Chapter 1

Your online material refers to this as Chapter 3

Double entry bookkeeping – an introduction

Outcome

By the end of this session you should be able to:

- identify the different types of business there are
- describe the different types of accounting and the financial statements
- understand the basic principles of accounting including the accounting equation
- define common terms used in accounting including capital income, capital expense, revenue income and revenue expense

and answer questions relating to these areas.

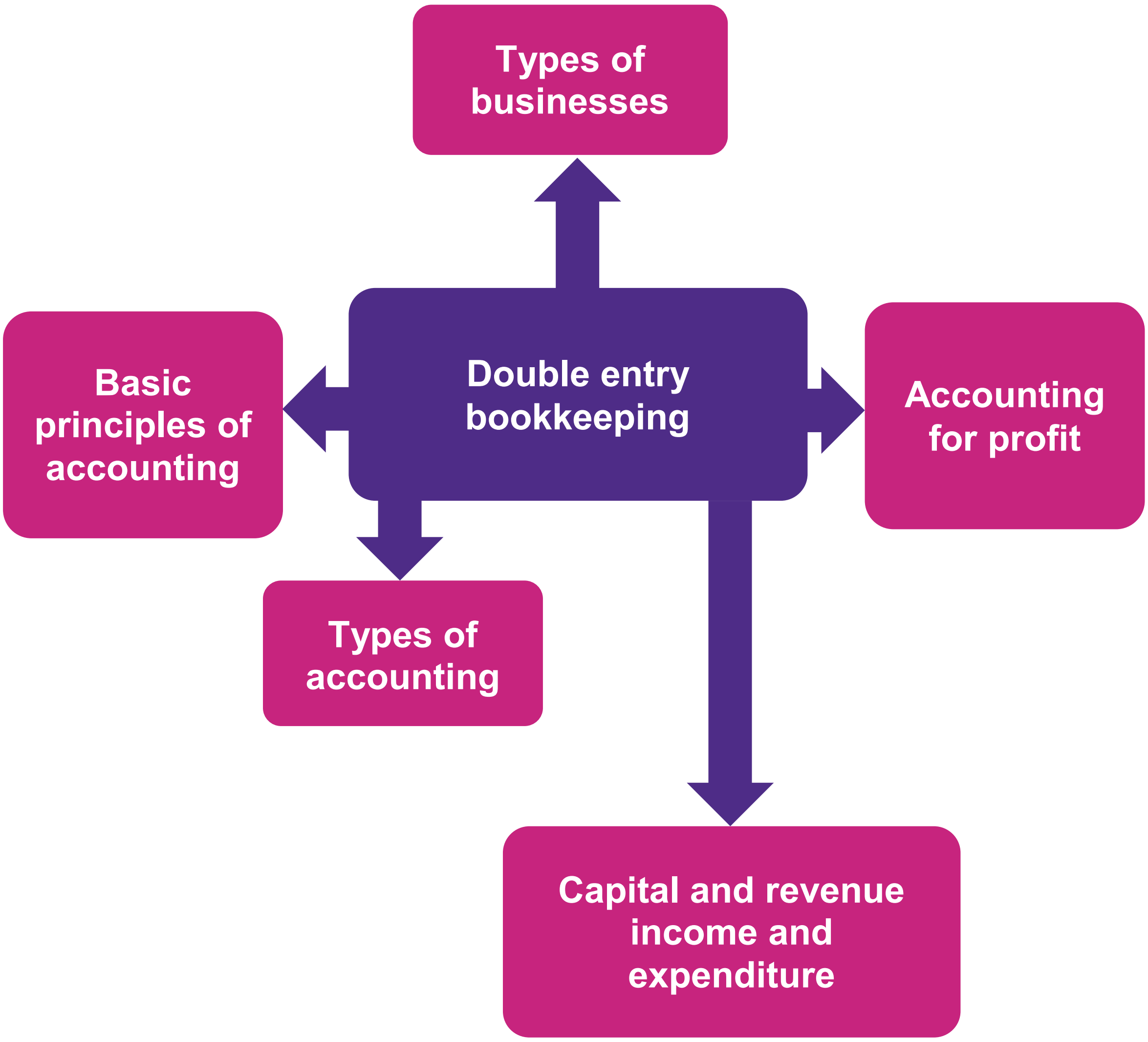
Resources

This topic is covered on MyKaplan

OnDemand module: Double entry bookkeeping and ledger accounting – Double entry – an introduction

The underpinning detail for this Chapter in your Workbook can be found in Chapter 3 of your Study Text

Overview


Types of businesses
Basic principles of accounting
Double entry bookkeeping
Accounting for profit
Types of accounting
Capital and revenue income and expenditure

1 Types of businesses

There are three types of businesses:

Sole trader – organisations that are owned and operated by one person.

Partnership – These are organisations owned by two or more persons working in common with a view to making a profit.

Company – These are organisations recognised in law as 'persons' in their own right. A company may own assets and incur liabilities in its own name. The accounting of these organisations must meet certain minimum obligations imposed by legislation, for example, via company law and other regulations.

Sole trader

- The business is owned and operated by one individual.
- The business is usually small.
- The owner is personally liable for the business debts (one legal entity).

Partnership

- Two or more people carry on a business together.
- Partners are usually personally responsible for business debts (one legal entity).
- Partners are usually jointly and severally liable for the business debt, unless an agreement has been drawn up that states otherwise.
- The business can be very large.

Company

- An incorporated business which has its own legal entity, distinct from the owners of the business.
- The owners of the business are shareholders who are not usually liable for business debt.
- Accounts preparation and presentation in accordance with international accounting standards.

Notes

2 Types of accounting

Depending on what purposes the statements are being produced for, the accounts can be referred to as being either **management accounts** or **financial accounts.**

Management accounts

These are usually prepared on a monthly basis to present timely financial and statistical information to business managers. This aids managers to run the business more effectively by making day-to-day and short-term decisions.

Financial accounts

These are prepared annually, mainly for the benefit of people outside the management of the business, such as the owners of the business (for example, shareholders who have appointed directors to run the business on their behalf), HM Revenue and Customs, banks, customers, suppliers and the government.

Financial statements

There are two key financial statements.

Statement of profit or loss

This summarises the effects of trading – the income and expenses, and shows the financial performance of the business for a given time period, usually the last twelve months.

Statement of financial position

This presents a snap shot of the financial position of the business at a specific moment in time, summarising the assets and liabilities of a business.

Notes

These items you will find on the statement of profit or loss:

Sales revenue	Income generated from the trading activities of the business.
Cost of sales	The cost of buying or producing the goods for resale.
Gross profit	The profit remaining, after the cost of sales have been deducted from sales revenue.
Sundry income	Other types of income that are not generated by the primary trading activities of the business. *Examples:* Commission received, bank interest received, rent received.
Expenses	The day to day running costs of the business. *Examples:* Heat and light, rent and rates, stationery and entertainment.
Net profit or loss	The profit or loss remaining after expenses have been deducted.

These items you will find on the statement of financial position:

Asset	Something owned or controlled by the business, available for use by the business. *Examples:* Buildings, Vehicles, Inventory, Receivables, Bank and Cash. Assets can be categorised as being either **'non-current'** or **'current'**.
Non-current asset	An asset which is to be used for the long term and not resold as part of the trading activities. *Examples:* Buildings, Vehicles, Plant and Machinery.
Current asset	A short term asset of the business which is either cash or will soon be converted into cash. *Examples:* Inventory, Receivables, Bank and Cash.
Receivable	An example of a current asset – a receivable is someone who owes the business money. A receivable is created when the business sells to a customer on credit.
Liability	An amount owed by the business. It is an obligation to pay money at a future date. *Examples:* Loans, Mortgages, Payables and Bank Overdraft. Liabilities can be categorised as being either **'current'** or **'non-current'**.

These items you will find on the statement of financial position:

Non-current liability	An amount owed by the business and due to be paid in the longer term (after 12 months). *Examples:* Loan, Mortgages.
Current liability	An amount owed and due to be paid by the business in the short term (less than 12 months). *Examples:* Trade payables, Bank overdraft, VAT payable.
Payable	An example of a current liability – a payable is someone the business owes money to. A payable is created when the business buys goods on credit from a supplier.
Capital	The amount which the owner has invested in the business – this is owed back to the owner and is therefore considered to be a special liability of the business.
Drawings	Amounts withdrawn from the business by the owner for the owner's personal use. Drawings can either be cash or inventory.

Notes

Shown below is a sample format of the statement of profit or loss:

Statement of profit or loss for the year ended 31 December 20X1

	£	£
Sales revenue		X
Less: sales returns		(X)
		X
Less: Cost of sales		
Opening inventory	X	
Purchases	X	
Purchase returns	(X)	
Closing inventory	(X)	(X)
Gross profit		X
Sundry income		X
Expenses		
Rent	X	
Electricity	X	
Irrecoverable debt	X	
Stationery	X	
Telephone	X	(X)
Net profit for the year		X

Notes

Shown below is a sample format of the statement of financial position:

Statement of Financial Position as at 31 December 20X1

	Cost	**Depreciation**	**Carrying amount**
	£	£	£
Non-current assets:			
e.g. land and buildings	X	X	X
Current assets:			
Inventories		X	
Trade receivables		X	
Bank		X	
			X
Non-current liabilities:			(X)
Current liabilities:			
Trade payables		X	
VAT payable		X	
			(X)
Total net assets			X
Capital account			
Capital			X
Profit/(Loss) for the year			X/(X)
Less: Drawings			(X)
			X

3 Capital and revenue income and expenditure

Capital income

Income received from the sale of non-current assets.

Example: The proceeds received from selling a motor vehicle.

Revenue income

Income received from the trading activities.

Example: The proceeds received from selling goods (inventory).

Capital expenditure

Expense of acquiring or improving non-current assets.

Examples: Buying a piece of machinery, removing single glazed windows and replacing with double glazed windows.

Revenue expenditure

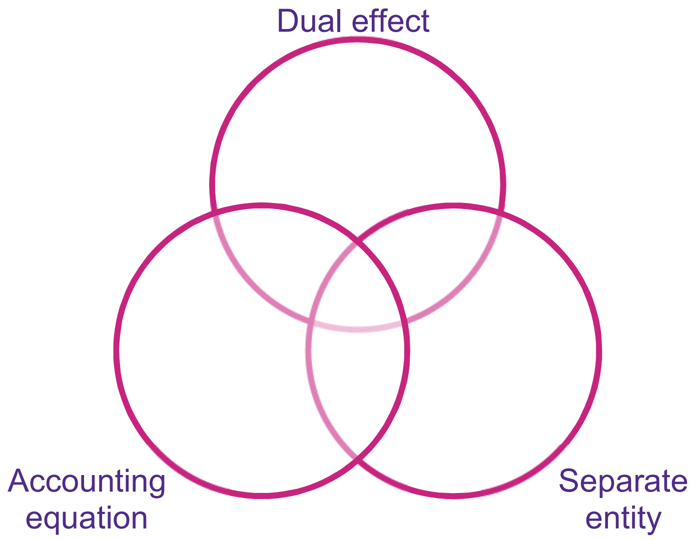
Day to day running expenses of the business, including the repair and maintenance of non-current assets.

Examples: Gas, electricity, rent, repairs and maintenance.

Notes

4 Basic principles of accounting

This chapter introduces the basic concepts and rules of bookkeeping. In particular we study the dual effect principle, the separate entity principle, and the accounting equation. Together these will show how the assets of a business will always equal its liabilities and will pave the way for studying double entry bookkeeping.



Dual effect

This states that every transaction has two financial effects.

For example, you buy a new printer for £500 cash.

You now have a new printer, which is an asset. But your cash has decreased by £500.

Separate entity

This states that the owner of the business is, for accounting purposes (not necessarily legal purposes), a completely separate entity from the business itself.

Notes

Example 1

e.g.

For each transaction write down the dual effect:

1 John started the business by putting £5,000 into his business bank account.

2 John pays himself £200.

3 John's business buys a van for £1,000 cash.

4 John's business buys a computer for £500 and promises to pay later (buys on credit).

The accounting equation

At its simplest, the accounting equation simply says that:

Assets = Liabilities

The owner's capital is treated as a special form of liability as the money is owed back to the owner. If we include this the accounting equation is now:

Assets = Liabilities + Capital

This can be re-stated as:

Assets – Liabilities = Capital

Any profit the business makes will increase what is owed back to the owner and any drawings taken will reduce it. Therefore, we can re-write the equation as:

Assets – Liabilities = Capital + Profit* – Drawings

**NB:* A loss would be subtracted from the capital

The statement of financial position is a more detailed display of the accounting equation.

Notes

Example 2

The example is based on a business named TLC – it shows a number of transactions that a business may enter into and how the basic principles of accounting are applied. Once we have reviewed the example we will consider the need to account for profit which paves the way for us learning about double entry bookkeeping.

1 Introduce capital

You win £10,000 and use it to create a retail business (called TLC) selling hearts and roses. What is the effect?

Answer 1

Dual effect

TLC's position is:

Assets	*Capital*
£	£

2 Buy inventory with cash

TLC buys 500 chocolate hearts for cash. The cost of each heart is £5. What is the effect?

Example 2 – continued

Answer 2

Dual effect

TLC's position is:

Assets	*Capital*
£	£

3 Buy inventory on credit

In reality a business will not always pay for its purchases with cash but is more likely to buy things on credit.

TLC buys inventory of 200 red roses on credit. Each red rose costs £10. What is the effect?

Answer 3

Dual effect

TLC's position is:

Net assets	*Capital*
£	£

Note: 'Assets' column is now referred to 'Net assets' due to the liability being deducted from assets.

Example 2 – continued

4 Buy a delivery van

The delivery van is bought for ongoing use within the business rather than for resale. Such assets are known as non-current assets.

TLC buys a delivery van for £1,000 cash. What is the effect?

Answer 4

Dual effect

TLC's position is:

	Net assets	*Capital*
	£	£

5 Sell inventory for profit

TLC sells 200 red roses for £15 cash each. What is the effect?

Answer 5

Dual effect

TLC's position is:

	Net assets	*Capital*
	£	£

Example 2 – continued

6 Sell inventory (on credit) for profit

It is equally likely that a business will sell goods on credit. When goods are sold on credit, an asset of the business called a receivable is generated.

TLC sells 400 chocolate hearts to Valentino for £12.50 each on credit. What is the effect?

Answer 6

Dual effect

TLC's position is:

	Net assets	*Capital*
	£	£

7 Pay expenses

In reality, TLC will have been incurring expenses from its commencement.
TLC received and paid a gas bill for £500. What is the effect?
Answer 7
Dual effect

TLC's position is:

	Net assets	*Capital*
	£	£

Example 2 – continued

8 Take out a loan

In order to fund your future expansion plans for TLC, you persuade your Aunt to lend TLC £2,000.

TLC is loaned £2,000 cash by your Aunt. She expects to be repaid in two years' time. What is the effect?

Answer 8

Dual effect

TLC's position is:

	Net assets	*Capital*
	£	£

Notes

5 Accounting for profit

So far when we have bought or sold inventory or paid expenses we have seen the effect on a single profit account.

However, in practice this is not ideal as the owners of the business will want to keep track of all of the separate elements that make up their profit and not have to calculate the profit after every single transaction.

To keep detailed accounting records we now need to record all sales, purchases and expenses separately, as opposed to working out the impacts on inventory and profit after every transaction.

From now on there will be no inventory account and no profit account as we have seen in the examples in this chapter. The inventory value will be calculated periodically by carrying out an inventory count or 'stock take' and will be entered into the accounts of the business as a year-end journal adjustment. The profit, or loss, for the period will be calculated by preparing the statement of profit or loss.

Notes

Example 3

Our dual effects are now:

Buy inventory for cash

Buy inventory on credit

Sell inventory for cash

Sell inventory on credit

Pay a bill for gas with cash

Receive an electricity bill and don't pay it yet

6 Summary

Types of businesses

- Sole traders
- Partnerships
- Companies

Types of accounting

- Management accounting
- Financial accounting

Financial statements

- Statement of profit or loss – summary of financial performance
- Statement of financial position – summary of financial position

Basic principles of accounting

- Dual effect – every transaction has two financial effects
- Separate entity – the business and the owner are seen as two separate accounting entities
- Accounting equation

  Assets – Liabilities = Capital

Notes

Illustrations and further practice

Further reading

For more detailed explanation, analysis and illustration of this topic please read Chapter 3 of the Bookkeeping Transactions Study Text.

Less detailed summaries can be found in Chapter 3 of the BTRN Pocket Notes.

Additional, more challenging questions

The following questions can be found within Chapter 3 of the BTRN Study Text.

1 – 3

Exam kit questions

You should now be able to answer the questions from this section of the Exam Kit

- understanding the double entry system

If you are attending a revision course, please do not attempt the Exam Kit questions until your tutor instructs you to do so.

Additional tutor resources

Tutor's question bank

Double entry bookkeeping – an introduction – support and advanced questions

These questions and answers may be printed off separately and distributed to students as necessary, to supplement the material listed above.

Additional tutor guidance

We recommend the following additional questions for the topics covered in this chapter:

Study Text (for teaching throughout the Chapter)

- Double entry bookkeeping – an introduction (Chapter 3): activities 1 – 3

7 Answers

Example 1

For each transaction write down the dual effect:

1 John started the business by putting £5,000 into his business bank account.

The business has £5,000 more cash – asset (cash) increases

The business owes £5,000 back to the owner – liability (capital) increases

2 John pays himself £200.

The business has £200 less cash – asset (cash) decreases

The business has repaid some of John's investment – drawings increase

3 John's business buys a van for £1,000 cash.

The business has a van for £1,000 – asset (nca-vehicles) increases

The business has £1,000 less cash – asset (cash) decreases

4 John's business buys a computer for £500 and promises to pay later (buys on credit).

The business has a computer for £500 – asset (nca-computer) increases

The business owes the supplier £500 – liability (payables) increases e.g.

Example 2

The example is based on a business named TLC – it shows a number of transactions that a business may enter into and how the basic principles of accounting are applied. Once we have reviewed the example we will consider the need to account for profit which paves the way for us learning about double entry bookkeeping.

1 Introduce capital

You win £10,000 and use it to create a retail business (called TLC) selling hearts and roses. What is the effect?

Answer 1

Dual effect

Increase cash £10,000 (asset)

Increase capital £10,000 (capital)

TLC's position is:

	Assets		*Capital*
	£		£
Cash	10,000	Capital introduced	10,000

2 Buy inventory with cash

TLC buys 500 chocolate hearts for cash. The cost of each heart is £5. What is the effect?

Example 2 – continued

Answer 2

Dual effect

Increase inventory £2,500 (asset)

Decrease cash £2,500 (asset)

TLC's position is:

	Assets		*Capital*
	£		£
Inventory	2,500	Capital introduced	10,000
Cash	7,500		

3 Buy inventory on credit

In reality a business will not always pay for its purchases with cash but is more likely to buy things on credit.

