Lesson 1

Introduction to Financial Accounting

Key Concepts One Should Know

- Accounting
- Book-Keeping
- Basic Accounting terms
- Double Entry System
- Accounting Equation
- Journal
- Subsidiary Books
- Ledger Accounts
- Trial Balance

Learning Objectives

To understand

- Basic concepts of accounting
- Types of accounts,
- Accounting principles, conventions, concepts and standards
- Meaning of double entry system
- The rules of debit and credit on which the entire concept of accounting is based
- Books of prime entry and Subsidiary books
- Features, purpose and preparation of Trial Balance

Lesson Outline

- Introduction
- Single Entry System
- Double Entry System
- The Concepts of 'Account', 'Debit' and 'Credit'.
- Kinds of Accounts
- The Accounting Process
- Accounting Equation
- Books of Prime Entry
- Subsidiary Books
- Ledger Accounts
- Trial Balance
- LESSON ROUND UP
- GLOSSARY
- TEST YOURSELF

INTRODUCTION

Business is an economic activity undertaken with the motive of earning profits and maximization of the wealth for owners. No business can run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This term is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, corporate body, etc. The rules of any business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer's demand.

The business activities require resources (which are limited and have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of a business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure that the businessman tracks the use of these resources. The resources are not free, and thus one must be careful to keep an eye on the cost of acquiring them as well. As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in the course of business. Two basic questions would have to be answered:

(a) What is the result of any business operations? This will be answered by finding out whether it has made profit or loss?

(b) What is the position of the resources acquired and used for business purposes? How are these resources financed? Where do the funds come from?

The answers to these questions are to be found continuously, and the best way to find them is to record all the business activities. Recording of business activities has to be done in a scientific manner so that they reveal the correct outcome. The science of book-keeping and accounting provides an effective solution. It is a branch of social sciences. This study material aims at giving a platform to the students to understand basic principles and concepts, which can be applied to accurately measure the performance of a business. After studying the various chapters included herein, the student should be able to apply the principles, rules, conventions and practices to different business situations like, trading, manufacturing or services.

Definition of Accounting

The definition given by the American Institute of Certified Public Accountants ('AICPA') clearly brings out the meaning of accounting. According to AICPA, accounting is "the art of recording, classifying and summarizing 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".

The definition brings out the following as attributes of accounting:

(i) **Accounting is an art.** Accounting is classified as an art, as it helps us in attaining our aim of ascertaining the financial results, that is, operating profit and financial position through analysis and interpretation of financial data which requires special knowledge, experience and judgment.

(ii) **It involves recording, classifying and summarizing.** Recording means systematically writing down the transactions and events in account books soon after their occurrence. Classifying is the process of grouping transactions or entries of the same type at one place. This is done by opening accounts in a book called ledger. Summarizing involves the preparation of reports and statements from the classified data (ledger), understandable and useful to management and other interested parties. This involves preparation of final accounts namely profit and loss account and balance sheet.

(iii) **It records transactions in terms of money.** All transactions are recorded in terms of common measure, i.e., money which increases the understanding of the state of affairs of the business.

(iv) **It records only those transactions and events which are of financial character.** If an event has no financial character then it will not be capable of being measured in terms of money; it will not be, therefore, recorded.

(v) **It is the art of interpreting the results of operations** to determine the financial position of the enterprise, the progress it has made and how well it is getting along.

OBJECTIVES OF ACCOUNTING

Providing Information to the Users for Rational Decision making	The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors and investors. Various outcomes of business activities such as costs, prices, sales volume, value under ownership and return on investment are measured in the accounting process. All these accounting measurements are used by stakeholders (owners, investors, creditors/bankers, etc.) in course of a business operation. Hence, accounting is identified as the language of a business.
Systematic Recording of Transactions	To ensure reliabity and precision for the accounting measurements, it is necessary to keep a systematic record of all financial transactions of a business enterprise which is ensured by book-keeping. These financial records are classified, summarized and reposted in the form of accounting measurements to the users of accounting information i.e., stakeholders.
Ascertainment of Results of Above Transactions	Profit/Loss is a core accounting measurement done and measured by preparing a Profit and Loss Account for a particular period. Various other accounting measurements, such as different types of revenue expenses and revenue incomes are considered for preparing thes profit and loos account. Difference between these revenue incomes and revenue expenses is known as the result of business trasactions identified as profit/loss. As this measure is used very frequently by stockholders for rational decision making, it has become the objective of accounting. For example, Income Tax Act requires that every business should have an accounting system that can measure taxable income of the business and also explain nature and source of every item reported in Income Tax Return.
Ascertain the Financial Position of Business	Financial position is another core accounting measurement. Financial position is identified by preparing a statement of ownership meaning Assets, and owing meaning Liabilities of the business as on a certain date. This statement is popularly known as Balance Sheet. Various other accounting measurements, such as different types of assets, and different types of liabilities as existed at a particular date, they are considered for preparing the balance sheet. This statement may be used by various stakeholders for financing and investment decisions.
To Know the Solvency Positon	Balance Sheet, and Profit and Loss Account prepared as above give useful information to stockholders regarding concerns, potential to meet their obligations in the short as well as in the long run.

Functions of Accounting

Functions of Accounting

- **Measurement:** Accounting measures past performance of a business entity and depicts its current financial position.
- **Forecasting:** Accounting helps in forecasting future performance and financial position of an enterprise using past data.
- **Decision-Making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.
- **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparig and evaluating financial results.
- **Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.
- **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

Book-Keeping

As defined by Carter, "Book-Keeping is a science as well as art of correctly recording in books of accounts all those business transactions that result in transfer of money or money's worth".

Book-keeping is an activity concerned with recording and classifying financial data related to business operations in order of occurrence.

Book-keeping is a mechanical task which involves:

- Collection of basic financial information
- Identification of events and transactions with financial character, i.e., economic transactions
- Measurement of economic transactions in terms of money
- Recording of financial effects of economic transactions in order of its occurrence
- Classifying effects of economic transactions
- Preparing organized statement known as Trial Balance

Distinction between Book-Keeping and Accounting

Book-Keeping	Accounting
1. Output of book-keeping is an input for accounting.	1. Output of accounting permits informed judgments and decisions by the user of accounting information.
2. Purpose of book-keeping is to keep systematic record of transactions and events of financial character in order of occurrence.	2. Purpose of accounting is to find results of operating activity of a business and to report its financial strength.
3. Book-keeping is the foundation of accounting.	3. Accounting is considered as a language of business.

4. Book-keeping is carried out by the junior staff.	4. Accounting is done by the senior staff who have skills of analysis and interpretation.
5. Objective of book-keeping is to summarize the cumulative effect of all economic transactions of business for a given period by maintaining permanent record of each business transaction with its evidence and financial effects on accounting variable.	5. Object of accounting is not only book-keeping but also analyzing and interpreting reported financial information for informed decisions.

Accounting Cycle

When complete sequence of accounting procedure is done, which happens frequently, and repeatedly in the same directions during an accounting period, it is called an Accounting Cycle.

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be developed as under:

Recording of trasaction	As soon as a transaction happens it is at first recorded in a subsidiary book.
Journal	The transactions are recorded in the journal chronologically.
Ledger	All journals are posted into ledger chronologically in a classified manner.
Trial balance	After taking all the ledger account closing balances, a Trial Balance is prepared at the end of the period for the preparation of financial statements.
Adjustment entries	All the adjustment entries are to be recorded properly and adjusted accordingly before preparing financial statements.
Adjusted trial balance	An adjusted Trail Balance may also be prepared.
Closing Enries	All the nominal accounts are to be closed by transferring them to Trading Account, and Profit and Loss Account.
Financial Statement	Financial Statements: Financial statements can now be easily prepared which will exhibit the true financial position and operating results.

Basic Accounting Terms

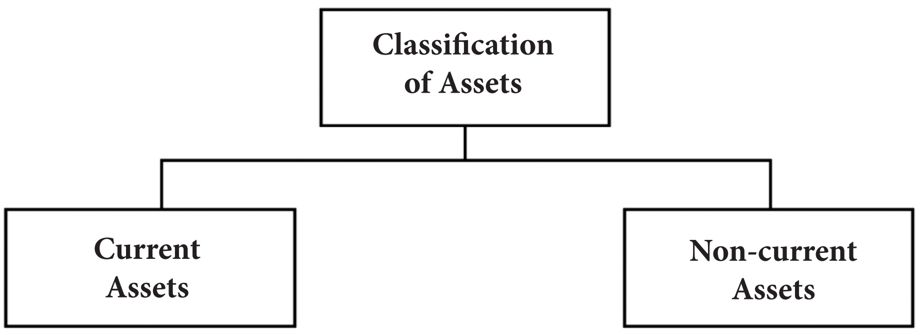
In order to understand the subject matter clearly, one must grasp the following common expressions used in business accounting. The aim here is to enable the student to understand these often used concepts before we embark on accounting procedures and rules. You may note that these terms can be applied to any business activity with the same connotation.

- **Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person, e.g., purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transactions, the payment is settled at a future date as per agreement between the parties.

- **Goods/Services:** These are tangible article or commodities in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as goods to one business firm may not be goods to the other firm, e.g., for a machine manufacturing company, the machines are goods as they are frequently made and sold. But for the buying firm, it is not goods as the intention is to use it as a long-term resource and not sell it. The services intangible in nature are rendered with or without the object of earning profits.
- **Profit:** The excess of revenue income over expenses is called profit. It could be calculated for each Transaction or for the business as a whole.
- **Loss:** The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.
- **Asset:** Asset is a resource owned by a business with the purpose of using it for generating future profits.

Assets can be tangible and intangible. Tangible Assets are the capital assets which have some physical existence. These can, therefore, be seen, touched and felt, e.g., plant and machinery, furniture and fittings, land and buildings, books, computers and vehicles. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as intangible assets. These cannot be seen or felt although these help to generate revenue in future, e.g., goodwill, patents, trade-marks, copyrights, brand equity, designs and intellectual property, etc.

Assets can also be classified as Current Assets and Non-Current Assets.



Current Assets – An asset can be classified as Current if it satisfies any of the following:

(a) It is expected to be realized in, or is intended for sale or consumption in the company's normal Operating cycle;

(b) It is held primarily for the purpose of being traded;

(c) It is due to be realized within 12 months after the Reporting Date; or

(d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other assets are classified as Non-Current Assets, e.g., Machinery held for Long-term, etc.

Liability: It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. For instance, when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date, or when a loan is taken from bank, an obligation to pay the interest and principal amount is created.

Depending upon the period of holding, these obligations could be further classified into long term or Non-current liabilities, and short term or current liabilities.

Current Liabilities – A liability is classified as current when it satisfies any of the following:

(a) It is expected to be settled in the company's normal Operating Cycle;

(b) It is held primarily for the purpose of being traded;

(c) It is due to be settled within 12 months after the Reporting Date; or

(d) The company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that, at the option of the counterparty, result in their settlement by the issue of Equity Instruments which do not affect its classification).

Non-Current Liabilities – All other liabilities shall be classified as Non-Current Liabilities. For example loan taken for 5 years, Debentures issued etc.

- **Internal Liability:** These represent proprietor's equity, i.e., all those amount which are entitled to the Proprietor, like Capital, Reserves and Undistributed Profits.

- **Contingent Liability:** It represents a potential obligation that could be created depending on the outcome of an event. For example, if a supplier of a business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that time it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed through a note in the financial statements.

- **Capital:** Capital is the amount invested in a business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activities. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

- **Drawings:** It represents the amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use, e.g., when in the life insurance premium of the proprietor or a partner of the business is paid from the business cash, it is called drawings.

  Drawings will result in a reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

- **Net worth:** It represents the excess of total assets over total liabilities of a business. Technically, this amount is made available to be distributed to the owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's Equity. A profit making business will result in the increase in the owner's equity, whereas losses will reduce it.

- **Non-Current Investments:** Non-Current Investments are investments which are held beyond the current period for sale or disposal, like a Fixed Deposit for 5 years.

- **Current Investments:** Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made 11-months Commercial Paper is an example of it.

- **Debtor:** The sum total or aggregate of the amounts which the customer owes to the business for the purchase of goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or a service rendered on credit.

These debtors may again be classified as under:

(a) **Good Debts:** The debts which are sure to be realized are called good debts.

(b) **Doubtful Debts:** The debts which may or may not be realized are called doubtful debts.

(c) **Bad Debts:** The debts which cannot be realized at all are called bad debts.

It must be remembered that while ascertaining the debtors balance at the end of the period certain Adjustments may have to be made, like Bad Debts, Discount Allowed and Returns Inwards.

- **Fictitious Assets:** Fictitious assets are not assets at all since they are not represented by any tangible possession. They appear on the asset side simply because of a debit balance in a particular account not yet written off, e.g., provision for discount to creditors, discount on issue of shares, etc.

- **Wasting Assets:** Such assets as mines, quarries, etc., that become exhausted or reduce in value by their workings are called wasting assets.

- **Creditor:** A creditor is a person to whom the business owes money or money's worth. For example, money payable to the supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

- **Capital Expenditure:** This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from, e.g., amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This will also be a capital expenditure. Capital expenditure forms a part of the Balance Sheet.

- **Revenue Expenditure:** This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. For example repairs, insurance, salary and wages to employees, travel, etc. The revenue expenditure results in the reduction in profit or surplus. It becomes part of the Income statement.

- **Balance Sheet:** It is the statement of the financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what it owes to outsiders (this denotes liabilities), and to the owners (this denotes capital). It is prepared after incorporating the resulting Profit/Loss or Income Statement.

- **Profit and Loss Account or Income Statement:** This account shows the revenue earned by the business and the expenses incurred by it to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, half a year or a year. The net result of the Profit and Loss Account shows profit earned or loss suffered by the business entity.

- **Trade Discount:** It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. For example, the list price of a TV set could be Rs. 15,000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for Rs.12,000 and is expected to sell it finally to a customer at the list price. Thus, the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In the above example, the transaction will be recorded at Rs. 12,000 only.

