

Lesson 1: Basics of Accounting

Lesson Objectives

On completion of this lesson, you will be able to understand

- Principles and concepts of Accounting
- Double Entry System of Accounting
- Financial Statements

1.1 Introduction

Accounting is a process of identifying, recording, summarising and reporting economic information to decision makers in the form of financial statements. Financial statements will be useful to the following parties:

- Suppliers
- Customers
- Employees
- Banks
- Suppliers of equipments, buildings and other assets
- Lenders
- Owners

1.1.1 Types of Accounts

There are basically three types of Accounts maintained for transactions :

- Real Accounts
- Personal Accounts
- Nominal Accounts

Real Accounts

Real Accounts are Accounts relating to properties and assets, which are owned by the business concern. Real accounts include tangible and intangible accounts. For example,

- Land
- Building
- Goodwill
- Purchases
- Cash

Personal Accounts

Personal Accounts are Accounts which relate to persons. Personal Accounts include the following.

- Suppliers
- Customers
- Lenders

Nominal accounts

Nominal Accounts are Accounts which relate to incomes and expenses and gains and losses of a business concern. For example,

- Salary Account
- Dividend Account
- Sales

Accounts can be broadly classified under the following four groups.

- Assets
- Liabilities
- Income
- Expenses

The above classification is the basis for generating various financial statements viz., Balance Sheet, Profit & Loss A/c and other MIS reports. The Assets and liabilities are taken to Balance sheet and the Income and Expenses accounts are posted to Profit and Loss Account.

1.1.2 Golden Rules of Accounting

	Real Accounts	Personal Accounts	Nominal Accounts
Debit	What Comes in	The Receiver	Expenses and Losses
Credit	What Goes out	The Giver	Incomes and Gains

1.1.3 Accounting Principles, Concepts and Conventions

The Accounting Principles, concepts and conventions form the basis for how business transactions are recorded. A number of principles, concepts and conventions are developed to ensure that accounting information is presented accurately and consistently. Some of these concepts are briefly described in the following sections.

Revenue Realisation

According to Revenue Realisation concept, revenue is considered as the income earned on the date, when it is realised. As per this concept, unearned or unrealised revenue is not taken into account. This concept is vital for determining income pertaining to an accounting period. It reduces the possibilities of inflating incomes and profits.

Matching Concept

As per this concept, Matching of the revenues earned during an accounting period with the cost associated with the respective period to ascertain the result of the business concern is carried out. This concept serves as the basis for finding accurate profit for a period which can be distributed to the owners.

Accrual

Under Accrual method of accounting, the transactions are recorded when earned or incurred rather than when collected or paid i.e., transactions are recorded on the basis of income earned or expense incurred irrespective of actual receipt or payment. For example, a seller bills the buyer at the time of sale and treats the bill amount as revenue, even though the payment may be received later.



The cash basis of accounting is a method wherein revenue is recognised when it is actually received, rather than when it is earned. Expenses are booked when they are actually paid, rather than when incurred. This method is usually not considered to be in conformity with accounting principles and is, therefore, used only in select situations such as for very small businesses.

Going Concern

As per this assumption, the business will exist for a long period and transactions are recorded from this point of view.

Accounting Period

The users of financial statements required periodical reports to ascertain the operational and the financial position of the business concern. Thus, it is essential to close the accounts at regular intervals. viz., 365 days or 52 weeks or 1 year is considered as the accounting period.

Accounting Entity

According to this assumption, a business is considered as a unit or entity apart from its owners, creditors and others. For example, in case of a Sole Proprietor concern, the proprietor is treated to be separate and distinct from the business, which he controls. The proprietor is treated as a creditor to the extent of his capital and all the business transactions are recorded in the books of accounts from the business stand point.

Money Measurement

In accounting, only business transactions and events of financial nature are recorded. Only transactions that can be expressed in terms of money are recorded.

1.1.4 Double Entry System of Book Keeping

As per Double Entry System of book-keeping, all the business transactions recorded in accounts have two aspects - Debit aspect (receiving) and Credit aspect (giving). For example, when a business acquires an asset (receiving) and pays cash (giving) for it. This accounting technique records each transaction as debit and credit, where every debit has a corresponding credit and vice versa.

Features of Double Entry System of Book Keeping

The Double entry system of book keeping comprises of the following features :

- Every business transaction affects two accounts
- Each transaction has two aspects, i.e., debit and credit
- Maintains a complete record of all business transactions
- Helps to check the accuracy of the accounting transactions, by preparation of trial balance
- Helps ascertaining profit earned or loss occurred during a period, by preparation of Profit & Loss Account
- Helps ascertaining financial position of the concern at the end of each period, by preparation of Balance Sheet
- Helps timely decision making based on sufficient information
- Minimises the possibilities of fraud due to its systematic and scientific recording of business transactions

The following chart explains the way in which accounting transactions are recorded in the Double Entry system and financial statements are prepared.

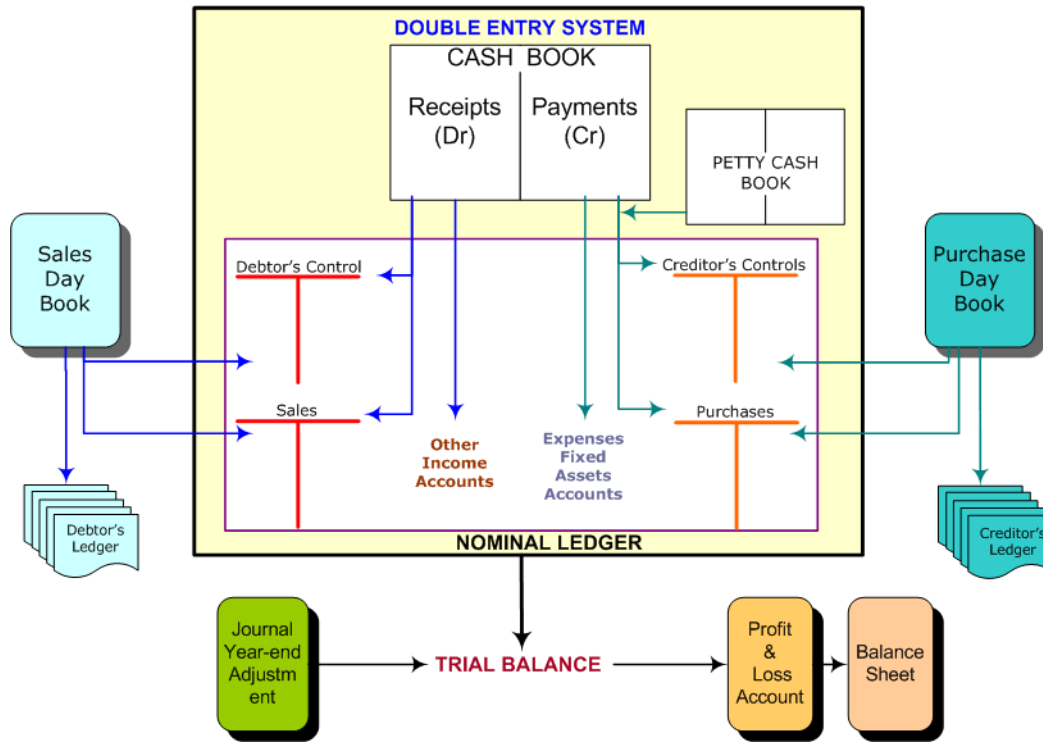


Figure 1.1 Double Entry System

1.1.5 Mode of Accounting

Accounting process begins with identifying and recording the transactions in the books of accounts i.e., the first step in the Accounting Process is recording of transactions in the books of accounts. Accounting identifies only those transactions and events which involves money and is sorted based on various source documents.

The following are the most common source documents.

- ❑ Cash Memo
- ❑ Invoice or Bill
- ❑ Vouchers
- ❑ Receipt
- ❑ Debit Note
- ❑ Credit Note

Voucher

A voucher is a document in support of a business transaction, containing the details of such transaction.

Receipt

When a trader receives cash from a customer against goods sold by him, issues a receipt containing the name of such customer, details of amount received with date.

Invoice or Bill

When a trader sells goods to a buyer, he prepares a sales invoice containing the details of name and address of buyer, name of goods, amount and terms of payments and so on. Similarly, when the trader purchases goods on credit receives a Invoice/bill from the supplier of such goods.

Journals and Ledgers

A **journal** is a record in which all business transactions are entered in a chronological order. A record of a single business transaction is called a **journal entry**. Every journal entry is supported by a voucher, evidencing the related transaction.

Account

An **account** is a statement of transactions affecting any particular asset, liability, expense or income.

Ledger

A **Ledger** is a book which contains all the accounts whether personal, real or nominal, which are entered in journal or subsidiary books.

Chart of Accounts

A **chart of accounts** is a list of all accounts used by an organisation. The chart of accounts also displays the categorisation and grouping of its accounts.

Posting

Posting is the process of transferring the entries recorded in the journal or subsidiary books to the respective accounts opened in the ledger i.e., grouping of all the transactions relating to a particular account to a single place.

Accounting Period

Generally, the financial statements are generated for a regular period such as a quarter or a year, for timely and accurate ascertainment of operating and financial position of the organisation.

Trial Balance

Trial balance is a statement which shows debit balances and credit balances of all Ledger accounts. As per the rules of double entry system, every debit should have a corresponding

credit, the total of the debit balances and credit balances should agree. A detailed trial balance has columns for

- Account name
- Debit balance
- Credit balance

1.1.6 Financial Statements

Financial statements are final result of accounting work done during the accounting period. Financial statement serves a significant purpose to users of accounting information in knowing about the profitability and financial position of the organisation. Financial statements normally include

- Trading
- Profit and Loss Account
- Balance Sheet

Trading Account

Trading refers to buying and selling of goods. The trading account displays the transactions pertaining to buying and selling of goods.

The difference between the two sides of the Trading Account indicates either Gross Profit or Gross Loss. If the credit side total is in excess of the debit side total, the difference represents Gross Profit. On the other hand, if the total of the debit side is in excess of the credit side total, the difference represents Gross Loss. Such Gross Profit / Gross Loss is transferred to Profit & Loss Account. The **Gross Profit** is expressed as :

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Sales}$$

Profit and Loss Account

The profit and loss account helps to ascertain the net profit earned or net loss suffered during a particular period. after considering all other incomes and expenses incurred over a period. This helps the company to monitor and control the costs incurred and improve its efficiency. In other words, the profit and loss statement shows the performance of the company in terms of profits or losses over a specified period.

The **Net Profit** is expressed as :

$$\text{Net Profit} = (\text{Gross Profit} + \text{Other Income}) - (\text{Selling and Administrative Expenses} + \text{Depreciation} + \text{Interest} + \text{Taxes} + \text{Other Expenses})$$

A key element of the Profit and Loss Account, and one that distinguishes it from a balance sheet, is that the amounts shown on the statement represent transactions over a period of time, while the items represented on the balance sheet show information as on a specific date.

All revenue and expense accounts are closed once the profit and loss account is prepared. The Revenue and Expenses accounts will not have an opening balance for the next accounting period.

Balance Sheet

The **balance sheet** is a statement that summarises the assets and liabilities of a business. The excess of assets over liabilities is the net worth of a business. The balance sheet provides information that helps in assessing

- ❑ A company's Long-term financial strength
- ❑ A company's Efficient day-to-day working capital management
- ❑ A company's Asset portfolio
- ❑ A company's Sustainable long-term performance

The balances of all the real, personal and nominal (capital in nature) accounts are transferred from trial balance to balance sheet and grouped under the major heads of assets and liabilities. The balance sheet is complete when the net profit/ loss is transferred from the Profit and Loss account.

