

Chapter

3

Basic Financial Accounting

Financial statements are produced to give information to the users. As mentioned earlier the most important financial statements are the statement of comprehensive income (income statement) and statement of financial position (balance sheet). These are prepared under the separate entity concept.

The separate entity concept means the business is treated separately from its owners. This applies to sole traders, partnerships and incorporated companies.

3.1 The statement of financial position (balance sheet)

The top half of the statement of financial position (balance sheet) shows all the assets owned by the business. The assets are either non current or current.

The bottom half off the statement of financial position (balance sheet) shows capital, reserves and liabilities. The liabilities are either non current or current.

Items in statement of financial position (balance sheet)	Description	Examples
Non current assets	These are long term assets used to generate profit. The business will hold on to these assets for more than one year.	Land & buildings, plant & machinery, fixtures & fittings and motor vehicles
Current assets	Short-term assets used for the day-to-day operations. These assets are for less than one year.	Inventories, trade receivables and cash
Non current liabilities	These are long term liabilities over one year which are owed to third parties.	Long term bank loans
Current liabilities	These are liabilities owed to third parties but which are due in less than one year's time	Trade payables, taxation and bank overdraft.
Capital	This is what the owners have put into the business as investment, and therefore are owed by the entity.	Share capital or cash. Owners can withdraw capital and this is known as drawings. Dividends for incorporated entities.
Accumulated profit or loss (reserves)	This is the profit or loss that the business has made. It belongs to the owners.	Income ó expenses = profit or loss

The income statement shows all the revenue or income generated for the period less all expenses arriving at the period's profit or loss.

3.2 Accounting equation

In the statement of financial position (balance sheet) the net assets of the business are equal to the capital and reserves.

Net assets are total assets less total liabilities. The net assets equal the capital and reserves in the statement of financial position (balance sheet). The capital and reserves are also known as the 'proprietors' funds or shareholders' funds' or 'Equity'.

Therefore putting this into an equation, we get:

$$\text{Assets} - \text{Liabilities} = \text{Capital} + \text{Profits} - \text{Losses} - \text{Drawings}$$

OR

$$\text{Net Assets} = \text{proprietors' funds} \text{ or } \text{Shareholders' funds}$$

Assets are positive figures on the statement of financial position (balance sheet). Liabilities and capital are negative figures. We can now re-arrange the accounting equation as follows:

$$\text{Assets} = \text{Capital} + \text{Profits} - \text{Losses} - \text{Drawings} + \text{liabilities}$$

Or

$$\text{Assets} = \text{proprietors' funds} + \text{liabilities}$$

Worked Example

1 Introduction of capital

Kitten sets up a new business selling designer makeup at low prices. The new business is called 'Beauty Within'

She puts £20,000 cash into the business.

This is how it effects the accounting equation

Assets	=	Proprietors' funds	+	Liabilities
Cash	20,000	Introduced	20,000	
<u>Total</u>	<u>20,000</u>		<u>20,000</u>	

£20,000 is a current asset in the form of cash, and this is what Beauty Within owes to Kitten. Beauty Within is a separate entity.

2 Purchase of assets

Kitten now buys a shop to sell the makeup from. The shop costs £10,000, and is paid for in cash. Kitten also purchases £5,000 worth of makeup in cash from a special dealer that she has contacts with.

This is how the above transactions effect the accounting equation.

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	5,000			
Cash	5,000			
<u>Total</u>	<u>20,000</u>		<u>20,000</u>	

3 Sale of inventory

Kitten who is a very shrewd sales woman has managed to sell all her stock of makeup to a television company for £8,000 in cash. This means a profit of £3,000 has been made (£8,000 ó 5,000). This profit belongs to the owner therefore is part of the capital.

This is how the above transactions effect the accounting equation.

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	0	Profit	3,000	
Cash	13,000			
<u>Total</u>	<u>23,000</u>		<u>23,000</u>	

4 Drawings

Kitten requires some cash for her personal use. She withdraws £500 from the business.

This is how the above transactions effect the accounting equation.

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	0	Profit	3,000	
Cash	12,500	Drawings	(500)	
<u>Total</u>	<u>22,500</u>		<u>22,500</u>	

Note that drawings are taken out by the owner therefore it does not affect the profit figure (ie it is not an expense).

5 Expenses of the business

Kitten has to pay some utility bills that are due for the shop. These amount to £300 in total and Kitten pays them in cash.

This is how the above transactions effect the accounting equation.

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	0	Profit	2,700	
Cash	12,200	Drawings	(500)	
<u>Total</u>	<u>22,200</u>		<u>22,200</u>	

Note that the business expenses have reduced the profit {£3,000 - £300} and reduced the cash by £300.

6 Purchases on credit

Kitten now purchases more makeup, but this time buys them on credit for one month. Stock worth £3,000 has been purchased this way.

This means that the business owes money, so therefore there is a liability in the form of trade payables.

This is how the above transactions effect the accounting equation.

