UNIT 4 ACCOUNTING PROCESS AND RULES

Structure

4.0 OBJECTIVES

After studying this unit, you should be able to:

- identify the different stages of accounting
- classify accounts
- analyse the dual effect of each transaction
- apply the rules of accounting, and determine the account to be debited and the account to be credited.

4.1 INTRODUCTION

So far you have learnt the definition of accounting, its objects, advantages, the terms commonly used in accounting, and the basic accounting concepts relevant to record keeping. You know accounting is the art of recording, classifying and summarising the business transactions, and interpreting the results thereof. So, the accounting process starts with recording of transactions and ends with the preparation of financial statements and their analysis. In this unit we shall first identify the different stages involved in the accounting process and then discuss different classes of accounts, the principle of double entry, and the rules of debit and credit which you are expected to master.

4.2 ACCOUNTING PROCESS

The accounting process consists of the following four steps:

i) Recording the Transactions
ii) Classifying the Transactions
iii) Summarising the Transactions
iv) Interpreting the Results.

Recording the Transactions

The accounting process begins with recording of transactions in the books of original entry. The book used for the original entries is called 'Journal'. Business transactions are recorded in the journal as and when they occur in the order of dates. You will learn the method of recording a transaction in the journal in Unit 5. Entries in the journal are made on the basis of various vouchers such as cash memos, invoices, receipts, etc.

Classifying the Transactions

The second step is to group the transactions of similar nature and post them in different accounts in another book called the 'Ledger'. For example all transactions relating to cash are brought together and are recorded at one place in Cash Account in the ledger. Similarly, dealings with different persons are recorded separately in the account of each person. The accounts so prepared are totalled and balanced periodically to know the net effect of related transactions. We shall discuss the process of posting into ledger and balancing of accounts in detail in Unit 6.

Summarising the Transactions

The next step is to prepare a year-end summary known as 'Final Accounts'. But before final accounts are prepared, we prepare a statement called 'Trial Balance' to test the arithmetical accuracy of the work done. In other words the trial balance is prepared to find out whether the Principle of Double Entry has been strictly followed or not, while recording the transaction. Then, with the help of the trial balance and some other relevant information we prepare the final accounts. The objectives of preparing the final accounts are: (i) to know the net result of business activities, and (ii) to know the financial position of the business. The final accounts consist of an income statement called 'Trading and Profit and Loss Account', and a position statement called 'Balance Sheet'. The Trading and Profit and Loss Account is prepared to know whether the business unit has earned profit or incurred loss. The Balance Sheet is prepared to know the financial position of the business, i.e., what the business owns and what it owes. (Units 11 to 19 deal with the preparation of Trial Balance and the Final Accounts).

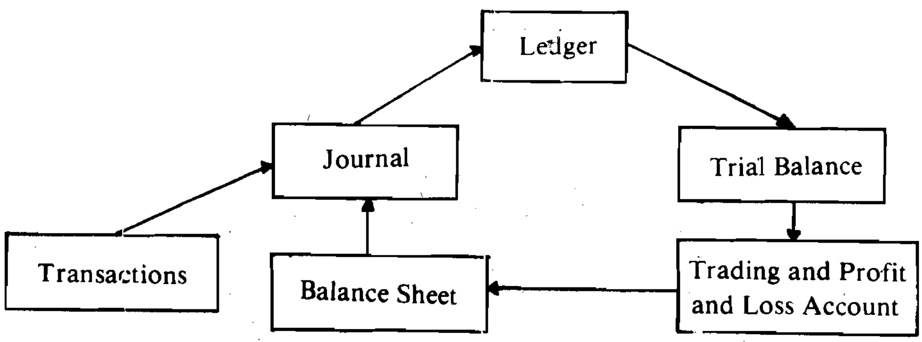
Interpreting the Results

The results are then analysed and interpreted with a view to assess the performance of the business, its future profit-earning capacity and its ability to pay short-term and long-term debts. The results and conclusions thus arrived at are reported to the interested parties like investors, management, bankers, creditors, tax authorities, etc.

The balances on various accounts shown in the Balance Sheet will then be transferred to the new books of account for the next year. The process of recording transactions for the next year is again started. This continuous process of accounting is referred to as the 'Accounting Cycle' because it repeats itself regularly and in the same order. The Accounting Cycle is presented in Chart 4.1.

CHART 4.1

ACCOUNTING CYCLE



4.3 WHAT IS AN ACCOUNT ?

We have seen in Unit 3 that an account is a summarised record of the effect of all transactions relating to a particular person or an item. Let us now learn more about this term.

