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Chapter 1

Introduction to accounting

Learning summary

By the end of this chapter you should understand:

- how to explain the difference between book-keeping and accounting
- the purposes of measuring business profit and loss
- the role of accounting in providing information for monitoring progress and decision-making
- the meaning of assets, liabilities and owner's equity
- explain and apply the accounting equation
- that statements of financial position record assets and liabilities on a specified date.

TERMS

Accounting is the process of using the information collected by the book-keeper to calculate key measures such as a business's profit or loss and what the business owns (assets) and owes (liabilities).

Assets are items a business owns or amounts owed to them by others. They can be categorised as current assets (to be used within the business with the aim to make profit, i.e. cash or inventory) or non-current assets (large, expensive items such as machinery and premises which stay longer in a business but also help to generate profit).

Book-keeping is the recording of a business's financial transactions. These transactions are placed in the books of prime entry.

Liabilities are amounts owed by the business to others and they can also be current (within the financial year or next 12 months) or non-current (due for repayment after the end of the current financial year or over 12 months).

Loss is when total costs exceed total revenue.

Owner's equity or capital represents the amount of money or assets, such as machinery or vehicles, an owner introduces into the business. It is essentially what the business owes to the owner.

Profit is when total revenue exceeds total costs.

Differences between book-keeping and accounting

It is essential that every business keeps track of its transactions in order to accurately calculate profit or loss at the end of the financial year. However, perhaps more important for the business owner themselves, keeping track of transactions enables them to make

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accurate decisions which will allow their business to grow. One of the main objectives of a business is to maximise profit, but profit cannot be calculated unless we record every transaction coming into and out of the business. Book-keeping is the straightforward recording of the original transactions into the books of prime entry and then into ledger accounts. The books of prime entry will be explored in a later chapter but just think of them as a reminder of where money has been spent or earned or inventory has been purchased on credit, for example. Purchasing on credit is a popular way for businesses to carry out transactions as it involves the inventory being delivered to the customer but payment is not required for several weeks. By the time payment is required the goods will hopefully have been sold for a profit. It is calculating the profit or loss which is the responsibility of the accounting function.

Book-keeping does not prevent errors happening or ensure accuracy. If an error has been made in the initial recording of a financial transaction then it will be revealed by the original document and may not come to light unless a supplier or customer questions the amount involved.

The purposes of measuring business profit and loss

Using the information recorded by the book-keeper the accountant is then able to produce two key documents which help to contribute to a business's financial statements. The first of these is the income statement which has a misleading name as it not only records the income but also the expenses of the business. This then allows the accounting staff to calculate the profit, if income exceeds expenses, or loss, if expenses exceed income. The statement of financial position also contains the key profit or loss for the year which is calculated in the income statement. In addition, this statement shows the assets and liabilities of the business. This, put simply, is what the business owns and owes and how it has been funded through the owner's equity.

Information for monitoring progress and decision-making

On a more practical level, decisions such as whether to increase staff pay, whether to find a cheaper supplier and whether external loans are needed can be explored. How can important decisions be made within a business unless they know if they are able to generate a profit? A business will not last long if it purely focuses on its bank and cash balances.

The accounting year for a business is a 12 month period which is often determined by when the business started. An income statement shows income and expenses for a period of time, whereas a statement of financial position shows assets and liabilities at a particular time.

Assets, liabilities and owner's equity

When a business is started resources are needed in the form of money, inventory of goods, property and motor vehicles (depending on the type of business). These resources may be funded by the owner or by external borrowing, perhaps using a bank loan. The owner can introduce money or any other types of assets which they think appropriate, such as a delivery van. Whatever they decide to contribute to the business is known as the owner's equity or capital. The more owner's equity available, the less will need to be borrowed from other sources.

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The assets are the items which the business owns or are owed to them. For example, if the business sells goods on credit to a customer (receive the goods and pay later), this customer is now a trade receivable and owes money for the goods they have received.

Liabilities are amounts which the business owes. The business may have a bank overdraft, a bank loan or may have bought goods on credit, in which case they are a trade payable and owe money for the goods received.

The accounting equation

Assets = Owner's equity + Liabilities

This equation shows that the assets of the business are always equal to the owner's equity and liabilities. If one element is missing you can calculate it using the other two elements.

Follow the example below to see that the equation always balances:

June 1 Jiao set up as a fitness instructor. She opened a business bank account and paid $5 000 in as capital
2 The business purchased sound equipment for $1 000, and paid by cheque
3 The business purchased clothing to sell to clients, $2 200, on credit
4 The business purchased yoga mats to use in classes, $800, and paid by cheque

Show the accounting equation after each of the above transactions.

