

ACCOUNTING: A BUSINESS LANGUAGE

Accounting is a language, a system that communicates information. It is often referred to as the language of the business, although it is just as important in the operation of government agencies, clubs, colleges and other kinds of organisations.

You probably have some idea already of what the term accounting means. It is frequently used in every day conversation to mean "answering for responsibility." Managers of business concerns are answerable to owners, creditors, labour unions and Government agencies etc. Managers of government units are answerable to chief executives, boards, taxpayers and others. In fact, accounting was developed by people, who were seeking better ways to gather and report useful information about organisations.

Some type of orderly system is needed to account for an organisation of any size and complexity. An accounting system is used to collect, process and report needed data about a business, government unit, or other type of association. Information is usually collected, processed and reported in financial terms, which simply means that 'money' is the basis of measurement.

Many authors have defined the term "Accounting" in different ways. There is difference of opinion among the authors as to its precise definition as the term accounting is so broad that it is difficult to give a precise definition. However, several possible definitions are given below:

1. "The act of collecting, processing, reporting, analyzing, interpreting and projecting financial information".
2. "The system of providing quantified information about an organisation to people who need such information."
3. "The process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information."

Of all the definitions available the most accepted is the one given by the American Institute of Certified Public Accountants Committee on Terminology According to it.

"Accounting is the art of recording, classifying and summarising 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 result thereof". An analysis of the definition will enable us to have a thorough idea of the functions of accounting. The salient features of the definition are:

1. CONNECTED WITH A MONETARY EVENT OR TRANSACTION:

Accounting must be in relation to a monetary event or transaction and the event or transaction must be measurable in terms of money. In other words, no accounting is possible for an event or transaction which is not measurable in terms of money, e.g. passing an examination, delivering lecture in a meeting, winning a game etc. These are events no doubt, but since these are not measurable in terms of money, there is no question of their accounting.

2. TRANSACTIONS ARE PROCESSED IN THREE DIFFERENT STAGES:

(a) Recording:

In the first stage the transactions are recorded chronologically in the books of accounts.

(b) Classifying:

In the second stage the transactions of the same or similar nature are classified and recorded separately.

(c) Summarising:

In the third stage all the necessary data and information are summarised on the basis of classified record of transactions and communicated to management and other interested persons.

(d) Interpretation:

In order to assertion the true position of a concern all the accounting data and information relating to it are analysed and interpreted.

All the above functions are performed on the basis of certain well-defined and well-coordinated rules and principles. An accountant must be familiar with all these rules and principles. In accounting we will study all these rules and principles.

Book-Keeping:

Process *money*
Book-keeping is the art of recording monetary transactions in the books of account in a proper manner. The books of accounts are recorded in such a way as will enable us to ascertain the complete and accurate result in the least possible time with minimum labour and cost.

Many authors have defined the terms 'Book-keeping' in different ways;

1. "Book-keeping means the recording of transactions, the record making phase of Accounting (it is only a small part of the field of Accounting and probably the simplest part." - Meigs, Johnson and Meigs.
2. "Book-keeping is the recording branch of Accounting." -- Encyclopaedia Britannica.
3. "Book-keeping is the art of recording in books of accounts the monetary aspect of commercial or financial transactions." Northcot.

BOOK-KEEPING VERSUS ACCOUNTING

A great deal of efforts goes into gathering and processing information about a concern before the facts end up in an accounting report. Much of the work required is clerical in nature and can be performed by office workers, machine and computers. The functions of Book-Keeping is to properly record the financial transactions in the books of account. But the function of Accounting is more extensive (it has many other functions to do except recording transactions, e.g. classification, summarisation and interpretation of transactions. Thus we see that Book-Keeping is confined to recording aspect of Accounting (it is a small and the simplest part of Accounting. Both represent two different phases of the main subject "Accountancy". Book-Keeping is the first stage, while Accounting is the final stage, that is why, it is said

Two types of Book keeping
 1) single entry system
 2) double entry system

that Accounting starts where Book-Keeping ends. The function of Book-Keeping ends with the recording of transactions in the books of account. But the function of Accounting is to classify the recorded transactions, summarise them, interpret them and collect and communicate necessary information to the management and other interested persons. Management performs its function on the basis of this information, e.g. laying down rules and regulations, taking so many vital decisions etc. Thus we may say that the function of Book-Keeping is primarily of clerical nature, while that of Accounting is concerned with organisational and administrative matters (it is more important and responsible).

Apparently, the functions of Book-Keeping seem to be less important than Accounting, but its necessity can hardly be denied. Just an article cannot be produced without raw material, similarly accounting function cannot be done without obtaining necessary data from Book-Keeping. Again, if there is any defect in raw material the article produced out of it will also be defective. Similarly, if there is any error or mistake in Book-Keeping, the accounting job will also be wrong and create anomalous situation. Thus we can conclude that Book-Keepers perform the routine, repetitive tasks of collecting and processing financial information. Accountants are responsible for designing the systems within which Book-Keepers work; supervising the day-to-day work of book-keepers; recording unusual and complex transactions, preparing, analysing and interpreting accounting reports; auditing the records; and performing a variety of other complex accounting activities.

ACCOUNTING VERSUS ACCOUNTANCY

The two words "Accounting" and "Accountancy" are often used to mean the same thing. But it is not correct. Accountancy is the main subject (Accounting is one of its branches. The word "Accountancy" is far extensive; i.e. the scope of accountancy is far wide and extensive compared to Accounting. It covers the entire body of theory and practice, e.g. Book-keeping, Accounting, costing, auditing, Taxation etc.

BRANCHES OF ACCOUNTING

In order to meet the ever increasing demands made on accounting by different interested parties (such as owners, management, creditors, taxation authorities etc.) the various branches of accounting have come into existence:

1. FINANCIAL ACCOUNTING:

Related to transaction

The main purpose of financial accounting is to ascertain the true result (profit or loss) of the business operations during a particular period of time and to state the financial position of the business on a particular point of time. Financial accounting produces general purpose reports for use by the great variety of people who are interested in the organisation but who are not actively engaged in its day-to-day operation.

2. COST ACCOUNTING:

The main object of cost accounting is to determine the cost of goods manufactured or produced by the business. It also helps the management of the business in controlling the costs by indicating avoidable losses and wastes.

3. MANAGERIAL ACCOUNTING:

System of division

The object of this accounting is to communicate the relevant information periodically to the management of the business to enable it to take suitable decisions.

It should be remembered that in this book, we are concerned only with financial accounting. Financial accounting is the oldest and the other branches have developed from it. The objects of financial accounting can only be achieved by recording business transactions in a systematic manner according to a set of principles.

OBJECTS OF ACCOUNTING

1. Financial information is necessary in order to run a business in an efficient manner. Reliable information will be available only through keeping proper books of accounts.
2. Proper accounting is essential, if money is to be borrowed for the purpose of business. The lender will only agree to lend money when he is satisfied as to the solvency of the borrower. Information available from books of accounts is the means of measuring such solvency.
3. Cash in hand can be verified and any defalcation can be detected, if proper books of accounts are maintained.
4. Payment of sales tax and income tax is only possible if books of accounts are maintained.
5. In case of any dispute, books of accounts can be produced in the court of law as a documentary evidence.
6. Government fixes up fair prices; formulates industrial policy, prepares economic plans, decides import-export quotas and does many other functions on the basis of accounting information available from books of accounts.

IMPORTANT ACCOUNTING TERMS AND CONCEPTS

1. BUSINESS ENTITY:

Profit making organisations are known as businesses. There are three main types of businesses; those selling services (such as dry cleaners, Motor workshops, Beauty salons, airlines etc.); those selling goods (such as food sellers, automobile dealers etc.); those manufacturing goods (such as automobile manufacturers, fans industries, sugar mills etc.).

A business entity is an economic unit which enters into business transactions that must be recorded, summarised and reported. The entity (organisation) is regarded as separate from its owner or owners; the entity owns its own property and has its own debts. The purpose of accounting is to provide useful information about an organisation (an entity) to people who need such information but not about the personal affairs of the owner or owners. So it should be remembered that accounting is done for business activities (what is happening in the business organisation) and it is not concerned with the personal or private matters of the owner. For example, the owner purchases furniture for business use (this is a business activity and it should be recorded in books of accounts. But if he purchases furniture for his domestic use, it will not be considered as a business activity and will not be recorded in books of accounts. In the same way, the owner may have a personal bank account, a car, a house, and other property, but since these things are not a part of the business, they are not included in the record of the business unit. So, each organisation for which accounting is done is an independent entity, separate from its owners, managers, customers, creditors, and all other persons and entities with which it deals.

FORMS OF BUSINESS ORGANISATION

There are three main forms of business organisation;

(a) Single or sole proprietorship: →

The simplest form of business organisation "to organise and operate" is a single or sole proprietorship. This is the most common form of ownership and is found in business such as small retail shops, service stations etc. The owner is the only one in control and makes all management decisions.

Imp Manufacturing Principle Expense
 Separate entity concept COST.

(b) Partnership:

In a partnership, ownership is divided between two or more persons who agree to share their property and skills to start and operate a business. Like the single proprietorship, a partnership business is simple to organise.

