

ACCOUNTING BASICS

1. What is accounting?

Accounting is a comprehensive and structured system that deals with the complete financial life of a business. It begins with the identification of financial transactions, such as sales, purchases, payments, receipts, incomes, and expenses. These transactions are then recorded systematically in the books of accounts in a chronological order, ensuring accuracy, consistency, and reliability of financial data. After recording, the data is classified into relevant accounts (assets, liabilities, capital, income, and expenses) and summarised to prepare financial statements like the Trading Account, Profit and Loss Account, and Balance Sheet.

Beyond recording and reporting, accounting also involves analysis and interpretation of financial information, which helps management understand the financial health, profitability, liquidity, and stability of the business. It supports managerial decision-making, such as investment planning, cost control, budgeting, pricing, and expansion strategies. Accounting also plays a crucial role in ensuring legal compliance, as it helps in tax calculation, audit requirements, and statutory reporting. Overall, accounting provides a reliable financial framework that enables transparency, accountability, trust, and effective financial control, making it an essential backbone of every business organisation.

2. Basic Accounting Concepts

✓ **Business Entity Concept**

This concept states that the business and the owner are treated as separate entities. The personal transactions of the owner are not recorded in the business books. Only business-related transactions are accounted for.

Example: If the owner buys a phone for personal use, it is not a business expense.

✓ **Money Measurement Concept**

Only those transactions that can be expressed in monetary terms are recorded in accounting. Non-financial events like employee loyalty, brand value, or customer satisfaction are not recorded.

Example: Cash sales are recorded, but employee honesty is not.

✓ **Going Concern Concept**

This concept assumes that the business will continue to operate in the future and is not likely to shut down soon. Therefore, assets are recorded at cost and not at market value.

Example: Machinery is recorded at purchase price, not resale value.

✓ **Cost Concept (Historical Cost Concept)**

Assets are recorded in the books at their original purchase cost, including expenses incurred to bring the asset into use.

Example: If land is bought for ₹10 lakh, it is recorded at ₹10 lakh even if market value becomes ₹15 lakh.

✓ **Dual Aspect Concept**

Every transaction has two aspects – one giving and one receiving. This is the foundation of the double entry system.

Example: Cash paid for furniture → Cash decreases, Furniture increases.

✓ **Accounting Period Concept**

The life of a business is divided into equal time periods (usually one year) to measure profit or loss and financial position.

Example: Financial year from April to March.

✓ **Accrual Concept**

Income and expenses are recorded when they are earned or incurred, not when cash is received or paid.

Example: Salary due but unpaid is still recorded as expense.

✓ **Matching Concept**

Expenses are matched with the related income of the same accounting period to calculate correct profit or loss.

Example: Sales revenue and cost of goods sold are recorded in the same period.

✓ **Prudence (Conservatism) Concept**

Anticipate losses, but do not anticipate profits. Expenses and losses are recorded as soon as they are known, but income is recorded only when it is realised.

Example: Provision for bad debts is created for doubtful debtors.

3. **Double Entry System of Accounting**

The Double Entry System is a scientific and systematic method of recording business transactions in which every transaction affects at least two accounts – one account is debited and another is credited. It is based on the principle of the Dual Aspect Concept, which states that every transaction has two sides: a giver and a receiver or a source and a use.

Under this system, the total amount debited is always equal to the total amount credited, which ensures accuracy and balance in accounting records. This system forms the basis for preparing the Trial Balance, and ultimately the Final Accounts (Trading Account, Profit and Loss Account, and Balance Sheet).

Example:

If furniture is purchased for cash ₹20,000

■ Furniture Account → Debit ₹20,000 (asset comes in)

■ Cash Account → Credit ₹20,000 (asset goes out)

4. **Books of Accounts**

Books of Accounts are the systematic records in which all financial transactions of a business are properly recorded, classified, and summarized in an organized manner. These books provide a complete financial history of the business and help in preparing the Trial Balance, Final Accounts, and Financial Statements. They ensure accuracy, transparency, accountability, and legal compliance, and serve as the base for audit, taxation, and financial analysis. In simple words, books of accounts are the official financial records of a business. Types of Books of accounts as follows :

✓ **Primary Books (Books of Original Entry)**

These are the books where transactions are first recorded in chronological order.

