UNIT 1 BASIC CONCEPTS OF ACCOUNTING

Structure

1.0 OBJECTIVES

After studying this unit you should be able to :

- appreciate the need for accounting
- define accounting and outline its scope
- distinguish between book-keeping, accounting and accountancy
- identify the parties interested in accounting information
- describe the advantages and limitations of accounting
- explain the accounting concepts to be observed at the recording stage
- explain the systems of book-keeping
- classify accounts
- analyse the transactions and identify the accounts to be debited and credited
- identify the stages involved in accounting

1.1 INTRODUCTION

In business numerous transactions take place every day. It is humanly impossible to remember all of them. Hence the need to record them. The recording of business transactions is the main function served by Accounting. With the help of accounting records the businessman is able to ascertain the profit or loss and the financial position of his Business at the end of a given period and communicate such information to all interested parties. In this unit we intend to have an overview of Accounting and discuss its nature, scope and importance. We shall also discuss the basic concepts which are to be observed at the recording stage and explain the principle of double entry i.e., the rules of debit and credit.

8.2 ACCOUNTING—AN OVERVIEW

You know there is a limit to human memory. You cannot remember everything you do or each transaction you make. If you are given Rs. 5,000 and asked to buy a number of items you will find it difficult to remember the detail of various items you purchased. Hence, it becomes necessary for you to write them on a piece of paper or a note book. It is still more difficult in case of business which usually involves a large number of transactions. In business you have to buy and sell more frequently. You make payments and receive payments every now and then. It becomes almost impossible to remember all these transactions. So, unless you record them properly you cannot obtain any financial information you need. For example, you cannot easily ascertain the amounts to be received from various customers to whom the goods were sold on credit. You will not know the detail of how much you owe to your suppliers. You may also find it difficult to work out the profit earned or loss incurred during a particular period. It is, therefore, necessary to maintain a proper record of all the transactions which take place from time to time. The recording of business transactions in a systematic manner is the main function served by accounting. Whichever the form of business organisation—a sole proprietorship, a partnership, a company, or a co-operative society—it has to maintain proper accounts. The accounting information is useful both for the management and the outside agencies like tax authorities, banks, creditors etc. The management needs it for purposes of planning, controlling and decision making. The banks and creditors require it for assessing the credit worthiness of the business and the tax authorities use it for determinirig the amount of income tax, sales tax, etc. In fact, accounting is necessary not only for business organisations but also for non-business organisations like schools, colleges, hospitals, clubs etc.

1.2.1 Objectives of Accounting

The objectives of accounting can be stated as follows :

1 To maintain systematic records: Accounting is used to maintain systematic record of all financial transactions like purchase and sale of goods, cash receipts and cash payments, etc. It is also used for recording various assets and liabilities of the business,

2 To ascertain net profit or net loss of the business: A businessman would be interested in periodically finding the net result of his business operations i.e., whether the business has earned profit or incurred some loss. A proper record of all income and expenses helps in preparing a Profit and Loss Account and ascertain the net result of business operations during a particular period.

3 To ascertain the financial position of the business: The businessman is also interested in ascertaining the financial position of his business at the end of a particular period i.e., how much it owns and how much it owes to others. He would also like to know what happened to his capital, whether it has increased or decreased or remained constant. A systematic record of assets and liabilities facilitates the preparation of a position statement called Balance Sheet which provides the necessary information.

4 To provide accounting information to interested parties: Apart from owners there are various parties who are interested in the accounting information. These are: bankers, creditors, tax authorities, prospective investors etc. They need such information to assess the profitability and the financial soundness of the business. The accounting information is communicated to them in the form of an annual report.

1.2.2 Definition and Scope of Accounting

The subject of 'Accounting' has been defined in different ways by different authorities. So, it is very difficult to define the subject through a single definition. However, the following definitions would give a general understanding of the subject.

According to the American Accounting Association "Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information". This definition stresses three aspects viz., identifying, measuring, and communicating economic information.

In the words of the Committee on Terminology, appointed by the American Institute of Certified Public Accountants, "Accounting is the art of recording, classifying and summarising 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 results thereof'. This is a popular definition of accounting and it outlines fully the nature and scope of accounting activity.

You know a business is generally started with the proprietor's funds known as capital. The proprietor may also borrow some funds from hanks end other agencies. These fundb are utilised to acquire the assets needed for the business and also to carry out'various business activities. In the process a number of transactions *take* place. The accountant·has to identify the transactions to be recorded, measure them in terms of money, and record them in appropriate books of account. Then he has to classify them under separate heads of account, prepare a summary in the form of Profit and Loss Account and Balance Sheet, and analyse, interpret and communicate the results to the interested parties. This is the sum and substance of accounting. The scope of accounting can, therefore, be outlined as follows :

1 Accounting is concerned with the transactions and events which are of a financial character. Such transactions have to be identified by the accountant. He can do so with the help of various bills and receipts.

2 Having identified the transactions, they should be measured orpxpressed in terms of money, if not expressed already. Every transaction is recorded in books only in terms of money and not in terms of physical quantities.

3 The transactions which are identified and measured are to be recorded in a book called 'Journal' or in one of its sub-divisions.

