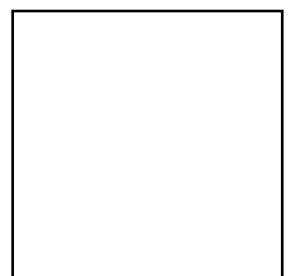
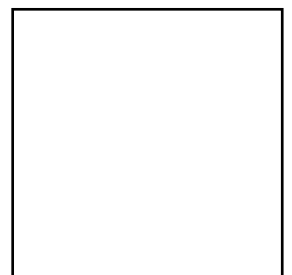
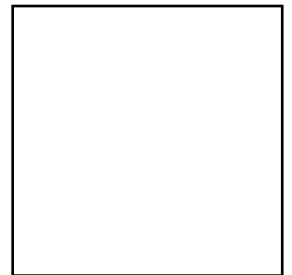


Nelson Thornes  
Distance Learning

# AS Accounting

Kevin Crosby



Nelson Thornes

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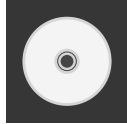
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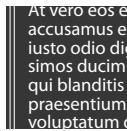
Hand-in activity (either by post or e-mail)



Listening



Discussion



Reading



Internet research or online activity



# Introduction



## **Hello and Welcome to AS Accounting**

Over the next year we shall be studying AS Accounting with in-depth consideration of: double entry bookkeeping; the preparation of final accounts for sole traders and limited companies; evaluation of performance using ratios and budgeting.

Each week, during the video conference, we shall review the unit you have worked on. It is essential that you complete all the activities in preparation for the video conference. Assignments must be completed on time and given to your link tutor to post or you can email them direct to your tutor.

Learning via distance learning is not a “soft” option. It is a full-time course. It is recommended that you allocate at least 4 additional hours of study per week, and you must work on the pack during your study periods and at home if you are to benefit from the course.

Over this year you will learn how to keep accurate accounting records using double entry bookkeeping, and prepare final accounts for sole traders. You will also learn about different types of business ownership and prepare accounts for limited companies. You will then assess the performance of businesses using ratio analysis and analyse the impact of ICT in accounting. You will also see how accountants help the management of business through budgeting and budgetary control.

At the end of the year you will sit **two** module examinations, Accounting 1 and 2, that will give you an AS in Accounting. Accounting 1 is covered by topics 1 to 4 and Accounting 2 by topics 5 to 10.

The subjects covered are:

- the purposes of accounting
- double entry bookkeeping
- the verification of accounting records
- final accounts (trading, profit and loss accounts and balance sheets)
- types of business organisations
- adjustments to final accounts
- accounting concepts and stock valuation
- internal final accounts of limited companies
- ratio analysis and assessment of business performance
- introduction to budgeting
- impact of ICT on accounting

The main textbooks:

***AQA AS Accounting***

**David Austen**

**Peter Hailstone      Nelson Thornes      ISBN 978-0-7487-9869-8**

**All students must have a copy of this textbook**

***AS Accounting for AQA***

David Cox & Michael Fardon 2nd edition Osborne Books ISBN 978-1-8729-6273-3

**In order to complete the activities in this unit students must read Chapter 1 of *AQA AS Accounting* (Nelson Thornes).**

# What is accounting?

We need to spend some time finding out what accounting is about and having a look at some of the skills accountants have; and **you** will need to develop.

So what do accountants do? How do you become an accountant? Perhaps more importantly how much do they earn?

## Activity 1

Investigate what accountants do and how you become an accountant.

Before we start to investigate this have a think about what you want to know.

There are some suggested questions below – add your own!



What do accountants do?	
Do they do different things if they work for a firm of accountants or for a business?	
What is the difference between a chartered accountant, certified accountant and management accountant?	
How many exams do accountants need to take?	
How long does it take to become an accountant?	
Do accountants stay as accountants for all their working lives?	
How much do accountants earn?	


To find the answers we can use the internet. Try the following websites and use search engines such as Google.

**www.aimhigher.ac.uk**

(look for career profiles)

**www.icaew.co.uk**

(try students and then how to become a chartered accountant)

**www.accaglobal.com**

(try why accountancy?)

**www.cimaglobal.com**

(try case studies)

**www.myaccountancyjobs.com**

(this site has adverts for a variety of jobs in accounting – try different jobs in different areas and see what you could earn!)

You should have found out that accountants do a huge variety of jobs and can earn good salaries.

The skills needed by accountants include:

- good mathematical skills
- being able to plan and present information
- understanding business and economics
- analysing data and solving problems
- being able to create a good rapport with clients
- good negotiating skills and being able to act on your own judgement
- information technology skills
- being discreet, tactful and assertive.

