Session Overview

This session covers Lesson 1 of the book, Accounting with Tally - Student Guide. It covers the fundamental need for financial accounting to prepare financial statements.

The main objective of this session is to introduce the students to the various financial accounting concepts and the double entry book-keeping system of recording and classifying financial information.

Accounting

Handling Tips

In this section, inform the students that financial accounting involves recording, classifying, and summarizing financial transactions of an organization and interpreting their results. Recording involves writing the financial transactions, soon after they occur, in an orderly and chronological manner. Classifying data related to transactions involves a systematic analysis of the recorded data so that similar items are classified under appropriate heads, such as all cash transactions being recorded in Cash account. Summarizing consists of presenting the classified data in a manner that is useful to the end-users of accounting statements such as the Profit and Loss account, which shows the profit earned or loss incurred by the business in a year. Thus, accounting involves:

- Understanding the standard accounting principles.
- Applying the accounting principles while recording all transactions.
- Classifying the recorded data under appropriate heads or accounts.
- Summarizing accounts into various accounting statements, which help the owners, managers and external users, such as investors, stock exchanges, government authorities such as income tax officials to understand the financial performance and position of the organization. At any point in time, a properly maintained record of transactions enables the owners or management of the business to understand the financial state of the organization. This record, in turn, assists the owners or the management in governing the course of the organization so that it achieves the goals of the organization.

Branches of Accounting

The changing business scenario over the centuries has given rise to specialized branches of accounting to cater to the changing requirements. These branches are:

- **Financial Accounting**: The accounting system that is concerned only with the financial state of affairs and financial results of operations is called financial accounting. It includes ascertainment of profit earned or loss incurred and position of the business at the end of the accounting period. It also provides financial information required by the management and other parties.

- **Cost Accounting**: With respect to information related to the cost of individual products, cost accounting was developed. The main purpose of cost accounting is to analyze the expenditure involved so as to ascertain the cost of various products manufactured and fix their prices. It also helps in exercising control over the cost being incurred. Cost accounting basically involves estimating cost in advance and providing detailed analysis.
- **Management Accounting**: The accounting system related to providing necessary information about funds, costs, and profits is called management accounting.

Transactions

Any organization, irrespective of its size, has to maintain a record of its monetary transactions. A transaction can be defined as a financial event that affects the financial position of a business. Transactions can be of the following types:

- Receipts
- Payments
- Purchases
- Sales

Types of Accounts

Accounts are classified as:

- **Personal accounts**: All accounts that exist in the name of a person, a firm or an organization fall under this type. Every entity, such as a small firm or a large organization, a government department or a private club or association is treated as a person.
- **Real accounts**: As suggested by the name itself, these accounts are tangible in nature and include assets, such as land, building, plant and machinery, fixtures, fittings, furniture, and vehicles of an entity.
- **Nominal accounts**: These are accounts in which all the incomes and expenses, such as interest earned, commission received, rent, wages, salaries, and taxes of an entity are recorded.

Accounting Principles, Concepts and Conventions

Financial accounting is based on various concepts of accounting. The frequently used concepts of accounting are:

- **Money Measurement Concept**: Under the money measurement concept, only the transactions that can be expressed in monetary terms are recorded in accounting. In other words, a transaction, however important it may be to business, will not be recorded unless its monetary effect can be measured accurately. For example, if you successfully pass your graduation exams, it will give you a great deal of satisfaction. However, this satisfaction cannot be expressed in monetary terms; thus, cannot be considered for accounting purposes. On the other hand, if you lose Rs 2,000 while travelling in a train, the loss suffered can be expressed in monetary terms.
- **Accounting Period Concept**: In order to judge the performance of the business entity, a regular performance appraisal should be planned. Such a period to measure business performance is called an accounting period. The accounting period is usually for one year.
- **Accrual Concept**: Accrual concept is the fallout of the accounting period concept. It suggests that incomes and expenses should be recognized as and when they are earned and incurred. The same holds true for revenue. Revenues earned in a specific accounting period are considered as incomes of the same period, irrespective of their receipts. For example, rent paid for fifteen months in advance on 1st January, 2008. The business follows a calendar year as the accounting year. In this case, rent for only the first twelve months should be recognized as expenses for the year 2008.
- **Business Entity Concept**: A business entity is an economic unit, which owns its assets and has its own obligations. The owner may have personal bank accounts, real estates, and other assets but these will not be considered as assets of the business. A business entity may be in the form a sole proprietorship concern, a partnership entity, or a corporate entity.
- **Going Concern Concept**: Under this concept, it is assumed that a business would continue its operations for a long time. Thus, it is also known as continuity assumption. In other words, it is assumed that the business will exist for an indefinite period of time and transactions are recorded from this point of view.
- **Matching Concept**: This concept requires matching of revenue earned in an accounting year with all the expenses incurred during the same period. This gives the revenue generated, thus providing a measure of the overall profitability.
- **Realization Concept**: The realization concept is also known as revenue concept. According to it, recognizing revenue has nothing to do with receipt of cash. If a firm gets an order to supply goods in future, it does not mean that revenue has been realized. Revenue will be earned only when the firm actually sells goods against this order. Thus, the revenue principle states that revenue should be measured for the period in which it is earned or realized.

There are certain internationally accepted conventions and principles that are strictly followed while recording transactions in the books of accounts and in preparing financial statements.

The most important accounting conventions are:

- Convention of Consistency
- Convention of Conservatism
- Convention of Disclosure
- Convention of Materiality

Convention of Consistency

The convention of consistency means that organizations must follow same accounting principles for preparing financial statements over various accounting periods. Consistency is essential to enable any financial analyst to analyze the financial statements on various parameters, such as profitability, growth, and financial position of organizations.

In case any changes are made to the accounting procedures, they should be mentioned in the financial statements along with its effects on the results for the year.

Convention of Conservatism

According to this convention, all anticipated losses or gains are recorded as and when they occur. This ensures that the income and expenditure as well as the value of the assets and liabilities are neither overstated nor understated. A conservative valuation, therefore, presents a reasonable and fair picture of the profit or loss of the business entity.

Convention of Disclosure

Convention of disclosure requires that all significant information relating to the economic affairs of the organization should be fully disclosed. Otherwise, financial statements would be incomplete, unreliable, and misleading

Convention of Materiality

According to the Convention of Materiality, only the transactions, important facts, and items that are useful and material for the business are shown in the financial statements. This convention puts a check on the unnecessary disclosure in the financial statements. The financial statements should not contain unnecessary details. However, the immaterial transactions should be clubbed under important heads. For example, pen, pencil, and paper can be shown under the head stationery.

Double Entry System

Financial transactions are recorded as they occur. Double entry accounting is a standard accounting method that involves each transaction being recorded in at least two accounts, resulting in a debit to one or more accounts and a credit to one or more accounts. For example, if I have purchased a table by paying cash, the cash balance in my hand has gone down and at the same time, now I own a table, which is an asset for me. Thus, while recording the transaction in my books, I have to ensure that both these effects on me are reflected in my books. This recording of the two-fold effect of a transaction in the books of account is called double entry book-keeping.

To understand this better, let us consider another example. A bank purchases a computer from IBM for Rs. 10000 on June 1, 2008. To record this transaction, the bank needs to identify its two-fold effect. The effects are:

- The bank receives a computer worth Rs. 10000.
- The bank has paid Rs. 10000 to IBM, which is the supplier of the computer, and so the cash balance has reduced.

The transaction is recorded in the Computer A/c and Cash A/c, respectively. The entries are made in an account on the debit side and in another account on the credit side. The Computer A/c will be debited and Cash A/c will be credited.

Whether an account has to be debited or credited for recording an entry depends on the nature of accounts involved and the applicable rules. These rules are called the golden rules of accounting. The nature of accounts and their rules are:

- **Personal accounts**: Debit the receiver and credit the giver.
- **Real accounts**: Debit what comes in and credit what goes out.
- **Nominal accounts**: Debit all expenses and losses and credit all incomes and gains.

Mode of Accounting

The process of accounting involves:

- Recording a transaction as and when it occurs
- Classifying the transaction so that a similar transaction is recorded
- Summarizing or preparing an accounting statement

As and when transactions occur, they are recorded in a book called journal in the form of journal entries. The journal constitutes the basic record in which a transaction is recorded. The process of recording the transactions in the journal is called journalizing. While making journal entries, you need to remember the following points:

- Follow the rules for debits and credits

- Begin writing the debit entry in a transaction close to the margin under the particulars column and end it with an abbreviation represented by ‘Dr.’.
- Enter the amount of the transaction under the debit column.
- The next entry (credit entry) begins indented towards the right from the margin and begins with ‘To’ followed by the account to which it is to be credited.
- Enter the amount under the credit column.
- Give brief details about the nature of the transaction. This is called Narration. Every journal entry should have a narration to make it comprehensible to a person looking at the entry.
- Make all journal entries in a chronological order as they take place.

In double entry accounting system, for every transaction, the amount involved is entered on the debit side of one account and the same amount is entered on the credit side of another account. Every debit is matched by an equivalent credit. Therefore, when the debit and credit balances in various accounts are listed and added, the totals will tally.

Trial Balance is a list of closing balances in all accounts with the debit and credit balances written separately. The total of the debit balances must tally with the total of the credit balances. When the balances do not tally, it indicates there is some error in posting, calculating the balances in the account, or totaling the two sides of the Trial Balance.

FAQs

- *Can more than one account be affected in a transaction? If yes, how are they recorded?*

  Yes, more than one account can be affected in a transaction. Such a journal entry is called a compound transaction and it is recorded in the format shown in the following table.

Date	***Accounts***	***Debit***	***Credit***
mm/dd	*account to be debited*	*xxxx.xx*	
	account to be credited		*xxxx.xx*
	account to be credited		*xxxx.xx*

Format for Recording Compound Entries

- *What is the difference between accounting and book-keeping?*

  Book-keeping is concerned with the recording of the transactions that result in the transfer of money or money's worth whereas accounting is comprehensive in perspective. It extends to classifying, summarizing, presenting and even analyzing accounting information.