Managerial Accounting
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Module - 1
Lecture - 2
Double Entry System, Forms of Organization

Students, we have already discussed our module 1 point 1 of management accounting. In the module, we have seen; what is management accounting, what is FA, what is cost accounting. We have also seen a very basic understanding of financial statements particularly, we have looked at money cycle, and how, from the money cycle, you get P and L account, and you get balance sheet. Now, let us try to understand a little bit into concepts. These concepts are the very assumptions on which, the accounting statements or financial statements are based. We will briefly look at 3 to 4 concepts in this module 1 point 1. This is in continuation of 1 point 1; now, let us go to 1 point 2.

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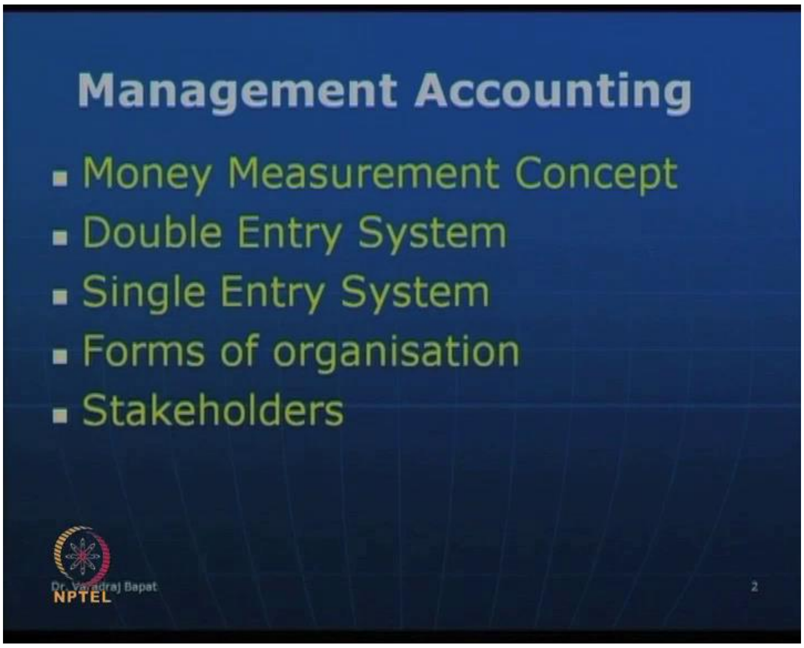

In this particular module, we are going to cover these four things; we will talk about money measurement concept; double entry and single entry system; after that, we will go into forms of organization, and we will also see who are the stakeholders, who are interested in looking at the financial statements. Now, the first concept; money measurement concept, at it is known as. Now, all of you know what is meant by money. Money is some value in which, transaction happens. So, you have a currency, like your Indian rupees in India or dollars in US and so on. Now, financial accounting essentially, measures only those things, which are valued in money. This is what is understood by this concept. Now, if we take an example of a transaction, which is valued in money, we have already seen money cycle. So, you know that perhaps, businessmen put in some money to start the business.

So, that is a transaction where, the valuation happens in money. Then, business or a company may buy some goods, pay the money. Again, it involves transaction of money. Business may sell some goods on credit. So, actual cash is not received, but still it is a monetary transaction, because the value of transaction is known, and in future, you are likely to receive that money. These are all the examples of transactions, which can be measured in money, and that is why they are recorded in the financial statements. Now, can you think of an example of a transaction, but which is not measurable?

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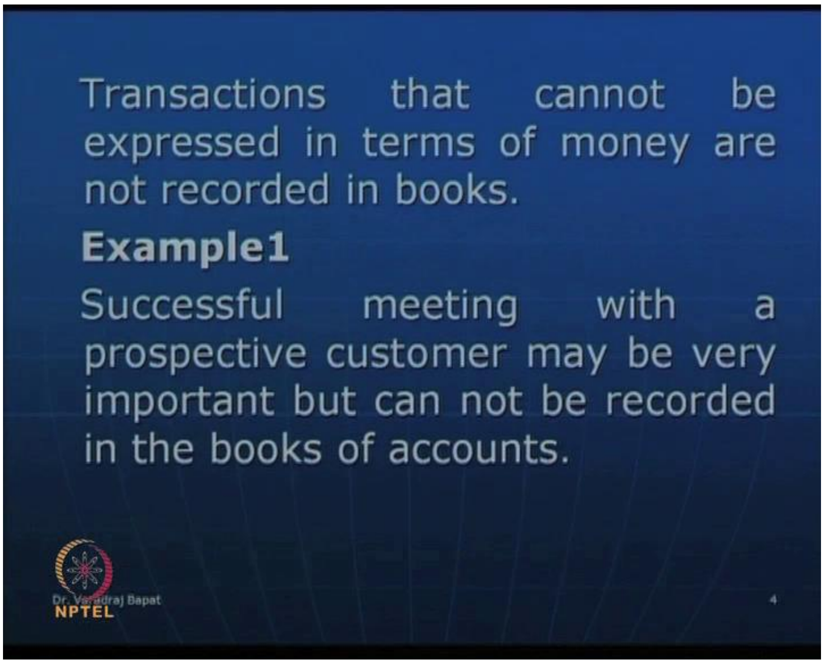

If you give a little thought, you will realize that you can have transactions, like successful meeting with a customer. Now, such a meeting is very important for business growth. However, just meeting does not mean any particular monetary effect or a monetary transaction. That is why it cannot be recorded in the books. I will also try to give you one more example. Suppose, company gets a very good employee; hires the person. Now, what can be recorded if just the cost of recruitment or the cost of induction, training; but value of the person, who comes in, will be very high for the concern. If the person is motivated, dedicated, and skilled and so on, but since, these features or these characteristics cannot be recorded in money terms, human asset, which is coming in into organization cannot be recorded.