You will need to develop similar skills if you are to be successful in this course. We will start by looking at the ability to present information.







Here is a version of Iam's financial position.

There is no absolutely correct answer as the information we have been given contains some estimates. I have decided to do this on a monthly basis as that is how a lot of people are paid, but you could have done this yearly or weekly and it would still have been useful.

**Tip**  
Please note carefully the comments on presentation as you will gain marks in examinations for laying out information logically and in acceptable formats.

<p><b>Name</b> is required so that you and others know who the client is</p> <p><b>Title</b> tells the reader (manager) what they are looking at</p>	<p><b>Iam N Debt</b></p> <p>Monthly income and expenditure statement</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 80%;"></th> <th style="width: 10%; text-align: right;">£</th> <th style="width: 10%; text-align: right;">£</th> </tr> </thead> <tbody> <tr> <td><b>Income</b></td> <td></td> <td style="text-align: right;">1,000</td> </tr> <tr> <td>Salary</td> <td></td> <td style="text-align: right;"><u>50</u></td> </tr> <tr> <td>Marking</td> <td></td> <td style="text-align: right;">1,050</td> </tr> <tr> <td><b>Less expenditure</b></td> <td></td> <td></td> </tr> <tr> <td>Rent</td> <td style="text-align: right;">450</td> <td></td> </tr> <tr> <td>Food (30×4)</td> <td style="text-align: right;">120</td> <td></td> </tr> <tr> <td>Clothes etc (100×4)</td> <td style="text-align: right;">400</td> <td></td> </tr> <tr> <td>Gas bills etc</td> <td style="text-align: right;">50</td> <td></td> </tr> <tr> <td>Car insurance (576/12)</td> <td style="text-align: right;">48</td> <td></td> </tr> <tr> <td>Petrol (20×52=1040/12=86.66)</td> <td style="text-align: right;">87</td> <td></td> </tr> <tr> <td>Car servicing (180×2=360/12)</td> <td style="text-align: right;">30</td> <td></td> </tr> <tr> <td>Credit card</td> <td style="text-align: right;"><u>50</u></td> <td style="text-align: right;"><u>1,235</u></td> </tr> <tr> <td>Deficit of income over expenditure</td> <td></td> <td style="text-align: right;"><u>(185)</u></td> </tr> </tbody> </table>		£	£	<b>Income</b>		1,000	Salary		<u>50</u>	Marking		1,050	<b>Less expenditure</b>			Rent	450		Food (30×4)	120		Clothes etc (100×4)	400		Gas bills etc	50		Car insurance (576/12)	48		Petrol (20×52=1040/12=86.66)	87		Car servicing (180×2=360/12)	30		Credit card	<u>50</u>	<u>1,235</u>	Deficit of income over expenditure		<u>(185)</u>
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Deficit of income over expenditure		<u>(185)</u>																																									

<p>Work in columns so that it is easy to add up also it is important to show currency</p>	
<p>Clear headings and sub-headings</p>	
<p>Show workings so that you can remember later how you got the answer and the manager can see what you have done</p>	
<p>How accurate you are with your workings can depend on how accurate the information is that you are given, e.g. food is an estimate so ×4 weeks but petrol is accurate so treated more accurately. Round answers as all other numbers are in pounds</p>	
<p>Single line sub-totals with answer carried across into 2nd column</p>	
	<p>Final total double underlined Negative numbers shown in brackets</p>



## Other skills

As well as presenting information neatly and logically, what other skills will you need?

You need to be numerate – that means you can handle numbers and see relationships between numbers. However, accountants are sensible and do not do more work than necessary so they use calculators and so should you. You will not be allowed programmable calculators in the examination and all you need for accounting is a basic calculator.

You need to be organised – both as an accountant and as a student. So make sure you have a file to keep your notes and activities in order. Accounting builds up as you go on, so you need to be able to refer back to things you have done earlier, for instance when you are doing control accounts in the verification topic

you will need to refer back to the accounting system and double entry. So try to keep your notes in order and up to date.

In the examination you will be asked for definitions of accounting terms, we will highlight these as we work through the topics. You should start a glossary of terms – this is a dictionary of accounting terms – this will help you with revision and to remember the terminology as we progress through the course.

# Activity 3



Start your glossary – draw up a table like this:

Terminology	Definition	Examples

When you come across some new terminology add this to your list – sometimes we will need to add examples to help with explanations, however, sometimes there may not be examples.

Start your glossary by defining: Accountant

## How will you study?

When you study accounting you need to understand the theory, or technique, but more importantly you need to practise using the theory or technique in a number of different situations. This pack will introduce each topic and give you some practice at tackling questions through the activities. At the end of each unit you will find some exam style questions that will test your understanding and help you to develop your exam technique. However, if you are going to really understand each topic you will need to read more and do lots more practice questions. We will be using *AQA AS Accounting* by David Austen and Peter Hailstone to support your study, give you more in-depth explanations and more question practice. If you want more practice or explanation you can use any other text book that you find useful.

When you are reading this pack and doing the activities you will have questions – make sure you have a notebook, or paper and write down the question straight away and then ask your tutor when you speak to them. Make sure you write it down at the time or you may forget it!

At the beginning of each unit in the pack you will see the title of the unit, but more importantly two vital pieces of information:

**Learning outcomes** these describe what you should be able to do when you have finished the unit.

These will be repeated at the end of the unit and you will tick them if you can do it. But if you are not sure then you will write down what you are going to do to make sure you are able to (this could include asking your tutor, doing some more reading or doing some more questions).

**Key terms** These are the key words contained in that unit.

## Background information

We are going to be preparing accounts for a range of businesses so we need to understand how different types of businesses are owned and how this will affect the accounts.

### Types of business ownership

#### Activity 4

You need to investigate different types of business ownership. Use the internet to find out as much as you can about the following types of business ownership and then complete the table below. Try to find local examples of each type.

Types of business ownership

Examples

Sole trader

Partnership

Limited company

You could start by looking at the following websites:

[www.bized.co.uk](http://www.bized.co.uk)

[www.tutor2u.net](http://www.tutor2u.net)

Type	Definition	Advantages	Disadvantages
Sole trader			
Partnership			

Type	Definition	Advantages	Disadvantages
Limited company			



## Accounting skills

Remember that accountants need to be good at analysing data and solving problems – so let's see how good you are? You might be surprised how much you can work out from a few clues and some logical thinking!

You are Sherlock Holmes the famous detective. You are currently investigating the activities of the evil Professor Moriarty.

Dr. Watson (your assistant) has just appeared in your study with the latest accounts for Moriarty Ltd. In his struggle to obtain the accounts from the evil Moriarty's henchmen they have been torn – see next page.

Dr. Watson has drawn up some questions. You have the following clues and your skill in deductive reasoning to help you answer his questions.

### CLUES

Turnover is the value of sales made during the year

Debtors are people who owe the business money for goods sold on credit

Creditors are people the business owes money to for goods and services bought on credit

Net Profit is gross profit minus expenses

Ordinary Shares plus Reserves = Total Assets less Current Liabilities

Using your investigative skills answer the following questions and state your evidence

Question	Answer	Evidence
How much did Moriarty Ltd sell during the year?		
Does Moriarty Ltd buy and sell goods or does it manufacture them?		
Do they give their customers credit?		
Do they own their own premises?		

Question	Answer	Evidence
How much profit did they make?		
Do they employ any staff?		
Have they borrowed any money?		
One figure appears on both accounts – which one?		
What is the value of the reserves?		
What do you think the business is worth?		

There is no one correct answer to the question how much is the business worth, but you should still be able to make a sensible suggestion.

Moriarty Ltd		
The Trading and Profit and Loss Account for the year ended 31.12.99		
	£000	£000
Turnover		10,000
Opening Stock	250	
Cost of Goods Manufactured	6,500	
	6,750	
Closing Stock	750	
Cost of Goods Sold		6,000
Gross Profit		4,000
Less Expenses		
Wages	500	
Rent	200	
Administration	100	
Marketing	600	
Bank Interest	100	
Depreciation	200	
	1,700	
Net Profit		1,700

Balance Sheet as at 31.12.99	Cost £000	Depreciation £000	NBV £000
Plant & Machinery	500	200	300
Motor Vehicles	300	100	200
			500
<b>Current Assets</b>			
Stock		750	
Debtors		250	
		1,000	
<b>Current Liabilities</b>			
Creditors	300		
Bank Loan	250	550	
Net Current Assets			450
Total Assets less Current liabilities			950
<b>Financed By</b>			
Ordinary Shares			500
Reserves			

Question	Answer	Evidence
How much did Moriarty Ltd sell during the year?	£10,000,000	Turnover figure on trading account – but note the £000 at the top means that we add three 0s to every figure – this makes the numbers easier to read and we don't get confused with lots of zeros
Does Moriarty Ltd buy and sell goods or does it manufacture them?	Manufacture them	The trading and profit and loss account shows “Cost of good <b>manufactured</b> ”
Do they give their customers credit?	YES	Debtors on the balance sheet – these are people who owe the business money for goods sold on credit
Do they own their own premises?	NO	The profit and loss account show rent as an expense. Also there are no premises shown on the balance sheet
How much profit did they make?	£2,300,000	Gross profit minus expenses, e.g. 4,000,000 – 1,700,000
Do they employ any staff?	YES	They pay wages – in profit and loss account
Have they borrowed any money?	YES	Balance sheet shows <b>Bank loan</b> Also Interest is expense in profit and loss account
One figure appears on both accounts – which one?	£750,000 Stock	Appears as closing stock in trading account and as stock in balance sheet
What is the value of the reserves?	£450,000	Total assets less current liabilities = Ordinary shares + reserves 950,000 = 500,000 + reserves So reserves = 450,000
What do you think the business is worth?	See below	

You may have said the business is worth £950,000 as this is the value of the assets – liabilities and this is one way of valuing a business. However, this ignores the profits the business is making – in this year £2,300,000.

The only time we actually know what a business is worth is when someone offers to buy it and the owners agree, e.g. the value set by the purchasers is the same as that of the sellers.

In this case if the business is making regular profits of £2,300,000 then the business is growing and would probably be worth a lot more than the balance sheet value of £950,000.

# Topic 1 Introduction to Financial Accounting

## Unit 1 Purposes of Accounting

**On completion of this unit, you should be able to:**

- explain the purposes of the accounting system
- explain the purpose of trading accounts
- explain the purpose of profit and loss accounts
- explain the purpose of balance sheets
- explain the purpose of cash budgets
- identify a range of stakeholders
- explain the reason that stakeholders are interested in accounts

**Key terms:**

- |                           |  |
|---------------------------|--|
| ■ Financial accounting    | ■ Preparing accounts showing what has happened in the business, usually for external users |
| ■ Management accounting   | ■ Providing accounting for management to help them plan, control and make decisions        |
| ■ Accounting system       | ■ The process of recording transactions using double entry bookkeeping                     |
| ■ Source documents        | ■ The sources of accounting information – the starting point of the accounting system      |
| ■ Ledger                  | ■ Book for keeping accounting records – there are 3 ledgers: sales, purchase and general.  |
| ■ Trading account         | ■ Where we calculate the gross profit  |
| ■ Profit and loss account | ■ Where we calculate net profit  |

- Balance sheet
- Cash budget
- Stakeholders
- A statement listing the assets, liabilities and capital of the business
- A prediction of the cash inflows and outflows of the business
- People or organisations that have an interest in the business.

**In order to complete the activities in this unit students must read Chapter 1 of *AQA AS Accounting* (Nelson Thornes) pages 3–5.**

## What are the purposes of accounting?

In this unit we will be identifying the reasons that businesses keep accounts and who is interested in them. This unit will also provide an overview of Accounting 1, because we will be looking at the process of gathering and processing accounting information – which will be dealt with in more depth in topics 2 and 3. Also we will look briefly at final accounts, which are covered in topics 4 and 5. It would be sensible to come back to this unit when you have finished the course as you will then be able to see how everything fits together.

There are a number of different reasons for people setting up businesses. So, how does accounting fit in? The answer could be different depending on the reason for setting up the business, however, we can summarise the purpose of accounting as:

1. **record transactions**
2. **record whether the business is making a profit or loss**
3. **record what the business owns and owes**
4. **record the owner's investment**
5. **provide information to help the owner(s) or managers to plan, control and make decisions.**

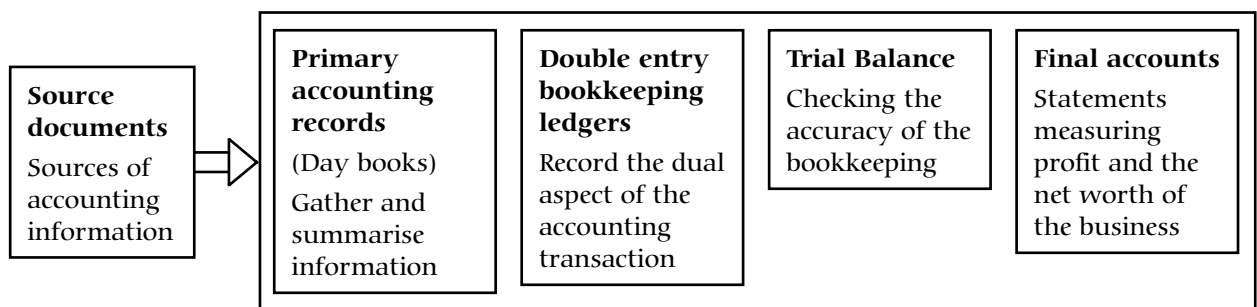
You will see that the first four are about recording what has happened in the past – we call this **financial accounting** – and this is the focus of the Accounting 1 exam. Number five is about providing information to help run the business and we call this **management accounting** – this is introduced in Topic 9 when we look at budgeting and is dealt with in much more depth in A2 Accounting Unit 4.

## Recording transactions

You may be concerned that the bookkeeper does not make mistakes and perhaps more importantly does not steal. To try to prevent this happening there is an **accounting system**, which is designed to reduce the possibility of mistakes and fraud happening.

## The Accounting System

The accounting system is shown below.



It is best to think of the accounting system as a sealed box – so that only those with the key can get into it and make entries. Once inside the box there are strict rules about what you can do and the order you do things.

## What is the key?

The key to getting into the system are **source documents**.

These include:

- Till rolls
- Cash receipts
- Sales invoices

Purchase invoices  
Credit notes  
Cheque stubs (counterfoils)  
Paying-in-slip counterfoils

## Activity 3

Use the internet to find definitions, explanations and examples of the source documents.

Write your definitions in your glossary.



### Inside the system

Once inside the system the transactions must follow these rules.

1. The transaction will be entered in one of the day books, or primary accounting records.

There are five day books:

Sales  
Purchases  
Sales returns  
Purchase returns  
Cash.

We will examine these in more detail later in Topic 2.

2. All transactions must be recorded in the double entry ledgers – this involves recording everything twice! This may seem like a waste of time, but it allows us to check whether we are doing things correctly or not. We will learn about double entry in Topic 2.
3. Before using the entries in the ledger to prepare final accounts we must check their accuracy by preparing a trial balance – this will tell us if our double entry and arithmetic is correct.
4. We can then prepare the final accounts to see if we have made a profit or not.

#### Tip

The purpose of the day book is to summarise information to make it easier to record in the double entry bookkeeping ledgers. Some businesses are small and do not have enough transactions to make it worthwhile keeping day books – we will start by looking at these.

#### Terminology

A **ledger** is an old fashioned word for a book and comes from the times when accounting records were all kept by hand and the accounts were kept in a ledger or book.

# Recording whether the business is making a profit or loss

In Accounting 1 we will concentrate on businesses that are owned by one person – called a **sole trader**. We will also focus on businesses that buy and sell or provide a service – we will not look at businesses that make things (manufacturing) as this is covered in A2.

We work out if the business has made a profit or loss in two stages:

1. The trading account – this shows the profit made from buying and selling – it is called the **gross profit**.

**Tip**

The term sole trader means a sole owner and not that the person works on their own – they might, like Imran, employ workers.

**Imrans' Cricket Shop**

**Trading account for the year ended 31 December 2008**

	£	£
<b>Sales</b>		175,864
Less Returns inwards		768
		<u>175,096</u>
Opening Stock	4,500	
Purchases	68,540	
Carriage inwards	1,375	
Returns outwards	325	
	<u>74,090</u>	
Less Closing Stock	5,450	
<b>Cost of goods sold</b>		<u>68,640</u>
<b>GROSS PROFIT</b>		<u>106,456</u>

**Tip**

Do not worry about the terminology in the trading account at this stage – we will cover it later in the course.

The important numbers here are:

Sales – the value of Imran's sales.

Cost of goods sold – how much it costs Imran to buy the equipment he sold.

Gross profit – how much profit he has made on the goods sold before expenses.

2. The profit and loss account – this show the profit made after taking away all Imran's expenses – we call this the **net profit**

**Imrans' Cricket Shop**

**Profit and loss account for the year ended 31 December 2008**

<b>GROSS PROFIT</b>		106,456
Less Expenses		
Wages	49,865	
Insurance	685	
Rent	2,785	
Rates	1,568	
Electricity	1,389	
Carriage out	1,266	
Discounts allowed	128	
Interest	158	
Depreciation	1,256	
	<u>59,100</u>	
<b>NET PROFIT</b>		<u><u>47,356</u></u>

**Tip**

Again do not worry too much about the terminology here.

Key numbers are:

Gross profit from the trading account

Expenses – these are the day to day running costs of the business – Imran has paid wages to his workers and bookkeeper and rent for the office and warehouse

Net profit is:

Gross profit minus expenses  
This profit belongs to Imran.

## Recording what the business owns, owes and how much the owner has invested.

We record these in the part of the final accounts called the **Balance sheet**. This shows what the business owns – its **assets**; what is owes – its **liabilities** and how much the owner has invested – **capital**.

### Imran's Cricket Shop

#### Balance Sheet as at 31 December 2008

	£	£	£
<b>FIXED ASSETS</b>	Cost	Depreciation to date	Net Book Value
Office equipment	3,500	1,050	2,450
Packing equipment	1,685	206	1,479
	<u>5,185</u>	<u>1,256</u>	<u>3,929</u>
<b>CURRENT ASSETS</b>			
Stock		5,450	
Debtors		5,660	
Cash at bank		<u>22,650</u>	
		<u>33,760</u>	
<b>CURRENT LIABILITIES</b>			
Creditors		<u>20,165</u>	
		<u>20,165</u>	
<b>NET CURRENT ASSETS</b>			<u>13,595</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>			<u>17,524</u>
<b>LONG-TERM LIABILITES</b>			
Loans			<u>10,000</u>
<b>NET ASSETS</b>			<u>7,524</u>
Capital introduced			5,000
Net Profit			47,356
Drawings			<u>(44,832)</u>
<b>Capital at 31.12.08</b>			<u>7,524</u>

#### Tip

Again do not worry too much about the terminology or layout – we will deal with this in later modules.

If you do have any questions then write them on your question sheet to ask your tutor.

Key figures here are:

#### Assets

What the business owns – these are divided into two:

#### Fixed assets

Things the business owns and intends to keep for more than one year.

#### Current assets

Things the business owns but does not intend to keep for more than one year.

#### Liabilities

Amounts the business owes – these are divided into **current** have to be paid in next year – and **long term** have to be paid after more than one year.

#### Capital

The amount the owner has invested.

## Who is interested in the accounts and accounting records?

For many small businesses the main reason for keeping accounting records and preparing accounts is to satisfy the “taxman”. Sole traders will pay Income Tax on the profits of their business and depending on the size of the business many will be registered for Value Added Tax (VAT). This means the Revenue and Customs will want to know how much profit they have made and in the case of VAT may want to see their accounting records to check that the VAT has been paid correctly.

However, there are others who will be interested in the accounts of a business, we call them **stakeholders**.

### Activity 4



Use these websites:

[www.tutor2u.net](http://www.tutor2u.net)

[www.bized.co.uk](http://www.bized.co.uk)

or textbooks

Complete the table below, identifying a range of stakeholders, explaining who they are and why they would be interested in the business accounts.

Stakeholder	Explanation	Why interested
Revenue and customs	The government department responsible for collecting income tax and VAT	To make sure the owner of the business pays the correct amount of income tax and VAT
Employees		
Customers		
Suppliers		
Lenders		

Stakeholder	Explanation	Why interested



## End of unit questions

1

Andrew has been told that he should produce a trading account, a profit and loss account and a balance sheet at the end of his first year of trading. What is the purpose of **each** of these statements?

**Tip**

In a question of this nature be specific. Take each statement in turn and identify its purpose.

2

Andrew has been told that stakeholders will be interested in the final accounts of his business.

- a. What is meant by the “stakeholders” in a business?
- b. List the stakeholders in a business and explain why they would be interested in Andrew’s final accounts.



Now you have completed the unit you should reflect on the learning outcomes identified at the beginning. It would be a good idea to leave these and come back when you have finished the course.

I can	✓	Action
explain the purposes of the accounting system		
explain the purpose of trading accounts		
explain the purpose of profit and loss accounts		
explain the purpose of balance sheets		
explain the purpose of cash budgets		
identify a range of stakeholders		
explain the reason that stakeholders are interested in accounts		



# Topic 1 Introduction to Financial Accounting

## Unit 2 The Accounting Equation

**On completion of this unit, you should be able to:**

- define capital, assets and liabilities
- define the accounting equation
- use the accounting equation to find missing figures
- prepare simple balance sheets

**Key terms:**

- |                       |   |
|-----------------------|---|
| ■ Accounting equation | ■ The basis of accounting:  |
| ■ Dual aspect         | ■ $\text{Capital} = \text{Assets} - \text{Liabilities}$                 |
| ■ Capital             | ■ Every transaction has two effects                                     |
|                       | ■ The owner's investment in the business – this could be cash or assets |
| ■ Proprietor          | ■ The owner   |
| ■ Assets              | ■ Resources owned by the business                                       |
| ■ Liabilities         | ■ Amounts owed by the business  |
| ■ Creditors           | ■ People the business owes money to                                     |
| ■ Debtors             | ■ People who owe the business money                                     |

**In order to complete the activities in this unit students must read Chapter 1 of *AQA AS Accounting* (Nelson Thornes) pages 6–7.**

# The accounting equation

In this unit we will be examining the theory that underpins double entry bookkeeping and financial accounting, and begin to understand why it is called double entry!

