Accounting Foundations

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1 Keeping Accounts

A *financial transaction* is the exchange of goods or services for money. Accounting involves recording transactions and determining the profitability of a business.

Bookkeepers actually record the transactions, but accountants check the records for errors, summarise the accounts and advise management. Accountants evaluate existing accounting systems - is the system fit for purpose? - and design new ones.

1.1 Assets and Liabilities

An *asset* is anything that is owned by the business. Examples of assets owned by a shop include cash in hand, stock for sale and a personal computer.

A *liability* is a debt owed by the business. Examples of liabilities include money owed to a supplier for electricity, tax owed to the government, and a bank loan.

1.2 Debtors and Creditors

A *debtor* owes money to the business. If a customer buys goods on credit, meaning that the goods will be paid for at a later date, then that customer is a debtor. A debtor is an asset because the business owns the debt.

A *creditor* is owed money by the business. Creditors include an electricity company waiting for payment for power supplied, the tax collection department of the government waiting for the company's tax bill to be paid, and the bank waiting for the business to pay off its bank loan.

1.3 Recording Transactions

A traditional format for recording transactions in an account is shown below.

DR		account name e.g. Cash	CR
	£		£
received from the sale of goods	2,000	given to pay for a weighing machine	150

DR stands for debit. Increases in cash are recorded as a debit.

CR stands for credit. Decreases in cash are recorded as credit.

An increase in an asset is recorded on the debit side of an account. This is the fundamental rule of accounting. The other rules follow.

A decrease in an asset is recorded on the credit side of an account.

An increase in a liability is recorded on the credit side of an account. A decrease in a liability is recorded on the debit side of an account.

Debit	*Credit*
increase an asset	decrease an asset

Debit	*Credit*
decrease a liability	increase a liability

1.4 Balances on the Account

The difference between the two sides of an account represents either what a business has or what a business owes.

DR	Cash Account		CR
	£		£
10 June Sale of Goods	2,000	30 June Bank Loan Payment	500

In the Cash Account shown above, the business has £1,500 in cash (£2,000 - £500).

In the Bank Loan Account shown below, the business owes £9,500

DR	Bank Loan Account		CR
	£		£
30 June Cash	500	1 June Loan	10,000

The normal balance for an asset is a debit. The normal balance for a liability is a credit.

In accounting terms a debit increases the value of an asset, and a credit increases the value of a liability.

1.5 Double Entry Accounting

You buy a company vehicle with a deposit of £1,000 cash and a bank loan for £14,000.

You decrease the money in your Cash Account (an asset).

DR	Cash Account		CR
	£		£
		Vehicle	1,000

You increase your liability by getting a bank loan for the vehicle.

DR	Bank Loan Account		CR
	£		£
		Vehicle	14,000

You increase your assets since you now own the vehicle.

DR	Vehicle Account		CR
	£		£
Cash	1,000		
Bank Loan	14,000		

Every transaction is recorded twice, once as a credit and once as a debit. This is known as double entry accounting. The result of double entry accounting is that the sum of all debits matches the sum of all credits over a company's accounts.

Double entry accounting may reveal errors such entering a credit without a matching debit, swapping digits in an entry, and miss-placing a decimal point.

Example 1.1

We create an account for each asset and liability.

1 June You start a new business with £120,000 cash.

DR		Cash Account			CR
		£			£
1 Jun	Capital	120,000			

DR		Capital Account			CR
		£			£
			1 Jun	Cash	120,000

Capital is an asset in the Cash Account because it is owned by the business. Cash is a liability in the Capital Account because it is money owed by the business to you, the owner.

4 June Your business pays £80,000 cash for premises.

DR		Cash Account			CR
		£			£
1 Jun	Capital	120,000	4 Jun	Premises	80,000

DR		Premises Account			CR
		£			£
4 Jun	Cash	80,000			

£80,000 for Premises in the Cash Account is a decrease in an asset (cash). £80,000 for Premises in the Premises Account is an increase in an asset (premises bought for cash).

10 June Your business purchases machinery for £6,000 cash.

DR		Cash Account			CR
		£			£
1 Jun	Capital	120,000	4 Jun	Premises	80,000
			10 Jun	Machinery	6,000

DR		Machinery Account			CR
		£			£
10 Jun	Cash	6,000			

The cash spent on machinery is a decrease in an asset (cash). The machinery purchased is an increase in an asset.

17 June The business purchases office furniture for £800 cash.

DR		Cash Account			CR
		£			£
1 Jun	Capital	120,000	4 Jun	Premises	80,000
			10 Jun	Machinery	6,000
			17 Jun	Office Furniture	800

DR		Office Furniture Account			CR
		£			£
17 Jun	Cash	800			

Your asset (cash) is decreased. Your asset (office furniture) is increased.

24 June The business purchases computer equipment for £600 on credit from A Bell.

DR		Computer Equipment Account			CR
		£			£
24 Jun	A Bell	600			

DR		A Bell Account			CR
		£			£
			24 Jun	Computer Equipment	600

The computer equipment is an asset. The money, £600, owed to A Bell is a liability. A Bell is a creditor.

27 June You introduce a further £10,000 cash into the business as capital.

DR		Cash Account			CR
		£			£
1 Jun	Capital	120,000	4 Jun	Premises	80,000
27 Jun	Capital	10,000	10 Jun	Machinery	6,000
			17 Jun	Office Furniture	800

DR		Capital Account			CR
		£			£
			1 Jun	Cash	120,000
			27 Jun	Cash	10,000

28 June The business pays £30,000 cash into its business bank account.

DR		Cash Account			CR
		£			£
1 Jun	Capital	120,000	4 Jun	Premises	80,000
27 Jun	Capital	10,000	10 Jun	Machinery	6,000
			17 Jun	Office Furniture	800
			28 Jun	Bank	30,000

DR		Bank Account			CR
		£			£
28 Jun	Cash	30,000			

Money in the bank is an asset (for your business, but not for the bank).

29 June The business purchases more computer equipment for £500. Payment is by cheque.

DR		Bank Account			CR
		£			£
28 Jun	Cash	30,000	29 Jun	Computer Equipment	500

DR		Computer Equipment Account			CR
		£			£
24 Jun	A Bell	600			
29 Jun	Bank	500			

30 June The business pays A Bell £400 on account by cheque.

DR		Bank Account			CR
		£			£
28 Jun	Cash	30,000	29 Jun	Computer Equipment	500
			30 Jun	A Bell	400

DR		A Bell Account			CR
		£			£
30 Jun	Bank	400	24 Jun	Computer Equipment	600

In general, when completing a debit or credit entry, you identfy the account where the money has come from or is going to.

Incidentally, if you have to pay installation costs, e.g. for installing computer equipment, the installation costs are usually regarded as part of the cost of the asset. The same applies to legal fees that might be incurred when buying premises for example.

1.6 Ledger

A ledger is just a collection of accounts.

DR		Bank Account			CR
		£			£
28 Jun	Cash	30,000	29 Jun	Computer Equipment	500
			30 Jun	A Bell	400

DR		Cash Account			CR
		£			£
1 Jun	Capital	120,000	4 Jun	Premises	80,000
27 Jun	Capital	10,000	10 Jun	Machinery	6,000
			17 Jun	Office Furniture	800
			28 Jun	Bank	30,000

DR		Premises Account			CR
		£			£
4 Jun	Cash	80,000			

DR		Machinery Account £			CR £
10 Jun	Cash	6,000			

DR		Office Furniture Account £			CR £
17 Jun	Cash	800			

DR		Computer Equipment Account £			CR £
24 Jun	A Bell	600			
29 Jun	Bank	500			

DR		A Bell Account £			CR £
30 Jun	Bank	400	24 Jun	Computer Equipment	600

DR		Capital Account £			CR £
			1 Jun	Cash	120,000
			27 Jun	Cash	10,000

Exercise 1.1

1. Write up the accounts of C Shore from the information given below. Tick off each transaction as you enter it.

Jan 1 C Shore starts a retail business with £80,000 cash. On the same day she buys shop fittings for £8,000 cash.
Jan 5 She buys a cash till for £600 on credit from B Goode .
Jan 10 C Shore purchases office equipment for £1,400 cash.
Jan 15 Pays £60,000 cash into a business bank account.
Jan 20 Pays a cheque for £600 to settle B Goode's account in full.
Jan 25 B Goode installs shop fittings for a cost of £1,800 on account.
Jan 31 New counter for the shop is installed for £1,300. C Shore pays by cheque.

2. Write up the accounts of B Wise from the information given below.

Feb 1 B Wise starts business with £140,000 cash and a van valued at £10,000.
Feb 3 Buys equipment for £16,000 cash.
Feb 6 Pays £120,000 cash into a business bank account.
Feb 9 Purchases loose tools on credit from D Liver for £2,800.
Feb 12 Buys land for £40,000. Pays by cheque.
Feb 15 Buys a mobile office for £9,000. Pays by cheque.
Feb 18 Buys office fittings for £1,700 on credit from E Den.
Feb 24 Pays D Liver a cheque for £1,600 as part payment of debt.
Feb 28 Takes £6,000 cash from the bank account for future cash expenses.

We have looked at how financial transactions are recorded. **Next**, we distinguish between real and nominal accounts.

Bibliography

HARRISON W *Stage One Financial Accounting* Northwick Publishers 1986 pp 1..25