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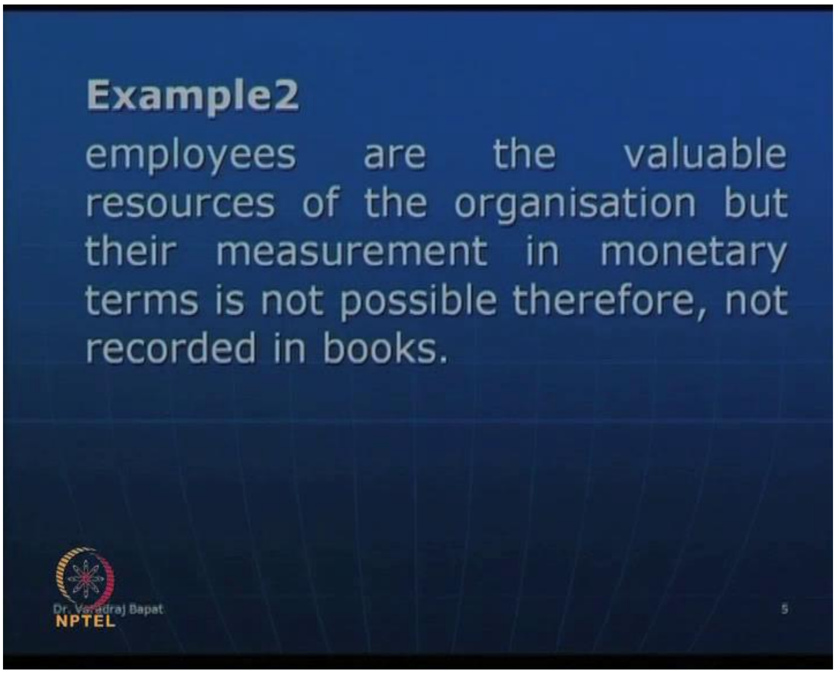

So, we have seen two examples of those items, which cannot be recorded, and of course, there can be many examples where, you can record, because it is a monetary transaction.

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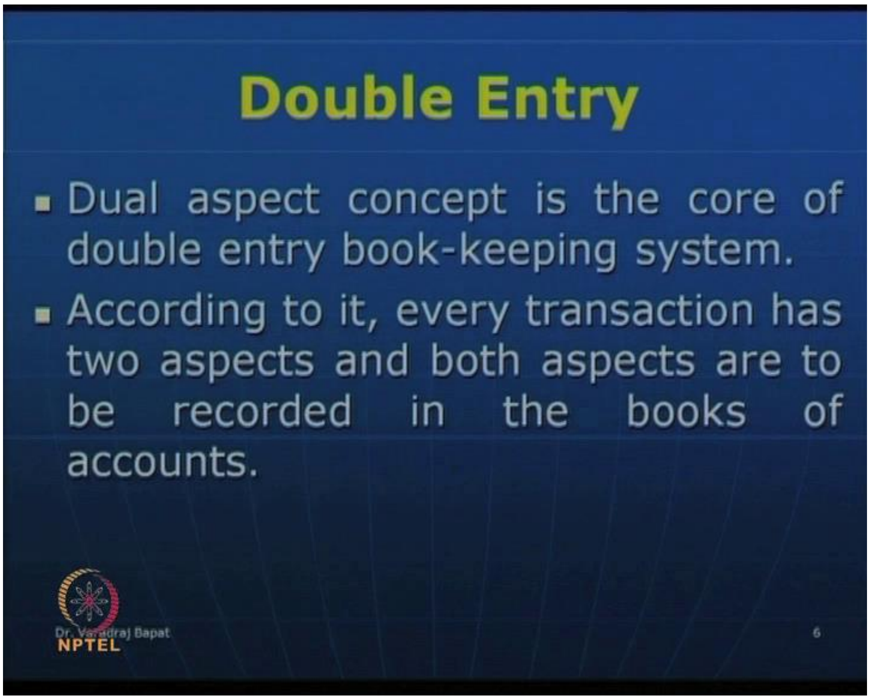

Now, let us go to another concept. You can also look to it as a system. It is known as double entry system of accounting. What is meant by double entry is that every transaction has two effects, and both the aspects of the transactions needs to be recorded.

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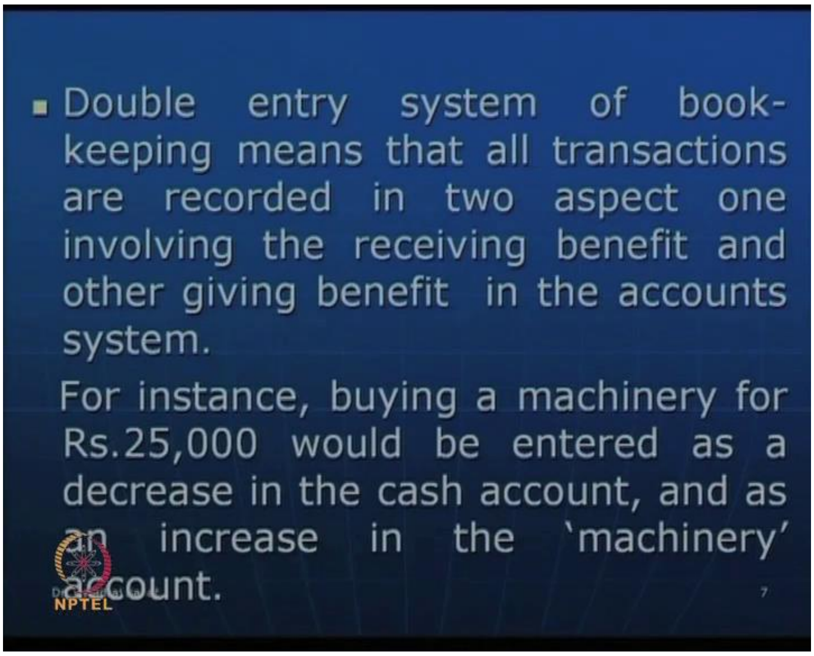

In double entry system of accounting, if you take an example of, let us say that you want to buy machinery. So, you have paid cash of 25000, and you have taken in the machinery. Now, what will happen is the balance of machinery in your records increases. In accounting terminology, we say machinery account will increase. Simultaneously, you are paying cash. So, your cash or bank balance decreases. So, you will realize that machinery has gone up, while cash has gone down. In this way, every transaction is going to have two effects, which will exactly match; that is an understanding under double entry system of accounting.

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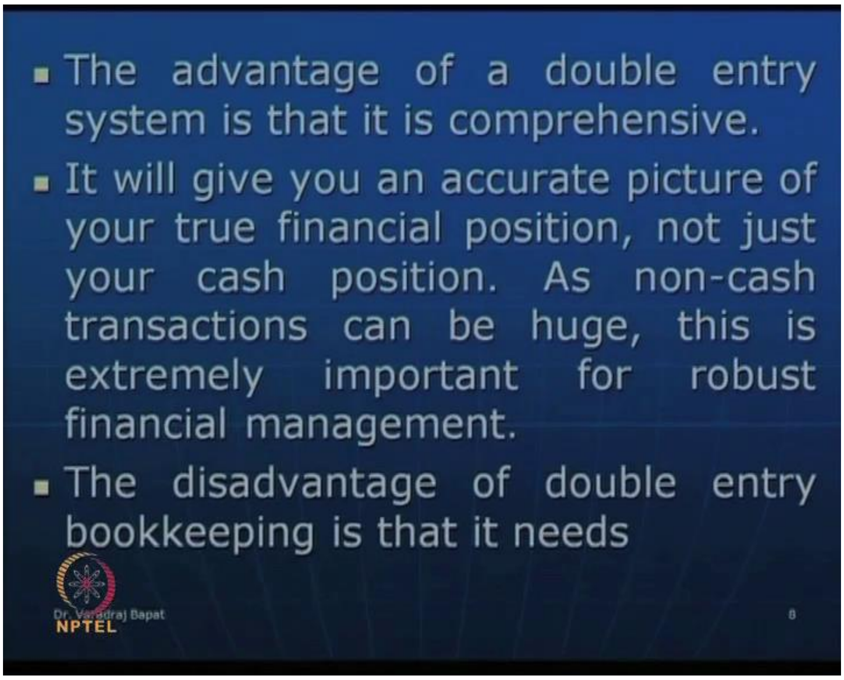

Now, what is the advantage of this system? Now, the advantage of this system is that you get a comprehensive recording of both the effects of the transaction, because you all know that in life, nothing comes for free. If you have got something, you have given something. So, every transaction essentially, has two effects and both the effects need to be recorded. Now, because it is a comprehensive and complete recording, it follows that it helps you to make proper financial statements, and you also, get to know your correct financial position whenever, you make the financial statements. This in turn, helps you to make proper financial management as well.

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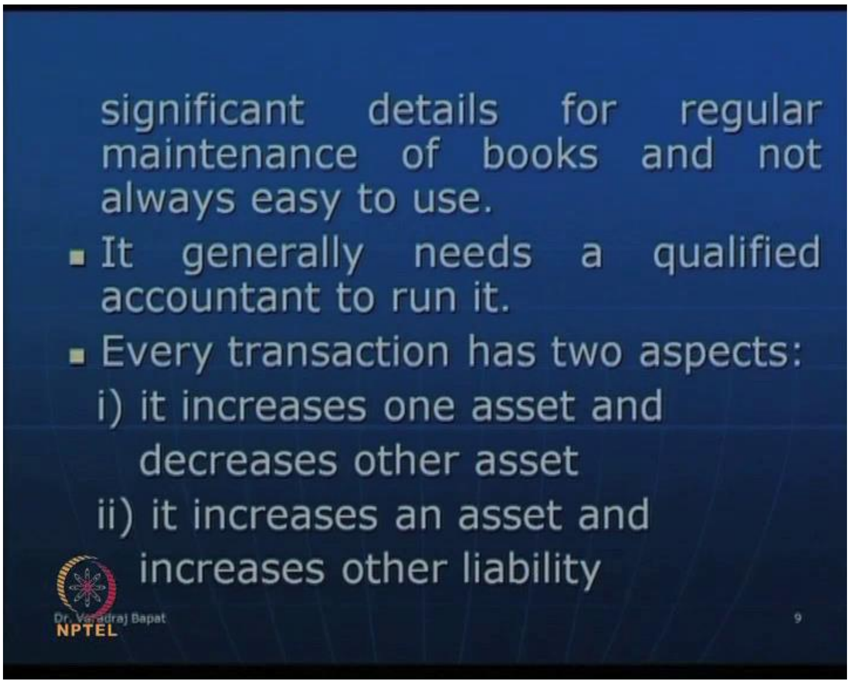

Now, there is a small disadvantage of this system. That is that it requires regular recording. So, when regular recording happens, you many times require a qualified accountant, and you will have to spend some time in recording the transaction moment, it happens, but the advantages, which you get of this regular recording, are so high that practically, all organized businesses do have a system of accounting, which is based on double entry. Let us take few examples of how transactions happen. We have already seen one example where, you pay cash of 25000; you get machinery.

