

A PITMAN INTERNATIONAL TEXT

# Basic Accounting Practice

M W E Glautier, B Underdown and A C Clark

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## FOREWORD

### On Financial Control

‘Coming home tonight I did go to examine my wife’s accounts, and finding things that seemed somewhat doubtful I was angry, though she did make it pretty plain, but confessed that when she do miss a sum she do add something to other things to make it, and upon my being very angry she do protest she will here lay up something for herself to buy a necklace with, which madded me and do still trouble me, for I fear she will forget by degrees the way of living cheap and under sense of want.’

Samuel Pepys (1633-1703) *Diaries*

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B. Underdown Pitman Publishing 1974

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*Basic Accounting Practice* a workbook M. W. E. Glautier B. Underdown A. C. Clark  
Pitman Publishing 1977

*Teachers' Guide to Basic Accounting Practice* a solutions manual M. W. E. Glautier  
B. Underdown A. C. Clark Pitman Publishing 1977

# Introduction

*Basic Accounting Practice* has been designed as a workbook to be used in conjunction with *Accounting Theory and Practice*, and it forms part of a teaching programme which covers both the theoretical and the practical problems of accounting. *Accounting Theory and Practice* discusses accounting practices and procedures in terms of a theoretical framework which provides an understanding of their purposes. *Basic Accounting Practice* focuses attention on the practical problems of implementing these practices and procedures.

Unlike other workbooks, however, *Basic Accounting Practice* does not simply pose a series of questions and problems. On the contrary, each question is preceded by an explanation of the particular accounting objective to which a procedure is addressed and an illustration is given, where necessary, by way of a more complete exposition of the accounting problem. Care has been taken to ensure a gradual introduction to the complexities involved, and in this sense, *Basic Accounting Practice* has been programmed to begin with the most simple questions and to proceed gradually to more advanced problems.

Moreover, *Basic Accounting Practice* reflects the experience of teaching accounting in the different settings and institutions with which the authors have been associated. A conscious effort has been made to clear away the initial difficulties which students find at the early stages of study by a variety of alternative teaching techniques. Thus, flow-charts, diagrams and illustrations are widely used *in addition to* the conventional accounting format which relies on the manner in which entries are made in the financial records. In some instances, the questions are themselves programmed to contain explanations which may be needed by the student, and which are uncovered by him as he proceeds through these questions. Finally, case problems and case studies are employed with a view to developing further insights into the nature of the accounting problem. Thus, *Basic Accounting Practice* will be found useful to those teaching situations where variety in teaching methods is appreciated by both the teacher and the student.

*Basic Accounting Practice* considers accounting as a social science: one which has emerged as a response to the requirements of society as a whole and, with varying degrees of relevance, to sub-groups of society. This approach, which has been essentially a pragmatic one, has militated against the emergence of a universally accepted theory of accounting with laws of the type associated with the natural sciences. Moreover, this pragmatic approach to the development of accounting method in the past resulted in the formulation of particular techniques which sought, with varying degrees of success, to deal with problems and conditions as they were perceived. However, accounting does not

possess inbuilt mechanism for shedding outworn practices, some of which have lingered in current texts and examination syllabuses. Accordingly, this text will attempt to identify those techniques which retain a relevance for the solution of modern accounting problems and, in this regard, will select out of the corpus of accounting method those practices which are appropriate to modern needs.

By reason of its concern with what are essentially socio-economic activities, accounting has emerged also as an interdisciplinary science which draws upon knowledge associated with other disciplines: for example, economics, the behavioural sciences and quantitative techniques which have their origins in mathematics. Having its roots in human behaviour and a concern with the logic of numbers, accounting seeks to provide information in the form of measurements relevant to decision making, and is thereby faced with a dilemma, for, in the last analysis, rationality can only be understood in a behavioural context. For this reason, this text will emphasize the role of accounting in a broad perspective. The predictive-ability of accounting numbers will be discussed, not only in terms of the inferences they imply for the future but also in terms of their influence on human behaviour.

*Basic Accounting Practice* is presented in three parts. Part 1 considers financial accounting, which traditionally has been concerned with the control of assets and liabilities by the provision of a system of record keeping. This function is also addressed to the provision of information to investors in the form of income statements and position statements. Recently, this has been extended to the disclosure of cash flow statements. In effect, financial accounting may be said to be concerned with the process of exchange between the organization and its environment by recording the financial implications of the acquisition of resources and the financial claims which are involved, as well as the disposal of the organization's output in the form of goods and services and the financial rights which are thereby created. Part 2 deals with management accounting, which is concerned with the provision of information for planning and controlling the internal operations of the firm. In effect, management accounting may be said to be concerned with the process of exchange or conversion of resources which have been acquired by the firm into the goods and services which will be dispensed in the course of trade. This exchange may be described as being internal rather than external. Finally, Part 3 provides some exposure to problem situations where accounting plays an influential role in decision making. This is achieved by means of case problems and case studies in which 'accounting numbers' are pitched into the 'business game' where logic and human behaviour interact.

Although *Basic Accounting Practice* is intended both to complement and supplement the main teaching text *Accounting Theory and Practice*, it may also be used in conjunction with other leading accounting texts. It is directed to the needs of first-year students reading accounting at universities and polytechnics, as well as students taking courses in business and management studies, both at undergraduate and postgraduate level, who require some knowledge of accounting methods. *Basic Accounting Practice* will be found to be particularly relevant for students preparing for the first examinations of the professional institution and courses which have a practical orientation, such as the High National Diploma in Business Studies.

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Except where acknowledged, the names and cases used in this book are totally fictitious and resemblances to any person or factual cases are purely coincidental.

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# 1 The Financial Accounting Framework

The purpose of this chapter is to outline the financial accounting framework and to analyse its major constituent elements. These are identified as comprising the following:

- (1) A conceptual framework which relates the accounting process to an entity defined as the *accounting entity*.
- (2) A method for handling financial data which is known as *double entry book-keeping*.
- (3) A data classification, processing, storage and retrieval system which is associated with the *ledger*.
- (4) A set of procedures for classifying, processing, storing and retrieving data which is known as the *bookkeeping system*.

Accordingly, this chapter is divided into four sections dealing with these respective aspects of the financial accounting framework.

## SECTION 1 THE ACCOUNTING ENTITY

The accounting entity is a concept which defines the boundaries of data collection, and determines what records are relevant to informed decision-making in respect of business activity. The accounting entity may be defined as an individual activity or group of activities which can be recognised clearly as having a separate identity and using economic resources in pursuit of its aims. The recognition of the separation of the economic activity of the accounting entity from the private affairs of its owner or owners is an essential feature of what is known as the *entity convention*, irrespective of the legal form which ownership may assume. Thus, the entity convention establishes a distinction between the owner of the business and the business itself, even though it is a one-man business having no separate legal identity. In this respect, L. Jones trading as L. Jones, Greengrocer is seen in accounting as being two separate entities – the former being essentially of a personal and private nature, the latter being the business activity which the entity convention treats as distinct and separate from the former.

Once the accounting entity has been identified, it is possible to view it in two different ways. The proprietary theory or concept views the entity as being merely a vehicle by means of which the owner or proprietor derives income. By contrast, the entity theory or concept views the entity as having its own objectives and interprets the status of the

legal owners as similar to that of other external claimants. Due to its distinct legal status, the joint stock company appears to afford the most realistic example of a form of enterprise which reflects the entity theory. This chapter begins with an examination of the business activities of a sole trader, that is, the typical small business which is usually both owned and managed by a single proprietor. Consequently, the approach adopted initially in this chapter will reflect the proprietary concept of the accounting entity.

## SECTION 2 BOOKKEEPING AND THE DUAL ASPECT

The double-entry bookkeeping system has been in existence for some 700 years and its survival has been due to its ability to fulfil certain functions. These functions include keeping an accurate record of indebtedness between the entity and other parties, providing an analysis of expenditure and measuring income. The first two of these functions are examined in this chapter. In this regard, the purpose of this analysis is to explain the manner in which accounting numbers are derived and aggregated as well as the bookkeeping techniques involved in the manipulation of these numbers.

Double-entry bookkeeping is associated with a standardized set of procedures for recording and explaining basic accounting data. The procedures make use of a specially designed form of stationery. Exhibit 1 below represents an 'account', which is a typical format used to record transactions and to provide at the same time the essential data which explain the circumstances surrounding such transactions.

Dr. (1)		NAME OF ACCOUNT				(2) Cr.			
Date	Details	Folio	£	p	Date	Details	Folio	£	p
	(3)	(4)							

EXHIBIT 1 Traditional form of Accounting Stationery

### Notes:

- (1) *Dr* is notation for *debit*. By convention this indicates the left-hand side of an account.  
 (2) *Cr* is notation for *credit*. By convention this indicates the right-hand side of an account.

Both these terms are Latin in origin but the abbreviated form of *Dr* and *Cr* are now merely notation. These terms are used as verbs, nouns and adjectives. Essentially, the term 'debit' indicates an inflow of money value *to* an account and the term 'credit' indicates an outflow of money value *from* an account. The meaning of these terms is different, therefore, from that associated with their use in everyday language.

- (3) Each side of an account has space to provide details of the origin and destination of the flow of money value recorded. In the case of a debit entry, the details given would be

the name of the account *from which* the flow of money value originated. In the case of a credit entry, the details given would be the name of the account *to which* the flow of money value has gone. The practice has now been abandoned of prefacing a debit entry by the word *To* and a credit entry by the word *By*.

(4) The reference or 'folio' column is used to indicate the corresponding accounting entry in the ledger.

The double-entry technique of recording financial transactions reflects a fundamental accounting principle which equates the resources held by an enterprise with the claims against an enterprise in respect of these resources. The nature of this basic accounting equation is explained in the following example.

#### Example 1

Varlberg commits his personal savings of £10,000 to starting his own business as a painter and decorator. He transfers this sum to the business's bank account. In accordance with the accounting entity convention, the financial position of the business may be expressed as follows:

Assets	=	Claims against the business
(Bank £10,000)		(Owner's claim £10,000)

#### EXHIBIT 2

The owner's claim against the business is more usually referred to as his *capital* whilst other external claims are referred to as *liabilities*. Exhibit 2 is really a balance sheet or position statement.

Suppose now that Varlberg purchases a van for £4500 and equipment such as ladders, trestles, brushes, etc., for £750. The basic accounting equation would be redrafted to read:

Assets	=	Claims against the business
(Van £4500 + Equipment £750 + Bank £4750)		(Capital £10,000)

#### EXHIBIT 3

It may be noted that the distribution of the assets has changed without disturbing the basic equation. The changes which have occurred are as follows:

Van	Equipment	Bank
+ £4500	+ £750	— £5250

If Varlberg now purchases from suppliers a quantity of paints and paper costing £500 which he intends to use as his stock-in-trade (inventory) on terms which allow him to make payment for them at the end of the month following that of purchase, the basic