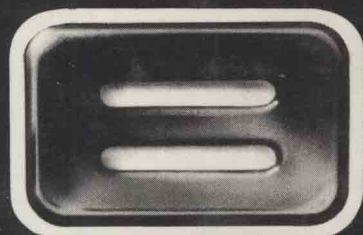
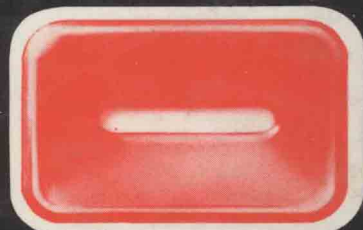
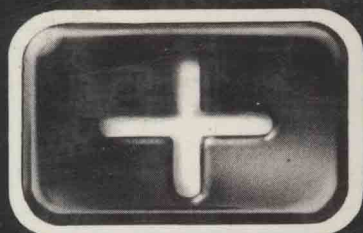


MACMILLAN MASTER SERIES

MASTERING PRINCIPLES OF ACCOUNTS



J. RANDALL STOTT

MASTERING PRINCIPLES OF ACCOUNTS

J. RANDALL STOTT, F.C.A.

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BASIC COMMERCE

PREFACE

The subject of accounting in this new textbook is built up progressively, step by step, with the interest of the student maintained through the recognition that 'double entry' is a working tool of management and not simply an exercise in balancing up sets of figures.

The book is designed specifically to cover the latest syllabuses of all major examining bodies in *Book-keeping and Accounts*.

The questions at the end of each chapter are based upon recent examination papers, and brief answers to all the problems questions are listed at the back of the book.

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CHAPTER 1

INTRODUCTION TO ACCOUNTING

1.1 HISTORICAL NOTE

Records of business transactions were kept before the days of the Pharaohs. Evidence of this has been found on crumbling clay tablets, buried deep in the sand of Ancient Babylonia.

Four thousand years ago a kind of paper was manufactured from reeds growing on the banks of the Nile. This was called papyrus, a Greek word from which our own word 'paper' is derived.

Centuries later, the Romans recorded their written word, command and deed on parchment vellum made from goatskin or calfskin. At that time, too, in south-east Asia, the Buddhist monks engraved an everyday 'account' of the revenue and expense of their monasteries upon *olas*, narrow strips cut from the young leaf to the talipot, a giant palm.

1.2 ORIGIN OF DOUBLE-ENTRY BOOK-KEEPING

Book-keeping, known in its correct form as 'double entry', has generally been attributed to Italy in the fifteenth century, when Venice was the centre of the maritime trade and merchant banking was being born. It is possible, however, that the Venetians adapted a system to suit their needs, copied perhaps from Moorish traders or some Semitic race who were extending their trade and commerce far from their native land.

For the past five hundred years huge leather-bound ledgers have recorded the rise and fall of financial empires, privately owned family businesses, monopolies of the State, and many firms of international repute.

Most of these cumbersome handwritten ledgers have been superseded by typewritten loose-leaf sectional ledgers, or by the even more up-to-date easy-for-reference individual files and folders housed in vertical or horizontal steel cabinets.

1.3 AGE OF BUSINESS EFFICIENCY

Specialisation and mass-production methods have led to mechanisation of office work, and machine accounting is now a characteristic of large and medium-sized firms.

Aids to speed and accuracy are to be seen in every modern office. The adding machine and calculator are within the reach, and purse, of every small trader.

Here again, we have an affinity with the past. The abacus of the Arab world was (and still is) similar in operation to the adding machine of today. The latter is simply the mechanical improvement and development of the other. The purpose of both is the same: to add up quickly and find an accurate total.

Despite modernistic trends in the method of recording transactions, accounting principles remain the same; there are still many handwritten ledgers, too, in various sections of the mercantile world of today.

Book-keeping is an essential part of the world of credit in which we live. Without credit in a limited form, everything would come to a stand-still. There would be a brake on forward planning and the many uncertainties and risk of the businessman would hold back production and large-scale enterprise.