So, one asset increases; the other asset decreases. Sometimes, it may happen that one asset increases and the other liability, also increases. Can you think of an example? If you continue the machinery case, let us say I have purchased machinery of 25000. So, asset increases, but I have not paid the party, but suppliers are now payable in my books, because I have to pay them in future. So, machinery account increases or the balance of machinery increases. At the same time, the amount payable to supplier also increases. So, this is an example where, there is a increase in the asset, and there is a increase in the liability of the equal amount.

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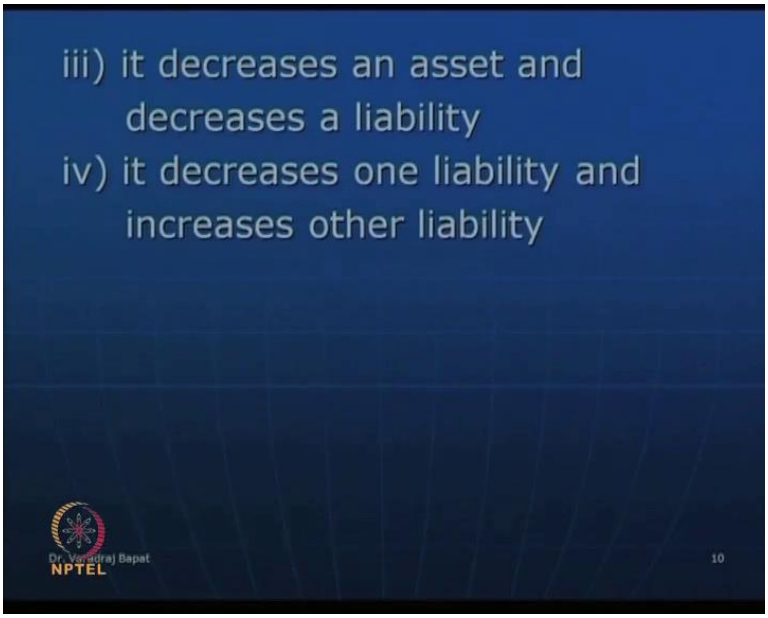

Third example; there could be a possibility of decrease in the asset and decrease in the liability. If we continue the same example, what will happen is; I have purchased machinery and I have not paid the party. So, machinery balance increases, the party's balance also increases. After, say a week, I pay the party. So, now, what happens is liability comes down and, because I am paying, my cash and bank balance also comes down. So, here, one asset decreases, one liability also decreases. I will also try to give you another example. Let us say I have taken some loan from bank, and I repay the installment. Now, moment I pay the installment, what happens is, loan balance decreases and my bank balance also decreases.

So, bank balance is an asset; asset goes down. Loan balance is a liability; liability also goes down. Now, there is also a possibility of fourth case where, there is a decrease in one liability, which is compensated by increase in another liability. Just think of an example. Suppose, I have some money, payable to a creditor or a supplier of goods. Now, I am not in a position to pay the party that money. So, instead of paying the supplier, I convert that money into loan balance, so that I will pay after 2 to 3 years, and the party agrees. In that case, what will happen is the balance of creditor will decrease, but the balance of loan will increase.

So, one liability goes down; other liability goes up. Like this, every transaction will always involve the changes in the two balances, with amongst the assets and liabilities.

There can be more examples, but here, I am just trying to tell you the concept. Later on, we will see the transactions and try to actually, take the case. That time, may be, it is more clear to you. Now, we have already seen double entry, as against that there can be a system known as single entry.

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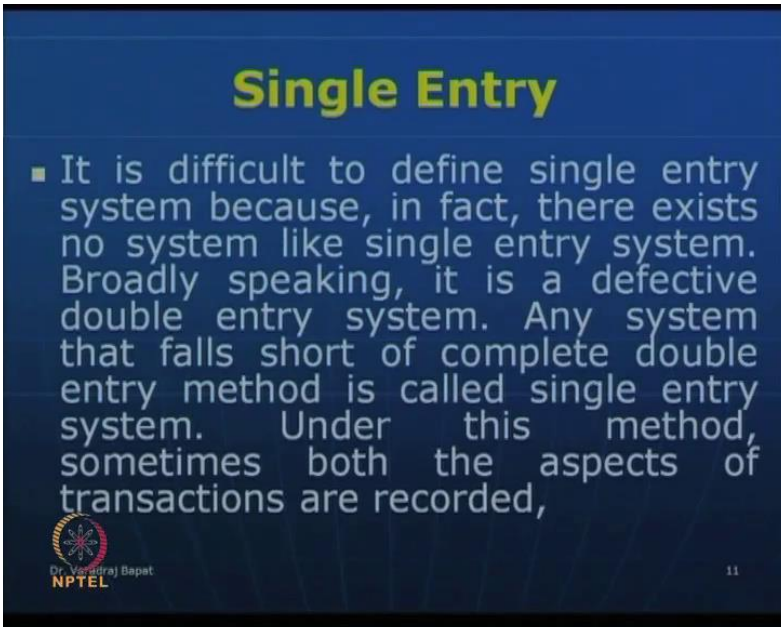

Now, properly speaking, there is no system per say, as a single entry, because this is not a systematic way of recording. Now, suppose instead of recording both the aspects, somebody only records one aspect of the transaction; it could be considered as a single entry. For example, let us say there is a Pan Wala in front of a hotel. Now, usually, Pan Wala is giving pan and collecting cash. He may have a small dairy where, he goes and recording the cash, which comes in. Now, here, he is only recording one aspect; that is the aspect of cash coming in. He is not recording the fact that there is a sale of goods or there is a reduction in the stock. So, this type of system is a cash system. Similarly, suppose, Pan Wala sells the goods or sells his pan, but does not receive the money; gives it on credit. The party may pay after a week or so. In that case, he may have another dairy and he records person’s name and goods given to that person, with a date. This could be also an example of a single entry, again, because the other aspect is not recorded.

