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CHAPTER 1

Accounting Principles and Concepts

Meaning and Scope of Accounting

Accounting is the language of business. The main objectives of Accounting is to safeguard the interests of the business, its proprietors and others connected with the business transactions. This is done by providing suitable information to the owners, creditors, shareholders, Government, financial institutions and other related agencies.

Definition of Accounting

The American Accounting Association defines accounting as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information."

According to AICPA (American Institute of Certified Public Accountants) it is defined as "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least of a financial character and interpreting the result thereof."

Steps of Accounting

The following are the important steps to be adopted in the accounting process:

(1) ***Recording:*** Recording all the transactions in subsidiary books for purpose of future record or reference. It is referred to as "Journal."

(2) ***Classifying:*** All recorded transactions in subsidiary books are classified and posted to the main book of accounts. It is known as "Ledger."

(3) ***Summarizing:*** All recorded transactions in main books will be summarized for the preparation of Trail Balance, Profit and Loss Account and Balance Sheet.

(4) ***Interpreting:*** Interpreting refers to the explanation of the meaning and significance of the result of finanal accounts and balance sheet so that parties concerned with business can determine the future earnings, ability to pay interest, liquidity and profitability of a sound dividend policy.

Functions of Accounting

From the definition and analysis of the above the main functions of accounting can be summarized as:

(1) Keeping systematic record of business transactions.

(2) Protecting properties of the business.

(3) Communicating the results to various parties interested in or connected with the business.

(4) Meeting legal requirements.

Objectives of Accounting

(1) Providing suitable information with an aim of safeguarding the interest of the business and its proprietors and others connected with it.

(2) To emphasis on the ascertainment and exhibition of profits earned or losses incurred in the business.

(3) To ascertain the financial position of the business as a whole.

(4) To ensure accounts are prepared according to some accepted accounting concepts and conventions.

(5) To comply with the requirements of the Companies Act, Income Tax Act, etc.

Definition of Bookkeeping

Bookkeeping may be defined as "the art of recording the business transactions in the books of accounts in a systematic manner." A person who is responsible for and who maintains and keeps a record of the business transactions is known as Bookkeeper. His work is primarily clerical in nature.

On the other hand, Accounting is primarily concerned with the recording, classifying, summarizing, interpreting the financial data and communicating the information disclosed by the accounting records to those persons interested in the accounting information relating to the business.

Limitations of Accounting

(1) Accounting provides only limited information because it reveals the profitability of the concern as a whole.

(2) Accounting considers only those transactions which can be measured in terms of money or quantitatively expressed. Qualitative information is not taken into account.

(3) Accounting provides limited information to the management.

(4) Accounting is only historical in nature. It provides only a post mortem record of business transactions.

Branches of Accounting

The main function of accounting is to provide the required informations for different parties who are interested in the welfare of that enterprise concerned. In order to serve the needs of management and outsiders various new branches of accounting have been developed. The following are the main branches of accounting:

(1) Financial Accounting.

(2) Cost Accounting.

(3) Management Accounting.

(1) ***Financial Accounting:*** Financial Accounting is prepared to determine profitability and financial position of a concern for a specific period of time.

(2) ***Cost Accounting:*** Cost Accounting is the formal accounting system setup for recording costs. It is a systematic procedure for determining the unit cost of output produced or service rendered.

(3) ***Management Accounting:*** Management Accounting is concerned with presentation of accounting information to the management for effective decision making and control.

Accounting Principles

Various accounting systems and techniques are designed to meet the needs of the management. The information should be recorded and presented in such a way that management is able to arrive at right conclusions. The ultimate aim of the management is to increase profitability and losses. In order to achieve the objectives of the concern as a whole, it is essential to prepare the accounting statements in accordance with the generally accepted principles and procedures.

The term principles refers to the rule of action or conduct to be applied in accounting. Accounting principles may be defined as "those rules of conduct or procedure which are adopted by the accountants universally, while recording the accounting transactions."

The accounting principles can be classified into two categories:

I. Accounting Concepts.

II. Accounting Conventions.

I. Accounting Concepts

Accounting concepts mean and include necessary assumptions or postulates or ideas which are used to accounting practice and preparation of financial statements. The following are the important accounting concepts:

(1) Entity Concept;

(2) Dual Aspect Concept;

(3) Accounting Period Concept;

(4) Going Concern Concept;

(5) Cost Concept;

(6) Money Measurement Concept;

(7) Matching Concept;

(8) Realization Concept;

(9) Accrual Concept;

(10) Rupee Value Concept.

II. Accounting Conventions

Accounting Convention implies that those customs, methods and practices to be followed as a guideline for preparation of accounting statements. The accounting conventions can be classified as follows:

(1) Convention of Disclosure.

(2) Convention of Conservatism.

(3) Convention of Consistency.

(4) Convention of Materiality.

The following table summarizes classifications of Accounting Principles:

Accounting Principles

Accounting Concept	*Accounting Conventions*
(1) Entity Concept	(1) Convention of Disclosure
(2) Dual Aspect Concept	(2) Convention of Conservatism
(3) Accounting Period Concept	(3) Convention of Consistency
(4) Going Concern Concept	(4) Convention of Materiality
(5) Cost Concept	
(6) Money Measurement Concept	
(7) Matching Concept	
(8) Realization Concept	
(9) Accrual Concept	
(10) Rupee Value Concept	

The classification of accounting concepts and conventions can be explained in the following pages.

I. Accounting Concepts

(1) Entity Concept: Separate entity concept implies that business unit or a company is a body corporate and having a separate legal entity distinct from its proprietors. The proprietors or members are not liable for the acts of the company. But in the case of the partnership business or sole trader business no separate legal entity from its proprietors. Here proprietors or members are liable for the acts of the firm. As per the separate entity concept of accounting it applies to all forms of business to determine the scope of what is to be recorded or what is to be excluded from the business books. For example, if the proprietor of the business invests Rs.50,000 in his business, it is deemed that the proprietor has given that much amount to the business as loan which will be shown as a liability for the business. On withdrawal of any amount it will be debited in cash account and credited in proprietor's capital account. In conclusion, this separate entity concept applies much larger in body corporate sectors than sole traders and partnership firms.

(2) Dual Aspect Concept: According to this concept, every business transaction involves two aspects, namely, for every receiving of benefit and, there is a corresponding giving of benefit. The dual aspect concept is the basis of the double entry book keeping. Accordingly for every debit there is an equal and corresponding credit. The accounting equation of the dual aspect concept is:

Capital + Liabilities = Assets

(or)

Assets = Equities (Capital)

The term Capital refers to funds provide by the proprietor of the business concern. On the other hand, the term liability denotes the funds provided by the creditors and debenture holders against the assets of the business. The term assets represents the resources owned by the business. For example, Mr.Thomas Starts business with cash of Rs.1,00,000 and building of Rs.5,00,000, then this fact is recorded at two places ; Assets Accounts and Capital Account. In other words, the business acquires assets of Rs.6,00,000 which is equal to the proprietor's capital in the form of cash of Rs.1,00,000 and building worth of Rs.5,00,000. The above relationship can be shown in the form of accounting equation:

Capital + Liabilities	=	Assets
Rs.1,00,000 + Rs.5,00,000	=	Rs.6,00,000

(3) Accounting Period Concept: According to this concept, income or loss of a business can be analysed and determined on the basis of suitable accounting period instead of wait for a long period, i.e., until it is liquidated. Being a business in continuous affairs for an indefinite period of time, the proprietors, the shareholders and outsiders want to know the financial position of the concern, periodically. Thus, the accounting period is normally adopted for one year. At the end of the each accounting period an income statement and balance sheet are prepared. This concept is simply intended for a periodical ascertainment and reporting the true and fair financial position of the concern as a whole.

(4) Going Concern Concept: It is otherwise known as Continue of Activity Concept. This concept assumes that business concern will continue for a long period to exit. In other words, under this assumption, the enterprise is normally viewed as a going concern and it is not likely to be liquidated in the near future. This assumption implies that while valuing the assets of the business on the basis of productivity and not on the basis of their realizable value or the present market value, at cost less depreciation till date for the purpose of balance sheet. It is useful in valuation of assets and liabilities, depreciation of fixed assets and treatment of prepaid expenses.

(5) Cost Concept: This concept is based on "Going Concern Concept." Cost Concept implies that assets acquired are recorded in the accounting books at the cost or price paid to acquire it. And this cost is the basis for subsequent accounting for the asset. For accounting purpose the market value of assets are not taken into account either for valuation or charging depreciation of such assets. Cost Concept has the advantage of bringing objectivity in the preparation and presentation of financial statements. In the absence of cost concept, figures shown in accounting records would be subjective and questionable. But due to inflationary tendencies, the preparation of financial statements on the basis of cost concept has become irrelevant for judging the true financial position of the business.

(6) Money Measurement Concept: According to this concept, accounting transactions are measured, expressed and recorded in terms of money. This concept excludes those transactions or events which cannot be expressed in terms of money. For example, factors such as the skill of the supervisor, product policies, planning, employer-employee relationship cannot be recorded in accounts in spite of their importance to the business. This makes the financial statements incomplete.

(7) Matching Concept: Matching Concept is closely related to accounting period concept. The chief aim of the business concern is to ascertain the profit periodically. To measure the profit for a particular period it is essential to match accurately the costs associated with the revenue. Thus, matching of costs and revenues related to a particular period is called as Matching Concept.

(8) Realization Concept: Realization Concept is otherwise known as Revenue Recognition Concept. According to this concept, revenue is the gross inflow of cash, receivables or other considerations arising in the course of an enterprise from the sale of goods or rendering of services from the holding of assets. If no sale takes place, no revenue is considered. However, there are certain exceptions to this concept. Examples, Hire Purchase / Sale, Contract Accounts etc.

(9) Accrual Concept: Accrual Concept is closely related to Matching Concept. According to this concept, revenue recognition depends on its realization and not accrual receipt. Likewise cost are recognized when they are incurred and not when paid. The accrual concept ensures that the profit or loss shown is on the basis of full fact relating to all expenses and incomes.

(10) Rupee Value Concept: This concept assumes that the value of rupee is constant. In fact, due to inflationary pressures, the value of rupee will be declining. Under this situations financial statements are prepared on the basis of historical costs not considering the declining value of rupee. Similarly depreciation is also charged on the basis of cost price. Thus, this concept results in underestimation of depreciation and overestimation of assets in the balance sheet and hence will not reflect the true position of the business.

II. Accounting Conventions

(1) Convention of Disclosure: The disclosure of all material information is one of the important accounting conventions. According to this conventions all accounting statements should be honestly prepared and all facts and figures must be disclosed therein. The disclosure of financial informations are required for different parties who are interested in the welfare of that enterprise. The Companies Act lays down the forms of Profit and Loss Account and Balance Sheet. Thus convention of disclosure is required to be kept as per the requirement of the Companies Act and Income Tax Act.

(2) Convention of Conservatism: This convention is closely related to the policy of playing safe. This principle is often described as "anticipate no profit, and provide for all possible losses." Thus, this convention emphasise that uncertainties and risks inherent in business transactions should be given proper consideration. For example, under this convention inventory is valued at cost price or market price whichever is lower. Similarly, bad and doubtful debts is made in the books before ascertaining the profit.

(3) Convention of Consistency: The Convention of Consistency implies that accounting policies, procedures and methods should remain unchanged for preparation of financial statements from one period to another. Under this convention alternative improved accounting policies are also equally acceptable. In order to measure the operational efficiency of a concern, this convention allows a meaningful comparison in the performance of different period.

