Learning Accountancy

Learning Accountancy:
The Novel Way
Second Edition

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I would like to dedicate this book to my wife, Feroza,
whose help, encouragement and inspiration have been invaluable
in bringing this project to fruition.

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CHAPTER 1

INTRODUCTION

Many books on accounting have been written over the years ranging from elementary bookkeeping to advanced accountancy, depending upon the needs and aspirations of the prospective readers. The question then is why write yet another book? There are two basic reasons why this book has been written.

Firstly, it does not follow the traditional approach of introducing double entry bookkeeping principles almost at the outset and then expounding those principles with the help of examples. In this book, no mention is made of double entry until Chapter 5. We start by examining three main financial statements which reflect our financial position: the Cash Flow Statement, the Profit and Loss Account, and the Balance Sheet. Then, with the help of examples, we see how business transactions affect those statements which in turn show how our financial position has changed. By following this approach, a number of problems of definition and concept can be ironed out at the outset. To take a simple example, while we all understand the concept of cash flow which is money received and spent, many of us are unclear about what profit or loss actually means and how precisely it differs from cash flow. That is why we fully examine, as early as Chapter 3, a number of fundamental differences between cash flow and profit or loss. There have been some well known cases of businesses going to the wall owing to severe cash flow problems despite the fact that they were trading profitably. Once we fully understand fundamental accounting concepts such as this, the logic of double entry can be quickly grasped and the endless heartache of waiting for “the penny to drop” avoided.

Secondly, this book endeavours to do more than merely impart a clear understanding of accounting rules and principles. It covers a wide range of topics, many of them concentrating on very practical issues. For instance, in view of today’s increasingly computerised world, a strong emphasis is placed on computerised accounting systems and records. Another important practical feature is an insight into accounting controls and management information systems within a typical accounts department or office, knowledge of which would be invaluable to the novice as well as to anyone with some accounting experience.

Finally, in this second recently-updated edition, a new chapter 15 entitled ‘Website access and creation’ has been added to summarize the invaluable help that websites give us these days to enable us to access information that we need. Furthermore, many individuals and businesses create their own websites as an essential marketing tool to provide information to potential customers about the products and services on offer.

In summary, this book does not attempt to transform a newcomer to the world of accounting into a full-fledged accountant! It does, however, set out to explain the principles of bookkeeping by following a clear, logical approach and then to provide an insight into the practical aspects of accounting. To the layman, this book offers a rapid introduction to the theory and practice of accountancy. For the student, it provides a valuable basis for deepening his or her knowledge and understanding of the subject.

CHAPTER 2

SOME BASIC ACCOUNTING TERMS AND CONCEPTS

In order to understand how transactions affect our financial position let us start by examining the terms "transaction" and "financial position".

A transaction is a piece of business based on an agreement to exchange goods or services for money. If, for instance, you buy a bar of chocolate for 50 pence, then a transaction has taken place between yourself and the shopkeeper whereby you give him 50 pence in exchange for a bar of chocolate.

"Financial position" refers to the wealth or capital of an individual or a business. In accounting terms our financial position is represented by a statement called the "Balance Sheet". We can all prepare our own Balance Sheets which summarise our wealth. The following is a simple example of a Balance Sheet showing assets, liabilities and capital:

Assets	£
3 bedroom house	150,000
Bank Account	20,000
Furniture, Jewellery, etc.	15,000
	185,000
Liabilities	
Mortgage outstanding	50,000
Bank Loan	5,000
	55,000
Capital (Assets minus Liabilities)	130,000

Assets are items owned by ourselves and liabilities are amounts owed to others. The difference is our net assets or net wealth or capital.

We have seen what is meant by a transaction and how our financial position is represented by the Balance Sheet. Let us now look at the way in which our financial position is altered by entering into transactions.

Let us suppose Mr. Austin starts the month with the above Balance Sheet and a number of transactions are entered into during the month, summarised as follows:

	£
Salary received	1,500
Expenses incurred	(1,300)
	200

(Salary received for services rendered to an employer is just as much a transaction, in the accounting sense, as money received for goods sold or payments for food, gas, electricity, telephone, etc.)

