assets and liabilities. In recent years changes in technology have also brought a remarkable change in the field of accounting. The whole concept of accounting has changed. "It has come to be recognised as a tool for mastering the various economic problems which a business organisation may have to face. It systematically writes the economic history of the organisation. It provides information that can be drawn upon by those responsible for decisions affecting the organisation's future. This history is written mostly in quantitative terms. It consists partly of files of data, partly of reports summarizing various portions of these data, and partly of the plans established by management to guide its operations."[1]

DEFINITION AND FUNCTIONS OF ACCOUNTING

From the above discussion it is clear that over a period of time the concept of accounting and the role of accountant has undergone a revolutionary change. The change is particularly noticeable during the last fifty years.

Earlier, accounting was considered simply as a process of recording business transactions and the role of accountant as that of record-keeper. However, accounting is now considered to be a tool of management providing vital information concerning the organisation's future. Accounting today is thus more of an information system rather than a mere recording system.

It will be useful here to give in a chronological order the definitions given by some of the well established accounting bodies which show how the concept of accounting has undergone a change over a period of time.

In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as follows:

"Accounting is the art of recording, classifying and summarizing in 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".

In 1966, the American Accounting Association (AAA) defined accounting as follows:

"Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information".

In 1970, the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as follows:

"The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions".

Thus, accounting may be defined as the process of recording, classifying, summarizing, analysing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

An analysis of the definition brings out the following functions of accounting:

1. **Recording** This is the basic function of accounting. It is essentially concerned with not only ensuring that all business transactions of financial character are, in fact, recorded but also that they are recorded in an orderly manner. Recording is done in the book "Journal". This book may be further sub-divided into various subsidiary books such as Cash Journal (for recording cash transactions), Purchases Journal (for recording credit purchase of goods), Sales Journal (for recording credit sales of goods), etc. The number of subsidiary books to be maintained will be according to the nature and size of the business.

1. Mryon J. Gordon Shillinglaw, "*Accounting: A Management Approach*", p. 3, 4th edition.

2. **Classifying** Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The work of classification is done in the book termed as "Ledger". This book contains on different pages individual account heads under which all financial transactions of similar nature are collected. For example, there may be separate account heads for Travelling Expenses, Printing and Stationery, Advertising etc. All expenses under these heads after being recorded in the Journal will be classified under separate heads in the Ledger. This will help in finding out the total expenditure incurred under each of the above heads.

3. **Summarizing** This involves presenting the classified data in a manner which is understandable and useful to the internal as well as external end-users of accounting statements. This process leads to the preparation of the following statements:

P&L a/c

(*i*) Trial Balance (*ii*) Income Statement (*iii*) Balance Sheet.

4. **Dealing with Financial Transactions** Accounting records only those transactions and events in terms of money which are of a financial character. Transactions which are not of a financial character are not recorded in the books of account. For example, if a company has got a team of dedicated and trusted employees, it is of great use to the business but since it is not of a financial character and capable of being expressed in terms of money, it will not be recorded in the books of the business.

5. **Analysing and Interpreting** The recorded financial data is analysed and interpreted in a manner that the end-users can make a meaningful judgement about the financial condition and profitability of the business operations. The data is also used for preparing the future plan and framing of policies for executing such plans.

A distinction here can be made between the two terms—'Analysis' and 'Interpretation'. The term 'Analysis' means methodical classification of the data given in the financial statements. The figures given in the financial statements will not help one unless they are put in a simplified form. For example, all items relating to 'Current Assets' are put at one place while all items relating to 'Current Liabilities' are put at another place. The term 'Interpretation' means explaining the meaning and significance of the data so simplified.

However, both 'Analysis' and 'Interpretation' are complementary to each other. Interpretation requires Analysis, while Analysis is useless without Interpretation.

6. **Communicating** The accounting information after being meaningfully analysed and interpreted has to be communicated in a proper form and manner to the proper person. This is done through preparation and distribution of accounting reports, which include besides the usual income statement and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, funds flow statements, cash flow statements etc. The initiative, imagination and innovative ability of the accountant are put to test in this process.

BOOK-KEEPING AND ACCOUNTING

Some people take book-keeping and accounting as synonymous terms, but they are different from each other. Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner. A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as a position of the Customers' accounts in a departmental store. A substantial portion of the book-keeper's work is of a clerical nature and is increasingly being accomplished through the use of mechanical and electronical devices.

Accounting is primarily concerned with designing the systems for recording, classifying and summarizing the recorded data and interpreting them for internal and external endusers. Accountants often direct and review the work of the book-keepers. The larger the firm, the greater is the responsibility of the accountant. The work of an accountant in the beginning may include some book-keeping. An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than what is required for a book-keeper.

The difference between book-keeping and accounting can be well understood with the help of the following example:

If *A* sells goods to *B* on credit, the only fundamental principle involved is of "dual aspect" and to give a true picture of the transaction, both the aspects must be considered. On the one hand, *A* has lost one asset, *i.e.*, good and on the other hand, he has obtained another asset, *i.e.*, a "debt due from *B*". The book-keeper should debit *B*'s account in *A*'s books and credit the sales account. However, if at the end of a year, *A* has got some stock of goods with him, they should be properly valued in order to ascertain the true profit of the business. The principle to be followed in valuing the stock and many adjustment that will have to be made before the books of account can be closed and true profit or loss can be ascertained, are all matters of accounting. Thus, book-keeping is more of a routine work and a book-keeper, if instructed properly, can record the routine transactions quite efficiently even if he does not know much of accounting principles.

IS ACCOUNTING A 'SCIENCE' OR AN 'ART'?

Any organized knowledge based on certain basic principles is a 'science'. Accounting is also a science. It is a organized knowledge based on scientific principles which have been developed as result of study and experience. Of course, accounting cannot be termed as a "perfect science" like Physics or Chemistry where experiments can be carried and perfect conclusions can be drawn. It is a social science depending much on human behaviour and other social and economic factors. Thus, perfect conclusions cannot be drawn. Some people, therefore, though not very correctly, do not take accounting as a science.

Art is the technique which helps us in achieving our desired objective. Accounting is definitely an art. The American Institute of Certified Public Accountants also defines accounting as "the art of recording, classifying and summarizing the financial transactions". Accounting helps in achieving our desired objective of maintaining proper accounts, *i.e.*, to know the profitability and the financial position of the business, by maintaining proper accounts.

END USERS OF ACCOUNTING INFORMATION

Accounting is of primary importance to the proprietors and the managers. However, other persons such as creditors, prospective investors, employees, etc., are also interested in the accounting information.

1. **Proprietors** A business is done with the objective of making profit. Its profitability and financial soundness are, therefore, matters of prime importance to the proprietors who have invested their money in the business.

5. **No problem of attrition** The organisation has not to face the problem of attrition atleast of persons enjoying key accounting positions, since, they are not in the firm's employment.

However, outsourcing of accounting function has certain disadvantages too. Some of these disadvantages are as under:

1. **No secrecy** The key accounting information is available with the outside agency. Hence, there is a greater possibility of exposure and disclosure of this information to third parties.
2. **Unsuitability** Outsourcing of accounting functions will not be suitable for a large organisation having multi-accounting functions at multi-locations.
3. **Dependence on outsiders** The organisation has to depend on an outside firm to whom the accounting functions have been outsourced. Any instability in the firm to whom the accounting functions have been outsourced may create problems for the organisation.

ACCOUNTING AS AN INFORMATION SYSTEM

An analysis of the definition of accounting in the preceding pages, show that accounting may rightly be termed as an information system that provides reports to various individuals or groups about economic activities of an organisation. It is the means by which most business information is communicated to different sections of public having interest in the business, *viz.*, owners, creditors, prospective investors, etc. Accounting information system is considered to be the most important part of overall management information system (MIS) on account of the following reasons:

(i) It enables both the insiders, *i.e.,* the management and the outsiders, *i.e.,* external information users to have a clear picture of the whole organisation;

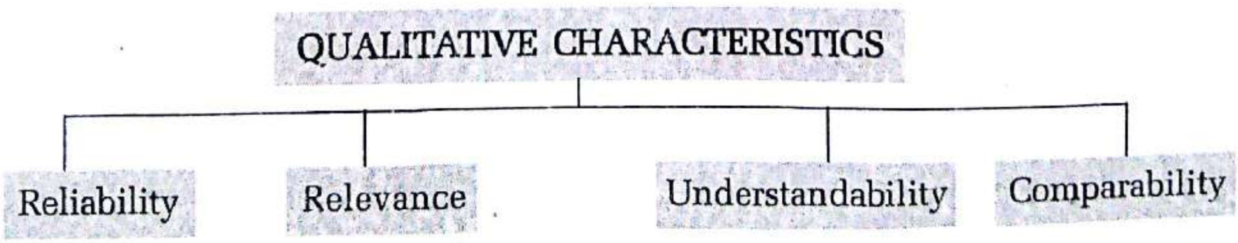
(*ii*) The integration of the accounting information system with other important information systems like marketing, personnel, production, etc., provide useful information for financial planning;

(*iii*) The integration of non-financial information such as social costs and benefits, development of human resources, etc., help the business as well as the government to take appropriate decisions keeping in view the interests of both the society and the business;

(*iv*) The integration of system with other sub-systems like personnel, marketing, production, etc., lead to greater accuracy and higher speed in the delivery of relevant information to the concerned users.

