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Catherine Coucom
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Chapter 1
Introduction to accounting

Learning objectives

In this chapter you will learn to:

- understand and explain the difference between book-keeping and accounting 1.1
- state the purposes of measuring business profit and loss 1.1
- explain the role of accounting in providing information for monitoring progress and decision-making 1.1
- explain the meaning of assets, liabilities and owner's equity 1.2
- explain and apply the accounting equation 1.2
- understand that statements of financial position record assets and liabilities on a specified date. 5.5

1.1 Introduction

Accounting is regarded as the language of business. Accounting can be divided into two sections:

Book-keeping

Book-keeping is a process of detailed recording of all the financial transactions of a business. It is necessary for even the smallest business to make a record of every transaction which affects the business. If the records are not maintained, it is likely that something will be forgotten or overlooked. The basis of maintaining these detailed records is double entry book-keeping. The actual records maintained by one business may vary from those maintained by another business because each business is different. However, all businesses apply the same principles while maintaining double entry records.

Accounting

Accounting uses the book-keeping records to prepare financial statements at regular intervals. The owner of a business needs to know whether the business is making a profit or a loss. Periodically (often at yearly intervals), an income statement is drawn up. This shows the calculation of the profit or loss earned by the business. If the business has earned a profit then the owner is receiving a return on his investment and funds are available for expanding or improving the business. However, if the business has made a loss then it may eventually close down as the owner is not receiving any return on his investment and funds are not available for running or maintaining the business.

You can now answer Question 1 at the end of this chapter.

The owner of the business also needs to know the financial position at regular intervals so a **statement of financial position** is prepared. This shows what the business owns and what is owing to it, its assets; and what the business owes, its liabilities. The term financial statements is often used as a collective name for an income statement and a statement of financial position.

The progress of the business can be measured by comparing the financial statements of one year with those of previous years, or with those of other similar businesses. The calculation of various accounting ratios is used to measure the relationship between figures within a set of financial statements. These are also useful for comparison purposes.

The information provided by the financial statements shows the owner of the business what has happened during a certain period of time and helps in monitoring the progress of the business. The plans for the future development of the business are also based on these financial statements.

TEST YOURSELF 1.1

1 Define the term book-keeping.
2 Define the term accounting.
3 State **two** reasons why it is necessary to prepare financial statements at regular intervals.
4 State what is included in the term financial statements.

KEY TERMS

Book-keeping is the detailed recording of all the financial transactions of a business.

Accounting is using book-keeping records to prepare financial statements and to assist in decision-making.

A **statement of financial position** shows the assets and liabilities of a business on a certain date.

LINK

You will learn more about financial statements in Chapters 8 and 9.

1.2 Assets, liabilities and capital

LINK

You will learn more about assets and liabilities in Chapter 9.

KEY TERMS

Capital is the total resources provided by the owner and represents what the business owes the owner.

Assets represent anything owed by or owing to the business.

Liabilities represent anything owed by the business.

It is important to remember that the accounting records of a business relate only to the business. From an accounting viewpoint, the owner of that business is regarded as being completely separate from the business.

When a person decides to start a business he will have to provide the necessary funds (resources). This is often in the form of monetary funds, but may consist of buildings, motors, goods and so on. Any resources provided by the owner of the business are known as **capital**. This represents the amount owed by the business to the owner of that business.

Once the business is formed and capital introduced, the business will own the money or other items provided by the owner. Things owned by the business (or owed to the business) are regarded as the resources of the business or the **assets** of the business.

In addition to the owner, other people may also provide assets to the business. The amount owed by the business to these people is known as **liabilities**.

TIP

Anything provided for a business by the owner represents capital. This is not necessarily in the form of money.

Many businesses are set up and operated by one person. These are known as sole traders. The early chapters in this book cover accounts maintained by sole traders.

LINK

You will learn about the accounting records of partnerships and limited companies in Chapters 19 and 21.

TEST YOURSELF 1.2

1 Define each of the following terms.

a assets **b** liabilities **c** capital

1.3 The accounting equation

Like any other mathematical equation, the two sides of the equation will always be equal. The formula for this equation is:

Assets = Capital + Liabilities.

Capital is sometimes referred to as owner's equity. So the previous equation can also be written as:

Assets = Owner's equity + Liabilities.

Like any mathematical equation, the accounting equation can be used to find any one of the three elements if the other two are present.

TIP

If you know two elements of the accounting equation you can easily calculate the third element.

This equation illustrates that the assets of a business (the resources used by a business) are always equal to the liabilities and capital of a business (the resources provided for the business by others). The assets represent how the resources are used by the business and the liabilities and capital represent where these resources come from.

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Walkthrough 1.1

20–7

January 1 Leena set up a business to trade under the name of The Dress Shop. She opened a business bank account and paid in $20 000 as capital.

2 The business purchased premises, $15 000, and paid by cheque.

3 The business purchased goods, $3 000, on credit.

4 The business sold goods, at the cost price of $1 000, on credit.

Show the accounting equation after **each** of the above transactions.

Date	Assets		=	Capital	+	Liabilities	
1 January	Bank	$20 000		$20 000		Nil	
2 January	Premises	15 000					
	Bank	5 000					
		$20 000		$20 000		Nil	
3 January	Premises	15 000					
	Inventory	3 000					
	Bank	5 000					
		$23 000		$20 000		Trade payable	$3 000
4 January	Premises	15 000					
	Inventory	2 000					
	Trade receivable	1 000					
	Bank	5 000					
		$23 000		$20 000		Trade payable	$3 000

- 1 January The assets of the business are equal to the capital of the business.
- 2 January The money in the bank has decreased because a new asset has been bought. The total assets are equal to the capital.
- 3 January Purchasing on credit means that the business does not pay immediately. A new asset **inventory** has been acquired, but the business has also acquired a liability as it owes money to the supplier (who is known as a creditor). In a statement of financial position this is described as a **trade payable**. The total assets are equal to the capital plus the liabilities.
- 4 January Selling on credit means that the business does not immediately receive the money. The inventory has decreased but a new asset has been acquired in the form of money owing to the business by a customer (who is known as a debtor). In a statement of financial position this is described as a **trade receivable**. The total assets are equal to the capital plus the liabilities. (For the sake of simplicity, the goods were sold to the customer at cost price. In practice, they need to be sold at a price above cost price to enable the business to make a profit.)

LINK

You will learn more about buying and selling on credit in Chapter 2.

KEY TERMS

Inventory is the goods a business has available for resale.

Trade payables represent the amount the business owes to the credit suppliers of goods (the trade creditors).

Trade receivables represent the amount owed to the business by its credit customers (the trade debtors).

TEST YOURSELF 1.3

1 Fill in the missing figures in the following table.

	Assets	Capital	Liabilities
	$	$	$
a	35 000	?	12 500
b	?	44 400	19 300
c	67 300	55 000	?

You can now answer Question 2 at the end of this chapter.

1.4 The statement of financial position

The accounting equation may be shown in the form of a statement of financial position. This shows the three elements of the accounting equation – the assets, the capital and the liabilities. The statement of financial position will be affected every time the business makes changes to the assets, liabilities or capital.

Walkthrough 1.2

Prepare the statement of financial position of The Dress Shop after **each** of the transactions shown in **Walkthrough 1.1**.

The Dress Shop
Statement of financial position at 1 January 20–7

Assets	$	Liabilities	$
Bank	20 000	Capital	20 000
	20 000		20 000

The Dress Shop
Statement of financial position at 2 January 20–7

Assets	$	Liabilities	$
Premises	15 000	Capital	20 000
Bank	5 000		
	20 000		20 000

The Dress Shop
Statement of financial position at 3 January 20–7

Assets	$	Liabilities	$
Premises	15 000	Capital	20 000
Inventory	3 000	Trade payable	3 000
Bank	5 000		
	23 000		23 000

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The Dress Shop
Statement of financial position at 4 January 20–7

Assets	$	Liabilities	$
Premises	15 000	Capital	20 000
Inventory	2 000	Trade payable	3 000
Trade receivable	1 000		
Bank	5 000		
	23 000		23 000

TEST YOURSELF 1.4

1 Give **two** examples of **each** of the following (excluding those shown in **Walkthrough 1.1** and **1.2**):
   a asset **b** liability.
2 Explain the meaning of **each** of the following terms:
   a trade payable **b** trade receivable

The statements of financial position shown in **Walkthrough 1.2** were presented in a horizontal format. There are different ways to present a statement of financial position and these are explained in Chapter 9 . A statement of financial position is also more useful if the assets and liabilities are divided into different types (see Chapter 9).

Walkthrough 1.1 showed that every single transaction involves a change to the assets and/or the liabilities and/or the capital. This means that it is necessary to prepare a statement of financial position after every single transaction, as shown in **Walkthrough 1.2**. However, this is not possible in practice as many transactions can take place every hour of each working day. In practice, the day-to-day business transactions are recorded using **double entry book-keeping** and a statement of financial position is prepared only periodically. This is usually done at the closing of a business on the last day of the financial year as part of the **financial statements**. As the business can be started on any day of the year, its financial year may not necessarily match the calendar year (i.e. from 1 January to 31 December). The financial statements are prepared for 12 month periods from the date the business started.

You can now answer Questions 3–6 at the end of this chapter.

LINK

You will learn more about statements of financial position in Chapter 9.

TIP

The totals of a statement of financial position must always agree: if they do not you know that there is an error.

LINK

You will learn more about double entry book-keeping in Chapters 2 and 4.

Revision checklist

- Book-keeping is the detailed recording of all the financial transactions of a business. Accounting uses these book-keeping records to prepare financial statements.
- It is necessary to prepare financial statements to show the profit or loss of the business and the financial position of the business and to help in decision-making.
- The accounting equation shows that the assets are always equal to the capital plus the liabilities of the business.
- A statement of financial position shows the assets and liabilities of a business on a certain date.

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Exam-style questions

1 Which task is performed by a book-keeper?

A analysing the trading results
B entering transactions in the ledger
C preparing year-end financial statements
D providing information for decision-making

2 A trader provided the following information:

	$
Premises	180 000
Inventory	23 420
Trade payables	26 180
Trade receivables	21 710
Office fixtures and fittings	32 600
Loan from bank	80 000
Cash at bank	2 550
Motor vehicles	15 900

a Calculate the value of the assets.
b Calculate the value of the liabilities.
c Use the accounting equation to calculate the trader's capital.

3 What is a statement of financial position?

A a calculation of the amount owed to the owner of the business
B a list of assets and liabilities of a business on a certain date
C a list of everything owned by and owed to a business
D a summary of money paid to and received by a business

4 A business had $9 420 in its bank account. The following transactions took place:

	$
Bought goods on credit	250
Sold goods on credit	1 100
Repaid a loan by cheque	5 000

How much was there in the bank after these transactions?

A $3 570 **B** $4 420 **C** $4 670 **D** $5 270

5 Complete the following table to show the effect of each of the following transactions. The first one has been completed as an example.

a Bought a motor vehicle and paid by cheque
b Bought goods on credit from a credit supplier
c Received a cheque from a credit customer
d Sold goods on credit
e Paid off a loan in cash

	Effect on assets	$	Effect on liabilities	$
a	Motor vehicles Bank	Increase Decrease	No effect	
b				
c				
d				
e				

6 The statement of financial position of Bharwani Traders on 31 October 20–4 is shown below.

Bharwani Traders Statement of financial position at 31 October 20–4			
Assets	$	Liabilities	$
Machinery	19 000	Capital	35 000
Motor vehicles	6 000	Trade payables	8 000
Inventory	4 900		
Trade receivables	3 000		
Bank	10 100		
	43 000		43 000

On 1 November 20–4 the following transactions took place:

A cheque for $3 000 was paid to a credit supplier.

A credit customer paid $500 in cash.

A loan for $8 000, which was paid into the bank, was received from Lenders Limited.

A cheque for $7 000 was paid for an additional machine.

Prepare the statement of financial position of Bharwani Traders on 1 November 20–4 after the above transactions have taken place.