

FINANCIAL ACCOUNTING: PREPARING FINANCIAL STATEMENTS

TUTORIAL



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Financial Accounting: Preparing Financial Statements

Tutorial

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The accounting system

this chapter covers...

Before studying financial accounting in detail, it is important to take an overview of the accounting system. Every business is unique and therefore no one accounting system will be exactly the same as another. This chapter provides:

- an introduction to financial transactions
- an explanation of how the transactions are recorded in an accounting system
- an introduction to some of the terms used in accounting

This book deals with the accounting systems of sole trader and partnership businesses.

Sole traders are people who run their own businesses — such as shops, factories, farms, garages, local franchises — which are often small businesses.

Partnerships are often larger businesses — normally consisting of between two and 20 partners. Exceptions to this include large professional firms, eg solicitors and accountants, who often set up what are known as 'limited liability partnerships' (LLPs).

The other types of businesses in the private sector are limited companies. These are not covered specifically in this book, but some financial transactions we will see may apply to limited companies.

ACCOUNTING AND THE ACCOUNTING SYSTEM

what is accounting?

Accounting involves keeping financial records up-to-date and the preparation of financial statements (final accounts). It includes:

- recording business transactions in financial terms
- reporting financial information to the owner or managers of the business and other interested parties
- advising the owner how to use the financial reports to assess the past performance of the business, and to make decisions for the future

why keep accounts?

Accounting is essential to the recording and presentation of financial records and financial statements. It is important for:

- **internal control**, to ensure that all financial transactions are correctly recorded so as to show the true financial position of the business, and to help prevent fraud
- **measuring business performance**, by means of financial reports and the year-end financial statements
- **obtaining credit/financing**, by providing lenders with the current financial position of the business
- **statutory requirements**, to provide the information for VAT Returns and income tax returns to HM Revenue & Customs, and for other financial reports

the role of the accountant

The accountant's job is to check, summarise, present, analyse and interpret the accounts for the benefit of the owner and other interested parties. In particular, the function of the **financial accountant** is concerned with financial transactions, and with taking further the information produced by the person who 'keeps the books'. The financial accountant extracts information from the accounting records in order to provide a method of control, for instance over trade receivables, trade payables, cash and bank balances. The role also requires the preparation of year-end financial statements (final accounts).

It is especially important for those involved in accounting to ensure that they follow the policies and procedures of the business they work for.

manual and digital accounts

This book is concerned with the preparation of financial records and their use in the year-end financial statements. Financial records are kept either in handwritten form or in digital form.

The latter may be:

- spreadsheet templates, for small businesses
- online tools such as apps and cloud-based software, for small to medium businesses
- desktop finance software, for medium to large businesses

The main record in a handwritten system is the **ledger** which, at one time, would be a weighty leather-bound volume, neatly ruled, into which the bookkeeper would handwrite each business transaction into individual accounts.

The major advantage of a digital system is that it is a very accurate method of recording business transactions. The word 'ledger' has survived into the digital age but, instead of being a bound volume, it is used to describe data files held electronically.

Whether business transactions are recorded by hand or digitally, the basic principles remain the same. In the first few chapters of this book we will concentrate on these basic principles.

keeping accounts – practical points

When maintaining financial accounts, you should bear in mind that they should be kept:

- accurately
- with integrity – in a straightforward and honest way
- up-to-date
- physically secure – eg computer passwords to prevent unauthorised persons accessing the accounts in order to enter false or fraudulent transactions
- with confidentiality:
 - not revealed to people outside the business (unless authorisation is given)
 - revealed only to those within the business who are entitled to the information

Maintaining financial accounts is a discipline, and you should develop disciplined accounting skills as you study with this book.

the stages of the accounting system

The diagram on page 6 shows the stages of the accounting system – these will have been covered in your earlier studies. Topics such as financial documents, books of prime entry, and some aspects of double-entry bookkeeping have been explained in Osborne Books' earlier texts. In this book we will focus on the double-entry accounts system and the trial balance in its extended form (showing figures transferred into the statement of profit or loss and the statement of financial position). If you should at any time lose sight of where your studies are taking you, refer back to this chapter, and the diagram, and it should help to place your work in context.

We will now look at each of the stages of the accounting system in turn.

FINANCIAL DOCUMENTS

Financial transactions generate documents. In this section we link the main business documents to the type of transaction involved.

sales and purchases – the invoice

When a business buys or sells goods or services on credit, the seller prepares an invoice stating:

- the amount owing
- when it should be paid
- details of the goods sold or service provided

cash and credit sales, cash and credit purchases

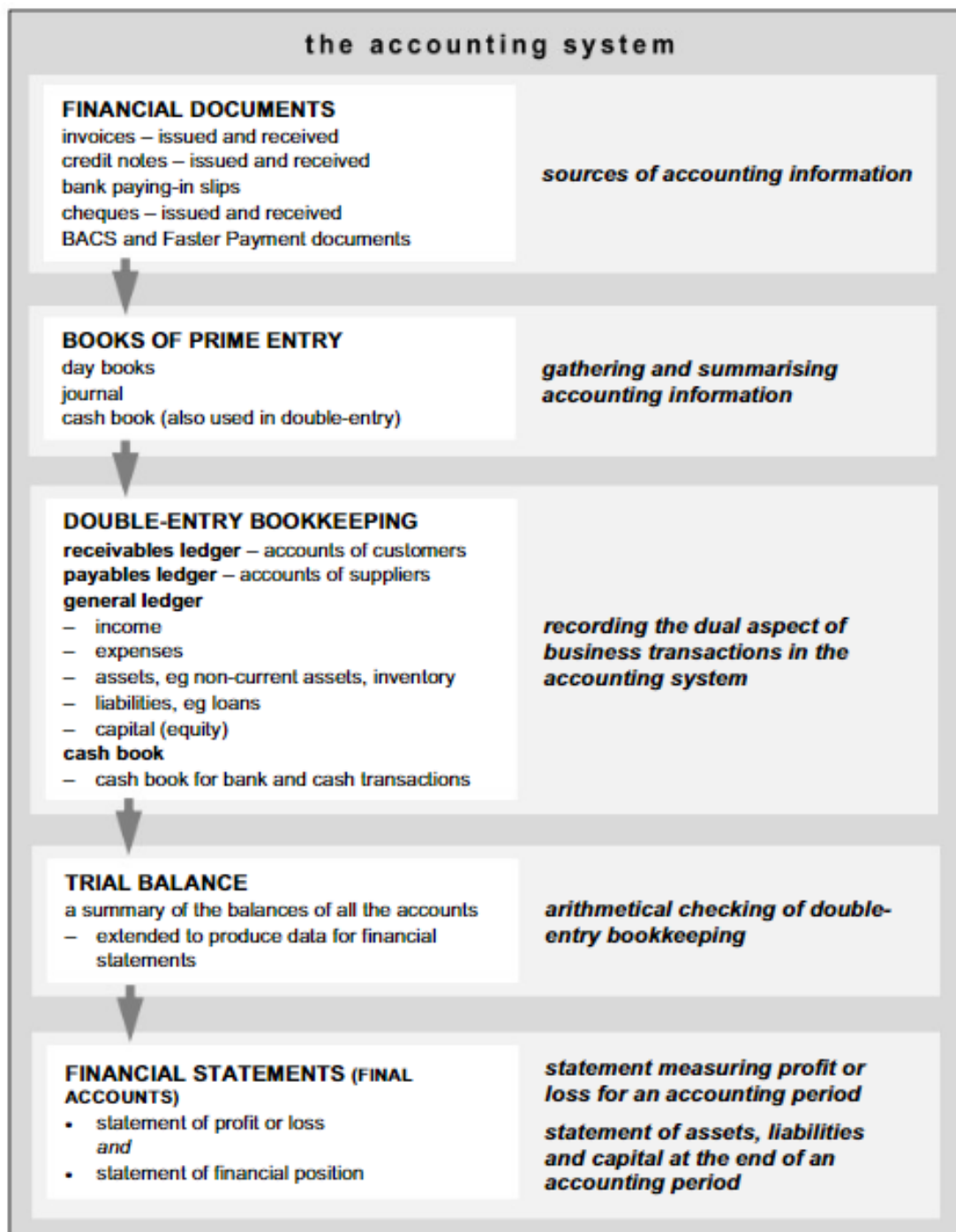
A sale by one business is a purchase by another business. The difference between cash and credit transactions is:

- **cash sales and cash purchases** – where payment is immediate, whether by cash or by bank payment
- **credit sales and credit purchases** – where payment is to be made at a later date (often 30 days later)

A **trade receivable** is a person who owes you money when you sell on credit.

A **trade payable** is a person to whom you owe money when you buy on credit.

Note that the total of sales, both cash and credit, for a particular time period is referred to as **revenue** or **sales revenue**.



return of goods – the credit note

If the buyer returns goods which are bought on credit (they may be faulty or incorrect), the seller will prepare a credit note which is sent to the buyer, reducing the amount of money owed. The credit note, like the invoice, states the money amount and the goods and services to which it relates.

bank transactions – cheques, BACS, Faster Payments

Businesses need to pay in money, draw out cash and make payments. Paying-in slips and cheques are used as financial (or business) documents for bank account transactions, as are BACS, direct credits and direct debits, and Faster Payment transfers.

BOOKS OF PRIME ENTRY

Businesses issue and receive quantities of invoices, credit notes and banking documents, and it is useful for them to list these in summary form. These summaries are known as **books of prime entry** or **day books**. They comprise:

- **sales day book** – a list of credit sales made, compiled from invoices issued
- **purchases day book** – a list of credit purchases made, compiled from invoices received
- **sales returns day book** – a list of returns in, ie goods returned by credit customers, compiled from credit notes issued
- **purchases returns day book** – a list of returns out, ie goods returned by the business to credit suppliers, compiled from credit notes received
- **discounts allowed day book** – a list of discounts allowed to customers for prompt payment of invoices to them (see page 32)
- **discounts received day book** – a list of discounts received from suppliers for prompt payment of invoices received from them (see page 32)
- **cash book** – the business's record of cash and bank transactions, compiled from receipts, paying-in slips, BACS and Faster Payment documents, and cheques issued
- **journal** – a record of non-regular transactions, which are not recorded in any other book of prime entry (the journal is covered in Chapter 11)

DOUBLE-ENTRY ACCOUNTS: THE LEDGER

The basis of most accounting systems is the **double-entry bookkeeping system** which is embodied in a series of records known as the **ledger**. This is divided into a number of separate **accounts**.

double-entry bookkeeping

Double-entry bookkeeping involves making two entries in the accounts for each transaction: for instance, if you are paying wages by BACS you will make an entry in bank account and an entry in wages account. If you are operating a manual accounting system, you will make the two entries by hand; if you are operating a digital accounting system, you will make *one* entry but indicate to the accounting program where the other entry is to be made by means of a numerical code.

accounts

The books of prime entry are the sources for the entries you make in the accounts. The ledger into which you make the entries is divided into separate accounts, eg a separate account for sales, purchases, each type of expense, each trade receivable, each trade payable, and so on. Each account is given a specific name, and a number for reference purposes.

digital accounts

As noted earlier, many small businesses and all large businesses use accounting software to handle their financial transactions. The separate accounts are represented by data files held digitally. The principles of double-entry bookkeeping remain the same; an input code is used to identify the two accounts involved in each transaction.

division of the ledger

Because of the large number of accounts involved, the ledger has traditionally been divided into a number of sections. These same sections are used in digital accounting systems.

- **receivables ledger** (also known as **sales ledger**) – personal accounts of trade receivables, ie customers to whom the business has sold on credit
- **payables ledger** (also known as **purchases ledger**) – personal accounts of trade payables, ie suppliers to whom the business owes money
- **cash book** – comprising cash account and bank account; note that cash book is also a book of prime entry for cash transactions
- **general ledger** – the remainder of the accounts: income, expenses, assets (eg non-current assets, inventory), liabilities (eg loans), capital/equity