1.8 ACCOUNTING CYCLE

An accounting cycle is a complete sequence beginning with the recording of the transactions and ending with the preparation of the final accounts. The sequential steps involved in an accounting cycle are as follows :

Step 1 : **Journalizing :** Record the transactions and events in the Journal.

Step 2 : **Posting :** Transfer the transactions in the respective accounts opened in the Ledger.

Step 3 : **Balancing :** Ascertain the difference between the total of debit amount column and the total of credit amount column of a Ledger account.

Step 4 : **Trail Balance :** Prepare a list showing the balance of each and every account to verity whether the sum of the debit balances is equal to the sum of the credit balances.

Step 5 : **Income Statement :** Prepare Trading and Profit and Loss Account to ascertain the profit or loss for accounting period.

Step 6 : **Position Statement** (Balance Sheet)

Prepare the Balance Sheet to ascertain the financial position as at the end of accounting period.

1.9 FINANCIAL ACCOUNTING

Accounting is often referred to as the language of the business. Financial accounting is concerned with recording of day to day transactions.

Definition

American Institute of certified Public Accountants has defined the Accounting as the art of recording, classifying and summarizing in a significant manner and in terms of monetary transactions and events which in part, at least of financial character and interpreting the results thereof.

Two principal statements of financial accounting are income and expenditure statement (Profit and Loss Account) and balance sheet. The profit and loss account reveals the profit earned or loss sustained for a given period i.e., for a year. All revenue transactions are included in this statement with a view to determine the profitability of the business concern. Balance Sheet reveals the financial position for the business concern on a particular date.

1.16 JOURNAL

Journal means a day book or daily record. It is the book wherein all the transactions are first recorded in chronological order. It is a book of prime, original or first entry, as all business transactions are first recorded in the journal. From journal the posting are made in the ledger. Journal is only subsidiary book i.e., a book which is sub-ordinate to the ledger.

Which is the principal book of accounts ? The journal analyses the various transactions into their debits and credits so that they could be easily posted to the ledger accounts. In other words journal is helpful in the preparation of accounts in the ledger. The process of recording transactions in journal is termed as 'Journalizing'.

The journal is ruled as follows :

Journal

Date	Particulars	L.F.	Debit Amount Rs.	Credit Amount Rs.
Year				
Month Day	Name of A/c (To be debited) Dr.		xxx	
	To Name of A/c (To be credited)			xxx
	(Narration or explanation)			

Column (1) : Date. The date on which the transaction took place in entered in this column. The year is written on the top, then the date column is divided in two parts, the first is divided into two parts, the first part is used for writing the month and the second part is used for writing the date.

Column (2) : Particulars. In the first line, the name of the account to be debited is written. The word 'Dr' (Debit) is written at the end of the First line. In the second line some space is left and the word 'To' is written before the name of the account to be credited. Then the name of the account to be credited is written. A brief explanation, usually beginning with the word. 'Being' or 'For' is written called 'narration'.

The 'narration' explains the reason for debiting and crediting the particular accounts and helps one to understand the nature and purpose of the Journal entry at a future date. To separate one entry from another, a line is drawn below every entry to cover particulars column only. The line does not extend to other columns.

Column (3) : L.F. The L.F. stand for "Ledger Folio" in this column the page numbers on which the various accounts appear in the Ledger are entered.

Column (4) : Debit Amount. In this column the amount to be debited against the debit account is written.

Column (5) : Credit Amount. In this column the amount to be credited against the credit account is written.

Advantages of Journal

1) It provides date wise record for all business transactions.
2) It provides an explanation of the transactions.
3) It shows all the necessary information regarding a transaction.
4) It helps to locate and prevent errors.

1.17 LEDGER

A number of transactions take place daily in a business. All these transactions are recorded in the journal in a chronological order. Transactions relating to particular account may take place in different dates and hence they are entered in different pages of the journal. By referring to the journal, it will not be possible to find out the position relating to any particular account on given date. To overcome this, necessity arises, for classifying the various transactions relating to a particular account to one place. This is done by posting them into ledger.

Ledger is a book which contains various accounts. Ledger is a set of accounts. It contains all accounts of the business whether Real, Nominal or Personal. With the help of ledger the trader can ascertain the true position of any account on any date. Ledger contains classified summary of the transactions which are recorded in the journal.

Ledger is the principal books of accounts where similar transactions relating to a particular person or thing are recorded. It helps the trader to achieve the objects of book-keeping.

Posting

The process of entering in the ledger accounts, the entries made in the journal is called posting. It means transferring the debit and credit items from the journal to their respective accounts in the ledger.

It should be remembered that the exact names of accounts used in the journal should be carried to ledger. Since all the transactions are appeared in the classified form in the ledger one can very easily find out the position of any account at any time from the ledger.

