



Principles of accounting

D. Leiwiy

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Undergraduate study in
**Economics, Management,
Finance and the Social Sciences**

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Chapter 1: Introduction

This subject guide has been written for those of you who are studying **AC1025 Principles of accounting**. The course is intended as a broad introduction to the subject, both for non-specialist students, and as a foundation for further study in the area.

1.1 Route map to the subject guide

This subject guide is divided into 20 chapters which, with the exception of the Introduction, are organised in two sections:

Chapter 1 is a general introduction to the subject and the course.

Chapters 2–12 form Section 1 on **Financial accounting**. This section distinguishes between financial accounting and management accounting; introduces and explains financial accounting concepts and conventions; and provides a grounding in double-entry book-keeping and the preparation of basic financial statements. This section also enables you to analyse and interpret the information contained in these financial statements, and to explain their limitations, with reference to underlying theories and principles. Although a grounding in double-entry book-keeping is provided, you should note that it is possible to prepare basic financial statements from both structured and unstructured information without making use of this technique; double-entry book-keeping is used by businesses to record financial transactions as they occur, but if this data is already provided then it can be directly manipulated for financial reporting purposes. This section corresponds to Section 1 of the syllabus for this course.

Chapters 13–19 form Section 2 on **Management accounting**. This section introduces a range of management accounting applications and techniques for planning, decision-making and control. These techniques are supported by discussion of the underlying theories and principles; and the emphasis is placed on the ability to interpret and critique their use. This section corresponds to Section 2 of the syllabus for this course.

Chapter 20 gives some revision advice.

Finally, suggested solutions to some of the exercises and Sample examination questions set in the chapters are provided in Appendix 1. In Appendix 2 you will find two Sample examination papers and extracts from interest (discount factor) tables. *Examiners' commentaries* relating to the 2014 examination papers can be found on the VLE.

1.2 Introduction to the study of accounting

From the outside, accounting can appear to be a purely practical subject. It would be very easy to focus on just the applications of techniques and procedures. However, accounting is more than just a set of calculations; unless we can understand and interpret the figures we produce, the calculations are pointless!

Accounting provides information for a wide variety of different users and purposes, and its practices can only be properly understood and assessed in relation to the economic and social environment in which they are applied. Therefore there are four aspects to this subject:

1. Techniques for recording, calculating, classifying and reporting of accounting information.
2. Legal and institutional background associated with accounting information.
3. Economic and administrative problems which the information is required to solve.
4. Interpretation of reports prepared using point 1 in the light of points 2 and 3.

The accounting information referred to in point 1 above need not be financial, although for our purposes in this course it will almost always be.

The problems referred to in point 3 above are largely concerned with the planning of, and control over, the use of economic resources. They are also concerned with the measurement of income and of various kinds of value changes.

In order to properly interpret accounting information as in point 4 above, and apply it to the problems in point 3, we need to understand the theory and principles which underlie the techniques in point 1.

The study of accounting is traditionally divided into two parts according to the types of users of the accounting information.

Financial accounting is primarily concerned with the needs of users **outside** the business (or other organisation). Therefore it relates to the **external** control and management of resources (for example, by shareholders of the company in which they have invested their funds, or by banks making loans). A key part of financial accounting is reporting the performance and position of the business to these external users, via the **financial statements**. The form and content of financial statements is usually highly regulated.

In contrast, **management accounting** is concerned with the needs of users **inside** the business. Therefore it relates to the **internal** control and management of resources (for example, by the directors, management or employees of a company). Management accounting statements may be more detailed than those prepared for external users, and do not normally need to meet any legal requirements.

Countries around the world organise their economic and financial activities in different ways so, inevitably, legal requirements, regulations and administrative procedures also vary across countries. The syllabus for this course is based on the system pertaining to the UK; however, the amount of institutional material that you need to know is kept to a minimum. Even though the material in this subject guide is based on the system in the UK, accounting rules and guidelines around the world are becoming more similar (converging) as a result of International Financial Reporting Standards (IFRSs) which are complied with by large companies in most countries. This is part of a general drive to harmonise international accounting practices.

It is important to note that knowledge of the following is **not** part of the syllabus: UK Statements of Standard Accounting Practice (SSAPs), Financial Reporting Standards (FRSs), and of International Accounting Standards (IASs) and International Financial Reporting Standards (IRFSs).

1.3 Syllabus

This course is designed to introduce you to accounting and financial management. Traditionally concerned with measuring, recording and reporting financial transactions and events, modern accounting provides a broad range of information for a wide variety of users. Financial accounting and reporting is primarily concerned with the needs of users outside the business, such as shareholders, regulators and creditors. In contrast, management accounting and financial management is concerned with the needs of users who are internal to the business, such as directors, managers, and employees.

The course is arranged in two sections. The first section introduces and explains financial accounting concepts and conventions, and provides a grounding in double-entry bookkeeping and the preparation of the primary financial statements. The second section introduces a range of applications and techniques for planning, decision-making and control.

Section 1 Financial accounting

Accounting harmonisation and International Financial Reporting Standards. Accounting concepts and conventions: their nature, purposes and limitations. How to prepare and interpret financial statements: 'Statement of Financial Position', income statement and statement of cash flows. Analysis and interpretation of financial statements.

Section 2 Management accounting and financial management

Cost behaviour, marginal and total absorption costing for inventory. Cost-volume-profit analysis. Introduction to budgetary planning and control, including standard costs, targets, and variance analysis. Making capital investment decisions.

1.3.1 Changes to the syllabus

The material covered in this subject guide reflects the syllabus for the year 2015–2016. The field of accounting changes regularly, and there may be updates to the syllabus for this course that are not included in this subject guide. Any such updates will be posted on the VLE. It is essential that you check the VLE at the beginning of each academic year (September) for new material and changes to the syllabus. **Any additional material posted on the VLE will be examinable.**

1.4 Aims of the course

The aims of the course are to:

- introduce you to the principles underlying accounting
- enable you to apply, interpret and explain key accounting techniques
- provide a broad understanding of the theory and practice of financial and management accounting.

The course is intended both for non-specialist students, and as a foundation for further study in the area.

1.5 Learning outcomes for the course

At the end of this course, and having completed the Essential reading and Activities, you should be able to:

- distinguish between different uses of accounting information and relate these uses to the needs of different groups of users
- explain the limitations of such statements and their analysis
- categorise cost behaviour, and prepare and contrast inventory valuations under different costing methods
- describe the budgeting process and discuss the use of budgets in planning and control
- explain, discuss and apply relevant techniques to aid internal users in decision-making.

1.6 Overview of learning resources

1.6.1 The subject guide

This subject guide is intended to supplement, not replace, the Essential reading indicated. The guide relies on the Recommended textbook (Leiwiy and Perks, 2013) to provide the theoretical grounding for the material and for many definitions, examples and explanations. The subject guide:

- provides a framework for your study of the subject using the recommended text
- contains aims and learning outcomes for each topic, and references to the Essential reading
- acts as a pointer to the most important issues dealt with in the reading
- provides additional explanations where appropriate
- contains additional worked examples, exercises for you to work through yourself, and Sample examination questions.

It is important to attempt all of the exercises and to ensure that you take the time to fully understand the material covered in each chapter of the subject guide.

You should complete this Introduction first of all, before progressing to the other sections of the subject guide. Thereafter, you are strongly advised to attempt the work relating to Financial accounting (Section 1) in the order in which it is presented in the subject guide. However, you may progress to Section 2 (Management accounting) before attempting Chapter 12.¹ Although it is also important to attempt the work relating to management accounting in the general order in which it is presented in the subject guide, Chapters 13 and 14 may be attempted (in that order) at any time after you have completed Chapter 8.

It is also possible to leave Chapters 5 to 8 and return to them at a later date, if double entry is causing you problems.

It is essential to have a good understanding of the underlying principles of financial accounting before moving onwards as the steps which culminate in the preparation (and interpretation) of financial statements are cumulative. However, you may find that the work on management accounting falls more readily into separate, albeit related, topics. In particular, Chapters 18 and 19, on long-term decision-making techniques, may be attempted separately from Chapters 15 to 17, on the use of budgets for planning and control.

¹ It is important to study Chapters 2–12 on financial accounting in the subject guide before starting the material on management accounting, because you will need to understand both terminology from the financial accounting material, and the way that financial statements fit together, in order to understand all of the material on management accounting.

Unless indicated otherwise, the order in which you should tackle the work specified in each chapter is as follows:

1. Read the chapter Aims and Learning outcomes, and the Introduction, to appreciate what material will be covered in the chapter, and what you are expected to achieve by the end of it. Bear these in mind as you work through the chapter.
2. Read through the specified Essential reading (Leiwy and Perks, 2013) to acquire an initial understanding of the text.
3. Work through the material in the subject guide chapter. Pay particular attention to the examples provided, as they contain materials that are either complementary to the textbook, or otherwise important to ensure you gain a full understanding of the material.
4. As you are working through the material in the subject guide chapter, attempt each Activity at the appropriate point. You may need to refer back to relevant parts of the specified reading in Leiwy and Perks (2013) in order to do so. Solutions for numerical Activities are provided in Appendix 1 of the subject guide.
5. Make notes from the specified reading and the subject guide chapter for future reference. If you struggled with any of the exercises, try to ensure that your notes will help you to avoid the same problems when you review the chapter at a later date.
6. Your knowledge and understanding will be reinforced if you also tackle the questions at the end of the corresponding Leiwy and Perks (2013) chapter(s). If you find you are having difficulties, you should work through the subject guide material again before returning to the questions.
7. Check that you have achieved the learning outcomes before moving on to the next chapter of the subject guide.
8. Where provided, prepare (note form) solutions for the Sample examination questions given at the end of the subject guide chapters and keep your note solutions for future reference.

Sample examination questions may be more difficult than the exercises in the body of the chapter, and require more thought. They are set at examination level, so you should make sure that you can answer them when you are preparing for the examination. Therefore you should write a full answer to each question when you are revising the chapter, once you have already completed a large part of the course. When you finish each full answer, look back at your first attempt in note form, which you should have kept. Hopefully, you will find that completing your study of the whole course has thrown more light on what you want to say in each answer. Of course, be sure not to wander off the point!

When you have completed all of Chapters 1–19 in the subject guide, including the Activities and the Sample examination questions at the end of each chapter, you will be ready to read the revision advice and Chapter 20 and attempt the two Sample examination papers. Before you do, make sure that you have read the *Examiners' commentaries*, the examination information in the *Handbook*, and the examination advice below.

1.6.2 Essential reading

Leiwy, D. and R. Perks *Accounting: understanding and practice*. (Maidenhead: McGraw-Hill, 2013) fourth edition [ISBN 9780077139131].

You are strongly advised to buy this textbook, which is referred to in every chapter of this subject guide and has many examples and both self-testing

and assessment questions closely related to this course. The textbook also has a companion website: www.mcgraw-hill.co.uk/textbooks/leiw

Detailed reading references in this subject guide refer to the edition of the set textbook listed above. New editions of this textbook may have been published by the time you study this course. You can use a more recent edition; use the detailed chapter and section headings and the index to identify relevant readings. Also check the virtual learning environment (VLE) regularly for updated guidance on readings.

1.6.3 Further reading

Please note that as long as you read the Essential reading you are then free to read around the subject area in any text, paper or online resource. You will need to support your learning by reading as widely as possible and by thinking about how these principles apply in the real world. To help you read extensively, you have free access to the VLE and University of London Online Library (see below).

Accounting is an evolving and, at times, controversial subject. You are encouraged to stay informed of the current issues in accounting. These issues are often reported in the press, so you may do this by reading the financial pages of a quality daily, or weekly, newspaper. In addition, specialist publications that are worth reading on a regular basis include: *economia*, the official monthly journal of the Institute of Chartered Accountants in England and Wales (ICAEW); *Accountancy*, formerly the official monthly journal of the ICAEW; and *Accountancy Age* which is available online at www.accountancyage.com. Journals of other professional accountancy bodies in the UK and elsewhere are also suitable. Press, comment and other information can also be found at: www.accountingweb.co.uk/

In recent times, accounting for pensions and financial instruments have been regular features in the UK news. Your country may have very different accounting issues. You may not be able to understand all the technical details, but you should try to understand the main arguments. Who do you think is right, and why? What may be the real motivations behind the arguments? How do the policy-makers respond? What are the causes of accounting scandals that occur? What do you think can be done to prevent these scandals, and why?

Reference books

- Nobes, C. *The Penguin dictionary of accounting*. (London: Penguin Books, 2006) second edition [ISBN 9780141025254].
- Owen, G. and J. Law *A dictionary of accounting*. (Oxford: Oxford Paperbacks, 2010) fourth edition [ISBN 9780199563050].

These (or any similar) dictionaries of accounting provide a quick source of reference for any new terms you meet in this course. You may find a dictionary particularly useful when you approach this course for the first time, as accounting terminology can sometimes cause unnecessary confusion. You should be aware that precise terminology, particularly with respect to financial reporting terms, may differ from one country to another. If you do not have a dictionary of accounting, you should be able to find the information you need in Leiw and Perks (2013) which includes a comprehensive glossary (pp.470–75).

1.6.4 Online study resources

In addition to the subject guide and the Essential reading, it is crucial that

you take advantage of the study resources that are available online for this course, including the VLE and the Online Library.

