

# 1. OVERVIEW

This chapter covers the following topics:

- Definition of Accounting
- Objectives & Scope
- Accounting Process
- Accounting Concepts
- Accounting Conventions
- Classification of Accounts
- System of Accounting
- Rules of Double Entry Accounting System

## Introduction

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Accounting is a business language. We can use this language to communicate financial transactions and their results. Accounting is a comprehensive system to collect, analyze, and communicate financial information.

The origin of accounting is as old as money. In early days, the number of transactions were very small, so every concerned person could keep the record of transactions during a specific period of time. Twenty-three centuries ago, an Indian scholar named **Kautilya** alias **Chanakya** introduced the accounting concepts in his book **Arthashastra**. In his book, he described the art of proper account keeping and methods of checking accounts. Gradually, the field of accounting has undergone remarkable changes in compliance with the changes happening in the business scenario of the world.

A bookkeeper may record financial transactions according to certain accounting principles and standards and as prescribed by an accountant depending upon the size, nature, volume, and other constraints of a particular organization.

With the help of accounting process, we can determine the profit or loss of the business on a specific date. It also helps us analyze the past performance and plan the future courses of action.

## Definition of Accounting

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The American *Institute of Certified Public Accountant* has defined Financial Accounting as:

*"the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which in part at least of a financial character and interpreting the results thereof."*

## Objectives and Scope of Accounting

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Let us go through the main objectives of Accounting:

- **To keep systematic records:** Accounting is done to keep systematic record of financial transactions. The primary objective of accounting is to help us collect financial data and to record it systematically to derive correct and useful results of financial statements.
- **To ascertain profitability:** With the help of accounting, we can evaluate the profits and losses incurred during a specific accounting period. With the help of a Trading and Profit & Loss Account, we can easily determine the profit or loss of a firm.
- **To ascertain the financial position of the business:** A balance sheet or a statement of affairs indicates the financial position of a company as on a particular date. A properly drawn balance sheet gives us an indication of the class and value of assets, the nature and value of liability, and also the capital position of the firm. With the help of that, we can easily ascertain the soundness of any business entity.
- **To assist in decision-making:** To take decisions for the future, one requires accurate financial statements. One of the main objectives of accounting is to take right decisions at right time. Thus, accounting gives you the platform to plan for the future with the help of past records.
- **To fulfill compliance of Law:** Business entities such as companies, trusts, and societies are being run and governed according to different legislative acts. Similarly, different taxation laws (direct indirect tax) are also applicable to every business house. Everyone has to keep and maintain different types of accounts and records as prescribed by corresponding laws of the land. Accounting helps in running a business in compliance with the law.

## Accounting Process

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Accounting cycle refers to the specific tasks involved in completing an accounting process. The length of an accounting cycle can be monthly, quarterly, half-yearly, or annually. It may vary from organization to organization but the process remains the same. The following chart shows the basic steps in an accounting cycle:



## Accounting Process

The following table lists down the steps followed in an accounting process:

<p>1. Collecting and Analyzing Accounting Documents</p>	<p>It is a very important step in which you examine the source documents and analyze them. For example, cash, bank, sales, and purchase related documents. This is a continuous process throughout the accounting period.</p>
<p>2. Posting in Journal</p>	<p>On the basis of the above documents, you pass journal entries using double entry system in which debit and credit balance remains equal. This process is repeated throughout the accounting period.</p>

