Basic Accounting Concepts

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1. Introduction

In any business it is possible to separate, among others, two distinct areas of practice.

On the one hand, what is termed *economic* or business-related, is any activity which quantifies aspects such as production, logistics, investment, supply, and also includes sales and marketing. On the other hand there are parts which may be termed *financial* and which permit the correct functioning of those economic areas previously mentioned, since they almost all require financial resources in contrast to the flow of goods and services which the company is originating. The sale of a good or service implies producing it, having staff, a factory or offices, or buying raw materials, all of which creates payments and outflows of funds.

This is the part that is studied in finance, that refers to those financial resources that the company requires in order to function, to the monetary flows that accompany the current operations of the company.

Traditionally the area of Accountancy has been associated with the financial side of the company management, which permits control and handling of results and the investment positions held by the company as well as in elements of financing.

There is no single definition of Accountancy, although all definitions share the same fundamental ideas: Accountancy permits the recording, classification and interpretation of the events that occur in the business and which have relevance on its financial or economic situation.

Accountancy provides a common language and is in itself an information system, an essential tool for making decisions in any economic or business activity.

It is present in whatever type of economic activity: from the largest public corporations to small family businesses or sole traders.

2. Accountancy in decision making

The accounting function is the accumulation and transmission of economic and financial data pertinent to the company.
The principal objective consists of the measurement and determination of the economic results. This helps the company control the financial and economic activity, and to avoid management problems such as liquidity deficiency or continuing losses that could result in the eventual disappearance of the company, etc.

The accounting function of a company can be of interest to different groups of people who have to make decisions related to the company.

1. Persons who, although outside the company, nevertheless have an interest in knowing what is going on within it, such as:

- Suppliers or lenders (e.g. banks), for the interest to assure that the company will be able to return the money/goods that have been lent or advanced.

- The State, for the possible fiscal effects.

2. Shareholders,(*US Stockholders*) who have invested funds, such as share capital, in the company and who are, therefore, its proprietors.

3. People directly responsible for the management of the company, who use the accounts as a tool for controlling the workings of the company, and to allow them to direct it more efficiently.

4. The employees

3. Types of accounting

Normally there are two classes of accounting:

- **General Accounting.** Also called external or financial accounting, has as its main objective the presentation of the overall situation of the company (through the Balance Sheet) and calculation of the global result (by means of the Profit and Loss Account).

  Accountancy is a *lingua franca*, understood throughout the business community, and unique in that it extends beyond the company itself, due to the obligations to present the finances of the company in official form.

- **Analytical Accounting**. Also known as cost or internal accounting, its objectives are the calculation of costs and margins for the different products, services and activities, the valuation of stocks (*US inventory*) of finished goods and work in progress, and the determination of the profitability of the distinct sections of business activities. Its scope is limited to within the company, and does not extend to outside.

General and analytical accounting are not two alternative systems, but rather are complementary, and the use of both together allows for making precise financial-economic analysis to help in decision making.

Other forms of accounting exist, such as that for Societies – dedicated to the recording of specific society activity, such as company mergers, acquisitions, liquidations etc.

4. Accounting Axioms: Concepts

The accounting records of a business should be based upon certain basic characteristics and follow norms or criteria fixed by authorities or professional accounting bodies, called Generally Accepted Accounting Principles.

The most important characteristics of accounting are the following:

- **"True and Fair view" concept.** The accounting information must show a faithful image of the company, and to do that must be:

    1. Comprehensible, easy to interpret by its users.

    2. Relevant, including only significant information, without excesses which could render it incomprehensible.

    3. Trustworthy, devoid of errors that could lead to interpretations far from the truth.

    4. Comparable, consistent and uniform for the time period, to be able to make analysis and comparison between different companies or within the same company in different time periods, and that the information be as uniform in its content as possible.

5. Timely, being produced in the moment when it is useful for those relying on it.

- **"Accounting Entity" concept**. The business is a separate entity, an economic unit, whose affairs are completely separate from those of its members and owners, and from those of any other business.

- **"Going Concern" concept.** Unless there are conclusive proofs to the contrary, it is assumed that a business will continue to function as it is and obtain a benefit during a period of time longer than the life of any of its assets. Consequently the valuation of the enterprise's assets must be made using applicable accounting norms**,** rather than looking for a liquidation valuation as if it is ceasing to operate and realise its assets.

- **Stable monetary unit concept.** Accounting is expressed in monetary terms. In order to value uniformly the transactions of a business, it is necessary to have a measurement and currency unit that denominates monetary value (in Spain, the euro). The function of accountancy is not to give an account of the actual value, but rather to record the monetary quantities used or gained in the business activity. In accounting it will be considered that one monetary unit recorded today has the same value than other recorded time ago. In summary, stable-monetary-unit concept states that each dollar has the same purchasing power as any other dollar at any other time

- **Realisation or periodicity concept.** The life of a business is divided into relatively short time periods, and the changes in wealth are arranged according to these divisions, normally a calendar year. This principle means that the net change in wealth of a company does not depend on the movement of money, but rather the changes effected for the net assets of the owners as a result of the business operations. That is to say, income and expenses are entered in the year that they actually take place, independently of whether of not they are actually collected or paid for. If a sale is made to a client in any given year, then it is entered in the calculation of results for that year, regardless of whether the client pays during that same year, or the following.

- **Duality concept**. This is a basic axiom in accounting. The enterprise consists of a series of rights and property that make up its ASSETS (INVESTMENT or APPLICATION OF FUNDS). On the other hand, the enterprise is financed by a series of sources of finance, internal as well as external, which are its LIABILITIES and EQUITY. (FINANCING or SOURCE OF FUNDS).

  - The ***Internal sources of funds (EQUITY)*** are those that come from the shareholders or which arise from within the enterprise itself. In short, it is the capital paid in by the shareholders and the non-distributed reserves that are generated by the business in the form of retained earnings.

  - The ***External sources of funds (LIABILITIES)*** are those from outside the enterprise, which implies that a third party lends funds to the business. For example, the money that is lent by a bank, or the credit allowed by a supplier, etc.

