Double entry bookkeeping – introduction

3

Introduction

We have reviewed the background to business transactions, looking at the different business documents we may encounter and how we record information from these source documents into the books of prime entry.

This chapter introduces the different business organisations that we may encounter. We then study the basic concepts and rules of bookkeeping. In particular:

- the dual effect principle
- the separate entity principle, and
- the accounting equation.

Together these will show how the assets of a business will always equal its liabilities and pave the way for studying ledger accounting in the next chapter.

KNOWLEDGE

Explain the accounting equation and how it relates to a double entry bookkeeping system (2.1)

Define capital income and capital expenditure (2.5)

Define revenue income and revenue expenditure (2.6)

CONTENTS

1 Business organisations
2 Types of accounting
3 Basic principles of accounting
4 The accounting equation: examples

1 Business organisations

1.1 Introduction

A business is an organisation that regularly enters into different transactions. There are three types of business organisations that you should have awareness of for your Level 2 AAT studies:

- Sole traders
- Partnerships
- Companies

1.2 Sole traders

These are organisations that are owned and operated by one person. They tend to be small as they are constrained by the limited financial resources of their owner. Preparing final accounts for sole traders is not assessed until Level 3 'Prepare final accounts for sole traders and partnerships' (FSTP).

1.3 Partnerships

These are organisations owned by two or more persons working in common with a view to making a profit. The greater number of owners compared with a sole trader increases the availability of finance and this is often the reason for forming this structure. Preparing final accounts for partnerships is not assessed until Level 3 'Prepare final accounts for sole traders and partnerships' (FSTP).

1.4 Companies

These are organisations recognised in law as 'persons' in their own right. A company may own assets and incur liabilities in its own name. The accounting of these organisations must meet certain minimum obligations imposed by legislation, for example, via company law and other regulations. Preparing final accounts for companies is not assessed until Level 4 'Financial statements' (FSTM).

2 Types of accounting

2.1 Management accounting and financial accounting

Depending on what purposes the statements are being produced for, the accounts can be referred to as being either **management accounts** or **financial accounts.**

Management accounts

These are usually prepared on a monthly basis to present the financial information in a way that enables the managers to run the business more effectively.

Financial accounts

These are prepared annually, mainly for the benefit of people outside the management of the business, such as the owners of the business (for example, shareholders who have appointed directors to run the business on their behalf), HM Revenue and Customs, banks, customers, suppliers and the government.

In this text we focus on financial accounting principles, though the majority of concepts also apply to management accounting.

2.2 The two main financial statements

The objective of financial accounting is to provide financial information about a business. This information is given in a set of financial statements (or accounts), which consists of two principal statements:

- The **statement of profit or loss.** This is a summary of the business's transactions (income and expense) for a given period.
- The **statement of financial position.** This is a statement of the assets and liabilities of the business at a given date. This date is the end of the period covered by the statement of profit or loss.

These financial statements are the final product of the accounting system of a business and it is useful to be aware of where all of the double entry bookkeeping that you will study in this chapter is leading. However, you do not need to know anything about the format or rules governing the preparation of the financial statements for Level 2.

2.3 Statement of profit or loss – definitions

The following definitions will be used throughout your studies.

Definitions

- **Sales revenue** is income generated from the trading activities of the business.
- **Cost of sales** is the cost of buying or producing the goods for resale.
- **Gross profit** is the profit remaining, after the cost of sales have been deducted from sales revenue.
- **Sundry income** – other types of income that aren't generated by the primary trading activities of the business.
- **Expenses** are the day to day running costs of the business.
- **Net profit or loss** – the profit or loss remaining after expenses have been deducted.

2.4 Statement of financial position – definitions

The following definitions will be used throughout your studies.

Definitions

- An **asset** is something owned by a business, available for use in the business.
- **Non-current asset –** an asset which is to be used for the long term in the business and not resold as part of the trading activities, for example the purchase of a delivery van.
- **Current asset –** a short-term asset of the business which is to be used in the business in the near future i.e. cash or something that will soon be converted into cash.
- A **receivable** is an example of a current asset. A receivable is someone who owes the business money i.e. a credit customer.
- **Non-current liability –** an amount owed by the business and due to be paid in the longer term (after 12 months).
- A **liability** is an amount owed by the business, i.e. an obligation to pay money at some future date.
- A **payable** is an example of a liability. A payable is someone the business owes money to i.e. a credit supplier.
- **Capital** is the amount which the owner has invested in the business; this is owed back to the owner and is therefore a special liability of the business.
- **Drawings** are amounts withdrawn by the owner for their own personal use: drawings may be of cash or items of inventory.

A typical statement of profit or loss is shown below.

Statement of profit or loss for the year-ended 31 December 20X2

	£	£
Sales revenue		X
Less: Cost of sales		
Inventory on 1 January (opening inventory)	X	
Add: Purchases of goods	X	
	X	
Less: Inventory on 31 December (closing inventory)	(X)	
		(X)
Gross profit		X
Sundry income:		
Discounts received	X	
Commission received	X	
Rent received	X	
		X
		X
Less: Expenses:		
Rent	X	
Rates	X	
Lighting and heating	X	
Telephone	X	
Postage	X	
Insurance	X	
Stationery	X	
Payroll expenses	X	
Accountancy fees	X	
Bank charges and interest	X	
Irrecoverable debts	X	
Delivery costs	X	
Van running expenses	X	
Selling expenses	X	
Discounts allowed	X	
		(X)
Profit/(loss) for the year		X/(X)

An example of a typical sole trader's statement of financial position is given below:

Statement of financial position as at 31 December 20X2

	Cost £	*Depreciation* £	*CV* £
Non-current assets			
Freehold factory	X	X	X
Machinery	X	X	X
Motor vehicles	X	X	X
	X	X	X
Current assets			
Inventories		X	
Trade receivables		X	
Cash at bank		X	
Cash in hand		X	
		X	
Current liabilities			
Trade payables		(X)	
Net current assets			X
Total assets less current liabilities			X
Non-current liabilities			
Loan			(X)
Net assets			X
Capital at 1 January			X
Net profit for the year			X
			X
Less: Drawings			(X)
Proprietor's funds			X

2.5 The difference between 'cash' and 'bank'

A possible confusion in terminology is caused by the apparent interchangeable use of the words 'cash' and 'bank'.

The normal use of the words suggests that a bank account operates by paying money out of the account with a cheque and paying either cash or cheques into the account. In practice you cannot pay 'cash' out of a bank account.

However, accounting terminology does not stick to this distinction, and the terms cash and bank are for the most part, interchangeable. Thus the bank account is often referred to as the 'cash book'. Similarly we will often refer to someone 'taking cash out of the bank' or we will say things like 'John bought a car for £5,000 cash', whereas in reality John would have paid for the car using a cheque.

For the early part of your studies all movements of cash/cheques shall be made through the bank account and references to 'cash' or 'cheques' effectively mean the same thing.

2.6 Capital and revenue

You must also be able to define capital expenditure, revenue expenditure, capital income and revenue income.

Definitions

- **Capital expenditure** is the purchase of, or improvement of, non-current assets.
- **Revenue expenditure** is the day to day running costs of the business.
- **Capital income** is income from the sale of capital assets of the business.
- **Revenue income** is income generated from the sale of goods or services

3 Basic principles of accounting

3.1 Introduction

Double entry bookkeeping is based upon three basic principles:

- the dual effect principle
- the separate entity principle
- the accounting equation.

3.2 The dual effect principle

This states that every transaction has two financial effects.

(a) If, for example, you spend £2,000 on a car and pay for it by a cheque, you will have £2,000 less money in the bank, but you will also have acquired an asset worth £2,000.

(b) Again, if you owe a payable £100 and send him a cheque for that amount, you will owe £100 less than before, but you will have £100 less money in the bank.

3.3 The separate entity principle

This states that the owner of a business is, for accounting purposes, a completely separate entity from the business itself. Therefore the money that the owner pays into the business as initial capital has to be accounted for as an amount that the business owes back to the owner. In just the same way, any money that the owner takes out of the business, known as 'drawings', is treated as a reduction of the initial capital that is owed back to the owner.

The dual effect principle works here as well. If the owner of the business pays £5,000 into his business, one effect is that the business has £5,000 more cash and the second effect is that the business has a £5,000 liability (called 'capital').

Note that we look at this from the **point of view of the business**, not from the owner's point of view. This is because when studying bookkeeping we are only interested in the business – we are not considering the owner's personal finances.

3.4 The accounting equation

At its simplest, the accounting equation simply says that:

Assets = Liabilities

If we treat the owner's capital as a special form of liability then the accounting equation is:

Assets = Liabilities + Capital

Or, rearranging:

Assets – Liabilities = Capital

Profit will increase the proprietor's capital and drawings will reduce it, so that we can write the equation as:

Assets – Liabilities = Capital + Profit – Drawings

4 The accounting equation: examples

Example 1

John starts his business on 1 July and pays £2,000 into his business bank account.

(a) What is the dual effect of this transaction?

(b) What is the accounting equation after this transaction?

Solution

(a) **The dual effect**

The business bank account has increased by £2,000 (an asset).
The business capital has increased by £2,000 (a liability).

(b) **The accounting equation**

Assets – Liabilities	= Capital
£2,000 – £0	= £2,000

Example 2

Percy started business on 1 January by paying £20,000 into a business bank account. He then spent £500 on a second-hand van by cheque, £1,000 on purchases of inventory for cash, took £500 cash for his own use and bought goods on credit costing £400.

What are the two effects of each of these transactions?

What would the accounting equation look like after each of these transactions?

Solution

(a) **Percy pays £20,000 into a business bank account**

The bank balance increases from zero to £20,000 (an asset) and the business now has capital of £20,000 (a liability). Capital is the amount that is owed back to the owner of the business, Percy.

Accounting equation:

Assets – Liabilities = Capital

£20,000 – £0 = £20,000

(b) **Percy buys a second-hand van for £500 by cheque**

The bank balance decreases by £500 (a reduction of assets) but the business has acquired a new £500 asset, the van.

The van is a specific type of asset known as a non-current asset as it is for long-term use in the business rather than an asset that is likely to be sold in the trading activities of the business.

The assets of the business are now:

	£
Van	500
Bank (20,000 – 500)	19,500
	20,000

The liabilities and capital are unchanged.

Accounting equation:

Assets – Liabilities = Capital

£20,000 – £0 = £20,000

(c) **Percy spends £1,000 on purchases of goods for cash**

The bank balance goes down by £1,000 but the business has another asset, inventory of £1,000.

Inventory is a short-term asset as it is due to be sold to customers in the near future and is known as a current asset.

The assets of the business are now:

	£
Van	500
Inventory	1,000
Bank (19,500 – 1,000)	18,500
	20,000

Accounting equation:

Assets – Liabilities = Capital

£20,000 – £0 = £20,000

(d) **Percy took £500 of cash out of the business**

The bank balance has decreased by £500 and capital has also decreased as the owner has taken money out of the business – this is known as drawings.

