

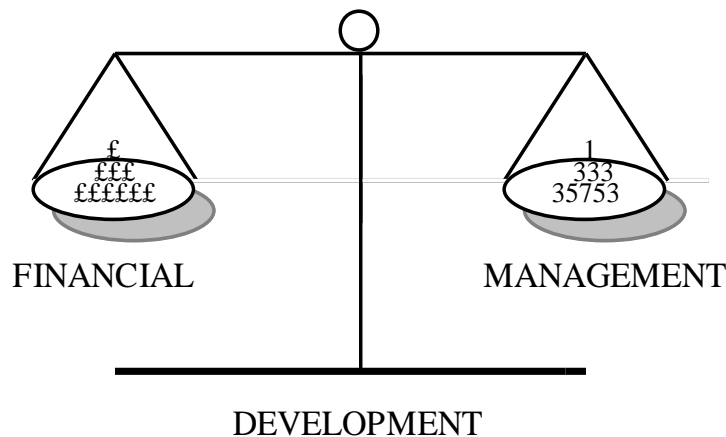
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Basic Accounting

NO 111

BASIC ACCOUNTING



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

BASIC ACCOUNTING

Overview

The basis of accounting is the double entry system - whereby all transactions result in two entries to the accounting system. Thus the books will always balance if entries are correctly processed. This note sets out the key details of the system and considers the use of associated factors - ledgers, day books, Trial balance and Journals. It is designed as an introduction to the topic, not a definitive guide. Every organisation will have its own names for different ledgers and transactions and its own unique set of policies and procedures. This document is designed to aid communications with client finance personnel regarding accounting matters.

The Double Entry System

The double entry system involves the use of debits and credits. Every transaction will result in both.

DEBITS Show increases in expenses or asset (and decreases in income or liabilities).

CREDITS Show increases in income or liabilities (and decreases in expenses or assets).

The simplest way of considering a transaction is to consider its cashflow impact and therefore its entry in the cash book. The cashbook is merely an account for cash (the mirror image of a bank statement). By convention Debits are always on the left.

A typical cashbook can be reduced to its component parts as follows:

Note	CASHBOOK	DR £	CR £
1	Balance b/f	100	-
2	Issue of Shares	200	-
3	Purchase of Stock		150
4	Cash from Customers	100	-
5	Advertising		20
6	Balance c/f		230
		=====	=====

Each transaction would have a date and a reference number. Frequently the reference is to a batch transaction so a line number may also be included. This should be unique to that transaction.

Notes

1. The Balance b/f or brought forward is the value of the asset (cash) at the end of the last period. (See also 6 below).
2. The issue of shares for cash will be a debit in the cashbook, because the asset cash has increased; and a credit of the same amount in the Shares Account where the liability for the amount now “owed” to shareholders will be recorded.
3. Purchase of Stock for Cash is a credit in the cashbook because it reduces the asset cash. This is matched by a debit in the Stock account to reflect the increase in the asset Stock.
4. Cash from Customers is a credit because the asset cash has increased. The credit could be either an increase in income; if it is a cash sale, with the credit being in the sales account; or if the cash is in payment of an existing debt, the credit will be in the Debtor Account as a reduction in that asset.
5. The cash payment for advertising will be a debit, the credit will be the recognition of the expense in the advertising account.
6. It is normal at the end of a period (a day, a month or a year) to calculate the balance on the account. Here the balance shows as a “credit” in order to balance the books and the amount will then be carried forward to be the balance brought forward for the start of the next period.

Day Books and Documents of Prime Entry

An accounting system is only as good as its inputs. It will balance even if wrong information is input provided the information is entered correctly. Therefore most systems have strict controls over the documents which cause entries to be made. Formerly many of these consisted of sales invoices and purchase invoices which were recorded in sales day books and purchase day books. This allowed for postings to the main accounts in total. Some computer systems still operate on this basis - some by using the coding system allow for direct posting. This demands more sophisticated controls since errors are harder to trace.

A simple system would have:

A Sales Day Book

All sales invoices are listed and the totals taken to the appropriate accounts at the end of the day (or period). Total sales to the credit of the sales account; individual debtors to their accounts in the Sales Ledger (see below). The credit may be split across headings e.g. Sales Tax, Sales by Product or Country of Destination etc.

A Purchase Day Book

All purchase invoices are listed and the totals taken to the debit, as expenses or purchase of assets, of the relevant accounts. The individual invoices will be credited to the relevant creditor account in the Purchase Ledger. (See below).

In some cases cash transactions are the norm. These can be put through day books or posted direct e.g. from till rolls or expense claim forms. Any such documents Sales Invoice, Purchase Invoice, Till Roll, Expense claim, Cheque, Deposit slip etc. is a document of prime entry - the basis for the posting of the transactions. These need a unique reference and for audit purposes should be filed in a way which recognises that reference.

Sales and Purchase Ledgers

Before computers, organisations would want to keep control over manual records of debtors and creditors. To do so they would maintain a Debtors Control Account and a Purchase Control Account in the Nominal Ledger. This is the name given to the Summary Level Ledger containing all Accounts. (See Chart of Accounts). They would then have the individual Debtor or Creditor accounts in the Sales or Purchase Ledger. The total in the accounts (by individual would then be checked against the total in the control account). Thus if five debtors paid £200 each the control account would show a credit (asset reduction) of £1,000 while the individual account would each show a £200 reduction. Misspostings within Ledgers were common - but at least the total would not be wrong.

Some computer systems maintain this format in which case it is normally the Control Accounts which form part of the Double Entry System. The Ledgers are purely analyses.

Different industries have variations on this theme for Job Costing, Franchises, Stock Control etc.

Chart of Accounts

This will be unique to each organisation but will normally have basic elements:

Nominal Ledger	-	Income Account	P+L
		Expense Account	P+L
		Asset Account	B/S
		Liability Account	B/S

Frequently the coding structure will reflect the chart of accounts e.g. 01/960/32/48/P52.

01 Income Account
 960 Sales of Products 960
 32 From Location 32
 48 To country destination 48
 P52 To customer first letter P number 52.

Codes may be alpha/numeric and will be determined by need. The greater the analysis the greater the possibility of error and the greater the need for control and reconciliation procedures. In many cases the chances of error are reduced by precoding the documents of prime entry - either on the document or on the batch header.

Journals

Journals are usually reserved for unusual transactions, carry a higher level of authority and need special controls. Journals are used for:

Corrections of Errors
 Posting/Removal of Accruals/Prepayments*
 Posting of Depreciation
 Stock or Debt Write Offs
 Sundry Income/Expenses

Frequently Journal entries need space for narrative.

* Accrual and Prepayment Journals are often self reversing in the next, or specified accounting periods.

Trial Balance

A trial balance used to be done yearly or monthly. Now it is frequently real time. It consists of printing or merely checking that the accounts balance and potentially producing the basis for financial or management accounts. If all transactions have been input (including those such as depreciation/accruals etc. which need to be initiated by someone internally) and correctly processed the result will produce a list of balances of incomes, expenditure, assets and liabilities.

The example shown earlier will illustrate this. Assume the opening Trial Balance was:

	Dr	Cr
Share Capital		100
Cash at Bank	100	
	===	===

After the four transactions shown above it would be

	Dr	Cr
	£	£
Income: Sales Account (Cash Sale)	-	100
Expenses: Purchases Account	150	
Advertising	20	

A balance could be struck at this point showing a Loss on Trading of £70.

Assets: Cash	230	
Liabilities: Share Capital		300
TOTAL	400	400
	===	===

The books are in balance. BUT?

What about closing stock?

Some companies keep stock records as part of the Accounting system. A sale will therefore result in a book entry reflecting the stock sold. Others merely count the closing stock and post it as a Journal entry: a debit to the Balance Sheet (reflecting the Asset) and a Credit to the Profit and Loss Account (reflecting the reduction of the expense of Purchases.)

Assuming closing stock worth £120 at cost price in the example above - Cost of goods sold would reduce from £150 to £30, profit on trading would be £50 and the Balance Sheet asset for stock would show £120.

Alternatively the Purchase Account could be a “stock” account. It would show a debit of £150 when stock is purchased. On the sale of goods (presumably worth £30 if closing stock is £150) a credit of £30 would be shown in this account with a corresponding debit in a “Cost of Goods Sold” or Job Cost Transferred Account.

Typically organisations will have a month end closing procedure to post accruals, prepayments, depreciation, stock write offs, bad debts etc. It is important that these reflect reality. The books may show stock but if it has “shrunk” there will need to be a write off.

At the end of a year it is normal for all Income and Expense accounts to be cleared to zero with the resulting total being left in a Retained Earnings Account. This would be done as part of the year end close down procedures which tend to be more rigorous than the month end.

Problem Areas

In many systems suspense accounts are used to allow batches to be fully processed even if not all items can be posted. This is particularly true of cash receipts - unmatched cash etc. It is vital that these accounts are reviewed and cleared on a regular basis.

Some systems allow back dating of entries. It is vital that such entries are identified and reported as exceptional. In particular some organisation will have a cut off date e.g. 10 January after which no items can be posted to the books prior to 31 December. Note Posting Date is often different from Transaction Date!

Rev. DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD

David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:

FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).