CHAPTER - 3

BASIC ACCOUNTING PROCEDURES - I DOUBLE ENTRY SYSTEM OF BOOK KEEPING

Learning Objectives

After studying this Chapter, you will be able to:

- *understand the Meaning, Features and Advantages of Double Entry System.*
- *know the Meaning and Types of Accounts.*
- *identify the Accounting Rules.*

Recording of business transactions has been in vogue in all countries of the world. In India, maintenance of accounts was practised not in such a developed form as we have today. **Kautilya's** famous **Arthasastra** not only relates to Politics and Economics, but also explains the art of account keeping in a separate chapter. Written in 4th century BC, the book gives details about account keeping, methods of supervising and checking of accounts and also about the distinction between capital and revenue, income and expenses etc.

Double entry system was introduced to the business world by an Italian merchant named Lucas Pacioli in 1494 A.D. Though the system

of recording business transactions in a systematic manner has **originated in Italy, it was perfected in England** and other European countries during the 18th century only i.e., after the Industrial Revolution. Many countries have adopted this system today.

3.1 Double Entry System

There are numerous transactions in a business concern. Each transaction, when closely analysed, reveals two aspects. One aspect will be "receiving aspect" or "incoming aspect" or "expenses/loss aspect". This is termed as the **"Debit aspect"**. The other aspect will be "giving aspect" or "outgoing aspect" or "income/gain aspect". This is termed as the **"Credit aspect".** These two aspects namely "Debit aspect" and "Credit aspect" form the basis of Double Entry System. The double entry system is so named since it records both the aspects of a transaction.

In short, the basic principle of this system is, for every debit, there must be a corresponding credit of equal amount and for every credit, there must be a corresponding debit of equal amount.

3.1.1 Definition

According to **J.R.Batliboi** "Every business transaction has a two-fold effect and that it affects two accounts in opposite directions and if a complete record were to be made of each such transaction, it would be necessary to debit one account and credit another account. It is this recording of the two fold effect of every transaction that has given rise to the term Double Entry System".

3.1.2 Features

i. Every business transaction affects two accounts.

ii. Each transaction has two aspects, i.e., debit and credit.

iii. It is based upon accounting assumptions concepts and principles.

iv. Helps in preparing trial balance which is a test of arithmetical accuracy in accounting.

v. Preparation of final accounts with the help of trial balance.

3.1.3 Approaches of Recording

There are two approaches for recording a transaction.

I. Accounting Equation Approach

II. Traditional Approach

I. Accounting Equation Approach

This approach is also called as the **American Approach**. Under this method transactions are recorded based on the accounting equation, i.e.,

Assets = Liabilities + Capital

This will be discussed in detail in the next chapter.

II. Traditional Approach

This approach is also called as the **British Approach**. Recording of business transactions under this method are formed on the basis of the existence of two aspects (debit and credit) in each of the transactions. All the business transactions are recorded in the books of accounts under the 'Double Entry System'.

3.1.4 Advantages

The advantages of this system are as follows:

i. **Scientific system:** This is the only scientific system of recording business transactions. It helps to attain the objectives of accounting.

ii. **Complete record of transactions:** This system maintains a complete record of all business transactions.

iii. **A check on the accuracy of accounts:** By the use of this system the accuracy of the accounting work can be established by the preparation of trial balance.

iv. **Ascertainment of profit or loss:** The profit earned or loss occured during a period can be ascertained by the preparation of profit and loss account.

v. **Knowledge of the financial position :** The financial position of the concern can be ascertained at the end of each period through the preparation of balance sheet.

vi. **Full details for control:** This system permits accounts to be kept in a very detailed form, and thereby provides sufficient informations for the purpose of control.

vii. **Comparative study :** The results of one year may be compared with those of previous years and the reasons for change may be ascertained.

viii. **Helps in decision making:** The mangement may be able to obtain sufficient information for its work, especially for making decisions. Weaknesses can be detected and remedial measures may be applied.

ix. **Detection of fraud:** The systematic and scientific recording of business transactions on the basis of this system minimises the chances of fraud.

3.2 Account

Every transaction has two aspects and each aspect has an account. It is stated that '**an account is a summary of relevant transactions at one place relating to a particular head**'.

3.2.1 Classification of Accounts

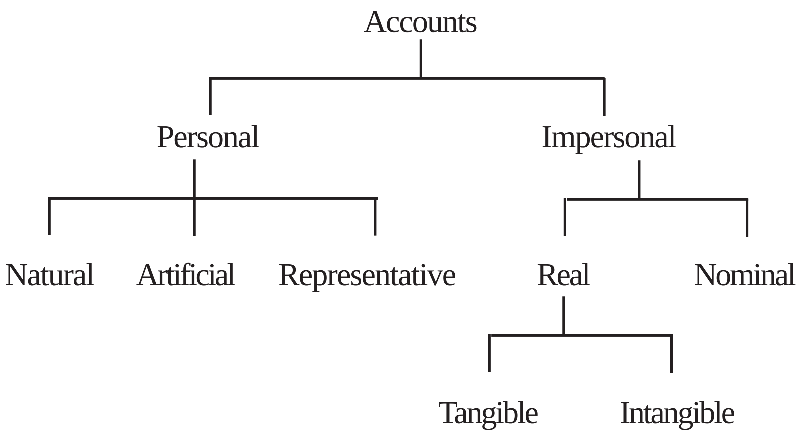
Transactions can be divided into three categories.

i. Transactions relating to individuals and firms

ii. Transactions relating to properties, goods or cash

iii. Transactions relating to expenses or losses and incomes or gains.

Therefore, accounts can also be classified into Personal, Real and Nominal. The classification may be illustrated as follows



I. Personal Accounts : The accounts which relate to persons. Personal accounts include the following.

i. **Natural Persons :** Accounts which relate to individuals. For example, Mohan's A/c, Shyam's A/c etc.

ii. **Artificial persons :** Accounts which relate to a group of persons or firms or institutions. For example, HMT Ltd., Indian Overseas Bank, Life Insurance Corporation of India, Cosmopolitan club etc.

iii. **Representative Persons:** Accounts which represent a particular person or group of persons. For example, outstanding salary account, prepaid insurance account, etc.

The business concern may keep business relations with all the above personal accounts, because of buying goods from them or selling goods to them or borrowing from them or lending to them. Thus they become either Debtors or Creditors.

The proprietor being an individual his capital account and his drawings account are also personal accounts.

II. Impersonal Accounts: All those accounts which are not personal accounts. This is further divided into two types viz. Real and Nominal accounts.

i. **Real Accounts:** Accounts relating to properties and assets which are owned by the business concern. Real accounts include tangible and intangible accounts. For example, Land, Building, Goodwill, Purchases, etc.

ii. **Nominal Accounts:** These accounts do not have any existence, form or shape. They relate to incomes and expenses and gains and losses of a business concern. For example, Salary Account, Dividend Account, etc.

Illustration : 1 ***Classify the following items into Personal, Real and Nominal Accounts.***

1. Capital	2. Sales
3. Drawings	4. Outstanding salary
5. Cash	6. Rent
7. Interest paid	8. Indian Bank
9. Discount received	10. Building

11. Bank
12. Chandrasekar
13. Murugan Lending Library
14. Advertisement
15. Purchases

Solution:

1. Personal account
2. Real account
3. Personal account
4. Personal (Representative) account
5. Real account
6. Nominal account
7. Nominal account
8. Personal (Legal Body) account
9. Nominal account
10. Real account
11. Personal account
12. Personal account
13. Personal account
14. Nominal account
15. Real account

3.3 Golden Rules of Accounting

All the business transactions are recorded on the basis of the following rules.

S.No.	Name of Account	Debit Aspect	Credit Aspect
1.	Personal	The receiver	The giver
2.	Real	What comes in	What goes out
3.	Nominal	All expenses and losses	All incomes and gains.

QUESTIONS

I. Objective Type :

a) Fill in the blanks:

1. The author of the famous book "Arthasastra" is ___________.
2. Every business transaction reveals ___________ aspects.
3. The incoming aspect of a transaction is called __________ and the outgoing aspect of a transaction is called __________.
4. Traditional approach of accounting is also called as __________ approach.
5. The American approach is otherwise known as __________ approach.
6. Impersonal accounts are classified into __________ types.
7. Plant and machinery is an example of __________ account.
8. Capital account is an example of __________ account.
9. Commission received will be classified under __________ account.

[Answers: 1. Kautilya, 2. two, 3. debit, credit, 4. British, 5. Accounting equation, 6. two, 7. real, 8. personal, 9. nominal]

b) Choose the correct answer:

1. The receiving aspect in a transaction is called as
   a) debit aspect   b) credit aspect   c) neither of the two
2. The giving aspect in a transaction is called as
   a) debit aspect   b) credit aspect   c) neither of the two
3. Murali account is an example for
   a) personal A/c   b) real A/c   c) nominal A/c

4. Capital account is classified under
   a) personal A/c   b) real A/c   c) nominal A/c
5. Goodwill is an example of
   a) tangible real A/c   b) intangible real A/c   c) nominal A/c
6. Commission received is an example of
   a) real A/c   b) personal A/c   c) nominal A/c
7. Outstanding rent A/c is an example for
   a) nominal account   b) personal account
   c) representative personal account
8. Nominal Account is classified under
   a) personal A/c   b) impersonal A/c
   c) neither of the two
9. Drawings account is classified under
   a) real A/c.   b) personal A/c.   c) nominal A/c.

[Answers : 1. (a), 2. (b), 3. (a), 4. (a), 5. (b), 6. (c), 7. (c), 8. (b), 9. (b)].

II. Other Questions:

1. Explain the meaning of Double Entry System.
2. Define Double Entry System.
3. What are the advantages of Double Entry System?
4. How are accounts classified?
5. Write notes on personal accounts.
6. Write notes on real accounts.

7. Explain nominal accounts.
8. What are the golden rules of Accounting?
9. Classify the following items into real, personal and nominal accounts

a. Capital	f. State Bank of India
b. Purchases	g. Electricity Charges
c. Goodwill	h. Dividend
d. Copyright	i. Ramesh
e. Latha	j. Outstanding rent

[Answers : Personal account – (a), (e), (f), (i), (j)
Real account – (b), (c), (d)
Nominal account – (g), (h)]