(c) Joint Stock Company:

A joint stock company is formed under the Companies Ordinance, 1984 and has the legal right to act as a person. It may be owned by many people. A company has its own name, in which it can buy, own, and sell property; make contracts; borrow money; and take court action. The persons who have made investment in the company are known as shareholders.

2. GOODS OR MARCHANDISE

In accounting the word "Goods" has a special meaning. It refers to something which has been purchased by a trader for resale purposes or anything which has been manufactured for selling purposes. For example, if a trader purchases furniture for use in the business, it will not be regarded as "goods", but if it is purchased for resale, it will be regarded as "goods". The same article may be "goods" for one trader but may not be so to another trader. For example, furniture is not "goods" for a book seller; but it will be regarded as "goods" to a furniture -dealer.

Thus, cloth will be "goods" to a cloth dealer

Watches will be "goods" to a Watch dealer

Books will be "goods" to a Book - Seller

Stationery will be "goods" to a Stationery dealer.

But watches, books or stationery will not be considered as "goods" to a cloth dealer.

3. PURCHASES:

In accounting language the word "Purchases" has a special meaning. When saleable goods are bought in a business, it is said that "purchases" have been made. For example, to a cloth dealer, whenever cloth is purchased, it will not be necessary to mention that cloth has been purchased (simply it will be said that purchases have been made. On the other hand, if stationery is purchased, then it will be essential to mention that stationery has been purchased.

4. CASH PURCHASES:

If goods are purchased from a supplier and payment is made to him at the same time, such purchases are known as "Cash Purchases". For example, Mr. X purchased goods from a seller, Mr. Y, for Rs. 5000 on 1st January, 2017, and payment is made to the seller (Mr. Y) at the same date (1.1.2017), it will be a case of cash purchases.

5. CREDIT PURCHASES OR "PURCHASES ON ACCOUNT:

When goods are purchased from a seller and payment is not made to him at the same time, rather the payment is arranged to be made at some future date, such purchases are known as "credit purchases" or "Purchases on account". For example, Mr. A purchased goods from Mr. B for Rs. 5000 on 1st January, 2017 and Mr. A agreed to make the payment of goods on 15th January, 2017 (payment has not been made on 1.1.2017), it will be a case of credit purchases. On 15th January Mr. A will pay Rs. 5000 to Mr. B.

6. PURCHASES RETURNS OR RETURNS OUTWARDS:

Goods once purchased may subsequently be sent back to the seller for certain reasons, i.e. goods are defective, not according to specification, damaged or below standard. Such return of goods to the seller

is known as "Purchases returns" or "Returns to suppliers". For example, we purchased 100 radio sets (goods) from Lahore Electronics for Rs. 15000. On receiving the delivery of goods, it is found that 10 radio sets are of inferior quality. The return of these 10 radio sets to the seller (Lahore Electronics) will be a case of purchases returns.

7. PURCHASES DISCOUNT AND SALES DISCOUNT:

The Concession given by the supplier to the buyer on purchases of goods is known as "Purchases discount" to the buyer and "Sales discount" to the seller (supplier).

8. ALLOWANCES:

Sometimes, the customers (buyers) find that goods purchased have minor defects. In that case, the seller may agree to reduce the price of damaged or defective goods to induce the buyer to keep the goods. Such reduction in price is known as "Purchases allowance" to the buyer and "Sales allowance" to the seller.

9. SALES:

We know that goods are purchased for selling purposes. When these goods are sold to customers at a specific price, it is said that sales have been made. For example, we purchased goods worth Rs. 5000 (our purchases). Suppose, these goods have been sold at a price of Rs. 6000 -- in accounting language it will be said that sales have been made at Rs. 6000. So goods sold are called "Sales".

10. CASH SALES:

If goods are sold to customers at a specific price and price of the goods is received from them at the time of sale of goods, such sales are known as "Cash sales". For example, we sold goods to a customer, Mr. A for Rs. 2000 on 10th January, 2017 and received the cash from him on the same date, it will be a case of cash sales.

11. CREDIT SALES:

If goods are sold to a customer and he does not pay the price of goods at the same time but agrees to make payment on some future date, the sales are called "credit sales" or "Sales on account." For example, we sold goods to Mr. X for Rs. 3000 on 15th January, 2017 and he agreed to make payment on 31st January, 2017, it will be a case of credit sales or sales on account.

12. SALES RETURNS OR RETURNS INWARDS:

If a customer to whom goods have been sold finds that the goods are defective, unsatisfactory, below standard or not according to specification, he may return these goods to the seller. To the seller, such return of goods is known as "Sales returns" or "Returns Inwards" or "Returns from customers."

13. TRADE DISCOUNT:

At the time of selling goods, the manufacturer or wholesaler allows ^{customer's} retailers such a discount (concession). It is allowed at a certain percentage of the listed or catalogue price. For example, the list price of the goods is Rs. 30000, and the wholesaler allows a trade discount of 10% on the listed price to the retailer. It means the net price of the goods is 27000 (30000-3000). The trade discount enables the retailer to sell goods at the listed price; and the customer can be sure about the fair price of the goods. It may be noted that both the buyer and seller will record Rs. 27000 (not Rs. 30,000) in their books of account. In other words trade discount is not recorded in books of account. Thus, discount allowed by manufacturer or wholesaler at the time of selling goods to retailer as a deduction from the listed price or catalogue price, is called Trade Discount.

*Assets . Accounting elements .
Trail Balance .*

14. DEBTORS OR ACCOUNTS RECEIVABLE:

When goods are sold to the customers on credit basis (credit sales are made to customers), debtors come into existence. Debtors are the persons or customers to whom goods have been sold on credit basis and from whom the business is to receive money in near future. The accounts of such customers are known as "Accounts Receivable". For example, we sold goods to A for Rs. 3000, to B for Rs. 2000 and to C for Rs. 4000 on credit basis. The amount receivable from them (A, B and C) is known as "Debts" and the three customers, A, B and C are our debtors or accounts receivable.

15. CREDITORS OR ACCOUNTS PAYABLE:

When goods are purchased from the suppliers (sellers) on credit basis, creditors come into existence. Creditors are the persons or suppliers from whom goods have been purchased on credit basis and to whom the money is to be paid in near future. The accounts of such persons (suppliers) are known as accounts payable". Accounts payable means, the amount which a business expects to pay to its suppliers for goods purchased or services received from them on credit basis.

The person or business who will receive the money - Creditor.

The person or business who will pay the money -- Debtor.

16. CASH DISCOUNT:

It is a deduction or allowance given by a creditor to a debtor if the amount due is paid by the debtor before the due date, or it is a reduction in price (usually 2% or less) offered by manufacturers or wholesalers (creditors) to encourage customers (debtors) to pay their debts within a specified discounted period. For example, X sold goods to Y (a customer) for Rs. 1000 on credit basis. It means, X is creditor and Y is debtor. X offers an allowance of 2% to Y, if he will pay his debts within 15 days. It means, if Y pays his debts within 15 days, then he will pay only Rs. 980 (1000 - 20) to X. Such a discount is known as "Cash Discount".

17. CAPITAL OR OWNER'S EQUITY:

To understand this term, recall that business is an entity (organisation) separate from its owner or owners. Equities mean the sources of funds provided to start or to operate a business entity. Now the question is: who provides funds to a business unit. Mainly there are two sources of funds:

- (a) Funds supplied by the owner/owners.
- (b) Funds supplied by the external parties like bank etc.

So, the amount of cash or goods invested (supplied) by the owner/owners in a business unit is known as "capital" or owner's equity.

Or

Capital is the money or moneys worth borrowed by a business unit from its owner or owners.

Or

It is the claim or right of the owner/owners against the assets (properties etc. possessed by business) of the business.

Or

It is the source of funds provided by the owner/owners of the business.

Or

It is a part of the total equity which is supplied by the owner/owners.

For example, Mr. X started a business with Rs. 100000. Out of Rs. 100000, Rs. 70000 have been provided by the owner, X and Rs. 30,000 have been borrowed from a bank. Now, the equity (total funds) of the business is Rs. 100000 but owner's equity (capital) of the business is Rs. 70,000.

18. ASSETS:

Assets are the economic resources (having certain value) ^{own (C&S)} owned by a business on a particular date and which are expected to benefit the future operation of the business.

Or

Assets are the properties and possessions of a business both tangible (have physical existence) and intangible (have no physical existence).

Or

Assets are the things having certain value possessed by a business and receivable by a business on a particular date. For example, cash, furniture, building, land, machinery, stock of goods, Debtors or Accounts receivable, Bank balance, Goodwill etc.

19. LIABILITIES:

Liabilities are the debts or obligations of a business.

Or

The outsider's (creditors etc.) claims against the assets of the business are known as "Liabilities". There are two main parties who have claims against the assets of a business; (a) Owner's claim; (b) Outsiders' claims. The owner's claim against the assets of a business is known as owner's equity and outsider's claims against the assets of the business are known as "liabilities."

Or

Liabilities mean the total amount which a business is legally bound to pay to the outsiders, e.g. creditors, Bills payable, Accounts payable, Bank loan etc.