In the next topic we will be looking at how we record business transactions using double entry bookkeeping, but before we do that we need to understand the theory that underpins double entry – the accounting equation and **dual aspect**. First some definitions – you will soon know these very well.

<b>Capital</b>	The owner's (sometimes called the proprietor) investment in the business. This can be in the form of money or assets such as their car, van or computer.
<b>Assets</b>	Things the business owns and uses
<b>Liabilities</b>	Amounts the business owes. This could be money borrowed or goods bought on credit.

The easiest way to understand the accounting equation is to work through what happens when a business starts up. So we will follow the start-up of Imran's cricket shop.

The basic accounting equation is:

$$\text{CAPITAL} = \text{ASSETS}$$

The first thing Imran did was to introduce £5,000 of his own money into the business to get it started. The £5,000 is his investment – called **capital**. The business now has assets of £5,000 cash

So the accounting equation would be:

<b>CAPITAL</b>	<b>ASSETS</b>
Cash £5,000	Cash £5,000

Imran uses some of the cash to buy a computer for £2,000. This does not affect Capital as he has not introduced any more of his own money or taken any out, It will affect his assets

<b>CAPITAL</b>	<b>ASSETS</b>
£5,000	Computer £2,000
	Cash £3,000

As you can see one asset has been reduced – cash and another has increased – computer. But the accounting equation still balances, because every transaction has two effects – **the dual aspect**. In the first transaction the two effects are:

1. to increase capital
2. to increase cash.

Imran, now, needs to buy some packing equipment and some cricket equipment to sell. He does not have enough cash in the business to do this and he does not have any more of his own money to invest. So he goes to the bank for a loan – **a liability**. How does this affect the accounting equation?

**The accounting equation:**

$$\text{CAPITAL} + \text{LIABILITIES} = \text{ASSETS}$$

We can also write this as:

$$\text{CAPITAL} = \text{ASSETS} - \text{LIABILITIES}$$

Imran has borrowed £10,000 from his bank – the accounting equation will now look like this:

<b>CAPITAL + LIABILITIES</b>		<b>ASSETS</b>	
Capital	£5,000	Computer	£2,000
Loan – liability	<u>£10,000</u>	Cash	<u>£13,000 (3,000 + 10,000)</u>
	<u>£15,000</u>		<u>£15,000</u>

So Imran now has a liability, but the asset of cash has increased.

Imran now uses some of the cash to buy packing equipment costing £1,685

The accounting equation will now look like this:

<b>CAPITAL + LIABILITIES</b>		<b>ASSETS</b>	
Capital	£5,000	Packing equipment	£1,685
Loan – liability	£10,000	Computer	£2,000
	<u>£15,000</u>	Cash	<u>£11,315 (13,000 – 1,685)</u>
			<u>£15,000</u>

**Tip**  
Whenever you do a calculation you should show it – we call these workings

The asset of packing equipment has increased and the asset of cash has decreased – but the equation still balances.

We can use the accounting equation to work out how much the owner has invested in the business, or the liabilities of the business – the accounting equation can be used to calculate profit when a business does not keep proper records.

## Activity 1



Use the accounting equation to calculate the missing figures

Assets	Liabilities	Capital
£	£	£
12,500	1,800	
28,000	4,900	
16,800		12,500
19,600		16,450
	6,300	19,200
	11,650	39,750
55,000	16,900	

**Tip**  
Remember the accounting equation can be written:

**Capital + liabilities = assets**

**Or**

**Capital = assets – liabilities**

(Continued)

Assets	Liabilities	Capital
£	£	£
	17,200	34,400
36,100		28,500
119,500	15,400	
88,000		62,000
	49,000	110,000

Before we move on to look at simple balance sheets, we need to make sure that we can identify capital, assets and liabilities.

## Activity 2



Identify whether each of these is an asset or liability and briefly explain why.

	Asset/liability	Explanation
Office equipment		
Loan from Shirley		
Fixtures and Fittings		
Motor vehicles		
Amount owing for goods (creditors)		
Bank balance		
Premises		
Creditors for goods		
Stock of goods		
Debtors		
Bank overdraft		
Cash in hand		
Loan from David		
Machinery		

### Tip

Before starting, check back to your definitions of assets and liabilities.

Update your glossary.

Remember to add to your questions for your tutor sheet if there are any things in this you do not understand.

When we showed the effect of transactions on the accounting equation we were in fact preparing simple balance sheets. We will have a look at another example and prepare a basic balance sheet after each transaction – to make this easier we will use:

$$\text{ASSETS} = \text{CAPITAL} + \text{LIABILITIES}$$

When we prepare balance sheets later in topic 4 we will show them with Assets – Liabilities = Capital, but the version we are using here can be used.

Transaction	Assets	£	Capital + Liabilities	£
1 David starts his business by depositing £150,000 into a business bank account	Bank	150,000	Capital	150,000

The two effects of the transaction are:

The business bank account is increased by £150,000

Capital increased by £150,000 – David is the owner of the business and capital shows his investment in the business

Transaction	Assets	£	Capital + Liabilities	£
2 David buys a computer to use in his business for £2,000 paying by cheque from the business bank account	Computer	2,000	Capital	150,000
	Bank (150,000 – 2,000)	<u>148,000</u>		
		<u>150,000</u>		<u>150,000</u>

The two effects are:

The assets are increased by the purchase of the computer for £2,000

The assets are decreased because he paid using the bank account

**Note: Capital only changes if David puts more of his own money or assets into the business or takes money or assets out for his own use.**

Transaction	Assets	£	Capital + Liabilities	£
3 He borrows £100,000 from the bank and deposits the money in the business bank account	Computer	2,000	Capital	150,000
	Bank (148,000 + 100,000)	<u>248,000</u>	Bank loan	<u>100,000</u>
		<u>250,000</u>		<u>250,000</u>

The two effects are:

Asset of bank is increased by £100,000

Liability of loan is increased by £100,000

Transaction	Assets	£	Capital + Liabilities	£
4 He buys a small shop for £135,000 paying by cheque	Shop	135,000		
	Computer	2,000	Capital	150,000
	Bank (248,000 – 135,000)	<u>113,000</u>	Bank loan	<u>100,000</u>
		<u>250,000</u>		<u>250,000</u>

The two effects are:

Assets increased by purchase of shop for £135,000

Assets decreased by using bank to pay for shop £135,000

Transaction	Assets	£	Capital + Liabilities	£
5 He buys Fixtures and Fittings costing £5,500 on credit	Shop	135,000		
	Fixtures & Fittings	5,500	Capital	150,000
	Computer	2,000	Bank loan	100,000
	Bank	<u>113,000</u>	Creditor	<u>5,500</u>
	<u>255,500</u>		<u>255,500</u>	

The two effects are:

Assets increased by £5,500 for purchase of fixtures and fittings (these are things such as counters, display stands, etc.)

Liabilities increased by £5,500 as purchased on credit.

## Activity 3



Prepare basic balance sheets to record the transactions at the start of Ruud's business.

### Tip

Remember capital is the owner's investment and this can include assets as well as money

Transaction	Assets	£	Capital + Liabilities	£
1 Ruud starts his business by depositing £5,000 into a business bank account				
2 Ruud buys a van for £3,000 paying by cheque from his business bank account				

Transaction	Assets	£	Capital + Liabilities	£
3 Ruud borrows £3,000 from the bank and deposits the money in the business bank account				
4 Ruud buys equipment for £500 on credit from A Supplier				
5 Ruud introduces his own computer valued at £1,500 for use in the business				
6 He pays £250 to his creditor by cheque				



## End of unit questions

**1**

Define and give an example of:

- i) Capital
- ii) Assets
- iii) Liabilities

**2**

Prepare a balance sheet from the following:

	£
Office equipment	3,000
Loan from Elaria	5,000
Fixtures and Fittings	1,750
Motor vehicles	8,500
Trade creditors	450
Bank balance	500
Debtors	850

Enter the capital as the balancing figure

3

Each column in the table below is a simple balance sheet

	1	2	3	4	5
	£	£	£	£	£
<b>ASSETS</b>					
Premises				38,500	38,500
Motor vehicles		8,000	8,000	8,000	8,000
Bank	15,000	7,000	47,000	8,500	6,500
<b>LIABILITIES</b>					
Loan			40,000	40,000	38,000
<b>CAPITAL</b>	15,000	15,000	15,000	15,000	15,000

State what transactions have taken place? Number 1 is completed for you

1. Capital introduced £10,000 and paid into the bank.

2.

3.

4.

5.

6.



Now work through Kerboodle Chapter 1: Purposes of Accounting test.

Now you have completed the unit you should reflect on the learning outcomes identified at the beginning. Look at the learning outcomes below and tick against those that you are confident you can do – if you are not sure then write down what you will do to make sure you can do it.

I can	✓	Action
define capital, assets and liabilities		
define the accounting equation		
use the accounting equation to find missing figures		
prepare simple balance sheets		