3. Posting in Ledger Accounts	Debit and credit balance of all the above accounts affected through journal entries are posted in ledger accounts. A ledger is simply a collection of all accounts. Usually, this is also a continuous process for the whole accounting period.
4. Preparation of Trial Balance	As the name suggests, trial balance is a summary of all the balances of ledger accounts irrespective of whether they carry debit balance or credit balance. Since we follow double entry system of accounts, the total of all the debit and credit balance as appeared in trial balance remains equal. Usually, you need to prepare trial balance at the end of the said accounting period.
5. Posting of Adjustment Entries	In this step, the adjustment entries are first passed through the journal, followed by posting in ledger accounts, and finally in the trial balance. Since in most of the cases, we used accrual basis of accounting to find out the correct value of revenue, expenses, assets and liabilities accounts, we need to do these adjustment entries. This process is performed at the end of each accounting period.
6. Adjusted Trial Balance	Taking into account the above adjustment entries, we create adjusted trial balance. Adjusted trial balance is a platform to prepare the financial statements of a company.
7. Preparation of Financial Statements	Financial statements are the set of statements like Income and Expenditure Account or Trading and Profit & Loss Account, Cash Flow Statement, Fund Flow Statement, Balance Sheet or Statement of Affairs Account. With the help of trial balance, we put all the information into financial statements. Financial statements clearly show the financial health of a firm by depicting its profits or losses.
8. Post-Closing Entries	All the different accounts of revenue and expenditure of the firm are transferred to the Trading and Profit & Loss account. With the result of these entries, the balance of all the accounts of income and expenditure accounts come to NIL. The net balance of these entries represents the profit or loss of the company, which is finally transferred to the owner's equity or capital

	account. We pass these entries only at the end of accounting period.
9. Post-Closing Trial Balance	Post-closing Trial Balance represents the balances of Asset, Liabilities & Capital account. These balances are transferred to next financial year as an opening balance.

## Accounting Concepts

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The most important concepts of accounting are as follows:

- Business Entity Concept
- Money Measurement Concept
- Going Concern Concept
- Cost Concept
- Dual Aspects Concept
- Accounting Period Concept
- Matching Concept
- Accrual Concept
- Objective Evidence Concept

The first two accounting concepts, namely, Business Entity Concept and Money Measurement Concept are the fundamental concepts of accounting. Let us go through each one of them briefly:

### Business Entity Concept

According to this concept, the business and the owner of the business are two different entities. In other words, I and my business are separate.

For example, Mr A starts a new business in the name and style of M/s Independent Trading Company and introduced a capital of Rs 2,00,000 in cash. It means the cash balance of M/s Independent Trading Company will increase by a sum of Rs 2,00,000/-. At the same time, the liability of M/s Independent Trading Company in the form of capital will also increase. It means M/s Independent Trading Company is liable to pay Rs 2,00,000 to Mr A.

### Money Measurement Concept

According to this concept, "we can book only those transactions in our accounting record which can be measured in monetary terms."

### Example

Determine and book the value of stock of the following items:

Shirts	Rs 5,000/-
Pants	Rs 7,500/-

Coats                      500 pieces

Jackets                    1000 pieces

Value of Stock = ?

Here, if we want to book the value of stock in our accounting record, we need the value of coats and jackets in terms of money. Now if we conclude that the values of coats and jackets are Rs 2,000 and Rs 15,000 respectively, then we can easily book the value of stock as Rs 29,500 (as a result of  $5000+7500+2000+15000$ ) in our books. We need to keep quantitative records separately.

## Going Concern Concept

Our accounting is based on the assumption that a business unit is a going concern. We record all the financial transaction of a business in keeping this point of view in our mind that a business unit is a going concern; not a gone concern. Otherwise, the banker will not provide loans, the supplier will not supply goods or services, the employees will not work properly, and the method of recording the transaction will change altogether.

For example, a business unit makes investments in the form of fixed assets and we book only depreciation of the assets in our profit & loss account; not the difference of acquisition cost of assets less net realizable value of the assets. The reason is simple; we assume that we will use these assets and earn profit in the future while using them. Similarly, we treat deferred revenue expenditure and prepaid expenditure. The concept of going concern does not work in the following cases:

- If a unit is declared sick (unused or unusable unit).
- When a company is going to liquidate and a liquidator is appointed for the same.
- When a business unit is passing through severe financial crisis and going to wind up.

## Cost Concept

It is a very important concept based on the Going Concern Concept. We book the value of assets on the cost basis, not on the net realizable value or market value of the assets based on the assumption that a business unit is a going concern. No doubt, we reduce the value of assets providing depreciation to assets, but we ignore the market value of the assets.