Remember that the owner is a completely separate entity from the business itself and if he takes money out of the business in the form of drawings then this means that the business owes him less.

The assets of the business are now:

	£
Van	500
Inventory	1,000
Bank (18,500 – 500)	18,000
	19,500

The capital of the business is now £(20,000 – 500) = £19,500.

Accounting equation:

Assets – Liabilities = Capital

£19,500 – £0 = £19,500

(e) **Purchased goods on credit for £400**

The asset of inventory increases by £400 and the business now has a liability of £400, the amount that is owed to the credit supplier. A liability is an amount that is owed by the business.

The assets of the business are now:

	£
Van	500
Inventory (1,000 + 400)	1,400
Bank	18,000
	19,900

The liability of the business is £400. The capital is unchanged.

Accounting equation:

Assets – Liabilities = Capital

£19,900 – £400 = £19,500

General notes:

1 Each and every transaction that a business undertakes has two effects. The accounting equation reflects the two effects of each transaction and the accounting equation should always balance.

2 The owner is a completely separate entity from the business, any money the owner puts into the business is known as capital and any amounts taken out by the owner are known as drawings.

5 Summary

You must understand the basic definitions covered in this chapter. You must also understand the principles of dual effect and separate entity. The accounting equation underlies the whole of bookkeeping and it is imperative that you fully understand these foundations which will be built on further. Re-work the examples in this chapter if necessary.

Ledger accounting

4

Introduction

In the first two chapters of this text we looked at different business documents and how these documents are entered into the books of prime entry. In the third chapter we reviewed the basic concepts and principles underlying double entry bookkeeping.

Before we review how details from the books of prime entry are entered into the accounting system we shall introduce how to record basic transactions in a 'ledger account' as part of the 'general ledger'. We will also learn how to balance of a ledger account and how those balances are brought together for the trial balance.

SKILLS

Total and balance ledger accounts, clearly showing balances carried down and brought down (8.2)

Extract an initial trial balance (8.3)

CONTENTS

1 Ledger accounting
2 Worked example
3 Additional example
4 Credit purchases
5 Credit sales
6 Procedure for balancing a ledger account
7 The trial balance

1 Ledger accounting

1.1 Introduction

The accounting equation introduced in Chapter 3 has limitations. Although we are able to calculate a profit figure, we are unable to determine which part of the profit are sales and which part are expenses. To be able to make this determination, we will now account for the movement in sales and purchases, rather than simply the movement of inventory.

Another limitation of the accounting equation is that in practice it would be far too time consuming to write up the accounting equation each time that the business undertakes a transaction. Instead the two effects of each transaction are recorded in ledger accounts.

1.2 The ledger account

A typical ledger account is shown below:

Title of account							
DEBIT				**CREDIT**			
Date	*Details*	*Folio*	*Amount* £	*Date*	*Details*	*Folio*	*Amount* £

The important point to note is that it has two sides. The left hand side is known as the **debit** side **(Dr)** and the right hand side is known as the **credit** side **(Cr).**

- The date column contains the date of the transaction.
- The details column (can also be referred to as the narrative column) usually contains the title of the other account that holds the second part of the dual effect. It may also have a brief description of the nature of the entry (e.g. 'rent 1.1.X3 to 31.3.X3').

- The folio column contains a reference to the source of the information, for example, 'sales day book p17' or 'payroll month 6'. You may not always see the folio column being used within a ledger account.
- The amount column simply contains the monetary value of the transaction.
- The title of the account is a name that reflects the nature of the transaction ('van account', 'bank account', 'electricity account', etc).

The importance of completing the ledger account correctly, in terms of the presentation, should not be underestimated. Vital marks can be gained in the exam by ensuring all details, including the date and narrative are completed accurately.

1.3 Simplified account

The ledger account in 1.2 is very detailed and in much of this book we use a simpler form of the account. Part of the reason for this is that it is easier to 'see' the entries being made if there is less detail in the accounts. Thus, we sometimes do without the date or folio to keep things clear and simple.

For example, we will often use accounts which look like this:

Bank account

	£		£
		Van	500

Van account

	£		£
Bank	500		

1.4 The golden rule for making entries in the ledger accounts

The golden rule for making entries in ledger accounts is:

Every debit entry must have an equal and opposite credit entry.

This reflects the dual effect of each transaction and ensures the accounting equation always balances.

It is also why we refer to the process as 'double entry bookkeeping'.

1.5 Which accounts to debit and credit?

The mnemonic 'DEAD/CLIC' is a good way to help determine if an entry should be made on the debit side or on the credit side of a ledger account.

Ledger account	
Debits increase:	**Credits increase:**
Expenses	**L**iabilities
Assets	**I**ncome
Drawings	**C**apital

We need to appreciate the effect a debit or a credit entry will have.

Ledger account	
A **debit entry** represents:	A **credit entry** represents:
• An increase in the value of an asset	• A decrease in the value of an asset
• A decrease in the value of a liability	• An increase in the value of a liability
• An increase to an item of expenditure	• An increase to an item of income (revenue)
• A decrease to an item of income	• A decrease to an item of expense.

1.6 What goes on the debit or credit side?

Example (part 1)

If John pays £2,000 into his business bank account as capital, we need to ask a number of questions to determine the double entry required.

(a) **Which** accounts are affected?

(b) What **type** of accounts are they i.e. asset/liability/income/expense?

(c) Is the transaction **increasing or decreasing** the account?

So let's consider these questions for John's investment of capital into his business.

(a) The accounts that are affected are the bank account and the capital account.

(b) The bank account is an asset whereas the capital is a special kind of liability.