(4) Convention of Materiality: According to Kohler's Dictionary of Accountants Materiality may be defined as "the characteristic attaching to a statement fact, or item whereby its disclosure or method of giving it expression would be likely to influence the judgment of a reasonable person." According to this convention consideration is given to all material events, insignificant details are ignored while preparing the profit and loss account and balance sheet. The evaluation and decision of material or immaterial depends upon the circumstances and lies at the discretion of the Accountant.

QUESTIONS

1. Define Accounting.
2. Explain nature and scope of accounting.
3. What are the important functions of accounting?
4. What are the objectives of accounting?
5. Define bookkeeping.
6. Briefly explain the basic accounting concept and conventions.
7. What are the important classification of accounting concepts? Explain them briefly.
8. Write short notes on :
   (a) Convention of Disclosure.
   (b) Convention of Conservatism.
   (c) Convention of Consistency.
9. What do you understand by Dual Aspect Concept?
10. Explain Going Concern Concept.
11. Write short notes on:
    (a) Cost Concept.
    (b) Money Measurement Concept.
    (c) Accounting Period Concept.
12. What are the limitations of Accounting?

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CHAPTER 2

Double Entry System of Accounting

System of Accounting

The following are the main system of accounting for recording the business transactions:

(a) Cash System of Accounting.

(b) Mercantile or Accrual System of Accounting.

(c) Mixed System of Accounting.

(a) Cash System of Accounting: Under this system, only actual cash receipts and cash payments are recorded. No credit transaction is made for a payment or receipt until cash is actually received or paid. This system usually adopted by the Government Organizations and Financial Institutions. The non-trading concerns are preparing Receipts and Payment Accounts based on the Cash Systems Accounting.

(b) Mercantile or Accrual System of Accounting: Under this system, all business transactions are recorded in the books of accounts for a particular period inclusive of cash receipts and cash payments or any amount having become due for payment or receipt. In other words, both cash transactions and credit transactions are recorded in the books of accounts.

(c) Mixed System of Accounting: This system is applicable only where a concern adopting combination of Cash System and Mercantile System. Under Mixed System of Accounting, some records are made under cash system whereas others are recorded under mercantile system.

Further, Accounting records can be prepared under any one of the following system:

1. Single Entry System.
2. Double Entry System.

(1) Single Entry System: Under this system, all transactions relating to a personal aspect are recorded in the books of accounts but leaves all impersonal transactions. Single Entry System is based on the Dual Aspect Concept and is incomplete and inaccurate.

(2) Double Entry System: This system was introduced by Iuco Pacioli, an Italian merchant during the year 1494. According to this system, every transaction has two aspects. Both the aspects are recorded in the books of accounts. Accordingly one is giving aspect and the other one is receiving aspect. Each aspect will be recorded in one account and this method of writing every transactions in two accounts is known as Double Entry System of bookkeeping. For example, Purchase of machinery for cash, in this transaction receiving machinery is one aspect is said to be an account is debited and giving cash is another aspect is said to be an account is credited with an equal amount. Thus, the basic principle of this system is that for every debit there must be a corresponding and equal credit and for every credit there must be a corresponding and equal debit.

Advantages of Double Entry System

(1) This system provides information about the concern as a whole.

(2) It is possible to evaluate the operational efficiency of the concern.

(3) This system helps to ascertain the profit or loss by preparing profit and loss account and balance sheet.

(4) Accuracy of accounting records can be verified by preparing a Trail Balance.

(5) This system helps to know the financial position of a concern for a particular period.

(6) It provides information for meeting various legal requirements.

(7) The values of assets and liabilities can be known at any time by preparing the balance sheet.

Factors Common to Every Business

In order to understanding the Double Entry System, it is essential to consider the following important factors which are common to every business.

(1) Every business has to enter into business transactions with a number of persons or firms. To record the transactions dealing with whom, accounts are opened in the name of each person or firm. Such accounts are known as Personal Accounts.

(2) Every business must necessarily have certain assets such as buildings, stocks, cash etc. for carrying on its activities. Therefore, an account of each asset is opened and such account is known as Real or Property Accounts.

(3) Every business earn incomes and gains in various sources and certain expenses and losses incurred to carry on its activities. Therefore, an account of each expense and income or gain is opened in the books. Such accounts are known as Nominal or Factious Accounts.

Types of Accounts

In order to keep a complete record of all transactions in the business the following are the important type of accounts, namely:

I. Personal Account

(a) Natural Person's Accounts.

(b) Artificial Person's Accounts.

(c) Representative Personal Accounts.

II. Impersonal Accounts

(1) *Real Accounts*

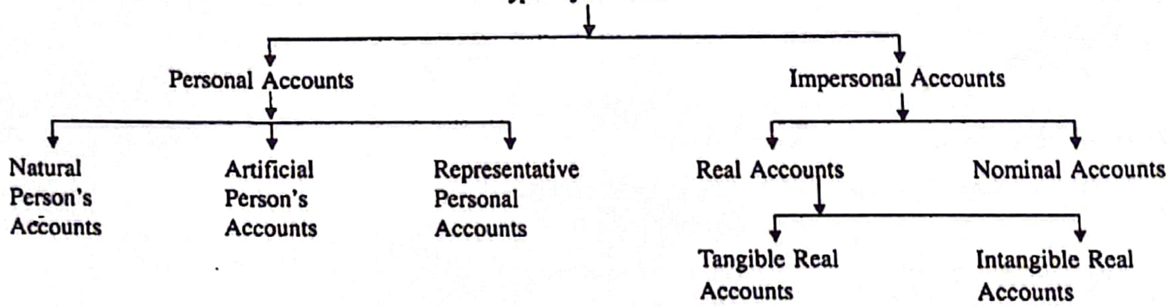
(a) Tangible Real Accounts.

(b) Intangible Real Accounts.

(2) *Nominal Accounts*

The following chart gives more explanation about the types of accounts:

Types of Accounts



I. Personal Accounts

An account recording transactions of business deals with person or firms or company is known as Personal Account. It takes the following forms:

(a) ***Natural Person's Account:*** Natural Person's Accounts are meant for recording transactions of business deals with individual persons. For example, Thomas Account, Raman's Account, Nancy Account etc.

(b) ***Artificial Persons or Legal Bodies:*** An account recording financial transaction of business deals with an artificial persons or legal bodies created by law or otherwise called an Artificial Personal Account. For example, Firm's Account, Limited Companies, Bank Account etc.

(c) ***Representative Personal Account:*** An account indirectly representing a person or persons is known as a Representative Personal Account. All accounts recording financial transactions of outstanding expenses and accrued or prepaid incomes are Representative Personal Account. For example, Salaries Outstanding Account is a personal account representing salaries payable to the staff.

II. Real Accounts (or) Property Accounts

Real Account refers to an account recording financial transactions of business connected with assets is known as Real Account or Property Accounts. The Real Accounts may be Tangible Real Account and Intangible Real Account. Tangible Real Account refers to an account relates to an asset which can be touched, felt and measured. For example, Building, Goods, Furniture, Machinery etc. On the other hand, Intangible Real Account refers to an account which relates to an asset which cannot be touched and measured physically. For example, Trade Mark, Goodwill, Patent, Copy Rights etc.

III. Nominal Account

Nominal Accounts are recording transactions of business connected with expenses, incomes, profit or losses etc. are known as Nominal Accounts. For example, Rent Account, Salaries Account, and Interest Account, etc.

Accounting Rules

According to Double Entry System of accounting every transaction of the business has two aspects. The transaction should be recorded in the books of accounts according to the two aspects. The two aspects are:

(1) Receiving Aspect otherwise known as Debit Aspect.

(2) Giving Aspect otherwise known as Credit Aspect.

Thus, every transaction involves two aspects:

(1) Debit Aspect.

(2) Credit Aspect.

There are three different rules for making entries under Double Entry System in respect of Personal Account, Real Account and Nominal Account.

(1) Personal Account:	Debit the Receiver Credit the Giver
(2) Real Account:	Debit What comes in Credit What goes out
(3) Nominal Account:	Debit all expenses and losses Credit all incomes and gains

The rule of double entry are show in the following chart:

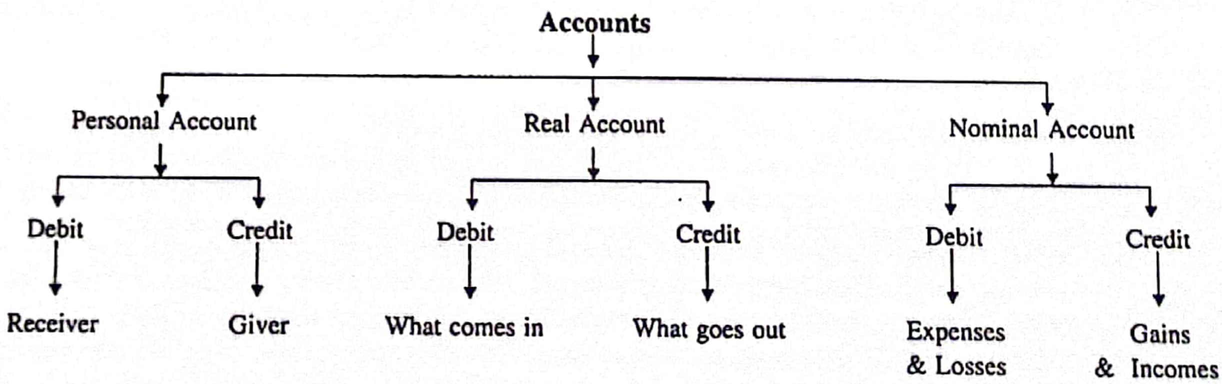


Illustration: 1

From the following transactions find out the nature of account and also state which account should be debited and which account should be credited:

(1) Salary paid
(2) Interest received
(3) Machinery purchased for cash
(4) Building sold
(5) Outstanding salary
(6) Received cash from Ramesh
(7) Proprietor introduced capital
(8) Dividend received
(9) Commission paid
(10) Furniture purchased for cash

Analysis of Transactions

Solutions:

Transactions	*Accounts Involved*	*Types of Accounts*	*Rules of Debit and Credit*
(1) Salaries	Salary A/c Cash A/c	Nominal Real	Debit all expenses and losses Credit what goes out
(2) Interest received	Cash A/c Interest A/c	Real Nominal	Debit what comes in Credit all incomes and gains
(3) Machinery Purchase	Machinery A/c Cash A/c	Real Real	Debit what comes in Credit what goes out
(4) Building Sold	Cash A/c Building A/c	Real Real	Debit what comes in Credit what goes out
(5) Outstanding Salary	Salary A/c Outstanding Salary A/c	Nominal Personal	Debit all expenses and losses Credit the giver
(6) Received cash Cash from Remesh	Cash A/c Ramesh A/c	Real Personal	Debit what comes in Credit the giver
(7) Capital introduced	Cash A/c Capital A/c	Real Personal	Debit what comes in Credit the giver
(8) Dividend received	Cash A/c Dividend A/c	Real Nominal	Debit what comes in Credit all incomes and gains
(9) Commission paid	Commission A/c Cash A/c	Nominal Real	Debit all expenses and losses Credit what goes out
(10) Furniture purchased	Furniture A/c Cash A/c	Real Real	Debit what comes in Credit what goes out

Illustration: 2

Classify the following under Personal, Real and Nominal accounts:

(1) Stock.	(2) Loan.	(3) Insurance.	(4) Salary.
(5) Interest.	(6) Bank.	(7) Cash.	(8) Capital.
(9) Prepaid Interest.	(10) Salary Outstanding.	(11) Drawing.	(12) Bank Overdraft.
(13) Salary Prepaid.	(14) Fixtures.	(15) Bills Receivable.	(16) Machinery.
(17) Building.	(18) Goodwill.		

Solution:

(1)	Stock	=	Real Account
(2)	Loan	=	Personal Account
(3)	Insurance	=	Nominal Account
(4)	Salary	=	Nominal Account
(5)	Interest	=	Nominal Account
(6)	Bank	=	Personal Account
(7)	Cash	=	Real Account
(8)	Capital	=	Personal Account
(9)	Prepaid Interest	=	Personal Account
(10)	Salary Outstanding	=	Personal Account
(11)	Drawings	=	Personal Account
(12)	Bank Overdraft	=	Personal Account

(13)	Salary Prepaid	=	Personal Account
(14)	Fixtures	=	Real Account
(15)	Bills Receivable	=	Real Account
(16)	Machinery	=	Real Account
(17)	Building	=	Real Account
(18)	Goodwill	=	Real Account

QUESTIONS

1. What are the important system of accounting?
2. What do you understand by Double Entry System?
3. Explain the advantages of Double Entry System.
4. Explain the three important types of accounts.
5. What do you understand by Accounting Rules?
6. Write short notes on:
   (a) Single Entry System
   (b) Double Entry System
   (c) Personal Accounts
   (d) Nominal Accounts
7. Classify the following under Personal Account, Real Account and Nominal Account:
   (1) Cash Account. (2) Bank Account. (3) Capital Account. (4) Drawing Account. (5) Salaries Account. (6) Rent Account (7) Inventory Account. (8) William Account. (9) Goodwill Account. (10) Commission Account.
   [Ans : Personal Account – 2, 3, 4, 8;
   Real Account – 1, 7, 9;
   Nominal Account – 5, 6, 10.]
8. Which account is to be debited and credited in the following transactions?
   (1) Cash from Ramesh
   (2) Rent paid in cash
   (3) Goods purchased by cash
   (4) Salary paid by cheque
   (5) Bought furniture from Prem on credit
   (6) Received cash from Kumar
   (7) Cash paid to Ramesh
   (8) Goods sold to Ramesh
   (9) Cash paid in to Bank
   [Ans : (1) Debit Cash A/c and Credit Ramesh's A/c (2) Debit Rent A/c and Credit Cash A/c (3) Debit Purchase A/c and Credit Cash A/c (4) Debit Salary A/c and Credit Bank A/c (5) Debit furniture A/c and Credit Prem's A/c (6) Debit Cash A/c and Credit Kumar's A/c (7) Debit Ramesh A/c and Credit Cash A/c (9) Debit Bank A/c and Credit Cash A/c]
9. What accounts should be debited and credited in the following transactions?
   (1) Goods sold for cash
   (2) Goods sold to Siva on Credit
   (3) Cash paid to Ramesh
   (4) Cash paid in to Bank
   (5) Goods purchased for cash
   (6) Goods purchased from Ram on Credit
   (7) Interest received on investment
   (8) Drew cash from bank for office use
   (9) Paid rent in cash
   (10) Discount received on sales
   (11) Received cash from Ramesh
   (12) Started business with cash
   [Ans : (1) Debit Cash A/c and Credit Sales A/c (2) Debit Siva's A/c and Credit Sales A/c (3) Debit Ramesh's A/c and Credit Cash A/c (4) Debit Bank's A/c and Credit Cash A/c (5) Debit purchase A/c and Credit Cash A/c (6) Debit purchase A/c and Credit Ram's A/c (7) Debit cash Account and Bank's A/c (9) Debit Rent A/c and Credit Cash A/c (10) Debit Cash A/c and Credit Sales A/c (11) Debit Cash A/c and Credit Ramesh's A/c (12) Debit Cash A/c and Credit Capital A/c]