The cost concept stops any kind of manipulation while taking into account the net realizable value or the market value. On the downside, this concept ignores the effect of inflation in the market, which can sometimes be very steep. Still, the cost concept is widely and universally accepted on the basis of which we do the accounting of a business unit.

## Dual Aspect Concept

There must be a double entry to complete any financial transaction, means debit should be always equal to credit. Hence, every financial transaction has its dual aspect:

- we get some benefit, and
- we pay some benefit.

For example, if we buy some stock, then it will have two effects:

- the value of stock will increase (get benefit for the same amount), and
- it will increase our liability in the form of creditors.

Transaction	Effect
Purchase of Stock for Rs 25,000	Stock will increase by Rs 25,000 (Increase in debit balance) Cash will decrease by Rs 25,000 (Decrease in debit balance) Or Creditor will increase by Rs 25,000 (Increase in credit balance)

## Accounting Period Concept

The life of a business unit is indefinite as per the going concern concept. To determine the profit or loss of a firm, and to ascertain its financial position, profit & loss accounts and balance sheets are prepared at regular intervals of time, usually at the end of each year. This one-year cycle is known as the accounting period. The purpose of having an accounting period is to take corrective measures keeping in view the past performances, to nullify the effect of seasonal changes, to pay taxes, etc.

Based on this concept, revenue expenditure and capital expenditure are segregated. Revenues expenditure are debited to the profit & loss account to ascertain correct profit or loss during a particular accounting period. Capital expenditure comes in the category of those expenses, the benefit of which will be utilized in the next coming accounting periods as well.

Accounting period helps us ascertain correct position of the firm at regular intervals of time, i.e., at the end of each accounting period.

## Matching Concept

Matching concept is based on the accounting period concept. The expenditures of a firm for a particular accounting period are to be matched with the revenue of the same accounting period to ascertain accurate profit or loss of the firm for the same period. This practice of matching is widely accepted all over the world. Let us take an example to understand the Matching Concept clearly.

The following data is received from M/s Globe Enterprises during the period 01-04-2012 to 31-03-2013:

Particulars	Amount
1. Sale of 1,000 Electric Bulbs @ Rs 10 per bulb on cash basis.	10,000.00
2. Sale of 200 Electric Bulb @ Rs. 10 per bulb on credit to M/s Atul Traders.	2,000.00
3. Sale of 450 Tube light @ Rs.100 per piece on Cash basis.	45,000.00
4. Purchases made from XZY Ltd.	40,000.00
5. Cash paid to M/s XYZ Ltd.	38,000.00
6. Freight Charges paid on purchases	1,500.00
7. Electricity Expenses of shop paid	5,000.00
8. Bill for March-13 for Electricity still outstanding to be paid next year.	1,000.00

Based on the above data, the profit or loss of the firm is calculated as follows:

Particulars	Amount	Total
<b>Sale</b>		
<b>Bulb</b>	12,000.00	
<b>Tube</b>	45,000.00	57,000.00
<b>Less:-</b>		
<b>Purchases</b>	40,000.00	
<b>Freight Charges</b>	5,000.00	
<b>Electricity Expenses</b>	1,500.00	
<b>Outstanding Expenses</b>	1,000.00	47,500.00
<b>Net Profit</b>		9,500.00

In the above example, to match expenditures and revenues during the same accounting period, we added the credit purchase as well as the outstanding expenses of this accounting year to ascertain the correct profit for the accounting period 01-04-2012 to 31-03-2013.

It means the collection of cash and payment in cash is ignored while calculating the profit or loss of the year.

## Accrual Concept

As stated above in the matching concept, the revenue generated in the accounting period is considered and the expenditure related to the accounting period is also considered. Based on the accrual concept of accounting, if we sell some items or we rendered some service, then that becomes our point of revenue generation irrespective of whether we received cash or not. The same concept is applicable in case of expenses. All the expenses paid in cash or payable are considered and the advance payment of expenses, if any, is deducted.

Most of the professionals use cash basis of accounting. It means, the cash received in a particular accounting period and the expenses paid cash in the same accounting period is the basis of their accounting. For them, the income of their firm depends upon the collection of revenue in cash. Similar practice is followed for expenditures. It is convenient for them and on the same basis, they pay their Taxes.

## Objective Evidence Concept

According to the Objective Evidence concept, every financial entry should be supported by some objective evidence. Purchase should be supported by purchase bills, sale with sale bills, cash payment of expenditure with cash memos, and payment to creditors with cash receipts and bank statements. Similarly, stock should be checked by physical verification and the value of it should be verified with purchase bills. In the absence of these, the accounting result will not be trustworthy, chances of manipulation in accounting records will be high, and no one will be able to rely on such financial statements.

## Accounting Conventions

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We will discuss the following accounting conventions in this section:

- Convention of Consistency
- Convention of Disclosure
- Convention of Materiality
- Conservation of Prudence

### Convention of Consistency

To compare the results of different years, it is necessary that accounting rules, principles, conventions and accounting concepts for similar transactions are followed consistently and continuously. Reliability of financial statements may be lost, if frequent changes are observed in accounting treatment. For example, if a firm chooses *cost or market price whichever is lower* method for stock valuation and *written down value method* for depreciation to fixed assets, it should be followed consistently and continuously.

Consistency also states that if a change becomes necessary, the change and its effects on profit or loss and on the financial position of the company should be clearly mentioned.

### **Convention of Disclosure**

The Companies Act, 1956, prescribed a format in which financial statements must be prepared. Every company that fall under this category has to follow this practice. Various provisions are made by the Companies Act to prepare these financial statements. The purpose of these provisions is to disclose all essential information so that the view of financial statements should be true and fair. However, the term 'disclosure' does not mean all information. It means disclosure of information that is significance to the users of these financial statements, such as investors, owner, and creditors.

### **Convention of Materiality**

If the disclosure or non-disclosure of an information might influence the decision of the users of financial statements, then that information should be disclosed.

For better understanding, please refer to General Instruction for preparation of Statement of Profit and Loss in revised scheduled VI to the Companies Act, 1956:

1. A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or Rs 1,00,000 whichever is higher.
2. A Company shall disclose in Notes to Accounts, share in the company held by each shareholder holding more than 5% share specifying the number of share held.

### **Conservation or Prudence**

It is a policy of playing safe. For future events, profits are not anticipated, but provisions for losses are provided as a policy of conservatism. Under this policy, provisions are made for doubtful debts as well as contingent liability; but we do not consider any anticipatory gain.

For example, If A purchases 1000 items @ Rs 80 per item and sells 900 items out of them @ Rs 100 per item when the market value of stock is (i) Rs 90 and in condition (ii) Rs 70 per item, then the profit from the above transactions can be calculated as follows:

Partiulars	Condition (i)	Condition (ii)
Sale Value (A) (900 x 100)	90,000.00	90,000.00
Less:- Cost of Goods Sold		
Purchases	80,000.00	80,000.00
Less Closing Stock	8,000.00	7,000.00
Cost of Goods Sold (B)	72,000.00	73,000.00
Profit (A-B)	18,000.00	17,000.00

In the above example, the method for valuation of stock is '*Cost or market price whichever is lower*'.

The prudence however does not permit creation of hidden reserve by understating the profits or by overstating the losses.

## Classification of Accounts

It is necessary to know the classification of accounts and their treatment in double entry system of accounts. Broadly, the accounts are classified into three categories:

- Personal accounts
- Real accounts
  - Tangible accounts
  - Intangible accounts
- Nominal accounts

Let us go through them each of them one by one.

### Personal Accounts

Personal accounts may be further classified into three categories:

#### Natural Personal Account

An account related to any individual like David, George, Ram, or Shyam is called as a *Natural Personal Account*.

#### Artificial Personal Account

An account related to any artificial person like M/s ABC Ltd, M/s General Trading, M/s Reliance Industries, etc., is called as an *Artificial Personal Account*.