20. ACCOUNTING PERIOD:

It is a span of time for which a business generally prepares its financial statements (the statement prepared to know the profit or loss of a business and to know its financial position). Mostly the financial reports are prepared for one year but they may also be prepared for one month or for one quarter.

21. REVENUE:

All business organisations are engaged in providing goods or services to their customers. The amount which a business charges its customers for these goods or services, measures the revenue of the business.

Or

It is the price of goods sold or services provided by a business to its customers.

Or

Revenue is the inflow of assets (cash or debtors) in return for services performed or goods delivered (sold) during an accounting period.

Or

It is inflow of cash and debtors (receivable) in exchange for goods sold or services rendered during an accounting period.

Accounting Cycle imp

For example, we sold goods to a customer for Rs. 1000 and he paid cash to us Rs. 1000. The revenue will be equal to inflow of cash Rs. 1000. But if the customer has paid only Rs. 500 and the remaining amounts he agreed to pay at some future date, again in that case the revenue will be equal to Rs. 1000 (inflow of cash Rs. 500 + Rs. 500 receivable).

TYPES OF REVENUE:

1. Sales: The total price of goods sold
2. Interest earned
3. Fees earned
4. Rent earned
5. Commission earned

22. EXPENSES:

Expenses are the costs of the goods and services used up in the process of obtaining revenue.

Or

Expenses are the cost of producing revenue in a particular accounting period.

Or

An expense is a sacrifice, or cost incurred to generate revenue.

For example, salaries for employees, telephone charges, rent of the building, insurance and transportation etc. All these costs are necessary to attract and serve the customers and thereby to obtain revenue. Expenses are sometimes also referred to as the "cost of doing business" or "expired costs".

23. NET INCOME OR NET PROFIT:

Net income or net profit is simply the amount by which the "revenue" for a particular period of time exceed the "expenses" incurred to generate them.

Net income or net profit = Revenue - Expenses:

ACCOUNTING PRINCIPLES

It has already been stated in this chapter that Accounting is the language of business through which economic information is communicated to all the parties concerned. In order to make this language easily understandable all over the world, it is necessary to frame or make certain uniform standards which are acceptable universally. These standards are termed as "Accounting Principles".

Accounting principles may be defined as those rules of action or conduct which are adopted by the accounts universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting. They are serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist. These principles can be classified into two groups.

(i) Accounting concepts

(ii) Accounting conventions.

Accounting Concepts:

The term 'concepts' includes those basic assumptions or conditions on which the science of accounting is based. The following are the important accounting concepts:

(i) Separate Entity Concept

(ii) Going concern concept

(iii) Money measurement concept

(iv) Cost concept

(v) Dual Aspect concept

(vi) Accounting period concept

(vii) Matching concept

(viii) Realisation concept.

Accounting Conventions:

The term 'conventions' includes those customs or traditions which guide the accountant while communicating the accounting information. The following are the important accounting conventions:

- | | |
|---------------------------------|------------------------------------|
| (i) Convention of conservatism | (ii) Convention of full disclosure |
| (iii) Convention of consistency | (iv) Convention of materiality. |

ACCOUNTING CONCEPTS**1. Separate Entity Concept:**

Business is separate from its owner

Accounts are kept for entities, as distinguished from the persons who are associated with these entities. In recording events in accounting, the important question is: "How do these events affect the entity?" How they affect the persons who own, operate, or otherwise are associated with the entity is irrelevant. For example, when a person invests Rs.200,000 into business it will be deemed that the owner has given that money to the business which will be shown as a 'liability' in the books of the business. In case the owner withdraws Rs.30,000 from the business, it will change the position and the net amount payable by the business to the owner will be shown only as Rs.170,000.

The concept of separate entity is applicable to all forms of business organizations. For example, in case of a sole proprietorship or partnership business, though the sole proprietor or partners are not considered as separate entities in the eyes of law, but for accounting purposes they will be considered as separate entities.

2. Going Concern Concept:

Business humane chalta raha ga

According to this concept it is assumed that an entity is a going concern — that it will continue to operate for an indefinite time period there is no intention to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant while valuing the asset does not take into account the sale value of assets. Moreover, he charges depreciation on fixed assets on the basis of their expected life rather than on their market values.

For example, suppose that a company has just purchased a three-year insurance policy for Rs.45000. If we assume that the business will continue in operation for three years or more. We will consider the Rs.45000 cost of insurance as an asset which provides services to the business over a three-year period. On the other hand, if we assume that the business is likely to terminate in the near future, the insurance policy should be reported at its cancellation value i.e. the amount refundable upon cancellation.

Moreover, the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going-concern is not impaired normally. The enterprise will not be considered as a going-concern when it has gone into liquidation.

3. Money Measurement Concept:

In financial accounting, a record is made only of those information that can be expressed in monetary terms. In other words, no accounting is possible for an event or transaction which is not measurable in terms of money, e.g. passing an examination, delivering lecture in a meeting, winning a prize etc. These are events no doubt, but since these are not measurable in terms of money, there is no question of their accounting.

Measurement of business events in money helps in understanding the state of affairs of business in a much better way. For example, If a business owns, 1500 kg of stock, one car, 1500 square feet of building space etc. these amounts cannot be added to produce a meaningful total of what the business owns. However, if a these items are expressed in monetary terms such as stock Rs.24000, car Rs.300,000 and building Rs.500,000, all such items can be added in better way and precise estimate about the assets of the business will be available.

4. ✓ Cost Concept:

The concept is closely related to going concern concept. According to this concept, "An asset is ordinarily entered on the accounting record at the price paid to acquire it, and this cost is the basis for all subsequent accounting for the asset". If business buys a building for Rs.5,00,000, the assets would be recorded in the books at Rs.500,000, even if its market value at that time may be Rs. 550,000. In case a year later the market value of this asset comes down to Rs.450,000 it will ordinarily continue to be shown at Rs.500,000 and not at Rs.450,000.

The cost concept does not mean that the asset will always be shown at cost. It has also been stated above that cost becomes the basis for all future accounting for the asset. It means that asset is recorded at cost at the time of purchase but it may systematically be reduced in its value by charging depreciation.

TRANSACTIONS AND ACCOUNTING EQUATION

The main function of an accountant is to record properly the financial transactions of a business concern in the books of accounts and to ascertain its true result at the year end. Thus transaction is the foundation of accounting - the first and foremost element of accounting. In a word, it is the life and blood of Accounting. Hence the accountant must have a fair idea about the term "transaction."

In ordinary language "transaction" means exchange of something. But in Accounting it is used in a special sense. *If the financial position of a business concern changes on the happening of an event which is measurable in terms of money, that event is regarded as a "transaction" in Accounting.*

Or

A business event which can be measured in terms of money and which must be recorded in books of account is called a "transaction".

WHAT IS AN EVENT?

EVENT:

In ordinary language "Event" means anything that happens. Human life is full of events. So many events take place in the family and social life of a person. The events may be classified into two:

(a) Monetary Events:

Events which are related with money, i.e. which change the financial position of a person are known as "monetary events". For example, daily shopping, marriage ceremony, birthday anniversary, marriage anniversary etc.

(b) Non-Monetary Events:

Events which are not related with money i.e. which do not change the financial position of a person are known as "non-monetary events". For example, winning a game, delivering a lecture in a meeting etc.

In business accounting only those events which change the financial position of the business and which call for accounting are recognised as "Events". In other words, all monetary events are regarded as "business transactions."

Remember, it is not that anything which results in exchange of something will be regarded as transaction. On the other hand, something may be regarded as a transaction even though it involves no exchange. For example, Rehman sends a price-list to his customer, Akram. This involves exchange of price-list between Rehman and Akram, yet it is not regarded as a transaction, because it is not measurable in terms of money and it does not change the financial position of both the persons. Again, suppose, goods worth Rs. 1000 are destroyed by fire. This does not involve any exchange, yet it is regarded as a transaction, because it is measurable in terms of money and it changes the financial position of the business.

It must be noted that an event, although measurable in terms of money, may not be regarded as a transaction. For example, we receive an order for supply of goods worth Rs. 1000. Although it is measurable in terms of money, it is not regarded as a transaction, since it has not changed the financial position. It will, however, be regarded as a transaction when the goods are supplied according to the order.

It appears from the above discussion that the following two conditions must be satisfied in order that an event may be regarded as a transaction in Accounting;

1. The event must be measurable in terms of money.
2. The financial position of the business must change on account of that event.

FEATURES:

To become a transaction an event must have the following features;

1. THERE MUST BE TWO PARTIES:

No transaction is possible without two parties. Just as it takes two hands to clap, so it takes two parties for a transaction to take place. There cannot be a giver unless there is a receiver. Suppose, X borrows Rs. 10,000 from a bank. This is a transaction, since there are two parties here - X and bank.

2. THE EVENT MUST BE MEASURABLE IN TERMS OF MONEY:

An event will not be regarded as a transaction, unless it is capable of being measured in terms of money.

