

Section 2: AS Unit 1: Accounting Principles

Introduction to Accounting Principles

The key aspect here will be the development of double entry book-keeping skills. This is an area well worth spending time on and the skills of recording transactions will be particularly useful throughout the specification.

The 'Role of Accounting' is the first section listed and this serves as an introduction to the course and should be quickly followed by the accounting equation where Balance Sheets can be introduced. The definition of assets, capital and liabilities should be given and their relationship in the form of a Balance Sheet. The horizontal Balance Sheet is useful for illustrating the accounting equation with assets on the left, and capital and liabilities on the right. A series of different transactions and the effects on the Balance Sheet helps candidates understand the relationship shown by the accounting equation. Transactions to use include:

- Introduction of capital
- Purchase of assets
- Purchase and sale of goods on credit.

A suitable layout would be:

Business name

Balance Sheet as at 31 December 2005

	£		£
<u>Assets</u>		<u>Capital and Liabilities</u>	
Premises	50	Capital	60
Stock	15	Creditors	20
Debtors	10		
Cash	<u>5</u>		<u>—</u>
	<u>80</u>		<u>80</u>

The accounting terms debtors and creditors are often mixed up by candidates. It is useful to ask candidates to describe an asset, linking it to a good thing, then saying a debtor is an asset (good thing) i.e. someone who owes us money. A similar approach linking a liability to something not so good and a creditor being a liability i.e. someone to whom we owe money.

Chief Examiner's tip

Marks are frequently awarded for correct titles and this can be emphasized right from the start with the Balance Sheet title. Quality of written communication marks for layout will include underlining titles, use of ruler, alignment of figures, ruling off – all these can be introduced.

The next stage covers the double entry system of book-keeping. There are two approaches which may be used to work out debit and credit sides.

- Debit receiving account
Credit giving/parting account
- Relating to increases/decreases in assets, capital and liabilities.

Either approach is acceptable, although the debit receiver/credit giver method succinctly covers the rules. If a transaction involves money, it is useful to think which way the money goes for one entry, with the other entry being on the opposite side. For example, equipment bought for £800 cash – if we are buying, then we will be parting with money i.e. credit the parting account (Cash), it then follows the other account (Equipment) will be the debit entry (we are receiving equipment).

Chief Examiner's tip

Spelling is taken into account when awarding quality of written communication marks, the word 'receive' is frequently spelt incorrectly as 'recieve'.

Double entry exercises should be developed to include capital, assets, liabilities, stock, purchases, sales, purchase returns, sales returns, expenses and revenues. Following this a two column cash book and three column cash book may be covered. Candidates frequently incorrectly refer to cash discount as discount for cash payment, rather than a discount for an early payment.

Chief Examiner's tip

Discount allowed and discount received are frequently mixed up (in ledger accounts and when taken from a Trial Balance). A useful way to remember is to think of the alphabet, asking which letter comes first, A or R. The A being first, is discount allowed (on the left) and the R is then next, discount received (on the right).

The Trial Balance

Following development of the double entry skills, balancing of accounts and the preparation of a Trial Balance will be a natural progression. At this stage a Trading and Profit and Loss Account and Balance Sheet (in more detail compared to the start of the unit) may be introduced. A benefit of using the horizontal format here is that it clearly identifies with the debit and credit sides in the Trading and Profit and Loss Account and this is very useful later in the course. The accounting equation is also further illustrated in the horizontal Balance Sheet. A format for this stage of the course is now shown.

Nian Traders

Trading and Profit and Loss Account for the year ended 31 December 2005

	£	£		£
Opening Stock		30	Sales	500
Add Purchases	160		Less Sales Returns	20
Add Carriage Inwards	<u>10</u>	<u>170</u>		
		200		
Less Purchase Returns		<u>10</u>		
		190		
Less Closing Stock		<u>50</u>		
Cost of Sales		140		
Gross Profit c/d		<u>340</u>		
		<u>480</u>		<u>480</u>
Rent		30	Gross Profit b/d	340
Electricity		20	Discount Received	20
Wages		50	Income Received	40
Carriage out		40		
Net Profit		<u>260</u>		
		<u>400</u>		<u>400</u>

Balance Sheet as at 31 December 2005

	£	£		£
<u>Fixed Assets</u>			<u>Capital</u>	
Land & Buildings		200	Opening Balance	500
Plant & Machinery		150	Add Net Profit	<u>260</u>
Motor Vehicles		<u>50</u>		760
		400	Less Drawings	<u>270</u>
				490
<u>Current Assets</u>			<u>Long Term Liabilities</u>	
Stock	50		Loan	10
Debtors	30			
Bank	30		<u>Current Liabilities</u>	
Cash	<u>40</u>		Creditors	<u>50</u>
		<u>150</u>		<u>50</u>
		<u>550</u>		<u>550</u>

Accounting Concepts

The concepts may be applied in all units across the specification. **GEMCARD MCC** is a useful way to remember the concepts.

- G** going concern
- E** entity of business
- M** monetary measurement
- C** cost
- A** accruals
- R** realization
- D** duality

- M** materiality
- C** consistency
- C** conservatism (prudence)

Chief Examiner's tip

The correct spelling of the concepts may be used in awarding quality of written communication marks. They are key accounting terms and candidates should ensure they are spelt correctly.

Capital and Revenue Expenditure

It is useful to give candidates a list of different types of expenditure, asking them to differentiate between capital and revenue expenditure. In addition to direct identification, this topic can appear as a footnote in Trial Balance/Final Account questions, where an item such as 'Repairs and Extension' can be given as one value in the Trial Balance with a footnote stating the value of repairs. The repairs (revenue expenditure) will be a profit and loss expense, whilst the remainder will be the extension (capital expenditure) and a balance sheet item.

Chief Examiner's tip

The extension aspect will usually be subject to depreciation and this is frequently overlooked.

Changing Asset Values

This covers depreciation and can be a mix of narrative and numerical questions. Narrative aspects sometimes ask for the reasons for accounting for depreciation – the key word is accounting. Candidates should relate to the accounts i.e. Profit and Loss Account and Balance Sheet rather than the reasons for depreciation (the common response). Narrative questions can also relate to problems involved in calculating depreciation. Here it is useful to remember the formula for the straight line method:

$$\frac{\text{Cost less residual value}}{\text{Life}}$$

From this, the problems can be identified:

- Cost (including delivery/installation)
- Residual value (difficulty in calculating)
- Life (difficulty in estimating)
- Choice of method (appropriateness of straight line/reducing balance).

Numerical aspects for depreciation usually include three accounts:

- Asset Account
- Provision for Depreciation of Asset Account
- Disposal Account.

Whilst candidates are usually able to correctly deal with depreciation for a full year, frequently questions will involve depreciation for part of a year and this can cause problems.

Chief Examiner's tip

When calculations are required for part of a year a listing of the months for the financial period and using it to calculate the number of months can help minimize errors. For example, if the financial year end is 31 March, then list as follows:

A M J J A S O N D J F M

If an asset is bought on 1 November then we can see from the above that 5 months depreciation is required. Frequently candidates treat for 6 months in error. It is also useful to set out a table for depreciation calculations particularly when disposals are involved. This can be shown in the following illustration.

Nian Traders commenced in business on 1 May 2002. It purchased the following equipment during its first year in business:

EQ1 £20,000 on 1 May 2002

EQ2 £30,000 on 1 October 2002

EQ3 £12,000 on 1 February 2003.

Depreciation is 10% straight line applied for each proportion of a year. Equipment EQ2 is sold on 31 July 2004. Calculate depreciation for each of the 3 years.

First list the months M J J A S O N D J F M A

We can see that in the first year EQ2 is 7 months and EQ3 is 3 months. In the year that EQ2 is disposed it is held for 3 months.

	<u>EQ1</u>	<u>EQ2</u>	<u>EQ3</u>	Total
	£	£	£	£
Cost	20,000	30,000	12,000	
Dep 2002/3	<u>2,000</u>	<u>1,750</u>	<u>300</u>	4,050
	18,000	28,250	11,700	
Dep 2003/4	<u>2,000</u>	<u>3,000</u>	<u>1,200</u>	6,200
	16,000	25,250	10,500	
Dep 2004/5	<u>2,000</u>	<u>750</u>	<u>1,200</u>	3,950
	14,000	Disp	9,300	

Depreciation values can be taken from the table and used in accounts as required. For example the depreciation on the disposed equipment EQ2 is $1,750 + 3,000 + 750 = 5,500$

Chief Examiner's tip

In addition to marks for correct calculations marks are frequently awarded for the correct narratives in ledger accounts. For example, if a disposal account was required for the previous illustration then marks could be awarded for the £5,500 and for the narrative alongside the value (Provision for Depreciation of Equipment).

Ledger Entries and Adjustments

These build on the double entry skills developed earlier in the unit. Questions will frequently involve prepayments/accruals at the beginning/end of a period. The following can help identify the correct sides for the opening and closing entries.

Expense Account

Bal b/d Debit side Debtor Asset Prepayment	Bal b/d Credit side Creditor Liability We owe (accrual)
--	---

From the above a prepayment at the start will be a debit balance b/d, whereas an amount owing at the start will be a credit balance b/d.

Chief Examiner's tip

Similarly to the comment on depreciation marks may be awarded for calculations and narratives within accounts.

The other adjustments in this section cover bad debts and provisions for doubtful debts. Candidates are usually good at general adjustments, where there are many examples in textbooks. Problems tend to arise when there is a specific provision coupled with a general provision, where there are few examples in textbooks. An illustration on this is now shown and this is followed by a set of additional questions (and answers).

Illustration

Debtors £10,000

Provision for doubtful debts balance £500

Adjust the provision to £200 for a specific debt plus 5% on the remainder of debtors.

Show

- (i) Provision for doubtful debts account
- (ii) Profit and Loss extract
- (iii) Balance sheet extract

Debtors	10,000				
Specific	<u>200</u>				
	9,800				
General	<u>x 5%</u>				
	<u>490</u>				
Was	500				
Now	<u>690</u>				
Inc	<u>190</u>				

Provision for Doubtful Debts

	£		£
Bal c/d	690	Bal b/d	500
	—	P & L	<u>190</u>
	<u>690</u>		<u>690</u>
Profit and Loss			
	£		£
Inc Provision for doubtful debts	190		

Balance Sheet

Current Assets

	£
Debtors	10,000
Less Provision for doubtful debts	<u>690</u>
	9,310

The following questions will provide useful practice on this topic.

In each of the following prepare:

- (i) Provision for Doubtful Debts Account
- (ii) Profit and Loss extract
- (iii) Balance Sheet extract

1. Debtors £22,000

Provision for Doubtful Debts balance £640

The provision is to be adjusted to £500 for a specific debt plus 2% on the remainder of debtors.

2. Debtors £49,000

Provision for Doubtful Debts balance £3,300

The provision is to be adjusted to £600 for a specific debt plus 5% on the remainder of debtors.

3. Debtors £31,000

Provision for Doubtful Debts balance £2,600

The provision is to be adjusted to £350 for a specific debt plus 6% on the remainder of debtors.

4. Debtors £16,000

Provision for Doubtful Debts balance £1,000

The provision is to be adjusted to £700 for a specific debt plus 5% on the remainder of debtors.

5. Debtors £54,000

Provision for Doubtful Debts balance £2,000

The provision is to be adjusted to £1,200 for a specific debt plus 2% on the remainder of debtors.