An account is vertically divided into two halves and resembles the shape of the English alphabet 'T' as under:

Name of the account

Dr.	**Cr.**

The left hand side is called the 'debit side'. It is indicated by writing 'Dr.' (abbreviation for debit) on the left hand top corner of the account. The right hand side known as the 'credit side', is indicated by writing 'Cr.' (abbreviation for credit) on the right hand top corner of the account. The name of the account is written at the top in the centre. The word 'Account' or its abbreviation 'A/c' is added to the name of the account. The rules of recording the transactions on the debit and credit sides shall be discussed later in this unit.

4.4 CLASSIFICATION OF ACCOUNTS

All business transactions can broadly be classified into three categories: (i) those relating to persons, (ii) those relating to property (assets), and (iii) those relating to incomes and expenses. Hence, it becomes necessary to keep an account for each person, each asset, and each item of income and expense. Thus, three classes of accounts are maintained for recording all business transactions. They are: (i) Personal Accounts, (ii) Real Accounts, and (iii) Nominal Accounts. Real and Nominal Accounts taken together are called Impersonal Accounts.

Personal Accounts

Accounts which show dealings with persons are called 'Personal Accounts'. Such dealings may relate to credit purchases of goods or credit sales of goods or loans taken, etc. A separate account is kept in the name of each person for recording the benefits received from, or given to, the person in the course of dealings with him. Examples are: Krishna's Account, Gopal's Account, Loan from Ratanlal Account, etc.

Personal accounts also include accounts in the names of institutions or companies (called artificial persons) such as Indian Bank Account, Nagarjuna Finance Limited Account, the Andhra Pradesh Paper Mills Limited Account, etc.

The accounts which represent expenses payable, expenses paid in advance, incomes receivable, and incomes received in advance are also personal accounts, though impersonal in name. For example, when salaries are due to the employees, but not paid before closing of the books of account for the year, an account called 'Salaries Outstanding Account' will be opened in the books. The Salaries Outstanding Account is regarded as a personal account representing the employees to whom salaries are payable by the business. Such a personal account is called 'Representative Personal Account' as it represents a particular person or a group of persons. Other examples of representative personal accounts are: Interest Outstanding Account, Prepaid Insurance Account, Rent Received in Advance Account, Commission Outstanding Account, etc.

Capital Account and Drawings Account are also treated as personal accounts as they represent dealings with the owner of the business.

Real Accounts

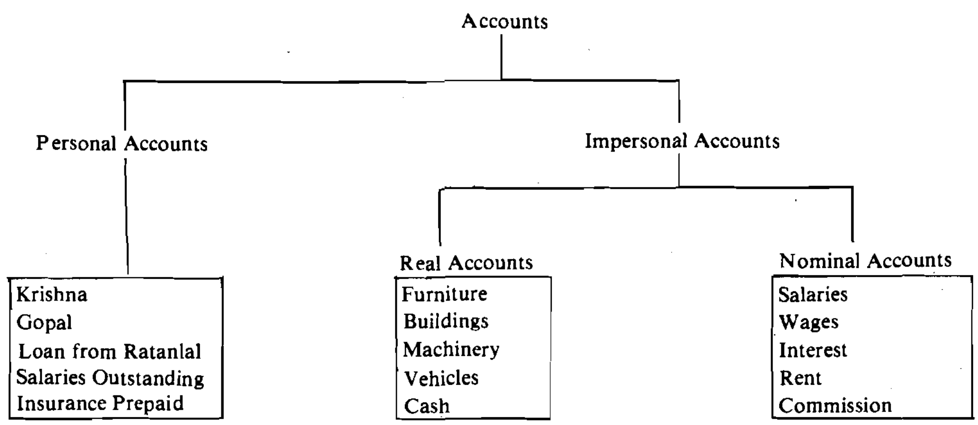
Accounts relating to properties or assets are known as 'Real Accounts'. Every business needs assets such as machinery, furniture, etc., for running its activities. In book-keeping, a separate account is maintained for each asset owned by the business. Dealings relating to purchase or sale of the asset are recorded through this account. Furniture Account, Machinery Account, Building Account, etc., are some examples of real accounts. Cash Account which shows receipts and payments of cash is also a real account. They are known as real accounts because they represent things of value owned by the business.

