UNIT 2
Accounting Process

(10 Hours) — Financial Accounting (CACS152)

1. Books of Account Leading to the Preparation of Trial Balance

The accounting process refers to the complete sequence of steps by which a business transaction is recorded, classified, and summarized until it is finally reflected in the trial balance and, ultimately, the financial statements. This unit builds the practical toolkit — journal, ledger, subsidiary books, and the trial balance — needed to carry a transaction from its origin to a summarized, reliable form.

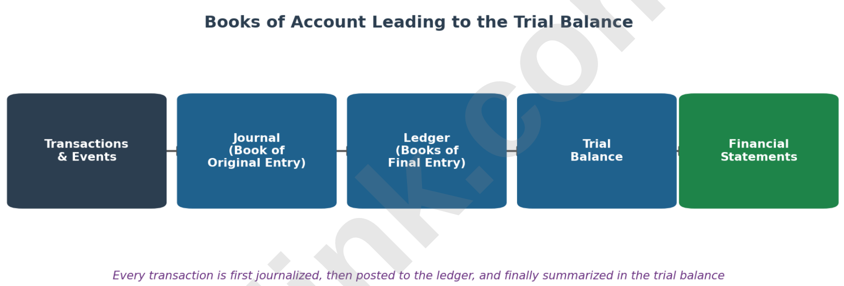

Fig 2.1 — Books of account leading to the trial balance.

1.1 Concepts of Transaction and Events

A transaction is an economic activity that involves a transfer of money or money's worth between two or more parties and changes the financial position of a business — for example, a cash sale, a credit purchase, or payment of rent. An event is a happening of consequence to a business; it is a broader term that includes transactions as well as occurrences such as loss of goods by fire, depreciation of an asset, or a change in the market value of an investment, which may not involve an exchange between parties but still affect the financial position of the business.

- Cash transactions — settled immediately in cash.
- Credit transactions — settlement is deferred to a future date.
- Internal events — arise within the business itself, such as depreciation, without involving an external party.
- External events — arise from the interaction of the business with an outside party, such as a purchase or sale.

2. Double Entry System

2.1 Meaning of the Double Entry System

The double entry system of bookkeeping is based on the principle that every transaction has two aspects — a receiving aspect (debit) and a giving aspect (credit) — and both aspects are recorded for every transaction. Because every debit has a corresponding and equal credit, the system keeps the accounting equation, Assets = Liabilities + Capital, in balance at all times. The system was first codified by the Italian mathematician Luca Pacioli in 1494 and remains the foundation of modern accounting worldwide.

2.2 Advantages of the Double Entry System

- Provides a complete and scientific record of both aspects of every transaction.
- Enables the ascertainment of profit or loss for a given period through the Trading and Profit & Loss Account.
- Enables the ascertainment of the financial position of the business through the Balance Sheet.
- Provides an arithmetical check on the accuracy of posting through the trial balance, since total debits must equal total credits.
- Facilitates comparison of results across periods and with other businesses.
- Helps in the detection and prevention of fraud and errors due to its systematic and cross-checked nature.
- Assists management, owners, and other stakeholders in effective decision-making with reliable financial data.
- Satisfies legal and tax reporting requirements more easily, since records are complete and auditable.

3. Classification of Accounts and the Golden Rules

3.1 Classification of Accounts

Every ledger account can be classified into one of three broad categories under the traditional (British) approach to accounting.

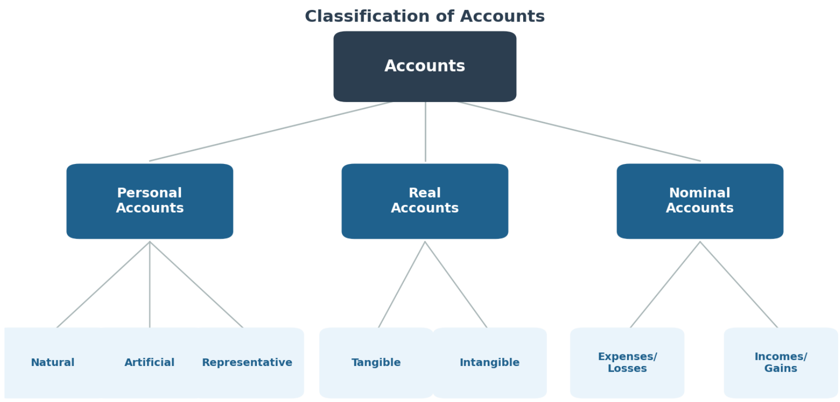

Fig 2.2 — Classification of accounts under the traditional approach.

- Personal Accounts — accounts of persons and entities with whom the business deals, further divided into natural (individuals), artificial (companies, firms, institutions), and representative (e.g., outstanding salary, prepaid insurance) personal accounts.
- Real Accounts — accounts of assets and properties owned by the business, divided into tangible (machinery, cash, building) and intangible (goodwill, patents, trademarks) real accounts.
- Nominal Accounts — accounts of expenses, losses, incomes, and gains, which do not have physical existence and are closed to the Profit & Loss Account at the end of the period.

3.2 Golden Rules of Accounting

Type of Account	Golden Rule
Personal Account	Debit the Receiver, Credit the Giver
Real Account	Debit What Comes In, Credit What Goes Out
Nominal Account	Debit All Expenses and Losses, Credit All Incomes and Gains

Example 3.1 — Applying the Golden Rules

Ram started business with cash Rs. 1,00,000; paid rent Rs. 5,000; sold goods to Shyam on credit for Rs. 20,000.

Solution — Identifying Accounts and Rules Applied

Cash A/c (Real) — Debit, what comes in; Capital A/c (Personal) — Credit, the giver.

Rent A/c (Nominal) — Debit, an expense; Cash A/c (Real) — Credit, what goes out.

Shyam's A/c (Personal) — Debit, the receiver; Sales A/c (Nominal) — Credit, an income.

4. Journal Entries

4.1 Meaning of the Journal

The journal is the book of original (or prime) entry in which transactions are first recorded, in chronological order, as they occur, showing the accounts to be debited and credited along with a brief explanation (narration).

4.2 Advantages of the Journal

- Provides a chronological record of all transactions as they occur.
- Reduces the possibility of a transaction being omitted, since each transaction is recorded only once, in one place, before posting.
- The narration accompanying each entry explains the nature of the transaction for future reference.
- Forms the basis for posting to the ledger and thus supports the entire subsequent accounting process.
- Serves as documentary evidence of a transaction in case of dispute.

Example 4.1 — Journalizing Transactions

Record the following transactions of Mr. Karki in the Journal: (a) Started business with cash Rs. 50,000; (b) Purchased goods for cash Rs. 15,000; (c) Paid salary Rs. 3,000; (d) Sold goods to Hari on credit Rs. 8,000.

Solution — Journal Entries

(a) Cash A/c ... Dr. Rs. 50,000   To Capital A/c Rs. 50,000 (Being business started with cash)

(b) Purchases A/c ... Dr. Rs. 15,000   To Cash A/c Rs. 15,000 (Being goods purchased for cash)

(c) Salary A/c ... Dr. Rs. 3,000   To Cash A/c Rs. 3,000 (Being salary paid)

(d) Hari's A/c ... Dr. Rs. 8,000   To Sales A/c Rs. 8,000 (Being goods sold to Hari on credit)

5. Ledger

5.1 Meaning of the Ledger

The ledger is the principal book of account, often called the book of final entry, in which all transactions relating to a particular account are collected together at one place in a classified and permanent form. Entries from the journal (and subsidiary books) are posted to the respective accounts in the ledger.

5.2 Advantages of the Ledger

- Brings together, at one place, all transactions relating to a particular account, showing its net effect.
- Provides the balances of individual accounts, which are the basis for preparing the trial balance.
- Facilitates the ascertainment of amounts due to or from individual customers and suppliers.
- Provides a ready reference for management on the position of any account, such as cash or a particular asset.
- Forms the basis for the preparation of financial statements.

Note: A ledger account is generally maintained in a 'T-format,' with debit entries on the left side and credit entries on the right side.

6. Subsidiary Books

6.1 Meaning and Need for Subsidiary Books

In a business with a large volume of transactions, recording every transaction in a single journal becomes impractical. Subsidiary books (also called books of original/prime entry, or day books) divide the journal into several specialized books, each dealing with one class of recurring transactions, allowing for division of labour and greater efficiency and control.

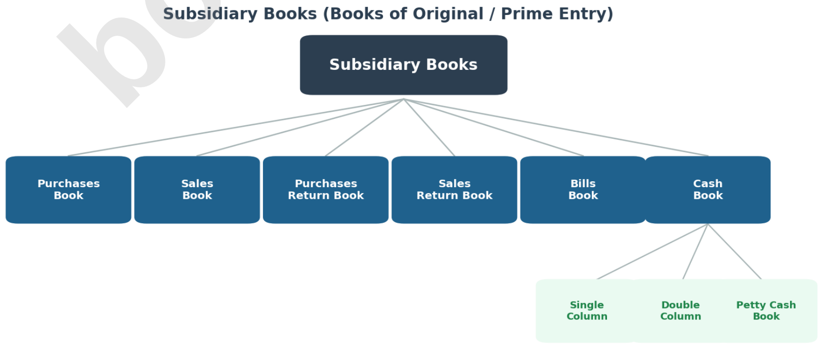

Fig 2.3 — Types of subsidiary books commonly maintained.

6.2 Types of Subsidiary Books

Subsidiary Book	Records
Purchases Book	Credit purchases of goods (trading items only).
Sales Book	Credit sales of goods (trading items only).

Subsidiary Book	Records
Purchases Return Book	Goods returned to suppliers (returns outward).
Sales Return Book	Goods returned by customers (returns inward).
Bills Receivable / Payable Book	Bills of exchange received from, or accepted in favour of, others.
Journal Proper	Transactions that do not fit any other subsidiary book, e.g., opening entries, rectification entries, and adjusting entries.
Cash Book	All cash and bank receipts and payments.

6.3 Cash Book

The cash book is a unique subsidiary book that also serves as a ledger account for cash (and bank), since it is both a book of original entry and, in effect, the Cash Account itself.

- Single Column Cash Book — records only cash receipts and payments.
- Double (Two) Column Cash Book — has separate columns for cash and bank, or for cash and discount, on each side.
- Triple Column Cash Book — has separate columns for cash, bank, and discount on each side.
- Petty Cash Book — maintained (often under the imprest system) to record small, recurring items of expenditure such as postage, stationery, and conveyance, freeing the main cash book from a large number of minor entries.

7. Trial Balance

7.1 Meaning and Purpose of the Trial Balance

A trial balance is a statement prepared on a particular date, listing the debit and credit balances of all ledger accounts, to verify the arithmetical accuracy of the ledger postings. Since every debit entry has a corresponding credit entry under the double entry system, the total of the debit column should equal the total of the credit column if the books have been correctly maintained.

7.2 Advantages of the Trial Balance

- Provides a check on the arithmetical accuracy of ledger postings.
- Serves as a summarized list of all ledger balances, forming the starting point for the preparation of final accounts.
- Helps in the location of certain types of errors before financial statements are prepared.
- Facilitates a quick review of the balances of all accounts on a given date.

Example 7.1 — Preparing a Simple Trial Balance

From the ledger balances of a small trader — Capital Rs. 50,000; Cash Rs. 27,000; Purchases Rs. 15,000; Salary Rs. 3,000; Sales Rs. 8,000; Hari's A/c (Debtor) Rs. 8,000; Furniture Rs. 5,000 — prepare the trial balance.

Solution — Trial Balance as at the given date

Debit balances: Cash Rs. 27,000; Purchases Rs. 15,000; Salary Rs. 3,000; Hari's A/c Rs. 8,000; Furniture Rs. 5,000 — Total Rs. 58,000

Credit balances: Capital Rs. 50,000; Sales Rs. 8,000 — Total Rs. 58,000

Since the debit total equals the credit total (Rs. 58,000), the ledger postings are arithmetically accurate.

Note: A trial balance that agrees does not guarantee that the books are free from all errors — certain errors (such as errors of omission, or compensating errors) do not affect the agreement of the trial balance.

8. Capital and Revenue Expenditures and Receipts

8.1 Capital Expenditure and Revenue Expenditure

Correctly distinguishing capital items from revenue items is essential for the accurate measurement of profit and the fair presentation of the balance sheet.

Basis	Capital Expenditure	Revenue Expenditure
Nature	Incurred to acquire, extend, or improve a fixed asset	Incurred for the day-to-day conduct of business
Benefit	Yields benefit over more than one accounting period	Benefit is exhausted within the current accounting period
Treatment	Shown in the Balance Sheet (capitalized)	Shown in the Trading / Profit & Loss Account
Example	Purchase of machinery, cost of installation, addition to a building	Rent, wages, carriage on goods sold, repairs and maintenance

Note: Certain expenditures, such as heavy advertisement expenses whose benefit spreads over several years, are treated as deferred revenue expenditure — written off over the periods expected to benefit, rather than charged entirely in the year incurred.

8.2 Capital Receipt and Revenue Receipt

Basis	Capital Receipt	Revenue Receipt
Nature	Arises from the sale of a fixed asset or raising of capital/loans	Arises from the normal operating activities of the business
Treatment	Shown in the Balance Sheet (or adjusted against the relevant asset/liability)	Shown in the Trading / Profit & Loss Account
Example	Sale of machinery, issue of shares, loan raised	Sale of goods, commission earned, interest received

9. Contingent Assets and Contingent Liabilities

9.1 Contingent Liability

A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. A contingent liability is not recognized in the books but is disclosed by way of a note to the financial statements, since the outflow of resources is not probable or cannot be reliably measured.

- Examples: a claim against the business not acknowledged as a debt, a bill discounted that may be dishonoured, a guarantee given on behalf of a third party, and a pending lawsuit whose outcome is uncertain.

9.2 Contingent Asset

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence of uncertain future events not wholly within the control of the enterprise. In keeping with the convention of conservatism, a contingent asset is neither recognized in the accounts nor generally disclosed, unless the inflow of economic benefit is virtually certain, in which case it is no longer treated as contingent.

- Example: a claim the business has lodged against another party for damages, the outcome of which is uncertain.

Note: Neither a contingent asset nor a contingent liability is entered as an actual figure in the ledger accounts; they are matters of disclosure, not of recognition, unless and until they crystallize into an actual asset or liability.

10. Errors and Their Rectification

10.1 Classification of Errors

Type of Error	Description
Errors of Omission	A transaction is either wholly or partially omitted from the books of account.
Errors of Commission	A transaction is recorded, but incorrectly — e.g., wrong amount posted, or posted to the correct account type but the wrong account (such as the wrong person's account).
Errors of Principle	A transaction is recorded in violation of accounting principles — e.g., treating a capital expenditure as a revenue expenditure.
Compensating Errors	Two or more errors are committed in such a way that the effect of one error is offset by the effect of another, leaving the trial balance unaffected.

Note: Errors of omission, errors of principle, and compensating errors generally do not affect the agreement of the trial balance, whereas many errors of commission (such as one-sided postings) do cause the trial balance to disagree.

10.2 Rectification of Errors

Errors discovered before the preparation of the trial balance are usually corrected directly in the relevant account. Errors discovered after the trial balance has been prepared but before the final accounts are closed are corrected through a journal entry, and if the error affects only one account (making the trial balance disagree), the difference is temporarily transferred to a Suspense Account pending identification of the underlying error.

Example 10.1 — Rectifying a One-Sided Error

Rs. 5,000 received from Ramesh was correctly entered in the Cash Book but was posted to Ramesh's Account as Rs. 500. The error was located after the trial balance was prepared and a Suspense Account was opened.

Solution — Rectifying Journal Entry

Ramesh's A/c ... Dr. Rs. 4,500   To Suspense A/c Rs. 4,500

(Being under-posting of Rs. 4,500 to Ramesh's Account now rectified)

Example 10.2 — Rectifying an Error of Principle

Rs. 20,000 spent on the purchase of a computer for office use was wrongly debited to the Purchases Account (a capital expenditure mistakenly treated as a revenue expenditure). The error was located before the trial balance was prepared.

Solution — Rectifying Journal Entry

Computer A/c (Office Equipment) ... Dr. Rs. 20,000   To Purchases A/c Rs. 20,000

(Being correction of a capital item wrongly debited to Purchases Account)

- If an error affects two accounts equally and oppositely, it can be rectified through a journal entry without opening a Suspense Account, since the trial balance would not have been affected.
- If an error causes the trial balance to disagree, the difference is posted to a Suspense Account; as each underlying error is identified, it is rectified through the Suspense Account until its balance becomes nil.

Key Takeaways

✓ A transaction is a completed exchange between parties; an event is any occurrence, transactional or not, that affects the financial position.

✓ The double entry system records both the debit and credit aspects of every transaction, keeping the accounting equation in balance.

✓ Accounts are classified as Personal, Real, or Nominal, each governed by its own golden rule of debit and credit.

✓ Transactions move from the Journal (book of original entry) to the Ledger (book of final entry) and are summarized in the Trial Balance.

✓ Subsidiary books, especially the Cash Book, divide the journal by transaction type for efficiency and control.

✓ Capital expenditure/receipts affect more than one accounting period and appear in the Balance Sheet; revenue expenditure/receipts are period-specific and appear in the Profit & Loss Account.

✓ Contingent assets and liabilities are disclosed, not recognized, until their occurrence becomes reasonably certain.

✓ Errors are classified as omission, commission, principle, or compensating errors, and are rectified through direct correction or a journal entry routed through a Suspense Account.

— End of Unit 2 —