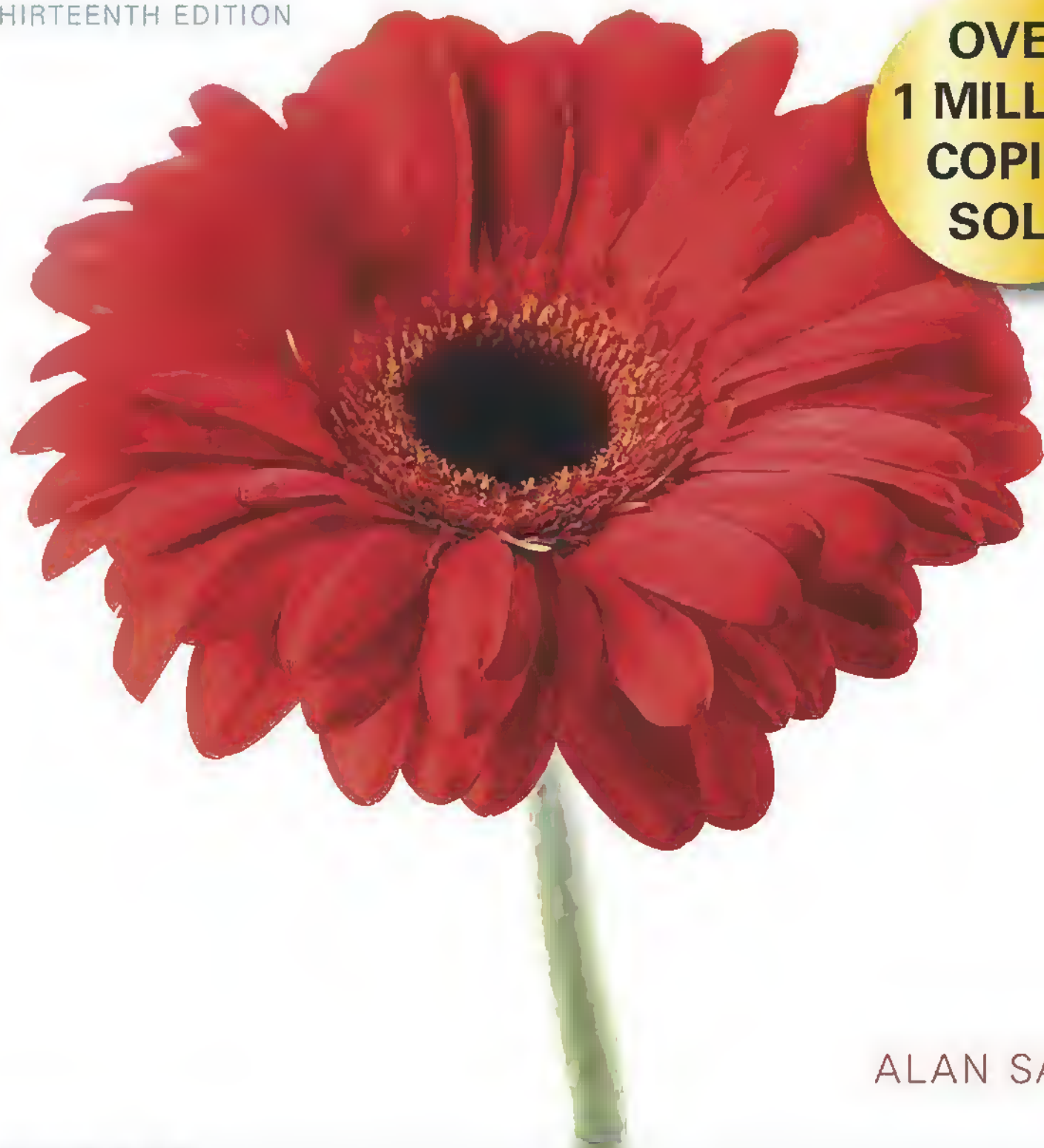


FRANK WOOD'S

# BUSINESS ACCOUNTING 1

THIRTEENTH EDITION

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**BUSINESS ACCOUNTING**

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Frank Wood  
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# FRANK WOOD'S BUSINESS ACCOUNTING

# 1

THIRTEENTH EDITION

**ALAN SANGSTER** BA, MSc, PhD, Cert TESOL, CA

Formerly authored by Frank Wood BSc (Econ), FCA

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# Notes for teachers and lecturers

This textbook has been written so that a very thorough introduction to accounting is provided in two volumes. The split into two volumes is a recognition of the fact that many students will find that Volume 1 contains all that they require. Volume 2 takes the studies of the topic of this book to a more advanced stage.

Anyone seeking to obtain a good grounding in financial accounting will find this book suitable to their needs. This includes those studying accounting on courses at school, college, or university; or studying for qualifications from the LCCI, Association of Accounting Technicians, the Institute of Secretaries and Administrators; or for qualifications of any of the six UK and Irish Chartered Accountancy bodies. The financial accounting requirements for National Vocational Qualifications and Scottish Vocational Qualification are also fully covered.

The book has the following features:

