Unit –I

Learning Objectives: Bills of Exchange

After studying this chapter, you should be able to understand:

- ☞ Meaning of bill of exchange
- ☞ Meaning of promissory Note
- ☞ Distinction between Bill of Exchange & Promissory Note
- ☞ Time and demand Bills
- ☞ Date of maturity of Bills
- ☞ Holder and Holder in Due course
- ☞ Negotiation & Endorsement
- ☞ Discounting of the bill
- ☞ Bill sent to the bank for collection
- ☞ Dishonour of Bills
- ☞ Renewal of Bills
- ☞ Insolvency of drawee
- ☞ Retiring a bill
- ☞ Bills receivable & Bills Payable Book
- ☞ Accommodation Bills
- ☞ Entries in the Books of the drawer & drawee in different situation

Business is not undertaken strictly on cash terms. Transactions are made on credit also when credit is allowed the seller may like that the buyer promise to pay at a later date must be in writing. Buyer's promise to pay may take in form of bill of exchange or promissory note which is the common instrument of credit. There instruments are governed by the negotiable instruments act, 1881.

1.1Bill of exchange: - Section 5 of the negotiable instruments Act defines a bill of exchange as follows:

"A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument".

1.1.1Features of Bill of Exchange:

An analysis of that about definition brings out the following features:

I. It must be in writing.
II. There is an unconditional order to pay.
III. It is signed by the drawer (seller or creditor).

IV. The drawer, drawee and payee are certain.
V. The amount payable is a certain sum of money.
VI. The sum payable is either on demand or at a fixed or determinable future time.
VII. The sum is payable to the bearer of the instrument or to the specified person or to the order of a certain person.
VIII. The instrument must be dated and stamped.

Note: A bill cannot be drawn payable to bearer on demand. It is payable on demand, then it must be payable to order.

1.1.2 Parties to a Bill of Exchange: There are three parties to a bill of exchanges such as drawer, drawee and payee.

Drawer: - The person who makes the bill is called the drawer (Creditor)

Drawee: - The person is directed to pay is called the drawee (Debtor)

Payee: - The person to whom the payment is to be made is called the payee.

The drawer and payee can be the same person.

1.1.3 Specimen of a Bill of Exchange: The Specimen of a bill of exchange is as under:

₹ 10,000 Bhubaneswar,
27th July 2016

Three months after date pay to X or order the sum of Rupees Ten thousand only for value received.

Accepted
Signature of B

To
B
25, Sahid Nagar, Bhubaneswar

Revenue Stamp
Signature of A

In this above specimen of a bill of exchange, A is the drawer of the bill, B is the drawee and X is the payee. When the bill is accepted it is signed by B after writing accepted.

1.2Promissory Note:

Section 4 of the Negotiable instruments Act defines a promissory note as under:

"A Promissory Note is an instrument in writing, containing an unconditional undertaking, signed by the marker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument".

Even though the above definition says that promissory note can be made payable to bearer, section 31 of the Reserve Bank of India Act, 1934 (Amendment Act, 1946) provides that no person in India other than the reserve bank or Central Government can make or issue a promissory note payable to bearer.

The person who promissory to pay is called the 'Maker' and to whom the payment is to be made is called the 'payee'.

1.2.1 Features of promissory Note: A promissory note has the following features:

i) It is in writing.
ii) It is a promise or undertaking to pay.
iii) The promise to pay is unconditional.
iv) It is signed by the marker (buyer or debtor).
v) The maker and payee are certain persons.
vi) The sum payable is certain.
vii) The amount payable is either on demand or at the fixed or determinable future time.
viii) The amount is payable to a certain person or to the order of such person or to the bearer of the instrument.

1.2.2 Specimen of a Promissory Note

₹ 10,000

Bhubaneswar,
28th July 2016

Three months after date I promise to pay B or his order the sum of Rupees Ten thousand, for value received.

Revenue Stamp
Signature of A

In the above specimen of promissory note, A is the maker or promissory and B is the payee.

1.3 Distinction between Bill of Exchange and promissory Note:

A bill of exchange can be distinguished from a promissory note as under:

Basics	Bill of Exchange	Promissory Note
1.Number of parties	There are three parties – drawer, drawee and payee	There are two parties – maker and payee
2.Maker/Drawer & Payee	The drawer and payee can be the same person	The maker and payee cannot be the same person.
3.Promise and order	There is an order to pay	There is a promise to pay
4.Acceptance	It must be accepted by the drawee	It requires no acceptance
5.Nature of liability	The liability of the drawer is secondary and conditional	The liability of the maker is primary and absolute.
6.payable to bearer	It can be drawn payable to bearer but not payable to bearer on demand	It cannot be drawn payable to bearer
7.Notice of dishonour	Notice of dishonour must be given by the holder of the bill to all prior parties who are liable to pay	Notice of dishonour is not required to be given to the maker
8.Protesting	In case of dishonour of bill, it requires protesting	Protesting is not required upon dishonour

1.4 Time and Demand Bills:

As instrument payable after a fixed time (after a specified period) or on a specified day or after happening of an event (which is certain to happen) is called time instrument. For example; Two months after date pay A or Order ₹ 1,000; Pay A on 10th July ₹ 1000; pay A ₹1,000 after B's Death.

An instrument payable on demand or at sight (on presentation in case of promissory note and on acceptance in case of bill of exchange) or where no time for payment is specified is called demand instrument. For example, pay A ₹1,000; pay A ₹1,000 or demand; pay A ₹1,000 at sight; pay A ₹ 1,000 on present month.

1.5 Maturity of Bills:

Maturity means the date on which the payment against the bill is due. Demand bills are due for payment on the date of its issue. On the other hand, maturity of time bills is calculated by adding three days of grace to the due date of the bill. For example; a bill drawn on 1st January payable three months after date shall mature on 4th April. If the month in which the bill is due has no corresponding date, then the due date shall be the last day of the same month. For example; a bill drawn on 30th January payable one month after date shall mature on 3rd March because the month February is of 28/29 days. When the bill is drawn payable a certain number of days after date or after sight or after certain event, the maturity date is calculated by excluding the day on which the bill is drawn. For example; a bill drawn on 1st January and payable 10 days after date shall mature on 14th January. Here 10 days is counted from 2nd January. If the date of maturity of the bill falls on Sunday or public holiday, the proceeding business day shall be the date of maturity.

1.6 Bills Receivable & Bills Payable:

When the bill is drawn by the creditor (drawer) upon the debtor (drawee) or promissory note given by the debtor to the creditor, it is Bills Receivable in the hands of the debtor (drawee). The creditor shall receive the payment against the bills receivable and the debtor shall pay against the bills payable.

1.7 Holder and Holder in Due course:

The holder of an instrument is the person who is entitled to the possession of the instrument in his own name and to receive the payment against that instrument. But a holder in due course is a person who acquired an instrument in good faith and for valuable consideration before the date of its maturity. Thus, a holder will not be a holder in due course if he has obtained the instrument by gift for an unlawful consideration or by illegal method or he has obtained the instrument after its maturity or he has not obtained the instrument bonafide. A holder in due course enjoys some special privileges. An important privilege is that the holder in due course gets a better title than that of the transfer.

1.8 Negotiation & Endorsement:

Negotiable instruments are transferred from one person to another. The process of transferring the ownership of such instruments is called negotiation. There are two ways of transferring the instrument such as negotiation by mere delivery and negotiation by endorsement and delivery. While bearer instruments are transferred by mere delivery, order instruments are transferred by endorsement and delivery.

When the holder of an instrument signs on the face or back of the instrument or on a slip of paper (called allonge) for the purpose of negotiation it is called endorsement. The person who endorses the instrument is called the 'endorser' and to whom the instrument is endorsed is called the 'endorsee'.

1.9 Option available to the drawer or holder of a Bill:

The drawer or holder of a bill has the following options to deal with the bill:

1. He may retain the bill till the date of maturity.
2. He may discount the bill with the bank.
3. He may endorse the bill in favour of his creditor.
4. He may send the bill to the bank for collection.

1.9.1 Retaining the Bill till the date of maturity

When the holder of the bill is not in need of money immediately, he can retain the bill till the date of maturity and present the bill to the drawee on the date of maturity and receive the payment. The entries in the books of the drawer and drawee shall be as follows:

	Books of the drawer	Books of the drawee
Acceptance of the Bill / Receipt of promissory note	Bills Receivable A/c ……… Dr To Drawee A/c (Being receipt of the bill)	Drawer A/c ………. Dr To Bills payable A/c (Being acceptance given)
Payment of the bill on maturity	Cash A/c / Bank A/c …….Dr. To Bills receivable A/c (Being amount received against the bill)	Bills payable A/c ……… Dr To Cash A/c / Bank A/c (Being payment made against the bill)

1.9.2 Discounting of the Bill:

When the drawer / holder is in need of money before the date of maturity, the bill can be discounted with the bank. Discounting is nothing but selling the bill to the bank. Since the bank pays the money before the due date of the bill, the bank charges certain amount which is called discount. The discount which is the interest charged by the bank depends on the rule of discount and the unexpired period of the bill (date of discounting and the due date of the bill). The amount of discount calculated as follows:

$$\frac{\text{Face value of the Bill} \times \text{Rate of discount} \times \text{Unexpired days (month) of the Bill}}{365\ (12)}$$

For example, if the face value of the bill is ₹ 10,000 and it was drawn or 1st August at three months, but discounted in the bank on 4th September at 15% per annum, the amount of discount shall be ₹ 10,000 x 15/100 x 2/12 = ₹ 250. When the bill is discounted in the books of the drawer, bank account is debited with the net amount of the bill and discount account is debited with the amount of discount, the credit being given to bills receivable account. However, no entry is passed in the books of the drawee because the drawee is not affected by discounting of the bill. The entry is the books of the drawer shall be:

Bank Account …………………. Dr

Discount Amount ……………….Dr

To bills receivable account (Being discounting of the bill with the banker @ - p.a.)