Now, this is not a regular system, which is followed in organized businesses. As we have just discussed, double entry system is essentially, followed in most of the large scale businesses. So, I cannot give you many examples. This single entry is rarely, used only by unorganized and very small businesses. Only advantage of a single entry is the cost of recording is less, but you do not get proper data. Similarly, you cannot make correct profit and loss, balance sheet from single entry. So, it is not recommended to use single entry system; double entry system should be used.

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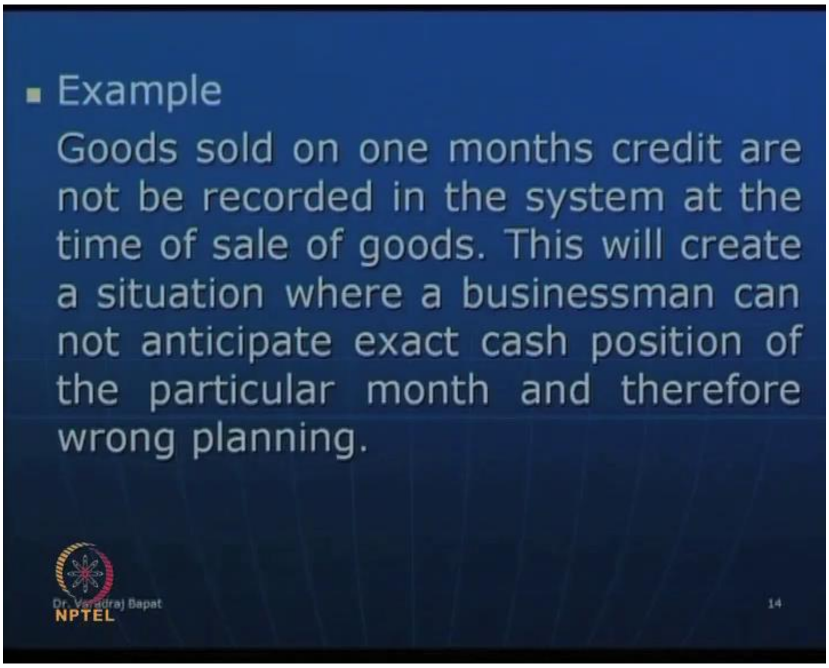

Now, let us go to the next concept. Here, there is one more example. Suppose, goods are given on credit; they are not recorded at the time of sale. Now, the problem will happen is you will not know, what is likely to be the cash position after a month, because proper system of recording does not exist. So, this is an example where, not use of double entry system, may significantly, harm the business. A time may come; suppose, you commit many people that; you will pay after fifteen days; you will pay after one month, but do not record these transactions. After fifteen days or one month, when the time up payment will come, business will face a lot of embarrassment. Even, company may go into liquidation, or may have to close, because of improper recording. So, double entry system is what is recommended, and should be followed.

Now, let us go to the next thing. Next thing is known as; now, here, we are going to discuss about various forms of organization. You all know that if you want to do business, it can be done in variety of ways. The smallest form of organization as you can see here, is sole proprietary business.

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Now, in sole proprietary business, what happens is you have a single owner. Little bigger firm is Hindu undivided family. Then, you have got partnership firms; you have got companies, and you have got co-operative societies. Now, basic accounting systems do not change. Whatever, is the form of organization, accounting continues to have same assumptions and same principles of recording, but for each of by entity, stakeholder slightly differ, and that is why, the reporting formats may change, and sometimes, some extra details are required to be given.

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Now, let us try to understand the different forms, and the advantages and disadvantages of these forms. Now, the first and the simplest form of organization is sole proprietorship. Now, sole proprietorship is a business, which is owned by a single person, and the person is known as the proprietor, and sole, because he is the single owner of the whole business. Now, naturally, ownership as well as management, is totally in the hands of one person. So, you can imagine now, based on this, what could be the advantages and disadvantages of single ownership. Can you think of any advantages of this? Now, what happens is if you have only one owner, one manager; same person is a manager; the decision making is in the hands of single person.

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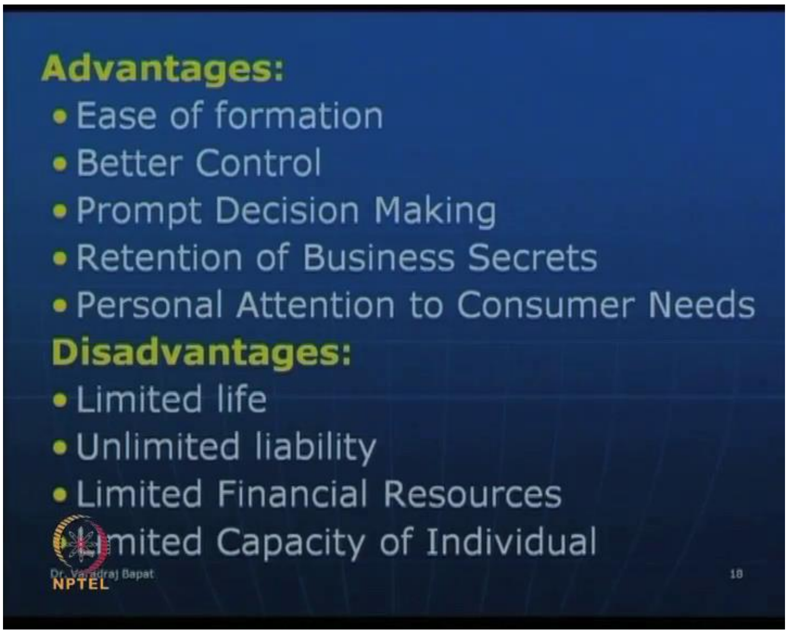

So, naturally, one can take very fast decisions. There is a better control over operations, because single person is going to control the whole thing. You do not have to disclose information to outsiders. So, there is retention of business secrets, and since, the owner is normally, personally attending the customer needs, usually, there is a personal touch, and there is an emotional attachment between the owner of business and also the customer. From the legal point of view, the advantage is that formation becomes very easy, because this form of organization does not require any formal registration. So, it is very easy to form it; time required as well as cost is negligible. So, any person, starting a new business; it becomes very easy to start as a proprietary concern, or a sole proprietary business. There are many disadvantages as well. First major disadvantage is life of the business is limited, because it is a single person. So, in case of illness, in case of disability, in case of lack of interest, in case of death of that owner business automatically, comes to end. Secondly, the liability is unlimited, because there is only one owner.

Suppose, I am the owner; I start a business. If there is any liability incurred in the business; from my personal money, I will have to meet that liability. So, for me, as an owner, the liability becomes unlimited. All the losses of the business totally, fall on me. Third major disadvantage is there is very limited availability of resources. So, suppose I am the owner; essentially, I have to put in my money. That is, I put in as a capital and few of my friends, few of my relatives, may put in money, but I cannot ask outsiders or unknown people to invest, and they will also not invest, because I am the sole owner. So, naturally, other people will not give me lot of money.

So, there are restrictions on how much money, a single proprietor can rise, and that is why these businesses cannot grow, and cannot have more financial power. Equally important is lack of managerial skills, because it is a only one person managing; the business cannot be expanded too much, because the resources available in terms of intellectual resources, in terms of skills; are also limited though, the person can hire few employees, but still, they are not owners. So, responsible people are comparatively, less. Since, sole proprietary business does not have very high status in the market, usually, skilled people or say, highly educated people do not join such businesses.

Again, that becomes a disadvantage, because hiring man power becomes difficult. In the market also, the credibility of a sole business is comparatively less than that of a company. So, customers become little susceptive to give more business to sole business; sole proprietorship. That is why this is a good one to start the business; it is the good form to start a business, but it is not a very good form to grow. Once a certain business level is reached, typically, people convert their sole proprietorship into partnership firm, or they may convert it into a company, so that they can grow very fast.

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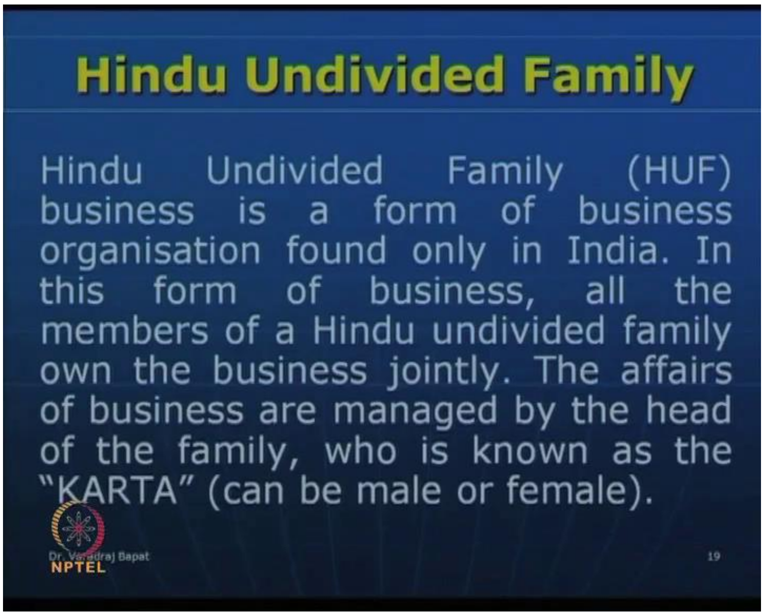

Now, we will go to the next form. Next form is known as Hindu Undivided Family. Now, this is not a form, which is actually, formed by the people. This is essentially, a creation of law, and as the name family suggests, actually, it comes from ancestors, and it gets form, because of relationship. Now, this is a unique form, which is only there in India. It has been recognize and has been used for a very long time. Now, the head of the family is known as KARTA, and KARTA is essentially, responsible for all business activities and his or her, whoever is the KARTA; KARTA's signatures are required to do the transactions on behalf of the family.

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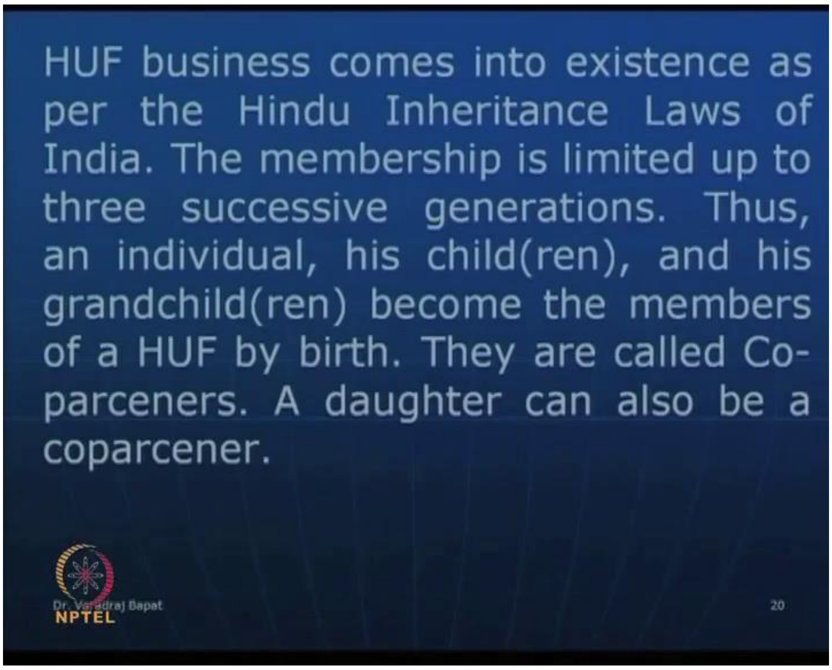

Now, HUF comes into existence from Hindu inheritance laws. All the individual children, grand children; all become the members of HUF. They are all known as coparceners. For many years, daughters used to be not coparceners, but now, both sons, daughters, grand children, grand sons, granddaughters; they all become coparceners of HUF. Now, HUF form of business traditionally, was used for agriculturist. It was also used for many of the businesses, which were family run. Now, it is not a very popular form, because you cannot invite outsiders. Neither you can leave at you will. So, it is not very popular form, but still, many businesses are run as HUF. There will be some tax advantages; both for individuals and also for HUF.

So, if you are running a sole proprietary business, certain basic amount of income, say, 1,60,000 for males and 1,0090 for females, becomes tax free. Same way for HUF also, some initial, up to some initial income, there is no income tax required to be paid. So, both sole proprietary business and HUF actually, enjoy some tax advantages. However, there is a disadvantage, because they are good forms to grow, as we have seen.

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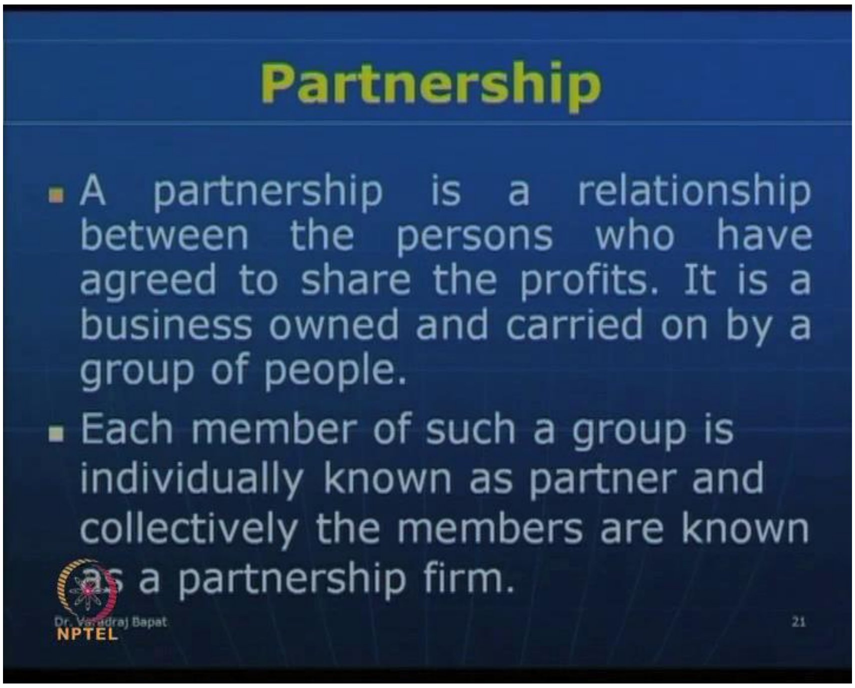

Let us go to the third form; that is known as partnership firm. Now, as the name suggests, partnership firm, this is essentially, a group of people, who are known as partners. So, say 4 to 5 friends join together, or sometimes, family members may join together, and they create a firm as a group, and that firm is known as partnership firm.

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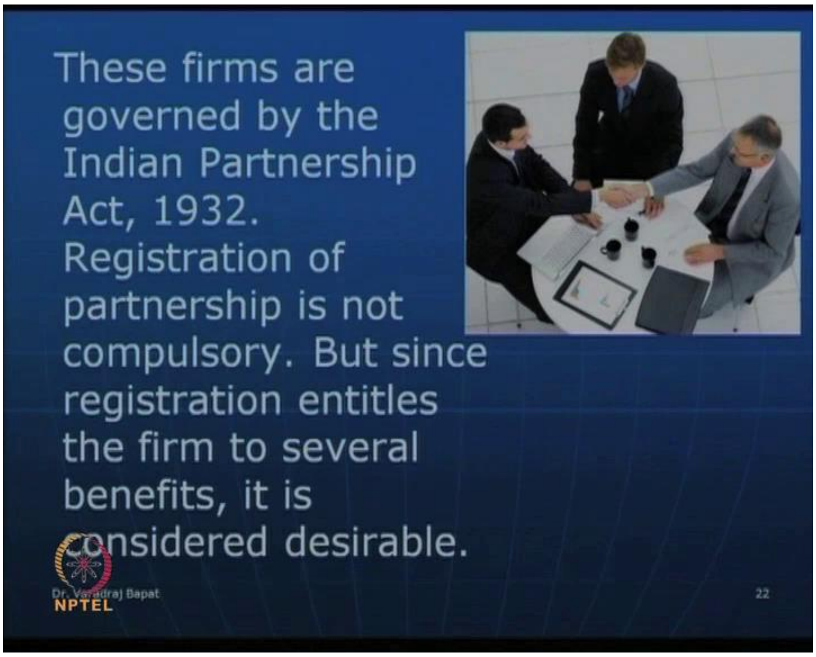

Now, this is formed under Indian partnership act, 1932. Here, the registration is not compulsory, but it is better to get registered, because if once, the firm is registered, you get legal sanction for the same.

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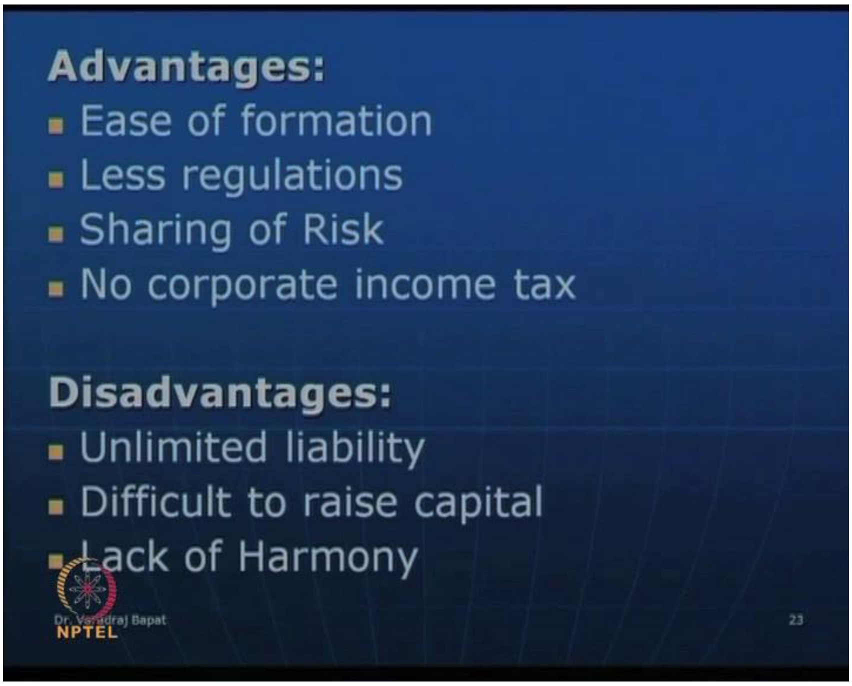

Now, there are many advantages of this type. One is, the formation continues to be easy, and it is not that costly. So, if you compare with a company, the formation of a firm is comparatively, much easier, but compared to sole proprietary business, it is slightly complicated, but it is not so costly. Then, partnership form of business is not much regulated. So, it retains the advantages of sole proprietary business, but there are some additional advantages, because in sole proprietary, you had only one owner; now, you have a group of owners. So, if you have 5 people, naturally, risk get shared. So, risk is not only on one person; it gets shared between 4 to 5 people. Then, you get to actually, pool the resources. So, one person may be good in marketing. Other may be good in technology or manufacturing. Third may be good in finance. If they join together, there will be lot of synergy. So, business can grow very fast.

So, there is more resource, in terms of money also. Since, 4 to 5 people will put in the money, there will be more resources. Partnership firms do not have to pay any corporate income tax. They have to pay some tax, but the level of taxation is comparatively low. So, in a way, this is a slightly, superior form over proprietary business. It retains many of the advantages of proprietary concern plus, it has more advantage, because it has a pool of people, but it has some disadvantages. First major disadvantage is the liability continues to be unlimited, in a sense that suppose, there are 5 businessmen, or 5 friends, joining the business, but one of them also defaults; all four have to actually, bear that liability without any limit. So, there is an unlimited liability. So, you cannot take outsiders into a firm. So, there is a difficulty in raising the capital. Similarly, there is a difficulty, because if there are any differences in the partners; there are 4 to 5 people; and if there are any differences, fights between them, then the whole business become, comes in problem.

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Now, there is one slight new origin of partnership that has come. That is known as limited liability partnership. In limited liability partnership, it is same like the partnership firm; group of people coming, but the liability of every partner is limited.

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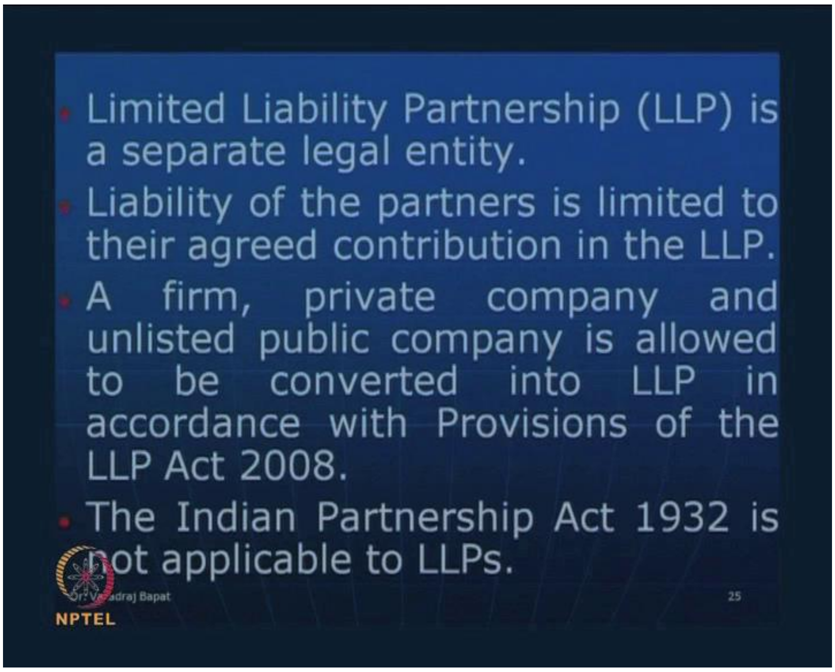

So, the disadvantage of unlimited liability is, I mean, overcome, and there is a separate provision for limited liability firms. There is a separate act for it known as LLP act, 2008. This firm has some advantages over the other forms. So, we will stop here. In the next session, we will discuss with some other forms of business, which are company. Then, we will go to co-operative society and so on.

Thank you so much.