• **Journal**

The journal is the primary book in which transactions are recorded for the first time based on the double entry system. Each transaction is recorded with date, debit account, credit account, amount, and narration. It is also called the book of original entry.

• **Subsidiary Books (Special Journals)**

To reduce workload and maintain efficiency, businesses maintain separate books for different types of transactions:

A) **Cash Book** – Records all cash and bank transactions (receipts and payments).

B) **Purchase Book** – Records credit purchases of goods.

C) **Sales Book** – Records credit sales of goods.

D) **Purchase Return Book (Return Outward)** – Records goods returned to suppliers.

E) **Sales Return Book (Return Inward)** – Records goods returned by customers.

F) **Bills Receivable Book** – Records bills receivable from debtors.

G) Bills Payable Book – Records bills payable to creditors.

H) Journal Proper – Records transactions not recorded in other subsidiary books (opening entries, closing entries, rectification entries, adjustment entries, etc.).

✓ **Secondary Books (Principal Books / Books of Final Entry)**

These are the books where transactions are classified and summarised after recording in primary books.

• **Ledger**

The ledger is the main book of accounts where all transactions are classified account-wise. Separate accounts are maintained for each asset, liability, income, expense, capital, and debtor/creditor.

It is called the book of final entry because it forms the basis for preparing trial balance and final accounts.

5. Golden Rules of Accounting

They are the basic principles used to decide which account should be debited and which account should be credited while recording business transactions under the double entry system. These rules are based on the classification of accounts into three main types, and each type has a specific debit and credit rule. These rules help in maintaining uniformity, accuracy, and consistency in journal entries. Let's see three types of accounts and their rules :

✓ **Personal Account**

Personal accounts relate to persons or entities with whom the business has financial dealings. This includes individuals, firms, companies, banks, and institutions.

Rule: Debit the receiver, Credit the giver

✓ **Real Account**

Real accounts relate to assets and properties of the business, both tangible and intangible.

Rule: Debit what comes in, Credit what goes out

✓ **Nominal Account**

Nominal accounts relate to expenses, losses, incomes, and gains of the business.

Rule: Debit all expenses/losses, Credit all gains/incomes

6. Modern Rules of Accounting

The Modern Rules of Accounting are based on the Accounting Equation approach and focus on the nature of accounts rather than the traditional classification into personal, real, and nominal accounts. These rules simplify accounting by classifying all accounts into five basic elements: Assets, Liabilities, Capital, Income, and Expenses. The modern approach is more logical, analytical, and widely used in computerized accounting systems and professional accounting practices. Classification under modern approach is as follows :

✓ **Assets**

Resources owned by the business that provide future economic benefit.

Examples: Cash, bank, stock, machinery, furniture, building, debtors, investments.

✓ **Liabilities**

Obligations or amounts payable by the business to outsiders.

Examples: Creditors, loans, outstanding expenses, bills payable.

✓ **Capital (Owner's Equity)**

Owner's claim on the business assets after liabilities.

Examples: Capital = Assets – Liabilities

✓ **Income (Revenue)**

Earnings or inflow of economic benefits.

Examples: Sales, commission received, interest received, rent received.

✓ **Expenses**

Costs incurred to earn income.

Examples: Salary, rent, wages, electricity, depreciation, carriage, advertising.

