2.2 DOUBLE- COLUMN CASH BOOK

If along with columns for amounts to record cash receipts and cash payments another column is added on each side to record the cash discount allowed or the discount received, or a column on the debit side showing bank receipts and another column on the credit side showing payments through bank. It is a double column cash book.

Cash discount is an allowance which often accompanies cash payments. For example, if a customer owes Rs. 500 but is promised that 2% will be deducted if payment is made within a certain period, the customer can clear his account by paying promptly Rs. 490. Cash received will be Rs. 490 and Rs. 10 will be the discount for the firm receiving the payment discount is a loss; for the person making the payment it is a gain. Since cash discount is allowed only if cash is paid, it is convenient to add a column for discount allowed on the receipt side of the cash book and a column for discount received on the payment side of the cash book.

In the cash column on the debit side, actual cash received is entered; the amount of the discount allowed, if any, to the customer concerned is entered in the discount column. Similarly, actual cash paid is entered in the cash column on the payments side and discount received in the discount column. Also the bank column on the debit side records all receipts through bank and the same column on the credit side shows payment through bank.

Balancing: It should be noted that the discount columns are not balanced. They are merely totalled. The total of the discount column on the receipts side shows total discount allowed to customers and is debited to the Discount Account. The total of the column on the payments side shows total discount received and is credited to the Discount Account. The Cash columns are balanced, as already shown. The bank columns are also balanced and the balancing figure is called bank balance. Thus a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

Illustration 2

Ganesh commenced business on 1st April, 2009 with Rs. 2,000 as capital. He had the following cash transactions in the month of April 2009:

		Rs.			*Rs.*
April 1	Purchased furniture		April 7	Paid for petty expenses	15
	and paid cash	250	" 8	Cash purchases	150
"2	Purchased goods	500			
"4	Sold goods for cash	950			
			13	Paid for Typewriter	1,000
"5	Paid cash to Ram Mohan	560			
"6	He allowed discount	10	""	Paid Ali & Sons	400
"6	Received cash from				
	Krishna & Co.	600	""	They allowed discount	8
	Allowed discount	20			

Make out the two-column Cash Book (Cash and discount column) for the month of April, 2006.

Solution

CASH BOOK

Dr. Date 2009	Receipts	L.F.	Discount Rs.	Amount Rs.	Cr. Date 2009	Payments	L.F.	Discount Rs.	Amount Rs.
April1	To Capital A/c			2,000	April1	By Furniture A/c			250
"4	To Sales A/c			950	"2	By Purchases A/c			500
"6	To Krishna A/c		20	600					
					"5	By Ram Mohan		10	560
					"7	By Petty Expenses A/c			15
					"8	By Purchases A/c			150
					"13	By Typewriter A/c			1,000
					"13	By Ali & Sons		8	400
					"30	By Balance c/d			675
			20	3,550				18	3,550
May 1	To Balance b/d			675					

To summarise :

(i) the discount columns in the cash book are not accounts;

(ii) they are not balanced; and

(iii) their totals are entered in the discount account in the ledger.

Note : The person who pays, is credited by both the cash paid by him and the discount allowed to him. Similarly, the person to whom payment is made, is debited with both the amount paid and the discount allowed by him.

2.3 THREE-COLUMN CASH BOOK

A firm normally keeps the bulk of its funds at a bank; money can be deposited and withdrawn at will if it is current account. Probably payments into and out of the bank are more numerous than strict cash transactions. There is only a little difference between cash in hand and money at bank. Therefore, it is very convenient if, on each side in the cash book, another column is added to record cash deposited at bank (on the receipt side of the cash book) and payments out of the bank (on the payment side of the cash book).

For writing up the three-column cash book the under mentioned points should be noted:

1. While commencing a new business, the amount is written in the cash column if cash is introduced and in the bank column if it is directly put into the bank with the description "To Capital Account". If a new cash book is being started for an existing business, the opening balances are written as : "To Balance b/d".

2. All receipts are written on the receipts side, cash in the cash column and cheques in the bank column. If any discount is allowed to the party paying the amount, the discount is entered in the discount column. In the particulars column the name of the account in respect of which payment has been received is written.

3. All payments are written on the payments side, cash payment in the cash column and payments by cheques in the bank column. If some discount has been received from the party receiving the payment, it is entered in the discount column.

4. *Contra Entries:* Often cash is withdrawn from bank for use in the office. In such a case the amount is entered in the bank column on the payments side and also in the cash column on the receipts side. In the reverse case of cash being sent to the bank, the amount is recorded in the bank column on the receipts side and in cash column on payment side. Against such entries, the letter "C" should be written in the LF. column, to indicate that these are contra transaction and no further posting is required for them.

   Note : If initially cheques received are entered in the cash column and then sent to the bank, the entry is as if cash has been sent to the bank.

   While recording contra entries, the basic but important rules should be followed -

   (a) The Receiver Dr.
       The Giver Cr.

   (b) All what comes in Dr.
       All what goes out Cr.

   e.g. where a Cash Book with separate columns for Bank Account is maintained.

   (a) If cash is deposited in Bank Account, the Bank will be the Receiver, hence it will be Debited and as the cash is going out, cash will be credited.

   (b) If cash is withdrawn from the Bank Account, the Bank will be the Giver, hence it will be Credited and, as the cash is coming in, cash will be Debited.

5. If some cheque sent to the bank is dishonoured, i.e., the bank is not able to collect the amount, it is entered in the bank column on the credit side with the name of the related party in the particulars column.

6. If some cheque issued by the firm is not paid on presentation, it is entered in the Bank column on the debit side with the name of the party to whom the cheque was given.

7. In a rare case, a cheque received may be given to some other party, i.e., endorsed. On receipt, it must have been entered in the bank column on the debit side;on endorsement the amount will be written in the bank column on the credit side.

   The advantages of such type of Cash Book are that -

   (a) the Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. Also the chances of error are reduced.

(b) the information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Bank Account.

In case of maintaining more than one Bank Account, separate column can be add for each Bank Account. Transactions between these two or more Bank Accounts can be recorded and tallied with a much less effort.

Suppose, there are two Bank Accounts namely PNB Current Account and SBI-Cash Credit Account. Now, if a cheque is deposited from PNB cheque Book to SBI Account, the receiver - i.e., PNB Account will be debited and the giver i.e. the SBI Account shall be credited.

Balancing: The discount columns are totalled but not balanced. The cash columns are balanced exactly in the same manner as indicated for the simple cash book. The process is similar for balancing the bank columns also. It is possible, however, that the bank may allow the firm to withdraw more than the amount deposited i.e., to have an overdraft, In such a case, the total of the bank column on the credit side is bigger than the one on the debit side. The difference is written on the debit side as "To Balance c/d." Then the totals are written on the two sides opposite one another, the balance is then entered on the credit side as "By Balance b/d."

However, the usual case is that payments into the bank will exceed the withdrawals or payments out of the bank. Then the bank columns are balanced just like the cash columns.

Illustration 3

Enter the following transactions in Cash Book with Discount and Bank Columns. Cheques are first treated as cash receipt.

2009		*Rs.*
Jan.1	Chandrika commences business with Cash	20,000
"3	He paid into Current A/c	19,000
"4	He received cheque from Kirti & Co. on account	600
"7	He pays in bank Kirty & Co's cheque	600
"10	He pays Rattan & Co. by cheque and is allowed discount Rs. 20	330
"12	Tripathi & Co pays into his Bank A/c	475
"15	He receives cheque from Warshi and allows him discount Rs. 35	450
"20	He receives cash Rs. 75 and cheque Rs. 100 for cash sale	
"25	He pays into Bank, including cheques received on 15th and 20th	1,000
"27	He pays by cheque for cash purchase	275
"30	He pays sundry expenses in cash	50

Solution

CASH BOOK

Dr. Date	Receipts Rs.	L.F. Rs.	Discount Rs.	Cash Rs.	Bank Rs.	Date Rs.	Payments	L.F.	Discount	Cash	Cr. Bank
2009						2009					
Jan. 1	To Capital A/c			20,000		Jan. 3	By Bank A/c	C		19,000	
3	To Cash	C			19,000	7	By Bank A/c	C		600	
4	To Kirti & Co.			600		10	By Ratan & Co.		20		330
7	To Cash	C			600	25	By Bank A/c	C		1,000	
12	To Tripathi & Co.				475	27	By Purchases A/c			275	
15	To Warsh		35	450		30	By S. Exp. A/c			50	
20	To Sales A/c			175							
25	To Cash	C			1,000						
						31	By Balance c/d			300	20,745
			35	21,225	21,075				20	21,225	21,075
Feb. 1	To Balance b/d			300	20,745						

3. POSTING THE CASH BOOK ENTRIES

Students would have seen that the cash columns in the cash book is actually the cash account and the bank column is actually bank account. Also, the discount columns are memorandum columns, meant only to provide information about the total discount allowed and total discount received.

The debit side columns for cash and bank indicate receipts. Therefore, the amounts debited in the cash book should be put to the credit of the account in respect of which cash or cheque has been received. For instance, in the cash book given above we see that Rs. 175 have been received for sale of goods. For posting, the amount is credited to the Sales Account as "By Cash Rs. 175." We also see M/s. Warsi have paid Rs. 450 and also they have been allowed Rs. 35 as discount; thus they have discharged a debt of Rs. 485. In the account of M/s. Warsi, the posting is on the credit side as

"By Cash	Rs. 450
By Discount	Rs. 35"
or as :	
By Sundries	Rs. 485"

All payments are recorded on the credit side. The particulars columns show on what account payments have been made. In the ledger accounts concerned the amount in put on the debit side. For example, the cash book shows that a cheque for Rs. 330 has been issued to M/s. Ratan & Co. and also that they have allowed a discount of Rs. 20; thus an obligation of Rs. 350 has been met. In the account of M/s. Ratan & Co. the posting is :

"To Bank	Rs. 330
"To Discount	Rs. 20"
Or	
"To Sundries	Rs. 350"

The rule thus develops: From the debit side of the cash book credit the various accounts with their respective amounts (including any discount that may have been allowed); from the credit side of cash book the posting will be to the debit of the accounts mentioned in the particular column with their respective amounts (including the discount which may have been received).

As has been shown already, the total of the discount columns on the debit side is debited to the discount account ;the total of the column on the credit side is credited to the discount account. From the cash book given on the previous page Rs. 35 is debited and Rs. 20 be credited to the discount account.

4. PETTY CASH BOOK

In a business house a number of small payments, such as for telegrams, taxi fare, cartage, etc., have to be made. If all these payments are recorded in the cash book, it will become unnecessarily heavy. Also, the main cashier will be overburdened with work. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making small payments say below Rs. 25, to him. Of course he will be reimbursed for the payments made. Later, on an analysis, the respective account may be debited.

4.1 IMPREST SYSTEM OF PETTY CASH

It is convenient to entrust a definite sum of money to the petty cashier in the beginning of a period and to reimburse him for payments made at the end of the period. Thus, he will have again the fixed amount in the beginning of the new period. Such a system is known as the imprest system of petty cash.

The system is very useful specially if an analytical Petty Cash Book is used. The book has one column to record receipt of cash (which is only from the main cashier) and other columns to record payments of various types. The total of the various columns show why payments have been made and then the relevant accounts can be debited.

(i) The amount fixed for petty cash should be sufficient for the likely small payments for a relatively short period, say for a week or a fortnight.

(ii) The reimbursement should be made only when petty cashier prepares a statement showing total payments supported by vouchers, i.e., documentary evidence and should be limited to the amount of actual disbursements.

(iii) The vouchers should be filed in order.

(iv) No payment should be made without proper authorization. Also, payments above a certain specified limit should be made only by the main cashier

(v) The petty cashier should not be allowed to receive any cash except for reimbursement.

In the petty cash book the extreme left-hand column records receipts of cash. The money column towards the right hand shows total payments for various purposes; a column is usually provided for sundries to record infrequent payments. The sundries column is analysed. At the end of the week or the fortnight the petty cash book is balanced. The method of balancing is the same as for the simple cash book.

Illustration 4

Shri Ramaswamy maintains a Columnar Petty Cash Book on the Imprest System. The imprest amount is Rs. 500. From the following information, show how his Petty Cash Book would appear for the week ended 12th September, 2009:

7-9-2009	Balance in hand	134.90
	Received Cash reimbursement to make up the imprest	365.10
	Stationery	49.80
8-9-2009	Miscellaneous Expenses	20.90
9-9-2009	Repairs	156.70
10-9-2009	Travelling	68.50
11-9-2009	Stationery	71.40
12-9-2009	Miscellaneous Expenses	6.30
	Repairs	48.30

Solution

PETTY CASH BOOK

Date	Receipts	Amount	Date	Payments	Total Amount	Stationery	Travelling	Misc. Exps.	Repairs
2009		Rs.	2009		Rs.	Rs.	Rs.	Rs.	Rs.
Sept. 7	To Balance b/d	134.90	7	By Stationery	49.80	49.80			
	To Reimbursement	365.10	8	By Misc. Expenses	20.90			20.90	
			9	By Repairs	156.70				156.70
			10	By Travelling	68.50		68.50		
			11	By Stationery	71.40	71.40			
			12	By Misc. Expenses	6.30			6.30	
				By Repairs	48.30				48.30
					421.90	121.20	68.50	27.20	205.00
				By Balance c/d	78.10				
		500.00			500.00				
13	To Balance b/d	78.10							

Illustration 5

Prepare a Petty Cash Book on the imprest System from the following:

2009		*Rs.*
Jan.1	Received Rs. 100 for petty cash	
" 2	Paid bus fare	.50
" 2	Paid cartage	2.50
" 3	Paid for Postage & Telegrams	5.00
" 3	Paid wages for casual labourers	6.00
" 4	Paid for stationery	4.00
" 4	Paid tonga charges	2.00
" 5	Paid for the repairs to chairs	15.00
" 5	Bus fare	1.00
" 5	Cartage	4.00
" 6	Postage and Telegrams	7.00
" 6	Tonga charges	3.00
" 6	Cartage	3.00
" 6	Stationery	2.00
" 6	Refreshments to customers	5.00

Solution

PETTY CASH BOOK

Receipts Rs.	Date 2009	V. No.	Particulars	Total Rs.	Conveyance Rs.	Cartage Rs.	Stationery Rs.	Postage & Telegrams Rs.	Wages Rs.	Sundries Rs.
100	Jan.1		To Cash							
	2	1	By Conveyance	.50	.50					
		2	By Cartage	2.50		2.50				
	3	3	By Postage and Telegrams	5.00				5.00		
		4	By Wages	6.00					6.00	
	4	5	By Stationery	4.00			4.00			
		6	By Conveyance	2.00	2.00					
	5	7	By Repairs to Furniture	15.00						15.00
		8	By Conveyance	1.00	1.00					
		9	By Cartage	4.00		4.00				
	6	10	By Postage and Telegrams	7.00				7.00		
	"	11	By Conveyance	3.00	3.00					
	"	12	By Cartage	3.00		3.00				
	"	13	By Stationery	2.00			2.00			
	"	14	By General Expenses	5.00						5.00
				60.00	6.50	9.50	6.00	12.00	6.00	20.00
			By Balance c/d	40.00						
				100.00						
40.00			To Balance b/d							
60.00	8		To Cash							

4.2 ADVANTAGES OF PETTY CASH BOOK

There are mainly three advantages:

(i) Saving of time of the chief cashier;

(ii) Saving in labour in writing up the cash book and posting into the ledger; and

(iii) Control over small payments.