1.1.7 Transactions

A **transaction** is a financial event that takes place in the course or furtherance of business and effects the financial position of the company. For example, when you deposit cash in the bank, your cash balance reduces and bank balance increases or when you sell goods for cash, your cash balance increases and your stock reduces.

Transactions can be classified as follows :

- ❑ Receipts – cash or bank
- ❑ Payments – cash or bank
- ❑ Purchases
- ❑ Sales

1.1.8 Recording Transactions

The important aspect of accounting is to record transactions promptly and correctly to ascertain the financial status of a company as on a particular date.

Generally, the business transactions may be of the following nature :

- ❑ Purchase of goods either as raw materials for processing or as finished goods for resale
- ❑ Payment of expenses incurred towards business
- ❑ Sale of goods or services
- ❑ Receipts (in Cash or by Cheques)
- ❑ Payments (in Cash or Cheques)

The Accounting information is useful to various interested parties, both internal and external viz.,

- ❑ Suppliers, who supply goods and services for cash or on credit
- ❑ Customers, who buy goods or services for cash or on credit
- ❑ Employees, who provide services in exchange of salaries and wages.
- ❑ Banks, with whom accounts are maintained
- ❑ Suppliers of equipment, buildings and other assets needed to carry on the business.
- ❑ Lenders from whom, you borrow money to finance your business
- ❑ Owners, who hold a share in the capital of your business

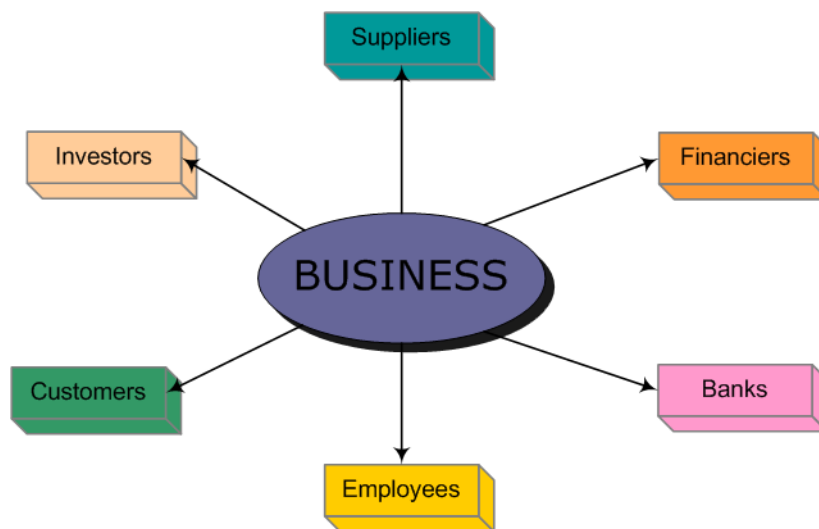


Figure 1.2 Parties dealt with in a business process

Points to Remember

- ❑ Accounting is a comprehensive system to collect, analyse and communicate financial information.
- ❑ Double Entry accounting is a system of recording transactions in a way that maintains the equality of the accounting equation.
- ❑ The three types of accounts maintained for transactions are real accounts, personal accounts and nominal accounts.
- ❑ Entity is the organisational unit for which accounting records are maintained.
- ❑ Journal entry is a record of a single business transaction.
- ❑ Voucher is a document evidencing the details of a financial transaction.
- ❑ Ledger is a book in which accounts are maintained.
- ❑ Trial balance is a list of the balances of all the ledger accounts.
- ❑ Profit and loss statement shows the performance of the company in terms of profits or losses made by it over a specified period.
- ❑ Balance sheet gives an overview of the financial position of a company as on a specific date.