7. **Modern Debit & Credit Rules**

<u>Type</u>	<u>Debit When</u>	<u>Credit When</u>
<u>Assets</u>	Increase	Decrease
<u>Expense</u>	Increase	Decrease
<u>Liability</u>	Decrease	Increase
<u>Capital</u>	Decrease	Increase
<u>Income</u>	Decrease	Increase

8. **Accounting Concepts**

- ✓ **Sundry debtors** – Sundry debtors are the customers or clients who have purchased goods or services from a business on credit and are yet to make the payment. They represent the amount of money that the business expects to receive in the future, making them a current asset in the balance sheet. The term "sundry" means various, so sundry debtors refer to multiple such credit customers. In accounting, they fall under personal accounts and follow the rule "debit the receiver" because they have received value from the business. Regular monitoring of sundry debtors is important to ensure timely collection and avoid bad debts.
- ✓ **Fixed assets** – Fixed assets are long-term tangible assets that a business owns and uses for its operations over a period of time, usually more than one year. These assets are not meant for resale but are used to generate income and support business activities. Examples include land, buildings, machinery, vehicles, and furniture. Fixed assets are recorded on the asset side of the balance sheet and are generally subject to depreciation, except for land. Since they provide long-term benefits, they are also known as non-current assets. Investing in fixed assets shows the business's long-term stability and growth potential.
- ✓ **Current assets** – Current assets are short-term assets that a business expects to convert into cash, sell, or consume within one year or within the normal operating cycle, whichever is longer. They include cash and cash equivalents, accounts receivable (sundry debtors), inventory (stock), prepaid expenses, bills receivable, and short-term investments. These assets are shown on the asset side of the balance sheet under the current assets heading. Current assets are important for a business's day-to-day operations and help maintain liquidity, which means the ability to meet short-term financial obligations.
- ✓ **Investments** – Investments in accounting refer to the amount of money or resources a business puts into financial instruments or assets with the expectation of earning a return or profit in the future. These can include shares, bonds, debentures, mutual funds, fixed deposits, or real estate not used in regular business operations. Investments are usually classified into two types:
 - **Current Investments** – short-term, held for less than one year (e.g., short-term mutual funds).
 - **Non-Current Investments** – long-term, held for more than one year (e.g., shares held for future growth).They are shown on the asset side of the balance sheet and help the business earn extra income besides its core operations.
- ✓ **Stock in hand** – Stock in hand, also known as inventory, refers to the goods or materials a business holds at a given point in time that are meant for sale, production, or consumption during its operations. It includes raw materials, work-in-progress, and finished goods that are unsold. Stock in hand is a current asset and is shown on

the asset side of the balance sheet. It plays a key role in calculating the cost of goods sold (COGS) and determining the profitability of a business. Proper management of stock in hand ensures smooth production and sales without overstocking or shortages.

- ✓ **Loans & advances (Asset side)** – Loans and Advances shown on the asset side of the balance sheet represent the amounts that a business has given to others—such as employees, suppliers, or related parties—with the expectation of getting it back in the future. These are not expenses, but recoverable amounts.
 - Loans are amounts lent by the business for a longer period, often with interest.
 - Advances are short-term payments made in advance for goods, services, or expenses (like salary advance, advance to suppliers).Since both represent money that will return to the business, they are recorded as current or non-current assets depending on the repayment period. They help track what the business is owed and are important for assessing liquidity and financial health.
- ✓ **Cash in hand** – Cash in hand refers to the physical cash (currency and coins) that a business has on its premises at a given point in time. It includes money kept in the cash box, cash counter, or petty cash drawer for daily business operations such as making small payments, giving change, or meeting urgent expenses. It is considered a current asset and is shown on the asset side of the balance sheet. Cash in hand is important for maintaining liquidity, ensuring smooth day-to-day functioning, and is usually verified at the end of each day or accounting period through a cash book or cash register.
- ✓ **Sundry creditors** – Sundry creditors are the individuals or entities (usually suppliers) to whom a business owes money because it has purchased goods or services on credit. These are people the business needs to pay in the future, making them a current liability. The term "sundry" means "various," so sundry creditors refer to multiple small or different suppliers. They are shown on the liability side of the balance sheet under current liabilities. In accounting, sundry creditors fall under personal accounts and follow the rule "credit the giver", since they have provided goods or services to the business without immediate payment.
- ✓ **Current liability** – Current liabilities are the short-term financial obligations of a business that are expected to be settled within one year or within the business's normal operating cycle, whichever is longer. These include sundry creditors, bills payable, outstanding expenses, short-term loans, advance received from customers, and taxes payable. Current liabilities are shown on the liability side of the balance sheet under the heading Current Liabilities. They represent the amounts a business needs to pay in the near future, so managing them properly is important for maintaining liquidity and ensuring smooth day-to-day operations.
- ✓ **Bank overdraft** – Bank overdraft is a short-term credit facility provided by a bank that allows a customer to withdraw more money than what is available in their bank account, up to a pre-approved limit. It is considered a current liability because the overdrawn amount must be repaid to the bank, usually with interest. Businesses often use bank overdraft to manage temporary cash shortages or working capital needs. In the balance sheet, a bank overdraft is shown on the liability side under current liabilities. It is a flexible financing option, but excessive use can lead to high interest costs and financial strain if not managed properly.
- ✓ **Loans** – Loans shown on the liability side of the balance sheet refer to the amounts borrowed by a business from banks, financial institutions, or other parties, which the business is obligated to repay in the future. These are considered liabilities because they represent money that the business owes. Loans can be classified as:
 - **Short-term loans** – repayable within one year, shown under current liabilities.
 - **Long-term loans** – repayable after one year, shown under non-current liabilities.



