Jan.1	By Balance b/d		10,000
Dec.31	To Balance c/d		5,000	Dec. 31	By Interest A/c		500
			10,500				10,500
2019				2016			
Dec.31	To Cash A/c		5,250	Jan 1	By Balance b/d		5,000
Dec.31					By Interest A/c		250
			5,250				5,250

6.7 LET US SUM UP

In this unit we have discussed the following

- Under hire- purchase system, the hire purchaser agrees to pay the price of the goods in periodical installments. It includes the cost price of the goods as well as interest.
- The advantages and disadvantages of hire- purchase system both from the points of view of hire purchaser and the hire vendor.