Double entry is a complete system. It tells the true story about the financial affairs of a business: the capital it started with, what it has bought and sold; the profit made or the loss incurred; what it was worth yesterday and what it is worth today.

1.4 ACCOUNTING

The term 'accounting' in the sense it is used here, simply means *correct* book-keeping.

'Accounts' is rather a loose term, meaning either the written (or type-written) books of account, the recorded details made up from these books or ledgers, or the statements of account to be presented in summary form at the annual general meeting by the chairman of a company or by the treasurer of a cricket club.

1.5 LIABILITY TO KEEP ACCOUNTS

Limited companies are compelled by law to keep proper records of their financial transactions. The regulations of Companies Acts safeguard the interests of company members (shareholders) and also those of the creditors, to whom money is owing by the company for goods supplied and for services rendered.

Although sole traders and partnerships are not subject to a legal obligation, it is very much in their interests to keep proper records so that audited copies may be submitted to the Inland Revenue as proof of their business profits or losses. Failure to do so will render them liable to over-assessment of income tax, which means that they will pay more than what they need, simply because they cannot prove that they are liable for less. There are also severe obligations imposed upon most trading firms to keep records of Value Added Tax (V.A.T.), which, periodically, must be handed over to the Commissioners of Customs and Excise.

Clubs, societies and associations, generally, are non-trading organisations, but there is the responsibility towards members and supporters. The elected committee must produce a periodic statement giving information about subscriptions and donations received, and show how the money has been spent.

1.6 THE LANGUAGE OF THE BUSINESS WORLD

Some of the following words and terms may already be familiar to you, but from now on you must think of them in their accounting sense:

ASSETS Property, machinery, equipment, stock and money belonging to a business, including money owing by customers. (*See Debtor.*)

LIABILITIES Obligations and debts owing by the business for goods supplied or for services rendered, and, in some instances, for loans made. (*See Creditor.*)

CAPITAL OR NET WORTH This is the proprietor's financial interest or holding in the business, represented by the value of net assets, i.e. total assets less liabilities.

BALANCE SHEET A final statement of reckoning; the conventional style in the United Kingdom, until quite recently, has been to list the capital and liabilities on the left of the statement, and the assets on the right. It is not an account.

DEBIT May mean the left-hand side, a posting to the left-hand side, or the actual invoice or charge to a customer's account.

DEBTOR A person or firm owing money. Normally a customer who has not yet paid his account. The debt owing to the firm is a business asset.

CREDIT May mean the right-hand side, a posting to the right-hand side, or may refer to goods bought to be paid at a later date.

CREDITOR Is owed money by the business. Normally a supplier or wholesaler whose account has not yet been paid, but can refer to expense creditors whose services have been used, and to whom money is owing.

CASH TAKINGS OR CASH SALES Money taken daily in exchange for goods sold across the counter. No record need be kept of the customer's name. The money paid into the till takes the place of the goods taken off the shelf.

TURNOVER Trading revenue from cash sales, cash takings and credit sales.

CREDIT SALE The goods are handed over against a written or implied promise to pay later. The name and address of the customer must be recorded, the amount being part of a debtor's list until paid.

PURCHASES The total amount of goods bought for resale for cash or on credit during a trading period.

STOCK Goods bought for resale but *not yet sold*.

QUESTIONS

1. State briefly three reasons for the 'keeping of accounts'.
2. Distinguish between:
 - (a) debit and credit
 - (b) debtor and creditor
 - (c) purchases and stock
 - (d) an asset and a liability
 - (e) a cash sale and a credit sale.

CAPITAL AND THE BALANCE SHEET

Capital is something more than money in the bank. The capital of a business, shown on a statement called the 'balance sheet', comprises:

ALL BUSINESS ASSETS

The property and possessions owned by the business, consisting of 'fixed assets' such as machinery, furniture and fittings, office equipment, and 'current assets' of money, stocks of goods and debts owing to the business by debtors.

LESS

BUSINESS LIABILITIES

Debts owing to suppliers of goods and services (called trade creditors and expense creditors) and obligations also to people who have loaned money to the business (called loan creditors).

