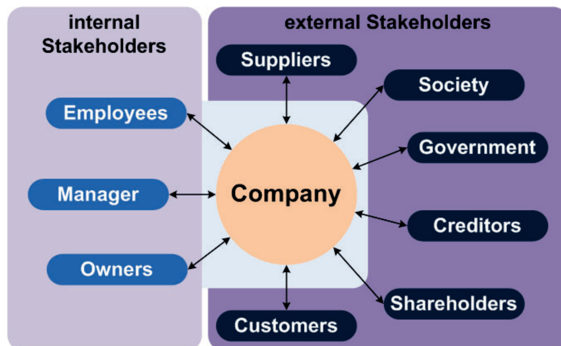
# Chapter 1

## What is Accounting?

In this chapter we will be looking at why we keep accounts. We will look at how accounts are recorded and at some of the financial documents needed to record them. We will look at how 'accounts' are kept and how the accounts are used to keep statutory financial statements. We will look at how double entry works and how double entry is based on the accounting equation.

Before we look at the process of recording financial accounts we will need to know why we are keeping them. Financial information is useful to **stakeholders**. Stakeholders are individuals, groups, or organisations that are affected by the activity of the business. A stakeholder may be the owner, a manager, an employee, a customer, a supplier, a lender or simply the local community. Stakeholders need to know that the company with which they are dealing will be able to produce enough sales to satisfy its customers and generate enough revenue to pay its creditors. Managers will need to plan for the future using the information provided by financial information. The local community will need to know if the business can sustain employment and maintain or increase benefits to the local economy.




**Why accounts are kept**

There are many reasons for keeping accurate accounts. Here are just a few:

- It enables the owner(s) to manage the business and make it grow. Accurate financial records let you see how the business is doing, how well the sales are doing, how much profit is being made and what goods are selling best. If you don't have good records, you can't make informed decisions about the future of the business.

- It helps in being organised when dealing with customers and suppliers, producing invoices, quotations and estimates promptly is vital. An early estimate can be the difference between winning and losing a job.

- It makes it easy to see whether you are making or losing money. You can also compare one period with another, this year with the previous year.

- It makes it possible to find important information and documents quickly. If someone is disputing an invoice you can quickly and easily find information regarding the original order and the goods and work supplied.

- It makes it easier to get a bank loan or overdraft. Banks like it when you seek an overdraft for the right reason and at the right time.

- It makes filling in the annual tax return easier and can save tax. All the information required for completing the tax return is readily available and by keeping accurate financial accounts you are sure to include everything you are entitled to in any claim or return you make to Her Majesty's Revenue and Customs (HMRC).

- Keeping accurate accounts complies with the law. Good record keeping is a legal requirement, so by being organised you stay within the law.

**What are the accountant's responsibilities?**

One of the primary roles of an accountant usually involves the collection and maintenance of financial data, as it relates to the company or firm. The accountant ensures that financial records are maintained in compliance with the law and the business's own procedures and policies.

Accountants may perform certain types of analysis using financial data that is used to assist in making business decisions. It may include which kinds of supplies to order, when to pay bills or prepare wages information. The accountant may advise on business operations such as future sales expectations or recommend how financially wise it is to buy extra resources for the business.

Accountants typically prepare financial statements that may include monthly and annual accounts. The preparation of financial management reports can include quarterly and year-end statements. The statements may be used in connection with budgetary forecasts.

An accountant may also be responsible for ensuring that all financial reporting deadlines are met, internally and externally. For example, there are specific deadlines for tax returns and filing accounts. The accountant also usually coordinates the audit process by assisting with financial data preparation.

Accounting information is also used by other departments within the organisation. The sales ledger information can be used by the sales representatives, showing those customers who place frequent orders, those that may be persuaded to place more orders, and those who are slow payers. The information provided by the cashier can be used by the buying department. Buyers will need to know whether purchases can be paid for in cash or whether credit facilities must be sought. Purchase ledger information will show the administration department how much is owed in overhead expenses and whether the overhead must be cut back or whether it can be developed.

**Financial accounts** are an historical record of a business's performance over a past period - usually one year - for the benefit of external users such as shareholders, employees, suppliers, bankers and authorities. Figures are mostly accurate to the nearest penny and estimations are not usually given. Financial accounts in some form or another are required by law. They are used mainly by outside authorities such as HMRC particularly in the calculation of tax. Financial statements are used by shareholders, suppliers and banks to see the financial situation of a business to decide on whether to invest in the company or lend money to it.

However, financial statements are of limited use to managers who will want to plan for the future. The financial data is purely historical and only shows what 'has been'. **Management accounts** analyse recent historical performance and usually include forward-looking elements such as sales, cash flow and profit forecasts.

**Efficiency in Financial Information**

For financial information to be of use it must be:

Complete

Accurate

Timely

Confidential

The sales representative may waste time and effort if only some of the customer accounts are available to him/her.

Managers may spend money on projects they can't afford if the amount of profit generated by the business is not accurate.

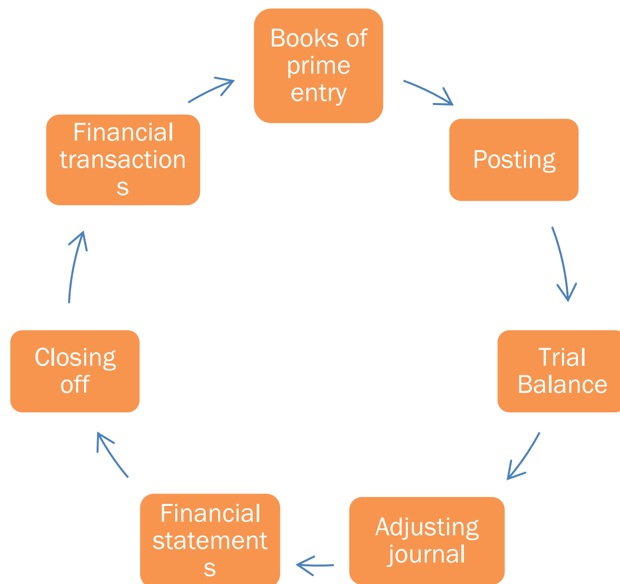
Investors will seek other investments if the information presented is not up-to-date. An investor will not speculate in the business if the information is several months old.

With the exception of the statutory limited company accounts, financial information is confidential. No information should be revealed to those outside the business and within the business it should only be revealed to those entitled to the information.

If the accounting information is supplied complete, accurate and on time, it will certainly contribute to the efficient running of the organisation.

**The accounting cycle**

All businesses are different and each will have its own system of recording financial transactions. However, the following procedure is a typical one




1. **Financial Transactions**

Financial transactions start the process. Transactions can include the sale or return of a product, the purchase of supplies, the purchase or sale of the business's assets, the creation or payoff of a debt, or paying money to the business's owner. These financial transactions will be documented. There will be an invoice, a credit note, a bank paying-in slip, a cheque book stub, a remittance advice or a bank statement.

2. **Books of Prime Entry**

The transaction is listed in the appropriate day book, journal or cash book in chronological order. The day books will be for sales or purchases. The journal will record non-routine transactions (such as the purchase of non-current assets – see p19). The cash book records the movement of cash in or out of the business. (Cash includes cheques, debit card and bank transfers). A book of prime entry is the first place a transaction is listed.

3. **Posting**

The transactions are posted to the relevant account. These accounts may be in the sales ledger (customer accounts), the purchases ledger (supplier accounts), the cash book (note that the cash book may be both a book of prime entry and part of the main ledger) and the general (main) ledger. Entries made to the general ledger will be by double entry (see later in this chapter)

4. **Trial Balance**

At the end of the accounting period (which may be a month, quarter, or year depending on a business's practices), a Trial Balance is created. This is a list of the balance on every account in the general ledger. A Trial Balance (as the name suggests) must balance, in that the total of the debits must equal the total of the credits.

5. **Adjusting journal entries**

Unfortunately, when creating accounts manually, sometimes your first calculation of the Trial Balance shows that the books aren't in balance. If that's the case, you should look for errors and make corrections called **adjustments**. Adjustments are shown in journals. This is so that you have a record of why you have made adjustments to the accounts. Correcting journals are the books of prime entry which you will need as an audit trail for entries in the general ledger. After the correcting journals have been completed and the accounts in the general ledger have been adjusted, another Trial Balance should be drawn up to be sure the accounts are in balance.

6. **Financial statements**

The balances shown on the Trial Balance are used to create the financial statements. The two statements we will deal with in this book are the Statement of Profit or Loss (SPL) or (SOPL), and the Statement of Financial Position (SFP) or (SOFP). We will deal with these later in this book.

7. **Closing off**

You close off the accounts for the revenue and expense accounts (those which are shown in the SPL) and begin the entire cycle again with zero balances in those accounts. We will see how this is done later in this book. Other accounts (those shown in the SFP) will not be closed off. Instead, a balance will be carried forward to the next accounting period.

**Accrual Accounting**

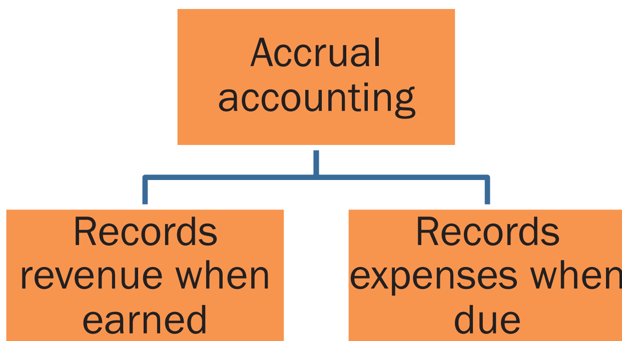
Accrual accounting is considered to be the standard accounting practice for most businesses. Only very small entities will use the cash accounting method.

Accrual accounting recognises sales and costs when they are made rather than when they are paid for. This method provides a more accurate picture of a business's financial position.

It is common for businesses to allow other businesses to pay for goods at a later date, particularly if they are a regular customer. This is known as a sale on credit. The cash

and accruals methods will treat the transaction differently. When using the cash method, the revenue generated by the sale will only be recognised when the money is received by the business. If the laptop is purchased on credit the revenue may not be recognised until next month or next year.

Accrual accounting says that the cash accounting method isn't accurate because it is likely (if not certain) that the business will receive the cash at some point in the future. Therefore, accruals accounting recognises the sale at the point the customer takes ownership of the goods. Although the cash isn't in the bank yet, the sale has been made.




**Double Entry**

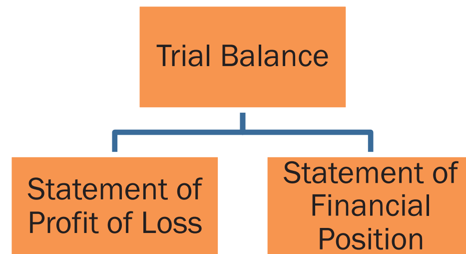
In the double entry accounting system, two (or more) accounting entries are required to record each financial transaction. Details of how this is done is covered in the *Introduction to Bookkeeping* book, available from Premier Books. It is covered at Level 2 of the AAT course. Basically, a debit amount to one or more accounts is matched by an equal credit amount to one or more accounts resulting in total debits being equal to total credits for all accounts in the general ledger. If the accounting entries are recorded without error, the aggregate balance of all accounts having debit balances will be equal to the aggregate balance of all accounts having credit balances. This will be shown at regular intervals (at least once a year) in the **Trial Balance**, which lists the balances from all the accounts in the main ledger. If a computer system is used, the double entry will be completed automatically and the trial balance will be continuously updated.

**Other ledgers**

Where customers are offered credit terms it is usual to separate the individual customer accounts from the general ledger. Similarly, credit suppliers' accounts will be separated from the general ledger. Double entry **only** takes place in the general ledger accounts, so the customer accounts (in the **receivables ledger**) and supplier accounts (in the **payables ledger**) will be held separately and usually one entry will be made in these accounts for each transaction.

However, these accounts must be replaced in the general ledger by a **control** account. There will be a **Receivables Ledger Control Account** and a **Payables Ledger Control Account**. Here the aggregate sum of all the balances in the receivables ledger and the payables ledger will be shown.

The **cash book** may or may not be held in the general ledger. If it is not, there will be additional accounts in the general ledger recording the aggregate balances. This may be a **bank account** and a **cash account**. The double entry will then be posted to these accounts.




**The Trial Balance**

As we have seen every debit entry made in the double entry system must have a credit entry for the same amount. We have also seen that accounts are balanced and that this is done on a regular basis.

You are already probably aware that there will be a large number of accounts in an accounting system and we need some way of checking that our figures are correct from time to time. This checking is done by drawing up a **Trial Balance**. How often this is done will depend on the company, how many accounts there are and how many transactions in each account. Some larger companies will '*extract*' a Trial Balance weekly, but smaller companies may do this once a month.

A Trial Balance is simply a list of **all** the accounts in the general ledger recorded as either a debit balance or a credit balance. This will mean, of course, calculating a balance for every account before the Trial Balance is extracted.

Of course, the balance brought down (b/d) figure will show whether it is a debit or a credit balance, but you will be expected to know what it should be in most cases. For example, the sales account will always be a credit balance, while the purchases account will always be a debit balance. All expenses will be debit balances and the Capital (or Equity) Account (the amount of money invested or due back to the owner) will always be a credit. The bank account will be a debit balance when there is money in the account and it will be a credit balance when it is overdrawn. Cash accounts cannot be credit balances as this would indicate a negative amount of notes and coins.

The Trial Balance is used to help draw up the **financial statements** of a business. There are two main financial statements we will deal with in this book.

## Statement of Profit or Loss

The **Statement of Profit or Loss** (SPL) is also known as a **'Profit and Loss Account'** (P&L) and an **'Income Statement'** (IS). It indicates how the revenues (money received from the sale of products and services) are transformed into the net income (the result after all expenses have been accounted for). This net income is known as **'net profit'**.

Statements of Profit or Loss represent a specific period of time. They show all the income and expenditure during that period of time. Some companies will draw up an SPL weekly or monthly, but usually a company will be required to draw up an annual SPL. Financial statements are required by law for limited companies.

The SPL shows:

INCOME minus EXPENSES equals PROFIT

## Statement of Financial Position

Those accounts not used in the SPL are used in the **Statement of Financial Position** (SFP). A SFP is also known as a Balance Sheet. It shows what the business owns and what it owes at any one point in time. It classifies items into:

- Assets – this is what a business owns. It includes the non-current assets (also called *fixed assets* - see p15), the stock of goods for resale (also called *inventory*), the money owed by customers (also called *debtors* or *receivables*), money in the bank and money on the premises, and any money paid in advance (e.g. next month's rent). Assets are divided into **non-current assets** (those that will be kept for more than 12 months) and **current assets** (those that are expected to be used up within 12 months).
- Liabilities – this is what a business owes. It includes any loans, or any money owed to suppliers (also called *creditors* or *payables*) or other bodies (e.g. HMRC for VAT or PAYE)
- Capital – this is money which has been used to finance the business (also called *equity*).

The SFP shows

ASSETS minus LIABILITIES equal CAPITAL

This is known as the **accounting equation** and is the foundation of all double entry accounting.

Being an equation, you can rearrange the order according to normal mathematical rules. So you may see the accounting equation set out as

ASSETS equal CAPITAL plus LIABILITIES

(You don't need to learn the mathematics behind this if you are not familiar with it. Simply learn the two forms of the equation.)

**Double Entry and the Financial Statements**

We have already seen the duality of every transaction. All items in the financial statements are subject to this duality. For example, an increase in income will also see an increase in assets. The effect of a debit or credit on each type of account is shown in the table below.

| | Debit | Credit |
|---|---|---|
| Income (revenue) | Decrease | Increase |
| Expense | Increase | Decrease |
| Asset | Increase | Decrease |
| Liability | Decrease | Increase |
| Capital(Equity) | Decrease | Increase |

So, if you make a cash sale you will increase income with a credit, but you will also increase the assets (your cash) with a debit.

If you take out a new bank loan you will increase liabilities with a credit and increase the assets (your bank account) with a debit.

If you take money from the business as drawings you will decrease assets (the cash or bank balance) with a credit and decrease capital with a debit.

Beware of transactions involving the same type of item. If you receive money from your credit customers you will reduce the assets (debtors or receivables) with a credit, but at the same time you will increase the assets (your bank or cash balance) with a debit. There will be no change in the overall level of assets.

## Chapter Summary

- Financial Accounts are useful to stakeholders.
- Accounts are kept for a variety of reasons.
- Accountants have a variety of responsibilities.
- Accountants will deal with both financial accounts and management accounts.
- Financial transactions are recorded according to the procedures in the accounting cycle.
- There are two methods of accounting – the accruals method and the cash method. The accruals method is more common and is seen to be more accurate.
- The main body of accounts are kept using a system of double entry.
- A Trial Balance is drawn up at regular intervals to verify the accuracy of the accounts.
- A Statement of Profit or Loss shows revenues and expenses and results in a net profit or loss.
- A Statement of Financial Position shows what a business owns and what a business owes. Items are divided into assets, liabilities and capital.
- The accounting equation is the basis of double entry accounting.

**You should now attempt the practice questions for this chapter in the Revision Kit.**