4.3 POSTING THE PETTY CASH BOOK

In the ledger, a petty cash account is maintained; when an amount is given to the petty cashier, the petty cash account is debited. Each week or forthnight, the total of the payments made is credited to this account. The petty cash account will then show the balance in the hand of the cashier; on demand he should be able to produce it for counting. At the end of the year, the balance is shown in the balance sheet as part of cash balance.

Of course, the payments must be debited to their respective amounts as shown by the petty cash book. For this two methods may be used:

(i) From the petty cash book the total of the various columns may be directly debited to the concerned accounts; or

(ii) A journal entry may first be prepared on the basis of the petty cash book, debiting the accounts shown by the various analysis columns, and crediting the total of the payment of the petty cash accounts.

For Illustration 5 the journal entry and relevant accounts are as follows:

2009			Rs.	Rs.
Jan. 6	Conveyance Account	Dr.	6.50	
	Cartage account	Dr.	9.50	
	Stationery account	Dr.	6.00	
	Postage and Telegrams account	Dr.	12.00	
	Wages Account	Dr.	6.00	
	Repairs Account	Dr.	15.00	
	General Expenses Account	Dr.	5.00	
	To Petty Cash Account			60.00
	(Being the analysis of the Petty Cash Book for the week ending Jan. 6)			
	Entry for cash handed over to the Petty Cashier			
	Petty Cash Account	Dr.	Rs. 100	
	To Cash Account			Rs. 100
	(Being Cash received)			

Petty Cash Account

Date 2009	Particulars	Folio	Amount Rs.	Date 2009	Particulars	Folio	Amount
Jan.1	To Cash		100.00	Jan.6	By Sundries:		
"8	To Cash		60.00		Conveyance		6.50
					Cartage		9.50
					Stationery		6.00
					Postage and Telegrams		12.00
					Wages		6.00
					Repairs		15.00
					General		
					Expenses		5.00

5. ENTRIES FOR SALE THROUGH CREDIT/DEBIT CARDS

Now-a-days sales through Credit/Debit Cards are issued by almost every Bank in India either directly or with collaboration of some other agencies. HSBC Card, SBI Card, BOB Card, ICICI Bank Card, HDFC Card and Andhra Bank Card are some of the popular Cards.

The procedure for issuing Credit/Debit Cards are as follows -

1. A small Plastic Card, called Credit Card is issued by bank to a prospective customer, after verifying his credibility, which is generally measured by his income sources. Debit Card is issued by bank to a customer who has an account with the bank, maintaining a minimum balance. Now a days ATM Card issued by the bank can also be used as Debit Card. This card would contain an embossed 16 digit number and also the name of the cardholder.
2. Generally Bank charges annual subscription fees from the credit card holder. No fee is charged in case of Debit Card, though some banks charge a nominal fee on Debit Card.
3. When the Card holder intends to buy some goods or services through Credit or Debit Card, the seller fills in a form, generally in triplicate, the details of the goods a with the amount of sales and uses the embossed card with the help of the Credit Card machine to print the data on that form. Also the customer has to countersign the form. One carbon copy of the form is given to the customer for the record.
4. The seller sums up the different amounts sold like this and submits, generally everyday, to his bank all the forms. The amount is credited by the bank to the seller's account and debited to the account of the Bank or the company issuing the Credit/Debit Card.
5. The bank issuing the Card, charges commission for each such transaction, which varies between 1% to 4% and is immediately debited to seller's bank account.
6. The bank sends a monthly statement to the card holder. In case of Debit Card the account is immediately debited to the card holder's account, whereas in case of Credit Card, card

holder has to pay the amount in full or part. However, if not paid in full, the interest is charged.

5.1 ACCOUNTING FOR CREDIT/DEBIT CARD SALE

From the seller's point of view, this type of sale is equivalent to a cash sale. Commission charged by the bank will be treated as selling expenses. The following general entries will be made in the seller's books of accounts

1. Bank A/c Dr.

   To Sales Account

   (Sales made through Credit/Debit Card)

2. Commission Account Dr.

   To Bank Account

   (Commission charged by bank)

Illustration 7

Enter the following transaction in Cash Bank with Discount and Bank columns. Cheques are first treated as cash receipts -

2009		***Rs.***
March1	Cash in Hand	15,000
	Overdraft in Bank	6,000
2	Cash Sales	3,000
3	Paid to Sushil Bros. by cheque	3,400
	Discount received	100
5	Sales through credit card	2,800
6	Received cheque from Srijan	6,200
7	Endorsed Srijan's cheque in favour of Adit	
9	Deposit into Bank	6,800
10	Received cheque from Aviral and deposited the same into Bank by allowing discount of Rs. 50	3,600
11	Adit informed that Srijan's cheque is dishonoured	
15	Sales through Debit Card	3,200
24	Withdrawn from Bank	1,800
28	Paid to Sanchit by cheque	3,000
30	Bank charged 1% commission on sales through Debit/Credit Cards	

Solution

CASH BOOK

Dr. Date	Particulars	L.F.	Discount Rs.	Cash Rs.	Bank Rs.	Date	Particulars	L.F.	Discount Rs.	Cash Rs.	Cr. Bank Rs.
2009						*2009*					
March 1	To Balance c/d			15,000		March 1	By Balance b/d				6,000
2	To Sales			3,000		3	By Sushil Bros.		100		3,400
5	To Sales				2,800	7	By Adit			6,200	
6	To Srijan			6,200		9	By Bank	C		6,800	
9	To Cash A/c	C			6,800	12	By Shijan			6,200	
10	To Aviral		50		3,600	24	By Cash A/c	C			1,800
12	Adit			6,200		28	By Sanchit				3,000
15	To Sales A/c				3,200	30	By Commisson				60
24	To Bank A/c	C		1,800		31	By Balance c/d			13,000	2,140
			50	32,200	16,400				100	32,200	16,400

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices:

1. (i) The total of discounts column on the debit side of the cash book, recording cash discount deducted by customers when paying their accounts, is posted to the

    (a) credit of the discount allowed account.

    (b) debit of the discount received account.

    (c) credit of the discount received account.

    (d) debit of the discount allowed account.

   (ii) Which of the following is the kind of a cash book ?

    (a) Simple column cash book

    (b) Double-column cash book

    (c) Three-column cash book

    (d) All of the above

   (iii) Cash book is a type of __________ but treated as a ____________ of accounts.

    (a) Subsidiary book, principal book

    (b) Principal book, subsidiary book

    (c) Subsidiary book, subsidiary book

    (d) Principal book, principal book

   (iv) Which of the following is not a column of a three-column cash book?

    (a) Cash column

    (b) Bank column

    (c) Petty cash column

    (d) Discount column

   (v) Salaries due for the month of March will appear

    (a) on the receipt side of the cash book

    (b) on the payment side of the cash book

    (c) as a contra entry

    (d) nowhere in the cash book

   (vi) Contra entries are passed only when

    (a) double-column cash book is prepared

    (b) three-column cash book is prepared

    (c) simple cash book is prepared

    (d) None of the above

2. Choose the most appropriate answer from the given choices.

(i) The Cash Book records

(a) all cash receipts

(b) all cash payments

(c) all cash receipts and payments

(d) cash and credit sale of goods.

(ii) The balance in the petty cash book is

(a) an expense

(b) a profit

(c) an asset

(d) a liability.

(iii) If Ram has sold goods for cash, the entry will be recorded

(a) in the Cash Book

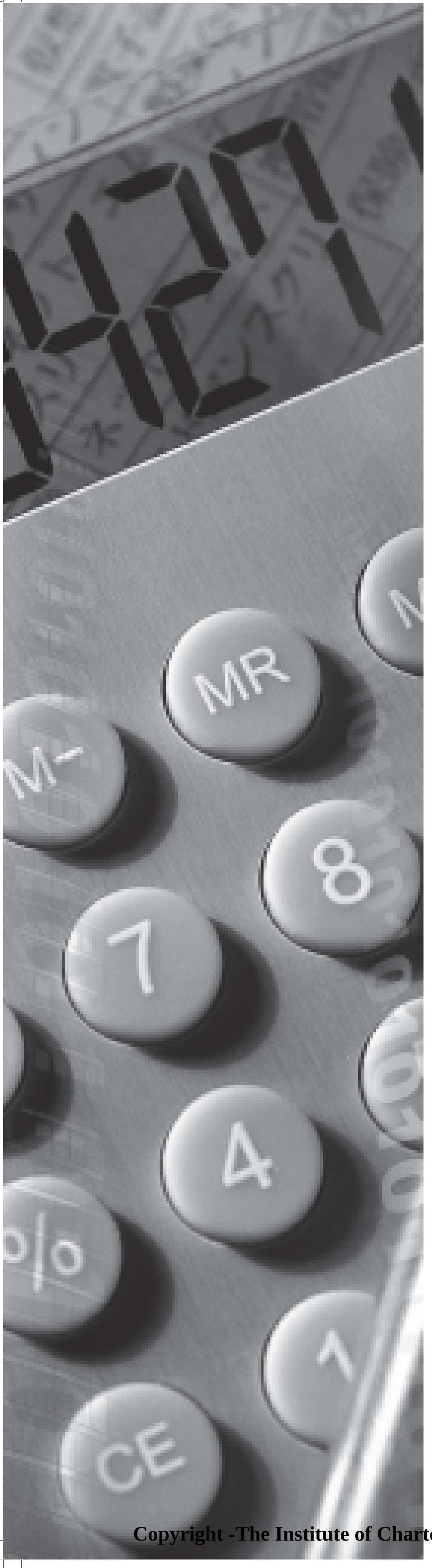
(b) in the Sales Book

(c) in the Journal

(d) in the Stock Book.

ANSWERS

1											
(i)	(d)	(ii)	(d)	(iii)	(a)	(iv)	(c)	(v)	(d)	(vi)	(b)
2											
(i)	(c)	(ii)	(c)	(iii)	(a)						



CHAPTER - 2

ACCOUNTING PROCESS

Unit 6

Capital and Revenue Expenditures and Receipts

Learning Objectives

After studying this unit you will be able to :

- Learn the criteria for identifying Revenue Expenditure and distinguishing from Capital Expenditure.
- Be familiar with the term Deferred Revenue Expenditure.
- Learn the distinction between capital and revenue receipts.
- Understand the linkage of such distinction with the preparation of final accounts.

1. INTRODUCTION

Accounting aims in ascertaining and presenting the results of the business for an accounting period. For ascertaining the periodical business results, the nature of transactions should be analysed whether they are of capital or revenue nature. The Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period. Capital Expenditure, on the other hand, generates enduring benefits and helps in revenue generation over more than one accounting period. Revenue Expenses must be associated with a physical activity of the entity. Therefore, whereas production and sales generate revenue in the earning process, use of goods and services in support of those functions causes expenses to occur. Expenses are recognised in the Profit & Loss Account through matching principal which tells us when and how much of the expenses to be charged against revenue. A part of the expenditure can be capitalised only when these can be traced directly to definable streams of future benefits.

The distinction of transaction into revenue and capital is done for the purpose of placing them in Profit and Loss account or in the Balance Sheet. For example: revenue expenditures are shown in the profit and loss account as their benefits are for one accounting period i.e. in which they are incurred while capital expenditures are placed on the asset side of the balance sheet as they will generate benefits for more than one accounting period and will be transferred to profit and loss account of the year on the basis of utilisation of that benefit in particular accounting year. Hence, both capital and revenue expenditures are ultimately transferred to profit and loss account.

Revenue expenditures are transferred to profit and loss account in the year of spending while capital expenditures are transferred to profit and loss account of the year in which their benefits are utilised. Therefore we can conclude that it is the time factor, which is the main determinant for transferring the expenditure to profit and loss account. Also expenses are recognized in profit and loss account through matching concept which tells us when and how much of the expenses to be charged against revenue. However, distinction between capital and revenue creates a considerable difficulty. In many cases borderline between the two is very thin.

2. CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

The basic considerations in distinction between capital and revenue expenditures are:

(a) Nature of business: For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.

(b) Recurring nature of expenditure: If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.

(c) Purpose of expenses: Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. However, determination of the cost of maintenance and ordinary repairs which should be expensed, as opposed to a cost which ought to be capitalised, is not always simple.

(d) Effect on revenue generating capacity of business: The expenses which help to generate income/revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.

When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.

(e) Materiality of the amount involved: Relative proportion of the amount involved is another important consideration in distinction between revenue and capital. Even, if expenditure does not increase the productive capacity of an asset, it may be capitalised because the amount is material or expenditure may increase the asset value and yet to be expensed because the amount is immaterial.

3. CAPITAL EXPENDITURES AND REVENUE EXPENDITURES

As we have already discussed, capital expenditure contributes to the revenue earning capacity of a business over more than one accounting period whereas revenue expense is incurred to generate revenue for a particular accounting period. The revenue expenses either occur in direct relation with the revenue or in relation with accounting periods, for example cost of goods sold, salaries, rent, etc. Cost of goods sold is directly related to sales revenue whereas rent is related to the particular accounting period. Capital expenditure may represent acquisition of any tangible or intangible fixed assets for enduring future benefits. Therefore, the benefits arising out of capital expenditure last for more than one accounting period whereas those arising out of revenue expenses expire in the same accounting period.

4. DEFERRED REVENUE EXPENDITURES

Deferred revenue expenditure is that expenditure for which payment has been made or a liability incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. In short, it refers to that expenditure that is, for the time being, deferred from being charged against income. Such suspension of 'charging of' operation may be due to the nature of expenses and the benefits expected there from. So, long as deferred revenue expenditure is not written off, this is shown on the assets side of the balance sheet under the head "Miscellaneous Expenditure."

Deferred revenue expenditure should be revenue expenditure by nature in the first instance, for example, advertisement. But its matching with revenue may be deferred considering the benefits to be accrued in future.

A thin line of difference exists between deferred revenue expenses and prepaid expenses. The benefits available from prepaid expenses can be precisely estimated but that is not so in case of deferred revenue expenses. Heavy advertising to launch a new product is a deferred expenditure since the benefit from it will be available over the next three to five years but one cannot say precisely how long the benefit would be available and the exact amount of benefit. On the other hand, insurance premium paid say, for the year ending 30th June, 2006 when the accounting year ends on 31st March, 2006 will be an example of prepaid expense to the extent of premium relating to three months' period i.e. from 1st April, 2006 to 30th June, 2006. Thus the insurance protection will be available precisely for three months after the close of the Year and the amount of the premium to be carried forward can be calculated exactly.

Illustration 1

State with reasons whether the following statements are 'True' or 'False'.

(1) Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.

(2) Money spent to reduce working expenses is Revenue Expenditure.

(3) Legal fees to acquire property is Capital Expenditure.

(4) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.

(5) Amount spent for replacement of worn out part of machine is Capital Expenditure.

(6) Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.

(7) Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.

(8) Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.

(9) Heavy advertising to introduce a new product or to explore a new market is Capital Expenditure.

Solution

(1) **False:** Overhaul expenses are incurred to put second-hand machinery in working condition to derive endurable long-term advantage. So it should be capitalised.

(2) **False:** It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. It becomes part of intangible fixed assets if it is in the form of technical know-how and tangible fixed assets if it is in the form of additional replacement of any of the existing tangible fixed assets. So this is capital expenditure.

(3) **True:** Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.

(4) **False:** Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.

(5) **False:** Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.

(6) **False:** Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.

(7) **True:** The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.

(8) **True:** Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

(9) **False:** The effect of heavy advertising with regard to the launching of a new product or to explore a new market will last generally for more than one accounting period. But it does not create any property of tangible or intangible nature and so the expenditure is spread over the period for which its effect would remain. This type of expenditure items are termed as deferred revenue expenditure.

Illustration 2

State with reasons whether the following are Capital or Revenue Expenditure:

(1) Expenses incurred in connection with obtaining a license for starting the factory for Rs. 10,000.

(2) Rs. 1,000 paid for removal of stock to a new site.

(3) Rings and Pistons of an engine were changed at a cost of Rs. 5,000 to get fuel efficiency.

(4) Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) Rs. 8,000 for installing telephone in the office.

(5) A factory shed was constructed at a cost of Rs. 1,00,000. A sum of Rs. 5,000 had been incurred in the construction of temporary huts for storing building material.

Solution

(1) Money paid Rs. 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.

(2) Rs. 1,000 paid for removal of stock to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.

(3) Rs. 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.

(4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.

(5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

5. CAPITAL RECEIPTS AND REVENUE RECEIPTS

Just as a clear distinction between Capital and Revenue expenditure is necessary, in the same manner capital receipts must be distinguished from revenue receipts.

Receipts which are obtained in course of normal business activities are revenue receipts (e.g. receipts from sale of goods or services, interest income etc.). On the other hand, receipts which are not revenue in nature are capital receipts (e.g. receipts from sale of fixed assets or investments, secured or unsecured loans, owners' contributions etc.). Revenue and capital receipts are recognised on accrual basis as soon as the right of receipt is established. Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

On the other hand, Capital receipts are not directly credited to Profit and Loss Account. For example, when a fixed asset is sold for Rs. 92,000 (cost Rs. 90,000), the capital receipts Rs. 92,000 is not credited to Profit and Loss Account. Profit/Loss on sale of fixed assets is calculated and credited to Profit and Loss Account as follows:

Sale Proceeds	Rs. 92,000
Cost	(Rs. 90,000)
Profit	Rs. 2,000

Illustration 3

Good Pictures Ltd., construct a cinema house and incur the following expenditure during the first year ending 30th June, 2009.

(i) Second-hand furniture worth Rs. 9,000 was purchased; repainting of the furniture costs Rs. 1,000. The furniture was installed by own workmen, wages for this being Rs. 200.

(ii) Expenses in connection with obtaining a license for running the cinema worth Rs. 20,000. During the course of the year the cinema company was fined Rs. 1,000, for contravening rules. Renewal fee Rs. 2,000 for next year also paid.

(iii) Fire insurance, Rs. 1,000 was paid on 1st January, 2009 for one year.

(iv) Temporary huts were constructed costing Rs. 1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready.

Point out how you would classify the above items.

Solution

1 The total cost of the furniture should be treated as Rs. 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If Rs. 1,000 and Rs. 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts will be credited to the Furniture Account.

2. License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of Rs. 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.

3. Half of the insurance premium pertains to the year beginning on 1st July, 2009. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.

4. Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

Illustration 4

State with reasons, how you would classify the following items of expenditure:

1. Overhauling expenses of Rs. 25,000 for the engine of a motor car to get better fuel efficiency.
2. Inauguration expenses of Rs. 25 lacs incurred on the opening of a new manufacturing unit in an existing business.
3. Compensation of Rs. 2.5 crores paid to workers, who opted for voluntary retirement.

Solution

1. Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long-term advantage. So this expenditure should be capitalised.
2. Inauguration expenses incurred on the opening of a new unit may help to explore more customers. This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.
3. The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

Illustration 5

Classify the following expenditures and receipts as capital or revenue:

(i) Rs. 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.

(ii) Amount received from debtors during the year.

(iii) Amount spent on demolition of building to construct a bigger building on the same site.

(iv) Insurance claim received on account of a machinery damaged by fire.

Solution

(i) Capital expenditure.

(ii) Revenue receipt.

(iii) Capital expenditure.

(iv) Capital receipt.

Illustration 6

Are the following expenditures capital in nature?

(i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was Rs. 20,000.

(ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent Rs. 10,000 on account of legal expenses.

(iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent Rs. 40,000 for transportation of such machinery.

(iv) M/s Dogra & Co. spent Rs. 1,00,000 for organising an Inter-school Hockey Tournament in Delhi. This was for advertising their new school bag and other books and stationery which they want to market.

(v) M/s Dogra & Co. installed a machinery for Rs. 5,00,000 on 1.1.2003. They were charging deprecation on straight line basis taking useful life of the machine as 10 years. In December, 2009 they found that the machine became obsolete which could not be used. The machine can fetch only Rs. 50,000.

Solution:

(i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus the renovation expense is capital expenditure in nature.

(ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus the legal expenses incurred in this case is revenue expenditure in nature.

(iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

(iv) The purpose of expenses incurred for organising the Inter-school Hockey Tournament is to advertise for some new products. This advertisement may have some enduring effect so far as marketability of the new products. This expense may be treated as deferred revenue expenditure.

(v) Loss arising out of obsolescence of machinery is revenue expenditure. This loss is to be charged against revenue of the year in which such loss is recognised. In this case, loss due to obsolescence is:

	Rs.
Cost	5,00,000
Less: Depreciation 2003-2009	3,50,000
Written down value at the end of 2009	1,50,000
Less: Estimated scrap value	50,000
	1,00,000

This loss is revenue loss in nature.

Illustration 7

Are the following expenses capital in nature?

(i) Wages paid for installation of fixed assets.

(ii) Expenses of trial run of a newly installed machine.

(iii) Money deposited with the wholesaler as security.

(iv) Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) Rs. 8,000 for installing Telephone in the office.

(v) Amount spent for inauguration of new selling centre.

(vi) Free gift to customers of a new product.

(vii) Diwali advance to employees.

(viii) Money advanced to suppliers for booking of goods.

Solution:

(i) Expenses incurred including wages for installation of any fixed asset is capital expenditure in nature.

(ii) Expenses incurred for trial run of a newly installed machinery is capital expenditure in nature.

(iii) Money deposited as security is not an expenditure item.

(iv) Money deposited with MTNL for installation of telephone is not expenditure item. This is treated as an asset.

(v) Expenses incurred for inauguration of branch is treated as revenue expenditure. Sometime heavy expenditures incurred at the inaugural are meant for advertisement purposes, which have enduring effect on the future revenue generating capability of the business. Such expenses may be treated as deferred revenue expenditure.

(vi) Free gift to customers is an advertisement expense. This is normally treated as a revenue expenditure. In case the amount involved in such free gift is heavy in relation to the volume of sales of the business and in case such free gift has an enduring effect on the future revenue generating capability of the business, it is treated as deferred revenue expenditure.

(vii) Diwali advance to employees is not an expense item.

(viii) Money advanced to supplies for booking goods is not an expense item.

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices:

1. Classify the following expenditures and receipts as capital or revenue:

   (i) Money spent Rs. 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is

   (a) Capital expenditures (b) Revenue expenditures

   (c) Deferred revenue expenditures (d) None of the above

   (ii) Amount of Rs. 5,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is

   (a) Capital expenditures (b) Revenue expenditures

   (c) Deferred revenue expenditures (d) None of the above

   (iii) Entrance fee of Rs. 2,000 received by Ram and Shyam Social Club is

   (a) Capital receipt (b) Revenue receipt

   (c) Capital expenditures (d) Revenue expenditures

   (iv) Subsidy of Rs. 40,000 received from the government for working capital by a manufacturing concern is

   (a) Capital receipt (b) Revenue receipt

   (c) Capital expenditures (d) Revenue expenditures

   (v) Insurance claim received on account of machinery damaged completely by fire is

   (a) Capital receipt (b) Revenue receipt

   (c) Capital expenditures (d) Revenue expenditures

   (vi) Interest on investments received from UTI is

   (a) Capital receipt (b) Revenue receipt

   (c) Capital expenditures (d) Revenue expenditures

   (vii) Amount received from IDBI as a medium term loan for augmenting working capital is

   (a) Capital expenditures (b) Revenue expenditures

   (c) Capital receipt (d) Revenue receipt

(viii) A bad debt recovered during the year will be

(a) Capital expenditures (b) Revenue expenditures

(c) Capital receipt (d) Revenue receipt

(ix) A second hand car is purchased for Rs. 10,000, the amount of Rs. 1,000 is spent on its repairs, Rs. 500 is incurred to get the car registered in owner's name and Rs. 1,200 is paid as dealer's commission. The amount debited to car account will be

(a) Rs. 10,000. (b) Rs. 10,500. (c) Rs. 11,500. (d) Rs. 12,700.

(x) Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which

(a) the sale is made. (b) the cash is collected.

(c) the products are manufactured. (d) the planning takes place.

(xi) If repair cost is Rs. 25,000, whitewash expenses are Rs. 5,000, cost of extension of building is Rs. 2,50,000 and cost of improvement in electrical wiring system is Rs. 19,000; the amount to be expensed is

(a) Rs. 2,99,000. (b) Rs. 44,000. (c) Rs. 30,000. (d) Rs. 49,000.

[Ans. 1: (i)-(a), (ii)-(b), (iii)-(a), (iv)-(b), (v)-(a), (vi)-(b), (vii)-(c), (viii)-(d), (ix)-(d), (x)-(a), (xi)-(c)]

2. Out of the following which are (1) capital expenditure; (2) revenue expenditure; and (3) deferred revenue expenditure?

(i) Rs. 1,200 spent on the repairs of machine is

(a) capital expenditure; (b) revenue expenditure;

(c) deferred revenue expenditure; (d) None of the above.

(ii) Rs. 2,500 spent on the overhaul of machines purchased second-hand is

(a) capital expenditure; (b) revenue expenditure;

(c) deferred revenue expenditure; (d) None of the above.

(iii) Whitewashing expenses are

(a) capital expenditure; (b) revenue expenditure;

(c) deferred revenue expenditure; (d) None of the above.

(iv) Paper purchased for use as stationery is

(a) capital expenditure; (b) revenue expenditure;

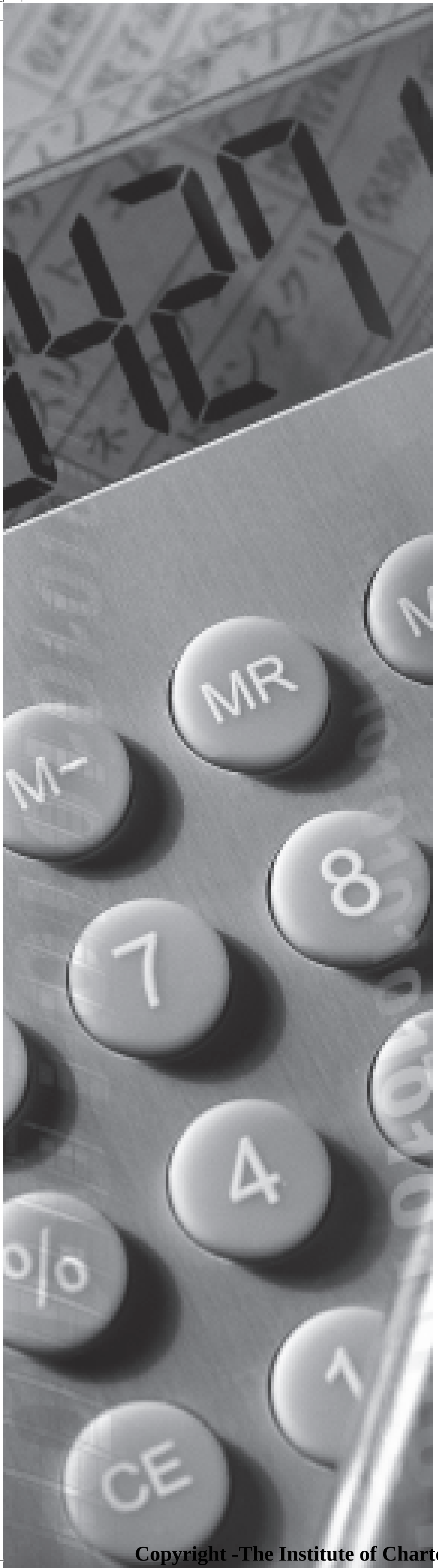
(c) deferred revenue expenditure; (d) None of the above.

(v) Advertising campaign to launch a new product is

(a) capital expenditure; (b) revenue expenditure;

(c) deferred revenue expenditure; (d) None of the above.

[Ans: 2: (ii) is a capital expenditure and Item no. (v) is deferred revenue expenditure, and remaining items are revenue expenditures.]



CHAPTER - 2

ACCOUNTING PROCESS

Unit 7

Contingent Assets and Contingent Liabilities

Learning Objectives

After studying this unit you will be able to :

- Understand the meaning of the terms 'Contingent Assets' and 'Contingent Liabilities'.
- Distinguish 'Contingent Liabilities' with 'Liabilities' and 'Provisions'.

1. CONTINGENT ASSETS

A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. It usually arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity. For example, a claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset.

As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset. These assets are uncertain and may arise from a claim which an enterprise pursues through a legal proceeding. There is uncertainty in realisation of claim. It is possible that recognition of contingent assets may result in recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset no longer remains as contingent asset.

A contingent asset need not be disclosed in the financial statements. A contingent asset is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise), if an inflow of economic benefits is probable. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

2. CONTINGENT LIABILITIES

The term 'Contingent liability' can be defined as

"(a) a possible obligation[1] that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation[2] that arises from past events but is not recognised because:

 (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

 (ii) a reliable estimate of the amount of the obligation cannot be made."

