



For tutor's reference only

The Importance of Accounting

A guide for those planning to start their own business



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Introduction

Accounting may be the last thing on your mind when you are setting up your own business. Trying to make the business a success, gaining customers and keeping them happy are more likely to be your priorities. However, your business is more likely to succeed if you understand the purpose and value of accounting. This booklet aims to explain why accounting is important, using examples drawn from two businesses, Anderson Security Systems (ASS) and Sunset Health and Fitness Club.

ASS was established by Tom Anderson in 2004. Tom had previously worked for a major UK security firm. The Darlington-based business installs security alarms, mainly for use in small commercial properties. ASS currently generates a healthy profit, although during its first year of trading problems were encountered because Tom did not take his financial record keeping responsibilities seriously.

Sunset has been based in Scarborough since 1985. Originally established by former body builder Andy Walters and his brother, the business is now a private limited company owned entirely by Andy. Over the years membership has risen from 50 in 1985 to over 600 today. In an increasingly competitive market, Sunset has a strong brand identity in the local area and is a successful business.

Part 1 - The Purpose of Accounting

It is essential that you **record** all your financial transactions. Without accurate records you may forget to pay suppliers or lose track of how much is owed to you. Andy keeps a record of all his members' payment details on a database. This allows him to keep track of who has paid, when, and how much. It also allows him to check who has *not* paid.

Without accounting it will be impossible to **monitor** the performance of your business and **control** the business. Monitoring involves checking how well the business is doing. For example, Andy closely monitors the revenue that Sunset receives by looking at his till records and examining the business bank statements.

Effectively **managing** your business requires accounting information. If profits have dropped then it may be because sales revenue is down or costs have risen; the accounting information should help to reveal what the problem is, so that you can solve it.

The **financial performance** of your business can be measured using financial information. The level of profits can only be calculated if you have accurate records of your sales revenue and your costs. Andy's accountant provides him with a monthly profit report. The accountant also produces the business's annual profit and loss account.

(P1) Task 1a



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In the early stages of running his business, Tom did not keep accurate records of his financial transactions. As a result, after only a few months of trading he began to make mistakes, such as forgetting to pay a key supplier, and lost track of whether or not his business was actually making a profit or a loss. Only with the help of an accountant did he avoid bankruptcy and go on to build a successful business.

(P1) Task 1b

Part 2 - Categorising Business Income and Expenditure

Whilst you may not want to be an accountant, it is useful to know some of the language of accountancy.

Capital income is the money that the owners of a business have put into the organisation, or finance received in the form of a loan or mortgage from a bank or other financial institution. Sole traders often rely on their own savings to set up their business. Tom used his redundancy money to help fund the establishment of ASS. When Andy started his business, it was a partnership and capital was introduced by both him and his brother. When the business became a private limited company in 2002 the money Andy put into Sunset was in the form of share capital, with Andy as the only shareholder. As a shareholder, he is entitled to dividends when the business makes a profit. The property that Sunset currently occupies is mortgaged and Andy often uses bank loans to purchase large items of exercise equipment.

(P2) Task 2a

Revenue income is income received by a business as a result of selling goods or services. This may be in the form of sales, or be in the form of rent or commission received. Credit payments, where customers have received goods earlier, also form part of revenue income for many businesses. Andy receives revenue income from gym memberships and from visitors to the gym. He also sells products such as sports drinks (eg Lucozade). Rental income is received from flats adjoining the gym and from a physiotherapist who uses a room also adjoining the main building. Andy has also received payments from a marketing company; they have recently purchased 75 memberships from him to sell at a profit.

(P2) Task 2b

Capital expenditure is spending by a business on fixed assets and on intangible assets. Fixed assets are long-term items of value that a business owns. Intangible assets cannot be touched, but still have value, such as goodwill, patents or trademarks. Andy has invested heavily in the gym. Apart from the premises themselves (an old wetsuit factory) he has purchased a vast quantity of exercise equipment. The gym also has sunbeds and saunas. Andy believes that one of the biggest strengths of the gym is its reputation for being friendly and welcoming; he includes the tagline 'Scarborough's friendliest gym' in his newspaper advertising. This reputation and established name of the business would add to the value of Sunset if it were sold.

(P2) Task 2c



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Revenue expenditure includes all the regular financial commitments that a business has. Andy has to make mortgage repayments, and pay for the heating, lighting and insurance for the premises. Water is also needed for the showers, toilets and kitchen. He also has to pay telephone bills and the postage cost of writing to existing and potential members. Andy currently employs five staff, three full time and two part time. The wages of these staff form part of his revenue expenditure. Andy spends money on advertising in the local newspaper and in the past has leafleted the area to generate interest in gym memberships. Staff receive a small commission from Andy if they enrol a new member. As explained earlier, loans are used by the business to buy larger items of gym equipment; these loans need to be repaid with interest. Andy also purchases sports drinks; for example, he buys Lucozade to place in the fridge provided by the supplier.

(P2) Task 2d

GRADING COMMENTS

To achieve P1 the booklet needs to be clear, concise and well presented. The purposes of accounting, using relevant examples, need to be described. This provides evidence for grading criterion P1.

For P2 learners need to explain, with examples, the differences between capital income and revenue income. For coverage of P2 they also need to explain, with examples, the difference between capital and income expenditure.