Qualitative Characteristics of Accounting Information System

In order that the information provided by an accounting system is useful to the users, it should possess characteristics as shown in the following chart:



1. Reliability Accounting information is said to be reliable if it is accurate, free from bias and it faithfully represents what it seeks to represent. Reliability of the accounting information, therefore, depends on the following factors.

(*a*) *Accuracy* The information should be free from any material error and capable of being verified.

(*b*) *Unbiased* The information provided must be free from any personal influence or judgement of the persons providing the information. In other words, it should be neutral.

(*c*) *Faithful Presentation* The accounting information must represent faithfully the transactions and other events which it represents or expected, to represent. For instance, if the financial information is subject to certain business risks or uncertainties, it must be disclosed in the accounting information.

(*d*) *Completeness* The information can be reliable if it is complete in all aspects. Any omission may cause the information to be false or misleading and this makes it unreliable.

2. Relevance The accounting information is said to be relevant if it influences the decision making. It should enable the users to evaluate their past, present or future events in entirety. The information should also be available in time and must help both in prediction and appropriate feedback.

3. Understandability The accounting information should be readily understandable by the users. Of course the users are expected to have a reasonable working knowledge of the business and the economic activities and also a willingness to readily understand the accounting information with reasonable diligence. It does not, however, mean that complex accounting information should not be excluded from the financial statements on the ground that such information is of complex nature and, therefore, will not be understood by the users.

4. Comparability The accounting information should be capable of being compared either over a period of time or between two or more entities. This requires that financial statements or accounting reports provide accounting information which relate to the same period based on same account principles and policies and use a common format. Comparability of accounting information will enable an entrepreneur to evaluate its performances *vis-a-vis* other entrepreneurs for evaluation with its own performance over different periods of time.

KEY TERMS

1. **Accounting**: The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of information.
2. **Financial Accounting**: The art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are at least in part of a financial character and interpreting the results.
3. **Management Accounting**: The presenting of accounting information in such a way as to assist the management in the creation of the policy and in the day-to-day operations of the undertaking.

CHAPTER TWO

MEANING OF ACCOUNTING PRINCIPLES

It has already been stated in the first chapter that accounting is the language of business through which normally a business house communicates with the outside world. In order to make this language intelligible and commonly understood by all, it is necessary that it should be based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

Accounting principles[1] may be defined as those rules of action adopted by the accountants universally while recording accounting transaction. "They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist". These principles can be classified into two categories:

(*i*) Accounting Concepts[2] (*ii*) Accounting Conventions

Accounting Concepts

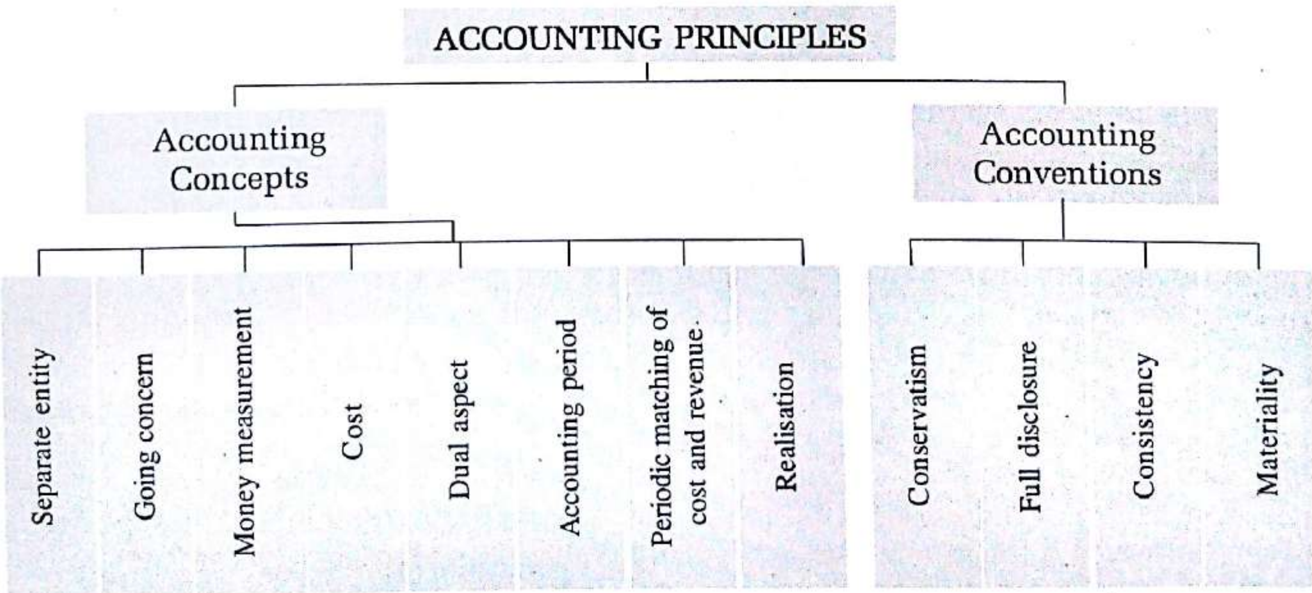
The term 'concepts' includes those basic assumptions or conditions upon which the science of accounting is based. The following are the important accounting concepts:

(*i*) Separate Entity Concept
(*ii*) Going Concern Concept
(*iii*) Money Measurement Concept
(*iv*) Cost Concept
(*v*) Dual Aspect Concept
(*vi*) Accounting Period Concept
(*vii*) Periodic Matching of Cost and Revenue Concept
(*viii*) Realisation Concept

Accounting Conventions

The term 'conventions' includes those customs or traditions which guide the accountant while preparing the accounting statements. The following are the important accounting conventions.

(*i*) Convention of Conservatism
(*ii*) Convention of Full Disclosure
(*iii*) Convention of Consistency
(*iv*) Convention of Materiality



All the above concepts and conventions are being explained below.

1. Also termed as 'Accounting standards' 2. Also termed as 'Accounting postulates'

Accounting Concepts

Corporate Personality

1. Separate Entity Concept In accounting business is considered to be a separate entity from the proprietor(s). It may appear to be ludicrous that one person can sell goods to himself but this concept is extremely helpful in keeping business affairs strictly free from the effect of private affairs of the proprietor(s). Thus, when one person invests ₹10,000 into business, it will be deemed that the proprietor has given that much of money to the business which will be shown as a 'liability' in the books of the business. In case the proprietor withdraws ₹2,000 from the business, it will be charged to him and the net amount payable by the business will be shown only as ₹8,000.

The concept of separate entity is applicable to all forms of business organisations. For example, in case of a partnership business or sole proprietorship business, though the partners or sole proprietor are not considered as separate entities in the eyes of law, but for accounting purposes they will be considered as separate entities.

2. Going Concern Concept According to this concept it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant while valuing the assets does not take into account forced sale value of assets. Moreover, he charges depreciation on fixed assets on the basis of their expected lives rather than on their market value.

It should be noted that the 'going concern concept' does not imply permanent continuance of the enterprise. It rather presumes that the enterprise will continue in operation long enough to charge against income, the cost of fixed assets over their useful lives, to amortise over appropriate period other costs which have been deferred under the actual or matching concept, to pay liabilities when they become due and to meet the contractual commitments. Moreover, the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is normally not impaired.

The enterprise will not be considered as a going concern when it has gone into liquidation or it has become insolvent. Of course, the receiver or the liquidator may endeavour to carry on business operations for some period pending arrangement with the creditors or the final buyer for the sale of the business as a going concern, the going concern status of the concern will stand terminated from the date of his appointment or will be at least regarded as suspended, pending the results of his efforts.

3. Money Measurement Concept Accounting records only monetary transactions. Events or transactions which cannot be expressed in money do not find place in the books of accounts though they may be very useful for the business. For example, if a business has got a team of dedicated and trusted employees, it is definitely an asset to the business but since their monetary measurement is not possible, they are not shown in the books of the business.

Measurement of business event in money helps in understanding the state of affairs of the business in a much better way. For example, if a business owns ₹10,000 of cash, 600 kg of raw materials, two trucks, 1,000 square feet of building space etc., these amounts cannot be added together to produce a meaningful total of what the business owns. However, if these items are expressed in monetary terms such as ₹10,000 of cash, ₹12,000 of raw materials, ₹2,00,000 of trucks and ₹50,000 of building, all such items can be added and much more intelligible and precise estimate about the assets of the business will be available.

4. **Cost Concept** The concept is closely related to going concern concept. According to this concept:

(*a*) an asset is ordinarily entered in the accounting records at the price paid to acquire it, and

(*b*) this cost is the basis for all subsequent accounting for the assets.

If a business buys a plot of land for ₹50,000, the asset would be recorded in the books at ₹50,000 even if its market value at that time happens to be ₹60,000. In case a year later the market value of this assets comes down to ₹40,000, it will ordinarily continue to be shown at ₹50,000 and not at ₹40,000.

The cost concept does not mean that the asset will always be shown at cost. It has also been stated above that cost becomes the basis for all future accounting for the asset. It means that asset is recorded at cost at the time of its purchase, but it may systematically be reduced in its value by charging depreciation.

Cost concept has the advantage of bringing objectivity in the preparation and presentation of financial statements. In the absence of this concept the figures shown in the accounting records would have depended on the subjective views of a person. However, on account of continued inflationary tendencies the preparation of financial statements on the basis of historical costs, has become largely irrelevant for judging the financial position of the business. This is the reason for the growing importance of inflation accounting.

5. **Dual Aspect Concept** This is the basic concept of accounting. According to this concept every business transaction has a dual effect. For example, if *A* starts a business with a capital of ₹10,000, there are two aspects of the transaction. On the one hand, the business has asset of ₹10,000 while on the other hand the business has to pay to the proprietor a sum of ₹10,000 which is taken as proprietor's capital. This expression can be shown in the form of following equation:

Capital (Equities) = Cash (Assets)
10,000 = 10,000

The term 'assets' denotes the resources owned by a business while the term "Equities" denotes the claims of various parties against the assets. Equities are of two types. They are: owners' equity and outsiders' equity. Owners' equity (or capital) is the claim of owners against the assets of the business while outsiders' equity (for liabilities) is the claim of outside parties, such as creditors, debenture-holders etc., against the assets of the business. Since all assets of the business are claimed by some one (either owners or outsiders), the total of assets will be equal to total of liabilities, Thus:

Equities = Assets
or Liabilities + Capital = Assets

In the example given above, if the business purchases furniture worth ₹5,000 out of the money provided by *A*, the situation will be as follows:

Equities = Assets
Capital ₹10,000 = Cash ₹5,000 + Furniture ₹5,000

Subsequently, if the business borrows ₹30,000 from a bank, the new position would be as follows:

Equities = Assets
Capital ₹10,000 + Bank Loan ₹30,000 = Cash ₹35,000 + Furniture ₹5,000

The term 'accounting equation' is also used to denote the relationship of equities to assets. The equation can be technically stated as "for each debit, there is an equivalent credit". As a matter of fact the entire system of double entry book-keeping is based on this concept. This has been explained in detail later in the chapter.

6. Accounting Period Concept According to this concept, the life of the business is divided into appropriate segments for studying the results shown by the business after each segment. This is because though the life of the business is considered to be indefinite (according to going concern concept), the measurement of income and studying the financial position of the business after a very long period would not be helpful in taking proper corrective steps at the appropriate time. It is, therefore, absolutely necessary that after each segment or time interval the businessman must 'stop' and 'see back', how things are going. In accounting such a segment or time interval is called 'accounting period'. It is usually of a year.

At the end of each accounting period an Income Statement and a Balance Sheet are prepared. The Income Statement discloses the profit or loss made by the business during the accounting period while the Balance Sheet depicts the financial position of the business as on the last day of the accounting period. While preparing these statements a proper distinction has to be made between capital and revenue expenditure.

7. Periodic Matching of Costs and Revenue Concept This is based on the accounting period concept. The paramount objective of running a business is to earn profit. In order to ascertain the profit made by the business during a period, it is necessary that 'revenues' of the period should be matched with the costs (expenses) of the period. The term matching, means appropriate association of related revenues and expenses. In other words, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. The question when the payment was received or made is 'irrelevant'. For example, if a salesman is paid commission in January, 2011, for sales made by him in December, 2010, the commission paid to the salesman in January, 2011 should be taken as the cost for sales made by him in December, 2010. This means that revenues of December, 2010 (*i.e.*, sales) should be matched with the costs incurred for earning that revenue (*i.e.*, salesman's commission) in December, 2010 (though paid in January, 2011). On account of this concept, adjustments are made for all outstanding expenses, accrued incomes, prepaid expenses and unearned incomes, etc., while preparing the final accounts at the end of the accounting period.

8. Realisation Concept According to this concept revenue is recognised when a sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. This can be well understood with the help of the following example:

A places an order with *B* for supply of certain goods yet to be manufactured. On receipt of order, *B* purchases raw materials, employs workers, produces the goods and delivers them to *A*. *A* makes payment on receipt of goods. In this case the sale will be presumed to have been made not at the time of receipt of the order for the goods but at the time when goods are delivered to *A*.

However, there are certain exceptions to this concept:

(*i*) In case of hire purchase the ownership of the goods passes to the buyer only when the last instalment is paid, but sales are presumed to have been made to the extent of instalments received and instalments outstanding (*i.e.* instalments due but not received).

(*ii*) In case of contracts accounts, though the contractor is liable to pay only when the whole contract is completed as per terms of the contract, the profit is calculated on the basis of work certified year after year as per certain accepted accounting norms.

Accounting Conventions

1. **Conservatism** In the initial stages of accounting, certain anticipated profits which were recorded, did not materialise. This resulted in less acceptability of accounting figures by the end-users. On account of this reason, the accountants follow the rule 'anticipate no profit but provide for all possible losses' while recording business transactions. In other words, the accountant follows the policy of "playing safe". On account of this convention, the inventory is valued 'at cost or market price whichever is less'. Similarly, a provision is made for possible bad and doubtful debts out of current year's profits. This concept affects principally the category of current assets.

The convention of conservatism has become the target of serious criticism these days especially on the ground that it goes against the convention of full disclosure. It encourages the accountant to create secret reserves (*e.g.*, by creating excess provision for bad and doubtful debts, depreciation etc.), and the financial statements do not depict a true and fair view of the state of affairs of the business. The Income Statement shows a lower net income, the Balance Sheet understates assets and overstates liabilities.

The research studies conducted by the American Institute of Certified Public Accountants have indicated that conservatism concept needs to be applied with much more caution and care if the results reported are not to be distorted.

2. **Full disclosure** According to this convention accounting reports should disclose fully and fairly the information they purport to represent. They should be honestly prepared and sufficiently disclose information which is of material interest to proprietors, present and potential creditors and investors. The convention is gaining more importance because most of big businesses are run by joint stock companies where ownership is divorced from management. The Companies Act, 1956 not only requires that Income Statement and Balance Sheet of a company must give a true and fair view of the state of affairs of the company but it also gives the prescribed forms in which these statements are to be prepared.[3] The practice of appending notes to the accounting statements (such as about contingent liabilities or market value of investments) is in pursuance to the convention of full disclosure.

3. **Consistency** According to this convention, accounting practices should remain unchanged from one period to another. For example, if stock is valued at "cost or market price whichever is less", this principle should by followed year after year. Similarly, if depreciation is charged on fixed assets according to diminishing balance method, it should be done year after year. This is necessary for the purposes of comparison. However, consistency does not mean inflexibility. It does not forbid introduction of improved accounting techniques. However, if adoption of such a technique results in inflating or deflating the figures of profit as compared to the previous period, a note to that effect should be given in the financial statements.

3. American Institute of Certified Public Accountants, 'Inventory of Generally Accepted Principles for Business Enterprises.'

4. **Materiality** According to this convention the accountant should attach importance to material details and ignore insignificant details. This is because otherwise accounting will be unnecessarily overburdened with minute details. The question what constitutes a material detail, is left to the discretion of the accountant. Moreover, an item may be material for one purpose while immaterial for another. For example, while sending each debtor "a statement of his account", complete details upto paise have to be given. However, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred. The Companies Act also permits ignoring of 'paise' while preparing financial statements. Similarly, for tax purposes, the income has to be rounded to nearest ten.

Thus, the term 'materiality' is a subjective term. The accountant should regard an item as material if there is reason to believe that knowledge of it would influence the decision of the informed investor. According to Kohler, "materiality means the characteristic attaching to a statement, fact or item whereby its disclosure or method of giving it expression would be likely to influence the judgement of a reasonable person."

It should be noted that accounting is a man-made art designed to help man in achieving certain objectives. "The accounting principles, therefore, cannot be derived from or proven by laws of nature. They are rather in the category of conventions or rules developed by man from experience to fulfil the essential and useful needs and proposes in establishing reliable financial and operating information control for business entities. In this respect, they are similar to the principles of commercial and other social disciplines."[4]

Generally Accepted Accounting Principles (GAAP)

Accounting practices follow certain guidelines. The rules that govern how accountants measure progress and communicate financial information fall under the heading "Generally Accepted Accounting Principles" (GAAP). GAAP comprises of conventions, rules and procedures that constitute accepted accounting practices at any given time. They are like the law or rules for conducting behaviour in a way acceptable to majority of the people. They may readily be defined as rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist.

It should be noted that GAAP differ from country to country because of the legislative requirements of each country, local accounting practices, customs, usage and business environment peculiar to each country. Each country has set up its own professional accounting body/regulatory authority to frame, implement and regulate the application of the GAAPs in the country. For example, in USA the Financial Accounting Standard Board (FASB) set up in 1973 makes major pronouncements called Statements of Financial Accounting Standards (SFAS) from time to time. Similarly, in UK the Accounting Standard Board set up in 1990 issues financial reporting standards. The Board has replaced the Accounting Standards Committee which was responsible for issuing Statements of Standard Account Practices (SSAPs) earlier from time to time. In

4. American Institute of Certified Public Accountants, "Inventuory of Generally Accepted Principles for Business Enterprises".

India, the Accounting Standard Board set up by the Institute of Chartered Accountants of India issues the accounting standards to be observed by Indian companies. It may, however, be noted that with the globalisation there is an urgent need of the corporates all over the world to synergies their country's generally accepted accounting principles with the international accounting standards now known as International Financial Reporting Standards (IFRS). This will result in the growth and development of a homogeneous accounting standard which will facilitate the stake holders all over the globe to understand accounting information before taking any investment decision.

ACCOUNTING STANDARDS AND INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE/BOARD

International Accounting Standards Committee (*IASC*) came into existence on 29th June, 1973 when 16 accounting bodies from nine nations (called founder-members)[5] signed the agreement and constitution for its formation. The Committee has its headquarters at London.

The objective of the Committee was "to formulate and publish in the public interest standards to be observed in the presentation of audited financial statements and to promote their world-wide acceptance and observance." The formulation of such standards will bring uniformity in terminology, approach and presentation of results. This will not only help in a correct understanding and exchange of economic and financial information but also in facilitating a smooth flow of international investment.

Between 1973 and 2000, the *IASC* issued several Accounting Standards, known as International Accounting Standards (*IASs*). Since 2001, the *IASC* was renamed as the International Accounting Standards Board (*IASB*). The *IASB* has now taken over the work of *IASC*. The *IASB* has issued a new series of pronouncements known as International Financial Reporting Standards (*IFRSs*) on topics on which there was no previous *IAS*. Besides this, the *IASB* has replaced some *IASs* with new *IFRSs*. Thus, now the *IASs* issued by the *IASC* and *IFRSs* issued by the *IASB* all come within the purview of *IASB*.

The list of 41 IASs issued[6] by the *IASC* between 2000-2003 and 13 *IFRSs* issued by the *IASB* is given below:

International Accounting Standards

IAS 1. Presentation of Financial Statements.

IAS 2. Inventories.

IAS 3. Consolidated Financial Statements. (Originally issued in 1976, effective 1 Jan. 1977. Superseded in 1989 by IAS 27 and IAS 28)

IAS 4. Depreciation Accounting. (Withdrawn in 1999, replaced by IAS 16, 22 and 38, all of which were issued or revised in 1998)

IAS 5. Information to be Disclosued in Financial Statements. (Originally issued in Oct. 1976, effective 1 Jan. 1997. Superseded by IAS 1 in 1997)

IAS 6. Accounting Responses to Changing Prices. (Superseded by IAS 15, which was withdrawn in Dec. 2003)

5. The nine nations are: United States of America, Canada, United Kingdom and Ireland, Australia, France, Germany, Japan, Mexico and the Netherlands.
6. Out of 41 IASs, 12 have been withdrawn/replaced or superseded.

SYSTEMS OF BOOK-KEEPING

Book-keeping, as explained earlier, is the art of recording pecuniary or business transactions in a regular and systematic manner. This recording of transactions may be done according to any of the following two systems:

1. **Single entry system** An incomplete double entry system can be termed as a single entry system. According to Kohler, " it is a system of book-keeping in which as a rule only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances". This system has been developed by some business houses, who for their convenience, keep only some essential records. Since all records are not kept, the system is not reliable and can be used only by small firms. The working of this system has been discussed in detail later in a separate chapter.
2. **Double entry system** The system of 'double entry' book-keeping which is believed to have originated with the Venetian merchants of the fifteenth century, is the only system of recording the two-fold aspect of the transaction. This has been, to some extent, explained while discussing the 'dual aspect concept' earlier in this chapter. The system recognises that every transaction has a two-fold effect. If someone receives something then either some other person must have given it, or the first mentioned person must have lost something, or some service etc., must have been rendered by him.

Accounting Equation

The double entry system of book-keeping can very well be explained by the "accounting equation" given below:

Assets = Equities

The properties owned by business are called 'assets'. The rights to the properties are called 'Equities'. Equities may be sub-divided into two principal types: the rights of the creditors and the rights of the owners. The equity of creditors representing debts of the business and are called "liabilities". The equity of owners is called "capital", or proprietorship or owner's equity. Thus:

Assets = Liabilities + Capital

or ***Capital = Assets – Liabilities***

The accounting equation can be understood with the help of the following transactions:

Transaction 1. *A* starts business with a capital of ₹10,000

There are two aspects of the transaction. The business has received cash of ₹10,000. It is its asset but on the other hand it has to pay a sum of ₹10,000 to *A*, the Proprietor. Thus:

Capital and Liabilities	₹	*Assets*	₹
Capital	10,000	Cash	10,000

Transaction 2. *A* purchases furniture for cash worth ₹2,000. The position of his business will be as follows:

Capital and Liabilities	₹	*Assets*	₹
Capital	10,000	Cash	10,000
		Furniture	2,000
	10,000		10,000

Transaction 3. *A* purchases cotton bales from *B* for ₹5,000 on credit. He sells for cash cotton bales costing ₹3,000 for ₹4,000 and ₹1,000 for ₹1,500 on credit to *P*.

As a result of these transactions the business makes a profit of ₹1,500 (*i.e.* ₹5,500 – ₹4,000) this will increase *A*'s Capital from ₹10,000 to ₹11,500. The business will have a liability of ₹5,000 to *B* and two more assets in the form of a debtor *P* for ₹1,500 and stock of cotton bales of ₹1,000. The position of his business will now be as follows:

Capital and Liabilities	₹	*Assets*	₹
Creditor (*B*)	5,000	Cash (`8,000 + 4,000)	12,000
Capital	11,500	Stock of Cotton Bales	1,000
		Debtor (*P*)	1,500
		Furniture	2,000
	16,500		16,500

Transaction 4. *A* withdraws cash of ₹1,000 and cotton bales of ₹200 for his personal use. The amount and the goods withdrawn will decrease relevant assets and *A*'s capital. The position will be now as follows:

Capital and Liabilities	₹	*Assets*	₹
Creditor (*B*)	5,000	Cash (₹12,000 – ₹1,000)	11,000
Capital (₹11,500 – ₹1,200)	10,300	Stock of Cotton Bales	800
		Debtor (*P*)	1,500
		Furniture	2,000
	15,300		15,300

The above type of statement showing the financial position of a business on a certain date is termed as balance sheet.

The result of applying the system of double entry system may be summarised in the form of following rule:

"For every debit there must be equivalent credit and *vice versa*."

The rules of *Debit* and *Credit* have been explained in the succeeding Chapter.

ILLUSTRATION 2.1. Anil had the following transactions. Use accounting equation to show their effect on his assets, liabilities and capital:

1.	Started business with cash	₹ 5,000
2.	Purchased goods on credit	400
3.	Purchased goods for cash	100
4.	Purchased furniture	50
5.	Withdrew for personal use	70
6.	Paid rent	20
7.	Received Interest	10
8.	Sold goods costing ₹50 on credit for	70
9.	Paid to creditors	40
10.	Paid for salaries	20
11.	Further capital invested	1,000
12.	Borrowed from *P*	1,000

ACCOUNTING TERMS

It will be appropriate to get familiarised with certain basic terms which are used in accounting before proceeding with the technique of recording of business transactions. It is necessary for the readers to go through these basic terms and understand them clearly, since it will be then convenient for them to understand clearly the contents of the chapters which are to follow:

1. Assets The term 'assets' include the resources acquired by a business from the funds made available either by the owners or by others. They are "tangible objects or intangible rights owned by an enterprise and carrying probable future benefits".[1] In other words, property of all kinds owned by a business comes within the category of the term 'assets'.

Assets may be classified into the following categories:

(i) *Fixed assets* These are assets which are acquired for relatively long period for carrying on the business of the enterprise. They are not meant for resale. The examples of such assets are land, buildings, plant, machinery, etc.

(ii) *Current assets* These are assets which are acquired with the intention of converting them into cash during the normal business operations of the company. They include "cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business".[2] The essential difference between current assets and fixed assets is that the current assets are held essentially for a short period and they are meant for converting into cash. Examples of such assets are cash, inventories (*i.e.*, stocks of raw material, work-in-progress and finished goods), bills receivable, debtors, etc. These assets are also termed as 'Floating' or 'Circulating' Assets.

(iii) *Liquid assets* These are assets which are immediately convertible into cash without much loss. As a matter of fact, all current assets excluding prepaid expenses and inventories are included in the definition of liquid assets.

(iv) *Fictitious assets* These are assets which have no real value but are shown in the books of accounts only for technical reasons. Examples of such assets are preliminary expenses incurred in connection with the establishment of a business or discount allowed on issue of shares by a company, etc.

(v) *Wasting assets* These are the assets which are exhausted with, or which lose themselves in the goods they produce. Mines and quarries are common examples of such assets. The term is also used for describing such assets which get exhausted with the lapse of time, *e.g.*, copyrights, patents, trademark, etc.

2. Liabilities The term 'Liabilities' is used to denote amounts which a business owes and has to return or account for. They are present obligations whose amounts can be ascertained with substantial accuracy. They can be divided into two categories:

(i) *Current liabilities* The term 'Current Liabilities' is used to denote liabilities which will be due within a short time (usually one year or less) and that are to be paid out of current assets or by creation of other current liabilities. Creditors for goods, bills payable, outstanding expenses are some of the examples of current liabilities.

(ii) *Fixed liabilities* Liabilities that will not be due for a comparatively long time (usually more than one year) are termed as 'Fixed Liabilities' or 'Long-term Liabilities'. These liabilities would continue to be treated as Fixed Liabilities if they are renewed rather than paid at maturity.

1&2. *Accounting Terminology* issued by Institute of Chartered Accountants of India (ICAI).

3. Capital The term 'Capital' is used to denote the owners' equity in the business. It is a residual claim against the assets of the business after the total liabilities are deducted. Owners' Equity, Proprietorship and Net-Worth are some of the other terms which are also used to denote Capital.

Capital may be classified into the following categories:

(i) *Fixed Capital* It is the capital invested in or represented by Fixed Assets.

(ii) *Circulating Capital* It is the capital in the form of Current or Floating Assets.

(iii) *Working Capital* It is the excess of Current Assets over Current Liabilities.

4. Contingent Asset An asset, the existence, ownership value of which may be known or determined only on the occurrence or non-occurrence of one more future uncertain events. It usually arises from unexpected events that give rise to possibility of inflow of economic benefits to the business enterprise. For example, a claim that the firm is pursuing the outcome of which is uncertain, is a contingent asset.

A contingent asset is not recognised in the books of an enterprise. It also does not require any disclosure in the financial statements. Such an asset is assessed continuously and when it becomes virtually certain that it will result in inflow to economic benefits to the enterprise, the asset and the related income may be recognised in the financial statements of the firm in which such change occurs.

5. Contingent Liability It is an obligation relating to existing condition or situation which may arise in future depending upon the occurrence or non-occurrence of one or more uncertain future events. It is a possible obligation which may or may not arise depending upon the situation.

Following are the examples of contingent liabilities:

1. A claim against the enterprise not acknowledged as debt.
2. Uncalled liability on shares partly paid.
3. Arrears of fixed cumulative dividends.
4. Estimated amount of contracts remaining to be executed on capital account and not provided for.

An enterprise should not recognise a contingent liability. However, it may be disclosed as a note to the financial statements. Such liabilities are assessed on a continuing basis to determine whether an outflow of economic resources has become probable, if so to the extent of the probable amount, the liability will have to be recognised in the books and a provision will have to be created.

6. Provision An amount written off or retained by way of providing for depreciation or diminution in value of assets or for providing any known liability, the amount of which cannot determined with substantial accuracy. Examples of a provision are provision for bad and doubtful debts, a provision for discount on debtors, etc.

Difference between a Contingent Liability, a Provision and a Liability This can be understood with the following example:

A lawsuit has been filed against a firm claiming damages of ₹1,00,000. The firm feels that the case against the firm may or may not be dismissed by the court. Such a liability is a contingent liability and may be disclosed by way of a note to the financial statements. However, if the firm feels that it may be required to pay the damages of around ₹20,000 in the suit in all probabilities, the provision to the extent of ₹20,000 for the lawsuit will be created. Finally if the court fixes the damages payable of ₹25,000 against the firms, a liability of ₹25,000 will be recognised in the books of the firm.

7. Transaction and Event Every economic activity is performed through transactions and events. A transaction may be a business, performance of an act or an agreement. While an event is the happening, consequence or result of a transaction.

For example, A starts business with a capital of ₹1,00,000. He makes cash purchases of ₹80,000 and makes cash sales of ₹90,000 of goods costing ₹60,000. He also pays ₹10,000 as rent of the godown.

The following results can be drawn from the above:

1. *Economic Activity*: Starting of business
2. *Transactions are*:
   (*a*) Investment of ₹1,00,000 in the business.
   (*b*) Purchasing of goods for ₹80,000.
   (*c*) Making cash sales of ₹90,000.
   (*d*) Payment of godown rent ₹10,000.
3. *Events are*:
   (*a*) Profit of ₹20,000, computed as under

			₹
	Sales		90,000
	Cost of Purchases	60,000	
Add:	Godown Rent	10,000	70,000
			20,000

(*b*) Cash balance of ₹1,00,000, computed as under:

	Capital introduced		1,00,000
Add:	Cash sales		90,000
			1,90,000
Less:	Cash Purchases	80,000	
	Godown Rent	10,000	90,000
			1,00,000

(*c*) Closing Inventory of ₹20,000 computed as under:

	Goods Purchased	80,000
Less:	Cost of Goods Sold	60,000
		20,000

(*d*) Capital of ₹1,20,000 computed as under:

	Initial capital introduced	1,00,000
Add:	Profit made	20,000
		1,20,000

8. Revenue The term 'Revenue' means income of a recurring nature from any source. The source may be sale of goods, performance of services for a customer or a client, the rental of a property, the lending of money and any other business or professional activity carried on for the purpose of earning income.

9. Expenditure The term includes incurring a liability disbursement of cases or transfer of property for the purpose of obtaining assets goods or services. It may be of three types:

(*i*) *Capital expenditure* An expenditure incurred for obtaining a long-term advantage for the business.

(*ii*) *Revenue expenditure* An expenditure where benefits expire within a year or which has been incurred merely to maintain the business or keep the assets in good working condition.

(*iii*) *Deferred expenditure* An expenditure or liability for which payment has been made or incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. This is also referred to as deferred revenue expenditure.

10. **Expense** The term 'Expense' denotes the cost of services and things used for generating revenue.

An 'Expense' is to be distinguished from a Loss. An Expense is supposed to bring some benefit to the firm, whereas a Loss brings no benefit to the firm, *e.g.*, loss by theft, loss by fire, etc.

The terms 8 to 10 discussed above have been explained in detail later in a separate chapter, "Capital and Revenue".

11. **Goods** The term 'Goods' means the property in which the business deals. In other words, 'Goods' are properties for resale. For example, if a furniture dealer purchases furniture for sale, the furniture so purchased will come within the definition of the term 'Goods'. However, if the furniture has been purchased by a furniture dealer for using it in his business, such furniture will come within the definition of the term 'Fixed Assets'.

12. **Debtor** The person who owes money to the business is called a 'Debtor'.

13. **Creditor** A person who has a claim for money against the business is termed as 'Creditor'.

14. **Bill of Exchange** It is a document in writing directing a certain person to pay a certain sum of money to the order of a certain person or to the bearer of the instrument. For example, if *A*, a creditor by a document in writing asks his debtor *B* to pay a sum of ₹10,000 (owed by *B* on account of purchase of certain goods) after 3 months, such a document is termed as 'Bill of Exchange'.

The document will be termed as 'Bill Receivable' for *A* (*i.e.*, the person entitled to get the payment) and a 'Bill Payable' for *B* (*i.e.*, the person who is liable to pay the money under the document).

15. **Accounts Receivable** The term includes both Debtors and Bills Receivable

16. **Accounts Payable** The term included both Creditors and Bills Payable.

17. **Discount** An allowance or a deduction allowed from an amount due is termed as 'Discount'. It may be of three types:

(*i*) *Trade discount* A deduction allowed to the buyers from the gross or catalogue price is termed as 'Trade Discount'.

(*ii*) *Quantity discount* A deduction allowed to the buyers from the gross catalogue price on making bulk purchases is termed as 'Quantity Discount'.

(*iii*) *Cash discount* A discount allowed to a debtor on prompt payment of cash is termed as 'Cash Discount'.

Trade or quantity discount is not taken into account evolute recording accounting transactions. The transactions are recorded at 'net' while cash discount is recorded in the books of account.

18. **Commission** Commission may be termed as remuneration payable to an employee for his services to the firm or to the agent for purchasing or selling goods, collection of debtors on behalf of the firm, etc. The commission is computed as a percentage of the amount involved. The commission earned is considered as an income while commission allowed is considered as an expense for the business.

Following are examples of persons to whom commission may be allowed:

(1) Selling or buying agents.

(2) Brokers and bankers.

(3) Property dealers for helping in renting out or purchase or sale of properties.

(4) Import-export agent in foreign trade.

19. **Merchandise Cost** It is the same as cost of goods sold. It is computed as follows:

	Opening Inventory	....
Add:	Net Purchases (*i.e.*, purchases *less* returns)	....
	Direct Expenses (*i.e.*, expenses incurred for acquiring the goods and making them fit for sale)	....
Less:	Closing Inventory	....
	Cost of goods sold	....

20. **Gross Profit** It is the excess of the selling price over the cost of goods sold (without deducting any expenses incurred in selling the goods).

21. **Net Profit/Income** It is the profit left after deducting all business expenses from the Gross Profit made by the business.

ILLUSTRATION 3.1. Find out merchandise cost, gross profit and net income from the following transactions:

	₹
Purchases (3,000 articles)	25,000
Freight	1,000
Local Taxes	1,000
Salaries	2,500
Shop Rent	500
Godown Rent	500
Electric Charges	600
Municipal Taxes	200
Stationery	250
Furniture (Estimated life 5 years)	12,000
Sales (2,700 articles)	32,000

SOLUTION:

	₹
(*i*) **Merchandise Cost**	
Purchases	25,000
Freight	1,000
Local Taxes	1,000
Cost of 3,000 articles	27,000
Less: Closing Inventory (300 articles)	2,700
	24,300

(*ii*) **Gross Profit**

Sales – Merchandise Cost

= ₹32,000 – 24,300 = ₹7,700

(*iii*) **Net Income**

Gross Profit – All Other Expenses

= ₹7,700 – 6,950* = ₹750

*Includes ₹2,400 as depreciation on Furniture and all other expenses.

22. **Drawings** The withdrawal of goods or cash from the business by the owner for personal use is called 'Drawings'.

23. **Entry** Recording of a transaction in any book of account is called an 'Entry'.

24. **Insolvent** A person who is not in a position to pay his debts in full. It means that the liabilities of such a person are more than his assets.

25. Solvent A person who is in a position to pay his debts as they become due.
26. Bad Debts The amount lost from a debtor on account of his inability to pay his debts.
27. **Net Assets** The excess of the book value of assets (other than fictitious assets) of an enterprise over its liabilities. This is also referred to as *Net Worth* or *Shareholders' Funds.*
28. **Working Capital** The funds available for day-to-day operations of an enterprise. Also represented by the excess of current assets over current liabilities including short-term loans.

KEY TERMS

1. **Asset:** A tangible object or an intangible right owned by an enterprise and carrying probable future benefits.
2. **Capital:** Owners' equity in the business.
3. **Capital Expenditure:** An expenditure incurred for the purpose of obtaining a long-term advantages for the business.
4. **Goods:** The property in which the business deals.
5. **Liability:** An amount which business owes and has to return or account for.
6. **Revenue:** An income of a recurring nature from any source.
7. **Revenue Expenditure:** An expenditure whose benefit expires within a year or which is incurred merely to maintain the business or keeping the assets in good working condition.

TEST QUESTIONS

Objective Type

1. **State whether each of the following statements is 'True' or 'False':**
   (*i*) The term 'Asset' means a property or possession of the business with the help of which the work of the concern is carried on.
   (*ii*) Wasting Assets are those assets which are meant to be converted into cash in the ordinary course of the firm's business.
   (*iii*) A 'Revenue' denotes the expenditure incurred by the business in earning income.
   (*iv*) A 'Liability' denotes the value in terms of money which the business owes.
   (*v*) Floating Assets are assets those whose value change constantly.
   (*vi*) Circulating Capital is represented by Fixed Assets.
   (*vii*) The terms 'Loss' and 'Expense' have synonymous meaning.
   (*viii*) Goodwill is a current Asset.
   [**Ans.** (*i*) True; (*ii*) False; (*iii*) False; (*iv*) True; (*v*) True; (*vi*) False; (*vii*) False; (*viii*) False]
2. **Fill in the blanks:**
   (*i*) A person who owes money to the firm is a ....
   (*ii*) A person who is entitled to get money from the firm is termed as ....
   (*iii*) All those things which a firm purchases for resale are called ....
   (*iv*) Drawings denote the withdrawal of cash or goods by the owner for ....
   (*v*) The assets used for long-term use in the business are termed as ....
   (*vi*) The excess of Current Assets over Current Liabilities is termed as ....
   [**Ans.** (*i*) debtor; (*ii*) creditor; (*iii*) goods; (*iv*) his personal use; (*v*) fixed assets; (*vi*) working capital]
3. **Choose the correct answer:**
   (*i*) Furniture for a cloth dealer is a
   (*a*) Fixed Asset (*b*) Current Asset
   (*c*) Wasting Assets

CHAPTER FOUR

It has been explained in Chapter 1, that Accounting is the art of recording, classifying and summarising the financial transactions and interpreting the results therefore. Thus, accounting cycle involves the following stages:

1. **Recording of transactions** This is done in the book termed as 'Journal'.
2. **Classifying the transactions** This is done in the book termed as 'Ledger'.
3. **Summarising the transactions** This includes preparation of the trial balance, profit and loss account and balance sheet of the business.
4. **Interpreting the results** This involves computation of various accounting ratios, etc., to know about the liquidity, solvency and profitability of business. The recording of transactions in the Journal is being explained in this chapter.

JOURNAL

The Journal records all daily transactions of a business into the order in which they occur. A Journal may, therefore, be defined as a book containing a chronological record of transactions. It is the book in which the transactions are recorded first of all under the double entry system. Thus, Journal is the book of original record. A Journal does not replace but precedes the Ledger. The process of recording transaction in a Journal, is termed as Journalising. A proforma of journal is given below:

Journal

Date	*Particulars*	*L.F.*	*Debit* ₹	*Credit* ₹
(1)	(2)	(3)	(4)	(5)

1. **Date** The date on which the transaction was entered is recorded here.
2. **Particulars** The two aspects of transaction are recorded in this column, *i.e.*, the details regarding accounts which have to be debited and credited.
3. **L.F.** It means Ledger Folio. The transactions entered in the Journal are later on posted to the ledger. The relevant ledger folio is entered here. Procedure regarding posting the transactions in the Ledger has been explained in the next chapter.
4. **Debit** In this column, the amount to be debited is entered.
5. **Credit** In this column, the amount to be credited is shown.

RULES OF DEBIT AND CREDIT

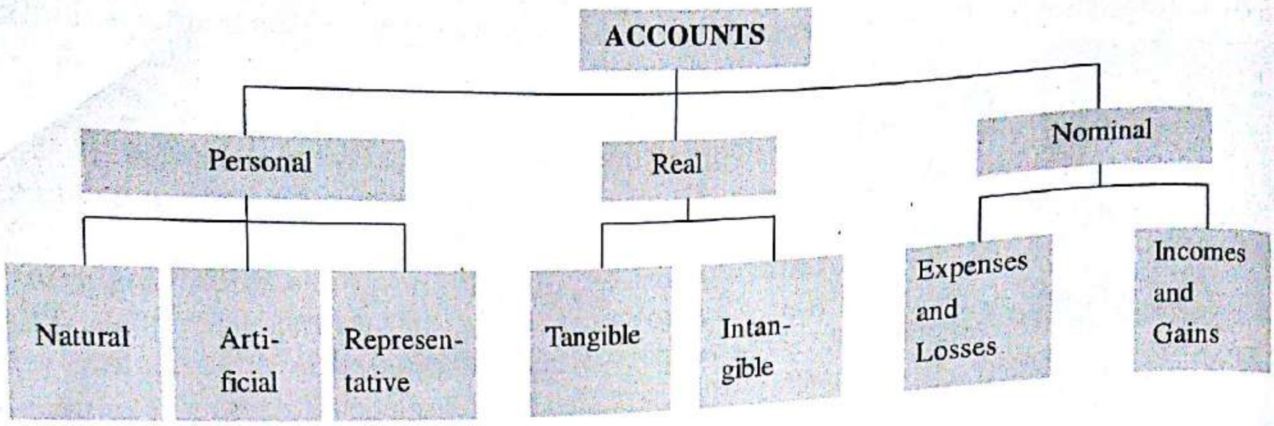
The transactions in the Journal are recorded on the basis of the rules of debit and credit. For this purpose business transactions have been classified into three categories:

(*i*) Transactions relating to persons.
(*ii*) Transactions relating to properties and assets.
(*iii*) Transactions relating to incomes and expenses.

On this basis, it becomes necessary for the business to keep an account of:

(*i*) Each person with whom it deals.
(*ii*) Each property or asset which the business owns.
(*iii*) Each item of income or expense.

The accounts falling under the first heading are called as 'Personal Accounts'. The accounts falling under the second heading are termed as 'Real Accounts'. The accounts falling under the third heading are termed as 'Nominal Accounts'. The classification of the accounts, as explained above, can be put in the form of the following chart:



Each of the above categories of accounts and the relevant rule for 'debit and credit' have been explained in detail in the following pages:

Personal accounts Personal accounts include the accounts of persons with whom the business deals. These accounts can be classified into the three categories.

1. *Natural Personal Accounts* The term 'Natural Persons' means persons who are creation of God. For example, Mohan's Account, Sohan's Account, Abha's Account etc.

2. *Artificial Personal Accounts* These accounts include accounts of corporate bodies or institutions which are recognised as persons in business dealings. For example, the account of a Limited Company, the account of a Co-operative Society, the account of a Club, the account of Government, the account of an Insurance Company etc.

3. *Representative Personal Accounts* These are accounts which represent a certain person or group of persons. For example, if the rent is due to the landlord, an outstanding rent account will be opened in the books. Similarly, for salaries due to the employees (not paid), an outstanding salaries account will be opened. The outstanding rent account represents the account of the landlord to whom the rent is to be paid while the outstanding salaries account represents the accounts of the persons to whom the salaries have to be paid. All such accounts are, therefore, termed as 'Representative Personal Accounts'.

The rule is:

> ➲ **DEBIT THE RECEIVER**
>
> ➲ **CREDIT THE GIVER**

For example, if cash has been paid to Ram, the account of Ram will have to be debited. Similarly, if cash has been received from Keshav, the account of Keshav will have to be credited.

Real accounts Real accounts may be of the following types:

1. *Tangible real accounts* Tangible Real Accounts are those which relate to such things which can be touched, felt, measured etc. Examples of such accounts are cash account, building account, furniture account, stock account, etc. It should be noted that bank account is a personal account; since it represents the account of the banking company—an artificial person.
2. *Intangible real accounts* These accounts represent such things which cannot be touched. Of course, they can be measured in terms of money. For example, patents account, goodwill account, etc.

The rule is:

➲ **DEBIT WHAT COMES IN**
➲ **CREDIT WHAT GOES OUT**

For example, if building has been purchased for cash, building account should be debited (since it is coming into the business) while cash account should be credited (since cash is going out of the business). Similarly when furniture in purchased for cash, furniture account should be debited while the cash account should be credited.

Nominal accounts These accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business, salary is paid to the manager, rent is paid to the landlord, commission is paid to the salesman—cash goes out of the business and it is something real; while salary, rent or commission as such do not exist. The accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information, it may be difficult for the person concerned to explain how the cash at his disposal was utilised.

Nominal Accounts include accounts of all expenses, losses, incomes and gains. The examples of such accounts are rent, rates lighting, insurance, dividends, loss by fire, etc.

The rule is:

➲ **DEBIT ALL EXPENSES AND LOSSES**
➲ **CREDIT ALL GAINS AND INCOMES**

Tutorial Note. Both Real Accounts and Nominal Accounts come in the category of Impersonal Accounts. The student should note that when some prefix or suffix is added to a Nominal Account, it becomes a Personal Account. A table is being given to explain the above rule:

Nominal Account	*Personal Account*
1. Rent account	Rent prepaid account, Outstanding rent account.
2. Interest account	Outstanding interest account, Interest received in advance account, Prepaid interest account.
3. Salary account	Outstanding salaries account, Prepaid salaries account.
4. Insurance account	Outstanding insurance account, Prepaid insurance account.
5. Commission account	Outstanding commission account, Prepaid commission account.

ILLUSTRATION 4.1. From the following transactions find out the nature of account and also state which account should be debited and which account should be credited.

(*a*) Rent paid.
(*b*) Salaries paid.
(*c*) Interest received.
(*d*) Dividends received.
(*e*) Furniture purchased for cash.
(*f*) Machinery sold.
(*g*) Outstanding for salaries.
(*h*) Telephone charges paid.
(*i*) Paid to Suresh.
(*j*) Received from Mohan (the proprietor).
(*k*) Lighting.

SOLUTION:

	Transaction	Accounts Involved	Nature of Accounts	Debit/Credit
(a)	Rent paid	Rent A/c Cash A/c	Nominal A/c Real A/c	Debit Credit
(b)	Salaries paid	Salaries A/c Cash A/c	Nominal A/c Real A/c	Debit Credit
(c)	Interest received	Cash A/c Interest A/c	Real A/c Nominal A/c	Debit Credit
(d)	Dividends received	Cash A/c Dividends A/c	Real A/c Nominal A/c	Debit Credit
(e)	Furniture purchased	Furniture A/c Cash A/c	Real A/c Real A/c	Debit Credit
(f)	Machinery sold	Cash A/c Machinery A/c	Real A/c Real A/c	Debit Credit
(g)	Outstanding for salaries	Salaries A/c Outstanding Salaries A/c	Nominal A/c Personal A/c	Debit Credit
(h)	Telephone charges paid	Telephone Charges A/c Cash A/c	Nominal A/c Real A/c	Debit Credit
(i)	Paid to Suresh	Suresh Cash A/c	Personal A/c Real A/c	Debit Credit
(j)	Received from Mohan (the proprietor)	Cash A/c Capital A/c	Real A/c Personal A/c	Debit Credit
(k)	Lighting	Lighting A/c Cash A/c	Nominal A/c Real A/c	Debit Credit

The journalising of the various transactions is explained now with the help of the following illustration:

ILLUSTRATION 4.2. Ram starts a business with capital of ₹20,000 on January 1, 2011.

In this case there are two accounts involved. They are:

(i) The account of Ram.

(ii) Cash Account.

SOLUTION:

1. Ram is natural person and, therefore, his account is a Personal Account. Cash Account is a tangible asset and, therefore, it is a Real Account. As per the rules of Debit and Credit, applicable to Personal Accounts, Ram is the giver and, therefore, his account, *i.e.*, Capital Account should be credited. Cash is coming in the business and, therefore, as per the rules applicable to Real Accounts, it should be debited. The transaction will now be entered in the Journal as follows:

Journal

Date	Particulars		L.F.	Debit ₹	Credit ₹
2011 Jan. 1	Cash Account To Capital Account *(Being commencement of business)*	Dr.		20,000	20,000

The words put within brackets "Being commencement of business" constitute the narration for the entry passed, since, they narrate the transaction.

2. He purchased furniture for cash for ₹5,000 on January 5, 2011.

The two accounts involved in this transaction are the Furniture Account and the Cash Account. Both are Real Accounts. Furniture is coming in and, therefore, it should be debited while cash is going out and, therefore, it should be credited. The Journal entry will, therefore, be as follows:

Journal

Date	*Particulars*		*L.F.*	*Debit* ₹	*Credit* ₹
2011 Jan. 5	Furniture Account	Dr.		5,000	
	To Cash Account				5,000
	(Being purchase of furniture)				

3. He paid rent for business premises ₹2,000 on January 10, 2011.

In this transaction, two accounts involved are the Rent Account and the Cash Account. Rent Account is Nominal Account. It is an expense and, therefore, it should be debited. Cash Account is a Real Account. It is going out of the business and, therefore, it should be credited. The journal entry will, therefore, be as follows:

Journal

Date	*Particulars*		*L.F.*	*Debit* ₹	*Credit* ₹
2011 Jan. 10	Rent Account	Dr.		2,000	
	To Cash Account				2,000
	(Being payment of rent)				

4. He purchased goods on credit of ₹2,000 from Suresh on January 20, 2011.

The two accounts involved in the transaction are those of Suresh and Goods. The account of Suresh is a Personal Account while that of Goods is a Real Account. Suresh is the giver of goods and, therefore, his account should be credited while Goods are coming in the business and, therefore, Goods Account should be debited.

Journal

Date	*Particulars*		*L.F.*	*Debit* ₹	*Credit* ₹
2011 Jan. 20	~~Cash~~ Purchase Account	Dr.		2,000	
	To Suresh				2,000
	(Being purchase of goods on credit)				

Classification of Goods Account The term goods include articles purchased by the business for resale. Goods purchased by the business may be returned back to the supplier. Similarly, goods sold by the business to its customers can also be returned by the customers back to the business due to certain reasons. In business, it is desired that a separate record be kept of all sale, purchase and return of goods. Hence, Goods Accounts can be classified into the following categories:

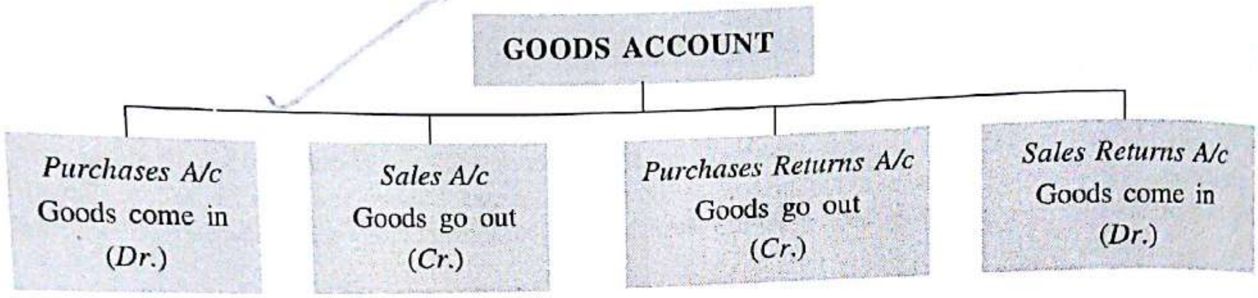
(*i*) *Purchases Account* The account is meant for recording all purchases of goods. Goods "come in" on purchasing of goods and, therefore, the Purchases Account is debited on purchase of goods.

(*ii*) *Sales Account* The account is meant for recording of selling of goods. The goods "go out" on selling of goods, and therefore, on sale of goods, the Sales Account is credited.

(*iii*) *Purchases Returns Account* The account is meant for recording return of goods purchased. The goods "go out" on returning of goods to the suppliers and, therefore, the account should be credited on returning goods purchased.

(*iv*) *Sales Returns Account* The account is meant for recording return of goods sold, by the customers. The goods "come in" and, therefore, the Sales Returns Account should be debited on return of goods.

The above classification of Goods Account can be shown in the form of the following chart:



COMPOUND JOURNAL ENTRY

Sometimes there are a number of transactions on the same date relating to one particular account or of one particular nature. Such transactions may be recorded by means of a single journal entry instead of passing several journal entries. Such entry regarding recording a number of transactions is termed as a "Compound Journal Entry". It may be recorded in any of the following three ways:

(*i*) One particular account may be debited while several other accounts may be credited.

(*ii*) One particular account may be credited while several other accounts may be debited.

(*iii*) Several accounts may be debited and several other accounts may also be credited.

This has been explained in the following illustration:

ILLUSTRATION 4.3. Pass a compound journal entry in each of the following cases:

1. Payment made to Ram ₹1,000. He allowed a cash discount of ₹50.
2. Cash received from Suresh ₹800 and allowed him ₹50 as discount.
3. A running business was purchased by Mohan with the following assets and liabilities:
   Cash ₹2,000; Land ₹4,000; Furniture ₹1,000; Stock ₹2,000; Creditors ₹1,000; Bank Overdraft ₹2,000.

SOLUTION:

Journal

Sl. No.	*Particulars*	*L.F.*	*Debit* ₹	*Credit* ₹
1.	Ram Dr. To Cash A/c To Discount A/c *(Being payment made to Ram ₹1,000 and he allowed ₹50 as discount)*		1,000	950 50

(Contd..)

Sl. No.	Particulars		L.F.	Debit ₹	Credit ₹
2.	Cash A/c	Dr.		800	
	Discount A/c	Dr.		50	
	To Suresh				850
	(Being cash received from Suresh ₹800 and discount allowed ₹50)				
3.	Cash A/c	Dr.		2,000	
	Land A/c	Dr.		4,000	
	Furniture A/c	Dr.		1,000	
	Stock A/c	Dr.		2,000	
	To Creditors				1,000
	To Bank Overdraft				2,000
	To Capital A/c				6,000
	(Being commencement of business by Mohan by taking over a running business)				

Notes:

1. The total of payment due to Ram was ₹1,050. A payment of ₹1,000 has been made to him and he allowed a discount of ₹50. This means by paying ₹1,000, a full credit for ₹1,050 has been obtained. The account of Ram is a Personal Account, and therefore, it has been debited as he is the receiver. The cash has gone out of the business and, therefore, Cash Account being a Real Account, has been credited. Discount Account is a Nominal Account; getting discount is a gain to the business and, therefore, it has been credited.
2. Suresh was to pay sum of ₹850. He paid ₹800 and he was allowed a discount of ₹50. It means by paying ₹800 only, Suresh could get a full credit of ₹850. The Cash Account is a Real Account and, therefore, it has been debited since cash is coming in. Discount Account is a Nominal Account; it has been debited since it is a loss to the business. Suresh is the giver. His account being a Personal Account, it has been credited by ₹850.
3. It is not necessary that a person should start business only with cash. He may bring the assets into the business or he may purchase a running business. Mohan in the present case has purchased the assets of some other business. The net assets (*i.e.* assets–liabilities taken over) will be the capital of Mohan. The business is getting various assets and, therefore, the assets accounts have been debited. The business creates certain liabilities in the form of creditors, bank overdraft, and, therefore, these accounts have been credited. Mohan's Account, *i.e.*, his Capital Account has been credited by the balance since it represents the capital brought in by him.

ILLUSTRATION 4.4. Journalize the following transactions for the month of Dec. 2011. Also state the nature of each account involved in the Journal entry.

1. Dec. 1: Ajit started business with Cash ₹40,000.
2. Dec. 3: He paid into the Bank ₹2,000.
3. Dec. 5: He purchased goods for cash ₹15,000.
4. Dec. 8: He sold goods for cash ₹6,000.
5. Dec. 10: He purchased furniture and paid by cheque ₹5,000.
6. Dec. 12: He sold goods to Arvind ₹4,000.
7. Dec. 14: He purchased goods from Amrit ₹10,000. means on credit as cash not mentioned
8. Dec. 15: He returned goods to Amrit ₹5,000.
9. Dec. 16: He received from Arvind ₹3,960 in full settlement.
10. Dec. 18: He withdrew goods for personal use ₹1,000.
11. Dec. 20: He withdrew cash from business for personal use ₹2,000.
12. Dec. 24: He paid telephone charges ₹1,000.
13. Dec. 26: Cash paid to Amrit in full settlement ₹4,900.
14. Dec. 31: Paid for stationary ₹200, rent ₹500 and salaries to staff ₹2,000.
15. Dec. 31: Goods distributed by way of free samples ₹1,000.

SOLUTION:

Journal

Sl. No.	Date	Particulars	Nature of Account	L.F.	Debit ₹	Credit ₹
1.	Dec. 1	Cash A/c Dr. To Capital A/c *(Being commencement of business)*	Real A/c Personal A/c		40,000	 40,000
2.	Dec. 3	Bank A/c Dr. To Cash A/c *(Being cash deposited in the bank)*	Personal A/c Real A/c		2,000	 2,000
3.	Dec. 5	Purchases A/c Dr. To Cash A/c *(Being purchase of goods for cash)*	Real A/c Real A/c		15,000	 15,000
4.	Dec. 8	Cash A/c Dr. To Sales A/c *(Being goods sold for cash)*	Real A/c Real A/c		6,000	 6,000
5.	Dec. 10	Furniture A/c Dr. To Bank A/c *(Being purchase of furniture, paid by cheque)*	Real A/c Personal A/c		5,000	 5,000
6.	Dec. 12	Arvind Dr. To Sales A/c *(Being sale of goods)*	Personal A/c Real A/c		4,000	 4,000
7.	Dec. 14	Purchases A/c Dr. To Amrit *(Being purchase of goods from Amrit)*	Real A/c Personal A/c		10,000	 10,000
8.	Dec. 15	Amrit Dr. To Purchases Returns A/c *(Being goods returned to Amrit)*	Personal A/c Real A/c/		5,000	 5,000
9.	Dec. 16	Cash A/c Dr. Discount A/c Dr. To Arvind *(Being cash received from Arvind in full settlement and allowed him ₹40 as discount)*	Real A/c Nominal A/c Personal A/c		3,960 40	 4,000
10.	Dec. 18	Drawings A/c Dr. To Purchases A/c *(Being withdrawal of goods for personal use)*	Personal A/c Real A/c		1,000	 1,000
11.	Dec. 20	Drawings A/c Dr. To Cash A/c *(Being cash withdrawal from the business for personal use)*	Personal A/c Real A/c		2,000	 2,000
12.	Dec. 24	Telephone Expenses A/c Dr. To Cash A/c *(Being telephone expenses paid)*	Nominal A/c Real A/c		1,000	 1,000

(Contd..)

Sl. No.	Date	Particulars		Nature of Account	L.F.	Debit ₹	Credit ₹
13.	Dec. 26	Amrit	Dr.	Personal A/c		5,000	
		To Cash A/c		Real A/c			4,900
		To Discount A/c		Nominal A/c			100
		(Being cash paid to Amrit and he allowed ₹100 as discount)					
14.	Dec. 31	Stationery Expenses	Dr.	Nominal A/c		200	
		Rent A/c	Dr.	Nominal A/c		500	
		Salaries A/c	Dr.	Nominal A/c		2,000	
		To Cash A/c		Real A/c			2,700
		(Being expenses paid)					
15.	Dec. 31	Advertisement Expenses A/c	Dr.	Nominal A/c		1,000	
		To Purchases A/c		Real A/c			1,000
		(Being distribution of goods by way of free samples)					
		TOTAL				1,21,700	1,21,700

Notes:

Transaction 9. Ajit was to receive ₹4,000 from Arvind. He accepts only ₹3,960 in full settlement. It means, he allows ₹40 as discount to him. The journal entries will be:

(*i*) Cash A/c	Dr.	3,960	
To Arvind			3,960
(*ii*) Discount A/c	Dr.	40	
To Arvind			40

A single entry may be passed in place of two entries stated above. Cash is a Real Account and, therefore, it should be debited. Discount is a Nominal Account and, therefore, it should also be debited. The account of Arvind is a Personal Account and he is entitled to get a full credit of ₹4,000 by paying only ₹3,960. His account should, therefore, be credited by ₹4,000.

It may be remembered that cash or bank account and discount account go together. It means if cash is debited, the discount account should also be debited. In case the cash is credited, the discount account should also be credited. This is because when cash is received, discount is allowed to debtors. Cash Account is a Real Account and, therefore, it should be debited by the amount of cash actually received. The discount account is a Nominal Account and, therefore, on receipt of cash when discount is allowed, this is a loss which should be debited. Similarly, when cash is paid, discount is earned from the creditors. On payment of cash, therefore, Cash Account should be credited (since cash is a Real Account and it is going out of the business) and Discount Account should be credited (since Discount Account is a Nominal Account and discount received is a gain to the business).

Transaction 10. When goods are withdrawn by the proprietor of the business for his personal use, he is to be charged for them since business and the proprietor are two different persons as per separate entity concept. The problem is at what price should he be charged? He cannot be charged at the selling price for the goods. It will not be fair. He has to be charged with only the cost price of the goods withdrawn by him. It will be, therefore, appropriate to reduce the purchase of the business by the amount of goods withdrawn by the proprietor for his personal use as if the goods were purchased partly for the business and partly for him.

The same rule applies in those cases, where the goods purchased by the business are used for the purpose of business itself. For example, in case of a stationary business, some stationery may be used for the business itself. In such case, the following journal entry will be passed: