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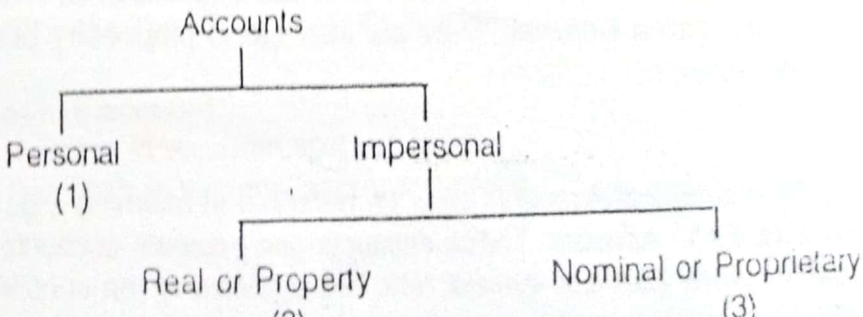
NATURE OF ACCOUNTS AND RULES OF DEBIT AND CREDIT

Definition: The term " Account " (a/c) is a record in summarised and classified form of all business transactions that take place between particular person or persons thing or things specified. The principal benefit from book-keeping is that it enables a trader to know the aggregate effect of his trade and also to keep due control over business affairs. In order to achieve this transactions of like nature or with same person are to be classified and grouped. For example, during a month we purchase goods for six times from Salman. In order to know the total amount due to him we must put all these transactions under due head or group called- Salman 's Account , and add together. On the other hand , to know our total purchases of goods during this period we must also put all these purchases under another group called Purchases Account . Similarly, we pay for salary. rent, postage, etc, on different dates to different parsons. To know the total amount of expenditure made on each item, they must be classified in respective groups such as " Salary, Rent, Postage", etc. Such a group is called an account . It is a summary of transactions relating to a particular person or a specified thing. Account is the root of Accounting.

Classification of Accounts: To record a transaction in the books of account, the first thing to do is to ascertain which account is to be debited and which account is to be credited. In order to ascertain this correctly, a clear idea about the different classes of accounts is essential. Accounts may be divided into the following three classes :-

Property



Proper

Proprietary

(1) Personal Accounts: Accounts relating to persons or firms are called personal Accounts. Personal Accounts can take the following forms: capital

(i) *Natural person's Accounts:* For Example Rahman's Account, Karim's Account etc.

(ii) *Artificial person's and body of person's Accounts :* For example, Habib Bank a/c, Bengal Oil Mills Ltd., a/c etc. or any institution's or any club's account.

(iii) *Representative personal Account :* When an account represents certain person or persons then it is called a representative personal account . In books the names of the actual parties appear. But since they are of the same nature and many in number, the amounts standing against these accounts are added and put under one common title . For example, if a business is not able to pay salary for the last two month to the workers, then the workers will be treated as creditors of the business. The amount due to these employees will be added and put under one common title " Salaries Outstanding Account" Thus the salary outstanding is a personal account. Other examples of the personal accounts of this nature are:

Unexpired insurance account; Rent prepaid account; Interest Outstanding; Interest received in advance account etc.

(2) **Real or property Accounts:** (Accounts of Properties and things) are those which keep records of properties or things owned by a trader e.g ; Machinery a/c, Land a/c, Furniture a/c, Building a/c, Cash a/c, etc. These accounts have existence and they are tangible, therefore, called Real a/c.

(3) **Nominal or Proprietary Accounts:** (Accounts of gains and losses) are those that record expenses, gains and losses such as Salary a/c, Wages a/c, Rent a/c, Repair a/c, Interest a/c, Discount a/c, etc. These accounts have no existence except mere in name and are therefore, called Nominal. They are also called proprietary being related to the proprietor of the business.

Note :

(a) Some Impersonal Accounts may be personal in meaning e.g., Capital Account, Drawing Account, Loan Account. These accounts are personal accounts of the proprietor of a business or of the partners thereof, who are creditors of the concern for the amount of their capital and debtors to the extent of their drawings.

(b) Some accounts may be both real and nominal e.g., Stationery Account. Stationery articles used during the year will be related to nominal but the unused stationery articles will be carried over to the next year. This will be treated as real and will be shown in the Balance Sheet.

Rules of Debit and Credit.: We know that two parties or rather two accounts are concerned in each transaction, one of them must be debtor and the other creditor. The following rules are applied for debiting and crediting accounts :—

(1) **Personal Accounts.** Debit the account of the person receiving and credit the account of the person giving.

(2) **Real Accounts.** Debit the account of property or thing coming in and credit the account of that going out.

(3) **Nominal Accounts.** Debit the account of all expenses and losses and credit the account of all gains.

How to apply Rules? Take each transaction separately and ask yourself the following questions :-

(a) What are the two accounts concerned?
(b) To which class does each of these two accounts belong?
(c) Which of them is Debtor or Creditor?

Illustration 3.1

		Rs.
(1)	M. Salman started business with cash	500,00
(2)	Purchased goods for cash	200,00
(3)	Sold goods to Rashid	150,00
(4)	Received cash from Rashid	125,00
(5)	Paid Rent	75,00
(6)	Purchased Machinery for cash	700,00

Solution:

The accounts and the reasons for their respective debits and credits for the above transactions are set out in the following table:

capital → personal

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Cr Reason

Item No.	Name of two Accounts	Kind of Accounts	Account to be debited	Account to be credited	Reasons
1.	Cash Account Capital Account	Real Personal	Cash a/c	Capital a/c	Cash comes in The Proprietor is giver.
2	Purchase Account Cash Account	Real Real	Purchase a/c	Cash a/c	Goods come in Cash goes out
3.	Rashid Sales Account	Personal Real	Rashid	Sales a/c	He receives goods. Goods go out.
4.	Cash Account Rashid	Real Personal	Cash a/c	Rashid	Cash comes in He is giver.
5.	Rent Account Cash Account	Nominal Real	Rent a/c	Cash a/c	Rent is an expense Cash goes out.
6.	Machinery Account Cash Account	Real Real	Machinery a/c	Cash a/c	Machinery comes in Cash goes out.

Rules of Debit and Credit (Equation Based)

The rules of debit and credit discussed above are based on classification of accounts. These rules are called as traditional rules of debit and credit. This approach is called as English or British approach . Modern writers on accounting apply accounting equation for determining debit and credit aspect of a transaction . The accounting equation is based on an arithmetical formula. The formula is : Assets = Liabilities. This means that in any organisation total assets will always be equal to total liabilities. This approach to decide Dr. & Cr., is also called as American approach . In order to understand the rules of debit and credit according to this approach the accounts are classified into five categories:-

1. Assets
2. Liabilities
3. Proprietorship
4. Revenues
5. Expenses.

Assets: Assets means the resources of the business or the commodities possessed by the business, e.g. land, building, cash, stock-in-trade etc.

Liabilities: Liabilities means the claims of the suppliers of cash or commodities on credit up to his balance due on the date e.g., suppliers of goods.

Proprietorship: It means the claims of the owner of the business for his interest up to his investment after finalising the expenses and revenue up to the date, e.g. capital.

Revenue: Revenue means any type of income directly or indirectly of the business, e.g. interest received, sale of goods, dividend received.

Expenses: Expenses means any type of expenses directly or indirectly of the business e.g. rent, salary, wages, carriage etc.

Rules of debit and credit: The rules of debit and credit in relation to these accounts are stated as under :

(i) **For Asset Account.**
Increase in an asset is debit.
Decrease in an asset is credit.

(ii) **For Liabilities Account**
Decrease in a liability account is debit.
Increase in a liability account is credit.

(iii) **For Proprietorship Account**
Decrease in proprietorship account is debit.
Increase in proprietorship account is credit.

(iv) **For Revenue Account**
Decrease in revenue account is debit.
Increase in revenue account is credit.

(v) **For Expense Account**
Increase in expense account is debit
Decrease in expense account is credit.

OR

Debit	Name of Accounts	Credit
Increase	1. Assets	Decrease
Increase	2. Expenses	Decrease
Decrease	3. Liabilities	Increase
Decrease	4. Proprietorship	Increase
Decrease	5. Revenues	Increase

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A careful perusal of the above rules will reveal that meaning of debit is the same for first two types of accounts on the one hand and last three types of accounts on the other. It also reveals that in the first two cases "debit" stands for increase, and for decrease in the last three cases. Similarly "Credit" stands for Decrease in the first two cases, and for increase in the last three cases. Thus the above rules can concisely be explained as under:

Rules of Debit and Credit

Assets & Expense Accounts.	Liabilities, Proprietorship & Revenue
Increase are recorded by debit Decrease are recorded by credit	Increase are recorded by credit Decrease are recorded by debit

How to apply Rules: The following four steps should be followed in analysing a business transaction before it is recorded :

(a) Accounts involved in the transaction.
(b) Nature of Accounts involved.
(c) Increase or Decrease (affected the account).
(d) Apply Debit and Credit rules (for the related account).

Illustration. 3.2

Capital

1. M. Salman started his business with cash investment Rs. 20,000
2. Purchased merchandise (goods) for cash Rs. 500.
3. Sold merchandise on cash Rs. 1,000
4. Purchased Furniture on cash Rs. 2,000.
5. Sold merchandise on credit to Rashid Rs. 3,000.
6. Paid Salaries Rs. 500 in cash.
7. Received cash from Rashid Rs 1,000 as part payment.
8. Received commission Rs. 1,000 in cash.

Soluton: The accounts and the reasons for their respective debits and credits in the above transactions are set out in the following table

Item No.	Name of Accounts	Nature of Accounts	Account to be debited	Account to be credited	Reasons
1.	Cash Capital (Salman)	Assets Proprietor-ship	Cash	Capital	Increase in assets Increase in Proprietor-ship.
2.	Purchase Cash	Expenses Assets	Purchases	Cash	Increase in Expenses Decrease in assets
3.	Cash Sales	Assets Revenue	Cash	Sales	Increase in assets Increase in revenue
4.	Furniture Cash	Assets Assets	Furniture	Cash	Increase in assets Decrease in assets
5.	Debtor (Rashid) Sales	Assets Revenue	Debtor (Rashid)	Sales	Increase in assets Increase in revenue
6.	Salaries Cash	Expenses Assets	Salaries	Cash	Increase in expenses Decrease in assets
7.	Cash Debtor (Rashid)	Assets Assets	Cash	Debtor (Rashid)	Increase in assets Decrease in assets
8	Cash Commission	Assets Revenue	Cash	Commission	Increase in assets Increase in revenue

It may be appreciated that both the English and American approaches do not give different conclusions. For example, if building has been purchased by the business then building will be debited. As per the American approach building is classified as an asset and increase in asset is debited. As per the English approach building is classified as real thing and real account is debited when a thing comes into business. Students are advised to choose one approach and master it.

QUESTIONS

Theoretical :

1. Under what heading (personal, real or nominal) would you clarify the following accounts
   Capital Account ; Salaries Account ; Cash Account ; Furniture Account ; Rent Outstanding Account ; Insurance Outstanding Account ; Purchases Account ;

   Answers : (P. N. R. R. P. P. R)

2. What are (i) Personal Accounts (ii) Nominal Accounts (iii) Real Accounts.

3. How will you clarify accounts ? What are the rules of debiting and crediting different classes of accounts ? two back

Objective :

1. Fill in the blanks by using terms 'debit' or 'credit' in the following transactions :—

   (a) Nazir started his business with Rs. 5000. His capital account will be ———; and cash account will be ————

   (b) He purchased furniture for cash. Furniture account will be ————. and cash account will be ——

   (c) He purchased goods for cash. Purchases account will be ————; and cash account will be ————.

   (d) He paid rent. Rent account will be ————; and cash account will be ————;

   Answers. (a) Credited, Debited; (b) Debited, Credited; (c) Debited, Credited; (d) Debited, Credited.

2. Fill up the blanks from the words given below :
   Personal Account, Real Account, Nominal Account, Debtor, Creditor, Capital, Debit, Credit, Two.

   (a) Nominal...... record profits and losses.
   (b) Every transaction has ......two...... aspects.
   (c) The money with which a business is started is known as ......capital......
   (d) The person who owes money is a ......Debter......
   (e) The person to whom money is owned is a ......Creditor......
   (f) ..Real a/c.. record properties and assets.
   (g) Personal.... record accounts of Debtors & Creditors.
   (h) For Personal Accounts, ..Debit.. the receiver of benefit and ......Credit.. the giver of benefit..
   (i) For Real Accounts.... Debit what comes in and ..Cre.... what goes out.
   (j) For Nominal Accounts, Deb it expenses and losses and Cred.. incomes and gains