
UNIT 3 BASIC ACCOUNTING PROCESS: PREPARATION OF JOURNAL, LEDGER AND TRIAL BALANCE

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3.0 INTRODUCTION

The Double Entry System was developed in the 15th century in Italy by Luca Pocioli. The Double Entry System is the basic framework of present day accounting. Every transaction has two aspects and according to this system, both the aspects are recorded. For example, if a business requires something then either it must have been given by someone or it must have been acquired by giving up something. On purchase of furniture, either the cash balance will be reduced, or a liability to the supplier will arise. This has been made clear already. The Double Entry System is so named since it records both the aspects of a transaction. This system has proved to be systematic, and has been found of great use for recording the financial affairs for all institutions requiring the use of money.

3.1 OBJECTIVES

After studying this unit, you should be able to:

- understand what is Double Entry System;
- understand how debit and credit are determined for business transactions;
- see classification of account as Personal and Impersonal accounts;
- learn the definitions of journal and ledger;
- learn the journalizing process;
- become familiar with the technique of ledger posting and how to balance an account, and
- understanding Trial Balance and the techniques to prepare it. See what is accounting cycle.

3.2 ACCOUNTING EQUATION

The whole structure of the Double Entry system is based on the Accounting Equation which explains the equal relationship between total claims and the total assets of the firm. Total claims include the claims of outsiders and of the proprietors. We can express the same as:

$$\begin{aligned}\text{Assets} &= \text{Total Claims} \\ \text{Assets} &= \text{Liabilities} + \text{Capital}\end{aligned}$$

If there is any change in the amount of assets, or of the liability, the owner's claim or the capital is bound to change correspondingly. It is totally based on Double Entry System principles.

The effect of transactions on Accounting Equation

1. Start business with Rs. 2000 as capital

Assets	=	Liabilities	+	Capital
2000	=	0	+	2000
2000	=	2000		

2. Purchase furniture for Rs. 200 cash

Assets Cash + Furniture	=	Liabilities	+	Capital
2700 + 200	=	0	+	2000
2000	=	2000		

Note: On the purchase of furniture, the cash is reduced but another asset, furniture, is increased by the same value.

3. Purchase goods for Rs. 300 on credit

Assets Cash + Furniture + Goods	=	Liabilities	+	Capital
2700 + 200 + 300	=	300	+	2000
2300	=	2300		

4. Paid Rs. 100 for rent

Assets Cash + Furniture + Goods	=	Liabilities	+	Capital
2700 + 200 + 300 -100 (Rent Paid)	=	300	+	2000 -100 (Rent)
2600 + 200 + 300	=	300	+	2900
3200	=	3200		

Note: Rent as an expense will be charged from capital, because all expenses and incomes are to be finally 'owned' by the proprietors as well as deducted from the cash, that a firm has.

5. Sold goods of Rs.300 on credit for Rs. 400

Assets Cash + Furniture + Goods+ Debtors	=	Liabilities	+	Capital
2600 + 300 + (300 - 300) + 400	=	300	+	2900 + 100
2600 + 300 + 400	=	300	+	3000
3300	=	3300		

Note: The net increase in assets (400-300 = 100) will be added to the capital as a profit.

Whatever we have done above is suitable only if the number of transactions is small. But, if the number is large, a different procedure – putting increases and decreases in different columns – will be required, and be useful for yielding significant information.

The procedure for large number is followed for a form, which is called the T form. In this form, the two sides are put together. The left-hand side is called the Debit-side and the right-hand side is called the Credit-side. It is called an account. When in an account a record is made on the debit, or left hand side, one says the one has debited that account; similarly to record an amount on the right side is to credit it.

The proper form of an account is as follows:

Dr. **Cr.**

Date	Particulars	Ref.*	Amount Rs.	Date	Particulars	Ref.*	Amount Rs.
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*Ref. indicates the sources where information about the entry is available.

To put the entries in ‘T’ form account, we have to follow some standard rules of debit and credit:

1. When there is an increase in the amount of **assets**, its account is debited; and when there is a decrease in the amount of an asset, its account is credited. For example, on the purchase of furniture, the assets have increased and the furniture account will be debited. But if cash is paid for the purchase, the asset has decreased and the cash account will be credited.
2. When there is an increase in the amount of **liability**, its account will be credited; and when there is a decrease in the amount of liability, its account will be debited. For example, if we borrow some money from “A”; A’s account will be credited. But if we pay the money back to “A”, A’s account will be debited since the liability no longer exists.
3. When there is an increase in the **owner’s capital**; the capital account will be credited, and when there is a decrease in owner’s capital, it will be debited. For example, if a proprietor introduces additional capital, the capital account will be credited. But, if the owner withdraws some money, the capital account will be debited.
4. Profit leads to an increase in the capital, and a loss leads to reduction. Since the impact of **profit or loss** can directly be seen on the capital, it is clear that the rule of capital will be applicable on profit / loss also. Profits may be directly credited, and losses may be similarly debited.

These rules can be summaries as below:

1. Increase in assets are debits; decrease in credits
2. Increase in liabilities are credits; decrease in debits
3. Increase in owner’s capital are credits; decrease in debits
4. Increase in expenses/losses are debits; decrease in credits
5. Increase in revenue/income are credits; decrease in debits.

It should be noted that an increase in assets is favourable to the firm, but an increase in expenses is not so, even though, in both cases, the increase will be recorded on the debit side. Similarly, an increase in liabilities is not favourable, but an increase in revenue is, even though both will be recorded on the credit side.

Thus the terms debit and credit should not be taken to mean, respectively, favourable and unfavourable things, they merely describes the two side of an account.

The system of recording into debits and credits is based on a very important accounting concept – the Dual Aspect Concept. As per this concept, every transaction is viewed as one that has a dual aspect, that is, one aspect of transaction has an impact on the debit side, and another on the credit side. For example, if a firm purchases machinery of Rs.20,000 for cash, this transaction has a dual aspect – one that affects the debit side of the Machinery Account (assets have increased), and another affects the credit side of the Cash Account (assets have decreased). The implication of the dual aspect concept is that the total of all debits are always equal to the total of credits.

Check Your Progress 1

1) Fill in the blanks with the words debits or credits.

- a. Decrease in liability are
- b. Increase in assets are
- c. Decrease in revenue are.....
- d. Increase in expenses are.....

2) What is the Accounting Equation? Also, explain its working.

.....
.....
.....

3) What is the Dual Aspect Concept?

.....
.....
.....

3.3 CLASSIFICATION OF ACCOUNTS

As per the accounting equation, the broad categories of the account are:

1. **Assets:** Includes all the resources which the firm has.
2. **Liabilities:** Amounts that the firm owes to outsiders.
3. **Capital:** Amounts that the firm owes to the owners and proprietor who have invested in the firm.
4. **Expenses:** Amounts that have been spent, or even lost, in carrying on operations.
5. **Incomes:** Amounts earned by the firm.

Accounts may be classified in another manner:

1. **Personal Account :** Personal accounts relate to personal, debtors, or creditors.
Example ABC & Co., Ram Account, etc.
2. **Impersonal Accounts:** Accounts that are not personal, such as Machinery account, Cash account, etc. These can be sub-divided as follows:
 - a) **Real Account :** Accounts which relate to assets of the firm, but not debt.
For example, Machinery, Furniture, etc.

- b) **Nominal Account** : Accounts, which related to expenses, losses, gains, revenue etc. like wages, salary, interest, commission etc. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are, therefore, temporary.

**Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance**

On the basis of the above, three classifications of accounts, three basic rules about recording transactions are:

1. Personal account

Debit the receiver and credit the giver

2. Real Account

Debit what comes in and credit what goes out

3. Nominal Account

Debit all expenses/losses and credit all income/gains

Hence, a Debit denotes

1. In case of a person, that s/he has received some benefit against which s/he has already rendered some service, or will render service in future. When a person becomes liable to do something in favour of the firm, the fact is recorded by debiting that person's account.
2. In case of goods or properties, that the stock and value of such goods or properties has increased; and
3. In case of other accounts like salary or rent, that the firm has enjoyed some benefit, or has lost money.

A Credit denotes

1. In the case of a person, that some benefit has been received from him, entitling him to claim from the firm, a return or a benefit in the form of cash, or goods, or services. In other words, when a person becomes entitled to money, or money's worth, for any reason, the fact is recorded by crediting him/her;
2. In the case of goods or proprieties, that the stock and value of such goods, or properties has diminished; and
3. In the case of other accounts like commission, that the firm has made a gain.

Illustration 1

1. Ram started business with Rs.10,000
2. He purchased furniture for Rs.2,000
3. Salary paid for Rs.100
4. Received interest Rs.50.

Solution as per debit/ credit rules of accounting equation

Explanation	Accounts involved	Nature of accounts	How effected	Dr.	Cr.
Rs.10,000 cash invested in business by Ram	Cash Capital	Assets Liabilities	Increased Increased	10,000	10,000
Purchased furniture for Rs. 2,000	Furniture Cash	Assets Assets	Increased Decreased	2,000	2,000
Paid Rs.100 for salary	Salary Cash	Expense Assets	Increased Decreased	100	100
Received interest Rs.50	Cash Interest	Assets Income	Increased Increased	50	50

Solution as per three basic rules of classification of accounts

Basic Accounting Process: Preparation of Journal, Ledger and Trial Balance

Explanation	Accounts involved	Classification of accounts	How effected	Dr.	Cr.
Rs.10,000 cash invested in business by Ram	Cash Capital	Real Personal	Comes in Giver	10,000	10,000
Purchased furniture for Rs.2,000	Furniture Cash	Real Real	Comes in Goes out	2,000	2,000
Paid Rs.100 for salary	Salary Cash	Nominal Real	Expenses Goes out	100	100
Received interest Rs.50	Cash Interest	Real Nominal	Comes in Income/gain	50	50

3.4 DEFINITIONS OF JOURNAL AND LEDGER

Journal : Transactions are first entered in this book to show which account should be debited, and which credited. Journal is also called primary book, as it is a book of first entry. Transactions are recorded in it in chronological order.

Ledger : Accounts are prepared on the basis of entries made in the journal. The book, that contains the accounts is called a 'ledger'. A ledger is also called secondary book, as the entries in the ledger are made subsequent to the journal.

3.4.1 The Journalising Process

Transactions are either written as they occur in the various documents, or papers, are filed, in the order in which transactions occur (chronological). On the basis of these records, first, one writes out which accounts are to be credited, and which accounts are to be debited. This is done in the Journal, the format of which is given below:

JOURNAL

Date (1)	Particulars (2)	L.F. (3)	Dr. Amount (4)	Cr. Amount (5)
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A

B

Note: The columns have been numbered for reference only.

1. In the first column, the date of the transaction is entered. The year is written at the top, then the month and in the narrow part of the column the date is entered.
2. In the second column, the name of the account to be debited is written first, and it is written close to the line marked (A). The word "Dr." is written near the line marked (B). In the next line the name of the account to be credited is written preceded by the word "To". This is written a few spaces away from the line (A). There must be an explanation of the entry and this should be recorded. This is known as narration. Narration records the facts leading to the entry and facilitates quick understanding.
3. In the third column, the number of the page in the ledger on which the account is written up is entered.

4. In the fourth column, the amounts to be debited to the various accounts concerned are entered. The amount is written in the extreme right hand side of the column.
5. In the fifth column, the amount to be credited to various accounts is entered in the extreme right hand side of the column.

**Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance**

Before one can journalise transactions, one must think from the basis of the rules, either from the five accounting equation rule, or from the three basic classification of accounts rules given above. In accordance with the rules/effects, the accounts to be debited, or credited will be determined. Then, the entry will be made in the journal as indicated above.

Illustration 2

Mohan's transactions for the month of April 05 are given below. Journalise them.