You can access the VLE, the Online Library and your University of London email account via the Student Portal at:

<http://my.londoninternational.ac.uk>

You should have received your login details for the Student Portal with your official offer, which was emailed to the address that you gave on your application form. You have probably already logged in to the Student Portal in order to register. As soon as you registered, you will automatically have been granted access to the VLE, Online Library and your fully functional University of London email account.

If you forget your login details, please click on the 'Forgotten your password' link on the login page.

The VLE

The VLE, which complements this subject guide, has been designed to enhance your learning experience, providing additional support and a sense of community. It forms an important part of your study experience with the University of London and you should access it regularly.

The VLE provides a range of resources for EMFSS courses:

- Self-testing activities: Doing these allows you to test your own understanding of subject material.
- Electronic study materials: The printed materials that you receive from the University of London are available to download, including updated reading lists and references.
- Past examination papers and *Examiners' commentaries*: These provide advice on how each examination question might best be answered.
- A student discussion forum: This is an open space for you to discuss interests and experiences, seek support from your peers, work collaboratively to solve problems and discuss subject material.
- Videos: There are recorded academic introductions to the subject, interviews and debates and, for some courses, audio-visual tutorials and conclusions.
- Recorded lectures: For some courses, where appropriate, the sessions from previous years' Study Weekends have been recorded and made available.
- Study skills: Expert advice on preparing for examinations and developing your digital literacy skills.
- Feedback forms.

Some of these resources are available for certain courses only, but we are expanding our provision all the time and you should check the VLE regularly for updates.

Making use of the Online Library

The Online Library contains a huge array of journal articles and other resources to help you read widely and extensively.

To access the majority of resources via the Online Library you will either need to use your University of London Student Portal login details, or you will be required to register and use an Athens login:

<http://tinyurl.com/ollathens>

The easiest way to locate relevant content and journal articles in the Online Library is to use the **Summon** search engine.

If you are having trouble finding an article listed in a reading list, try removing any punctuation from the title, such as single quotation marks, question marks and colons.

For further advice, please see the online help pages:
www.external.shl.lon.ac.uk/summon/about.php

1.7 Examination advice

Important: the information and advice given here are based on the examination structure used at the time this guide was written. Please note that subject guides may be used for several years. Because of this we strongly advise you to always check both the current *Regulations* for relevant information about the examination, and the VLE where you should be advised of any forthcoming changes. You should also carefully check the rubric/instructions on the paper you actually sit and follow those instructions.

The assessment for this course is by examination. The examination is **three hours and 15 minutes** long, which includes 15 minutes' reading time. The examination paper is divided into sections and you are required to answer certain questions from each section. Each question you answer carries a mark allocation of 25 marks and there are 100 marks available in total. The compulsory Question 1 comprises of four questions, of which three are allocated six marks each, and one question is worth seven marks. You should divide your time in the examination between the questions according to the number of marks.

A good student who has completed all their work and who is sitting an examination at an appropriate level for their abilities, should achieve a pass mark or better in the examination. However, some of you will find that, despite your hard work, ability and preparation, you fail. This is usually because marks are thrown away needlessly, through poor examination technique. Examination technique can be learnt and practised. Here are a few tips that may help you to achieve the mark you deserve:

- Do not panic! Take a few moments to pause and collect your thoughts before you start. This will help you to make the best use of your time, rather than rushing in without thinking about what you are doing. Also, try not to pay attention to other students around you. This applies just as much to time spent waiting outside the room where you will take the examination, as it does during the examination.
- Read the instructions on the front of the examination paper. Make sure you understand which, and how many, questions you should answer. If you need to choose between questions, read their requirements first so that you know which areas they are examining before you make your choice.
- You do not have to answer the questions in the order in which they appear in the examination paper. It is likely that there will be some topics about which you will feel more confident, and some which you find more difficult. You may decide to tackle the questions you feel most confident about first, so that you can spend your remaining time on the more difficult questions.
- Read the question and the requirements carefully. You must answer the question you have actually been asked, not what you might like

to have been asked. You must also try to answer every part of the question. This is particularly important for discussion questions. It is very easy to read a question and assume it is asking you to repeat everything you know about a particular topic. This is rarely the case! You must apply your knowledge to answer the specific question at hand. Remember, this is an examination for people, not parrots.

- Read the question and the requirement again! You should find yourself referring back to the requirement from time to time as you prepare your answer, especially with a discussion question. Sometimes it is a good idea to underline parts of the question to remind yourself what you need to do. Words in the requirement such as 'explain' are asking you to justify your answer or describe the underlying theory; whereas words like 'discuss' are asking you to present all the sides of an argument, or points in favour and against the use of a particular technique. If you are asked to prepare a report, or a set of financial statements, then make sure that your answer is in the appropriate format. If you are asked to recommend a course of action, or to comment on your answer, remember to do so.
- Pay attention to the time. You should divide your time between the questions (and between parts of questions) according to the number of marks available. You cannot expect to pass if you do not attempt the required number of questions in each section. Spending too long on any one question means you will be losing important marks on another. You will usually pick up more marks by moving on to a new question when the time is up, than by desperately trying to finish a question you have not completed and which you may be struggling with. You can return to these questions later if you have any spare time after you have attempted the rest of the examination.
- If your balance sheet does not balance in the examination, it does not matter. You may have made any number of small mistakes. Trying to find the error could mean you run out of time, and lose out on marks available in other questions. When the time you have allocated for your answer runs out, you should move on to the next question (or part of question). You will still be awarded marks for the parts of your answer which are correct.
- Questions may have several parts to them; for example, a numerical calculation, followed by a discussion. Always leave enough time for the discussion parts of questions. Where a question is divided into different parts, you should split your time between those different parts according to the mark allocation. Marks are often lost because students use up all of their time to calculate the numbers, and ignore the discussion. Sometimes you can answer the discussion part of a question before you answer the numerical part, in which case it can be a good idea to answer the discussion part first.
- When performing calculations, you must show all your workings and state any necessary assumptions that you make. If you do not show how you arrived at your numerical solutions and you have made a mistake, the Examiners will not be able to award you any marks for the bits you have done correctly. Your workings may be quite rough, so it is a good idea to cross-reference them to your solutions so that the Examiners can easily find them.

Finally, remember that in accounting, **practice is everything**. Try to attempt the Sample examination paper, or past examination papers, under examination conditions. Put away all your books and time yourself. Try to

work by yourself in a quiet place where you will not be disturbed. This is especially important if you are not used to sitting three-hour examinations, as the experience itself can be quite stressful.

This may seem like a lot to take in now, but if you follow this advice you will have the best chance of doing well in this course. Take things one step at a time, and you should find that the subject is much less daunting than you might think!

Remember, it is important to check the VLE for:

- up-to-date information on examination and assessment arrangements for this course
- where available, past examination papers and *Examiners' commentaries* for the course which give advice on how each question might best be answered.

1.7.1 Examination materials

When you sit the examination, apart from the question paper and booklet to write your answers in, you will be provided with the following materials:

- Extracts from compound interest tables. You will be provided with a one page extract from these tables (which is included in Appendix 2 at the end of the Sample examination papers).
- Eight-column accounting paper. An example of what this looks like is given at the end of the subject guide. We suggest that you might like to remove this page from the subject guide and make photocopies of it to practise on. You can also buy pads of accounting paper at a commercial stationery shop. You do not have to use this paper in the examination, but many students find it very useful for questions such as those requiring the preparation of income statements, cash flow statements, budgets and investment appraisal calculations.

A hand-held calculator may be used when answering questions on this paper, but it must not be pre-programmed or able to display graphics, text or algebraic equations. The make and type of your machine must be clearly stated on the front cover of the answer book.

1.7.2 Changes to the syllabus

The material covered in this subject guide reflects the syllabus for the year 2015–2016. The field of accounting changes regularly, and there may be updates to the syllabus for this course that are not included in this subject guide. Any such updates will be posted on the VLE. It is essential that you check the VLE at the beginning of each academic year (September) for new material and changes to the syllabus. **Any additional material posted on the VLE will be examinable.**

1.8 Overview of the Introduction

Now that you have read this Introduction, and looked at the Essential reading (Leiwiy and Perks, 2013), you should have an overview of accounting as a subject. You should also understand how to use this subject guide to help you with the material in this course.

The best approach to studying accounting is to be as organised as possible. Make yourself a timetable and stick to it. Try to keep up with the work, and study the subject regularly so that you do not forget topics as you go

along. Many people enjoy the logic behind accounting techniques and you should find that ideas and concepts make more sense as you continue through the course. I hope that you enjoy accounting and I am sure that you will find many uses for it in the future.

Good luck!

1.9 List of abbreviations used in this subject guide

ABC	Activity-based costing
a/c	Account
ARR	Accounting rate of return
AVCO	Average cost
b/d	Brought down (from the previous period)
b/f	Brought forward (from the previous period)
	(Note: these last two abbreviations are sometimes used interchangeably)
BEP	Break-even point
BS	Balance sheet or Statement of Financial Position
c/d	Carried down (to the next period)
c/f	Carried forward (to the next period)
	(Note: these last two abbreviations are sometimes used interchangeably)
CFS	Cash flow statement
Cr	Credit
C-V-P	Cost-volume-profit analysis
DF	Discount factor
Dr	Debit
EBIT	Earnings before interest and tax
EPS	Earnings per share
F	Favourable (variance)
FIFO	First-in, first-out
FRS	Financial Reporting Standard (accounting standards issued by the UK ASB)
GAAP	Generally accepted accounting principles
HCA	Historic cost accounting
IAS	International Accounting Standard
IFRS	International Financial Reporting Standard
IRR	Internal rate of return
IS	Income statement (formerly known as a profit and loss account (P&L account))
LIFO	Last-in, first-out
Ltd	Limited company (these companies are usually referred to as 'private' companies; however, 'private' may also be used more generally to mean 'not listed on a stock exchange')
MC	Marginal costing
NBV	Net book value
NPV	Net present value
NTV	Net terminal value

p.a.	Per annum (that is, each year)
PBIT	Profit before interest and tax
P/E	Price/earnings ratio
P&L	Profit and loss account (now more commonly referred to as an 'income statement')
plc	Public limited company (this is usually referred to as a 'public' company; however, sometimes 'public' is used to mean something more, namely 'listed on a stock exchange' and some, but not all, public limited companies are listed on a stock exchange)
ROCE	Return on capital employed
ROE	Return on shareholders' equity
RPI	Retail price index (in some countries, this is termed the Consumer Price Index – CPI)
SOCE	Statement of changes in equity
S of FP	Statement of financial position (formerly known as a balance sheet)
SSAP	Statement of Standard Accounting Practice (this is the name given to UK accounting standards created before 1990)
TAC	Total absorption costing
TB	Trial balance
U	Unfavourable or adverse (variance)
WAC	Weighted average cost
WIP	Work-in-progress

Section 1: Financial accounting



Notes

Chapter 2: Accounting in context

2.1 Introduction

This chapter discusses the role and development of accounting. This overview of accounting will enable you to place the subject in a social and historical context, and appreciate the influence and importance of accounting in many features of everyday life. Accounting produces a wide range of information for a variety of different users. The subject is split into two key areas; namely, **financial accounting** and **management accounting**. This chapter distinguishes between these two areas in terms of the different types of users of the information provided; and the purposes for which the information is used.

Understanding why information is needed and how it is used is central to determining what information to provide; how best to produce and present it; and what its limitations are. You should keep these ideas in mind throughout this course and whenever you read any commentaries or news stories in the financial press.

2.1.1 Aims of the chapter

The aims of this chapter are to:

- place accounting in its social, economic and historic context
- relate accounting to the needs of different users of accounting information
- distinguish between financial and management accounting
- introduce accounting theory and its role in policy-making.

2.1.2 Learning outcomes

By the end of this chapter, and having completed the Essential reading and Activities, you should be able to:

- briefly describe the development of accounting through time
- outline the changing role of accounting in relation to the changing economic and social environment, including the influence of accounting theory
- identify the different groups of users of accounting information and discuss their information needs
- compare and contrast financial and management accounting.

2.1.3 Essential reading

Leiwty, D and R. Perks *Accounting: understanding and practice*. (Maidenhead: McGraw-Hill, 2013) Introduction, pp.1–5; Chapter 3, pp.53–61; Chapter 13, p.318.

2.1.4 Synopsis of chapter content

This chapter first considers the question: what is accounting, moves on to discuss accounting in theory and practice, and finally distinguishes between financial accounting and management accounting.

Stop and read

Chapter 3 in Leiwiy and Perks (2013), pp.53–61 describes the development of accounting through time and relates the scope of accounting to the changing environment; the Introduction, pp.1–5 discusses the role of accounting in the provision of information to different user groups, and how this information is used; and p.318 distinguishes between financial accounting and management accounting.

2.2 What is accounting?

This is not an easy question. What do you think accounting is? The scope and definition of accounting changes throughout time. In general, it is argued that accounting is concerned with the provision of information about the position and performance of an enterprise that is useful to a wide range of potential users in making decisions.