(c) As we have paid money into the bank account, the asset is increasing – therefore a debit entry is required.

As John (the owner) has invested £2,000 into the business, the business owes him this amount back. This is an increase to a liability – therefore a credit entry is required.

To summarise:

Debit Bank account

Credit Capital account

Bank account

	£		£
Capital	2,000		

Capital account

	£		£
		Bank	2,000

Example (part 2)

If John's business now pays £1,000 out of the bank to buy a van, considering the questions again:

(a) The accounts that are affected are the bank account and the van account.

(b) The bank account is an asset and the van account is also an asset (a non-current asset).

(c) As we have paid money out of the bank account, the asset is decreasing – therefore a credit entry is required.

The business has acquired a van, which is a non-current asset, this is an increase to an asset – therefore a debit entry is required.

To summarise:

Debit Van account

Credit Bank account

Bank account

	£		£
Capital	2,000	Van	1,000

Capital account

	£		£
		Bank	2,000

Van account

	£		£
Bank	1,000		

2 Worked example

2.1 Introducing capital into the business – explanation

The owner of a business starts the business by paying money into the business bank account. This is the capital of the business. The business will need this money to 'get going'. It may need to pay rent, buy inventory for sale or pay wages to its staff before it has actually generated money itself through making sales.

Example

Frankie starts a business and pays £5,000 into the business bank account. What is the double entry for this transaction?

Solution

- £5,000 has been paid into the bank account.

  It represents an asset of the business.

  This is therefore a debit in the bank account.
- The business has a liability because it owes Frankie (the owner) £5,000.

  This liability will be a credit in the capital account.

Bank				Capital			
Capital	£5,000					Bank	£5,000

2.2 Purchasing goods for resale

A business buys goods for resale to customers – that is how most businesses (e.g. shops) make their money. These goods (known as 'inventory') are assets which the business owns (until the inventory is sold). Buying inventory is referred to as making a 'purchase' which is a type of expense.

Example

Frankie buys £300 of chocolate bars for resale. He pays with a cheque to his supplier.

What is the double entry for this transaction?

Solution

- The business has paid £300 out of its bank account.

  Therefore, the £300 will be credited to the bank account.
- Buying the chocolate bars (inventory) is known as making a purchase (a type of expense).

  This expense will be debited to the purchases account.

Purchases				Bank			
Bank	£300					Purchases	£300

2.3 Paying office rent

A business will typically rent premises in order to carry out its operations. It will pay rent to the landlord of the premises. Rent is an expense of the business.

Example

Frankie pays £1,000 per quarter for the rent of his offices. He pays with a cheque to the landlord.

What is the double entry for this transaction?

Solution

- The business has paid £1,000 out of its bank account.

  Therefore, the £1,000 will be credited to the bank account.
- The rent is an expense.

  This expense will be debited to the rent account.

Rent

Bank	£1,000		

Bank

		Rent	£1,000

2.4 Buying stationery

A business will buy stationery in order to be able to operate. The items of stationery (pens, paper, etc) are not for resale to customers but they tend to be used quickly after they are purchased. Therefore, stationery tends to be classified as an expense of the business, as opposed to an asset.

Example

Frankie pays £200 for items of stationery. He pays with a cheque to the supplier.

What is the double entry for this transaction?

Solution

- The business has paid £200 out of its bank account.

  Therefore, the £200 will be credited to the bank account.
- The stationery is an expense.

  This expense will be debited to the stationery account.

Stationery				Bank			
Bank	£200					Stationery	£200

2.5 Buying a computer

A business will buy computers in order to streamline its operations. These computers are not bought with a view to re-sale and are to be used in the business for the long term. They are therefore a non-current asset of the business.

Example

Frankie pays £900 to purchase a computer. He pays with a cheque to the supplier.

What is the double entry for this transaction?

Solution

- Once again start with the bank account.

  The business has paid £900 out of its bank account.

  Therefore, the £900 will be credited to the bank account.
- The computer is a non-current asset.

  The £900 will be debited to the non-current asset computer account.

Computer				Bank			
Bank	£900					Computer	£900

2.6 Receiving income from sales of goods

A business will sell the goods it has purchased for re-sale. This is income for the business and is referred to as 'sales'. You may also hear the terms 'revenue' or 'sales revenue'.

Example

Frankie sells goods for £1,500. The customer pays cash.

What is the double entry for this transaction?

Solution

- Once again start with the bank account.
  The business has received £1,500 into its bank account.
  Therefore, the £1,500 will be debited to the bank account.
- The cash received is income.
  This income will be credited to the sales account.

Sales			Bank		
	Bank	£1,500	Sales	£1,500	

2.7 Receiving income for services provided

A business may provide services to its customers, e.g.it may provide consultancy advice. This is income for the business and will usually be referred to as 'sales'.

Example

Frankie provides consultancy services to a client who pays £2,000 in cash. What is the double entry for this transaction?

Solution

- Once again start with the bank account.
  The business has received £2,000 into its bank account.
  Therefore, the £2,000 will be debited to the bank account.
- The cash received is income.
  This income will be credited to the sales account.

Sales			Bank		
	Bank	£2,000	Sales	£2,000	

3 Additional example

Example

Percy started business on 1 January and made the following transactions.

1 Paid £20,000 into a business bank account.

2 Spent £500 on a second-hand van.

3 Paid £1,000 on purchases of inventory.

4 Took £50 cash for his own personal use.

5 On 5 January bought goods for cash costing £500.

6 Made sales for cash of £2,000.

7 On 15 January paid £200 of rent.

Task 1

Show how the debit and credit entries for each transaction are determined.

Task 2

Enter the transactions into the relevant ledger accounts.

Solution

Task 1

(1) *Capital invested*

Percy has paid £20,000 into the bank account – therefore the bank account is debited.

Debit (Dr)	Bank	£20,000

The business now owes the owner £20,000. Capital is the amount owed by the business to its owner – this is a liability, therefore a credit entry is required in the capital account.

Credit (Cr)	Capital	£20,000

(2) *Purchase of van*

The business has paid £500 out of the bank account – therefore a credit entry in the bank account.

Cr	Bank	£500

The business now has a van costing £500 – this is an asset therefore a debit entry in the van account. This is a non-current asset of the business.

Dr	Van	£500

(3) *Purchase of inventory for cash*

The business has paid out £1,000 out of the bank account – therefore a credit to the bank account.

Cr	Bank	£1,000

The business has made purchases of inventory costing £1,000 – this is an item of expenditure therefore a debit entry in the purchases account. Note that the debit entry is to a purchases account not a inventory account. The inventory account is a different account altogether and inventory movements will be considered later.

Dr	Purchases	£1,000

(4) *Drawings*

The business has paid £50 out of the bank account – therefore credit the bank account.

Cr	Bank	£50

The proprietor has made drawings of £50 – this is a reduction of capital and therefore a debit entry to the drawings account.

Dr	Drawings	£50

Drawings should not be directly debited to the capital account. A separate drawings account should be used.

(5) *Purchase of goods for cash*

The business has paid out £500 – therefore credit the bank account.

Cr	Bank	£500

The business has made purchases of inventory costing £500 – an expense therefore debit the purchases account.

Dr	Purchases	£500

(6) *Sale for cash*

The business has paid £2,000 into the bank account – therefore a debit to the bank account.

Dr	Bank	£2,000

The business has made sales of £2,000 – this is income therefore a credit to the sales account.

Cr	Sales	£2,000

(7) *Payment of rent*

The business now paid £200 out of the bank account – therefore a credit to the bank account.

Cr	Bank	£200

The business has incurred an expense of rent – as an expense item the rent account must be debited.

Dr	Rent	£200

Task 2

Bank

Date			£	*Date*			£
1 Jan	Capital	(1)	20,000	1 Jan	Van	(2)	500
5 Jan	Sales	(6)	2,000		Purchases	(3)	1,000
					Drawings	(4)	50
				5 Jan	Purchases	(5)	500
				15 Jan	Rent	(7)	200

Capital

Date			£	*Date*			£
				1 Jan	Bank	(1)	20,000

Van

Date			£	*Date*			£
1 Jan	Bank	(2)	500				

Purchases

Date			£	*Date*			£
1 Jan	Bank	(3)	1,000				
5 Jan	Bank	(5)	500				

Drawings

Date			£	*Date*			£
1 Jan	Bank	(4)	50				

Sales

Date			£	*Date*			£
				5 Jan	Bank	(6)	2,000

Rent

Date			£	*Date*			£
15 Jan	Bank	(7)	200				

Activity 1

Write up the following cash transactions in the ledger accounts.

Transaction	*Details*
1	Set up the business by introducing £150,000 in cash.
2	Purchase property costing £140,000. Pay in cash.
3	Purchase goods costing £5,000. Pay in cash.
4	Sell goods for £7,000. All cash sales.
5	Purchase goods costing £8,000. Pay in cash.
6	Pay a sundry expense of £100, by cheque.
7	Sell goods for £15,000. All cash sales.
8	Pay wages of £2,000 to an employee.
9	Pay postage costs of £100, by cheque.

4 Credit purchases

Definitions

A cash purchase occurs when goods are bought (or a service received) and the customer pays immediately using cash, cheques or credit cards. A receipt is issued for the amount of cash paid.

A credit purchase occurs when goods are bought (or a service received) and the customer does not have to pay immediately but can pay after a specified number of days. An invoice is then issued to request that payment is made.

Example

We have already seen the double entry for a cash purchase and we shall now contrast this with the double entry for a credit purchase by means of an illustration.

John buys goods from Sam for £2,000.

(a) Record the double entry in John's books if John pays for the goods immediately with a cheque.

(b) Record the double entry in John's books if John buys the goods on credit and pays some time later.

Solution

(a) **Cash purchase**

The double entry is simply to:

Credit the bank account with £2,000 because £2,000 has been paid out.

Debit the purchases account with £2,000 because goods have been purchased with £2,000.

Bank

	£		£
		Purchases	2,000

Purchases

	£		£
Bank	2,000		

(b) **Credit purchase**

We have to record two transactions separately:

(i) *At the time the purchase is made*

At the time the purchase is made we debit £2,000 to the purchases account because a purchase has been made, but we do not make any entry in the bank account yet, because at that point, no cash has been paid. The other effect is that John has a liability, he owes £2,000 to the supplier, Sam, who we can refer to as a payable.

The double entry is:

Debit the purchases account with £2,000 because expenses have increased by £2,000.

Credit payables account with £2,000 (this is a liability of the business).

Purchases

	£		£
Payables	2,000		

Payables

	£		£
		Purchases	2,000

(ii) *When John pays the £2,000*

The double entry now will be:

Credit the bank account with £2,000 because £2,000 has been paid out.

Debit the payable account because John has paid and the payable has been reduced by £2,000.

Payables

	£		£
Bank	2,000	Purchases	2,000

Purchases

	£		£
Payables	2,000		

Bank

	£		£
		Payables	2,000

4.1 Summary

The net effect of the above credit purchase is that the payable has a nil balance because John has paid, and we are left with a debit in the purchases account and a credit in the cash book. This is exactly as for a cash purchase – we just had to go through the intermediate step of the payables account to get there.

5 Credit sales

Definitions

A cash sale occurs when goods are sold (or a service provided) and the customer pays immediately with cash, cheque or credit card. A receipt is issued for the amount of cash received.

A credit sale occurs when goods are sold (or a service provided) and the customer does not have to pay immediately but can pay after a specified number of days. An invoice is issued to request that the balance owed is then paid.

Example

We have already seen the double entry for a cash sale and we shall now contrast this with the double entry for a credit sale by means of an illustration.

George sells goods to Harry for £1,000.

(a) Record the double entry in George's books if Harry pays for the goods immediately with a cheque.

(b) Record the double entry in George's books if Harry buys the goods on credit and pays some time later.

Solution

(a) **Cash sale**

The double entry is simply to:

Debit the bank account with £1,000 because £1,000 has been paid in.

Credit the sales account with £1,000 because income has increased by £1,000.

Bank

	£		£
Sales	1,000		

Sales

	£		£
		Bank	1,000

(b) **Credit sale**

The double entry will be made at two separate times.

(i) *At the time the sale is made*

At the time the sale is made we credit £1,000 to the sales account because a sale has been made, but we cannot make any entry in the bank account at the time of the sale because no cash is received. However, the dual effect principle means that there must be another effect to this transaction, and in this case it is that the business has acquired a receivable.

The double entry is:

Debit receivables account with £1,000 (this is an asset of the business).

Credit the sales account with £1,000 because income has increased by £1,000.

Receivables

	£		£
Sales	1,000		

Sales

	£		£
		Receivables	1,000

(ii) *When Harry pays the £1,000*

The double entry now will be:

Debit the bank account with £1,000 because £1,000 has been paid in.

Credit the receivables account because Harry has paid and the receivable has been reduced by £1,000.

Receivables

	£		£
Sales	1,000	Bank	1,000

Sales

	£		£
		Receivables	1,000

Bank

	£		£
Receivables	1,000		

5.1 Summary

The net effect of the above credit sale is that the receivable has a nil balance because Harry has paid and we are left with a credit in the sales account and a debit in the cash book. This is exactly as for a cash sale – we just had to go through the intermediate step of the receivable account to get there.

Activity 2

We shall now revisit the activity TLC from Chapter 3 and record the transactions with debits and credits to ledger accounts.

Date	*Detail*
1.1.X5	TLC commenced business with £10,000 cash introduced by you, the proprietor
2.1.X5	TLC bought inventory of 500 chocolate hearts for £2,500 cash
3.1.X5	TLC bought inventory of 200 red roses on credit for £2,000
4.1.X5	TLC bought a delivery van for £1,000 cash
5.1.X5	TLC sold all the red roses for £3,000 cash
6.1.X5	TLC sold 400 chocolate hearts for £5,000 on credit
7.1.X5	TLC paid a gas bill for £500 cash
8.1.X5	TLC took out a loan of £2,000
9.1.X5	TLC paid £1,500 cash to trade payables
10.1.X5	TLC received £3,000 cash from receivables
11.1.X5	The proprietor withdrew £750 cash

Required:

Record these transactions in the relevant ledger accounts. Make your entries in the ledger accounts below.

Cash

£	£

Capital

£	£

Purchases

£	£

Payables

£	£

Delivery van

£	£

Sales

£	£

Receivables

£	£

Gas

£	£

Loan

£	£

Drawings

£	£

6 Procedure for balancing a ledger account

6.1 Steps to follow

Step 1 Total both the debit and the credit side of the ledger account and make a note of each total.

Step 2 Insert the higher of the two totals as the total on both sides of the ledger account leaving a line beneath the final entry on each side of the account.

Step 3 On the side with the smaller total insert the figure needed to make this column add up to the total. Call this figure the balance carried down (or 'Bal c/d' as an abbreviation).

Step 4 On the opposite side of the ledger account, below the total insert this same figure and call it the balance brought down (or 'Bal b/d' as an abbreviation).

Example

The bank account of a business has the following entries:

Bank

	£		£
Capital	1,000	Purchases	200
Sales	300	Drawings	100
Sales	400	Rent	400
Capital	500	Stationery	300
Sales	800	Purchases	400

Calculate the balance on the account and bring the balance down as a single amount.

Solution

Step 1 Total both sides of the account and make a note of the totals. (Note that these totals that are asterisked below would not normally be written into the ledger account itself. They are only shown here to explain the process more clearly.)

Bank

	£		£
Capital	1,000	Purchases	200
Sales	300	Drawings	100
Sales	400	Rent	400
Capital	500	Stationery	300
Sales	800	Purchases	400
*Sub-total debits**	*3,000*	*Sub-total credits**	*1,400*

Step 2 Insert the higher total as the total of both sides.

Bank

	£		£
Capital	1,000	Purchases	200
Sales	300	Drawings	100
Sales	400	Rent	400
Capital	500	Stationery	300
Sales	800	Purchases	400
*Sub-total debits**	*3,000*	*Sub-total credits**	*1,400*
Total	3,000	Total	3,000

Step 3 Insert a balancing figure on the side of the account with the lower sub-total. This is referred to as the 'balance carried down' or 'bal c/d' for short.

Bank

	£		£
Capital	1,000	Purchases	200
Sales	300	Drawings	100
Sales	400	Rent	400
Capital	500	Stationery	300
Sales	800	Purchases	400
*Sub-total debits**	*3,000*	*Sub-total credits**	*1,400*
		Bal c/d	1,600
Total	3,000	Total	3,000

Step 4 Insert the balance carried down figure beneath the total on the other side of the account. This is referred to as 'bal b/d' for short.

Bank

	£		£
Capital	1,000	Purchases	200
Sales	300	Drawings	100
Sales	400	Rent	400
Capital	500	Stationery	300
Sales	800	Purchases	400
*Sub-total debits**	*3,000*	*Sub-total credits**	*1,400*
		Bal c/d	1,600
Total	3,000	Total	3,000
Bal b/d	1,600		

The closing balance carried down at the end of the period is also the opening balance brought down at the start of the next period. This opening balance remains in the account as the starting position and any further transactions are then added into the account. In this case the balance brought down is a debit balance as there is money in the bank account making it an asset.

Example

Consider again the ledger accounts from the earlier example Percy in this chapter which are reproduced below and balance them.

Bank

Date			£	*Date*			£
1 Jan	Capital	(1)	20,000	1 Jan	Van	(2)	500
5 Jan	Sales	(6)	2,000		Purchases	(3)	1,000
					Drawings	(4)	50
				5 Jan	Purchases	(5)	500
				15 Jan	Rent	(7)	200

Capital

Date			£	*Date*			£
				1 Jan	Bank	(1)	20,000

Van

Date			£	*Date*	£
1 Jan	Bank	(2)	500		

Purchases

Date			£	*Date*	£
1 Jan	Bank	(3)	1,000		
5 Jan	Bank	(5)	500		

Drawings

Date			£	*Date*	£
1 Jan	Bank	(4)	50		

Sales

Date			£	*Date*			£
				5 Jan	Bank	(6)	2,000

Rent

Date			£	*Date*	£
15 Jan	Bank	(7)	200		

Solution

(a) **The bank account**

Bank

Date		£	*Date*		£
1 Jan	Capital	20,000	1 Jan	Van	500
5 Jan	Sales	2,000		Purchases	1,000
				Drawings	50
			5 Jan	Purchases	500
			15 Jan	Rent	200

Step 1 Total both the debit and the credit side of the ledger account and make a note of each total – debit side £22,000, credit side £2,250.

Step 2 Insert the higher of the two totals, £22,000, as the total on both sides of the ledger account leaving a line beneath the final entry on each side of the account.

Bank

Date		£	*Date*		£
1 Jan	Capital	20,000	1 Jan	Van	500
5 Jan	Sales	2,000		Purchases	1,000
				Drawings	50
			5 Jan	Purchases	500
			15 Jan	Rent	200
		22,000			22,000

Step 3 On the side with the smaller total insert the figure needed to make this column add up to the total. Call this figure the balance carried down (or Bal c/d as an abbreviation).

Step 4 On the opposite side of the ledger account, below the total insert this same figure and call it the balance brought down (or Bal b/d as an abbreviation).

Bank

Date		£	*Date*		£
1 Jan	Capital	20,000	1 Jan	Van	500
5 Jan	Sales	2,000		Purchases	1,000
				Drawings	50
			5 Jan	Purchases	500
			15 Jan	Rent	200
			31 Jan	Balance c/d	19,750
		22,000			22,000
1 Feb	Balance b/d	19,750			

This shows that the business has £19,750 left in the bank account at the end of January and therefore also on the first day of February. As the balance that is brought down to start the next period is on the debit side of the account this is known as a debit balance and indicates that this is an asset – money in the bank account.

(b) **Capital**

Capital

Date		£	*Date*		£
			1 Jan	Bank	20,000

As there is only one entry in this account there is no need to balance the account. The entry is on the credit side and is known as a credit balance. A credit balance is a liability of the business and this account shows that the business owes the owner £20,000 of capital.

(c) **Van**

Van

Date		£	*Date*		£
1 Jan	Bank	500			

Again, there is no need to balance this account as there is only one entry. This is a debit balance as it is an asset – the non-current asset, the van, which cost £500.

(d) **Purchases**

Purchases

Date		£	*Date*		£
1 Jan	Bank	1,000			
5 Jan	Bank	500	31 Jan	Balance c/d	1,500
		1,500			1,500
1 Feb	Balance b/d	1,500			

This now shows that during the month £1,500 of purchases was made. This is a debit balance as purchases are an expense of the business.

(e) **Drawings**

Drawings

Date		£	*Date*		£
1 Jan	Bank	50			

This is a debit balance as drawings are a reduction of the capital owed to the owner which is a credit balance.

(f) **Sales**

Sales

Date		£	*Date*		£
			5 Jan	Bank	2,000

There is no need to balance the account as there is only one entry – a £2,000 credit balance representing income.

(g) **Rent**

Rent

Date		£	*Date*	£
15 Jan	Bank	200		

As there is only one entry there is no need to balance the account. This is a debit balance indicating that there has been an expense of £200 of rent incurred during the month.

Activity 3

Given below is a bank account ledger account for the month of March. You are required to 'balance off' the ledger account.

Bank

Date		£	*Date*		£
1 Mar	Capital	12,000	3 Mar	Purchases	3,000
7 Mar	Sales	5,000	15 Mar	Non-current asset	2,400
19 Mar	Sales	2,000	20 Mar	Purchases	5,300
22 Mar	Sales	3,000	24 Mar	Rent	1,000
			28 Mar	Drawings	2,000

7 The trial balance

7.1 List of balances

The trial balance is a list showing the balances brought down on each ledger account. An example of a simple trial balance is given below:

	Debit	*Credit*
	£	£
Sales		5,000
Opening inventory	100	
Purchases	3,000	
Rent	200	
Car	3,000	
Receivables	100	
Payables		1,400
	6,400	6,400

The trial balance is produced immediately after the double entry has been completed and balances extracted on the accounts. If the double entry has been done correctly, the total of the debits will equal the total of the credits.

7.2 Reasons for extracting a trial balance

Drafting a trial balance is a way of ensuring that double entries have been correctly completed.

Example

The following are the balances on the accounts of Ernest at 31 December 20X8.

	£
Sales	47,140
Purchases	26,500
Receivables	7,640
Payables	4,320
General expenses	9,430
Loan	5,000
Plant and machinery at cost	7,300
Motor van at cost	2,650
Drawings	7,500
Rent and rates	6,450
Insurance	1,560
Bank overdraft	2,570
Capital	10,000

Required:

Prepare Ernest's trial balance as at 31 December 20X8.

Solution

Step 1 Set up a blank trial balance

Step 2 Work down the list of balances one by one using what you have learned so far about debits and credits. Assets and expenses are debit balances and liabilities and income are credit balances.

The mnemonic DEAD CLIC may help.

Drs increase:	**Crs increase:**
Expenses	Liabilities
Assets	Income
Drawings	Capital

Trial balance at 31 December 20X8

	Dr £	*Cr* £
Sales		47,140
Purchases	26,500	
Receivables	7,640	
Payables		4,320
General expenses	9,430	
Loan		5,000
Plant and machinery at cost	7,300	
Motor van at cost	2,650	
Drawings	7,500	
Rent and rates	6,450	
Insurance	1,560	
Bank overdraft		2,570
Capital		10,000
	69,030	69,030

Take care with drawings. These are a reduction of the capital owed back to the owner therefore as a reduction of a liability they must be a debit balance.

The bank overdraft is an amount owed to the bank therefore it must be a credit balance.

Activity 4

Continuing with the example of Percy, complete the trial balance.

8 Summary

In this chapter we have studied cash and credit transactions. It is important to always start with the bank account and remember that cash received is a debit in the bank account and cash paid out is a credit in the bank account. If you get that right then the rest really does fall into place.

You should also be aware of the definitions of assets, expenses and income and the normal entries that you would make in the accounts for these.

Balancing an account is a very important technique which you must be able to master. You must understand how to bring the balance down onto the correct side and what that balance represents.

Answers to chapter activities

Activity 1

The figures in brackets are used here to indicate the transaction number in the activity. They can be used to match the debit entry for the transaction with the corresponding credit entry.

Capital

	£		£
		Cash at bank (1)	150,000

Property

	£		£
Cash at bank (2)	140,000		

Purchases

	£		£
Cash at bank (3)	5,000		
Cash at bank (5)	8,000		

Sales

	£		£
		Cash at bank (4)	7,000
		Cash at bank (7)	15,000

Sundry expenses

	£		£
Cash at bank (6)	100		

Wages expense

	£		£
Cash at bank (8)	2,000		

Postage

	£		£
Cash at bank (9)	100		

Cash at bank

	£		£
Capital (1)	150,000	Property (2)	140,000
Sales (4)	7,000	Purchases (3)	5,000
Sales (7)	15,000	Purchases (5)	8,000
		Sundry expenses (6)	100
		Wages payable (8)	2,000
		Postage (9)	100

Activity 2

Cash

Date	*Narrative*	£	*Date*	*Narrative*	£
1.1.X5	Capital	10,000	2.1.X5	Purchases	2,500
5.1.X5	Sales	3,000	4.1.X5	Delivery van	1,000
8.1.X5	Loan	2,000	7.1.X5	Gas	500
10.1.X5	Receivables	3,000	9.1.X5	Payables	1,500
			11.1.X5	Drawings	750

Capital

Date	*Narrative*	£	*Date*	*Narrative*	£
			1.1.X5	Cash	10,000

Purchases

Date	*Narrative*	£	*Date*	*Narrative*	£
2.1.X5	Cash	2,500			
3.1.X5	Payables	2,000			

Payables

Date	*Narrative*	£	*Date*	*Narrative*	£
9.1.X5	Cash	1,500	3.1.X5	Purchases	2,000

Delivery van

Date	*Narrative*	£	*Date*	*Narrative*	£
4.1.X5	Cash	1,000			

Sales

Date	*Narrative*	£	*Date*	*Narrative*	£
			5.1.X5	Cash	3,000
			6.1.X5	Receivables	5,000

Receivables

Date	*Narrative*	£	*Date*	*Narrative*	£
6.1.X5	Sales	5,000	10.1.X5	Cash	3,000

Gas

Date	*Narrative*	£	*Date*	*Narrative*	£
7.1.X5	Cash	500			

Loan

Date	*Narrative*	£	*Date*	*Narrative*	£
			8.1.X5	Cash	2,000

Drawings

Date	*Narrative*	£	*Date*	*Narrative*	£
11.1.X5	Cash	750			

Activity 3

Bank

Date		£	*Date*		£
1 Mar	Capital	12,000	3 Mar	Purchases	3,000
7 Mar	Sales	5,000	15 Mar	Non-current asset	2,400
19 Mar	Sales	2,000	20 Mar	Purchases	5,300
22 Mar	Sales	3,000	24 Mar	Rent	1,000
			28 Mar	Drawings	2,000
			31 Mar	Balance c/d	8,300
		22,000			22,000
1 Apr	Balance b/d	8,300			

Activity 4

Trial balance

	Dr £	*Cr* £
Bank	19,750	
Capital		20,000
Van	500	
Purchases	1,500	
Drawings	50	
Sales		2,000
Rent	200	
	22,000	22,000