1.9.3 Endorsement of the Bill:

Endorsing the bill means transferring the bill in favour of a creditor in full or part settlement of a debt. When the drawer or holder transfers the bill to his creditor, the entry is the books of the drawer shall be.

Endorsee (Creditor) Account . . . . Dr.

To Bills Receivable Account (Being endorsement of the bill)

However, there shall be no entry in the books of the drawee since the drawee is not affected by the endorsement. But in the books of the endorsee the entry shall be:

Bills receivable Account . . . . Dr

To Endorser's Account

(Being the receipt of the bill duly endorsed)

1.9.4 Bill sent to the Bank for collection:

When a bill is no be discounted or endorsed by the drawer it may be retained by him till the date of maturity or simply sent to the bank for collection where the bank shall present the bill on the due date and credit the amount so collected to the account of the drawer. The entry in the books of the drawer shall be:

Bills sent for collection Account. . . . . Dr.

To Bills receivable Account

(Being the bill sent to the bank for collection)

Bank Account . . . . . . Dr.

To Bills sent for collection Account

(Being the amount collected by the bank)

Illustration 1

Mahendra draw a bill upon Akshaya for ₹7,000 at three months. Akshaya accepted the bill and returned the same to Mahendra. Pass journal entries in the books of both the parties in each of the following circumstances. The bill was met on the due date.

i. Mahendra retained the bill till the date of maturity
ii. The bill was discounted @ 10% p.a.
iii. Mahendra endorsed the bill in favour of Tapas; and
iv. Mahendra sends the bill to the bank for collection.

Books of Mahendra

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	Bill receivable A/c..... Dr. To Akshaya A/c (Being Acceptance of Akshya received)		7,000,	7,000
(i)	<u>Bill is retained:</u> Cash A/c . . . . Dr To Bills receivable A/c (Being the bill met on maturity)		7,000,	7,000
(ii)	<u>Discounting of the Bill:</u> Bank A/c …… Dr Discount A/c ……. Dr To Bills receivable A/c (Being discounting of the bill @10% p.a.)		6,825 175	7,000
(iii)	<u>Endorsement of the Bill:</u> Tapas A/c ……. Dr To Bills receivable A/c (Being the bill endorsed in favour of Tapas.)		7,000	7,000
(iv)	<u>Bill is sent to the Bank for collection :</u> Bill is sent to the Bank for collection A/c……. Dr To Bills receivable A/c (Being the bill sent to the bank for collection)		7,000	7,000
	Bank A/c...... Dr To bill sent for collection A/c (Being the amount collected by the bank)		7,000	7,000

Books of Akshaya

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	Mahendra A/c..... Dr. To Bills payable A/c (Being the acceptance given to Mahendra)		7,000	 7,000
(i) (ii) (iii) (iv)	<u>Bill is retained/Discounted/Endorsed/Sent to the Bank for collection:</u> Bill Payable A/c …… Dr To Cash A/c (Being the bill met on due date)		7,000	 7,000

1.10 Dishonour of Bill:

When the drawee fails to make the payment on the due date of the bill, the bill is said to be dishonoured. It may be mentioned here that a bill of exchange can be dishonoured by non acceptance. When the bill is dishonoured, the drawer may get the bill noted with Notary Public (a solicitor empowered for the purpose) for which the Notary public charges certain fees called noting charges. The purpose of noting the bill is to record the legal evidence of dishonour of the bill. The amount of noting charges shall be borne by the drawee. The entries in the books of the drawer and drawee upon dishonour in each of the options shall be as under;

(i) Bill is retained and noting charges paid	<u>Books of Drawer</u> Drawee A/c ……. Dr To Bills receivable A/c To Cash A/c (Noting Charges) (Being the bill dishonoured on the due date and noting charges paid)	<u>Books of Drawee</u> Bills Payable A/c ... Dr Noting Charges A/c .. Dr To Drawer A/c (Being dishonoured of the bill and noting charges paid by drawer)
(ii) Discounting of the bill	Drawee A/c ……. Dr To Bank A/c (Being dishounour of the bill which was discounted in the bank and noting Charges paid by Bank)	Entry As above
(iii) Endorsement of the bill	Drawee A/c ……. Dr To Endorsee's A/ c (Being dishonour of the bill which was endorsed in favour of creditor and noting charges paid by endorsee)	Entry As above
(iv) Bill is sent to the Bank for collection	Drawee A/c ……. Dr To Bill sent for collection A/c To Bank A/c (Noting Charges) (Being dishonour of the bill which was sent to the bank for collection and noting charges paid by bank)	Entry As above

Illustration 2: Taking the information as in illustration 1, pass journal entries in the books of the both the parties in the event of dishonour of the bill and noting charges of ₹ 50 incurred.

Solution:

Books of Mahendra

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	Bill receivable A/c..... Dr. To Akshaya A/c (Being Acceptance of Akshaya received)		7,000	 7,000
(i)	Bill is retained: Akshaya A/c …….Dr To Bills Receivable A/c To Cash A/c (Being dishonour of the bill and noting charge paid)		7,050	 7,000 50
(ii)	Bill is discounted: Bank A/c …….. Dr Discount A/c …….. Dr To Bills receivable A/c (Being the bill discounting @10% p.a.)		 6,825 175	 7,000
	Akshya A/c …….. Dr To Bank A/c (Being dishounour of the bill which was discounted and noting charges paid by bank)		7,050	 7,050
(iii)	Bill is endorsed: Tapas A/c …….. Dr To Bills receivable A/c (Being the bill endorsed in favour of Tapas.)		 7,000	 7,000
	Akshya A/c . . . . Dr To Tapas A/c (Being dishounour of the bill which was endorsed in favour of Tapas and nothing charges paid by him)		7,050	 7,050
(iv)	Bill is sent to the Bank for collection : Bill sent for collection A/c...... Dr To Bills receivable A/c (Being the bill sent to the bank for collection)		 7,000	 7,000
	Akshaya A/c …… Dr To Bill sent for collection A/c To Bank A/c (Being dishonour of the bill which was sent to the bank for collection and noting charges paid by the bank)		 7,050	 7,000 50

Books of Akshaya

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	Mahendra A/c..... Dr. To Bill payable A/c (Being Acceptance given to Mahendra)		7,000	 7,000
	Same for the all options Bills payable A/c.... Dr Noting Charges A/c . . . Dr To Mahendra A/c (Being dishonour of bill and noting charges paid by Mahendra)		 7,000 50	 7,050

1.11 Renewal of Bill:

If the drawee of a bill finds that he is not in a position to honour the bill on the date of maturity he may request the drawer to draw a fresh bill for an extended period in place of the old bill. This is nothing but renewal of a bill. Simply speaking, renewal is cancellation of the old bill and drawal of the new bill for an extended period of time. Of course, the drawee agrees to pay interest for the extended period which may be paid in cash or included in the amount of the new bill. The following entries are passed in the books of the drawer and the drawee upon renewal.

	Books of Drawer	Books of Drawee
(i) Cancellation of old Bill	Drawee A/c . . . . Dr. To Bills receivable A/c (Being cancellation of the bill for renewal)	Bills payable A/c . . . . Dr To Drawer A/c (Being cancelation of acceptance for renewal)
(ii)Interest due upon renewal	Drawee A/c . . . . Dr To Interest A/c (Being interest due for the extended period)	Interest A/c . . . Dr To Drawer A/c (Being interest charged for the extended period)
(iii)Part payment against the due amount	Cash A/c / Bank A/c . . . Dr To drawee A/c (Being part payment received against the amount due)	Drawer A/c . . . .Dr To Cash A/c / Bank A/c (being part payment made against the amount due)
(iv)Drawing of new bill including interest	Bills receivable A/c . . . . Dr. To Drawee A/c (Being fresh acceptance received including interest)	Drawer A/c . . . Dr. To Bills payable A/c (Being fresh acceptance given including interest)

Illustration 3: Y accepted a bill for ₹ 15,000 at three months. On the date of maturity Y was not in a position to meet the bill and requested X to renew the bill for two month. He offered to make payment of ₹ 6,000 to X. X drew a fresh bill for the balance amount plus interest at 10% p.a. Pass journal entries in the books of X and Y assuming that the new bill was honoured on the due date.

