

FRANK WOOD'S **BUSINESS ACCOUNTING**

ALAN SANGSTER
LEWIS GORDON



An introduction to
FINANCIAL ACCOUNTING

 Pearson

15th edition

FRANK WOOD'S
BUSINESS ACCOUNTING



Frank Wood
1926–2000

FRANK WOOD'S **BUSINESS ACCOUNTING**

An Introduction to Financial Accounting

FIFTEENTH EDITION

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Lecturer Resources

For password-protected online resources tailored to support the use of this textbook in teaching, please visit

go.pearson.com/uk/he/resources



Notes for teachers and lecturers

This edition marks a major change in focus that reflects the consolidation of the previous two volumes into one. The emphasis is now exclusively on financial accounting. This change, and the resulting increased focus on company accounting and International GAAP within the text, were made in response to the comments of reviewers of the previous edition, who felt this was what we should be focusing on.

This textbook has been written to provide a very thorough introduction to accounting. Anyone seeking to obtain a good grounding in financial accounting will find this book suitable to their needs. This includes those studying accounting on courses at school, college or university; or studying for qualifications from the LCCE, Association of Accounting Technicians, the Institute of Secretaries and Administrators; or for qualifications of any of the six UK and Irish Chartered Accountancy bodies. The financial accounting requirements for National Vocational Qualifications and Scottish Vocational Qualifications are also fully covered.

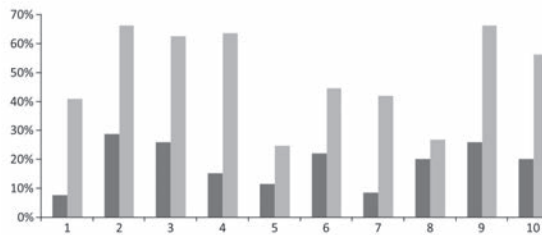
The book has the following features:

- 1 Each chapter:
 - starts with **Learning objectives**;
 - contains **activities** designed to broaden and reinforce students' understanding of the concepts being covered and, in some cases, to introduce new concepts in such a way that they do not come as a surprise when introduced formally later in the book;
 - ends with **Learning outcomes** that can be mapped back to the Learning objectives, reinforcing the major topics and concepts covered in the chapter;
 - contains **answers** to all the activities immediately after the Learning outcomes.
- 2 There is an alphabetical **Glossary** in Appendix 3 of all the significant terms introduced. Each entry is referenced back to the chapter in which it appeared.
- 3 Five sets of 20 **multiple-choice questions** are positioned in the book (at the end of Chapters 6, 16, 22, 30 and 40) at the point at which they should be attempted, rather than as a group at the end of the book. All the answers are at the back of the book in Appendix 2.
- 4 At the end of Part 5 (*Controls, checks and errors*), there are five **Scenario questions** designed to reinforce learning of the adjustments through their application in the preparation of financial statements previously learnt in Parts 1–5.
- 5 A set of **Notes for students** appears at the front of the book. This covers how to use this book, how to tackle the end-of-chapter **Review questions**, and how to study for and sit examinations. **It should be read by students before they start working through the main text.**
- 6 Blue is used in the text to enhance readability and bring out key points.

A new approach

For over 500 years, teachers of double entry have complained that students could not understand it and struggled to learn it. The solution throughout that period was to give students rules to guide them, but teachers continued to observe how difficult students found double entry. Comparing typical present-day comments with those of the mid-16th century reveals that little has changed. For many students, rules only work up to a point. In the 13th edition of this book, a different approach was adopted for the teaching of this topic. It does not use rules. Instead, it uses generalisable principles that provide a foundation from which the double entry for any

Exhibit 1 The result of a switch to a principles-based approach to double entry



transaction can be made. This principles-based approach to double entry has been fully adopted and is the focus of Chapter 2 (Recording transactions).

When a colleague and I used this principles-based approach with 250 students, their learning and understanding of double entry improved by more than 150 per cent; this is shown in Exhibit 1. The histogram shows the percentage of the 250 students who selected the correct answer to each of 10 multiple-choice questions compared with the percentage of another group of 250 students who had learnt double entry by rules, such as ‘debit the receiver and credit the giver’. The multiple-choice questions required them to identify the correct double entry for each of 10 transactions. This is why the approach adopted in this text has been changed: students find it far easier to learn!

The underlying truth behind this approach is that there are two elements to every transaction and *all* transactions involve at least one thing belonging to a business, either before, or as a result of the transaction. This is the *item exchanged*. The other thing involved in the transaction is the *form of settlement*, e.g. cash, bank, a debt, or capital. The approach adopted in this edition is simple: if you know how to record cash received or cash given, you can record receipts or givings of any *form of settlement*. **A form of settlement, e.g. cash, is credited when it is given and debited when it is received.** The entry for the *item exchanged* is the opposite.

It is a straightforward method. And it never fails to give the correct treatment for a transaction, not least because you only have to identify the *form of settlement* and the *item exchanged* in a transaction to know what to debit and what to credit.

The confusing language of bookkeeping

One of the most confusing aspects of double entry is the two meanings of the term ‘credit’: (1) as the opposite of ‘debit’; and, (2) as the granting of time in which to pay the amount due following a transaction. To address this, in the first 10 chapters when a transaction involves credit, the term ‘credit’ is *not* used to describe the transaction. Instead, as shown in examples 3 and 4 of Section 1.10 and in example 3 of Section 2.16, the transaction is described as being settled ‘on time’. Also, as discussed in Section 2.6, when a transaction is settled ‘on time’ the term ‘IOU’ is used as the *form of settlement*. In classes over the past six years, this approach has been found to make it easier for students to understand the principles of recording transactions.

In Chapter 11, the term ‘credit sale’ is introduced. Thereafter, ‘credit’ is used in place of ‘on time’. By delaying this use of ‘credit’ until that chapter, students find double entry much less confusing.

We hope that you will find these innovations of help in the teaching of this topic; and we are sure that your students will find it much easier to learn from it. Please let us know your views on this, and those of your students.

Changes made in this edition

Several changes, some major, others less so, have been made to the content of this textbook since the last edition. Some were made because of the switch from two volumes to one, others to enhance the suitability and usefulness of the book:

- There has been some restructuring and resequencing of the parts:
 - Part 3 (*Financial statements*) is now Part 2 and has been renamed ‘The financial statements of sole proprietors’.
 - Part 2 (*Books and transactions*) is now Part 3.
 - Part 4 (*Accounting today*) is now Part 10.
 - Part 8 (*Partnership accounts and company accounts*) has been split between Part 7 (*Accounting for partnerships*) and Part 8 (*Accounting for companies*).
 - Part 8 (*Accounting for companies*) is completely new to this edition. The three new chapters in this part significantly increase the book’s coverage of companies, including (for the first time) their *published* financial statements. IAS 1 *Presentation of Financial Statements*, IAS 10 *Events after the Reporting Period*, and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* also receive increased attention in this part of the book.
 - Part 10 (*An introduction to management accounting*) has been moved online.
- Chapter 29 (*Manufacturing accounts*) has been moved online.
- Chapters 30 (*Departmental accounts*), and 37 (*Purchase of existing partnership and sole proprietor businesses*) have been deleted. These are both available if you wish to include them in a customized version of this book, as are the chapters moved online.
- Chapter 38 (*Maths for accounting*) is now Chapter 17.
- Most people view financial accounting as a never-changing subject. This is wrong. Financial accounting is a dynamic subject with new and revised accounting standards as a constant reminder that this is the case. These changes impact how material is presented in this book. Six chapters have been rewritten to be consistent with the current requirements of IFRS:
 - Chapter 7 (*Accounting concepts and assumptions*), which is now Chapter 10 (*Accounting concepts and the conceptual framework*).
 - Chapter 9 (*Cash books*), which is now Chapter 12.
 - Chapter 18 (*Inventory valuation*).
 - Chapter 20, which is now Chapter 19, has been renamed ‘*Bad debts, allowances for doubtful debts, and allowances for prompt payment discounts*’.
 - Chapter 17 (*Capital expenditure and revenue expenditure*), which is now Chapter 20.
 - Chapter 21 (*Depreciation*).
- Coverage of the Statement of cash flows has been doubled in this edition:
 - Chapter 25, which is now Chapter 28, has been renamed ‘*Introduction to the statement of cash flows*’.
 - Chapter 37 (*The statement of cash flows for companies*) takes it further, and also introduces students to the interpretation of the statement.
- In response to many requests, the terms ‘accounts receivable’ and ‘accounts payable’ have been replaced with the terms ‘trade receivables’ and ‘trade payables’.
- Several other chapters have been revised in order to make some sections clearer, including Chapter 38 (*Accounting ratios*).
- There are over 100 new end of chapter Review questions in this edition, 37 of which are in Part 8 (*Accounting for companies*), reflecting the significantly increased emphasis on companies in this edition.
- Twenty-one of the 100 multiple-choice questions are new.
- The text is fully compliant with International GAAP.

We hope that you find these changes helpful and appropriate. We would welcome comments on these and any other changes you feel ought to be made in future editions. You can contact us by email at alan.j.a.sangster@gmail.com and L.W.Gordon@liverpool.ac.uk.

Finally, we would like to thank all those teachers and lecturers who offered us advice on the changes they would like to see incorporated in this edition. Above all, we would like to acknowledge the assistance received from Graeme C. Reid and Christopher Foo for all their help and advice over the past 29 years.

Alan Sangster and Lewis Gordon

Notes for students

This textbook presents your topics in what has been found to be the most appropriate sequencing to build the foundations of your accounting knowledge. You will find that a number of features of the book, properly used, will enhance your understanding and extend your ability to cope with what will possibly appear, at first, to be a mystifying array of rules and procedures.

To make best use of this resource, you should consider the following as being a proven path to success:

- At the start of each chapter, **read the Learning Objectives**. Then, while you work through the material, try to detect when you have achieved each of these objectives.
- At the end of each chapter, **check what you have learnt against the Learning Outcomes** that follow the main text.
- If you find that you cannot say ‘yes, I have learnt that’ to any of the Learning Outcomes, look back through the chapter and reread the topic you have not yet learnt.
- **Learn the meaning of each new term as it appears**. Do not leave learning what terms mean until you are revising for an exam. Accounting is best learnt as a series of building blocks. If you don’t remember what terms mean, your knowledge and ability to ‘do’ accounting will be very seriously undermined, in much the same way as a wall built without mortar is likely to collapse the first time someone leans against it.
- Attempt each of the **Activities** in the book **at the point at which they appear**. This is *very* important. They will reinforce your learning and help set in context some of the material that may otherwise appear very artificial and distant from the world you live in. The answers are at the end of each chapter. **Do not look at the answers before you attempt the questions – you’ll just be cheating yourself**. Once you have answered one, check your answer against the answer provided in the book and be sure you understand it before moving on.
- Attempt each of the sets of multiple-choice questions when you reach them in the book. There are five sets of 20 questions, one at the end of each of Chapters 6, 16, 22, 30 and 40. The answers are in Appendix 2 at the back of the book. **Do not look at the answers before you attempt the questions – you’ll just be cheating yourself**. If you get any wrong, be sure you understand why before moving on to new material.
- Attempt the Scenario Questions at the end of Part 5. They will help you see how the items covered in Parts 4 and 5 affect the preparation of financial statements.
- **Learn the accounting equation when you first come across it in Chapter 1**. It is *the* key to understanding many of the aspects of accounting that students find difficult. Make sure that you learn it in both the forms presented to you or that you can rearrange it to produce the alternative form when appropriate.
- Do not be disillusioned by the mystery of double entry. The technique has been in common use for over 700 years and is probably the most tried and trusted technique for doing anything you are ever likely to encounter. It really is not difficult, so long as you remember to identify what to do with the *form of settlement* you will learn about in Chapter 1. Like riding a bike, once you understand it, you’ll never forget it and, the more you do it, the easier it gets.
- Because of time pressure, some teachers and lecturers will need to omit Chapter 30 (*Joint ventures*). Make sure that you work through it on your own before you look at the material in Chapter 31, the first chapter on accounting for partnerships. This is very important, as accounting for joint ventures bridges the gap between accounting for sole proprietors and accounting for partnerships and will make it much easier for you to understand the differences between them.

- Above all, remember that accounting is a vehicle for providing financial information in a form that assists decision-making. Work hard at presenting your work as neatly as possible and remember that pictures (in this case, financial figures) only carry half the message. When you are asked for them, words of explanation and insight are essential in order to make an examiner appreciate what you know and that you actually understand what the figures mean.

There are two subjects we would like you to consider very carefully – making best use of the end-of-chapter Review Questions, and your examination technique.

Review questions: the best approach

Review questions are included at the end of most chapters. They are there for you to gauge how well you understand and can apply what you have learnt. **If you simply read the chapters without attempting the questions, you will not pass your examinations.** You should first attempt each question, then check your answer fully against the answers at the back of the book. **Do not simply compare the question with the answer and tick off the bits of the answer against the relevant part of the question.** No one ever learnt to do accounting properly that way. It is tempting to save time, but you will regret it eventually.

Need for practice

Try to find the time to answer as many exercises as possible. This is why:

- 1 Even though you may think you understand, when you come to answer the questions you may find you don't. The true test of understanding is whether or not you can tackle the questions competently.
- 2 Practice makes perfect. If you don't practice doing accounting questions, you will almost certainly not become good at accounting.
- 3 You need to be able to answer questions quickly: many students fail accounting exams because they run out of time. A lot is expected from you in an accounting exam in a very short time because examining boards believe, and have always believed, that an 'adequately prepared' student will be able to work quickly on the problems set. By an 'adequately prepared' student, they mean a student who not only has the knowledge, but has been trained to work quickly and, at the same time, maintain accuracy and neatness.
- 4 Speed is not enough. You also have to be neat and tidy and follow all the proper practices and procedures while working at speed. Fast, correct, but really scruffy and unreadable work can also cause you to fail the exam. Why? At this level, the accounting examiner is mainly concerned about your practical ability in the subject. Accounting is a practical subject, and your practical competence is being tested. The examiner will, therefore, expect the answers to be neat and well set out. Untidy work with numbers spread over the page in a haphazard way, badly written numbers, and columns of figures in which the vertical columns are not set down in straight lines, will be penalised and can easily mean the difference between a pass and a fail.
- 5 Appropriate presentation of information is important. Learn how to present the various financial statements you may need to produce in an examination. Examiners expect to see the items in statements of profit or loss, statements of financial position, and statements of cash flow in the correct order and will probably deduct marks if you don't do this. Practise by writing down examples of these statements without any numbers until you always get the layout correct. One exam trick most students overlook is that the layout of a financial statement is often included in an examination paper as part of one question while another question asks you to produce an answer using the format of that financial statement. **The one you need to produce will contain different numbers but the general layout should be very similar.**

Need for headings

Your work should not only be neat, it should be well presented. Headings should always be given, and any dates should be inserted. The test you should apply is to imagine that you are a partner in a firm of professional accountants and have taken a few weeks holiday. During that time your assistants have completed all sorts of work including reports, drafting final accounts, various forms of other computations, and so on. All of this is waiting for you when you return. When you return you look at each item in the pile. Suppose the first one looks like a balance sheet as at 31 December in respect of one of your clients. When you look at it you can see that it is a balance sheet, but you don't know for which client, neither do you know which year it is for. Would you be annoyed with your assistant who prepared it? Of course, you would. So, in an exam, why should the examiner give you high marks if you prepare a balance sheet answer without the date, or the name of the business, or the fact that it is a balance sheet position written clearly across the top? If proper headings are not given you will lose a lot of marks. Don't wait until your examination to do this. You also need to take similar care with sub-totals and sub-headings that need to be shown, such as those for non-current assets or for current liabilities.

The examiner

When answering an examination question, think about what you would say if you were employing an accounts assistant who gave you a sheet of paper with accounting entries written in the same style as your own efforts in answering the exam question. Would you have told your assistant to go back and do the work again because it is untidy? If you say that about your own work, why should the examiner think any differently?

Anyone who works in accounting knows that untidy work leads to completely unnecessary errors. This is why examiners penalise unclear, untidy, poorly-presented work. Examiners want to ensure that you are not going to mess up the work of an accounting department. Even today, accountants still write down many things on paper, so don't imagine that examiners will overlook such messy work just because most accounting is now done using a computer. Imagine going to the savings bank and the manager saying to you: 'We don't know whether you've got £5 in the account or £5,000. You see, the work of our clerks is so untidy that we can never sort out exactly how much is in anybody's account.' We would guess that you would not want to put a lot of money into an account at that bank. How would you feel if someone took you to court for not paying a debt of £100 when, in fact, you owed them nothing? This sort of thing would happen all the time if we simply allowed people to keep untidy accounts. The examiner is there to ensure that the person to whom they award a pass will be worthy of it and will not continually mess up the work of any firm at which they may work in the future.

If you want to pass your accounting exam, and your work is untidy, what can you do about it? Well, the answer is simple enough: start right now to be neat and tidy in your work. I did. My writing was so bad that my accounting teacher at school told me to print everything in capital letters. I thought he was mad, but my marks improved immediately, and so did my handwriting and my overall neatness in preparing answers. Start being neat now. You cannot suddenly become neat in an examination.

The structure of the questions

The review questions in each chapter generally start with the easiest and then get gradually more difficult. Some are very difficult and time consuming. If all the questions were easy, the shock of meeting more complicated questions for the first time in an examination could lead you to fail it. By giving you a mixture of straightforward and complicated questions, you will learn how to deal with the complex issues before meeting them in an exam. It's in your best interests not to ignore review questions you find hard. Put in the effort, the practice will increase your knowledge and understanding, and your performance in the exam will improve as a result.

The answers

At the back of the book, you will find answers to approximately half of the Review Questions. The answers to the other review questions (indicated by the letter 'A' after the question number) are only available to you from your teacher or lecturer. Don't worry if you are studying this subject on your own. There are still more than sufficient review questions with answers in the book to ensure you know and understand the material you are learning.