Historically, this information has been financial, but accounting is increasingly being used to address the ‘triple-bottom-line’ of social and environmental – as well as economic – concerns. In this course we focus on financial uses of accounting but you can study social and environmental reporting later in course **AC3093 Auditing and assurance**. Similarly, in this course the types of enterprises that we will focus on are businesses whose aim is to make profit or otherwise to increase their owners’ wealth.¹ However, it is important to remember that other types of enterprises such as charities, other non-government organisations, and public sector bodies such as schools, universities, hospitals, and local and national government, also use accounting. You can also find out more about accounting for these types of enterprises in course **AC3093 Auditing and assurance**.

The decisions that users of accounting information make may be economic or legal in nature. Economic decisions are concerned with the allocation of resources; for example, whether to sell or invest in a business, or invest in the equipment to manufacture a new product. ‘Legal’ decisions are concerned with determining whether managers have made a good job of running a business on the owners’ behalf (stewardship); and how much managers should be paid; or they concern matters such as how much tax a business should pay; or whether a business has broken the terms of its borrowing agreements.

Users of accounting information are usually thought of as individuals, but there is also a social role for accounting, and it can be regarded as a ‘public good’ which aims to improve the allocation of scarce resources for the welfare of society in general.

Pause and think

What do you think might be the practical difficulties involved in reporting on social and environmental performance, in addition to financial performance? Who would benefit from this type of information?

2.2.1 A brief history

Accounting originally served a stewardship function, as a result of the separation of ownership and control of resources. First wealthy landowners, and later company shareholders, hired managers or ‘stewards’ to run their properties and businesses. The landowners and shareholders owned the resources, but the stewards and managers controlled them. As the business owners could not always be on hand to watch their stewards

¹ We deal with three main business forms during this course. Sole traders are single owners of businesses. Small shopkeepers, plumbers and electricians are often sole traders. Typically, the business owner also manages the business and is fully liable if the business is sued.

Partnerships differ from sole traders because ownership is shared between more than one owner. Firms of accountants and lawyers, and doctors’ practices, are often partnerships. Companies, however, are set up quite differently. They are treated as being separate from their owners, who are called shareholders. Shareholders are often far removed from the day-to-day management of the business, and have limited liability if the business is sued. We will meet these different business forms again in Chapter 3, and see how these different types of business affect financial statements in Chapter 7.

or managers perform their duties, they required the stewards to make regular reports on their activities, using accounting to prepare the figures.

This is what we call financial reporting. The separation of ownership and control has grown wider and wider throughout the last century, as companies increased in number, and became larger and more complicated. Their owners became an increasingly distant and diverse body, often buying and selling shares on stock exchanges with no direct dealings with the company at all. As the opportunities to hide or manipulate information have therefore also increased, financial reporting by businesses to their owners has required more and more regulation.

Step by step with the increased demand for financial reporting, demand has arisen for independent audits to check the reported information. Recent accounting and auditing scandals such as that involving Enron and Arthur Andersen have thrown the problems with financial reporting into the spotlight.²

Alongside the growth in financial reporting, has been the development of the use of accounting for the benefit of the business managers themselves. The practice of using accounting information as a direct aid to management arose later than financial reporting, but is no less important. Increasing business complexity and changes to the economic environment have meant that more and more sophisticated systems of collecting and recording information are required.

In contrast to financial accounting, this information is used to help make decisions about the future, not just report on past events. Different types of information, and different tools with which to analyse it, are required.

Finally, as accounting has been recognised as a social science, the impact of the use of accounting information (whether as aid to management, or for financial reporting purposes) on the employees of the business has been widely explored. Managers or employees who are paid salary bonuses based on figures provided by accounting systems may change their actions as a result of the incentives (or disincentives!) this provides.

Pause and think

How is information required to make decisions about the future likely to differ from information required to report on past events?

2.2.2 The changing role of accounting

Accounting is shaped by the environment in which it operates. As a result, accounting systems vary from country to country. The most obvious differences concern financial reporting, as this is the area where there are most likely to be rules and regulations in place. One of the most important issues affecting the development of accounting today is the need for internationally comparable financial information and the drive for harmonisation of accounting practices.³

Many businesses operate globally and they face costs of having to prepare financial reports in different ways to satisfy different regulators. Also, investors from one country may wish to buy shares in or make loans to businesses in another country. These investors need to be able to compare all businesses fairly in order to decide where to invest their funds. In order for businesses all over the world to be treated similarly and reduce their reporting costs, different accounting regimes need to agree a common set of rules. As you can imagine, this is a difficult process, and one that is dominated by a handful of the most influential bodies.

² Audits are the main topic of course **AC3093 Auditing and assurance** which you can study after you have completed this course.

³ There are many different sets of accounting rules and regulations operating in different countries. There are even 'international' accounting standards. These 'international' standards are very widely accepted but many countries such as the USA still prefer their own national standards. This is not discussed in this course because you do not need to know the details of these accounting standards.

The management uses of accounting information are also developing. Businesses face increasingly complex decisions in an increasingly complex world. Advances in technology create both new markets, and new tools and capacities for recording and analysing data.

For instance, the increasing importance of social and environmental reporting means that accountants need to develop new ways of collecting, classifying and measuring non-financial data. This information may include the levels of pollutants emitted by a factory; or whether the factory meets health and safety standards. Some businesses are choosing to report this kind of information in order to avoid negative publicity or to gain business from 'green' consumers (or finance from 'ethical' investors). There is also an increasing demand for government and public sector bodies to be held accountable to tax-payers and citizens for their actions. For example, schools publish their examination results, and hospitals their waiting lists. Although social and environmental reporting are outside the scope of this course, thinking about these issues helps us to understand the changing nature of accounting throughout time.

Pause and think

Who would benefit most from, and who do you think should bear the cost of, providing information on social and environmental performance?

2.2.3 Towards a definition

Perhaps the best way of thinking about the role and development of accounting is to consider the functions that accounting information performs. Not all of these functions have been expected or required of accounting at all times in the past, and it is likely that additional functions will be demanded in the future. Therefore, if accounting is defined by the functions it performs, you can see that this definition changes through time.

The earliest roles of accounting information were to measure and record financial transactions and provide information for stewardship purposes. At present, accounting is generally viewed as serving the following functions:

- **Recording:** accounting systems supply a means of recording data, so as to enable the production of reports or for use in calculations. For example, for the preparation of financial statements, the calculation of performance indicators on which managerial bonuses are based, or for costing inventory.
- **Classification:** accounting systems assist in categorising data so as to enable the production of reports or for use in calculations. For example, identifying whether an item is an asset or an expense, or which costs should be included in an inventory.
- **Measurement:** accounting systems quantify data so as to enable the production of reports or for use in calculations. For example, determining how much profit a business has earned in a year, or the value of a piece of machinery.
- **Stewardship:** accounting systems provide information which enables owners to determine how funds entrusted to managers have been used by them, and to what ends.
- **Information for decisions:** accounting systems provide information which enables users to make decisions about the future.

For example, to assist investors or managers in deciding how to allocate their limited resources.

- **Monitoring and control:** accounting systems provide information which enables management to monitor performance, and take corrective action if necessary.
- **Performance evaluation and compensation:** accounting systems provide information on the performance of different individuals and parts of the business in order to determine how much managers and employees should be rewarded, according to the terms of their contracts.
- **Communication:** accounting systems provide a means by which information is transmitted to users. For example, to external users via the financial statements, or to internal users via the budget-setting process.

These functions can be divided into two types. The first three functions concern the production of accounting information. The last five functions concern the uses of the information produced.

Pause and think

Can you think of any other functions or uses of accounting? Which do you think are the most important, and why?

To what extent are these functions interlinked? Is it possible to achieve each function individually without also achieving at least some of the others?

2.3 Accounting theory and practice

The nature of any theory is to provide a logical basis for the practice or procedure to which the theory is applied. Accounting theory has evolved over a long passage of time during which substantial changes in human behaviour and market structures have taken place.

There are two main types of accounting theory that impact on the practice of accounting. **Normative theory** concerns how things should be done. For example, ideas about the meaning of economic income can influence the way in which regulators decide that accounting systems should measure profit. You will see some examples of different ideas of how profit should be measured in course **AC3091 Financial reporting** which further examines more theoretical measures of income and capital.

In contrast, **positive accounting theory** tries to explain why things are the way they are. For example, why managers choose a particular accounting method over another, or choose not to invest in research and development activities. On the one hand, money spent on research and development could be viewed as an asset which will generate future revenues for a business. On the other hand, research and development costs could be viewed as an expense which, for example, large pharmaceutical companies spend each year simply in order to remain in business. For policy-makers to make changes to accounting systems, they not only need to know what they are trying to achieve (that is, they need to form an opinion as to the desired outcome); but they also need to understand why people are currently behaving differently and how any changes will affect them. They will refer to normative theory for the former, and positive theory for the latter.

Positive accounting theory is tested by gathering and analysing data. Usually, researchers either study a single organisation in great depth over a long

period of time, or they collect a smaller amount of data about a much larger number of organisations. Analysing a single organisation may mean that the research findings are not generalisable to other organisations. However, analysing a large number of organisations to reach conclusions about the 'average' organisation, does not tell you very much about individual cases.

2.4 Accounting information and its uses

We have seen that financial reporting provides information to users who are not normally involved in actually running the organisation. These users are external to the business. They include actual and potential shareholders, lenders and other investors. They may also include customers, suppliers, the government, and the general public.

We have also seen that management use accounting information themselves.⁴ Directors, other managers, and employees are internal to the business, and use information to make economic decisions (for example, which new product to manufacture, or what price to charge to a new customer).

External users may wish to make both economic decisions (for example, whether or not to invest their money in the business by buying shares); and legal/stewardship decisions (for example, the government needs to calculate how much tax to charge, and shareholders need to determine how well the managers have performed in managing their funds).

These different types of decisions require different types of information. There is usually a trade-off between:

- **relevant** information (that can influence decisions of users of financial information about the future or confirm the outcome of a past transaction); and
- **reliable** information (that is based on fact, free from errors and bias and which faithfully represents economic reality).

Economic decisions need forward-looking information. This information is unlikely to be reliable as no one has a crystal ball that can predict the future with total accuracy! Legal and stewardship decisions need information about the past. It is usually important that this information is very reliable, as getting it wrong may result in fines and penalties.

Pause and think

In addition to relevance and reliability, what other characteristics do you think are important for accounting information?

2.5 Financial accounting

Financial accounting is concerned with the preparation of accounting information for the needs of users who are external to the business. Financial accounting is therefore part of financial reporting. Other aspects of financial reporting include the timing and manner in which the information is communicated. Companies publish their financial accounting information in the form of financial statements. Other forms of business do not need to publish their financial statements but are usually required to provide them to the government for taxation purposes.

In general, financial accounting information tends to be:

- prepared on a periodic basis (most companies publish their financial statements only once a year, in their annual report)⁵ while public

⁴ The information requirements of each type of user are detailed in Leiwiy and Perks (2013).

⁵ In many countries, companies also publish interim statements for their shareholders. These statements generally contain summarised key financial information for the most recent quarter or the first six months of the financial year.

companies listed on a stock exchange are likely to be required to produce interim accounts, either half-yearly or quarterly

- based on past events, transactions and historic data
- comprised primarily of financial information
- governed by rules and regulations.

Pause and think

The earliest role of financial accounting was for stewardship purposes and this function heavily influences the nature of financial accounting today. How relevant and reliable is financial accounting information likely to be? How does this relate to the needs of the different external user groups?

2.6 Management accounting

Management accounting is concerned with the preparation of accounting information for the needs of users who are internal to the business. In general, management accounting tends to be:

- prepared frequently, as and when it is needed (most large businesses will prepare some information on a monthly basis and many use daily accounting information)
- more likely to contain forward-looking information (such as forecasts and budgets)
- more likely to incorporate non-financial information (such as quantities of products sold or numbers of customer complaints)
- not regulated (managers are free to produce whatever information they need in whatever format is most helpful to them, subject to available data and technology).

Pause and think

Why do you think financial accounting (and reporting) is governed by rules and regulations whereas management accounting is not?

Activity 2.1

Visit the website of a large, publicly traded (listed) company such as Marks and Spencer plc or BP plc. Find and download the most recent set of the company's financial statements. These are usually part of a larger document called the annual report, and may be in a part of the website designed specifically for investors. Make a list of as many different groups of people (users) as you can, who would be interested in information on the company; and make a note of what kinds of information you think they would like to see reported. Now look through the annual report and determine to what extent you think these different information needs are actually being met.

Pause and think

As there are many different user groups for business information, and their information needs differ, do you think that it is possible to meet all these needs in a single document? If it is possible, do you think it would be a good idea?

2.7 Overview of chapter

In this chapter we discussed the role and development of accounting. Accounting produces a wide range of information for a variety of different users. These users require different types of information.

Financial accounting provides information for users who are external to the business. The information tends to be historic in nature. This is because the traditional role of financial accounting is for legal and stewardship purposes but it is increasingly recognised that many users make economic decisions based on financial reports.

In contrast, management accounting is for users internal to the business. The information provided is more likely to be forward-looking and is used to plan, monitor and control business activities.

Being based on historic data, financial accounting information is more likely to be reliable than forward-looking management accounting information. However, it is less likely to be relevant for economic decision needs.

2.8 Reminder of learning outcomes

Having completed this chapter, and the Essential reading and Activities, you should be able to:

- briefly describe the development of accounting through time
- outline the changing role of accounting in relation to the changing economic and social environment, including the influence of accounting theory
- identify the different groups of users of accounting information and discuss their information needs
- compare and contrast financial and management accounting.