3. THE EVENT MUST RESULT IN TRANSFER OF PROPERTY OR SERVICE:

Suppose, we buy a motor-car from Saleem for Rs. 40000. This results in transfer of property from Saleem to us, so it is a transaction. Again suppose, we pay salary to our employee Rs. 2000. This results in transfer of service -- the employee renders service and we receive it. So it is a transaction.

4. THE EVENTS MUST CHANGE THE FINANCIAL POSITION OF THE BUSINESS:

Transaction takes place only when there is a change in the financial position of the business. The change in financial position may be of two kinds:

(a) Quantitative change:

This changes the total value of assets and liabilities of a business concern. Suppose, machinery of Rs. 50,000 is destroyed. This reduces the total value of the assets of the business. As a result, the financial position changes and hence it is a transaction.

(b) Qualitative change:

This causes increase or decrease in the different elements of assets or liabilities, but the value of total assets and total liabilities remains unchanged. Suppose, we buy machinery worth Rs. 50,000. This results in exchange of properties - cash Rs. 50,000 goes out of our possession and at the same time machinery of an equal value comes into our possession. This does not change the total value of our assets, but this causes a qualitative change in our financial position, hence it is a transaction.

CLASSIFICATION

Transactions may be divided into three groups:

1. CASH TRANSACTION:

If the value of a transaction in met is cash immediately, it is called cash transaction. For example, we buy furniture for Rs. 2000 from Asif and immediately pay him in cash. It is a cash transaction.

2. CREDIT TRANSACTION:

If the value of the transaction is not met in cash immediately, it is called credit transaction. In the above example, if we do not pay Asif Rs. 2000 immediately, it will be credit transaction.

3. PAPER TRANSACTION:

When there is no question of meeting the value of a transaction, it is regarded as a paper transaction. For example, I have lost Rs. 500. This changes my financial position-my properties decrease in value by Rs. 500. But there is no question of meeting the value of such a transaction. This is a paper transaction.

Transactions may again be divided into the following two classes;

1. EXTERNAL TRANSACTIONS:

A transaction taking place with an outside person or organisation, is called an external transaction. For example, a machine is purchased for Rs. 20,000 from Kashif Bros. This is an external transaction.

2. INTERNAL TRANSACTIONS:

A transaction with which no outside person or institution is involved, is called internal transaction. For example, loss of furniture by fire, decrease in the value of assets on account of use (depreciation) etc.

RULES FOR DECIDING WHETHER A TRANSACTION IS CASH OR CREDIT:

Sometimes transactions are worded in such a way that it becomes difficult to decide whether they are cash or credit transactions. The following rules will make the position clear;

1. A transaction is regard as a cash transaction if:

- (a) The word "cash" is mentioned in the transaction. For example Bought goods for cash Rs. 5000 from Arshad.
- (b) The name of the seller or buyer is not mentioned in the transaction. For example, Bought goods Rs.5000.

2. A transaction is regarded as a credit transaction if:-

- (a) The words "on credit" or "on account" are mentioned in the transaction. For example, Bought goods Rs. 5000 on credit.
- (b) The name of the seller or buyer is mentioned in the transaction and the word "Cash" is not mentioned. For example, Bought goods from Arshad Rs. 5000.

Thus we may conclude from the above discussion that every business transaction brings a double change in the financial position of the business. It brings a change in the assets, liabilities, owner's equity, expenses or revenues of a business.

ILLUSTRATION NO. 1

State with reasons whether the following events are transactions to my business;

1. I started a business with Rs. 50,000.
2. I bought furniture for Rs. 2,000 for business use.
3. Submitted a tender for goods worth Rs. 10,000.
4. Appointed a cashier on a salary of Rs. 2,000 per month.
5. Paid salary to cashier Rs. 2,000.
6. I took away goods worth Rs. 500 from the business for my private use.
7. Paid salary Rs. 1,000 to Salesman of the business.
8. Paid rent of my house from my own funds.

Solution:

Here transaction is to be considered from the viewpoint of my business, not from my personal viewpoint. So, an event changing the financial position of my business will be regarded as a transaction:

1. It is a transaction. It changes the financial position of the business -- Cash (asset) increases by Rs. 50,000 and owner's equity increases by an equal amount.
2. It is a transaction. It changes the financial position of my business--Furniture (an asset) increases by Rs. 2,000 and cash (an asset) decreases by an equal amount.
3. It is not a transaction. It does not change the financial position of my business.
4. It is not a transaction. Mere appointment of a cashier does not change the financial position of my business.
5. It is a transaction. It changes the financial position of my business-- cash (an asset) decreases by Rs. 2,000 and an expense (salary) increases by an equal amount.
6. It is a transaction. It changes the financial position of my business - goods decrease by Rs. 500 and owner's equity also decreases by an equal amount.
7. It is a transaction. It changes the financial position of my business cash (an asset) decreases by Rs. 1,000 and owner's equity also decreases by an equal amount.
8. It is not a transaction. It does not change the financial position of my business.

THE ACCOUNTING EQUATION

The three basic elements of accounting are assets, liabilities and owners' equity (capital). The assets represent the things of value that a business owns. The liabilities are the claims of the creditors against those assets. The owner's equity (capital) is the claim of the owner against those assets. Whatever is not claimed by the creditors belongs to the owner. As a result, the total claims against the assets are always equal to the total assets. This equality between the assets and the liabilities and the owner's equity is expressed by the "accounting equation".

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity.}$$

The two sides of the accounting equation must always be equal because the rights to all the assets of a business are owned by someone. The creditors have a claim against the assets of a business until the liabilities have been paid. The owner has a claim against the remaining assets of the business. If no liabilities exist, then the owners' equity will equal to the total assets.

A clear understanding of the accounting equation is essential, because most of accounting systems are based on it. The equation actually identifies the claims (or rights) against the assets held by a business. The two sides represent different versions of the same thing. The left side of the equation, assets, consists of the "resources" (properties) held by the business; the right side of the equation, equities (creditor's claim and owner's claim against the assets) consists of the "sources".

Resources	= Sources
Assets	= Claims against assets

"The expression of the equality of an entity's assets with the claims against them is referred to as the accounting equation."

It should be remembered that the two sides of the equation are always equal because these two sides are merely two views of the same business resources. The assets side shows us "what resources" the business owns, the other side (liabilities and owner's equity) tells us "who supplied these resources" to the business and how much each group supplied.

EFFECT OF BUSINESS TRANSACTIONS UPON THE ACCOUNTING EQUATION:

Recall that every business transaction brings about a double change in the financial position of the business. The financial position of a business is represented by the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's equity.}$$

Regardless of whether a business grows or contracts this equality between the assets and the claims against the assets is always maintained. Any increase in the amount of total assets is necessarily accompanied by an equal increase on the other side of the equation, that is, by an increase in either the liabilities or the owner's equity. Any decrease in the amount of total assets is necessarily accompanied by an equal decrease in liabilities or owner's equity. Any expense incurred will decrease the owner's equity on one side and decrease cash on the other side of the equation. Any revenue earned will increase the owner's equity on one side and increase assets on the other side.

The effect of transactions upon the accounting equation can best be illustrated by taking a brand-new business as an example:-

SETTING UP A BRAND - NEW BUSINESS

Assume that Mr. Naveed decided to start a "shoes business" of his own, to be known as Naveed Shoes Company." The new business was started on 1st January, 2017, when Mr. Naveed invested Rs. 5,00,000 in his business. Recall that the business entity is kept separate from its owner.

The business unit has borrowed Rs. 5,00,000 from its owner. This is a first transaction of the business. It brought a double change in the financial position of the business-- an asset (cash) increased by Rs. 5,00,000 and a liability (owner's equity or capital) increased also by Rs. 5,00,000. In other words, this transaction is consisting of two elements;

1. The receipt of Rs. 500,000 cash
2. Supplied by the owner of the business.

TRANSACTION NO. 1

The initial accounting equation of the new business then appeared as follows;

	<u>Assets</u>	=	<u>Liabilities + Owner's equity</u>
2017			
1st Jan.	Cash		: Capital
	Rs. 500,000	=	Nil + Rs. 500,000

TRANSACTION NO. 2

Mr. Naveed purchased a building for Rs. 2,00,000. This transaction brought two changes-- cash (asset) decreased by Rs. 2,00,000 and Building (a new asset) increased by Rs. 2,00,000. Now the equation will be;

	<u>Assets</u>	=	<u>Liabilities + Owner's equity</u>
	Cash + Building		: Capital
	Rs. 300,000 + 200,000	=	Nil + Rs. 500,000

It may be noted that there is no change on the right side of the equation. Simply one asset (cash) has been converted into another asset (Building). The two sides of the equation remains equal.