Solution:

Books of X

Journal

Date	Particular	L.F	Dr. (₹)	Cr. (₹)
	Bills receivable A/c . . . Dr. To Y's A/c (Being the acceptance of Y received)		15,000	15,000
	Y's A/c . . . . Dr To Bill receivable A/c (Being cancellation of the bill for renewal)		15,000	15,000
	Cash A/c . . . Dr To Y's A/c (Being part payment received against the amount due)		6,000	6,000
	Y's A/c . . . . Dr To interest A/c (Being interest due for the extended period of two months on the balance amount)		150	150
	Bills receivable A/c . . . Dr To Y's A/c (Being fresh acceptance including interest received from Y)		9,150	9,150
	Cash A/c . . . . Dr To Bills receivable A/c (Being payment received on due date)		9,150	9,150

Books of Y

Journal

Date	Particular	L.F	Dr. (₹)	Cr. (₹)
	X's A/c . . . Dr. To Bills payable A/c (Being acceptance given to X)		15,000	15,000
	Bills payable A/c . . . . Dr To X's A/c (Being cancellation of the bill for renewal)		15,000	15,000
	Interest A/c . . . Dr		150	

	To X's A/c (Being interest due upon renewal)			150
	X's A/c . . . . Dr To Cash A/c (Being part payment made against the amount due)		6,000	6,000
	X's A/c . . . Dr To Bills payable A/c (Being new acceptance given for the balance amount including interest)		9,150	9,150
	Bills Payable A/c ….. Dr To Cash A/c Being bill met on the due date)		9,150	9,150

1.12 Insolvency of the drawee:

Insolvency arises when the liabilities of a party exceeds his assets. When the drawee becomes involvements the bills accepted by him are automatically dishonoured. The official receiver or liquidator appointed by the court to sell the properties of the insolvent person and distribute the same among the creditors may pay certain amount to the drawer out of the amount due which is called 'dividend'. The following entries are passed in the books of the drawer as well as the drawee;

	Books of drawer	Books of drawee
Dishonour of the bill	Drawee A/c. . . . Dr To Bills receivable A/c Bank A/c / Endorsee A/c / Bill sent for collection A/c (as explained under dishonour of bill)	Bills payable A/c . . .Dr To Drawer A/c (As explained under dishonour)
Receipt of final dividend	Bank A/c . . . Dr. Bad Debt A/c. . . Dr. To drawee A/c (Being the receipt of final dividend)	Drawer A/c . . . Dr To Bank A/c To deficiency A/c (Being payment of final dividend)

1.13 Retiring a Bill:

When the drawee of the bill desires to make the payment before the date of its maturity, it is called retiring the bill. Usually the drawer allows a discount (rebate) because he gets the payment immediately. The rebate is an expense to the drawer and an income to the drawee and accordingly recorded in the books of the drawer and the drawee.

Books of drawer	Books of drawee
Cash/Bank A/c . . . Dr. Rebate on Bill retired A/c. . . Dr. To Bills receivable A/c (Being retirement of the bill under rebate)	Bills payable A/c Dr. To Cash / Bank A/c To Rebate on Bill retired A/c (Being retirement of the bill under rebate)

1.14 Bills receivable & Bills Payable Book:

When a number of bills are drawn or accepted it is better to record these in subsidiary books instead of journalizing each of the drawn or accepted bills. Such subsidiary books are called Bills Receivable Books and Payable Book. The Bills Receivable and Bills Payable books are periodically totalled. While the total of bills received is posted to the debit of Bills Receivable account, the total of Bills Payable Book is posted to the credit of Bills payable Account. Of course, the individual accounts of the drawee are credited for the received bills and individual accounts of drawer are debited for the acceptance given. The formats of the Bills Receivable Book and Bills Payable Book are on follows:

Bills Receivable Book

Sl.No.	Date	From whom received	Name of Acceptor	Date of Bill	Term	Date of maturity	Where receivable	L.F	Amount (Rs)	How dealt with

Bills Payable Book

Sl.No.	Date of bill	Name of Drawer	Name of Payee	Term	Date of Maturity	Where payable	L.F	Amount (Rs)	Remark

1.15 Accommodation Bills:

Normally bills are used where trading relation exists between seller and buyer. Here the bills are supported by consideration. But sometimes bills are drawn to meet the financial needs of drawer or drawee or both for a temporary period. Such bills are called accommodation bills. The relationship here between the drawer and drawee is not that of creditor and debtor and they are mostly friends. As we know, bills are readily accepted by banks for discounting. Thus, the drawer of accommodation bill get the bill discounted and the proceeds are shared or utilized by only one of the parties as per agreement. The amount of discount is borne by the parties in proportion to the sharing of proceeds of the bill. Before the date of maturity the drawer remits his share of the proceeds to the drawee so that the drawee can meet the bill on the due date. The accommodation bills can be differentiated from ordinary or trade bills as under:

Trade Bills	Accommodation Bills
1. These bills are drawn where trading relation exists between the seller and buyer.	1. These bills are drawn to meet the financial needs of the parties temporarily.
2. These bill are supported by consideration.	2. These bills are not supported by consideration because no consideration moves from the drawer to the drawee.
3. These bills act as an evidence of indebtedness.	3. These bills act as a source of finance.
4. The proceeds after discounting is not shared.	4. The proceeds after discounting is shared as per agreement.
5. The drawer can due the drawee upon dishonour.	5. The drawer cannot due the drawee upon dishonour.

Accommodation bills may be drawn for the accommodation of the drawer only or for the accommodation of both the drawer and the drawee. As far as entries in the books of the drawer and the drawee are concerned, no special entries are made excepting sharing of discount. In the books of the drawer, drawee account is debited and discount account is credited with the share of discount. On the other hand, discount account is debited in the books of the drawee for the share of discount.

Illustration 4: on 1st January Arun drew a bill for ₹ 10,000 for three months on Utpal for the benefit of Arun. Arun got the bill discounted at 10% p.a. on 4th Jan. On the due date Arun sent Utpal a cheque for ₹ 10,000 in order to enable him to honour the bill. Utpal duly honoured his acceptance. Pass journal entries in the books of Arun and Utpal.

Solution:

Books of Arun

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
Jan 1	Bills Receivable A/c ……. Dr. To Utpal A/c (Being the acceptance of Utpal received)		10,000	 10,000
Jan 4	Bank A/c . . . . Dr Discount A/c . . . Dr		9,750 250	

	To Bills Receivable A/c (Being the bill discounted with the bank at 10%)			10,000
April 4	Utpal A/c . . . Dr To Bank A/c (Being the amount of the bill remitted to Utpal through cheque)		10,000	 10,000

Books of Utpal

Journal

Date	Particular	L.F	Dr. (₹)	Cr. (₹)
Jan 1	Arun A/c . . . Dr. To Bills Payable A/c (Being the acceptance of given to Arun)		10,000	 10,000
April 4	Bank A/c . . . Dr To Arun A/c (Being receipt of cheque from Arun)		10,000	 10,000
April 4	Bills Payable A/c . . . Dr To Cash A/c (Being acceptance honoured)		10,000	 10,000

Illustration 5: X drew a bill for ₹ 9,000 on Y for mutual accommodation of both X and Y and to share the proceeds in the ratio of 2:1. X got the bill discounted at ₹ 8,400 and remitted one-third of the proceeds to Y. Just before the due date Y drew a bill on X for ₹ 10,500 in order to provide fund to meet his own acceptance. The bill was discounted for ₹ 10,200 out of which Y met his acceptance on the due date and remitted ₹ 800 to X.

X became insolvent before meeting his acceptance. A final dividend of 50 paisa in a rupee was paid to Y. Pass journal entries in the books of X and Y and prepare ledger accounts of the parties in respective books.

