

BANKING CERTIFICATE SERIES

INTRODUCTION TO ACCOUNTING

KARL HARPER



Banking Certificate Series

Introduction to Accounting

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Preface

This book has been written specifically for those taking the CIB 'Introduction to Accounting' examination. As the key to success is continued practice, I have included progress tests throughout each chapter in order to develop and consolidate understanding, and self-assessment questions at the end of each chapter to both revise and test students' understanding and ability.

The inclusion of progress tests together with answers outlining the methodology is intended to provide a suitable workbook for those studying at home, while also reducing the lesson preparation for lecturers who could simply work through the text.

Finally, I would like to thank the many people who have assisted me, in particular David Palfreman (Series Editor) and Dominique de Buys who gave me confidence and set me on the road to writing; Elizabeth Tarrant and Sarah Sutton who helped turn manuscript into finished text; David 'Gordon' Eyles for his accounting knowledge and expertise, and Harry Revell for all the inspiration 'what he has given me'.

KH

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An introduction to accounting

Objectives

After studying this chapter you should be able to:

- 1 understand the nature and purpose of accounting;
- 2 list the financial information recorded by businesses;
- 3 explain the importance of recording financial information;
- 4 appreciate that while trading profitability is important, so too is a company's cashflow position

Introduction

You are now about to start the final section of the Banking Certificate and possibly wondering why you need to study accountancy; after all you are bankers not accountants.

The aim of this course, however, is not to turn you into accountants – preparing accounts for customers and helping them with their tax problems – but to help you to become better bankers, more capable of understanding a customer's financial position through an examination of their *accounts* (i.e. their financial information).

As banks have a variety of customers, we will examine the accounts of individuals trading as shopkeepers, taxi-drivers etc, and also of partnerships, limited companies and clubs and societies, first, through the recording of their financial information, and then through the interpretation and use of this information in order to make decisions, assess loan applications and assist your customers

What is accountancy?

As you may well be aware accountancy is concerned with *the recording of financial information*, but what financial information do we need to record and why?

What financial information do we need to record?

Imagine that you have started your own business, let us say a clothes shop; what financial information would you record? Before reading any further, see if you can make a list of the information you would record.

Now, let us see how our lists compare.

1 Details of any *items you purchased* in order to commence business such as:

Premises

Fixture and fittings (carpets, etc)

Equipment (cashtill)

• Van (to collect your stock)

Stock of clothes

2 *Your source of finance* (where you obtained the money to purchase such items). Most new businesses need to borrow money either to start their operation or to see them through the first year until the company is generating sufficient cash of its own. A loan may therefore be one of the company's sources of finance. Before agreeing to provide such finance the manager of your bank would wish to see that the owners of the company have also invested some of their own money in the business, i.e. capital. Your sources of finance may therefore be a combination of your own money, capital and loans.

3 *Cash received* in respect of sales.

4 *Cash paid out* in respect of further purchases of stock and overheads such as gas, electricity and wages.

5 As a banker I am sure you will realise that not everybody pays for goods in cash, and you will therefore need to record details of *all cheque and credit card transactions* which you both receive and pay.

6 Hopefully, after a period of trading you will be able to purchase your stock on credit, and therefore *purchases made on credit* are another item that needs to be recorded.

7 After a while you may decide to allow your regular customers to buy on credit and only a fool would fail to record details of *sales made on credit*.

Why do we need to record financial information?

Now that we have outlined the financial information we need to record, see if you can make a list of the reasons for recording

such information. Look back at the list of information in order to assist you, then compare your list with mine. While some of the points are obvious, others are more obscure, so don't worry if you don't manage to get all the points.

1 *To determine whether your clothes shop has achieved a profit or suffered a loss.* More sophisticated bookkeeping could be used to indicate the strong and weak areas of your business, e.g. to determine whether the ladies' section of your shop is profitable.

2 *To determine whether or not the business will be able to meet its financial commitments as they fall due,* through an examination of the company's *cashflow position*. (i.e. the flow of cash in and out of the business).

3 *To determine the financial strength and health of the business.*

4 *Credit given to customers* must be recorded to ensure payment is received on the due date, and *credit received* must be recorded to ensure we have the necessary funds available when payment is required.

5 *In order to assess your past performance.*

6 *To enable you to exercise control over your future progress.*

7 *To assist your decision-making.* While you may feel that the ladies' section of your shop is running at a loss, the financial information will provide the answer and therefore assist, or even make, your decision to discontinue this side of your business.

8 *In order to comply with the law.* As you will later discover, limited companies are required by law to publish an audited set of accounts.

9 The financial information *provides a valuable source of information* and is of interest to a number of people:

- (a) shareholders; or
- (b) partners — as the owners or joint owners, they are entitled to a share of the profits;
- (c) potential creditors; purchasers and shareholders;
- (d) existing creditors;
- (e) banks;
- (f) financial institutions — all of whom wish to see whether or not the company is financially healthy before they either invest in the company or provide credit or finance;
- (g) Inland Revenue — who are keen to see that the company meets its full tax liability at the appropriate date;
- (h) auditors — who are responsible for checking the accounts of the company;
- (i) managers within the company — who will be keen to monitor the profitability of their section.

How do businesses record their financial information?

As you have discovered, a considerable amount of information needs to be recorded. It is the accountant's task to collate all the information and to present it in a meaningful manner so that one can determine the profit or loss, whether or not the business will be able to meet its financial commitments, the financial strength and health of the business and so on.