At the end of the month Mr. Austin's wealth has increased by £200 to £130,200 and his Balance Sheet at the end of the month would appear as follows:

	£
Assets	
3 bedroom house	150,000
Bank Account	20,200
Furniture, Jewellery, etc.	15,000
	185,200
Liabilities	
Mortgage outstanding	50,000
Bank Loan	5,000
	55,000
Capital (Assets minus Liabilities)	130,200

We can see that there are two ways in which Mr. Austin's financial situation has altered. First, there has been an increase in his bank account balance by £200. Second, there has been an increase in his capital by £200.

Changes in the bank account balance are described as "cash flow", and a change in capital as "profit" or "loss". An increase in capital represents a profit, and a decrease in capital represents a loss.

As we will see in the next chapter, cash flow and profit (or loss) are not necessarily one and the same thing. We will see how, in fact, cash flow is often quite different from profit (or loss) during the same accounting period. We will also see how ‘income’ and ‘expenditure’ which determine profit or loss, are quite different in the accounting sense from ‘receipts’ and ‘payments’ which determine cash flow.

In our simple example, however, cash flow and profit increase by the same amount, £200, since ‘income’ happens to be the same as ‘receipts’ and ‘expenditure’ the same as ‘payments’. The movement in cash flow is itemised in a record one would normally call the “Cash Book”, which is a detailed cash flow statement, and the change in capital recorded in a statement called the “Profit and Loss Account”. Let us see how the details for the month might appear in Mr Austin’s Cash Book:

	£	£
Salary received	1,500	
Expenses incurred:		
Food	200	
Household	150	
Gas	120	
Electricity	70	
Telephone	50	
Mortgage interest*	500	
Other	210	1,300
Surplus		200

(* In practice, part of the £500 mortgage repayment might relate to the capital element and therefore slightly reduce the amount of the mortgage outstanding shown on the Balance Sheet. However, in this example, the mortgage has been treated as an interest-only mortgage.)

The details in the Profit and Loss Account would be exactly the same as in the Cash Book, except that the £200 excess of income over expenditure would be described as a profit in the Profit and Loss Account and as a cash surplus in the Cash Book.

Using our simple example of monthly income and expenses, we have seen how transactions affect an individual’s wealth or financial position and how those changes are reflected in the Cash Book, the Profit and Loss Account and the Balance Sheet.

Now let us summarise the terms and concepts we have dealt with so far:

A *transaction* is a piece of business based on an agreement to exchange goods or services for money.

Financial position refers to the wealth of an individual or a business and is represented by the Balance Sheet, which is a statement showing assets, liabilities and capital. The excess of assets over liabilities is the capital.

Cash flow refers to the increase or decrease in cash and bank balances.

A *Cash Book* or *Cash Flow Statement* shows the starting balance at the bank, details of receipts and payments during the accounting period, and the closing balance at the bank.

Profit is the excess of income over expenditure during an accounting period, resulting in an increase in capital. *Loss* is the excess of expenditure over income, resulting in a decrease in capital.

A *Profit and Loss Account* is a statement that shows details of income and expenditure during an accounting period, and the resultant profit or loss.

An *accounting period* is the period during which the change in financial position is assessed. The financial position at the start of an accounting period is represented by the "opening" Balance Sheet. The details making up the change in financial position during the accounting period are shown in the Cash Book and the Profit and Loss Account. The financial position at the end of the accounting period is represented by the "closing" Balance Sheet.

CHAPTER 3

CASH FLOW, PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

We have examined some basic accounting terms and concepts and seen how relevant they are even in everyday life. Once the fundamentals have been thoroughly grasped, the most complicated transactions, business or private, can be dealt with relatively quickly and without much difficulty, as we shall see in later chapters.

a) Cash Flow and Profit or Loss

We will now examine the difference between cash flow, on the one hand, and profit or loss, on the other. There are several differences, but let us start with a simple example.

Supposing all I possess is £10,000, which lies in my bank account. My Balance Sheet will be as follows:

	£
Bank Account	10,000
Capital	10,000

Suppose I decide to buy a second-hand car for £6,000. My Balance Sheet will then alter as follows:

	£
Bank Account	4,000
Car	6,000
	10,000
Capital	10,000

Notice that my bank balance has altered; it has been reduced by £6,000, but my capital is exactly the same as before. The reason for this is that although my wealth is held in a different form, the total remains unchanged. Instead of all my wealth existing in a bank account, £4,000 is now held in a bank account and £6,000 in the form of a motor car - my capital remaining unchanged at £10,000.

So we can see that, whilst there has been a movement in cash flow as a result of this transaction and a change in the form in which the capital is held, there has been no change in total capital, and therefore no profit or loss has arisen. This very simple example highlights the difference in concept between cash flow and profit.

Let us now define cash flow and profit or loss more explicitly by making a clear distinction between income and expenditure on the one hand and receipts and payments on the other. In accounting terms, income does not mean the same as receipts, and expenditure does not mean the same as payments.

Firstly, profit or loss is arrived at by taking into account income and expenditure. Income results in an increase in capital, and expenditure results in a decrease in capital. Cash flow, on the other hand, is arrived at by taking into account receipts and payments. Receipts, in the accounting sense, do not necessarily increase capital nor do payments necessarily decrease capital. We saw, in our example, how the purchase of a car resulted in a cash payment but not in a reduction in capital.

Secondly, income and expenditure are in respect of amounts *relating to* a particular accounting period, whether or not they are actually received or actually paid during that accounting period. Receipts and payments, on the other hand, are in respect of amounts actually received or actually paid in an accounting period, whether or not they relate to the accounting period. For example, if an item is sold for £100 in month 1, but the money is received in month 2, then the £100 sale which relates to month 1 is treated as income in month 1, but as a receipt in month 2. Similarly, a £300 electricity invoice relating to month 1 is treated as expenditure in month 1, but as a payment in month 2 (or later) when the payment is actually made.

Now let us illustrate the various ways in which differences between cash flow and profit or loss can arise, highlighting, with examples, the differences between income and expenditure on the one hand and receipts and payments on the other.

1. *Where cash flow is affected but profit or loss is not*

We have seen in our earlier example how cash flow is affected by the purchase of a car, but profit (or loss) is not.

2. *Where profit or loss is affected but cash flow is not*

a) Continuing with that example, supposing I buy the car at the beginning of the month, we must provide for wear and tear, i.e. depreciation, since cars, like most other assets, depreciate or lose value over a period of time.

If we assume that my car is likely to be worth nothing at the end of four years, the depreciation for each month will be 1/48 (i.e. spread over 48 months) of £6,000 or £125 per month. At the end of the month my Balance Sheet will be:

	£	£
Bank Account		4,000
Motor car:		
Cost	6,000	
Depreciation	(125)	
		5,875
		9,875
Capital:		
Beginning of the month	10,000	
Loss (depreciation)	(125)	
		9,875

As we can see, depreciation is a form of expenditure since it represents a loss of value of my car and hence results in a reduction of my profit, i.e. my wealth or capital. Whilst the value of my car is reduced by depreciation which is treated as expenditure, my bank balance is entirely unaffected. (In real life, depreciation would be highest soon after the car's purchase, and lowest towards the end of its useful life.)

b) Supposing I work as a freelance consultant and send my client an invoice for £1,500 for services rendered during the month but am not paid until the following month, then my Balance Sheet at the end of the month will be:

	£	£	£
Bank Account			4,000
Motor car:			
Cost		6,000	
Depreciation		(125)	5,875
Amount owing to me for services rendered			1,500
			11,375
Capital			
Beginning of month		10,000	
Profit during the month:			
Depreciation	(125)		
Consultancy services	1,500		
		1,375	
End of the month			11,375

In this case my profit, and hence my wealth, has increased even though there has been no increase in my bank balance. It has increased because I have sent out an invoice amounting to £1,500 for consulting services rendered. Even though I have not actually received the £1,500, it nevertheless relates to the current month and is therefore treated as income this month, resulting in an increase in my profit. At the same time my client becomes a debtor for £1,500. (Note: a debtor is a person who owes money to another, and a creditor is a person to whom money is owed.)

c) Suppose I receive my telephone bill for the current month, amounting to £70, but I do not pay the bill until the following month. My Balance Sheet will alter as follows:

	£	£	£
Bank Account			4,000
Motor car:			
Cost		6,000	
Depreciation		(125)	
			5,875
Amount owing to me for services rendered			1,500
Telephone bill payable by me			(70)
			11,305
Capital:			
Beginning of month		10,000	
Profit during the month:			
Depreciation	(125)		
Consultancy services	1,500		
Telephone bill	(70)	1,305	
End of the month			11,305

In this case, although I have not yet paid my £70 telephone bill, it relates to the current month and is therefore expenditure in the current month, thereby reducing my profit by that amount. My bank account is still unaffected since I do not pay the bill until the following month. The telephone company becomes my creditor for £70 until I actually pay the bill.

3. *Where both profit or loss and cash flow are affected, but by different amounts*

Continuing with the above example, supposing I receive a rates bill of £600 for the year and I pay it in advance. This means that although I pay £600 right at the beginning of the year, only 1/12 or £50 relates to each month. So my expenditure for the current month is £50, reducing my profit by £50 even though I have actually paid £600. The rating authorities will, at the first month end, in an accounting sense ‘owe’ me £550 (£600-£50) for the amount paid in advance. At the end of the second month they will owe £500, at the end of the third £450, and so on.

My Balance Sheet will alter as follows, at the end of the first month:

	£	£	£
Bank Account (£4,000-£600)			3,400
Motor car:			
Cost		6,000	
Depreciation		(125)	
			5,875
Amount owing to me for services rendered			1,500
Rates prepaid by me			550
Telephone bill payable by me			(70)
			11,255
Capital:			
Beginning of month		10,000	
Profit during the month			
Depreciation	(125)		
Consultancy services	1,500		
Telephone bill	(70)		
Rates	(50)	1,255	
End of the month			11,255

We have seen the various ways in which cash flow and profit or loss can be very different for the same accounting period.

Let us now prepare a summary of cash flow and profit or loss based on the above transactions which began with the purchase of a car:

	Cash Flow	Profit or Loss
	£	£
Purchase of car	(6,000)	
Depreciation	-	(125)
Consultancy services	-	1,500
Telephone bill	-	(70)
Rates	(600)	(50)
Movement in the month	(6,600)	1,255
Balance at the beginning of the month	10,000	-
Balance at the end of the month	3,400	1,255

In our example, while there has been a profit of £1,255 in the month, there has been a reduction of £6,600 in the bank balance during the same month, clearly demonstrating the distinction between cash flow and profit or loss.

Let us, finally, take another example which shows how, despite good trading results, a business can end up facing a cash flow crisis.

XYZ Limited starts the year with the following Balance Sheet as at 1/1/2014:

Assets:	£	£
- Premises, Fixtures and Fittings, Car etc.		100,000
- Bank Account		5,000
		105,000
Capital:		
- Beginning of the month	80,000	
- Accumulated profits	25,000	105,000

During the first three months of 2014, XYZ Limited expands its business rapidly, but at the same time there are long delays in payment by the customers. At 31/3/2014, the Balance Sheet is as follows:

Assets:	£	£
- Premises, Fixtures etc.		100,000
- Amount owing by customers		40,000
- Bank Overdraft		(15,000)
		125,000
Capital:		
- Beginning of the month	80,000	
- Accumulated profits	45,000	125,000

The deadline set by the bank for a drastic reduction of the overdraft passes in April 2014. The management of XYZ Limited is unable, despite strenuous efforts, to obtain sufficient funds from customers who owe money. In June, the bank concerned starts liquidation proceedings against the company.

This is a very simple example that illustrates how a business can go to the wall even though it has been trading profitably right up to the very end.

b) Balance Sheet

Having examined the differences between cash flow and profit or loss, let us now turn to the Balance Sheet and its main features.

In Chapter 2 we defined a Balance Sheet as a statement reflecting the financial position or wealth of an individual or a business. We saw that a Balance Sheet is made up of assets (items owned) and liabilities (amounts owed), the excess of assets over liabilities being the capital of the individual or the business.

There are two further points of fundamental importance in relation to a Balance Sheet, which should be clearly understood.

Firstly, a Balance Sheet, as the name suggests, must always balance. By that we mean that the value of assets minus the value of liabilities must always equal the amount shown as capital. The same equation can be expressed as follows:

Assets - Liabilities = Capital
or Assets = Liabilities + Capital

If, therefore, having prepared a Balance Sheet at the end of an accounting period it is found that the total of assets does not equal the total of liabilities plus capital, we can then immediately conclude that there has been some error in the accounting process leading up to the preparation of the Balance Sheet. Of course it is possible to have negative capital, i.e. where liabilities exceed assets, for example, where losses have occurred which exceed the original capital. In such cases, the assets minus liabilities would be negative and would equal the negative capital. Here again, the Balance Sheet would still balance.