Books of X

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	Bills Receivable A/c . . . Dr To Y's A/c (Being acceptance of Y received for mutual accommodation)		9,000	 9,000
	Bank A/c . . . Dr Discount A/c . . .Dr		8,400 600	

	To Bills Receivable A/c (Being discounting of the bill)			9,000
	Y's A/c . . . . Dr To Bank A/c To Discount A/c (Being remittance of one-third of the proceeds and discount shared by Y)		3,000	 2,800 200
	Y's A/c . . . Dr To Bills Payable A/c (Being acceptance given)		10,500	 10,500
	Bank A/c . . . Dr Discount A/c . . . Dr To Y's A/c (Being two third of surplus proceeds received and discount share)		800 200	 1,000
	Bill Payable A/c . . . Dr To Y's A/c (Being dishonour of acceptance)		10,500	 10,500
	Y's A/c . . . Dr To Bank A/c To Deficiency A/c (Being final dividend paid and balance transferred to deficiency A/c)		7,000	 3,500 3,500

Y's Account

Dr Cr

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To Bank A/c To Discount A/c To Bills Payable A/c To Bank A/c To Deficiency A/c	2,800 200 10,500 3,500 3,500 20,500	By Bills Receivable A/c By Bank A/c By Discount A/c By Bills Payable A/c	9,000 800 200 10,500 20,500

Books of Y

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	X's A/c . . . Dr To Bills Payable A/c (Being acceptance given for mutual accommodation)		9,000	 9,000
	Bank A/c . . . Dr Discount A/c . . .Dr To X's A/c (Being received of one-third of the proceeds and discount shared)		2,800 200	 3,000
	Bills Receivable A/c . . . . Dr To X's A/c (Being acceptance of X received)		10,500	 10,500
	Bank A/c . . . Dr Discount A/c . . . Dr To Bills receivable A/c (Being discounting of the bill)		10,200 300	 10,500
	X's A/c . . . Dr To Bank A/c To Discount A/c (Being two- third of proceeds after meeting he acceptance remitted and discount shared by X)		1,000	 800 200
	Bill Payable A/c . . . Dr To Bank A/c (Being acceptance honoured)		9,000	 9,000
	X's A/c . . . Dr To Bank A/c (Being dishonour of the bill upon insolvency of X)		10,500	 10,500
	Bank A/c …. Dr Bad Debt A/c . . . Dr To X's A/c (Being final dividend received upon insolvency of X)		3,500 3,500	 7,000

X's Account

Dr Cr

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To Bills Payable A/c	9,000	By Bank A/c	2,800
To Bank A/c	800	By Discount A/c	200
To Discount A/c	200	By Bills Receivable A/c	10,500
To Bank A/c	10,500	By Bank A/c	3,500
		By Bad Debt A/c	3,500
	20,500		20,500

Illustration 6: A for mutual accommodation of himself and B draws a bill for ₹ 5,000 at three months upon B. The bill was discounted at 12% p.a. and A remitted half of the proceeds to B as per agreement. B at the same time draws a bill upon A for ₹3,600 at three months and discounted the same at 10% p.a. Out the proceeds B remitted 50% of the amount to A. On the date of maturity B became insolvent and 30 paisa in a rupee is received as final divided by A. Journalize in the books of A and B.

Solution:

Books of A

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	Bills receivable A/c . . . Dr To B's A/c (Being the acceptance of B received for mutual accommodation)		5,000	 5,000
	Bank A/c . . . Dr Discount A/c . . .Dr To Bills receivable A/c (Being discounting of the bill @ 12% p.a.)		4,850 150	 5,000
	B's A/c . . . . Dr To Bank A/c To Discount A/c (Being remittance of half of the proceeds and discount to be borne by B)		2,500	 2,425 75
	B's A/c . . . Dr To Bills Payable A/c (Being acceptance given to B for mutual accommodation)		3,600	 3,600
	Bank A/c . . . Dr Discount A/c . . . Dr To B's A/c (Being receipt of half of the proceeds and discount shared)		1,755 45	 1,800
	B's A/c . . . Dr To Bank A/c (Being dishonour of acceptance of B upon his insolvency)		5000	 5000
	Bills payable A/c . . . Dr To Bank A/c (Being honour of own acceptance)		3,600	 3,600
	Bank A/c ….. Dr Bad Debt A/c …. Dr To B's A/c (Being receipt of final dividend of 30 paise in a rupee)		1,290 3,010	 4,300

Books of B

Jounal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
	A's A/c …… Dr To Bills Payable A/c (Being acceptance given for mutual accommodation)		5,000	 5,000
	Bank A/c ……. Dr Discount A/c …….Dr To A's A/c (Being received of half of the proceeds and discount shared)		2,425 75	 2,500
	Bill receivable A/c …….. Dr To A's A/c (Being acceptance of A received for mutual accommodation)		3,600	 3,600
	Bank A/c ……… Dr Discount A/c …….. Dr To Bills receivable A/c (Being discounting of the bill @ 10% p.a.)		3,510 90	 3,600
	A's A/c ……. Dr To Bank A/c To Discount A/c (Being remittance of half of the proceeds and discount to be borne by A)		1,800	 1,755 45
	Bill Payable A/c …… Dr To A's A/c (Being dishonour of acceptance given to A upon insolvency)		5,000	 5,000
	A's A/c ……. Dr To Bank A/c To deficiency A/c (Being payment of final dividend and balance transferred to deficiency A/c)		4,300	 1,290 3,010

Check your progress:

1. Find out the date of maturity of the following bills:

	Date of Drawal	Date of Acceptance	Payable
a)	1.1.2015	3.1.2015	1 month after date
b)	1.1.2015	3.1.2015	1 month after sight
c)	12.7.2015	14.7.2015	1 month after date
d)	29.1.2015	3.2.2015	30 days after date
e)	2.1.2015	3.1.2015	On demand (demanded on 15.1.15)
f)	2.1.2015	4.1.2015	At sight (demanded on 12.1.15)
g)	5.1.2015	9.1.2015	On presentment (demanded on 16.1.15)

2. Differentiate between:

a) Bill of Exchange and Promissory Note
b) Trade Bill and Accommodation Bill
c) Time and demand Bills

3. A owed money to B and hence accepted two bills each of ₹4,850 of three months duration drawn on him by B on 1st July, 2015. B endorsed one of the bills in favour of C on 7th July, 2015. On the same date he discounts the other bill with his bank and received net proceeds of ₹4,675. A failed to meet both the bills on the due date. On 4th October, 2015 bank debited the account of B with the value of the second bill plus their charges of ₹20. A is adjudicated insolvent and his estate paid 60 paise in the rupee on 1st November, 2015.

Show the entries in the books of A and B.

4. Y accepted a bill for ₹ 10,000 at three months drawn by X. On the date of maturity, Y not being in position to meet the bill, offers X ₹4,000 and requests him to draw a fresh bill for the balance plus interest at 10% p.a. for three months. X agreed to the proposal of Y. Give journal entries in the books of X and Y.

5. P draws a bill upon Q for mutual accommodation amounting to ₹9,000 on 1st February, 2015, at three months. The bill was discounted at 10% p.a. and P remitted two-third of the proceeds to Q. On the due date P fails to remit his share to Q and therefore accepted a bill for ₹ 6000 at four months. Q discounted the bill for ₹5,400 and remits ₹600 to P. Before the bill is due for payment, P becomes involvement. Subsequently, a final dividend of 20 paise in a rupee is received from his estate. Pass journal entries in the books of Q and Q's account in the books of P.

1.16 Key Words:

Bill of Exchange: An instrument in writing whereby the creditor directs the debtor to pay a certain sum of money on demand or at a specified future time.

Promissory Note: An instrument in writing whereby the debtor undertakes to pay a certain sum of money on demand or at a specified future time.

Drawer: The person who makes the bill.

Drawee: The person who is directed to pay.

Payee: The person to whom the payment is to be made.

Time bills: An instrument payable after a specified period or after happening of an event.

Demand Bills: An instrument payable on demand or at sight.

Holder: A person who is entitled to the possession of the instrument in his own name and to receive payment.

Holder in Due Course: A person who in possession of the instrument in good faith and for valuable consideration before its maturity.

Negotiation: The process of transferring the instrument.

Endorsement: Transferring the instrument to a creditor by signing on the instrument.

Allonge: A slip of paper attached to the instrument.

Dishonour of bill: Drawee's failure to make the payment on the due date against the bill.

Notary Public: A solicitor appointed by the government to record the fact of dishonour.

Noting Charges: The fee charged by notary public.

Renewal of bill: Drawal of a new bill for an extended period in cancellation of the old bill.

Retiring a bill: Making payment against the bill before its due date.

Trade Bills: Bills in use between the seller and buyer in their trading relationship.

Accommodation Bills: Bills drawn to meet the financial needs of drawer or drawee or both.

1.17 Summary:

Bill of exchange and promissory notes are common instruments of credit. A bill is drawn by the seller (creditor) upon the buyer (debtor).

The drawer may retain the bill till maturity or discount the bill with his banker or endorse the bill in favour of his creditor. The bill may be honoured or dishonoured by the drawee. The drawee may request the drawer to renew the bill.

Bill may be used for mutual accommodation of the parties or for accommodation of one of the parties.

Entries are made in the books of the drawer as well as the drawee in each of the above situations.

1.18 Solution / Answers:

Check your progress:

1. Check your progress:

a) 4.2.2015
b) 6.2.2015
c) 14.8.2015 (15.08.2015 is a public holiday)
d) 3.3.2015
e) 15.1.2015
f) 12.1.2015
g) 16.1.2015

Unit – II.1

1. TRAIL BALANCE

Learning Objectives:

After studying this chapter, you should be able to understand:

- ☞ Meaning of Trail Balance
- ☞ Objectives of Trail Balance
- ☞ Methods of preparation of Trial Balance
- ☞ Limitations of Trail Balance

2.1 Meaning of a Trail Balance:

After the transactions are recorded in the books of primary entry (journal) and posted into respective ledger accounts, the next step in the accounting process is to prepare a statement to check the arithmetical accuracy of the accounting work done. This statement is nothing but a Trial Balance. It may be mentioned here that Trial Balance is not prepared to check the total accuracy of the accounting work because certain accounting errors might still be there even of Trial Balance agrees (total of both the columns tallies). As we know, according to Dual aspect concept for each debit there is a corresponding credit. Therefore, the total of debit or debit balance ledger accounts must correspond with the total of credit or credit balance in such accounts. When both the total of debit and credit column of Trial Balance tallies, we are certain that arithmetical accuracy of the accounting work is there. Trial Balance is a statement containing the list of balances of ledger accounts and cash book. It is prepared on a particular date. Through it is normally prepared at the end of the accounting period; it can be prepared at any time during the accounting period to check the accuracy.

2.2 Objectives of a Trail Balance:

The following are the main objectives of preparing a Trial Balance.

i. To check the arithmetical accuracy: - Arithmetical accuracy of the accounting work done is ensured from the agreement of Trail Balance.
ii. Basis for Financial Statement: - Trial Balance is the base upon which financial statements (profit and loss account and Balance Sheet) are prepared.
iii. Summary of Ledger Account: - Trial Balance sources as a summary of all ledger accounts including the cash book.
iv. Location of Errors: - Errors in accounting work can be detected before preparation of financial statements and steps taken to locate and verify the same.

2.3 Method of preparation of Trial Balance:

There are three methods of preparing a Trial Balance such as Balance Method, Total Method and Balance with Total Method.

1. Balance Methods: After balancing the ledger accounts the debit and credit balances of ledger accounts including that of the cash book are put in the respective column of the Trial Balance. The Trail Balance have contains five columns such as Serial No., Names of Account, Ledger Folio (L.F.), debit balance and credit balance.
2. Total Method: Before the ledger accounts are balanced, the total of the debit and credit side of each ledger account is incorporated in the Trail balance. The format of the Trial Balance is the same as that of Balance method excepting the Debit Balance and Credit Balance columns are titled as Debit Total and Credit Total.
3. Combined Balance and Total Method: The Balance method and Total method can combined by incorporating all the amount columns in the Trial Balance where the Trail Balance shall have four amount columns instead of two.

Of the above methods, the balance method is commonly used.

2.4 Limitation of Trail Balance: As mentioned entries, agreement of the Trial Balance is not a conclusive proof the accuracy of the accuracy of the accounting work. The following errors are not disclosed by the Trial Balance even of the Trial Balance agrees.

1. Complete omission of a transaction from being recorded in the books of primary entry.
2. Entry of incorrect amount of both debit and credit aspect.
3. Entry of correct amount in wrong amount.
4. Partial posting or double posting in ledger account.
5. Errors of principle (capital items treated as revenue and vice versa etc).

Illustration 1: Entry the following transactions in respective ledger accounts of Mr. A and prepare the Trial Balance under both Balance method and Total Method as on 30th April 2016.

2016 April	1	Started business with cash	₹ 1,00,000
	2	Purchased goods for cash	₹ 20,000
	3	Paid salaries	₹ 5,000
	4	Stationeries purchased	₹ 1,000
	5	Sold goods for cash	₹ 17,000
	6	Postage expenses	₹ 400
	7	Advertisement expenses	₹ 3,000
	15	Purchased goods on credit form Mr. Anand	₹ 30,000
	18	Cash Sales	₹ 22,000
	20	Credit Sale to Mr. Mohan	₹ 8,000
	25	Payment made to Mr. Anand on account	₹ 25,000
	27	Mr. Mohan paid 50% of the amount due	
	30	paid electricity bill in cash	₹ 2,000

Solution

Ledger of Mr. A

Dr. Cash Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 1	To Capital A/c	1,00,000	2016 April 2	By Purchases A/c	20,000
5	To Sales A/c	17,000	3	By salaries A/c	5,000
18	To Sales A/c	22,000	4	By stationeries A/c	1,000
27	To Mohan A/c	4,000	6	By Postage A/c	400
			7	By advertisement A/c	3,000
			25	By Anand A/c	25,000
			30	By Electricity Charge A/c	2,000
			30	By Balance c/d	86,600
		1,43,000			1,43,000

Dr. Capital A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 30	To Balance c/d	1,00,000 1,00,000	2016 April 1	By Cash A/c	1,00,000 1,00,000

Dr. Purchases A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 2 15	To Cash A/c To Anand A/c	20,000 30,000 50,000	2016 April 30	By Balance c/d	50,000 50,000

Dr. Salaries A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 3	To Cash A/c	5,000 5,000	2016 April 30	By Balance c/d	5,000 5,000

Dr. Stationeries A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 4	To Cash A/c	1,000 1,000	2016 April 30	By Balance c/d	1,000 1,000

Dr. Sales A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 30	To Balance c/d	47,000 47,000	2016 April 5 18 20	By Cash A/c By Cash A/c By Mohan A/c	17,000 22,000 8,000 47,000

Dr. Postage A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 6	To Cash A/c	400 400	2016 April 30	By Balance c/d	400 400

Dr. Advertisement A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 7	To Cash A/c	3000 3000	2016 April 30	By Balance c/d	3000 3000

Dr. Anand A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 25 30	To Cash A/c To Balance c/d	25,000 5,000 30,000	2016 April 15	By Purchases A/c	30,000 30,000

Dr. Mohan A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 20	To Sales A/c	8,000 8,000	2016 April 27 30	By Cash A/c By Balance c/d	4,000 4,000 8,000

Dr. Electricity Charges A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 April 30	To Cash A/c	2,000 2,000	2016 April 15	By Balance c/d	2,000 2,000

Trial Balance of Mr. A as at 30th April, 2016: **(Balance Method)**

Sl No.	Name of Account	L.F	Dr. Balance ₹	Cr. Balance ₹
1	Cash A/c		86,600	
2	Capital A/c			1,00,000
3	Purchases A/c		50,000	
4	Salaries A/c		5,000	
5	Stationeries A/c		1,000	
6	Sales A/c			47,000
7	Postage A/c		400	
8	Advertisement A/c		3,000	
9	Anand A/c			5,000
10	Mohan A/c		4,000	
11	Electricity Charges A/c		2,000	
	Total		1,52,000	1,52,000

Trial Balance of Mr. A as at 30th April, 2016: **Total Method**

Sl No.	Name of Account	L.F	Total Dr. ₹	Total Cr. ₹
1	Cash A/c		1,43,000	56,400
2	Capital A/c			1,00,000
3	Purchases A/c		50,000	
4	Salaries A/c		5,000	
5	Stationeries A/c		1,000	
6	Sales A/c			47,000
7	Postage A/c		400	
8	Advertisement A/c		3,000	
9	Anand A/c		25,000	30,000
10	Mohan A/c		8,000	4,000
11	Electricity Charges A/c		2,000	
	Total		2,37,400	2,37,400

Illustration 2: Taking the information in Illustration 1, extract a Trial Balance of Mr. A as on 30th April, 2016 under combined Balance Method and Total method.

Solution:

Trial Balance of Mr. A as on 30th April 2016: (**Combined Method)**

Sl No.	Name of Account	L.F	Dr. Balance ₹	Cr. Balance ₹	Total Dr. ₹	Total Cr. ₹
1	Cash A/c		86,600		1,43,300	56,400
2	Capital A/c			1,00,000		1,00,000
3	Purchases A/c		50,000		50,000	
4	Salaries A/c		5,000		5,000	
5	Stationeries A/c		1,000		1,000	
6	Sales A/c			47,000		47,000
7	Postage A/c		400		400	
8	Advertisement A/c		3,000		3,000	
9	Anand A/c			5,000	25,000	30,000
10	Mohan A/c		4,000		8,000	4,000
11	Electricity Charges A/c		2,000		2,000	
	Total		1,52,000	1,52,000	2,37,400	2,37,400

Check your Progress:

1. What is a Trial Balance? What are its Objectives?
2. Is it prepared periodically or at the end of the accounting period?
3. Out of the following errors which can be detected by the trial balance?
   a) Wages paid for installation of machinery debited to wages A/c.
   b) Credit sale to X posted to the account of X & Co.
   c) Purchase of ₹ 560 passed through the Purchase Book as ₹ 650.
   d) Discount allowed to Mr. A has not been posted to his account.

4. An inexperienced book keeper has prepared the following Trial Balance for the year ended 31st March, 2016

Sl No.	Name of Account	L.F	Dr. Balance₹	Cr. Balance ₹
1	Capital			50,000
2	Stock (1.4.2015)		6,500	
3	Discount Allowed			500
4	Commission received			700
5	Fixed Assets			60,000
6	Sales		85,000	
7	Purchases			45,000
8	Return Outward			1,000
9	Return Inward		2,000	
10	Carriage Inward			600
11	Carriage outward			700
12	Wages & Salary		20,000	
13	Bills Receivable		7,000	
14	Debtors		14,000	
15	Bills Payable			17,000
16	Rent		1,500	
17	Interest Paid			2,000
18	Cash		800	
19	Creditors		6,900	
20	Stock (31.3.2016)		33,800	
	Total		1,77,500	1,77,500

Draw up a corrected Trial Balance Stating reasons for your correction.

5. The total of debit side of the Trial Balance of a business as on 31st March 2016 is ₹ 1, 80,590 and that of the credit side is ₹ 36,470. The following mistakes were discovered on scrutiny.

Name of Account (₹)	Figure in Trial Balance (₹)	Current Figure
Stock (Opening)	12,600	12,700
Sundry Debtors	8,400	8,150
Sundry Creditors	6,000	6,170
Salary	2,500	2,260
Commission received (appears in Debit column)	71,780	71,780

Find the correct total of the Trial Balance.

2.5 KEY WORDS:

Balance Method: Method of preparing Trial Balance where balance of ledger accounts are taken to the concerned column of the trial balance.

Total Method: The total of the debit and credit side of ledger accounts are taken to draw up the trial balance instead of balance of ledger accounts.

Trial Balance: A statement prepared periodically or at the end of the accounting period to check the arithmetical accuracy of accounting work.

2.6 Summary:

Trial Balance is a statement prepared periodically or at the end of the accounting period to check the arithmetical accuracy of accounting work. It may be prepared on balance method or total method or combined method. It is also the basis for preparation of financial statements. Trial Balance has certain limitations as all types of error are not disclosed by it.

2.7 **Solutions / Answer**:

Check your progress;

1. Trial Balance is a statement prepared to check the arithmetical accuracy of accounting work. The main objectives are (a) to check the arithmetical accuracy (b) basis for financial statements (c) summary of ledger accounts (d) Location of errors.
2. It is prepared periodically or at the end of the accounting period.
3. (a), (b) & (c) cannot be detected by Trial Balance only (d) can be detected.

4. Trial Balance as 31st March, 2016

Sl No.	Name of Account	L.F	Dr. Balance ₹	Cr. Balance ₹
1	Capital			50,000
2	Stock (1.4.2015)		6,500	
3	Discount Allowed		500	
4	Commission received			700
5	Fixed Assets		60,000	
6	Sales			85,000
7	Purchases		45,000	
8	Return Outward			1,000
9	Return Inward		2,000	
10	Carriage Inward		600	
11	Carriage outward		700	
12	Wages & Salary		20,000	
13	Bills Receivable		7,000	
14	Debtors		14,000	
15	Bills Payable			17,000
16	Rent		1,500	
17	Interest Paid		2,000	
18	Cash		800	
19	Creditors			6,900
	Total		1,60,000	1,60,000

Reason: All expenses and assets have debit balance and all expenses, incomes and liabilities have credit balance. Closing stock is not an account, hence it is not shown in Trial Balance. But closing stock appears in Trial Balance only when it is adjusted against purchase.

5. Trial Balance Total ₹1,08,420

Unit – II.2

2. ERRORS & RECTIFICATION

Learning Objectives:

After studying his chapter, you should be able to understand:

- ☞ Meaning of Errors
- ☞ Types of Errors
- ☞ Steps to locate Errors
- ☞ Errors affecting the agreement of Trial Balance
- ☞ Errors not affecting the agreement of Trial Balance
- ☞ Suspense Account
- ☞ Rectification of Error
- ☞ Before preparation of Trial Balance
- ☞ After Preparation of Trial Balance
- ☞ After Preparation of Final Accounts

2.1 Meaning of Errors:

The maxim 'To err is human' clearly say that the activities by human beings are subject to errors or mistakes. Since human beings are involved in the accounting process it is quite but natural that certain mistakes are committed unintentionally in the accounting process. Such mistakes may be in the nature of mathematical figures, oversight or simply mistakes in application of accounting principle. Thus, errors are mistakes in the accounting process committed by the book-keeper unintentionally.

2.2 Types of Errors:

Errors can be classified into the following categories

1. Errors of Omission
2. Errors of Commission
3. Compensating Errors
4. Errors of principle

2.2.1 Errors of Omission:

When a transaction is completely or partially omitted to be recorded in the books of accounts, it is called errors of omission. It may be errors of complete omission or partial omission.

i. Error of complete Omission: When a transaction has not at all been recorded in the books of original entry, error of complete omission will arise. For example – sale of goods to Rajiv on credit not recorded in the Sales Day Book. The agreement of the trial balance is not affected by these errors.
ii. Error of partial omission: When a transaction has been recorded in the books of original entry but posting has not been made in both the ledger accounts, such error arises. For example – credit purchases of goods from Avinash & co. recorded in the Purchases Day Book and accordingly posted to Purchase Account but Avinash & Co.'s account has not been credited. Such types of error affect the agreement of the trial balance.

2.2.2 Errors of commission:

Mistakes committed by the book-keeper in the accounting process are categorized as errors of commission. Such errors do arise when recording is done in wrong books or wrong casting (totalling) or wrong posting etc. Accordingly errors of commission may be classified as follows:

i. Error of recording: When transactions wrongly recorded in the books of primary entry such errors do occur. For example, sale of goods to Mr. Swain wrongly passed through the Purchase Day Book or purchase worth of ₹ 495 recorded at ₹ 945. The Trail Balance is not affected by such type of errors.
ii. Error of posting: When a transaction is correctly entered in the books of primary entry but mistake is committed at the time of posting to ledger accounts, such type of errors arise. For example, purchase of goods on credit from R.C. Dash correctly entered in Purchase Day Book and accordingly debited to purchase Account but wrongly debited to R.C Dash. Such types of error may or may not affect the trail balance.
iii. Error of Casting: When mistake is committed by the book-keeper in casting (totaling) such types of error arises. For example, the purchase return book is totalled ₹ 100 less. The trial balance is affected by such types of errors.
iv. Errors in carry forward: While carrying forward the total of one page to the next page mistake is committed. The agreement of the Trial Balance is affected by such types of errors. For example – the total of Purchase Day Book of ₹10,200 is carried forward to the subsequent page as ₹ 12,000.

2.2.3 Compensating Errors:

Compensating errors are a group of errors where the effect of one or more errors is compensated by the effect of other error or errors. Thus, the net effects of such errors do not affect the agreement of the trial balance. For example, the Sales Day Book under cast by ₹ 1,000 (less credit) is compensated by less debit of ₹ 1,000 in salary account.

2.2.4 Errors of Principle:

When there is violation of accounting principles such types of errors arise. In other words, the incorrect allocation of expenditure or receipt between capital and revenue items results in such types of errors. The agreement of the trial balance is not affected by occurrence of such errors. For example, wages paid to mason for making a platform for installation of a machine is wrongly debited to wages account instead of machinery account or purchase of an asset is passed through Purchase Book etc.

2.3 Location of Errors:

When the Trial Balance do not agree, certain steps need to be taken to locate the errors. The various steps are as follows:

1. Check the totaling of both the column of the Trial Balance.
2. Find out the difference between the totals of debit and credit column. If the difference is exactly divisible by 9, it might have been caused by transposition of figures (ex. 975 is written as 597 or 795). However, if the difference is divisible by

2, an identical amount might have been entered in wrong column of the Trial Balance (ex. debit balance of ₹ 150 in discount account has been wrongly entered in the credit column of Trial Balance as ₹150)

3. Check that all the balances in ledgers accounts have been correctly entered in the Trial Balance.
4. Check the opening Balance in ledger accounts from the Balance sheet of the previous year.
5. Check the balancing of ledger accounts including cash book.
6. Check the posting to ledger accounts from the journal or subsidiary Books.
7. Check the casting (totaling) of subsidiary Books and its carry forward.

2.4 Errors affecting the agreement of Trial Balance:

Before we discuss the process of rectification of errors, we need to be clear which errors affect the agreement of the Trial Balance and which do not. The following errors affect the agreement of the Trial Balance:

i. Wrong totaling or casting of subsidiary books.
ii. Incorrect balancing of ledger accounts.
iii. Posting in the wrong side of ledger accounts.
iv. Posting on the wrong side (debit side instead of credit side or vice versa).
v. Omission of posting from the subsidiary book to the respective ledger (ex. total of return inward book has not been posted to the debit of return inward Account)
vi. Omission of taking the balance of ledger accounts including cash book to the Trial Balance.
vii. Writing the ledger account Balance in wrong column of the Trial Balance.
viii. Casting mistake in Trial Balance.

2.5 Errors not affecting the agreement of the Trial Balance:

The following errors do not affect the agreement of the Trial Balance:

i. Complete omission of an entry in the books of original entry.
ii. Posting on the correct side of wrong account.
iii. Recording the transaction in the books of original entry with wrong amount.
iv. Recording the transaction in the books of original entry twice.
v. Errors of principle.
vi. Compensating errors.

2.6 Suspense Account:

After a reasonable check to locate errors if few errors still remain making the trail balance disagree, the difference in Trial Balance is transferred to an account called 'Suspense Account'. Thus Suspense Account is an account to which the difference in Trial

Balance is transferred temporarily till the errors are located and rectified. Unless we balance the Trial Balance, the financial statements
(Profit and loss account and Balance Sheet) cannot be prepared. The Suspense Account shall have a debit balance or credit balance depending upon which column of the Trial Balance is short (Suspense Account shall have debit balance if total of debit column of trial balance is short than credit column and vice-versa). The errors which affect the agreement of the Trial Balance are rectified through suspense account. After rectification if the suspense account still shows a balance then it is transferred to the asset side or liabilities side of the Balance sheet (suspense account with debit balance is taken to asset side and with credit balance is taken to liabilities & capital side of the balance sheet.)

2.7 Rectification of Errors:

When errors are located, steps are taken to rectify such errors. But rectification of errors is not done by overwriting but by passing appropriate entry. But the procedure of rectification depends on the stage of location of errors. The stages of rectification may be:

1. Before the preparation of Trial Balance or when no Suspense Account has been created.
2. After the preparation of Trial Balance or when suspense account has already been created.
3. After the preparation of final accounts (P&L A/c and Balance Sheet).

We shall discuss the procedure of rectification of errors at each of the above stages.

2.7.1 Before the preparation of Trial Balance (No Suspense Account):

Errors may affect only one account or two accounts. When it affects only one account it may be called one-sided errors and when it affects two accounts it may be called two-sided errors. One-sided errors are rectified by passing an entry (suitable explanation) either on the debit side or credit side of the concerned ledger account. But such errors are not rectified by passing journal entries.

Example:-

i. Overcasting of Purchase Day Book by ₹1,000 results in excess debit of ₹1,000 in purchase Account. Since the error lies in only one account (Purchase Account) and it is one-sided error, it is rectified by passing a suitable explanation in purchase account. As follows:

Dr ₹ Purchase Account Cr. ₹

	₹	By overcasting of purchase Book	₹1,000

ii. The Sales Day Book has been over cast by ₹ 300 (total of Sales Book has been made ₹20,800 instead of ₹20,500). The over casting results in excess credit of ₹ 300 in Sales Account in the ledger and it is rectified as follows:

Dr ₹ Sales Account Cr. ₹

To Over casting of Sales Day Book	₹300	By Sundries	₹20,800

iii. Goods returned by Mr. X (customer) ₹800 correctly entered in Return Inward Book and accordingly posted to the debit side of Return Inward Account. But while posting in the ledger account of Mr.X, the same has been posted on the debit side of Mr. X's Account instead of credit side. This error (one-sided error) is rectified in following way:

Dr ₹ Mr.X's Account Cr. ₹

To Return inward A/c	₹ 800	By mistake in posting	₹1,600

After above rectification, the posting of ₹ 800 in the wrong side (debit side) is rectified as Mr. X's Account is credited with ₹ 1,600 resulting in net credit of ₹ 800 in his account.

iv. Discount of ₹ 505 allowed to Mr. Y (customer) correctly posted in Mr.Y's Account but while posting in Discount account, it is posted as ₹ 55. This error lies only in Discount Account (one-sided error) resulting in less debit of ₹ 450 in discount account. The rectification is done in the following way:

Dr ₹ Discount Account
Cr. ₹

	₹		₹
To Mr. Y 's Account	55		
To mistake in posting of wrong account	450		

After the rectification, discount account shall have the correct debit of ₹ 505.

Rectification of Two-sided Errors: Two-sided errors are rectified by passing suitable journal entry. Example :

i. Wages for installation of machinery of ₹ 500 wrongly debited to wages account. The error lies in two accounts (wages account as well as machinery account). A clear understanding of the rectification process calls for looking at the wrong entry and correct entry.

   Wrong entry made: wages account ……. Dr ₹ 500, To cash account ₹ 500
   Correct entry: Machinery account ……. Dr ₹ 500, To cash account ₹ 500
   Rectifying entry: Machinery account ……. Dr ₹ 500, To wages account ₹ 500

ii. Credit purchase of ₹ 3,000 from Mr. Z's completely omitted to be recorded in the books.

   Entry mode: Nil
   Correct entry: Purchase Account ……. Dr ₹ 3,000,
   To Mr. Z's account ₹ 3,000
   Rectifying entry: Purchase Account ……. Dr ₹ 3,000,
   To Mr. Z's account ₹ 3,000

iii. Credit Sale of ₹ 1,000 to Mr. K's wrongly passed through Purchase Day Book.

   Wrong entry mode: Purchase Account ……. Dr ₹ 1,000,
   To Mr. K's Account ₹ 1,000
   Correct entry: Mr. K's Account ……. Dr ₹ 1,000,
   To Sales account ₹ 1,000
   Rectifying entry: Mr. K's Account ……. Dr ₹ 2,000
   To Sales Account ₹1,000
   To Purchase Account ₹ 1,000

iv. Return outward of ₹ 2,500 to Mr. S (supplier) wrongly recorded as ₹ 2,000

   Wrong entry mode: Mr. S's Account ……. Dr ₹ 2,000
   To Return Outward Account ₹ 2,000
   Correct entry: Mr. S's Account ……. Dr ₹ 2,500
   To return outward Account ₹ 2,500
   Rectifying entry: Mr. S's Account ……. Dr ₹ 500
   To return outward Account ₹ 500

Illustration:1 Rectify the following errors:

i. Purchase Book under cast by ₹ 100.
ii. Sales Day Book wrongly totaled ₹10,230 instead of ₹10,023.
iii. Credit sale to Mr. A posted in A's Account ₹670 instead of ₹570.
iv. Discount received from supplier omitted to be posted to supplier account ₹150.
v. Depreciation of ₹1,000 on Machinery not posted to Depreciation account.
vi. Total of discount column in Cash Book (receipt side) ₹375 wrongly posted to the credit side of discount account.

Solution:

i. The Purchase Account shall be debited by ₹100 as there is short debit of the same account. The entry shall be made in the debit side of Purchase Account "To under casting of Purchase Book ₹100".
ii. Sales Account shall be debited by ₹207 as there is excess credit because of over casting of the Sales Day Book. The entry shall be made in the debit side of Sales Account "To over casting of Sales Day Book ₹207".
iii. Mr. A's Account shall be credited by ₹100 (₹670 - ₹570) as there is excess debit of the same amount. The required entry in the credit side of Mr. A's Account shall be "by mistake in posting of account ₹100".
iv. Supplier Account shall be debited by ₹150 as there is omission of posing in Supplier Account. The entry in supplier account shall be "To omission of posting ₹150".
v. Depreciation Account shall be debited by ₹1,000 as there is omission of posting in depreciation account. The entry shall be "To omission in posting ₹1000".
vi. Discount Account shall be debited by ₹750 as wrongly discount Account has been credited by ₹375 instead of debit of ₹375. The debit entry shall be "To posting of amount in wrong side ₹750".

Illustration:2 Give journal entries to rectify the following errors:

i. Purchase of machinery of ₹5,000 wrongly passed through the purchase book.
ii. Repairs to machinery wrongly debited to machinery amount ₹700.
iii. Rent of ₹1,000 paid to Landlord debited to landlord account.
iv. Cheque of ₹3,500 received from S.K. Nayak credited to the account of S.K. Das.
v. Sale of goods to Hari on credit amounting to ₹450 wrongly recorded in the Sales Day Book as ₹540.
vi. Sales of old furniture for ₹500 wrongly passed through Sales Day Book.

Solution:

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
(i)	Machinery Account . . . . Dr. Purchase Account (Being rectification of purchase of machinery wrongly passed through purchase book)		5,000	5,000
(ii)	Repairs Account . . . . Dr. To machinery Account (Being rectification of repairs to machinery wrongly debited to machinery account)		700	700
(iii)	Rent Account . . . . Dr. To Landlord Account (Being rectification of rent paid to landlord wrongly debited to landlord Account)		1,000	1,000
(iv)	S.K Das . . . Dr. To S.K Nayak Account (Being rectification of cheque received from S.K Nayak wrongly credited to S.K Das Account)		3,500	3,500
(v)	Sales Account . . . . Dr. To Hari's Account (Being rectification of sales of goods for ₹450 wrongly passed as ₹ 540 (₹ 540 - ₹ 450)		90	90
(vi)	Sales Account . . . . Dr. To Furniture Account (Being rectification of sales of old furniture wrongly passed through sales day book)		500	500

2.7.2 Rectification of Errors after preparation of Trail Balance (Suspense Account created): When the difference in Trial Balance is transferred to the newly created suspense account to make the trial balance agree, one-sided errors (which affect the agreement of the trial balance) are rectified by passing suitable journal entries by debiting or crediting suspense account. On the other hand, two-sided errors (which do not affect the agreement of the Trial Balance) are rectified by passing suitable journal entries without taking suspense account into consideration.

For example, Sales Day Book under cast by ₹1,000. The effect of this error in trial balance shall be less credit total for which suspense account is created with a credit balance of ₹1,000. The rectifying entry shall be

Suspense account Dr. ₹1,000
To Sales Account ₹1,000

Thus, the error in sales account is rectified and the suspense account created with a credit balance of ₹1,000 is now debited and ultimately suspense account is closed.