2.9 Test your knowledge and understanding

2.9.1 Sample examination question

Short answer question

1. For two of the following groups of users of accounting information, describe their information requirements, and briefly discuss to what extent financial accounting and reporting is likely to meet their needs:
 - suppliers
 - employees
 - company shareholders
 - company directors and management
 - banks and other lenders
 - the government
 - customers
 - competitors
 - the public.

Chapter 3: Income statement and Statement of financial position

3.1 Introduction

This chapter introduces the three main financial statements that businesses prepare for financial reporting purposes. Chapters 4–12 of the subject guide focus on preparing and interpreting financial statements under the historic cost accounting (HCA) convention. HCA records costs, revenues, assets and liabilities at the values which apply to them on the date of the original transaction. Costs (expenses) and revenues (income) are reported in the **income statement** (sometimes called the **profit and loss account**); whereas assets and liabilities are reported in the **statement of financial position** (sometimes called the **balance sheet**).

The income statement (IS) (or profit and loss account (P&L)) presents a history of the business transactions over some past period (usually a year); whereas the statement of financial position (S of FP) or balance sheet (BS) presents a 'snapshot' of what the business owns and owes and the sources of finance at a single point in time.

Leiwy and Perks (2013) introduce the S of FP (or BS) in Chapter 1 and the IS (or P&L) in Chapter 2. They also list and explain the key accounting characteristics and concepts in Chapter 3 (pp.58–61) which are essential for preparing these financial statements. It is especially important at this stage that you understand these characteristics and concepts:

- relevance
- reliability
- understandability
- completeness
- going concern
- accruals
- matching
- consistency
- prudence
- business entity.

In addition to these accounting concepts, this chapter also defines and explains the meaning of accounting bases and policies, and discusses the role of accounting standards in the preparation of financial statements.

Finally, this chapter will also introduce you to the third main financial statement, the **cash flow statement** (CFS). In order to understand the relationship between the CFS and the other main financial statements, you will need to have a good grasp of the **accruals concept** in particular.

Chapters 2 and 3 introduce two of the three main financial statements (**the statement of financial position** and the **income statement**); and also **the accruals basis of accounting**. Accruals is an extremely important concept in accounting and the general use of the term 'accruals basis' of accounting refers to the application of the accruals concept and also incorporates the 'matching' concept.¹

¹ You should note that you will meet yet another use of the term 'accruals' later in your studies, which means 'expenses incurred before the year end date but not yet invoiced or paid'; because these uses are related it is easy to get confused, so make sure that you keep a careful note of the two different meanings.

3.1.1 Aims of the chapter

The aims of this chapter are to:

- introduce you to financial accounting qualitative characteristics, concepts, bases and policies
- explain the nature of a sole trader, a partnership, a limited liability company and a limited liability partnership, and the differences between these business structures
- explain the nature and purpose of accounting standards
- introduce the three main financial statements that appear in a set of published accounts.

3.1.2 Learning outcomes

By the end of this chapter, and having completed the Essential reading and Activities, you should be able to:

- explain the different accounting concepts and their application
- distinguish between a sole trader, a partnership, a limited liability company and a limited liability partnership
- define accounting bases and policies, and discuss the role of accounting standards
- identify and describe the three main financial statements
- explain how these financial statements are linked together.

3.1.3 Essential reading

Leiwty, D. and R. Perks *Accounting: understanding and practice*. (Maidenhead: McGraw-Hill, 2013) Chapters 1, 2 and 3.

3.1.4 Synopsis of chapter content

This chapter first considers the structure of a private sector business, offers an introduction to the three main financial statements, and discusses accounting characteristics and concepts, bases and policies. It then goes on to discuss the advantages and disadvantages of accounting standards.

Stop and read

Chapter 3 pp.58–61 in Leiwty and Perks (2013) which identifies the key accounting concepts and conventions and also accounting bases, policies and standards.

3.2 The structure of a private sector business

In the UK, private sector business can be structured as sole traders, partnerships, limited liability companies (or corporations) or limited liability partnerships.

Sole traders are owned by a single person, there are no legal formalities involved in setting up such a business and all the profits belong to the owner. Among the advantages of such a structure is that any accounts that are prepared are only provided to the owner and the tax authority. Among the disadvantages are that it is hard to raise finance and since such a business has no separate legal personality, the owner has unlimited liability. Hence anyone owed money by a sole trader can recover the sum owed not only from the business itself but, if necessary, also from the owner of the business.

Partnerships are similar to sole traders except that there is more than one owner. The difficulty in raising finance is mitigated to the degree that

more owners have access to more capital. There is no legal requirement to provide accounts except for the tax authority but the partners, much like a sole trader, have no limited liability. In fact, the partners are 'jointly and severally' liable for the debts of the business, if the business itself is unable to meet the debts of the business. This can be a very nerve-wracking position for the owners of such businesses!

A limited liability company is formed by completing forms at Companies House, an executive agency of the UK Department of Business, Innovation and Skills. A company has its own 'legal personality'. Its owners are called shareholders who appoint directors to manage the business. The shareholders (also called 'members') have limited liability which means that anyone owed money by such a business can only recover the sum owed from the company itself, and cannot recover the debt from the shareholders. However, the directors have a legal obligation to produce accounts containing specific information, by a specific date and in a specified format which is to be sent to the shareholders and to Companies House within a specified time limit. Also, anyone can download those accounts from the Companies House website. Hence the activities, performance and state of affairs of a limited liability company are in the public domain and are no longer private. There are more than 3 million active companies in the UK of which about 2,500 are listed on the London Stock Exchange; that is, the shares of such companies can be bought and sold by the general public. A limited liability partnership is somewhat like a cross between a partnership and a limited liability company where only the partner responsible for a specific debt is personally liable for that debt and a limited liability partnership (llp) is required to file accounts at Companies House, much like a company.

3.3 An introduction to the financial statements

The purpose of the three main financial statements is to report the business's financial performance and position to external users of accounting information. It is important that they only reflect the transactions of the business, and not the transactions of its owner(s).

Until we reach Chapter 4 of this subject guide we will mainly deal with financial statements for a business with a single owner that is **not** a company (**sole trader**). Examples of sole traders are small shopkeepers, plumbers and electricians, although such businesses might very well operate as limited liability companies because of the risks involved. Accountants and lawyers may also be sole traders but it is more usual for them to form **partnerships**, or **llps**.

The business is accounted for separately to the owner's personal belongings and transactions, whether they are structured as sole traders, partnerships, llps or companies. However, because companies and llps have a separate legal personality, the Companies Act 2006 has specific rules regarding the content of the accounts for such businesses. There are also some items (such as 'share capital') that only appear in company financial statements. We will learn more about this in Chapter 7 of the subject guide. Irrespective of the legal structure of the business (namely, whether it is a sole trader, a partnership or a company) those using the accounts are interested in the business transactions of the entity, not the personal transactions of the owners of the business. This is called the 'entity concept'.

To summarise, the three main financial statements are:

- the **statement of financial position** (S of FP) (or balance sheet (BS))
- the **income statement** (IS) (or profit and loss account (P&L)) statement of comprehensive income
- the **cash flow statement** (CFS).

The statement of financial position, or balance sheet, shows the financial position of the business at a single point in time, showing the **assets**, the **liabilities** and the **equity** or the finance provided by the owners or shareholders. However, this only tells part of the story about the business.

The income statement (IS), or profit and loss account, shows the financial performance of the business in the past accounting period (usually one year) so that the profits of the business can be determined. The IS shows the **revenues** or sales or turnover of the business less its **expenses**, the difference between these two sums being the **profit**. Both of these financial statements, the S of FP and the IS, are prepared on an accruals basis and are closely linked to each other. The statement of comprehensive income shows, in addition to the profit, other sources of income and expense such as certain foreign exchange gains and losses arising.

The cash flow statement is usually only prepared by companies. However, there is no reason why a sole trader or a partnership could not prepare a CFS, and without one, it is difficult to understand the position and performance of the business in terms of the availability and generation of cash. The CFS is prepared on a 'cash basis' and shows the inflows and outflows of cash during the year. When an accountant uses the term 'cash', he means not only 'cash' but also movements in the bank balance.

Pause and think

Sole traders and partnerships are usually managed directly by their owners. This is less likely for companies, particularly public listed companies. How might this explain why cash flow statements are usually only prepared by companies?

3.3.1 Statement of financial position (S of FP) (or balance sheet (BS))

The S of FP shows at a single point of time the:

- **assets** of a business
- **liabilities**
- **owners' equity**.

An **asset** is a resource controlled by the enterprise as a result of past transactions or events and from which future economic benefits are expected to flow to the enterprise. Examples of assets are land and buildings, plant and equipment, computer equipment, goods for resale (**inventory** or stock), cash and customers who owe the business money (**trade receivables** or trade debtors). Assets which are not acquired with the intention to sell them and are expected to be held for more than one year are called **non-current assets** (or fixed assets); whereas cash or other assets which are expected to become cash within one year are called **current assets**.

A **liability** is an obligation to be paid by the business as a result of a prior transaction. As with assets, some liabilities are **non-current liabilities**, such as bank loans owed by the business which are repayable after more than one year; while others are **current liabilities** such as **trade payables** (or trade creditors); sums owing to suppliers who have

supplied goods or services to the business but have not yet been paid; and **taxation** and **bank overdrafts**, a negative bank balance. You may also find items called **provisions** in a balance sheet. These are estimated figures, either used to make reductions in the value of an asset, or are liabilities where the amount or timing of the payment is uncertain. You will see some examples of provisions later in the subject guide.

Owners' equity is capital paid into the business by the owners (in a company this is called **share capital**), together with profits made by the business on behalf of the owners. In a manner of speaking, owners' equity is a type of liability of the business but this particular liability is owed by the business to the owners. It consists of the original capital invested in the business by the owner(s), and any profits (or other changes in value) that the business has made in the past which have been **retained**, or reinvested, in the business. These retained profits (or other changes in value) are known as **reserves**.²

The assets equals the liabilities plus the owners' equity; that is:
Assets = Liabilities + Owners' equity.

Another way of saying this, by rearranging this equation is:
Assets – Liabilities = Owners' equity or Net assets = Owners' equity.

These statements are commonly known as the **balance sheet equation** or **accounting equation** which, as you can see, can be expressed in more than one way. And, as you can see, the statement of financial position, or (balance sheet) 'balances'.

² Other reserves which may appear in financial statements include 'share premium' (when a company issues new shares for consideration greater than the nominal value of the shares) and 'revaluation reserve' (when a business recognises an increase in the value of its non-current assets).

Activity 3.1

Plants 'R' Us is a small gardening shop. For the following list of items, in the year ended 31.12.XX, decide whether each item is an asset, a liability, or part of the owners' equity for the business. Are the assets or liabilities likely to be non-current (i.e. long-term), or current?

1. 100 plastic plant pots on sale to the public
2. the owner's flat where she lives (this is above the shop)
3. the cash register (till)
4. £500 owed to Red Roses Ltd, which supplies Plants 'R' Us with potted flowers
5. £50,000 owed to the bank for purchase of the shop
6. the shop
7. £25 in the cash register
8. £2,045 in the business's bank account
9. £40 owed by a local restaurant, which bought two window boxes of plants to display
10. £10,000 of the owner's own money used to buy the shop fittings (e.g. shelves) and initial stock purchases.

Now we can rewrite the balance sheet equation again:

Non-current Assets + Current Assets = (Current Liabilities + Long-Term Liabilities) + Capital + Reserves.

Pause and think

Make sure that you agree with each formulation of the balance sheet equation. Long-term liabilities are more permanent sources of funding than current liabilities (since, if a business borrows money repayable in 10 years' time, it can use that money to buy new assets and expand its business operations). Are there any other ways that you can rewrite this equation, which might be more useful when thinking about the business's sources and applications of finance in the long term?

The S of FP can be presented in a number of different ways, according to which version of the balance sheet equation you prefer. It may be presented in a **horizontal format**. In this format, all the assets are listed in one column on the left, and all the **claims** (namely, the liabilities and the owners' equity) are listed in another column on the right. However, it is more usual to use a **vertical format** (especially with company financial statements). An example of the vertical format is in Leiwiy and Perks (2013) on p.9. As you can see, the total assets (the top half of the S of FP) equals the total of the liabilities and the equity (the bottom half of the S of FP).

The vertical format comes in two versions.

The first version lists:

- all the assets in the top section to arrive at the Total assets
- liabilities and owners' equity in the bottom section.

The second version of the vertical format, which is often used for small companies and sole traders and partnerships, lists:

- the assets less the liabilities in the top section
- owners' equity on the bottom section.

As sole traders and partnerships have fewer rules about their financial reporting than companies, they can use whichever format they like. Some companies in the UK, particularly private companies, use a version of the vertical format with the assets less the liabilities on the top while the owners' equity is in the bottom half. However, when producing an S of FP, you are advised to use the format outlined in IAS1 shown on pp.9–17 of Leiwiy and Perks, with assets at the top and liabilities and equity at the bottom, as shown in Example 3.1, below.

Example 3.1

With some more information about Plants 'R' Us, it would be possible to prepare the S of FP for the business, in the first vertical format, as follows:

Plants 'R' Us

Statement of financial position at 31.12.XX

	£	£
Non-current assets		
Shop		50,000
Fixtures and fittings		<u>8,000</u>
		58,000
Current assets		
Inventory	1,490	
Receivables	40	
Cash at bank and in hand	<u>2,070</u>	
		<u>3,600</u>
Total assets		<u>61,600</u>
Current liabilities		
Payables		1,200
Electricity costs owed (accrued)		<u>30</u>
		1,230

Long-term liabilities		
Bank loan		<u>50,000</u>
Total liabilities		51,230
Owner's equity		
Owner's capital invested	10,000	
Retained profits	<u>370</u>	
Total equity		<u>10,370</u>
Total liabilities and equity		<u>61,600</u>

Pause and think

Think about the information content of this S of FP. Why do you think the users of accounts want to know the assets and liabilities and equity of the business at the year-end date? Why do you think the assets are categorised as 'Non-current' and 'current'? Why are the liabilities divided into 'current' and 'non-current'? And why is the owners' equity divided into the original sum invested and the retained profits arising since then?

The two columns of numbers are used to make the S of FP easier to read. Lines are used wherever there is a subtotal calculated. Because the S of FP is said to be a 'snapshot' of the business at a single point in time, the title of the S of FP should also include the date. Finally, brackets are sometimes used to denote an amount which is to be deducted, if it makes the S of FP easier to read. In the above example, you could put brackets around the £50,000 figure for the bank loan.

The presentation of owners' equity in a company is slightly different to the owners' equity in a sole trader or partnership. In Example 3.1, the owners' equity is divided between the capital injected by the owners (called 'shareholders' in a company) termed in the S of FP 'share capital' and the retained profits made by the company since its formation. Such a format can be seen in Leiwy and Perks (2013) p.9.

In a sole trader or partnership, the owners' interest, usually in such cases, called 'owners' capital' is shown as one figure without any distinction between the opening capital and the retained profit since the formation. In such businesses, the owners' capital figure in the S of FP is one figure with both the capital introduced and any retained profits of the business lumped together in a single figure called 'owners' capital'.

Pause and think

In the absence of any other financial information, which method of presentation of owners' equity do you think gives the most information?

Activity 3.2

Rearrange the S of FP in Example 3.1 so that it is in:

- k. horizontal format
- l. second vertical format.

3.3.2 Income statement (profit and loss account)

Retained profits are part of the owners' equity recorded in the S of FP. However, the S of FP does not tell us how the retained profits were earned by the business. This is the job of the IS. The IS shows the income (revenues) and expenses of the business over an accounting period (usually one year).

The difference between the **income** and **expenses** of the business is called **profit**. To understand how the business makes its profits, the income and expenses are split into different categories and a number of different profit figures – the gross profit, the profit before tax and after tax – are reported in the IS.

An example of an IS is given in Leiwy and Perks (2013), p.32.

- Gross profit is the profit that the business earns by trading. It is the difference between sales revenue (sometimes called turnover) and cost of sales. Cost of sales, the cost of the goods which have been sold, is calculated as opening inventory (at the beginning of the accounting period) plus purchases of goods for resale (or production costs if the business is a manufacturer), minus closing inventory (at the end of the accounting period).³
- Profit before tax is the profit that the business earns after adding any additional income (such as interest receivable) and after deducting further business expenses (such as rent, wages and salaries, or heating and lighting costs).
- Profit for the year (or profit after tax) is the profit before tax less the tax calculated on the profit before tax.
- Retained profit for the year is the final profit figure, after deducting distributions to owners. Distributions to owners are called either drawings if the business is a sole trader or partnership, or dividends if the business is a company. If there are no distributions to owners, then retained profit is equal to the profit for the year (that is, profit after tax) profit. Very often, the IS ends with the profit for the year (namely, the profit after tax) and the retained profit calculation is shown in a separate note called 'Statement of changes in equity'.

³ Note that inventory (stock) therefore appears twice in the accounts. It appears in the S of FP under current assets (the inventory figure on the year end date), and also in the IS. The 'closing inventory' figure in the IS is the same figure that appears in the S of FP. However, the 'opening inventory' figure in the IS is the figure that appeared in the previous S of FP.

Hence you can see that there are a variety of formats and, in some cases, terminology for both the S of FP and the IS, and the one chosen often depends upon the legal structure and size of the business.

3.3.3 The link between the income statement and the statement of financial position

The final profit for the year, after tax, appears in a reconciliation note called 'statement of changes in equity' (SOCE). This profit for the year is added to the retained profits brought forward at the beginning of the year. From this are deducted any distributions to owners, and this is the final retained figure at the year end. This total appears in the statement of financial position. The income statement together with the SOCE explains how this retained profit is earned and retained. The cumulative retained profit at the year-end appears in the owners' equity in the S of FP. Therefore, assuming there are no changes to any other reserves, the difference in owners' equity (and hence net worth) from the previous S of FP to the current S of FP is equal to the retained profit for the year; that is, the profit for the year less dividends paid to shareholders.

Returning to the income statement, **income and expenses are recorded in the IS in the period in which it is earned or incurred, regardless of the timing of the associated cash flows.**

So, for example, sales revenue is recorded as income even when the sale has been made on credit to a customer, who has two months before they need to pay; and a purchase is recorded as an expense even when the purchase has been made on credit from a supplier that allows a month before payment.

As well as ‘matching’ income and expenses in this way to the period to which they relate, income and expenditure are also matched to each other, so that where possible expense is recognised in the same period in which it generates sales.

You can see that the S of FP is also prepared on the accruals basis, because the S of FP contains all the ‘missing pieces’ of the puzzle at any point in time. When a sale has been recorded and the customer pays immediately, the sale is recorded in the IS and the asset ‘cash’ rises. If, however, goods are sold on credit, whereby the customer will pay at a later date, the sale is recorded in the IS and the asset ‘receivables’ will rise. When a purchase has been recorded but the supplier has not yet been paid, the IS will record the purchase and the S of FP will show current liability ‘payables’.

Example 3.2

Plants ‘R’ Us makes cash sales to members of the public and makes sales on credit to local businesses. Local businesses have a month to settle the sales invoices they receive from Plants ‘R’ Us. The following information relates to the month of June:

	£
Amounts owed by customers on 1 June	630
Cash sales	3,500
Credit sales	790
Cash received from credit customers	550

How much is owed by receivables (customers) on 30 June? How much will be recorded as sales for the month of June? Where should these amounts be reflected in the financial statements?

At the beginning of the month, credit customers owed £630. During the month, they paid back £550, but bought an additional £790 from Plants ‘R’ Us. Therefore, at the end of the month, customers owe $£630 + £790 - £550 = £870$. This would be shown as ‘receivables’ in current assets in the S of FP. Total sales for the month are cash sales of £3,500 plus credit sales of £790 = £4,290. This would be shown as revenues (or sales or turnover) in the IS.

Activity 3.3

Plants ‘R’ Us buys all of its goods on credit from various suppliers. The following information relates to the month of July:

	£
Amounts owed to payables (suppliers) on 1 July	2,180
Cash paid to payables	2,245
Credit purchases	2,520

How much is owed to payables (suppliers) on 31 July? How much will be recorded as purchases for the month of July? Where should these amounts be reflected in the financial statements?

You will see many examples of the application of the accruals (and matching) concepts in Chapters 4, 5 and 6 of this subject guide. Understanding how the S of FP and IS are linked together is very important in Chapter 12 of the subject guide and the interpretation of financial accounting information.

3.3.4 Asset or expense?

Sometimes it is hard to decide whether the cost of a given item should be recorded as an expense in the IS, or whether in fact it creates an asset that should be recorded in the S of FP. This is not a trivial question and some of the most debated areas of financial accounting concern whether or not costs such as research and development should be treated as assets or expenses.

Part of the problem is the definition of an asset, as this can be so vague that it could include almost anything. Under most current definitions of an asset, preparers of financial statements need to decide whether the transaction gives rise to 'expected future benefits'.

Sometimes, they are helped to make their decision by referring to accounting concepts, or they are told what to do by the rules in accounting standards, which we will discuss later.

Pause and think

How would you treat the cost of buying petrol for a delivery van, the cost of an advertising campaign, or the cost of training your staff to provide better customer service?

3.3.5 Cash flow statement

The CFS is used to demonstrate sources and applications of funds over the accounting period. It provides information on the liquidity of the business as it explains what has happened to the cash balance from one S of FP to the next. The final balance in the CFS is this change in the cash figure. You have to be careful when you work this figure out, because it is possible for a business to have a negative cash balance. This is called an 'overdraft' and is a form of short-term borrowing. Bank overdrafts appear as current liabilities in the S of FP, because the bank can request the business to repay the amount at any time.

The main types of sources and applications of cash that are reported in the CFS are described in Leiwty and Perks (2013) in Chapter 6, and an example is provided on p.140.

3.3.6 Why cash is different to profit

As already discussed, the IS and S of FP are prepared on an accruals basis. Adopting an accruals basis of accounting results in the recognition of sales revenue when goods (or services) are sold even if payments for these goods and services are made to the business at a later date. The costs of the business are not shown as an expense when they are paid for but when they are incurred. The business might buy goods to sell but they will only be recognised as a cost in the income statement and be offset against the revenue when those goods are sold. Similarly, a business might incur expenses such as advertising but pay for them at a later date but the advertising cost will be recognised as an expense when it is incurred, irrespective of when the invoice is actually paid. However, the CFS is prepared on a cash basis. The CFS records actual cash flows into and out of the business throughout the accounting period. In contrast, the IS records income and expenses matched to the accounting period in which it is earned or incurred, regardless of whether or not any cash has actually changed hands.

Activity 3.4

What is the effect on cash (i.e. increase or decrease) of the transactions described in Example 3.2 and Activity 3.3 above?

Example 3.3

The owner of Plants 'R' Us is preparing her accounts for the year ended 31 December 20X4. On 1 January 20X4, the business owed £450 interest on the bank loan of £50,000. The £50,000 loan capital will not be repaid until 20X8. On 31 December 20X4, the business owed £475 interest. The average interest rate on the loan during the year was 11 per cent. What amounts should be included in respect of interest in each of the three main financial statements?

The S of FP at 31 December 20X4 will include a current liability for the interest owed (at that date) of £475.

The IS for the year ended 31 December 20X4 will include interest expense of 11 per cent \times £50,000 = £5,500.

The CFS for the year ended 31 December 20X4 will include interest paid of £5,475. This is calculated as £450 (owed at start of year) + £5,500 (incurred during year) – £475 (still owed at end of year) = £5,475.

We need a CFS as well as an IS because they report different things, and because cash is so important to the survival of a business. It is possible for a business to be making profits but to run out of cash. This often happens to young or rapidly expanding businesses, when it is known as 'over-trading'. If a business runs out of cash and cannot pay its staff, its suppliers, the interest on its loans, or tax to the government, it will cease to be able to trade.

3.4 Accounting characteristics and concepts, bases and policies

You should understand the distinction between accounting concepts, accounting bases and accounting policies.

3.4.1 Accounting characteristics and concepts

It is a common misconception that financial statements can be considered as 'right'; or, in other words, that there is only one 'correct' way that they should be prepared. This is especially true in the case of profit. However, there is no universally accepted measure of profit (unlike, say, distance, although even this can be measured in different units). Because of this, accountants have developed certain broad assumptions on which the financial statements are prepared. These assumptions are known as accounting characteristics and concepts. You should note that even these underlying assumptions are not set in stone, and different accounting regimes may also regard some concepts as more important than others, especially when they seem to conflict with each other.

Leiwiy and Perks (2013) gives a detailed discussion of a comprehensive list of accounting concepts. You should read Chapter 3 in this textbook very carefully. In particular, you have already seen how important the accruals concept is, and you should make very sure that you understand this concept as it will be used every time you prepare a set of financial statements. In addition to the concepts in the textbook, the following three concepts are included for completeness:

- **Duality.** There are two effects from any economic event. These are reflected in accounting using the system of double-entry book-keeping. The ultimate result is the connection between the S of FP and IS: if the business makes a profit, it increases its net worth. You will see this discussed in more detail in Chapter 3 of the textbook.
- **Objectivity.** Accounting information should be provided in a manner that is free of bias.
- **Materiality.** Significant ('material') items should be given more emphasis than insignificant ones. An item is material if its disclosure is likely to affect users' decisions. Material items should always be disclosed in the financial statements; however, immaterial items may sometimes be excluded. Materiality is a very subjective concept as preparers have to judge what they think will be important to different users. What seems to be material to one user may be insignificant to another.

Activity 3.5

Healthy Foods plc has just spent £6m on an advertising campaign. The marketing director believes that it will generate at least 10 per cent more sales per annum (year) over the next three years. The current year's sales figure for the company is £50m. Referring to accounting concepts, discuss how this advertising expenditure should be reported in the financial statements. What are the accounting problems associated with its treatment?

Accounting characteristics and concepts can be divided into several categories. First, there are four qualitative characteristics of: **relevance, reliability, comparability** and **understandability**. Secondly, there are boundary rules (**entity, periodicity** and **going concern**) which are used to determine what should and should not be reported in the financial statements. Once the boundary is set, recording rules determine how and when data should be recorded (**money measurement, cost, realisation, accruals, matching, duality** and **materiality**). Finally, ethical rules have been developed to limit the room for manipulation of data to mislead users (**prudence, consistency** and **objectivity**).

At one point the four fundamental accounting concepts were going concern, accruals (incorporating the matching concept), consistency and prudence. If prudence and accruals conflicted, prudence was supposed to take precedence.

Pause and think

- The concepts of accruals and prudence are quite likely to conflict with each other. Can you explain why this is so? (Hint: Think of research and development expenditure in a pharmaceutical company).
- What do you think are the benefits of treating either accruals, or prudence, as more important? (Hint: consider the different characteristics of accounting information, and the needs of different groups of users.)
- Can you think of any other concepts which might conflict with each other? Which would you treat as more important, and why?

However, in recent years new regulations have introduced a different emphasis, superseding this list of priorities and giving more importance to the four qualitative characteristics of relevance, reliability, comparability and understandability.

3.4.2 Bases and policies

Accounting bases are the various possible methods of applying accounting concepts to the preparation of financial statements. For example, in accounting for non-current assets, such as vehicles, in

accordance with the accruals concept, a company might adopt the straight-line base or the reducing balance base for depreciation. These bases for depreciation will be explained in Chapter 6 of the subject guide.

Accounting policies are the specific methods chosen and applied by the business. For example, there are many different possible methods of inventory (stock) valuation. However, only one will be chosen. In many countries (including the UK) accounting policies must be disclosed in the notes to the financial statements. Of the two accounting bases above, the company might consider the straight-line depreciation the more appropriate and this will be its accounting policy.

Pause and think

Why is it important to disclose the specific accounting policies applied?

3.4.3 Accounting standards: advantages and disadvantages

Accounting standards such as International Financial Reporting Standards (IFRSs), International Accounting Standards (IASs) and UK Financial Reporting Standards (FRSs) are prepared by regulators in order to assist both preparers and users of financial statements. They usually set out rules, for example, over what may or may not be treated as an asset in the S of FP, or they restrict the choice of accounting policy to very few, or even just one, acceptable accounting basis. Accounting standards in the UK have to be applied by companies, and by some other entities such as charities, where there is a public interest in the financial statements. However, sole traders and partnerships do not need to follow accounting standards.

The advantages of accounting standards include:

- improved comparability between financial statements prepared by different businesses
- reduced costs to users (in terms of understanding) and preparers (in terms of applying) different accounting policies and definitions because there are fewer choices to make.

However, disadvantages include:

- some choice is often still allowed (so it is still difficult to compare financial statements prepared under different accounting policy choices)
- if there is no choice at all, some businesses may be forced to apply inappropriate accounting policies
- it is usually hard to write accounting standards so that unscrupulous businesses cannot still find a way to manipulate or abuse the rules in order to mislead readers
- the economic and reporting environment is changing so rapidly that new accounting standards (or changes to old ones) are always being required
- new standards may be inconsistent with old standards
- it can be so difficult to get everyone to agree on a new accounting standard that compromises have to be made.

Pause and think

Do you think it is better to allow businesses at least some choice over their accounting policies, or none at all? Consider businesses of different sizes, in different industries.

3.5 Overview of chapter

This key chapter has introduced you to the three main financial statements. The remaining chapters in this section on financial accounting will teach you more about how to prepare and interpret these financial statements, and help you understand and explain their weaknesses. This chapter also defined accounting concepts, bases and policies, and briefly discussed the role of accounting standards. The concept of accruals is fundamental to the preparation of the S of FP and IS. However, the CFS is prepared on a cash flow basis.

It is extremely important that you understand:

- the concept of accruals
- the link between the S of FP and IS via the SOCE
- the difference between accruals accounting and cash flow accounting.

If you are confused about the link between the S of FP and IS it should become clearer as you work through the chapters on preparation of financial statements later in this guide. However, it would be a good idea to keep referring back to this chapter as you progress.

3.6 Reminder of learning outcomes

Having completed this chapter, and the Essential reading and Activities, you should be able to:

- explain the different accounting concepts and their application
- distinguish between a sole trader, a partnership, a limited liability company and a limited liability partnership
- define accounting bases and policies, and discuss the role of accounting standards
- identify and describe the three main financial statements
- explain how these financial statements are linked together.

3.7 Test your knowledge and understanding

3.7.1 Sample examination questions

Short answer questions

1. At the directors' meeting of Mistletoe plc at which the draft accounts for the year ended 30 September 20X3 were discussed, the marketing director made the following comment:

‘The cost of the recent expenditure on the mailshot and television campaign advertising our products for Christmas 20X3 will benefit profits in the year ended 30 September 20X4. I cannot understand why this has all been treated as an expense in the 20X3 accounts.’

Evaluate this comment, making reference to any accounting concepts and principles which seem appropriate.

2. Explain what you understand by the accruals concept, giving an example. Explain why this concept is important in accounting, and how it affects the three main financial statements.

Your answers (to each question) are not to exceed 200 words in length. Excessive length will be penalised.

Chapter 4: Double-entry book-keeping

4.1 Introduction

This chapter introduces data processing in an accounting system. Even though most businesses now employ computerised accounting systems, the underlying logic and procedures of recording transactions are identical to those applied in a manual system. There is always the possibility of error (or deliberate fraud) in the accounting data and procedures have been developed to identify and prevent problems. This is known as internal control and will be a key theme of this chapter.

First, we return to the accounting concept of duality which you encountered in Chapter 3 of this subject guide. Later in the chapter you will see how the system of double-entry book-keeping records the two effects of each transaction, one as a debit ('DR' or 'Dr') and one as a credit ('CR' or 'Cr'). Recording each effect separately acts as a check on the other.

Next, the chapter explains that in order to reduce the likelihood of errors in the recording of financial transactions, accounting data is first recorded both in the books of prime entry, and in the receivables (sales) and payables (purchases) ledgers and the nominal ledger.

This chapter then demonstrates the application of double-entry; how to record each transaction using journal entries and in 'T' accounts; and finally how to 'balance' the 'T' accounts to prepare the trial balance (TB). The TB consists of two columns, one of Dr balances, and one of Cr balances.

If you struggle with double-entry, you can leave it and return to it later, but it is important that you understand the relationship between the Dr and Cr columns of balances in the TB, and items subsequently appearing in the statement of financial position (S of FP) and income statement (IS), before you move to subsequent chapters of this subject guide.

4.1.1 Aims of the chapter

The aims of this chapter are to:

- explain the process of recording accounting data in a business
- provide a grounding in double-entry book-keeping
- demonstrate the preparation and use of the trial balance.

4.1.2 Learning outcomes

By the end of this chapter, and having completed the Essential reading and Activities, you should be able to:

- explain the purpose and nature of the books of prime entry for recording accounting transactions
- record simple accounting transactions in ledgers using 'T' accounts, and document these entries using journals
- produce and balance 'T' accounts and extract information for the preparation of the trial balance
- explain the relationship between debit and credit entries in the trial balance and items appearing in the S of FP and income statement
- discuss the problems inherent in accounting systems and the importance of internal control to safeguard the completeness and accuracy of the accounting records
- identify and correct simple errors in the accounting records.

4.1.3 Essential reading

Leiwty, D. and R. Perks *Accounting: understanding and practice*. (Maidenhead: McGraw-Hill, 2013) Chapter 9, pp.205–23.

4.1.4 Synopsis of chapter content

This chapter considers the two effects of one accounting transaction, discusses internal control and goes on to introduce double-entry book-keeping.

Stop and read

Chapter 9 in Leiwty and Perks (2013) which explains accounting data processing systems and how accounting transactions and data are first generated, then recorded in the source books (i.e. books of prime entry) and ledgers. Chapter 9 describes the dual effects of every accounting transaction and how these transactions are recorded using double-entry book-keeping and demonstrates how accounting transactions are recorded in the books of account and in a trial balance. The chapter is very detailed and you need to work through it very carefully.

4.2 One transaction: two effects

You were first introduced to the concept of duality in Chapter 3 of this subject guide. This concept states that there are two effects from any economic event. So, for every financial transaction, there are two effects. Later in this chapter you will see that there is a debit effect, and an equal credit effect (being the two effects). This is easiest to see when transactions do not generate profits (or losses), as they only affect S of FP items.

Because the S of FP balances, these two effects should work in opposite directions and cancel each other out. Net assets should remain the same. However, when the IS is affected (because a profit or a loss is made), even though there will still be two S of FP effects, the overall result will be that net assets has either increased or decreased. This is because the IS is linked to the S of FP through the retained profit reserve. Net assets will increase if the business has made a profit, but they will decrease if the business has made a loss.

Example 4.1

Here are some examples of S of FP effects:

1. Joe Smith invests £1,000 cash to start up a new business, running a small shop. The business now has cash of £1,000, and capital invested of £1,000. The business has net assets of £1,000.
2. Joe Smith uses £500 of this money to buy shelves and other fixtures and fittings for the shop. The business now has £500 less cash, but has gained £500 of non-current assets. The business still has net assets of £1,000.
3. Joe Smith uses a further £100 of the money to buy inventory (stock) to sell in the shop. The business now has £100 less cash, but has gained £100 worth of inventory. The business still has net assets of £1,000.
4. The shop now sells all of the inventory for £150 cash. The business now has £150 more cash, and £100 less inventory. These two effects do not cancel each other. The £50 difference is the profit that Joe has made on the sale. This effect increases the retained profit reserve, in owner's equity. Net assets have now increased to £1,050.

Let us consider how these transactions affect the accounting equation, which you will recall from Chapter 3 is:

Assets = Liabilities + Owners' equity

Assets:	Owner's equity:	
1. Cash 1,000	= Owner's equity	1,000
2. Cash 500 + Fittings 500	= Owner's equity	1,000
3. Cash 400 + Fittings 500 + Inventory 100	= Owner's equity	1,000
4. Cash 550 + Fittings 500	= Owner's equity	1,050

The Owner's equity is:		
	Opening capital	1,000
	Profit for the period	<u>50</u>
	Closing capital	<u>1,050</u>

We also need to consider the effects on the IS. The IS will only be affected when the business incurs expenses or earns income. Transactions 1 and 2 do not affect the IS at all. However, transactions 3 and 4 do affect items which appear in the IS.

Transaction 3 affects the IS because inventory is in the IS as well as in the S of FP. Inventory is part of cost of sales. In transaction 3, the business has made purchases of £100, and has closing inventory (right after transaction 3) of £100 (the opening inventory was, of course, zero as the business is brand new). But because Joe has not made any sales yet, the total cost of sales in this case works out as being zero, and we can see that he has not made any profit.

In contrast, with transaction 4, Joe makes a sale and also a profit. The sales affect the IS, and the change in inventory affects cost of sales. The two IS effects (on sales and cost of sales) differ by £50. This £50 difference is the profit Joe has made by selling the inventory.

The income statement, showing revenues and expenses, is as follows:

	£
Sales revenue	150
Cost of goods sold	<u>(100)</u>
Profit for the period	<u>50</u>

This is what the shop's S of FP and IS¹ would look like if we stopped and prepared them at this point:

Joe Smith S of FP after transaction 4

	£
Non-current assets	
Fixtures and fittings	500
Current assets	
Cash (1,000 – 500 – 100 + 150)	<u>550</u>
Total assets	<u>1,050</u>
Capital invested	1,000
Retained profit	<u>50</u>
Total owners' equity	<u>1,050</u>

¹ We can ignore the CFS for the time being, because the effects of transactions on the CFS are just the change in cash.

Joe Smith IS for transactions 1 to 4

	£	£
Sales		150
Less: cost of sales		
Opening inventory	0	
Purchases	100	
Less: Closing inventory	<u>(0)</u>	
		<u>(100)</u>
Profit		<u>50</u>

Activity 4.1

What would be the effects on the business if Joe Smith now bought a further £50 of inventory from his suppliers, on credit (i.e. he does not have to pay the £50 cash to the suppliers immediately)? Prepare a new S of FP and IS for Joe Smith's business.

4.3 Recording transactions: books of prime entry

The first step in an accounting system is to input accounting data into the accounting records. Joe Smith was a very simple example with only a few transactions, so it was possible to stop and prepare financial statements after each one if we wished. But of course, in a real business there may be hundreds or thousands of transactions every day, and financial statements may only be prepared once a year. Double-entry book-keeping is a system which records the transactions of the business and then reflects each transaction twice much like this was demonstrated in Joe Smith, above. In Joe Smith's business we produced a statement of financial position after each transaction using the accounting equation and for any transactions affecting the income statement (in Joe's case, transaction 4).

All the accounting transactions need to be recorded in such a way that the chances of making an error, when it comes to eventually preparing the financial statements, are small. In order to identify errors, transactions are recorded in several places at the same time, so that these records can be compared later to make sure they are equal in amount.

There are three main **books of prime entry** (source books). These are the:

- **cash book**
- **sales day book**
- **purchases day book.**

Each transaction is recorded on a document – for example, every sales transaction is recorded on a sales invoice. And all these documents are then recorded, listed and analysed in a book of prime entry.

At the same time, the business will keep a number of different ledgers, depending on its size.² Most businesses will keep:

- **sales (or receivables) ledgers**
- **purchases (or payables) ledgers.**

These ledgers are records of all the individual amounts owed by or to the business's different customers and suppliers. From these ledgers it is possible to extract lists of all the individual amounts owed or owing at any point in time.

² A 'ledger' is a name for a book (or computer document or database) that contains accounting records relating to assets, liabilities, revenues and expenses.

4.3.1 Cash book

The cash book is used to record every cash payment that the business makes, and every cash receipt. Sometimes businesses keep separate cash books for cash at bank, and cash in hand (petty cash). The cash payments are recorded separately from the cash receipts. Generally, receipts are recorded on the left side, while payments are recorded on the right side.

4.3.2 Sales and purchases day books

These books are used to record every sale and every purchase that the business makes. Whenever the business makes a sale, the date, the invoice number and amount of the sale appearing on each sales invoice are included in the sales day book, together with the name of the customer. Whenever the business makes a purchase, the date, invoice number and amount of the purchase are included in the purchases day book, together with the name of the supplier.

It is important to record the date for each transaction, so that eventually when the financial statements are prepared, all of, and only, the transactions for the particular accounting period in question are included. The name of the customer or supplier should also be recorded, so that the records in the day books can be compared to the records in the receivables and payables listings.

Businesses will record any other information, such as invoice numbers, in the day books, that they will find useful in order to check their records at some future date.³

Generally, goods returned are recorded on a credit note which is much like a negative invoice. Sales credit notes are recorded in the sales day book as a minus figure while purchase credit notes are recorded in the purchase day book as a minus figure.

³ Keeping records of information which allows the business to retrace its steps and check its records is known as keeping an **audit trail**.

4.3.3 Receivables and payables ledgers

The entries in the receivables ledger are related to the sales day book, whereas the payables ledger entries are related to the purchases day book. These two ledgers record all the transactions recorded in the days books, with each ledger divided with a 'page' for each individual customer or supplier. And, as well as sales transactions or purchases transactions, the ledgers also record the cash receipts and cash payments related to each individual customer or supplier.

Therefore, at any point in time, these two ledgers, the Sales (or Receivables) ledger and the Purchase (or Payables) ledger can be used to provide a list of all the outstanding balances owed to the business by receivables, separately by each customer or owed to payables to each supplier. Because individual cash payments and receipts are also recorded in the ledgers, the ledger entries are also related to the cash book.

The way that the cash book, day books and ledgers work together is best illustrated with an example.

Example 4.2

Joanne Brown runs a business. On 1 March, her customers owe the following amounts:

1.	Green Ltd	£360
2.	Blue plc	£690
3.	Yellow & Son	£245

On the same date, she owes her suppliers the following amounts:

4. First Supplies plc £325
5. Second Ltd £170

During March, the following occur:

6. 2 March Green Ltd pays £150
7. 8 March Joanne buys £260 worth of goods from Second Ltd
8. 10 March Yellow & Son purchase £200 worth of goods from Joanne
9. 12 March Blue plc pays £400
10. 15 March Joanne pays First Supplies plc £180
11. 15 March Joanne pays Second Ltd £170
12. 20 March Green Ltd purchases £320 worth of goods from Joanne
13. 23 March Yellow & Son pay £200
14. 26 March Joanne buys £90 worth of goods from First Supplies plc
15. 28 March Blue plc purchases £120 worth of goods from Joanne

All sales and purchases are made on credit. Each of these transactions will be recorded in the appropriate book of prime entry and then each entry in the books of prime entry will be 'posted' to the receivables and payables ledgers. You should make sure that you understand where each of the following entries has come from:

Step 1: We list the transactions in the appropriate book of prime entry. All the receipts and payments are listed in the cash book, the receipts on the left side (we call this the debit side) and all the payments on the right side (we call this the credit side). All the sales invoices are listed in the Sales Day Book and all the purchase invoices are listed in the Purchase Day Book.

Extract from cash book:

Cash receipts			Cash payments		
Date	Details	£	Date	Details	£
2 March	6. Green Ltd	150	15 March	10. First Supplies plc	180
12 March	9. Blue plc	400	15 March	11. Second Ltd	170
23 March	13. Yellow & Son	200			
Total		<u>750</u>	Total		<u>350</u>

Sales day book:

Date	Details	£
10 March	8. Yellow & Son	200
20 March	12. Green Ltd	320
28 March	15. Blue plc	120
Total		<u>640</u>

Purchases day book:

Date	Details	£
8 March	7. Second Ltd	260
26 March	14. First Supplies plc	90
Total		<u>350</u>

Step 2: The opening balances are 'posted' into the correct account in the sales or purchase ledgers. In the sales ledger, the individual balances are entered as debits (i.e. on the left side of the 'T' account) while in the purchase ledger, the opening balances are entered as credits (i.e. on the right side of the 'T' account). The debit balances are assets since these balances reflect sums owed to the business and are receivables. The credit balances are liabilities since these balances reflect sums owed by the company to payables.

Step 3: The sales invoices are debited to the appropriate 'T' account in the sales ledger, increasing the amount owing by Joanne's customers while the purchase invoices are credited to the appropriate 'T' account in the purchase ledger, increasing the amount owed by Joanne to her suppliers.

Step 4: The individual bank receipts listed in the cash book are credited to the appropriate 'T' account in the sales ledger, reducing the amount owed by each customer while the individual bank payments are debited to the appropriate 'T' account in the purchase ledger thereby reducing the amount owed by Joanne to her suppliers.

Activity 4.2

In the receivables and payables ledgers below, there would normally be a closing balance owed by or to each individual. How much does each individual customer owe Joanne at the end of March? How much does Joanne owe each individual supplier at the end of March?

Receivables ledger:

Green Ltd

Date	Details	£	Date	Details	£
1 March	1. Balance b/f ⁴	360			
20 March	12. Sales	320	2 March	6. Cash receipts	150

⁴The 'balance b/f' is the opening balance. 'B/f' means 'brought forward'.

Blue plc

Date	Details	£	Date	Details	£
1 March	2. Balance b/f	690			
28 March	15. Sales	120	12 March	9. Cash receipts	400

Yellow & Son

Date	Details	£	Date	Details	£
1 March	3. Balance b/f	245			
10 March	8. Sales	200	23 March	13. Cash receipts	200

Payables ledger:

First Supplies plc

Date	Details	£	Date	Details	£
		325	1 March	4. Balance b/f	
15 March	10. Cash Payments	180			
		90	26 March	14. Purchases	

Second Ltd

Date	Details	£	Date	Details	£
		170	1 March	5. Balance b/f	
15 March	11. Cash Payments	170	8 March	7. Purchases	260

4.4 Double-entry book-keeping

The second part of the accounting system is processing data by applying double-entry book-keeping.

As well as the receivables and payables ledgers, a business will have a nominal (or general) ledger in which records are kept for all sorts of items (revenues and expenses, assets and liabilities and equity) in the accounts. These records are kept in the form of ‘T’ accounts much like in the receivables and payables ledgers. ‘T’ accounts are called ‘T’ accounts because they are ruled much like the letter ‘T’.

To summarise the information in the receivables and payables ledgers, there will be one ‘T’ account for the total amounts of receivables transactions and one for the total amounts of payables transactions. These special ‘T’ accounts are called ‘total accounts’ or more commonly ‘control accounts’. There will also be ‘T’ accounts for cash, each of the non-current assets, sales, purchases, and indeed for as many different S of FP or IS items as necessary. A business can have as many ‘T’ accounts as it needs so that it can classify and measure each of its assets and liabilities and its revenues and expenses.

Data is entered into ‘T’ accounts using double-entry book-keeping. It is called ‘double-entry’ because, for each transaction, there is a debit (Dr) and a credit (Cr) effect, and each effect must be recorded. Sometimes several different Dr and Cr effects need to be recorded in different ‘T’ accounts, but the total Dr effects must always be equal in value to the total Cr effects. This is because the S of FP should always balance.

4.4.1 Debits and credits: recording the two effects

Look back at the example of Joe Smith and Example 4.1 earlier in this chapter. Read through the list of transactions and the discussion of the effects that each transaction has on items in the S of FP and IS.

Items in the S of FP

We debit the ‘T’ account for an asset if the asset has increased. In contrast, we credit the ‘T’ account for an asset if the asset has decreased. We debit the ‘T’ account for a liability (or part of owners’ equity) if the liability has decreased, but we credit the ‘T’ account if the liability has increased. This can seem rather confusing at first so you should make sure you learn these rules.

Items in the IS

We credit the ‘T’ account for a type of income (e.g. sales) when the income is earned. In contrast, we debit the ‘T’ account for an income if the income has decreased (e.g. when a customer returns goods). We debit the ‘T’ account for an expense (or distribution to owners)⁵ when the expense is incurred, but we credit the ‘T’ account if the expense has decreased (e.g. the business’s purchases decrease when the business returns goods to a supplier). You should also learn these rules.

In summary:

Debits:	Increases in assets	Decreases in liabilities
	Increases in expenses	Decreases in revenues
Credits:	Increases in liabilities	Decreases in assets
	Increases in revenues	Decreases in expenses

⁵A distribution to owners is called drawings if the owner is a sole trader or a partner. It is called dividends if the owner is a shareholder.

We can see the connection considering the double entry and the accounting equation as follows:

Assets = Liabilities + Owners' equity

Dr: assets = Cr: liabilities + Owners' equity

Example 4.3

Joe Smith's transactions would have the following results:

1. Cash is an asset which has increased, so debit Cash. Capital Invested is part of Owners' equity. This has also increased, so credit Capital Invested.
2. Cash is an asset which has decreased, so credit Cash. Fixtures and fittings are a type of fixed asset, which has increased, so debit Fixtures and fittings.
3. There are two ways of dealing with this kind of transaction (involving the purchase of inventory). Both methods are equally valid and you should decide which method you prefer. One method would ignore the effect on inventory for the time being. It would record the decrease in cash as a credit, and debit an account for Purchases (purchases are a type of expense in the IS). Method 2 would ignore purchases instead. It would also record the decrease in cash as a credit, but it would record the increase in inventory (an asset in the S of FP) as a debit.⁶
4. Depending on which method you use for purchases, there are two corresponding methods for recording cash sales. The first bit is easy. Under both methods, the increase in cash is recorded as a debit, and the sales are recorded as a credit (they are a type of income). If you adopt Method 1 for purchases, there is nothing else you need to do. If you follow Method 2 you also need to record the reduction in the asset 'inventory' (credit Inventory), and debit a new account for Cost of sales. (The Leiw and Perks (2013) method uses a separate 'T' account for Purchases, which is then later incorporated into Cost of Sales.)⁷
5. This is another purchase. Following Method 1, we would credit Payables instead of Cash (we have created a liability by buying inventory but not paying for it yet) and debit Purchases. Following Method 2, we would also credit Payables, but we would debit Inventory.

⁶ Many businesses these days have 'perpetual inventory systems' that record all changes to inventory throughout the year. But in the past most businesses would not have kept up-to-date inventory records. They would have recorded purchases following the Leiw and Perks (2013) method, and only worked out how much inventory they had once or twice a year at the accounting year end date, by counting their inventory in a stocktake. Of course, businesses that keep perpetual inventory records also perform stocktakes, in order to check that their records are accurate.)

⁷ The Leiw and Perks (2013) method uses a separate 'T' account for Purchases, which is then later incorporated into Cost of Sales.

Journal entries

There is a quick way to write down the two sides (debit and credit) of each double-entry. These are called journals. It is important to record as much information as possible in a journal, in case you need to go back and check the details at a future date. At a minimum, they should include the date on which the entries were made in the 'T' accounts, the names of the 'T' accounts, and the value of each entry.

Example 4.4

Joe Smith's transactions would be recorded in the following manner:

	£	£
1. Dr Cash	1,000	
Cr Capital Invested		1,000
2. Dr Fixtures and Fittings	500	
Cr Cash		500

3.	Either Method 1		
	Dr Purchases	100	
	Cr Cash		100
	or Method 2		
	Dr Inventory	100	
	Cr Cash		100
4.	Either Method 1		
	Dr Cash	150	
	Cr Sales		150
	or Method 2		
	Dr Cash	150	
	Dr Cost of Sales	100	
	Cr Sales		150
	Cr Inventory		100
5.	Either Method 1		
	Dr Purchases	50	
		Cr Payables	50
	or Method 2		
	Dr Inventory	50	
		Cr Payables	50

Activity 4.3

How would you record the transactions in Example 4.2, using journal entries to show the double-entry? It will take a long time if you record separate journals for each individual receivables or payables, so instead record the entries for the total figures (for sales, purchases, cash receipts, cash payments, receivables and payables) for the month of March.

4.4.2 Using 'T' accounts

When making the entries to 'T' accounts, remember that:

- debit balances always go on the left-hand side
- credit balances always go on the right-hand side.

For S of FP 'T' accounts (assets, liabilities and owners' equity), there will usually be an opening balance, called the balance brought forward or brought down. This is shortened to balance b/f or b/d. It does not matter which you use. The opening balance always goes on the 'correct' side of the 'T' account. So, for receivables, the opening balance is a debit balance, because receivables are an asset. Therefore it should be put on the left-hand side of the 'T' account. However, for payables, the opening balance is a credit balance, because payables are a liability. Therefore it should be put on the right-hand side of the 'T' account.

There is one account where the opening balance could go on either side – this is the 'T' account for cash at bank. If the business has money in the bank (a positive bank balance), then the opening balance is a debit because the cash is an asset. However, it is possible for businesses to have a negative bank balance. This is called an overdraft and it is a form of short-term borrowing. This is a liability, so the opening balance will be a credit.⁸

⁸ If you have your own bank account, you will know that the bank uses the words 'debit' and 'credit' to record payments and receipts, respectively, to your bank account. This is the opposite way round to the way that you should record payments and receipts in your own records. It is easy to get confused because the bank uses the terms debit and credit from its own point of view, rather than from yours! The bank's perspective on your bank account is a mirror image of your perspective.

Whenever you make an entry into a 'T' account, it is important to record as much information as you can in case you need to retrace your steps (for example, to correct a mistake) at a future date. As well as recording the date of the entry and the amount, you should write the name of the 'T' account in which the other side of the double-entry is being recorded.

Example 4.5

Joe Smith's transactions would be recorded in the following manner:

Cash			
Receipts	£	Payments	£
1. Capital invested	1,000	2. Fixtures and Fittings	500
		3. Either Purchases or Inventory	100
4. Sales	150		
Capital Invested			
	£	1. Cash	1,000
Fixtures and Fittings			
	£		£
2. Cash	500		
Sales			
		£	£
		4. Cash	150
Payables			
	£		£
		5. Either Purchases or Inventory	50
Either Method 1			
Purchases			
	£		
3. Cash	100		
5. Payables	50		
or Method 2			
Inventory			
	£		£
3. Cash	100	4. Cost of sales	100
5. Payables	50		
and Method 1			
Cost of sales			
	£		£
4. Inventory	100		

Note that in this example there are no opening balances, because the business has only just come into existence.

Activity 4.4

Using your answers to Activity 4.3, create the necessary 'T' accounts and perform the double-entry for the transactions in Example 4.2. Use Method 1 to account for purchases of inventory. Assume that the opening balance for cash is £1,300 (debit).

4.4.3 Closing 'T' accounts

Closing, or 'balancing', a 'T' account is done at the end of an accounting period, when the business wants to prepare a trial balance (and presumably also a set of financial statements). It is a technical operation which gives us the figures we need for the financial statements.

The closing balances we find for the S of FP 'T' accounts will be carried forward or carried down (c/f or c/d) to become the next period's opening balances. However, the balances on the IS 'T' accounts do not get carried forward to the next period (this is a consequence of the accruals basis of accounting). Instead, they get transferred to the income statement, and eventually to the Retained Profit reserve, which is a S of FP 'T' account. You do not need to make the entries to transfer IS items to the S of FP Retained Profit reserve.

To close off a 'T' account:

1. calculate the totals of the debit and credit entries in the 'T' account
2. one total is usually greater than the other: calculate the difference between the two totals to give the closing balance
3. add the closing balance to the side with the lowest total in order to make the totals of the two sides agree (balance).

This is illustrated in the cash 'T' account in Example 4.6. Sometimes, there is only one entry on each side of a 'T' account, for equal amounts. In these cases it would be a waste of time to close the 'T' account off formally (because the closing balance will be zero). When there is only one entry in a 'T' account, it is similarly unnecessary to write down the totals on each side. This is illustrated in the Capital invested 'T' account in Example 4.6.

Example 4.6

Joe Smith's 'T' accounts would be closed off as follows:

Cash			
£		£	
1. Capital invested	1,000	2. Fixtures and Fittings	500
		3. Either Purchases or inventory	100
4. Sales	<u>150</u>	Bal c/f	<u>550</u>
	1,150		<u>1,150</u>
Bal b/f	550		
Capital Invested			
£		£	
Bal c/f	<u>1,000</u>	1. Cash	1,000
	<u>1,000</u>	Bal b/f	<u>1,000</u>
Fixtures and Fittings			
£		£	
2. Cash	<u>500</u>	Bal c/f	<u>500</u>
	<u>500</u>		<u>500</u>
Bal b/f	500		

Sales			
	£		£
Income statement	<u>150</u>	4. Cash	<u>150</u>
	<u>150</u>		<u>150</u>
Payables			
	£		£
Bal c/f	<u>50</u>	5. Either Purchases or inventory	<u>50</u>
	<u>50</u>		<u>50</u>
Either		Bal b/d	50
Purchases			
	£		£
3. Cash	100		
5. Payables	<u>50</u>	Income statement a/c ⁹	<u>150</u>
	<u>150</u>		<u>150</u>
Or			
Inventory			
	£		£
3. Cash	100	4. Cost of Sales	100
5. Payables	<u>50</u>	Bal c/f	<u>50</u>
	<u>150</u>		<u>150</u>
Bal b/f	50		
And			
Cost of Sales			
	£		£
4. Inventory	<u>100</u>	Income statement a/c	<u>100</u>
	<u>100</u>		<u>100</u>

⁹ Strictly speaking, the purchases figure should first be transferred to a Cost of Sales 'T' account. The value of closing inventory would be recorded as a debit in a S of FP 'T' account, and as a credit in the Cost of Sales 'T' account. These entries are not illustrated here but they are given in Leiwiy and Perks (2013) Chapter 10, p.248. The end result should be closing inventory in the S of FP of £50, and cost of sales (a debit in the income statement a/c) of £100.

Activity 4.5

Close off the 'T' accounts from your answer to Activity 4.4.

4.5 Trial balance

The final part of an accounting system is obtaining output. This involves the preparation of the Trial Balance (TB), and using the TB to prepare the financial statements (S of FP and IS).¹⁰ Once all the 'T' accounts are closed, the final balances are collected and listed in two columns, the Dr column and the Cr column. The final balances for S of FP 'T' accounts are the c/f balances for the next accounting period, corresponding to assets, liabilities and owners' equity. The final balances for IS 'T' accounts, corresponding to revenues and expenses, are eventually transferred to the S of FP reserves (as retained profit).

You need to decide whether each final balance represents a debit or a credit, but you can see that the final balances are on the 'wrong' sides of each 'T' account (for example, the c/f balance for receivables is on the credit side of the 'T' account). So you have to imagine swapping them all over. All the debit balances are put into the left-hand column of the TB, and all the credit balances are put into the right-hand column.

¹⁰ The S of FP and IS are then used to prepare the CFS. You will see how this is done later in the course.

If all the accounting entries are correct, the two columns of the TB should balance (equal the same total amount) since every transaction posted into the ledgers was posted as a debit to one ‘T’ account and as a credit to another ‘T’ account. This is one way of checking to see if there have been any accounting errors. However, it is possible for the TB to balance, and still contain an error.

Pause and think

Can you explain why the two columns of the TB should balance? What kinds of error can occur, but not affect this?

Example 4.8

Here is the TB for Joe Smith after transaction 5, using Method 1:

	Dr	Cr
	£	£
Cash	550	
Capital invested		1,000
Fixtures and fittings	500	
Sales		150
Trade payables		50
Purchases	150	
	1,200	1,200

The TB balances, but it is missing something – it is missing closing inventory. We can include closing inventory in two ways. First, we can record it both as a debit (for the S of FP) and as a credit (for the IS – closing inventory reduces cost of sales and therefore increases profit):

	Dr	Cr
	£	£
Cash	550	
Capital invested		1,000
Fixtures and fittings	500	
Sales		150
Trade payables		50
Purchases	150	
Closing inventory – S of FP	50	
Closing inventory – IS		50
	1,250	1,250

Alternatively, we can replace the Purchases figure with Cost of sales, from which the IS closing inventory figure is deducted, and we will end up with the same TB as if we had followed the Method 2. The subject of closing inventory will be examined further in Chapter 5.

	Dr	Cr
	£	£
Cash	550	
Capital Invested		1,000
Fixtures and fittings	500	
Sales		150
Trade Creditors		50
Cost of Sales	100	
Closing inventory – S of FP	50	
	1,200	1,200

Pause and think

Check that you agree that this last TB is identical to that which you would prepare from the 'T' accounts prepared using Method 2.

Pause and think

Compare the TBs in Example 4.8 with the S of FP and IS you prepared in Activity 4.1, for Joe Smith after transaction 5. Check that the balances in the Dr column of the TB have been recorded as either assets or expenses, and that the balances in the Cr column of the TB have been recorded as either liabilities or owners' equity or income.

4.5.1 Notes on using the TB

If the figures in the TB are all present and correct, they can be simply read off from the TB and placed directly into the S of FP and IS. Figures in the Dr column of the TB are either assets (which go into the S of FP) or expenses or drawings (which go into the IS). Figures in the Cr column of the TB are either liabilities or owners' equity (which go into the S of FP) or income (which goes into the IS). A TB therefore provides data which is clearly structured for you to use in preparing financial statements.

You must always remember the link between the S of FP and the IS. When you prepare the S of FP and IS using a TB you will need to add the retained profit figure you calculate in your IS, to the brought-forward retained profit reserve from the TB, to create the new retained profit reserve figure in the S of FP which in a company is a note called statement of change in equity (SOCE). In the Joe Smith example, because the business is brand new, there is no balance brought forward on this reserve, but in all subsequent years there will be. This opening balance would appear in the Cr column of the TB as it is part of owners' equity.

You need to be extra careful when dealing with inventory (stocks). Usually, the balance brought forward on the S of FP inventory 'T' account at the beginning of the year (i.e. the opening inventory) will still appear as a debit balance on the TB at the end of the year. This is correct because opening inventory is included in the IS as part of cost of sales (i.e. it is part of an expense). Note that because the business in the Joe Smith example is brand new, there was no opening inventory.

Often, the closing inventory figures will be missing (as in the first TB of Example 4.8) so we need to remember to include them in the financial statements. The information to help you to do this will be provided in the question. You will not need to rewrite the TB to do this unless you are specifically asked to do so.¹¹

¹¹ If you are asked to rewrite the TB to include closing inventory, you should put the closing inventory figure down twice, once in the Dr column (to represent the asset of closing inventory in the S of FP) and once in the Cr column (to represent the effect of closing inventory on cost of sales in the IS).

Finally, you must always be aware that there may be errors in the figures in the TB, or figures (like closing inventory) which are missing because they have not yet been accounted for (recorded in the “T” accounts). Later in this subject guide we will see examples of dealing with information about accounting errors, missing data and other adjustments when preparing financial statements. It will not be necessary to use double-entry book-keeping and prepare “T” accounts in order to do this.

4.6 Overview of chapter

This chapter has described the processes of generating and recording accounting data and has introduced some of the methods of internal control which companies use to discover and prevent accounting errors. We have also seen that the accounting concept of duality leads to the system of double-entry book-keeping, which records both the debit (Dr) and credit (Cr) effects of each transaction.

The output of double-entry book-keeping is the trial balance (TB), which is generated from “T” accounts in the ledgers. It is most important that you understand how the data in the Dr and Cr columns of the TB is used to prepare the S of FP and IS; you should be able to do this even if you find performing double-entry book-keeping itself difficult or confusing. Do not worry if you struggle with double-entry – you can leave it and come back to it at a later stage.

4.7 Reminder of learning outcomes

Having completed this chapter, and the Essential reading and Activities, you should be able to:

- explain the purpose and nature of the books of prime entry for recording accounting transactions
- record simple accounting transactions in ledgers using “T” accounts, and document these entries using journals
- produce and balance “T” accounts and extract information for the preparation of the trial balance
- explain the relationship between debit and credit entries in the trial balance and items appearing in the S of FP and income statement
- discuss the problems inherent in accounting systems and the importance of internal control to safeguard the completeness and accuracy of the accounting records
- identify and correct simple errors in the accounting records.

4.8 Test your knowledge and understanding

4.8.1 Sample examination question

4.1 Mac

At 1.1.20X4, the balances of Mac's business were as follows:

	\$
Cash in till	150
Bank balance (overdrawn)	13,200
Receivables	20,100
Payables	17,550
Inventory, at cost	48,690
Capital	38,190

On 1 January 20X4, he takes a lease on the adjacent shop, with a view to growing the business. The rent to be paid in the year is \$27,000.

Transactions in the year ended 31 December 20X4 are summarised as follows:

1. Since each night any money in excess of the \$150 till float is banked, that balance is to be maintained throughout. Hence, treat all cash transactions as though they go through the bank account.
2. A bank loan of \$24,000 is arranged with interest at 13 per cent pa and with that sum, three vans are purchased.
3. Mac pays \$7,500 from his personal funds to fit out the new shop with fittings.
4. Inventory of \$18,000 is purchased for cash.
5. Inventory of \$585,000 is purchased on credit.
6. Sales of items costing \$74,000 were sold for \$99,000, cash.
7. Sales of items costing \$455,000 were sold for \$640,000 on credit.
8. Payables were paid \$567,000.
9. \$627,000 was received from receivables.
10. Goods purchased on credit for \$8,000 were returned to the supplier.
11. The following payments were made from the bank account:

	\$
Rent	27,000
Interest	3,120
Wages	42,000
Heat and light	5,400
Telephone	2,100
Other expenses	3,660
Holiday	<u>1,200</u>
Total payments	<u>84,480</u>

12. Additionally, drawings paid from the bank were \$7,200.

Required

1. Prepare double-entry T-accounts reflecting the above.
2. Prepare a trial balance at 31 December 20X4.
3. Mac, himself, does not maintain proper books of account. The transactions above were summarised from the bank statements and files of invoices. Set out, in a memorandum, the problems of running a business in this manner.