TRANSACTION NO. 7

He sold goods costing Rs. 50,000 for Rs. 70,000 on credit basis. The result of this transaction is ---
 - (a) Stock of goods is reduced by Rs. 50,000; (b) A new asset (debtor) is increased by Rs. 70,000, as goods have been sold on credit basis; (c) The owner's equity is increased by Rs. 20,000 (the profit):
 The equation will be;

<u>Assets</u>	=	<u>Liabilities + Owner's equity</u>
Cash + Building + Furniture + Goods + Debtors	=	Creditors + : Capital
200000+200000 + 30000 + 120000 + Nil	=	30000 + 520,000
- 50000 + 70000	=	+ 20000
200000 + 200000 + 30000 + 70000 + 70000	=	30000 + 540000

TRANSACTION NO. 8

Creditor was paid Rs. 30,000. The result of this transaction is -- a liability (creditor) is decreased by Rs. 30,000 and cash (asset) is also decreased by Rs. 30,000. Now, the equation is;

<u>Assets</u>	=	<u>Liabilities + Owner's equity</u>
Cash + Building + Furniture + Goods + Debtors	=	Creditors + : Capital
200000+200000 + 30000 + 70000 + 70000	=	30000 + 540,000
- 30000	=	- 30000
170000 + 200000 + 30000 + 70000 + 70000	=	Nil + 540000

TRANSACTION NO. 9

Cash received from the debtor Rs. 40,000. The result of this transaction is -- cash (asset) increased by Rs. 40,000 and debtor (asset) decreased by Rs. 40,000. The equation is;

<u>Assets</u>	=	<u>Liabilities + Owner's equity</u>
Cash + Building + Furniture + Goods + Debtors	=	Creditors + : Capital
170000+200000 + 30000 + 70000 + 70000	=	Nil + 540,000
+ 40000 - 40000	=	
210000 + 200000 + 30000 + 70000 + 30000	=	Nil + 540000

TRANSACTION NO. 10

Goods costing Rs. 25,000 were lost by fire. The result of this transaction is-- stock of goods is reduced by Rs. 25,000 and owner's equity is also decreased by Rs. 25,000 (as loss will be born by the owner). The equation is;

this chapter.

✓ DOUBLE ENTRY SYSTEM:

We have already seen in this chapter that every business transaction causes at least two changes in the financial position of a business concern at the same time – hence, both the changes must be recorded in the books of account. Otherwise, the books of accounts will remain incomplete and the result ascertained therefore will be inaccurate. For example, we buy machinery for Rs. 100,000. Obviously, it is a business transaction. It has brought two changes – machinery increases by Rs. 100,000 and cash decreases by an equal amount. While recording this transaction in the books of accounts, both the changes must be recorded. In accounting language these two changes are termed as "a debit change" and "a credit change"

(1) Start Pr. copy -

(the detail about these two terms is given later in this chapter under the topic "Account"). Thus we see that for every transaction there will be two entries - one debit entry and another credit entry. For each debit there will be a corresponding credit entry of an equal amount. Conversely, for every credit entry there will be a corresponding debit entry of an equal amount. So, the system under which both the changes in a transaction are recorded together - one change is debited, while the other change is credited with an equal amount - is known as Double Entry system.

Locus Pacioli, an Italian wrote a first book on double entry system in 1494. It is regarded as the best and the only scientific method of accounting system universally accepted throughout the world. It has been built on well defined rules and principles which is the foundation of modern Accountancy.

The fundamental principle of this system lies in analysing the two changes (parties) involved in business transactions and properly recording of both the changes in the books of accounts. There is no exception to this principle. If a complete picture of the transactions is to be reflected through books of accounts, the double entry system must be duly observed. Otherwise, the books of accounts will fail to provide complete information and the very objective of accounting will be defeated.

In this connection, the successive processes of the Double Entry System may be noted:

(1) **JOURNAL:** → *Daily record / Book keeping.*

First of all, transactions are recorded in a book known as Journal.

(2) **LEDGER:** → *Each person has a personal record.*

In the second process, the transactions are classified in a suitable manner and recorded in another book known as Ledger.

(3) **TRIAL BALANCE:**

In the third process, the arithmetical accuracy of the books of account is tested by means of Trial Balance.

(4) **FINAL ACCOUNTS:**

In the fourth & final process the result of the full year's working is determined through Final Accounts.

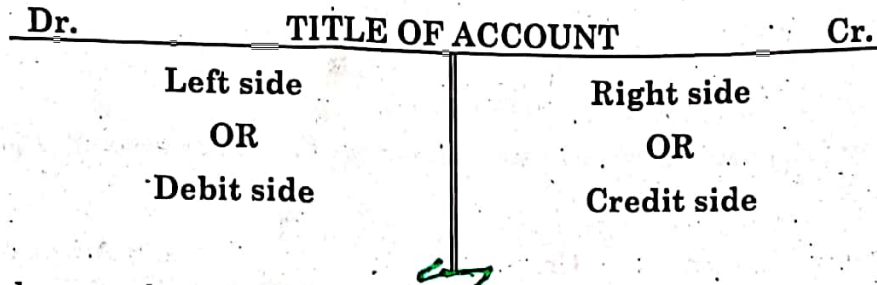
All the above process have been discussed in details in the following Chapter.

ADVANTAGES:

Double Entry system is acknowledged as the best method of accounting in the modern world. The following advantages are derived from it:

- (1) Under this system both the aspects of each and every transaction are recorded. So, it is possible to keep complete account.
- (2) Since both the aspects of a transaction are recorded, for each debit there must be a corresponding credit of an equal amount. Therefore, total debits must be equal to total credits. In fact, it is possible to verify the arithmetical accuracy of the books of account by ascertaining whether the two sides become equal or not through a process known as Trial Balance.

They are two types of changes that may take place in an Account, e.g. either there will be increase or there will be decrease. Take the example of Cash (an asset), either there is inflow of cash or there is outflow of cash. To record these two types of changes, every account (a page) is divided into sides. Increase is recorded on one side and decrease is recorded on the other side. The specimen of an account (a 'T' form of an account) is shown below:



When a change takes place in an account, either it will be recorded on the left side (Debit Side) or on the right side (credit side). Amounts recorded on the left side of an account, regardless of the account title, are called **debts**, and the account is said to be **debited**. Amounts recorded on the right side of an account are called **Credits**, and the account is said to be **credited**. Now keeping in mind the concept of double change in every business transaction, we can say that every business transaction affects a minimum of two accounts and every change (in a particular transaction) is recorded in a separate account. Now question arises, how the changes are recorded in different account? It depends upon the rules of debiting and crediting which have been discussed below:

IMPORTANT NOTES:

All the accounts are kept in a register known as '**LEDGER**'. Recording business transactions in various accounts in ledger is in fact the 2nd phase of accounting cycle (the first phase is **JOURNAL**). But to have a better understanding of rules of debiting and crediting, the topic of accounts has been discussed in this chapter. The proper format of ledger accounts will be discussed in chapter No. 5.

RULES FOR DEBITING AND CREDITING:

All the accounts maintained in the ledger of a business are classified into five;

- ✓(1) Accounts of Assets.
- (2) Accounts of Liabilities.
- (3) Accounts of Owner or Owner's Equity.
- ✓(4) Accounts of Expenses.
- ✓(5) Accounts of Revenues.

Debit +
Credit -

1. RULE FOR DEBITING OR CREDITING ACCOUNTS OF ASSETS: AN EXAMPLE:

- (i) Increase in an asset is recorded on the left side or debit side of the account.
- (ii) Decrease in a asset is recorded on the right side or credit side of the account.

3

In simple words, when there is increase in an asset, the amount is recorded on the debit side of that particular asset account and when there is decrease in an asset, the amount is recorded on the credit side of that particular asset account.

For example, furniture is purchased for Rs. 20,000 on cash basis. This is a business transaction and it has brought two changes:

- (a) Increase in furniture by Rs. 20,000 (an asset).
- (b) Decrease in cash by Rs. 20,000 (an asset).

These two changes are recorded in two accounts:- Furniture account and cash account in the following way:

Dr.	Furniture Account	Cr.	Dr.	Cash Account	Cr.
	Rs. 20,000				Rs. 20,000

When an amount of Rs. 20,000 is recorded on the debit side of Furniture account, it is said that Furniture account is **debited** and when an amount of Rs. 20,000 is recorded on the credit side of cash account, it is said that cash account is **credited**.

The rule may be illustrated in the following way;

Dr.	ASSETS ACCOUNT	Cr.
(1)	Debit side for Increase	Credit side for Decrease

The other rules for debiting and crediting the accounts are given below:

Dr.	Liability Account	Cr.
(2)	Debit side for Decrease	Credit side for Increase

Dr.	Expense Accounts	Cr.
(3)	Debit side for Increase	Credit side for Decrease

Dr.	Capital Account	Cr.
(4)	Debit side for Decrease	Credit side for Increase

Dr.	Revenue Accounts	Cr.
(5)	Debit side for Decrease	Credit side for Increase

WHAT IS AN ACCOUNT?

In business concerns, numerous transactions take place every day. For example, goods are sold to various customers every day, purchases are made from suppliers, cash is paid to creditors and is received from debtors, expenses are paid etc. All these transactions should be properly analysed and recorded. Again, the concept of double entry system of accounting is important to keep in mind. To record these changes different accounts are maintained in the Ledger (Detailed discussion about Ledger is made in chapter No. 5). Now, what is an account? Account is the individual record of an asset, a liability, revenue, an expense or capital in a summarized manner. For example, the individual record of cash (an asset) is known as Cash Account, the individual record of purchases is Purchases Account, the individual record of owner is Capital Account, the individual record of sales is Sales Account. In the same way there are so many accounts which are opened in the Ledger like Salary Account, Machinery Account, Furniture Account etc. How many accounts there should be in the Ledger of a business? It depends upon the nature and size of the business.