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	Trade payables 3,000
Inventory	3,000	Profit	2,700	
Cash	12,200	Drawings	(500)	
<u>Total</u>	<u>25,200</u>		<u>22,200</u>	<u>3,000</u>

7 Sale on credit

Kitten has found a buyer for her entire stock of makeup for £5,000, but the sale is made on credit, meaning that the buyer will pay for the goods in 2 months time (trade receivables).

This is how the above transactions effect the accounting equation.

Assets	=	Proprietors' funds	+	Liabilities	
Shop	10,000	Introduced	20,000	Trade payables	3,000
Inventory	0	Profit	4,700		
Trade receivables	5,000	Drawings	(500)		
Cash	12,200				
<u>Total</u>	<u>27,200</u>		<u>24,200</u>		<u>3,000</u>

The business has made a profit of £2,000 {£5,000 - £3,000}. Therefore the total profit now stands at £4,700.

8 Settlement of trade receivables and trade payables

The trade payables get paid and the trade receivables send a cheque to Kitten.

This is how the above transactions effect the accounting equation.

Assets	=	Proprietors' funds	+	Liabilities	
Shop	10,000	Introduced	20,000	Trade payables	0
Inventory	0	Profit	4,700		
Trade receivables	0	Drawings	(500)		
Cash	14,200				
<u>Total</u>	<u>24,200</u>		<u>24,200</u>		<u>0</u>

This is how the statement of financial position (balance sheet) will appear after the last transaction

<u>Statement of financial position (balance sheet) of Beauty Within</u>		
<u>Non current assets</u>		
Shop		10,000
<u>Current assets</u>		
Cash		<u>14,200</u>
<u>Total assets</u>		<u>24,200</u>
<u>Capital and reserves (or proprietors' funds)</u>		
Capital		20,000
Drawings		(500)
Profit		<u>4,700</u>
		24,200
<u>Current liabilities</u>		
		0
<u>Total capital, reserves and liabilities</u>		<u>24,200</u>

3.3 Double entry

As you can see from the above examples regarding the accounting equation, a single transaction has a **dual effect** on the equation.

For example, introduction of the capital:

- 1 Cash increased by £20,000 = increase in assets
- 2 Capital increased by £20,000 = increase in capital

Another example is expenses of the business:

- 1 Cash decreased
- 2 Profit also decreased.

This is not a coincidence; it's actually a method of accounting, known as **double entry**.

With double entry every transaction has a dual effect. This is ALWAYS the case.

We shall come back to double entry later, but first let's have a look at some other basics.

Revenue and capital expenditure

Revenue expenditure affects the profit and loss account and is expensed in the period it is incurred. Revenue expenditure includes wage expenses, rent payments and utility expenses. Revenue expenditure is also known as period expenses.

Capital expenditure is taken to the statement of financial position (balance sheet) and doesn't affect the profit and loss for the period. Capital expenditure includes buying non current assets. Capitalisation means taking items to the statement of financial position (balance sheet).

3.4 Recording transactions

A business will need to record every transaction relating to its business.

Source documents	These are the initial documentation, which show the source of information needed to record financial information. Examples include invoices, sales orders, payslips etc.
Books of prime entry	This is where the source documents are recorded at the first stage of the accounting system. Examples include sales daybook, purchase daybook, cashbook etc.
Ledger accounts (nominal or general ledger)	The ledger contains accounts for assets, liabilities, capital, income and expenditure. These individual accounts record all the transactions.

3.5 Ledger accounting

The general ledger is the heart of the accounting system. It contains a separate account for each item that appears in the balance sheet and income statement. Most ledgers are now computerised eg SAGE, QuickBooks. Each account is given a code, which may comprise of numbers, text or both.

A ledger account has 'TWO' sides to it. Below is an example of what a ledger account looks like for a non current asset account.

Non current assets					
Date	Description	£	Date	Description	£
DEBIT			CREDIT		

This is often referred to as a T-account.

The two sides allow the double entry to be recorded. The left hand side is the DEBIT and the right hand side is the CREDIT.

The history of debits and credits dates back to the 15th century!!

3.6 Rules for double entry

For every debit there is an equal credit

Every transaction will give rise to two accounting entries, a debit and a credit. Because of this basic fundamental rule, it means that all the debits and all the credits in the ledger will be equal.

To master double entry it is useful to identify from the transaction the element and whether that element is a debit or credit in its normal state.

Element	
Assets	Debit
Liabilities	Credit
Capital	Credit
Revenue	Credit
Expenses	Debit