Date	Assets		= Owner's equity	+ Liabilities
June 1	Bank	$50 000	$50 000	Nil
2	Equipment	1 000		Nil
	Bank	49 000		
		$50 000		
3	Equipment	1 000		
	Inventory	2 200		
	Bank	49 000		
		$52 200	$50 000	Trade payable $2 200
4	Equipment	1 800		
	Inventory	2 200		
	Bank	48 200		
		$52 200	$50 000	Trade payable $2 200

June 1 Jiao has paid $50 000 into the business bank account which increases both the assets of the business and the owner's equity.
2 The money in the bank has decreased because the sound equipment, which is an assets, has been purchased. The total assets still equal the owner's equity.
3 Buying goods on credit means that Jiao has a chance to sell them on to her clients before the date she needs to pay. This means her asset of inventory increases and so do her liabilities as she now owes money to the credit supplier who is a trade payable.

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4 The yoga mats are to be used by the business so will be included in the asset of equipment. The bank was used to make the payment so the asset of equipment will increase and the asset of bank will decrease. The total assets are equal to the owner's equity plus liabilities.

The statement of financial position

The accounting equation forms the basis of the statement of financial position. It shows the assets of the business, what it owns or has owed to it, and the liabilities, what the business owes and what the owner has contributed in terms of assets (owner's equity). In the same way that the accounting equation always balances, the statement of financial position must too.

Sample questions

1 Calculate the missing amounts:

Assets $	Owner's equity $	Liabilities $
150 000	100 000	
	84 000	35 000
48 000		22 500

Answer:

Assets $	Owner's equity $	Liabilities $
150 000	100 000	**50 000**
119 000	84 000	35 000
48 000	**25 500**	22 500

2 A business may employ both a book-keeper and an accountant. What is the role of the book-keeper?

A to make financial decisions about the business's future

B to prepare income statements at regular intervals

C to record all the financial transactions of the business

D to summarise the assets and liabilities of the business

Answer: The answer is C. The book-keeper could be involved in all sorts of aspects of a business and its finances. However, their primary role is to record all the financial transactions of the business. This information is then used by the accountant to produce financial statements.

3 State whether each item is an asset or liability by ticking next to each item the category in which it belongs:

	Asset	Liability
Motor vehicle		
Bank overdraft		
Trade payables		
Trade receivables		

Answer:

	Asset	Liability
Motor vehicle	✓	
Bank overdraft		✓
Trade payables		✓
Trade receivables	✓	

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TIPS

Think of assets as being positive items you would be happy to have. Liabilities aren't necessarily bad, as often a business needs to borrow to expand, but on a personal level you would rather have lots of assets and few liabilities.

Owner's equity isn't necessarily just cash or bank amounts introduced by the owner. It could be equipment or a motor vehicle. This can increase throughout the business's life depending on what the owner's plans are and does not just happen at the start of the business.

Progress check

1 What is the difference between book-keeping and accounting?

2 State the accounting equation.

3 Define assets, liabilities and owner's equity.

4 What does a statement of financial position show?

Examination-style questions

1 What is the purpose of accounting? [1]

A to check the bank statement

B to control trade receivables

C to ensure all financial transactions are recorded

D to prepare financial statements

2 Give one example of an asset. [1]

3 Prepare the following table to show the effect of each of the following transactions. [6]

The first one has been completed as an example.

a Bought equipment and paid by cash

b Received a loan into the bank account

c Bought property using a loan

d Sold goods for cash

	Effect on assets	$	Effect on liabilities	$
a	*Equipment*	*Increase*		*No effect*
	Cash	*Decrease*		
b				
c				
d				

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4 A simplified statement of financial position of Meera Traders on 31 May 20–9 is shown below.

Meera Traders
Statement of financial position at 31 May 20–9

	$
Assets	
Property	160 000
Equipment	12 500
Inventory	3 300
Trade receivables	2 800
Bank	6 200
Cash	450
	185 250
Capital and liabilities	
Owner's equity	128 380
Liabilities	
Bank loan	50 000
Trade payables	6 870
	185 250

On 1 June 20–9 the following transactions took place:

- Repaid $2 000 bank loan by cheque.
- Paid a credit supplier $90 in cash.
- Received a cheque from a credit customer for $125.
- Bought goods on credit for $140.

Prepare the statement of financial position of Meera Traders on 1 June 20–9 after the above transactions have taken place. [11]

5 A business provided the following information:

	$
Property	125 000
Inventory	32 500
Trade payables	8 430
Bank overdraft	2 200
Cash	125
Machinery	12 600
Delivery van	5 800

a Calculate the value of the assets. [1]

b Calculate the value of the liabilities. [1]

c Use the accounting equation to calculate the owner's equity. [1]

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Revision checklist

In this chapter you have learnt:

- ☐ the difference between book-keeping, recording financial transactions and accounting which uses the book-keeping records to prepare financial statements and to assist in decision-making
- ☐ the purpose of measuring business profit and loss is so that a business owner can makes plans according to the outcomes
- ☐ the role of accounting in providing information for monitoring progress and decision-making
- ☐ the meaning of assets, which represent items owned by or owing to the business; liabilities, which represent anything owed by the business; and owner's equity, which is also known as capital and is what the business owes to the owner
- ☐ the accounting equation which is Assets – Liabilities = Owner's equity or capital
- ☐ that statements of financial position record assets and liabilities on a specified date and also show the owner's equity.

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Double entry book-keeping – Part A

Learning summary

By the end of this chapter you should understand:

- an outline of the double entry system of book-keeping
- how to process accounting data using the double entry system
- how to prepare ledger accounts
- how to post transactions to the ledger accounts
- how to balance ledger accounts as required
- how to interpret ledger accounts and their balances.

TERMS

A **balance** on a ledger account is the difference between the debit side and the credit side.

Carriage is the cost of transporting goods. **Carriage inwards** is the cost of bringing the goods to the business and **carriage outwards** is the cost of delivering the goods to the customer.

Double entry book-keeping is the process of making a debit entry and a credit entry for each transaction.

Drawings represent any value taken from the business by the owner of that business. It could be in the form of money, non-current assets or inventory.

Purpose of the double entry system of book-keeping

A concept which you may not have considered prior to studying accounting is that every financial transaction actually has two outcomes. For example, if you travel by bus to your place of study you are losing your asset of money in return for the bus travel. If you buy some lunch in the canteen you are losing the asset of money and gaining the asset of food. The business records each transaction in ledger accounts for each type of asset, expense, liability, income and each trade receivable and trade payable.

A ledger was originally a large bound book but nowadays even the smallest of businesses will use a computer system which acts in a similar manner. It keeps track of every financial transaction. One account will be debited and the other credited. You cannot debit both accounts or credit both accounts. The rules are debit the account which gains value, or records an asset or an expense, and credit the account which gives value, or records a liability or an income item.

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Accounts	To record	Entry in the account
Assets	An increase	Debit
	A decrease	Credit
Liabilities	An increase	Credit
	A decrease	Debit
Capital	An increase	Credit
	A decrease	Debit

Sample question

1

20–8		
Feb	1	Pari opened her business and deposited $65 000 in the business bank account as owner's equity
	2	A delivery van was purchased for $12 000 and was paid by cheque
	4	A long term loan was received from the bank for $10 000
	5	Computer equipment costing $5 500 was purchased by cheque

Prepare Pari's ledger by entering these transactions.

Answer:

Pari
Bank account

Date	Details	$	Date	Details	$
20–8			20–8		
Feb 1	Capital	65 000	Feb 2	Delivery van	12 000
4	Bank loan	10 000	5	Computer equipment	5 500

Capital account

Date	Details	$	Date	Details	$
			20–8		
			Feb 1	Bank	65 000

Delivery van account

Date	Details	$	Date	Details	$
20–8					
Feb 2	Bank	12 000			

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Bank loan account

Date	Details	$	Date	Details	$
			20–8		
			Feb 4	Bank	10 000

Computer equipment account

Date	Details	$	Date	Details	$
20–8					
Feb 5	Bank	5 500			

TIPS

You can abbreviate months in ledger accounts. Dates are very important in ledger accounts and if a date column in supplied in the question you should always use it.

Many transactions involve bank or cash items. To help you remember the double entry just think money comes in on the debit side and out on the credit side. If you do the entry which involves the bank or cash first it is much easier to work out the opposing entry.

The word 'goods' should not be used in ledger accounts. Goods are either purchased, sold or returned and each movement of goods has its own account.

Carriage inwards and carriage outwards are both types of delivery expenses so are both debited. They are not the opposite of each other like sales returns and purchases returns.

Sample question

2

20–9		
Apr	1	Jamil received $6 600 from his tenant for rent received by cheque
	2	He paid wages of $480 by cheque
	4	He paid motor expenses of $230 by cheque

Enter these transactions in Jamil's ledger.

Answer:

Jamil
Bank account

Date	Details	$	Date	Details	$
20–9					
Apr 1	Rent received	6 600	Apr 2	Wages	480
			4	Motor expenses	230