Personal accounts will reveal the amounts that the business man owes or has to pay his creditors and amounts he has to recover from his debtors. Real accounts reveal his assets. The nominal accounts will reveal the sources of his income and expenditure incurred by him to run the business.

Steps in Ledger Posting

1. **Date Column :** The date of the transaction as noted in Journal is recorded in the date column.

2. **Particulars column :** Every entry on the debit side of this column must begin with the word "to" and on credit side with the word "By"

   i) On the debit side of the account after the word "To" write "Name of the credit part of the journal entry."

relating to any particular account on given date. To overcome this, necessity arises, for classifying the various transactions relating to a particular account to one place. This is done by posting them into ledger.

Ledger is a book which contains various accounts. Ledger is a set of accounts. It contains all accounts of the business whether Real, Nominal or Personal. With the help of ledger the trader can ascertain the true position of any account on any date. Ledger contains classified summary of the transactions which are recorded in the journal.

Ledger is the principal books of accounts where similar transactions relating to a particular person or thing are recorded. It helps the trader to achieve the objects of book-keeping.

1.18 DISTINGUISH BETWEEN JOURNAL AND LEDGER

1. The journal is a book of original (i.e., first) entry whereas the ledger is the book of second entry. In otherwords, transactions recorded in the journal have to be further processed by doing posting from the journal to the ledger.
2. In the journal, transactions are recorded in the chronological order as and when they occur whereas the ledger is a book for analytical record. Transactions pertaining to a particular account appear at one place. For example, there may be twenty transactions relating to Trade Expenses Account scattered at different places in the journal in order of their sequence of occurrence. These transactions will appear in Trade Expenses Account in the ledger at one place.
3. In case of disputes, the journal as a book of source entry has greater weight as legal evidence than the ledger. However, for accounting purposes, ledger is the main source of information.
4. The journal is a subsidiary book which helps in the preparation of the principal book of account (i.e., ledger).
5. The unit of classification of data in the journal is the transaction whereas the unit of classification of data in the ledger is the account.
6. The process of recording financial transactions in the journal is called journalising whereas the process of recording transactions in the ledger is known as posting.

1.19 TRIAL BALANCE

After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the Trial Balance. It may also be prepared by listing each and every account and entering in separate columns the totals of the debit and credit sides. Whichever way it is prepared, the totals of the two columns should agree. An agreement indicates reasonable accuracy of the accounting work; if the two sides do not agree, then there is simply an arithmetic error(s).

This follows from the fact that under the double entry system, the amount written on the debit side of various accounts is always equal to the amounts entered on the credit side of other accounts and vice versa. Hence the totals of the debit sides must be equal to the totals of the credit side. Also, total of the debit balances will be equal to the total of the credit balances.

Once this agreement is established, there is a reasonable confidence that the accounting work is free from clerical errors, though is not proof of cent percent accuracy, because some errors of principles and compensating errors may still remain.

Generally, to check the arithmetic accuracy of accounts, trial balance is prepared at monthly intervals. But because double entry system is followed, one can prepare a trial balance at anytime. Though a trial balance can be prepared anytime, but it is preferable to prepare it at the end of the accounting year to ensure the arithmetic accuracy of all the accounts before the preparation of the financial statements. It may be noted that trial balance is a statement and not an account.

1.19.1 Objectives of Trial Balance

The preparation of trial balance has the following objectives :

1) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors.

2) Financial statements are normally prepared on the basic of agreed trial balance; otherwise the work may be cumbersome. Preparation of financial statements therefore is the second objective.

3) The trial balance serves as a summary of what is contained in the ledger; the ledger may have to be seen only when details are required in respect of an account.

The form of the trial balance is simple and as shown below :

Trial Balance as at ....

S.No.	Ledger	Account	L.F.	Dr. Amount (Total or Balance) Rs.	Cr. Amount (Total or Balance) Rs.

Some important points to be noted are as follows :

1) A trial balance is prepared as on a particular date which should be mentioned at the top.

2) In the second column the name of the account is written.

3) In the fourth column the total of the debit side of the account concerned or the debit balance, if any is entered.

4) In the next column, the total of the credit side or the credit balance is written.

5) The two columns are totaled at the end.

Limitations of Trial Balance

Errors cannot be found

One should note that the agreement of trial balance is not a conclusive proof of accuracy. In spite of the agreement of the trial balance some errors may remain. These may be of the following types :

1) Transaction has not been entered at all in the journal.

2) Wrong amount has been written in both column of the journal.

3) A wrong amount has been mentioned in the journal.

4) An entry has not at all been posted in the ledger.

5) Entry is posted twice in the ledger.

