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ACCOUNTING MECHANICS

As we discussed earlier, the business entity principle requires accounts to be maintained under the basic assumption that the business or service or the like of it, for which the accounts are being written, is a *separate and distinct entity*. When it is created (or born), it has no assets and no liabilities. And any funds that it will get, will always be invested somewhere immediately. When it gets the first contribution from the owners it owes that much amount to the owners. This fund is also invested, if no where else, then in cash! For the business entity, which is like a lotus leaf, even holding cash is an investment or utilization of funds. The assets and the liabilities will always be equal. In other words, *the assets will always be equal to the liablilites & vice versa.*

Let us see this process step-by-step, by considering the following examples:

1. When the owner, say Mr. X, brings in his initial capital of Rs. 1,00,000, from the point of view of accounting, two effects are to be given:
   a. Cash will go up by Rs. 1,00,000.
   b. The business entity will have to acknowledge its liability to Mr. X of Rs. 1,00,000 towards his capital contribution.
2. Similarly, if Mr. X buys a machine worth Rs. 50,000 the effects will be:
   a. cash will go down by Rs. 50,000.
   b. a new asset, vis., machinery, will be created worth Rs. 50,000.
3. If this asset is purchased on credit,
   a. an asset of Rs. 50,000 is created, and
   b. a liability of Rs. 50,000 to supplier is created.
4. When this supplier is paid his amount due,
   a. cash will go down by Rs. 50,000.
   b. the liability of Rs. 50,000 will be extinguished.
5. Now, when Mr. X buys goods worth Rs, 5,000 on cash terms,
   a. cash will go down by Rs. 5,000.
   b. inventory will go up by Rs. 5,000.

6. When he sells the same goods for Rs. 6,000 cash, as we can immediately know, there is a profit of Rs. 1,000. The accounting effects will be as follows:
   a. cash will go up by Rs. 6,000.
   b. inventory will go down by Rs. 5,000 and Mr. X's equity (capital) will go up by Rs. 1,000.

Here it can be noticed that profit of Rs. 1,000 is directly added to Mr. X's capital. The reason is simple. Since Mr. X is the owner of this business, the profits belong to him. So as far as the business entity is concerned, its liability towards Mr. X is increased to that extent.

In this way, all possible business transactions have two effects which are equal in amount, but opposite in effect. *The Balance Sheet will always tally*! (big deal!?)

The following table shows various permutations and combinations of transactions:

TRANSACTION	EFFECT
Increases in assets	another asset will decrease, and/or a liability will increase, and/or owner's equity will increase.
Increase in liability	another liability will decrease, and/or asset will increase, and/or owner's equity will decrease
Decreases in assets	another asset will increase, and/or liability will decrease and/or the owner's equity will decrease
Decreases in liability	another liability will increase, and/or an asset will decrease and/or the owner's equity will increase

Points to Ponder

1. Please indicate corresponding effects for:
   a. Increase in the owner's equity...
   b. Decreases in the owner's equity…

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In actual practice, transactions are large in number. Everyday, thousands of transactions are taking place. To keep a track of each is extremely difficult unless a planned course of action with proper tabulation and division of work is adopted. This is called *Accounting System*.

As you will appreciate, in a business, hundreds of assets are created, similarly a large number and types of liabilities, expenses and incomes are generated. In order to keep track of each one of these, usually a page is allocated to them in a book called Ledger. This page is called *'T' account* or a *Ledger Account* or just an *Account*. It represents a particular asset, or a liability or a revenue or an expense.

This page is divided into two parts:
Left Hand Side (LHS) called as DEBIT or Dr. side
Right Hand Side (RHS) called as CREDIT or Cr. side

Format of a typical "T Account"

XYZ Account

Dr (Debit Side)				(Credit Side) Cr	
Date	Particulars	Rs.	Date	Particulars	Rs.
	To......... a/c			By......... a/c	
	To......... a/c			By......... a/c	
	To......... a/c			By......... a/c	
	Balance c/f				
Total			Total		

1. In a T-account (page) which represents a liability, all increases will be recorded on the RHS and all decreases will be recorded on the LHS.
2. In a T-account which represents an asset, all increases will be recorded on the LHS and all decreases will be recorded on the RHS.

   As we know, profits from various transactions ultimately gets added up the owner's capital. For accounting purposes, the T Accounts, that effect the owners equity due to business dealing (operations), are segregated into Revenue (the income from operations) and expenses (the cost that you have to incur in order to earn those revenues). These revenues and expenses are shown on either side of one account, which is called Profit & Loss Account. It is the net balance of this Profit & Loss Account after appropriations, that is taken to the owners equity.
3. In a T account representing Income/Revenue, all increases are shown on RHS and all decreases are shown on LHS.
4. In a T account representing Expenses, all increases are shown on LHS and all decreases are shown on RHS.
5. All the transactions are first written down in accounting form in a book called Journal, from which a relevant effects are given to the respective T Accounts

   The book containing all T Accounts is called Ledger and a T Account is called a Ledger Account.

   Entering effects of transactions in Ledger Accounts is called 'Posting'.
6. After the entries for the period are posted in various T accounts, the totals of the LHS and RHS of the ledger accounts are compared, the Balance is arrived at. If the total of LHS is greater than the total of RHS, the difference or the balance is called 'Debit Balance' and if the total of RHS is greater than the total of LHS, it is called 'Credit Balance'.
7. Listing of all the accounts in a systematic format, with all accounts having debit balances of LHS and all accounts having credit balances on RHS with the respective balances of accounts as on a particular date is called a Trial Balance on that particular date.

8. If there is no mistake, especially arithmetic mistake, in ledger accounts, both side total of the Trial balance will tally.

CAPTURING OF TRANSACTIONS

Since every transation has two effects, for each and every transaction there has to be a journal entry in which certain accounts are debited and certain other account/s are credited. Transactions pertaining to bank, cash, credit purchase, credit sales, purchase and sales returns, etc mostly constitute 80% to 90% of the total transactions. Passing a journal entry for each such transaction becomes very tedious. Therefore, certain registers are maintained to keep similar transactions recorded separately. These transactions are captured by way of different registers called *day-books.*

The main capturing points for various transactions are:

1. All the transactions affecting the bank balances are captured through bank book.
2. All the transactions affecting credit sales or revenue are captured through sales book or sales register.
3. Similarly transactions pertaining to credit purchases are captured through purchase register.
4. Sales returns, purchase returns, price adjustments etc. are captured through debit note register or credit note registers.

The balance of transactions normally represent rectification of mistakes, inter party transactions and adjustment entries which are noted down in journal. From the various day-books and journal, the posting is done in the ledger as explained earlier and it is from these ledgers that *'Trial Balance'* is prepared.

In the trial balance therefore one will have a long list of different accounts showing either debit or credit balance.

The accounts in the trial balance are then sub divided into four basic categories.

1. Accounts that Represent Assets
2. Accounts that Represent Liabilities
3. Accounts that Represent Revenues
4. Accounts that Represent Expenses.

The account that represents expense or revenue are placed on two different sides of profit and loss account and the net difference is called *'Profit'* (if credit side is heavier than the debit side) or *'Loss'* (if debit side is heavier than the credit side).

This profit or loss is then transferred to owners fund after being duly appropriated in the *Profit and Loss Appropriation Account.*

The remining T Accounts will naturally represent either Assets or Liabilities. They can easily be arranged in a Balance Sheet format.

Thus the Profit & Loss Account and Balance Sheet are drawn out from the Trial Balance.

Typical formats of balance-sheet and profit & loss account are given in the following tables.

Before you study these formats, please note that:

1. There were hundreds of transactions during 2006 .

   All Cash and Bank transactions were entered in the *Cash Book*, and the *Bank book.* The Sales and Purchase transactions were entered in the *Sales Registers* and *Purchase Registers.*

   Transaction other than cash, bank, sales and purchase were entered in a register called *'Journal'.*

2. A ledger was prepared having a separate ledger account of all the debtors, creditors, expenses, incomes and all assets and liabilities. These transactions were posted in the respective ledger accounts.

3. The balance of the ledger accounts, were listed in a statement called Trial Balance. From these balances appearing in the trial balance, Profit and Loss Account and Balance Sheet were drawn up.

4. Quantitative records were also maintained for all the stocks giving details about all the *Receipt* and *Issues.* A register of fixed assets was maintained giving details about different fixed assets.

5. Please note that these formats are not strictly as per the Companies Act. They only provide you, a fair idea about Profit & Loss Account & Balance Sheet.

6. Have a close look at Table C. This shows the increase and decrease in funds/cash during the year. It is generally called *'Cashflow'*, but is also better known as *'Fundflow Statement.'*

Table 'A'

M/s. P K Enterprises

Balance Sheet as on 31.12.2006

Liabilities	2005	2006	Assets	2005	2006
Capital			*Fixed Assets*		
Opening Balance	30000	30000	Gross Block	120000	180000
Additions	10000	30000	Accumulated Depn.	40000	75000
Less: Drawings	10000	5000	Net Block	80000	105000
Balance	30000	55000	Investments	1000	1000
Profit & Loss Account	10000	—	Raw Materials Stock	45000	20000
Loan from GSFC	82000	70000	Work-in-Process Stock	25000	20000
SBI Cash Credit Account	85000	80000	Finished Goods Stock	60000	40000
Unsecured Deposits	11000	25000	Debtors	38000	60000
Creditors for Goods	40000	48000	Loans and Advances	10000	15000
Creditors for Expenses	11000	28000	Cash Balances	4000	21000
			Profit and Loss Account	—	20000
			Preliminary Expenses	6000	4000
TOTAL	269000	306000	TOTAL	269000	306000

Note: Excise duty claim of Rs. 2,00,000 is disputed and hence not provided for.

Table 'B'

Profit And Loss Statement For The Year Ended 31.12.2006

	PARTICULARS		AMOUNT In Rs.	AMOUNT In Rs.
i.	Sales	(a)		1138000
ii.	Cost of Sales			
	a) Opening Stock of Raw Materials		45000	
	Purchases		730000	
			775000	
	Less: Closing Stock		(20000)	
	Raw Materials Consumed			755000
	Add:			
	1. Opening Stock of Work-in-Process		25000	
	2. Manufacturing Expenses			
	- Wages		185000	
	- Repairs, Stores		25000	
	- Depreciation		25000	
	- Other Manufacturing Expenses		40000	
			1055000	
	Less: Closing Stock of Work-in-Process		(34000)	266000
	Cost of Goods Manufactured			1021000
	Add:			
	1. Opening Stock of Finished Goods		60000	
	2. Selling, Administration and General Expenses		85000	
	3. Depreciation on Office Building, etc.		10000	155000
				1176000
	Less: Closing Stock of Finished Goods		(40000)	
	Cost of Goods Sold	(b)		1136000
	Gross Profit	(a-b)		2000
	Less:			
	i) Interest			30000
	ii) Preliminary Expenses			2000
	Net Profits/(Loss)			(30000)
	Add/Less Opening Balance of P&L Account			10000
	Net Loss Transferred to Balance Sheet			(20000)

Table 'C'

Cash Flow Statement for 2006

	PARTICULARS	AMOUNT In Rs.	AMOUNT In Rs.
	Opening Balance		4,000
	Add:		
i.	Income from Operations		
	Loss	(30,000)	
	Add : Depreciation	35,000	
	w/off of preliminary Exp.	2,000	
	Income : Net from operations		7,000
ii.	Net Increase in Capital	25,000	
iii	Increase in Unsecured loan	14,000	
iv	Increase in creditors for goods	8,000	
v	Increase in creditors for expencses	17,000	
vi	Reduction in Inventories		
	- Raw Materials	25,000	
	- Work - in - progress	15,000	
	- Finish Goods	20,000	
			1,14,000
	Less:		
i	Capital Expenses	60,000	
ii	Increase in Loans & Advances	5,000	
iii	Repayment of Loan from GSFC	12,000	
iv	Repayment of Loan from SBI	5,000	
v	Increase in Debtors	22,000	
			(1,04,000)
	Net Increase During 2006		17,000
	Closing Cash Balance on 31-12-2006		21,000