Examination technique

By the time you sit your first accounting exam, you will have spent a lot of hours trying to master such things as double entry, balance sheet and final adjustments. Learning accounting demands a lot of discipline and practice. Compared with the many hours learning the subject, most students spend very little time actually considering in detail how to tackle the examination. You may be one of them. Start changing this now by planning for the day when you will need to be able to demonstrate that you have learnt and understood, and can apply, the material in this book. Here are some of the things you should be thinking about:

Understanding examiners

If you want to understand anything about examinations, then you have to understand examiners. Let's look at what these peculiar creatures get up to in an examination. The first thing is that when they set an examination, they are looking at it on the basis that they want good students to pass. Obviously, anyone who doesn't achieve the pass mark will fail, but the object of the exercise is to find those who will pass, not find the failures. This means that if you have done your work properly, you should manage to pass. It is important to stress this: if you study and practice properly, you should pass, no matter what questions you are asked.

Unfortunately, some students who should pass will fail, not because they haven't put in enough hours on their studies, nor because they are unintelligent, but simply because they throw away marks unnecessarily by poor examination technique. If you can read the rest of this and then say honestly that you wouldn't have committed at least one of the mistakes that are mentioned, then you are certainly much more aware of how to approach an exam than most students we have met. These things appear obvious, but most students never think them through and prepare for them.

Punctuality

Before you even think about the examination paper and what you should do with it, think about how you are going to get to the exam room. Do you know where it is? How are you going to get there? If you are going by bus or train, do you know which bus or train to catch? Will it be the rush hour when it may well take you much longer than if it were held at midday? How much time will you allow for the journey in case anything should go wrong?

Quite a large proportion of students lose their way to the examination room, or else arrive, breathless and flustered, at the very last minute. They then start the exam anxious and nervous: a recipe for disaster for a lot of students. So, plan how you are going to get there and give yourself enough time.

Cramming

Trying to learn everything at the last minute rarely works. The last few days before the exam should not be spent cramming. You can look at past examination papers and rework some of them, but this is totally different from trying to cram new facts into your head. Worst of all,

don't try to learn anything during the night before the exam, especially if you don't get any sleep. You may get away with this a few times, but you will be found out eventually, fall asleep during the exam, or simply find that you cannot think straight. Apart from the risk of failing the exam because you are exhausted, it is well known that anything you learn before you go to bed the night before an exam will be remembered far better than anything you try to learn on the day of the exam. Studying through the night means you are learning things in the 'morning' of the exam. Your mind needs a rest, even if you don't.

On your way to the exam, try to relax. Try taking your mind off the exam by doing something else, such as chatting with friends, listening to music, or scanning Facebook, Twitter, or other social media for something entertaining to pass the time. Of course, everyone needs some adrenalin to spur them into action when they begin to answer an exam paper, but you do not want to waste your adrenalin before the examination by doing something stressful, like learning something important you've not yet looked at. Doing so will only make you more nervous and less able to cope in the exam. If you haven't learnt something when you leave home, it's not likely you'll be able to concentrate enough to do so on your way to the exam.

Read the rubric carefully and follow its instruction

The rubric appears at the start of the examination paper, and says something such as:

'Attempt five questions only: the *three* questions in Section A and *two* from Section B.'

That instruction from the examiner is to be followed *exactly*. You cannot change the instruction – it means what it says. You have to do what it says.

You may think that is so simple that it is not worthwhile my pointing it out to you, but I cannot remember an exam I have marked when at least some students did not fail to follow the instructions they were given. Let's look at two typical examples where students have ignored the rubric above and what will happen to their mark:

- (a) Instead of answering three questions from Section A and two from Section B, a student answered *two* questions from Section A and *three* from Section B. Here the examiners will mark the two Section A answers plus the first two answers shown on the student's script in respect of Section B. They will not read any part of the third answer to Section B. The student can therefore only get marks for four answers.
- (b) A student answered *three* questions from Section A and *three* from Section B. Here the examiners will mark the three answers to Section A plus the first two answers to Section B. They will not look at the third answer to Section B.

In the case of (b), the student may have done it that way deliberately, thinking that the examiner would mark all three Section B answers, and then award the student the marks from the best two answered questions. Examiners will not waste time marking an extra answer.

If you have time and want to give an extra answer, thinking that you will get better marks for it than one answered previously, then do. But, if you do, make certain that the examiner is fully aware that you have deleted the answer that you do not want to have marked. Strike lines right through it, and also write across the answer that you wish to delete it. Otherwise, it is possible that the first answers only will be marked and your new answer ignored.

Always remember in examinations that you should try to make life easier for the examiner. Give examiners what they want, in the way that they want it. If you do, you will get better marks.

Make their job harder than it needs to be and you will suffer. Examiners are only human. They do their job and their job is to mark what they asked you to do. Do something else and they will ignore it.

Time planning

Let's look at the way in which you should tackle the examination paper. One of the problems with accounting exams is that students are expected to do a lot of work in a relatively short time. It will be the same for every other student taking your exam, so it is not unfair so far as any one student is concerned. Working at speed does bring various disadvantages and makes the way you tackle the examination of even greater importance.

Time per question

The marks allotted to each question will indicate how long you should take in tackling it. Most exams are of two hours, i.e. 120 minutes. This means that in a normal examination, with 100 marks in total, a twenty-mark question should be allocated 20 per cent of the time, i.e. $20\% \times 120 = 24$ minutes. Similarly, a question worth 30 marks should take up 30 per cent of the time, i.e. $30\% \times 120 = 36$ minutes, and so on. Alternatively, in a 2-hour exam worth 100 marks, you have 1.2 minutes for each mark.

If the question is in parts, and the marks awarded are shown against each part, then that will tell you what time you should spend on each part. If part of the question asks for a description, for instance, and only three marks are awarded to that part, then you should not spend twenty minutes on a long and detailed description. Instead a brief description, taking about four minutes, is what is required.

If a question requires a discussion of something, you should spend the time indicated by the mark when you write your answer. A short answer to a discussion question worth 10 marks will not gain a good mark: the examiner expects you to write for $1.2 \text{ minutes per mark} = 12 \text{ minutes}$. In 12 minutes, most people can write more than 200 words.

Do the easiest questions first

Always tackle the easiest question first, then the next easiest question and so on. It is amazing how many students do not do this! Leave the most difficult question as the last one to be attempted. Why is this good advice? The fact is, most exams include what might be called 'warm-up' questions. These are usually fairly short, and not very difficult.

You may be able to do the easiest question in less than the time allocated. The examiner is trying to be kind to you. The examiner knows that there is a certain amount of nervousness on the part of a student taking an examination, and wants to give you the chance to calm down by letting you tackle these short, relatively easy questions first of all, and generally settle down to your work. The easiest question is usually *not* the first question in the exam paper.

Even where all the questions are worth equal marks, you are bound to find some easier than others. It is impossible for an examiner to set questions which are exactly equal in difficulty. So, remember, start with the easiest question. This will give you a feeling of confidence that will help you when you get to the more difficult questions later.

As mentioned above, *do not* expect that these 'warm-up' questions will be numbered 1 and 2 on your exam paper. Many accounting exams have a rather long question, worth quite a lot of marks, as the first question on the paper. A lot of students are fascinated by the fact that such a question is number 1, that it is worth a lot of marks, and their thinking runs: 'If I do this question first, and make a good job of it, then I am well on the way to passing the examination.'

There is no doubt that a speedy and successful attempt at such a question could possibly lead to a pass. The trouble is that this doesn't usually happen, and many students have admitted afterwards that their failure could be put down to simply ignoring our advice to start with the easy questions. What happens very often is that a student starts off on the long first question, things don't go very well, a few mistakes are made, the student then looks at the clock and sees that they are not 'beating the clock' in terms of possible marks, and then panic descends. Leaving that

question very hastily, the student then proceeds to the next question, which normally might have been well attempted but, because of the student's state of mind, a mess is made of that one as well, and so the student fails an exam that they ought to have passed.

Attempt every required question

Attempt each and every question you are required to do. If you are asked to do four questions, don't just do three. On each question, the first few marks are the easiest to get. For instance, on a 20-mark essay question it is reasonably easy to get the first five marks. Managing to produce a perfect answer to get the last five marks, from 15 to 20, is extremely difficult. This applies also to computational questions.

This means that in an examination of, say, five questions with 20 marks for each question, there is not much point in tackling only three questions and trying to make a good job of them. Your maximum possible mark would be 60, and if you had not achieved full marks for each question, in itself extremely unlikely, you could easily fail to reach the pass mark. It is better to leave questions unfinished when your allotted time for them, calculated as described above, has expired, and to then go on immediately to the other questions. It is so easy, especially in an accounting exam, to find you have exceeded the time allowed for a question by a considerable margin. Although you may find it difficult to persuade yourself to do so, *always* move on to the next question when your time for a question has expired.

Computations

When you sit an exam, you should be attempting to demonstrate how well you know the topics being examined. In accounting exams, there are three things in particular to remember. If you fail to do so, you will probably earn less marks than your knowledge deserves. One of these things has already been mentioned – be neat and tidy. The other two have to do with computations: *show all your workings* and *don't worry if your balance sheet does not balance*.

Workings

One golden rule which should *always* be observed is to **show all of your workings**. Suppose you have been asked to work out the Cost of Goods Sold, not simply as part of a Trading Account but for some other reason. Let's imagine that on the exam paper, or on a scrap of paper, you write down the (incorrect) calculation shown below:

	£
Opening inventory	4,000
Add Purchases	11,500
	<u>15,500</u>
Less Closing inventory	(3,800)
	<u><u>12,700</u></u>

You then use this wrong answer of £12,700 in your exam script. At the end of the exam, you take the exam paper home or crumple up the scrap of paper with your workings on it and throw it in a bin. This answer should have been £11,700 and not £12,700 and the examiner may well have allocated four marks for this bit of the question. What will the examiner do when marking your answer? Will the examiner think: 'I should imagine that the candidate mis-added to the extent of £1,000 and, as I am not unduly penalising students for poor arithmetic, I will give the candidate $3\frac{1}{2}$ marks'? Unfortunately, the examiner cannot do this. You will get a mark of zero. If you had attached the workings to your answer, then you could have got 3 or even $3\frac{1}{2}$ marks.

It is a good idea to put the workings of any calculated sum on the face of the any financial statements you have been asked to prepare. For instance, if rent paid is £1,900 and £300 of it has been paid in advance, you can show it on the face of the income statement as:

Rent (1,900 – 300)	£1,600
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By showing the workings in brackets you are demonstrating that you realise that they would not be shown on the published accounts. It also makes it easier for the examiner to mark, and it is always a good idea to make the examiner think you are trying to help.

Do balance sheets have to balance?

Many students ask: ‘What should I do if my balance sheet doesn’t balance?’ The answer is quite simple: leave it alone and get on with answering the rest of the exam paper.

One of the reasons for this is to try and ensure that you answer the required number of questions. You might take twenty minutes to find the error, which might save you one mark. If, instead, you had tackled the next question, in that time you might have gained, say, 10 marks, for which you would not have had time if you had wasted it by searching for the error(s). That assumes that you actually find the error(s)! Suppose you don’t, you have spent twenty minutes looking for it, have not found it, so how do you feel now? The answer is, of course: worried. You may make an even bigger mess of the rest of the paper than you would have done if you had simply ignored the fact that the balance sheet did not balance. In any case, it is quite possible to get, say, 29 marks out of 30 even though the balance sheet does not balance. The error may be a very minor one for which the examiner deducts one mark only.

Of course, if you have finished all the questions, then by all means spend the rest of your time tracing the error and correcting it. Be certain, however, that your corrections are carried out neatly. Untidy crossings-out can result in a loss of marks. So, sometimes, an error found can get back one mark, which is then lost again because your corrections made an untidy mess of your answer, and examiners often deduct marks for untidy work.

Essay questions

There are some basic things about essay questions that every student should know.

Typical questions

Let’s look at two typical exam questions. In doing so, visualise carefully what you would write when answering them.

- (a) You are employed as a bookkeeper by G. Jones, a trader. State briefly what use you would make of the following documents in relation to your bookkeeping records.
 - (i) A bank statement.
 - (ii) A credit note received to correct an overcharge on an invoice.
 - (iii) A pay-in slip.
 - (iv) A petty cash voucher.
- (b) Explain the term ‘depreciation’. Name and describe briefly two methods of providing for depreciation of non-current assets.

Now let’s see whether you would have made a reasonably good attempt at the questions. With question (a) a lot of students would have written down what a bank statement is, what a pay-in slip is, what a petty cash voucher is, and so on. Marks gained by you for an answer like that would be . . . virtually nil. Why is this? Well, you simply have not read the question properly. The question asked what *use* you would make of the documents, not to *describe* what the documents were. The bank statement would be used to check against the bank column in the Cash Book or cash records to see that the bank’s entries and your own are in accordance with one another, with

a bank reconciliation statement being drawn up to reconcile the two sets of records. The petty cash voucher would be used as a basis for entering up the payments columns in the Petty Cash Book. The *use* of the items was asked for, *not* the *descriptions* of the items.

Let us see if you have done better on question (b). Would you have written down how to calculate two methods of depreciation, probably the reducing balance method and the straight-line method? But have you remembered that the question also asked you to *explain the term depreciation*? In other words, what is depreciation generally? Some students will have omitted that part of the question. More students would have made a poor attempt at question (a), but some will have made the mistake described above with question (b).

Underline the key words

I have already described how a large percentage of students fail to answer the question set, instead answering the question they imagine it to be. Too many students write down everything they know about a topic, rather than what the examiner has asked for.

To remedy this defect, *underline the key words* in a question. This brings out the meaning so that it is difficult to misunderstand the question. For instance, let's look at the following question:

‘Discuss the usefulness of a statement of cash flows to a business.’

Many students will write down all they know about statements of cash flows, how to draw them up, what each section contains, how to reconcile them to the change in cash and cash equivalents in the balance sheet, etc.

Number of marks gained . . . virtually nil.

Now underline the key words. They will be:

Discuss usefulness statement of cash flows

The question is now seen to be concerned not with *describing* statements of cash flows, but instead discussing the *usefulness* of statements of cash flows.

Lastly, if the question says ‘Draft a report on . . .’ then the answer should be in the form of a *report*; if it says ‘List the . . .’ then the answer should consist of a *list*. Similarly ‘Discuss . . .’ asks for a *discussion*. ‘Describe . . .’ wants you to *describe* something, and so on.

You should ensure, therefore, that you are going to give the examiners

- (i) what they are asking for; *and*
- (ii) in the way that they want it.

If you do not comply with (i), you may lose all the marks. If you manage to fulfil (i) but do not satisfy the examiner on (ii), you will still lose a lot of marks.

It is also just as important in computational questions to underline the key words to get at the meaning of a question, and then answer it in the manner required by the examiner. With computational questions it is better to look at what is required first before reading the rest of the question. That way, when you are reading the rest of the question, you are able to decide how to tackle it.

Never write out the question

Often – too often – students spend time writing out the text of essay questions before they set about answering them. This is a complete waste of time. It will not gain marks and should *never* be done. It is probably the most common way that students waste time in an exam. Why waste time when you have only a limited amount of it available to you?

Running out of time?

If your plans don't work out, you may find yourself with a question you could answer, but simply do not have the time to do it properly. It is better to write a short note to the examiner to that effect, such as, 'out of time'; and put down what you can of the main points in an abbreviated fashion. This will show that you have the knowledge and should gain you some marks.

Summary

Remember:

- 1 Read the instructions.
- 2 Plan your time before you start.
- 3 Tackle the easiest questions first.
- 4 Finish off answering each question when your time allocation for the question is up.
- 5 Hand in all your workings.
- 6 Do remember to be neat, and to include all proper headings, dates, sub-totals, etc. A lot of marks can be lost if you don't.
- 7 Only answer as many questions as you are asked to tackle by the examiner. Extra answers will not normally be marked and certainly won't get credit.
- 8 Underline the *key* words in each question to ensure that you answer the question set, and *not* the question you wrongly take it to be.
- 9 Never copy the question onto your answer.

Good luck with your exam. We hope you get the rewards you deserve!

Alan Sangster and Lewis Gordon

The Last Lecture

*Our course is run, our harvest garnered in,
And taking stock of what we have, we note how life,
This strange, mysterious life which now we hold and now
eludes our grasp,
Is governed still by natural law, and its events
Tread on each other's heels, each one compelled to follow
where the first has led.
Noting all this, and judging by the past,
We form our plans, until we know at last
The treasure in the future's lap.*

*The man, the plant, the beast, must all obey this law,
Since in the early dawn of this old world
The law was given, and the stuff was made
Which still alone can hold the breath of life:
Whereby we know that grass and man are kin,
The bond a common substance which within
Controls their growth.*

*Can we know all? Nay, but the major part
Of all that is must still elude our grasp,
For life transcends itself, and slowly noting what it is,
Gathers but fragments from the stream of time.
Thus what we teach is only partly true.
Not knowing all, we act as if we knew,
Compelled to act or die.*

*Yet as we grow in wisdom and in skill
The upward path is steeper and each step
Comes higher unto heaven, piercing the clouds
Which heretofore have hid the stars from view.
The new-gained knowledge seems to fill the air,
It seems to us the soul of truth is there.
Our quest is won.*

*Bold climber, all that thou hast won
Lies still in shadow of the peaks above;
Yet in the morning hours the sun
Rewards thy work of love,
Resting a moment on thy lesser height,
Piercing the vault with rays too bright to face,
Strengthens thy soul and gives thee ample might
To serve thy human race.*

Theodore Dru Alison Cockerell (1866–1948)

Zöology: A Textbook for Colleges and Universities, Yonkers-on-Hudson, NY: World Book Company, 1920, pp. 538–9

Publisher's acknowledgements

To the memory of Frank Wood, who, in 1967, had a vision that changed the way accounting textbooks presented this subject, forever.

