

# Accounting basics: concepts, conventions and the accounting process

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1. Accounting: meaning, users, accounting concepts and conventions
2. The accounting process: accounting equation, double entry, types of accounts and rules of debit and credit

# 1 Accounting: meaning, users, accounting concepts and conventions

Accounting records, classifies and summarises money transactions of a business and reports the results to its users; a common set of concepts (assumptions) and conventions (customs) makes those reports reliable and comparable.

## Core facts

- **Accounting:** the art of **recording, classifying and summarising** transactions of a financial character, in money terms, and **interpreting** the results (American Institute of Accountants, now the AICPA, 1941). The AAA (1966) calls it identifying, measuring and **communicating** economic information to users.
- **Book-keeping** = recording and classifying (the clerical part). **Accounting** = book-keeping + summarising, analysing and interpreting. **Accountancy** = the whole body of knowledge.
- **Father of double entry: Luca Pacioli**, Italy, book *Summa de Arithmetica* (**1494**).
- **Branches:** financial accounting (past results for outsiders), cost accounting (cost per unit, cost control), management accounting (information for managers' decisions).
- **Users:**
  - internal: owners, management, employees;
  - external: creditors and suppliers, banks and lenders, investors, government and tax authorities, customers, researchers and the public.
- **Accounting concepts (assumptions/principles):** business entity, money measurement, going concern, accounting period, cost (historical cost), dual aspect, realisation (revenue recognition), accrual, matching.
- **Accounting conventions (customs):** consistency, full disclosure, materiality, conservatism (prudence).
- **AS 1 (ICAI) fundamental accounting assumptions: going concern, consistency, accrual.** Considerations in choosing policies: **prudence, substance over form, materiality**.
- **Standard setters in India:** Accounting Standards Board of the **ICAI** (set up **1977**) issues AS; **Ind AS** (converged with IFRS) are notified by the **Ministry of Corporate Affairs**, phased in from **1 April 2016**.
- **GAAP:** Generally Accepted Accounting Principles, the rules and customs that the profession follows.

## Explained

The nine concepts, each with what it means in the books

| Concept           | Meaning                                                         | Effect in the books                                                      |
|-------------------|-----------------------------------------------------------------|--------------------------------------------------------------------------|
| Business entity   | Business is separate from its owner                             | Owner's capital is a liability of the business; personal use is drawings |
| Money measurement | Only events measurable in money are recorded                    | Staff skill, a strike or a quarrel among directors is not recorded       |
| Going concern     | Business will continue for the foreseeable future               | Fixed assets at cost less depreciation, not at sale value                |
| Accounting period | Life of the business is split into periods (usually a year)     | Profit is found every year; in India 1 April to 31 March                 |
| Cost              | Assets are recorded at the price paid                           | Land bought for ₹5,00,000 stays at ₹5,00,000 even if now worth more      |
| Dual aspect       | Every transaction has two equal aspects                         | Assets = Liabilities + Capital; double entry                             |
| Realisation       | Revenue is earned when goods or services pass to the buyer      | Not when an order is received, not only when cash comes                  |
| Accrual           | Income and expenses are recorded when earned or incurred        | Outstanding and prepaid items are adjusted                               |
| Matching          | Expenses of a period are set against the revenue of that period | Cost of goods sold is matched with sales                                 |

### The four conventions

- **Consistency:** the same method year after year (for example straight-line depreciation), so results can be compared. A change is allowed only for a good reason and must be disclosed with its effect.
- **Full disclosure:** all material information is shown in the accounts or the notes (contingent liabilities, method of stock valuation).
- **Materiality:** items too small to affect a user's decision need not be shown separately or treated strictly (a stapler costing ₹150 is written off as an expense, not shown as an asset).
- **Conservatism (prudence):** "anticipate no profit but provide for all possible losses". Stock is valued at **cost or net realisable value, whichever is lower**; provision is made for doubtful debts.

**Example 1 (conservatism).** Closing stock cost ₹50,000; it can now be sold for only ₹46,000. At what value is it shown? *Solution.* Lower of cost (50,000) and realisable value (46,000). **Answer: ₹46,000**

**Example 2 (accrual).** A firm pays salary of ₹10,000 a month. By 31 March it has paid ₹1,10,000 for the year; March salary is unpaid. What is the salary expense for the year? *Solution.* Expense belongs to the year in which it is incurred: 12 × 10,000. Cash paid (₹1,10,000) is not the test. **Answer: ₹1,20,000**, with ₹10,000 shown as outstanding salary (a liability).

**Example 3 (realisation).** Order received 25 March, goods delivered 5 April, cash received 20 April; the year ends 31 March. In which year is the sale recorded? *Solution.* Revenue is realised when goods pass to the buyer. **Answer: the year beginning 1 April (delivery on 5 April)**

**Qualitative characteristics** that make accounting information useful: **reliability, relevance, understandability, comparability.**

## Deeper

- **Concept or convention?** Concepts are the basic assumptions on which accounts are built; conventions are customs that grew with practice. Textbooks differ in the label (some call all of them "principles"), so answer by the list each idea belongs to in the standard B.Com syllabus: consistency, disclosure, materiality and conservatism are the **conventions**.
- **Conflicts between principles.**
  - Conservatism vs consistency: switching to the lower of cost or market in one year breaks comparability; the change must be disclosed.
  - Cost vs relevance: historical cost is verifiable but can be far from current value in inflation, which is why inflation accounting and fair value (under Ind AS) exist.
  - Accrual vs cash: accrual shows true profit; the cash basis is simpler and used by some professionals and small non-trading bodies.
- **Going concern fails** when a business is to be closed: assets are then shown at realisable values, and prepaid expenses may have no value.
- **Business entity and the law.** For a sole trader the law does not separate owner and business, but accounting does. A company is a separate legal person as well.
- **Systems of accounting:** double entry (complete, used by companies) and single entry (incomplete records of small traders; see the single entry note). **Bases:** cash basis, accrual (mercantile) basis, and a hybrid. Companies must use accrual under the Companies Act, 2013 (section 128).
- **Limitations of financial accounting:** historical cost, money measurement only (ignores quality of staff), estimates (depreciation, provisions), window dressing is possible.

**Example 4.** Which principle is violated if a trader records his house rent paid from the shop's cash as a business expense? (a) Money measurement (b) Business entity (c) Going concern (d) Matching *Solution.* The owner's personal expense must be treated as drawings. **Answer: (b) Business entity**

**Example 5.** A machine bought for ₹2,00,000 has a resale value of ₹1,20,000 today. The firm will keep using it and shows it at cost less depreciation. Which concept justifies this? *Solution.* The firm is expected to continue, so resale value is not relevant. **Answer: going concern** (supported by the cost concept)

## Common traps

✗ "Book-keeping and accounting are the same." ✓ Book-keeping is only the **recording** stage; accounting also summarises and **interprets**.

✗ "Conservatism means recording expected profits early." ✓ It means **no anticipated profits, but provide for all possible losses**.

✗ "Stock is valued at market price." ✓ At **cost or net realisable value, whichever is lower**.

✗ "Revenue is recognised when the order is received." ✓ When goods or services **pass to the buyer** (realisation).

✗ "AS 1's fundamental assumptions are entity, money measurement and cost." ✓ They are **going concern, consistency and accrual**.

✗ "Capital is not a liability because the owner owns the business." ✓ Under the **business entity** concept, capital is owed by the business to the owner.

✗ "Double entry was introduced by Adam Smith." ✓ **Luca Pacioli, 1494**.

## Quick revision

- Accounting: record, classify, summarise, interpret (in money terms).
- Book-keeping = recording part only.
- Luca Pacioli, Summa, 1494: double entry.
- Concepts: entity, money measurement, going concern, period, cost, dual aspect, realisation, accrual, matching.
- Conventions: consistency, full disclosure, materiality, conservatism.
- AS 1 assumptions: going concern, consistency, accrual.
- Conservatism: stock at lower of cost or NRV; provide for losses.
- Accrual: expense when incurred, not when paid.
- Matching: costs set against revenue of the same period.
- Indian year: 1 April to 31 March; Ind AS from 1 April 2016.

## 2 The accounting process: accounting equation, double entry, types of accounts and rules of debit and credit

Every transaction has two equal sides (double entry), so  $\text{Assets} = \text{Liabilities} + \text{Capital}$  always holds; each side is a debit or a credit in some account, decided by the type of account and its rule.

### Core facts

- **Accounting process (cycle):** identify the transaction (with a voucher) → **journal** (book of original or prime entry) → **ledger** (posting, the book of final entry) → balancing → **trial balance** → adjustments → **final accounts** (trading account, profit and loss account, balance sheet) → closing entries.
- **Accounting equation:  $\text{Assets} = \text{Liabilities} + \text{Capital}$  ( $A = L + C$ ).** Hence  **$\text{Capital} = \text{Assets} - \text{Liabilities}$**  and  **$\text{Liabilities} = \text{Assets} - \text{Capital}$** .
- **Capital** grows with profit and fresh capital; it falls with losses and **drawings**.
- **Double entry:** every transaction affects at least two accounts, one **debited** and one **credited**, by the **same amount**. Total debits always equal total credits.
- **Debit (Dr)** = left side of an account; **Credit (Cr)** = right side.
- **Traditional (British) classification:**
  - **Personal:** natural (Ram, Sita), artificial (SBI, a company, a club), representative (outstanding salary, prepaid rent, accrued interest, income received in advance). The owner's capital and drawings accounts are also personal accounts.
  - **Real:** tangible (cash, building, machinery, furniture, goods) and intangible (goodwill, patents, trademarks).
  - **Nominal:** expenses, losses, incomes and gains (rent, wages, salary, discount, commission, interest, bad debts, depreciation).
- **Golden rules:**
  - Personal: **debit the receiver, credit the giver.**
  - Real: **debit what comes in, credit what goes out.**
  - Nominal: **debit all expenses and losses, credit all incomes and gains.**

### Explained

**Modern (American, accounting-equation) approach.** Accounts are grouped into five kinds; an increase is entered on the side shown.

| Account type        | Increase | Decrease | Normal balance |
|---------------------|----------|----------|----------------|
| Assets              | Debit    | Credit   | Debit          |
| Expenses and losses | Debit    | Credit   | Debit          |
| Liabilities         | Credit   | Debit    | Credit         |

| Account type      | Increase | Decrease | Normal balance |
|-------------------|----------|----------|----------------|
| Capital           | Credit   | Debit    | Credit         |
| Revenue and gains | Credit   | Debit    | Credit         |

Drawings reduce capital, so drawings are **debited**. Both approaches give the same entry.

**Example 1 (effect on the equation).** Arun's transactions:

1. Starts business with cash ₹1,00,000.
2. Buys furniture for cash ₹20,000.
3. Buys goods on credit from Ravi ₹30,000.
4. Sells goods costing ₹20,000 for ₹28,000 cash.
5. Pays salary ₹3,000.
6. Pays Ravi ₹25,000.
7. Withdraws ₹2,000 cash for personal use.

| After | Assets (₹) | Liabilities (₹) | Capital (₹) |
|-------|------------|-----------------|-------------|
| 1     | 1,00,000   | 0               | 1,00,000    |
| 2     | 1,00,000   | 0               | 1,00,000    |
| 3     | 1,30,000   | 30,000          | 1,00,000    |
| 4     | 1,38,000   | 30,000          | 1,08,000    |
| 5     | 1,35,000   | 30,000          | 1,05,000    |
| 6     | 1,10,000   | 5,000           | 1,05,000    |
| 7     | 1,08,000   | 5,000           | 1,03,000    |

*Working.* Final assets: cash  $1,00,000 - 20,000 + 28,000 - 3,000 - 25,000 - 2,000 = 78,000$ ; furniture 20,000; stock  $30,000 - 20,000 = 10,000$ ; total **₹1,08,000**. Liabilities: creditor Ravi **₹5,000**. Capital 1,00,000 + profit 5,000 ( $8,000 - 3,000$ ) – drawings 2,000 = **₹1,03,000**. Check:  $5,000 + 1,03,000 = 1,08,000$ . Note that transaction 2 only changes the form of an asset (cash to furniture), so totals do not move.

**Example 2 (applying the rules).**

| Transaction                                   | Debit                 | Credit                       | Rule used                    |
|-----------------------------------------------|-----------------------|------------------------------|------------------------------|
| Paid rent ₹5,000                              | Rent a/c (nominal)    | Cash a/c (real)              | Expense Dr; what goes out Cr |
| Sold goods to Suresh on credit                | Suresh a/c (personal) | Sales a/c                    | Receiver Dr; goods go out Cr |
| Bought machinery from Lakshmi & Co. on credit | Machinery a/c (real)  | Lakshmi & Co. a/c (personal) | Comes in Dr; giver Cr        |
| Received commission ₹1,200                    | Cash a/c (real)       | Commission a/c (nominal)     | Comes in Dr; income Cr       |

| Transaction               | Debit                                    | Credit          | Rule used                             |
|---------------------------|------------------------------------------|-----------------|---------------------------------------|
| Deposited cash in SBI     | SBI (bank) a/c<br>(personal, artificial) | Cash a/c (real) | Receiver Dr; goes out<br>Cr           |
| Owner took goods for home | Drawings a/c<br>(personal)               | Purchases a/c   | Owner receives Dr;<br>goods go out Cr |

**Example 3.** Total assets ₹5,00,000, outside liabilities ₹1,80,000. Find capital. *Solution.* 5,00,000 – 1,80,000.

**Answer: ₹3,20,000**

**Goods account.** Goods are a real account, kept in parts: purchases, sales, purchases returns (returns outward) and sales returns (returns inward). Goods taken by the owner or given as charity are credited to **purchases**, not sales.

## Deeper

- **Profit from the equation (capital comparison).** Profit = closing capital – opening capital + drawings – additional capital introduced. This is the basis of the statement of affairs method for single entry.

**Example 4.** Opening capital ₹2,00,000, closing capital ₹2,60,000, drawings ₹30,000, fresh capital ₹40,000. Find the profit. (a) ₹60,000 (b) ₹50,000 (c) ₹90,000 (d) ₹1,30,000 *Solution.* 2,60,000 – 2,00,000 + 30,000 – 40,000. **Answer: (b) ₹50,000**

**Example 5.** A firm's total assets are ₹3,50,000. It buys goods for ₹1,50,000 on credit and then pays creditors ₹1,20,000 in cash. What are the total assets now? *Solution.* Credit purchase raises assets: 3,50,000 + 1,50,000 = 5,00,000; paying liabilities lowers assets: 5,00,000 – 1,20,000. **Answer: ₹3,80,000**

- **Four kinds of transactions on the equation:**
  - both sides rise (credit purchase, capital brought in);
  - both sides fall (paying a creditor, drawings);
  - one asset up, another down (cash purchase of an asset): totals unchanged;
  - one liability up, another down (bill accepted for a creditor; the creditor becomes bills payable): totals unchanged.
- **Advantages of double entry:** complete record, arithmetical check through the trial balance, profit and financial position can be found, fraud is harder to hide.
- **Limits:** the trial balance agreeing does not prove accuracy; errors of **complete omission, commission (wrong person, same side and amount), principle and compensating errors** do not disturb it.
- **Bases of recording:** source documents (cash memo, invoice, debit and credit notes, receipt, vouchers) support each journal entry.
- **Debit balance or credit balance?** Assets, expenses, drawings: debit balance. Liabilities, capital, incomes, provisions: credit balance. A bank overdraft (owed to the bank) is a **credit** balance in the bank account.

## Common traps

✗ "Capital = Assets + Liabilities." ✓ **Capital = Assets – Liabilities.**

✗ "Drawings are credited because they reduce capital." ✓ Drawings are **debited** (a decrease in capital is a debit).

✗ "Outstanding salary is a nominal account." ✓ It is a **representative personal** account; salary itself is nominal.

✗ "Bank account is a real account like cash." ✓ The bank is an **artificial person**: personal account.

✗ "Goods taken by the owner are credited to sales." ✓ Credit **purchases** account (at cost); debit drawings.

✗ "The ledger is the book of original entry." ✓ The **journal** is the book of original entry; the ledger is the book of **final** entry.

✗ "Buying furniture for cash increases total assets." ✓ One asset replaces another; totals are **unchanged**.

✗ "Goodwill is a nominal account." ✓ It is an **intangible real** account.

### Quick revision

- Cycle: voucher → journal → ledger → trial balance → final accounts.
- $A = L + C$ ; capital = assets – liabilities.
- Personal: debit receiver, credit giver.
- Real: debit what comes in, credit what goes out.
- Nominal: debit expenses and losses, credit incomes and gains.
- Modern: assets and expenses rise on debit; liabilities, capital, revenue rise on credit.
- Drawings: debit; reduce capital.
- Bank, company, outstanding and prepaid items: personal accounts.
- Goodwill, patents: intangible real.
- Profit = closing capital – opening capital + drawings – fresh capital.