Chapter

3

Basic Financial Accounting

Syllabus Content

Accounting systems – 20%

Ledger accounts; double-entry bookkeeping.;

D - Preparation of accounts – 45%

Trading, profit and loss accounts and balance sheets from trial balance; accounting for the appropriations of profit.

Financial statements are produced to give information to the users. As mentioned earlier the most important financial statements are the income statement and 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 Balance sheet

The top half of the balance sheet shows all the assets owned by the business. The assets are either non current or current.

The bottom half off the balance sheet shows capital, reserves and liabilities. The liabilities are either non current or current.

Items in 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 – 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 balance sheet the assets of the business are equal to the liabilities.

Net assets are total assets less total liabilities. The net assets equal the capital and reserves in the balance sheet. The capital and reserves is also known as the "proprietors' funds or Shareholders' funds".

Therefore putting this into an equation, we get:

Assets – Liabilities = Capital + Profits – Losses – Drawings

OR

Nets Assets = proprietors' funds or Shareholders' funds

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

Assets = Capital + Profits – Losses - Drawings + liabilities

Or

Assets = proprietors' funds + 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	
Total	20,000		20,000	

£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			
Total	20,000		20,000	

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.

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			
Total	23,000		23,000	

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)	
Total	22,500		22,500	

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)	
Total	22,200		22,200	

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)		
Total	25,200		22,200		3,000

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				
Total	27,200		24,200		3,000

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				
Total	24,200		24,200		0

This is how the balance sheet will appear after the last transaction

Balance sheet of Beauty Within		
Non current assets		
	Shop	10,000
Current assets		
	Cash	14,200
Total assets		**24,200**
Capital and reserves (or proprietors' funds)		
Capital		20,000
Drawings		(500)
Profit		4,700
		24,200
Current liabilities		0
Total capital, reserves and liabilities		**24,200**

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 income statement 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 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 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

<u>For every debit there is an equal credit</u>

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.

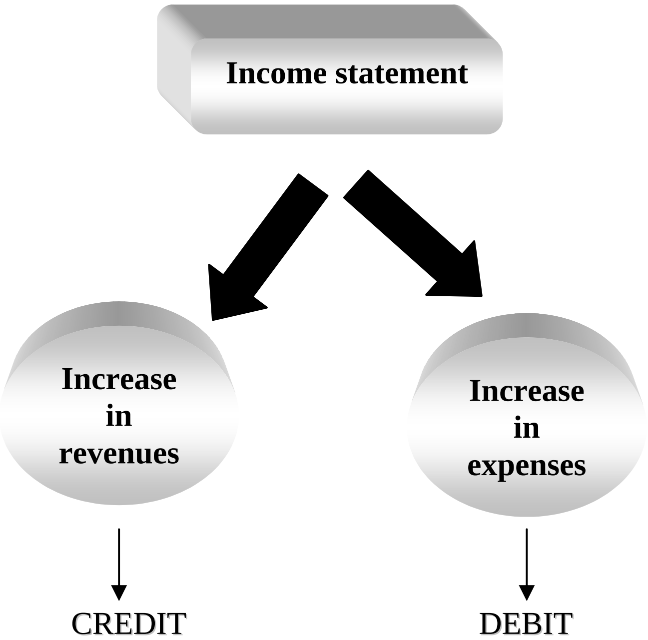
A useful matrix may help in understanding double entry:

Event	**Financial statement**	**Debit or Credit**
Increase in assets	Balance sheet	Debit
Decrease in assets	Balance sheet	Credit
Increase in liability	Balance sheet	Credit
Decrease in liability	Balance sheet	Debit
Increase in capital	Balance sheet	Credit
Decrease in capital	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

Another way of remembering the double entry rule is:

