Accountancy-I

By: Saritha Ravi

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1

INTRODUCTION

Every organisation needs to maintain good records to track how much money they have, where it came from, and how they spend it. These records are maintained by using an accounting system. The modern method of accounting is based on the system created by an Italian Monk *Fra Luca Pacioli*. He developed this system over 500 years ago. This great and scientific system was so well designed that even modern accounting principles are based on it. In the past many businesses maintained their records manually in books – hence the term "book-keeping" came about. This method of keeping manual records was cumbersome, slow, and prone to human errors of translation.

CHAPTER AT A GLANCE

ACCOUNTING: AN OVERVIEW

Book-keeping is the recording of all financial transactions undertaken by an individual or organisation (including a corporation or legal person). Book-keeping is "keeping records of what is bought, sold, owed, and owned; what money comes in, what goes out, and what is left." Book-keeping is a part of the accounting cycle, and book-keepers' work is closely related to that of accountants.

The American Institute of Certified Public Accountants defines accounting as *"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."* A business house must necessarily keep a systematic record of its day-to-day transactions to enable stakeholders to get a complete financial picture of the company and to take stock of its financial position on a periodic basis. Stakeholders include the company's promoters, shareholders, creditors, employees, government and the public.

Accounting is the system a company uses to measure its financial performance by noting and classifying all the transactions like sales, purchases, assets, and liabilities in a manner that adheares to certain accepted standard formats. It helps to evaluate a company's past performance, present condition, and future prospects.

Accountancy or **Accounting** is the measurement, statement, or provision of assurance about financial information primarily used by lenders, managers, investors, tax authorities and other decision makers to make resource allocation decisions between and within companies, organisations, and public agencies.

Accounting *vs.* Accountancy

Body of knowledge (consisting of principles, postulates, assumptions, conventions, concepts and rules) governing the science of recording classifying and analysing financial transactions is accounting, whereas the practice of the art and science of accounting is termed as accountancy. To meet the ever increasing demands made on accounting by different interested parties (such as owners, management, creditors, taxation authorities etc.) the various branches have come into existence

Branches of Accounting: In order to meet the ever increasing demands made on accounting by different interested parties the various branches of accounting have come into existence.

Financial Accounting: The main purpose of financial accounting is to ascertain the true result of the business operations during a particular period of time and to state the financial position of the business on a particular point of time. Financial accounting produces general purpose reports for use by the great variety of people who are interested in the organisation but who are not actively engaged in its day-to-day operation. Financial accounting is the oldest and the other branches have developed from it. The objects of financial accounting can only be achieved by recording business transactions in a systematic manner according to a set of principles.

Cost Accounting: The main objective of cost accounting is to determine the cost of goods manufactured or produced by the business. It also helps the management of the business in controlling the costs by indicating avoidable losses and wastes.

Managerial Accounting: The object of this accounting is to communicate the relevant information periodically to the management of the business to enable it to take suitable decisions.

We have seen that Accounting Consists of following Functions:

- Recording
- Classifying
- Summarizing
- Reporting and
- Evaluating the financial activities of a business.

Before any recording can take place, there must be something to record. In accounting, the something consists of a transaction or event that has affected the business. Evidence of the transaction is called a document. For example: A sale is made, evidenced by a sales slip. A purchase is made, as evidenced by a cheque and other documents such as an invoice and a purchase order. Wages are paid to employees with the cheques and payroll records as support. Accountants do not record a conversation or an idea. They must first have a document. In almost any business, these documents are numerous and their recording requires some sort of logical system. Recording is first carried out in a book of original entry called the journal. A journal is a record, listing transactions in a chronological order. At this point, we have a record of a great volume of data. How can this data best be used? Aside from writing down what has occurred for later reference, what has been accomplished? The answer is, of course, that the accountant has only started on his task. This great volume of data in detailed listings must be summarised in a meaningful way. When asked, the accountant must turn to these summaries to answer questions like: What were total sales this month? What were the total expenses and what were the types and amounts of each expense? How much cash is in hand? How much does the business owe? How much are the accounts receivable?

The next task after recording and classifying is summarising the data in a significant fashion. The records kept by the accountant are of little value until the information contained in the records is reported to the owner(s) or manager(s) of the business. These records are reported to the owners by preparing a wide variety of financial statements. The accountant records, classifies, summarises, and reports transactions that are mainly financial in nature and affect the business. The reporting, of course, involves placing his interpretation on the summarised data by the way he arranges his reports. Every business has a unique method of maintaining its accounting books. However, all accounting systems are similar in the following manner:

- Business documents representing transactions that have taken place. (A business transaction occurs when goods are sold, a contract is signed, merchandise is purchased, or some similar financial transaction has occurred).
- Various journals where the documents are recorded in detail and classified.
- Various ledgers where the details recorded in the journals are summarised .
- Financial reports where the summarised information is presented.
- Where variations exist, they have to do with the way the business transaction is assembled, processed, and recorded.

BASIC ACCOUNTING CONCEPTS

The two fundamental accounting concepts which were developed centuries ago, but remain central to the accounting process are:

1 The Accounting Equation
2 Double-entry Book-keeping

Now let us discuss the accounting equation, which keeps all the business accounts in balance. We will create this equation in steps to clarify your understanding of this concept. In order to start a business, the owner usually has to put some money down to finance the business operations. Since the owner provides this money, it is called **Owner's equity**. In addition, this money is an **Asset** for the company. This can be represented by the equation: **ASSETS = OWNER'S EQUITY.**

If the owner of the business were to close down this business, he would receive all its assets. Let's say that owner decides to accept a loan from the bank. When the business decides to accept the loan, their assets would increase by the amount of the loan. In addition, this loan is also a Liability for the company. This can be represented by the equation: **Assets = Liabilities + Owner's Equity.** Now the Assets of the company consist of the money invested by the owner, **(i.e. Owner's Equity),** and the loan taken from the bank, **(i.e. a Liability)**. The company's liabilities are placed before the owners' equity because creditors have first claim on assets. If the business were to close down, after the liabilities are paid off, anything left over (assets) would belong to the owner.

The Double Entry System: As we had mentioned earlier that today's accounting principles are based on the system created by an Italian *Monk Luca Pacioli*. He developed this system over 500 years ago. Pacioli had devised this method of keeping books, which is today known as the Double Entry system of accounting. He explained that every time a transaction took place whether it was a sale or a collection – there were two offsetting sides. The entry required a two-part "give-and-take' entry for each transaction. Here is a simple explanation of the double entry system. Say you took a loan from the bank for Rs. 5,000. Now if you can recall in an earlier discussion we had mentioned that: **ASSETS = LIABILITIES + OWNER'S EQUITY.**

Since the company borrowed money from the bank, the Rs. 5,000 is a liability for the company. In addition, now that the company has the extra Rs. 5,000, this money is an asset for the company. If we were to record this information in our accounts, we would put Rs. 5,000 in an account called **Loan taken from the Bank**, and Rs. 5,000 in an account called **Cash saved in the Bank**. The former account will be a Liability and the second account would be an Asset. As you can see, we created two entries. The first one is to show from where the money was received (i.e. the source of the money). The second entry is to show where the money was sent (i.e. the destination of the money received). In a double entry accounting system, every transaction is recorded in the form of debits and credits. Even for the simplest double entry, transaction there will be a debit and a credit. In simpler terms, a debit is the application of money, and credit is the source of money. Let us discuss some examples to help you understand the concept of debits and credits:

Example 1: Let's say you wrote a cheque for Rs.100 to purchase some stationery. This transaction would be recorded as a Credit of Rs.100 to the Cash in Bank Account, and a Debit of Rs.100 to the Stationary Account. In this case, we made a credit to the Cash in Bank, as it was the source of the money. The Stationery Account was debited, as it was the application of the money.

Example 2: Let's say you received Rs. 200 cash for services rendered to a client. This transaction would be recorded as a Credit of Rs. 200 to the Income from Services account, and a Debit of Rs. 200 to the Cash in Bank account. In this case, we made a credit to the Income from Services, as it was the source of the money. The Cash in Bank account was debited, as it was the application of the money.

SYSTEMS OF BOOK–KEEPING: The systems of book-keeping are divided in to two namely double entry system and single entry system.

Double Entry System: In the 15th century an Italian *Monk, Luca Pacioli*, described a method of arranging accounts in such a way that the dual aspect (present in every account transaction) would be expressed by a debit amount and an equal and offsetting credit amount. Double Entry system is the system under which each transaction is regarded to have two fold aspects and both the aspects are recorded to obtain complete record of dealings. Double Entry system of book-keeping adhares to the rule that for each transaction the debit amount(s) must equal the credit amount(s). That is why this system is called Double Entry.

