Economics, Management and Entrepreneurship
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Lecture - 12
Double - Entry Bookkeeping

Good morning welcome to the 12th lecture on economics, management and entrepreneurship. Today we shall discuss about double-entry bookkeeping system, this is a very popular method of keeping accounts and is widely used in industries and in all forms of business and it is highly relevant to even a new entrepreneur. So we start the discussion on double-entry bookkeeping systems.

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EXPLANATIONS OF A FEW TERMS

Entity: It is a specific area of accountability, a clear-cut boundary for reporting (such as a firm)

Transaction: Any event that changes the financial position of an entity

Bookkeeping: Recording of business transactions

Entry: Record in the books of accounts in respect of a transaction.

Double-Entry: Two entries are made for every transaction

First of all, as we had been doing everytime we are first of all giving certain definitions or explanations of a few terms. First of all, the word entity we shall use quite often to indicate a specific area of accountability requiring a clear-cut boundary for reporting such as a firm. A firm could be an entity for whom accounts are to be kept. Transaction, by transaction we would mean any event that changes the financial position of an entity.

Later on we shall give a large number of examples of transactions and we shall say how they influence the financial position of an entity. Bookkeeping, bookkeeping basically means recording of business transactions. Whenever a transaction takes place, it has got financial implication and these transactions and the financial implications are to be recorded in books of accounts and this process is known as a bookkeeping process.

Next we define a word entry. Entry would mean recording in the books of accounts in respect of a transaction, every entry that is made in a book of account refers to a particular aspect of a transaction and since the topic is double-entry bookkeeping we would try to say that for every transaction there will be 2 entries, that is double-entry, it says 2 entries are made for every transaction and not one.

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For any transaction, the following exist:

- Receiver (or debtor), whose amount increases
- Giver (or creditor), whose amount decreases

Example:

Transaction: Cash is paid to buy two chairs.

- The total amount invested in chairs increases
  The amount is ***debited*** to Chairs Account (Dr.).
- Cash is given, decreasing the cash position of the entity
  The amount is ***credited*** to Cash Account (Cr.)

We shall explain in great detail the meaning of the word double-entry. Now in this slide we are giving an example let us say that whenever money is transacted there is a receiver whose amount of cash increases and there is a giver whose cash position decreases. So you can see that for a transaction which is cash changing hands actually 2 sub transactions are involved requiring 2 entries.

We shall call the person who receives the money as a debtor and a person who gives the money is a creditor. So this word debtor and creditor has got wider ramifications and we will discuss that in many examples that will follow. Let us say this is one example that we are saying. Cash is paid by the firm to buy 2 chairs. Now in this case the total amount invested in chairs increases.

The firm purchases chairs therefore the inventory of chairs in the firm increases whereas cash is given out to the supplier of chairs and therefore cash position reduces. So in this case the cash position reduces that is something like a giver so it is whose amount decreases therefore

it is credited to cash account. In the language of an accountant it is called the amount is credited to cash account.

Whereas the receiver is the chairs account, because the number of chairs and if money involved in it increases in the chairs account, so therefore it is a receiver whose amount increases and in the language of an accountant this is called the amount is debited to chairs account. So sometimes the term Dr is used for debited and Cr is used for credited.

Now we will in our next slide say the historical background regarding the use of the short form Dr and Cr. In fact, this should be Dr. and Cr. Dr. for debit, Cr. for credit.

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Account

Form of an account:

Dr. *Cr.*

Date	Particulars	Amount		Date	Particulars	Amount

Types of Account

- Personal: Debtors, Creditors, Capital Account of the Owner

- Impersonal:

- Real Accounts: Assets of the firm (land, buildings, cash, etc.)
- Nominal Accounts: Expenses, Losses, Gains, and Revenue

Now here we are talking about the form of an account. When an account is kept for a particular asset there is a debit side and there is a credit side. Normally these data are kept on the debit side we have the date in which transaction takes place. The explanation of the transaction and the amount transacted and Cr. is date, particulars of the transaction and the amount.

So for every account these details are kept. The lefthand side is called the debit side and the righthand side of the account is known as a credit side. Now there can be different types of account there could be personal accounts or could be impersonal accounts. Personal account means the debtors, the creditors, the capital account of the owner. So in the name of particular persons or it could be impersonal like in the real accounts.