- **Cash Discount:** It is allowed to encourage prompt payment by the debtor. It has to be recorded in the books of accounts. It is calculated after deducting the trade discount, like if list price is Rs. 15,000 on which a trade discount of 20% and cash discount of 2% apply, the first trade discount of Rs.3,000 (20% of Rs. 15,000) will be deducted and the cash discount of 2% will be calculated on Rs.12,000 (Rs.15,000 – Rs.3,000). Hence, the cash discount will be Rs.240 (2% of Rs. 12,000) and net payment will be Rs. 11,760 (Rs. 12,000 - Rs. 240)

SINGLE ENTRY SYSTEM

Single Entry System is an incomplete 'double entry system'. In case of double entry system of book-keeping both the aspects of every transaction are recorded. In this system, the first entry is made to the debit of an account, and the second entry to the credit of second account. However, in case of single entry system, the business houses for their convenience and more practical approach ignore the strict rules of double entry system. The users of this system maintain only the essential records. In other words, it is a system which may not keep some books of subsidiary records, and some ledger accounts too which otherwise are kept in case of double entry system.

According to a Dictionary of Accountancy by Kohler, "A system of book-keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances." Thus, under the so-called single entry system both the aspects of business transactions and events are not recorded. Therefore, this may be defined, "as any system which is not exactly the Double Entry System". Under the single entry system usually a cash book and personal accounts are maintained.

DOUBLE ENTRY SYSTEM

Genesis

It was in 1494 that Luca Pacioli, the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System. The use of principles of double entry system made it possible to record not only cash but also all sorts of mercantile transactions. It had created a profound impact on auditing too, because it enhanced the duties of an auditor to a considerable extent.

Features of Double Entry System

(a) Every transaction has two-fold aspects, i.e., one party giving the benefit and the other receiving the benefit.

(b) Every transaction is divided into two aspects, debit and credit. One account is to be debited and the other account is to be credited.

(c) Every debit must have its corresponding and equal credit.

Advantages of Double Entry System

(a) Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.

(b) It ensures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically, or at the end of the financial year.

(c) It prevents and minimizes frauds. Moreover frauds can be detected early.

(d) Errors can be checked and rectified easily.

(e) The balances of receivables and payables are determined easily, since the personal accounts are maintained.

(f) The businessman can compare the financial position of the current year with that of the past years.

(g) The businessman can justify the standing of his business in comparison with the previous year purchase, sales, and stocks, incomes and expenses with that of the current year figures.

(h) Helps in decision-making.

(i) The net operating results can be calculated by preparing the Trading and Profit and Loss A/c for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.

(j) It becomes easy for the Government to calculate the tax.

(k) It helps the Government to decide sickness of business units and extend help accordingly.

(l) The other stakeholders, like suppliers and banks take a proper decision regarding grant of credit or loans.

Limitations of Double Entry System

(a) The system does not disclose all the errors committed in the books accounts.

(b) The Trial Balance prepared under this system does not disclose certain types of errors.

(c) It is costly as it involves maintenance of numbers of books of accounts.

THE CONCEPTS OF 'ACCOUNT', 'DEBIT' AND 'CREDIT'

The Concept of Account

(a) An account is defined as a summarized record of transactions related to a person or a thing, e.g., when the business deals with customers and suppliers, the customer and supplier will each be a separate account.

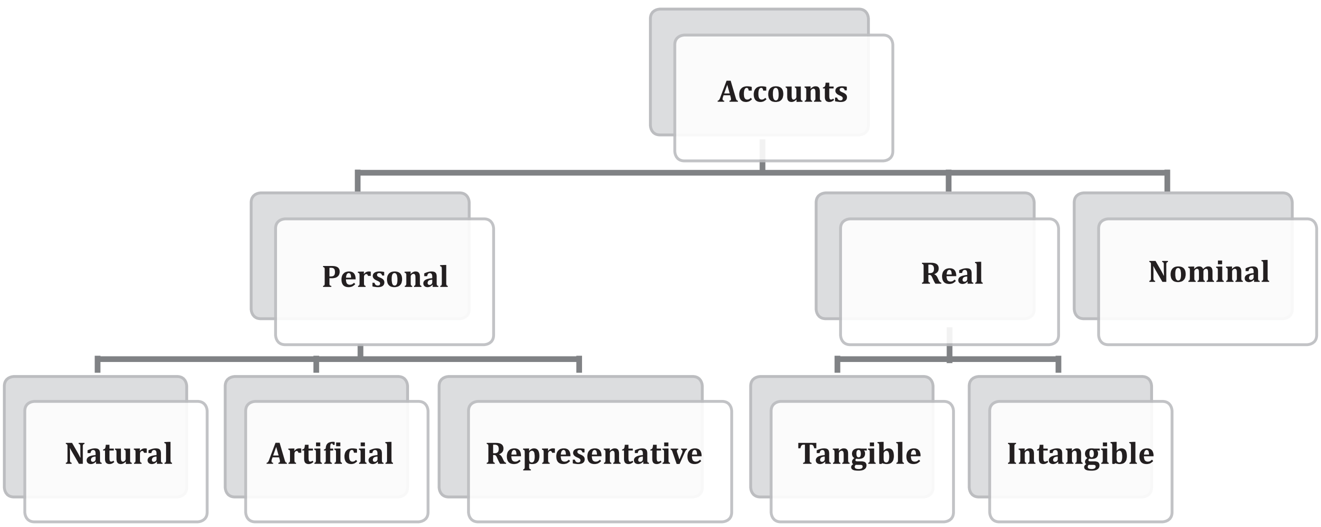
(b) The account is also related to things – both tangible and intangible, like, land, building, equipment, brand value and trademarks are some of the things. When a business transaction happens, one has to identify the account that will be affected by it and then apply the rules to decide its accounting treatment.

(c) Typically, an account is expressed as a statement in the form of English letter 'T'. It has two sides. The left hand side is called as the Debit side, and the right hand side is called as the Credit side. The debit is denoted as 'Dr' and the credit as 'Cr'. The convention is to write the Dr. and Cr. labels on both sides as shown below.

Cash Account

Debit side (Dr.)		Credit side (Cr.)

Types of Accounts



Let us see what each type of account signifies:

1. **Personal Account:** As the name suggests these are accounts related to persons.

   (a) These persons could be natural persons, like Suresh's A/c, Anil's A/c and Rani's A/c.

   (b) The persons could also be artificial persons like companies, bodies corporate or association of persons or partnerships. Accordingly, we could have Videocon Industries A/c, Infosys Technologies A/c, Charitable Trust A/c, Ali and Sons Trading A/c and ABC Bank A/c.

   (c) There could be representative personal accounts as well. Although the individual identity of persons related to these is known, the convention is to reflect them as collective accounts, e.g., when salary is payable to employees, we know how much is payable to each of them, but collectively the account is called as Salary Payable A/c. Similar examples are rent payable, insurance prepaid, commission pre-received, etc. The students should be careful to have clarity on this type and the chances of error are more here.

2. **Real Accounts:** These are accounts related to assets or properties or possessions.

   Depending on their physical existence or otherwise, they are further classified as follows:

   (a) *Tangible Real Account* – Assets that have physical existence and can be seen and touched, under this as Machinery A/c, Stock A/c, Cash A/c, Vehicle A/c, and the like.

   (b) *Intangible Real Account* – These represent possession of properties that have no physical existence but can be measured in terms of money and have value attached to them like Goodwill A/c, Trade Mark A/c, Patents & Copy Rights A/c and Intellectual Property Rights A/c.3. Nominal Account: These accounts are related to expenses or losses and incomes or gains e.g. Salary and Wages A/c, Rent and Rates A/c, Travelling Expenses A/c, Commission received A/c and Loss by fire A/c.