1. 22,000
 500
 21,500
 x 2%
 430 930 new provision

Was 640
 Now 930
 Inc 290

Provision for Doubtful Debts

	£		£
Bal c/d	930	Bal b/d	640
	<u> </u>	P & L	<u>290</u>
	<u>930</u>		<u>930</u>

Profit and Loss

	£		£
Inc Provision for doubtful debts	290		

Balance Sheet

Current Assets

	£
Debtors	22,000
Less Provision for doubtful debts	<u>930</u>
	21,070

2. 49,000
 600
 48,400
 x 5%
 2,420 3,020 new provision

Was 3,300
 Now 3,020
 Dec 280

Provision for Doubtful Debts

	£		£
P & L	280	Bal b/d	3,300
Bal c/d	<u>3,020</u>		
	<u>3,300</u>		<u>3,300</u>

Profit and Loss

	£		£
		Dec Provision for doubtful debts	280

Balance Sheet

Current Assets

Debtors	49,000
Less Provision for doubtful debts	<u>3,020</u>
	45,980

3. 31,000
 350
 30,650
 x 6%
 1,839 2,189

Was 2,600
 Now 2,189
 Dec 411

Provision for Doubtful Debts

	£		£
P & L	411	Bal b/d	2,600
Bal c/d	<u>2,189</u>		
	<u>2,600</u>		<u>2,600</u>

Profit and Loss

	£		£
		Dec Provision for doubtful debts	411

Balance Sheet

	£
<u>Current Assets</u>	
Debtors	31,000
Less Provision for doubtful debts	<u>2,189</u>
	28,811

4.

16,000	
<u>700</u>	
15,300	
<u>x 5%</u>	
<u>765</u>	

1,465 new provision

Was	1,000
Now	<u>1,465</u>
Inc	<u>465</u>

Provision for Doubtful Debts

	£		£
Bal c/d	1,465	Bal b/d	1,000
		P & L	<u>465</u>
	<u>1,465</u>		<u>1,465</u>

Profit and Loss

	£		£
Inc Provision for doubtful debts	465		

Balance Sheet

Current Assets	£
Debtors	16,000
Less Provision for doubtful debts	<u>1,465</u>
	14,535

5. 54,000
 1,200
 52,800
 x 2%
 1,056 2,256 new provision

Was 2,000
 Now 2,256
 Inc 256

Provision for Doubtful Debts

	£		£
Bal c/d	2,256	Bal b/d	2,000
		P & L	<u>256</u>
	<u>2,256</u>		<u>2,256</u>

Profit and Loss

	£	£
Inc Provision for doubtful debts	256	

Balance Sheet

Current Assets	£
Debtors	54,000
Less Provision for doubtful debts	<u>2,256</u>
	51,744

Final Accounts

This brings together much of the work covered to this point in the specification. Whereas it was suggested that the horizontal was useful earlier, at this point the vertical format should be adopted. An illustration for this format is now shown.

Nian Traders

Trading and Profit and Loss Account for the year ended 31 December 2005

	£	£
Sales		500
Sales Returns		<u>20</u>
		480
Opening Stock	30	
Purchases	160	
Carriage Inwards	<u>10</u>	
	200	
Purchase Returns	<u>10</u>	
	190	
Closing Stock	<u>50</u>	
Cost of Sales		<u>140</u>
Gross Profit		340
Discount Received		20
Income Received		<u>40</u>
		400
Rent	30	
Electricity	20	
Wages	50	
Carriage Out	<u>40</u>	
		<u>140</u>
Net Profit		<u><u>260</u></u>

Balance Sheet as at 31 December 2005

	£	£
<u>Fixed Assets</u>		
Land & Buildings		200
Plant & Machinery		150
Motor Vehicles		<u>50</u>
		400
<u>Current Assets</u>		
Stock	50	
Debtors	30	
Bank	30	
Cash	<u>40</u>	
	150	
<u>Current Liabilities</u>		
Creditors	<u>50</u>	
Working Capital		<u>100</u>
		500
<u>Long Term Liabilities</u>		
Loan		<u>10</u>
		<u>490</u>
<u>Financed By</u>		
Capital		500
Add Net Profit		<u>260</u>
		760
Less Drawings		<u>270</u>
		<u>490</u>

It is useful for candidates to adopt the following procedure when dealing with Trial Balance/Final Accounts questions.

- Alongside each account name in the Trial Balance, note where the account fits in the final accounts i.e. T, P&L, BS (once)
- Alongside each footnote, again note where the footnote fits in the final accounts (twice)
- Where a footnote affects an account in the Trial Balance, mark the value in the Trial Balance with a cross or show the adjustment required
- Cross items as they are dealt with.

If this is followed then if any items are uncrossed at the end, then a warning is given that the item needs to be dealt with. Candidates can get over confident with this topic and ignore the procedure. Under exam pressures this can lead to an item not being dealt with and no warning signal shown.

Chief Examiner's tip

This is a key topic in unit 1; a specimen question has been included in the assessment material with a list of tips given at that point.