The basic rule of accounting is that ASSETS = LIABILITIES + EQUITY. This is to say that all the wealth of a business, reflected in its assets, has been acquired from the sources of finance of the enterprise. All the finance obtained (Equity and Liabilities) is invested in the elements of the Assets. In general terms, and to simplify the explanations, in some manuals and information systems, it is said that assets must equal liabilities, without mentioning the capital and reserves, but of course counting these within the global liabilities, as without it would not be possible to balance the equation.

5. Accounting Principles: How to account

The accounting of an enterprise is made applying obligatory principles in each country or area, these are usually statements on accounting made by competent authorities or professional associations.

Some of the most common are mentioned below.

- **Prudence (*US conservatism*) concept**. Only accounting for profits realised as at the closing of the accounting period. Contingencies and eventual losses with origins within the accounting period (or prior) should be accounted for as soon as known, distinguishing between contingent and (potentially) reversible, and the irreversible or realised.

- **Continuing business concept**. It is considered that the running of a company is virtually without time limit, so that the accounting principles should not be directed at measuring shareholder wealth in terms of liquidation or disposal, be it partial or total. This idea has also been mentioned above in the going concern concept.

- **Registry principle**. The economic events must be registered at the time when the rights or obligations first arise.

- **Historical Cost basis**. The assets and rights of the enterprise are accounted for at the historical cost of purchase or production. Under the new International Accounting Standards companies may instead elect to use a current valuation basis on specific assets.

- **Accruals concept.** The recording of flow of income and expenditure must be made at the time of the actual benefits gained, independent of the moment in which the monetary payment is made or received.

- **Matching concept**. The result for the period is made of the income for the period less the realised expenses pertaining to that income. Additionally it is necessary to consider those profits and losses not directly related to the business activity (extra-ordinary).

- **Principle of no-netting**. In no case may assets and liabilities accounts in the Balance Sheet, or income and expenses in the Profit and Loss account be netted off against each other. As an example, if we have a relationship with a certain company both as client and supplier, we may not make a “net” of the amounts sold and bought, but rather account in full for all sales and all purchases. Likewise with those accounts that reflect at any time what we owe to them and they to us may not be set off against each other.

- **Consistency concept**. The criteria adopted for accounting of economic events should be maintained with time. If any practice is altered during the accounting period, then the situation should be reflected also in the past records, in order to show the quantitative and qualitative effects of the variation.

- **Materiality concept**. It is possible to relax the application of any of the above accounting principles if the effect in absolute quantitative terms is immaterial.

6. The international standards for accounting

There are different set of standards in different countries. In the USA, the basic rules are set under the name of US GAAP (generally accepted accounting principles). Listed companies in the EU are now subject to a broader set of standards which are termed International Accounting Standards. The *Plan General de Contabilidad* (P.G.C.) offers a guide for Accountancy giving guidelines and rules for Spain.

The rules shows how to account for the various events that occur within a business, amongst which we may point out the following: what produces a sale, how to pay a supplier, how to account for employee costs, etc. These are events common to all businesses, and accounting regulations have standardised and defined how to manage them.

7. Basic accounting process

Each time that an economic event occurs in the enterprise, this should be recorded in the books of account according to certain norms and principles, which have been mentioned

The basis of the accounting process is the account. Each separate action is recorded in an account specific for itself. For example, the account for *Euro Deposits* reflects the amount of euros that the business has deposited on call. The account for *Bank – current account* would show the balance of money that the business has available in its bank current account.

Every time that an event occurs that affects one of these accounts, the entry must be made therein.
The basic principle of accounting is that of **double entry**, which means that all entries and operations should be booked simultaneously in at least two different accounts.

For example, the event when the enterprise receives finance through a bank loan has two effects:

On one hand, there is a new source of finance for the business which originates outside the enterprise and generates as such, a debt with the bank. This is a **liability** for the company.

On the other hand, there is cash coming into the enterprise, which becomes the property of the business. The business will probably transform this cash into an element of fixed investment, such as machinery. This capital is an **asset** of the company.

Therefore, a single event has brought into being a new asset and a new liability.

All the accounts follow a common format. If one could represent it graphically it would be as an open book, with the page on the left, which we may call Debit, and that on the right, which we shall call Credit. We make bookings on either side (debit or credit) according to how the account corresponds, in that each type of account increases or decreases on different sides, as shall be discussed later.

Accountants call this ledger the “General Ledger” and describe it as a “T” (letter T) in which the left side represents the debits, and the ride side, credits.

An example of the ledger of two accounts, share capital and Banks is shown below.

CAPITAL (EQUITY)			
DEBIT		**CREDIT**	
		3/1/05	10,000
BALANCE	**10,000**		

BANKS (ASSET)			
DEBIT		**CREDIT**	
3/1/05	10,000	4/01/05	3,000
17/01/05	2,000	20/01/05	500
24/01/05	6,000	27/01/05	100
		BALANCE	**14,400**

There are four types of account:

<u>Asset</u>

Accounts that show increases or decreases in an element of company property or a right that it possesses.
For example, cash, material stocks, or the payments receivable from clients.

Asset accounts **increase by debit, and decrease by credit.**

The balances that asset accounts have at the end of an accounting period are carried forward as opening balances in the following period.

<u>Liabilities and Equity</u>

Accounts that record increases or decreases in an element of finance for the enterprise, For example, its share capital, bank loans, credit from suppliers etc.

Accounts for **liabilities and equity increase by credit and decrease by debit.**

The balances that liability or equity accounts have at the end of an accounting period are carried forward as opening balances in the following period.

Income

Accounts that record income generated by the enterprise and which are, basically, its sales. There may be also other types of income – of a financial nature or derived from extraordinary events, such as the sale of a building or other fixed asset.

Accounts for **income increase by credit and decrease by debit.**

The balance on these accounts at the end of the accounting period is cancelled and set to zero, compensated by the account that assumes all the income and expenses accounts, that is the "Profit and Loss" account. The income accounts begin each new accounting period with a zero balance.

Expenditure

Accounts which collect the various costs that are incurred by the business. For example, the payment of staff salaries, purchases of raw materials, finance costs, travel expenses, etc.

Accounts for **expenditure increase by debit and decrease by credit.**

The balance on these expenses accounts at the end of the accounting period is cancelled and set to zero, compensated by the account that assumes all the income and expenses accounts, that is the Profit and Loss Account. The expenditure accounts begin each new accounting period with a zero balance.

8. Journals and the General Ledger

Each event that occurs in the business is recorded in what is termed a Journal, where all individual movements are booked. For each movement there is an entry in the debit and credit of an account (one account for the debit, and another for the credit). For example, an increase in the cash balance due to a payment from a client implies that, since both are asset accounts, that that which is increased is debited, and that which decreases is credited. The entry in the Journal (presuming that the operation is for 10,000 euros) shall be as follows:

Journal:

10,000 euros Bank (debit) - Debtors (Clients) (credit) 10,000 euros

Having recorded this in the Journal, immediately it must also be entered in the general ledger (in the T form) for each account. This collates all the entries that are made in the Journal, account by account, during the whole year.

The Journal shows the movements of all the accounts for each entry that is made of each economic event.

JOURNALS: ALL THE ACCOUNTS, ONE ECONOMIC EVENT

General Ledger.

The General ledger shows, in the format shown above, the analysis of the four types of accounts. It collates the movements and balances of each account. The movements of each account are shown as debits (left side of the account) or credits (right side) according to the type of account and following the guidelines discussed for each different type of account.

The general ledger shows the movements relating to each economic event and the balance of each account during, and of course, at the end of the year.

GENERAL LEDGER: ALL THE ECONOMIC EVENTS, ONE ACCOUNT

9. End of year procedures

When the accounting period ends, the General ledgers show the final balance for each account. The business must make what is known as closing the books, which consists of taking balances of all the income and expenditure accounts, resetting to zero, and taking the balance to the single account which is known as the Profit and Loss Account, and which, by comparing the income with the expenses shows whether there is a profit or loss for the business during the year. To do this, there are a series of adjustments in the annual accounts to reflect the true position of the business, in accordance with the accounting principles detailed above, to close out the year. For example, at the end of the year certain expenses of the business are adjusted to take into account that a payment is made, but the benefit continues also into the next period. Consider this case: an insurance premium is paid to provide cover for a warehouse, paid annually in June of 2001, it must be considered as an expense for part of 2001 and also part of 2002 since the risk covers some months of each year. For this, when the insurance premium is paid in 2001, at the end of the year an adjustment must be made so that in the accounts only that part which corresponds to the months June to December 2001 is shown, and that the other part of the premium is reflected in the following year's figure for that same risk.

Next is prepared the Balance Sheet, showing in a report in which, generally, the assets are put on the debit side (left) and the liabilities and capital on the credit (right) side, classified as it shall be seen later in some practical examples.

10. Basic Accounting Statements

Among the basic accounting statements we shall study the Balance Sheet, and the Profit and Loss account, as mentioned above.

a. BALANCE SHEET

The Balance Sheet is an accounting document which reflects the economic-financial situation of the enterprise at a given moment in time, in such a way that the situation is expressible in monetary terms.

As the balance sheet is like a picture of the enterprise at a particular moment, it gives a static view.

It shows, separately, the sum of goods and properties owned by the enterprise (ASSETS) and the sum of all obligations and debts owed either to the owners or members (EQUITY) or those owed to third parties (LIABILITIES).
This brings us to the fundamental identity of Accounting:

ASSETS = LIABILITIES + EQUITY

The resources of the enterprise, both internal and external, are collated in the Liabilities and Equity of the Balance Sheet, representing the sources of its finance, the origins of its funds.

LIABILITES + EQUITYY = SOURCES OF FINANCE (INTERNAL OR EXTERNAL)

The Assets in the Balance sheet, on the other hand, reflect how these funds have been applied by the enterprise. It represents the goods and rights owned by the business, which it has gained thanks to the resources represented by the liabilities. The Assets, therefore, are the uses made of the funds by the enterprise.

ASSET = INVESTMENTS, GOODS AND RIGHTS

We shall study in more detail the different groups.

ASSETS

The Assets show the sum of goods and rights owned by the business at a determined moment, expressed in monetary terms. From an economic-financial viewpoint, it represents the use made by the enterprise of the sources of finance that it has obtained (Liabilities and equity)

Within the class of Assets can be distinguished:

- **Current Assets**.- Comprised of all the asset elements which it is considered can be converted into money in less than a year. For example, the debts of its clients, which are presumed to be payable in a short time, in general, less than a year, so that the concept of client debt is convertible into cash.

Within current assets there are further divisions:

- Available Assets: Those which at any time are actually in liquid form. For example cash and bank accounts.
- Realisable Assets: Those that are not in liquid form at the moment of the balance sheet, but that can be converted to liquid form in less than a year. For example, commercial credit extended to clients (Debtors), stocks (*US inventory*) of finished goods at the warehouse, short-term investments, etc.

- **Fixed Assets**.- Made up of those investments that are long-term or permanent in character (more than one year). They are, for example, the factories or installations of the business. The Fixed Assets are shown in the Balance Sheet at their cost of acquisition, to which should be added all the expenses incurred in bringing them to working order. To this acquisition value must be set off the total amount of depreciation (amortisation for non-tangible assets) accumulated for that asset at the Balance Sheet date. It must be said that according to the new International Accounting Standards, some fixed assets may be revalued.

  Depreciation is an accounting procedure that allows the business to take to an expense account a value equivalent to the decrease in useful value that is suffered by a fixed asset that is used in the production process. If, for example, a machine is bought for 10,000 euros, which has a useful life estimated at ten years, then a charge is made to the expense account (Depreciation Charge) of 1,000 euros each year, and in a contra-account (decreasing the asset's value) termed accumulated depreciation which increases each year by that same depreciation charge. The accumulated depreciation account is actually shown in the Balance Sheet with the assets, although as a negative figure, placed together with the asset to which it corresponds. There are different methods for calculating depreciation, we just mentioned the most common one termed linear basis depreciation.

LIABILITIES AND EQUITY

The Liabilities and equity sections of the Balance Sheet show the sum of obligations and debts of the enterprise at a particular moment, in respect of its own members or shareholders on the one hand, and of third parties on the other. From the economic-financial point of view, it also shows the origins of the financial resources which the business is employing at the moment of the Balance Sheet.

The principal sources for the enterprise to receive funds may be classified in two groups, as mentioned above:

. Internal sources or SHAREHOLDER WEALTH

. Contributions from the shareholders, through share capital at the time the company starts operations or further amplifications.

. Generation of retained earnings by the business itself through the retention of profits not distributed (self financing). The retained earnings are the part of profits, after tax, that the business does not distribute in the form of dividends, but rather retains as a source of finance.

. External sources or LIABILITIES

. Transfer title to a third party for a loan or credit. For example, a bank loan.

Within the external sources, it is also possible to make another classification, based upon what are the terms of the agreement for this sourcing:

- **Current liabilities:** are those debts and obligations to third parties which are falling due in less than a year. For example, a loan or credit for less than a year, the credit granted by suppliers (accounts payable), etc.

- **Long term liabilities:** are those debts and obligations to third parties which fall due after more than one year, for example, a credit or loan agreement for 3 years, a leasing operation, etc.

Below is the scheme of a Balance Sheet.

Normally assets are shown on the left, and liabilities on the right, as a result of the asset accounts to have a natural debit balance (shown on the left in the General Ledger) and the Liabilities to have a natural credit balance (shown on the right in the General Ledger). Recall that debits are shown on the left, and credits on the right.

ASSETS	**LIABILITIES/CAPITAL**

CURRENT ASSETS
• Treasury (Cash and Bank accounts)
• Accounts receivable/Debtors(*Clients*)
• Stocks (*US Inventories*)
  • Finished goods
  • Work in progress
  • Raw materials
• Short term financial investments
 	
FIXED ASSETS
• Machinery, computers, buildings, vehicles, equipment, software, etc
	CURRENT LIABILITIES
	• Accounts payable/Payments due - suppliers
	• Commercial paper (Bill of exchange)
	• Short term bank loans
	
	LONG TERM LIABILITIES
	• Long term bank loans
	• Bonds issued
	
	EQUITY
	• Capital
	• Retained earnings

b. PROFIT AND LOSS ACCOUNT

The Profit and Loss account, or the financial result, is that which collates the various activities during the accounting period, with the income and expenditure entered into it.

There are different formats for the presentation of the Profit and Loss account.

Each revenue or expense of the business is included in the appropriate category.

Income and costs of production that is related to the core business or activities of the business, with the most frequent movements (income from sales, costs of purchases of raw materials, payments of salaries, utility costs, etc.)

Financial income is what is produced when the business earns money from investment in some kind of financial instrument, for example a bank account, investment in a deposit or Treasury bill, etc.

Finance expenses are those produced when the business must pay money for its external sources of funds. These are, above all, the interest that must be paid to the bank for loans or credit.

Extra-ordinary income and expenditure is what is produced by activities outside the normal workings of the business. For example on the sale of a fixed asset (a machine that is no longer required for the production process, an obsolete computer...). This is not considered part of the ordinary activity of the business, and if income or expenses are generated, then these are considered to be “extra-ordinary”.

Model for Profit and loss Account

OPERATING INCOME

less

OPERATING COSTS

RESULT OF OPERATIONS (Profit or loss)

FINANCIAL INCOME

less

FINANCE COSTS

RESULT OF FINANCING (Positive or negative)

RESULT OF OPERATIONS (Profit or loss)

plus

RESULT OF FINANCING (Positive or negative)

RESULT OF ORDINARY ACTIVITIES (Profit or loss)

EXTRA-ORDINARY INCOME

less

EXTRA-ORDINARY EXPENDITURE

EXTRA-ORDINARY RESULTS (Positive or negative)

RESULT OF ORDINARY ACTIVITIES (Profit or loss)

plus

EXTRA-ORDINARY RESULTS (Positive or negative)

RESULT BEFORE TAXATION (Profit or loss)

RESULT BEFORE TAXATION (Profit or loss)
less
TAXATION ON THE PROFITS (CORPORATION OR OTHER)

RESULT FOR THE PERIOD (Profit or loss)

11. Case Study: End of year procedures

PREPARATION OF THE BALANCE SHEET

In order to better understand the concepts studied up until now, we include an example to show how to realise and prepare a Profit and Loss account, and Balance Sheet, from the General ledger balances at the year end (balances for each account after all the movements for the year).

In this exercise, we are not building the accounts from the beginning, since we are not preparing the Journals: We are assuming that the business has accounted for all the movements of the year in the Journals, and has passed these for all the accounts to the General Ledger, and that the balances we have are those from the General Ledger.

We find the company López S.A. on 1 January 2005 with the following list of balances from the General Ledger as at 31 December 2004.

Account	Amount
Transport of materials	500
Equipment	10,500
Clients	24,000
Bank	1,500
Bank loan – 3 years	7,200
Share Capital	7,800
Wages and Salaries	12,000
Sales	40,000
Suppliers	13,500
Shares in García S.A.	400
Purchases	23,000
Consultancy fees	500
Computer and photocopier	1,000
Accounts payable-Various	4,500
Costs of heat and light	400
Finance costs	200
Office materials costs	300
Tax payable	900
Accounts payable to Social Security	400

Given that we wish to know the situation of the business at the period end, we must do the following:

1. Determine, account by account, to which of the four types it corresponds: asset, liability/equity, income or expenditure.

2. Once the above is done, calculate the result for the year, bringing together the various accounts for income and expenditure into a single account, the Profit and Loss account.