THE ACCOUNTING PROCESS

The two approaches for deciding whether an account is debited or credited are:

(A) British Approach or Traditional Approach

(B) American Approach or Accounting equation Approach

(A) British Approach or Traditional Approach:

When one identifies the account that is getting affected by a transaction and type of that account, the next step is to apply the rules to decide whether the accounting treatment is to be debited or credited from that account. The Golden Rules will guide us whether the account is to be debited or credited.

These rules are shown below :

Personal Account →	Debit the receiver or who owes business Credit the giver or the business owner
Real Account →	Debit what comes into business Credit what goes out of business
Normal Account →	Debit all expenses or losses Credit all income or gains

(B) American Approach or Accounting equation Approach:

Under this approach transactions are recorded based on the accounting equation, i.e.,

Assets = Liabilities + Owner's equity

or A = L + P

or P = A – L

Where A = Assets, L = Liabilities, P = Capital or L = A - P

The accounting equation is a statement of equality between the debits and the credits. The rules of debit and credit depend on the nature of an account. For the purpose of the accounting equation approach, all the accounts are classified into the following five types: assets, capital, liabilities, revenues/incomes, or expenses/losses.

(a) Transactions relating to owner, e.g., capital – these are personal accounts.

(b) Transactions relating to other liabilities, e.g., suppliers of goods – these are mostly personal accounts.

(c) Transactions relating to assets, e.g., land, building, cash, bank, stock-in-trade, bills receivable – these are basically real accounts.

(d) Transactions relating to expenses, e.g., rent, salary, commission, wages, cartage – these are nominal accounts.

(e) Transactions relating to revenues, e.g., interest received, dividend received, sale of goods – these are nominal accounts

According to this approach, if there is an increase or decrease in a set of accounts, there will be equal decrease or increase in another set of accounts. Accordingly the rules of debit and credit transactions are divided into the following five categories:

1. *Assets Accounts:* debit entry represents an increase in assets and a credit entry represents a decrease in assets.
2. *Capital Account:* credit entry represents an increase in capital and a debit entry represents a decrease in capital.
3. *Liabilities Accounts:* credit entry represents an increase in liabilities and a debit entry represents a decrease in liabilities.
4. *Revenues or Incomes Accounts:* credit entry represents an increase in incomes and gains, and debit entry represents a decrease in incomes and gains.
5. *Expenses or Losses Accounts:* debit entry represents an increase in expenses and losses, and credit entry represents a decrease in expenses and losses.

These five rules help learning about accounting entries and also are comparable with traditional (British) accounting rules.

BOOKS OF PRIME ENTRY

A journal is often referred to the Book of Prime Entry or Book of Original Entry. In this book transactions are recorded in their chronological order. The process of recording transaction in a journal is called 'Journalization'. The entry made in this book is called 'journal entry'.

Functions of Journal

(a) **Analytical Function:** Each transaction is analyzed into the debit aspect as well as the credit aspect.

This helps to find out how each transaction will financially affect the business.

(b) **Recording Function:** Accountancy is a business language which helps to record the transactions based on the principles. Each such recording entry is supported by a narration, which explains, the transaction in simple language. Narration means to narrate – i.e., to explain. It starts with the word – Being.

(c) **Historical Function:** It contains a chronological record of the transactions for future references.

Advantages of Journal

The following are the advantages of a journal:

(a) **Chronological Record:** It records transactions as and when it happens. So it is possible to get detailed day-to-day information.

(b) **Minimizing the possibility of errors:** The nature of transaction and its effect on the financial position of the business is determined by recording and analyzing into both debit and credit aspects.

(c) **Narration:** It means explanation of the recorded transactions.

(d) **Helps to finalize the accounts:** Journal is the basis of ledger posting and the ultimate Trial Balance.

The Trial Balance helps to prepare the final accounts.

The specimen of a journal book is shown below:

Date	Particulars	Voucher number	Ledger folio	Debit amount (Rs.)	Credit amount (Rs.)
dd-mm-yy	Name of A/c from which to be debited Name of A/c to be credited (narration describing the transaction)	----------	Reference of page number of the A/c in ledger	-----------	-----------

Explanation of Journal

(a) **Date Column:** This column contains the date of the transaction.

(b) **Particulars:** This column contains which account is to be debited and which account is to be credited. It is also supported by an explanation called narration.

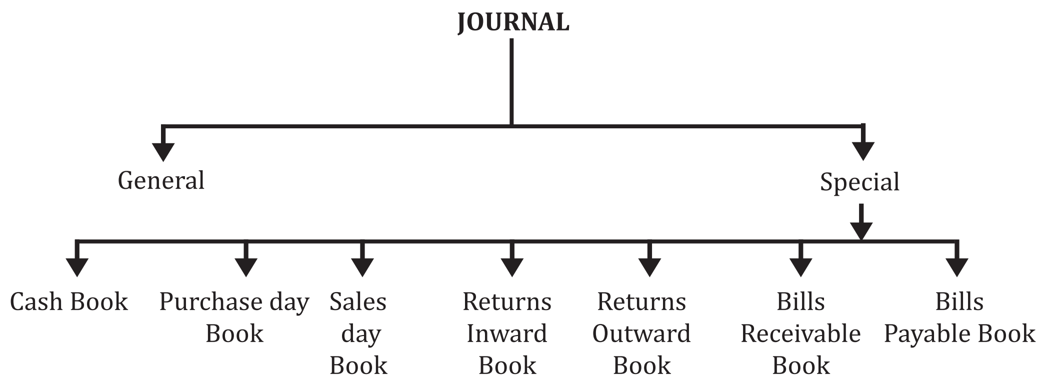
(c) **Voucher Number:** This column contains the number written on the voucher of the respective transaction.

(d) **Ledger Folio (L.F.):** This column contains the folio (i.e., page no.) of the ledger, where the transaction is posted.

(e) **Dr. Amount and Cr. Amount:** This column shows the financial value of each transaction. The amount is recorded in both the columns, since for every debit there is a corresponding and equal credit. All the columns are filled in at the time of entering the transaction, except for the column of ledger folio. This is filled at the time of posting of the transaction to ledger.

Sub-division of Journals

Journal is divided into two types -(i) General Journal and (ii) Special Journal.



(i) General Journal

(a) This is a book of chronological record of transactions.

(a) This book records those transactions which occur so infrequently that they do not warrant the setting up of special journals.

Examples of such entries: (i) opening entries (ii) closing entries (iii) rectification of errors.

The form of this general journal, is as under:

JOURNAL

Date	Particulars	L.F.	Dr. Amount	Cr. Amount

L.F. : Ledger Folio

Dr : Debit

Cr : Credit

Recording of transactions in this book is called journalizing and the record of transactions is known as journal entry.

(ii) Special Journal

It is sub-divided into Cash Book, Purchase Day Book, Sales Day Book, Returns Inward Book, Returns Outward Book, Bills Receivable Book and Bills Payable Book. These books are called subsidiary books.

Importance of Sub-division of Journal

When the number of transactions is large, it is practically not possible to record all the transactions through one journal because of the following limitations of journal:

(a) The system of recording all transactions in a journal requires (a) writing down the name of the account involved as many times as the transaction occurs; and (b) an individual posting of each account debited and credited and hence, involves the repetitive journalizing and posting labour.

(b) Such a system cannot provide the information on a prompt basis.

(c) Such a system does not facilitate the installation of an internal check system because the journal can be handled by only one person.

(d) The journal becomes huge and voluminous.

To overcome the shortcomings of the use of the journal only as a book of original entry, it is sub-divided into special journal.

The journal is sub-divided in such a way that a separate book is used for each category of transactions which are repetitive in nature and are sufficiently large in number.

Compound Journal

If for a single transaction, only one account is debited and one account is credited, it is known as simple journal. If the transaction requires more than one account to be debited or more than one account to be credited, it is known as Compound Journal.

SUBSIDIARY BOOKS

Subsidiary Books refer to books meant for specific transactions of similar nature. These books are also known as special journals or day books. To overcome shortcoming of the use of the journal only as a book of original entry, the journal is sub-divided into specific journals or subsidiary books.

The sub-division of journal is done as follows:

Transaction	Subsidiary Book
All cash and bank transactions	Cash Book has columns for cash, bank and cash discount
All credit purchase of goods – only those goods that are purchased for resale are covered here	Purchase Day Book or Purchase Register
All credit sale of goods	Sales Day Book or Sales Register
All purchase returns – i.e., return of goods back to suppliers due to defects	Purchase Return Book or Return Outward Book

All sales returns – i.e., return of goods back from Customers	Sales Return Book or Return Inward Book
All bill receivables – these are bills accepted by Customers to be honored at an agreed date	Bills Receivable Book
All bills payable - these are bills accepted by the business to be honored by paying to suppliers at an agreed date	Bills Payable Book
For all other transactions not covered in any of the above categories – i.e., purchase or sale of assets, expense accruals, rectification entries, adjusting entries, opening entries and closing entries	Journal Proper

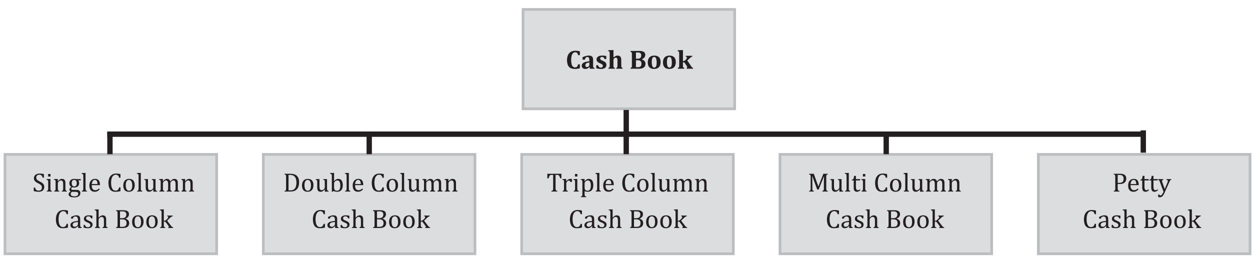
Recording of Cash and Bank Transactions

Cash Book

A Cash Book is a special journal which is used for recording all cash receipts and cash payments. Cash Book is a book of original entry since transactions are recorded for the first time from the source documents. The Cash Book is larger in the sense that it is designed in the form of a Cash Account and records cash receipts on the debit side and cash payments on the credit side. Thus, the Cash Book is both a journal and a ledger.

Types of Cash Book

There are different types of Cash Book as follows :



(a) **Single Column Cash Book-** Single Column Cash book has one amount column on each side. All cash receipts are recorded on the debit side and all cash payments on the payment side; this book is nothing but a Cash Account and there is no need to open separate cash account in the ledger.

(b) **Double Column Cash Book-** The Double Column Cash Book has two amounts columns on each side as under:

   (a) Cash and discount columns
   (b) Cash and bank columns
   (c) Bank and discount columns

(c) **Triple Column Cash Book-** Triple Column Cash Book has three amount columns, one for cash, one for bank and one for discount on each side. All cash receipts, deposits into book and discounts allowed are recorded on the debit side and all cash payments, withdrawals from bank and discounts received are recorded on the credit side. In fact, a triple-column cash book serves the purpose of both Cash Account and Bank Account. Thus, there is no need to create these two accounts in the ledger.

(d) **The multi-column cash book** has multiple columns on both the sides of the cash book.

(e) **The petty cash book.**

Dr. **Specimen of Single Column Cash Book** ***Cr.***

Receipts				**Payments**			
Date	*Particulars*	*L.F.*	*Cash*	*Date*	*Particulars*	*L.F.*	*Cash*

Dr. **Specimen of Double Column Cash Book** ***Cr.***

Receipts					**Payments**				
Date	*Particulars*	*L.F.*	*Cash*	*Disc. Allowed*	*Date*	*Particulars*	*L.F.*	*Cash*	*Disc. Received*

Dr. **Specimen of Triple Column Cash Book** ***Cr.***

Receipts						**Payments**				
Date	*Particulars*	*L.F.*	*Cash*	*Bank*	*Discount Allowed*	*Date*	*Particulars*	*L.F.*	*Bank*	*Discount Received*

Is the Cash Book a Journal or a Ledger?

(a) Cash Book is a book of original entry since transactions are recorded for the first time from the source documents.

(b) It is a ledger in the sense that it is designed in the form of a Cash Account and records cash receipts on the debit side and cash payments on the credit side.

Thus, the cash book is both a journal and a ledger.

(i) Contra Transactions

Transactions which discount or receive discounts in cash after the settlement of the dues are known as Contra Transactions.

(ii) Cheque Transactions

When a cheque is received and no any other information at a later date about the same is given, it will be assumed that the said cheque has already been deposited into the bank on the same day when it was received. Then the entry should be as under:

Bank A/c Dr.

To Debtor's/Party's A/c

But if it is found that the said cheque has been deposited into the bank at a later date, the entry will be:

(i) When the cheque is received

Cash A/c Dr.

To Debtor's/Party's A/c

(ii) When the same was deposited into bank at a later date

Bank A/c Dr.
To Cash A/c

(iii) When the said cheque is dishonoured by the bank

Debtor's/Party's A/c Dr.

To Bank A/c

Purchase Day Book

The purchase day book records the transactions related to credit purchase of goods only. It follows that any cash purchase or purchase of things other than goods is not recorded in the purchase day book. Periodically, the totals of purchase day book are posted to purchase account in the ledger. A specimen of purchase day book is given below:

In the Books of .... Purchase Day Book

Date	Name of the Suppliers and details of Goods purchased	Invoice reference	L. F.	Amount (Rs.)	Remarks

The format for Purchase Return Book is exactly the same; hence separate illustration is not given.

Sales Day Book

The sales day book records transactions of credit sale of goods to customers. Sale of other things, even on credit, will not be entered in the sales day book, but is entered in Journal Proper. If goods are sold for cash, it is entered in the cash book. Total of sales day book is periodically posted to the sales account in the ledger. A specimen of a sales day book is given below.

In the books of ....Sales Day Book

Date	Particulars	Invoice reference	L. F.	Amount (Rs.)	Remarks

The format of sales return book is exactly the same; hence a separate illustration is not given.

OTHER SUBSIDIARY BOOKS – RETURNS INWARD, RETURN OUTWARD, BILLS RECEIVABLE, BILLS PAYABLE

i) **Return Inward Book-** The transactions relating to goods which are returned by the customers for various reasons, such those which are as not according to sample, or not up to the mark are contained in this book. It is also known as Sales Return Book.

Generally, when a customer returns goods to suppliers he issues a Debit Note for the value of the goods returned by him. Similarly, the supplier who receives those goods issues a Credit Note.

Returns Inward Day Book

Date	Particulars	Outward Invoice	L. F.	Details	Totals	Remarks

ii) **Return Outward Book-** This book contains transactions relating to goods that are returned by us to our creditors, e.g., goods broken in transit, or not matching with the sample, etc.

It is also known as Purchase Return Book.

Return Outward Day Book

Date	Particulars	Debit Note	L. F.	Details	Totals	Remarks

iii) **Bills Receivable Book-** It is a book where all bills received are recorded and therefrom posted directly to the credit of the respective customer's account. The total amounts of the bills so received during the period (either at the end of the week or month) is to be posted in one sum to the debit of Bills Receivable A/c.

Bills Receivable Day Book

No. of Bills	Date of Receipt of Bill	From whom	Name of the Receiver	Name of Drawer	Name of Acceptor	Date of Bill	Due Date	L.F.	Amount of Bill	How disposed off

iv) **Bills Payable Book-** Here all the particulars relating to bills accepted are recorded and therefrom posted directly to the debit of the respective creditor's account. The total amounts of the bills so accepted during the period (either at the end of the week or month) is posted in one sum to the credit of Bills Payable Account.

Bills Payable Day Book

No. of Bills	Date of Acceptance	To whom given	Name of Drawer	Name of Payee	Name of Payable	Date of Bill	Term	Due Date	L.F.	Amount of Bill How disposed off

Journal Proper

Credit transactions that cannot be entered in any other subsidiary book are entered in journal proper.

It will cover purchase or sale of assets, expense accruals, rectification entries, adjusting entries, opening entries and closing entries. The format of journal proper is exactly the same as the Journal.

LEDGER ACCOUNTS

The book which contains accounts is known as the ledger. Since finding information pertaining to the financial position of a business emerges only from the accounts, the ledger is also called the Principal Book. As a result, all the necessary information relating to any account is available from the ledger. This is the most important book of the business and hence is rightly called the "King of All Books". Also Known as Book of Final Entry.

The specimen of a typical ledger account is given below:

Dr. **Ledger-Account** ***Cr.***

Date	Particulars	J. F.	Amount (Rs.)	Date	Particulars	J. F.	Amount (Rs.)

LEDGER POSTING

As and when the transaction takes place, it is recorded in the journal in the form of journal entry. This entry is posted again in the respective ledger accounts under double entry principle from the journal. This is called ledger posting.

The rules for writing up accounts of various types are as follows:

Assets: Increases on the left hand side or the debit side and decreases on the credit side or the right hand side.

Liabilities: Increases on the credit side and decreases on the debit side.

Capitals: The same as liabilities.

Expenses: Increases on the debit side and decreases on the credit side. Incomes or gain: Increases on the credit side and decreases on the debit side.

To summarize:

Dr.	Assets	Cr.	Dr.	Expenses or Loses	Cr.
Increase	|	Decrease	Increase	|	Decrease
Dr.	Liabilities & Capital	Cr.	Dr.	Income or Gains	Cr.
Decrease	|	Increase	Decrease	|	Increase

The students should clearly understand the nature of debit and credit.

A debit denotes:

(i) the case of a person who has received some benefit against which he has already rendered some service or will render a service in future. When a person becomes liable to do something in favour of the firm, the fact is recorded by debiting from that person‘s account : (relating to Personal Account);

(ii) in the case of goods or properties, where the value and stock of such goods or properties has increased, (relating to Real Accounts);

(iii) in the case of other accounts where losses or expenses that the firm has incurred, (relating to Nominal Account);

A credit denotes:

(i) in case of a person, where some benefit has been received from him, entitling him to claim from the firm a return benefit in the form of cash or goods or service then a person becomes entitled to money or money‘s worth for any reason. The fact is recorded by crediting him (relating to Personal Account);

(ii) in the case of goods or properties, where the stock and value of such goods or properties has decreased, (relating to Real Accounts);

(iii) in the case of other accounts like interest or dividend or commission received, or discount received, that the firm has made a gain, (relating to Nominal Account).

Posting to Ledger Accounts from Subsidiary Books

In the above section, we have explained how posting is done to ledger accounts directly on the basis of journal entries.

In practice, however, we know that use of subsidiary books is in vogue. Let us see how the posting to ledger accounts is done based on these records.

For each of the subsidiary books, there is a ledger account, e.g., for purchase book, there is Purchase Account, for sales book there is Sales A/c, for cash book there is Cash A/c as well as Bank A/c and so on.

Typical Ledger Account Balances

We have seen how to balance various ledger accounts, some accounts show debit balance, while the others show credit balance. Is there any relationship between the type of account (whether it is the account of asset, liability, capital, owner‘s equity, income or gain, expenses or losses) and the kind of balance (debit or credit).

The answer is generally ‘Yes‘. You may test to find the following are typical relationships.

Type of Account	**Type of balance**
All asset accounts	Debit balance
All liability accounts	Credit balance
Capital & Owner‘s equity account	Credit balance
Expenses or loss accounts	Debit balance
Income or gain accounts	Credit balance

Let us test these possibilities for confirmation. How does one go about testing this?

Consider ‘Cash A/c‘.

Whenever business receives cash we debit it, and whenever it pays we credit it. Is it possible to see a situation where credits to cash are more than debits? In other words could we have negative cash in hand? No. Cash account will therefore always show a debit balance. So is true for all real asset accounts.

After solving problems, if the contrary is observed, there is every chance that an error has been made while passing the accounting entries.

Closing Balance and Opening Balance

The debit or credit balance of an account that we get at the end of the accounting period is known as closing balance of that account.

The "balance of the nominal accounts" is closed by transferring to trading account, and the profit and loss account which shows the net operating results – net profit or net loss.

The "balance of the personal accounts and real accounts" representing assets, liabilities, owner's equity are reflected in the Balance Sheet, which shows the financial position of a business on a particular date. These balances are transported as opening balance in the succeeding accounting period.

Some terms used:

Casting — totaling

Balancing — to find the difference between debit side total and credit side total of an account.

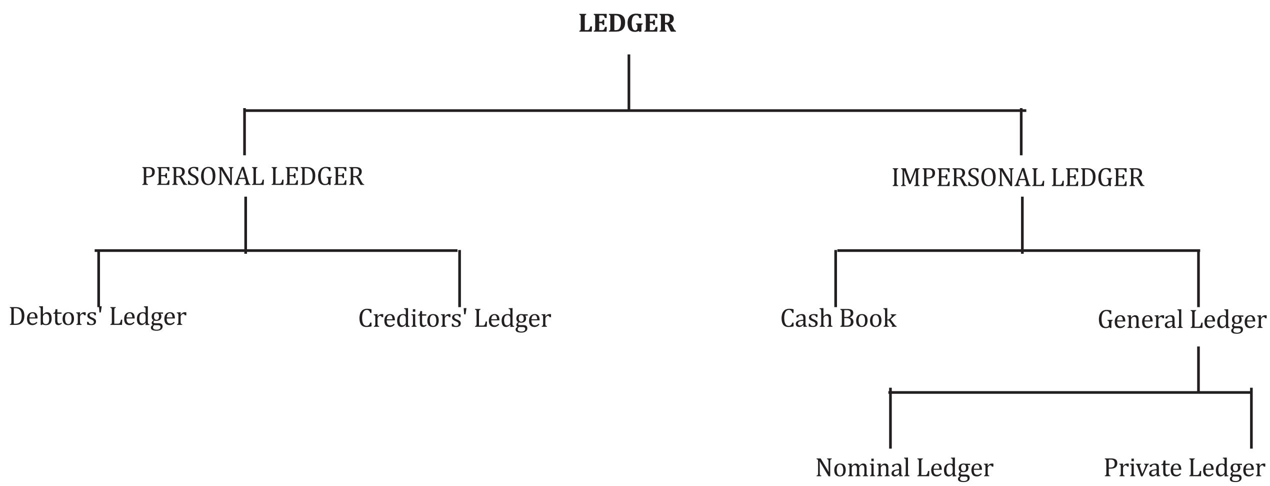
C/d -Carried down	B/d -Brought down
C/o - Carried over	B/o - Brought over
C/f - Carried forward	B/f - Brought forward

Sub-divisions of Ledger

Practically, the Ledger may be divided into two groups -

Personal Ledger and (b) Impersonal Ledger.

They are again sub-divided as :



Personal Ledger: The ledger where the details of all transactions about persons who are related to the accounting unit are recorded is called Personal Ledger.

Impersonal Ledger: The ledger where details of all transactions about assets, income & expenses, etc., are recorded is called Impersonal Ledger.

Again, Personal Ledger may be divided into two groups: viz. (a) Debtors' Ledger, and (b) Creditors' Ledger.

i) **Debtors' Ledger:** The ledger where the details of transactions about the persons to whom goods are sold, cash is received, etc., are recorded is called Debtors' Ledger.

ii) **Creditors' Ledger:** The ledger where the details of transactions about the persons from whom goods are purchased on credit, cash paid to them, etc., are recorded, is called Creditors' Ledger.

Impersonal Ledger may, again be divided into two group, viz., (a) Cash Book; and (b) General Ledger.

i) **Cash Book:** The book wherein all cash & bank transactions are recorded is called Cash Book.

ii) **General Ledger:** The ledger where all transactions relating to real accounts, nominal accounts, details of Debtors' Ledger and Creditors' Ledger are recorded is called General Ledger.

General Ledger may again be divided into two groups, viz., Nominal Ledger & Private Ledger.

i) **Nominal Ledger:** The ledger where all transactions relating to income and expenses are recorded is called Nominal Ledger.

ii) **Private Ledger:** The Ledger where all transactions relating to assets and liabilities are recorded is called Private Ledger.

Advantages of sub-division of Ledger

The advantages of sub-division of ledger are:

i) **Easy to divide work :** As a result of sub-division, records can be maintained efficiently by the concerned employees.

ii) **Easy to handle:** As a result of sub-division, the size and volume of ledger is reduced.

iii) **Easy to collect information:** From the different classes of ledger any particular type of transaction can easily be found out.

iv) **Minimization of mistakes:** As a result of sub-division chances of mistakes are minimized.

v) **Easy to compute:** As a result of sub-division, the accounting work may be computed quickly which is very helpful to the management.

vi) **Fixation of responsibility:** Due to sub-division, allotment of different types of work to different employees is done for which concerned employee will be responsible.

TRIAL BALANCE

Trial Balance may be defined as a statement or a list of all ledger account balances taken from various ledger books on a particular date to check the arithmetical accuracy. According to the Dictionary for Accountants by Eric. L. Kohler, Trial Balance is defined as "a list or abstract of the balances or of total debits and total credits of the accounts in a ledger, the purpose being to determine the equality of posted debits and credits and to establish a basic summary for financial statements". According to Rolland, "The final list of balances, totaled and combined, is called Trial Balance".

As this is merely a listing of balances, it will always be on a particular date. Further, it must be understood that Trial Balance does not form part of Books of Account, but it is a report prepared by extracting balances of accounts maintained in the books of accounts.

When this list with tallied debit and credit balances is drawn up, the arithmetical accuracy of basic entries, ledger posting and balancing is ensured. However, it does not guarantee that the entries are correct in all respect. This will be explained later in this chapter.

Although it is supposed to be prepared at the end of accounting period, computerized accounting packages are capable of providing instant Trial Balance reports even on a daily basis, as the transactions are recorded almost online.

It can be seen that the respective total of debit and credit balances is exactly matching. This is the result of double entry book-keeping wherein every debit has equal corresponding credit.

Features of a Trial Balance

(i) It is a list of debit and credit balances which are extracted from various ledger accounts.

(ii) It is a statement of debit and credit balances.

(iii) The purpose is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts.

(iv) It does not prove arithmetical accuracy which can be determined by audit.

(v) It is not an account. It is only a statement of account.

(vi) It is not a part of the final statements.

(vii) It is usually prepared at the end of the accounting year but it can also be prepared anytime as and when required like weekly, monthly, quarterly or half-yearly.

(viii) It is a link between the Books of Accounts, Profit and Loss Account and Balance sheet.

Preparation of Trial Balance

(i) It may be prepared on a loose sheet of paper.

(ii) The ledger accounts are balanced at first. They will have either "debit-balance" or "credit balance" or "nil-balance".

(iii) The accounts containing debit-balance are written on the debit column, and those with credit-balance are written on the credit column.

The sum total of both the balances must be equal for "Every debit has its corresponding and equal credit".

Purpose of a Trial Balance

It serves the following purposes:

(i) To check the arithmetical accuracy of the recorded transactions.

(ii) To ascertain the balance of any ledger account.

(iii) To serve as an evidence of the fact that the double entry has been completed in respect of every transaction.

(iv) To facilitate the preparation of final accounts promptly.

Is Trial Balance Indispensable?

It is a mere statement prepared by the accountants for their convenience, and if it agrees, it is assumed that at least arithmetical accuracy has been done, although there may be a lots of errors.

Trial Balance is not a process of accounting, but its preparation helps us to finalize the accounts. Since it is prepared on a particular date, as at .... / as on .... is stated.

Forms of a Trial Balance

A trial balance may be prepared in two forms, they are –

(i) Journal Form

(ii) Ledger Form

The trial balance must tally irrespective of the form of a trial balance.

(a) **Journal Form:** This form of a trial balance will have a format of Journal Folio. It will have columns for serial number, name of the account, ledger folio, debit amount and credit amount in the journal form.

Specimen of journal form of trial balance:

Trial Balance as on …………

Sl. No.	Name of the Account	L.F.	Debit Balance (Rs.)	Credit Balance

(b) **Ledger Form:** This form of a trial balance has two sides, i.e., debit side and credit side. In fact, the ledger form of a trial balance is prepared in the form of an account. Each side of the trial balance will have particulars like name of the account column, folio column and amount column.

Specimen of ledger form of trial balance

Dr. **Trial Balance as on ……** ***Cr.***

Date	Name of the Account	L.F.	Amount (Rs.)	Date	Name of the Account	L.F.	Amount (Rs.)

Method of Preparation

(a) Total Method or Gross Trial Balance.

(b) Balance Method or Net Trial Balance.

(c) Compound Method.

These are explained as hereunder:

(a) Total Method or Gross Trial Balance : Under this method, two sides of the accounts are totalled. The total of the debit side is called the "debit total", and the total of the credit side is called the "credit total". Debit totals are entered on the debit side of the trial balance while the credit total is entered on the credit side of the trial balance.

If a particular account has total in one side, it will be entered either in the debit column or the credit column as the case may be.

Advantages:

(a) It facilitates arithmetical accuracy of the accounts.

(b) Extraction of ledger balances is not required at the time of preparation of trial balance.

Disadvantages: Preparation of final accounts is not possible.

(b) Balance Method or Net Trial Balance: Under this method, all the ledger accounts are balanced. The balances may be either "debit-balance" or "credit balance".

Advantages:

(a) It helps in the easy preparation of final accounts.

(b) It saves time and labour in preparing a trial balance.

Disadvantages: Errors may remain undisclosed irrespective of the agreement of trial balance.

(c) Compound Method: Under this method, totals of both the sides of the accounts are written in separate columns. Along with this, the balances are also written in the separate columns. Debit balances are written in the debit column and credit balances are written in the credit column of the trial balance.

Advantages: It offers the advantage of both the methods.

Disadvantages: It is a lengthy process and more time is consumed in the preparation of a trial balance.

Summary of Rules

Debit Balance — All Assets, Drawings, Debtors, Expenses and Losses.

Credit Balance — All Liabilities, Capital, Creditors, Gains and Incomes.

Trial Balance – Utility and Interpretation

The utility of trial balance could be found in the following:

(a) It forms the basis for the preparation of financial statements, i.e., Profit and Loss Account and Balance Sheet.

(b) A tallied trial balance ensures the arithmetical accuracy of the entries made. If the trial balance does not tally, the errors can be found out, rectified and then financial statements can be prepared.

(c) It acts as a quick reference. One can easily find out the balance in any ledger account without actually referring to the ledger.

(d) If the listing of ledger accounts is systematically done in the trial balance, one can do a quick time analysis. Hence, listing is usually done in the sequence of Asset accounts, Liability accounts, Capital accounts, Owner's equity accounts, Income or gain accounts and Expenses or Losses accounts in that order.

One can draw some quick inferences from trial balance by interpreting it. If one plots monthly trial balances side by side, one can analyze the movement of balances in various accounts, e.g., one can see how expenses are increasing or decreasing or showing a trend of movements. By comparing the owner's equity balances as on two dates, one can interpret the business result, e.g., if the equity has gone up, one can interpret that business has earned net profit and vice versa.

LESSON ROUND-UP

- Accounting information should be relevant, reliable, comparable, understandable, timely, neutral, verifiable and complete.
- Accounting can be based on cash or accrual system. In cash system, accounting entries are passed only when cash is received or paid, while in accrual system transactions are recorded on the basis of amounts having become due for payment or receipt.
- Book-keeping is different from accounting. Book-keeping is concerned with the permanent recording or maintaining of all transactions in a systematic manner to show their financial effects on the business.

  Accounting is concerned with the summarizing of the recorded transactions.
- Accounting principles are guidelines to establish standards for sound accounting practices and procedures in reporting the financial status of a business. These principles can be accounting concepts and accounting conventions.
- Accounting concepts are defined as basic assumptions on the basis of which financial statements of a business entity are prepared. While 'convention' denotes custom or tradition or practice based on general agreement between the accounting bodies which guide the accountant while preparing the financial statements.
- Some of the important accounting concepts are: business entity concept, money measurement concept, cost concept, going concern concept, dual aspect concept, realization concept, accrual concept, accounting period concept and revenue match concept.
- Accounting conventions are consistency, disclosure, conservatism and materiality.
- Two classes of accounts are personal accounts and impersonal accounts. Impersonal accounts can be further classified into real and nominal accounts.
- Accounting Equation represents that sum of resources (assets) is equal to the obligations (capital and liabilities) of the business.
- Accounting cycle includes identifying, recording, classifying and summarizing of the transactions.
- Every transaction is recorded in the journal before being posted into the ledger. It is the book of account in which transactions are recorded in a chronological order.

- Recording in the journal is done following the rules of debit and credit.
- Posting is the process of recording transactions in the ledger based on the entries in the journal.
- The main function of a ledger is to classify or sort out all the items appearing in the journal or other subsidiary books under their appropriate accounts so that at the end of the accounting period summary of each account is easily available.
- Balancing of ledger accounts involves equalization of both sides of the account by putting the difference on the side where the amount is short.
- Various subsidiary books are: purchases book; sales book; purchases returns book; sales returns book; bills receivable book; bills payable book and cash book.
- General journal or journal proper is maintained for recording those transactions for which there are no other appointed subsidiary book.
- Trial balance is prepared after posting and balancing the entries in ledger to verify the arithmetical accuracy of entries made in the ledger.

GLOSSARY

Accounting

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

Book-Keeping

Book-Keeping is a science as well as art of correctly recording in books of accounts all those business transactions that result in transfer of money or money's worth.

Journal

A journal is often referred to the Book of Prime Entry or Book of Original Entry. In this book transactions are recorded in their chronological order.

Subsidiary Books

Subsidiary Books refer to books meant for specific transactions of similar nature. These books are also known as special journals or day books.

Ledger

The book which contains accounts is known as the ledger.

Trial Balance

Trial Balance is a statement or a list of all ledger account balances taken from various ledger books on a particular date to check the arithmetical accuracy.

TEST YOURSELF

1. Define accounting and state its characteristics.
2. Discuss the system of accounting.
3. What are the functions of accounting?
4. Distinguish between book-keeping and accounting.
5. Explain important accounting conventions.
7. Explain the basic rules of debit and credit in accounting.
8. Define the term 'account' and name the types of accounts? Also explain with examples.
9. What do you mean by contra-entries in a columnar cash book?
10. What is meant by columnar cash book?
11. Point out the accounts which will be debited and credited for each one of the following transactions:
    - Cash received from X and discount allowed to him.
    - Cash paid to Y and discount received from him.
    - Credit Sales to Z.
    - Cash Sales to A.
    - Purchases from B on credit.
    - Salary paid to clerk by means of cheque.
    - Payment of cash to landlord for rent.
    - Depreciation on furniture.
    - Interest due but not yet paid.
    - Interest provided on capital.
12. Give Accounting Equation for the following transactions of Jitesh:
    - Started business with cash Rs. 36,000
    - Paid rent in advance Rs. 800– Purchased goods for cash Rs.10,000 and on credit Rs. 4,000
    - Sold goods for cash Rs. 8,000
    - Rent paid Rs. 2000 and rent outstanding Rs. 400
    - Bought cycle for personal use Rs. 16,000
    - Purchased equipments for cash Rs. 10,000
    - Paid to creditors Rs. 1,200
    - Some business expenses paid Rs. 1,800
    - Depreciation on equipment Rs. 2,000.