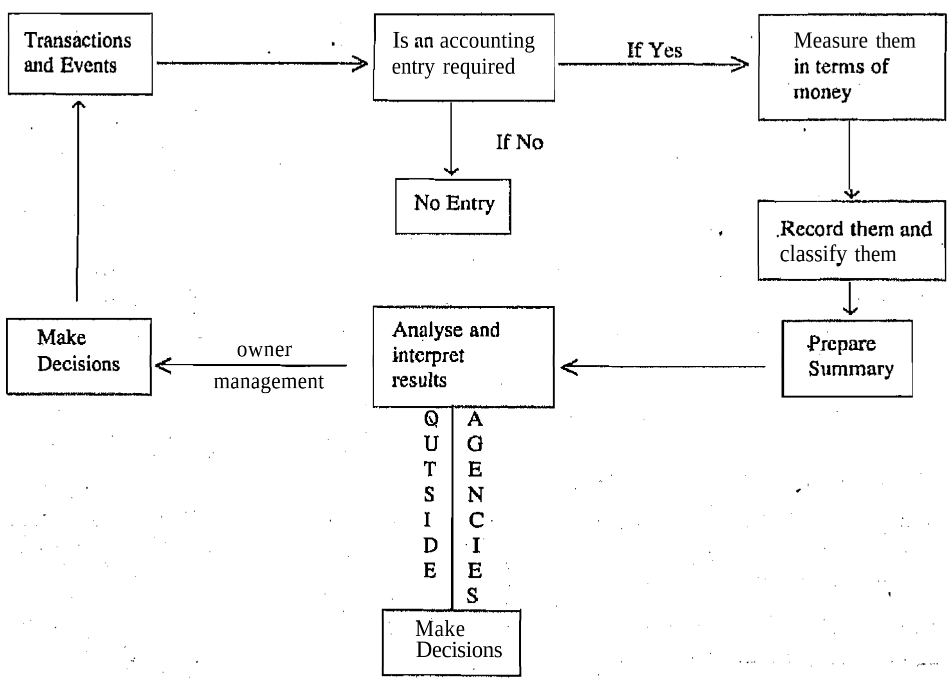
4 The recorded transactions have to be classified with a view to group transactions of similar nature at one place. This work is done in a separate book called 'Ledger'. In the ledger, a separate account is opened for each item so that all transactions relating to it can be brought at one place. For example, salaries paid at different times are brought under 'Salaries Account'.

5 The transactions which are recorded and classified will result in a mass of financial data. It is, therefore, necessary to summarise such data periodically (at least once a year) in a significant and meaningful fonn. This is done in the form of a Profit and Loss Account which reveals profit or loss, and a Balance Sheet which indicates the financial position of the business.

6 The summarised results have to be analysed and interpreted with the help of statistical tools like ratios, averages, etc., and examined critically. Later on, this data will be communicated in the form of reports to the interested parties.

Look at Figure 1.1 and note the activities involved in accounting which starts with identifying the transactions to be recorded and ends with communicating the results to ,owners, management and the other interested parties who use them for decision making.

Figure 1.1: Accounting Activities



1.2.3 Book-keeping, Accounting and Accountancy

According to **G.A.** Lee, the accounting system has following two stages:

i) the making of routine records, in prescribed form and according to set rules, of all events which affect the financial state of the organisation; and

ii) the summarisation from time to time of the information contained in the records, its presentation in a significant form to interested parties, and its interpretation as an aid to decision making by these parties.

Stage (i) is called Book-keeping and stage (ii) is called Accounting.

Book-keeping is thus a narrow term concerned mainly with the maintenance of the books of account and covers the first four activities listed in the scope of accounting **viz.,** identifying the transactions and events to be recorded, measuring them in terms of money, recording them in the books of prime entry, and posting them into ledger. Accounting, on the other hand, is concerned with summarising the recorded data, interpreting the financial results and communicating them to all interested parties. In other words, accounting starts where book-keeping ends. But in practice, the accountants also direct and review the work of book-keepers and therefore the term accounting is generally used in a broader sense covering all the accounting activities, Thus, Book-keeping is regarded as a part of Accounting.

The term 'Accountancy' refers to a systematised knowledge of accounting and is regarded as an academic subject like economics, statistics, chemistry, etc. It explains 'why to do' and 'how to do' of various'aspects of accounting. In other words, while Accounting refers to the actual process of preparing and presenting the accounts, Accountancy tells us why and how to prepare the books of account and how to summarise the accounting information and communicate it to the interested parties. **Thus, Accountancy is a science (a body of systematised knowledge) whereas Accpunting is the art of putting such knowledge into practice.**

In general usage, however, Accountancy and Accounting are used as synonyms (meaning the same thing). But, of late, the term accounting is becoming more and more popular.

1.2.4 Parties Interested in Accounting Information

You have learnt that many people are interested in examining the financial information provided in the form of a Profit and Loss Account and a Balance Sheet. This helps them

a) to study the present position of business,

b) to compare its present performance with that of its past years, and

c) to compare its performance with that of similar enterprises.

Now let us see who such parties are and how accounting information is useful to them.

Owners: Owners contribute capital and assume the risk of business. Naturally, they are interested in knowing the amount of profit earned by the business and so also its financial position. If, however, the management of the business is entrusted to paid managers, the owners also use the accounting information to evaluate the performance of the managers.

Managers: Accounting information is of immense use to managers. It helps them to plan, control and evaluate all business activities. They also need such information for making various decisions.

Lenders: Initially the funds are provided by the owners. But, when the business requires more funds, they are usually provided by banks and other lenders of money. Before lending money they would like to know about the solvency (capacity to repay debts) of the enterprise so as to satisfy themselves that their money will be safe and the repayments will be made on time.

Creditors: Those who supply goods and services on credit are called creditors. Like lenders, they too want to know about credit worthiness of the enterprise. This helps them to determine the limits up to which credit can be granted.

Prospective Investors: A person who wants to become a partner in a firm or a person who wants to become a shareholder of a company, would like to know how safe and rewarding the proposed investment would be.

Tax Authorities: Tax authorities of the Government are interested in the financial statements so as to assess the tax liability of the enterprise.

Employees: The employees of the enterprise are also interested in knowing the state of affairs of the organisation in which they are working, so as to know how safe their interests are in that organisation.

1.2.5 Branches of Accounting

Accounting as we know it today has evolved over many centuries in response to the changing economic, social and political conditions. The economic development and technological improvements have resulted in an increase in the scale of operations and the advent of the company form of business organisation. This has made the management function more and more complex and increased the importance of accounting information. This gave rise to special branches of accounting. These are briefly explained below.

Financial accounting: The purpose of this branch of accounting is to keep a record of all financial transactions so that

a) the profit earned or loss incurred by the business during an accounting period can be worked out,

b) the financial position of the business as at the end of the accounting period can be ascertained, and

c) the financial information required by the management and other interested parties can be provided.

Financial Accounting is mainly confined to the preparation of financial statements and their communication to the interested parties.

Cost Accounting: The purpose of cost accounting is to analyse the expenditure so as to ascertain the cost of various products manufactured by the firm and fix the prices. It also helps in controlling the costs and providing necessary costing information to management for decision making.

Management Accounting: The purpose of management accounting is to assist the management in taking rational policy decisions and to evaluate the impact of its decisions and actions. Examples of such decisions arc: pricing decisions, make or buy decisions, capital expenditure decisions, etc. This branch of accounting is primarily concerned with providing the necessary accounting information about funds, costs, profits, etc., to the management which may help them in such decisions and also in planning and controlling business operations.

1.2.6 Advantages of Accounting

1 **Replaces memory:** Since all the financial events are recorded in the books, there is no need to rely on memory. The books of account will serve as historial records. Any information required at any time can be easily had from these records.

2 **Provides control over assets:** Accounting provides information regarding cash in hand. cash at bank, the stock of goods, the amounts receivable from various parties and the amounts invested in various other assets. Information about such matters help the owners and the management to make use of the assets in the best possible way.

3 **Facilitates the preparation of financial statements:** With the help of information contained in the accounting records the Profit and Loss account and the Balance Sheet can be easily prepared. These financial statements enable the businessman to know the net result of business operations during the accounting period and the financial position of the business as at the end of the accounting period.

4 **Meets the information requirements:** Various interested parties such as owners, lenders, creditors, etc., get the necessary information at frequent intervals which help them in their decision making.

5 **Facilitates a comparative study:** With the help of accounting information one can compare the present performance of the enterprise with that of its past and with that of similar organisations. This enables the management to draw useful conclusions about the business and make efforts to improve the performance.

6 **Assists the management in many other ways:** The accounting information provided to the management helps them in taking rational decisions and in planning and controlling all business activities.

7 **Difficult** to conceal fraud or **theft:** It is difficult to conceal fraud, theft, etc. because of the periodic balancing of books of account. Further, in big organisations the book-keeping work is divided among many persons which minimises the chances for committing fraud.

8 Tax matters: The Government levies various taxes such as customs duty, excise duty, sales tax, and income tax. Properly maintained accounting records will help in the settlement of all tax matters with the tax authorities.

9 Ascertaining **value** of business: In the event of sale of a business firm, the accounting records will help in ascertaining the correct value of business.

10 Acts as reliable evidence: Systematic record of business transactions is generally treated by courts as good evidence in case of disputes.

1.2.7 Limitations of Accounting

The accounting information is used by various parties who form judgement about the profitability and the financial soundness of a business on the basis of such information. It is, therefore, necessary to know about the limitations of accounting. These are as follows:

1 They do not record transactions and events which are not of a financial character. Hence, they do not reveal a complete picture because facts like quality of human resources, licences possessed, locational advantage, business contacts, etc. do not find any place in books of account.

2 The data is historical in nature. The accountants adopt historical cost as the basis in valuing and reporting all assets and liabilities. They do not reflect current values. It is quite possible that items like land **and** buildings may have much more value than what is stated in the balance sheet.

3 Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgements. Hence, they do not reveal the true picture. In many cases, estimates may be used to determine the value of various items. For example, debtors are estimated in terms of collectibility, inventories are based on marketability, and fixed assets are based on useful working life. All these estimates are materially affected by personal judgements.

4 Data provided in the financial statements is insufficient for proper analysis and decision making. It only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities.

Check Your Progress **A**

1 What is Accounting?

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2 List the activities involved in Accounting.

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3 Name the parties interested in accounting information.

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4 State whether each of the following statements is True or False.

i) Accounting is concerned only with the recording of transactions. ....

ii) Accounting records only those transactions which are of a financial character. ....

iii) Book-keeping and Accounting are synonymous terms. ....

iv) Cost Accounting helps in ascertaining and controlling costs. ....

v) Management Accounting provides necessary information to management which helps them in planning, controlling and decision making. ....

vi) The main objective of financial accounting is to ascertain the profit or loss and the financial position of the business. ....

1.3 BASIC ACCOUNTING CONCEPTS

Accounting is a system evolved to achieve a set of objectives as outlined earlier (refer to 1.2.1). In order to achieve these objectives we maintain systematic record of all business transactions and prepare annual reports for the interested parties. Any activity that you perform is facilitated if you have a set of rules to guide you. When you are driving your vehicle you keep to the left. You are in fact following a traffic rule. If drivers do not follow this rule, there will be a chaos on the road. The same thing is true of accounting which has evolved over a period of several centuries. During this period, certain rules and conventions have been adopted which serve as guidelines in identifying the events and transactions to be accounted for, measuring them, recording them in books of account, summarising them, and reporting them to the interested parties. These rules and conventions are termed as 'Generally Accepted Accounting Principles'. To explain these principles, the writers have used a variety of terms such as concepts, postulates, conventions, underlying principles, basic assumptions, etc. The same rule may be described by one author as a concept, by another as a postulate and still by another as a convention. This often confuses the learners. Hence, it is better to call all rules and conventions which guide accounting activity and practice as 'Basic Accounting Concepts' These are the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are the broad working rules for all accounting activities developed and accepted by the accounting profession. This brings about uniformity in the practice of accounting.

These concepts can be classified into two broad groups as follows :

i) concepts to be observed at the recording stage i.e., while recording the transactions, and

ii) concepts to be observed at the reporting stage i.e., at the time of preparing the final accounts.

It must however be remembered that some of them are overlapping and even contradictory.

1.3.1 Concepts to be observed at the recording stage

The concepts which guide us in identifying, measuring and recording the transactions are :

1 Business Entity Concept

2 Money Measurement Concept

3 Objective Evidence Concept

4 Historical Record Concept

5 Cost Concept

6 Dual Aspect Concept

Let us take them one by one and learn the accounting implications of each concept.

Business Entity Concept: Business entity means a unit of organised business activity. In that sense, a provision store, a cloth dealer, an industrial establishment, an electricity supply undertaking, a bank, a school, a hospital, etc. are all business entities.

From the accounting point of view every business enterprise is an entity separate and distinct from its proprietor(s)/owner(s). The accounting system gives information only about the business and not its owner(s). In other words, we record those transactions in the books of account which relate only to the business. The owner's personal affairs (his expenditure on housing, food, clothing, etc.) will not appear in the books of accounr of his business. However, when personal expenditure of the owner is met from business funds it shall also be recorded in the business books. It will be recorded as drawings by the proprietor and not as business expenditure.

Another implication of business entity concept is that the owner of a business is to be treated as a creditor who also has a claim over the assets of the business. As such, the amount invested by him (capital) is regarded as a liability for the business.

The business entity concept is applicable to all forms of business organisations. This distinction can be easily maintained in the case of a limited company because the company has a legal entity of its own. But such distinction becomes difficult in case of a sole proprietorship or partnership, because in the eyes of the law the partner or the sole proprietor are not considered separate entities. They are personally liable for all business transactions. Eut for accounting purposes, they are to be treated as separate entities. This enables them to ascertain the profit or loss of business more conveniently and accurately.

Money Measurement Concept: Usually, business deals in a variety of items having different physical units such as kilograms, quintals, tons, metres, litres, etc. If the sales and purchases of different items are recorded in tenns of their physical units, adding them together will pose problotns. But, if these are recorded in a common denomination, their total becomes homogeneous and meaningful. Therefore, we need a common unit of measurement. Money does this function. It is adopted as the common measuring unit for the purpose of accounting. All recording, therefore, is done in terms of the standard currency of the country where business is set up. For example, in India it is done in terms of Rupees, in USA it is clone in terms of US Dollars, and so on.

Another implication of money measurement concept is that only those transactions and events are to be recorded in the books of account which can be expressed in terms of money such as purchases, sales, payment of salaries, goods lost in accident, etc. Other happenings (non-monetary) like death of an efficient manages or the appointment of an accountant, howsoever important they may be, are not recorded in the books of account. This is because their effect is not measurable or quantifiable in terms of money.

This approach has its own drawbacks. The value of money changes over a period of time. The value of rupee today is much less than what it was in 1961. Such a change is nowhere reflected in accounts. That is why the accounting data does not reflect the true and fair view of the affairs of the business.

Hence, now-a-days, it is considered desirable to provide additional data showing the effect of changes in the price level on the reported income and the assets and liabilities of the business.

Objective Evidence Concept: The term objectivity refers to being free from bias or free from subjectivity. Accounting measurements are to be unbiased and verifiable independently. For this purpose, all accounting transactions should be evidenced and supported by documents such as invoices, receipts, cash memos, etc. These supporting documents (vouchers) form the basis for making entries in the books of account and for their verification by auditors afterwards. AS for the items like depreciation and the provision for doubtful debts where no documentary evidence is available, the policy statements made by management are treated as the necessary evidence.

Historical **Record** Concept: You know that after identifying the transactions and measuring them in terms of money we record them in the books of account. According to the historical record concept, we record only those transactions which have actually taken place and not those which may take place (future transactions). It is because accounting record presupposes that the transactions are to be identified and objectively evidenced. This is possible only in the case of past (actually happened) transactions. The future transactions can hardly be identified and measured accurately. You also know that all transactions are to be recorded in chronological (datewise) order. This leads to the preparation of a historical record of all transactions. It also implies that we simply record the facts and nothing else.

As you will study later, we also make provision for some expected losses such as doubtful debts. This may be contrary to what is stated in historical record concept. But this is done only at the time of ascertaining the profit or loss of the business. It is not a routine item. This is done in accordance with another concept called Conservatism Concept about which you will study later.

Cost Concept: Business activity, in essence, is an exchange of money. The price paid (or agreed to be paid in case of a credit transaction) at the time of purchase is called cost. According to the cost concept, all assets are recorded in books at their original purchase price. This cost also forms an appropriate basis for all subsequent accounting for the assets. For example, if the business buys a machine for Rs. 80,000 it would be recorded in books at Rs. 80,000. In case its market value increases to Rs. 1,00,000 later on (or decreases to Rs. 50,000) it will continue to be shown at Rs. 80,000 and not at its market value.

This does not mean, however, that the asset will always be shown at cost. You know that with passage of time the value of an asset decreases. Hence, it may systematically be reduced from year to year by charging depreciation and the asset be shown in the balance sheet at the depreciated value. The depreciation is usually charged as a fixed percentage of cost. It bears no relationship with changes in its market value. In other words, the value at which the assets are shown in the balance sheet has no relevance to its market value. This, no doubt, makes it difficult to assess the true financial position of the business and is therefore regarded as an important limitation of the cost concept. But this approach is preferred because, firstly it is difficult and time consuming to ascertain the market values, and secondly there will be too much of subjectivity in assessing the current values. However, this limitation has been overcome with the help of inflation accounting.

Dual Aspect Concept: This is a basic concept of accounting. According to this concept every business transaction has a two-fold effect. In commercial context it is a famous dictum that "every receiver is also a giver and every giver is also a receiver". For example, if you purchase a machine for Rs. 8,000, you receive machine on the one hand and give Rs. 8,000 on the other. Thus, this transaction has a two-fold effect i.e., (i) increase in one asset and (ii) decrease in another asset. Similarly, if you buy goods worth Rs. 500 on credit, it will increase an asset (stock of goods) on the one hand and increase a liability (creditors) on the other. Thus, every business transaction involves two aspects: (i) the receiving aspect, and (ii) the giving aspect, In case of the first example you find that the receiving aspect is machinery and the giving aspect is cash. In the second example the receiving aspect is goods and the giving aspect is the creditor. If complete record of transactions is to be made, it would be necessary to record both the aspects in books of account. This principle is the core of double entry book-keeping and if this is strictly followed, it is called 'Double Entry System of Book-keeping' about which you will learn in detail later.

Let us understand another accounting implication of the dual aspect concept. To start with, the initial funds (capital) required by the business are contributed by the owner. If necessary, additional funds are provided by the outsiders (creditors). As per the dual aspect concept all these receipts create corresponding obligations for their repayment. In other words, a contribution to the business, either in cash or kind, not only increases its resources (assets), but also its obligations (liabilities/equities) correspondingly. Thus, at any given point of time, the total assets and the total liabilities must be equal.

This equality is called 'balance sheet equation' or 'accounting equation'. It is stated as under :

$$\text{Liabilities (Equities)} = \text{Assets}$$
or
$$\text{Capital} + \text{Outside Liabilities} = \text{Assets}$$

The term 'assets' denotes the resources (property) owned by the business while the term 'equities' denotes the claims of various parties against the business assets. Equities are of two types: (i) owners' equity, and (ii) outsiders' equity. Owners' equity called capital is the claim of the owners against the assets of the business. Outsiders' equ'ity called liabilities is the claim of outside parties like creditors, bank, etc. against the assets of the business. Thus, all assets of the business are claimed either by the owners or by the outsiders, Hence, the total assets of a business will always be equal to its liabilities.

When various business transactions take place, they effect the assets and liabilities in such a 'way that this equality is always maintained. Let us take a few transactions and see how this equality is maintained.

1 Mr. **Gyan Chand** started business **with Rs.** 50,000 **cash:** The cash received by the business is its asset. According to the business entity concept, business and the owner are two separate entities. Hence, the capital contributed by Mr. Gyan Chand is a liability to the business. Thus :

Capital = Assets
Rs. 50,000 = Rs. 50,000 (cash)

2 He purchased goods on credit from Chakravarty **for** Rs. **5,000:** This increases an asset (stock of goods) on the one hand and a liability (creditors) on the other. Now the equation will be :

Capital + Liabilities = Assets
Rs. 50,000 + Rs. 5,000 = Rs. 5,000 + Rs. 50,000
Capital Creditors Stock Cash

3 He purchased furniture worth Rs. **10,000** and paid cash: This increases one asset (furniture) and decreases another asset (cash). Now the equation will be :

Capital t Liabilities = Assets
Rs. 50,000 + Rs. 5,000 = Rs. 10,000 + Rs. 5,000 + Rs. 40.000
Capital Creditors Furniture Stock Cash

This equation can be presented in the form of a Balance Sheet (a statement of assets and liabilities) as follows :

Gyan Chand's Balance Sheet

Capital nnd Liabilities	Rs.	Assets	Rs.
Capital	50,000	Furniture	10,000
Creditors		Stock of goods	5,000
(Mr. Chakravarty)	5,000	Cash	40,000
	55,000		55,000

Note that the totals on both sides of the Balance Sheet are equal. This equality remains valid irrespective of the number of transactions and the items affected thereby. It is so because of their dual effect on the assets and liabilities of the business.

1.3.2 Concepts to be observed at the reporting stage

The following concepts have to be kept in mind while preparing the final accounts.

1 Going Concern Concept
2 Accounting Period Concept
3 Matching Concept
4 Conservatism Concept
5 Consistency Concept
6 Full disclosure Concept
7 Materiality Concept

You will learn about these concepts in Unit 6.

Check Your Progress B

1 What do you understand by business entity concept?

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2 Fill in the blanks.

i) Basic accounting concepts are broad .... for the accounting activity.

ii) According to the business entity concept the owner's capital in business is to be treated as a .... for the business.

iii) Every business pansaction has a dual effect on assets and .... of the business.

iv) An asset is recorded in books of account at ....

v) The system of recording transactions based on dual aspect concept is called ....

3' Mr. Radhey Lal has a shoe factory. A few transactions and events are given below. State which of these will be recorded in the books of his business.

i) Purchased a machine for the factory.

ii) A pair of shoes taken home for his'son.

iii) Appointed Ganesh as an assistant accountant.

iv) Borrowed Rs. 8,000 from Saraf for the business.

v) He paid salary to his domestic servant.

vi) The production manager went on medical leave.

vii) He paid wages for the month of May to factory workers.

viii) Appointed Ballu Shoe & Co. as dealers for the town.

4 Show the dual effect of the following transactions on assets and liabilities of the business.

i) Purchased goods for cash for Rs. 8,000.

ii) Purchased a delivery van on credit for Rs. 40,000.

iii) Paid Rs. 5,000 to a creditor.

iv) The proprietor took Rs. 2,000 from the business for personal expenses.

5 Find out the missing amounts on the basis of the accounting equation.

i) Capital Rs. 40,000 + Liabilities Rs. 15,000 = Assets Rs. ....

ii) Capital Rs. 65,000 + Liabilities Rs. .... = Assets Rs. 80,000

iii) Capital Rs.......... + Liabilities Rs. 30,000 = Assets Rs. 90,000.

1.4 SYSTEMS OF BOOK-KEEPING

Book-keeping as explained earlier is the art of recording business transactions in a systematic manner. Broadly, there are two systems of book-keeping: (i) Double Entry System, and (ii) Single Entry System.

1.4.1 Double Entry System

Under the dual aspect concept you learnt that every business transaction has two aspects: (i) the receiving aspect, and (ii) the giving aspect. For example, when you purchase goods for cash, goods come in arid cash goes out. Thus, a transaction affects two items (also called accounts) at the same time. When you record the transactions in the books of account of a business, it would be better if you record the effects relating to both the items. In the above example the items affected are goods and cash, stock of goods increases and cash decreases. So, we should record the increase in stock of goods and also the decrease in cash. This involves two entries, one in Goods Account and the other in Cash Account. This method of recording business transactions is called 'Double Entry System'. It recognises and records both the aspects of every transactions. According to this system the account which involves receiving aspect is debited and the account which involves giving aspect is credited. Thus, for every debit there will be an equivalent credit. For this purpose certain rules have been framed. These are discussed in detail later in this unit.

The advantages of Double Entry System are as follows :

1 It provides complete and reliable record of all business transactions because it records both the aspects.

2 It supplies full information about the incomes, expenses, assets and liabilities of the business. This helps the management in taking appropriate decisions.

3 The arithmetical accuracy of the books of account can be easily verified by preparing a trial balance.

4 The financial result of business organisations i.e., profit or loss, can be correctly ascertained.

5 The financial position of the business can also be ascertained at any point of time.

1.4.2 Single Entry System

Single Entry System does not mean that only one aspect of a transaction is recorded. It simply refers to incomplele records or the defective double entry system. Under this system neither all the transactions are recorded nor all the account books are maintained. In certain cases the two aspects of a transaction are duly recorded while in others only one aspect is recorded. Sotne transactions are simply ignored, they are not recorded at all. The Single Entry System is thus a mixture of double entry, single entry and no entry. The accounts maintained under this system are incomplete and unsystematic and, therefore, not reliable. The main defect in this system is that the arithmetical accuracy of the books of account cannot be checked, because a trial balance cannot be prepared. It also becomes difficult to ascertain the correct amount of profit or Ioss. This system is normally followed by small business firms. You will learn more about it in Unit 15.

1.5 WHAT IS AN ACCOUNT ?

You have learnt that every business transaction has dual effect and that under Double Entry System entries are made in both the accounts affected. You also learnt that the account which involves receiving aspect is debited and the account which involves giving aspect is credited. In order to understand the rules of debit and credit you must know more about the term 'account'. An account is a summarised record of all transactions relating to a particular person, a thing, or an item of income or expense. It is vertically divided into two halves and resembles the shape of the English alphabet 'T' as under :

Name of the account

Dr.	Cr.

The left hand side is called the 'debit side'. It is indicated by 'Dr.' (abbreviation for debit) on the left hand top corner of the account. The right hand side, known as the 'credit side', is indicnted by 'Cr.' (abbreviation for credit) on the right hand top comer of the account. The name of the account is written at the top in the centre. The ward 'Account' or its abbreviadon 'A/c' is added to the name of the account. For example, if the account is related to machinery, it is written as 'Machinery Account'.

1.6 CLASSIFICATION OF ACCOUNTS

All business transactions are broadly classified into three categories: (i) those relating to persons, (ii) those relating to property (assets), and (iii) those relating to incomes and expenses. Thus, three classes of accounts are maintained for recording all business transactions. They are: (i) Personal Accounts (ii) Real Accounts, and (iii) Nominal Accounts. Real and Nominal Accounts taken together are called Impersonal Accounts.

Personal **Accounts:** Accounts which show transactions with persons are called 'Personal Accounts'. A separate account is kept in the name of each person for recording the benefit! received from, or given to, the person in the course of dealings with **him.** Examples are: Krishna's Account, Gopal's Account, Loan from Ratanlal's Account, etc.

Personal accounts also include accounts in the names of firms, companies or institutions such as **Hiralal** & **Sons'** Account, Nagarjuna Finance Limited Account, The Andhra Bank Account, etc.

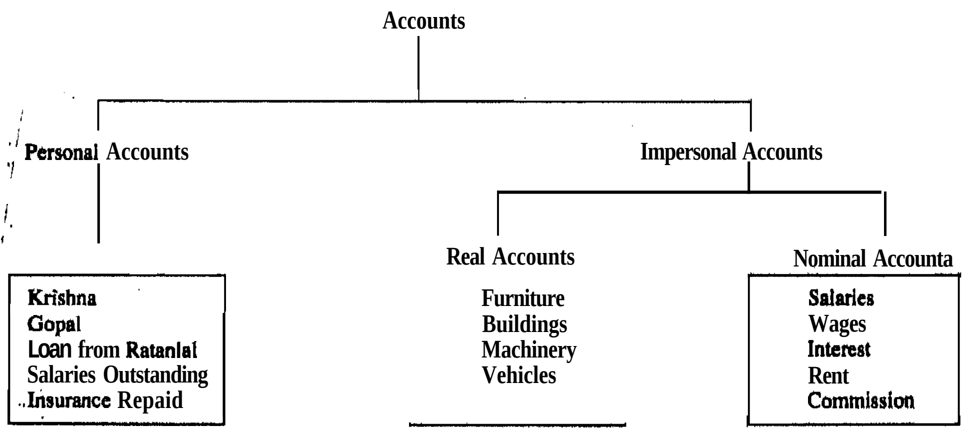
The accounts which represent expenses payable, expenses paid in advance, incomes receivable, and incomes received in advance are also personal accounts, though impersonal in name. For example, the salaries due to employees, which have not been paid before closing of the books of account for the year, are recorded in 'Salaries Outstanding Account'. It is regarded as a personal account because it represents the employees to whom salaries are payable by the business. Such a personal account is called 'Representative Personal Account'. Other examples of representative personal accounts are: Interest Outstanding Account, Prepaid Insurance Account, Rent Received in Advance Account, etc. Capital Account and Drawings Account are also treated as personal accounts as they show dealings with the owner of the business.

Real Accounts: Accounts relating to properties or assets are known as 'Real Accounts'. Every business needs assets such as machinery, furniture, etc. for running its activities. A separate account is maintained for each asset owned by the business. All transactions relating to a particular asset are recorded in the concerned asset account. Cash Account, Fumiture Account, Machinery Account, Building Account, etc., are some examples of real accounts. They are known as real accounts because they represent things of value owned by the business.

Nominal Accounts: Accounts relating to expenses, losses, incomes and gains are known as 'Nominal Accounts'. A separate account is maintained for each item of expense, loss; income or gain. Wages Account, Salaries Account, Commission Received Account, and Interest Received Account are some examples of nominal accounts.

Classification of accounts is presented in Figure 1.2

Figure 1.2: Classification of Accounts



1.7 RULES OF DEBIT AND CREDIT

You have learnt that every transaction affects two accounts and according to Double Entty System, entries have to be made in both the accounts. Before recording a transaction, therefore, it is necessary to find out which of the two accounts is to be debited and which is to be credited. The general rule, as stated earlier, is to debit the account which involves a receiving aspect and credit the account which involves a giving aspect. But, for convenience, three different rules have been laid down for the three classes of accounts. These are as follows:

1 For Personal Accounts: The account of the person receiving benefit (receiver) of the transaction (from the business) is debited and the account of the person giving the benefit (giver) of the transaction (to the business) is credited. Thus, the rule is 'debit the **receiver** and **credit** the **'giver'.**

2 For Real Accounts: When an asset is coming into the business, the accdunt of that asset is debited. When an asset is going out of the business, the account of that asset is, credited. Thus, the rule is **'debit what comes in and credit what goes out'.**

3 For Nominal Accounts: When an expense is incurred or loss suffered, the account representing the expense or the loss is debited because the business receives the benefit thereof. When any income is earned or gain made, the account representing the income or the gain is credited. This is because the business gives some benefit. Thus, the rule is 'debit all **expenses** and **losses** and credit all **incomes** and **gains'.**

We shall now see the application of these rules, taking a few transactions.

Example 1 : Paid cash to Ramesh & Co. Rs. 5,000.
la this case the two accounts affected are Ramesh & Co.'s Account and Cash Account. Ramesh & Co.'s Account is a personal account and Cash Account is a real account. Ramesh & Co. has received the benefit (cash Rs. 5,000) from the business and, therefore, it has to be debited as per the first part of the rule for personal accounts 'debit the receiver'. As cash has gone out, Cash Account will be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 2: Received sash from Ajay Rs. 1,000.
In this case Cash Account and Ajay's Account are the two accounts affected. Cash Account is a real account and Ajay's account is a personal account. As cash has come in, Cash Account will have to be debited according to the first part of the rule for real accounts 'debit what comes in'. Ajay has given the benefit (cash Rs. 5,000) to the business and, therefore, his account will liave to be credited as per the second part of the rule for personal accounts 'credit the giver'.

Example 3: Paid rent Rs. 1,000.
In this case, the accounts affected are Rent Account and Cash Account. Rent Account is a nominal account and Cash Account is a red account. As per the first part of the rule for nominal accounts 'debit expenses and losses', Rent Account will have to be debited as it is an expense to the business. As cash has gone out, Cash Account will have to be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 4: Received Rs. 400 as **commission.**
In this case, Cash Account and Commission Account are the two accounts affected. Cash Account is a real account and Commission Account is a nominal account. As cash has come in, Cash Account will liave to be debited according to the first part of the rule for real accounts 'debit what cotnes in'. As per second part of the rule for nominal accounts, 'credit incomes and gains', Commission Account will be credited as it is an income to the business.

You have seen that the three rules of debit and credit as explained above, make it convenient for you to analyse the transactions and identify the accounts to be debited and credited.

Check Your Progress C

1 State whether each of eke statements is True or False.

i) An Account is a summarised record of 211 transactions relating to a particular person'or an item. ....

ii) Right hand side of an account is called debit side. ....

iii) Account which represents an item of asset is called representative personal account. ....

ivj Accounts relating to assets held in the name of the firm are called nominal accounts. ....

v) Capital Account is a personal acccunt. ....

vi) Goodwill Account is a personal account. ....

2 Names of some accounts are given below. Classify them into Personal, Real or Nominal.

Name of Account	Class of Account
i) Bank A/c	....
ii) Interest A/c	....
iii) Interest outstanding A/c	....
iv) Patents A/c	....
v) Loan from Gopaldas A/c	....
vi) Loose Tools A/c	....
vii) Commission Received in Advance A/c	....
viii) Prepaid Salaries A/c	....
ix) Stationery and Printing A/c	....
x) Electricity Charges A/c	....

3 From the following transactions determine the accounts affected, classify them and state whether they are to be debited or credited; ---

		Rs.
i)	Purchased typewriter for cash	5,000
ii)	Purchased furniture from R & Co. on credit	50,000
iii)	Interest received	300
iv)	Paid wages	800
v)	Received cash from A	2,000
vi)	Additional capital introduced into the business	5,000
vii)	Paid cash to B	1,500
viii)	Paid carriage	200
ix)	Purchased goods from F & Co. on credit	12,000
x)	Sold goods for cash	1,400

1.8 ACCOUNTING PROCESS

The accounting process consists of the following four stages:

i) Recording the Transactions

ii) Classifying the Transactions

iii) Summarising the Transactions

iv) Interpreting the Results

Let us now briefly discuss these stages.

Recording the Transactions: The accounting process begins with recording of all transactions in the book of original entry. This book is called 'Journal'. All transactions are recorded in the Journal in a chronological order (datewise) with the help of various vouchers such as cash memos, cash receipts, invoices, etc.

Classifying the Transactions: The second stage consists of grouping the transactions of similar nature and posting them to the concerned accounts in another book called 'Ledger'. For example, all transactions related to cash me posted to Cash Account and the transactions related to different persons are entered separately in the account of each person. The objective of classifying the transactions in this manner is to ascertain the combined effect of all transactions of a given period in respect of each account, For this purpose, all accounts are balanced periodically.

Summarising the Transactions: The next step is to prepare a year-end summary known as 'Final Accounts'. But before preparing the final accounts, we prepare a statement called Trial Balance in order to check the arithmetical accuracy of the books of account. If the Trial Balance tallies, it means that the transactions have been currently recorded and posted into ledger. Then, with the help of the Trial Balance and some other relevant information we prepare the final accounts. The objectives of preparing the final accounts are (i) to know the net result of business activities, and (ii) to ascertain the financial position of the business. The final account consists of an income statement called 'Trading and Profit land Loss Account' and a position statement called 'Balance Sheet'. The Trading and Profit and Loss Account gives us the information about the amount of profit made or the loss incurred during the year and the Balance Sheet shows the position of assets and liabilities of the business as at the end of the year.

Interpreting the Results: The last stage consists of analysing and interpreting the results shown by the final accounts. This involves computation of various accounting ratios to assess the liquidity, solvency, and profitability of the business. Such analysis is meant for interested parties like management, investors, bankers, creditors, etc. The balances on various accounts appearing in the Balance Sheet will then be transferred to the new books of account for the next year, Thereafter the process of recording transactions for the next year starts again.

1.9 LET US SUM UP

In business a number of transactions take place every day. It is not possible to remember all of them. Hence the need to record them. The recording of business transactions in a systematic manner is the main function served by accounting. It enables us to ascertain the profit and loss and the financial positions of the business. It also provides the necessary financial information to all interested parties.

Accounting is the process of identifying, measuring, recording, classifying and summarising the transactions, and analysing, interpreting and communicating the results thereof. The accounting system has two stages: (i) Book-keeping, and (ii) Accounting. Book-keeping is mainly concerned with the maintenance of books of account, while accounting is concerned with summarising the recorded data, interpreting the financial results and communicating them to all interested parties. Changes in economic environment and increasing complexity of management have given rise to the specialised branches of accounting such as financial accounting, cost accounting and management accounting,

The accountants, over a period of time, have developed certain guidelines for all accounting work. These are called basic concepts of accounting. Certain concepts are to be observed at the time of recording the transactions, while others are relevant at the summarising and reporting stages. The concepts to be observed at the recording stage are business entity, money measurement, objective evidence, historical record, cost and the dual aspect concepts.

According to Dual Aspect concept every business transaction involves two aspects (i) the receiving aspect, and (ii) the giving aspect. Under 'Double Entry System' both the aspects must be recorded in books of account. As per rules the receiving aspect is recorded on the debit side of account affected by transaction and giving aspect on the credit side of the account affected, For convenience, accounts have been classified into personal, real and nominal accounts and separate rules have been framed for debiting and crediting different classes of accounts. These are called Rules of Debit and Credit.

The accounting process is divided into four stages: (i) recording the transactions in the books of original entry, (ii) classifying the transactions, (iii) summarising the transactions, and (iv) Interpreting the results.

1.10 KEY WORDS

Account! A summarised statement of transactions relating to a particular person, thing expense or income,

Accounting Period: **A** period of twelve months for which the accounts are usually kept.

Asset: Anything having an economic value, a ptoperty.

Balance Sheet: A statement of assets and liabilities as at the end of an accounting period.

Books of **Account:** Books in the form of bound registers or loose sheets wherein transactions are recorded.

Business: Any activity carried on with profit motive.

Business Unit: A unit formed for the purpose of carrying on some kind of business activity.

Capital: Owner's investment and equity in the business.

Company: An association of persons registered under the Companies Act.

Credit: **It** represents the giving aspect of a transaction.

Creditor: **A** person to whom the business owes.

Debit: It represents the receiving aspect of a transaction.

Debtor! **A** peraon owing to the business.

Expenditure: Spending of money or incurring a liability for some benefit, service or asset received by the business.

Expense: An expenditure incurred for some benefit or service.

Equity: A claim or right over the business. It includes both the owners' and creditors' claims.

Financial **Position:** Position of assets and liabilities of a business at a given point of time.

Financial Statement: Summary of accounting information such as Profit and Loss Account and Balance Sheet prepared at the end of an accounting period. These are also called Final Accounts.

Income: Amount earned through business operations.

Liability: Amount owed by the business to outsiders.

Nominal Accounts: Accounts relating to incomes and expenses.

Partnership Firm: A business unit owned by two or more persons who have agreed to share the profits of the business carried on by all or any of them acting for all.

Personal Accounts: Accounts relating to persons, firms and institutions.

Profit: Excess of income over expenses during a given period.

Profit and Loss Account: An account showing profit or loss of the business during an accounting period.

Real Accounts: Accounts relating to the properties of business.

Sole Proprietorsliip: A business unit owned by one person.

Transaction: Transfer of money or money's worth between the two business units.

1.11 SOME USEFUL BOOKS

1 Harold Bierman Jr. and Allan R. Drebin, 1978: ***Financial Accounting,*** An ***Introduction,*** W.B. Saunders Company, Philadelphion, London. (Chapters 1-3)

2 Maheshwari, S.N., 1986. ***Introduction to Accounting,*** Vikas Publishing House: New Delhi. (Chapters 1, 2)

3 Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting, R.*** Chand & Co., New Delhi. (Chapters 1-3)

4 Gupta, R.L. and M. Radhaswarny, 1986. ***Advanced Accountancy,*** Sultan Chand & Sons: New Delhi. (Chapter 1, 2)

1.12 ANSWERS TO CHECK YOUR PROGRESS

A. 4 i) False ii) True iii) False iv) True v) True vi) True

B. 2 i) Working rules ii) liability iii) liabilities iv) cost v) Double Entry System

3 i, ii, iv, and vii will be recorded in books of his business.

4 i) Stock of goods increases, cash decreases

ii) An asset increases, creditors increase

iii) Creditors decrease, cash decreases

v) Capital decreases, cash decreases

5 i) Rs. 55,000

ii) Rs. 15,000

iii) Rs, 60,000

C. 1 i) True ii) False iii) False iv) False v) True vi) False

2 i) Personal ii) Nominal iii) Personal iv) Real v) Personal vi) Real vii) Personal viii) Personal ix) Nominal. x) Nominal

Transaction	Account to be debited	Nature of account	Account to be credited	Nature of account
i)	Typewriter A/c	Real	Cash A/c	Real
ii)	Furniture A/c	Real	R & Co. A/c	Personal
iii)	Cash A/c	Real	Interest A/c	Nominal
iv)	Wages A/c	Nominal	Cash A/c	Real
v)	Cash A/c	Real	A's A/c	Personal
vi)	Cash A/c	Real	Capital A/c	Personal
vii)	B's A/c	Personal	Cash A/c	Real
viii)	Carriage A/c	Nominal	Cash A/c	Real
ix)	Goods A/c	Real	F & Co. A/c	Personal
x)	Cash A/c	Real	Goods A/c	Real

1.13 TERMINAL QUESTIONS

1 Define Accounting and explain its scope.

2 What are the objectives of Accounting? Name the different parties interested in accounting information and state why they want it.

3 Write notes on:

a) Advantages of Accounting

b) Branches of Accounting

c) Accounting Process

d) Types of Accounts

4 Briefly explain the accounting concepts which guide the accountant at the recording stage.

5 What do you understand by Dual Aspect Concept? Explain its accounting implications.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 2 THE ACCOUNTING PROCESS

Structure

2.0 OBJECTIVES

After studying this unit you should be able to:

- explain what a journal is
- describe how different, types of transactions will he recorded in the journal
- post journal entries in the concerned ledger accounts
- balance a ledger account and explain the significance of balances in different types of accounts
- prepare a trial balance to test the arithmetical accuracy of recording in the books of account
- explain what an opening entry is and how it is posted into ledger

2.1 INTRODUCTION

In Unit 1 you learnt that the accounting process involves four stages: (i) recording the transactions, (ii) classifying the transactions, (iii) summarising the transactions, and (iv) interpreting the results. Thus, you are aware that all transactions are recorded first in the books of original entry viz., Journal, and then posted into the concerned accounts in the ledger. You have also learnt the basic accounting concepts to be observed at the recording stage and the rules of debit and credit. With the help of these rules we shall discuss in this unit how various transactions are recorded in the Journal and how they will be posted into the concerned ledger accounts. We shall also explain how to balance different accounts and prepare a Trial Balance in order to test the arithmetical accuracy of the books of account.

2.2 JOURNAL

Journal is a daily record of business transactions. It is also called a 'Day Book' and is used for recording all day to day transactions in the order in which they occur. It is a book of prime entry (also called book of original entry) because all transactions are recorded first in this book. The process of recording a transaction in the journal is called 'Journalising' and the entries made in this book are called 'Journal Entries'. The proforma of Journal is given in Figure 2.1.