1.22 TRADING ACCOUNT

Preparation of Trading Account is the first stage in the Final Accounts. Trading Account is prepared by the trader for ascertaining the gross profit or gross loss. This account is prepared to find out the difference between the actual cost of the goods sold and the sale proceeds. It shows the profit or loss made by purchase and sale of goods without taking into account all the items of business expenditure such as general distributive and administrative expenses. Therefore, in the trading account it is necessary to include all items of charge directly affecting the cost of goods sold.

Gross Profit is said is be made when the sale proceeds exceed the cost of goods sold. When sale Proceeds are less than the cost of the goods sold, gross loss to incurred. The following is the usual form of a Trading Account.

Trading Account of --- for the year ending ----

Dr.			Cr.		
To Opening stock		xxx	By Sales	xxx	
" Purchases	xxx		Less : Returns	xxx	xxx
Less : Returns	xxx	xxx			
" Wages		xxx	" Goods destroyed in fire		xxx
" Carriage inwards		xxx	" Closing Stock		xxx
" Freight		xxx			
" Duty and clearing charges		xxx			
" Marine insurance		xxx			
" Dock expenses		xxx			
" Gross profit c/d		xxx			
		xxx			xxx

Note :

- When credit side of the Trading Account is more than the debit side, the difference represents Gross Profit.
- When the debit side of the Trading Account is more than the credit side, the difference represents Gross Loss.
- Expenses relating to the trading period should be taken into consideration.

1.24 PROFIT & LOSS ACCOUNT

In financial statement

Trading Account is prepared to ascertain the gross profit or gross loss made by the Trader for any given period. The next step in the preparation of Final Accounts is to prepare a Profit and Loss Account. The main object of the profit and loss account is to know the net profit or net loss made by the business for a particular period.

The Trading Account is closed by transferring the gross profit or gross loss to the Profit and Loss Account. Therefore the Profit and Loss Account strats with gross profit on the credit side or with gross loss on the debit side as the case may be.

The profit and loss account is credited with the gains and incomes whether actually received or yet to be received relating to the business and belonging to the period such as discount received, commission received, interest received, rent received etc. It is debited with all expenses (whether paid or yet to be paid) incidental to carry on the business such as office salaries, printing and stationery, postage, advertising, insurance etc. All nominal accounts balances with the exception of those in the Trading Account should be transferred to Profit and Loss Account.

Thus, the net profit is the surplus remaining after charging against gross profit, all the expenses, including depreciation and other provisions properly attributable to the normal activities of the particular business. The following are usual expenses that are charged to profit and loss account namely.

a) Administrative expenses (also called as office expenses or Management expenses)

b) Selling and Distribution expenses

c) Financial expenses

d) Maintenance and depreciation expenses

The expenses come under each head is given in the specimen form of Profit and Loss Account. The following is the specimen form of a Profit and Loss Account.

Profit and Loss Account ..... for period ending .....

Dr.	Rs.			Cr. Rs.
To Administrative expenses	xxx	By	Gross Profit b/d	xxx
Office Salaries	xxx	"	Discount Received	xxx
Office Rent, Rates and Tades	xxx	"	Commission received	xxx
Office lighting	xxx	"	Interest received	xxx
Office insurance	xxx	"	Rent received	xxx
Printing & Stationery	xxx	"	Dividends	xxx
Postage and Telegrams	xxx	"	Income from investments	xxx
Legal expenses	xxx	"	Reserve for discount on Creditors	xxx
Audit fee	xxx	"	Bad Debts recovered	xxx
General expenses	xxx	"	Apprentice premium	xxx
Repairs & renewals	xxx	"	Profit on sales of asset	xxx
Bank charges & commission	xxx	"	Sundry incomes	xxx
		"	Net loss	xxx
To Selling and Distribution expenses :				
Godown Rent & Insurance	xxx			
Packing expenses	xxx			
Advertising	xxx			
Agents Commission	xxx			
Bad debts	xxx			
Travelling expenses	xxx			
Discount allowed	xxx			
Brokerage	xxx			

Free samples	xxx
Trade expenses	xxx
Salesmen salaries	xxx
Carriage outward	xxx
Delivery Van expenses	xxx
Packing expenses	xxx
To Financial expenses	
Discount allowed	xxx
Interest on capital	xxx
Interest on loans	xxx
To Maintenance and depreciation	
Repairs to Building	xxx
Repairs to Furniture	xxx
Repairs to Machinery	xxx
Depreciation on various Assets, such as Buildings, Machinery Furniture etc.	xxx
To Provisions :	
Provision of Reserve for any other expenses	xxx
To Net Profit (transferred to capital Account)	xxx
	xxx

xxx

Note :

- If the Credit side total of the Profit and Loss Account is more than debit side total, the difference is said to be Net Profit.
- If the Debit side total of the Profit and Loss Account in more than the Credit side total, the difference is said to be Net Loss.
- The Net Profit or Net Loss should be transferred to Capital Account, Net Profit increase the Capital while Net Loss decreases it.

1.25 BALANCE SHEET

The Trading Account provides the information regarding the Gross Profit or Gross Loss during the accounting period. Similarly, the Profit and Loss Account provides the information regarding Profit or Loss made by a businessman during the accounting period. But this is not at all that a businessman wants. What he wants is his financial position on the closing date of the accounting period. He wishes to know whether his capital increase or decreased since the beginning of the period and various Assets and Liabilities he has on the closing date of the business period.

Purpose

For obtaining this information he prepares a statement of his assets and liabilities, know as the Balance Sheet. Thus, a Balance Sheet is prepared to know the financial position of the business and the capital of the trader on a particular date. The Balance Sheet shows that what a business owns and what is owes to others on a particular date. We can say that Balance Sheet is a snap shot of the financial conditions of the business.

A Balance Sheet is defined as a statement prepared with a view to measure the exact financial position of a business on a certain fixed ~~are.~~ date

It is also defined as a statement prepared with an aim to know the exact financial position of the business on the last date of the financial year.

The Trial Balance and the adjustments given provides the necessary information for preparing the Balance Sheet. The Nominal Accounts shown in the Trial Balance are transferred to the Trading Account or Profit and Loss Account. The remaining balances represent either assets or liabilities. These assets and Liabilities are shown in the Balance Sheet in a classified form.

A Balance Sheet has two sides - the left hand side and the right hand side. The left hand side is known as the Liabilities side and the right hand side is known as the Assets side. Since, Balance Sheet is only a statement and not an account the words 'Dr' or 'Cr' and 'To' or 'By' should not be used.

The various liabilities of the trader are shown on the liabilities side of the Balance Sheet. Similarly, the various Assets of the trader are shown on the Assets side of Balance Sheet. The excess of assets over liabilities is called as capital and is shown on the Liabilities side. The net profit is added to opening capital and there from the drawings are deducted. If there is net loss it is to be deducted from the capital. The total value of assets is always equal to the total value of the claims or liablities. In other words.

xxx	xxx

2. **Balance Sheet under Order of Performance :** Under the second method i.e., where the order of performance is followed, the Balance Sheet appears as given below.

Balance Sheet as at . . . .

Capital and Liabilities		**Rs.**	**Assets**	**Rs.**
Capital			Intangible or Invisible	
Opening Balance		xxx	Assets	
Add : Additional			Goodwill	xxx
Capital introduced		xxx	Copy rights	
Interest on capital		xxx	Trade marks	xxx
Net Profit		xxx	Patents	xxx
		xxx	Fixed Assets	
			Motor vehicles	xxx
Less : Drawings	xxx		Freehold property	xxx
Interest on			Leasehold property	xxx
Drawing	xxx		Land & Buildings	xxx

Income Tax	xxx		Plant and Machinery	xxx
Insurance	xxx		Furniture and Fittings	xxx
Premium of			*Current Assets*	
properties	xxx	xxx	Accrued Income	xxx
Reserve Fund		xxx	Unexpired expenses	xxx
Loans			Closing stock	xxx
Long term loans		xxx	Investments	xxx
Short term loans		xxx	Sundry debtors	xxx
Current Liabilities			Bills Receivable	xxx
Income received in advance	xxx		Cash at bank	xxx
Outstanding expenses		xxx	Cash in hand	xxx
Mortgage		xxx		
Bank overdraft		xxx		
Bills payable		xxx		
Sundry creditors		xxx		
		xxx		xxx

1.26 DISTINCTION BETWEEN TRIAL BALANCE AND BALANCE SHEET

The following are the differences between a Trial Balance and a Balance Sheet.

Trial Balance	Balance Sheet
1. The main purpose of preparing a Trial Balance is to check the arithmetical accuracy of the books of account.	1. The main object of the Balance Sheet is to ascertain the correct financial position of a business at a given date.
2. The Trial Balance contains all three types of accounts viz., Personal, Real and Nominal Accounts.	2. Balance Sheet contains only the balances of real and personal accounts.
3. Trial Balance does not reveal the financial position of the business.	3. Balance Sheet reveals the financial position of the Business.
4. Trial Balance does not reveal profit.	4. Balance Sheet reveals the profit.
5. The column heads of Trial Balance are date, particulars, debit and credit.	5. The column heads of the Balance Sheet are Assets and liabilities.
6. The preparation of the Trial Balance is not compulsory.	6. The preparation of Balance Sheet is compulsory.
7. Closing stock will not be shown in Trial Balance.	7. Closing stock is shown in the Balance Sheet.