Generally one full page is fixed in the Ledger for each account. But it depends, how many times the changes take place in that particular account. Some accounts are very busy accounts like Cash Account, Bank Account and Sales Account. Obviously, for such accounts one page for each will not be enough and so, they need more pages in the ledger to be fixed. In some accounts, changes take place only once or twice in a year, so only one page will be enough, e.g. Machinery Account, Capital Account, Loan Account etc.

EXPLANATION OF THE RULES:

1. Rule regarding the debiting and crediting the accounts of assets has been explained earlier.
2. When a liability is created or increased by an amount, that amount is recorded on the credit side of the concerned liability account and when a liability is reduced or decreased, the amount is recorded on the debit side of that particular liability account. For example, if furniture is purchased for Rs. 10,000 from Mr. Arif on credit basis, two changes will take place;

- (a) Furniture is increased by Rs. 10,000 (an asset).
- (b) A liability (creditor Mr. Arif) is increased by Rs. 10,000.

The two changes are recorded in two accounts:

Dr.	Furniture Account	Cr.	Dr.	Mr. Arif Account (a liability)	Cr.
	Rs.				Rs.
	10,000				10,000

Suppose, after sometime cash is paid to Mr. Arif (a liability) amounting to Rs. 6,000. Again, there are two changes;

- (a) Cash is decreased by Rs. 6,000 (an asset).
- (b) Liability (creditor Mr. Arif) is decreased by Rs. 6,000.

The two changes are recorded in two accounts; on the debit side of Mr. Arif account (for decrease in liability Mr. Arif account is debited) and on the credit side of cash account (Being decrease in asset).

3. When an expenses is incurred (increased) by an amount, that amount is recorded on he debit side of that particular Expense account. For example, wages are paid in cash amounting to Rs. 18,000. The two changes have taken place;

- (a) Wages incurred (increase in expense) by Rs. 18,000.
- (b) Cash decreased (an asset) by Rs. 18,000.

These two changes are recorded in two accounts:

Dr.	Wages Account (An Expense)	Cr.	Dr.	Expense Accounts	Cr.
	Rs.				Rs.
	18,000				18,000

NOTE:

There are very rare examples of decrease in expenses. So, all expenses accounts are generally debited.

(5)

4. When Capital or Owner's Equity is increased (amount invested by the owner is increased) by an amount, that amount is recorded on the credit side of the capital account. For example, Mr. Ashraf (the owner) invested Rs. 200,000 in cash in his business. There are two changes:

- (a) Increase in capital or Owner's Equity (internal borrowing) by an amount of Rs. 200,000.
- (b) Increase in cash by an amount of Rs. 200,000 (an asset).

These two changes are recorded in two accounts:

Dr. Capital or Owner's Equity A/c Cr.	Dr. Cash Account Cr.
Rs. 200,000	Rs. 200,000

5. When there is increase in the revenue (increase in sales, Discount received, commission received, interest received) of the business by an amount, that amount is recorded on the credit side of that particular revenue account. For example, goods worth Rs. 30,000 are sold for cash. The two changes are:

- (a) Increase in sales (a revenue) by Rs. 30,000.
- (b) Increase in cash (an asset) by Rs. 30,000.

These two changes are recorded in two accounts:

Dr. Sales Account (A revenue) Cr.	Dr. Cash Account (An Asset) Cr.
Rs. 30,000	Rs. 30,000

NOTE:

There are very rare examples, when revenue is decreased. So, all revenue accounts are generally credited.

STEPS TO REMEMBER FOR APPLICATION OF RULES:

1. See the number of changes which have taken place in a business transaction.
2. In which accounts those changes should be recorded?
3. Apply the rules for debiting and crediting according to the classifications of those accounts.

A COMPREHENSIVE ILLUSTRATION TO UNDERSTAND THE RULES:

TRANSACTION NO. 1

Mr. Zeeshan started his business by investing Rs. 200,000 cash.

ANALYSIS:

- (a) This transaction has brought two changes.
 - (i) Cash is increased by Rs. 200,000.
 - (ii) Capital or Owner's Equity is increased by Rs. 200,000.

- (b) These two changes are recorded in two accounts, Cash Account and Capital Account.
- (c) Increase in cash (an asset) is recorded on the debit side, increase in capital is recorded on the credit side:

See the rules for Assets & Capital Account	Dr. Cash Account		Cr. Capital Account		
	Rs.		Rs.		
(1)	200000	(2)	20000	(1)	200000
(6)	18000	(5)	28600		
(9)	7200	(10)	10000		
		(11)	9000		

TRANSACTION NO. 2

He purchased furniture for Rs. 20,000 and paid cash.

ANALYSIS:

- (a) The two changes are:
- (i) Furniture is increased by Rs. 20,000.
 - (ii) Cash is decreased by Rs. 20,000.
- (b) These two changes are recorded in two accounts; Furniture Account and Cash Account.
- (c) Increase in furniture is recorded on the debit side of furniture account and decrease in cash is recorded on the credit side of cash account.

See the rule
for Assets
Accounts.

Dr.	Furniture Account	Cr.
	Rs.	
(2)	20,000	

TRANSACTION NO. 3

Goods are purchased from Mr. Aslam for Rs. 30,000 on credit basis.

ANALYSIS:

- (a) The two changes are;
- (i) Goods (purchases) increased by Rs. 30,000 (an expense).
 - (ii) A creditor, Mr. Aslam is created by Rs. 30,000 (a liability).
- (b) These two changes are recorded in two accounts:- Purchases Account and Mr. Aslam Account (a liability).
- (c) Increase in goods is recorded on the debit side of Purchases account and increase in liability on the credit side of Mr. Aslam account.

See the rules
for Expenses
and liability
accounts.

JOURNAL: THE ORIGINAL BOOK OF ENTRY

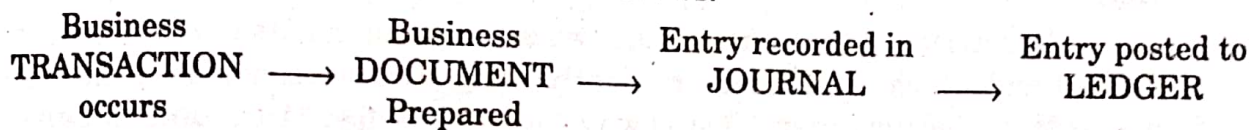
JOURNAL: 1ST PHASE OF ACCOUNTING CYCLE

In the previous chapter, we have discussed in detail that how the business transactions are analysed and how different accounts are debited and credited. Now, we are in a good position to record various business transactions in proper books of accounts. According to Double Entry System transactions are recorded in the books of accounts in two stages:

First Stage — Journal

Second Stage — Ledger

The flow of accounting information from the time a transaction takes place to its recording in the ledger may be illustrated as follows:



NOTE:

The initial record of each transaction is evidenced by a business document such as invoice, cash voucher etc.

Transactions are first recorded in Journal and thereafter posted to the two or three concerned accounts in the Ledger. Ledger has been discussed in details in the next Chapter.

DEFINITION:

The word "Journal" has been derived from the French word "Jour". Jour means day. So, Journal means daily. Transactions are recorded daily in Journal and hence it has been named so. As soon as a transaction takes place its debit and credit aspects are analysed and first of all recorded chronologically in a book together with its short description. This book is known as **Journal**. Thus we see that the most important function of Journal is to show the relationship between the two accounts connected with a transaction. This facilitates writing of Ledger. **Walter Grierson** has rightly described the book as "simply assistant of Ledger". Since transactions are first of all recorded in Journal, so it is called **Book of Original Entry** or **Prime Entry** or **Primary Entry** or **Preliminary Entry** or **First Entry**.

ENTRY:

Recording a transaction in the appropriate place of the concerned book of account is called **Entry**. Entry may be divided into two:

JOURNAL ENTRY:

Recording a transaction in a Journal is called **Journal Entry** or **Journalising**.

LEDGER ENTRY:

Recording a transaction from Journal to the concerned account in Ledger is called **Ledger Entry**. It is also known as **Ledger posting**.

NARRATION:

A short explanation of each transaction is written under each entry which is called **Narration**. The subject matter of the transaction can be ascertained through narration. Besides this, if there be any mistake in determining debit or credit aspect of a transaction, can be easily detected from narration. "A Journal entry is not complete without narration".

CHARACTERISTICS:

Journal has the following features:

- (1) Journal is the first successful step of the Double Entry system. A transaction is recorded first of all in the Journal. So, Journal is called the book of **Original Entry**.
- (2) A transaction is recorded on the same day it takes place. So, Journal is also called a **Day Book**.
- (3) Transactions are recorded chronologically. So, Journal is called **Chronological Book**.
- (4) For each transaction the names of the two concerned accounts indicating which is debited and which is credited, are clearly written in two consecutive lines. This makes ledger-posting easy. That is why Journal is called "Assistant to Ledger" or "**Subsidiary Book**".
- (5) Narration is written below each entry.
- (6) The amount is written in the last two columns - debit amount in Debit column and credit amount in Credit column.

ADVANTAGES:

The following are the advantages of Journal:

- (1) Each transaction is recorded as soon as it takes place. So there is no possibility of any transaction being omitted from the books of account.
- (2) Since the transactions are kept recorded in Journal chronologically with narration, it can be easily ascertained when and why a transaction has taken place.
- (3) For each and every transaction which of the two concerned accounts will be debited and which account credited, are clearly written in Journal. So, there is no possibility of committing any mistake in writing the Ledger.
- (4) Since all the details of transactions are recorded in Journal, it is not necessary to repeat them in Ledger. As a result Ledger is kept tidy and brief.
- (5) Journal shows the complete story of a transaction in one entry.
- (6) Any mistake in Ledger can be easily detected with the help of Journal.

FORMAT OF THE JOURNAL

Date	Details	L/F	Amount Rs.	Amount Rs.
	Account to be debited..... Dr.		x x x	
	Account to be credited (Narration)			x x x

RULES FOR JOURNALISING

How a transaction is recorded in Journal, is discussed below: Suppose the transaction is —

Purchased furniture from M. Asif on 10.1.05 for Rs. 16,000.

Here Furniture A/c is debited and M. Asif A/c is credited.

JOURNAL

Date	Details	L/F	Dr.	Cr.
			Amount, Rs.	Amount Rs.
2005 Jan. 10	Furniture A/c Dr. M. Asif A/c (Being cost of furniture purchased)		16,000	16,000

Now the various columns of Journal are explained in details below:

1. DATE:

The date of transaction is written in this column in two lines - in the first line, the year and in the second line, first the name of month and thereafter the actual date.

2. DETAILS:

In this column the names of the two connected accounts are written in two consecutive lines - in the first line the name of Account debited and in the second line the name of Account credited. While the name of Account debited always placed close to the left-hand margin line, the name of Account credited is commenced a short distance away from the margin line. This arrangement will show clearly which account is debited and which credited. This also shows that Credit Amount is placed on the right side of Debit Amount. The word "Dr" is used at the end of the name of Account debited. It is not necessary to place the word "Cr" after the name of Credited Account, because if one account is Dr. it follows that the other account must be Cr. Below the names of the two Accounts, i.e. in the third line **Narration** is written usually within a bracket. According to tradition, narration is written starting with the word "Being". But modern practice is not to use this word.

NOTE:

In most of the countries, (even in Great Britain) using the word "TO" at the beginning of the name of account credited has become out-dated. So, in this book it has not been used. But it is optional for the students.

3. L.F. (LEDGER FOLIO):

The page numbers of the Ledger where the two concerned accounts have been posted are written in this column against the name of each account. This will help locating easily the two concerned accounts from the Ledger. On the other hand, when a transaction is posted to Ledger, the concerned folio number of the Ledger is written in this column. Thus if a folio number stands written in this column, it will mean that the transaction has already been posted to Ledger.

4. AMOUNT:

The debit amount is written in the first "Amount" column against the name of Account debited and the credit amount in the second "Amount" column against the name of Account credited.

NOTE:

Although the above form of Journal is used in examination answer book, it is not fully correct. Because in large concerns Journal is divided into eight subdivisions for the sake of convenience. Out of them only in one subdivision (i.e. Journal Proper) the above form is used. In the remaining seven subdivisions the form of Journal is different.

SIMPLE ENTRY & COMPOUND ENTRY

Every transaction affects two accounts - one account is debited and another account is credited. Thus in recording a transaction in a Journal one account is debited and another account is credited. This type of entry is called Simple Entry. For example, on 10.4.05 we bought furniture for Rs. 10,000 from Salman Bros. The entry is:

JOURNAL				
Date	Details	L.F.	Dr.	Cr.
			Amount	Amount
			Rs.	Rs.
2005 Apr. 10	Furniture A/c Dr. Salman Bros. A/c (Being furniture bought on credit)		10,000	10,000

The entry in which more than one account is debited or more than one account is credited, is known as Compound Entry. Three or more accounts are connected with compound entry. For example suppose, on 18.5.05 we paid Rs. 1,000 on account of salaries and Rs. 600 on account of rent. For this the entry will be:

e.g.

JOURNAL

Date	Details	L.F.	Dr.	Cr.
			Amount Rs.	Amount Rs.
2005 May 16	Salaries A/cDr. Rent A/c..... Dr. Cash A/c (Being salaries and rent paid)		1,000 600	1,600

Here two accounts have been debited and the entry involves three accounts. Hence, it is a compound entry.

In this connection, it may be noted that the business and its proprietor are different and separate. So transactions relating to business are to be recorded in the books of business, while the private transactions of the proprietor of business are to be recorded in the personal books of the proprietor. No private transactions of the proprietor can be recorded in the books of business. On the other hand, no transactions of the business can be recorded in the books of its proprietor. But transaction in between the proprietor and his business must be recorded in the books of both the proprietor and his business. If these rules are not strictly followed, the books of account will fail to disclose the true result of business.

NOTE:
We are concerned with the books of business, not with the private books of proprietor. Transactions between the business and its proprietor are recorded in the following two accounts:

1. CAPITAL ACCOUNT:

The money with which proprietor starts his business, is called capital. When proprietor brings capital in the business, it is recorded in Capital A/c. Capital A/c is in fact the personal account of the proprietor. So, it is a Personal Account. The proprietor has given benefit to the business through introduction of capital. So Proprietor's A/c, i.e. Capital A/c will be credited. From the viewpoint of book-keeping the introduction of capital to the business by proprietor means that the proprietor lends the money to his business and the business becomes indebted to him. The proprietor is regarded as a special or internal creditor to the business.

EXAMPLE:

M. Rashid started a business with Rs. 20,000.

Date	Details	L.F.	Dr.	Cr.
			Amount Rs.	Amount Rs.
	Cash A/cDr. Capital A/c (Being capital brought in)		20,000	20,000

2. DRAWINGS ACCOUNT:

If the proprietor draws any money or goods from his business for his personal use will be recorded in Drawings A/c. Drawings A/c is the personal account of the proprietor and is classified as Personal Account. Proprietor receives benefit, when he withdraws money or goods from business. So the Proprietor's A/c, i.e. Drawings A/c is debited.

EXAMPLE:

Date	Details	L.F.	Dr.		Cr.	
			Amount Rs.		Amount Rs.	
	Drawings A/c	Dr.	2,000			
	Cash A/c				2,000	
	(Being amount withdrawn by proprietor)					

CASH DISCOUNT

The manufacturers and whole sellers frequently grant a cash discount to their debtors who will pay their debts before due date for goods purchased by them on credit. The seller regards it a 'Cash discount' or 'Sales discount, or discount allowed', the buyer calls the discount as 'Purchase discount' or 'discount received'. The use of sales discounts not only stimulate prompt collection but also tend to reduce the possibilities of losses resulting from 'Bad Debts'.

The type and amount of Cash discounts depend upon the 'CREDIT TERMS' settled mutually at the time of bargaining.

The terms have been discussed below:

Types of Terms	Explanation
1. 2/10, n/30	A discount of 2 % is allowed, if payment is made within 10 days from the date of sale. The term of credit allowed is 30 days.
2. 1/15, n/30	A discount of 1 % is allowed, if the payment is made within 15 days from the date of sale of goods. The term of credit allowed is 30 days.

GOODS TAKEN BY THE OWNER FOR PERSONAL USE:

Sometimes goods are taken away by the owner from the business for his personal or family use. Undoubtedly, goods are going out of the business but not sold. So, sales account should not be credited, instead Purchases Account should be credited because this is reduction in the goods purchased.

GOODS GIVEN AWAY AS CHARITY, FREE SAMPLES OR GOODS LOST:

When goods are given away as charity or free samples, this is not sale of goods, so not credited to sales account. Similarly, when goods are lost by fire or by theft or an accident, purchases account should be given the credit.

LEDGER: THE MAIN BOOK OF ACCOUNTS

Does the journal replace the need for a Ledger? No, the journal does not replace the ledger. The journal provides a complete listing of the daily transactions of a business. But it does not provide information about a specific account in one place. To know how much cash balance we have, for example, the accounting clerk would have to check all the journal entries in which cash is involved, and this is very labourious job; because, there are hundreds or even thousands of cash transaction are recorded on different pages of Journal. To avoid this difficulty, the debits and credits of journalised transactions are transferred to ledger accounts. Thus all the changes for a single account are located in one place-- in a ledger account. This makes it easy to determine the current balance of any account.

The book in which accounts are maintained, is called **Ledger**. Generally, one account is opened on each page of this book, but if transactions relating to a particular account are numerous, it may extend to more than one page. All transactions relating to that account are recorded therein chronologically. From journal each transaction is posted to at least two concerned accounts --- Debit side of one account and credit side of another account. Remember that, **if there are two accounts involved in a journal entry, it will be posted to two accounts in the ledger and if the journal entry consists of three accounts (compound entry) it will be posted to three different accounts in the ledger.**

This process of transferring information --- debits and credits --- from Journal to Ledger is known as **posting**. The goal of all transactions is ledger. **William Pickles** has rightly said that ledger is "**the destination of the entries made in the journal**". According to Arther Field house, ledger is the "**permanent store -- house of all the transactions**". But it must be remembered that transactions cannot be recorded directly in the ledger --- they must be routed through journal.

Transactions → Journal → Ledger.

So, the book in which all the transactions of a business concern are finally recorded in the concerned accounts in a summarised and classified form, is called **Ledger**.

FEATURES :

The ledger has the following features :

1. It has two identical sides - left hand side (debit side) and right hand side (credit side).
2. Debit aspect of all the concerned transactions is recorded on Debit side, while credit aspect on credit side according to date.
3. The difference of the totals of the two sides represents balance. The excess of debit side over credit side indicates **debit balance**, while excess of credit side over debit side indicates **credit balance**. If the two sides are equal, there will be no balance.
4. Generally, balance is drawn at the year end and recorded on the lesser side to make the two sides equal. This balance is known as closing balance.
5. The closing balance of the current year will be the opening balance of the next year.

FORMS OF LEDGER ACCOUNTS:

There are two forms of ledger accounts;

1. Standard form.
2. Self-balancing form.

1. STANDARD FORM OF LEDGER ACCOUNT:

To understand clearly as to how to write the accounts in ledger, the standard form of an account given below with two separate transactions;

Dr.						Cr.	
Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
2005 Dec. 17	Cash A/c		1,200	2005 Dec. 11	Purchase A/c		2,000

It appears that each account has got two similar sides -- the left hand side is called Debit (briefly Dr.) side and the right hand side is called Credit (briefly Cr.) side. Now a days these two words Dr. and Cr. are not used, because it is obvious that the left hand side is Debit side and right hand side is credit side.

Detailed discussions are being made below about the columns of an account :

1. DATE:

The date of the transaction is written in this column in two lines ___ in the first line the year and in the second line, first the name of month and thereafter the actual date.

2. REFERENCES:

In this column the name of the opposite account in the journal entry is written. For example, a journal entry contains two accounts, cash account is debited and sales is credited. While making the posting in the cash account, amount will be written on debit side of cash account in the amount column but in the reference column the opposite account (Sales account) will be written. In the same way while making the posting in the sales account, amount will be written on credit side of sales account in the amount column but in the reference the opposite account (Cash account) will be written.

3. JOURNAL REFERENCE (J. R.):

The page number of the journal from where the transaction has been posted, is mentioned in this column. This will help in locating the entry in the Journal easily.

4. AMOUNT:

The amount of the transaction is recorded in this column.

NOTE: While making the posting in ledger accounts it should be borne in mind that the name of the same account will never appear in "Reference" column of that account, but the name of the opposite account should be stated.

POSTING PROCEDURE

1. Locate the ledger account for the first debit in the Journal entry.
2. Record the date in the Date column on the debit side of the account. The date is the date of transaction rather than the date of the posting.

3. Record the name of the opposite account (account credited in entry) in the reference column.
4. Record the page number of the Journal in the Journal Reference column from where the entry is being posted.
5. Record the amount of the debit in the "Amount column" on the debit side of the account.
6. Locate the ledger account for the first credit in the Journal entry and follow the same procedure.

BALANCING AN ACCOUNT

The difference between the two sides of an account is its balance. The balance is written on the lesser side to make the two sides equal. This process of equalising the two sides of an account is known as **Balancing**.

The rules for balancing an account are stated below:

1. Add up the amount columns of both the sides of an account and write the totals in a separate slip of paper. *Rules for balancing*
2. Find out the difference of the two totals.
3. Write down the difference on the lesser side of the account.
4. Now total up both the sides and write the totals and draw double lines under them.
5. Again write the difference on the opposite side below the double lines.

If the Debit side of an account is heavier, its balance is known as **debit balance** and if credit side is heavier, its balance is known as **credit balance**. If the two sides of an account are equal, that account will show zero balance. The rules for determining the balance are as follows:

Total Debit	➤	more than total credit	=	Debit balance
Total Credit	➤	more than total Debit	=	Credit balance ✓
Total Debit	=	Total credit	=	Nil balance

It may be noted that at the time of balancing an account debit balance is placed on the credit side and credit balance on the debit side. This balance is known as **closing balance** and when next year will start, it will be the opening balance. In other words, **what is closing balance in this year, is the opening balance of next year.**

NORMAL BALANCES

The normal balances of various accounts are illustrated below :

Accounts of Assets normally have	=	Debit balance.
Accounts of Expenses normally have	=	Debit balance.
Accounts of Revenue normally have	=	Credit balance.
Accounts of Liabilities normally have	=	Credit balance.
Account of Owner (capital) normally has	=	Credit balance.

TRIAL BALANCE

The fundamental principle of Double entry system is that at any stage, the total of Debits must be equal to the total of credits. If entries are recorded and posted correctly, the ledger will reflect equal debits and credits, and the total credit balances will then be equal to the total debit balances.

Every business concern prepares Final Accounts at the end of the year to ascertain the result of the activities of the whole year. To ensure correct result, the concern must be free from doubt that the books of accounts have been correctly recorded throughout the year. Trial Balance is prepared to test the arithmetical accuracy of the books of accounts. As we know that under double entry system for each and every transaction one account is debited and another account is credited with an equal amount. If all the transactions are correctly recorded strictly according to this rule, the total amount of Debit side of all the ledger accounts must be equal to that of Credit side of all the ledger accounts. This verification is done through Trial Balance.

If the trial balance agrees, we may reasonably assume that the books are correct. On the other hand, if it does not agree, it indicates that the books are not correct - there are mistakes somewhere. There are, however, a few types of errors which the trial balance cannot detect. In other words, the trial balance will agree in spite of the existence of those errors.

The trial balance is not an absolute or solid proof of the accuracy of books of accounts. Thus, if trial balance agrees, there may be errors or may not be errors. But if it does not agree, certainly there are errors.

The trial balance serves two main purposes.

1. To check the equality of debits and credits -- an arithmetical or mathematical test of accuracy.
2. To provide information for use in preparing Final Accounts.

Thus in the light of above discussion a Trial Balance may be defined as "an informal accounting schedule or statement that lists the ledger account balances at a point in time and compares the total of debit balances with the total of credit balances."

METHODS OF PREPARING TRIAL BALANCE:

There are three methods for the preparation of Trial Balance;

1. Total or Gross Trial Balance.
2. Balance or Net Trial Balance.
3. Total - Cum - Balance Trial Balance.

The methods No. 1 and 2 are discussed below in details :

1. TOTAL OR GROSS TRIAL BALANCE: ✓

Under this method the two sides of all the ledger accounts are totaled up. Thereafter, a list of all the accounts is prepared in a separate sheet of paper with two "Amount" columns on the right hand side. The first one for debit amounts and the second one for credit amounts. The total of debit side and credit side of each account is then placed on "Debit Amount" column and "Credit Amount" column respectively of the list. Finally, the two columns are added separately to see whether they agree or not. This method is generally not followed in practice.

2. BALANCE OR NET TRIAL BALANCE:

Under this method first of all the balances of all ledger accounts are drawn. Thereafter, the debit balances and credit balances are recorded in "Debit Amount" column and "Credit Amount" column respectively and the two columns are added separately to see whether they agree or not. **This is the most popular method and generally followed.**

The various steps involved in the preparation of "Balance or Net Trial Balance" are given below;

1. Find out the balance of each account in ledger.
2. Write up the name of account in the first column.
3. Record the account number in second column.
4. Record the debit balance of each account in Debit column and credit balance in credit column.
5. Add up the debit and credit columns and record the totals.

ILLUSTRATION NO. 3

Prepare the Balance or Net Trial Balance from the balances extracted in illustration No. 2.

TRIAL BALANCE

as at 8.1.2005

S. No	Account Names	A/c No.	Debit	Credit
1.	Cash Account			
2.	Furniture Account	5	105,800	
3.	Capital Account	7	20,000	
4.	Purchases Account	9	--	100,000
5.	Ahsan Account	11	30,000	
6.	Sales Account	13	--	30,000
7.	Shakeel Account	15	--	26,000
8.	Discount Account	17	--	--
		19	200	--
			156,000	156,000

NOTE:

If an account shows zero balance, it is not necessary to record it in Trial Balance.

ACCOUNTING CYCLE TO THE TRIAL BALANCE: ✓

The different stages of accounting cycle are given below:

1. DOCUMENTING:

All transactions which have taken place in a business concern and have no written evidence (vouchers) are noted on business printed forms called source documents.

2. RECORDING:

In this stage all business transactions with their source documents are recorded chronologically in Journal.

3. SUMMARISING:

The debit and credit aspects of transactions are transferred from journal to the concerned accounts in ledger. A trial balance is prepared which is a summary of the transactions which have taken place during an accounting period.

REPORTING:

The Trial Balance provides information to prepare financial statements or Final Accounts for the people who need them.

The accounting cycle is illustrated below;