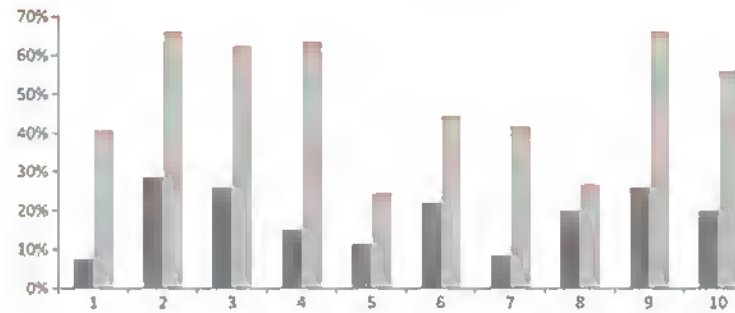
- 1 Each chapter:
  - starts with Learning Objectives;
  - contains Activities designed to broaden and reinforce students' understanding of the concepts being covered and, in some cases, to introduce new concepts in such a way that they do not come as a surprise when introduced formally later in the book;
  - ends with Learning Outcomes that can be mapped back to the Learning Objectives, reinforcing the major topics and concepts covered in the chapter;
  - contains answers to all the Activities immediately after the Learning Outcomes.
- 2 There is an alphabetical Glossary in Appendix 3 of all the significant terms introduced. Each entry is referenced back to the chapter in which it appeared.
- 3 Five sets of twenty multiple choice questions are positioned in the book (in Chapters 6, 13, 27, 33 and 45) at the point at which they should be attempted, rather than as a group at the end of the book. All the answers are at the back of the book in Appendix 2.
- 4 At the end of Part 5 (*Adjustments for financial statements*), there are five Scenario Questions which are designed to reinforce learning of the adjustments through their application in the preparation of financial statements previously learnt in Parts 1–4.
- 5 A set of Notes for Students appears at the front of the book. This covers how to use this book, how to tackle the end-of-chapter Review Questions, and how to study for and sit examinations. **It should be read by students before they start working through the main text.**
- 6 Blue is used in the text to enhance readability and bring out key points.

## A new approach

The greatest change in this textbook since the last edition concerns how to learn *Double Entry*. This has always been a problem for students, and continues to be so. In the previous edition, the approach presented in this edition was first mentioned, but only briefly. Now, this principles-based approach to double entry has been fully adopted and is the focus of a new chapter, Chapter 2 (*Recording transactions*). This approach *has* been found to work and Chapters 1, 3, and 4 have all been fully revised making it the approach students adopt to learn double entry from this book.

When a colleague and I used this principles-based approach with 250 students, their learning and understanding of double entry improved by more than 150 per cent. This is what is shown in Exhibit 1. The histogram shows the percentage of students in that group who selected the correct

## Exhibit 1 The result of a switch to a principles-based approach to double entry



answer to each of 10 multiple choice questions compared with the percentage of 250 students in another group who had learnt double entry by rules, such as debit the receiver and credit the giver. The multiple choice questions required them to identify the correct double entry for each of 10 transactions. This is why the approach adopted in this text has been changed: students find it far easier to learn!

The underlying truth behind the approach is that there are two elements to every transaction: (1) the item exchanged; and, (2) the form of settlement. One is the debit and the other is the credit. The item exchanged belongs to the business, either before or as a result of the transaction. The other thing involved in the transaction is the form of settlement, e.g. cash, bank, or a debt. If you know how to record increases or decreases in things that belong to the business, its possessions, the other side of each double entry is obvious. From this, two *axioms* have been developed. The first is that any increase in a possession (assets and expenses both ‘belong’ to the business) is a debit. The second is that any increase in capital (and anything else not owned by the business) is a credit. It is simple. It is straightforward. And it never fails to give the correct treatment for a transaction, not least because you only have to identify the item exchanged in a transaction to know how what to debit and what to credit: the form of settlement (cash, bank, or a debt) is treated in the opposite way to the item exchanged.

In addition, in order to avoid confusion between ‘credit’ as a term in double entry and ‘credit’, when a transaction is not paid for immediately, for the first 13 chapters, ‘credit transactions’ are referred to transactions settled ‘on time’. In Chapter 14, the term ‘credit sale’ is introduced. Thereafter, ‘credit’ is used in place of ‘on time’. Focusing on the single use of ‘credit’ as a term in double entry up until that point has been found to make learning double entry easier.

I hope that you find these innovations of help in the teaching of this topic, and I am sure that your students will find it much easier to learn double entry bookkeeping in this way. Please let me know your views on it, and those of your students.

Other changes, some major, others less so, have also been made to the content of this textbook since the last edition:

- The term ‘Income statement’ has been replaced throughout with, ‘Statement of profit or loss’. This is in line with IFRS. The change was requested by a number of users of the book who felt it more appropriate, not simply because it was recommended by the IASB, but because it reflected more accurately the content of the statement.
- Part 1 has been renamed *Introduction to financial accounting*.
- Chapters 1 (*The background and the main features of financial accounting*), 3 (*Inventory*), 4 (*The effect of profit or loss on capital and the double entry system for expenses and revenues*), 22 (*information technology and accounting*), and 23 (*Computerised information systems*) have all been updated, retitled, and extensively rewritten.
- Part 2 has been renamed *The financial statements of sole proprietors*.
- Chapter 10 (*Accounting concepts and assumptions*) has been completely updated and Activity 10.3 has been replaced.

- Chapter 12 (*The banking system in the UK*) has been completely updated and a new Activity (12.3) added.
- Chapter 14 has been retitled *Accounting for sales*.
- Chapter 15 has been retitled *Accounting for purchases*.
- Chapter 16 has been retitled *Accounting for returns*.
- Chapter 19 (*Value added tax*) has been updated, including use in examples of the current VAT rate of 20 per cent.
- Chapter 21 has been retitled *Payroll accounting*.
- A new part has been inserted, Part 4: *Computerised accounting*.
- Two new sections have been added to Chapter 45: 45.11 on the conceptual framework and 45.19 on professional ethics.
- There are over 100 new end of chapter *Review Questions* in this edition.
- The text is fully compliant with International GAAP.

People generally view accounting as a never-changing subject. This is not true. Despite appearances, accounting is a dynamic subject. The current major ongoing change, begun in 2005 and still in progress, is the switch from domestic accounting rules to international rules. Specifically, the rules that have been developed in the UK since 1970, known as Statements of Standard Accounting Practice (SSAPs) and Financial Reporting Standards (FRSs) are, effectively, being phased out. In their place, most businesses are now using International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

Some small and medium-sized businesses continue to use UK standards. These were consolidated and revised in 2013 and 2014 and now have simpler requirements more in keeping (in terms of length and detail, but not in substance) with those issued under International GAAP.

It seems likely that all businesses will soon move to using international standards and that the UK standards will disappear. Indeed, the UK's standard-setters are currently working on convergence of UK and international rules.

You will find below a very simple comparative table that provides an 'at a glance' view of the key terminology changes from UK to international standards. Also, when a key international term first appears in the text you will sometimes see the UK equivalent placed next to it in colour and in bold to make it clear how the terminology has changed, such as statement of financial position (**balance sheet**).

International	Traditional UK
Accounts payable	Creditors
Accounts receivable	Debtors
Allowance for doubtful debts	Provision for doubtful debts
Statement of profit or loss	Profit and loss account
Inventory	Stock(s)
Loan note	Debenture
Non-current assets	Fixed assets
Non-current liabilities	Long-term liabilities
Retained profits	Profit and loss account (on Statement of financial position)
Revenue	Turnover
Statement of financial position	Balance sheet
No equivalent	Exceptional item
No equivalent	Extraordinary item

I hope that you find these changes helpful and appropriate and would welcome comments on these and any other changes you feel ought to be made in future editions. You can contact me by email at [a.j.a.sangster@btinternet.com](mailto:a.j.a.sangster@btinternet.com)

Finally, I would like to thank all those teachers and lecturers who gave me their advice as to the changes they would like to see incorporated in this edition. Above all, I would like to acknowledge the assistance received from Graeme C. Reid, FCA FCCA, lecturer in Financial Accounting, Auditing and Entrepreneurship at the University of Hull, who contributed questions for Chapters 6, 7, 8, 9, 13, 15, 18, 24, 25, 26, 27, 28, 30, 31, 32, 33, 34, 35, 37, 41, 43 and 45, plus the five Scenario Questions at the end of Part 5; and, of course, Christopher Foo of St. George's School, Malaysia for all his help and advice during the past decade.

Alan Sangster

## Notes for students

This textbook presents your topics in what has been found to be the most appropriate sequencing to build the foundations of your accounting knowledge. You will find that a number of features of the book, properly used, will enhance your understanding and extend your ability to cope with what will possibly appear, at first, to be a mystifying array of rules and procedures.

To make best use of this resource, you should consider the following as being a proven path to success:

- At the start of each chapter, **read the Learning Objectives**. Then, while you work through the material, try to detect when you have achieved each of these objectives.
- At the end of each chapter, **check what you have learnt against the Learning Outcomes** that follow the main text.
- If you find that you cannot say ‘yes, I have learnt that’ to any of the Learning Outcomes, look back through the chapter and reread the topic you have not yet learnt.
- **Learn the meaning of each new term as it appears**. Do not leave learning what terms mean until you are revising for an exam. Accounting is best learnt as a series of building blocks. If you don’t remember what terms mean, your knowledge and ability to ‘do’ accounting will be very seriously undermined, in much the same way as a wall built without mortar is likely to collapse the first time someone leans against it.
- Attempt each of the **Activities** in the book *at the point at which they appear*. This is *very* important. They will reinforce your learning and help set in context some of the material that may otherwise appear very artificial and distant from the world you live in. The answers are at the end of each chapter. **Do not look at the answers before you attempt the questions – you’ll just be cheating yourself**. Once you have answered one, check your answer against the answer provided in the book and be sure you understand it before moving on.
- Attempt each of the sets of multiple choice questions when you reach them in the book. There are five sets of twenty questions, one at the end of each of Chapters 6, 13, 27, 33 and 45. The answers are in Appendix 2 at the back of the book. **Do not look at the answers before you attempt the questions – you’ll just be cheating yourself**. If you get any wrong, be sure you understand why before moving on to new material.
- Attempt the Scenario Questions at the end of Part 5. They will help you see how the items covered in Part 5 affect the preparation of financial statements.
- **Learn the accounting equation when you first come across it in Chapter 1**. It is *the* key to understanding many of the aspects of accounting that students find difficult. Make sure that you learn it in both the forms presented to you or that you can rearrange it to produce the alternate form when appropriate.
- Do not be disillusioned by the mystery of double entry. The technique has been in common use for over 500 years and is probably the most tried and trusted technique for doing anything you are ever likely to encounter. It really is not difficult, so long as you remember the two **Axioms** you are given in Chapter 2 and can distinguish between things belonging to a business and things that the business owes. Like riding a bike, once you understand it, you’ll never forget it and, the more you do it, the easier it gets.
- Because of time pressure, some teachers and lecturers will need to omit Chapter 40 (*Joint venture accounts*). Make sure that you work through it on your own before you look at the material in Chapter 41, the first chapter on accounting for partnerships. This is very important, as accounting for joint ventures bridges the gap between accounting for sole proprietors and accounting for partnerships and will make it much easier for you to understand the differences between them.

- Above all, remember that accounting is a vehicle for providing financial information in a form that assists decision-making. Work hard at presenting your work as neatly as possible and remember that pictures (in this case, financial figures) only carry half the message. When you are asked for them, words of explanation and insight are essential in order to make an examiner appreciate what you know and that you actually understand what the figures mean.

There are two subjects I would like you to consider very carefully – making best use of the end-of-chapter Review Questions, and your examination technique.

## Review questions: the best approach

Review questions are included at the end of most chapters. They are there for you to gauge how well you understand and can apply what you have learnt. **If you simply read the chapters without attempting the questions, you will not pass your examinations.** You should first attempt each question, then check your answer fully against the answers at the back of the book. **Do not simply compare the question with the answer and tick off the bits of the answer against the relevant part of the question.** No one ever learnt to do accounting properly that way. It is tempting to save time, but you will regret it eventually.

## Need for practice

Try to find the time to answer as many exercises as possible. This is why:

- 1 Even though you may think you understand, when you come to answer the questions you may find you don't. The true test of understanding is whether or not you can tackle the questions competently.
- 2 Practice makes perfect. If you don't practice doing accounting questions, you will almost certainly not become good at accounting.
- 3 You need to be able to answer questions quickly: many fail accounting exams because they run out of time. A lot is expected from you in an accounting exam in a very short time because examining boards believe, and have always believed, that an 'adequately prepared' student will be able to work quickly on the problems set. By an 'adequately prepared' student, they mean a student who not only has the knowledge, but has been trained to work quickly and, at the same time, maintain accuracy and neatness.
- 4 Speed is not enough. You also have to be neat and tidy, and follow all the proper practices and procedures while working at speed. Fast, correct, but really scruffy and unreadable work can also cause you to fail the exam. Why? At this level, the accounting examiner is mainly concerned about your practical ability in the subject. Accounting is a practical subject, and your practical competence is being tested. The examiner will, therefore, expect the answers to be neat and well set out. Untidy work with numbers spread over the page in a haphazard way, badly written numbers, and columns of figures in which the vertical columns are not set down in straight lines, will be penalized and can easily mean the difference between a pass and a fail.
- 5 Appropriate presentation of information is important. Learn how to present the various financial statements you may need to produce in an examination. Examiners expect to see the items in statements of profit or loss, statements of financial position, and statements of cash flow in the correct order and will probably deduct marks if you don't do this. Practise by writing down examples of these statements without any numbers until you always get the layout correct. One exam trick most students overlook is that the layout of a financial statement is often included in an examination paper as part of one question yet another question asks you to produce an answer using the format of that financial statement. **The one you need to produce will contain different numbers but the general layout should be very similar.**

## Need for headings

Your work should not only be neat, it should be well presented. Headings should always be given, and any dates should be inserted. The test you should apply is to imagine that you are a partner in a firm of professional accountants and have taken a few weeks holiday. During that time your assistants have completed all sorts of work including reports, drafting final accounts, various forms of other computations, and so on. All of this is waiting for you when you return. When you return you look at each item in the pile. Suppose the first one looks like a statement of financial position as at 31 December in respect of one of your clients. When you look at it you can see that it is a statement of financial position, but you don't know for which client, neither do you know which year it is for. Would you be annoyed with your assistant who prepared it? Of course you would. So, in an exam, why should the examiner give you high marks if you prepare a statement of financial position answer without the date, or the name of the business, or the fact that it is a statement of financial position written clearly across the top? If proper headings are not given you will lose a lot of marks. Don't wait until your examination to do this. You also need to take similar care with sub-totals and sub-headings that need to be shown, such as those for non-current assets or for current liabilities

## The examiner

When answering an examination question, think about what you would say if you were employing an accounts assistant who gave you a sheet of paper with accounting entries written in the same style as your own efforts in answering the exam question. Would you have told your assistant to go back and do the work again because it is untidy? If you say that about your own work, why should the examiner think any differently?

Anyone who works in accounting knows that untidy work leads to completely unnecessary errors. This is why examiners penalise unclear, untidy, poorly-presented work. Examiners want to ensure that you are not going to mess up the work of an accounting department. Even today, accountants still write down many things on paper, so don't imagine that examiners will overlook such messy work just because most accounting is now done using a computer. Imagine going to the savings bank and the manager saying to you: 'We don't know whether you've got £5 in the account or £5,000. You see, the work of our clerks is so untidy that we can never sort out exactly how much is in anybody's account.' We would guess that you would not want to put a lot of money into an account at that bank. How would you feel if someone took you to court for not paying a debt of £100 when, in fact, you owed them nothing? This sort of thing would happen all the time if we simply allowed people to keep untidy accounts. The examiner is there to ensure that the person to whom they award a pass will be worthy of it, and will not continually mess up the work of any firm at which they may work in the future.

If you want to pass your accounting exam, and your work is untidy, what can you do about it? Well, the answer is simple enough: start right now to be neat and tidy in your work. I did. My writing was so bad that my accounting teacher at school told me to print everything in capital letters. I thought he was mad, but my marks improved immediately, and so did my handwriting and my overall neatness in preparing answers. Start being neat now. You cannot suddenly become neat in an examination.

## The structure of the questions

The review questions in each chapter generally start with the easiest and then get gradually more difficult. Some are very difficult and time consuming. If all the questions were easy, the shock of meeting more complicated questions for the first time in an examination could lead you to fail it. By giving you a mixture of straightforward and complicated questions, you will learn how to deal with the complex issues before meeting them in an exam. It's in your best interests not to ignore

review questions you find hard. Put in the effort, the practice will increase your knowledge and understanding, and your performance in the exam will improve as a result.

### The answers

At the back of the book, you will find answers to approximately half of the Review Questions. The answers to the other review questions (indicated by the letter 'A' after the question number) are only available to you from your teacher or lecturer. Don't worry if you are studying this subject on your own. There are still more than sufficient review questions with answers in the book to ensure you know and understand the material you are learning.

## Examination technique

By the time you sit your first accounting exam, you will have spent a lot of hours trying to master such things as double entry, statements of financial position, and final adjustments. Learning accounting demands a lot of discipline and practice. Compared with the many hours learning the subject, most students spend very little time actually considering in detail how to tackle the examination. You may be one of them. Start changing this now by planning for the day when you will need to be able to demonstrate that you have learnt and understood, and can apply, the material in this book. Here are some of the things you should be thinking about:

### Understanding examiners

If you want to understand anything about examinations then you have to understand examiners. Let's look at what these peculiar creatures get up to in an examination. The first thing is that when they set an examination they are looking at it on the basis that they want good students to get a pass mark. Obviously anyone who doesn't achieve the pass mark will fail, but the object of the exercise is to find those who will pass, not find the failures. This means that if you have done your work properly, you should manage to get a pass mark. It is important to stress this: if you study and practice properly, you should pass, no matter what questions you are asked.

Unfortunately, some students who should pass will fail, not because they haven't put in enough hours on their studies, nor because they are unintelligent, but simply because they throw away marks unnecessarily by poor examination technique. If you can read the rest of this and then say honestly that you wouldn't have committed at least one of the mistakes that are mentioned, then you are certainly much more aware of how to approach an exam than most students I have met. These things appear obvious, but most students never think them through and prepare for them.

### Punctuality

Before you even think about the examination paper and what you should do with it, think about how you are going to get to the exam room. Do you know where it is? How are you going to get there? If you are going by bus or train, do you know which bus or train to catch? Will it be the rush hour when it may well take you much longer than if it were held at midday? How much time will you allow for the journey in case anything should go wrong?

Quite a large proportion of students lose their way to the examination room, or else arrive, breathless and flustered, at the very last minute. They then start the exam anxious and nervous: a recipe for disaster for a lot of students. So plan how you are going to get there and give yourself enough time.



## Cramming

Trying to learn everything at the last minute rarely works. The last few days before the exam should not be spent cramming. You can look at past examination papers and rework some of them, but this is totally different from trying to cram new facts into your head. Worst of all, don't try to learn anything during the night before the exam, especially if you don't get any sleep. You may get away with this a few times, but you will be found out eventually, fall asleep during the exam, or simply find that you cannot think straight. Apart from the risk of failing the exam because you are exhausted, it is well known that anything you learn before you go to bed the night before an exam will be remembered far better than anything you try to learn on the day of the exam. Studying through the night means you are learning things in the 'morning' of the exam. Your mind needs a rest, even if you don't.

On your way to the exam, try to relax. Try taking your mind off the exam by doing something else, such as chatting with friends, listening to music, or scanning *Facebook* or other social media for something entertaining to pass the time. Of course, everyone needs some adrenalin to spur them into action when they begin to answer an exam paper, but you do not want to waste your adrenalin before the examination by doing something stressful, like learning something important you've not yet looked at. Doing so will only make you more nervous and less able to cope in the exam. If you haven't learnt something when you leave home, it's not likely you'll be able to concentrate enough to do so on your way to the exam.

## Read the rubric carefully and follow its instruction

The rubric appears at the start of the examination paper, and says something such as:

'Attempt five questions only: the *three* questions in Section A and *two* from Section B.'

That instruction from the examiner is to be followed *exactly*. You cannot change the instruction – it means what it says. You have to do what it says.

You may think that is so simple that it is not worthwhile my pointing it out to you, but I cannot remember an exam I have marked when at least some students failed to follow the instructions they were given. Let's look at two typical examples where students have ignored the rubric above and what will happen to their mark:

- (a) Instead of answering three questions from Section A and two from Section B, a student answered *two* questions from Section A and *three* from Section B. Here the examiners will mark the two Section A answers plus the first two answers shown on the student's script in respect of Section B. They will not read any part of the third answer to Section B. The student can therefore only get marks for four answers.
- (b) A student answered *three* questions from Section A and *three* from Section B. Here the examiners will mark the three answers to Section A plus the first two answers to Section B. They will not look at the third answer to Section B.

In the case of (b), the student may have done it that way deliberately, thinking that the examiner would mark all three Section B answers, and then award the student the marks from the best two answered questions. Examiners will not waste time marking an extra answer.

If you have time and want to give an extra answer, thinking that you will get better marks for it than one answered previously, then do. But, if you do, make certain that the examiner is fully aware that you have deleted the answer that you do not want to have marked. Strike lines right through it, and also state that you wish to delete it. Otherwise, it is possible that the first answers only will be marked and your new answer ignored.

Always remember in examinations that you should try to make life easier for the examiner. Give examiners what they want, in the way that they want it. If you do, you will get better marks.

Make their job harder than it needs to be and you will suffer. Examiners are only human. They do their job and their job is to mark what they asked you to do. Do something else and they will ignore it.

## Time planning

Let's look at the way in which you should tackle the examination paper. One of the problems with accounting exams is that students are expected to do a lot of work in a relatively short time. It will be the same for every other student taking your exam, so it is not unfair so far as any one student is concerned. Working at speed does bring various disadvantages, and makes the way you tackle the examination of even greater importance.

### Time per question

The marks allotted to each question will indicate how long you should take in tackling it. Most exams are of two hours, i.e. 120 minutes. This means that in a normal examination, with 100 marks in total, a twenty-mark question should be allocated 20 per cent of the time, i.e.  $20\% \times 120 = 24$  minutes. Similarly, a question worth 30 marks should take up 30 per cent of the time, i.e.  $30\% \times 120 = 36$  minutes, and so on. Alternatively, it is 1.2 minutes for each mark awarded for the question.

If the question is in parts, and the marks awarded are shown against each part, then that will tell you what time you should spend on each part. If part of the question asks for a description, for instance, and only three marks are awarded to that part, then you should not spend twenty minutes on a long and detailed description. Instead a brief description, taking about four minutes, is what is required.

### Do the easiest questions first

*Always* tackle the easiest question first, then the next easiest question and so on. It is amazing how many students do not do this! Leave the most difficult question as the last one to be attempted. Why is this good advice? The fact is, most exams include what might be called 'warm-up' questions. These are usually fairly short, and not very difficult.

You may be able to do the easiest question in less than the time allocated. The examiner is trying to be kind to you. The examiner knows that there is a certain amount of nervousness on the part of a student taking an examination, and wants to give you the chance to calm down by letting you tackle these short, relatively easy questions first of all, and generally settle down to your work.

Even where all the questions are worth equal marks, you are bound to find some easier than others. It is impossible for an examiner to set questions which are exactly equal in difficulty. So, remember, start with the easiest question. This will give you a feeling of confidence that will help you when you get to the more difficult questions later.

Do not expect that these 'warm-up' questions will be numbered 1 and 2 on your exam paper. Most accounting exams start with a rather long question, worth quite a lot of marks, as the first question on the paper. A lot of students are fascinated by the fact that such a question is number 1, that it is worth a lot of marks, and their thinking runs: 'If I do this question first, and make a good job of it, then I am well on the way to passing the examination.'

There is no doubt that a speedy and successful attempt at such a question could possibly lead to a pass. The trouble is that this doesn't usually happen, and many students have admitted afterwards that their failure could be put down to simply ignoring this advice. What happens very often is that the student starts off on such a question, things don't go very well, a few mistakes are made, the student then looks at the clock and sees that they are not 'beating the clock' in terms of possible marks, and then panic descends. Leaving that question very hastily, the student then proceeds to the next question, which normally might have been well attempted but, because of

the student's state of mind, a mess is made of that one as well, and so the student fails an exam that ought to have been passed.

### Attempt every required question

Attempt each and every question you are required to do. If you are asked to do four questions, don't just do three. On each question the first few marks are the easiest to get. For instance, on a 20-mark essay question it is reasonably easy to get the first five marks. Managing to produce a perfect answer to get the last five marks, from 15 to 20, is extremely difficult. This applies also to computational questions.

This means that in an examination of, say, five questions with 20 marks for each question, there is not much point in tackling only three questions and trying to make a good job of them. Your maximum possible mark would be 60, and if you had not achieved full marks for each question, in itself extremely unlikely, you could easily fall below the pass mark. It is better to leave questions unfinished when your allotted time, calculated as described above, has expired, and to then go on immediately to the other questions. It is so easy, especially in an accounting exam, to find you have exceeded the time allowed for a question by a considerable margin. So, although you may find it difficult to persuade yourself to do so, move on to the next question when your time for a question has expired.

### Computations

When you sit an exam, you should be attempting to demonstrate how well you know the topics being examined. In accounting exams, there are three things in particular to remember. If you fail to do so, you will probably earn less marks than your knowledge deserves. One of these things has already been mentioned – be neat and tidy. The other two have to do with computations: *show all your workings* and *don't worry if your statement of financial position does not balance*.

### Workings

One golden rule which should *always* be observed is to **show all of your workings**. Suppose you have been asked to work out the Cost of Goods Sold, not simply as part of a Trading Account but for some other reason. On a scrap of paper you do the (incorrect) calculation shown below:

	£
Opening inventory	4,000
Add Purchases	<u>11,500</u>
	15,500
Less Closing inventory	<u>(3,800)</u>
	<u>12,700</u>

You then use this wrong answer of £12,700 in your exam script. The scrap of paper with your workings on it is then crumpled up by you and thrown in the wastepaper basket as you leave the room. This answer should have been £11,700 and not £12,700 and the examiner may well have allocated four marks for this bit of the question. What will the examiner do when marking your answer? Will the examiner think, 'I should imagine that the candidate mis-added to the extent of £1,000 and, as I am not unduly penalising students for poor arithmetic, I will give the candidate 3½ marks'? Unfortunately, the examiner cannot do this. You will get a mark of zero. If you had attached the workings to your answer, then you would have got 3 or even 3½ marks.

It is a good idea to put the workings of any calculated sum on the face of the any financial statements you have been asked to prepare. For instance, if rent paid is £1,900 and £300 of it has been paid in advance, you can show it on the face of the statement of profit or loss as:

Rent (1,900 – 300)	£1,600
--------------------	--------

By showing the workings in brackets you are demonstrating that you realise that they would not be shown on the published accounts. It also makes it easier for the examiner to mark, and it is always a good idea to make the examiner think you are trying to help.

### Do statements of financial position have to balance?

Many students ask: ‘What should I do if my statement of financial position doesn’t balance?’ The answer is quite simple: leave it alone and get on with answering the rest of the exam paper.

One of the reasons for this is to try and ensure that you answer the required number of questions. You might take twenty minutes to find the error, which might save you one mark. If, instead, you had tackled the next question, in that time you might have gained, say, ten marks, for which you would not have had time if you had wasted it by searching for the error(s). That assumes that you actually find the error(s)! Suppose you don’t, you have spent twenty minutes looking for it, have not found it, so how do you feel now? The answer is, of course: worried. You may make an even bigger mess of the rest of the paper than you would have done if you had simply ignored the fact that the statement of financial position did not balance. In any case, it is quite possible to get, say, 29 marks out of 30 even though the statement of financial position does not balance. The error may be a very minor one for which the examiner deducts one mark only.

Of course, if you have finished all the questions, then by all means spend the rest of your time tracing the error and correcting it. Be certain, however, that your corrections are carried out neatly. Untidy crossings-out can result in the loss of marks. So, sometimes, an error found can get back one mark, which is then lost again because the corrections make an untidy mess of your paper, and examiners often deduct marks for untidy work. It might be better to write against the error ‘see note’, indicating exactly where the note of the correction you wish to make is shown. You can then illustrate to the examiner that you know what the error is and how to correct it.

## Essay questions

There are some basic things about essay questions that every student should know.

### Typical questions

Let’s look at two typical exam questions. In doing so, visualise carefully what you would write when answering them.

- (a) You are employed as a bookkeeper by G. Jones, a trader. State briefly what use you would make of the following documents in relation to your bookkeeping records.
- (i) A bank statement.
  - (ii) A credit note received to correct an overcharge on an invoice.
  - (iii) A pay-in slip.
  - (iv) A petty cash voucher.
- (b) Explain the term ‘depreciation’. Name and describe briefly two methods of providing for depreciation of non-current assets.

Now let’s see whether you would have made a reasonably good attempt at the questions. With question (a) a lot of students would have written down what a bank statement is, what a pay-in

slip is, what a petty cash voucher is, and so on. Marks gained by you for an answer like that would be . . . virtually nil. Why is this? Well, you simply have not read the question properly. The question asked what *use* you would make of the documents, not to *describe* what the documents were. The bank statement would be used to check against the bank column in the Cash Book or cash records to see that the bank's entries and your own are in accordance with one another, with a bank reconciliation statement being drawn up to reconcile the two sets of records. The petty cash voucher would be used as a basis for entering up the payments columns in the Petty Cash Book. The *use* of the items was asked for, not the *descriptions* of the items.

Let us see if you have done better on question (b). Would you have written down how to calculate two methods of depreciation, probably the reducing balance method and the straight line method? But have you remembered that the question also asked you to *explain the term depreciation*? In other words, what is depreciation generally? Some students will have omitted that part of the question. More students would have made a poor attempt at question (a), but some will have made the mistake described above with question (b).

### Underline the key words

I have already described how a large percentage of students fail to answer the question set, instead answering the question they imagine it to be. Too many students write down everything they know about a topic, rather than what the examiner has asked for.

To remedy this defect, *underline the key words* in a question. This brings out the meaning so that it is difficult to misunderstand the question. For instance, let's look at the following question:

‘Discuss the usefulness of departmental accounts to a business.’

Many students will write down all they know about departmental accounts, how to draw them up, how to apportion overheads between departments, how to keep columnar sales and purchases journals to find the information, etc.

Number of marks gained . . . virtually nil.

Now underline the key words. They will be:

Discuss    usefulness    departmental accounts

The question is now seen to be concerned not with *describing* departmental accounts, but instead discussing the *usefulness* of departmental accounts.

Lastly, if the question says ‘Draft a report on . . .’ then the answer should be in the form of a *report*; if it says ‘List the . . .’ then the answer should consist of a *list*. Similarly ‘Discuss . . .’ asks for a *discussion*. ‘Describe . . .’ wants you to *describe* something, and so on.

You should ensure, therefore, that you are going to give the examiners

(i) what they are asking for; *and*

(ii) in the way that they want it.

If you do not comply with (i), you may lose all the marks. If you manage to fulfil (i) but do not satisfy the examiner on (ii), you will still lose a lot of marks.

It is also just as important in computational questions to underline the key words to get at the meaning of a question, and then answer it in the manner required by the examiner. With computational questions it is better to look at what is required first before reading the rest of the question. That way, when you are reading the rest of the question, you are able to decide how to tackle it.

### Never write out the question

Often – too often – students spend time writing out the text of essay questions before they set about answering them. This is a complete waste of time. It will not gain marks and should *never* be done. It is probably the most common way that students waste time in an exam. Why waste time when you have only a limited amount of it available to you?

### Running out of time?

If your plans don't work out, you may find yourself with a question you could answer, but simply do not have the time to do it properly. It is better to write a short note to the examiner to that effect, and put down what you can of the main points in an abbreviated fashion. This will show that you have the knowledge and should gain you some marks.

### Summary

Remember:

- 1 Read the instructions.
- 2 Plan your time before you start.
- 3 Tackle the easiest questions first.
- 4 Finish off answering each question when your time allocation for the question is up.
- 5 Hand in all your workings.
- 6 Do remember to be neat, and to include all proper headings, dates, sub-totals, etc. A lot of marks can be lost if you don't.
- 7 Only answer as many questions as you are asked to tackle by the examiner. Extra answers will not normally be marked and certainly won't get credit.
- 8 Underline the *key words* in each question to ensure that you answer the question set, and not the question you wrongly take it to be.
- 9 Never copy the question onto your answer.

Good luck with your exam. I hope you get the rewards you deserve!

*Alan Sangster*

## The Last Lecture

*Our course is run, our harvest garnered in,  
And taking stock of what we have, we note how life,  
This strange, mysterious life which now we hold and now  
eludes our grasp,  
Is governed still by natural law, and its events  
Tread on each other's heels, each one compelled to follow  
where the first has led.  
Noting all this, and judging by the past,  
We form our plans, until we know at last  
The treasure in the future's lap.*

*The man, the plant, the beast, must all obey this law,  
Since in the early dawn of this old world  
The law was given, and the stuff was made  
Which still alone can hold the breath of life:  
Whereby we know that grass and man are kin,  
The bond a common substance which within  
Controls their growth.*

*Can we know all? Nay, but the major part  
Of all that is must still elude our grasp,  
For life transcends itself, and slowly noting what it is,  
Gathers but fragments from the stream of time.  
Thus what we teach is only partly true.  
Not knowing all, we act as if we knew,  
Compelled to act or die.*

*Yet as we grow in wisdom and in skill  
The upward path is steeper and each step  
Comes nigher unto heaven, piercing the clouds  
Which heretofore have hid the stars from view.  
The new-gained knowledge seems to fill the air,  
It seems to us the soul of truth is there.  
Our quest is won.*

*Bold climber, all that thou hast won  
Lies still in shadow of the peaks above;  
Yet in the morning hours the sun  
Rewards thy work of love,  
Resting a moment on thy lesser height,  
Piercing the vault with rays too bright to face,  
Strengthens thy soul and gives thee ample might  
To serve thy human race.*

Theodore Dru Allison Cockerell (1866–1948)

*Zoölogy: A Textbook for Colleges and Universities*, Yonkers-on-Hudson, NY: World Book Company, 1920,  
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# INTRODUCTION TO FINANCIAL ACCOUNTING



## Introduction

This part is concerned with the basic principles underlying the double entry system of bookkeeping and the impact of each transaction upon the financial performance and financial position of a business.

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# The background and the main features of financial accounting

## Learning objectives

After you have studied this chapter, you should be able to:

- explain what accounting is about
- briefly describe the history of accounting
- explain the relationship between bookkeeping and accounting
- list the main users of accounting information and what accounting information they are interested in
- describe the main difference between financial accounting and management accounting
- present and explain the accounting equation
- explain the relationship between the accounting equation and the layout of the statement of financial position (**balance sheet**)
- explain the meaning of the terms assets, capital, liabilities, accounts receivable (**debtors**), and accounts payable (**creditors**)
- describe how accounting transactions affect the items in the accounting equation
- draw up statements of financial position after different accounting transactions have occurred

## Introduction

In this chapter, you will learn: what accounting is; what led to its development into what it is today; who uses accounting information; and the relationship between the various components that, together, comprise what is known as the 'accounting equation'.

### 1.1 What is accounting?

What do you think of when you read or hear the word, 'accounting'? What do you believe it means or represents?

If you have already attended some accounting classes or if you have spoken to someone who knows something about accounting, you will probably have a fairly good idea of what accounting is and what it is used for. If not, you may find it useful to have this knowledge before you start studying the subject. During the course of the next few pages, let's see if you can gain that knowledge and learn what accounting is.

Accounting can be defined as:

**The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of that information.**

A bit of a mouthful really but, what it means is that accounting involves deciding what amounts of money are, were, or will be involved in transactions (often buying and selling transactions) and then organising the information obtained and presenting it in a way that is useful for decision-making.

Despite what some people think, accounting is not a branch of mathematics, although the man credited with writing the first book to be printed on the subject, Luca Pacioli (c. 1446/7–1517), was a mathematician and teacher. He wrote on the topic ‘*in order that the subjects of the most gracious Duke of Urbino [his sponsor or benefactor] may have complete instructions in the conduct of business*’, and to ‘*give the trader without delay information as to his assets and liabilities*’. (‘Assets’ are things that you own; ‘liabilities’ are things that you owe.)

What Pacioli wrote is contained in 27 pages of a school textbook and reference manual for merchants on business and mathematics (*Summa de arithmetica, geometria, proportioni et proportionalita – Everything about Arithmetic, Geometry and Proportion*). It was first published in Italy in 1494. His bookkeeping treatise has been translated into many languages, including English, and is acknowledged as the chief reason why we maintain accounts in the way we do today.

Accounting may not require a knowledge of mathematics but you do need to be able to add, subtract, multiply and divide – things you need to be able to do in your daily life anyway. Otherwise, you would not know how much money you had with you, how much you would have if you spent some of it, or whether the change you received was correct. So, let’s remove one big misconception some people have concerning accounting: **you do not need to be good at arithmetic to be good at accounting, though you will find it easier to ‘do’ accounting if you are.**

## 1.2 The history of accounting

Accounting began because people needed to:

- record business transactions; and
- know how much they owned and how much they owed.

It is known to have existed in one form or another for at least 10,000 years. (Records exist which indicate its use at that time in Mesopotamia modern-day Iraq.) There is also considerable evidence of accounting being practised in ancient times in Egypt, China, India, Greece and Rome. In England, the ‘Pipe Roll’, the oldest surviving accounting record in the English language, contains an annual description of rents, fines and taxes due to the King of England, from 1130 to 1830.

In India, a system of accounting, called *Bahi-khata*, was developed many centuries ago but it did not spread beyond that region, probably because a description of it was never written down until the twentieth century. It spread by word of mouth and, even today, is a standardised method of keeping accounting records in parts of that region.

In the rest of the world, accounting appears to have developed slowly for thousands of years. The first known example of business records maintained for a whole business using what we call ‘double entry bookkeeping’ – the method described by Pacioli and the method used universally today – was in a branch of an Italian firm in southern France in 1299. But, it was another 150 years before it became relatively commonly used by northern Italian partnerships and joint ventures. The rest of the world took considerably longer to adopt the method. It is due to Pacioli and what he wrote about it in 1494 that this system of double entry book keeping came to be universally adopted.

It has been suggested that no standard system for maintaining accounting records had been developed before this because the circumstances of the day did not make it practicable for anyone to do so. There was little point, for example, in anyone devising a formal system of accounting if the people who would be required to ‘do’ accounting did not know how to read or write.

One accounting scholar (A. C. Littleton) suggested that seven key ingredients were required before a formal system like double entry bookkeeping could be developed and that all seven existed when Pacioli wrote his treatise:

- *Private property.* The power to change ownership exists and there is a need to record the transaction.
- *Capital.* Wealth is productively employed such that transactions are sufficiently important to make their recording worthwhile and cost-effective.
- *Commerce.* The exchange of goods on a widespread level. The volume of transactions needs to be sufficiently high to motivate someone to devise a formal, organised system that could be applied universally to record transactions.
- *Credit.* The present use of future goods. Cash transactions, where money is exchanged for goods, do not require that any details be recorded of who the customer or supplier was. The existence of a system of buying and selling on time (i.e. paying later for goods and services purchased today) led to the need for a formal organised system that could be applied universally to record credit transactions of this type.
- *Writing.* A mechanism for making a permanent record in a common language. Writing had clearly been around for a long time prior to Pacioli but it was, nevertheless, an essential element required before accounting could be formalised.
- *Money.* There needs to be a common denominator for exchange. So long as barter was used rather than payment with currency, there was no need for a bookkeeping system based upon transactions undertaken using a uniform set of monetary values.
- *Arithmetic.* As with writing, this has clearly been in existence far longer than accounting. Nevertheless, it is clearly the case that without an ability to perform simple arithmetic, there was no possibility that a formal organised system of accounting could be devised.

Of these, the most important catalyst for the emergence of double entry bookkeeping was the use of credit in business. In the Middle Ages, a businessman who did not know how much was owed to him and how much he owed, could lose his business, his home and everything he owned.

During the Crusades (1096–1292), trade routes to the east were opened and merchants, many from the Italian ports like Venice, began to expand their activities along the new routes. Venice dominated trade and another Italian city, Florence, was the major banking centre in the western world up to at least the mid-fifteenth century.

This expansion of trade led merchants to start operating in joint ventures (where they shared costs and profits) with businessmen located elsewhere. They were heavily involved in importing raw materials and exporting finished goods, particularly in Florence. Many merchants also employed agents to conduct business on their behalf. The need to record details of these transactions and arrangements was obvious.

This did not transform into double entry bookkeeping for many years. In the Middle Ages, when accounting information was recorded it initially took the form of a note of the details of each credit transaction that had not been paid and each receipt and payment. These notes were used by the owner mainly in order to keep track of payments outstanding. However, in Florence, merchants were more accustomed to keeping details of their activities than elsewhere. Many of them already maintained a record of important personal events in a book called a *Ricordanze*. It was a very popular practice and Florentine merchants started to record transactions, receipts and payments in their *Ricordi*.

The larger the business, the greater the number of entries that were made. They were made when they occurred and it could be some time before the next transaction with the same person occurred. Even with these records in a *Ricordanze*, it became difficult to tell what total amounts were owed and due.

To address this problem, merchants started transferring details from the *Ricordanze* into another book and entries in that book were organised into what we now call ‘accounts’, one for each person or item.