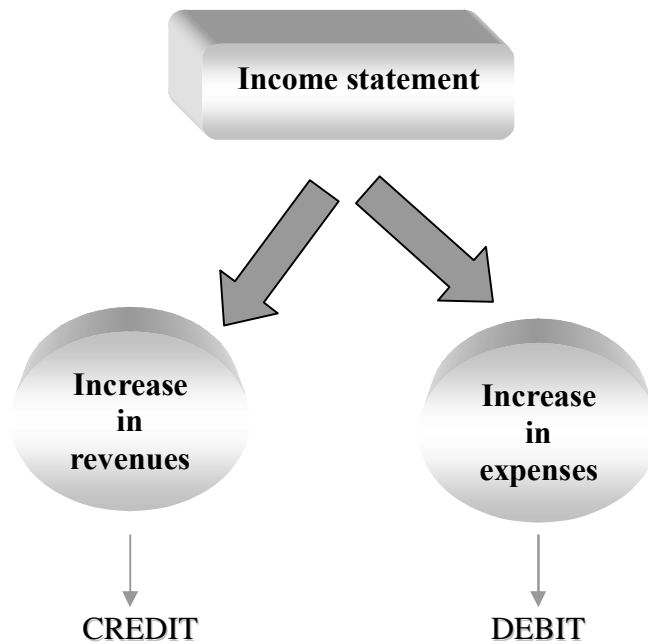
Then from the transaction identify whether the elements have increased or decreased to establish the double entry.

Event	Financial statement	Debit or Credit
Increase in assets Decrease in assets	Statement of financial position (balance sheet) Statement of financial position (balance sheet)	Debit Credit
Increase in liability Decrease in liability	Statement of financial position (balance sheet) Statement of financial position (balance sheet)	Credit Debit
Increase in capital Decrease in capital	Statement of financial position (balance sheet) Statement of financial position (balance sheet)	Credit Debit
Increase in revenue Decrease in revenue	Income statement Income statement	Credit Debit
Increase in expense Decrease in expense	Income statement Income statement	Debit Credit

Another way of remembering the double entry rule is:

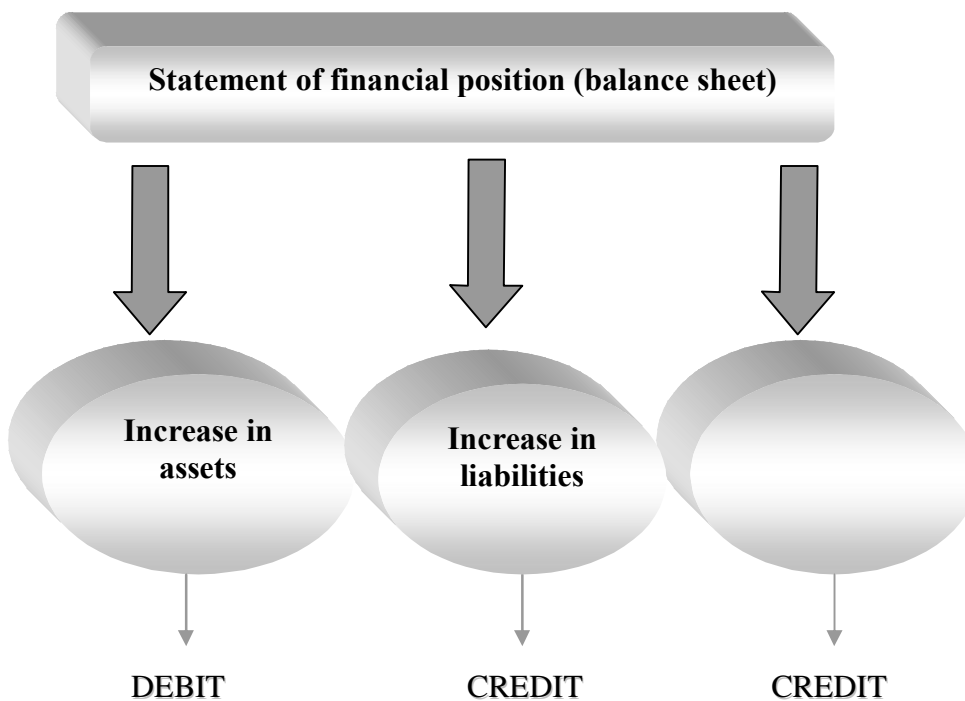
An	Asset	Debit
Elephant	Expenses	Debit
Is	Income / Revenue	Credit
Lumpy	Liabilities	Credit

In the income statement, the revenue items like sales are credits in the ledger. Expenses are debits.



All decreases are opposites

In the statement of financial position (balance sheet), debits are assets and credits are liabilities and capital.



All decreases are opposites

3.7 Journal entries

Entries to the ledger are made through journal entries. This is simply writing out the amount, the account code, description and whether it's a debit or credit entry.

For example

Date	Account Code	Account Name	Description	Debit £	Credit £
1/1/X5	100353	Non current assets	Purchase of machine	10,000	
1/1/X5	100454	Bank	Cheque 35		10,000

For exam purposes you can simply write out the journal entry as follows:

Dr	Non current asset	£10,000
	Cr Bank	£10,000

It is also useful in the exam to write out which financial statement it affects. So for the above example, both fixed asset and bank are statement of financial position (SOFP) / (balance sheet - SOFP) items. For income statement use (IS).

Dr	Non current asset (SOFP)	£10,000
	Cr Bank (SOFP)	£10,000

Going back to our example of Kitten, the transactions will affect the ledger accounts as follows:

1 Introduction of capital

Kitten sets up a new business selling designer makeup at low prices. The new business is called öBeauty Withinö. She puts £20,000 cash into the business.

Journal entry

Debit (Dr)	Bank	£20,000	
	Credit (Cr)	Capital	£20,000

T accounts

Capital account

		Cash introduced	£20,000
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Bank account

Capital introduced	£20,000		
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Account equation

Assets	=	Proprietors' funds	+	Liabilities
Bank	20,000	Introduced	20,000	
<u>Total</u>	<u>20,000</u>		<u>20,000</u>	

2 Purchase of assets

Kitten now buys a shop to sell the makeup from. The shop costs £10,000, and is paid for in cash. Kitten also purchases £5,000 worth of makeup in cash from a special dealer that she has contacts with.

Journal entry

Dr	Non current asset ó Shop (SOFP)	£10,000	
Dr	Inventory (SOFP)	£ 5,000	
	Cr	Bank (SOFP)	£15,000

T Accounts

Non current asset - Shop

Shop bought with cash	£10,000		
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Inventory

Stock bought with cash	£5,000		
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Bank account

Capital introduced	£20,000	Non current asset - Shop	£10,000
		Inventory	£ 5,000

Accounting equation

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	5,000			
Bank	5,000			
<u>Total</u>	<u>20,000</u>		<u>20,000</u>	

3 Sale of inventory

Kitten who is a very shrewd sales woman has managed to sell all her stock of makeup to a television company for £8,000 in cash. This means a profit of £3,000 has been made (£8,000 - £5,000). This profit belongs to the owner therefore is part of the capital.

Journal entry

1 Record the sale

Dr Bank (SOFP) £8,000
Cr Sales (IS) £8,000

2 Adjust for the inventory

The inventory has now been sold, so it needs to be removed from the balance sheet.

Dr Cost of sales (IS) £5,000
Cr Inventory (SOFP) £5,000

The net affect to the income statement is £3,000, which is the profit earned from the sale.

T accounts

Sales

	Sale of makeup in cash	£8,000
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Bank account

Capital introduced	£20,000	Non current asset - Shop	£10,000
Sale of makeup	£ 8,000	Inventory	£ 5,000

Cost of sales

Inventory	£ 5,000	
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Inventory

Inventory bought with cash	£5,000	Cost of sales	£5,000
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Accounting equation

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	0	Profit	3,000	
Bank	13,000			
<u>Total</u>	<u>23,000</u>		<u>23,000</u>	

4 Drawings

Kitten requires some cash for her personal use. She withdraws £500 from the business.

Journal entry

Dr	Drawings (SOFP)	£500	
	Cr Bank (SOFP)		£500

T accounts

Drawings

Bank	£ 500	
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Bank account

Capital introduced	£20,000	Non current asset - Shop	£10,000
Sale of makeup	£ 8,000	Inventory	£ 5,000
		Drawings	£ 500

Accounting equation

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	0	Profit	3,000	
Bank	12,500	Drawings	(500)	
<u>Total</u>	<u>22,500</u>		<u>22,500</u>	

5 Expenses of the business

Kitten has to pay some utility bills that are due for the shop. These amount to £300 in total and Kitten pays them in cash.

Journal Entry

Dr	Utility Expenses (IS)	£300	
	Cr	Bank (SOPF)	£300

T accounts

Utility expenses

Bank	£ 300	
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Bank account

Capital introduced	£20,000	Non current asset - Shop	£10,000
Sale of makeup	£ 8,000	Inventory	£ 5,000
		Drawings	£ 500
		Utility Expenses	£ 300

Accounting equation

Assets	=	Proprietors' funds	+	Liabilities
Shop	10,000	Introduced	20,000	
Inventory	0	Profit	2,700	
Bank	12,200	Drawings	(500)	
<u>Total</u>	<u>22,200</u>		<u>22,200</u>	

Note that the business expenses have reduced the profit {£3,000 - £300} and reduced the cash by £300.

6 Purchases on credit

Kitten now purchases more makeup, but this time buys them on credit for one month. Inventory worth £3,000 has been purchased this way.

This means that the business owes money, so therefore there is a liability in the form of trade payables.

Journal entry

Dr	Inventory (SOFP)	£3,000	
	Cr	Trade Payables (SOFP)	£3,000

T accounts

Inventory			
Inventory bought with cash	£5,000	Cost of sales	£5,000
Inventory bought on credit	£3,000		

Trade payables			
		Inventory bought on credit	£3,000

Accounting equation

Assets	=	Proprietors' funds	+	Liabilities	
Shop	10,000	Introduced	20,000	Trade payables	3,000
Inventory	3,000	Profit	2,700		
Bank	12,200	Drawings	(500)		
<u>Total</u>	<u>25,200</u>		<u>22,200</u>		<u>3,000</u>

7 Sale on credit

Kitten has found a buyer for her entire stock of makeup for £5,000, but the sale is made on credit, meaning that the buyer will pay for the goods in 2 months time (trade receivables).

Journal entry

1 Record the sale

Dr	Trade receivables (SOFP)	£5,000	
	Cr	Sales (IS)	£5,000

2 Adjust for the inventory

The inventory has now been sold, so it needs to be removed from the balance sheet.

