Study notes: Accounting Fundamentals

LEARNING OBJECTIVES

Explain the purpose of accounting and who uses financial information
Apply the basic accounting concepts and conventions
Show how every transaction affects the accounting equation
Record transactions using debit and credit rules
Post entries to ledgers and prepare a trial balance
Make year-end adjustments, including depreciation
Prepare a trading and profit and loss account and a balance sheet

WHAT ACCOUNTING IS AND WHY IT MATTERS

Accounting is the process of identifying, recording, classifying, summarising and interpreting financial transactions so that people can make decisions.

Who uses accounting information?

User | What they want to know
Owners and partners | Is the business profitable? How much can be withdrawn?
Banks and lenders | Can the business repay the loan and interest?
Tax authorities | What is the taxable income and GST liability?
Investors | What return will they earn? Is the business growing?
Management | Which products, branches or costs need attention?

Bookkeeping vs accounting: bookkeeping is the day-to-day recording of transactions; accounting goes further and summarises, analyses and reports them.

Example: a shop records each sale in its sales book (bookkeeping). At the year end, the accountant totals sales, deducts costs and works out profit and tax (accounting).

BASIC ACCOUNTING CONCEPTS AND CONVENTIONS

These assumptions make financial statements reliable and comparable.

Concept | Meaning | Example
Business entity | The business is separate from its owner | The owner's personal car is not a business asset
Money measurement | Only transactions measurable in money are recorded | Staff morale is not recorded
Going concern | The business will continue in the foreseeable future | Machinery is shown at cost less depreciation, not scrap value
Accrual | Income and expenses are recorded when earned or incurred, not when cash moves | March salary paid in April is a March expense
Matching | Expenses are matched with the revenue they help earn | Cost of goods sold is matched with sales of the same year
Consistency | The same methods are used year after year | Do not switch depreciation methods without reason
Prudence (conservatism) | Anticipate losses, do not anticipate profits | Stock is valued at the lower of cost and net realisable value
Materiality | Small items may be treated simply | A Rs 200 stapler is expensed, not capitalised
Dual aspect | Every transaction has two equal effects | The basis of double-entry bookkeeping

Companies must follow the accrual basis and double-entry system under section 128 of the Companies Act, 2013, and the notified Accounting Standards (AS or Ind AS).

THE ACCOUNTING EQUATION

Every transaction keeps this equation in balance:

Assets = Liabilities + Capital (Equity)

Capital increases with profits and fresh investment, and decreases with losses and drawings.

Worked example: Ravi starts a trading business.

Transaction | Assets | Liabilities | Capital
Introduces Rs 5,00,000 cash | +5,00,000 (cash) | | +5,00,000
Takes a bank loan of Rs 2,00,000 | +2,00,000 (cash) | +2,00,000 |
Buys furniture for Rs 1,00,000 cash | +1,00,000 furniture, -1,00,000 cash | |
Buys goods on credit Rs 80,000 | +80,000 (stock) | +80,000 (creditor) |
Sells goods costing Rs 50,000 for Rs 70,000 cash | +70,000 cash, -50,000 stock | | +20,000 (profit)
Withdraws Rs 10,000 for personal use | -10,000 (cash) | | -10,000 (drawings)
Closing totals | Rs 7,90,000 | Rs 2,80,000 | Rs 5,10,000

Check: 2,80,000 + 5,10,000 = 7,90,000. The equation balances after every transaction.

DEBITS AND CREDITS: THE RULES

In double entry, every transaction is recorded with a debit in one account and an equal credit in another.

Modern (accounting equation) rules

Type of account | Increase | Decrease
Assets | Debit | Credit
Expenses and losses | Debit | Credit
Liabilities | Credit | Debit
Capital | Credit | Debit
Income and gains | Credit | Debit

Traditional (golden) rules

Account type | Rule
Personal (people, firms, banks) | Debit the receiver, credit the giver
Real (assets) | Debit what comes in, credit what goes out
Nominal (expenses, income) | Debit all expenses and losses, credit all incomes and gains

Both sets of rules give the same entries; use whichever you find easier.

JOURNAL ENTRIES WITH EXAMPLES

The journal is the book of original entry. Each entry shows the date, accounts debited and credited, amounts and a short narration.

Transaction | Debit | Credit | Amount (Rs)
Owner brings in cash | Cash A/c | Capital A/c | 5,00,000
Goods bought on credit from Sita Traders | Purchases A/c | Sita Traders A/c | 80,000
Goods sold for cash | Cash A/c | Sales A/c | 70,000
Rent paid by bank | Rent A/c | Bank A/c | 15,000
Paid Sita Traders by cheque | Sita Traders A/c | Bank A/c | 80,000
Owner withdraws cash | Drawings A/c | Cash A/c | 10,000
Machinery bought by bank | Machinery A/c | Bank A/c | 1,50,000
Interest received from bank | Bank A/c | Interest Received A/c | 2,000

With GST: goods bought for Rs 1,00,000 plus 18% GST within the State are recorded as: Purchases A/c Dr 1,00,000; Input CGST A/c Dr 9,000; Input SGST A/c Dr 9,000; to Supplier A/c 1,18,000.

LEDGER, BALANCING AND THE TRIAL BALANCE

Journal entries are posted to ledger accounts, one account per item (Cash, Sales, Rent, each customer and supplier). At the period end, each ledger is balanced: the difference between the debit and credit sides is the closing balance.

A trial balance lists every ledger balance. If total debits equal total credits, the arithmetic of the books is correct.

Example trial balance (extract)

Account | Debit (Rs) | Credit (Rs)

Capital		5,00,000
Bank loan		2,00,000
Furniture	1,00,000	
Purchases	3,00,000	
Sales		4,20,000
Rent	60,000	
Salaries	1,20,000	
Debtors	90,000	
Creditors		40,000
Cash and bank	4,90,000	
Total	11,60,000	11,60,000

Errors a trial balance does not reveal: errors of omission (entry missed completely), errors of commission (posted to the wrong person's account), errors of principle (capital expense treated as revenue), and compensating errors (two errors cancelling each other).

YEAR-END ADJUSTMENTS AND DEPRECIATION

Before preparing final accounts, adjust the books so that each year shows only its own income and expenses (accrual and matching).

Adjustment	Entry	Effect
Outstanding expense (salary due Rs 10,000)	Salaries Dr / Outstanding Salaries Cr	Increases expense; liability in balance sheet
Prepaid expense (insurance paid in advance Rs 6,000)	Prepaid Insurance Dr / Insurance Cr	Reduces expense; asset in balance sheet
Accrued income (interest earned not received Rs 4,000)	Accrued Interest Dr / Interest Cr	Increases income; asset
Income received in advance (Rs 12,000)	Commission Cr reduced / Advance Commission (liability) Cr	Reduces income; liability
Closing stock (Rs 75,000)	Closing Stock Dr / Trading A/c Cr	Reduces cost of goods sold; asset
Bad debts and provision	Bad Debts Dr / Debtors Cr	Expense; debtors reduced

Depreciation spreads the cost of a fixed asset over its useful life.

- Straight line method (SLM): (Cost - Residual value) / Useful life. Machine costing Rs 1,00,000, residual Rs 10,000, life 5 years: Rs 18,000 every year.
- Written down value (WDV): a fixed percentage of the opening book value. At 20%, year 1 = Rs 20,000; year 2 = 20% of Rs 80,000 = Rs 16,000.

Companies follow useful lives in Schedule II to the Companies Act, 2013. For income tax, depreciation is computed separately at the rates and block method prescribed under the Income-tax law.

FINAL ACCOUNTS: TRADING, PROFIT AND LOSS, AND BALANCE SHEET

Trading account finds gross profit:

Sales - (Opening stock + Purchases + Direct expenses - Closing stock) = Gross profit

Profit and loss account finds net profit:

Gross profit + Other income - Indirect expenses (rent, salaries, depreciation, interest) = Net profit

Balance sheet shows the position on the last day:

Liabilities side	Assets side
Capital (+ net profit - drawings)	Fixed assets (less depreciation)
Long-term loans	Investments
Creditors	Closing stock
Outstanding expenses	Debtors
	Cash and bank, prepaid expenses

Example: sales Rs 4,20,000, purchases Rs 3,00,000, closing stock Rs 75,000, no opening stock. Cost of goods sold = Rs 2,25,000; gross profit = Rs 1,95,000. After rent Rs 60,000, salaries Rs 1,30,000 (including Rs 10,000 outstanding) and depreciation Rs 10,000, there is a net loss of Rs 5,000.

Companies present financial statements in the format of Schedule III to the Companies Act, 2013 (statement of profit and loss, balance sheet, cash flow statement and notes).

CAPITAL VS REVENUE, AND CASH VS ACCRUAL

Capital expenditure creates a long-term asset or benefit: buying machinery, building, software licences for several years. It goes to the balance sheet and is depreciated.

Revenue expenditure is consumed within the year: rent, salaries, repairs, electricity. It goes to the profit and loss account.

Item	Treatment	Why
New delivery van	Capital	Benefit over many years
Fuel for the van	Revenue	Used up in the year
Major engine overhaul that extends life	Capital	Increases useful life
Routine servicing	Revenue	Maintains existing condition

Cash vs accrual basis: under the cash basis, income and expenses are recorded when money is received or paid. Under the accrual basis, they are recorded when earned or incurred. Companies must use the accrual basis; small businesses and professionals may use either for tax purposes, subject to the Income-tax law.

FURTHER READING

Accounting Standards issued by ICAI (AS 1, AS 2, AS 10)

Section 128 and Schedules II and III, Companies Act, 2013

Ind AS 1 for companies covered by Ind AS

Educational material only; not personalised professional advice.