Nominal Accounts

Accounts relating to expenses, losses, incomes and gains are known as 'Nominal Accounts'. Every business unit incurs certain expenses such as payment of salaries to employees, payment of wages to workers, etc., while carrying out its activities. It may also suffer losses such as loss by fire, loss by theft, etc. It may also earn certain incomes and gains such as receipt of commission, receipt of interest, profit on sale of an asset, etc. A separate account is maintained for recording each item of expense, loss, income or gain. Thus, Wages Account, Salaries Account, Commission Received Account, and Interest Received Account are all nominal accounts. Classification of accounts is presented in Chart 4.2.

CHART 4.2

CLASSIFICATION OF ACCOUNTS



Check Your Progress—A

1 State whether each of the following statements is True or False.
   a) First recording of transactions is done in Journal.
   b) Summarising of all business transactions is done in Ledger.
   c) Interpretation of the results is done by preparing Trial Balance.
   d) Right hand side of an account is called credit side.
   e) Personal accounts include accounts of persons with whom the business deals.
   f) Accounts which represent an item of asset is called Representative Personal Accounts.
   g) Accounts relating to assets held in the name of the firm are called Nominal Accounts.

2 Names of some accounts are given below, classify them into Personal, Real or Nominal.

Name of Account	Class of Account
a) Bank A/c	
b) Interest A/c	
c) Interest Outstanding A/c	
d) Patents A/c	
e) Loan from Gopaldas A/c	
f) Loose Tools A/c	
g) Commission Received in Advance A/c	
h) Prepaid Salaries A/c	
i) Stationery A/c	
j) Electricity Charges A/c	

3 State whether the following classification of accounts is correct or not. Give the correct classification, wherever necessary.

Name of Account	Class of Account	If correct, put a tick mark. If wrong, state the correct class of account
a) Fixtures A/c	Nominal Account	
b) Discount Received A/c	Personal Account	
c) Discount Received in Advance A/c	Nominal Account	
d) Ram & Co. A/c	Personal Account	
e) Goodwill A/c	Personal Account	
f) Office Expenses A/c	Real Account	
g) Office Equipment A/c	Nominal Account	
h) Cash A/c	Real Account	
i) Cartage A/c	Real Account	
j) Import Duty/A/c	Real Account	

4.5 PRINCIPLE OF DOUBLE ENTRY

You have learnt earlier that a transaction results in the transfer of money or money's worth i.e., goods or services. Hence, every business transaction involves a transfer and as such consists of two aspects: (i) the receiving aspect, and (ii) the giving aspect. It is necessary to note that these two aspects go together, as receiving necessarily implies giving and vice versa. For example, let us consider a transaction where machinery is purchased for cash. In this case, the receiving aspect is machinery (as machinery comes in) and giving aspect is cash (as cash goes out). Similarly, in a transaction where wages are paid to workers, the receiving aspect is the service of the workers and the giving aspect is cash. The receiving and giving take place between two parties or the accounts representing those parties. Thus, in the first example discussed above, from the point of view of the business, Machinery Account is receiving the benefit and Cash Account is giving the benefit. In the second example, Wages Account is receiving the benefit in the form of service and Cash Account is giving the benefit. These two aspects are represented in every account by the terms 'Dr.' and 'Cr.'. The 'Dr.' represents the receiving aspect and the 'Cr.' the giving aspect. The record of any business transaction will be complete only when both of these aspects are recorded. This recording of the two aspects of each transaction is known as 'Double Entry' and the system is called 'Double Entry System'.

Thus, every transaction affects two accounts and according to Double Entry system entries will be made in both of them on the debit side (left hand side) in one account and on the credit side (right hand side) in the other. In case of the first example (machinery purchased for cash), entries will be made on the debit side of Machinery Account and the credit side of Cash Account. In the case of second example (wages paid to workers), entries will be made on debit side of Wages Account and the credit side of Cash Account. **Hence, for every debit there must be a corresponding credit for an equal amount and vice versa.** This is known as the 'Principle of Double Entry, and all business transactions are recorded in books of account according to this principle.

In order to develop a clear understanding of the receiving and giving aspects of various business transactions and the accounts affected thereby study Table 4.1 carefully.

Table 4.1
Dual Aspect of Transactions and the Account Affected

Transaction	First Aspect		Second Aspect	
	Receiving/ Receiver	**Account affected**	**Giving/ Giver**	**Account affected**
1 Commenced business with Rs. 50,000 as capital.	Cash	Cash A/c	Proprietor	Capital A/c
2 Bought goods for cash Rs. 5,000	Goods	Goods A/c	Cash	Cash A/c
3 Bought goods from Ramesh & Co. on credit Rs. 10,000	Goods	Goods A/c	Ramesh & Co.	Ramesh & Co. A/c
4 Sold goods for cash Rs. 12,000	Cash	Cash A/c	Goods	Goods A/c
5 Sold goods to Ajay on credit Rs. 2,500	Ajay	Ajay's A/c	Goods	Goods A/c
6 Paid cash to Ramesh & Co. Rs. 5,000	Ramesh & Co.	Ramesh & Co. A/c	Cash	Cash A/c
7 Received Cash from Ajay Rs. 1,000	Cash	Cash A/c	Ajay	Ajay's A/c
8 Paid rent Rs. 1,000	Benefit of accommodation	Rent A/c	Cash	Cash A/c
9 Purchased Typewriter Rs. 4,500	Typewriter	Typewriter A/c	Cash	Cash A/c
10 Paid interest on loan Rs. 1,200	Benefit of using the loan	Interest A/c	Cash	Cash A/c

Check Your Progress—B

Manohar had the following transactions. Determine the two aspects of each transaction and the accounts affected.

Transaction	First Aspect		Second Aspect	
	Receiving/ Receiver	Account affected	Giving/ Giver	Account affected
a) Purchased machinery for Rs. 60,000				
b) Purchased goods from Karim & Co. on credit Rs. 10,000				
c) Sold goods for cash Rs. 2,400				
d) Loan taken from bank Rs. 25,000				
e) Travelling expenses paid to salesman Rs. 122				
f) Paid electricity charges Rs. 110				
g) Received Cash from Shanker Rs. 1,200				
h) Paid cash to Karim & Co. Rs. 2,000				
i) Cash drawn for personal expenses Rs. 500				
j) Paid cash into bank Rs. 5,000				

4.6 ACCOUNTING RULES

We have already seen that every transaction affects two accounts and this effect will have to be entered in both of them, on the debit side in one account and on the credit side in the other account. It is, therefore, necessary to find out which of the two accounts is to be debited and which is to be credited. For this purpose, one has to first identify the class to which these two accounts belong i.e., personal, real or nominal; and then certain rules known as 'rules of debit and credit' are applied. These rules are as follows:

1 **For Personal Accounts:** The account of the person receiving the benefit (receiver) of the transaction (from the business) is debited and the account of the person giving the benefit (giver) of the transaction (to the business) is credited.

2 **For Real Accounts:** When an asset is coming into the business, the account of that asset is debited. When an asset is going out of the business, the account of that asset is credited.

3 **For Nominal Accounts:** When an expense is incurred or loss suffered, the account representing the expense or the loss is debited because the business receives the benefit thereof. When any income is earned or gain made, the account representing the income or the gain is credited. This is because the business gives some benefit.

The above rules have been shown in Table 4.2

Table 4.2

Rules of Debit and Credit

Class of Account	Debit	Credit
Personal Accounts	The Receiver	The Giver
Real Accounts	What comes in	What goes out
Nominal Accounts	Expenses and Losses	Income and Gains

We shall now see the application of these rules, taking a few transactions.

Example 1: Paid cash to Ramesh & Co. Rs. 5,000.
In this case the two accounts affected are Ramesh & Co.'s Account and Cash Account. Ramesh & Co.'s Account is a personal account and Cash Account is a real account. Ramesh & Co. has received the benefit (cash Rs. 5,000) from the business and, therefore, it has to be debited as per the first part of the rule for personal accounts 'debit the receiver'. As cash has gone out, Cash Account will be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 2: Received cash from Ajay Rs. 1,000.
In this case Cash Account and Ajay's Account are the two accounts affected. Cash Account is a real account and Ajay's account is a personal account. As cash has come in, Cash Account will have to be debited according to the first part of the rule for real accounts 'debit what comes in'. Ajay has given the benefit (cash Rs. 1,000) to the business and, therefore, his account will have to be credited as per the second part of the rule for personal accounts 'credit the giver'.

Example 3: Paid rent Rs. 1,000.
In this case, the accounts affected are Rent Account and Cash Account. Rent Account is a nominal account and Cash Account is a real account. As per the first part of the rule for nominal accounts, 'debit expenses and losses', Rent Account will have to be debited as it is an expense to the business. As cash has gone out, Cash Account will have to be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 4: Received Rs. 400 as commission.
In this case, Cash Account and Commission Account are the two accounts affected. Cash Account is a real account and Commission Account is a nominal account. As cash has come in, Cash Account will have to be debited according to the first part of the rule for real accounts 'debit what comes in'. As per second part of the rule for nominal accounts, 'credit incomes and gains', Commission Account will be credited as it is an income to the business.

You have seen that the three rules of debit and credit explained above, make it possible to analyse the transaction and identify the account to be debited and the account to be credited. Even though it has been explained that there are three different rules for the three classes of accounts, it is to be noted that these three rules, in reality, are a manifestation of the dual aspect concept as explained in Unit 3. In other words, the account that receives the benefit of the transaction is to be debited and the account that gives the benefit is to be credited, irrespective of the class of account involved.

Let us now apply these rules to the transactions given in Table 4.1 and ascertain which account is to be debited and which account is to be credited. This has been analysed in Table 4.3. You may go through it carefully and grasp the application of the Rules of Debit and Credit.

Table 4.3
Analysis of Accounts Affected

Transaction	Accounts affected	Class of Accounts	Debit/ Credit	Reasons
1 Commenced business with Rs. 50,000 as capital	i) Cash A/c ii) Capital A/c	Real Personal	Debit Credit	Cash comes in Proprietor gives benefit
2 Bought goods for cash Rs. 5, 000	i) Goods A/c ii) Cash A/c	Real Real	Debit Credit	Goods come in Cash goes out
3 Bought goods from Sohan on credit Rs. 10,000	i) Goods A/c ii) Sohan A/c	Real Personal	Debit Credit	Goods come in Giver
4 Sold goods for cash Rs. 1,500	i) Cash A/c ii) Goods A/c	Real Real	Debit Credit	Cash comes in Goods go out
5 Sold goods to Vijay on credit Rs. 2,500	i) Vijay A/c ii) Goods A/c	Personal Real	Debit Credit	Receiver Goods go out
6 Purchased furniture Rs. 4,000	i) Furniture A/c ii) Cash A/c	Real Real	Debit Credit	Furniture comes in Cash goes out
7 Sold old typewriter Rs. 500	i) Cash A/c ii) Typewriter A/c	Real Real	Debit Credit	Cash comes in Typewriter goes out
8 Purchased postage stamps Rs. 50	i) Postage A/c ii) Cash A/c	Nominal Real	Debit Credit	Postage is an expense Cash goes out
9 Paid salaries Rs. 6,000	i) Salaries A/c ii) Cash A/c	Nominal Real	Debit Credit	An expense Cash goes out
10 Received interest Rs. 200	i) Cash A/c ii) Interest A/c	Real Nominal	Debit Credit	Cash comes in An income

4.7 LET US SUM UP

1 The accounting process starts with recording of transactions in the journal. From the journal, they are posted to ledger accounts. Then, a trial balance is prepared to verify the accuracy of the work done and the final accounts are prepared to know the profit or loss made and the financial position of the business. Finally, the results are analysed and reported to the interested parties.

2 Accounts are classified as Personal, Real, and Nominal accounts. Accounts showing dealings with persons are called personal accounts. Accounts relating to assets are known as real accounts and those relating to expenses, losses, incomes and gains are known as nominal accounts.

3 Every transaction consists of two aspects: (i) the receiving aspect, and (ii) the giving aspect. The recording of this two-fold effect of each transaction is called 'Double Entry'. The principle of double entry is, for every debit there must be an equal and a corresponding credit and vice versa.

4 Certain rules are followed for recording business transactions. In the case of personal accounts, the rule is, 'Debit the receiver and Credit the giver'. For real accounts, the rule is, 'Debit what comes in and Credit what goes out', and for nominal accounts the rule is, 'Debit expenses and losses and Credit incomes and gains'.

4.8 KEY WORDS

Account: A summarised record which shows the effect of the transactions relating to a particular person or thing.

Credit: Credit represents the giving aspect of a transaction.

Debit: Debit represents the receiving aspect of a transaction.

Double Entry Principle: Principle of recording both the receiving and the giving aspects of each transaction.

Nominal Accounts: Accounts relating to expenses, losses, incomes and gains.

Personal Accounts: Accounts which relate to persons.

Real Accounts: Accounts which relate to assets.

4.9 SOME USEFUL BOOKS

Briston, R.J. *Introduction to Accountancy and Finance,* (London: The Macmillan Press Ltd., 1981) Chapter 1-3.

Birman, Harold & Derbin, Allan R. *Financial Accounting: An Introduction,* (Philadelphia: W.B. Saunders Company, 1978) (Chapter 1-4.)

Grewal, T.S. *Double Entry Book-Keeping* (New Delhi: Sultan Chand & Sons, 1986) Chapter 3.

Maheshwari, S.N. *Principles & Practice of Accountancy Part-I* (New Delhi: Arya Book Depot, 1986) Chapter 3.

Patil V.A. & Korlahalli, J.S. *Principles and Practice of Book-Keeping* (New Delhi: R. Chand & Co., 1985) Chapter 3.

4.10 ANSWERS TO CHECK YOUR PROGRESS

A 1 a) True b) False
c) False d) True
e) True f) False
g) False

2 a, c, e, g, h are Personal Accounts.
d, f are Real Accounts.
b, i, j are Nominal Accounts.

3 a) Real Account b) Nominal Account
c) Personal Account d) Correct
e) Real Account f) Nominal Account
g) Real Account h) Correct
i) Nominal Account j) Nominal Account

B

Transaction	First Aspect		Second Aspect	
	Receiving Receive	**Account affected**	**Giving/Giver**	**Account affected**
a)	Machinery	Machinery A/c	Cash	Cash A/c
b)	Goods	Goods A/c	Karim & Co.	Karim & Co. A/c
c)	Cash	Cash A/c	Goods	Goods A/c
d)	Cash	Cash A/c	Bank	Bank Loan A/c
e)	Benefit of service (Transport)	Travelling Expenes A/c	Cash	Cash A/c
f)	Benefit of service (Electricity)	Electricity Charges A/c	Cash	Cash A/c
g)	Cash	Cash A/c	Shanker	Shanker's A/c
h)	Karim & Co.	Karim & Co. A/c	Cash	Cash A/c
i)	Proprietor	Drawings A/c	Cash	Cash A/c
j)	Bank	Bank A/c	Cash	Cash A/c

4.11 TERMINAL QUESTIONS/EXERCISES

Questions

1 Discuss the various stages involved in the accounting process.
2 What is an Account? Describe the various classes of accounts with examples.
3 What do you understand by the Principle of Double Entry? Give the rules of debit and credit with suitable examples.

Exercises

1 From the following transactions determine the accounts affected, classify them and state whether it is to be debited or credited.

		Rs.
a)	Purchased typewriter for cash	5,000
b)	Purchased furniture from R & Co. on credit	50,000
c)	Interest received	300
d)	Paid wages	800
e)	Received cash from A	2,000
f)	Additional capital introduced into the business	5,000
g)	Paid cash to B	1,500
h)	Paid carriage	200
i)	Purchased goods from F & Co. on credit	12,000
j)	Sold goods for cash	1,400

Answer:

Transaction	Account to be debited	Nature of account	Account to be credited	Nature of account
a)	Typewriter A/c	Real	Cash A/c	Real
b)	Furniture A/c	Real	R & Co. A/c	Personal
c)	Cash A/c	Real	Interest A/c	Nominal
d)	Wages A/c	Nominal	Cash A/c	Real
e)	Cash A/c	Real	A's A/c	Personal
f)	Cash A/c	Real	Capital A/c	Personal
g)	B's A/c	Personal	Cash A/c	Real
h)	Carriage A/c	Nominal	Cash A/c	Real
i)	Goods A/c	Real	F & Co. A/c	Personal
j)	Cash A/c	Real	Goods A/c	Real

2 Ram had the following transactions. Determine the accounts to be debited and credited:

		Rs.
a)	Command business with cash	1,00,000
b)	Purchased goods for cash	15,000
c)	Paid for advertisement	600
d)	Bought goods from P & Co. on credit	20,000
e)	Sold goods for cash	6,000
f)	Sold goods to Z on credit	12,000
g)	Paid commission	900
h)	Paid salaries	8,000
i)	Paid rent	600
j)	Loan taken from Hiralal	50,000

Answer:

Transaction	Account to be debited	Account to be credited
a)	Cash A/c	Capital A/c
b)	Goods A/c	Cash A/c
c)	Advertisement A/c	Cash A/c
d)	Goods A/c	P & Co. A/c
e)	Cash A/c	Goods A/c
f)	Z A/c	Goods A/c
g)	Commission A/c	Cash A/c
h)	Salaries A/c	Cash A/c
i)	Rent A/c	Cash A/c
j)	Cash A/c	Loan from Hiralal A/c

Note: These questions and exercises will help you to understand the unit better. Try to write answers for them. But do not send your answers to the University. These are for your practice only.