2005		Rs.
April 1	Mohan started business with cash	5000
„ 2	Deposit in the bank	500
„ 3	Furniture purchased for cash	200
„ 5	Purchased goods for cash	400
„ 8	Purchased goods from M/s Ram Narain on credit	1000
„ 16	Goods sold to M/s Ram & Co. for cash	600
„ 24	Goods sold on credit to Ramesh	300
„ 28	Received cash from Ramesh	300
„ 30	Paid Rent	100
„ 30	Paid Salary	200

In the book of Mohan
JOURNAL ENTRIES

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
2005 April 1	Cash Account Dr. To Capital Account (Being the amount invested by Mohan in the business as capital)		5000	5000
„ 2	Bank Account Dr. To Cash Account (Being the amount paid into bank)		500	500
„ 3	Furniture Account Dr. To Cash Account (Being furniture purchased for cash)		200	200
„ 5	Purchases Account Dr. To Cash Account (Being goods purchased for cash)		400	400
„ 8	Purchases Account Dr. To M/s Ram Narain (Being goods purchased for cash)		1000	1000

„	16	Cash Account Dr. To Sales Account (Being goods sold for cash)	600	600
„	24	Ramesh Dr. To Sales Account (Being goods sold to Ramesh on credit)	300	300
„	28	Cash Account Dr. To Ramesh (Being cash received from Ramesh)	300	300
„	30	*Rent Account Dr. *Salary Account Dr. To Cash Account (Being Rent and salary paid)	100 200	300

**Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance**

* When transactions of similar nature take place on the same date, they may be combined while they are journalized.

Detailed discussion of the above solution:

April 1: Mohan started business with Rs.5,000

Firm received cash Rs.5,000 – Assets increases – Debited

Firm owes Rs.5,000 to proprietor – Capital increases – Credited

April 2: Rs.500 is deposited in the bank

Bank balance increased – Assets increased – Debited

Cash balance reduced – Assets decreased – Credited

April 3: Furniture is purchased for cash Rs.200

Furniture purchased – Assets increased – debited

Cash paid – Assets decreased – Credited

April 5: Purchased goods for cash Rs.400

Goods purchased – Assets increased – debited

Cash paid – Assets decreased – Credited

April 8: Purchased goods on credit for Rs.1,000 from M/s Ram Narain

Goods purchased – Assets increased – debited

Firm owes Rs.1,000 to M/s. Ram Narain – Liability increases – Credited

April 16: Goods sold to M/s. Ram & Co. for cash

Cash received – Assets increased – Debited

Sale to merchandise is revenue item so it is to be Credited or

On Sale stock decreases – assets decreases - Credited

April 24: Sold goods to Ramesh on credit for Rs.300

Ramesh owes – Assets increases – Debited

Sale to merchandise is revenue item so it is to be Credited or

On Sale stock decreases – assets decreases - Credited

April 28: Received cash from Ramesh Rs.300

Amount of cash increases- Assets increases – Debited

Ramesh is no longer owes to firm – Assets decreases – Credited

April 30: Paid rent and salary

Services enjoyed – Expenses increases – Debited

Cash decreased – Assets decreased – Credited

3.4.2 Ledger Posting

Basic Accounting Process: Preparation of Journal, Ledger and Trial Balance

The ledger is the most important book of accounts. It is the principal book of accounts and contains all the information regarding business. It is very difficult to prepare a final account in the absence of the ledger. The ledger provides the necessary information regarding various accounts. The personal account in the ledger shows how much money the firm owes to debtors, and how much money creditors owe to the firm. The real account shows the value of asset and the value of stock. Nominal accounts reflect the sources of income, and amount spent on various items.

Till now, with the help of journal entries, we are able to ascertain how the accounts are to be debited and credited and also the amounts involved. Through ledger posting we will learn how to prepare a summarized and classified form of all the accounts.

Consider the following entry

April 8	Furniture Account	Dr.	500	
	To ABC Furniture & Co.			500

From the above journal entry, we will prepare two ledger accounts: the Furniture Account, and the ABC Furniture & Co.

While posting entries from journal to ledger, we have to remember the following:

- Nowhere in a given account, will the name of that account will appear. For example, if we are in a journal entry, then its ledger account will be credited with the name of the debited account of journal entry.