Advantages of Double Entry System

(i) It enables to keep a complete record of business transactions.

(ii) It provides a check on the arithmetical accuracy of books of accounts based on equality of debit and credit.

(iii) It gives the results of business activities either profit or loss during the accounting period.

(iv) It tells the financial position of the business at a point of time. Total resources of the business, claims of the outsiders, amount due by outsiders etc. are revealed by a statement known as Balance Sheet.

(v) It makes possible comparison of the current year with those of previous years helping the owner to manage his business on better lines.

(vi) It reduces the chances of errors creeping in the accounting records because of its equality principle.

(vii) It helps to ascertain the details regarding any account easily and accurately.

The process of accounting that we deal with is called the "Double Entry System of Accounting". This is called so, based on the dual entity concept–"Every transaction has its effect on two accounts/elements." One another interpretation being every transaction has its effect on two Ledger Accounts i.e. it has got two entries in the ledger. This is the accounting system that is predominantly in use in most parts of the world.

Single Entry System: Single-entry book-keeping uses only income and expense accounts, recorded primarily in a Revenue and Expense Journal. Single-entry book-keeping is adequate for many small businesses. The single-entry system is "a system of book-keeping in which as a rule only records of cash and of personal account are maintained"; it is always incomplete double entry varying with circumstances. Such system may be economical but it is incomplete, unscientific and full of defects.

WHAT IS AN ACCOUNT?

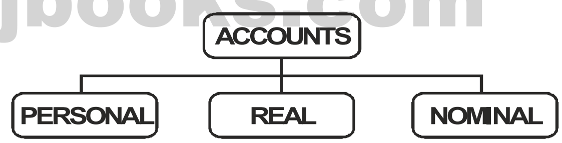
An account is the summarised record of transactions applicable to person, property, liability, income or expenditure. A separate page is allotted for a particular account and only transactions affecting it are written in that page. The page is divided into two sides. The left hand side of an account is called debit side (Dr.) and the right hand side is called the credit side (Cr.). Transactions involving receipts and payments of cash affect the cash balance. Receipts increase the cash balance and payments decrease the cash balance. Instead of increasing or decreasing the balance after every transaction we may put all increases together in one column and all decreases together in another column and find the balance only when required. It will be much convenient and time saving.

In accounting, the device called an account is used for this purpose. The simple form of account is called a "T" account which is shown below. Increases of cash have been listed on the left hand side and the decreases on the right hand side; the closing balance has been ascertained by deducting the total payments from the total of the left-hand side.

Name of the Account (A/c).

CLASSIFICATION OF ACCOUNTS

Accounts are mainly classified into two namely personal accounts and impersonal accounts. Impersonal accounts are again divided into two: Real and Nominal. Thus there are three principal types of accounts namely personal, real and nominal.



1. Personal Accounts: These are accounts opened in the name of the persons, firms, or companies e.g., Mohan's account, Ram & Co's account, Krishna & Bros. account. Personal accounts may further be classified as:

(i) **Natural Person's Personal Accounts:** The accounts recording transactions relating to individual human beings e.g., Anand's A/c, Rajesh's A/c, Pankaj's A/c are classified as natural person's personal accounts.

(ii) **Artificial Person's Personal Account:** The accounts recording transactions relating to limited companies, Bank, firm, institution, club. etc., e.g. Delhi University College; Rotary Club are classified as artificial persons' personal accounts.

(iii) **Representative Personal Accounts:** The accounts recording transactions relating to the expenses and incomes are classified as nominal accounts. But in certain cases due to the matching concept of accounting the amount, on a particular date, is payable to the individuals

or recoverable from individuals. Such amount (i) relates to the particular head of expenditure or income and (ii) represents persons to whom it is payable or from whom it is recoverable. Such accounts are classified as representative personal accounts e.g. "Wages Outstanding Account", Pre-paid Insurance Account. etc.

2. Real Accounts: Real accounts are also called property accounts as they record the transactions of business related to properties, assets or possession e.g. cash, goods, furniture, machinery, bank account etc.

3. Nominal Accounts: These are accounts that record transactions relating to expenses, losses, incomes or gains of the business. A separate account is opened for each head of expense, such as salary, rent, wages, stationery, interest, discount etc., and also for incomes such as commission received, dividend received, discount etc.

According to *Modern approach* Accounts are classified into five groups:

• Asset • Expense • Revenue • Liability • Capital.

RULES OF DEBIT AND CREDIT

The golden rules of accounting are:

Personal A/c - Debit the receiver, Credit the giver.

Real A/c - Debit what comes in, Credit what goes out.

Nominal A/c - Debit all incomes and gains, Credit all expenses and losses.

Debit and Credit are two actions of opposing nature that are relevant to the process of accounting. They are as fundamental to accounting as addition (+) and subtraction (–) are to mathematics. It would not be appropriate to apply this mathematical analogy in all cases as it would give a distorted meaning. Thus, it would not be appropriate to consider debit to be an equivalent of addition and credit to be an equivalent of subtraction. The debit and credit are two actions that are opposite in nature.

These are the backbone of any accounting system. Every accounting entry in the general ledger contains both a debit and a credit. Further, all debits must equal all credits. If they don't, the entry is out of balance, and then the balance sheet will also be out of balance.

Therefore, the accounting system must have a mechanism to ensure that all entries balance. Indeed, most automated accounting systems won't let you enter an out-of-balance entry-they'll just beep at you until you fix your error.

Depending on what type of account you are dealing with, a debit or credit will either increase or decrease the account balance. (Here comes the hardest part of accounting for most beginners, so pay attention.) **Table 1** illustrates the entries that increase or decrease each type of account.

Table 1

Debits and Credits* vs. *Account Types

Account Type	Debit	Credit
Assets	Increases	Decreases
Liabilities	Decreases	Increases
Income	Decreases	Increases
Expenses	Increases	Decreases

Notice that for every increase in one account, there is an opposite (and equal) decrease in another. That's what keeps the entry in balance. Also notice that debits always go on the left and credits on the right.

An element (account) that is effected by an accounting transaction is either debited or credited (with an amount that is reflected in the transaction) depending on the nature of the account and the rule applicable to it.

- A purchase of Furniture worth Rs. 10,000 for Cash.
  This transaction would result in:
  (i) Furniture A/c being debited by an amount of Rs. 10,000 and
  (ii) Cash A/c being credited by a similar amount.
- A payment of Rs. 5,000 received from Mr. Mohit by Cheque.
  This transaction would result in:

1. Mr. Mohit A/c being credited to the extent of Rs. 5,000 and
2. The Bank A/c being debited with a similar amount.

The Total Process of Accounting is driven by

- The dual entity concept
- The nature of the accounts and
- The rules/principles of debit and credit.

All the account heads used in the accounting system of an organisation are classified under three heads Real, Personal and Nominal. Each account type has a pair of principles or rules of debit and credit relevant to it. One for debit and another for Credit.

Real Accounts

Debit what comes in

Consider the following Transaction: Bought Furniture for Credit from M/s New Mart

The two elements affected by the transaction are

(i) Furniture A/c (Real account) and

(ii) M/s New Mart A/c (Personal account).

Since furniture is being bought, we can say that it is coming in. Thus we say that Furniture a/c is to be debited based on the principle "Debit what comes in".

Credit what goes out

Consider the following Transaction: Sold Goods to Mr. Rohit on credit

The two elements affected by the transaction are

(i) Goods A/c (Real account) and

(ii) Mr. Rohit A/c (Personal account).

Since we are selling goods, we can say that it is going out. Thus we say that Goods a/c is to be credited based on the principle "Credit what goes out".

Thought to be applied: Is it Coming in (Or) Is it Going out

To decide whether a particular Real Account (element) effected by an accounting transaction is to be debited or credited; we need to identify whether the element is coming into the organisation or going out of it.

Personal Accounts

Debit the benefit receiver

Consider the following Transaction: Paid Cash to Mr. John

The two elements affected by the transaction are

(i) Cash A/c (Real account) and

(ii) Mr. John A/c (Personal account).

Since cash is being paid, we can say that Mr. John is receiving (benefit) from the organisation. Thus we say that Mr. John's A/c is to be debited based on the principle "Debit the benefit receiver".

[Please ignore the effect relating to the other element]