Loans are usually taken to meet business needs such as buying machinery, expanding operations, or managing working capital. Since they involve a repayment obligation, often with interest, they must be managed responsibly to avoid financial stress.

- ✓ **Secured loans** – Secured loans are loans that are backed by collateral, meaning the borrower pledges an asset (such as property, vehicle, or equipment) to the lender as security for the repayment of the loan. If the borrower fails to repay, the lender has the legal right to seize and sell the pledged asset to recover the outstanding amount. In accounting, secured loans are shown on the liability side of the balance sheet under non-current liabilities (if long-term) or current liabilities (if short-term). Common examples of secured loans include home loans, car loans, and business loans against machinery or inventory. These loans typically come with lower interest rates compared to unsecured loans because the risk to the lender is reduced.
- ✓ **Unsecured loans** – Unsecured loans are loans that are not backed by any collateral or security. In these loans, the lender provides funds based solely on the borrower's creditworthiness and repayment capacity. Since there is no asset pledged, unsecured loans carry higher risk for the lender and therefore often come with higher interest rates. In accounting, unsecured loans are shown on the liability side of the balance sheet, under non-current liabilities (if repayable after one year) or current liabilities (if repayable within a year). Examples include personal loans, business loans without collateral, and credit card borrowings. These loans are useful for quick funding but must be managed carefully due to strict repayment terms and higher costs.
- ✓ **Provisions** – Provisions are amounts set aside from a business's profits to cover future known liabilities or losses, even though the exact amount or timing is uncertain. They are a type of adjustment entry made to ensure that all expected expenses are accounted for in the current accounting period. Provisions are shown on the liability side of the balance sheet, under current or non-current liabilities, depending on when the payment is expected.
- ✓ **Duties & Taxes** – Duties and Taxes refer to the various government levies that a business is required to collect, pay, or account for during its operations. These are considered current liabilities in accounting because they are usually payable within a short period (monthly, quarterly, or annually), and are shown on the liability side of the balance sheet under current liabilities. These amounts may be collected from customers or deducted from employees/vendors and must be paid to the respective government authorities. Timely payment and accurate reporting of duties and taxes are essential to avoid penalties, interest, or legal issues.
- ✓ **Reserves & Surplus** – Reserves and Surplus refer to the portion of a company's retained profits that are not distributed as dividends but are set aside to strengthen the financial position of the business. They are shown on the liability side of the balance sheet under shareholders' funds and represent the accumulated earnings over time. This includes capital reserves (created from non-operating profits like asset sales), revenue reserves (from regular business profits for future use), and surplus or retained earnings (profits left after paying dividends and taxes). Reserves and surplus help a company meet future uncertainties, fund expansion, and maintain financial stability without relying heavily on external borrowing.
- ✓ **Purchase** – Purchases refer to the total cost of goods bought by a business for resale or for use in production during an accounting period. It includes both cash purchases and credit purchases, and is recorded in the trading account on the debit side because it represents an expense incurred to earn revenue. Purchases are a key component in calculating the Cost of Goods Sold (COGS), which directly affects the gross profit of a business. If any goods are returned to suppliers, they are recorded as Purchase Returns and deducted from the total purchases.

- ✓ **Direct expenses** – Direct expenses are the costs that are directly related to the production of goods or services or to the purchase of goods for resale. These expenses are necessary to bring the goods to a saleable condition and are shown on the debit side of the trading account. Direct expenses are important because they help calculate the cost of goods sold (COGS) and determine the gross profit of a business.
- ✓ **Indirect expenses** – Indirect expenses are the costs that are not directly related to the production or purchase of goods but are necessary to run the overall business operations. These expenses are incurred after the goods are ready for sale and are shown on the debit side of the profit and loss account.
Indirect expenses help in managing, selling, and administering the business, and while they don't affect the cost of goods sold, they do reduce the net profit.
- ✓ **Miscellaneous expenses** – Miscellaneous expenses refer to small, irregular, or minor expenses that do not fall under any specific category but are necessary for the day-to-day running of a business. These are usually indirect expenses and are recorded on the debit side of the profit and loss account. Since these expenses are not significant individually, they are grouped together under the head "Miscellaneous Expenses" to simplify accounting records. While small, they are still important and must be properly tracked to ensure accurate profit calculation.
- ✓ **Capital** – Capital refers to the amount of money or assets invested by the owner into the business to start or run its operations. It represents the owner's claim on the business and is shown on the liability side of the balance sheet under "Capital Account" because, from the business's point of view, it is an amount payable to the owner. Capital can be in the form of cash, goods, or other assets contributed at the beginning or during the life of the business. Any additional investment increases capital, while withdrawals (drawings) or losses reduce it. In simple terms, capital is the financial foundation of the business.
- ✓ **Sales** – Sales refer to the total amount earned by a business from selling goods or services during an accounting period. It includes both cash sales and credit sales and is recorded on the credit side of the trading account because it generates revenue for the business. Sales are a key component in calculating gross profit (Sales – Cost of Goods Sold). If customers return goods, it is recorded as Sales Returns or Returns Inward, which is deducted from total sales to arrive at net sales. Sales reflect the core income of a trading or manufacturing business.
- ✓ **Indirect income** – Indirect income refers to the income earned by a business from sources other than its main operating activities, such as selling goods or services. It is not directly related to the core business but still contributes to the overall profit. Indirect income is recorded on the credit side of the profit and loss account. Indirect income helps improve the net profit of a business and is important for understanding additional sources of revenue beyond the regular business operations.
- ✓ **Branch & division** – A branch is a physically separate unit of a business that operates in a different location but remains under the control of the main office or head office. It usually performs similar activities as the main business, such as selling goods, providing services, or managing operations in a specific area. On the other hand, a division is an internal part of the organization structured around products, services, or functions, and may or may not have physical separation. For example, a company may have a Marketing Division, Finance Division, or Electronics Division. While branches focus on geographical spread, divisions focus on organizational structure and specialization. Both help in efficient management, performance tracking, and expansion of business operations.
- ✓ **Suspense account** – A suspense account is a temporary account used in accounting to record transactions when there is uncertainty or incomplete information about where the entry should go. It helps ensure that the trial

balance still tallies even if some details are missing at the time of recording. Once the correct account is identified, the amount is transferred from the suspense account to the appropriate account, and the suspense account is cleared. Suspense accounts can appear on either the asset or liability side of the balance sheet, depending on whether the amount is a debit or credit. It is mainly used to avoid delay in bookkeeping and is only a short-term solution until proper classification is done.