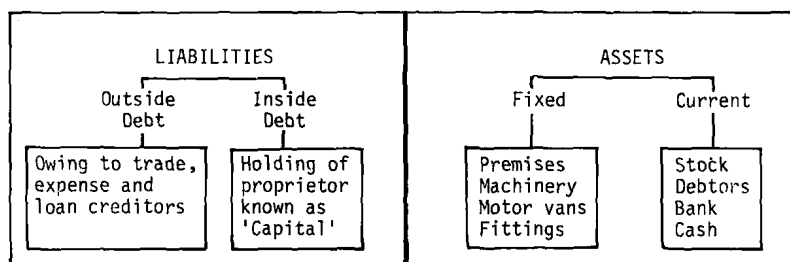
The difference, in the case of a sole trader, being his NET WORTH or CAPITAL.

2.1 THE BALANCE SHEET

A balance sheet is a statement of assets and liabilities showing their money values or estimated worth on a certain date. The date is important. The asset and liability values are *as shown on that date* – not the day before, nor the day after, when their values may be quite different.

It is customary for most trading firms to produce a summary record of their financial dealings at least once every twelve months. Many firms 'close their books' on December 31 each year and a large number adopt March 31 as their balancing-up date to coincide approximately with the Income Tax year.

Balance Sheet as at December 31



Note that the capital and financial holding of the proprietor is also a liability of the business, and that the two sides of the balance sheet should agree in their arithmetic totals in accordance with the simple equation:

$$\text{CAPITAL} + \text{LIABILITIES} = \text{ASSETS}$$

2.2 THE CHANGING FORM OF ASSETS AND LIABILITIES

Fixed assets are more permanent than current assets. Fixed assets are purchased for the long term by the business, whereas current assets change from day to day in the process of trading. Similarly with the liabilities, a mortgage or a long-term loan is regarded as a long-term or fixed liability, whereas amounts owing to trade and expense creditors fluctuate as debts are incurred and payments are made by the business, and consequently are referred to as 'current liabilities'.

Since statements of profit and loss are drawn up only at intervals of perhaps six or twelve months, you are not visibly aware of the effect of every small trading transaction.

BUT each change of an asset or of a liability affects the business (and the balance sheet if one was drawn up) in **TWO WAYS**.

Take, for example, three common instances, of goods bought on credit, the payment of the creditor's account, and the purchase of a fixed asset for cash.

- | | |
|--|--|
| <p>(a) £100 of goods are bought on credit on January 5</p> | <p>A current asset comes into the business. At the same time a liability is created.</p> |
| <p>(b) The creditor's account is paid on January 15</p> | <p>An asset (cash) goes out and a liability is cancelled.</p> |
| <p>(c) £50 of fittings are bought for cash on January 20</p> | <p>A fixed asset comes into the business, and the current assets are reduced by the payment.</p> |

These are all characteristics of *double-entry book-keeping* where every transaction has a *twofold aspect*.

Assuming you start in business on January 1 with £500 cash and a van worth £1000, your balance sheet on this date will show total assets of £1500, and one liability (your commencing capital) of £1500, thus:

Balance Sheet as at January 1

	£		£
Capital Account	1500	Fixed assets	
		Van	1000
Current liabilities	-	Current assets	
		Cash	500
	<u>1500</u>		<u>1500</u>

Note the *two-way* changes after the transactions recorded above.

(a) After £100 value in goods has been bought *on credit* on January 5

Balance Sheet as at January 5

	£		£
Capital Account	1500	Fixed assets	
		Van	1000
Current liabilities	100	Current assets	
		Stock	100
		Cash	500
	<u>1600</u>		<u>1600</u>

(b) After the creditor's account has been paid on January 15

Balance Sheet as at January 15

	£		£
Capital Account	1500	Fixed assets	
		Van	1000
Current liabilities	-	Current assets	
		Stock	100
		Cash	400
	<u>1500</u>		<u>1500</u>