Indian Accounting Association

Subject: Financial Accounting

Unit-I

Financial Accounting: Accounting Process

Name of the Contributor:

Soumita Mukherjee

Affiliation:

Assistant Professor of Commerce

Fakir Chand College, Diamond Harbour, West Bengal

Email: soumita.mukherjee88@gmail.com

Unit-I Accounting Process

LEARNING OUTCOMES

- Have an idea about the various branches of accounting.
- Understand the accounting cycle.
- Explain the system of accounting.
- Have an Idea about the various approaches to accounting.
- Understand the rules of debit and credit.
- Explain the accounting equation.
- Appreciate the applicability of journal, ledger and trial balance.

1.7 Branches of Accounting

The different branches of accounting are:

At a glance

Financial Accounting

- Management Accounting

Cost Accounting

- Social responsibility Accounting
- Human Resource Accounting

I. ***Financial Accounting*** is concerned with preparation and analyzing financial statements. The last step in financial accounting is preparation of income statement which shows the net profit or net loss during a particular period and balance sheet reflecting the position of the business as on a particular date. All transactions in financial statements are recorded at historical cost.

II. ***Management Accounting*** is concerned with presentation of accounting information to the management in such a way as to assist them in their managerial functions of decision making, policy framing, planning and control.

III. Accounting for cost is known as ***Cost Accounting***. It is a specialized branch of accounting which involves collection, classification, accumulation, assignment and cost control.

IV. ***Social Responsibility Accounting*** is concerned with measuring the social costs and social benefits due to the operating activities of a business. It is does not involve the application of a new set of accounting principle or practice, it is just measuring and disclosing the social responsibility met by a business. Companies Act, 2013 has made it mandatory for every company to spend 2% of their net profit on social activities.

V. ***Human Resource Accounting*** is a new branch of accounting. American Accounting Society Committee has defined human resource accounting as, 'human resource accounting is the process of identifying, and measuring data about human resources and communicating this information to interested parties.'

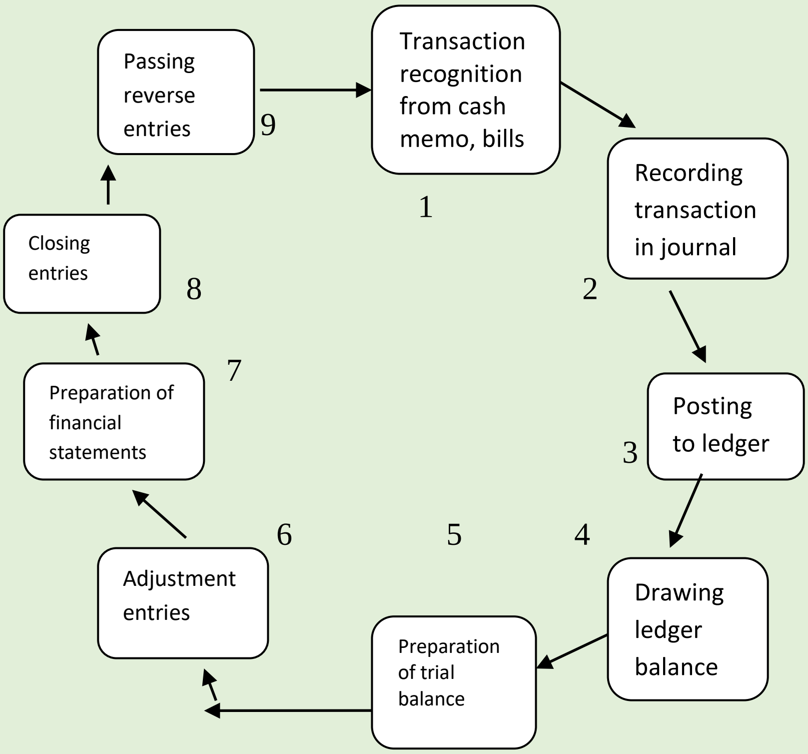
Another two recently developed branches of accounting are-

- Price level accounting which deals with accounting for changes in price level i.e. inflation or deflation.
- Environmental accounting that is concerned with recording and disclosing the impact of business operations on the environment and vice versa.

