INTRODUCTION TO ACCOUNTING – I

Introduction To Accounting

HISTORY OF ACCOUNTING

- The early developments of accounting date back to Mesopotamia.
- It was basically a system of counting money and writing about it.
- The Indian Connect of Accounting can be found in the famous book ***“Arthashastra”*** written by ***Chanakya***.
- The father of Accounting is considered to be ***“Luca Pacioli”*** who published a work on ***“Double Entry Book-Keeping.”***

INTRODUCTION

- Accounting is generally related to ***“Business”*** which is an economic activity.
- Such a business is run by an ***“Organisation”*** which is a team that does a set of activities like Purchases, Production, Sales, Procurement of Properties, Loans, etc.
- All such business activities or business events are called ***“Transactions.”***

BOOK-KEEPING AND ACCOUNTING

- The tool that we use to keep a track of such transactions is known as ***“Book-Keeping.”***
- Book-Keeping deals with the Recording and Classification of Transactions.
- ***“Accounting”*** is however a broader concept.
- Accounting also deals with Interpretation and Decision making besides recording and Classification of Transactions.
- So we can say that Book Keeping is a part of Accounting.

OBJECTIVES OF ACCOUNTING

- Providing data and information to the users of rational decision-making.
- Systematic recording of transactions.
- Ascertainment of results of such transactions.
- Ascertain the financial position and solvency position of the business.
- Government regulation and Taxation.

CONCEPT OF “ACCOUNT”

- An ***“Account”*** can be defined as a summarised record of transactions relating to a person or a thing.
- Typically an account is expressed as a statement in the form of the English letter ***“T”.***
- It has ***“2”*** sides.

- The left-hand side is called the ***"Debit"*** side and the right-hand side is called the ***"Credit"*** side.

PROFORMA ACCOUNT

PARTICULARS (Debit Side)	Rs.	Rs.	PARTICULARS (Credit Side)	Rs.	Rs.
To A. Account		xx	By C. Account		xx
To B. Account		xx	By D. Account		xx
TOTAL		XXX	TOTAL		XXX

TYPES OF ACCOUNTS

1. **Personal Account** – Accounts of Natural or Artificial persons.
2. **Real Account** – These are accounts of possessions and properties.
3. **Nominal Account** – These are accounts related to incomes and expenses.

GOLDEN RULES

1. **Personal Account -**
   - Debit the ***"Receiver"***
   - Credit the ***"Giver"***
2. **Real Account -**
   - Debit what ***"Comes in"***
   - Credit what ***"Goes out"***
3. **Nominal Account -**
   - Debit all ***"Expenses and Losses"***
   - Credit all ***"Incomes and Gains"***

ACCOUNTING PROCESS

- Transaction

- Journal
- Ledger
- Trial Balance
- Adjustment Entries
- Closing Entries
- Financial Statements

ACCOUNTING PROCESS

1. **Transaction** – An event which involves exchange of money or money's worth.
2. **Journal** – It's a book for primary recording of transactions in chronology.
3. **Ledger** – All journal entries are classified according to the accounts involved.
4. **Trial Balance** – Taking all the ledger account closing balances, a trial balance is prepared at the end of the period.
5. **Adjustment Entries** – Entries made to rectify and update any entry.
6. **Closing Entries** – All the nominal accounts are closed by transferring their balances.
7. **Financial Statements** – These include Manufacturing Account, Trading and P&L Account and Balance Sheet.

ACCOUNTING ASSUMPTIONS

- **Going Concern** – It's assumed that an entity will go on. It has no plans of closing down.
- **Accrual** – Transactions are recorded when they occur and not when actually realised.
- **Consistency** – Procedures and policies will remain the same over the years.

ACCOUNTING CONCEPTS

1. **Business Entity** – It states that "Business is Different from the Owner"
2. **Money Measurement** – Every transaction is recorded in terms of "Money"
3. **Cost** – Everything in the statements of Accounts should be maintained at "Cost"
4. **Dual Aspect** – Each transaction affects 2 accounts (Double Entry system)
5. **Accounting period** – Statements are created for a particular period of time.
6. **Matching** – The revenues and expenses should be matched while recording.

ACCOUNTING CONVENTIONS

- **Materiality** – Significant items should be recorded separately.
- **Conservatism** – Account for future losses but not for future profits. "Prudence"

- **Full Disclosure** – All events and other relevant information should be disclosed.

“CAPITAL” & “REVENUE” NATURE OF TRANSACTIONS

INTRODUCTION

- We record activities relating to the “***Operations”***, ***“Finance”*** and ***“Investment”***
- ***“Operations”*** – Activities relating to the actual business that we carry out.
- ***“Finance”*** – Activities which help us to raise money for the business.
- ***“Investing”*** – Involves purchases of assets and Investments (Use of Capital).

CAPITAL EXPENDITURE

- Capital Expenditure is an expenditure carrying future probable benefits.
- Hence, Capital Expenditures generally include purchases of Fixed Assets.
- These transactions have Long term benefits and are Non-Recurring.
- Capital Expenditure relates to Investment Activities.

REVENUE EXPENDITURE

- Revenue expenditure does not have any future benefit expected.
- These are the costs related to the regular business activities (Operations).
- These expenditures are recurring in nature.
- It includes the cost of production, administration, selling, and distribution, etc.

REVENUE RECEIPTS

- These are the incomes relating to regular business activities (Operations).
- It also includes incomes from investment activities or other incomes.
- These expenditures are recurring in nature.
- It includes the Sale of Goods and Services, Interest, Dividend, etc.

DEFERRED REVENUE EXPENDITURE

- Deferred Revenue Expenditure is carried forward to the next year.
- These expenses have medium-term benefits.

- These expenses have characteristics of both capital and revenue exp.
- D.R.Es include Share issue expenses, Preliminary expenses, etc.

KEY POINTS

- Financing activities lead to Capital Receipts.
- Investing activities result in Capital Expenditures.
- Income statements are a summary of all Revenue Receipts and Revenue Expenditures.
- The balance sheet is a summary of all Capital Receipts and Capital expenditures.

Accounting Standards

ACCOUNTING PROCESS

SUBSIDIARY BOOKS OF ACCOUNTS

- Subsidiary books are books of ***"Original Entry"***
- These are like ledgers treated as sub–journals for recording similar transactions.
- As the majority of transactions related to sales, purchases, or cash.
- So instead of journalising, such transactions are recorded in subsidiary books.
- This system of Accounting is called the ***"Practical"*** or ***"English"*** system of Accounting.

EXAMPLES OF SUBSIDIARY BOOKS

- Purchase Books.
- Sales Book.
- Purchase Return Book.
- Sales Return Book.
- Cash Book.

1. PURCHASE BOOK

- Purchase Book or Purchase day book is used to record Credit Purchases of inventory.
- It neither records Cash purchases nor Purchases of Assets.
- The entries are recorded with the net amount of the invoice.. (Hence, NO trade discount).
- Every month the total of the purchase book is debited in the Purchases A/c.

PURCHASE BOOK - FORMAT

Date	Invoice No.	Name of Supplier	L.F.	Calculations/ Details	Amount (Rs.)

PURCHASE RETURN BOOK

- Purchase Return Book is used to record Returns of Credit Purchases of inventory.
- Generally, Goods are returned when the goods are defective or of low quality.
- A Debit Note is prepared for the return of goods. It contains the details of goods returned.
- The total of the purchase return book is credited in the Purchases Return A/c.

PURCHASE RETURN BOOK - FORMAT

Date	Debit Note	Name of Supplier	L.F.	Calculations/ Details	Amount (Rs.)

SALES BOOK

- Sales Book or Sales day book is used to record all Credit Sales of inventory.
- It neither records Cash Sales nor the Sale of Assets.
- The entries are recorded with the net amount of the invoice.. (Hence, NO trade discount).
- Every month the total of the Sales book is credited in the Sales A/c.

SALES BOOK - FORMAT

Date	Invoice No.	Name of Customer	L.F.	Calculations/ Details	Amount (Rs.)

SALES RETURN BOOK

- Sales Return Book is used to record Returns of Credit Sales of inventory.
- Generally, Goods are returned when the goods are defective or of low quality.
- A Credit note is prepared for the return of goods. It contains the details of goods returned.
- The total of the Sales return book is debited in the Sales Return A/c.

SALES RETURN BOOK - FORMAT

Date	**Credit Note**	**Name of Customer**	**L.F.**	**Calculations/ Details**	**Amount (Rs.)**

CASH BOOK

- Cash Book is a subsidiary book that records all cash transactions.
- Since the number of cash transactions is very large companies maintain Cash books.
- A cash book works as both a journal and a ledger.
- Cash Receipts are recorded on the Debit side while Cash payments are on the Credit side.

KINDS OF CASH BOOK

1. **Simple Cash Book (Single Column)** – Only Cash Entries.
2. **Two Column Cash Books** – Cash and Discount Entries.
3. **Three Column Cash Books** – Cash, Discount, and Bank Entries.

THREE COLUMN CASH BOOK - FORMAT

Date	Particulars	L. F.	Disc.	Cash	Bank	Date	Particulars	L. F.	Disc.	Cash	Bank

Accounting standards issued by ICAI
&
Inventory Valuation

INTRODUCTION

- Accounting standards are written policy documents issued by an expert Accounting body or the Government.
- In India, AS are issued by Accounting Standards Board (ASB).
- ASB is a committee under ICAI that consists of people from Governments, ICAI, and other professional bodies.
- AS helps us to set a model yardstick or benchmark of Accounting policies.
- It takes into consideration the Generally Accepted Accounting Practices (GAAP) and other legal aspects of that region to create a framework for all accounting activities.
- It helps to standardise the accounting scenario.

TYPES OF STANDARDS

1. **Disclosure** – Basic standards which talk about reporting.
2. **Presentation** – The format of the Financial Statements.
3. **Measurement** – Methods and Calculations.

SIGNIFICANCE OF A.S.

- Reliability of the Financial Statements.
- Uniformity of Financial Statements.
- Prevents Frauds and Accounting manipulations.
- Comparability of 2 entities or 2 periods.
- Helps the auditors.
- Helps in Decision making.

LIMITATIONS OF A.S.

- Rigidity.
- Uniformity is not fully achieved.
- They cannot override the legal statutes.

AS 1: DISCLOSURE OF ACCOUNTING POLICIES

- An entity's financial statements show its financial position or performance.
- This position or performance can be affected due to the accounting policies.
- Accounting policies can vary from entity to entity.
- So AS-1 emphasises on "Disclosure" of such accounting policies.
- Many organisations list the accounting policies followed by them in the notes to their Financial Statements.
- However, this practice is not followed by each and every organisation.
- Thus, the main motive of this AS is to develop and establish the practice of the disclosure.

AREAS OF DIFFERING ACCOUNTING POLICIES

1. Methods of Depreciation.
2. Valuation of Inventories.
3. Treatment of Goodwill.
4. Valuation of Investment.
5. Valuation of Fixed Assets.
6. Treatment of Contingent liabilities.

ACCOUNTING ASSUMPTIONS

- Going Concern.
- Accrual.
- Consistency.

EXCEPTIONS TO CONSISTENCY

- Change in Law.
- Compliance of an AS.
- Better presentation of Financial Statements.

CONSIDERATIONS FOR SELECTION OF ACCOUNTING POLICIES

1. Prudence or Conservatism.
2. Substance over Form.
3. Materiality.

AS 2: VALUATION OF INVENTORIES

- This AS prescribes the accounting treatment of inventories.
- It also sets guidelines to determine the value at which the inventories are carried in the F/S.
- It explains the different methods of accounting for the closing stock.

DEFINITIONS

Inventory – The definition of ***"Inventory"*** includes –

1. Held for sale in the normal course of business (Finished goods).
2. Goods that are in the production process (Work-in-progress).
3. Raw materials are used for the production process. (Consumable stores).

Net Realisable Value (NRV)

It is the estimated selling price in the ordinary course of business less the estimated costs required to make the sales.

COST OF INVENTORIES

1. **Purchasing Cost** – Purchases, carriage inwards, other costs attributable to purchases.
2. **Conversion Cost** – Labour, Manufacturing, Administrative costs, etc.
3. **Other Cost** – Costs incurred to bring the inventory to its present condition or place.

VALUATION OF INVENTORIES

Cost of Inventories is the Lower of the following 2 –

1. Cost of Inventories.
2. Net Realisable Value (NRV).

Methods of Inventory Valuation

1. Specific Identification Methods.
2. First-In-First-Out (FIFO).
3. Weighted Average Cost (WAC).
4. Standard Cost or Retail Cost.

AS 9 – REVENUE RECOGNITION

- **REVENUE** - "It is the gross inflow of cash, receivables or other considerations arising in the course of the ordinary activities of an enterprise from the sale of goods, rendering of services and from various other sources like interests, royalties, and dividends." - (ICAI).
- "Recognition" basically means, taking into consideration.
- Revenue recognition emphasises the timing of the recognition of revenue.
- The amount of revenue arising from a transaction is determined by an agreement between the parties involved in the transaction.
- Revenue has to be measured by the amount charged to clients.

AS 9 FOR SALE OF GOODS

- Normally sale is considered to be done when the property in the goods is transferred by the seller to the buyer.
- However, the revenue needs to be recognized only when the significant risks and rewards (ownership) are transferred.
- Sometimes, the points of transfer of goods and the transfer of ownership can be different.
- For e.g. – Sale on Approval.

AS 9 FOR RENDERING OF SERVICES

It can be done in the following 2 ways –

1. **Proportionate Completion Method -**
   There are multiple parts of activities and after each part, the revenue is recognized.
2. **Complete Service Contract Method -**
   This is where the revenue is recognized at the end of the full contract.

Final Accounts
of a
Manufacturing Concern

INTRODUCTION

- The period matching concept leads to the preparation of Final Accounts.
- Final Accounts include Income Statements and Balance Sheet.
- Income statements are Manufacturing A/c, Trading A/c, and Profit & Loss A/c.
- Final Accounts help us to evaluate the Financial Performance and Financial Position.

MANUFACTURING ACCOUNT

- This account is to be prepared by a "Manufacturing Concern"
- All items relating to production and factory costs are recorded in the Manufacturing A/c.
- It is just like any other income statement (Ledger Account).
- It is an account prepared before the Trading A/c.

PROFORMA MANUFACTURING ACCOUNT

PARTICULARS	Rs.	PARTICULARS	Rs.
To Opening Stock (Raw Materials)	xxx	By Sale of Scrap	xxx
To Opening Stock (WIP)	xxx	By Closing Stock (Raw Materials)	xxx
To Purchases of Raw Material	xxx	By Closing Stock (WIP)	xxx
To Carriage Inward	xxx		
To any Purchase related expenses	xxx		
To Direct Wages	xxx	By Trading A/C (Cost of Production) [Balancing Figure]	xxx
To Factory Expenses -			
Salary to supervisors	xxx		
Power, Fuel, and Heat	xxx		
Wages	xxx		
Rent of Factory expenses	xxx		
Depreciation on factory assets	xxx		
TOTAL	**XXX**	**TOTAL**	**XXX**

TRADING ACCOUNT

- This account is for transactions relating to the finished goods.
- Thus for a manufacturing concern, the scope of trading accounts is very limited.
- It is just like any other income statement (Ledger Account).
- It is an account prepared after the Manufacturing A/c and before the P&L Account.

PROFORMA TRADING ACCOUNT

PARTICULARS	Rs.	PARTICULARS	Rs.
To Opening Stock (Finished Goods) To Manufacturing A/C (C.O.P.) To Purchase of Finished Goods To Carriage Inward on Finished Goods To Gross Profit c/d [Balancing Figure]	xxx xxx xxx xxx xxx	By Sales By Goods lost or destroyed By Goods taken by the proprietor By Goods given as free samples By Gross Loss c/d [Balancing Figure]	xxx xxx xxx xxx xxx
TOTAL	**XXX**	**TOTAL**	**XXX**

PROFIT AND LOSS ACCOUNT

- P&L Account shows the balances of all remaining Nominal Accounts (Income and Exp.).
- These include admin exp, selling exp, Finance exp, and Income other than Sales.
- It is just like any other income statement (Ledger Account).
- It is an account prepared after the Trading A/c and before the Balance Sheet.

PROFORMA PROFIT & LOSS ACCOUNT

PARTICULARS	**Rs.**	**PARTICULARS**	**Rs.**
To Gross Profit b/d [Trading A/c]	xxx	By Gross Profit b/d [Trading A/c]	xxx
To Office Rent	xxx	By Commission received	xxx
To Salaries	xxx	By Discount received	xxx
To Postage, Telephone, Printing	xxx	By Interests on Loans given	xxx
To General Expenses	xxx	By Interest on Investments	xxx
To Salesman's Expenses	xxx	By Dividends on Investments	xxx
To Carriage Outward, discount allowed	xxx	By Profit on Sale of Fixed Assets	xxx
To Advertising	xxx	By Net Loss (transfer to Capital A/c)	xxx
To Interest and Bank Charges	xxx		
To Bad Debts and Provisions	xxx		
To Depreciation (Non-Factory Assets)	xxx		
To Net Profit (transfer to Capital A/c)	xxx		
TOTAL	**XXX**	**TOTAL**	**XXX**

BALANCE SHEET

- The balance Sheet shows the balances of all Assets and Liabilities (Personal and Real).
- The balance sheet shows the financial position at a particular date.
- It is a "***Statement***" and not an ***"Account"***
- It is the last statement to be prepared in the Final Accounts.

PROFORMA BALANCE SHEET

LIABILITIES		**Rs.**	**ASSETS**	**Rs.**
Capital A/c [Opening Balance]	xx		Goodwill	xxx
+/(-) Fresh Cap./ (Drawings)	xx		Patents	xxx
+/(-) Net Profit/ (Net Loss)	xx	xxx	Land and Building	xxx
General Reserve		xxx	Plant and Machinery	xxx
Capital Reserve		xxx	Furniture and Fittings	xxx
Loans Taken		xxx	Investments	xxx
Bank Overdraft		xxx	Closing Stock	xxx
Sundry Creditors		xxx	Debtors/ Bills Receivable	xxx
Bills Payable		xxx	Loans given (Advances)	xxx
Outstanding Expenses		xxx	Prepaid expenses	xxx
Income received in advance		xxx	Cash in hand/ Cash at Bank	xxx
			Fictitious assets (Prelim. Exp., etc.)	xxx
TOTAL		**XXX**	**TOTAL**	**XXX**

KEY POINTS TO REMEMBER

- Manufacturing A/c includes all the production-related expenses.
- Expenses like depreciation and rent need to be classified for Factory and Office Assets.
- Manufacturing A/c will always have balance as Cost of Production and not profit or loss.
- Most of the expenses in the trading A/c of the trader are shifted to the Manufacturing A/c.

ADJUSTMENTS

1. CLOSING STOCKS

The effects of this adjustment are as follows –

- Record as closing stock in the Asset side (Debit effect).
- Record on the Manufacturing A/c Credit side (Raw material and WIP).
- Record on the Trading A/c Credit side (Finished Goods).

2. OUTSTANDING EXPENSES

The effects of this adjustment are as follows –

- Record as Outstanding expense in the Liability side (Credit effect).
- Add to that particular expense (Debit Effect).

3. PREPAID EXPENSES

The effects of this adjustment are as follows –

- Record as Prepaid expense in the Asset side (Debit effect).
- Subtract from that particular expense (Credit Effect).

4. ADVANCE INCOME

The effects of this adjustment are as follows –

- Record as Advance Income in the Liability side (Credit effect).
- Subtract from that particular Income (Debit Effect).

5. INCOME RECEIVABLE (ACCRUED)

The effects of this adjustment are as follows –

- Record as Accrued Income in the Asset side (Debit effect).
- Add to that particular Income (Credit Effect).

6. DEPRECIATION

The effects of this adjustment are as follows –

- Subtract from the Fixed Asset in the Asset side (Credit effect).
- Record on the P&L A/c Debit side (Debit Effect).

7. BAD DEBTS

The effects of this adjustment are as follows –

- Subtract from Debtors in the Asset side (Credit effect).
- Record on the P&L A/c Debit side (Debit Effect).

8. RESERVE FOR DOUBTFUL DEBTS (NEW RDD)

The effects of this adjustment are as follows –

- Subtract from Debtors in the Asset side (Credit effect).

- Record on the P&L A/c Debit side (Debit Effect).

Note – To be calculated after subtracting actual bad debts.

9. <u>PROVISION FOR DISCOUNT ON DEBTORS</u>

The effects of this adjustment are as follows –

- Subtract from Debtors in the Asset side (Credit effect).
- Record on the P&L A/c Debit side (Debit Effect).

Note – To be calculated after subtracting New R.D.D

10. <u>GOODS LOST BY FIRE/ THEFT / ACCIDENT</u>

The effects of this adjustment are as follows –

- Record on the Credit side of the Manufacturing A/c or Trading A/c (Credit effect).
- Record on the P&L A/c Debit side as ***"Loss on Goods Lost"*** (Debit Effect).

11. <u>GOODS DISTRIBUTED AS FREE SAMPLES</u>

The effects of this adjustment are as follows –

- Record on the Credit side of the Manufacturing A/c or Trading A/c (Credit effect).
- Record on the P&L A/c Debit side as ***"Advertising Expense"*** (Debit Effect).

12. <u>GOODS WITHDRAWN BY THE OWNER</u>

The effects of this adjustment are as follows –

- Record on the Credit side of the Manufacturing A/c or Trading A/c (Credit effect).
- Subtract from the Capital from the Liability side (Debit Effect).

Hire Purchase Accounts

INTRODUCTION

- Hire Purchase is an arrangement for buying expensive goods.
- The buyer makes an initial ***"Down Payment"***
- The balance (with interest) is paid in ***"Instalments"***
- This system is very similar to the ***"Instalment plan system"***
- The ***"POSSESSION"*** of the Asset (Good) is immediately transferred immediately at the time of purchase.
- The ***"OWNERSHIP"*** however is not transferred until the last installment is paid by the Hirer.
- Parties Involved in a Hire Purchase Transaction -
  Hire Purchaser – Hirer or Buyer.
  Hire Vendor – Seller.

ADVANTAGES OF HIRE PURCHASE

- Entities with very little working capital can go for this system.
- Startups with no reputation/background may use this.
- Short-run losses could be sustained.
- No need to incur a lot of debt.

DISADVANTAGES OF HIRE PURCHASE

- Eventually, in the long run, it would prove to be very expensive.
- Might tempt entities to buy beyond their reach and requirement.
- Interest costs are very high.
- If goods are returned, the amount paid towards purchase till that point is lost.

KEY TERMS

1. **Cash price** - Original price of the asset if bought in cash. (Principal amount).
2. **Hire Purchase price** - Total price to be paid under the hire purchase agreement (Actual amount paid).
3. **Interest** – Additional amount paid under the higher purchase agreement i.e. (Hire Purchase price – Cash price).
4. **Down Payment** – Initial payment made by the hirer at the time of purchase.
5. **Installment** – Periodic payments made to repay the remaining amount.

ACCOUNTING TREATMENT (HIRER)

Let us first understand the flow of transactions –

- The Hire purchaser enters into the HP agreement and pays a Down Payment.
- The Asset is credited to the Hire Vendor's (Seller's) A/c at the Cash price.
- Payment of Instalments which include (Principal + Interest) payment is made.
- At the end of the year, Depreciation is charged to the asset.
- The remaining Accounts are closed.

ACCOUNTS TO BE PREPARED

1. Asset Account.
2. Hire Vendor's Account (Seller's Account).
3. Interest Account.
4. Depreciation Account.

Working Note – Calculation of interest *MOST IMPORTANT*