3. Subsequently, prepare the Balance Sheet, incorporating the final result from the Profit and Loss account. The Balance Sheet must be ordered as described above, that is to say, distinguishing between fixed and current assets, current and long-term liabilities, and the internal resources.

In order to complete this exercise, we follow the hypothesis that there are no stocks either on 1 Jan 2004 or 31 December 2004. All the figures are in euros.

FIRST STAGE: INDENTIFICATION OF EACH ACCOUNT, DECISION BETWEEN THE FOUR TYPES OF ACCOUNT: ASSET, LIABILITY/CAPITAL, INCOME OR EXPENDITURE.

We consider each account, and, regarding the function of its contents, decide which of the four types of account it relates to.

The asset accounts contain the goods and rights of the business, where investments have been made or where money has been deposited.

The liabilities and capital accounts contain the debts and obligations of the business, the funds that have been advanced by its members, or loaned by third parties.

The income accounts show what is income for the enterprise, such as a sale.
The expenditure accounts show what have been the costs for the business, such as the salaries, the interest on bank loans, the invoices for utilities etc.

Below is the classification for each account.

ACCOUNT	AMOUNT	
Transport of materials	500	**EXPENSE**
Equipment	10,500	**FIXED ASSET**
Clients	24,000	**CURRENT ASSET**
Bank	1,500	**CURRENT ASSET**
Bank loan – 3 years	7,200	**LONG TERM LIABILITY**
Share Capital	7,800	**EQUITY**
Wages and Salaries	12,000	**EXPENSE**
Sales	40,000	**INCOME**
Suppliers	13,500	**CURRENT LIABILITY**
Shares in García S.A.	400	**FIXED ASSET**
Purchases	23,000	**EXPENSE**
Consultancy fees	500	**EXPENSE**
Computer and photocopier	1,000	**FIXED ASSET**
Accounts payable-Various	4,500	**CURRENT LIABILITY**
Costs of heat and telephone	400	**EXPENSE**
Finance costs	200	**EXPENSE**
Office materials costs	300	**EXPENSE**
Tax payable	900	**CURRENT LIABILITY**
Accounts payable to Social Security	400	**CURRENT LIABILITY**

The accounts in the General Ledger, as has been detailed above, collate the balances which, after all the movements during the year, are left on each account. The General ledger is like a summary of the Journals, but by accounts.

In the Journal each movement was annotated in every account where there was some event. The General Ledger exists for each account and in that is annotated what, previously was entered in the Journal.

SECOND STAGE : CALCULATION OF THE PROFIT OR LOSS FOR THE PERIOD

At the end of the period, we take all the accounts for income and expenditure, and, through the differences between these, we can calculate the profit or loss for the enterprise. Afterwards, the income and expenditure accounts show a zero balance to start the new period.

Income	
Sales	40,000
Total Income	**40,000**
Expenditure	
Transport of materials	500
Wages and salaries	12,000
Purchases	23,000
Consultancy fees	500
Costs of heat and telephone	400
Finance costs	200
Office materials costs	300
Total Expenditure	**36,900**
PROFIT	**3,100**

THIRD STAGE: PREPARATION OF THE BALANCE SHEET

Once the result for the period has been calculated, we take the accounts for assets and liabilities/equity and prepare the Balance Sheet.

In the Balance Sheet, INCOME AND EXPENDITURE ACCOUNTS NEVER APPEAR. Only the final result of the enterprise is brought across, as a profit or loss. This is carried into the liabilities section within equity, under the account Profit and loss of the year, till the general shareholders' meeting decides which portion of the profit is to be paid out as dividends to shareholders and which portion is to be kept as retained earnings thus increasing the company's equity. If there is a profit, this is shown as a positive number within the equity section (a profit is an internal generation of funds or self-financing). If there has been a loss for the period, then this amount is entered, also in the equity section, but as a negative amount.

ASSETS		LIABILITIES	
CURRENT ASSETS		**CURRENT LIABILITIES**	
24,000	DEBTORS (CLIENTS)	SUPPLIERS	13,500
1,500	BANK	VARIOUS CREDITORS AND ACCRUALS	4,500
		TAX CREDITOR	900
		S.S. CREDITOR	400
FIXED ASSETS		**LONG TERM LIABILITIES**	
10,500	EQUIPMENT	3 YEAR BANK LOAN	7,200
400	SHARES	**CAPITAL AND RESERVES**	
1,000	COMPUTER	CAPITAL	7,800
		PROFIT	3,100
37,400	**TOTAL ASSETS**	**TOTAL LIABILITIES**	**37,400**

12. Practical example of the accounts preparation for a company: Journal, General Ledger, preparation of the Balance Sheet.

We shall now deepen out understanding of the knowledge acquired and complete an example of how to make up the accounts for a company, using the Journal and General Ledger, sorting out the year end matters and preparing the closing Income statement (profit and loss account) and Balance Sheet.

Introduction

Every business engages in some type of activity, being its reason for existence. In order to bring this activity into being, which could be either the manufacture of a product, or the offering of a service, two basic things are required:

.Equipment or long term investments: installations, machinery, computers, tables etc

.Working capital: money in liquid form to pay for invoices and costs as they fall due, stocks of finished goods in store ready for sale to customers, stocks of raw materials to be used in the upcoming manufacturing process etc.

The company, in order to realise its function, requires a series of elements that we may call investments. The machinery will be a long term or permanent investment, and those elements that we call current assets presume the setting aside of funds for them on a short term basis.

But, in order to make these investments, the business has to be able to call on financial resources. If it cannot raise money from its members, or via a bank loan, it will not be able to make any kind of investment, and therefore will not be able to carry out its activity. The methods that the enterprise uses to undertake its activities we call financing.

Moreover, the fundamental equation in accountancy tells us that the investments equal the financing. All investment must be funded, all funds must be invested. Investment = Financing, or Assets = Liabilities + Capital.

For practical and didactic reasons we have left out of this exercise certain elements that are necessary in real-life Accounting in a business, such as the accounting for Value added tax (VAT) on sales and purchases, Corporation Tax and others. Additionally, we are assuming that the business is only producing to order, and that therefore there are neither stocks of raw materials nor finished goods nor work in progress in the store at the year end.

We take the case of a company created with the object of manufacturing widgets. The company is called PIEZAS METÁLICAS, S.A.

PIEZAS METÁLICAS, S.A. is founded on January 1 2004 with two shareholders D. José and D. Francisco. Each decides to put in 5,000 euros into the business. This investment is called the Share Capital.

At the moment of constitution, the two members invest cash into a new bank account opened in the name of the company. From this moment, the funds are available to the company, and not to the shareholders individually. This money now forms part of the wealth of the company.

Given the principle of double entry, we show the beginning of the activity with the issue of Share Capital (**source of Finance**), which , in the first instance, remains deposited in a current account at the bank (**Investment**).

ENTRY 1. INITIAL ENTRY. BEGINNING OF THE ACTIVITY.

In the ***Journal***, we make the following entry:

Jan 1				
DEBIT			CREDIT	
10,000	Bank	to	Share Capital	10,000

Normally, what is entered on the left side of the Journal is noted on the debit side of the ledger of the corresponding account, and that entered on the right side, goes to the credit. This is important for the subsequent transfer to the General Ledger, in that there we must put each movement on the side to which it corresponds.

Since, as we have already commentated, for the creation of the business, the members have deposited cash in the bank, we make an entry in the Bank account, which, as it is an asset account, increases with debits. On the other hand, the Share Capital account is an equity account, which also has an increasing entry, this time the movement is shown on the credit side.

From the Journal, each entry is passed to the accounts ledgers, one for each account, which are collated later in this document.

ENTRY 2. ACQUISITION OF A MACHINE (LONG TERM INVESTMENT IN FIXED ASSET).

The company decides, on the first day of functioning, to purchase a machine to begin the production of widgets, for which the cost is 3,000 euros, paid for from the bank account.

JAN 2				
DEBIT			CREDIT	
3,000	Fixed asset: Machinery	to	Bank	3,000

We open an entry for the fixed asset. As it is an asset account and increases by debit, it is entered as a debit.

The bank account suffers a diminution, due to the outflow of funds. As this is an asset account, this is registered as a credit.

The purchase of a fixed asset has a rather different treatment from the registering of a purchase for goods for consumption. We shall use this example of the acquisition of a machine, and as a comparison, the purchase of industrial oil to lubricate the same equipment.

The purchase of the machine presumes that it is a material operation (high cost) and that its usage will be over some years, until such time as it has no value, or it is inefficient compared with other newer, more powerful models on the market. We take the cost to be 3,000 euros, and estimate the useful life to be some 10 years. The purchase of such a fixed asset is considered as an investment, and not a cost to be written down during the year, and as such the value of the good is taken as an asset in the balance sheet .If it is paid for from the bank account, then a credit to Bank is made, if it is financed through a loan, then the credit is made to a loan account.

However the machine will lose value with usage and with time, so we cannot keep it in the balance sheet (in assets) at the original cost of purchase. For this purpose, we have depreciation. Each year, the company makes a charge to expenses (depreciation charge on fixed assets) for the amount that is considered to be the decrease in value suffered by the asset over the course of the year. In this case we use a linear method for calculating the depreciation. If the machine cost is 3,000 euros, with an estimated useful life of 10 years, than each year we make a charge of 1/10 part of its value, that is, 300 euros.

The balancing entry for this *Depreciation charge* is an account which is termed **Accumulated depreciation of fixed assets**, and which is a contra-account and shown within fixed assets as a negative amount, correcting the book value of the assets by the decrease sustained during the years.

That is to say, with any fixed asset, when it is purchased, the whole value is shown in the assets, and afterwards an amount is taken to expenditure each year for a proportion of its value, and that same amount stays also as the accumulated depreciation figure. In our example, the accumulated depreciation account balance is 300. After the second year, this figure will be 600, and 900 after the third year, etc.

Depreciation, by taking the decrease in value of the machine to expenses over several years, spreads the initial cost to the business over its usage. It would not be fair to write off to expenses the entire cost of the machine in the initial year of purchase, when it will be serving the enterprise for some years to come. With the depreciation charge we spread this cost over a number of years.

However, an expense like the oil which we use to service the machine, is charged to expenditure (in the Profit and Loss account) during the course of the year, and is never considered an asset. Oil is purchased and consumed within one year, therefore the results for this year must reflect the cost of this purchase.

ENTRY 3. PURCHASE OF RAW MATERIALS ON CREDIT

The company receives an order for 100 widgets and, in order to start production, needs to buy raw materials (metal) to cut and shape. This purchase is for 1,000 euros, and the supplier grants a credit period of 20 days to pay (this granting of credit produces a new source of financing for the company).

January 5					
DEBIT			CREDIT		
1,000	Purchases Raw materials	to	Suppliers		1,000

The purchases account is an expenditure account which increases by debit. Since the purchase is already made, thereby increasing the purchases, we enter it in the debits.

The suppliers account is a liability, which is increasing, as we now owe money to the supplier. For this we note a movement in the credit of this account, which is where liability accounts increase.

ENTRY 4. PAYMENT OF SALARIES

In order to complete the production process, the business must pay 500 euros in wages and salaries to its employees, so the payment is made from the bank account.

January 10					
DEBIT			CREDIT		
500	Wages and Salaries	to	Bank		500

The account for wages and salaries is an expenditure account, and, as such, increases by debit. The bank account is an asset, and as there is an outflow of funds, this produces a movement in the credits.

ENTRY 5. PAYMENT OF ELECTRICITY INVOICE

The production process needs electrical power. The Utility company invoices us for 100 euros, which is paid from the Bank account.

January 15				
DEBIT			CREDIT	
100	Utilities	to	Bank	100

The use of electricity is a cost which we put in an expenditure account called Utilities. As an expense account, it grows by debit. The payment we make from the bank reduces the balance in our account, and as such, being an asset account, we enter it as a credit.

ENTRY 6. SALE OF PRODUCTS FOR CREDIT

Once the production has been completed, we can sell the product to the customer who made the order. Normally one sells with a profit over the costs of production. In this case the costs have been 1,600 euros, and we set the sale price as having a profit margin of 25%, so we sell for 2,000 euros. The customer has asked for 30 days to pay us, as we are selling for credit, and we are therefore financing him. Therefore we set up a new account for Debtors (Clients). It is an asset account as it is a right that we hold over this client.

January 22				
DEBIT			CREDIT	
2,000	Debtors	to	Sales	2,000

The debtors account, which is an asset, increases, and we show this with a debit. The sales account is an income account, which increases by credit, therefore we show this movement in the credits.

ENTRY 7. PAYMENT TO SUPPLIER

The 20 days credit allowed by the supplier for the financing of raw materials have now passed, so we shall liquidate this debt, using a cheque from our bank account.

January 25				
DEBIT			CREDIT	
1,000	Suppliers	to	Bank	1,000

The suppliers account shows a decrease as we no longer have this debt with them. As a liability account, the decrease is by debit.

The bank account also suffers a decrease since the money is no longer there. As this is an asset account, the diminution this time is by credit.

It is important in Accountancy to differentiate between two concepts: cost and payment. We account for the cost at the moment when it arises, that is to say, when we buy the goods. If we pay immediately at the time, then cost and payment coincide. But if the supplier allows us to pay later, then the cost and payment are separated in time. The cost is incurred at the point of sale, and the payment when there is a movement of funds, which in this case of entry 7, is 20 days after the accounting for the cost (entry 3).

ENTRY 8. CLIENT PAYS

The 30 days that we have allowed the customer have now passed, and the client pays us into the bank account.

February 22					
DEBIT			CREDIT		
2,000	Bank	to	Debtors		2,000

The bank account registers a rise, and as it is an asset account, that is noted in the Debits.

The Debtors account is also an asset account, but in this case it is reducing, since the client is paying its debt. Therefore this is entered as a credit, reflecting the diminution of the asset account.

It is important in Accountancy to differentiate between the two concepts: income and receipt. We account for the income as it arises, that is to say, when we make the sale. If it is paid for at the time, then the income and the receipt coincide. However if the client asks us to pay later, the income and receipt are separated in time. The income when the sale is made, and the receipt when the client pays and produces the movement of funds, which, in this case, entry 8, is 30 days after the accounting for the income (entry 6).

ENTRY 9 . PURCHASE OF RAW MATERIALS FOR CASH.

The business receives a new order for 300 widgets, and, in order to start production, needs to buy raw materials (metal) for cutting and pressing. The purchase is for 3,000 euros, but the supplier requires payment in cash, which we do through the bank account.

March 25					
DEBIT			CREDIT		
3,000	Purchases Raw materials	to	Bank		3,000

The purchases account is an expenditure account, that increases by debit. As we are making a purchase, we enter that in the debit side.

The bank account is an asset account which in this case is decreasing. For this we record the movement as a credit in the bank account.

ENTRY 10. SALE OF GOODS FOR CASH.

This produces a new sale, and on this occasion the client pays cash. That is to say, the sale and the receipt happen simultaneously.

May 2					
DEBIT			CREDIT		
6,000	Bank	to	Sales		6,000

The bank account has a payment in, the balance increases, so as it is an asset account, this is done as a debit.

The sales account is an income account and also increases, so that is done as a credit.

ENTRY 11. PURCHASE OF RAW MATERIALS ON CREDIT.

The enterprise receives an order for 200 widgets, and in order to start production, it is necessary to buy raw materials costing 2,000 euros. This time the supplier generously allows us 120 days of credit (as the supplier is essentially financing us, this gives rise to a new source of funds).

September 20					
DEBIT			CREDIT		
2,000	Purchases Raw materials	to	Suppliers		2,000

The purchases account is an expenditure account, which grows by the Debit side. As this is a purchase of materials, increasing purchases, we enter a debit.

The suppliers account is a liability and is increasing, since we now owe money to the supplier. For this reason we enter the transaction as a credit, since that is where liability accounts increase.

ENTRY 12. SALE OF GOODS ON CREDIT.

November 23					
DEBIT			CREDIT		
5,000	Debtors	to	Sales		5,000

The Debtors (Clients) account, which is an asset, increases, and therefore we enter a debit. The Sales account is an income account which grows by credit, and as there an increase, we thus put the entry on the credit side.

ENTRY 13. OBTAINING A LOAN

The company is making plans to expand its activity, for which it needs to buy some new machinery. Given that there are not enough ready funds, they decide to apply for a loan from the bank of 4,000 euros over a period of 3 years.

December 24				
DEBIT			CREDIT	
4,000	Bank	to	Long term loan	4,000

ENTRY 14. DEPRECIATION OF FIXED ASSET.

The company, at the end of the accounting period, must account for the depreciation of the fixed assets that are in the books. This company only has one machine which was bought on January 2 for 3,000 euros. As discussed in Entry 2, this machine is to be depreciated over a period of 10 years, so we charge 300 euros annually to this depreciation.

December 31				
DEBIT			CREDIT	
300	Depreciation charge for year	to	Accumulated depreciation of fixed asset	300

SUMMARY OF THE JOURNAL

We include now a summary of all the entries made in the journal,

DEBIT			CREDIT	
		January 1 . Entry 1		
10,000	Bank	to	Share Capital	10,000
		January 2 . Entry 2		
3,000	Fixed asset: Machinery	to	Bank	3,000
		January 5 . Entry 3		
1,000	Purchases Raw materials	to	Suppliers	1,000
		January 10 . Entry 4		
500	Wages and Salaries	to	Bank	500
		January 15 . Entry 5		
100	Utilities	to	Bank	100
		January 22 . Entry 6		
2,000	Debtors	to	Sales	2,000
		January 25 . Entry 7		
1,000	Suppliers	to	Bank	1,000
		February 22 . Entry 8		
2,000	Bank	to	Debtors	2,000
		March 25 . Entry 9		
3,000	Purchases Raw materials	to	Bank	3,000
		May 2 . Entry 10		
6,000	Bank	to	Sales	6,000
		September 20 . Entry 11		
2,000	Purchases Raw materials	to	Suppliers	2,000

November 23 . Entry 12				
5,000	Debtors	to	Sales	5,000
December 24 . Entry 13				
4,000	Bank	to	Long term loan	4,000
December 31 . Entry 14				
300	Depreciation charge	to	Accumulated Depreciation	300

GENERAL LEDGER

We now collate all the movements from the journal to the general Ledgers, one ledger for each account that is used in the journal.

Each entry in the journal is transferred immediately to the ledger, which collects all that has happened in each account, and at the end of the period shows the balance outstanding on each account.

SHARE CAPITAL (L)

DEBIT		CREDIT	
		Entry1	10,000
BALANCE	**10,000**		

BANK (A)

DEBIT		CREDIT	
Entry 1	10,000	Entry 2	3,000
Entry 8	2,000	Entry 4	500
Entry 10	6,000	Entry 5	100
Entry 13	4,000	Entry 7	1,000
		Entry 9	3,000
		BALANCE	**14,400**

FIXED ASSET: MACHINERY(A)			
DEBIT		**CREDIT**	
Entry 2	3,000		
		BALANCE	**3,000**

PURCHASES (E)			
DEBIT		**CREDIT**	
Entry 3	1,000		
Entry 9	3,000		
Entry 11	2,000		
		BALANCE	**6,000**

SUPPLIERS (L)			
DEBIT		**CREDIT**	
Entry 7	1,000	Entry 3	1,000
		Entry 11	2,000
BALANCE	**2,000**		

WAGES AND SALARIES (E)			
DEBIT		**CREDIT**	
Entry 4	500		
		BALANCE	**500**

UTILITIES (E)			
DEBIT		**CREDIT**	
Entry 5	100		
		BALANCE	**100**

DEBTORS (A)			
DEBIT		**CREDIT**	
Entry 6	2,000	Entry 8	2,000
Entry 12	5,000		
		BALANCE	**5,000**

SALES (I)			
DEBIT		**CREDIT**	
		Entry 6	2,000
		Entry 10	6,000
		Entry 12	5,000
BALANCE	**13,000**		

LONG TERM LOAN (L)			
DEBIT		**CREDIT**	
		Entry 13	4,000
BALANCE	**4,000**		

DEPRECIATION CHARGE (E)	
DEBIT	**CREDIT**
Entry 14 300	
	BALANCE 300

ACCUMULATED DEPRECIATION (L)	
DEBIT	**CREDIT**
	Entry 14 300
BALANCE 300	

PREPARATION OF THE PROFIT AND LOSS ACOUNT

The next step is to take all the accounts for income and expenditure and set them to zero for the new year, and include the closing balances in the Profit and Loss account to determine the profit or loss for the year.

Income	
Sales	13,000
Total Income	**13,000**
Expenditure	
Purchases of raw materials	6,000
Wages and salaries	500
Utilities	100
Depreciation charge	300
Total expenditure	**6,900**

PROFIT	**6,100**

BALANCE SHEET

Finally we can prepare the Balance Sheet, taking only the Asset and Liability accounts and the result from the Profit and Loss account. If there is a profit, then that is shown in the equity as a positive number. If there is a loss, then it is shown in the same place, but as a negative number. This is because a profit is essentially a generation of funds for the business. From the entries of income in the credits and expense in the debits, if there is a profit then there will be a balance in the Profit and Loss account of a credit which is then shown in the Balance Sheet as the final result of the period. With this profit we have generated internal funds which can be used by the business in the future for whatever use.

ASSETS		LIABILITIES	
CURRENT ASSETS		**CURRENT LIABILITIES**	
5,000	DEBTORS	SUPPLIERS	2,000
14,400	BANK ACCOUNTS		
FIXED ASSETS		**LONG TERM LIABILITIES**	
3,000	MACHINERY	LOAN– 3 YEARS	4,000
		EQUITY	
		CAPITAL	10,000
- 300	ACCUMULATED DEPRECIATION	PROFIT FOR THE PERIOD	6,100
22,100	**TOTAL ASSETS**	**TOTAL LIABILITIES**	**22,100**

Throughout the exercise we have worked under the assumption that, at the beginning and end of the year there have been no stocks, since we have used the accounting for stocks known as periodic. In this case we do not register the movements in stocks during the year, but rather account directly to the income and expenditure accounts for purchases, and only at the year end, do we make an adjustment for any stocks in store, taking to expenses any difference between opening and closing amounts if there was more stock initially, and taking the difference to income in the case of closing stock being greater than opening.

13. Inventory Management

Inventory is a special asset that requires covering two aspects: how we record its variations and how we value it in the accounting books.

About how to record, there are two basic methods: perpetual and periodic

About how to value inventory, there are different methods, but the most frequent and widely used are: FIFO (FIRST IN FIRST OUT, that is the first items we bought and at their acquisition prices are the first items we sell), LIFO (LAST IN FIRST OUT, opposite to the previous one since the last items we buy are the first ones to be considered sold) and weighted average methods (where an average cost is calculated).

- Perpetual inventory

Every time inventory is bought, is recorded as an asset, in the inventory account. Whenever the merchandises or goods are sold are then recorded as a revenue at the price of sale and the cost of the merchandise is recorded as an expense at the time of the sale.

So, a margin from the sale is calculated whenever there is a sale.

The asset (inventory) account always shows an updated value since we register all the incomes and outcomes, and there is no need to make adjustments at the end of the year.

- Periodic inventory

The inventory account (asset) is not used during the year.

Every time inventory is bought, is recorded as an expense.

Whenever the merchandise is sold, nothing will be recorded in the inventory account. At the end of the year and based on the physical count, the inventory (asset) account is adjusted to show the real amount in the warehouse and the expense account is adjusted to show the real consumption coming from the sale of inventories.