#### Representative Personal Account

Representative personal account represents a group of account. If there are a number of accounts of similar nature, it is better to group them like salary payable

account, rent payable account, insurance prepaid account, interest receivable account, capital account and drawing account, etc.

## Real Accounts

Every Business has some assets and every asset has an account. Thus, asset account is called a real account. There are two type of assets:

- **Tangible** assets are touchable assets such as plant, machinery, furniture, stock, cash, etc.
- **Intangible** assets are non-touchable assets such as goodwill, patent, copyrights, etc.

Accounting treatment for both type of assets is same.

## Nominal Accounts

Since this account does not represent any tangible asset, it is called nominal or fictitious account. All kinds of expense account, loss account, gain account or income accounts come under the category of nominal account. For example, rent account, salary account, electricity expenses account, interest income account, etc.

## Accounting Systems

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There are two systems of accounting followed:

- Single Entry System
- Double Entry System

### Single Entry System

Single entry system is an incomplete system of accounting, followed by small businessmen, where the number of transactions is very less. In this system of accounting, only personal accounts are opened and maintained by a business owner. Sometimes subsidiary books are maintained and sometimes not. Since real and nominal accounts are not opened by the business owner, preparation of profit & loss account and balance sheet is not possible to ascertain the correct position of profit or loss or financial position of business entity.

### Double Entry System

Double entry system of accounts is a scientific system of accounts followed all over the world without any dispute. It is an old system of accounting. It was developed by '**Luco Pacioli**' of Italy in 1494. Under the double entry system of account, every entry has its dual aspects of debit and credit. It means, assets of the business always equal to liabilities of the business.

Assets = Liabilities

If we give something, we also get something in return and vice versa.

## Rules of Debit and Credit under Double Entry System of Accounts

The following rules of debit and credit are called the golden rules of accounts:

Classification of accounts	Rules	Effect
<b>Personal Accounts</b>	Receiver is Debit Giver is Credit	Debit = credit
<b>Real Accounts</b>	What Comes In Debit What Goes Out Credit	Debit = credit
<b>Nominal Accounts</b>	Expenses are Debit Incomes are Credit	Debit = credit

### Example:

Mr A starts a business regarding which we have the following data:

Introduces Capital in cash	Rs 50,000
Purchases (Cash)	Rs 20,000
Purchases (Credit) from Mr B	Rs 25,000
Freight charges paid in cash	Rs 1,000
Goods sold to Mr C on credit	Rs 15,000
Cash Sale	Rs 30,000
Purchased computer	Rs 10,000
Commission Income	Rs 8,000

S.No.	Journal Entries	Classification	Rule
1	Cash A/c Dr. 50,000 To Capital A/c 50,000	Real A/c Personal A/c	Debit what comes in; Credit the giver(Owner)
2	Goods Purchase A/c Dr. 20,000 To Cash A/c 20,000	Real A/c Real A/c	Debit what comes in; Credit what goes out
3	Goods Purchase A/c Dr. 25,000	Real A/c	Debit what comes in;

	To B A/c		25,000	Personal A/c	Credit the giver
4	Freight A/c	Dr.	1,000	Nominal A/c	Debit all expenses;
	To Cash A/c		1,000	Real A/c	Credit what goes out
5	C A/c	Dr.	15,000	Personal A/c	Debit the receiver;
	To Sale A/c		15,000	Real Account	Credit what goes out
6	Cash A/c	Dr.	30,000	Real A/c	Debit what comes in;
	To Sale A/c		30,000	Real A/c	Credit what goes out
7	Computer A/c	Dr.	10,000	Real A/c	Debit what comes in;
	To Cash A/c		10,000	Real A/c	Credit what goes out
8	Cash A/c	Dr.	8,000	Real A/c	Debit what comes in;
	To Commission A/c		8,000	Nominal A/c	Credit all incomes

It is very clear from the above example how the rules of debit and credit work. It is also clear that every entry has its dual aspect. In any case, debit will always be equal to credit in double entry accounting system.