1.8 Accounting Cycle

Different steps of accounting constitute the accounting cycle.

Accounting Cycle

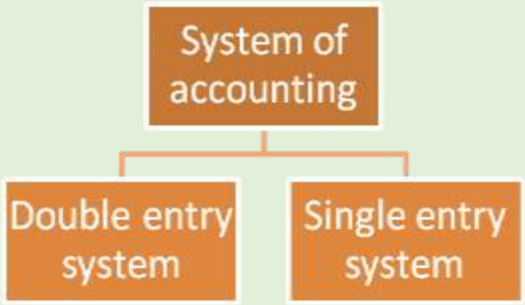


1.9 System of Accounting

When an event brings about a change in the financial position of a business and can be measured in monetary terms, it is called 'transaction.' When there is no change in financial position of a business it is called 'event.' Suppose some furniture is purchased for ₹10,000 and a gift received from Mr. X worth ₹ 700. The former is a transaction whereas the later is an event.

When a transaction takes place, it needs to be recorded since it changes the financial position of a business.

Such system of recording transaction can be broadly classified as –



Double entry system of recording transactions recognizes that every transaction has two aspects. One account is credited, and the other account is debited. Every debit has an equal credit. Under this system transactions are recorded in full. Example- Mr. B has purchased a motor car costing ₹1,00,000. The transaction in the books of Mr. B will be recorded as motor car account debited by ₹1,00,000 and cash account credited by ₹1,00,000.

Certain advantages of this system are:

- Complete set of records are maintained.
- Financial position can be ascertained from financial statements.
- Facilitates comparative study.
- Helps in effective decision making.

Some limitations of this system are-

- It is a complex process of accounting since details of every transaction are to be recorded in dual aspect.
- It is time consuming as well as laborious.
- Requires person with knowledge of accounting.

Single entry entails recording of transactions in an incomplete manner. In this system, both the aspects of a transaction are not recorded. This system is an admixture of single entry, double entry and no entry.

This system does not have any advantages as such since it is an incomplete system of accounting. A person without knowledge of accounting can use this system in business.

There are various limitations of single entry-

- Trial balance cannot be prepared.
- High chances of fraud and misappropriations.

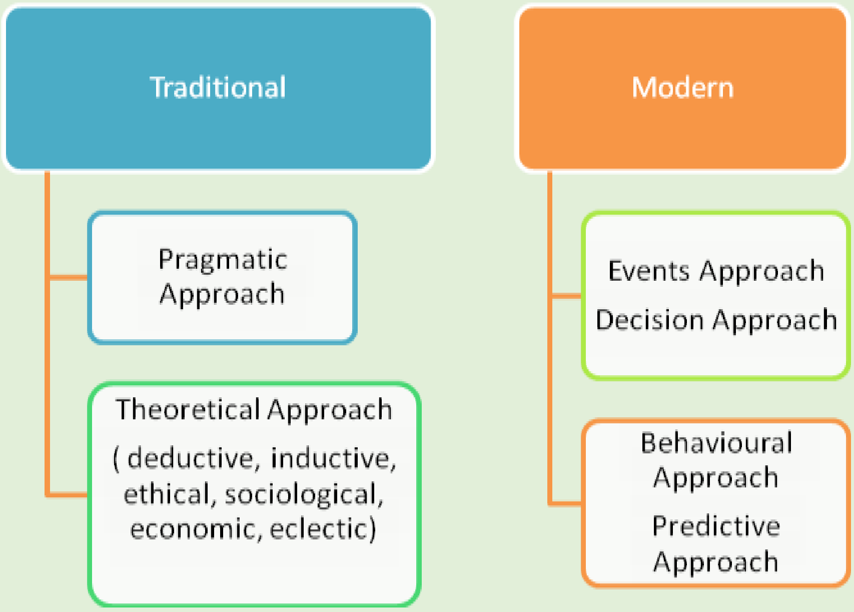
- Difficulty in preparation of financial statements.
- Limited company cannot use this system.

1.10 Approaches to Accounting

Generally, there are two approaches to accounting, one is the traditional approach and another is the modern approach. The traditional approach to accounting deals with debit and credit and with personal and impersonal accounts. Golden rule is under the traditional approach to accounting. The modern approach to accounting tries to explain debit and credit by an equation.

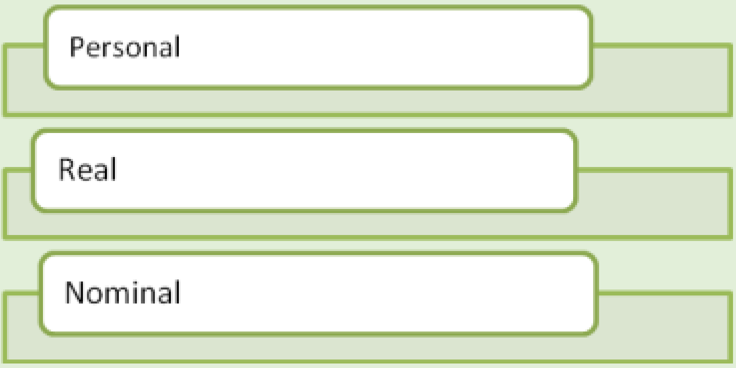
Formulation of accounting theory means the different opinion, concepts, ideas based on which accounting theories are invented. The approaches to formulation of accounting theory can be discussed under two broad categories viz Traditional and Modern. The following is an overview of the different approaches to formulation of accounting theory:

Traditional approaches to accounting theory focuses on construction of theories, whereas modern approaches deal with not only construction of theories as well as verifying the same.



1.11 Types of Account

Accounts can be classified as follows-



- **Personal-** Personal accounts deals with transactions with customers, suppliers and owner. This account is prepared to ascertain the balances due to or due from persons or organizations. Personal accounts may be in the form of natural persons, artificial persons and representative persons. Examples – X &Co a/c, Mr. M. Basu a/c, Sunrise Traders Ltd a/c, Bank a/c etc.
- **Real-** Real accounts are accounts of assets and properties. Examples- Machinery, Furniture, Investments etc.
- **Nominal-** Nominal accounts deals with income, expense, profit and loss. Examples- rent, salary, commission, interest, discount etc.
- Another type of account is **'valuation account'** or '**contra account'**. Examples- provision for depreciation, provision for bad debt etc.

  Illustration-1

  Classify the following accounts:

  Interest, Motor Car, Depreciation, D Ltd, Provision for depreciation.

  Solution:

  Interest- Nominal Account

  Motor Car- Real Account

  Depreciation- Nominal Account

  D Ltd- Personal Account

  Provision for depreciation- Valuation Account

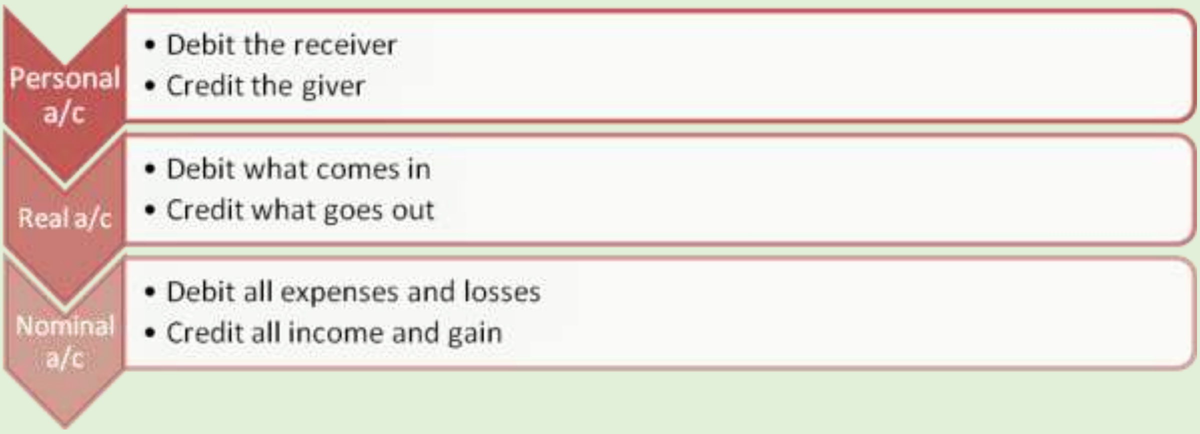
1.12 Rules of Debit and Credit

As per double entry system of accounting, there are two-fold aspect of a transaction. They are – one is 'debit' and another is 'credit'. An increase in asset, expenses is taken as debit whereas an increase in liability, revenue is taken as credit.

Rules of debit and credit can be summarized as follows-

A/C Name	Increase(+)	Decrease(-)
Assets a/c	A/c to be debited	A/c to be credited
Liabilities a/c	A/c to be credited	A/c to be debited
Capital a/c	A/c to be credited	A/c to be debited
Revenue a/c	A/c to be credited	A/c to be debited
Expenses a/c	A/c to be debited	A/c to be credited
Withdrawal / Drawings a/c	A/c to be debited	A/c to be credited

Golden Rules for Debit and Credit



The accounts will appear as follows:

Dr Asset A/C Cr	
Increase (+)	Decrease (-)

Dr Liability A/C Cr	
Decrease (-)	Increase (+)

Dr Expense A/C Cr	
Increase (+)	Decrease (-)

Dr Revenue A/C Cr	
Decrease (-)	Increase (+)

1.14 Accounting Equation

Accounting equation implies total assets are equal to total liabilities. Liabilities to the outsider are known as liability but the liability to the owner is called capital. Accounting equation is the basis of double entry system.

Accounting equation can be expressed as follows:

Wealth = Equity (Capital)

Assets - Liabilities = Capital

Assets = Liabilities + Capital

The double entry system implies an increase in asset is always counter balanced by decrease in liability.

Example- Total assets = ₹70,000. Owner's equity= ₹ 40,000. Find out the liabilities.

Total assets= Total liabilities + Capital

70,000= 40,000 + total liabilities

Total Liabilities= ₹70,000 - ₹40,000

Total liabilities = ₹30,000

The accounting equation: wealth is equal to equity does not consider revenue and expense. Revenue is the income earned by selling goods and services. It results in inflow of asset in business. Expenses are incurred for earning revenues. It results in outflow of asset or increase in liability. Revenue and expenses are flow items occurring during a period.

If these two items are included in accounting equation, the expanded accounting equation becomes-

$Asset_1 = Liabilities_1 + [Capital_0 + (Revenue_1 – Expense_1)]$

$Asset_1 = Liabilities_1 + Capital_0 + Revenue_1 – Expense_1$

$Asset_1 + Expense_1 = Liabilities_1 + Capital_0 + Revenue_1$

Subscript 1 denotes at the end of period 1; Subscript 0 denotes at the beginning of period 1.

Example- $Asset_1$ = ₹ 80,000, $Liabilities_1$ = ₹50,000, $Revenue_1$ = ₹10,000 and $Expense_1$ = ₹8,000. Find out the $Capital_0$.

$Asset_1 + Expense_1 = Liabilities_1 + Capital_0 + Revenue_1$

$80,000 + 8,000 = 50,000 + Capital_0 + 10,000$

$88,000 = 60,000 + Capital_0$

$Capital_0 = 88,000 – 60,000$

$Capital_0$ = ₹ 28,000

1.15 Journal, Ledger and Trial balance

Journal is the book of prime entry. When a transaction occurs, it is first recorded in journal. In journal, transactions are recorded in chronological order i.e. in the order of the occurrence. Recording of transaction in journal is known as entry. When a journal is recorded it is accompanied by an explanation known as narration. In a transaction, one account is debited while another account is credited.

In journal, there is date, particulars, ledger folio, debit amount and credit amount.

The date column shows the year, month and date of occurrence of the transaction.

Particulars column shows the account to be debited and account to be credited, along with the explanation which is known as 'narration'.

Ledger folio indicates the page number of the ledger in which these accounts appear.

Debit account indicates the account debited

Credit account indicates the account credited.

All debits must have equal credit.

Proforma of a Journal

In the books of……

Journal

			Dr	***Cr***
Date	**Particulars**	**L.F**	**Amount (₹)**	**Amount (₹)**

Simple and Compound Journal Entries

A journal entry which has only one debit entry and one credit entry is known as Simple journal entry.

Example- Purchased furniture for cash ₹30,000

Furniture A/C…………….Dr ₹ 30,000

To Cash A/C ₹ 30,000

A journal entry which has more than one debit entry and more than one credit entry is known as compound journal entry. The debit total must be equal to the credit total.

Example- Furniture- ₹5000, Building – ₹4000, Plant- ₹ 2,000, Cash- ₹3,000 introduced as Capital.

Furniture A/C …… Dr 5000

Building A/C …….. Dr 4000

Plant A/C………. Dr 2000

Cash A/C ………. Dr 3000

To Capital A/C 14,000

Subdivision of Journal

A medium size organization maintains the following types of journals-

- Cash book- cash book records cash transactions.
- Sales day book- records credit sale transactions
- Purchases day book- records credit purchase transactions
- Sales return/ Return Inward day book - records sales return or return inward.
- Purchase return/ Return outward day book - - records purchase return or return outward.
- Bills receivable book- records bills receivable
- Bills payable book- records bills payable
- Petty cash book- records petty cash transactions
- Journal proper- records those transactions which cannot be recorded in any of the above journals.

Illustration-1

Journalize the following transactions:

Mr. D started business with cash ₹60,000

Purchased goods from R for ₹ 4,000

Sold goods for cash ₹ 5,000

Paid wages ₹2,000

Return goods worth ₹1,000

In the books of……

Journal

Date	Particulars	L.F	*Dr* Amount (₹)	*Cr* Amount (₹)
	Cash A/C ….Dr		60,000	
	To Capital A/C			60,000
	(Being cash introduced as capital)			
	Purchase A/C …….Dr		4,000	
	To R A/C			4,000
	(Being goods purchased from R on credit)		Narration	
	Cash A/C……..Dr		5,000	
	To Sales A/C			5,000
	(Being goods sold for cash)			
	Wages A/C…….Dr		2,000	
	To Cash A/C			2,000
	(Being wages paid)			
	Cash A/C……Dr		1000	
	To Return Outward A/C			1000
	(Being goods returned)			
			72,000	72,000

Ledger

Ledger is the book of account where similar transactions relating to a particular person or a thing are recorded. In journal transactions are recorded in chronological order from there ledger posting is made. In ledger, all accounts relating to the transactions recorded in journal are maintained. A businessman usually is not interested in knowing the individual effect of each transaction on the financial statements rather he prefers to known the total balance for an accounting period. Ledger accounts provide the total balance. For example, if he wants to known the total asset account balance, it is reflected in the asset account.

The standard proforma of a ledger contains the following columns like date, particulars, journal folio (J.F), Amount. It is usually in 'T' form. It has two sides one debit side another credit side. Left side is the debit side and right side is the credit side.

The ***proforma*** of a ledger is given below:

Name of the Account **(Account No..)**

Dr **Cr**

Date	**Particulars**	**J.F**	**Amount (₹)**	**Date**	**Particulars**	**J.F**	**Amount (₹)**

Classification of Ledger

Usually ledger is classified as follows:

- Sales Ledger or Debtors' ledger- it deals with the personal accounts of all customers to whom goods have been sold on credit. From this ledger the total sundry debtors' balance can be obtained. The accounts in this ledger are usually maintained in alphabetical order for convenience.
- Bought ledger or Creditors' ledger- - it deals with the personal accounts of all those from whom goods have been bought on credit. From this ledger the total sundry creditors' balance can be obtained. The accounts in this ledger are usually maintained in alphabetical order for convenience.
- General Ledger- it contains the real accounts like Plant and Machinery, Furniture, building etc.

- Nominal Ledger- it contains all the nominal accounts like item of expenses, losses, gains etc.
- Private Ledger- those accounts which are considered as 'confidential' in nature in some cases, are maintained under private ledger like drawings , capital etc.
- Cash Book- it contains the cash and bank account.

Posting in Ledger

The mechanism of transferring debits and credits from journal to ledger is known as ledger posting. The debit amount in the journal is posted in the debit side of the account in ledger and the credit amount is entered in the credit side of the account in ledger. In debit side of the ledger account posting is made as 'To' and credit side of the ledger account posting is made as 'By'. The account debited in journal is to be first located in ledger and in debit side of that particular account in ledger; posting is made with the name of the account credited with a prefix i.e. 'To' and vice-versa.

Illustration-2

Refer to Illustration- 1, First journal entry.

Cash A/C……….Dr 60,000

To Capital A/C 60,000

The ledger posting for that journal entry will be:

Dr **Cr**

Cash A/C

Date	**Particulars**	**J.F**	**Amount (₹)**	**Date**	**Particulars**	**J.F**	**Amount (₹)**
	To Capital A/C		60,000				

Dr **Cr**

Capital A/C

Date	**Particulars**	**J.F**	**Amount (₹)**	**Date**	**Particulars**	**J.F**	**Amount (₹)**
					By Cash A/c		60,000

After all the postings are made the account is balanced. If debit total is more than the credit total it shows debit balance and it is written in credit column as ‘By Balance c/d’ and the opening balance in debit side is written as ‘To balance b/d’, if credit total is more than debit side total it shows credit balance.

Trial Balance

Trial balance is a statement prepared to verify the arithmetical accuracy of the books of accounts. It is not a part of the double entry system. Trial balance is an additional statement prepared with the balances of all the ledger accounts, after all the transactions for that period have been entered.

As every transaction has two aspects i.e. a debit and a credit, so it follows that the debit total must be equal to the credit total.

Preparation of trial balance is not mandatory. If any organization is confident about the arithmetical accuracy of the ledger balances they may not prepare trial balance. Trial balance is just prima facie evidence of the arithmetical accuracy of the books of accounts. Hence trial balance is not indispensible.

Errors that are not disclosed by trial balance

Trial balance is not a conclusive proof of the arithmetical accuracy of the books of accounts. There are certain errors that cannot be detected by trial balance, like:

- Errors of principle
- Omission
- Duplication
- Errors of original entry
- Errors of commission
- Compensating errors

Important points

- Trial balance is a statement
- It is prepared as on a particular date
- The left column of trial balance shows the debit balances and the right column shows the credit balances

- It can be prepared on monthly, yearly, quarterly basis, as desired
- The debit and credit columns of trial balance should agree
- It is just a proof of arithmetical accuracy of books of accounts
- The balances of *assets, expenses, losses, drawings and debtors account shows a debit balance and the balances of liabilities, income, revenue, gain and creditors shows a credit balance.*

Proforma of a trial balance

A trial balance has five (5) columns viz Serial number, particulars or heads of Account, L.F., Debit balance (in rupees) and credit balance (in rupees) respectively.

Sl No.	**Heads of account**	**L.F.**	**Debit Balance (₹)**	**Credit Balance (₹)**

Treatment of closing stock in preparation of trial balance

Closing stock generally does not appear in trail balance since no separate account is opened for closing stock in general ledger. There is an exception when closing stock will appear in trial balance. If closing stock is adjusted against purchase then closing stock will appear in trial balance.

Closing stock A/C……..Dr

To Purchase A/C

Suspense Account

If trial balance fails to agree, due to some errors which remains undetected despite several attempts to detect such errors in that case the difference in the trial balance is transferred to an account known as 'Suspense Account' temporarily. Later if errors are detected then it can be rectified through Suspense account.

Illustration-3

From the following balances prepare a trail balance as on 31.03.2021 of R Ltd.

Furniture – ₹ 15,000, Capital – ₹8,000, Discount allowed- ₹1000, Sales- ₹30,000, Return outward –₹ 5000, Purchase- ₹ 25,000, Opening stock – ₹4000

In the books of R Ltd

Trial Balance as at 31st March, 2021

Sl No.	**Heads of account**	**L.F.**	**Debit Balance (₹)**	**Credit Balance (₹)**
1.	Furniture		15,000	
2.	Capital			8000
3.	Discount allowed		10,000	
4.	Sales			30,000
5.	Return Outward			5000
6.	Purchase		25000	
7.	Opening stock		4000	
8.	Creditors			11000
	TOTAL		**54,000**	**54,000**

SUMMARY

- There are five branches of accounting.
- Accounting cycle starts from recording transactions in journal and ends at preparation of final accounts.
- There are two system of accounting viz double entry, single entry.
- There are two approaches to accounting, traditional and modern.
- Real, personal, nominal accounts are the three main accounts in double entry system of accounting.
- Golden rule is followed in recording transactions.
- Every debit must have equal credits.
- Modern approach to accounting follows equation for analyzing transactions.
- Journal is the book of prime entry.
- From journal ledger posting is made.
- Trial balance preparation is not mandatory; it is just a proof of arithmetical accuracy of books of accounts.

TEST YOURSELF:

A. Multiple Choice Questions:

1. The first step of accounting cycle is-
   a) Recording transactions in journal
   b) Ledger posting
   c) Final accounts preparation
   d) Trial balance
2. …………….system of accounting says every debit must have an equal credit.
   a) Single entry
   b) Double entry
   c) Both
   d) None of the above
3. ……………..usually do not appear in trial balance.
   a) Purchase
   b) Sales
   c) Carriage outward
   d) Closing stock
4. Building is an example of ………account.
   a) Real
   b) Personal
   c) Nominal
   d) Valuation
5. Which approach to accounting uses equation?
   a) Traditional
   b) Modern
   c) Both
   d) None of the above

Answer keys

1. a) 2. b) 3. d) 4. a) 5. b)

B. **Theoretical Questions**:

1. Explain the double entry system of accounting.
2. Explain the accounting cycle.
3. How many branches of accounting are there?
4. Explain the accounting equation.
5. What is trial balance? Is it mandatory to prepare trial balance

Suggested Readings

- Batty, J. *Principles of Accounting.*
- Grewal, T.S. *Introduction to Accountancy*. S. Chand and Co. New Delhi
- Gupta R. L. and Gupta, V.K. *Principles & Practice of Accounting*. Sultan Chand and Sons, New Delhi.
- Haneef and Mukherjee. Accountancy-I & II, Tata McGraw Hill Co
- Jain S.P. & Narang, K.L. *Accountancy-I*. Kalyani Publishers.
- Jawaharlal Lal. *Financial Accounting*. Himalaya Publishing House.
- Sehgal, Deepak. *Fundamentals of Financial Accounting*. Tax Mann Publication
- Tulasian, Accountancy–I & II: Tata McGraw Hill Co.