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[1] *Possible Obligation: An obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.*

[2] *Present Obligation: An obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.*

A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events [part (a) of the definition]. A contingent liability may also be a present obligation that arises from past events [(part (b) of the definition)].

An enterprise should not recognise a contingent liability. A Contingent liability is required to be disclosed unless possibility of outflow of a resource embodying economic benefits is remote. These liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow or future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in financial statements of the period in which the change in probability occurs except in the extremely rare circumstances where no reliable estimate can be made.

3. DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

The distinction between a liability and a contingent liability is generally based on the judgement of the management. A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability. Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc. In addition to present obligations that are recognised as liabilities in the balance sheet, enterprises are required to disclose contingent liability in their balance sheets by way of notes.

4. DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

It is important to know the difference between provisions and contingent liabilities. The distinction between both of them can be explained as follows:

	Provision	Contingent liability
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.
(2)	A provision meets the recognition criteria.	A contingent liability fails to meet the same.
(3)	Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability.

Let us take an example to understand the distinction between provisions and contingent liabilities. The Central Excise Officer imposes a penalty on Alpha Ltd. for violation of a provision in the Central Excise Act. The company goes on an appeal. If the management of the company estimates that it is probable that the company will have to pay the penalty, it recognises a provision for the liability. On the other hand, if the management anticipates that the judgement of the appellate authority will be in its favour and it is less likely that the company will have to pay the penalty, it will disclose the obligation as a contingent liability instead of recognising a provision for the same.

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices:

1. (i) Contingent asset usually arises from unplanned or unexpected events that give rise to

   (a) The possibility of an inflow of economic benefits to the business entity.

   (b) The possibility of an outflow of economic benefits to the business entity.

   (c) Either (a) or (b)

   (d) None of the above.

(ii) If an inflow of economic benefits is probable then a contingent asset is disclosed

(a) in the financial statements.

(b) in the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).

(c) In the cash flow statement.

(d) None of the above.

(iii) In the case of ___________, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

(a) Liability.

(b) Provision.

(c) Contingent liabilities.

(d) Contingent assets.

(iv) Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as ________.

(a) Provision.

(b) Liability.

(c) Contingent liability.

(d) None of the above.

(v) In the financial statement, contingent liability is

(a) Recognised

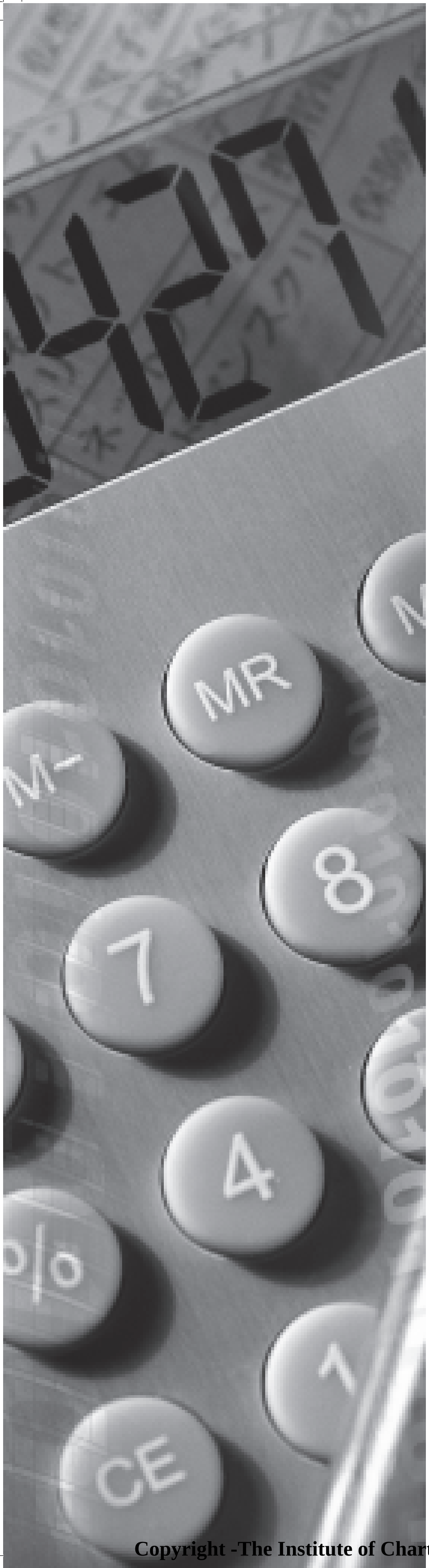
(b) Not recognised.

(c) Adjusted.

(d) None of the above.

ANSWERS

(i) (a)	(ii) (b)	(iii) (c)	(iv) (a)	(v) (a)	



CHAPTER - 2

ACCOUNTING PROCESS

Unit 8

Rectification of Errors

Learning Objectives

After studying this unit, you will be able to :

- ♦ Understand different types of errors which may occur in course of recording transactions and events.
- ♦ Be familiar with the steps involved in locating errors.
- ♦ Learn the nature of one-sided errors and two-sided errors.
- ♦ Understand why suspense account is opened for rectification of errors.
- ♦ Understand the technique of correcting errors of one period in the next accounting period.

1. INTRODUCTION

Unintentional omission or commission of amounts and accounts in the process of recording the transactions are commonly known as errors. These various unintentional errors can be committed at the stage of collecting financial information/data on the basis of which financial statements are drawn or at the stage of recording this information. Also errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. To check the arithmetic accuracy of the journal and ledger accounts, trial balance is prepared. If the trial balance does not tally, then it can be said that there are errors in the accounts which requires rectification thereof. Some of these errors may affect the Trial Balance and some of these do not have any impact on the Trial Balance although such errors may affect the determination of profit or loss, assets and liabilities of the business.

Illustrative Case of Errors and their Nature

We have seen that after preparing ledger accounts a trial balance is taken out where debit and credit balances are separately listed and totalled. If the two totals do not agree, it is definite that there have been some errors. We shall now study the types of errors which may be committed and how they may be rectified. For this purpose, the working of the following illustrative cases should be carefully seen.

Illustrative Cases of Errors

(a) Wrong Entry: Let us start from the first phase in the accounting process. Wrong entry of the value of transactions and events in the subsidiary books, Journal Proper and Cash Book may occur.

Example 1: Credit purchases Rs. 17,270 are entered in the Purchases Day Book as Rs. 17,720. Credit sales of Rs. 15,000 gross less 1% trade discount are wrongly entered in Sales Day Book at Rs. 15,000. Cheque issued Rs. 19,920 are wrongly entered in the credit of bank column in the Cash Book as Rs. 19,290.

(b) Wrong positing from subsidiary books: Subsidiary books are totalled periodically and posted to the appropriate ledger accounts. There may arise totalling errors. Totalling errors may arise due to wrong entry or simply these may be independent errors.

Example 2: For the month of January, 2006 total of credit sales are Rs. 1,75,700, this is wrongly totalled as Rs. 1,76,700 and posted to sales account as Rs. 1,76,700.

(**c**) **Wrong casting of subsidiary book:** For example, wrong castings of the Cash Book result in balancing error.

Example 3: The following cash transactions of M/s Tularam & Co. occurred:

2009

Jan. 1	Balance - cash Rs. 1,200 bank Rs. 16,000;
Jan. 2	Cheque issued to M/s Bholaram & Co., a supplier, for Rs. 22,500;
Jan. 6	Cheque collected from M/s Scindia & Bros. Rs. 42,240 and deposited for clearance;
Jan. 7	Cash sales Rs. 27,200 paid wages Rs. 12,400;
Jan. 8	Cash sales Rs. 37,730 cash deposited to bank Rs. 35,000.

The following Cash Book entries are passed:

Cash Book

Dr. *Date* *2009*	*Particulars*	*Cash Rs.*	*Bank Rs.*	*Date* *2006*	*Particulars*	*Cash Rs.*	*Cr.* *Bank Rs.*
Jan. 1	To Balance b/d	1,200	16,000	Jan. 2	By M/s Bholaram & Co. A/c		22,500
Jan. 6	To M/s Scindia & Bros A/c		**42,420**		By Wages A/c	**12,200**	
Jan. 7	To Sales A/c	27,200			By Bank A/c	**34,500**	
Jan. 8	To Sales A/c	**37,370**			By Balance c/d	19,070	71,420
Jan. 8	To Cash A/c		**34,500**				
		65,770	**93,920**			65,770	**93,920**

Wrong entries and casting are shown in bold prints. However, errors of cash entries generally are not carried. Usually cash balances are tallied daily. So errors are identified at an early stage. But bank balance cannot be checked daily and thus errors may be carried until bank reconciliation is made. In the above example, there are four wrong entries and one wrong casting Bank and cash balances are affected by these errors.

(d) Wrong casting of ledger balances: Likewise Cash Book, any ledger account balance may be cast wrongly. Obviously wrong postings make the balance wrong; but that is not wrong casting of balances. Whenever there arises independent casting error as in the case of bank column in the Cash Book of example (4), that is called wrong casting of ledger balances.

Example 4: The following are the credit purchases of M/s Ballav Bros.:

2009

Jan. 1 Purchases from M/s Saurabh & Co.- gross Rs. 1,00,000 less 1% trade discount.

Jan. 3 Purchases from M/s Netai & Co.- gross Rs. 70,000 less 1% trade discount.

Jan. 6 Purchases from M/s Saurabh & Co.- gross Rs. 60,000 less 1% trade discount

Let us cast M/s Saurabh & Co.'s Account:

M/s Saurabh & Co. Account

Dr. *Date* *2009*	*Particulars*	*Amount Rs.*	*Date* *2009*	*Particulars*	*Cr.* *Amount Rs.*
Jan. 1	To Balance c/d	1,55,000	Jan. 1	By Purchases A/c	99,000
			Jan. 6	By Purchases A/c	59,000
		1,55,000			1,55,000

While casting the credit side an error has been committed and so the account is wrongly balanced.

Example 5: Goods are purchased on credit from M/s Saurabh & Co. for Rs. 27,030 and from M/s Karnataka Suppliers for Rs. 28,050. The following Day Book is prepared:

Purchases Day Book

Date	*Particulars*	*Amount Rs.*
	M/s Saurabh & Co.	27,050
	M/s Karnataka Suppliers	28,030
		55,080

In the Day Book both the transactions are entered wrongly but the first error has been compensated by the second. Even if these errors are not rectified Trial Balance would tally.

Trial Balance

Particulars	*Dr.*	*Cr. Rs.*
M/s Saurabh & Co.		27,050
M/s Karnataka Suppliers		28,030
Purchases Account	55,080	
	55,080	55,080

2. STAGES OF ERRORS

Errors may occur at any of the following stages of the accounting process:

2.1 AT THE STAGE OF RECORDING THE TRANSACTIONS IN JOURNAL

Following types of errors may happen at this stage:

(i) Errors of principle,

(ii) Errors of omission,

(iii) Errors of commission.

2.2 AT THE STAGE OF POSTING THE ENTRIES IN LEDGER

(i) Errors of omission:
- (a) Partial omission,
- (b) Complete omission.

(ii) Errors of commission:
- (a) Posting to wrong account,
- (b) Posting on the wrong side,
- (c) Posting of wrong amount.

2.3 AT THE STAGE OF BALANCING THE LEDGER ACCOUNTS

- (a) Wrong Totalling of accounts,
- (b) Wrong Balancing of accounts.

2.4 AT THE STAGE OF PREPARING THE TRIAL BALANCE

- (a) Errors of omission,
- (b) Errors of commission:
  1. Taking wrong account,
  2. Taking wrong amount,
  3. Taking to the wrong side.

On the above basis, we can classify the errors in four broad categories:

1. Errors of Principle,
2. Errors of Omission,
3. Errors of Commission,
4. Compensating Errors.

3. TYPES OF ERRORS

Basically errors are of two types:

(a) **Errors of principle:** When a transaction is recorded in contravention of accounting principles, like treating the purchase of an asset as an expense, it is an error of principle. In this case there is no effect on the trial balance since the amounts are placed on the correct side, though in a wrong account.

(b) **Clerical errors:** These errors arise because of mistake committed in the ordinary course of the accounting work. These are of three types:

   (i) *Errors of Omission:* If a transaction is completely or partially omitted from the books of account, it will be a case of omission. Examples would be: not recording a credit purchase of furniture or not posting an entry into the ledger.

   (ii) *Errors of Commission:* If an amount is posted in the wrong account or it is written on the wrong side or the totals are wrong or a wrong balance is struck, it will be a case of "errors of commission."

   (iii) *Compensating Errors:* If the effect of errors committed cancel out, the errors will be called compensating errors. The trial balance will agree.

   From another point of view, error may be divided into two categories:

   (a) Those that affect the trial balance - because of the errors that trial balance does not agree; and

      (i) Wrong casting of the subsidiary books [see (b) above.]

      (ii) Wrong balancing of an account [see (a) above.]

      (iii) Posting an amount on the wrong side [see (d) above.]

      (iv) Wrong posting, ie., writing the wrong amount [see (d) above.]

      (v) Omitting to post an amount from a subsidiary book.

      (vi) Omitting to post the totals of subsidiary book.

      (vii) Omitting to write the cash book balances in the trial balance.

      (viii) Omitting to write the balance of an account in the trial balance.

      (ix) Writing a balance in wrong column of the trial balance.

      (x) Totalling the trial balance wrongly.

   (b) The errors that do not affect the trial balance are the following:

      (i) Omitting an entry altogether from the subsidiary book [see (i) above.]

      (ii) Making an entry in the wrong subsidiary book [see (ii) above.]

      (iii) Posting an amount in a wrong account but on the correct side, e.g., an amount to be debited to A is debited to B, the trial balance will still agree.

   (iv) *Errors of principle:* Suppose on the purchase of a typewriter, the office expenses account is debited; the trial balance will still agree.

   (v) *Compensating errors:* If the effect of an error is cancelled by the effect of some other error, the trial balance will naturally agree. Suppose an amount of Rs. 10 received from A is not credited to his account and the total of the sales book is Rs. 10 in excess. The omission of credit to A's account will be made up by the increased credit to the Sales Account; there will not be any effect on the trial balance.

A chart of the types of errors is given below:

- ERRORS
  - Errors of Principle (Treating a revenue expense as capital expenditure or *vice versa* or the sale of a fixed asset as ordinary sale). Trial Balance will agree.
  - Clerical Errors
    - Errors of Omission
      - Omitting an entry completely from the subsidiary books. Trial Balance will agree.
      - Omitting to post the ledger account from the subsidiary books. Trial Balance will not agree.
    - Errors of Commission
      - Writing the wrong amount in the subsidiary books. Trial Balance will agree.
      - Wrong casting of subsidiary books.
      - Posting the wrong amount in the ledger.
      - Posting an amount on the wrong side.
      - Wrong balancing of an account
      - Trial Balance will not agree.
    - Compensating Errors. Trial Balance will agree.

4. STEPS TO LOCATE ERRORS

Even if there is only a very small difference in the trial balance, the errors leading to it must be located and rectified. A small difference may be the result of a number of errors. The following steps will be useful in locating errors :

(i) The two columns of the trial balance should be totalled again. If in place of a number of accounts, only one amount has been written in the trial balance the list of such accounts should be checked and totalled again. List of debtors is the example from which Sundry debtors balance is derived.

(ii) It should be seen that the cash and bank balances have been written in the trial balance.

(iii) The exact difference in the trial balance should be established. The ledger should be gone through; it is possible that a balance equal to the difference has been omitted from the trial balance. The difference should also be halved; it is possible that balance equal to half the difference has been written in the wrong column.

(iv) The ledger accounts should be balanced again.

(v) The casting of subsidiary books should be checked again, especially if the difference is Re. 1, Rs. 100 etc.

(vi) If the difference is very big, the balance in various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially the cases should be seen; it is possible that an error has been committed. Suppose the sales account for the current year shows a balance of Rs. 32,53,000 whereas it was Rs. 36,45,000 last year; it is possible that there is an error in the Sales Account.

(vii) Postings of the amounts equal to the difference or half the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.

(viii) If there is still a difference in the trial balance, a complete checking will be necessary. The posting of all the entries including the opening entry should be checked. It may be better to begin with the nominal accounts.

5. RECTIFICATION OF ERRORS

Errors should never be corrected by overwriting. If immediately after making an entry it is clear that an error has been committed, it may be corrected by neatly crossing out the wrong entry and making the correct entry. If however the errors are located after some time, the correction should be made by making another suitable entry, called rectification entry. In fact the rectification of an error depends on at which stage it is detected. An error can be detected at any one of the following stages:

(a) Before preparation of Trial Balance.

(b) After Trial Balance but before the final accounts are drawn.

(c) After final accounts, i.e., in the next accounting period.

5.1 BEFORE PREPARATION OF TRIAL BALANCE

There are some errors which affect one side of an account or which affect more than one account in such a way that it is not possible to pass a complete rectification entry. In other words, there are some errors which can be corrected, if detected at this stage, by making rectification statement in the appropriate side(s) of concerned account(s). It is important to note here that such errors may involve only one account or more than one account. Read the following illustrations:

(i) The sales book for November is undercast by Rs. 200. The effect of this error is that the Sales Account has been credited short by Rs. 200. Since the account is posted by the total of the sales book, there is no error in the accounts of the customers since they are posted with amounts of individual sales. Hence only the Sales Accounts is to be corrected. This will be done by making an entry for Rs. 200 on the credit side: "By undercasting of Sales Book for November Rs. 200".

(ii) While posting the discount column on the debit side of the cash book the discount of Rs. 10 allowed to Ramesh has not been posted. There is no error in the cash book, the total of discount column presumably has been posted to the discount account on the debit side. The error is in not crediting Ramesh by Rs. 10. This should now be done by the entry "By omission of posting of discount on ----- Rs. 10".

(iii) Rs. 200 received from Ram has been entered by mistake on the debit side of his account. Since the cash book seems to have been correctly written, the error is only in th account of Ram - he should have been credited and not debited by Rs. 200. Not only is the wrong debit to be removed but also a credit of Rs. 200 is to be given.This can be done now by entering Rs. 400 on the credit side of his account. The entry will be "By Posting on the wrong side - Rs. 400".

(iv) Rs. 50 was received from Mahesh and entered on the debit side of the cash book but was not posted to his account. By the error, which affects only the account of Mahesh, Rs. 50 has been omitted from the credit side of his account. The rectification will be by the entry. "By Omission of posting on the Rs. 50"

(v) Rs. 51 paid to Mohan has been posted as Rs. 15 to the debit of his account. Mohan has been debited short by Rs. 36. The rectifying entry is "To mistake in posting on Rs. 36".

(vi) Goods sold to Ram for Rs. 1,000 was wrongly posted from sales day book to the debit of purchase account. Ram has however been correctly debited. Here the error affects two accounts, viz., purchases account and sales account but we cannot pass a journal entry for its rectification because both the accounts need to be credited . The rectification will be by the entry "By wrong posting on Rs. 1,000" in the credit of purchases account and also "By omission of posting on - Rs. 1,000" in the credit sales account.

(vii) Bills receivable from Mr. A of Rs. 500 was posted to the credit of Bills payable Account and also credited to A account. Here also although two accounts are involved we cannot pass a complete journal entry for rectification. The rectification will be by the entry "To wrong posting on Rs. 500" in debit of Bills payable Account and also "To omission of posting on Rs. 500" in the debit of Bills Receivable Account.

(viii)Goods purchased from Vinod for Rs. 1,000 was wrongly credited to Vimal account by Rs. 100. Again we cannot pass a complete journal entry for rectification even though two accounts are involved. The rectification will be done by the entry "To wrong posting on Rs. 100" in the debit of Vimal account and "By omission of posting on Rs 1,000" in the credit of Vinod account.

Thus, from the above illustrations we are convinced that the general rule that errors affecting two accounts can always be corrected by a journal entry is not always valid.

Such errors will be rectified as follows:

(a) To correct the wrong balancing of the bank column, an entry will be made on the debit side on first November as follows. "To mistake in balancing Rs. 500".

(b) To correct the excess posting in purchases book the entry will be "By Mistake in totalling the purchases book for October, 2005 Rs 100".

(c) The discount account will be opened and posted as already shown.

(d) In account of G. Norwood we shall first debit Rs. 640 so that the wrong credit of Rs. 320 is converted into the debit of Rs. 320.

The entry will be "To Wrong posting on October 5, Rs. 640." Then to remove the wrong debit of Rs. 312 and give the correct credit of Rs. 320 Rs. 632 will be entered on the credit side by the entry. "By Wrong posting on October 16, Rs. 632." The account of G.Norwood will appear as shown below:

G. Norwood

***Dr.* 2005**		***Rs.***	***2005***		***Cr.* *Rs.***
Oct. 16	To Cash Book	312	Oct. 5	By Sales Book	320
" 11	To Wrong posting on Oct. 5 (wrong side)	640	" 31	By Wrong posting on Oct. 16 (wrong side, wrong amount)	632
		952			952

(e) Rs. 36 has to be debited to the Purchases Account since on the 26th October, Rs. 36 was credited to this account in excess. The entry will be "To Wrong posting on Oct. 26 Rs. 36".

Illustration 2

How would you rectify the following errors in the book of Rama & Co.?

1. The total to the Purchases Book has been undercast by Rs. 100.
2. The Returns Inward Book has been undercast by Rs. 50.
3. A sum of Rs. 250 written off as depreciation on Machinery has not been debited to Depreciation Account.

4. A payment of Rs. 75 for salaries (to Mohan) has been posted twice to Salaries Account.
5. The total of Bills Receivable Book Rs. 1,500 has been posted to the credit of Bills Receivable Account.
6. An amount of Rs. 151 for a credit sale to Hari, although correctly entered in the Sales Book, has been posted as Rs. 115.
7. Discount allowed to Satish Rs. 25 has not been entered in the Discount Column of the Cash Book. It has been posted to his personal account.

Solution

1. The Purchases Account should receive another debit of Rs. 100 since it was debited short previously :
   "To Undercasting of Purchases Book for the month of --- Rs. 100."
2. Due to this error the Returns Inward Account has been posted short by Rs. 50 : the correct entry will be :
   "To Undercasting of Returns Inward Book for the month of --- Rs. 50."
3. The omission of the debit to the Depreciation Account will be rectified by the entry :
   "To Omission of posting on Rs. 250".
4. The excess debit will be removed by a credit in the Salaries Account by the entry :
   "By double posting on Rs. 75".
5. Rs. 1,500 should have been debited to the Bills Receivable Account and not credited. To correct the mistake, the Bills Receivable Account should be debited by Rs. 3,000 by the entry:
   "To Wrong posting of B/R received on Rs. 3,000"
6. Hari's personal A/c is debited Rs. 36 short the rectification entry will be :
   "To Wrong posting Rs. 36".
7. Due to this error, the discount account has been debited short by Rs. 25. The required entry is :
   "To Omission of discount allowed to Satish on Rs. 25."

So far we have discussed the correction of errors which affected only one Account of more than one account but for which rectifying entries were not complete journal entries in fact that rectifying entry is made directly in the account(s) concerned. We shall now take up the correction of errors which affect more than one account in such a way that complete journal entries are possible for their rectification. Read the following illustrations :

(i) The purchase of machinery for Rs. 2,000 has been entered in the purchases book. The effect of the entry is that the account of the supplier has been credited by Rs. 2,000 which is quite correct. But the debit to the Purchases Account is wrong : the debit should be to Machinery Account. To rectify the error, the debit in the purchases Account has to be transferred to the Machinery Account. The correcting entry will be to Credit Purchases Account and debit the Machinery Account. Please see the three entries made below: the last entry rectifies the error:

		Rs.	Rs.
Wrong Entry :			
Purchases Account	Dr.	2,000	
To Creditor			2,000

Correct Entry :

Machinery Account	Dr.	2,000	
To Creditor			2,000

Rectifying Entry :

Machinery Account	Dr.	2,000	
To Purchases Account			2,000

(ii) Rs. 100 received from Kamal Kishore has been credited in the account of Krishan Kishore. The error is that there is a wrong credit in the account of Krishan Kishore and omission of credit in the account of Kamal Kishore; Krishan Kishore should be debited and Kamal Kishore be credited. The following three entries make this clear :

Wrong Entry :		Rs.	Rs.
Cash Account	Dr.	100	
To Krishan Kishore			100
Correct Entry :			
Cash Account	Dr.	100	
To Kamal Kishore			100
Rectifying Entry :			
Krishan Kishore	Dr.	100	
To Kamal Kishore			100

(iii) The sale of old machinery, Rs. 1,000 has been entered in the sales book. By this entry the account of the buyer has been correctly debited by Rs. 1,000. But instead of crediting the Machinery Account. Sales Account has been credited. To rectify the error this account should be debited and the Machinery Account credited. See the three entries given below:

Wrong Entry :		Rs.	Rs.
Buyer's Account	Dr.	1,000	
To Sales Account			1,000
Correct Entry :			
Buyer's Account	Dr.	1,000	
To Machinery Account			1,000
Rectifying Entry :			
Sales Account	Dr.	1,000	
To Machinery Account			1,000

Illustration 3

The following errors were found in the book of Ram Prasad & Sons. Give the necessary entries to correct them.

(1) Rs. 500 paid for furniture purchased has been charged to ordinary Purchases Account.

(2) Repairs made were debited to Building Account for Rs. 50.

(3) An amount of Rs. 100 withdrawn by the proprietor for his personal use has been debited to Trade Expenses Account.

(4) Rs. 100 paid for rent debited to Landlord's Account.

(5) Salary Rs. 125 paid to a clerk due to him has been debited to his personal account.

(6) Rs. 100 received from Shah & Co. has been wrongly entered as from Shaw & Co.

(7) Rs. 700 paid in cash for a typewriter was charged to Office Expenses Account.

Solution

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	Particulars		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
(1)	Furniture A/c To Purchases A/c (Correction of wrong debit to Purchases A/c for furniture purchased)	Dr.		500	500
(2)	Repairs A/c To Building A/c (Correction of wrong debit to building A/c for repairs made)	Dr.		50	50
(3)	Drawings A/c. To Trade Expenses A/c (Correction of wrong debit to Trade Expenses A/c for cash withdrawn by the proprietor for his personal use)	Dr.		100	100
(4)	Rent A/c To Landlord's Personal A/c (Correction of wrong debit to land-lord's A/c for rent paid)	Dr.		100	100
(5)	Salaries A/c To Clerk's (Personal) A/c (Correction of wrong debit to Cleark's personal A/c for salaries paid)	Dr.		125	125
(6)	Shaw & Co. To Shah & Co. (Correction of wrong credit to Shaw & Co. Instead of Shah & Co.)	Dr.		100	100
(7)	Typewriter A/c To Office Expenses A/c (Correction of wrong debit to Office Expenses A/c for purchase of typewriter)	Dr.		700	700

Illustration 4

Give journal entries to rectify the following :

(1) A purchase of goods from Ram amounting to Rs. 150 has been wrongly entered through the Sales Book.

(2) A Credit sale of goods amounting Rs. 120 to Ramesh has been wrongly passed through the Purchase Book.

(3) On 31st Dec. 2003 goods of the value of Rs. 300 were returned by Hari Saran and were taken into stock on the same date but no entry was passed in the books.

(4) An amount of Rs. 200 due from Mahesh Chand, which had been written off as a Bad Debt in a previous year, was unexpectedly recovered, and had been posted to the personal account of Mahesh Chand.

(5) A Cheque for Rs. 100 received from Man Mohan was dishonoured and had been posted to the debit of Sales Returns Account.

Solution

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	Particulars		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
(1)	Purchases A/c	Dr.		150	
	Sales A/c Dr.	Dr.		150	
	To Ram				300
	(Correction of wrong entry in the sales Book for a purchases of goods from Ram)				
(2)	Ramesh	Dr.		240	
	To Purchases A/c				120
	To Sales A/c				120
	(Correction of wrong entry in the Purchases Book of a credit sale of goods to Ram)				
(3)	Returns Inwards A/c	Dr.		300	
	To Hari Saran				300
	(Entry of goods returned by him and taken in stock omitted from records)				
(4)	Mahesh Chand	Dr.		200	
	To Bad Debts Recovered A/c				200
	(Correction of wrong credit to Personal A/c in respect of recovery of previously written off bad debts)				
(5)	Man Mohan	Dr.		100	
	To Sales Return A/c				100
	(Correction of wrong debit to Sales Returns A/c for dishonour of cheque received from Man Mohan)				

Thus it can be said that errors detected before the preparation of trial balance can be rectified either through rectification statements (not entries) or through rectification entries.

5.2 AFTER TRIAL BALANCE BUT BEFORE FINAL ACCOUNTS

The method of correction of error indicated so far is appropriate when the errors have been located before the end of the accounting period. After the corrections the trial balance will agree. Sometimes the trial balance is artificially made to agree inspite of errors by **opening a suspense account** and putting the difference in the trial balance to the account - the suspense account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column; it will be credited in the other case.

One must note that such agreement of the trial balance will not be real. Effort must be made to locate the errors.

The rule of rectifying errors detected at this stage is simple. Those errors for which complete journal entries were not possible in the earlier stage of rectification (i.e., before trial balance) can now be rectified by way of journal entry(s) with the help of suspense account, for it these errors which gave rise to the suspense account in the trial balance. The rectification entry for other type of error i.e. error affecting more than one account in such a way that a complete journal entry is possible for its rectification, can be rectified in the same way as in the earlier stage (i.e. before trial balance).

In a nutshell, it can be said that each and every error detected at this stage can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry(s), the difference or the unknown side is being taken care of by suspense account. Those errors for which entries were possible even at the first stage will now be rectified in the same way.

Suppose, the sales book for November, 2005 is cast Rs. 100 short; as a consequence the trial balance will not agree. The credit column of the trial balance will be Rs. 100 short and a Suspense Account will be credited by Rs. 100. To rectify the error the Sales Account will be credited (to increase the credit to the right figure. Since now one error remains, the Suspense Account must be closed- it will be debiting the Suspense Account. The entry will be :

Suspense Account	Dr.	Rs. 100	
To Sales Account			Rs. 100
(Correction of error of undercasting the sales Book for Nov. 2005)			

Illustration 5

Correct the following errors (i) without opening a Suspense Account and (ii) opening a Suspense Account :

(a) The Sales Book has been totalled Rs. 100 short.

(b) Goods worth Rs. 150 returned by Green & Co. have not been recorded anywhere.

(c) Goods purchased Rs. 250 have been posted to the debit of the supplier Gupta & Co.

(d) Furniture purchased from Gulab & Bros, Rs. 1,000 has been entered in Purchases Day Book.

(e) Discount received from Red & Black Rs. 15 has not been entered in the Discount Column of the Cash Book.

(f) Discount allowed to G. Mohan & Co. Rs. 18 has not been entered in the Discount Column of the Cash Book. The account of G. Mohan & Co. has, however, been correctly posted.

Solution

If a Suspense Account is not opened.

(a) Since sales book has been cast Rs. 100 short, the Sales Account has been similarly credited Rs. 100 short. The correcting entry is to credit the Sales Account by Rs. 100 as "By wrong totalling of the Sales Book Rs. 100".

(b) To rectify the omission, the Returns Inwards Account has to be debited and the account of Green & Co. credited. The entry :

Returns Inward Account	Dr.	Rs. 150	
To Green & Co.			Rs.150
(Goods returned by the firm, previously omitted from the Returns Inward Book)			

(c) Gupta & Co. have been debited Rs. 250 instead of being credited. This account should now be credited by 500 to remove the wrong debit and to give the correct debit. The entry will be on the credit side... "By errors in posting Rs. 500".

(d) By this error Purchases Account has to be debited by Rs. 1,000 whereas the debit should have been to the Furniture Account. The correcting entry will be :

Furniture Account	Dr.	Rs. 1,000	
To Purchases Account			Rs. 1,000
(Correction of the mistake by which purchases Account was debited instead of the Furniture Account)			

(e) The discount of Rs. 15 received from Red & Black should have been entered on the credit side of the cash book. Had this been done, the Discount Account would have been credited (through the total of the discount column) and Red & Black would have been debited. This entry should not be made :

Red & Black	Dr.	Rs. 15	
To Discount Account			Rs. 15
(Rectification of the error by which the discount allowed by the firm was not entered in Cash Book)			

(f) In this case the account of the customer has been correctly posted; the Discount Account has been debited Rs. 18 short since it has been omitted from the discount column on the debit side of the cash book. The discount account should now be debited by the entry; "To Omission of entry in the Cash Book Rs. 18."

If a Suspense Account is opened :

	Particulars		***L.F.***	***Dr. Rs.***	***Cr. Rs.***
(a)	Suspense Account	Dr.		100	
	To Sales Account				100
	(Being the correction arising from under-casting of Sales Day Book)				
(b)	Return Inward Account	Dr.		150	
	To Green & Co.				150
	(Being the recording of unrecorded returns)				
(c)	Suspense Account	Dr.		500	
	To Gupta & Co.				500
	(Being the correction of the error by which Gupta & Co. was debited instead of being credited by Rs. 250).				
(d)	Furniture Account	Dr.		1,000	
	To Purchases Account				1,000
	(Being the correction of recording purchase of furniture as ordinary purchases)				
(e)	Red & black	Dr.		15	
	To Discount Account				15
	(Being the recording of discount omitted to be recorded)				
(f)	Discount Account	Dr.		18	
	To Suspense Account				18
	(Being the correction of omission of the discount allowed from Cash Book customer's account already posted correctly).				

Suspense Account

Dr. Date	Particulars	Amount Rs.	Date	Particulars	Cr. Amount Rs.
	To Sales A/c	100		By Difference in	
	To Gupta & Co.	500		Trial Balance	582
				By Discount A/c	18
		600			600

Note :

(i) One should note that the opening balance in the Suspense Account will be equal to the difference in the trial balance.

(ii) If the question is silent as to whether a Suspense Account has been opened, the student should make his assumption, state it clearly and then proceed.

Illustration 6

Correct the following errors found in the books of Mr. Dutt. The Trial Balance was out by Rs. 493 excess credit. The difference thus has been posted to a Suspense Account.

(a) An amount of Rs. 100 was received from D. Das on 31st December, 2009 but has been entered in the Cash Book on 3rd January, 2010.

(b) The total of Returns Inward Book for December has been cast Rs. 100 short.

(c) The purchase of an office table costing Rs. 300 has been passed through the Purchases Day Book.

(d) Rs. 375 paid for Wages to workmen for making show-cases had been charged to "Wages Account".

(e) A purchase of Rs. 67 had been posted to the creditors' account as Rs. 60.

(f) A cheque for Rs. 200 received from P. C. Joshi had been dishonoured and was passed to the debit of "Allowances Account".

(g) Rs. 1000 paid for the purchase of a motor cycle for Mr. Dutt had been charged to "Miscellaneous Expenses Account".

(h) Goods amounting to Rs. 100 had been returned by customer and were taken in to stock, but no entry in respect there of, was made into the books.

(i) A sale of Rs. 200 to Singh & Co. was wrongly credited to their account.

Solution

(a) The following entry should be passed on 31st December, 2009:

Particulars		L.F.	Rs.	Rs.
Bank Account	Dr.		100	
To D. Das (Being the amount received)				100

The entry already passed in the Cash Book on 3rd January, 2010 will be reversed by entering on the credit side of the Cash Book : "By D. Das Rs. 100" (to reverse entry wrongly passed on January 3).

(b)	Returns Inward Account To Suspense Account (Being the mistake in totalling the Returns Inward Book corrected)	Dr.		100	 100
(c)	Furniture Account To Purchases Account (Being the rectification of mistake by which purchase of furniture was entered in Purchases book and hence debited to Purchases Account)	Dr.		300	 300
(d)	Furniture Account To Wages Account (Being the wages paid to workmen for making show-cases which should be capitalised and not to be charged to Wages Account)	Dr.		375	 375
(e)	Suspense Account To Creditor's (personal) Account (Being the mistake in crediting the Creditors Account less by Rs. 7, now corrected)	Dr.		7	 7
(f)	P.C. Joshi To Allowances Account (Being the cheque of P.C. Joshi dishonoured, previously debited to Alloweances Account)	Dr.		200	 200
(g)	Drawings Account To Miscellaneous Expenses (Being the motor cycle purchased for Mr. Dutt debited to his Drawings Account instead of Miscellaneous Expenses Account as previously done by mistake)	Dr.		1,000	 1,000
(h)	Returns Inward Account To Customer's (Personal) Account (Correction of the omission to record return of goods by customers)	Dr.		100	 100
(i)	Singh & Co. To Suspense Account (Being the correction of mistake by which the account of Singh & Co. was credited by Rs. 200 instead of being debited)	Dr.		400	 400

Suspense Account

Dr. Date 2009	Particulars	Amount Rs.	Date 2009	Particulars	Cr. Amount
Dec.31	To Difference in		Dec. 31	By Returns	
	Trial Balance	493	" "	Inwards A/c	100
" "	To Creditor's A/c	7	" "	By Singh & Co.	400
		500			500

Illustration 7

The following errors, affecting the account for the year 2005 were detected in the books of Jain Brothers, Delhi:

(1) Sale of old Furniture Rs. 150 treated as sale of goods.

(2) Receipt of Rs. 500 from Ram Mohan credited to Shyam Sunder.

(3) Goods worth Rs. 100 brought from Mohan Narain have remained unrecorded so far.

(4) A return of Rs. 120 from Mukesh posted to his debit.

(5) A return of Rs. 90 to Shyam Sunder posted as Rs. 9 in his account.

(6) Rent of proprietor's residence, Rs. 600 debited to rent A/c.

(7) A payment of Rs. 215 to Mohammad Sadiq posted to his credit as Rs. 125.

(8) Sales Book added Rs. 900 short.

(9) The total of Bills Receivable Book Rs. 1,500 left unposted.

You are required to pass the necessary rectifying entries and show how the trial balance would be affected by the errors.

Solution

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	Particulars		L.F.	Dr. Amount Rs.	Cr. Amount Rs.
(1)	Sales Account	Dr.		150	
	To Furniture Account				150
	(Rectification of sales of furniture treated as sales of goods)				
(2)	Shyam Sunder	Dr.		500	
	To Rama Mohan				500
	(Rectification of a receipt from Ram Mohan credited to Shyam Sunder)				

(3)	Purchases Account	Dr.		100	
	To Mohan Narain				100
	(Purchases of goods from Mohan Narain unrecorded)				
(6)	Drawing Account	Dr.		600	
	To Rent Account				600
	(Rectification of Payment of rent of proprietor's residence treated as payment of office rent)				

N.B. : For 4, 5, 7, 8, 9 no journal entry can be passed as they affect a single account. The correction will be as under:

(4) Credit Mukesh's Account with Rs. 240.

(5) Debit the account of Shyam Sunder by Rs. 81.

(7) Debit the account of Mohammad Sadiq by Rs. 340.

(8) Credit Sales Account by Rs. 900.

(9) Debit Bills Receivable Account with Rs. 1,500.

Effect of the Errors on Trial Balance

1. No effect
2. No effect
3. No effect
4. Trial Balance credit total short by Rs. 240.
5. Trial Balance debit total short by Rs. 81.
6. No effect
7. Trial Balance debit total short by Rs. 340.
8. Trial Balance credit total short by Rs. 900.
9. Trial Balance debit total short by Rs. 1,500.

Illustration 8

The trial balance of Mr. W & H failed to agree and the difference Rs. 20,570 was put into suspense pending investigation which disclosed that :

(i) Purchase returns day book had been correctly entered and totalled at Rs. 6,160, but had been posted to the ledger.

(ii) Discounts received Rs. 1,320 had been debited to discounts allowed.

(iii) The Sales account had been under added by Rs. 10,000.

(iv) A credit sale of Rs. 1,470 had been debited to a cutomer account at Rs. 1,740.

(v) A vehicle bought originally for Rs. 7,000 four years ago and depreciated to Rs. 1,200 had been sold for Rs. 1,500 in the beginning of the year but no entries, other than in the bank account had been passed through the books.

(vi) An accrual of Rs. 560 for telephone charges had been completely omitted.

(vii) A bad debt of Rs. 1,560 had not been written off and provision for doubtful debts should have been maintained at 10% of debtors which are shown in the trial balance at Rs. 23,390 with a credit provision for bad debts at Rs. 2,320.

(viii) Tools bought for Rs. 1,200 had been inadvertently debited to purchases.

(ix) The proprietor had withdrawn, for personal use, goods worth Rs. 1,960. No entries had been made in the books.

Required :

(i) Pass rectification entries without narration to correct the above errors before preparing annual accounts.

(ii) Prepare a statement showing effect of rectification on the reported net profit before correction of these errors.

Solution

	Particulars			Dr.	Cr.
(i)	Suspense Account		Dr.	6,160	
	To Return Outward A/c				6,160
(ii)	Suspense Account		Dr.	2,640	
	To Discount Allowed Account				1,320
	To Discount Received Account				1,320
(iii)	Suspense Account		Dr.	10,000	
	To Sale Account				10,000
(iv)	Suspense Account		Dr.	270	
	To Customer Account				270
(v)	Suspense Account		Dr.	1,500	
	To Vehicle Account				1,200
	To Profit on Sale of Vehicle Account				300
(vi)	Telephone Charges Account		Dr.	560	
	To Outstanding Expenses Account				560
(vii)	Bad Debts Account		Dr.	1,560[1]	
	To Sundry Debtors Account				1,560
	Provision for Doubtful Debts Account		Dr.	164[2]	
	To Profit and Loss Account				164
(viii)	Loose Tools Account		Dr.	1,200	
	To Purchases Account				1,200
(ix)	Drawing Account		Dr.	1,960	
	To Purchases				1,960

[1] *Bad debts will be debited in the profit and loss account.*

[2] *Provision @ 10% of Rs. 2,156; Excess provision Rs. 164.*

Working Notes :

(i)	Sundry Debtors as per books		23,390
	Deduction vide item (iv)	270	
	Bad Debts	1,560	1,830
			21,560

(ii) **Suspense Account**

	Rs.		*Rs.*
To Return outward Account	6,160	By balance b/d	20,570
To Discount allowed Account	1,320		
To Discount Received Account	1,320		
To Sales	10,000		
To Customers	270		
To Vehicles	1,200		
To Profit on Sale of Vehicle	300		
	20,570		20,570

Illustration 9

Show by means of Journal entries how the following matters should be adjusted when preparing the Annual Accounts of a firm for the year ended 30th September, 2009.

(a) Goods sold and recorded as sales for Rs. 4,000 were packed and the invoice for them sent to the customers. Stock taking intervened and the parcel of goods was not despatched but was included in stock-in-hand.

(b) Several employees took their salary in advance in the month of September, 2005 which was payable to them in October, 2003 amounting to Rs. 2,500.

(c) A cheque of Rs. 2,500 received for a loss of stock sustained by fire has been paid by the proprietor into his private bank account and not recorded in the business books.

(d) A cheque for Rs. 1,250 received as Insurance claim for loss of goods in transit at the time of import, was deposited by the proprietor into his private bank account. The full value of the invoice was passed through the purchase book.

(e) A purchase was made for a staff member of Rs. 1,000 and the cost was included in purchases. A deduction of similar amount was made from his salary and the net payment to him posted to salaries account.

(f) Bill received from Mr. Anup for repairs to furniture Rs. 300/- and new furniture supplied for Rs. 1,000 was entered in the invoice book as Rs. 1,100.

(g) Furniture which stood in the books at Rs. 500 was sold for Rs. 275 in part exchange of new furniture costing Rs. 875 and the new invoice of Rs. 600 was passed through the purchase book.