Dr	Cost of sales (IS)	£3,000	
	Cr	Inventory (SOFP)	£3,000

The net affect to the income statement is £2,000, which is the profit earned from this sale.

T accounts

Sales			
	Sale of makeup in cash	£8,000	
	Sale of makeup on credit	£5,000	
Trade receivables			
Sale	£ 5,000		
Cost of sales			
Stock	£ 5,000		
Stock	£ 3,000		
Inventory			
Inventory bought with cash	£5,000	Cost of sales (cash)	£5,000
Inventory bought on credit	£3,000	Cost of sales (credit)	£3,000

Accounting equation

Assets	=	Proprietors' funds	+	Liabilities	
Shop	10,000	Introduced	20,000	Trade payables	3,000
Inventory	0	Profit	4,700		
Trade receivables	5,000	Drawings	(500)		
Bank	12,200				
<u>Total</u>	<u>27,200</u>		<u>24,200</u>		<u>3,000</u>

The business has made a profit of £2,000 {£5,000 - £3,000}. Therefore the total profit now stands at £4,700.

8 Settlement of trade receivables and trade payables

The trade payables get paid and the trade receivables send a cheque to Kitten.

Journal entry

1 Payment to the trade payables

Dr	Trade payables (SOPF)	£3,000
	Cr Bank (SOPF)	£3,000

2 Cheque received from trade receivables

Dr	Bank (SOPF)	£5,000
	Cr Trade receivables (SOPF)	£5,000

T accounts

Trade payables			
Bank	£3,000	Inventory bought on credit	£3,000

Trade receivables			
Sale	£ 5,000	Bank	£5,000

Bank account			
Capital introduced	£20,000	Non current asset - Shop	£10,000
Sale of makeup	£ 8,000	Inventory	£ 5,000
Trade receivables	£ 5,000	Drawings	£ 500
		Utility expenses	£ 300
		Trade payables	£ 3,000

Accounting equation

Assets	=	Proprietors' funds	+	Liabilities		
Shop		10,000	Introduced	20,000	Trade payables	0
Inventory		0	Profit	4,700		
Trade receivables		0	Drawings	(500)		
Bank		14,200				
	<u>Total</u>	<u>24,200</u>		<u>24,200</u>		<u>0</u>

3.8 Balancing and closing the ledger accounts

At the end of the accounting period, after all the transactions have been entered, the ledger accounts are balanced and closed off.

All the debits are totalled and so are all the credits. Both sides must equal each other, and therefore a 'balancing figure' is entered to ensure they equal.

Statement of financial position (balance sheet)

The balancing figure is 'carried forward (c/f)' into the next period. Then in the next period, this balancing figure is known as the 'brought forward (b/f)'. This is done for assets, liabilities and capital.

Income statement items

The balancing figure in all the income statement items are transferred into a new ledger account called the **profit and loss ledger account** or trading, profit and loss ledger account. Double entry is used to transfer all income and expenses into this account, (which appears in the final statement of financial position (balance sheet) under capital). The profit and loss ledger account is the accumulation of all profits and losses since trading began and is a statement of financial position (balance sheet) account. The income statement accounts (all expenses and revenues) are re-set to zero for the next accounting period.

Balancing off Kittens accounts

Income statement accounts

Sales			
<i>P&L Ledger account (balancing figure)</i>	£13,000	Sale of makeup in cash	£8,000
		Sale of makeup on credit	£5,000
<u>Total</u>	<u>£13,000</u>	<u>Total</u>	<u>£13,000</u>

Cost of sales			
Inventory	£ 5,000	<i>P&L Ledger account (balancing figure)</i>	£ 8,000
Inventory	£ 3,000		
<u>Total</u>	<u>£ 8,000</u>	<u>Total</u>	<u>£ 8,000</u>

Utility expenses			
Cash	£ 300	<i>P&L Ledger account (balancing figure)</i>	£ 300
<u>Total</u>	<u>£ 300</u>	<u>Total</u>	<u>£ 300</u>

Statement of financial position (balance sheet)

Trade payables			
Payment	£3,000	Inventory bought on credit	£3,000
<u>Total</u>	<u>£3,000</u>	<u>Total</u>	<u>£3,000</u>

Trade receivables			
Sale	£ 5,000	Cash	£5,000
<u>Total</u>	<u>£5,000</u>	<u>Total</u>	<u>£5,000</u>

Cash account

Capital introduced	£20,000	Non current asset - shop	£10,000
Sale of makeup	£ 8,000	Inventory	£ 5,000
Trade receivables	£ 5,000	Drawings	£ 500
		Utility Expenses	£ 300
		Trade payables	£ 3,000
		<i>Balance c/f</i>	<i>£14,200</i>
<u>Total</u>	<u>£33,000</u>	<u>Total</u>	<u>£33,000</u>

Inventory

Inventory bought with cash	£5,000	Cost of sales (cash)	£5,000
Inventory bought on credit	£3,000	Cost of sales (credit)	£3,000
<u>Total</u>	<u>£ 8,000</u>	<u>Total</u>	<u>£ 8,000</u>

Non current asset - Shop

Shop bought with cash	£10,000	<i>Balance c/f</i>	<i>£10,000</i>
<u>Total</u>	<u>£10,000</u>	<u>Total</u>	<u>£10,000</u>

Capital account

<i>Balance c/f</i>	<i>£20,000</i>	Cash Introduced	£20,000
<u>Total</u>	<u>£20,000</u>	<u>Total</u>	<u>£20,000</u>

Drawings

Cash	£ 500	<i>Balance c/f</i>	<i>£ 500</i>
<u>Total</u>	<u>£ 500</u>	<u>Total</u>	<u>£ 500</u>

The profit and loss ledger account is opened to take in the entries from the closing off the income statement items

Profit and loss ledger account

Cost of sales £8,000 Utility Expenses £ 300 <i>Balance c/f</i> £4,700 <u>Total</u> <u>£13,000</u>	Sales £13,000 <u>Total</u> <u>£13,000</u>
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Note the profit is the same as in the accounting equation

Understanding the “carried forward”

The carried forward figures in the statement of financial position (balance sheet) accounts are the opening balances for the next period.

For example the carried forward of the cash account is £14,200, this will then be brought forward (b/f) in the next period as follows:

Cash account	
<i>Balance b/f</i> £14,200	

Note how the b/f balance is on the opposite side of the carried forward. This is always the case, as the balancing item of £14,200 represents the fact that the debits exceed credits from the last period.

Therefore balances c/f on the credit side are debit balances when b/f (assets). And balances c/f on the debit side are credit balances when b/f (liability).

Always try to think in terms of whether it's an asset or liability. With the cash account, we have received more money than paid out, so it must mean that we have a positive bank balance. This is represented by the debit balance of £14,200 (remember debits in the statement of financial position are assets).

3.9 The trial balance

A trial balance is created, which is simply a list of all the ledger accounts and their balances. It is used to prepare the financial statements.

For Kitten the trial balance is as follows:

Account name	Debit	Credit
Sales		13,000
Cost of Sales	8,000	
Utility expenses	300	
Cash account	14,200	
Non current asset	10,000	
Capital		20,000
Drawings	500	
Total	33,000	33,000

Note how there are no accounts for inventory, trade receivables and trade payables. This is because the balances on these accounts are zero as they have all been cleared at the period end, (i.e. all inventories have been sold, trade receivables have paid up and trade payables are settled).

Note how the accounting equation, the balances on the T accounts and the trial balance all tie in.

3.10 Preparing the financial statements

The income statement and statement of financial position (balance sheet) can now be prepared from the trial balance.

<u>Income statement for Kitten for the current period</u>		£
Sales		13,000
Less cost of sales		<u>(8,000)</u>
Gross Profit		5,000
Less expenses		
Utility expenses		<u>(300)</u>
<u>Net profit</u>		<u>4,700</u>

<u>Statement of financial position (balance sheet)</u>		£
<u>for Kitten as at the end of the period</u>		
Non current assets		10,000
Current assets		
Cash		14,200
		<hr/>
<u>Total assets</u>		<u>24,200</u>
<u>Capital and reserves</u>		
Capital		20,000
Drawings		(500)
Profit		<u>4,700</u>
		24,200
Liabilities		0
		<hr/>
<u>Total capital, reserves and liabilities</u>		<u>24,200</u>

3.11 Capital, drawings and profit & loss ledger account

There are a few final adjustments that need to be done to complete the double entry system. The proprietor's capital consists of any cash introduced by them, plus any profits (less losses) and less any drawings.

Let's now transfer the balances from the drawings account and P&L ledger account into the capital account. This is only done for sole traders and partnership accounts, not for incorporated entities.

Drawings

Cash	£ 500	<i>Transfer to capital a/c</i>	£ 500
<u>Total</u>	<u>£ 500</u>	<u>Total</u>	<u>£ 500</u>

Profit and loss ledger account

Cost of sales	£8,000	Sales	£13,000
Utility Expenses	£ 300		
<i>Transfer to capital a/c</i>	<i>£4,700</i>		
<u>Total</u>	<u>£13,000</u>	<u>Total</u>	<u>£13,000</u>

Capital account

Drawings	£ 500	Cash Introduced	£20,000
<i>Balance c/f</i>	<i>£24,200</i>	Profit and loss ledger a/c	£ 4,700
<u>Total</u>	<u>£24,700</u>	<u>Total</u>	<u>£24,700</u>

The statement of financial position (balance sheet) can now be shown as follows:

Non current assets	10,000
Current assets	
Cash	14,200
<u>Total assets</u>	<u>24,200</u>
Proprietors' capital	24,200
Liabilities	0
<u>Total proprietors' capital and liabilities</u>	<u>24,200</u>

Note: Capital b/f

Statement of financial position (balance sheet) that are drawn up for businesses who started before the current accounting period (i.e. this is not the first time the statement of financial position (balance sheet) is produced), will have capital brought forward. In this case the balance sheet must show the capital at the start of the period and the capital at the end of the period.

For Example

Capital b/f	£ 5,000
Net profit for the year	£ 3,000
Drawings	<u>(£2,000)</u>
Capital at end of period	<u>£ 6,000</u>

New accounting period

At the start of the new accounting period, all income statement accounts (revenues and expenses) are re-set to zero (as all the balances have been transferred to the P&L ledger account and taken to the statement of financial position (balance sheet)).

All statement of financial position (balance sheet) balances are brought forward into the new account period (assets, liabilities and capital).

3.12 Summary of ledger accounting

Transactions are entered into the accounting system using double entry through journals

The accounting system has ledger accounts for all balance sheet and income statement items.

At the end of the accounting period, the ledger accounts are balanced and closed off.

The trial balance is produced to show all the debits and credits

Income and expenses are transferred to the Profit and loss ledger account.

Statement of financial position (balance sheet) accounts are left with carried forward balancing figures.

The profit and loss ledger account and drawing account are transferred to the capital account.

The only accounts remaining on the ledger with balances to be carried forward are those for statement of financial position (balance sheet) items – assets, liabilities and capital.

From the above the financial statements are produced, the income statement and statement of financial position (balance sheet).

Lecture Example 3.1

Dirty Den started a new business on 1 April 20X5. He wanted to sell quality quilts to the elderly. He put £25,000 into the business.

The following transactions took place in the first year of trading.

	£
Payment to acquire shop	10,000
Purchase of shop fittings	500
Purchase of quilts on credit	8,000
Payment to trade payables for quilts	7,000
Sales for cash	6,000
Sales on credit	10,000
Cash received from trade receivables	8,000
Wages for assistant	2,000
Utility expenses	1,000
Telephone costs	600
Drawings	3,000

All inventories have been sold by the end of the year.

Requirement

- Prepare journal entries for all the above transactions and the ledger (T) accounts.
- Prepare the trial balance
- Prepare the income statement and statement of financial position (balance sheet).

Key summary of chapter 3

The separate entity concept means the business is treated separately from its owners. This applies to sole traders

Income statement (IS) includes revenues and expenses

Statement of financial position (SOFP) includes assets, liabilities, capital and reserves

The **accounting equation** is:

Assets ó Liabilities = Capital + Profits ó Losses ó Drawings

or

Nets Assets = proprietorsøfunds or Shareholdersøfunds

Transactions are recorded in the accounting system. The accounting system will have an account for each type of asset, liability, revenue and expense.

The **general ledger** is the heart of the accounting system. It contains a separate account for each item that appears in the balance sheet and IS.

Double entry is the method of accounting used. Every transaction has a dual effect. For every debit there is an equal credit and vice versa

In the income statement:

- Revenues are credits
- Expenses are debits

In the statement of financial position:

- Assets are debits
- Liabilities are credits
- Capital and reserves are credits

Event	Financial statement	Debit or Credit
Increase in assets	Statement of financial position (balance sheet)	Debit
Decrease in assets	Statement of financial position (balance sheet)	Credit
Increase in liability	Statement of financial position (balance sheet)	Credit
Decrease in liability	Statement of financial position (balance sheet)	Debit
Increase in capital	Statement of financial position (balance sheet)	Credit
Decrease in capital	Statement of financial position (balance sheet)	Debit
Increase in revenue	Income statement	Credit
Decrease in revenue	Income statement	Debit
Increase in expense	Income statement	Debit
Decrease in expense	Income statement	Credit

A T-account is often used to record transactions, the left hand side is a debit and the right hand side is a credit

Transactions are entered into the accounting system using double entry through journals

The accounting system has ledger accounts for all balance sheet and income statement items

At the end of the accounting period, the ledger accounts are balanced and closed off.

The trial balance is produced to show all the debits and credits

Income and expenses are transferred to the profit and loss ledger account.

Statement of financial position accounts are left with carried forward balancing figures.

The profit and loss ledger account and drawing account are transferred to the capital account.

The only accounts remaining on the ledger with balances to be carried forward are those for statement of financial position items ó assets, liabilities and capital.

Solution to Lecture Examples

Solution to Lecture Example 3.1

a) Journal entries and ledger accounts

1 Introduction of Capital

Dr	Bank (SOFP)	£25,000	
	Cr	Capital (SOFP)	£25,000

2 Payment to acquire shop

Dr	Non current asset ó Shop (SOFP)	£10,000	
	Cr	Bank (SOFP)	£10,000

3 Purchase of shop fittings

Dr	Non current asset ó Shop (SOFP)	£500	
	Cr	Bank (SOFP)	£500

4 Purchase of quilts on credit

Dr	Inventory (SOFP)	£8,000	
	Cr	Trade payables (SOFP)	£8,000

5 Payment to trade payables for quilts

Dr	Trade payables (SOFP)	£7,000	
	Cr	Bank (SOFP)	£7,000

6 Sale for cash

Dr	Bank (SOFP)	£6,000	
	Cr	Sales (IS)	£6,000

7 Sales on credit

Dr	Trade receivables (SOFP)	£10,000	
	Cr	Sales (IS)	£10,000

8 Cash received from trade receivables

Dr	Bank (SOFP)	£8,000	
	Cr	Trade receivables (SOFP)	£8,000

9 Wages for assistant

Dr	Wage expenses (IS)	£2,000	
	Cr	Bank (SOFP)	£2,000

10	Utility expenses			
	Dr	Utility expenses (IS)	£1,000	
		Cr	Bank (SOFP)	£1,000
11	Telephone Costs			
	Dr	Telephone Expenses (IS)	£600	
		Cr	Bank (SOFP)	£600
12	Drawings			
	Dr	Drawings (SOFP)	£3,000	
		Cr	Bank (SOFP)	£3,000
13	Inventory			
	Dr	Cost of sales (IS)	£8,000	
		Cr	Inventory (SOFP)	£8,000

Prepare T accounts, balance and close off.

Non current assets

New shop bank	10,000	<i>Balance c/f</i>	<i>10,500</i>
Shop fittings	500		
<u>Total</u>	<u>10,500</u>	<u>Total</u>	<u>10,500</u>

Inventory

Inventory on credit	8,000	Cost of sales	8,000
<u>Total</u>	<u>8,000</u>	<u>Total</u>	<u>8,000</u>

Trade receivables

Sales	10,000	Payment received	8,000
		Bank	
		<i>Balance c/f</i>	<i>2,000</i>
<u>Total</u>	<u>10,000</u>	<u>Total</u>	<u>10,000</u>

Trade payables

Payment made Bank	7,000	Inventory	8,000
<i>Balance c/f</i>	<i>1,000</i>		
<u>Total</u>	<u>8,000</u>	<u>Total</u>	<u>8,000</u>

Bank

Capital	25,000	Trade payables	7,000
Trade receivables	8,000	Wages	2,000
Cash Sales	6,000	Utilities	1,000
		Telephone	600
		Drawings	3,000
		Non current assets	10,500
		<i>Balance c/f</i>	<i>14,900</i>
<u>Total</u>	<u>39,000</u>	<u>Total</u>	<u>39,000</u>

Sales

<i>Profit and loss ledger a/c</i>	<i>16,000</i>	Cash sales	6,000
		Credit sales	10,000
<u>Total</u>	<u>16,000</u>	<u>Total</u>	<u>16,000</u>

Cost of Sales

Inventories	8,000	<i>Profit and loss ledger a/c</i>	<i>8,000</i>
<u>Total</u>	<u>8,000</u>	<u>Total</u>	<u>8,000</u>

Wages

Bank	2,000	<i>Profit and loss ledger a/c</i>	<i>2,000</i>
<u>Total</u>	<u>2,000</u>	<u>Total</u>	<u>2,000</u>

Utility Expenses

Bank	1,000	<i>Profit and loss ledger a/c</i>	1,000
<u>Total</u>	<u>1,000</u>	<u>Total</u>	<u>1,000</u>

Telephone Expenses

Bank	600	<i>Profit and loss ledger a/c</i>	600
<u>Total</u>	<u>600</u>	<u>Total</u>	<u>600</u>

Drawings

Bank	3,000	<i>Capital a/c</i>	3,000
<u>Total</u>	<u>3,000</u>	<u>Total</u>	<u>3,000</u>

Profit and Loss Ledger Account

Cost of Sales	8,000	Sales	16,000
Wages	2,000		
Utility Expenses	1,000		
Telephone Expenses	600		
<i>Capital A/c</i>	4,400		
<u>Total</u>	<u>16,000</u>	<u>Total</u>	<u>16,000</u>

Capital Account

Drawings	3,000	Bank	25,000
		Profit and loss ledger a/c	4,400
Bal c/f	26,400		
<u>Total</u>	<u>29,400</u>	<u>Total</u>	<u>29,400</u>

b)

Trial balance

Account name	Debit	Credit
Sales		16,000
Cost of Sales	8,000	
Wages	2,000	
Utility expenses	1,000	
Telephone	600	
Non current asset	10,500	
Trade receivables	2,000	
Bank	14,900	
Trade payables		1,000
Capital		25,000
Drawings	3,000	
Total	<u>42,000</u>	<u>42,000</u>

c)

Income statement for Dirty Den for the year ending 31 March 20X6

		£
Sales		16,000
Less cost of sales		<u>(8,000)</u>
<u>Gross Profit</u>		8,000
Less expenses		
Wages	(2,000)	
Utility expenses	(1,000)	
Telephone	<u>(600)</u>	
Total Expenses		<u>(3,600)</u>
<u>Net profit</u>		<u>4,400</u>

**Statement of financial position for Dirty Den as at
the end 31 March 20X6**

		£
Non current assets		10,500
<u>Current assets</u>		
Trade receivables	2,000	
Cash	<u>14,900</u>	
		16,900
<u>Total assets</u>		<u>27,400</u>
<u>Capital, reserves and liabilities</u>		
Capital		25,000
Drawings		(3,000)
Profit		<u>4,400</u>
		26,400
<u>Current liabilities</u>		
Trade payables		1,000
<u>Total capital, reserves and liabilities</u>		<u>27,400</u>