Secondly, every transaction must always affect the Balance Sheet, even though it may or may not affect cash flow or profit or loss.

Let us examine both these fundamentals by reviewing the example shown earlier in the section on profit or loss and cash flow, and demonstrate the impact of those transactions on the Balance Sheet.

Impact on the Balance Sheet

		Assets		Capital/Liabilities	
			£		£
1.	Purchase of a car	Car	+ 6,000		
		Bank A/c	- 6,000		
2.	Depreciation	Car	- 125	Capital	- 125
3.	Consultancy services	Amount owing to me	+ 1,500	Capital	+1,500
4.	£70 telephone bill			Amounts owing by me	+ 70
				Capital	- 70
5.	£500 rates bill	Amount owing to me (prepayment)	+ 550	Capital	- 50
		Bank account	- 600		
	Total of changes		+1,325		+1,325

The overall effect of the above transactions is that the total of assets increases by £1,325 and the total of capital plus liabilities by the same amount, represented by the equation:

Assets (+£l, 325) = Capital (+£1,255) + Liabilities (+£70)

We can see that each of the above transactions has two sides to it, one side balancing the other, so that the balance between assets on the one hand and capital and liabilities on the other is always maintained. Hence, for instance, as a result of purchasing the car, the bank balance is reduced by £6,000 but is replaced by another asset in the form of a car worth £6,000; therefore, assets continue to equal capital + liabilities. Again, for instance, as a result of one month's depreciation, the assets side is reduced by £125 and the capital plus liabilities side is also reduced by the same amount; once more, assets continue to equal capital plus liabilities. Even where, as quite often happens in practice, a single transaction affects more than two items on the Balance Sheet, the effect of the transaction on the Balance Sheet must be such that the equation, Assets = Capital + Liabilities, *always* holds good.

In summary, whether or not a transaction affects cash flow or profit or loss, it must always affect the Balance Sheet, and the Balance Sheet must always balance after the recording of each transaction.

CHAPTER 4

RECORDING BUSINESS TRANSACTIONS— JOHN SMITH EXAMPLE

We have so far seen how transactions we enter into in our ordinary day-to-day lives affect our financial position in terms of cash flow, profit or loss and the Balance Sheet. The basic terms and concepts we have already examined in some detail are just the same when applied to a business as they are when applied to our private affairs, even though business transactions are normally far more numerous and complex.

Let us now move on from private finances to a business situation with an example in which John Smith starts a business on 1st January. To reinforce our understanding of the concepts dealt with so far, we will look at each transaction, one at a time, and see how it affects the Balance Sheet, the Profit and Loss Account and the Cash Book.

Remember: every transaction must affect the Balance Sheet, but not necessarily the Profit and Loss Account or the Cash Book. Also, the Balance Sheet must always balance.

1. On 1st January John Smith starts a furniture business with £10,000 capital which he deposits in his bank account

Effect on the Cash Book and the Balance Sheet:

Cash Book			Balance Sheet				
Receipts	£	Payments	£	Assets	£	Capital & liabilities	£
Capital invested	10,000			Bank Account	10,000	Capital	10,000

There is no effect on the Profit and Loss Account since he has yet to start trading (i.e. generating income and incurring expenditure).

2. ***On 4th January some furniture is bought and a purchase invoice for £5,000 received. £500 is paid immediately on account. (The furniture is for resale – not for his office use).***

Effect on the Cash Book and the Balance Sheet:

Cash Book				Balance Sheet			
Receipts	£	Payments	£	Assets	£	Capital & Liabilities	£
Capital invested	10,000	Payment on account	500	Bank Account (10,000-500)	9,500	Creditor (5,000-500)	4,500
		Balance	9,500	Stock	5,000	Capital	10,000
	10,000		10,000		14,500		14,500

Although goods have been purchased, the cost of those goods is treated as stock, an asset, and not as expenditure, since the goods have not yet been sold. There has been some movement in the bank account, and the Balance Sheet now includes stock and a creditor for unpaid goods. It is only when the goods are sold that a profit or loss will arise, as the next transaction will show.

3. ***On 10th January £4,000 worth of furniture in stock is sold for £5,800 on credit (i.e. none of the £5800 is received immediately).***

Effect on the Profit and Loss Account and the Balance Sheet: