Fundamentals of Accounting

Learning Objectives

- The meaning and importance of accounting.
- Commonly used accounting terms.
- Accounting assumptions, concepts and principles.
- Types of accounts.
- Golden rules of accounting.
- Double entry system of accounting.

1.1 Introduction

Commercial businesses run with the objective of earning profit, and financial transactions are the order of the day. It becomes essential for a business owner to keep a record of the business' income and expenditure, in order to find answers to numerous questions, a few of which are:

- Is the business earning profits or is it incurring a loss?
- How much do third parties owe the business?
- How much does the business owe to third parties?
- Can the business be expanded?
- Should a specific operation be withdrawn?
- What is the total value of business assets?

These answers can be arrived at, by studying the financial information of a business operation. Thus, accounting is an integral part of any business.

Accounting is the practice of maintaining precise records of the financial dealings of a business. It involves identifying business transactions, recording them, and summarising the same in such a way that important financial information can be communicated to the stakeholders of the business. Accounting is also called as language of business.

The stakeholders of a typical business concern are:

- Owners
- Management
- Employees
- Investors (existing and potential)
- Suppliers
- Customers
- Lending institutions
- Government authorities

1.2 Accounting Terms

To help you understand accountancy better, a few commonly-used accounting terms are explained below:

1. **Transaction**

   A transaction is a business activity that involves the transfer of money or money's worth between two accounts.

   A transaction can be of two types:

   - **Cash transaction:** A cash transaction is one where money is immediately received or paid in the form of cash.

- **Credit transaction:** A credit transaction is one where money is paid later, but the benefits are enjoyed immediately.

2. **Capital**

   Total amount of money or money worth invested in the business by owner is called capital.

3. **Assets:**

   Anything possessed or owned by an individual or company, which are not for usual selling or trading purpose and utilised over a period of time are called assets

4. **Liability**

   Liability is the amount due for the goods, services or anything taken from party or anyone is called as liability of the business

5. **Drawings**

   The money withdrawn or taken something of money worth from business for the personal use is called drawings.

6. **Bad debts**

   The amount which is unrecoverable from the debtor due to reason like insolvency or absconding and company will not be able to realize due amount from the debtor, hence the unrealized amount is called bad debts.

7. **Purchases**

   A purchase is the amount of goods bought by a business for further use or for reselling. Goods purchased with immediate payment of cash are called cash purchases. Goods purchased on credit are called credit purchases.

8. **Purchase returns**

   Goods that have been purchased but are returned to the seller before consumption due to reasons like poor quality and damage are called 'purchase returns'.

9. **Sales**

   Sales refer to the amount of goods sold by a business. Sales made against immediate payment of cash are called cash sales. Sales on credit, are called credit sales.

10. **Sales returns**

    Goods that have been sold but are returned by the buyer before consumption, due to reasons like poor quality and damage, are called 'sales returns'.

11. **Debtor**

A debtor is a person who receives benefits from the business immediately, but is obligated to pay for the same in future. For example, a buyer who purchases goods from the business on credit, becomes a debtor to the business.

12. Creditor

A person who provides benefit without receiving immediate payment for the same, and who will claim the payment in future, is called a ‘creditor’. For example, when the business purchases goods on credit from a supplier, the supplier becomes a creditor to the business.

13. Stock

Unsold goods, raw material, etc., that lie with the business are collectively known as ‘stock’.

14. Revenue

The earnings of a business through its activities and operations, is called ‘revenue’.

1.3 Accounting Assumptions, Concepts and Principles

To ensure that the interpretation of financial information derived from accounting is uniform, the following assumptions, concepts, and principles have been developed. They form the basis for accountancy.

1.3.1 Assumptions

1. Accounting Entity Assumption

As per this assumption, a business is considered as a separate unit or entity from its owner. That is, the proprietor and his business are treated as two distinct entities. Therefore, the transactions of the business are separate from its owner’s personal transactions. All the business transactions are recorded in the Books of Accounts from the business’ perspective.

Example: A vehicle purchased by the business owner for his personal use, should not be recorded in the business’ Books of Accounts.

2. Accounting Period Assumption

The stakeholders of a business use its financial statements and periodical reports to assess the operational and the financial position of the business concern. Thus, it is essential for a business to close its accounts at regular intervals. A time span of 365 days or 52 weeks or 1 year is generally considered as the accounting period.

Note: A year that begins on 1st January and ends on 31st December is a Calendar Year. For some businesses the calendar year is also the financial year.

For Example: In Bangladesh, the financial year starts from 1 July and ends on next 30 June. In Iran, the financial year starts from 21st March and ends on next 20th March.

3. **Going Concern Assumption:** As per this assumption, accounts have to be maintained with an expectation that the business will exist for a long period. That is, the business will run with the assumption that it intends to continue, and there will be no need to close operations in the near future. Example: The cost of a plant or machinery acquired by a company, will be accounted for across financial year that is, the total cost of acquisition will not be reflected in the accounts of the same year as its acquisition; the cost will be broken into specific amounts which will be accounted for in subsequent years of the business. This is done with the assumption that the business concern will continue to operate in the forthcoming year
4. **Money Measurement Assumption:** According to this assumption, only those business transactions that can be measured in terms of money are recorded. Example: The sales made by a business during a particular day will be recorded in its books of accounts, as it can be expressed in terms of money. However, aspects like employee satisfaction will not be recorded in the books of accounts, as they cannot be accounted in terms of money.

1.3.2 Concepts

1. **Accrual Concept**

   This concept requires that income or expenditure are recorded when they become receivable or payable rather than when they are collected or paid i.e., transactions are recorded on the basis of income earned or expense incurred irrespective of actual receipt or payment.

   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.

2. **Dual Aspect Concept**

   This concept states that every financial transaction has two aspects: one where the business receives a benefit, and the other where it provides a benefit. Therefore, every transaction should be recorded in such a way that its effect is reflected in two places in a business' books of accounts. This concept forms the basis for the Double Entry System of Accounting.

   Example: When a business buys a machinery, it receives a benefit (the machinery), and also provides a benefit (pays for the machinery).

3. **Full Disclosure Concept**

The various stakeholders of a business derive important information from its financial statements. Hence, this concept explains that the financial records of a business concern give a true and fair view of the business' financial position.

4. **Historical Cost Concept**

This concept states that assets need to be recorded at the price paid for their acquisition, and not at their current market value. Thus, a business' financial statement will not indicate the price at which its assets could be sold for.

Example: If a business has purchased a machinery for ₹ 10,00,000, and its market value has come down to ₹ 8,00,000 at the time of preparing final accounts, the value will be recorded as ₹ 10,00,000.

5. **Matching Concept**

As per this concept, the revenue earned and the cost incurred to earn such revenue, need to belong to the same period, and hence they need to be 'matched'. This will help ascertain the result of the business operations. This concept serves as the basis for calculating accurate profit earned during a period.

Example: A business pays ₹1, 00,000 as factory rent. Other expenses incurred for business operations like salaries and wages paid, maintenance of machinery, etc., amount to ₹ 15, 00,000. The sales made for the month, amount to ₹ 25, 00,000. The profit of the business will be ₹ 9, 00,000, which is the revenue minus expenses.

6. **Revenue Realisation Concept**

According to this concept, revenue is considered as the income earned on the date when it is received. 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.

Example: On 25th December 2017, ABC Company received a sales order to supply goods worth ₹ 50, 00,000 to M/s. National Traders ABC Company delivered goods worth ₹ 35, 00,000 on 31th December. The remaining supply was delivered on 2nd January 2017. The revenue from this transaction for 2017 will be ₹ 35, 00,000 only. The remaining amount of ₹ 15, 00,000 should be accounted for in 2017.

7. **Verifiable and Objective Evidence Concept**

This concept requires that all financial transactions be supported with documentary evidence. Such evidence should be easy to verify, and also provide unbiased proof of transaction.

Example: If a piece of land is purchased by a business, the transaction needs to be supported by the relevant documents like the Title Deed.

1.3.3 Principles

1. **Cost Benefit Principle**

   This principle states that the cost incurred for applying an accounting principle should be lesser than the profits derived from doing so.

2. **Materiality Principle**

   As stated earlier in this chapter, financial statements are used by the various stakeholders to do analysis and arrive at decisions. Hence, all information that is disclosed in financial statements, should aid the interested parties in arriving at decisions.

3. **Consistency Principle**

   The accounting practices adopted by a business for a year should be applied in the coming years too. That is, the accounting practices followed for one financial year should not vary from those of the previous financial year. Consistency in accounting practices facilitates the comparison of financial statements across years and can help draw important conclusions about a business.

4. **Prudence (Conservatism) Principle**

   This principle highlights the uncertainty with which businesses operate. It requires that a business make provisions for probable losses, but operate by anticipating profits.

   Conservatism leads accountants to anticipate/disclose losses, but it does not allow a similar action for gains.

1.4 Double Entry System of Accounting

Every business transaction has a two-fold effect, wherein two accounts are affected in opposite directions. Thus, if a complete record were to be made of each such transaction, it is necessary to debit one account and credit another account. Recording of this two fold effect of every transaction is called the **Double Entry System of Accounting.**

As explained in the **Dual Aspect Concept**, every financial transaction has two aspects: one where the business receives a benefit, and the other where it provides benefit. Therefore, every transaction should be recorded in such a way that its effect is reflected in two places in a business **Books of Accounts.** The receiving aspect is termed the '**Debit**' aspect. The giving aspect is termed the '**Credit**' aspect. Therefore, every business transaction will have an effect on two accounts; one will be debited, whereas the other will be credited.

1.5 Types of Accounts

An 'account' is a statement of transactions relating to one of the two aspects of a business transaction. Based on the aspect being recorded, an account can be 'debited' or 'credited.

Accounts are classified based on the three categories of business transactions:

- Transactions involving individuals or other business entities
- Transactions involving assets, goods, cash
- Transactions involving incomes, expenses, losses and gains.

In effect, there are three types of accounts maintained for transactions:

- **Personal Accounts**
  Personal Accounts are relating to individuals, a group of individuals, firms and institutions.

  They are of three types:

  - **Natural person's accounts:** represents the accounts of real persons the business deal with. The proprietor's account, the accounts of suppliers and customers are some examples of natural person's accounts.
  - **Artificial person's accounts:** represents the accounts of firms the business deals with. The accounts of a limited companies or banks that are not real persons are the examples of artificial person's accounts.
  - **Representative personal account:** If a business has not paid the rent of a number of shops for the past two months then all the landlords are creditors of the business and the amount due to them is recorded under a common head called Rent Outstanding Account. This is a representative personal account.

- **Real Accounts**
  Real accounts are relating to the property or assets and cash belonging to a business concern.

  They can be of two types:

  - **Tangible Real accounts:** are accounts of things that can be touched, measured, sold or purchased. Examples of tangible real accounts are furniture account, plant and machinery account, and cash account.
  - **Intangible Real accounts**: are accounts of things that cannot be touched in the physical sense but can be measured in terms of money value. Goodwill, trademark, and patents, copyrights are examples of intangible real accounts

- **Nominal Accounts**
  Nominal accounts relating to the incomes, expenses, losses and gains of a business concern. Without nominal accounts, it is difficult for the management to find out where the money was spent. The net result of all the nominal accounts helps the management to find out the

profit earned or loss incurred by the business.

Example: Salary accounts, discount allowed, discount received, etc.

1.6 Golden Rules of Accounting

The Golden Rules of Accounting are guidelines that every accountant should follow while recording business transactions. The Rules are:

Type of Accounts	Golden Rules
Personal accounts	Debit the receiver
	Credit the giver
Real accounts	Debit what comes in
	Credit what goes out
Nominal accounts	Debit all expenses and losses
	Credit all income and gains

Table 1.1

Note: *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 used by businesses and is, therefore, used only in select situations such as for very small businesses.*

Rule for Personal Accounts

In a Personal account, the rule to be followed is, "Debit the receiver; Credit the giver".

The debit balance in a personal account shows that the business has to receive money or money equivalent, and the credit balance shows that the business owes something.

pay ₹ 80,000 to PG & Co. Hence, in the books of accounts of PG& Co., Mr.Praveen account is debited since he has received goods.

Similarly, if PG & Co. has purchased from Mr.Praveen, the account of Mr.Praveen will have to be credited and purchases will be debited.

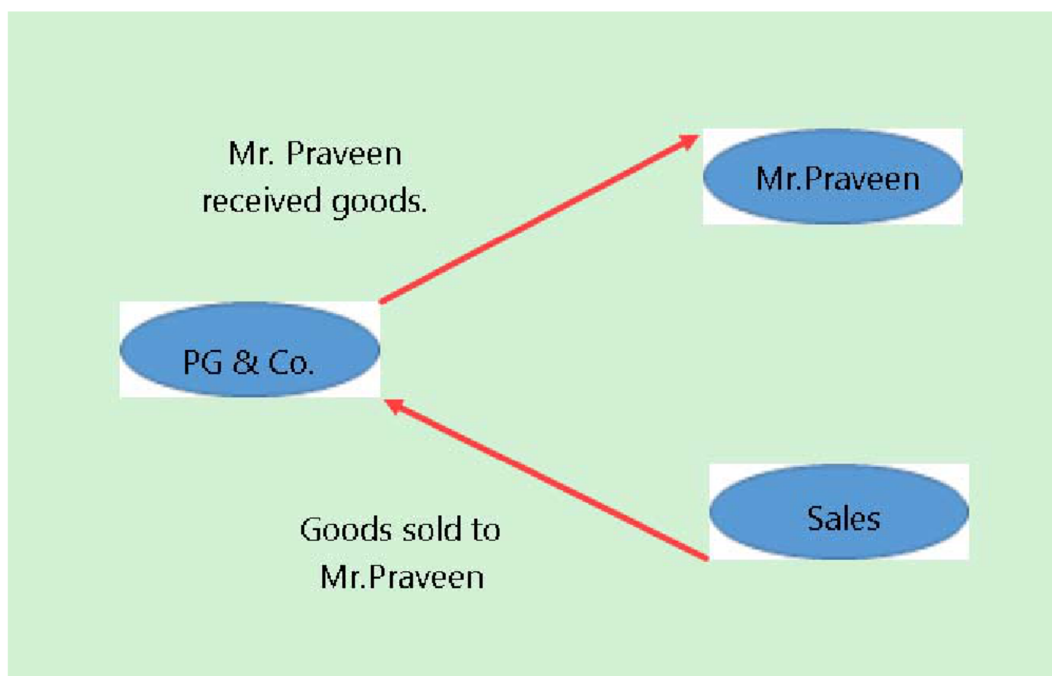

Figure 1.1 Personal Account

Below given table 1.2 is a tabular representation of the accounts and the effect on the accounts.

Ledger Account	Nature of Accounts	Golden Rule Applied	Debited/Credited	Amount (₹)
Mr.Praveen	Personal	Rule 1	Debited: Received Goods	80,000
Sales	Nominal	Rule 3	Credited: Goods gone out of the business	80,000

Table 1.2

Rule for Real Accounts

In a Real account, the rule to be followed is, "debit what comes in; credit what goes out."

Debiting a real account implies increase in the value of goods, stocks, and any other property in a business, and crediting a real account decreases in the value of the goods, stocks, and properties in a business.

The debit balance in a real account means that the firm owns and has assets, such as goods, stocks, and properties, and the credit balance shows that the business has negative balance for these assets.

In practice, there cannot be a credit balance in a real account except when the property has been sold at a profit.

For example: If PG & Co. bought Machinery for ₹ 1, 25,000 then value of Machinery in the business increases. Hence, Machinery account is debited, since payment is made in cash the balance of cash decreases and Cash account is credited.

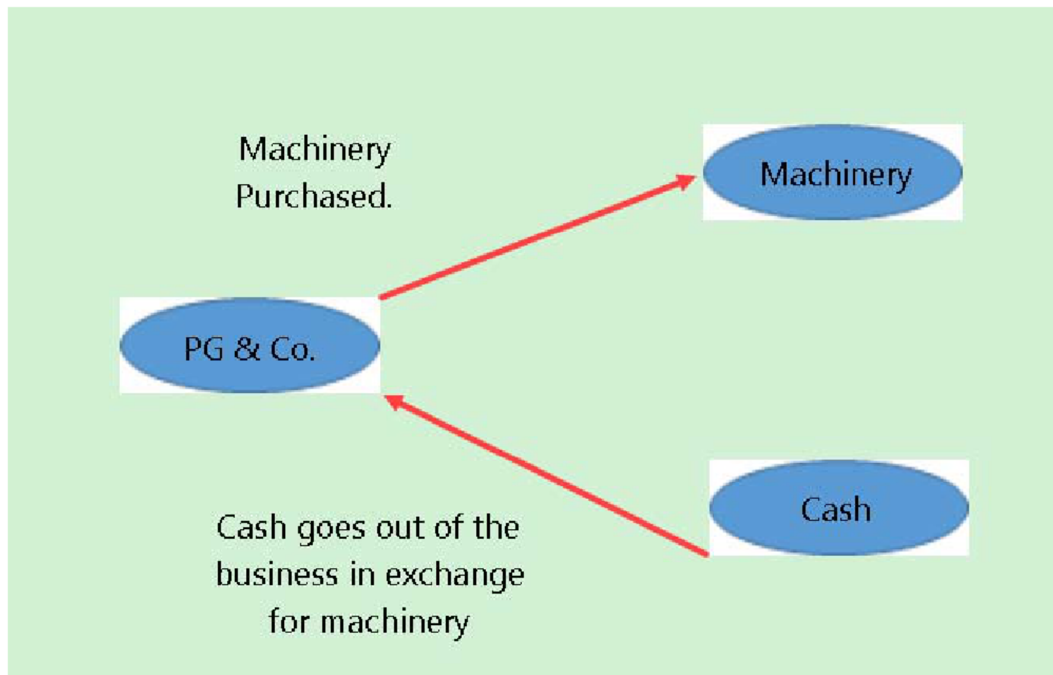

Figure 1.2 Real Account

Below given table 1.3 is a tabular representation of the accounts and the effect on the accounts.

Ledger Account	Nature of Accounts	Golden Rule Applied	Debited/Credited	Amount (₹)
Machinery	Real	Rule 2	Debited: Machinery has come in the business	1,25,000
Cash	Real	Rule 2	Credited: Cash has gone out of the business	1,25,000

Table 1.3

Rule for Nominal Accounts

In a Nominal account, the rule to be followed is, "Debit all expenses and losses; Credit all incomes and gains."

All debits in a nominal account infer that there has been an expense or the business has made a loss in a transaction, and a credit in a nominal account denotes that the business has earned money, income or profit.

A debit balance in nominal account indicates a loss or an expense, and credit balance indicates a gain or an income.

For example, PG & Co. pays ₹ 16,000 salaries in cash. Since payment of salaries is an expense for the company, Salaries account is debited. Moreover, payment of salaries is made in cash, thus the balance of cash decreases and cash account is credited.

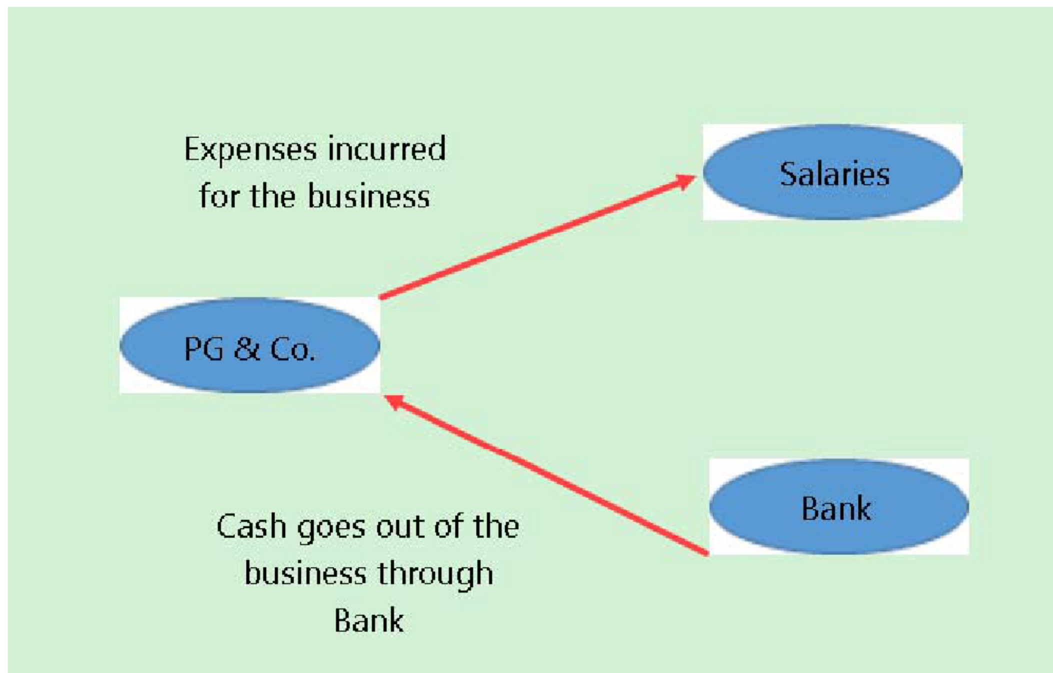

Figure 1.3 Nominal Account

Given table 1.4 is a tabular representation of the accounts and the effect on the accounts.

Ledger Account	Nature of Accounts	Golden Rule Applied	Debited/Credited	Amount (₹)
Salaries	Nominal	Rule 3	Debited: Salary expenses for the business	16,000
Cash	Real	Rule 2	Credited: Cash has	16,000

			gone out of the business through Bank	

Table 1.4

1.7 Source Documents for Accounting

The accounting process begins with identifying and recording the transactions in the books of accounts. A 'source document' serves as an evidence that a business transaction has occurred. A source document contains details like the date of transaction, goods sold, amount, and party involved.

The following are the most common source documents:

- **Bill/Invoice** : When a trader sells goods to a buyer on credit (agreeing to a delayed payment by the buyer), he provides a "sales invoice" with the details of the name and address of the buyer, the name of goods, the amount, terms of payments, etc.

- **Cash Memo**: When goods are sold for cash, the seller issues a 'Cash Memo' to the purchaser. The cash memo contains details of quantity of goods sold, rate per unit of goods sold, and total value of the sale.

- **Cheque**: Cheques' issued by a buyer become source documents for recording transactions in the Books of Accounts of both the buyer and the seller.

- **Credit Note**: A 'credit note' is recorded by the seller, when goods sold by him are returned to him by the buyer. It contains details of the goods returned, the buyer's details, and the amount involved.

  A 'credit note' is even used by the banking sector The credit note is issued to the account holder when a certain amount is credited in his account.

  A 'credit note' is also used to increase the value of the previous invoice sent by the supplier and the credit note will be issued by the customer to the supplier.

- **Debit Note:** A 'debit note' is recorded by a buyer when goods purchased by them are returned to the seller. It contains details of the goods being returned, the seller's details, and the amount involved.

  A 'debit note' is also recorded to adjust an under billed invoice. Debit note is issued by the supplier to the customer.

- **Receipt:** A trader issues a 'receipt' to a buyer, when payment is in the form of cash. It contains details of date, amount of cash received, and the buyer's details.

- **Voucher:** Vouchers' are prepared by the accountant, and signed by the designated person in the organization and they contain detailed information regarding the payee, monetary

value of the payment, a description of the transaction, and more.

Conclusion

This chapter summarises the fundamentals of Accountancy, starting with the Accounting terms, assumptions, concepts, principles, right up to the double entry system of accounting. It explains the need and usage of Golden Rules of Accounting in the books of accounting.

Key Takeaways

- Accounting is a comprehensive system to collect, analyse and communicate financial information.
- Entity is the organisational unit for which accounting records are maintained.
- 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.