Illustration:**3** Taking the errors in illustration, the rectification shall be as follows:

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
(i)	Purchase Account . . . . Dr. To Suspense Account (Being rectification of under casting of purchase book		100	 100
(ii)	Sales Account . . . . Dr. To Suspense Account {Being rectification of over casting of sales day book (₹10,230-₹10,023)}		207	 207
(iii)	Suspense Account. . . . Dr. To A's Account (Being rectification of posting of wrongly amount)		100	 100
(iv)	Suppliers Account. . . .Dr. To Suspense Account (Being rectification of omission of posting in suppliers Account)		150	 150
(v)	Depreciation Account . . . . Dr. To Suspense Account (Being rectification of omission of posting in depreciation Account)		1,000	 1,000
(vi)	Discount Account . . . . Dr. To Suspense Account (Being rectification of posting in wrong side of discount Account))		750	 750

Illustration:4 The book-keeper could not make the trial balance agree. He finds that the debit column is in excess of credit column by ₹ 8,620. The difference was transferred to suspense account. Subsequently, the following errors were found:

i. Sales day book was under cast by ₹4,000.
ii. Purchase book was overcast by ₹ 3,000.
iii. Cash received from a customer (sai prakash) was debited to his account ₹650.
iv. Purchase of computer table costing ₹ 2,000 passed through purchase day book.
v. Machinery purchased amounting to ₹2,750 posted to machinery account as ₹2,570.
vi. The total of the return outward book carried forward to the next page as ₹ 2,100 instead of ₹2,700.
vii. Cash discount of ₹100 allowed to a customer has not been posted to discount account.

Give journal entries to rectify the above errors and prepare suspense account.

Solution:

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
(i)	Suspense Account . . . . Dr. To Sales Account (Being rectification of under casting of sales day book)		4,000	 4,000
(ii)	Suspense Account . . . . Dr. To Purchase Account (Being rectification of over casting of purchase book)		3,000	 3,000
(iii)	Suspense Account. . . . Dr. To Sai Prakash Account (Being rectification of posting of wrongly side)		1,300	 1,300
(iv)	Furniture . . . Dr. To Purchase Account (Being rectification of purchase of office furniture wrongly passed through purchase day book)		2,000	 2,000
(v)	Machinery Account . . . . Dr. To Suspense Account (Being rectification of posting of wrong amount in machinery account)		180	 180
(vi)	Suspense Account . . . . Dr. To Return Outward account (Being rectification of mistake of carry forward in return outward book)		600	 600
(vii)	Discount Account . . . . Dr. To Suspense Account (Being rectification of omission of posting in discount account)		100	 100

Dr. Suspense Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Sales account To purchase account To Sai prakash account To Return outward account	4,000 3,000 1,300 600 8900		By Balance b/d By machinery account By discount account	8,620 180 100 8900

2.7.3 Rectification of errors after preparation of Final Accounts:

When the book-keeper could not locate the errors before preparation of final accounts (profit and loss account and Balance sheet), the final accounts are prepared by transferring the suspense account balance to either assets side or liabilities side of the balance sheet under current assets or current liabilities. If the suspense account is having a debit balance, it is taken to the asset side and when it is having a credit balance, it is transferred to liabilities side of the Balance sheet. While preparing the profit & loss account all nominal accounts have already been transferred and profit or loss ascertained.

The procedure of rectification of errors at this stage is similar to the procedure of rectification before preparation of final accounts excepting that the rectification in nominal accounts shall be done in profit & loss adjustment account. Since all nominal accounts have already been closed, rectification is not done by debiting or crediting nominal accounts.

For example, Railway freight of ₹500 paid on purchase of machinery wrongly charged to railway freight account.
If this error is rectified before preparation of final accounts, the rectifying entry shall be:

Machinery account ……….. Dr. ₹ 500
To Railway freight account ₹ 500

But the rectifying entry after preparation of final accounts shall be

Machinery account ……….. Dr. ₹ 500
To profit & Loss adjustment amount ₹ 500

The effect of this rectification on profit would result in increase in profit by ₹ 500 or decrease in loss to the same extent.

Illustration:5

Taking the information as in illustration, rectify the errors after preparation of final accounts.

Solution :

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
(i)	Suspense Account . . . . Dr To profit & loss adjustment Account		4,000	 4,000
(ii)	Suspense Account . . . . Dr To profit & loss adjustment Account		3,000	 3,000
(iii)	Suspense Account. . . . Dr To Sai Prakash Account		1,300	 1,300

(iv)	Furniture Account. . . . Dr. To profit & loss adjustment		2,000	 2,000
(v)	Machinery Account . . . . Dr. To Suspense Account		180	 180
(vi)	Suspense Account . . . . Dr To return outward account		600	 600
(vii)	Profit & Loss Adjustment Account… Dr To Suspense Account		100	 100

Dr. Suspense Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Profit & loss adj. A/c	4,000		By Balance b/d	8,620
	To Profit & loss adj. A/c	3,000		By machinery account	180
	To Sai Prakash account	1,300		By discount account	100
	To Profit & loss adj. A/c	600			
		8,900			8,900

Check your progress:

1. Which of the following errors will affect the trial balance?
   i. Purchase of furniture of ₹2,600 was passed through Purchase Book ₹1,600.
   ii. Sales Day Book under cast by ₹1,300.
   iii. Wages paid for installation of machinery ₹600 debited to wages account ₹1,600.
   iv. Credit sale of ₹250 to S.K. Menon posted to the account of S.K Mishra.
   v. ₹2,000 recovered from a customer which was previously written off as bad debt wrongly credited to the customer account.
   vi. Return of goods by Mahesh ₹1,000 posted to his debit.

2. Rectify the following errors by passing journal entries.
   i. Goods withdrawn by the proprietor for personal use amounting to ₹700 omitted to be recorded.
   ii. Credit sale of ₹5,000 to Mr. X wrongly passed through the purchase book.
   iii. Repairs to machinery ₹500 wrongly debited to machinery account.
   iv. A cheque for ₹1,600 received from Mr. Y was dishonoured and debited to discount account.
   v. Credit note for ₹700 received from Mr. A, the supplier debited to the account of M/s A. & Co.
   vi. Wages of workmen engaged in construction of building amounting to ₹1,200 debited to wages A/c.

3. Give journal entries to rectify the following errors using suspense account
   i. Credit sale of ₹2,400 to Mr. X credited to his account ₹240.
   ii. Discount column on receipt side of the cash book totaled ₹513 instead of ₹613.
   iii. An item of ₹2,635 paid for purchase of a new typewriter for the accounts department has been wrongly passed through the purchase book.
   iv. The addition in return inward book has been cast ₹123 short.
   v. A bill of exchange for ₹2,650 accepted by Mr. Ashok which was discounted with the bank has been returned as dishonoured. On dishonour, this amount has been debited to sales account.

Key words:

One-Sided Error: Errors affecting only one account.

Two-sided Errors: Error affecting two accounts.

Suspense Account: An account to which the difference is trial balance is transferred temporarily.

Error of Omission: When a transaction is completely or partially omitted to be recorded in the books of accounts, the error is called error of omission.

Error of commission: Errors committed by the book-keeper in the accounting process.

Compensating Error: Group of errors where the effect of one or more errors is compensated by the effect of other error or errors.

Errors of Principle: Errors arising due to violation of accounting principles (incorrect allocation between capital and revenue items).

Summary

Errors are classified as errors of omission, errors of commission, compensating errors and errors of principle. Some errors affect the agreement of the trial balance and some errors do not. When the trial balance did not tally the difference is transferred to suspense account. Errors need to be located and rectified. It can be rectified at three stages i.e. before preparation of trial balance (no suspense account is created), and after preparation of trial balance (suspense account is created) and after preparation of final account. The procedure of rectification varies depending upon the stage of rectification.

Solution /Answers:

1. (i), (ii), (iii) & (iv) will affect the trial balance.
2.

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
(i)	Drawings accounts …. Dr To purchase Account (Being rectification of omission of recording of goods withdrawn for person use)		700	 700
(ii)	X's account ….. Dr. To purchase account To sales account (Being rectification of credit sale wrongly passed through purchase book)		10,000	 5,000 5,000
(iii)	Repairs account ….. Dr. To machinery account (Being rectification of repairs wrongly debited to machinery account)		500	 500
(iv)	Y's account ….. Dr. To discount account (Being rectification of dishonour of cheque wrongly debited to discount account)		1,600	 1, 600
(v)	A's account ….. Dr. To M/s. A & Co. account (Being rectification of debit in wrong account)		700	 700
(vi)	Building account ….. Dr. To wages account (Being rectification of wages paid for construction of building wrongly debited to wages account)		1,200	 1,200

3.

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
(i)	X's accounts …. Dr To Suspense Account (Being rectification of credit sale to X wrongly credited to his account)		2,640	 2,640
(ii)	Discount account ….. Dr. To suspense Account (Being rectification of casting mistake in discount column of cash book)		100	 100
(iii)	Typewriter account ….. Dr. To Purchase Account (being rectification of purchase of typewriter		2,635	 2,635

	wrongly passed through purchase book)			
(iv)	Return inward account ….. Dr. To Suspense Account (Being rectification of under casting of return inward book)		123	 123
(v)	Mr. Ashok account ….. Dr. To Sales Account (Being rectification of dishonour of bill accepted by Mr. Ashok wrongly debited to sales account)		2650	 2650

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