Solution

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Adjustment Entries

Date 2009	*Particulars*		*Dr. Rs.*	*Cr. Rs.*
Sep. 30				
(a)	Sales Account*	Dr.	4,000	
	To Sundry Debtors Account			4,000
	(Entry for credit sales reversed as goods have not been despatched to the customer)			
(b)	Prepaid Salaries Account**	Dr.	2,500	
	To Salaries Account			2,500
	(Salaries paid in advance for Oct. and debited to Salaries Account, now transferred to Prepaid Salaries Account)			
(c) ***	(i) Insurance Company Account	Dr.	2,500	
	(or Loss by Fire Account)			
	To Trading Account			2,500
	(Being the claim admitted by the Insurance Company for loss of stock due to fire)			
	(ii) Drawings Account	Dr.	2,500	
	To Insurance Company Account			2,500
	(Being the rectification of cheque received for loss of stock due to fire deposited in the private account of the proprietor)			
(d)	Drawings Account	Dr.	1,250	
	To Purchases Account			1,250
	(Being the rectification of cheque received as insurance claim for loss of goods in transit deposited into private bank Account of the proprietor)			
(e)	Salaries Account	Dr.	1,000	
	To Purchases Account			1,000
	(Goods purchased for staff-member recorded as trade purchases, new charged to Salaries Account)			

Note : * Alternatively in (a) goods recorded as sales may not be reversed, instead may be excluded from closing stock, as the goods have been ascertained and appropriated according to the contract. This treatment is recommended if the title in the goods have already passed to customer.

** In (b) it has been assumed that advance salary paid was for the month of Oct. 2005 and has been debited to Salaries Account.

*** In (c) it has been assumed that no entry has been passed in respect of the loss.

(f)	Repairs Account Dr.	300	
	Furniture Account Dr.	1,000	
	To Purchases Account		1,100
	To Mr. Anup		200
	(Being the rectification of Bill received from Mr. Anup for repairs to furniture Rs. 300 and new furniture supplied for Rs. 1,000 entered in the purchases book at Rs. 1,100)		
(g)	Furniture Account Dr.	375	
	Loss on sale of Furniture Account	225	
	To Purchases Account		600
	(Being the rectification of net exchange of old and new furniture passed through purchases day book)		

Illustration 10

On going through the Trial balance of Ball Bearings Co. Ltd. you find that the debit is in excess by Rs. 150. This was credited to "Suspense Account". On a close scrutiny of the books the following mistakes were noticed:

(1) the totals of debit side of "Expenses Account" have beeen cast in excess by Rs. 50

(2) The "Sales Account" has been totalled in short by Rs. 100.

(3) One item of purchase of Rs. 25 has been posted from the day book to ledger as Rs. 250.

(4) The sale return of Rs. 100 from a party has not been posted to that account though the Party's account has been credited.

(5) A cheque of Rs. 500 issued to the Suppliers' account (shown under Sundry Creditors) towards his dues has been wrongly debited to the purchases.

(6) A credit sale of Rs. 50 has been credited to the Sales and also to the Sundry Debtors Account.

(i) Pass necessary journal entries for correcting the above;

(ii) Show how they affect the Profits; and

(iii) Prepare the "Suspense Account" as it would appear in the ledger.

JOURNAL ENTRIES

Particulars		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
Suspense Account	Dr.		50	
To Expenses Account				50
(Being the mistake in totalling of Expenses Account, rectified)				
Suspense Account	Dr.		100	
To Sales Account				100
(Being the mistake in totalling of Sales Accounts rectified)				
Supplier*	Dr.		225	
To Suspense Account				225
(Being the mistake in posting from Day Book to Ledger rectified)				
Sales Returns Account	Dr.		100	
To Suspense Account				100
(Being the sales return from a party not posted to "Sales Returns" now rectified)				
Sundry Creditors	Dr.		500	
To Purchases Account				500
(Being the payments made to supplier wrongly posted to purchases now rectified)				
Sundry Debtors	Dr.		100	
To Suspense Account				100
(Being the sales wrongly credited to Customer's Account now rectified)				

* *It is assumed that the day-book is the Purchase Day Book in which case only the supplier's account would be posted wrongly (creditor of Rs. 250 instead of Rs. 25). If however, by day-book is meant a book in which all transactions are recorded and posted at the ledger therefrom, it would mean that both the Supplier's Account and Purchases Account are wrongly posted.*

Suspense Account

Dr.	Rs.		Cr. Rs.
To Expenses Account	50	By Difference in Trial Balance	150
To Sales Account	100	By Sundry Creditors	225
To Balance c/d	425	By Sales Returns Account	100
		By Sundry Debtors	100
	575		575
		By Balance b/d	425

Since the Suspense Account does not balance, it is clear that all the errors have not been traced. As a result of the above corrections the Net Profit will be :

	Increased by Rs.	Decreased by Rs.
Mistake in totalling in "Expenses"	50	
Mistake in totalling in "Sales"	100	
Mistake in posting from day book to Ledger under "Purchases"	500	
Omission in posting under "Sales Returns"		100
	650	100
Net Increase	550	

As a result of these adjustments, the Profits will be increased by Rs. 550.

Illustration 11

Write out the Journal Entries to rectify the following errors, using a Suspense Account.

(1) Goods of the value of Rs. 100 returned by Mr. Sharma were entered in the Sales Day Book and posted there from to the credit of his account;

(2) An amount of Rs. 150 entered in the Sales Returns Book, has been posted to the debit of Mr. Philip, who returned the goods;

(3) A sale of Rs. 200 made to Mr. Ghanshyam was correctly entered in the Sales Day Book but wrongly posted to the debit of Mr. Radheshyam as Rs. 20;

(4) Bad Debts aggregating Rs. 450 were written off during the year in the Sales ledger but were not adjusted in the General Ledger; and

(5) The total of "Discount Allowed" column in the Cash Book for the month of September, 2005 amounting to Rs. 250 was not posted.

Solution

JOURNAL

	Particulars		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
(1)	Sales Account	Dr.		100	
	Sales Returns Account	Dr.		100	
	To Suspense Account				200
	(The value of goods returned by Mr. Sharma wrongly posted to Sales and omission of debt to Sales Returns Account, now rectified).				
(2)	Suspense Account	Dr.		300	
	To Mr. Philip				300
	(Wrong debit to Mr. Philip for goods returned by him, now rectified).				
(3)	Mr. Ghanshyam	Dr.		200	
	To Mr. Radheshyam				20
	To Suspense Account				180
	(Omission of debit to Mr. Ghanshyam and wrong credit to Mr. Radhesham for sale of Rs. 200, now rectited)				
(4)	Bad Debts Account	Dr.		450	
	To Suspense Account				450
	(The amount of Bad Debts written off not adjusted in General Ledger, now rectified)				
(5)	Discount Account	Dr.		250	
	To Suspense Account				250
	(The total of Discount allowed during September, 2003 not posted from the Cash Book; error now rectified).				

Illustration 12

The Trial balance of Messrs. A, B and C did not agree. A Suspense Account was opened with the amount of the difference. The following errors were discovered on scrutiny:

(1) The addition of the Analysis Column of the Tabular Purchase Journal posted to Goods Purchased for Resale Account was found to be short by Rs. 150 though the addition of the total column was correct.

(2) A dishonoured B/R for Rs. 400 returned to the firm by bank had been credited to Bank Account for collection of bills and debited to B/R Account. A cheque was later received from the customer for Rs. 400 and was duly paid into the firm's bank account.

(3) An amount of Rs. 450 treated as paid in advance on account of insurance in the previous year was not brought forward.

(4) Sales on approval amounting to Rs. 2,000 were included in the Sales Account. Half of these were returned but no entries were passed in respect of these goods. However, the returned goods have been included in the closing stock at their cost price of Rs. 500.

(5) Of the total amount of Rs. 38,356 shown as Sundry Debtors, Rs. 1,260 represent credits given to customers when the payments against sales invoices were received. However, these invoices themselves were not entered in the books. A discount of 10% is allowed on the selling price in all such invoices.

You are required to pass rectifying entries making use, of the Suspense Account, wherever necessary.

Solution

Journal of M/s. A, B and C

	Particulars		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
1.	Purchase for Resale A/c	Dr.		150	
	To Suspense Account				150
	(Short debit to 'purchases for Resale Account' on account of undercasting on now corrected)				
2.	Customers A/c	Dr.		400	
	To Bill Receivable A/c				400
	(Amount of dishonoured bill receivable previously debited to Bills Receivable Account, error now rectified)				
3.	Insurance Account	Dr.		450	
	To Suspense Account				450
	(Prepaid insurance in the previous year not brought forward now debited to the Insurance Account)				
4.	Sales Accounts	Dr.		1,000	
	To Customer's Account				1,000
	(Goods worth Rs. 1,000 returned by a customer on sale or return basis, previously omitted to be recorded; error now rectified)				
5.	Discount Account	Dr.		140	
	Customers Account	Dr.		1,260	
	To sales Account				1,400
	(Credit sales of Rs. 1,400 previously omitted from the books, error now corrected)				

Note : Payment being equal to 90% of the gross sale is Rs. 1,400, i.e., 1,260 × 100/90. 1/10 of this amount is discount.

Since the discount of 10% is allowed in all cases, it would be better to treat the sale to be Rs. 1,260 and not Rs. 1,400, the discount is trade discount for which no account is opened, the sales being recorded, at the net amount.

Illustration 13

The trial balance of Anil Traders did not agree. The difference was put in the Suspense Account and the following trial balance was drafted :

Trial Balance as on 31st March, 2009

	Dr.	*Cr.*
Capital Account		45,000
Drawing Account	6,500	
Purchases Account	92,750	
Sales Account		1,07,200
Salaries and Wages Account	12,250	
Furniture and Fittings Account	17,500	
Sundry Debtors Account	30,250	
Sundry Creditors Account		21,250
Stationery Account	1,250	
Cash at Bank	5,700	
Cash in Hand	2,300	
Bills Receivable Account	15,750	
Bills Payable Account		9,000
Rent and Rates Account	3,200	
Suspense Account		5,000
	1,87,450	1,87,450

On scrutiny the following errors were subsequently detected :

(a) Goods drawn by Mr. Anil, the proprietor, for personal consumption of Rs. 1,500 have not at all been recorded.

(b) Goods sold to Ram for Rs, 1,250 on credit was debited to Rahim account for Rs. 250 only.

(c) Wages paid for fittings Rs. 500 was debited to salaries and wages account.

(d) Goods Purchased from Atul for Rs. 2,500 on credit was wrongly debited to his account.

(e) Bill received from Arun, a debtor, for Rs. 500 was debited to Ajay's account.

(f) A credit sale of Rs. 1,500 was recorded in Purchased Day Book and a credit purchase of Rs. 2,000 was entered in Sales Day Book.

You are required to pass the rectification entries and redraft the trial balance.

Solution

M/s Anil Traders

Journal

	Particulars		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
(a)	Drawings Account	Dr.		1,500	
	To Purchases Account				1,500
	(Goods withdrawn for personal consumption by the proprietor, now recorded)				
(b)	Ram (Debtor) Account	Dr.		1,250	
	To Rahim (Debtor) Account				250
	To Suspense Account				1,000
	(Goods sold to Ram for Rs. 1,250 wrongly debited to Rahim account for Rs. 250, now rectified)				
(c)	Furniture and Fittings Account	Dr.		500	
	To Salaries and Wages Account				500
	(Wages paid for fittings wrongly debited to salaries and wages account, now rectified)				
(d)	Suspense Account	Dr.		5,000	
	To Atul (Creditor) Account				5,000
	(Goods brought on credit from Atul wrongly debited to his account, now rectified)				
(e)	Suspense Account	Dr.		1,000	
	To Arun (Debtor) Account				500
	To Ajay (Debtor) Account				500
	(Bill received from Arun wrongly debited to Ajay Account, now rectified)				
(f)	Purchases Account	Dr.		500	
	Sales Account	Dr.		500	
	To Debtors Account*				500
	To Creditors Accont*				500
	(A credit sale and a credit purchase wrongly entered in purchases day book and sales day book respectively, now rectified)				

* In the debtors' ledger and creditors' ledger, the affected individual accounts should be rectified with the full amount. In other words, in the debtors' ledger the concerned debtors account should be debited by Rs. 1,500 for credit sales and the debtor account wrongly debited for credit purchase should be credited by Rs. 2,000.

Trial Balance of M/s. Anil Traders as on 31.3.2009

Particulars	*Dr.*	*Cr.*
Capital Account		45,000
Drawings Account	8,000	
Purchases Account	91,750	
Sales Account		1,06,700
Salaries and Wages Account	11,750	
Furniture and Fittings Account	18,000	
Sundry Debtors Account	29,750	
Sundry Creditors Account		26,750
Stationery Account	1,250	
Cash at Bank	5,700	
Cash in Hand	2,300	
Bills Receivable Account	15,750	
Bills Payable Account		9,000
Rent and Rates Account	3,200	
	1,87,450	1,87,450

Working Notes :

1. Suspense Account

Dr.	*Rs.*		*Cr.* *Rs.*
To Atul Account (entry 'd')	5,000	By Balance b/d	5,000
To Arun Account [entry 'e']	500	By Ram Account (entry 'b')	1,000
To Ajay Account [entry 'e']	500		
	6,000		6,000

2. **Corrected Ledger Balances**

	Balance as per given trial balance *Rs.*	*Rectification effect* *Rs.*	*Reference (entry no.)*	*Rectified balance* *Rs.*
Drawings	6,500	(+) 1,500	(a)	8,000
Purchases	92,750	(-) 1,000	(a) & (f)	91,750
Sundry Debtors	30,250	(-) 500	(b), (e) & (f)	29,750
Furniture & Fittings	17,500	(+) 500	(c)	18,000
Salaries & Wages	12,250	(-) 500	(c)	11,750
Sundry Creditors	21,250	(+) 5,500	(d) & (f)	26,750
Sales	1,07,200	(-) 500	(f)	1,06,700

5.3 CORRECTION IN THE NEXT ACCOUNTING PERIOD

Rectification of errors discussed so far assumes that it was carried out before the books were closed for the concerned year. However, sometimes, the rectification is carried out in the next year, carrying forward the balance in the Suspense Account or even transferring it to the Capital Account. Suppose, the Purchase Book was cast short by Rs. 1,000 in December, 2005 and a Suspense Account was opened with the difference in the trial balance. If the error is rectified next year and the entry passed is to debit Purchase Account (and credit Suspense Account), it will mean that the Purchases Account for year 2006 will be Rs. 1,000 more than the amount relating to year 2006 and thus the profit that year 2006 will be less than the actual for that year. Thus, correction of errors in this manner will 'falsify' the Profit and Loss Account.

To avoid this, correction of all amounts concerning nominal accounts, i.e., expenses and incomes should be through a special account styled as "Prior Period Items" or "Profits and Loss Adjustment Account". The balance in the account should be transferred to the Profits and Loss Account. However, these Prior Period Items should be charged after deriving net profit of the current year. 'Prior Period items' are material income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more periods. Prior Period Items should be separately disclosed in the current statement of profit and loss together with their nature and amount in a manner that their impact on current profit or loss can be perceived.

Illustration 14

Mr. A closed his books of account on September 30, 2009 inspite of a difference in the trial balance. The difference was Rs. 830 the credits being short; it was carried forward in a Suspense Account. In 2010 following errors were located :

(i) A sale of Rs. 2,300 to Mr. Lala was posted to the credit of Mrs. Mala.

(ii) The total of the Returns Inward Book for July, 2007 Rs. 1,240 was not posted in the ledger.

(iii) Freight paid on a machine Rs. 5,600 was posted to the Freight Account as Rs. 6,500.

(iv) White carrying forward the total in the Purchases Account to the next page, Rs. 65,590 was written instead of Rs. 56,950.

(v) A sale of machine on credit to Mr. Mehta for Rs. 9,000 was not entered in the books at all. The book value of the machine was Rs. 7,500. The firm has the practice of writing off depreciation @10% on the balance at the end of the year.

Pass journal entries to rectify the errors. Have you any comments to make?

Solution

Journal of Mr. A

Date	*Particulars*		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
2010 (i)	Mrs. Mala	Dr.		2,300	
	Mr. Lala	Dr.		2,300	
	To Suspense A/c				4,600
	(Correction of error by which a sale of Rs. 2,300 to Mr. Lala was posted to the Credit of Mrs. Mala)				
(ii)	Profit and Loss Adjustment A/c	Dr.		1,240	
	To Suspense A/c				1,240
	(Rectification of omission to post the total of Returns Inward Book for July, 2009)				
(iii)	(a) Machinery A/c	Dr.		5,600	
	Suspense A/c	Dr.		900	
	To Profit & Loss Adjustment A/c				6,500
	(Correction of error by which freight paid for a machine Rs. 5,600 was posted to Freight Account at Rs. 6,500 instead of capitalising it)				
	(b) Profit & Loss Adjustment A/c	Dr.		560	
	To Plant and Machinery A/c				560
	(Depreciation @ 10% charged on freight paid on a machine capitalised)				
(iv)	Suspense A/c	Dr.		8,640	
	To Profit & Loss Adjustment A/c				8,640
	(Correction of wrong carry forward of total in the purchase Account to the next page Rs. 65,590 instead of Rs. 56,950)				
(v)	Mr. Mehta	Dr.		9,000	
	To Plant & Machinery A/c				6,750
	To Profit & Loss Adjustment A/c				2,250
	(Correction of omission of a sale of machine on credit to Mr. Mehta for Rs. 9,000 with a book value of Rs. 7,500 on which depreciation @ 10% has been charged in 2009)				

Comments

The Suspense Account will now appear as shown below :

Suspense Account

Dr. Date	Particulars Rs.	Amount	Date	Particulars Rs.	*Cr.* Amount
2010	To Profit and Loss		2009	By Balance b/d	830
	Adjustment A/c	900	Oct. 1	By Sundries	
	To Profit and Loss			Mrs. Mala	2,300
	Adjustment A/c	8,640		Mr. Lala	2,300
				By Profit and Loss	
				Adjustment A/c	1,240
				By balance c/d	2,870
		9,540			9,540

Since the Suspense Account still shows a balance, it is obvious that there are still some errors left in the books.

Profit & Loss Adjustment A/c

(For Prior Period Items)

Dr. Date 2010	Particulars	Amount Rs.	Date 2010	Particulars	*Cr.* Amount Rs.
	To Suspense A/c	1,240		By Machinery A/c	5,600
	To Plant and			By Suspense A/c	900
	Machinery A/c	560		By Suspense A/c	8,640
	To Balance c/d	15,590		By Mr. Mehta	2,250
		17,390			17,390

Illustration 15

A merchant's trial balance as on June 30, 2009 did not agree. The difference was put to a Suspense Account. During the next trading period, the following errors were discovered :

(i) The total of the Purchases Book of one page, Rs. 4,539 was carried forward to the next page as Rs. 4,593.

(ii) A sale of Rs. 573 was entered in the Sales Book as Rs. 753 and posted to the credit of the customer.

(iii) A return to a creditor, Rs. 510 was entered in the Returns Inward Book; however, the creditor's account was correctly posted.

(iv) Cash received from C. Dass, Rs. 620 was posted to the debit of G. Dass.

(v) Goods worth Rs. 840 were despatched to a customer before the close of the year but no invoice was made out.

(vi) Goods worth Rs. 1,000 were sent on sale or return basis to a customer and entered in the Sales Book. At the close of the year, the customer still had the option to return the goods. The sale price was 25% above cost.

You are required to give journal entries to rectify the errors in a way so as to show the current year's profit or loss correctly.

Solution

Journal Entries

	Particulars		*L.F.*	*Dr. Rs.*	*Cr. Rs.*
(i)	Suspense Account	Dr.		54	
	To Profit and Loss Adjustment A/c				54
	(Correction of error by which Purchase Account was over debited last year- Rs. 4,593 carried forward instead of Rs. 4,539.)				
(ii)	Profit & Loss Adjustment A/c	Dr.		180	
	Customer's Account	Dr.		1,326	
	To Suspense Account				1,506
	(Correction of the entry by which (a) Sales A/c was over credited by Rs. 180 (b) customer was credited by Rs. 753 instead of being debited by Rs. 573.)				
(iii)	Suspense Account	Dr.		1,020	
	To Profit & Loss Adjustment A/c				1,020
	(Correction of error by which Returns Inward Account was debited by Rs. 510 instead of Returns Outwards Account being credited by Rs. 510)				
(iv)	Suspense Account	Dr.		1,240	
	To C. Dass				620
	To G. Dass				620
	(Removal or wrong debit to G. Dass and giving credit to C. Dass from whom cash was received).				

(v)	Customer's Account	Dr.		840	
	To Profit & Loss Adjustment A/c				840
	(Rectification of the error arising from non-preparation of invoice for goods delivered)				
(vi)	Profit & Loss Adjustment A/c	Dr.		200	
	Stock Account	Dr.		800	
	To Customer's Account				1,000
	(The Customer's A/c credited with Rs. 1,000 for goods not yet purchased by him; cost of the goods debited to Stock and "Profit" debited to Profit & Loss Adjustment Account)				
(vii)	Profit & Loss Adjustment A/c	Dr.		1,534	
	To Capital Account				1,534
	(Transfer of the Profit & Loss Adjustment A/c balance to the Capital Account)				

Will the students find out the difference in the Trial Balance?[1]

Illustration 16

Mr. Roy was unable to agree the Trial Balance last year and wrote off the difference to the Profit and Loss Account of that year. Next Year, he appointed a Chartered Accountant who examined the old books and found the following mistakes :

(1) Purchase of a scooter was debited to conveyance account Rs. 3,000.

(2) Purchase account was over-cast by Rs. 10,000.

(3) A credit purchase of goods from Mr. X for Rs. 2,000 entered as a sale.

(4) Receipt of cash from Mr. A was posted to the account of Mr. B Rs. 1,000.

(5) Receipt of cash from Mr. C was posted to the debit of his account, Rs. 500.

(6) Rs. 500 due by Mr. Q was omitted to be taken to the trial balance.

(7) Sale of goods to Mr. R for Rs. 2,000 was omitted to be recorded.

(8) Payment of Rs. 2,395 for purchase was wrongly posted as Rs. 2,593.

Mr. Roy used 10% depreciation on vehicles. Suggest the necessary rectification entries.

[1] *Credit side is short by Rs. 808*

Solution

Journal Entries in the books of Mr. Roy

Date	*Particulars*			*Dr. Rs.*	*Cr. Rs.*
(1)	Motor Vehicles Account	Dr.		2,700	
	To Profit and Loss Adjustment A/c				2,700
	(Purchase of scooter wrongly debited to conveyance account now rectified-capitalisation of Rs. 2,700, i.e., Rs. 3,000 less 10% depreciation)				
(2)	Suspense Account	Dr.		10,000	
	To Profit & Loss Adjustment A/c				10,000
	(Purchase Account overcast in the previous year; error now rectified).				
(3)	Profit & Loss Adjustment A/c	Dr.		4,000	
	To P's Account				4,000
	(Credit purchase from P Rs. 2,000, entered as sales last year; now rectified)				
(4)	B's Account	Dr.		1,000	
	To A's Account				1,000
	(Amount received from A wrongly posted to the account of B; now rectified)				
(5)	Suspense Account	Dr.		1,000	
	To C's Account				1,000
	(Rs. 500 received from C wrongly debited to his account; now rectified)				
(6)	Sundry Debtors (Q)	Dr.		500	
	To Suspense Account				500
	(Rs. 500 due by Q not taken into trial balance; now rectified)				
(7)	R's Account	Dr.		2,000	
	To Profit & Loss Adjustment A/c				2,000
	(Sales to R omitted last year; now adjusted)				
(8)	Suspense Account	Dr.		198	
	To Profit & Loss Adjustment A/c				198
	(Excess posting to purchase account last year, Rs. 2,593, instead of Rs. 2,395, now adjusted)				
(9)	Profit & Loss Adjustment A/c	Dr.		10,898	
	To Roy's Capital Account				10,898
	(Balance of Profit & Loss Adjustment A/c transferred to Capital Account)				
(10)	Roy's Capital Account	Dr.		10,698	
	To Suspense Account				10,698
	(Balance of Suspense Account transferred to the Capital Account)				

Note : Entries No. (2) and (8) may even be omitted; but this is not advocated, Entry (6) will not be posted in Q's Account.

Profit and Loss Adjustment Account
(Prior Period Items)

	Rs.		*Rs.*
To P	4,000	By Motor Vehicles A/c	2,700
To Roy's Capital (transfer)	10,898	By Suspense A/c	10,000
		By R	2,000
		By Suspense Account	198
	14,898		14,898

Suspense Account

	Rs.		*Rs.*
To Profit & Loss Adjustment Account	10,000	By Sundry Debtors (Q)	500
To C	1,000	By Roy's Capital Account (Transfer)	10,698
To Profit & Loss Adjustment Account	198		
	11,198		11,198

SELF EXAMINATION QUESTIONS

I. Pick up the correct answer from the given choices:

1. (i) Goods purchased from A for Rs. 10,000 passed through the sales book. The error will result in

   (a) Increase in gross profit. (b) Decrease in gross profit.

   (c) No effect on gross profit. (d) Either (a) or (b).

   (ii) If a purchase return of Rs. 1,000 has been wrongly posted to the debit of the sales returns account, but has been correctly entered in the suppliers' account, the total of the

   (a) trial balance would show the debit side to be Rs. 1,000 more than the credit

   (b) trial balance would show the credit side to be Rs.1,000 more than the debit.

   (c) the debit side of the trial balance will be Rs. 2,000 more than the credit side.

   (d) the credit side of the trial balance will be Rs. 2,000 more than the debit side.

   (iii) If the amount is posted in the wrong account or it is written on the wrong side of the account, it is called

   (a) error of omission. (b) error of commission.

   (c) error of principle. (d) compensating error.

[Ans 1 : (i)-(a), (ii)-(c), (iii)-(b),]

2. Choose the most appropriate option from the given choices:

(i) Rs. 200 paid as wages for erecting a machine should be debited to

(a) Repair account. (b) Machine account.

(c) Capital account. (d) Furniture account

(ii) On purchase of old furniture, the amount of Rs. 1,000 spent on its repair should be debited to

(a) Repair account; (b) Furniture account;

(c) Cash account; (d) Bank account

(iii) Goods worth Rs. 50 given as charity should be credited to

(a) Charity account; (b) Sales account;

(c) Purchase account. (d) Cash account

(iv) Goods worth Rs. 100 taken by proprietor for domestic use should be credited to

(a) Sales account; (b) Proprietor's personal expenses;

(c) Purchases account (d) Expenses account.

(v) Errors of commission do not permit;

(a) Correct totalling of the balance sheet; (b) Correct totalling of the trial balance;

(c) The trial balance to agree. (d) None of the above

(vi) The preparation of a trial balance is for:

(a) Locating errors of commission; (b) Locating errors of principle;

(c) Locating clerical errors. (d) All of the above

(vii) Rs. 200 received from Smith whose account, was written off as a bad debt should be credited to :

(a) Bad Debts Recovered account; (b) Smith's account;

(c) Cash account. (d) Bad debts account

(viii) Purchase of office furniture Rs. 1,200 has been debited to General Expense Account. It is :

(a) A Clerical error; (b) An error of principle;

(c) An error of omission. (d) Compensating error.

(ix) Sales of office furniture should be credited to

(a) Sales Account; (b) Furniture Account.

(c) Purchase Account. (d) Cash Account

[Ans: **2 :** (i) (b); (ii) (b); (iii) (c); (iv) (c); (v) (c); (vi) (c); (vii) (a); (viii) (b); (ix) (b);]

II. From the given information, choose the most appropriate answer.

1. Classify the following errors under (a) Errors of omission, (b) Errors of commission and (c) Errors of principle, (d) Compensating errors

(i) The total of sales book was not posted to the ledger.

(ii) Sales to Heena Rs. 143 was posted to Meena as Rs. 143.

(iii) Goods taken away by the proprietor for personal use not recorded anywhere.

(iv) The total of a folio in the sales book Rs. 1,000 was carried forward as Rs. 100.

(v) Repairs of newly purchased second-hand machinery debited to repairs accounts.

[Ans: 1: (i)-(a), (ii)-(b), (iii)-(a), (iv)-(b), (v)-(c)]

2. Point out the type of the errors given below: (put 1 against errors of omission, 2 against errors of commission, 3 against errors principle, 4 if it is not an error).

(a) Sale of Rs. 120 was written in the purchases book.

(b) Salary paid to Ram, has been debited to his account.

(c) Purchase of furniture has been entered in the purchases book.

(d) Rs. 120 received from Ganesh has been debited to his account.

(e) Freight paid on machinery has been debited to the freight account.

(f) The discount columns of the cash book have not been posted.

(g) Repairs to buildings have been debited to the buildings account.

(h) The total of the Sales Book is Rs. 100 short.

(i) The sale of worth Rs. 337 has been posted as Rs. 373.

(j) The amount of a dishonoured bill has been debited to general expenses account.

[Ans : 2 : - 1 : (f); 2 : (a) (d) (h) (i); 3 : (b) (c) (e) (g) (j)]

III. Given below are the questions containing multiple answers. Choose the correct answer(s).

1. Which of the following errors will not be revealed by the Trial Balance:

   (a) compensating errors; (b) errors of principle;

   (c) wrong balancing of an account; (d) wrong totalling of an account;

   [Ans : 1 : (a) and (b) will not be revealed]

2. Which of the following errors will be revealed by the Trial Balance:

   (a) compensating errors; (b) errors of principle;

   (c) wrong balancing of an account; (d) wrong totalling of an account;

   [Ans : (c) and (d) will be revealed]