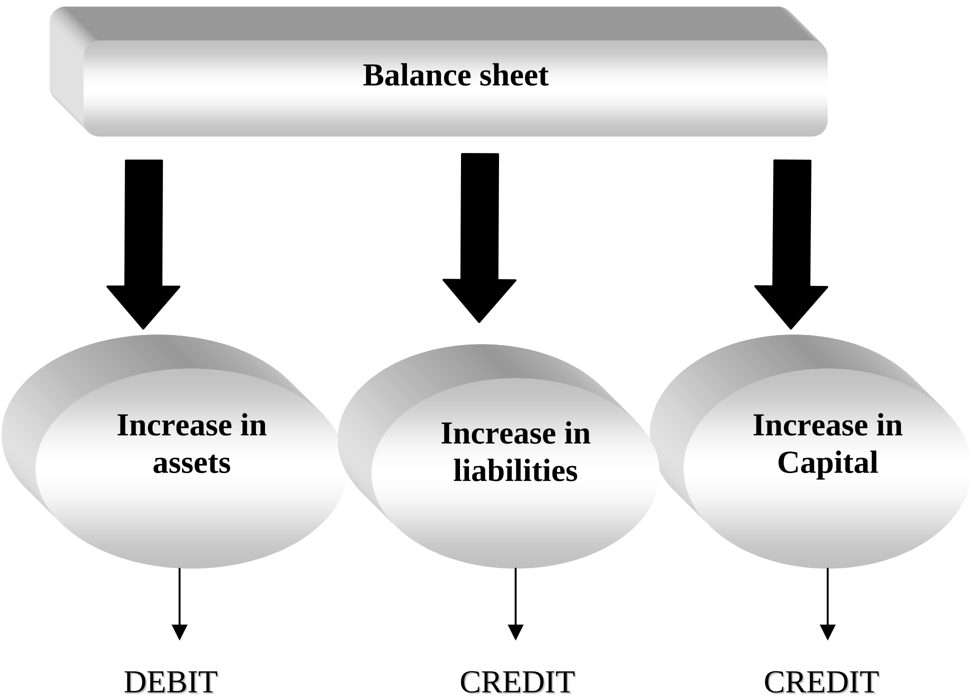
An	**Asset**	**Debit**
Elephant	**E**xpenses	Debit
Is	**I**ncome / Revenue	Credit
Lumpy	**L**iabilities	Credit

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



All decreases are opposites

In the 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 Balance Sheet (BS) items.

Dr	**Non current asset (BS)**		**£10,000**
	Cr	**Bank (BS)**	**£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 "Beauty Within". She puts £20,000 cash into the business.

<u>Journal entry</u>

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

T accounts

Capital Account

		Cash Introduced	£20,000

Bank Account

Capital introduced	£20,000		

Account Equation

Assets	=	Proprietors' funds	+	Liabilities
Bank	20,000	Introduced	20,000	
Total	20,000		20,000	

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 – Shop (BS)	£10,000	
Dr	Inventory (BS)	£ 5,000	
	Cr Bank (BS)		£15,000

T Accounts

Non current asset - Shop

Shop bought with cash	£10,000		

Inventory

Stock bought with cash	£5,000		

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			
Total	20,000		20,000	

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 (BS)	£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 (BS)		£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

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		

Inventory

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

Accounting Equation

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

4 Drawings

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

Journal entry

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

T accounts

Drawings

Bank	£ 500		

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)	
Total	22,500		22,500	

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 (BS)		£300

T accounts

Utility Expenses

Bank	£ 300		

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)	
Total	22,200		22,200	

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 (BS)		£3,000	
	Cr	Trade Payables (BS)		£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)		
Total	25,200		22,200		3,000

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 (BS)	£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 (BS)		£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				
Total	27,200		24,200		3,000

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 (BS)	£3,000	
	Cr Bank (BS)		£3,000

2 Cheque received from trade receivables

Dr	Bank (BS)	£5,000	
	Cr Trade receivables (BS)		£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				
	Total	24,200		24,200		0

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.

Balance sheet

The balancing figure is "carried forward" into the next period. Then in the next period, this balancing figure is known as the "bought forward". 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 balance sheet under capital). The profit and loss ledger account is the accumulation of all profits and losses since trading began and is a 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

Profit and loss accounts

Sales

P&L Ledger account (balancing figure)	*£13,000*	Sale of makeup in cash	£8,000
		Sale of makeup on credit	£5,000
Total	**£13,000**	**Total**	**£13,000**

Cost of Sales

Inventory	£ 5,000	***P&L Ledger account (balancing figure)***	***£ 8,000***
Inventory	£ 3,000		
Total	**£ 8,000**	**Total**	**£ 8,000**

Utility Expenses

Cash	£ 300	***P&L Ledger account (balancing figure)***	***£ 300***
Total	**£ 300**	**Total**	**£ 300**

Balance sheet Accounts

Trade payables

Payment	£3,000	Inventory bought on credit	£3,000
Total	**£3,000**	**Total**	**£3,000**

Trade receivables

Sale	£ 5,000	Cash	£5,000
Total	**£5,000**	**Total**	**£5,000**

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
		Balance c/f	***£14,200***
Total	**£33,000**	**Total**	**£33,000**

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
Total	**£ 8,000**	**Total**	**£ 8,000**

Non current asset - Shop

Shop bought with cash	£10,000	*Balance c/f*	*£10,000*
Total	**£10,000**	**Total**	**£10,000**

Capital Account

Balance c/f	*£20,000*	Cash Introduced	£20,000
Total	**£20,000**	**Total**	**£20,000**

Drawings

Cash	£ 500	***Balance c/f***	***£ 500***
Total	**£ 500**	**Total**	**£ 500**

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	Sales	£13,000
Utility Expenses	£ 300		
Balance c/f	***£4,700***		
Total	**£13,000**	**Total**	**£13,000**

Note the profit is the same as in the accounting equation

Understanding the "carried forward"

The carried forward figures in the 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 "bought forward (b/f)" in the next period as follows:

Cash Account

Balance b/f	***£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 on balance sheet is an asset).

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 will look something like this:

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, (ie 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 balance sheet can now be prepared from the trial balance.

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

Balance sheet for Kitten as at the end of the period	£
Non current assets	10,000
Current assets	
Cash	14,200
Total assets	**24,200**
Capital and reserves	
Capital	20,000
Drawings	(500)
Profit	4,700
	24,200
Liabilities	0
Total capital, reserves and liabilities	**24,200**

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	***Transfer to capital a/c***	***£ 500***
Total	**£ 500**	**Total**	**£ 500**

Profit and Loss ledger account

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

Capital Account

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

The balance sheet can now be shown as follows:

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

Note: Capital b/f

Balance sheets that are drawn up for businesses who started before the current accounting period (ie this is not the first time the balance sheet is produced), will have capital bought 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	(£2,000)
Capital at end of period	**£ 6,000**

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 balance sheet).

All balance sheet balances are bought 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.
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.
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 balance sheet items – assets, liabilities and capital.

From the above the financial statements are produced, the income statement and 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 inventory has been sold by the end of the year.

Requirement

a) Prepare journal entries for all the above transactions and the ledger (T) accounts.
b) Prepare the trial balance
c) Prepare the income statement and balance sheet.

Solution to Lecture Examples

Solution to Lecture Example 3.1

a) Journal entries and ledger accounts

1 Introduction of Capital

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

2 Payment to acquire shop

Dr	Non current asset – Shop (BS)		£10,000	
	Cr	Bank (BS)		£10,000

3 Purchase of shop fittings

Dr	Non current asset – Shop (BS)		£500	
	Cr	Bank (BS)		£500

4 Purchase of quilts on credit

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

5 Payment to trade payables for quilts

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

6 Sale for cash

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

7 Sales on credit

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

8 Cash received from trade receivables

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

9 Wages for assistant

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

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

Prepare T accounts, balance and close off.

Non current assets

New shop bank	10,000	*Balance c/f*	*10,500*
Shop fittings	500		
Total	**10,500**	**Total**	**10,500**

Inventory

Inventory on credit	8,000	Cost of sales	8,000
Total	**8,000**	**Total**	**8,000**

Trade receivables

Sales	10,000	Payment received Bank	8,000
		Balance c/f	*2,000*
Total	**10,000**	**Total**	**10,000**

Trade payables

Payment made Bank	7,000	Inventory	8,000
Balance c/f	*1,000*		
Total	**8,000**	**Total**	**8,000**

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
		Balance c/f	*14,900*
Total	**39,000**	**Total**	**39,000**

Sales

Profit and loss ledger a/c	*16,000*	Cash sales	6,000
		Credit sales	10,000
Total	**16,000**	**Total**	**16,000**

Cost of Sales

Inventories	8,000	*Profit and loss ledger a/c*	*8,000*
Total	**8,000**	**Total**	**8,000**

Wages

Bank	2,000	*Profit and loss ledger a/c*	*2,000*
Total	**2,000**	**Total**	**2,000**

Utility Expenses

Bank	1,000	*Profit and loss ledger a/c*	*1,000*
Total	**1,000**	**Total**	**1,000**

Telephone Expenses

Bank	600	*Profit and loss ledger a/c*	*600*
Total	**600**	**Total**	**600**

Drawings

Bank	3,000	*Capital a/c*	*3,000*
Total	**3,000**	**Total**	**3,000**

Profit and Loss Ledger Account

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

Capital Account

Drawings	3,000	Bank	25,000
		Profit and loss ledger a/c	4,400
Total	**29,400**	**Total**	**29,400**

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	**42,000**	**42,000**

c)

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

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

Balance sheet for Dirty Den as at the end 31 March 20X6

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