TLC buys inventory of 200 red roses on credit. Each red rose costs £10. What is the effect?

Answer 3

Dual effect

Increase Inventory £2,000 (asset)

Increase Payables £2,000 (liability)

TLC's position is:

	Net assets		*Capital*
	£		£
Inventory	4,500	Capital introduced	10,000
Cash	7,500		
Payables	(2,000)		
Net assets	10,000		

Note: 'Assets' column is now referred to 'Net assets' due to the liability being deducted from assets.

Example 2 – continued

e.g.

4 Buy a delivery van

The delivery van is bought for ongoing use within the business rather than for resale. Such assets are known as non-current assets.

TLC buys a delivery van for £1,000 cash. What is the effect?

Answer 4

Dual effect

Increase non-current asset £1,000 (asset)
Decrease cash £1,000 (asset)

TLC's position is:

	Net assets		*Capital*
	£		£
NCA	1,000	Capital introduced	10,000
Inventory	4,500		
Cash	6,500		
Payables	(2,000)		
Net assets	10,000		

5 Sell inventory for profit

TLC sells 200 red roses for £15 cash each. What is the effect?

Answer 5

Dual effect

Increase cash £3,000 (asset)
Decrease inventory £2,000 (asset)
Increase profit £1,000

TLC's position is:

	Net assets		*Capital*
	£		£
NCA	1,000	Capital introduced	10,000
Inventory	2,500	Profit	1,000
Cash	9,500		
Payables	(2,000)		
Net assets	11,000		

Example 2 – continued

e.g.

6 Sell inventory (on credit) for profit

It is equally likely that a business will sell goods on credit. When goods are sold on credit, an asset of the business called a receivable is generated.

TLC sells 400 chocolate hearts to Valentino for £12.50 each on credit. What is the effect?

Answer 6

Dual effect

Increase Receivables £5,000 (asset)
Decrease Inventory £2,000 (asset)
Increase profit £3,000

TLC's position is:

	Net assets		*Capital*
	£		£
NCA	1,000	Capital introduced	10,000
Inventory	500	Profit	4,000
Receivables	5,000		
Cash	9,500		
Payables	(2,000)		
Net assets	14,000		

7 Pay expenses

In reality, TLC will have been incurring expenses from its commencement.
TLC received and paid a gas bill for £500. What is the effect?
Answer 7
Dual effect
Decrease cash £500 (asset)
Decrease profit £500

TLC's position is:

	Net assets		*Capital*
	£		£
NCA	1,000	Capital introduced	10,000
Inventory	500	Profit	3,500
Receivables	5,000		
Cash	9,000		
Payables	(2,000)		
Net assets	13,500		

Example 2 – continued

e.g.

8 Take out a loan

In order to fund your future expansion plans for TLC, you persuade your Aunt to lend TLC £2,000.

TLC is loaned £2,000 cash by your Aunt. She expects to be repaid in two years' time. What is the effect?

Answer 8

Dual effect

Increase cash £2,000 (asset)

Increase loan £2,000 (liability)

TLC's position is:

	Net assets		*Capital*
	£		£
NCA	1,000	Capital introduced	10,000
Inventory	500	Profit	3,500
Receivables	5,000		
Cash	11,000		
Payables	(2,000)		
Loan	(2,000)		
Net assets	13,500		

Example 3

Our dual effects are now:

Buy inventory for cash

Cash decreases

Purchases increase

Buy inventory on credit

Payables increase

Purchases increase

Sell inventory for cash

Sales increase

Cash increases

Sell inventory on credit

Sales increase

Receivables increase

Pay a bill for gas with cash

Cash decreases

Gas expense increases

Receive an electricity bill and don't pay it yet

Payables increase
Electricity expense increases