INTRODUCTION TO FINANCIAL ACCOUNTING

Introduction

This part is concerned with the basic principles underlying the double entry system of bookkeeping and the impact of each transaction upon the financial performance and financial position of a business.

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The background and the main features of financial accounting

Learning objectives

After you have studied this chapter, you should be able to:

- Explain what accounting is about.
- Describe briefly the history of accounting.
- Explain the relationship between bookkeeping and accounting.
- List the main users of accounting information and what accounting information they are interested in.
- Describe the main difference between financial accounting and management accounting.
- Present and explain the accounting equation.
- Explain the relationship between the accounting equation and the layout of the balance sheet.
- Explain the meaning of the terms 'assets', 'capital', 'liabilities', 'trade receivables' and 'trade payables'.
- Describe how accounting transactions affect the items in the accounting equation.
- Draw up balance sheets after different accounting transactions have occurred.

Introduction

In this chapter, you will learn: what accounting is; what led to its development into what it is today; who uses accounting information; and the relationship between the various components that, together, comprise what is known as the “**accounting equation**”.

1.1 What is accounting?

What do you think of when you read or hear the word, ‘accounting’? What do you believe it means or represents?

If you have already attended some accounting classes or if you have spoken to someone who knows something about accounting, you will probably have a fairly good idea of what accounting is and what it is used for. If not, you may find it useful to have this knowledge before you start studying the subject. During the course of the next few pages, let’s see if you can gain that knowledge and learn what accounting is.

Accounting can be defined as:

The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of that information.

A bit of a mouthful really but, what it means is that accounting involves deciding what amounts of money are, were, or will be involved in transactions (often buying and selling transactions) and then organising the information obtained and presenting it in a way that is useful for decision-making.

Despite what some people think, accounting is not a branch of mathematics, although the man credited with writing the first book to be printed on the subject, Luca Pacioli (c. 1446/7–1517), was a mathematician and teacher. He wrote on the topic ‘because the deeply respectful subjects of your domain, serene, magnanimous Lord, have great need of all mercantile methods, . . . to give them sufficient and enough guidance to keep all their accounts and books in good order.’

What Pacioli wrote is contained in 27 pages of a textbook and reference manual for merchants on business and mathematics (*Summa de arithmetica, geometria, proportioni et proportionalita – Everything about Arithmetic, Geometry, Proportions and Proportionality*). It was first published in Italy in 1494. His bookkeeping treatise has been translated into many languages, including English, and is acknowledged as the chief reason why we maintain accounts in the way we do today.

Accounting may not require a knowledge of mathematics but you do need to be able to add, subtract, multiply and divide – things you need to be able to do in your daily life if you are not to make mistakes in your decision making. Otherwise, you would not know how much money you had with you, how much you would have if you spent some of it, or whether the change you received was correct. To help you with the mathematics you do need to be able to do, Chapter 17 (*Maths for accounting*) sets down the basics you will need to know. **It is very important that you complete this chapter before you begin any of the chapters that follow it.**

1.2 The history of accounting

Accounting began because people needed to:

- record business transactions; and
- know how much they owed others and how much others owed them.

It is known to have existed in one form or another for at least 10,000 years. (Records exist which indicate its use at that time in Mesopotamia – modern-day Iraq.) There is also considerable evidence of accounting being practised in ancient times in Egypt, China, India, Greece and Rome. In England, the ‘Pipe Roll’, the oldest surviving accounting record in the English language, contains an annual description of rents, fines and taxes due to the King of England, from 1130 to 1830.

In India, a system of accounting, called *Bahi-khata*, was developed many centuries ago but it did not spread beyond that region, probably because a description of it was never written down until the twentieth century. It spread by word of mouth and, even today, is a standardised method of keeping accounting records in parts of that region.

In the rest of the world, accounting appears to have developed slowly for thousands of years. The first known example of business records maintained for a whole business using what we call ‘double entry bookkeeping’ – the method described by Pacioli and the method used universally today – was in a branch of an Italian firm in southern France in 1299. It was another 150 years, however, before it became relatively commonly used by northern Italian partnerships and joint ventures. The rest of the world took considerably longer to adopt the method. It is due to Pacioli and what he wrote about it in 1494 that this system of double entry bookkeeping came to be universally adopted.

It has been suggested that no standard system for maintaining accounting records had been developed before this because the circumstances of the day did not make it practicable for anyone to do so – there was little point, for example, in anyone devising a formal system of accounting if the people who would be required to ‘do’ accounting did not know how to read or write.

One accounting scholar (A. C. Littleton) suggested that seven key ingredients were required before a formal system like double entry bookkeeping could be developed and that all seven existed when Pacioli wrote his treatise:

- **Private property.** The power to change ownership exists and there is a need to record the transaction.
- **Capital.** Wealth is productively employed such that transactions are sufficiently important to make their recording worthwhile and cost-effective.
- **Commerce.** The exchange of goods on a widespread level. The volume of transactions needs to be sufficiently high to motivate someone to devise a formal, organised system that could be applied universally to record transactions.
- **Credit.** The present use of future goods. Cash transactions, where money is exchanged for goods, do not require that any details be recorded of who the customer or supplier was. The existence of a system of buying and selling on time (i.e. paying later for goods and services purchased today) led to the need for a formal organised system that could be applied universally to record transactions of this type.
- **Writing.** A mechanism for making a permanent record in a common language. Writing had clearly been around for a long time prior to Pacioli but it was, nevertheless, an essential element required before accounting could be formalised.
- **Money.** There needs to be a common denominator for exchange. So long as barter was used rather than payment with currency, there was no need for a bookkeeping system based upon transactions undertaken using a uniform set of monetary values.
- **Arithmetic.** As with writing, this has clearly been in existence far longer than accounting. Nevertheless, it is clearly the case that without an ability to perform simple arithmetic, there was no possibility that a formal organised system of accounting could be devised.

Of these, the most important catalyst for the emergence of double entry bookkeeping was the use of credit in business. In the Middle Ages, a businessman who did not know how much was owed to him and how much he owed, could lose his business, his home and everything he owned.

During the Crusades (1096–1292), trade routes to the east were opened and merchants, many from Italian ports like Genoa and Venice, began to expand their activities along the new routes. Venice dominated trade and another Italian city, Florence, was the major banking centre in the western world up to at least the mid-fifteenth century.

This expansion of trade led merchants to start operating in joint ventures (where they shared costs and profits) with businessmen located elsewhere. They were heavily involved in importing raw materials and exporting finished goods, particularly in Florence. Many merchants also employed agents to conduct business on their behalf. The need to record details of these transactions and arrangements was obvious.

This did not transform into double entry bookkeeping for many years. In the Middle Ages, when accounting information was recorded it initially took the form of a note of the details of each credit transaction that had not been paid and each receipt and payment. These notes were used by the owner mainly in order to keep track of payments outstanding. However, in Florence, merchants were more accustomed to keeping details of their activities than elsewhere. Many of them already maintained a record of important personal events in a book called a *Ricordanze* – a book of memories. It was a very popular practice and Florentine merchants started to record transactions, receipts and payments in their *Ricordi*.

The larger the business, the greater the number of entries that were made. The entries were prepared when they occurred and it could be some time before the next transaction with the same person occurred. Even with these records in a *Ricordanze*, it became difficult to tell what total amounts were owed and due.

To address this problem, merchants started transferring details from the *Ricordanze* into another book and entries in that book were organised into what we now call ‘accounts’, one for each person or item. Merchants also started using a book for debtors (people who owed money)

and creditors (people who were owed money) and a separate book to record transactions involving cash; plus other books for special reasons, such as a wages book, and a book in which all the transactions of a venture were recorded. This had all developed in and around Florence by the end of the 13th century.

This was the beginning of the system of double entry bookkeeping. When Pacioli wrote his manual on double entry bookkeeping, he based it on the system that had developed in Venice. It was a more compact system than the one that developed elsewhere, though it included specialist books for things like wages and voyages. In Pacioli's description of the system, he focused on the core of the system. A book called a *Memorandum* replaced the *Ricordanze*. The details recorded in it were abbreviated, organised and transferred into another book called a *Journal*. Details from that book were then further summarised and entered into accounts maintained in a third book called a *Ledger*.

The accountant of the Middle Ages was someone who knew how to enter data relating to financial transactions into the accounting books. He was what we call a 'bookkeeper'. Often, it would be the owner of the business who performed all the accounting tasks. Otherwise, an employee would be given the job of maintaining the accounting records.

As businesses grew in size, it became less common for the owner to personally maintain the accounting records and more usual for someone to be employed as a bookkeeper. Then, as companies began to dominate the business environment, managers became separated from owners – the owners of companies (shareholders) often have no involvement in the day-to-day running of the business. This led to a need for some monitoring of the managers. Auditing of the financial records became the norm and this, effectively, established the accounting profession.

Long before that happened in the 19th century, the first association of accountants, the *Collegio dei Rexionati*, was formed in Venice in 1581. It was a body of government accountants and auditors. It took a long time before this was replicated in the private sector. When it did, it was on a regional rather than national basis. National bodies arose as these regional associations matured, towards the end of the 19th century.

If you wish to discover more about the history of accounting, you will find that it is readily available on the internet. Perform a search on either of the terms 'history of accounting' or 'accounting history' and you should find more information than you could ever realistically read on the subject.

1.3 Accountants

From its roots among the scribes of Mesopotamia, accounting is one of the oldest professions in the world. Today, there are around 200 professional accountancy bodies, each with its own requirements to be met before anyone can become a member. While there are notable exceptions, nowadays these generally consist of a series of examinations plus relevant work experience, the same requirement as applied to anyone seeking admission to the Venetian *Collegio dei Rexionati* in 1581.

Today, accountants go beyond the role of the bookkeepers of the Middle Ages. As they did then, accountants record and manipulate financial data in order to provide financial information. In addition, today's accountants are also expected to interpret the information they produce, all in order to assist in decision-making.

It is not necessary to be a member of a professional accountancy body in order to work as an accountant, although few who are not are likely today to rise above the level of a bookkeeper.

Being a member of a professional accountancy body indicates a minimum level of knowledge and expertise that would be expected and upon which employers and others using information provided by such accountants may rely. Because membership of such a body presents an image of professional expertise and understanding, it is important that accountants act in a manner that is consistent with what is expected of them. Any failure to do so places the image of the profession

at risk. In Chapter 40, you will learn that the accounting profession seeks to maintain this image by presenting its members with a Code of Ethics that they must follow.

1.4 The objectives of financial accounting

Financial accounting is the branch of accounting that is concerned with (i) recording business transactions, (ii) preparing financial statements that report on how an entity (a business, charity, club, society, government department, etc.) has performed and, (iii) reporting on its financial position. It has many objectives, including letting people and entities know:

- if they are making a profit or a loss;
- what the entity is worth;
- what a transaction was worth to them;
- how much cash they have;
- how wealthy they are;
- how much they are owed;
- how much they owe;
- enough information so that they can keep a financial check on the things they do.

However, the primary objective of financial accounting is to provide information for decision-making. The information is primarily financial, but it can include data on volumes, for instance the number of cars sold in a month by a car dealership or the number of cows in a farmer's herd.

So, for example, if a business recorded what it sold, to whom, the date it was sold, the price at which it was sold, and the date it received payment from the customer, along with similar data concerning the purchases it made, information could be produced summarising what had taken place. The profitability of the business and the financial status of the business could also be identified, at any time. It is the primary task of financial accounting to take such information and convert it into a form that is useful for decision-making.

People and businesses

Accounting is something that affects people in their personal lives just as much as it affects very large businesses. We all use accounting ideas when we plan what we are going to do with our money. We have to plan how much of it we will spend and how much we will save. We may write down a plan, known as a budget, or we may simply keep it in our minds.

Recording accounting data

However, when people talk about accounting, they are normally referring to financial accounting performed by businesses and other entities. No-one can remember all the details of what has taken place, so records of it have to be kept. These records contain the accounting data.

Entities not only record cash received and paid out. They will also record goods bought and sold, items bought to use rather than to sell, and so on. This part of accounting is usually called the *recording of data*.

Classifying and summarising

Once the accounting data has been recorded, it has to be organised so as to be most useful to the entity. In doing so, we *classify* and *summarise* the accounting data.

Once data has been classified and summarised, it is much easier to work out how much profit or loss has been made by the entity during a particular period. It is also much easier to show what resources are owned by it, and what it owes on the closing day of the period.

Communicating information

From this data and the information it can be used to produce, people skilled in financial accounting should be able to tell whether or not an entity is performing well financially. They should be able to ascertain the strengths and weaknesses of the business, and what it is worth.

Finally, they should be able to tell or *communicate* their results to the owners of the entity, or to others allowed to receive this information.

Financial accounting is, therefore, concerned with:

- recording data;
- classifying and summarising data;
- communicating what has been learnt from the data.

This is also the case for the other main branch of accounting, **Management accounting**, which is accounting undertaken to assist managers within a business to take effective decisions. We will return to this topic later in this chapter.

1.5 What is bookkeeping?

Until about 100 years ago, records of all accounting data was *kept* manually in *books*. This is why the part of accounting that is concerned with recording data is often known as **bookkeeping**.

- Nowadays, although handwritten books may sometimes be used (particularly by very small entities), most accounting data is recorded and stored electronically.

Bookkeeping is the process of recording data relating to accounting transactions in the accounting books. You'll learn more about this in Chapter 2.

1.6 Financial accounting is concerned with ...

Financial accounting is concerned with how accountants use bookkeeping data. This book will cover many such uses.

1.7 Users of financial accounting information

Possible users of financial accounting information include:

- **Managers.** These are the day-to-day decision-makers. They need to know how well things are progressing financially and about the financial status of the business.
- **Owner(s) of the business.** They want to be able to see whether or not the business is profitable. In addition they want to know what the financial resources of the business are.
- **A prospective buyer.** When the owner wants to sell a business the buyer will want to see such information.
- **The bank.** If the owner wants to borrow money for use in the business, then the bank will need such information.
- **Tax inspectors.** They need it to be able to calculate the taxes payable.
- **A prospective partner.** If the owner wants to share ownership with someone else, then the would-be partner will want such information.
- **Investors,** either existing ones or potential ones. They want to know whether or not to invest their money in the business.
- **Creditors.** They want to know if there is any risk of not being paid what they are due.

There are many other users of financial accounting information – suppliers and employees, for example. It is obvious that without properly recorded accounting data a business would have many difficulties providing the information these various users (often referred to as **stakeholders**) require.

**Activity
1.1**

Which two of these stakeholder groups do you think are considered to be the most important? Why?

However, the information produced by financial accounting needs to be a compromise – the existence of so many different groups of stakeholders make it impossible to produce accounting information at a reasonable cost in a form that suits them all. As a result, financial accounting focuses on producing information for owners and creditors. The other stakeholder groups often find the accounting information provided fails to tell them what they really want to know. As any accountant would tell you, if organisations made the effort to satisfy the information needs of all their stakeholders, financial accounting would be a very costly exercise indeed!

1.8 The two branches of accounting

So far, you have learned that financial accounting is accounting performed for the owners of a business. It is used to show them how much profit has been made and what their business is worth. There is also another branch of accounting that is used by managers and decision makers within a business. It is called **management accounting**. A management accountant produces reports that help managers *plan* and enable managers to *control* what the business is doing. Qualified accountants know how to do both forms of accounting, though some specialise more in financial accounting while others specialise in management accounting.

Financial accounting is concerned with what has already happened assessing performance and considering where we are now. Management accounting is interested in explaining what has happened and in looking into the future.

The reports produced by each of these two branches of accounting are mainly expressed in terms of money, though there are some exceptions, particularly in management accounting. For example, units of a product bought, manufactured, or sold may be the focus of a report on how much of a product to manufacture. However, even then, the amounts involved financially will also be presented and will be used to justify any conclusions drawn in the report.

Management accounting is beyond the scope of this book, but you can find out more about it very easily online.

Let's now look at the relationship upon which financial reporting is based: the **Accounting Equation**.

1.9 The accounting equation

By adding up what the accounting records say belongs to a business and deducting what they say the business owes, you can identify what a business is worth according to those accounting records. The whole of financial accounting is based upon this very simple idea. It is known as the *accounting equation*.

It can be explained by saying that if a business is to be set up and start trading, it will need resources. Let's assume first that it is the owner of the business who has supplied all of the resources. This can be shown as:

$$\text{Resources supplied by the owner} = \text{Resources in the business}$$

In accounting, special terms are used to describe many things. The amount of the resources supplied by the owner is called **capital**. The actual resources that are then in the business are called **assets**. This means that when the owner has supplied all of the resources, the accounting equation can be shown as:

$$\text{Capital} = \text{Assets}$$

Usually, however, people other than the owner have supplied some of the assets. **Liabilities** is the name given to the amounts owing to these people for these assets. The accounting equation has now changed to:

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

This is the most common way in which the accounting equation is presented. It can be seen that the two sides of the equation will have the same totals. This is because we are dealing with the same thing from two different points of view – the value of the owners' investment in the business and the value of what is owned by the owners.

Activity 1.2

What piece of useful information that is available from these three items is not directly shown by this equation? (*Hint: you were introduced to it at the start of this section.*)

Unfortunately, with this form of the accounting equation, we can no longer see at a glance what value is represented by the resources in the business. You can see this more clearly if you switch assets and capital around to produce the alternative form of the accounting equation:

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

This can then be replaced with words describing the resources of the business:

Resources: what they are	=	Resources: who supplied them
(Assets)		(Capital + Liabilities)

It is a fact that no matter how you present the accounting equation, the totals of both sides will *always* equal each other, and that this will *always* be true no matter how many transactions there may be. The actual assets, capital and liabilities may change, but the total of the assets will always equal the total of capital + liabilities. Or, reverting to the more common form of the accounting equation, the capital will always equal the assets of the business *minus* the liabilities.

Assets consist of property of all kinds, such as buildings, machinery, inventories of goods and motor vehicles. Other assets include debts owed by customers and the amount of money in the business's bank account.

Liabilities include amounts owed by the business for goods and services supplied to it and for expenses incurred by it that have not yet been paid for. Liabilities also include funds borrowed by the business.

Capital is often called the owner's **equity** or net worth. It comprises (i) the funds invested in the business by the owner *plus* (ii) any profits retained for use in the business *less* (iii) any share of profits paid out of the business to the owner.

Activity 1.3

What else would affect capital? (*Hint: this item causes the value of capital to fall.*)

1.10 The balance sheet and the effects of business transactions

The accounting equation is expressed in a financial report called the **balance sheet**.

Activity 1.4

Without looking back, write down the commonly used form of the accounting equation.

The balance sheet shows the financial position of an organisation *at a point in time*. In other words, it presents a snapshot of the organisation at the date for which it was prepared. The balance sheet is not the first accounting report to be prepared, nor the first that you will learn how to do, but it is a convenient place to start to consider accounting.

Let's now look at how a series of transactions affects the balance sheet.

1 The introduction of capital

On 1 May 2018, B. Blake started in business and deposited £60,000 into a bank account opened specially for the business. The balance sheet would show:

B. Blake Balance Sheet as at 1 May 2018	
	£
Assets: Cash at bank	<u>60,000</u>
Capital	<u>60,000</u>

Note how the top part of the balance sheet contains the assets and the bottom part contains the capital. This is always the way the information is presented in a balance sheet.

2 The purchase of an asset

On 3 May 2018, Blake buys a kiosk (a small shop) for £32,000 and pays for it by internet transfer from the business bank account. The effect of this transaction on the balance sheet is that the cash at the bank is decreased and the new asset, the shop, is added:

B. Blake Balance Sheet as at 3 May 2018	
	£
Assets	
Shop	32,000
Cash at bank	<u>28,000</u>
	<u>60,000</u>
Capital	<u>60,000</u>

Note how the two parts of the balance sheet 'balance'. That is, their totals are the same. This is always the case with balance sheets, and is why they have that name.

3 The purchase of an asset and the incurring of a liability

On 6 May 2018, Blake buys some goods on time for £7,000 from D. Smith. 'On time' means that Blake has not yet paid for them but will do so at some time in the future. The effect of this is that a new asset, **inventory**, is acquired, and a liability for the goods is created. A person to whom money is owed for goods is known as a **creditor**, and is described in the balance sheet as a **trade payable**. The balance sheet becomes:

B. Blake Balance Sheet as at 6 May 2018	
Assets	£
Shop	32,000
Inventory	7,000
Cash at bank	<u>28,000</u>
	67,000
Less: Trade payables	<u>(7,000)</u>
	<u>60,000</u>
Capital	<u>60,000</u>

Note how the liability (the trade payable) is shown as a deduction from the assets. This is exactly the same calculation as is presented in the most common form of the accounting equation.

Activity 1.5

Why do you think the £7,000 value for trade payables is shown in brackets?

Now, let's return to our example.

4 Sale of an asset on time

On 10 May 2018, goods that cost £600 were sold on time to J. Brown for the same amount. 'On time' means that Brown will pay for them later. The effect is a reduction in the amount of goods held, i.e. inventory, and the creation of a new asset. A person who owes the business money is a **debtor**, and is described in the balance sheet as a **trade receivable**. The balance sheet is now:

B. Blake Balance Sheet as at 10 May 2018	
Assets	£
Shop	32,000
Inventory	6,400
Trade receivables	600
Cash at bank	<u>28,000</u>
	67,000
Less: Trade payables	<u>(7,000)</u>
	<u>60,000</u>
Capital	<u>60,000</u>

5 Sale of an asset for immediate payment

On 13 May 2018, goods that cost £400 were sold to D. Daley for the same amount. Daley paid for them immediately by debit card. Here one asset, inventory, is reduced, while another asset, cash at bank, is increased. The balance sheet becomes:

B. Blake	
Balance Sheet as at 13 May 2018	
Assets	£
Shop	32,000
Inventory	6,000
Trade receivables	600
Cash at bank	<u>28,400</u>
	<u>67,000</u>
Less: Trade payables	<u>(7,000)</u>
	<u>60,000</u>
<i>Capital</i>	<u><u>60,000</u></u>

6 The payment of a liability

On 15 May 2018, Blake pays D. Smith with £3,000 by internet transfer in part payment of the amount owing. The asset of cash at bank is therefore reduced, and the liability to the creditor is also reduced. The balance sheet is now:

B. Blake	
Balance Sheet as at 15 May 2018	
Assets	£
Shop	32,000
Inventory	6,000
Trade receivables	600
Cash at bank	<u>25,400</u>
	<u>64,000</u>
Less: Trade payables	<u>(4,000)</u>
	<u>60,000</u>
<i>Capital</i>	<u><u>60,000</u></u>

Note how the total of each part of the balance sheet has not changed. The capital is still £60,000 and that is what the business is worth to the owner.

7 Collection of an asset

J. Brown, who owed Blake £600, makes a part payment of £200 by cheque on 31 May 2018. The effect is to reduce one asset, trade receivables, and to increase another asset, cash at bank. The balance sheet becomes:

B. Blake Balance Sheet as at 31 May 2018	
Assets	£
Shop	32,000
Inventory	6,000
Trade receivables	400
Cash at bank	25,600
	<u>64,000</u>
Less: Trade payables	(4,000)
	<u>60,000</u>
Capital	<u>60,000</u>

1.11 Equality of the accounting equation

It can be seen that every transaction has affected two items. Sometimes it has changed two assets by reducing one and increasing the other. In other cases, the effect has been different. However, in each case other than the very first (when the business was started by the owner injecting some cash into it), no change was made to the total of either section of the balance sheet and the equality between their two totals has been maintained. The accounting equation has held true throughout the example, and it always will. The effect of each of these seven accounting transactions upon the two sections of the balance sheet is shown below:

Number of transaction as above	Assets	Capital and Liabilities	Effect on balance sheet totals
1	+	+	Each side added to equally
2	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out
3	+	+	Each side has equal additions
4	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out
5	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out
6	–	–	Each side has equal deductions
7	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out

These are not the only types of accounting transactions that can take place. Two other examples arise when

- (8) the owner withdraws resources from the business for his or her own use; and where
- (9) the owner pays a business expense personally.

A summary of the effect upon assets, liabilities and capital of each type of transaction you've been introduced to so far is shown below:

Example of transaction	Effect	
(1) Owner pays capital into the bank	↑ Increase asset (Bank)	↑ Increase capital
(2) Buy inventory by cheque	↓ Decrease asset (Bank)	↑ Increase asset (Inventory)
(3) Buy inventory on time	↑ Increase asset (Inventory)	↑ Increase liability (Trade payables)
(4) Sale of inventory on time	↓ Decrease asset (Inventory)	↑ Increase asset (Trade receivables)
(5) Sale of inventory for cash (cheque)	↓ Decrease asset (Inventory)	↑ Increase asset (Bank)
(6) Pay creditor	↓ Decrease asset (Bank)	↓ Decrease liability (Trade payables)
(7) Debtor pays money owing by cheque	↑ Increase asset (Bank)	↓ Decrease asset (Trade receivables)
(8) Owner takes money out of the business bank account for own use	↓ Decrease asset (Bank)	↓ Decrease capital
(9) Owner pays creditor from private money outside the firm	↓ Decrease liability (Trade payables)	↑ Increase capital

Transactions (8) and (9) cause the totals of each part of the balance sheet to change (as did the very first, when capital was introduced to the business by the owner). When the capital changes, the totals of the two parts of the balance sheet both change.

1.12 More detailed presentation of the balance sheet

Let's now look at the balance sheet of B. Blake as at 31 May 2018, presented according to how you will learn to present the information later in this book:

B. Blake Balance Sheet as at 31 May 2018

<i>Non-current assets</i>	£	£
Shop		32,000
<i>Current assets</i>		
Inventory	6,000	
Trade receivables	400	
Cash at bank	<u>25,600</u>	
		32,000
Total assets		64,000
<i>Less: Current liabilities</i>		
Trade payables		(4,000)
Net assets		<u>60,000</u>
Capital		<u>60,000</u>

You will have noticed in this balance sheet the terms ‘non-current assets’, ‘current assets’ and ‘current liabilities’. **Chapter 8 contains a full explanation of these terms.** At this point we will simply say:

- **Non-current assets** are assets which have a long life bought with the intention to use them in the business and not with the intention to simply resell them, e.g. buildings, machinery, fixtures & fittings (e.g. shelves), motor vehicles.
- **Current assets** are assets consisting of cash, goods for resale or items having a short life (i.e. no more than a year remaining on the date of the balance sheet). For example, the amount (and so the value) of inventory goes up and down as it is bought and sold. Similarly, the amount of money owing to a business by debtors will change quickly, as the business sells more to them on time and when they pay their debts. The amount of money in the bank will also change when it is received or paid out.
- **Current liabilities** are those liabilities which have to be paid within no more than a year from the date on the balance sheet, e.g. trade payables for goods purchased.

Don't forget that there is a Glossary of accounting terms at the back of the book.

Learning outcomes

You should now have learnt:

- 1 Accounting is concerned with the recording, classifying and summarising of data, and then communicating what has been learnt from it.
- 2 Accounting has existed for at least 10,000 years but a formal, generally accepted method of recording accounting data has only been in existence for the last 700 years.
- 3 It may not only be the owner of a business who will need the accounting information. It may need to be shown to others, e.g. the bank or the Inspector of Taxes.
- 4 Accounting information can help the owner(s) of a business to plan for the future.
- 5 Financial accounting is performed for the owners of a business so that they can assess its performance and financial position. Management accounting is prepared for those running a business so that they can plan and control its activities.
- 6 The accounting equation is: $\text{Capital} = \text{Assets} - \text{Liabilities}$.
- 7 The two sides of the accounting equation are represented by the two parts of the balance sheet.
- 8 The total of one part of the balance sheet should always be equal to the total of the other part.
- 9 Every transaction affects two items in the accounting equation. Sometimes that may involve the same item being affected twice, once positively (going up) and once negatively (going down).
- 10 Every transaction affects two items in the balance sheet.

Note: Generally, the values used in exhibits and exercises are relatively small amounts. You may think this wrong, that it is unrealistic, and it is, but it has been done to make things easier for you. It means that you can concentrate on learning accounting rather than having to also cope with complex calculations. Constantly handling large figures does not add anything to the study of the principles of accounting. It simply wastes a lot of your time. This is especially true today because in the ‘real world’ most of what you are going to learn is done using computers, and they deal with all the complex mathematics for you, so you don't really need to learn that aspect at all.

Answers to activities

- 1.1 Owners and creditors are considered to be the most important stakeholders because they have most to lose if the business fails.
- 1.2 Who supplied the resources of the business.
- 1.3 Capital will be reduced if a business makes a loss. The loss means that assets have been reduced and capital is reduced by the same amount so as to maintain the balance in the accounting equation.
- 1.4 $\text{Capital} = \text{Assets} - \text{Liabilities}$.
- 1.5 It is a negative number. In accounting, we **always** use brackets to indicate negative numbers.

Review questions

If you haven't already started answering them, you now have a set of graded review questions to try. 'Graded' means that they get more difficult as you go through them. Ideally, they should be done in the sequence they appear. *However, don't forget that the questions with an 'A' after the question number do not have any answers provided in this book.* Your teacher or lecturer will be able to provide you with the answers to those questions but be sure to attempt them first before asking for the answers! The answers to the other questions can be found at the back of the book.

We realise that you would like to have *all* the answers in the book. However, teachers and lecturers would not then be able to test your knowledge with questions from this book, as you would already possess the answers. It is impossible to please everyone, and the compromise reached is that of putting a large number of review questions in the book.

This means that appropriate reinforcement of what you have learnt can take place, even if you are studying on your own and have to miss out all the 'A' questions because you have no access to the answers.

Multiple-choice questions. In addition to these Review questions, there are questions relating to the material in this chapter in a bank of multiple-choice questions at the end of Chapter 6. You should wait and attempt them when you reach them, not before.

- 1.1 Complete the gaps in the following table:

	Assets	Liabilities	Capital
	£	£	£
(a)	42,000	22,000	?
(b)	78,500	43,300	?
(c)	59,900	?	25,700
(d)	61,700	?	18,600
(e)	?	32,900	21,300
(f)	?	19,400	31,300

- 1.2A Complete the gaps in the following table:

	Assets	Liabilities	Capital
	£	£	£
(a)	89,000	38,000	?
(b)	?	42,900	37,700
(c)	96,500	?	42,200
(d)	103,800	61,300	?
(e)	119,100	?	61,400
(f)	?	49,100	51,300





1.3 Which of the items in the following list are liabilities and which of them are assets?

- | | |
|-------------------------------------|--------------------------------------|
| (a) Motor vehicle | (d) Bank overdraft |
| (b) Amounts owed to us by customers | (e) Inventory of goods held for sale |
| (c) Land | (f) Amounts owed by us to suppliers |

1.4A Classify the following items into liabilities and assets:

- | | |
|-----------------------|--------------------|
| (a) Computers | (f) Cash in bank |
| (b) Buildings | (g) Bank overdraft |
| (c) Trade payables | (h) Loan from bank |
| (d) Inventory | (i) Vans |
| (e) Trade receivables | |

1.5 State which of the following are wrongly classified:

<i>Assets</i>	<i>Liabilities</i>
Loan from K. Jones	Delivery van
Bank overdraft	Trade payables
Trade receivables	Computer equipment
Warehouse	Machinery
Office furniture	Cash in hand

1.6A Which of the following are shown under the wrong headings?

<i>Assets</i>	<i>Liabilities</i>
Cash at bank	Bank overdraft
Fixtures and fittings	Equipment
Trade payables	Computers
Premises	Loan from building society
Inventory	
Trade receivables	
Capital	

1.7 Winston is setting up a new business. Before selling anything, he bought a van for £9,995; a transportable market stall for £2,050; a computer for £495; and an inventory of goods for £11,720. He did not pay in full for his inventory of goods and still owes £2,380 for them. He borrowed £5,000 from G Orwell. After the events just described, and before trading starts, he has £100 cash in hand and £920 in the bank. Calculate the amount of his capital.

1.8A Danielle is starting a business. Before starting to sell anything, she bought fixtures for £4,100, a van for £5,950 and an inventory of goods for £3,620. Although she has paid in full for the fixtures and the van, she still owes £1,670 for some of the inventory. M Johnson lent her £3,000. After the above, Danielle has £780 in the business bank account and £50 cash in hand. You are required to calculate her capital.

1.9 Draw up Tom Galley's balance sheet from the following information as at 31 December 2024:

	£
Capital	37,650
Trade receivables	9,290
Motor vehicle	11,610
Trade payables	10,230
Equipment	14,160
Inventory	12,340
Cash at bank	480

1.10A Draw up Amy Banfield's balance sheet as at 30 June 2024 from the following items:

	£
Capital	22,960
Equipment	11,660
Trade payables	6,390
Inventory	7,920
Trade receivables	9,400
Cash at bank	370

1.11 Complete the columns to show the effects of the following transactions:

	<i>Effect upon</i>		
	<i>Assets</i>	<i>Liabilities</i>	<i>Capital</i>
(a) We pay a creditor £310 by cheque.			
(b) Bought fixtures £175 paying in cash.			
(c) Bought goods on time £630.			
(d) The proprietor introduces another £1,200 cash into the business.			
(e) J. Walker lends the business £2,500 in cash.			
(f) A debtor pays us £50 in cash.			
(g) We return goods costing £90 to a supplier whose bill we had not paid.			
(h) Bought an office computer paying £610 by cheque.			

1.12A Complete the columns to show the effects of the following transactions:

	<i>Effect upon</i>		
	<i>Assets</i>	<i>Liabilities</i>	<i>Capital</i>
(a) Bought a van on time £8,700.			
(b) Repaid by cash a loan owed to F. Duff £10,000.			
(c) Bought goods for £1,400 paying by cheque.			
(d) The owner puts a further £4,000 cash into the business.			
(e) A debtor returns to us goods worth £150. We agree to make an allowance for them.			
(f) Bought goods on time £760.			
(g) The owner takes out £200 cash for his personal use.			
(h) We pay a creditor £1,150 by cheque.			





1.13 T. Ross has the following items in his balance sheet on 30 April 2024: Capital £26,060; Trade payables £5,510; Fixtures £12,390; Motor vehicle £7,500; Inventory £4,210; Trade receivables £6,350; Cash at bank £920; Cash in hand £200.

During the first week of May 2024:

- (a) He bought extra inventory for £490 on time.
- (b) One of the debtors paid him £350 by cheque.
- (c) He bought a computer by cheque £720.

You are asked to draw up a balance sheet as at 7 May 2024 after the above transactions have been completed.

1.14A J. Hill has the following assets and liabilities on 30 November 2019: Trade payables £2,800; Equipment £6,200; Motor vehicle £7,300; Inventory £8,100; Trade receivables £4,050; Cash at bank £9,100; Cash in hand £195.

You are not given the capital amount at that date.

During the first week of December 2019:

- (a) Hill bought extra equipment on time for £110.
- (b) Hill bought extra inventory by cheque £380.
- (c) Hill paid creditors by cheque £1,150.
- (d) Debtors paid Hill £640 by cheque and £90 by cash.
- (e) Hill put an extra £1,500 into the business, £1,300 by cheque and £200 in cash.

You are to draw up a balance sheet as at 7 December 2019 after the above transactions have been completed.

Recording transactions

Learning objectives

After you have studied this chapter, you should know that:

- There are two elements to every transaction: an *Item exchanged* and a *Form of settlement*.
- Double entry bookkeeping requires that for each transaction, an entry is made once for the *Item exchanged*; and once for the *Form of settlement*.
- The treatment of the *Item exchanged* is always the opposite of the treatment of the *Form of settlement*.
- Debit means 'place on the left of the account called ...'.
- Credit means 'place on the right of the account called ...'.
- The total of the debit must always equal the total of the credit.
- Capital is what the owner contributes to a business.
- Capital does not belong to a business; it belongs to the owner of the business.
- Liabilities are all other items that do not belong to a business, such as loans from banks.
- Debtors are people who owe money to a business.
- Creditors are people who are owed money by a business; the owner of a business is not a creditor of the business; the owner is an investor in the business.
- Expenses are immediately used-up but, they belong to the business and are treated the same way as all other possessions.
- Possessions that last some time are called 'assets'.
- When the *Form of settlement* is given, it is a credit.
- When the *Form of settlement* is received, it is a debit.
- The entry for the *Item exchanged* is always the opposite of the entry for the *Form of settlement*.
- To identify the accounts to debit and credit, you *always* focus upon the *Form of settlement*.

Introduction

In this chapter, you will learn the *Principles of double entry*: how to do double entry bookkeeping. You will learn how double entry is used to record financial transactions. You will also learn how to use T-accounts, the traditional way to make such entries under the double entry system.

Part One The principles of double entry

2.1 The nature of a transaction

In Chapter 1, you saw how various events had each changed two items in the balance sheet. These events are known as ‘transactions’. Transaction involves two things: the **Item exchanged** and a **Form of settlement** that is either cash, an **IOU**, or capital. ‘IOU’ is usually called ‘credit,’ but ‘IOU’ is easier to learn to use at this stage of your studies. ‘Capital’ is what has been invested by the owner in a business. The *Item exchanged* and the *Form of settlement* are the two ‘*elements of a transaction*’. If there is no *Item exchanged* (i.e. bought or sold), there is no transaction:

- If a businessman asks the price of something, but does not buy it, there is no transaction.
- If a businessman asks the price of something and then buys it, that event is a transaction.

When we enter the data relating to a **transaction** in the accounting records, we need to ensure that the items that were affected by the transaction, *and only those items*, are shown as having changed. Bookkeeping is the first stage in doing so. It can take many forms, but the one that is most used is called **double entry bookkeeping**.

Activity 2.1

What do you think a likely name might be for other forms of bookkeeping?
(Hint: double beds and ____ beds.)

Double entry bookkeeping is therefore all about recording the financial results of transactions. Examples of transactions include a purchase of a machine, payment of an electricity bill, sale of a sandwich, and interest received from a bank for money deposited.

There is a wide range of possible transactions for any business, and we need a system of bookkeeping that is flexible enough to record any of them. We do this by having places where we record each entry. These are called **accounts**. We can add a new account whenever we want and there is no limit to the number of accounts we can have.

What we record in accounts are the two **elements of transactions**.

2.2 The elements of a transaction

As mentioned above, in accounts we record the outcome of transactions involving two elements: the *Item exchanged*, such as a car or a computer; and the *Form of settlement*, such as cash.

So, if you buy a computer with cash, the *Item exchanged* is the computer. You need to create an account called ‘computer account’. In that account, you record that you now own a computer, which means that the total value of the account has increased.

You also need an account for the *Form of settlement*, in this case ‘cash’. You call that account, ‘cash account’. In that account, you record that your cash has been reduced because you used some cash to become the owner of a computer.

Traditionally, each account has a left-hand side and a right-hand side. You can see one for a computer in Exhibit 2.1.

Exhibit 2.1

Computer account

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**Activity
2.2**

What do you think we call this form of account? (*Hint: what shape do the lines make?*)

The amount of each transaction is entered on one of those two sides in the account for the *Form of settlement*; and on the other side in the account for the *Item exchanged*. That is the **double entry**: one entry made in two different accounts for each transaction. When we make these entries, we describe one as a **debit** and the other as a **credit**. Let's see what these terms mean.

2.3 Debit and credit

Debit means '*place on the left of the account called . . .*' and credit means '*place on the right of the account called . . .*'. You can see why we just use the words 'debit' and 'credit', instead of the whole eight-word phrase each time, can't you?

These two words 'debit' and 'credit' are central to understanding double entry bookkeeping. Every time you record a transaction, you *debit* one account, and you *credit* another account. This is why we call this form of bookkeeping, 'double entry'. The amount you *debit* will always be equal to the amount you *credit*.

Debit ALWAYS equals Credit

**Activity
2.3**

Why do you think debit always equals credit?

Let's now look at what guides you in making these 'double entries': the *Principles of double entry bookkeeping*.

2.4 The principles of double entry bookkeeping

When recording a transaction, you need to decide which account to *debit* and which account to *credit* for each entry. In order to do so, there are three things that are always true:

- 1 A *Form of settlement* given is always a credit.
- 2 A *Form of settlement* received is always a debit.
- 3 The entry for the *Item exchanged* is always the opposite to the entry for the *Form of settlement*.

These are what ensure you make the correct entries *every* time.

Now that you know what an account is, what *debit* and *credit* mean, and the principles to follow, let's see what happens when we record the elements of a transaction.

If you remember these principles, you will always know which account to debit and which account to credit.

2.5 Recording the elements of a transaction

The amount of each transaction is entered in the accounts of the two elements of the transaction: on one side in the account for the *Form of settlement*, and on the other side in the account for the *Item exchanged*.

So, imagine that you entered into a transaction worth £100. After the entries for the transaction have been made, the two accounts would *either* look like this:

Exhibit 2.2

Item exchanged account	Form of settlement account
£100	£100

or like this:

Exhibit 2.3

Item exchanged account	Form of settlement account
£100	£100

These are the only two possibilities. **The *Form of settlement* will tell you which of these to use:**

- If you *purchased* something for cash, you would record the entries as in Exhibit 2.2: the *Form of settlement* was given, so it must be credit; the *Item exchanged* must be debit.
- If you *sold* something for cash, you would record the entries as in Exhibit 2.3: the form of settlement was received, so it must be debit; the *Item exchanged* must be a credit.

Do you see how the *Form of settlement* guides you in how to make these entries?

Always use the *Form of settlement* to guide you in what to debit and what to credit.

This is straightforward when cash is involved. And it is the same when it is not. When you purchase goods that you will pay for later, you have given the seller an IOU, i.e. a promise to pay later. So, you must credit the *Form of settlement* and debit the goods account. What account do you use to record this IOU?

2.6 When the form of settlement is an IOU

An IOU is a 'debt'. A 'debt' is created whenever a seller agrees to wait for the payment until some-time in the future. In the accounts of the seller, whenever a new debt is created, it is the *Form of Settlement* in the transaction.

Let's assume that the *Form of settlement* in both Exhibit 2.2 and Exhibit 2.3 is an IOU:

- In Exhibit 2.2 (a purchase): a *Form of settlement* has been given, so it is a credit. That is, the debt *due to the seller* is a credit.
- In the case of Exhibit 2.3 (a sale): a *Form of settlement* has been received so it is a debit. That is, the debt *due from the customer* must be a debit.

Activity 2.4

Describe the two entries in Exhibit 2.2 using 'debit' and 'credit'; and give an example of a transaction that fits this description.

Whenever a debt is repaid, it is the *Item exchanged*. This is because you pay a debt using a *Form of settlement*.

2.7 Balance

Once you have made some transactions, you may want to find out how much an account is worth. For example, how much a debtor owes you, or how much you owe someone else. You do this by calculating the difference between the totals of the debits and the total of the credits entered in that account. We call that difference, the **balance**. In Exhibit 2.2, the *Item exchanged* account has £100 more on the debit side: it has a ‘debit balance’ of £100; and the *Form of settlement* account has £100 more on the credit side: it has a ‘credit balance’ of £100.

Let’s now use the *Principles of double entry bookkeeping* to see what happens when you have a list of balances and want to know what your business is worth. We’ll use an example that involves ‘capital’. Capital is a *Form of settlement*.

2.8 Drawing-up a list of what a business is worth

Imagine you have been in business for a few months but, you have not kept any proper records of your transactions. You have decided to end that business and start a new one by transferring everything to the new business. You now also want to start using double entry bookkeeping.

The first step is to write down a list of everything belonging to the old business and everything the old business owes. Here is the list you prepared:

Exhibit 2.4

	£
1 Cash	600
2 Cash in US dollars’ worth	200
3 Cash in the bank	1,200
4 Cash in the bank in euros worth	430
5 Computer	500
6 Mobile phone	240
7 Sales register	320
8 Printer	150
9 Printing supplies	40
10 Goods for sale	18,000
11 Amount due by Fred Palmer	300
12 Amount due by Winnie Woo	370
13 Loan from bank	10,000

Activity 2.5

If you now enter these items in T-accounts of the new business, what do you think the *Form of settlement* will be for each one?

You are exchanging all of these items shown in Exhibit 2.4. That is, you are giving them to the new business and it will give you something in return for each of them. In each case, the *Form of settlement* account will be one called **capital account**. You, the business owner, have transferred all

these items from your old business into your new business. They are now all possessions of your new business. We use a capital account to record what the business owner has put into the business.

Once the business is active, making purchases and sales, we add any profits to that account, subtract any losses from it, and also subtract any items taken out of the business for the owner's own personal use. We call the balance on that account, **capital**. It is what the business is worth to the owner on the date when the balance is calculated. In other words, it is what the owner has invested in the business at that point in time.

'Capital' at any point in time is equal to the amount the owner has invested in the business plus any profits, less any losses, less everything taken out of the business by the owner, such as cash or goods.

Activity 2.6

What do you think the balance on the capital account will be once you have entered each of these 13 items into the correct accounts?

It is important to remember: it is the transactions of the business that you are recording. The business is *not* you. When you begin a business, you give it many things. It settles each of those transactions by giving you capital. The only exceptions are debts owing to someone else. When you give the new business a debt that you owe someone else, that transaction is settled by you giving the business back some of the capital it has given you. When you give back capital the business receives it and enters receipt of this *Form of settlement* as a debit.

Let's now look at how you make these 'double entries'.

2.9 Making double entries

You need to decide which account to debit and which account to credit for each entry. In order to do so, we consider the *Form of settlement*.

Activity 2.7

What is the entry to the capital account when it has decreased?
Is it a debit or a credit?

Let's see what the double entries are for the first four items you are transferring into the new business from your list in Exhibit 2.4. In each case, these things being transferred to the new business are the *Item exchanged*. You give them to the business and it settles each of these transactions using the *Form of settlement*, capital.

Exhibit 2.5

Item Exchanged	Debit	Credit
1 Cash	Cash account	Capital account
2 Cash in US dollars	Cash in US dollars account	Capital account
3 Cash in the bank	Cash in the bank account	Capital account
4 Cash in the bank in euros	Cash in the bank in euros account	Capital account

In each case, the *Form of settlement* (capital) is given to you by the business. That is why it is a credit. Do you see how the debit is always to a cash account? (You have four accounts in which ‘cash’ is kept: one for cash; one for cash held at your bank; one for cash in US dollars; and one for cash in euros.) These four entries are all debits because the *Form of settlement* is a credit.

What do you think the credit entry will be for items 5 to 12? Let’s see:

Exhibit 2.6

Item Exchanged	Debit	Credit
5 Computer	Computer account	Capital account
6 Mobile phone	Mobile phone account	Capital account
7 Sales register	Sales register account	Capital account
8 Printer	Printer account	Capital account
9 Printing supplies	Printing supplies account	Capital account
10 Goods for sale	Goods for sale account	Capital account
11 Amount due by Fred Palmer	Amount due by Fred Palmer account	Capital account
12 Amount due by Winnie Woo	Amount due by Winnie Woo account	Capital account

Capital given is always a credit.

Activity 2.8

What does the fact that capital is credited for each of these items tell you about the debits?

Items 5 to 12 confirm to you that **any increase in something that belongs to the business is a debit**. You should remember that in accounting we call all these items that belong to the business ‘assets’.

Activity 2.9

Look carefully at the wording of the debit entry for items 11 and 12. What is being debited, the amount due, or the people who owe the business these amounts? (*Hint: these are entries for the ‘item’ exchanged.*)

Think back to items 1 and 2 (‘cash’ and ‘cash in US dollars’). They are both items of **cash** but they each have their own account *because they are different types of cash* – you cannot spend the US dollars in a shop unless you are in the United States but, you can spend cash that is in your local currency in any shop in your country. For this reason, you need two accounts to record these different types of cash.

Similarly, items 11 and 12 are both **debts** owed by other people that have been transferred from the old business but *they are debts of different people* so each of them must have its own account. By including the identity of the person who owes you the money in the name of the account, you know who is in debt to you. We call a person who owes you money a ‘debtor’.

In Exhibit 2.7, we have entered the debt owed to us by Winnie Woo (Item 12) into her account.

Exhibit 2.7

Amount due by Winnie Woo	
£370	

You can see that the debit side of Winnie Woo's account (£370) is a higher amount than the credit side (£0). The account has a debit balance, so Winnie Woo is a debtor. **When a person's account has a debit balance, that person is a debtor.**

**Activity
2.10**

What do you think we call someone whose account has a credit balance?

Now let's look at the final item in your list: Loan from bank. What does this mean? Does it mean that you have £10,000 in the bank? Or, does it mean that you owe the bank £10,000?

It means that you owe the bank £10,000. So, this is an amount your old business owes the bank. **It is not a possession of the business.** The loan is the *Item exchanged*. It is being transferred into the new business and the *Form of settlement* is *capital*, just as it was with all the other items in Exhibit 2.4. But the business is not giving capital in exchange for the loan. It is receiving it so, the entry for the *Form of settlement* (capital) is a debit.

And, this loan is not a possession of the business, so it is treated in the opposite way to a possession of the business. That is, it is a credit.

The double entries for item 13 therefore go in the opposite direction to those for the 12 items that did belong to the business. It has reduced your investment in the new business, so you must settle this transaction with capital. Because the business receives the *Form of settlement* (capital), it is a debit, and the entry for the *Item exchanged* is a credit.

Exhibit 2.8

Item exchanged	Debit	Credit
13 Loan from bank	Capital account	Loan from bank account

As you learnt in Activity 2.10, we call a person or an organisation that we owe money a **creditor**. The credit side of their account is a higher amount than the debit side. You can confirm this by looking at the 'Loan from bank' account in Exhibit 2.9: the credit side (£10,000) is higher than the debit side (£0).

Exhibit 2.9

Loan from bank account	
	£10,000

All items that do *not* belong to the business are called **liabilities**. These are things the business *must* pay to its *creditors*. **The only exception is capital.** It is *not* a liability because it belongs to the owners of the business and the business does not have to pay its owners back what they have invested.

So far, you have only seen a few entries in **T-accounts**. Let's now look at two of these accounts with the amounts from Exhibit 2.4 entered on the correct side and then look at what happens when we make a new transaction involving those two accounts.

2.10 Making double entries into existing accounts

Exhibit 2.10 shows you the entries for the printing supplies and the cash from Exhibit 2.4 in their T-accounts.

Exhibit 2.10

Printing supplies account	Cash account
£40	£600

Now, let's imagine that you decide you need some more printing supplies for your new business. You go to a shop and pay £50 in cash for what you need. What would the double entries be?

The *Form of settlement* is cash. It has been given, so it is a credit. The *Item exchanged* is printing supplies (e.g. toner, ink, paper, etc.). It must be the opposite: a debit.

Debit Printing supplies account Credit Cash account

Let's now look at those two accounts with the amount of the purchase entered.

Exhibit 2.11

Printing supplies account	Cash account
£40	£600
50	£50

What are the balances on these two accounts?

The balance – the difference between the total of the debits and the total of the credits – on the Printing supplies account has now increased from £40 to £90. At the same time, the balance on the Cash account has reduced from £600 to £550. The total belonging to the business has not changed. You have simply entered a transaction where printing supplies were exchanged for cash: the supplier gave them to you, and you gave the supplier cash.

What would the double entries be if you now sold some of your goods? Let's see.

2.11 Recording a sale

Let's assume an old friend contacts you asking to buy some of your goods. You decide to sell him the goods at the same price as they cost you to purchase them. They cost you £60. You give him the goods and he gives you £60 in cash.

In Exhibit 2.11, you prepared the two T-accounts. Once you had entered the items from Exhibit 2.4 and the purchase of printing supplies for £50, they looked like this:

Goods for sale account	Cash account
£18,000	£600
	£50

The double entries for this sale transaction would be:

Debit Cash account Credit Goods for sale account

The *Form of settlement* (cash) has been received, so it must be debited. The *Item exchanged* ('Goods for sale') must be the opposite, so you must credit the Goods for sale account. The two accounts now contain:

Goods for sale account		Cash account	
£18,000	£60	£600	£50
		60	

Your Cash has increased and your Goods for sale have decreased. Your accounts continue 'in balance'. That is, the total of all the debits in all your accounts equals the total of all the credits in all your accounts.

Activity 2.11

Confirm that the total of all the debit balances of the accounts listed in Exhibits 2.5 and 2.6 is the same as the total of all the credit balances. Why is this?

Remember the Principles of double entry bookkeeping:

- 1 A *Form of settlement* given is always a credit.
- 2 A *Form of settlement* received is always a debit.
- 3 The entry for the *Item exchanged* is always the opposite to the entry for the *Form of settlement*.

These principles are all you need to know so that you *always* select the correct account to debit and the correct account to credit for any transaction. Apply them correctly to the *Form of settlement* and your debits and credits should always be in the correct account.

The examples above will guide you if you ever forget the principles.

Activity 2.12

What are the double entries if you repay a loan by paying the creditor in cash?

You can also be guided by the item received. Whenever something is received that belongs to the business, it is a debit. When something received does not belong to the business, like a loan from a bank, it is always a credit. This is very useful to know when you are recording adjustments to accounts. We will do that later in this book. When recording transactions, if you always use the principles, you should always make the correct decisions on the debits and credits.

So far, we have not mentioned expenses. Let's look at how they are recorded in double entry.

2.12 Expenses and double entry

When you incur an expense, *it belongs to the business* in the same way that a computer, a machine, or a building belongs to the business. The difference is that an expense is used-up immediately whereas a computer is used for a long time. (We call possessions that you keep for some time *assets*. We call possessions that are used-up immediately 'expenses'.)

For example, if you pay an electricity bill for £120 by cash, the *Item exchanged* is electricity. Cash was the *Form of settlement* and it was given, so must be a credit. The *Item exchanged* (the expense) must be the opposite, so you debit electricity. You will learn later that expenses are always debits.

2.13 Purchases accounts and Sales accounts

Instead of recording purchases and sales in an account for the *Item exchanged*, many businesses use accounts for purchases and accounts for sales. In that case, **if you purchase something to sell in your shop, you make the entry in the 'Purchases account'**. When you **sell it, you make the entry in the 'Sales account'**.

The purchases and the sales are kept apart. This is done because the balances on both these accounts are needed when you prepare an **Income Statement**, the report accountants produce that shows how profitable the business has been.

Purchases are possessions so, when they increase, the entry is a debit.

Sales are also possessions (that you have exchanged for money or a debt). When your possessions decrease (as they do when you make a sale), the entry is a credit.

2.14 Finally

You now know all you need to know about debits and credits. You will use this knowledge a lot during the rest of this book. If you ever get confused and cannot remember the *Principles of double entry* or how to record an entry, return to this chapter. You will soon know again how to do double entry.

Remember:

Always start by looking at the *Form of settlement*.

Remember:

When a *Form of settlement* is given, it is a credit.

Remember:

When a *Form of settlement* is received, it is a debit.

Remember:

The entry for the *Item exchanged* is always the opposite.

Remember:

The amount of the debit always equals the amount of the credit.

Part Two Some worked examples

Before showing you how a series of transactions are recorded, we'll first look at what else needs to be included when an entry is made in an account.

2.15 Completing the entry in an account

So far you have learnt how to decide which account to debit and which account to credit. You know where to enter the value of each transaction. Now, we shall add the other items that also need to be included when you make an entry:

- the date
- the name of the other account in which the transaction is being entered.

When you make your first entry in an account, you need to enter the year, month and day, plus the name of the other account involved in the transaction. Let's assume that you transferred all the items into the new business on 1 January 2019. To make the entries for Item 1 in Exhibit 2.4, you need to create an account for Cash and an account for Capital. Here is how the entries would look after you have made them.

Exhibit 2.12

Cash Account				Capital Account			
2019	£			2019	£		
January 1		Capital	600	January 1		Cash	600

You only enter the year when you make the first entry on each side. So, if on the same day you used £10 of the cash to buy some stamps, the entries would be made as shown in Exhibit 2.13.

Exhibit 2.13

Cash Account				Stamps Account			
2019	£			2019	£		
January 1		Capital	600	January 1		Stamps	10
				January 1		Cash	10

The year only appears once on each side of the account, no matter how many entries are made. Now we'll go through some worked examples.

2.16 Worked examples

- 1 Imagine that the owner of a new business has invested £10,000 in cash in the business on 1 August 2019. The result of this transaction is entered in the two accounts as follows. First, a debit entry is made in the Cash account. The entry includes the name of the other account involved. In this case, it is the Capital account:

Cash			
2019	£		
Aug 1		Capital	10,000

Similarly, the double entry to the item in the capital account is completed by an entry in the cash account, so the word 'Cash' will appear in the capital account:

Capital				
	2019			£
	Aug	1	Cash	10,000

- 2 A van is bought for £4,500 cash on 2 August 2019.

Van				
2019				£
Aug	2	Cash	4,500	

Cash				
2019				£
Aug	1	Capital	10,000	
2019				£
Aug	2	Van	4,500	

- 3 Fixtures (e.g. shelves) are bought on time from Shop Fitters for £1,250 on 3 August 2019.

Fixtures				
2019				£
Aug	3	Shop Fitters	1,250	

Shop Fitters				
	2019			£
	Aug	3	Fixtures	1,250

Note how a separate account is maintained for each person or organisation to whom you owe money. Each of these creditor accounts is known as a 'trade payable'.

- 4 Paid the amount owing to Shop Fitters in cash on 17 August 2019.

Shop Fitters				
2019				£
Aug	17	Cash	1,250	
2019				£
Aug	3	Fixtures	1,250	

Cash				
2019				£
Aug	1	Capital	10,000	
2019				£
Aug	2	Van	4,500	
	17	Shop Fitters	1,250	

Combining all four of these transactions, the accounts now contain:

Cash				
2019				£
Aug	1	Capital	10,000	
2019				£
Aug	2	Van	4,500	
	17	Shop Fitters	1,250	

Capital				
		2019		£
	Aug	1	Cash	10,000
Van				
2019				£
Aug	2		Cash	4,500
Shop Fitters				
2019				£
Aug	17		Cash	1,250
2019				£
Aug	3		Fixtures	1,250
Fixtures				
2019				£
Aug	3		Shop Fitters	1,250

Note how you enter each transaction in an account in date order and how, once you open an account (e.g. Shop Fitters), you continue to make entries in it rather than opening a new account for every entry.

Before you read further, work through Review questions 2.10 and 2.11A.

2.17 A further worked example

Have you noticed how each column of figures is headed by a '£' sign? This is important. You always need to indicate what the figures represent. In this case, it is pounds; in other cases you will meet during this book, the figures may be thousands of pounds (represented by '£000') or they could be in a different currency altogether. **Always include appropriate column headings.**

Let's now go carefully through the following example. Make certain you can understand every entry and, if you have any problems, reread Part One of this chapter until you are confident that you know and understand what you are doing.

First, here is a table showing a series of transactions of a new business and the double entry action to take:

Transactions		Debit	Credit
2019 May	1 Started a household machines business putting £25,000 into a bank account.	Bank account	Capital account
	3 Bought equipment on time from House Supplies £12,000.	Equipment account	House Supplies account
	4 Withdrew £150 cash from the bank and placed it in the cash box.	Cash account	Bank account

Transactions		Debit	Credit
7	Bought a van for £6,800 and paid by internet transfer from the bank account	Van account	Bank account
10	Sold some equipment that was not needed at cost of £1,100 on time to J. Rose	J. Rose account	Equipment account
21	Returned some of the equipment costing £2,300 to House Supplies	House Supplies account	Equipment account
23	J. Rose pays the amount owing of £1,100 by cheque	Bank account	J. Rose account
28	Bought another van for £4,300 paying by cheque.	Van account	Bank account
31	Paid £9,700 to House Supplies by internet transfer from the bank account.	House Supplies	Bank account

You may find it worthwhile trying to enter all these transactions in T-accounts before reading any further. You will need to know that, similarly to trade payables (i.e. accounts of creditors), a separate trade receivable account (i.e. debtor account) is kept for each debtor. You will need accounts for Bank, Cash, Capital, Equipment, Vans, House Supplies, and J. Rose.

In T-account form this is shown below:

Bank			
2019	£	2019	£
May 1 Capital	25,000	May 4 Cash	150
28 J. Rose	1,100	7 Van	6,800
		30 Van	4,300
		31 House Supplies	9,700
Cash			
2019	£		
May 4 Bank	150		
Capital			
		2019	£
		May 1 Bank	25,000
Equipment			
2019	£	2019	£
May 3 House Supplies	12,000	May 10 J. Rose	1,100
		21 House Supplies	2,300

Vans							
2019			£				
May	7	Bank	6,800				
	30	Bank	4,300				
House Supplies							
2019			£	2019			£
May	21	Equipment	2,300	May	3	Equipment	12,000
	31	Bank	9,700				
J. Rose							
2019			£	2019			£
May	10	Equipment	1,100	May	28	Bank	1,100

If you tried to do this before looking at the answer, be sure you understand any mistakes you made before going on.

2.18 Abbreviation of 'limited'

In this book, when we come across transactions with limited companies the letters 'Ltd' are used as the abbreviation for 'Limited Company'. So, if you see that the name of a business is 'W. Jones Ltd', it is a limited company. In our accounting books, transactions with W. Jones Ltd will be entered in the same way as for any other customer or supplier. It will be seen later that some limited companies use plc (which stands for 'public limited company') instead of Ltd.

2.19 Value added tax (VAT)

You may have noticed that VAT has not been mentioned in the examples covered so far. This is deliberate, so you are not confused as you learn the basic principles of accounting. In Chapter 16, you will be introduced to VAT and shown how to make the entries relating to it.

2.20 The mystery of making double entries

Double entry bookkeeping appears very simple: for every debit entry there is an equal credit entry. However, students often find that they cannot decide which account to debit and which account to credit. If you have this problem, you are not alone – virtually everyone struggles with this from time to time. But you don't need to find this difficult.

If you focus upon the *Form of settlement* and remember that, when it is given it is a credit and when it is received, it is a debit you'll get it right, time after time.

This approach was first proposed in 1494 by an Italian friar and teacher called Luca Pacioli. He did so in the first ever printed book to contain a detailed description of double entry bookkeeping. In his book, he describes double entry from three perspectives: capital of the owner; cash; and obligations (i.e. debt). All transactions involve at least one of these. **That is what to focus upon when you are deciding which account to debit and which account to credit.**

Learning outcomes

You should now have learnt that:

- 1 There are two elements to every transaction: an *Item exchanged* and a *Form of settlement*.
- 2 Double entry bookkeeping requires that for each transaction, an entry is made once for the *Item exchanged*; and once for the *Form of settlement*.
- 3 The treatment of the *Item exchanged* is always the opposite of the treatment of the *Form of settlement*.
- 4 Debit means 'place on the left of the account called ...'.
- 5 Credit means 'place on the right of the account called ...'.
- 6 The total of the debit must always equal the total of the credit.
- 7 Capital is what the owner contributes to a business.
- 8 Capital does not belong to a business. It belongs to the owner of the business.
- 9 Liabilities are all other items that do not belong to a business, such as loans from banks.
- 10 Expenses are immediately used-up but, they belong to the business and are treated the same way as all other possessions.
- 11 Possessions that last some time are called 'assets'.
- 12 Debtors (trade receivables) are people or organisations that owe money to a business.
- 13 Creditors (trade payables) are people or organisations that are owed money by a business. The owner of a business is *not* a creditor of the business. The owner is an investor in the business.
- 14 When the *Form of settlement* is given, it is a credit.
- 15 When the *Form of settlement* is received, it is a debit.
- 16 The entry for the *Item exchanged* is always the opposite of the entry for the *Form of settlement*.
- 17 To identify the accounts to debit and credit, you *always* focus upon the *Form of settlement*: identify whether it is a debit or a credit; the *Item exchanged* will be the opposite.

Answers to activities

- 2.1 Other forms of bookkeeping include 'single entry bookkeeping' and 'triple entry bookkeeping'. You will be told about single entry bookkeeping soon. Triple entry bookkeeping was a technique recommended a few years ago that records more information than double entry bookkeeping. It did not catch-on, accountants preferring to stick with what they knew.
- 2.2 This is known as a 'T-account'.
- 2.3 Each transaction you record involves two things, the *Item exchanged* and the *Form of settlement*. They have the same value because they are the two elements involved in the transaction. The amount debited will, therefore, always equal the amount credited.
- 2.4 Debit *Item exchanged* account £100. Credit *Form of settlement* account £100. An example would be the purchase of an external drive for a laptop computer, paid in cash, but many, many other items could have been exchanged. Instead of cash, another *Form of settlement* could be involved, such as doing so using an IOU.

- 2.5** The *Form of settlement* is 'capital'. These items all belong to you and you are now transferring them into your new business using double entry. When you do this, they become possessions of the business. The business pays for them by giving you capital. We call your account, the 'capital account'. **Your 'capital' does not belong to the business.** It belongs to you. So, every time you record one of these items, you are going to credit your Capital account. The capital account tells you how much you have invested in the business.
- 2.6** £12,350. You have added 12 items belonging to the business totalling £22,350 and one item worth £10,000 that is owed by the business. The balance on the capital account is therefore £22,350 minus £10,000 = £12,350. This is what your business is worth.
- 2.7** It is a debit. Your capital account decreases if you make a loss. It also decreases if you withdraw resources (cash or goods, for example) from the business for your own use. In Exhibit 2.4, you have transferred a loan you received from the bank to the business. This also reduces your investment in the business (see Activity 2.6) and so that item was entered as a debit to the capital account. Capital is a *Form of settlement*. It has been received from you when you gave the business your debt owing to the bank. By giving this capital back to the business, you compensated it for the debit it took over from you.
- 2.8** Whenever capital increases, the *Item exchanged* is debited. So, all items belonging to a business are debited when they increase, not just cash. The item exchanged now belongs to the business. This tells you that when a business receives something that belongs to it that it can use in the business, it will be a debit.
- 2.9** It is the amount due. We call this a 'debt'.
- 2.10** A 'creditor'.
- 2.11**

Cash account	Cash in US dollars account
£600 £50	£200
Cash in the bank account	Cash in the bank in euros account
£1,200	£430
Computer account	Mobile phone account
£500	£240
Sales register account	Printer account
£320	£150
Printing supplies account	Goods for sale account
£40	£18,000
50	
Amount due by Fred Palmer account	Amount due by Winnie Woo account
£300	£370

Loan from bank account		Capital account	
	£10,000	£10,000	£600
			200
			1,200
			430
			500
			240
			320
			150
			40
			18,000
			300
			370

£22,350. Yes. The total of the debit balances is the same as the total of the credit balances because each transaction is entered twice, once as a debit and once as a credit.

2.12 Debit loan from creditor account; credit cash account.

Review questions

2.1 Imagine you have been in business for a few months but you have not kept any proper records of your transactions. You have decided to end that business and start a new one by transferring everything to the new business. You now also want to start using double entry bookkeeping. The first step is to write down a list of everything belonging to the old business and everything the old business owes. Here is the list you prepared:

	£
1 Cash	400
2 Cash in US dollars' worth	280
3 Cash in the bank	900
4 Cash in the bank in Euros worth	350
5 Computer	710
6 Mobile phone	590
7 Office furniture	840
8 Printer	160
9 Delivery van	2,950
10 Goods for sale	12,300
11 Amount due from J. Gidman	560
12 Amount due from K. Bailey	230
13 Loan from bank	6,000





Required:

What is the debit and credit entry for each of these items? (Ignore the amounts.)

1	Cash	Debit	account	Credit	account
2	Cash in US dollars' worth	Debit	account	Credit	account
3	Cash in the bank	Debit	account	Credit	account
4	Cash in the bank in euros worth	Debit	account	Credit	account
5	Computer	Debit	account	Credit	account
6	Mobile phone	Debit	account	Credit	account
7	Office furniture	Debit	account	Credit	account
8	Printer	Debit	account	Credit	account
9	Delivery van	Debit	account	Credit	account
10	Goods for sale	Debit	account	Credit	account
11	Amount due from J. Gidman	Debit	account	Credit	account
12	Amount due from K. Bailey	Debit	account	Credit	account
13	Loan from bank	Debit	account	Credit	account

2.2 Make the entries in the T accounts for the items in question 2.1.

Cash account	Cash in US dollars account
Cash in the bank account	Cash in the bank in euros account
Computer account	Mobile phone account
Office furniture account	Printer account
Delivery van account	Goods for sale account
Amount due from J. Gidman account	Amount due from K. Bailey account
Loan from bank account	Capital account

2.3 What are the two elements of every transaction?

2.4 If a customer pays you the amount she owes in cash, what is the item exchanged?

2.5 If you use cash to pay a supplier of goods the amount you owe him for goods you purchased two months ago, what is the item exchanged?

2.6 If you obtain a loan of £5,000 from a bank, what is the item exchanged?

2.7 What is the form of settlement in each of questions 2.4, 2.5 and 2.6?

2.8 What are the principles of double entry bookkeeping?

2.9 What is the debit entry and the credit entry in each of questions 2.4, 2.5 and 2.6?

2.10 Complete the following table:

	<i>Account to be debited</i>	<i>Account to be credited</i>
(a) Bought laptop computer on time from Timeless Ltd.		
(b) The proprietor paid a creditor, B. Burt, from his private funds.		
(c) A debtor, T. Robb, paid us by cheque.		
(d) Repaid part of loan from I. Simms in cash.		
(e) Returned the computer to Timeless Ltd.		
(f) A debtor, P. Bell, pays us by cheque.		
(g) Bought van on time from Tangle Motors.		

2.11A Complete the following table:

	<i>Account to be debited</i>	<i>Account to be credited</i>
(a) Bought trailer for cash.		
(b) Paid creditor, J. Tough, by cheque.		
(c) Repaid W. Small's loan by cash.		
(d) Sold trailer for cash.		
(e) Bought office equipment on time from Dexter Ltd. It will be paid for later.		
(f) A debtor, T. Walls, pays us by cash.		
(g) A debtor, L. Tait, pays us by cheque.		
(h) Proprietor puts a further amount into the business by cheque.		
(i) A loan of £650 in cash is received from F. Burns.		
(j) Paid a creditor, J. Fife, by cash.		





2.12 Write up the asset, liability and capital accounts to record the following transactions in the records of B. Spector's business:

- July
- 1 Started business by putting £15,000 of his own money into a business bank account.
 - 2 Bought office furniture by internet transfer from bank account £2,800.
 - 3 Bought computer equipment £1,260 on time from TVC Ltd.
 - 5 Bought a car paying by cheque £4,950.
 - 8 Sold some of the office furniture – original cost £750 – for £750 on time to Jevons & Co.
 - 15 Paid the amount owing to TVC Ltd £1,260 by internet transfer from bank account.
 - 23 Received the amount due from Jevons & Co £750 by cheque.
 - 31 Bought machinery using the business's debit card £710.

2.13 You are required to open the asset and liability and capital accounts and record the following transactions for June in the records of P. Bernard:

- June
- 1 Started business with £17,500 in cash.
 - 2 Paid £9,400 of the opening cash into a bank account for the business.
 - 5 Bought office furniture on time from Dream Ltd for £2,100.
 - 8 Bought a van paying by internet transfer from the bank account £5,250.
 - 12 Bought equipment from Pearce & Sons on time £2,300.
 - 18 Returned faulty office furniture costing £260 to Dream Ltd.
 - 25 Sold some of the equipment for £200 cash (its original cost).
 - 26 Paid amount owing to Dream Ltd £1,840 by internet transfer from the bank account.
 - 28 Took £130 out of the bank and added to cash.
 - 30 F. Brown lent us £4,000 – sending us the money by internet transfer.

2.14A Write up the asset, capital and liability accounts in the books of D. Gough to record the following transactions:

- June
- 1 Started business with £16,000 in the bank.
 - 2 Bought van paying by cheque £6,400.
 - 5 Bought office fixtures £900 on time from Old Ltd.
 - 8 Bought van on time from Carton Cars Ltd £7,100.
 - 12 Took £180 out of the bank and put it into the cash till.
 - 15 Bought office fixtures paying by cash £120.
 - 19 Paid Carton Cars Ltd by internet transfer from the bank account.
 - 21 A loan of £500 cash is received from B. Berry.
 - 25 Paid £400 of the cash in hand into the bank account.
 - 30 Bought more office fixtures, paying with the business debit card £480.

2.15A Write up the accounts to record the following transactions:

- May
- 1 Started business with £1,500 cash and £18,000 in the bank.
 - 2 Received a loan of £4,000 from T. Fox by cheque.
 - 3 Bought a computer for cash £1,200.
 - 5 Bought display stands on time from Drop Ltd £840.
 - 8 Took £400 out of the bank and put it in the cash till.
 - 15 Repaid part of Fox's loan using the business debit card £1,000.
 - 17 Paid amount owing to Drop Ltd £840 by internet transfer from the bank account.
 - 24 Repaid part of Fox's loan by cash £500.
 - 31 Bought a colour laser printer on time from P. Blake for £400.

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why it is inappropriate to use an inventory account to record increases and decreases in inventory of individual products.
- Describe the two causes of inventory increasing.
- Describe the two causes of inventory decreasing.
- Explain the difference between a purchase account and a returns inwards account.
- Explain the difference between a sales account and a returns outwards account.
- Explain how to record increases and decreases of inventory in the appropriate accounts.
- Explain the meanings of the terms 'purchases' and 'sales' as used in accounting.
- Explain what is meant when the term 'on time' is used to describe a purchase or a sale.
- Explain the differences in recording purchases on time as compared to recording purchases that are paid for immediately in cash.
- Explain the differences in recording sales on time as compared to recording sales that are paid for immediately in cash.

Introduction

In this chapter, you will learn how to record movements in inventory in the appropriate ledger accounts and how to record purchases and sales on time, as opposed to purchases and sales for cash.

3.1 Inventory movements

In the examples in Section 1.10 of Chapter 1, inventory was sold at the same price at which it was bought. When this happens and an inventory account is used rather than having separate accounts for purchases and sales (refer back to Section 2.12 if this is unclear), the difference between the two sides of the inventory account represents the cost of the goods unsold at that date. This is, of course, extremely unusual. In fact, any new business selling its inventory at 'cost' wouldn't last long. Businesses need to make profits to survive, as many 'dot.com' internet companies discovered a few years ago when their bubble burst and all the losses they had been making took effect.

**Activity
3.1**

Let's think about the double entry implications if all sales were at cost price. Fill in the blanks in the following using 'an increase', 'a decrease', 'debited', and 'credited':

As we did in Chapter 1, it would be possible to have an inventory account with goods purchased being _____ to the inventory account (as purchases represent _____ in the asset, inventory) and goods sold being _____ to it (as sales represent _____ in the possession, inventory).

When selling price is the same as cost, the balance on the inventory account would represent the cost of the inventory still held. When selling price is not the same as cost, maintaining an inventory account on this basis would no longer result in the balance representing the cost of the inventory still held. At face value, the account would serve no useful purpose. Or would it?

Let's assume that a supermarket had a separate inventory account for each product it sold – e.g. own brand skimmed milk, Cravendale skimmed milk, own brand semi-skimmed milk, Cravendale semi-skimmed milk, own brand whole cream milk, Cravendale whole cream milk. Each of these inventory accounts would serve a very useful purpose: they reveal the basic profit on each item of inventory once all the units of the item have been sold. This is very useful information for the managers of a business, which can be extended to be even more useful if the number of units of inventory involved in each transaction is also noted in the account.

**Activity
3.2**

How does adding the units to the entry in the account result in more useful information?

Normally, goods or services are sold at above cost price, so that the selling price includes elements of profit. When goods or services are sold for less than their cost, the difference is a loss.

Because businesses usually sell goods for more than their cost, the difference between the two sides of the inventory account would not represent the cost of the unsold goods. It would represent the cost of what remained *less* the profit earned on the goods that have been sold.

However, when preparing the financial statements of a business, we want the overall picture. We do not wish to know the profit on each type of good or service we have sold. (That is something management accountants would be involved in calculating so that the managers of the business know how profitable each item sold is.)

Thus, when preparing the financial statements of a business, we seek to identify the overall profit, on all items sold. Consequently, rather than using a separate account for each product, most businesses adopt what is known as the 'periodic inventory valuation' system. Under this approach, we subdivide the way inventory is reported into several accounts, each one showing a movement of inventory. As you will see, under this approach one account is used for all purchases of goods for resale and another account is used for all sales of those goods.

Firstly, we must distinguish between transactions that cause inventory to increase and those that cause it to decrease. Let's deal with each of these in turn.

1 Increase in inventory. This can be due to one of two causes:

- (a) The purchase of additional goods.
- (b) The return into the business of goods previously sold – there are many reasons why this may happen. For example, they may have been the wrong type, not required, or faulty.

To distinguish the two causes of an increase in inventory, two accounts are opened:

- (i) a **Purchases account** – in which purchases of goods are entered; and
- (ii) a **Returns Inwards account** – in which goods being returned into the business are entered.
(Another name for this account is the **Sales Returns account**.)

We then *debit* the appropriate one of these two accounts.

2 Decrease in inventory. Ignoring things like wastage and theft, this can be due to one of two causes:

- (a) The sale of goods.
- (b) Goods previously bought by the business now being returned to the supplier.

Once again, in order to distinguish the two causes of a decrease in inventory, two accounts are opened:

- (i) a **Sales account** – in which sales of goods are entered; and
- (ii) a **Returns Outwards account** – in which goods being returned out to a supplier are entered.
(This is also known as the **Purchases Returns account**.)

We then *credit* the account from these two alternatives that is the appropriate one to use in the context of what caused the inventory to decrease.

As inventory is a possession (and an asset), and these four accounts are all connected with this asset, the double entries are those used for possessions.

Activity 3.3

If assets are all possessions, what are the double entries for assets?

Accounts	To record	Entry in the account
Assets	an increase a decrease	_____ _____

Let's now look at some inventory entries in the following sections. We'll use the *Principles of double entry* to guide us.

3.2 Purchase of inventory to be paid for later

On 1 August 2019, goods for resale costing £165 are bought on time from D. Henry. (**Remember: when something is bought or sold 'on time' it means that it will be paid for later.**) First, the two elements of the transaction must be considered so that the bookkeeping entries can be made: the *Item exchanged* and the *Form of settlement*.

- The *Form of settlement* is an IOU. It has been given, so it is a credit. The IOU is a debt owed to D. Henry, so it goes in that account.
- The *Item exchanged* is goods for resale. Its entry is the opposite of the *Form of settlement*, which was a credit. So, the *Item exchanged* is a debit. Goods for resale received are purchases, so the entry goes in that account.

These two entries appear in the T-accounts as:

Purchases		
2019	£	
Aug 1 D. Henry	165	

D. Henry

	2019		£
	Aug 1	Purchases	165

Note that these entries are identical to those you would make if you were using an account for the goods rather than a purchases account. (If an account for the goods were being used, the name of the goods would replace 'Purchases'.)

3.3 Purchases of inventory for cash

On 2 August 2019, goods costing £310 are bought, cash being paid for them immediately at the time of purchase.

- 1 This time the *Form of settlement* is cash. It has been given, so it is a credit.
- 2 As before the *Item exchanged* is goods for resale. The movement of inventory is the result of a 'purchase', so the purchases account is used. The entry is the opposite of the entry for the *Form of settlement*, so it is a debit.

Purchases			
2019	£		
Aug 2	Cash	310	

Cash			
	2019		£
	Aug 2	Purchases	310

3.4 Sales of inventory on time

On 3 August 2019, goods were sold on time for £375 to J. Lee.

- 1 The *Form of settlement* is an IOU. It has been received, so it is a debit. The IOU is owed by J. Lee, so it goes in that account.
- 2 The *Item exchanged* is goods for resale. The movement of inventory is the result of a 'sale', so the sales account is used. The entry is the opposite of the entry for the *Form of settlement*, so it is a credit.

Sales			
	2019		£
	Aug 3	J. Lee	375

J. Lee			
2019	£		
Aug 3	Sales	375	

3.5 Sales of inventory for cash

On 4 August 2019, goods are sold for £55, cash being received immediately at the time of sale.

- 1 This time the *Form of settlement* is cash. It has been received, so it is a debit.
- 2 As before the *Item exchanged* is goods for resale. The movement of inventory is a 'sale', so the sales account is used. The entry is the opposite of the entry for the *Form of settlement*, so it is a credit.

Sales		
	2019	£
	Aug 4 Cash	55

Cash		
2019	£	
Aug 4 Sales	55	

So far, so good. Apart from replacing the account in the name of the goods with the purchases account when inventory increases and the sales account when it decreases, you've done nothing different in your entries to the accounts compared with what you learnt in Chapters 1 and 2.

Go back to Chapters 1 and 2 and refresh your understanding of account entries.

Let's now look at the other inventory-related transactions that cause inventory to increase and decrease – returns inwards (sales that are being returned) and returns outwards (purchases that are being returned to the supplier).

3.6 Returns inwards

On 5 August 2019, goods which had been previously sold to F. Lowe for £29 are now returned *to the business*. This could be for various reasons such as:

- you sent goods of the wrong size, the wrong colour, or the wrong model;
- the goods were damaged in transit;
- the goods are of poor quality.

As shown below, the account we use to record the return of the goods is the 'Returns inwards account':

- 1 The *Form of settlement* is an IOU. As the IOU has been given to F. Lowe, it is a credit in the account of F. Lowe.
- 2 The *Item exchanged* is goods for resale. The movement in inventory is that of a 'returns inwards', so it is made to that account. It is the opposite of the entry for the *Form of settlement*, so it is a debit.

Returns inwards		
2019	£	
Aug 5 F. Lowe	29	

F. Lowe		
	2019	£
	Aug 5 Returns inwards	29

(Remember, another name for the Returns Inwards account is the 'Sales Returns account'.)

3.7 Returns outwards

On 6 August 2019, goods previously bought for £96 are returned *by the business* to K. Hoff.

- 1 The *Form of settlement* is an IOU. As the IOU was received from K. Hoff, it is a debit in the account of K. Hoff.
- 2 The *Item exchanged* is goods for resale. The movement in inventory is that of a 'returns outwards', so it is made to that account. It is the opposite to the entry for the *Form of settlement*, so it is a credit.

Returns outwards			
	2019		£
	Aug 6	K. Hoff	96
K. Hoff			
2019	£		
Aug 6	Returns outwards	96	

(Remember, another name for the Returns Outwards account is the Purchases Returns account.)

You'll have seen how using the *Principles of double entry* made the selection of the accounts to debit and credit very easy. You only had to decide what to do with the account of the *Form of settlement*. The second part of the double entry is always the opposite of the first so, if the account of the *Form of settlement* is a debit, the account of the *Item exchanged* is a credit.

You may now be thinking this is all very straightforward. Check to see if that's the case by looking at two review questions. Once you've done that, we'll show you a worked example.

Before you read further, work through Review questions 3.1 and 3.2.

3.8 A worked example

2020		
May	1	Bought goods on time £220 from D. Small.
	2	Bought goods on time £410 from A. Lyon & Son.
	5	Sold goods on time to D. Hughes for £60.
	6	Sold goods on time to M. Spencer for £45.
	10	Returned goods £15 to D. Small.
	11	Goods sold for cash £210.
	12	Goods bought for cash £150.
	19	M. Spencer returned £16 goods to us.
	21	Goods sold for cash £175.
	22	Paid cash to D. Small £205.
	30	D. Hughes paid the amount owing by him £60 in cash.
	31	Bought goods on time £214 from A. Lyon & Son.

You may find it worthwhile trying to enter all these transactions in T-accounts before reading any further. You will need the following accounts: Purchases, Sales, Returns Outwards, Returns Inwards, D. Small, A. Lyon & Son, D. Hughes, M. Spencer and Cash.

Here are the entries in the T-accounts:

Purchases							
2020			£				
May	1	D. Small	220				
	2	A. Lyon & Son	410				
	12	Cash	150				
	31	A. Lyon & Son	214				
Sales							
		2020		£			
		May	5	D. Hughes	60		
			6	M. Spencer	45		
			11	Cash	210		
			21	Cash	175		
Returns outwards							
		2020		£			
		May	10	D. Small	15		
Returns inwards							
2020			£				
May	19	M. Spencer	16				
D. Small							
2020			£				
May	10	Returns outwards	15	2020	£		
	22	Cash	205	May	1	Purchases	220
A. Lyon & Son							
		2020		£			
		May	2	Purchases	410		
			31	Purchases	214		
D. Hughes							
2020			£				
May	5	Sales	60	2020	£		
				May	30	Cash	60
M. Spencer							
2020			£				
May	6	Sales	45	2020	£		
				May	19	Returns inwards	16
Cash							
2020			£				
May	11	Sales	210	2020	£		
	21	Sales	175	May	12	Purchases	150
	30	D. Hughes	60		22	D. Small	205

Did you get this right? Be sure you understand any mistakes you made before going on.

3.9 Special meaning of 'sales' and 'purchases'

You need to remember that 'sales' and 'purchases' have a special meaning in accounting when compared to their meaning in everyday English.

In accounting, **purchases** means the *purchase of those goods that the business buys with the sole intention of selling*. (i.e. goods for resale). Obviously, sometimes goods are altered, added to, or used in the manufacture of something else, but it is the intention of resale that is important. Thus, to a business that deals in computers, computers are treated as purchases. To most businesses, they are not: they treat them as assets *because they are bought to be kept*.

Thus, if something is bought *that the business does not intend to sell*, such as a van, it *cannot* be called a 'purchase', even though in ordinary language you would say that a van has been purchased. The van was bought to be used and *not* for resale. You *must* use an account for the van for any entries, *not* the purchases account.

Similarly, **sales** means the *sale of those goods in which the business normally deals and which were bought with the sole intention of resale*. The account for 'sales' must never be used to record the disposal of other items, such as vans or buildings that were purchased to be used and *not* to be sold.

If we did not keep to these meanings, we would find it very difficult to identify which of the items in the purchases and sales accounts were inventory and which were assets that had been bought to be kept and then sold once they were no longer of use to the business.

Learning outcomes

You should now have learnt:

- 1 That it is *not* appropriate to use individual inventory accounts for each product purchased with the intention of selling it.
- 2 That inventory increases either because some inventory has been purchased or because inventory that was sold has been returned by the buyer.
- 3 That inventory decreases either because some inventory has been sold or because inventory previously purchased has been returned to the supplier.
- 4 That a purchase account is used to record purchases of inventory (as debit entries in the account) and that a returns inwards account is used to record inventory returned by customers (as debit entries in the account).
- 5 That a sales account is used to record sales of inventory (as credit entries in the account) and that a returns outwards account is used to record inventory returned to suppliers (as credit entries in the account).
- 6 How to record increases and decreases of inventory in the appropriate accounts.
- 7 When an item is not paid for at the time when it is purchased (or sold), we can say that it was purchased (or sold) 'on time'.
- 8 That in accounting, the term 'purchases' refers to purchases of inventory. Acquisitions of any other assets, such as vans, equipment and buildings, are *never* entered in the purchases account.
- 9 That in accounting, the term 'sales' refers to sales of inventory. Disposals of any other assets, such as vans, equipment and buildings, are *never* entered in the sales account.
- 10 That purchases for cash are *never* entered in the supplier's account.

- 11 That purchases on time are *always* entered in the supplier's (i.e. creditor's) account.
- 12 That sales for cash are *never* entered in the customer's account.
- 13 That sales on time are *always* entered in the customer's (i.e. debtor's) account.

Answers to activities

- 3.1 As we did in Chapter 1, it would be possible to have an inventory account with goods purchased being DEBITED to the inventory account (as purchases represent AN INCREASE in the possession, inventory) and goods sold being CREDITED to it (as sales represent A DECREASE in the possession, inventory).
- 3.2 If the inventory account shows a debit of £100 and two credit entries totalling £120, the basic profit so far on the goods is £20. If there are no units left, the figure of £20 represents the basic profit earned from that good – a 20 per cent profit.

Assume that the debit entry includes a note that 5 units were purchased, and the credit entries include notes indicating that 1 unit was sold for £40 and then 2 units were sold for £80. Overall basic profit would still be £20 but there are still 2 units in inventory. This information about the units can be used to identify the profit earned on the units sold.

Managers know that 5 units cost £100, so the 2 remaining units cost £40. If they add this £40 to the balance, it would rise from £20 to £60. That is the profit earned to date. They may decide to sell off the remaining units at a lower price, or to increase the selling price, or to do nothing to the selling price. The point is that they have the information in the inventory account with which to make such a decision.

To add the units of inventory to an account, an extra column could be added on each side. This was often done during the 500 or so years when this method of recording inventory was widely used. This type of inventory account is no longer used in financial accounting. However, as you will see in Chapter 18, this detail is included in the data maintained for inventory control and other management accounting purposes.

3.3

Accounts	To record	Entry in the account
Assets	an increase	Debit
	a decrease	Credit

Review questions

- 3.1 Complete the following table:

	Account to be debited	Account to be credited
(1) Goods sold for cash.		
(2) Vehicles bought on time from F. Smith.		
(3) Computer sold for cash.		
(4) Goods sold on time to J. Lilly.		
(5) Goods purchased by us returned to supplier, M. Peel.		
(6) Goods bought on time from F. Day.		





	<i>Account to be debited</i>	<i>Account to be credited</i>
(7) Goods sold, a cheque being received immediately.		
(8) Goods we returned to W. Brown.		
(9) Goods returned to us by customer, I. Gray.		
(10) Goods bought on time from T. Gow.		

3.2A Complete the following table for a business that buys and sells cleaning products:

	<i>Account to be debited</i>	<i>Account to be credited</i>
(a) Goods bought on time from B. Cowan.		
(b) Goods returned to us by L. Keith.		
(c) Filing cabinets returned to C. Riddle Ltd.		
(d) Goods bought for cash.		
(e) Lorry bought on time from M. Davis Ltd.		
(f) Goods returned by us to J. Hicks.		
(g) N. Peters paid us his account by cheque.		
(h) Goods bought by cheque.		
(i) We paid creditor, F. Toms, by cheque.		
(j) Goods sold on time to S. Mulligan.		

3.3 You are to write up the following in the books:

July	1	Started in business with £3,800 cash.
	3	Bought goods for cash £480.
	7	Bought goods on time £1,200 from J. Gill.
	10	Sold goods for cash £172.
	14	Returned goods to J. Gill £240.
	18	Bought goods on time £1,460 from F. Genesis.
	21	Returned goods to F. Genesis £104.
	24	Sold goods to A. Prince £292 on time.
	25	Paid J. Gill's account by cash £960.
	31	A. Prince paid us his account in cash £292.

3.4A Enter the following transactions in the appropriate accounts:

Aug	1	Started in business with £7,400 cash.
	2	Paid £7,000 of the opening cash into the bank.
	4	Bought goods on time £410 from J. Watson.
	5	Bought a van by cheque £4,920.
	7	Bought goods for cash £362.
	10	Sold goods on time £218 to L. Less.
	12	Returned goods to J. Watson £42.
	19	Sold goods for cash £54.
	22	Bought fixtures on time from Firelighters Ltd £820.
	24	F. Holmes lent us £1,500, paying us the money by cheque.
	29	We paid J. Watson his account by cheque £368.
	31	We paid Firelighters Ltd by cheque £820.

3.5 Enter the following transactions in the accounts of L. Linda:

- July
- 1 Started in business with £20,000 in the bank.
 - 2 D. Rupert lent us £5,000 in cash.
 - 3 Bought goods on time from B. Brown £1,530 and I. Jess £4,162.
 - 4 Sold goods for cash £1,910.
 - 6 Took £200 of the cash and paid it into the bank.
 - 8 Sold goods on time to H. Rise £1,530.
 - 10 Sold goods on time to P. Taylor £341.
 - 11 Bought goods on time from B. Brown £560.
 - 12 H. Rise returned goods to us £65.
 - 14 Sold goods on time to G. Farm £535 and R. Sim £262.
 - 15 We returned goods to B. Brown £94.
 - 17 Bought van on time from Aberdeen Cars Ltd £9,100.
 - 18 Bought office furniture on time from J. Winter Ltd £1,800.
 - 19 We returned goods to I. Jess £130.
 - 20 Bought goods for cash £770.
 - 24 Goods sold for cash £110.
 - 25 Paid money owing to B. Brown by cheque £1,924.
 - 26 Goods returned to us by G. Farm £34.
 - 27 Returned some of office furniture costing £180 to J. Winter Ltd.
 - 28 L. Linda put a further £2,500 into the business in the form of cash.
 - 29 Paid Aberdeen Cars Ltd £9,100 by cheque.
 - 31 Bought office furniture for cash £365.

3.6A Enter the following transactions in T-accounts:

- May
- 1 Started in business with £18,000 in the bank.
 - 2 Bought goods on time from B. Hind £1,455.
 - 3 Bought goods on time from G. Smart £472.
 - 5 Sold goods for cash £210.
 - 6 We returned goods to B. Hind £82.
 - 8 Bought goods on time from G. Smart £370.
 - 10 Sold goods on time to P. Syme £483.
 - 12 Sold goods for cash £305.
 - 18 Took £250 of the cash and paid it into the bank.
 - 21 Bought a printer by cheque £620.
 - 22 Sold goods on time to H. Buchan £394.
 - 23 P. Syme returned goods to us £160.
 - 25 H. Buchan returned goods to us £18.
 - 28 We returned goods to G. Smart £47.
 - 29 We paid B. Hind by cheque £1,373.
 - 31 Bought machinery on time from A. Cobb £419.

The effect of profit or loss on capital and the double entry system for expenses and revenues

Learning objectives

After you have studied this chapter, you should be able to:

- Calculate profit by comparing revenue with costs.
- Explain how the *Principles of double entry* can guide you in identifying whether an account should be debited or credited.
- Explain how the accounting equation is used to show the effects of changes in assets and liabilities upon capital after goods or services have been traded.
- Explain why separate accounts are used for each type of expense and revenue.
- Explain why an expense is entered as a *debit* in the appropriate expense account.
- Explain why an item of revenue is entered as a *credit* in the appropriate revenue account.
- Explain how to identify the correct double entry for service revenue, such as commission received and rent received.
- Enter a series of expense and revenue transactions into the appropriate T-accounts.
- Explain how the use of business cash and business goods for the owner's own purposes are dealt with in the accounting records.

Introduction

In this chapter, you will learn how to calculate profits and losses and how to enter expense and revenue transactions into the ledger. You will also learn about **drawings** (i.e. amounts withdrawn from the business by the owner), and how to record them.

4.1 The nature of profit or loss

To an accountant, **profit** means the amount by which **revenue** is greater than the cost of a set of transactions. The term 'revenue' means the sales value of goods and services that have been supplied to customers. The 'cost' is the total monetary amount of all the possessions (assets and expenses) that were used up in obtaining those revenues – i.e. it is the cost incurred in generating the revenue.

For example, if our customers pay us £100,000 for goods and services, that is our revenue. If the cost we incurred in providing those goods and services was £70,000, that is our cost. The

difference between the revenue and the cost is £30,000. Because our revenue is greater than our cost, that is our profit:

		£
Revenue:	goods and services supplied to our customers for the sum of	100,000
Less Costs:	value of all the assets and expenses used up to enable us to supply these goods and services	(70,000)
Profit is therefore:		<u>30,000</u>

On the other hand, it is possible for our costs to exceed our revenues for a set of transactions. In this case the result is a **loss**. For example, a loss would be incurred given the following:

		£
Revenue:	what we have charged to our customers in respect of all the goods and services supplied to them	60,000
Less Costs:	value of all the assets and expenses used up to supply these goods and services to our customers	(80,000)
Loss is therefore:		<u>(20,000)</u>

Activity 4.1

In each of these two examples, a different explanation was given for the terms 'revenue' and 'costs'. What is the difference between the two explanations given for 'revenue'? What is the difference between the two explanations given for 'costs'?

4.2 The effect of profit and loss on capital

Businesses exist to make a profit and so increase their capital. Let's look at the relationship between profit and capital in an example.

On 1 January the assets and liabilities of a business are:

Assets:	Fixtures £10,000; Inventory £7,000; Cash at the bank £3,000.
Liabilities:	Trade payables £2,000.

The capital is found from the accounting equation:

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

In this case, capital is £10,000 + £7,000 + £3,000 – £2,000 = £18,000

During January, the whole of the £7,000 inventory is sold for £11,000 cash. On 31 January the assets and liabilities have become:

Assets:	Fixtures £10,000; Inventory nil; Cash at the bank £14,000.
Liabilities:	Trade payables £2,000.

The capital is now £22,000:

$$\text{Assets (£10,000 + £14,000)} - \text{Liabilities £2,000}$$

So capital has increased by £4,000 from £18,000 to £22,000. It has increased by £4,000 because the £7,000 inventory was sold (for £11,000) at a profit of £4,000. Profit, therefore, increases capital:

$$\text{Old capital} + \text{Profit} = \text{New capital}$$

$$£18,000 + £4,000 = £22,000$$

A loss, on the other hand, would reduce the capital:

$$\text{Old capital} - \text{Loss} = \text{New capital}$$

4.3 Profit or loss and sales

Profit will be made when goods or services are sold for more than they cost, while the opposite will result in a loss.

(You will learn later that there are different types of profit, some of which you may have heard of, such as 'gross profit' and 'net profit'. For now, we're not going to complicate things by going into that level of detail. So, whatever you may already know about these different types of profit, try to focus for the time being on the simple definition of profit presented here.)

4.4 Profit or loss and costs

Once profits or losses have been calculated, you can update the capital account. How often this will be done will depend on the business. Some only attempt to calculate their profits and losses once a year. Others do it at much more frequent intervals. Generally speaking, the larger the business, the more frequently profits are calculated.

In order to calculate profits and losses, revenues and costs must be entered into appropriate accounts. All the costs could be charged to one 'Costs Account', but you would be able to understand the calculations of profit better if full details of each type of cost were shown in those profit calculations. The same applies to each type of revenue.

For this reason, a separate account is opened for each type of revenue and each type of cost. For example, accounts relating to the costs of **expenses** may include:

Commissions account	Subscriptions account	Rent account
Bank overdraft interest account	Motor expenses account	Postages account
Royalties account	Telephone account	Stationery account
Business rates account	General expenses account	Wages account
Electricity account	Audit fees account	Insurance account

Note: The costs of assets used-up in generating revenue are known as 'depreciation'. Depreciation is also included in total costs when calculating profit. You will learn about depreciation costs later in this book.

The title of each cost or revenue account is a matter of choice – they can be called anything – but it is best to give them names that reflect what they are for. For example, an account for postage stamps could be called 'Postage stamps account', 'Postages account', 'Communication expenses account', and so on. Also, different businesses combine different types of expenses into one account, such as having a 'Rent and telephone account', or a 'Rent, telephone and insurance

account', Rare or small value items of expense are usually put into a 'Sundry expenses account' or a 'General expenses account'.

Most organisations do use names for their accounts that make it obvious which accounts are for revenue and which accounts are for expenses. However, some don't: an account for commission, for example, may be for commission income or for commission expenses. When in doubt as to whether an account is for revenue or expenses, you have two obvious indicators to consult. The first is on which side the entries are mainly appearing in the account. If it is the debit side, the account is almost certainly an expense account. The other indicator is the nature of the business. For example, a commission account in the accounting books of a firm of stockbrokers is almost certainly a revenue account.

Activity 4.2

Identify which of the accounts listed in the table could be either expense accounts or revenue accounts.

4.5 Debit or credit

You need to know whether cost accounts for expenses should be debited or credited with the amounts involved. You already know that an increase in any possession of the business is a debit. And you know from Section 2.11 that when you incur an expense, it belongs to you but, it is used-up immediately. So, you treat expenses the same way as you treat any other possession.

Before reading any further, answer Activity 4.3:

Activity 4.3

When you pay an expense using cash, which account do you debit? The expense account or the cash account?

As you found in Activity 4.3, expenses are *always* debited to the expense account. Apart from the guidance you have from what the *Principles of double entry* tell you about debits (and credits) for possessions, what other reason can you think of to explain this?

Well, if you think about how businesses obtain assets and incur expenses, transactions for them both have to be settled by giving something for the item received in the exchange (i.e. the asset or the expense). The *form of settlement*, for example cash or an IOU owed to the supplier (if the supplier allowed you time to pay), will always be the credit because they are given to the supplier in settlement of the transaction. You must, therefore, make the same type of entry in an expense account as you would in an account for an asset.

Putting it another way, looking at how businesses generate revenue, they use resources to pay for expenses and to pay for assets. These are then used to provide goods and services that are sold, so generating revenue. Expenses are used-up in the short term, while assets are used up in the long term. Because both expenses and assets are utilised in order to get revenue, the entries in their accounts are the same. Increases in assets and increases in expenses are entered on the debit side of the appropriate accounts and the form of settlement is credited.

So, for example, if you pay rent of £500 in cash, the rent account will be debited, because the total rent expense has increased by £500. The account for the *Form of settlement*, cash, will be credited. If you had not yet paid the £500, you would still debit the account for the item exchanged, the rent. The credit for the unpaid debit, i.e. an IOU, would be to the account of the creditor who you have not yet paid.

**Activity
4.4**

You can use the accounting equation to confirm this. Write down the accounting equation and see if you can work out what happens to it if (a) a business spends £30 in cash hiring a van for a day and (b) if a business hires a van for a day at a cost of £30 and is given 1 month to pay the bill. Assume in each case that the business has assets of £200, liabilities of £80 and capital of £120 before the transaction. What happens to capital in each case?

4.6 Revenue from services

You already know how to record revenue from Sections 3.4 and 3.5, where we looked at the double entries for sales. We entered the sales as credits into the sales account because they represented the value of the items exchanged with (i.e. sold to) your customers. Like costs, revenue is collected together in appropriately named accounts, such as a 'sales account', where it is shown as a credit until it is used in the profit calculations at the end of the period.

When revenue is from the sale of services, not from the sale of goods, the treatment of the debits and credits does not change. However, it can be difficult to understand why.

In the case of virtually all services, what is being paid for is the time of the seller: **time is the item exchanged**. If you want to think of this in terms of units, imagine that you have an inventory of units of time. You can only provide a few each day and, once provided, you have less units available to sell during the rest of that day. Think of an auctioneer. The auctioneer has only a certain amount of time each day in which to sell items on behalf of clients. When she sells one, the client pays commission to compensate the auctioneer for her time. Time is the item exchanged.

So, think of each unit of time you sell as being like a unit of a good. If you have 10 units and you sell one, you only have nine left. If you have sold one of your 10 units of time, you have less to offer, but only temporarily because services are provided 'against the clock' – an auctioneer can only auction so many things in a day, a plumber can only fix so many broken pipes in a day, an accountant can only do work for clients for so many hours in the day, taxi drivers can only drive their taxis for so many hours in the day, and so on.

The next day, the auctioneer, the plumber, the accountant, and the taxi driver are again able to provide a full day of services, no matter how many units of their time were sold the day before.

So, the sale of a service decreases your possession of time temporarily and this must be recorded. However, we do not record this in an account for time. When we record the units of service sold, we use account names that describe the type of service provided: 'commission received' for the auctioneer, 'plumbing fees' for the plumber, 'accountancy fees' for the accountant, 'taxi fares' for the taxi driver. This allows us to distinguish between the revenues and costs of providing or obtaining each form of service that our business sells or purchases. As a result of doing this, it is a straightforward process discovering if the services we sell are each being sold at a profit or at a loss.

Keep all this in mind and you will be able to apply the *Principles of double entry* to guide you in the double entry for any services you purchase or sell.

**Activity
4.5**

If they increase, which of the following items are debited and which are credited: expenses, revenue, assets, liabilities, capital, profits, and losses?

4.7

Double entries for expenses and for revenue from sale of services

Let's look at some examples that demonstrate the double entry required:

1 Rent of £200 is paid in cash.

(a) The *Form of settlement*, cash, is given so it is a credit.

(b) The total of the *Item exchanged* (the expense of rent) is increased, and so is a debit.

Summary: Debit the *rent account* with £200.

Credit the *cash account* with £200.

2 Motor expenses of £355 are paid by debit card.

(a) The *Form of settlement*, bank, is given so it is a credit.

(b) The total of the *Item exchanged* (motor expenses) has increased, and so is a debit.

Summary: Debit the *motor expenses account* with £355.

Credit the *bank account* with £355.

3 £60 cash is received for commission earned by the business. (This is revenue from sale of a service.)

(a) The *Form of settlement*, cash, is received so it is a debit.

(b) The *Item exchanged*, your time, has been decreased (see Section 4.6). The appropriate name for the revenue account is 'commission received', and it is a credit.

Summary: Debit the *cash account* with £60.

Credit the *commission received account* with £60.

Before you look at the next example, you need to know that if you rent out an asset of your business, the rent you receive is for the use of that asset of the business, such as a building, a storage unit in a warehouse, or an office. It is compensation for the service you have provided (i.e. temporary use of the asset). Providing the service (in this case renting out an asset) has decreased the availability of that asset to the business and is recorded in the same way as any other service you sell. So, when rent is received, the *Item exchanged* is the asset provided on loan to the customer. When recording rent received, we use a revenue account with the name 'Rent received'. No entries are ever made in the account of the asset you have rented out because, just like the auctioneer's units of time from Section 4.6, you will have the asset back and fully available to you very soon.

Now look at some more transactions and their effect upon the accounts in the following table:

		Form of settlement	Increase or Decrease	Account debited	Account credited
June 1	Paid for postage stamps by cash £50	Cash	Decrease	Postage stamps	Cash
2	Paid for electricity by debit card £229	Bank	Decrease	Electricity	Bank
3	Received rent in cash £138	Cash	Increase	Cash	Rent
4	Paid insurance by debit card £142	Bank	Decrease	Insurance	Bank