Using the above rules, the posting of the given journal entry into the furniture account is done as follows:

Dr.	FURNITURE ACCOUNT				Cr.
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Date	Particulars	Amount	Date	Particulars	Amount
2005 April 8	To ABC Furniture & Co	500			

Since the furniture account is debited in the journal entry, the furniture account is debited, but by writing the name of ABC Furniture & Co. , appearing as credit item in journal entry. This ledger posting will be read as – The Furniture Account is debited by ABC Furniture & Co. just, as ABC Furniture & Co. Account is credited in the journal entry, the same will find an entry in its ledger account on credit side but with the name of Furniture Account; and it is shown below:

Dr.	ABC FURNITURE & Co.				Cr.
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Date	Particulars	Amount	Date	Particulars	Amount
			2005 April 8	By Furniture Account	500

The above ledger posting will be read as: The ABC Furniture & Co. is credited by Furniture account.

The transactions, which have been journalized in illustration 2, are posted below.

**Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance**

Dr. **CASH ACCOUNT** Cr.

Date	Particulars	Amt.	Date	Particulars	Amt.
2005			2005		
April 1	To Mohan's Capital a/c	5000	April 2	By Bank Account	500
„ 16	To Sales Account	600	„ 3	By Furniture Account	200
„ 28	To Ramesh Account	300	„ 5	By Purchase Account	400
			„ 30	By Rent Account	100
			„ 30	By Salary Account	200
			„ 30	By Balance c/d	4500
		900			5900
May 1	To Balance b/d	4500			

Dr. **CAPITAL ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
			2005		
			April 1	By Cash Account	5,000

Dr. **BANK ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2005			2005		
April 2	To Cash Account	500	April 30	By Balance c/d	500
May 1		500			500
	To Balance b/d	500			

Dr. **PURCHASE ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2005					
April 5	To Cash Account	400			
April 8	To M/s Ram Narain	1,000			

Dr. **SALES ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
			2005		
			April 16	By Cash Account	600
			April 24	By Ramesh	300

Dr. **FURNITURE ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2005			2005		
April 3	To Cash Account	200	April 30	By Balance c/d	200
May 1		200			200
	To Balance b/d	200			

Dr. M/S RAM NARAIN Cr.

**Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance**

Date	Particulars	Amount	Date	Particulars	Amount
April 30	To Balance c/d	1,000	2005 April 8	By Purchase Account	1,000
1,000					
1,000			May 1	By Balance b/d	1,000

Dr. RAMESH Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2005 April 24	To Sales Account	<u>300</u> 300	2005 April 28	By Cash Account	<u>300</u> 300

Dr. RENT ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2005 April 30	To Cash Account	100			

Dr. SALARY ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2005 April 30	To Cash Account	200			

3.4.3 Balancing an Account

At the end of the each month, or year, or any particular day it may be necessary to ascertain the balance in an account. The difference between the total of two sides is said to be balancing figure. For instance, if the total of the debit side is Rs.1,000, and the total of credit is Rs.850, then the balancing figure is Rs.150 only. As the total of the debit side is greater than the total of credit side, the balancing figure is called the debit balance. The debit balance is written on the credit side as “By Balance C/d”. C/d means carried down. By doing this, the two side will be balance. Then, this balance is written on the debit side as “To Balance B/d” (i.e., brought down). This is the opening balance for the new period. The similar, but reverse procedure is applied for credit balance. It should be noted that Nominal Accounts (such as rent, salary, etc.) are not balanced. The balance at the end of the accounting year are transferred to the profit and loss account. Only Personal and Real Accounts show balances.

Check Your Progress 2

- 1) Differentiate Between Real, Personal and Nominal Account.
- 2) Identify Personal, Real and Nominal Accounts.
 - a. Cash Account
 - b. Sales Account
 - c. Capital Account
 - d. Purchase Account
 - e. Discount Account

3) Give the narration of the following journal entries

- a. Salary A/c Dr
 To Cash A/c
- b. Ram A/c Dr
 To Cash A/c
 To Discount A/c
- c. Purchase A/c Dr
 To Anil
- d. Cash A/c Dr
 To Capital A/c
- e. Machinery A/ c Dr.
 To Cash A/c

4) Record the following transactions in general journal and post them to ledger.

- a. Commenced business with cash of Rs.50,000
- b. Purchased goods for cash Rs.16,000.
- c. Paid rent for the month, Rs.2,000.
- d. Purchased equipments for cash, Rs.6,000.
- e. Paid miscellaneous expenses, Rs.2,600.
- f. Paid creditors, Rs. 11,000.
- g. Received Rs. 4,200 as commission.
- h. Received from cash sales, Rs.12,000.

5) On April 1, 2005, Sanjeev established an enterprise under the name DP Sons. Transactions completed during the months were as follows:

- a. Started business with cash Rs.60,000.
- b. Opened a business bank account with a deposit of Rs.20,000.
- c. Purchased sundry equipment for Rs.22,000, paying cash of Rs.15,000, and the balance on account.
- d. Purchased supplies for the office for cash, Rs.1,500.
- e. Paid creditors on account, Rs.3,000.
- f. Paid office rent for the month, Rs.1,150.
- g. Earned commission (in cash), Rs.9,000.
- h. Paid miscellaneous expenses, Rs.25.
- i. Withdrew cash Rs.2,700 from bank.

You are required to give entries in the general journal, and post them to ledger.

3.5 TRIAL BALANCE

A statement which is prepared to show the debit balances and credit balances separately for each account is known as the Trial Balance. It is prepared after posting the accounts in the ledger, and the balance of each account has been found. It is prepared by listing each and every account, and entering their balances into separate columns of the debit and credit. The totals of the debit and credit columns of a trial balance must be equal. An equality indicates that the trial balance does not contain an arithmetical error. 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 total of the debit side must be equal to the total of credit side. Also, the total of the debit side balances will be equal to the total of the credit side balances. Once this agreement is established, there is reasonable confidence that the accounting work is free from arithmetical errors, though it is not proof of cent per cent accuracy, because some other error (such as principle and compensating errors) may still remain.

3.6 OBJECTIVES OF PREPARING TRIAL BALANCE

1. The 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 basis of agreed trial balance, otherwise the work may be cumbersome.
3. The trial balance serves as a summary of what is contained in the ledger.
4. Trial balance helps in locating errors in book-keeping work.

The Ruling of Trial Balance is given below:

TRIAL BALANCE

As at.....

S.No.	Name of Account	L.F.	Dr. Amount (Total /Balance)	Cr. Amount (Total /Balance)
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3.6.1 The Total Method of Preparing the Trial Balance

In this, the total of each side of the account is entered respectively in the debit and credit columns of the Trial Balance. This is known as the Gross Trial Balance.

TRIAL BALANCE

As at April 30, 2004

S.No.	Name of Account	L.F.	Dr. Amount (Total)	Cr. Amount (Total)
1.	Cash Account		5900	
2.	Capital Account			1400
3.	Bank Account		500	5000
4.	Purchase Account		1400	
5.	Sales Account			900
6.	Furniture Account		200	
7.	M/s Ram Narain Account			1000
8.	Ramesh Account		300	300
9.	Rent Account		100	
10.	Salary Account		200	
			8600	8600

3.6.2 The Balance Method of Preparing the Trial Balance

In this, balances are entered separately in the debit and credit columns of the Trial Balance. This is known as the Net Trial Balance.

TRIAL BALANCE
As at April 30, 2004

Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance

S.No.	Name of Account	L.F.	Dr. Amount (Balance)	Cr. Amount (Balance)
1.	Cash Account		4500	5000
2.	Capital Account			
3.	Bank Account		500	
4.	Purchase Account		1400	900
5.	Sales Account			
6.	Furniture Account		200	1000
7.	M/s Ram Narain Account			
9.	Rent Account		100	
10.	Salary Account		200	
			6900	6900

3.6.3 The Limitations of Trial Balance

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

1. The transactions has not been entered at all in the journal.
2. An incorrect amount has been written in both column of the journal.
3. An incorrect account has been mentioned in the journal.
4. An entry has not been completely posted in the ledger.
5. Entry is posted twice in the ledger.

3.7 THE ACCOUNTING CYCLE

The accounting cycle is the sequence of procedures used to keep track of what has happened in the business, and to report the financial effect of those things. The following is a depiction of the steps in the accounting cycle, which helps an organization in maintaining their information system, and a description of each.

1. **Transaction:** Basically, a transaction is doing business. A financial transaction which is the kind of transaction we are interested in here, is doing something in a business that involves the exchange of money.
2. **Business paper, or computer record:** Usually, the accounting department is not where the transaction takes place. It is necessary that a paper, or computer record be prepared at the point of sale so that the accounting department is aware that a transaction has occurred.
3. **Analyze:** When personnel in accounting get a business paper, it is necessary to determine:
 - a. What happened?
 - b. What accounts will change?
 - c. How will they change?
 - d. Do they get a debit or credit?
4. **Journalize:** The journal that we will be discussing is called the general journal. Journals are also, called the 'book of original entry'.
5. **Post and Balance:** Posting is the act of transferring the information in the journal to the appropriate accounts. Balancing is adding the increase to, and subtracting the decrease from the previous balance in an account.

6. **Trial balance:** Trial balance is a list of all the accounts and their balance where the total of Debit side should be equal to the total of Credit side.
7. **Adjustments:** Adjusting entries are made at the end of a period to ensure that revenues are reported when earned, and expenses reported when incurred.
8. **Adjusted Trial Balance:** A trial balance after all adjustments have been analyzed, journalized, posted, and the affected accounts balanced.
9. **Close:** Closing an account means to 'bring the balance to zero'.
10. **Prepare Financial Statements:** Financial statements used to report the final position and results from operating a business. They are the balance sheet, the owner's equity statement, the income settlement, and the cash flow.

Similar to information technology process (input – process – output), the accounting cycle accepts data input- monetary transactions– which is processed according to pre-defined accounting principals, and the output is in the form of final accounts.



Check Your Progress 3

- 1) From the following transactions of M/s Divya Sharma & Co., write up the journal in proper form, post the ledger, and take out a trial balance.

2004		Rs.
April 1	Started business with cash	1000
„ 2	Deposit in the bank	50
„ 3	Furniture purchased for cash	20
„ 5	Purchased goods for cash	40
„ 7	Old furniture sold for cash	80
„ 8	Purchased goods from M/s Sanjeev Tomar on credit	100
„ 9	Received cheque of money due to M/s Sanjeev Tomar	
„ 12	Deposited the cheque into bank	
„ 15	Paid taxes in cash	50
„ 16	Goods sold to M/s Ram & Co. for cash	560
„ 24	Goods sold on credit to Ramesh	210
„ 28	Received cash from Ramesh	310
„ 30	Bank interest credited	70
„ 30	Paid Rent	150
„ 30	Paid Salary	150

- 2) What is trial balance? What are the objectives of preparing it?
- 3) Point out the **errors** disclosed by trial balance:
 - a) An item omitted from subsidiary records.
 - b) An error in balancing an account
 - c) Correct amount posted to correct account.
 - d) An error in carry forward of a total of one page to another page.
- 4) Prepare the trial balance for question numbers 4 and 5 (Check Your Progress 2).

3.8 KEY WORDS

Accounting Equation explains the equal relationship between total claims, and total assets of the firm.

Double Entry System: Every transaction has two aspects and according to this system, both the aspects are recorded.

Journal: Transactions are first entered in this book to show which account should be debited, and which one should be credited. The journal is also called a subsidiary book.

Ledger: Accounts are prepared on the basis of entries made in the journal. The book, that contains the accounts is called a 'ledger'. The ledger is also called the principal book.

Total Claims = Liabilities + Capital

"T" Form Account: Two sides are put together, and the left-hand side is called the "Debit-side", while the right-hand side is called the 'Credit-side'.

Trial Balance is a statement which is prepared to show the debit and credit balances separately.

3.9 SUMMARY

The basic unit accounting procedure is a combination of various subunits. Double entry accounting system is a scientific system for recording transactions in which each transaction has its two effects—debit and credit. By this process the total of debit becomes equal to the total of credit. As per the accounting equation, transactions are: journalized on the basis of five elements (assets, liabilities, capital, expenses (loans), and revenue (profit)). Further, the accounts are classified by real and nominal account. Trial balance is prepared just to check the arithmetical accuracy of all the ledger accounts. It is drawn by taking the balances of all ledger accounts periodically, or at the end of the accounting period. In the accounting cycle, how transactions and events are recorded and processed to get final result is explained.

3.10 SOLUTIONS / ANSWERS

Check Your Progress 1

- 1) a) Dr. b) Dr. c) Dr. d) Dr.
- 2) Assets = capital + liabilities
- 3) Every transaction has two aspects—The first is the debit and the other credit.

Check Your Progress 2

- 1) Real accounts relate to assets of the firm where personal accounts relate to persons dealing with the firm, and nominal accounts related to expense, losses, gains and revenue etc.
- 2) a) Real b) Real c) Personal d) Real e) Nominal

- 3) a) Being salary paid in cash
- b) Being payment made to Ram and discount allowed.
- c) Being goods purchased on credit
- d) Being the capital invested in cash
- e) Being machinery purchased for cash.

**Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance**

4)

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
	Cash Account Dr. To Capital Account (Being the amount invested by Mohan in the business as capital)		50,000	50,000
	Purchase Account Dr. To Cash Account (Being goods purchased for cash)		16,000	16,000
	Rent Account Dr. To Cash Account (Being Rent paid for cash)		2,000	2,000
	Equipment Account Dr. To Cash Account (Being equipment purchased for cash)		6,000	6,000
	Miscellaneous Expenses Account Dr. To Cash (Being Expenses paid for cash)		2,600	2,600
	Creditors Account Dr. To Cash Account (Being creditors paid on account)		11,000	11,000
	Cash Account Dr. To Commission Account (Being Commission received)		1,200	1,200
	Cash Account Dr. To Sales account (Being cash received from sales)		12,000	12,000

Dr. **CASH ACCOUNT** Cr.

Date	Particulars	Amt.	Date	Particulars	Amt.
2005			2005		
April 1	To Capital Account	50000	April 2	By Equipment	6000
„ 16	To Commission Account	1200	„ 3	Account	2600
„ 28	To Sales Account	12000	„ 5	By Misc.exp.	16000
			„ 30	Account	2000
			„ 30	By Purchase	11000
			„ 30	Account	25600
				By Rent Account	
		63200		By Creditors	63200
May 1	To Balance b/d	25600		Account	
				By Balance c/d	

Dr. **CAPITAL ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	50,000		By Cash Account	50,000
				By Balance b/d	50,000

Dr. **MISC. EXPENSES ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2005					
	To Cash Account	2600		By Balance c/d	2600
		2600			2600
	To Balance b/d	2600			

Dr. **PURCHASE ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Cash Account	16000		By Balance c/d	16000
	To Balance b/d	16000			

Dr. **SALES ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	12000		By Cash Account	12000
				By Balance b/d	12000

Dr. **EQUIPMENT ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Cash Account	6000		By Balance c/d	6000
		6000			6000
	To Balance b/d	6000			

Dr. **COMMISSION ACCOUNT** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	1200		By Cash Account	1200
				By Balance b/d	1200

Dr. CREDITORS ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Cash Account	11000		By Balance c/d	11000
	To Balance b/d	11000			

**Basic Accounting Process:
Preparation of Journal,
Ledger and Trial Balance**

Dr. RENT ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Cash Account	2000		By Balance c/d	2000
	To Balance b/d	2000			

5) (Similar to Question no. 4).

Check Your Progress 3

- 1) Similar to Question no.4 (Ref. Check Your Progress 2).
- 2) The Trial Balance is a list of all the accounts and their balance.
- 3) a) True b) True c) False d) True.
- 4) TRIAL BALANCE
As at April 30, 2004

S.No.	Name of Account	L.F.	Dr. Amount	Cr. Amount
1.	Cash Account		(Total) 25600	(Total) 50000
2.	Capital Account			
3.	Misc. exp.		2600	
4.	Purchase Account		16000	
5.	Sales Account			12000
6.	Equipment Account		6000	
7.	Commission Account			1200
8.	Creditors Account		11000	
9.	Rent account		2000	
			63200	63200

3.11 FURTHER READINGS

Financial Accounting, Dr. R.K. Sharma and Dr. R.S. Popli, Kitab Mahal, 2005.

Basic Financial Accounting, J.R. Monga, Girish Ahuja, Mayur Paperbacks, 2001.