Such as the assets of the firm like land, buildings, cash et cetera or it could be nominal accounts such as expenses, losses, gains, and revenue. We shall later show that for all real accounts and for all personal accounts the debit sides total equals the credit side totals. Whereas for nominal account it is not so, these accounts help in finding out the profit in a particular period.

Whereas these accounts particularly real accounts and also personal accounts they help in developing the financial statements of a company. These details will be discussed in the future.

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DEBIT

Debit is the left-hand side of an account.
It has a Latin origin.

Latin verb:	***Debere*** (to owe)
Past particle:	***Debitum*** (that which is owed)
French:	***Debet***
English:	***Debit***

It is written as "***Dr***."

A debit increases the value of an asset, but it decreases the value of a liability.

Now let us discuss what is the historical background for the word debit and for the short form Dr. The usual definition of debit is that it is the lefthand side of an account. Now the word has a Latin origin. The Latin form from where this word is derived is debere meaning to owe. It is past particle is debitum that which is owed. From there the French term is debet and the English term is debit, spelling, debet and debit.

Now historically these term because it is debere it is Dr. and this actually this double-entry bookkeeping system was developed by a Roman Catholic monk and he used the word debere and from there used debitum and then Dr. So today we are using debit and Dr. So a debit increases the value of an asset, but it decreases the value of a liability. So we will talk about the meaning of asset and liability in some more detail later.

But for the time being let us understand that a debit increases the value of an asset, but reduces the value of a liability.

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The word "charge" is often used in its place.

It can be used as a verb, noun, or adjective.

Verb: Debit the amount to Cash Account.
Noun: A debit is made to the Cash Account.
Adjective: Cash has a debit balance of Rs25,000.

Sometimes the word charge is also used in place of debit. Now the word debit can be used as a verb or as a noun or very as an adjective. These 3 sentences are examples as a verb we may say debit the amount to cash account. We can say as a noun, a debit is made to the cash account, or we can use the word debit as an adjective like saying cash has a debit balance of rupees 25,000. So this is verb, this is noun and this is adjective.

So basically if the account is for an asset a debit side increases the value of the asset but if the account is for a liability the debit side reduces the value of the liability. Now let us look at the origin of the word credit.

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CREDIT

Credit is the right side of an account.
It has a Latin origin.

Latin verb: ***Credere*** (to trust or entrust)
Past particle: ***Creditum*** (that which is entrusted or loaned)
English: ***Credit***

It is written as "***Cr***.".

A credit decreases the value of an asset, but it increases the value of a liability.

This also has a Latin origin and this is usually, this will indicate the righthand side of an account. The Latin verb is credere, past particle is creditum that which is entrusted or loaned, the English word is credit from creditum and in abbreviation we say Cr. This is the historicity of the word credit. A credit decreases the value of an asset, but increases the value of a liability, it is just the opposite of the debit side of an asset or of a liability.

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JOURNAL

- The book in which entries are recorded.
- It is also called the book of original entry.

Transaction: Material is bought on payment of Rs 20,000.

Date	Particulars		Dr. Amount (Rs)	Cr. Amount (Rs)
	Purchase Account To Cash Account		20,000	 20,000

With this now let us go to some other term. A new term now we are introducing that is journal. Journal is the book in which entries are recorded one after the other date wise various entries for various transactions the entries are made and this is also known sometimes as the book of original entry. Whenever a transaction takes place the first thing to be filled up is the journal.

On this day this is the transaction and every transaction has got 2 aspects, 2 entries are made one is it says suppose that the material is bought on payment of rupees 20,000 so material is bought, so either it is purchase account or inventory account. It increases by 20,000, but payment of cash has been made for 20,000 therefore cash reduces both are assets.

And therefore increases meaning that this is in the debit side purchase increases or inventory increases the amount is written in the Dr. column whereas cash reduces, because cash has been paid, so cash reduces, therefore this amount appears in the credit column. 2 entries have been made. Suppose after sometime another transaction takes place there will be 2 more entries and correspondingly they will be written here. This is called a journal.

So journal basically contains entries for various transactions that take place. 2 entries are made for every transaction and particulars, date and the amount debited or credited are written down.

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LEDGER

- The book which contains the accounts.
- It is also called the Principal Book.
- It contains various accounts – both personal and impersonal
- Entries in the journals are ***posted*** in the ledger.

Transaction: Raw Material is bought on payment of Rs 20,000.

The relevant ledger accounts (also called the ***T-accounts***) are shown below.

INVENTORY A/C

Dr.	Cr.
To Cash A/C 20,000	

CASH A/C

Dr.	Cr.
	By Inventory A/C 20,000

Next we talk about ledger. This is also another new term and this basically contains various accounts. Basically if you recall a journal contains various transactions and it says for every transaction which accounts are going to be affected and by the by we had already said what an account looks like. Basically an account is for a particular item there is a cash, for cash on different dates we write down entries here and here.

This is for every particular entity or account we maintain. We maintain an account for every particular asset or liability whereas a journal says for every transaction different accounts and

their explanations and the amounts are mentioned here. This is the book of original entry. And in a ledger basically from the journals that we have mentioned here various accounts are maintained.

The entries in the journals are posted on to the ledger. Say for example, let us say that this is also known as the principal book, it contains various accounts both personal and impersonal. Say the transaction is raw material is bought on payment of rupees 20,000. The ledger accounts various accounts are kept in the ledger, they look like T and therefore these accounts are also known as T-accounts.

So you may have an inventory account here or a purchase account here. Inventory account we are writing; it is raw material. So inventory account and cash account. Now here inventory and cash both are assets and for every account there is a lefthand side which is Dr., the debit and the righthand side which is credit. Cash account also debit and credit. So when raw material is bought the raw material position increases therefore this increases by 20,000.

And cash account cash position reduces therefore this amount is credited to the cash account. Now there is a cross reference that this amount 20,000 refers to also the cash account therefore we write to cash account 20,000 and when we are maintaining the cash account we also give reference to inventory by writing inventory account 20,000 so this is how there is a cross reference between the accounts.

So 3 things, one is the journal where on every date has various transactions take place, the 2 entries are made indicating different accounts where the entries have to be basically posted and finally maybe at the end of the day from the journals to the ledger different individual accounts the entries are basically posted in this manner. There is a cross reference as you can see. The amount is written on the lefthand side for debit and for the credit also amounts written.

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First Entry in the Journal

The opening balance in an account in the beginning of a new year is the closing balance of the account in the previous year.

It is written as:

To Balance brought down (To Bal. b/d)

It is written in the

Dr. side for assets and
Cr. side for liabilities.

Now in any account there is always a first entry, that is the opening balance. The opening balance in an account in the beginning of a new year is the closing balance of the account in the previous year. So say cash position in the year 2011 March end cash position was something so when 2011-12 financial year, April 1st the first entry will be the closing balance of the previous financial year and that is called the first entry.

And there we sometimes write balance brought down or Bal. b/d, so it is written both in the debit side for assets and for the credit side for liabilities, 2 balance brought down.

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Example:

Hari opened a new hardware shop by investing Rs. 1,00,000.

In the first month of operation there were four transactions:

1. Hari bought furniture worth Rs. 20,000.
2. He bought goods worth Rs. 50,000, with Rs. 30,000 on credit and the remaining amount on cash payment.
3. He sold material worth Rs 7,000 for Rs 10,000 on cash payment.
4. He paid back Rs 10,000 to the supplier of goods.

Now we are giving an example of how to maintain an account. Let us say that Hari an entrepreneur opened a new hardware shop by investing rupees 1,00,000. So this is the amount he pays from his own funds. Now in the first month of operation there were we are assuming

only 4 transactions, there will be many transactions but for the sake of an example we are assuming that there are 4 transactions.

He bought furniture worth rupees 20,000, first transaction, he bought goods worth rupees 50,000 with rupees 30,000 on credit and the remaining amount on cash. So 50,000 is the amount of goods he bought but he paid only 20,000 and 30,000 he promised to pay later. He bought it on credit. Out of this 50,000 he sold material worth rupees 7,000 for 10,000.

It means that out of this 50,000 he bought some material which he bought for 7,000 rupees but he could sell for 10,000 rupees on cash payment, so making here a profit of 3,000 on the items worth 7,000 that he had bought. Now you recall that he had not paid 30,000 rupees to the supplier of the goods. Now he pays back 10,000 rupees to the supplier.

Now there are thus 4 transactions and how Hari would keep his accounts by following the double-entry bookkeeping system. Let us see that here.

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INVENTORY

Dr.	Cr.
2. 50,000	3. 7,000
43,000	

CASH

Dr.	Cr.
To Paid-in-captial A/C 1,00,000	1. 20,000
	2. 20,000
3. 10,000	4. 10,000
60,000	

FURNITURE

Dr.	Cr.
1. 20,000	
20,000	

PAID-IN CAPITAL

Dr.	Cr.
	1,00,000
	1,00,000

PAYABLE

Dr.	Cr.
4. 10,000	2. 30,000
	20,000

RETAINED EARNINGS

Dr.	Cr.
	Month 1-end Bal 3,000
	3,000

EXPENSE & REVENUE

Dr.	Cr.
COGS Tr. 3: 7,000	Sales Tr. 3: 10,000
	3,000

NPTEL

First of all, let us understand that he pays from out of his own money 1,00,000 rupees to start the business. So that is reflected in the form of cash. So cash increases by 1,00,000 rupees and there is a cross reference to the paid-in capital. Paid-in capital is the amount of money that the entrepreneur Hari has invested when the business started that is usually called the paid-in capital.

And as far as the company is concerned or this particular entity, the hardware shop is concerned this will be considered as a liability to the shop because it is Hari's money and not the hardware shop's money. Hardware shop own 1,00,000 rupees' cash but it owes that money to Hari so the paid-in capital is basically something like a liability and that increases. So if it is a liability the credit side says that it increases.

So the entry is made here in the righthand side of the T-account has 1,00,000 whereas cash increases cash is an asset of the hardware shop therefore the entry is 1,00,000 rupees is debited to cash account. So this is the first thing to note that Hari, the entrepreneur and the hardware shop, the entity for whom we are writing the accounts they are 2 different things. There are not one and the same.

This has to be understood right at the beginning. Now these transactions let us understand. The first transaction was that Hari bought furniture worth rupees 20,000 that means he paid 20,000 rupees from his cash and he got the furniture therefore the cash position will come down but furniture position will improve. So we have a furniture which is an asset, cash is also an asset.

So the first transaction this 1 is transaction number, this is transaction number so instead of following the convention that we had introduced earlier we are now putting the transaction number this is also followed. So we are saying the cash position reduces, cash is an asset, it is value reduces therefore the amount 20,000 is credited to cash. So if it is an asset credit side will reduce, but furniture is also an asset it is value increases therefore this amount is debited.

So 2 entries are made for the first transaction. Now let us look at the second transaction. Second transaction is not so straightforward, it says he bought goods worth rupees 50,000 with rupees 30,000 on credit and remaining amount on cash payment. So cash payment of 20,000 has been made therefore cash position will come down. Therefore, this amount of 20,000 would be credited to cash because cash is an asset.

Goods is basically an asset so goods inventory increases therefore these 50,000 rupees will be debited to goods. Whereas this amount he has not paid this is to be paid later so this is called accounts payable. He has to pay it later. This is a liability. The liability has increased from 0 to 30,000. When it is a liability the credit side increases.

So these 30,000 rupees will be credited to accounts payable account, let us see this, number 2 he bought goods worth 50,000 rupees, so transaction number #2; 50,000 rupees is debited to the inventory account, this is the T-account, 50,000 is debited. Payment of cash is made by 20,000 rupees, cash payment. Therefore, the cash position reduces. Cash being an asset and since the value reduces, the entry is made in the credit side.

Whereas this accounts payable has gone up by 30,000 therefore the entry is made in the credit side because payable is basically a liability. This has to be paid back, so it has gone up therefore the amount is credited to accounts payable account. Now let us look at the 3rd entry. The 3rd entry says he sold material worth 7,000 rupees for 10,000 on cash payment by the buyer.

So the buyer has paid 10,000 rupees which means his cash position has gone up. But the cost of goods sold, this is COGS, the goods that he has sold he had bought only for 7,000 rupees so from his inventory of 50,000 rupees 7,000 rupees will be less. These are the minimum 2 entries that must be made. Now let us looks at #3. First the inventory position has come down. Because 7,000 rupees worth of goods that he had bought earlier he was able to sell.

So inventory being an asset the value is reduced by 7,000, therefore this amount is credited to inventory and he could get 10,000 rupees by selling it. Therefore, cash position has gone up, cash being an asset this amount is debited to cash in the 3rd transaction but let us also understand that in the process he has made a profit, now this is written down in the expense and revenue account.

The so called nominal account that I was saying, impersonal nominal account, this is the expense and revenue account, now here we are showing the cost of goods sold as 7,000. This is same as this, transaction number #3, whereas he was able to sell 10,000 rupees it is credited making a profit of 3,000 rupees. This 3,000 rupees goes here and is shown as retained earning profit made in the business, 3000 rupees.

Now why the entry for cogs is on the lefthand side that is in the debit side and sales on the credit side we shall know a short while from now. Meanwhile let us go for the 4th transaction. He paid back rupees 10,000 to the supplier of goods. So he paid back 10,000

rupees so cash position comes down, 10,000 rupees is credited therefore to cash, but at the same time his accounts payable has also gone down.

Accounts payable was 30,000. He had bought goods worth rupees 30,000 sometime ago without making payment, so the whole amount was payable and since it is a liability which has increased therefore it is credited to payable, but now with the payment of 10,000 rupees back to the supplier is payable as reduced since payable is a liability it is debited to this account. So 4 transactions we have posted like this.

Now these are totals, whichever is the higher side we write that side, you will see that assets will always have their debit side as the total amount. So 50,000 – 7,000 is 43,000, this is 1,10,000 – 50,000 = 60,000. This is 20,000, so the debit side of all assets are positive after the totaling and here the credit side of all the liabilities are also totalled and positive. So this is 1,00,000, this is 20,000, this is 3,000.

Basically this 3,000 comes from the difference between the credit side and debit side. Now from out of these transactions we write down the trial balance.

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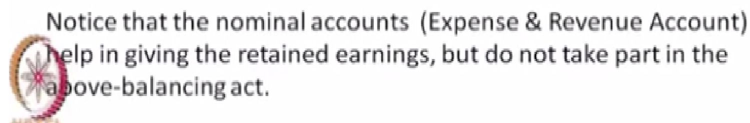
TRIAL BALANCE

The debit balances and credit balances should be equal.

Check:

Assets		Liabilities & Owner's Equity	
Inventory	43,000	Paid-in Capital	1,00,000
Cash	60,000	Accounts Payable	20,000
Furniture	20,000	Retained Earnings	3,000
	1,23,000		1,23,000



So what we have basically done you will see that the debit balances and credit balances will always be equal. To check this what we have done is inventory was 40,000, cash was 60,000, furniture 20,000. So 43, 60 and 20 that is what we have written down here 43, 60 and 20 for different accounts. Inventory account, cash account and furniture account.

And the liability side we have 1,00,000; 20,000 and 3,000, not this because already we have summarized them and posted it here, so 1,00,000; 20,000 and 3,000. When we add them up we see that they are equal. Notice that the nominal accounts that is expense and revenue account help in giving the retained earnings, but do not take part in the above balancing act.

So we have not considered the expenses and revenue account when we create our trial balance, in fact this is also an example of what we say balance sheet about which we will discuss later, but just now we are trying to tell you about how for different financial transactions accounts are kept by with the use of double-entry bookkeeping system.

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ACCOUNTING EQUATION

Total Assets = Total Liabilities
= Liabilities + Owners' Equity
= Outsiders' Claim + Owners' Claim
= Outsiders' Claim + Paid-in Capital + Retained Earnings
= Outsiders' Claim + Paid-in Capital + (Revenue – Expenses)

Revenue is treated as a liability and is credited to the Revenue & Expenses Account.

Expense is treated as an asset and so it is debited to the Revenue & Expenses Account.

Now this balancing act gives rise to an accounting equation which is that the total assets must equal the total liabilities. Now what we mean by total liabilities? It is the liability such as accounts payable plus the owner's equity in this case in our previous example Hari was the owner. So basically liabilities is the outsiders' claim and owner's equity is the owner's claim, Hari's claim.

Now in our previous example the suppliers were the outsiders and their claim was basically accounts payable. Whereas owner was Hari and his claim is the paid-in capital that is of 1,00,000 rupees and the profit that he has made which he has at this point of time forfeited is as 3,000 rupees. So owner's claim in our previous example is 1,03,000 rupees, that is what we are writing down here.

That the total assets = total liabilities = outsider's claim + paid-in capital + retained earnings. So this is also = outsider's claim + paid-in capital + what is return earning? it is same as revenue – expense. So please recall, revenue – expense, this is the revenue side, this is the expense side. Revenue is sales, expense is COGS – 3,000 and that is considered as profit and is added to the retained earnings, 3,000.

So paid-in capital is basically the amount or he has invested initially, so naturally that is his claim, he must get back, also since by doing this business he has got a profit of 3,000 rupees. He also has a claim to get this amount. Therefore, owner's equity is the paid-in capital plus 3,000 rupees. The outsider's claim is the extent in this case of 20,000 rupees only because the hardware shop has not made full payment towards buying the goods from the suppliers.

That is accounts payable. So this is outsider's claim and these 2 added together is Hari's claim, the owner's claim and these are the assets of the company and all assets together must equal the liabilities plus the owner's equity that is what we have shown. Now here the last equation will say that retained earnings is revenue minus expense. If you take expense to the left-hand side, then you will see the total assets plus expenses become equal to outsider's claim plus paid-in capital plus revenue.

Therefore, revenue is to be considered like a liability. It has a same positive sign as those of outsider's claim and paid in capital. Whereas expense when it goes to this side this is positive like total assets. Therefore, expense is treated as an asset. Therefore, our rule for debit and credit will apply accordingly. Recall that for asset if it values increase because of a transaction then that entry is to be put in the debit side that should also be done for expense.

Because they are treated as similar to asset, therefore if expense increases it should be debited whereas when revenue increases it should be credited because it is like a liability that is the reason why we have sales being a revenue it is treated as a liability when the liability increases it is credited to the account similarly when revenue increases this is credited to sales. Whereas expense is like an asset when it is value increases like an asset increasing it is debited.

Similarly, here the expense rises therefore it is debited whereas this is credited. Now we have introduced quite a few terms let us give proper examples.

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EXPLANATIONS OF A FEW MORE TERMS

Corporation: A business organized as a separate legal entity and owned by stockholders

Assets: Economic resources that are expected to benefit future activities

Liabilities: Entity's economic obligations to non-owners

Equity: Claims against, or interests in, the assets

Owners' Equity: It is the excess of assets over the liabilities

Stockholders' Equity: It is the owners' equity of a corporation

Paid-in Capital: The ownership claim arising from funds paid-in by the owners

First of all, we sometimes use the word corporation is basically legal entity and is owned by stock holders if Hari of course is only one owner, but there can be situation when there are quite a large number of owners graphically or geographically distributed and this usually called a corporation. Assets is any economic resource that is expected to benefit future activities basically an investment that the corporation makes to be able to generate products and services for making profits, usually profits.

And liabilities are entities economic obligations to outsiders meaning non-owners. Equity as we have already seen is the claims against or interests in the assets and when we say owner's equity it is the excess of assets over liabilities. So assets minus liabilities will be the owner's equity which is same as paid in capital plus retained earnings from the equation that we had shown earlier.

Stockholder's equity, it is the owner's equity of a corporation because there are large number of owners not one, so we sometimes call them stockholder's equity. Paid-in capital is the amount invested in the beginning when the corporation start. The ownership claim arising from funds paid in by the owners. Some more term also we have now introduced.

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Retained Earning: The ownership claim arising from the reinvestment of previous profits.

Accounts Receivable (Debtor) : Amounts due from customers for sales on open account

Accounts Payable (Creditor): Amounts owed to vendors for purchases on open account

Revenue: Increase in the owner's claims arising from the delivery of goods or services

Expense: Decrease in the owner's claims arising from delivering goods or services or using up assets

Profits (Earnings, Income): The excess of revenues over expenses

Retained earnings, it is ownership claim arising from the reinvestment of previous profits. So basically in our earlier example 3,000 rupees was basically the profit out of the sales, but Hari, the owner did not take that money to his own pocket, instead it remained with the company so it is reinvested with the hardware shop, so it is reinvested. So that is the ownership claim of Hari, that is called retained earnings.

Accounts receivable also called debtor is the amounts due from receivable from customers so that means, suppose that I sell my goods to customers on credit then this amount is receivable from the customers, amounts due from customers for sales on open account. Open account means on credit. The opposite is accounts payable which example we had already considered and that is also known as creditor.

Amounts owed to vendors for purchase on open account. So Hari bought goods on credit for 30,000 rupees so that is accounts payable. Revenue is the owner's claims arising from the delivery of goods or services and expense is decrease in owner's claims arising from delivering goods or services or using up assets. So in Hari's case 7,000 rupees worth of goods were sold out for 10,000 rupees. So 10,000 rupees is the increase in the owner's claim.

But that claim was reduced by 7,000 rupees which is the cost of the goods. So expenses are always subtracted from the revenues. Profit also known as earning or income is the excess of revenues over expenses. So these terms we have now given formal definitions for you to understand.

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ACCRUAL BASIS OF ACCOUNTING

- **Accrual basis** of accounting recognizes the impact of a transaction on the financial statements in the periods when revenues and expenses occur instead of when the company receives or pays cash.

Examples:

5. Hari sells goods worth Rs 20,000 for Rs 30,000 all on credit.
Here revenue is used in the current month rather than in a future month when cash will be received.

6. Hari could not pay the rent (Rs 2,000) for the current month; he would pay it the next month.

Here, in the current month, rent is taken as an ***expense*** and is also recorded as ***Accrued Expense Payable***.

Now here we would like to introduce to you also a very important concept known as accrual basis in contrast with cash basis of accounting. We had considered an example of Hari's hardware shop where he bought goods worth rupees 50,000; 20,000 he paid cash but 30,000 he did not, he bought on credit. So what we did? this is what example I am saying, this is of course sells goods worth rupees 20,000 for 30,000 all on credit.

This is the reverse example. Now here revenue is used in the current month rather than in a future month when cash will be received. Now he did not receive cash. This is the example when Hari sells goods worth rupees 20,000 but all on credit, so he will get this amount of money later in some later month or at a later date, but his inventory position comes down. Still according to if it was a cash basis then he would not show he sells as rupees 30,000.

But on an accrual basis when a transaction has actually taken place whether or not cash changes hands we shall show sales as rupees 30,000 that is the accrual basis and in accrual basis we show sales as 30,000, in cash basis we do not. Accrual basis of accounting he recognizes the impact of transaction on the financial statements. In the periods when revenues and expenses occur instead of when the company receives or pays cash.

So here revenue is used in the current month rather than in a future month when cash will be received. A second example is Hari could not pay the rent of 2,000 rupees in the current months he would pay it in the next month, here in the current month rent is taken as an expense and is recorded as accrued expense payable. We have shown this here.

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INVENTORY

Dr.	Cr.
To Bal b/d 43000	5. 20,000

RETAINED EARNINGS

Dr.	Cr.
	To Bal b/d: 3,000
	5. 10,000
	13,000

ACCRUED EXPENSES PAYABLE

Dr.	Cr.
	6. Rent: 2,000

ACCUNTS RECEIVABLES

Dr.	Cr.
5. 30,000	

EXPENSE & REVENUE

Dr.	Cr.
5. COGS: 20,000	5. Sales: 30,000
6. Rent: 2,000	

The first example is that he sold 30,000 rupees worth of goods, but all on credit, now here although cash has not reached Hari, we are still showing sales having taken place and we are crediting it as a revenue putting in the credit side, sales 30,000 we are showing and expense we are showing 20,000 because the cost of goods sold was 20,000.

So cash has not actually exchanged hands, but we are still showing this amount and at the same time we are maintaining another account accounts receivables that this amount has not been received by Hari, by the hardware shop. Therefore, this account is an asset and it is therefore shown on the debit side 30,000 rupees. The second example was that Hari could not pay rent of 2,000 in the current month.

So rent is an expense, it is shown as an expense in this month's account 2,000 rupees but at the same time we maintain another account saying accrued expenses payable, it has not been paid, we have to pay later, it is a liability and since it is a liability the rent is shown here as 2000 rupees.

Now look at these examples, the cash account is not at all involved, because cash has not changed hands yet we maintain the account as if the transactions have taken place this month and this basis is called the accrual basis compared to the cash basis. So friends today we introduced a very important concept of accounting, of how to actually keep your accounts. So we initially talked about account.

We introduced journal, and we introduced ledger, then we gave various examples and showed how different accounts had to be maintained and important thing is that whenever a transaction takes place there are always 2 or more than 2 entries, they require debiting or crediting. Debit is the lefthand side of an account, credit is the righthand side of an account.

If that account is an asset the debit side entry means that the asset value will increase, the credit side entry means the asset value will come down. The reverse is the case if the account is a liability. If an entry is made in the debit side it means the value decreases. If it is made in the credit side the value increases.

And a very important concept of accounting is the accrual basis which says that whenever a transaction takes place make the entries not waiting for actual exchange of cash. We shall elaborate on these points and use these concepts in both costing as well as financial accounting later. Thank you.