ACCOUNTANCY SUPPORT MATERIAL-CLASS XI

CHAPTER 1

INTRODUCTION TO ACCOUNTING

LEARNING OBJECTIVES

After studying this chapter, student will be able to

- Describe the meaning, significance, objectives, advantages and limitations of accounting
- Identify the individuals and entities that use accounting information.
- Explain the various terms used in accounting and differentiate between different related terms.

According to American institute of certified public accountants, "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."

Accounting principles board (APB) defined accounting as follows, "accounting is a service activity. Its function is to provide quantitative information primarily financial in nature , about economic entities that is intended to be useful in making economic decisions in making reasoned choices among alternative courses of action."

In simple words, accounting is the process of identifying, recording, classifying, summarizing, interpreting and communicating financial information to the users for judgement and decision marking.

Objectives of accounting

1. to keep systematic and complete record of business transaction in the books of accounts according to specified principles and rules to avoid the possibility of omissions and fraud.
2. To ascertain the profit earned or loss incurred during a particular accounting period which further help in knowing the financial performance of a business.
3. To ascertain the financial position of the business by means of financial statement i.e. balance sheet which shows assets on one side and capital & liabilities on the other side.
4. To provide useful accounting information to users like owners, investors, creditors, banks, employees and government authorities etc who analyse them as per their requirements.

6. To provide financial information to the management which help in decision making, budgeting and forecasting.

Advantages of accounting

1. It provides information which is useful to management for making economics decisions.
2. It help owners to compare one year's results with those of other years to know the factors which leads to changes.
3. It provide information about the financial position of the business by means of balance sheet which shows assets on one side and capital & liabilities on the other side.
4. It help in keeping systematic and complete record of business transactions in the books of accounts according to specified principles and rules, which is accepted by the courts as evidence.
5. It help a firm in the assessment of its correct tax liabilities such as income tax, sales tax, vat, excise duty etc.
6. Properly maintained accounts help a business entity in determining its proper purchase price.

Limitations of accounting

1. It is historical in nature, it does not reflect the current worth of a business. Moreover, the figures given in financial statements ignore the effects of changes in price level.
2. It contain only those information's which can be expressed in terms of money. It ignore qualitative elements such as efficiency of management, quality of staff, customers satisfaction etc.
3. It may be affected by window dressing i.e. manipulation in accounts to present a more favourable position of a business firm than its actual position.
4. It is not free from personal bias and personal judgment of the people dealing with it for example different people have different opinions regarding life of asset for calculating depreciation, provision for doubtful debts etc.
5. It is based on various concepts and conventions which may hamper the disclosure of realistic financial position of a business firm. For example assets in balance sheet are shown at their cost and not at their market value which could be realized on

Their sale.

Book keeping- the basis of accounting

Book keeping is the record-making phase of accounting which is concerned with the recording of financial transaction and events relating to business in a significant and orderly manner.

Book keeping should not be confused with accounting. Book keeping is the recording phase while accounting is concerned with the summarizing phase of an accounting system. The distinction between the two are as under.

Book keeping	Accounting
t is the recording phase of an accounting system.	1) it is the summarizing phase of an accounting system.
t is a primary stage and basis for accounting.	is a secondary stage which begins where the book keeping process ends.
t is routine in nature and does not require any special skill or knowledge	is analytical in nature and required special skill or knowledge.
t is done by junior staff called book-keepers.	is done by senior staff called accountants.
t does not give the complete picture of the financial conditions of the business unit.	gives the complete picture of the financial conditions of the business unit.

Types of accounting information

Accounting information can be categorized into following:

1. Information relating to profit or loss i.e. income statement. It shows the net result of business operations of a firm during a particular accounting period.
2. Information relating to financial position i.e. balance sheet. It shows assets on one side and capital & liabilities on the other side.
3. Schedules and notes forming part of balance sheet and income statement to give details of various items shown in both of them.

Subfields/Branches of accounting

1. **Financial accounting:-**

   It is that subfield/branch of accounting which is concerned with recording of business transactions of financial nature in a systematic manner, to ascertain the profit or loss of the accounting period and to present the financial position of the business.

2. **Costaccounting:-**

   It is that subfield/branch of accounting which is concerned with ascertainment of total cost and per unit cost of goods or services produced/provided by a business firm.

3. **Management accounting:-**

   It is that subfield/branch of accounting which is concerned with presenting the accounting information in such a manner that help the management in planning and controlling the operations of a business and in better decision making.

Interested user/parties of accounting information and their needs

There are number of users interested in knowing about the financial soundness and the profitability of the business.

Users	**Classification**	**Information the user want**
Internal	1. Owner	Return of their investment, financial health of their company/business.
	2. Management	To evaluate the performance to take various decisions.
External	1. Investors and potential investors	Safety and growth of their investments, future of the business.
	2. Creditors	Assessing the financial capability, ability of the business to pay its debts.
	3. Lenders	Repaying capacity, credit worthiness.

4.	TaxAuthorities	Assessment of due taxes, true and fair disclosure of accounting information,
5.	Employees	Profitability to claim higher wages and bonus, whether their dues (PF,ESI,etc.) deposited regularly.
6.	Others	Customers, researchers etc., may seek different information for different reasons.

Qualitative characteristics of accounting information

Accounting information is useful for interested users only if it posses the following characteristics:

1. **Reliability** : Means the information must be based on facts and be verified through source document by anyone. It must be free from bias and errors.
2. **Relevance** : To be relevant, information must be available in time and must influence the decisions of users by helping them to form prediction about the outcomes.
3. **Understandability** : The information should be presented in such a manner that users can understand it well.
4. **Comparability**: The information should be disclosed in such a manner that it can be compared with previous years figures of business itself and other firm’s data.

Basic accounting terms Business transaction

An economic activity that affect financial position of the business and can be measured in terms of money e.g., purchase of goods for use in business.

Account

Account refers to a summarized record of relevant transaction of particular head at one place. All accounts are divided into two sides. The left side of an account is called debit side and the right side of an account is called credit side.

Capital

Amount invested by the owner in the firm is known as capital. It may be brought in the form of cash or assets by the owner.

Drawings

The money or goods or both withdrawn by owner from business for personal use, is known as drawings. Example: purchase of car for personal use by withdrawing money from business.

Assets

Assets are valuable and economic resources of an enterprise useful in its operations. Assets can be broadly classified as:

1. **Current assets:** Current assets are those assets which are held for short period and can be converted into cash within one year. For example: debtors, stock etc.
2. **Non-current assets:** Non-current assets are those assets which are hold for long period and used for normal business operation. For example: land, building, machinery etc. They are further classified into:

   a) **Tangible assets:** Tangible assets are those assets which have physical existence and can be seen and touched. For example: furniture, machinery etc.

   b) **Intangible assets:** Intangible assets are those assets which have no physical existence and can be felt by operation. For example: goodwill, patent, Trade mark etc.

Liabilities:

Liabilities are obligations or debts that an enterprise has to pay after some time in the future.

Liabilities can be classified as:

1. **Current liabilities:** Current liabilities are obligation or debts that are payable within a period of one year. For example: creditors, bill payable etc.
2. **Non-current liabilities:** Non-current liabilities are those obligation or debts that are payable after a period of one year. Example: bank loan, debentures etc.

Receipts

1. **Revenue receipts:** Revenue receipts are those receipts which are occurred by normal operation of business like money received by sale of business products.
2. **Capital receipts:** Capital receipts are those receipts which are occurred by other than business operation like money received by sale of fixed assets.

Expenses

Costs incurred by a business for earning revenue are known as expenses. For example: rent, wages, salaries, interest etc.

Expenditure

Spending money or incurring a liability for acquiring assets, goods or services is called expenditure. The expenditure is classified as:

1. **Revenue expenditure:** If the benefit of expenditure is received within a year, it is called revenue expenditure. For example: rent interest etc.
2. **Capital expenditure:** If benefit of expenditure is received for more than one year, it is called capital expenditure. Example purchase of machinery.
3. **Deferred revenue expenditure:** There are certain expenditures which are revenue in nature but benefit of which is derived over number of years. For example: huge advertisement expenditure.

Profit

The excess of revenues over its related expenses during an accounting year is profit.

Profit=Revenue-Expenses

Gain

A non- recurring profit from event or transaction incidental to business such as sale of fixed assets, appreciation in the value of an assets etc.

Loss

The excess of expenses of a period over its related revenue is termed as loss.

Loss= expenses -revenue

Goods

The products in which the business deal in. The items that are purchased for the purpose of resale and not for use in the business are called goods.

Purchase

The terms purchase is used only for the goods procured by a business for resale. In case of trading concerns it is purchase of final goods and in manufacturing concern it is purchase of raw materials. Purchases may be cash purchases or credit purchases.

Purchase return

When purchased goods are returned to the suppliers, these are known as purchase return.

Sales

Sales are total revenues from goods sold or serviced provided to customers. Sales may be cash sales or credit sales.

Sales return

When sold goods are returned from customer due to any reasons is known as sales return.

Debtors

Debtors are persons and/or other entities to whom business has sold goods and services on credit and amount has not received yet. These are assets of the business.

Creditors

If the business buys goods/services on credit and amount is still to be paid to the persons and /or other entities, these are called creditors. These are liabilities for the business.

Bill receivable

Bill receivable is an accounting term of bill of exchange. A bill of exchange is bill receivablefor seller at time of credit sale.

Bill payable

Bill payable is also an accounting term of bill of exchange. A bill of exchange is bill payable for purchaserattime of credit purchase.

Discount

Discount is the rebate given by the seller to the buyer. It can be classified as:

1. **Trade discount:** The purpose of this discount is to persuade the buyer to buy more goods. It is offered at an agreed percentage of list price at the time of selling goods. This discount is not recorded in the accounting books as it is deducted in the invoice/cash memo..
2. **Cash discount:** The objective of providing cash discount is to encourage the debtors to pay the dues promptly. This discount is recorded in the accounting books.

Account

Account refers to a summarised record of relevant transaction of particular head at one place.

Income

Income is a wider term, which includes profit also. Income means increase in the wealth of the enterprise over a period of time.

Stock

The goods available with the business for sale on a particular date is known as stock.

Cost

Cost refers to expenditures incurred in acquiring manufacturing and processing goods to make it saleable.

Voucher

The documentary evidence in support of a transaction is known as voucher. For example, if we buy goods for cash we get cash memo, if we buy goods on credit, we get an invoice, when we make a payment we get a receipt.

CHAPTER 2
THEORY BASE OF ACCOUNTING

LEARNING OBJECTIVES

After studying this chapter, student will be able to:

- Describe the meaning of Accounting Assumptions and Accounting Principles.
- Explain the Accounting Standards and IFRS along with their objectives.
- Descri be the Bases of Accou nti ng.
- Distinguish between Cash Basis of Accounting and Accrual Basis of Accounting

Main objective of accounting is to provide appropriate, useful and reliable information about the financial performance of the business to its various users to enable then in judicious dicision- making. This objective can be achieved only when accounting records are maintained on the basis of uniform rules and principles.

Accounting principles, concepts and convention are known as generally accepted accounting principles (GAAP). These principles are the base of accounting. Generally accepted accounting principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity and consistency in the preparation and the presentation of financial statements.

These principles have evolved over a long period of time on the basis of experiences of the accountants, customs, legal decisions etc., and which are generally accepted by the accounting professionals.

Fundamental accounting assumptions

1. **Going concern assumption:** This concept assumes that an enterprise has an indefinite life or existence. It is assumed that the business has neither intention to liquidate nor to scale down its operations significantly.

   Relevance:

   a) Distinction is made between capital expenditure and revenue expenditure.

b) Classification of assets and liabilities into current and non-current.

c) Depreciation is charged on fixed assets, and fixed assets appear in the balance sheet at book value, without having reference to their market value.

2. **Consistency assumption:** According to this assumption, accounting practices once selected and adopted, should be applied consistently year after year. This will ensure a meaningful study of the performance of the business fora number of years.

Consistency assumption does not means that particular practice, once adopted, cannot be changed. The only requirement is that when a change is desirable, it should be fully disclosed in the financial statements along with its effect on income statement and balance sheet.

Any accounting practice may be changer if the law or accounting standard requires so, to make the financial information more meaningful and transparent.

Relevance : It helps the management in decisionmaking by utilizing the comparable financial information.

3. **Accrual assumption:** Accrual concept applies equally to revenue and expenses. As per this assumption, all revenue and cost are recognized when they are earned or incurred.

It is immaterial, whether the cash is receive or paid at the time of transaction or later date e.g., if a credit sale (credit for two months) for? 15,000 is made on 15th feb .2016, then the revenue earned is to be recorded on 15th feb. 2016 not on the date of cash realized, i.e., after two months. In case of expenses, if at the end of the year the two months salary is due but not paid, the the expenses of salary will be recorded in the current yerar in which salary is due, not in the next year in which it will be paid.

Relevance: Earning of a revenue and consumption of a resource (expenses) can be accurately matched to a particular accounting period.

ACCOUNTING PRINCIPLES

1. **Accounting Entity:** An entity has a separate existence from its owner. According to this principle, business is treated as an entity, which is separate and distinct from its owner. Therefore transaction are recorded; analyzed and financial statements are prepared from the business point of view and not of the owner.

   The owner is treated as a creditor (internal liability) for his investment in the business, as if the firm has borrowed from its owner instead of the outside parties. Interest on capital is treated as expense like any other business expense. His private expenses are treated as drawings leading to reduction in capital.

2. **Money measurement principle:** According to this principle, only those transactions that are measured in money or can be expressed in term of money are recorded in the books of accounts of the enterprise. Non-monetary events like death of any employee/manager, strikes, disputes etc., are not recorded at all, even though these also affect the business operations significantly.

Limitations:

1. It ignores qualitative aspect e.g., efficient human resources (assets), satisfied customers (assets) and dishonest employee (liabilities).

2. Value of money (currency) is not stable.

To make accounting records simple, relevant, understandable and homogeneous, fact are expressed in a common unit of measurement-money, which is not stable.

3. **Accounting Period Principle:** According to this principle, the whole indefinite life of an enterprise is divided into parts , know as accounting period.

Accounting period is defined as interval of time, at the end of which the profit and loss account and balance sheet are prepared, so that the performance is measured at regular intervals and decision can be taken at the appropriate time. Accounting period is usually a period of one year.

Relevance:

1. This assumption requires showing the allocation of expenses between capital and revenue.
2. Portion of capital expenditure that is consumed during

the current year is charged to income statement and rest of the portion i.e., unconsumed portion is shown as an asset in the balance sheet.

3. As per income tax law, tax on income is calculated on annual basis from 1 stApril to 31st March (financial year).
4. Timely action for corrective measures can be taken by management.

4. **Full disclosure principle:** According to this principle, apart from legal requirements all significant and material information relating to the Economic affairs of the entity should be completely disclosed in its financial statements and accompanying notes to accounts.

   The financial statements should act as means of conveying and not concealing the information. Disclosure of information will result in better understanding and the parties may be able to take sound decisions on the basis of the information provided.

   e.g., footnotes such as:

   1. Contingent liabilities in respect to a claim of very big amount against the business are pending in a Court of Law.
   2. Change in the method of providing depreciation.
   3. Market value of investment.

5. **Materiality principle:** Disclosure of all material facts is compulsory but it does not imply that even those figures which are irrelevant are to be included in financial statements. According to this principle, only those items or information should be disclosed that have material effect and relevant to the users. So, items having an insignificant effect or being irrelevant to user need not be disclosed separately, these may be merged with other items.

   If the knowledge of any information may affect the user's decision, it is termed as material information.

   It should be noted that an item material for one enterprise may not be material for another enterprise, e.g., an item of expenses RS. 50,000 is immaterial for an enterprise having turnover of Rs. 100 crore.

6. **Prudence principle:** According to this principle, profit in

anticipation should not be recorded but loss in anticipation should immediately be recorded. The objective of this principle is not to overstate the profit of the enterprise in any case. When different equally acceptable alternative methods are available, the method which having least favourable immediate effect on profit should be adopted, e.g.,

1. Valuation of stock at cost or realizable values, whichever is lower.
2. Provision for doubtful debts and provision for discount on debtors is made.

7. **Cost principle:** According to this principle, an asset is recorded in the books of accounts at its original cost comprising cost of acquisition and all expenditure incurred for making the assets ready to use.

   This cost becomes the basis of all subsequent accounting transactions for the asset, since the acquisition cost relates to the past, it is referred to as historical cost. Example: machinery purchased for Rs. 1,50,000 in cash and Rs. 20,000 was spent on installation of machine then Rs. 1,70,000 be recorded as cost of machine in the books and depreciation will be charged on this cost. If market value of machine due to inflation has gone upto Rs. 2,00,000 then the increased value will not be recorded. This cost is systematically reduced from year after year by charging depreciation and the assets are shown in the balance sheet at book value (cost-depreciation).

8. **Matching principle:** According to this principle, all expenses incurred by any enterprise during an accounting period are matched with the revenue recognized during the same period.

   The matching principle facilitates to ascertain the amount of profit or loss incurred in a particular period by deducting the related expenses from the revenue recognized during that period.

   The following treatment of expenses and revenue are done due to matching principle:

   1) Ascertainment of prepaid expenses.
   2) Ascertainment of income received in advance.
   3) Accounting of closing stock.

4) Depreciation charged on fixed assets.

9. **Dual Aspect Principle:** According to this principle, every business transaction has two aspects-a debit and a credit of equal amount. In other words, for every debit there is a credit of equal amount in one or more accounts and vice-versa.

The system of recording transactions based on this principles is called as “Double Entry System”.

Due to this principle, the two sides of Balance Sheet are always equal and the following accounting equation will always hold good at any point of time.

Assets = liabilities + capital

Example: Ram started business with cash Rs. 1,00,000. It increases cash in assets side and capital in liabilities side by Rs. 1,00,000.

Assets (Rs. 1,00,000) = liabilities + capital (Rs. 1,00,000)

Base of accounting

There are two bases of ascertaining profit or loss, namely (1) cash basis, and (2) accrual basis.

1. **Cash Basis of Accounting:** Under this system of accounting transactions are recorded in the books of accounts only on the receipt/payment of cash. The income is calculated as the excess of actual cash receipts (in respect of sale of goods, service, properties etc.) over actual cash payments (regarding purchase of goods, rent, electricity, salaries etc.)

   Entry is not recorded when a payment or receipts is merely due

   i. e., outstanding expenses, accrued income are not treated.

   This method is contrary to the matching principle.

2. **Accrual Basis of Accounting** : Under this system of accounting, revenue and expenses are recorded when they are recognized i.e., income is recorded as income when it is accrued (when transaction takes place)

   Irrespective of fact whether cash is received or not. Similarly expenses are recorded when they are incurred or become due and not when the cash is paid for them.

   Under this system, expenses such as outstanding expenses, prepaid expenses, accrued income and received in advance are identified and taken into account.

Under the companies amendments Act 2013, all companies are required to maintain their accounts according to accrual basis of accounting.

Basis	**Accrual basis of accounting**	**Cash basis of accounting**
Recording of	Both cash and credit transactions are. recorded	Only cash transaction are recorded.
Profit or loss	Profit or loss in ascertained correctly due to complete recorded of transaction.	Correct profit/loss is not ascertained because it records only cash transactions
Distinction between capital and revenue	This method makes a distinction between capital and revenue items.	This method does not make distinction between capital and revenue nature items
Legal position	The basis is recognized underthe companies Act.	This basis is not recognized underthe companied Act.

Accounting standards: concept and objectives

The accounting principles or GAAP in the from of concepts and convention have been developed to bring comparability and uniformity in the financial statements. But GAAP also allow a large number of alternative treatments for the same item. Different organizations may adopt different accounting policies for the same transaction or an organization may follow different accounting policies for the same item over different accounting periods. As a result, the financial statements become inconsistence and incomparable.

So it was felt that certain minimum standards should be universally applicable, so that the accounting statements have the qualitative characteristics of realiability, relevance, understandability and comparability.

International Accounting Standard Committee (IASC) was set up in 1973. (now renamed as International Financial Reporting committee IFRC). The Institute of Chartered Accountants of India (ICAI) and the Institute of Cost and Works Accountants of India (ICWAI) are members of this committee. ICAI set up the Accounting Standard Board (ASB) in 1997 to identify the areas in which uniformity in accounting is required. ASB prepares and submits a draft accounting standard to the council of ICAI. The council of ICAI issues the draft for the comments to the govt., industry and professionals etc. After due consideration on comments received, the council of ICAI notifies it for its use in financial statements.

Concept of Accounting Standards

Accounting Standard are written statements, issued from time- to-time by institutions of accounting professionals, specifying uniform rules or practices for drawing the financial statements.

Objectives of Accounting Standards

1. Accounting standards are required to bring uniformity in accounting practices and policies by proposing standard treatment in preparation of financial statements.
2. To improve realiability of the financial statement: Accounts prepared by using accounting standards are reliable for various users, because these standards create a sense of confidence among the users.
3. To prevent frauds and manipulation by codifying the accounting methods and practices.
4. To help Auditors: Accounting Standards provide uniformity in accounting practices, so it helps auditors to audit the books of accounts.

IFRS (International Financial Reporting Standards)

This term refers to the financial standards issued by International Accounting Standards Board (IASB). It is the process of improving the financial reporting internationally to help participants in various capital markets of the world and other users.

IFRS based financial statements

Following financial statement are produced under IFRS:

1. Statement of financial position: The element of this statement are
   (a) Assets (b) liability (c) Equity

2. Comprehensive income statement: The elements of this statement are
   (a) Revenue (b) Expense

3. Statement of changes in equity
4. Statement of cash flow
5. Notes and significant accounting policies

Main difference between IFRS and IAS (Indian Accounting Standards)

1. IFRS are principle based while IAS are rule based.
2. IFRS are bases on fair value while IAS are based on historical cost

CHAPTER - 3
RECORDING OF TRANSACTIONS

ACCOUNTING EQUATION

An Accounting equation is based on the dual concept of accounting, according to which, every transaction has two aspects namely Debit and Credit. It means that every transaction in accounting effect both Debit (Dr.) and Credit (Cr.) side equally.

Total assets of the business firm are financed through the funds raised from either the outsiders (which consists generally Creditors and Lenders) orthe Owners(which is called Capital).

According to Business entity concept, Business is separate legal entity from its owner thus the amount invested by the owner in the business is liability of the business is called Capital. Accounting equation thus referred to a equation in which total assets is always equal to total Liabilities (i.e. Capital + Liabilities)

Assets = Capital + Liabilities

ANALYSIS OF BUSINESS TRANSACTIONS

Business transaction may effect either both sides of the equation or one side of the equation but the ultimate effect must be equal on the both sides. Some of the effects are as follows:-

1. Transaction affecting both sides of the equation:

A. Commenced business with Cash Rs. 3,00.000. Effect

Assets	
	Cash
Transaction	3,00,000

Capital + Liabilities
Capital_________

Explanation:-As Cash is invested by the owner, it should be shown in Capital (anything which is bring in by the owner is termed as Capital) & Business is receiving asset in the form of cash, it is to be shown in the Assets side as Cash

B. Bought goods from Ram 30,000

Effect

Assets		=	Capital + Liabilities
	Cash Stock		Capital Creditors
Old Equation	30000 +	=	30000 +
Transactions	0 + 30000	=	0 + 30000
N.E.	300000+ 30,000	=	300000+ 30000

Explanation:-As goods is purchased on credit, one effect is that it should be shown in the assets side as Goods & other effect is that goods are purchased on credit so it is to be shown in Liabilities as Creditors.

C. Sold goods (costing x10000) for cash at x13000

Effect

Assets			= Capital + Liabilities	
	Cash	Stock	Capital	Creditors
Old Equation	300000	+ 30,000	300000 +	
Transactions	13000	■ 10000	3000	+ 30000
N.E.	313000	+ 20,000	303000	+ 30000

Explanation:- The transaction will affect both sides as cash has been received so it is to be added back in cash (x13,000) & Goods are to be reduced by 10,000 as goods has been sold also profit of? 3,000 Is to be added back in Capital. Net effect will remain same for both sides

D. Paid to creditors Rs. 20,000

Effect

Assets			Capital + Liabilities
	Cash Stock		Capital Creditors
Old Equation	313000 + 20,000		303000 + 30000
Transactions	-20000 + 0		0 - 20000
N.E.	293000 + 20,000		303000 + 10000

Explanation:- The transaction will affect both sides as cash has been paid so it is to be deducted from cash as well from creditors as payment made to them.

- Transaction related to Expenses

  All the expense or Losses is to born by the owner although business has separate legal entity from its owner as He/She is the person who has taken risk to do business.

E. Rent paid Rs. 5,000.

Effect

Assets				Capital + Liabilities	
	Cash	Stock		Capital	Creditors
Old Equation	293000	+ 20,000		303000 +	10000
Transactions	-5000	+ 0		-5000 +	0
N.E.	288000	+ 20,000		298000 +	10000

Explanation:- The transaction will affect both sides as cash has been paid so it is to he reduced as well as Capital is to be reduced because expense is to be born by the owner.

- Transaction related to Income

  Income or Profit is the reward for taking risk, as risk is taken by the owner so it is to be added in Capital.

F. Commission received Rs. 8,000.

Effect

Assets			=	Capital +	Liabilities
	Cash	Stock		Capital	Creditors
Old Equation	288000	+ 20,000	=	303000 +	10000
Transactions	+8000	+ 0	=	-5000 +	0
N.E.	296000	+ 20,000	=	306000 +	10000

Explanation:- The transaction will affect both sides as cash has been received so it is to be added back in cash as well as in Capital.

- Transaction related to Accrued/outstanding Income

  Income is to be added back into the capital but as it is not received should be shown in the Assets Side as accrued Income because it meant to be received in this financial year.

A. Accrued Interest Rs. 10,000

Effect

	Assets	=	Capital + Liabilities
	Accrued Cash Goods Income	=	Capital Creditors
Old Equation	296000+ 20000 +-	=	306000 + 10,000
Transactions	00+ 10000	=	+10000 + 0
N.E.	296000 + 20000 + 10000	=	316000 + 10000

Explanation:- The transaction will effect both sides as Accrued Income has been added back to the capital & as it is not received so it is to be shown in the assets side as an asset.

- Transaction related Advance Income

  As Income received in advance so it does not belong to current financial year, so it can not be added back to the Capital. It is an amount which is received by the business firm for the future course of activity till the activity not happened it is the Liability of the business.

A. Rent received in advanced Rs. 5,000

Effect

	Assets			
	Cash	+	Goods	Accrued
				Income
Old Equation	296000	+	20000 +	10000
Transactions	+5000	+	0 +	0
N.E.	301000	+	20000 +	10000

Capital	+ Liabilities	
Capital	+ Creditors	Advance
		Rent
316000	+10000 +	
+0	+ 0 +	5000
316000	+10000 +	5000

Explanation:-The transaction will effect both sides as Advance Income is a Liability should be shown in the Liability side & Cash received by the business should be added back to the Cash column of assets side

2. Transaction affecting one side of the equation:

(I) Transaction affecting Assets side of the equation:

- Transaction related to Prepaid or Advance Expense

As Expense paid in advance so it does not belong to current financial year, so it can not be deducted from Capital. It as an amount which is paid by the business firm for the future course of activity till the activity not happened it is the Assets of the business.

	Assets				=	Capital + Liabilities		
	Cash	Stock	Accrued Income	Prepaid Expense		Capital	Creditors	Advance Rent
Old Equation	301000	+ 20000	+ 10,000	-	=	316000	+ 10000 +	5000
Transactions	-4000	+ 0	+ 0	+ 4000	=	+0	+ 0 +	0
N.E.	297000	+ 20000	+ 10000	+ 4000	=	316000	+ 10000 +	5000

Explanation:- The transaction will affect both sides as Prepaid expense is a Asset should be shown in the Assets side & Cash paid by the business should be deducted from Cash column of assets side.

B. Purchased Machinery for Cash?. 80,000

Effect

	Assets					=	Capital + Liabilities	
	Cash	Stock	Accrued Income	Prepaid Expense	Machinery		Capital Creditors	Advance Rent
Old Equation	297000 +	20000 +	10000 +	4000 +	-	=	316000 + 10000 +	5000
Transactions	-80000 +	0 +	0 +	0 +	80,000	=	+ 0 + 0	0
N.E.	217000 +	20000 +	10000 +	4000 +	80,000	=	316000 + 10000 +	5000

Explanation:- The transaction will affect one side as cash has been paid for purchased of machinery & Machine is a fixed asset so it is separately shown in the asset side as well as cash is to be reduced.

(II) Transaction affecting Liability side of the equation:

- Transaction related to outstanding Expense

As Expense not paid yet or Outstanding but belong to current financial year so it is deducted from Capital & business has to pay it in near future so it is the liability of the firm.

	Assets					=	Capital + Liabilities		
	Cash	Stock	Accrued Income	Prepaid Expense	Machinery		Capital Creditors	Advance Rent	Outstanding Expense
Old Equation	217000 +	20000 +	10000 +	4000 +	80,000	=	316000+10000 +	5000	
Transactions	0 +	0 +	0 +	0 +	0	=	-8000 + 0 +	0 +	8000
N.E.	217000 +	20000 +	10000 +	4000 +	80,000	=	308000+10000 +	5000 +	8000

Explanation:- The transaction will affect Liability side as outstanding expense is a Liability should be shown in the Liability side & Expense should be deducted from Capital

Transaction related to Interest on Capital
As interest on capital Is the Expense of business it should be shown or deducted in the capital as well as interest of capital is the amount which is to be given to the owner as capital is the amount which is invested by the owner, therefore it is to be added back to Capital.

A. Interest on Capital Rs. 10,000

Effect

	Assets					=	Capital + Liabilities			
	Cash	Stock	Accrued Income	Prepaid Expense	Machinery		Capital	Creditors	Advance Rent	Outstanding Exp.
Old Equation	217000 +	20000 +	10000 +	4000 +	80,000	=	308000+10000 +		5000	8000
Transactions	-0 +	0 +	0 +	0 +	0	=	-10000			-10000
						=	+10000 + 0 +		0 +	0
N.E.	217000 +	20000 +	10000 +	4000 +	80,000	=	308000+10000 +		5000	8000

Explanation:-The transaction will affect Liability side as Interest of Capital should be added back & deducted from Capital as both of them belong to the owner.

- Transaction related to interest on Drawing

As interest on Drawing is the Income of business it should be shown or added back in the capital as well as interest of Drawing is the amount which is to be given by the owner to the business so it is treated as drawing and deducted from the Capital.

A. Interest on Drawing Rs. 1,000 Effect

	Assets					=	Capital + Liabilities			
	Cash	Stock	Accrued Income	Prepaid Expense	Machinery		Capital	Creditors	Advance Rent	Outstanding Exp.
Old Equation	217000 +	20000 +	10000 +	4000 +	80,000	=	308000+10000 +		5000	8000
Transactions	0 +	0 +	0 +	0 +	0	=	-10000			
						=	+10000 + 0 +		0 +	
N.E.	217000 +	20000 +	10000 +	4000 +	80,000	=	308000+10000 +		5000	8000

Explanation:- The transaction will effect Liability side as Interest of Drawing should be added back & deducted from Capital as both of them belong to the owner.

Transaction related to Drawing
As Drawing is the amount withdrawn by owner from business for personal use so it is to be deducted from Capital & also from the Cash.

A. Owner withdrew cash of Rs. 10,000 for personal use

Effect

	Assets					=	Capital + Liabilities		
	Cash	Stock	Accrued Income	Prepaid Expense	Machinery		Capital Creditors	Advance Rent	Outstanding Exp.
Old Equation	217000 +	20000 +	10000 +	4000 +	80,000	=	308000+10000 +	5000	8000
Transactions	-10000 +	0 +	0 +	0 +	0	=	10000 + 0 +	0 +	0
N.E.	207000 +	20000 +	10000 +	4000 +	80,000	=	298000+10000 +	5000	8000

Explanation:- The transaction will effect both sides as Drawing should be deducted from Capital & also deducted from Cash as withdraw by owner.

RULES OF DEBIT & CREDIT

Every business transaction affects two or more accounts. An account is summarized record of transaction at one place relating to a particular head. An account is divided into two parts i.e. debit and credit. Debit refer to the left side of an account and Credit refers to the right side of an account.

Approaches for the rules of Debit & Credit

1. Traditional Approach

Under this approach, all ledger accounts are mainly classified into two categories:-

(I) Personal Accounts:-It includes all those accounts which are related to any person i.e. Individuals, firms, companies, Banks etc. This can further classified into three categories:-

1. **Natural Persons :** All the accounts of human beings/ Persons are included such Ram A/C, Shyam NC etc.
2. **Artificial Persons :** This includes all such accounts which are treated as persons in the eyes of law & have separate leagal entity such as Reliance Ltd., XYZ Ltd.
3. **Representative Persons** : This includes all such accounts which represents some persons such as Capital (Represent Owner) Outstanding Salary (Represent Employee)

(II) Impersonal Accounts:- It includes all those accounts which are not related to any person this can be classified as :-

1. Real Accounts : Under this all accounts related to assets are

included (except Debtors). These can be Tangible i.e. Machinery, Furniture . Building, Cash etc. and Intangible I.e. Goodwill, Trade Mark, Patents copy Rights etc.

2. Nominal Accounts : This includes all the accounts related to Expenses/Losses & Incomes / Gains e.g. Salary, Rent, Commission received etc. they are used to record the transaction in the books of accounts.

Classification of Accounts	Rules of Dr./ Cr.
Personal Accounts (All Personal Accounts)	Debit the receiver. Credit the Giver
Real Account	Debit what Comes In, Credit whats Goes Out
Nominal Account	Debit all Losses/Expenses, Credit all Income/Gains.

Rules of Debit/Credit under Traditional Approach

Illustration 2.

Analyse the following transactions by using the **"Traditional Approach"** of Debit/ Credit

S. No.	Transactions	Amount in (Rs.)
1	Ram Started business with cash	**1,00,000**
2	He purchased goods for cash	**20,000**
3	sold goods to ram	**30,000**
4	paid salary	**5,000**
5	withdrew cash for personal use	**10,000**
6	cash deposited into Bank	**20,000**
7	bought goods from Mohan	**15,000**
8	sold goods for cash	**16,000**
9	purchased machinery for cash	**50,000**
10	Depreciate machinery @ **10** %p.a.	**5,000**

Rules of Debit/Credit under Modern Approach.

Modern Rules of Debit and Credit

i) Increase(+) in assets are debits; decreases(-) are credits.
ii) Increase in expenses(+) are debits; decreases(-) are credits.
iii) Increased) in liabilities are credits; decreases(-) are debits.
iv) Increased) in revenues are credits; decreases(-) are debits.
v) Increased) in owner's capital are credits; decreases(-) are debits.

DEBIT-CREDIT-MATHEMATICS OF ACCOUNTS

1

“Debit" and "Credit" are like "Plus" and "Minus"

But a very important Difference is there........

"PLUS" always means ....to 'ADD'

"MINUS" always means ....to 'SUBSTRACT'

Whereas, MEANING (use) of DEBIT & CREDIT depends upon the NATURE OF ACCOUNT.

In case of: Assets and Expenses

"Debit" is "Plus" & "Credit" is "Minus"

FOR **Liabilities. Capital and** Revenue

Credit"Plus" & "Debit" means "Minus"

	For Increase (Plus) +	For Decrease (Minus) -
Assets	Debit t	Credit ^
Expenses	Debit f	Credit I

	For Increase (Plus) +	For Decrease (Minus)-
Liabilities	Credit t	Debit 1
Revenue	Credit t	Debit
Capital	Credit t	Debit *

NOTE The accounts of Assets and Expenses show Debit Balance and accounts of Liabilities, Capital and Revenue show Credit Balance.

Illustrations.

Analyze the transactions of illustration 2 by using the "Modern Approach" of Debit/Credit

Solution: Analysis of Transactions

S.N.	Transactions	Accounts Effected	Nature OfA/C	Rules	Debit (Rs.)	Credit (Rs.)
1	Commenced Business	Cash Capital	Assets Capital	Increase Increase	100000	 100000
2	Bought Goods for cash	Purchase Cash	Expense Assets	Increase Decrease	20000	 20000
3	Sold goods to ram	Ram Sales	Assets Revenue	Increase Increase	30000	 30000
4	paid salary	Salary Cash	Expense Assets	Increase Decrease	5000	 5000
5	Drawing	Drawing Cash	Capital Assets	Decrease Decrease	10000	 10000
6	Cash deposited into bank	Bank Cash	Assets Assets	Increase Decrease	20000	 20000

7	Boughtgoods from Mohan	Purchase Mohan	Expense Liabilities	Increase Increase	15000	15000
8	Sold goods for cash	Cash Sales	Assets Revenue	Increase Increase	16000	16000
9	Machinery purchased	Machinery Cash	Assets Assets	Increase Decrease	50000	50000
10	Depreciate machinery @10%	Depreciation Machinery	Expense Assets	Increase Decrease	5000	5000

SOURCE DOCUMENTS

A written document which provides evidence of the transactions is called the Source Documents. Source document is the first evidence of a transaction which takes place such as Cash Memo, Bill or Invoice, Receipt, Pay-in-slip, cheques, Debit-Note & Credit-Note.

(a) **Invoice (Bill):-**An invoice is prepared by Seller at the time of sale of goods on credit. It contains details such as the goods sold, the party to whom goods are sold, sales amount, date etc.

(b) **Cash Memo** It is prepared by the Seller at the time of Sale of goods on Cash. It contains details such as goods sold, quantity, amount received, date etc.

(c) **Pay-in-Slip**It is used to deposit cash or cheque into bank. It has a counterfoil which is returned to the depositor with the Signature of the authorized person.

(d) **Receipt:-** It is used when a customer give cash to the Business firm. It is an acknowledgment of payment or cash received by firm.

(e) **Cheque** :-A cheque is a order in writing, drawn upon a specified banker and payable on demand.

(f) **Debit Note**:- It is prepared when a buyer returned goods to seller or when purchased return transaction is entered in the books of accounts. It is prepared by the buyer of the goods.

(g) **Credit Note** :- It is prepared when a seller received goods from buyer or when Sales return transaction is entered in the books of accounts. It is prepared by the Seller of the goods.

VOUCHER

Avoucher is a document evidencing a business transaction. Recording in books of accounts are done on the basis of voucher. It is an accounting evidence of a business transaction.

Credit Voucher

Credit voucher is prepared for cash received by the business firm Such as Sale of goods for Cash, Payment received from any of Debtors, Income received etc.

Classification of Accounting Vouchers

Vouchers	Further classification	Purpose
Cash Vouchers	Debit Vouchers Credit Vouchers	To show Cash Payment To show Cash Receipt
Non Cash Voucher	Transfer Voucher	To show Transactions not involving cash

CASH VOUCHERS
Cash voucher is prepared to record all the transactions which involve cash either in the form of receipt or payment. Thus cash voucher is further classified into Debit Voucher & Credit Voucher.

Debit Voucher
Debit voucher is prepared for all cash payment made by the business firm such as Payment of Rent. Payment of salary, payment for purchase of goods etc

Credit voucher is prepared for cash receits.

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Transfer Voucher/Non-Cash Voucher

This type of vouchers are prepared in those transactions which do not involve Cash. Such as Credit Sales, Credit Purchases, Bad Debts, Depreciation charged etc.