Just how this is done is the subject of this book. The initial chapters are primarily concerned with the recording of financial information for various businesses — sole traders (i.e. someone who is the sole owner of a business, say a shopkeeper), partnerships and limited companies, in order to establish the profit or loss and demonstrate the financial position of the business through the Balance Sheet, which is the subject of Chapter 2.

Summary

1 Accountancy is concerned with the recording, collating and presenting of financial information in a meaningful manner.

2 The following financial information needs to be recorded:

- (a) items purchased to commence business, such as premises, equipment, stock etc;
- (b) your sources of finance, (where you obtained the money to purchase such items);
- (c) the amount of capital (money contributed by the owners of the business);
- (d) cash received;
- (e) cash paid out;
- (f) cheques and credit card transactions;
- (g) purchases on credit;
- (h) sales on credit.

3 You need to record financial information in order to:

- (a) determine your profit or loss;
- (b) assess whether or not the business will be able to meet its financial commitments as they fall due through an examination of the company's cashflow position;
- (c) determine the financial strength and health of the business;

- (d) ensure payment is received from customers buying on credit on the due date;
 - (e) ensure you have adequate funds available to meet demands from suppliers who have allowed you to buy on credit;
 - (f) assess past performance;
 - (g) exercise control over future progress;
 - (h) assist management in decision-making;
 - (i) comply with the law;
 - (j) provide information to interested parties.
- 4 Cashflow refers to the flow of cash in and out of the business.
- 5 The financial position of a company is of interest to the following people:
- (a) shareholders;
 - (b) partners;
 - (c) potential creditors, purchasers and shareholders;
 - (d) creditors;
 - (e) banks;
 - (f) financial institutions;
 - (g) Inland Revenue;
 - (h) auditors;
 - (i) managers.
- 6 A sole trader is someone who is the sole owner of a business.

Self-assessment questions

- 1 Make a list of financial information a businessman would need to record.
- 2 What is meant by a company's source of finance?
- 3 What is capital?
- 4 To which types of customer are businesses likely to offer credit facilities?
- 5 Make a list of the reasons for recording financial information.
- 6 What is meant by a company's cashflow position?
- 7 Why is it important for companies to monitor their cashflow position?

8 Who is interested in a company's financial position?

9 Bert is the owner of a small hotel. Describe three pieces of financial information which you think he should have so that he can exercise control over his business. Explain why these would be important to him in his day-to-day work. (6)
(CIB May 1987)

10 'In very few businesses could one obtain an accurate view of the profit or loss for a period by the simple study of cash receipts and payments for that accounting period'. Comment on this statement. (8)
(CIB October 1988)

11 List *six* separate reasons why businesses maintain financial records, and explain for each one why such records are needed. (20).
(CIB November 1989)

The balance sheet

Objectives

After studying this chapter you should be able to:

- 1 explain in simple terms the nature and purpose of a Balance Sheet;
- 2 define various accounting terms such as assets, liabilities, capital, etc;
- 3 distinguish between fixed and current assets, current and long-term liabilities;
- 4 understand what happens when a business buys or sells goods on credit;
- 5 produce a Balance Sheet in a horizontal format.

Introduction

You will recall from Chapter 1 that two important pieces of information recorded by businesses are:

- 1 details of *items purchased* in order to commence or continue in business, such as premises, equipment and stock, i.e. items the business *owns*; and
- 2 *the source of finance* (where they obtained the money to purchase such items). So far we have considered two sources:
 - (a) *capital* (money contributed by the owners) and
 - (b) *loans* (possibly from a bank) i.e. items the business owes.

You may be wondering why capital is considered to be money owed by the business; after all, it represents money contributed by the owners.

The reason for this is because we make a distinction between the owners and the business, treating each one separately.

Capital is therefore money owed by the business to the owners of the business.

The Balance Sheet format

So we have two pieces of information:

- 1 Items the business *owns*, which are known as *assets*.
- 2 Items the business *owes*, which may take the form of:
 - (a) *capital* (owed to the owners);
 - (b) *liabilities* (owed to outside providers of finance).

The Balance Sheet is a record of these details with *assets* on one side and the *capital* and *liabilities* on the other. It therefore reflects the company's financial position at a particular date.

Balance Sheet of example as at 1.9.X0

<i>Items the business owns</i>	<i>Source of finance/money owed</i>
Assets	Capital (owners)
	Liabilities (outside providers)

Let us look at an example.

Mr Davenport has just won £50 000 on the football pools and wishes to use the money to start his own business, designing and constructing conservatories, (i.e. the £50 000 is a *source of finance*, and as it is contributed by himself it is known as *capital*).

Having done some research he realises that he needs a further £10 000 and therefore approaches the bank for a loan. As his plans for the business appear sound and in view of his credit-worthiness the bank agrees to the loan but asks for a mortgage on his house as security (i.e. if Mr Davenport fails to repay the loan, the bank will be able to look towards the sale of the house for repayment). The loan is therefore another *source of finance*, but as it is contributed by someone other than the owners it is known as a *liability*. With the money Mr Davenport purchases the following *assets*:

Premises	£30 000
Fixtures	£5 000
Equipment	£2 000
Stock of material	£3 000

The Balance Sheet being a record of these details would appear as follows: