FAC1502

STUDY UNIT 4

THE DOUBLE-ENTRY SYSTEM AND THE ACCOUNTING PROCESS

Financial Accounting I:

Financial Accounting Concepts, Principles and Procedures

STUDY UNIT

4

The double-entry system and the accounting process

Learning outcome

You should be able to analyse and record transactions in the books of an entity and prepare financial statements.

Contents

KEY CONCEPTS
• debit and credit • ledger • transaction • contra account • effect on financial position • folio number • T-account • trial balance

4.1 INTRODUCTION

We mentioned the double-entry system in section 2.6 of study unit 2 - read that section again. To make a double-entry correctly, you need a good working knowledge of the appropriate names for different concepts in accounting, particularly the **concepts of "debit" and "credit"**. It is very important that you master this study unit since it explains the foundation on which the accounting system is built.

4.2 THE DOUBLE-ENTRY SYSTEM

At this stage we are simply using the accounting equation as a teaching aid to explain the analysis of transactions. The BAE **does not** form part of a formal accounting system.

To make a double-entry you must:

- think about what **effect the transaction is going to have on the BAE**, in other words, how it is going to affect the financial position of the entity
- **identify the components (accounts) that are involved**, that is, the components that will have the desired effect on the equation
- **determine which account(s) has/have to be debited and which account(s) has/have to be credited**
- be sure that the **amount(s) debited is/are equal to the amount(s) credited**
- be able to indicate **the date of the transaction**
- indicate the **name of the contra ledger account in the account in which you are making the entry**, the contra account is the other account that is involved in the transaction: the one account refers to the other
- indicate the **folio number of the subsidiary journal**

4.3 THE EFFECT OF TRANSACTIONS ON THE BASIC ACCOUNTING EQUATION

A transaction is an agreed-upon transfer of value from one party to another that affects (i.e., changes) the amount, the nature or the composition of an entity's assets, liabilities or equity. In other words, it affects the BAE. Entering into a transaction gives rise to the **first step** in the accounting cycle, namely, **the completion of a source document**.

Transactions may

- affect assets and/or equity and/or liabilities
- generate income or give rise to expenditure

4.4 TRANSACTIONS THAT AFFECT ONLY ASSETS, EQUITY AND LIABILITIES

Below we give practical examples of transactions that affect only assets or interests. (**A "+" indicates an increase** and a **"-" indicates a decrease**.)

4.4.1 Capital contributions

Transaction 1 Feb 20.1	T Tom decided to start a carpet-cleaning business called Fix-'n-Mat. He made a direct EFT of R130 000 from his personal savings account to the bank account of Fix-'n-Mat.

Analysis	(1)	The asset "Bank" increases by R130 000 and there is now money in Fix-'n-Mat's bank account.
	(2)	The owner, T Tom, provides Fix-'n-Mat with funds and increases his interest in Fix-'n-Mat. The equity "Capital" increases by R130 000.

	ASSETS	=	**EQUITY**	+	**LIABILITIES**
	Bank		**Capital**		
	R		**R**		**R**
Previous balances	0		0		0
This transaction	+ 130 000		+ 130 000		0
New balances	130 000	=	130 000	+	0

COMMENTS

- *In an entity that has not yet entered into any transaction, the elements of the equation will always be 0.*
- *The terms "bank" and "capital" in the analysis are actually names of accounts.*
- *The investment of capital is usually the first transaction.*
- *Capital may be contributed in the form of cash or any other asset (e.g., furniture). **"Furniture"** instead of **"Bank"** will then increase.*
- *The BAE balances after the transaction.*

4.4.2 Acquisition of loans

Transaction 2 Feb 20.1	Fix-'n-Mat obtained a loan of R25 000 with a payback period of more than a year from ABC Bank. The amount was paid into Fix-'n-Mat's bank account.

Analysis	(1) The asset **"Bank"** increases by R25 000. (2) ABC Bank now has a claim against or an interest in Fix-'n-Mat, and a liability, namely, **"Loan: ABC Bank"** comes into being.

	ASSETS	=	EQUITY	+	LIABILITIES
	Bank				**Loan: ABC Bank**
	R		**R**		**R**
Balances brought down	130 000		130 000		0
This transaction	+ 25 000		0		+ 25 000
New balances	155 000	=	130 000	+	25 000

COMMENTS

- *The results of the first transaction form the balances that are brought down in this transaction.*
- *Liabilities arise when another party or institution supplies funds (makes loans) to the entity.*
- *Amounts (in this case, R25 000) are **added** to both the left-hand side and the right-hand side of the BAE.*
- *The BAE balances after the transaction.*

4.4.3 Purchase of assets for cash

Transaction 6 Feb 20.1	Fix-'n-Mat bought equipment from XY Furnishers for R100 000 and paid the amount directly, via EFT (Electronic Funds Transfer) into XY Furnishers's bank account.

Analysis	(1) The asset **"Bank"** decreases by R100 000 since money has been withdrawn. (2) The asset **"Equipment"** increases.

	ASSETS		=	**EQUITY**	+	**LIABILITIES**
	Equipment **R**	**Bank** **R**		**Capital** **R**		**Loan:** **ABC Bank** **R**
Balances brought down		155 000		130 000		25 000
This transaction	+100 000	–100 000		0		0
New balances	100 000	55 000	=	130 000	+	25 000

COMMENTS

- *Assets now consist of bank and equipment.*
- *The left-hand side of the equation increases and decreases. One asset is exchanged for another asset.*
- *The BAE balances after the transaction.*

4.4.4 Buying assets on credit (debt)

Transaction 10 Feb 20.1	Fix-'n-Mat bought furniture for R2 000 on credit from Joc Limited.

Analysis	(1) The asset "**Furniture**" increases by R2 000. (2) A liability, "**Trade payables**", comes into being.

	ASSETS			=	EQUITY	+	LIABILITIES	
	Furniture R	**Equipment** R	**Bank** R		**Capital** R		**Loan: ABC Bank** R	**Trade payables** R
Balances brought down	0	100 000	55 000		130 000		25 000	0
This transaction	+2 000	0	0		0		0	+2 000
New balances	2 000	100 000	55 000	=	130 000	+	25 000	2 000

COMMENTS

- *Assets may also be bought on credit, in which case a creditor (trade payables) comes into being.*
- *The transaction is recorded when it is entered into and not when the payment is made.*
- *The left-hand side and the right-hand side of the BAE increase.*
- *The BAE balances after the transaction.*

4.4.5 Payments to creditors (trade payables)

Transaction 11 Feb 20.1	Fix-'n-Mat made an EFT to Joc Limited's account to pay its account of R2 000.

Analysis	(1) The asset "**Bank**" decreases by R2 000. (2) A liability, **"Trade payables"**, decreases by R2 000.

	ASSETS			=	EQUITY	+	LIABILITIES	
	Furniture R	Equipment R	Bank R		Capital R		Loan: ABC Bank R	Trade payables R
Balances brought down	2 000	100 000	55 000		130 000		25 000	2 000
This transaction	0	0	−2 000		0		0	−2 000
New balances	2 000	100 000	53 000	=	130 000	+	25 000	0

COMMENTS

- *The left-hand side and the right-hand side of the BAE decrease.*
- *The BAE balances after the transaction.*

4.4.6 Withdrawals by owner

Transaction 12 Feb 20.1	The owner took R1 000 cash for his own use.

Analysis	(1) Fix-'n-Mat's "**Bank**" decreases by R1 000. (2) T Tom's, "**Capital**" (equity) in Fix-'n-Mat decreases by R1 000.

	ASSETS			=	EQUITY	+	LIABILITIES	
	Furniture R	Equipment R	Bank R		Capital R		Loan: ABC Bank R	Trade payables R
Balances brought down	2 000	100 000	53 000		130 000		25 000	0
This transaction	0	0	−1 000		−1 000		0	0
New balances	2 000	100 000	52 000	=	129 000	+	25 000	0

COMMENTS

- *Withdrawals are the opposite of capital contributions and reduce capital. Remember, withdrawals are not expenditure.*
- *Where the entity pays personal expenses of the owner, it is also treated as a withdrawal, called "Drawings".*
- *The left-hand side and the right-hand side of the BAE are reduced.*
- *The BAE balances after the transaction.*

4.5 TRANSACTIONS THAT GIVE RISE TO INCOME AND EXPENDITURE

4.5.1 Income (cash)

Transaction 13 Feb 20.1	Fix-'n-Mat provided services for a client, S Silver, after which an amount of R1 000 was paid directly into the bank account of Fix-'n-Mat.

Analysis	(1) The asset **"Bank"** increases by R1 000. (2) The service fees that Fix-'n-Mat earns are income. **Equity** therefore increases by R1 000.

	ASSETS			=	EQUITY		+	LIABILITIES	
	Furniture **R**	**Equipment** **R**	**Bank** **R**		**Capital** **R**	**Income/ Expenditure** **R**		**Loan: ABC Bank** **R**	**Trade payables** **R**
Balances brought down	2 000	100 000	52 000		129 000	0		25 000	0
This transaction	0	0	+1 000		0	+1 000		0	0
New balances	2 000	100 000	53 000	=	129 000	1 000	+	25 000	0

COMMENTS

- *Income earned increases equity. It is the **objective of the entity** to **earn income for the entrepreneur**.*
- *The left-hand side and the right-hand side of the BAE increase.*
- *The BAE balances after the transaction.*

4.5.2 Expenditure (cash)

Transaction 16 Feb 20.1	Fix-'n-Mat paid wages of R800 cash.

Analysis	(1) The asset "**Bank**" decreases by R800. (2) Wages are an expenditure item and therefore equity decreases by R800.

	ASSETS			=	EQUITY		+	LIABILITIES	
	Furniture R	Equipment R	Bank R		Capital R	Income/ Expenditure R		Loan: ABC Bank R	Trade payables R
Balances brought down	2 000	100 000	53 000		129 000	1 000		25 000	0
This transaction	0	0	–800		0	–800		0	0
New balances	2 000	100 000	52 200	=	129 000	200	+	25 000	0

COMMENTS

- *In essence, expenditure incurred decreases income and therefore also decreases equity.*
- *The left-hand side and the right-hand side of the BAE decrease.*
- *The BAE balances after the transaction.*

4.5.3 Income (credit)

Transaction 18 Feb 20.1	Fix-'n-Mat provided services worth R6 000 to C Canon on credit.

Analysis	(1) C Canon becomes a debtor of Fix-'n-Mat. The asset **"Trade receivables"** comes into being and increases by R6 000. (2) **"Service fees"** earned are an income item, and equity increases by R6 000.

	ASSETS				=	EQUITY		+	LIABILITIES	
	Trade receivables **R**	**Furniture** **R**	**Equipment** **R**	**Bank** **R**		**Capital** **R**	**Income/ Expend-iture** **R**		**Loan: ABC Bank** **R**	**Trade payables** **R**
Balances brought down	0	2 000	100 000	52 200		129 000	200		25 000	0
This transaction	+ 6 000	0	0	0		0	+6 000		0	0
New balances	6 000	2 000	100 000	52 200	=	129 000	6 200	+	25 000	0

COMMENTS

- *Organisations or clients who owe money to the entity are known as debtors (trade receivables). Debtors arise when the entity renders services or goods on credit.*
- *The left-hand side and the right-hand side of the BAE increase.*
- *The **realisation principle** applies here, and **the income is shown as having been earned on 18 February, when the service was provided, and not the date on which the cash is received**.*

4.5.4 Expenditure (credit)

Transaction 21 Feb 20.1	Fix-'n-Mat placed an advertisement in a local newspaper for R200. Payment was due only in 30 days.

Analysis	(1) The liability "Trade payables" increases by R200. (2) "**Advertising expenses**" are an expenditure item, and the equity decreases by R200.

	ASSETS				=	EQUITY		+	LIABILITIES	
	Trade receivables **R**	**Furniture** **R**	**Equipment** **R**	**Bank** **R**		**Capital** **R**	**Income/ Expend-iture** **R**		**Loan: ABC Bank** **R**	**Trade payables** **R**
Balances brought down	6 000	2 000	100 000	52 200		129 000	6 200		25 000	0
This transaction		0	0	0		0	–200		0	+200
New balances	6 000	2 000	100 000	52 200	=	129 000	6 000	+	25 000	200

COMMENTS

- *Expenditure may also be incurred on credit (for goods/services received).*
- *The organisations to which money is owed are known as creditors (trade payables).*
- *The right-hand side of the BAE increases and decreases.*
- *The expenditure is* ***shown on 21 February 20.1 and not only when the amount is paid****. The* ***accrual principle applies here****.*
- *The BAE balances after the transaction.*

4.5.5 Payments received from debtors (trade receivables)

Transaction 28 Feb 20.1	C Canon settled part of its account, R2 000, in cash.

Analysis	(1) The asset **"Bank"** increases by R2 000. (2) The asset **"Trade receivables"** decreases by R2 000.

	ASSETS				=	EQUITY		+	LIABILITIES	
	Trade receivables **R**	**Furniture** **R**	**Equipment** **R**	**Bank** **R**		**Capital** **R**	**Income/ Expend-iture** **R**		**Loan: ABC Bank** **R**	**Trade payables** **R**
Balances brought down	6 000	2 000	100 000	52 200		129 000	6 000		25 000	200
This transaction	–2 000	0	0	+2 000		0	0		0	0
New balances	4 000	2 000	100 000	54 200	=	129 000	6 000	+	25 000	200

COMMENTS

- *This transaction affects assets only.*
- *The left-hand side of the BAE increases **and** decreases.*
- *The BAE balances after the transaction.*

4.6 SUMMARY OF TRANSACTIONS

Fix-'n-Mat's transactions for February 20.1 can now be summarised as follows:

	ASSETS				=	INTERESTS				
						EQUITY		+	LIABILITIES	
Date	Trade receivables	Furniture	Equipment	Bank		Capital	Income/ Expenditure	+	Loan: ABC Bank	Trade payables
20.1 Feb	R	R	R	R		R	R		R	R
1				+130 000	=	+130 000				
2				+25 000	=				+25 000	
6			+100 000	–100 000	=					
10		+2 000			=					+2 000
11				–2 000	=					–2 000
12				–1 000	=	–1 000				
13				+1 000	=		+1 000			
16				–800	=		–800			
	+6 000				=		+6 000			
21					=		–200			+200
28	–2 000			+2 000	=					
	+4 000	+2 000	+100 000	+54 200	=	+129 000	+6 000	+	+25 000	+200
	$\underbrace{\qquad}$ 160 200				=	$\underbrace{\qquad}$ 135 000		+	$\underbrace{\qquad}$ 25 200	
					=	160 200				

COMMENT

- *Note that these totals correspond to the closing balances in section 4.5.5 above.*

4.7 BASIC FORM OF A STATEMENT OF FINANCIAL POSITION (PREVIOUSLY KNOWN AS THE BALANCE SHEET)

Now we are going to prepare a statement of financial position using the totals of the BAE (refer to section 4.6). The basic form of the statement of financial position is based on the BAE. You have already come across a very simple statement of financial position in section 2.5. A statement of financial position is a report and, in essence, it is a formal presentation of the elements of the BAE.

FIX-'N-MAT

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20.1

ASSETS	Note	R
Non-current assets		102 000
Equipment		100 000
Furniture		2 000
Current assets		58 200
Trade and other receivables		4 000
Cash and cash equivalents		54 200
Total assets		160 200
EQUITY AND LIABILITIES		
Total equity		135 000
Capital		135 000
Non-current liabilities		25 000
Long-term borrowings *		25 000
Current liabilities		200
Trade and other payables		200
Total equity and liabilities		160 200

** The loan from ABC Bank is classified as long-term-borrowings because it is only repayable after 12 months. (See the definition of non-current liabilities under section 2.5.2.)*

COMMENTS

- *The statement of financial position balances and shows the same totals as the BAE.*
- *Note the heading -- the statement of financial position is prepared to reflect the financial position **on a specific date**.*
- *The withdrawals are subtracted from the capital. As mentioned earlier, withdrawals **are not an expenditure item**.*
- *The equity in the BAE is also R135 000.*

4.8 REVISION EXERCISES AND SOLUTIONS

4.8.1 REVISION EXERCISE 1

D Paulus started a television antenna installation business on 1 June 20.1. The following transactions took place in the first month:

Transactions:

June 1 Cash was deposited directly into the bank account of the business as opening capital, R25 000.

2 D Paulus made his private equipment available to the business, R9 000.

3 Additional equipment purchased and paid for with the credit card of the business, R12 000.

4 Installation fees for work done on account for Kannadrift Municipality, R4 200.

6 Vehicle purchased on credit from Virginia Cars Limited, R22 400. This vehicle was financed by obtaining a loan from Crown Bank at an interest rate of 9% per annum.

17 Kannadrift Municipality paid R2 200 on its account.

28 Wages paid, R4 000.

29 Money drawn for private use, R1 300.

30 Paid R9 000 for loan from Crown Bank.

REQUIRED

Using the basic accounting equation, analyse the abovementioned transactions as follows:

NB: (1) Show the effect of each transaction on the basic accounting equation, using a plus sign (+) for an increase and a minus sign (-) for a decrease.

(2) Balance the equation.

Example: On 1 July 20.1 D Paulus received R2 000 in cash for an installation done for Cook Financing Corporation.

Date	Basic accounting equation		
	A =	**E +**	**L**
20.1	**R**	**R**	**R**
July 1	+2 000	+2 000	0

SOLUTION: REVISION EXERCISE 1

D PAULUS

ACCOUNTING EQUATION

Date	**Basic accounting equation** **A**	**=** **E**	**+** **L**
20.1	**R**	**R**	**R**
June 1	+25 000	+25 000	
2	+9 000	+9 000	
3	+12 000		+12 000
4	+4 200	+4 200	
6	+22 400		+22 400
17	+2 200		
	–2 200		
28	–4 000	–4 000	
29	–1 300	–1 300	
30	–9 000		–9 000
Total	46 300	32 900	13 400

46 300

COMMENT

- *If a payment is made by credit card the business paid is paid directly but D Paulus will still owe the amount to the bank until the credit card amount due is paid in full. A creditor (liability) bank: credit card will be created.*

4.8.2 REVISION EXERCISE 2

The following transactions in January 20.1 relate to the business of F Fox, an attorney.

Date	Transactions	Amount
20.1		**R**
Jan 3	F Fox deposited opening capital, directly into the bank account of the business.	20 000
	Paid rental for January 20.1	2 300
4	Bought law books on credit from Book Limited	24 000
	Bought a computer for cash from Leo Limited	1 700
6	Provided services for cash	7 200
9	Debited D Dunn with fees for services rendered	8 318
10	Leo Limited repaired equipment on credit	100
13	F Fox withdrew money for private use	1 234
18	F Fox, the business, received commission on a property transaction	1 350
29	Made the following EFTs:	
	(i) Salaries	8 350
	(ii) Leo Limited (on account)	100
30	Received payment from D Dunn on his account	1 500

REQUIRED

(1) Analyse the above transactions in tabular form as follows:

ASSETS				=	EQUITY		+	LIABILITIES
Date	Law books and Equipment	Trade receivables/ Debtors	Bank		Capital	Income/ Expenditure		Trade payables/ Creditors
	R	R	R		R	R		R
				=			+	
Total				=			+	

(2) Prepare the statement of financial position of F Fox as at 31 January 20.1.

SOLUTION: REVISION EXERCISE 2

F FOX

(1) ACCOUNTING EQUATION

ASSETS				=	EQUITY		+	LIABILITIES
Date	**Law books and Equipment**	**Trade receivables/ Debtors**	**Bank**		**Capital**	**Income/ Expenditure**		**Trade payables/ Creditors**
20.1	**R**	**R**	**R**		**R**	**R**		**R**
Jan 3			+20 000	=	+20 000		+	
			–2 300	=		–2 300	+	
4	+24 000			=			+	+24 000
	+1 700		–1 700	=			+	
6			+7 200	=		+7 200	+	
9		+8 318		=		+8 318	+	
10				=		–100	+	+100
13			–1 234	=	–1 234		+	
18			+1 350	=		+1 350	+	
29			–8 350	=		–8 350	+	
			–100	=			+	–100
30		–1 500	+1 500	=			+	
Total	+25 700	+6 818	+16 366	=	+18 766	+6 118	+	+24 000

$\underbrace{\text{Assets}}_{R48\ 884}$ = $\underbrace{\text{Equity + Liabilities}}_{R48\ 884}$

R48 884

R48 884

F FOX
STATEMENT OF FINANCIAL POSITION AS AT 31 JANUARY 20.1

ASSETS	Note	R
Non-current assets		25 700
Equipment		1 700
Library		24 000
Current assets		23 184
Trade and other receivables		6 818
Cash and cash equivalents		16 366
Total assets		48 884
EQUITY AND LIABILITIES		
Total equity		24 884
Capital		24 884
Current liabilities		24 000
Trade and other payables		24 000
Total equity and liabilities		48 884

4.9 THE GENERAL LEDGER ACCOUNT

Up to now, we have dealt only with asset, equity and liability items appearing in a statement of financial position or a BAE.

We recorded transactions in columns in a summary of a BAE to show their effect on a specific asset, equity or liability item. We had columns for debtors/trade receivables, furniture, equipment, capital and so on. But it is impractical to prepare a new equation after every new transaction - just think what would happen in a business with thousands of transactions! Therefore, we are now going to open an **account** in the general ledger for every column of the BAE. We speak of the **general ledger** because there are also subsidiary ledgers, which we will explain later.

An account is opened in the general ledger for every asset, equity and liability item. Every account appears on its own on a page in the ledger and each account is given a number, which is known as a **folio number**.

An account is an accounting record in which all transactions relating to a specific item are recorded. Please have a look at page 10 of study unit 2, as well as the content explanation for study unit 2.

Dr **Name of account** **Cr**

Year Month	Day	Contra account details	Fol	Amount R	Year Month	Day	Contra account details	Fol	Amount R

4.9.1 Assets

Please have a look at section 2.5.1 of study unit 2, as well as the content explanation for study unit 2.

4.9.2 Equity and liabilities

Please have a look at section 2.5.2 and 2.5.3 of study unit 2, as well as the content explanation for study unit 2.

4.10 BALANCING AN ACCOUNT

Considering what you have learnt about an account, you now know that an account may have entries on the debit or the credit side or on both sides. Please have a look at the content explanation for study unit 2.

NB:

The closing balance of the previous period becomes the opening balance of the next period.

- c/d = carried down, which indicates the amount to be carried down to the following month
- b/d = brought down, which indicates that the amount has been brought down from the previous month

4.11 Schematic representation

Refer to Study unit 4_Schematic representation.

COMMENTS

- *The top level of the schematic representation shows the basic accounting equation (BAE).*
- *The second level of the schematic representation shows how each of the components of the BAE becomes part of the accounting system. The left-hand side of the account is known as the debit side (Dr) and the right-hand side is known as the credit side (Cr).*
- *The total of the amounts on the debit side of an asset account is usually larger than that on the credit side. The account therefore usually has a debit balance (brought down). The total of the amounts on the credit side of a liability account is usually larger than that on the debit side. The account therefore usually has a credit balance (brought down).*
- *The capital account reflects the equity of the owner at the date of the statement of financial position. The balance on this account is the result of income, expenditure, drawings and capital investment. These components are all dealt with separately in the accounting system.*
  - *Additional capital contributions and income increase equity.*
  - *Drawings and expenditure decrease equity.*
  - ***But note: drawings are not an expenditure and therefore do not reduce the profit.***
- *The left-hand side (EQUITY SECTION) forms the basis for the preparation of the statement of profit or loss and other comprehensive income and the statement of changes in equity.*
- *The Capital (EQUITY SECTION) and the right-hand side (ASSETS and LIABILITIES) form the basis for the preparation of the statement of financial position.*

4.12 RECORDING OF TRANSACTIONS IN LEDGER ACCOUNTS

When we enter a transaction in a ledger account, we have to ask ourselves: **Which accounts are affected?** In answer to this question, we are now going to record the transactions discussed in sections 4.4 and 4.5 in ledger accounts (T-accounts).

Transaction
(4.4.1)

Dr	Bank	Cr	Dr	Capital	Cr
130 000					130 000

(4.4.2)

Dr	Bank	Cr	Dr	Loan	Cr
25 000					25 000

(4.4.3)

Dr	Equipment	Cr	Dr	Bank	Cr
100 000					100 000

(4.4.4)

Dr	Furniture	Cr	Dr	Trade payables (Joc Ltd)	Cr
2 000					2 000

(4.4.5)

Dr	Bank	Cr	Dr	Trade payables (Joc Ltd)	Cr
		2 000	2 000		

(4.4.6)

Dr	Bank	Cr
		1 000

Dr	Drawings	Cr
1 000		

COMMENT

All drawings by the owner are recorded in a separate account, namely, ***"Drawings"****, and not directly in the capital account. Drawings represent* ***a*** *disbursement of the profit to the owner and are* ***not expenses*** *resulting from business operations.*

(4.5.1)

Dr	Bank	Cr
1 000		

Dr	Service fees	Cr
		1 000

(4.5.2)

Dr	Bank	Cr
		800

Dr	Wages	Cr
800		

(4.5.3)

Dr	Trade receivables (C Canon)	Cr
6 000		

Dr	Service fees	Cr
		6 000

(4.5.4)

Dr	Trade payables	Cr
		200

Dr	Advertising expenses	Cr
200		

(4.5.5)

Dr	Bank	Cr
2 000		

Dr	Trade receivables (C Canon)	Cr
		2 000

> **GOLDEN RULE**
>
> For each transaction you need to make a debit entry as well as a credit entry for the debit side (dr) to be equal to the credit side (cr).

4.13 THE GENERAL LEDGER

In the previous example two accounts were opened each time for each transaction. In practice, all transactions that affect, say, bank are summarised in **one account for bank**. Given the information we have above, the accounts will take the following form (each one is closed off and the balance determined):

> **GOLDEN RULE**
>
> Assets (e.g., Bank) increase on the debit side (dr) and decrease on the credit side (cr) of the account.

Dr **Bank** **Cr**

Date	Details	Fol	Amount	Date	Details	Fol	Amount
20.1			**R**	**20.1**			**R**
Feb 1	Capital		130 000	Feb 6	Equipment		100 000
2	Loan:ABC Bank		25 000	11	Trade payables		2 000
13	Service fees		1 000	12	Drawings		1 000
28	Trade receivables		2 000	16	Wages		800
				28	Balance	c/d	54 200
			158 000				158 000
20.1							
Mar 1	Balance	b/d	54 200				

Dr **Equipment** **Cr**

20.1			**R**				
Feb 6	Bank		100 000				

Dr **Furniture** **Cr**

20.1			**R**				
Feb 10	Trade payables		2 000				

Dr **Trade receivables** **Cr**

20.1			**R**	**20.1**			**R**
Feb 18	Service fees		6 000	Feb 28	Bank		2 000
					Balance	c/d	4 000
			6 000				6 000
20.1							
Mar 1	Balance	b/d	4 000				

GOLDEN RULE

Equity (e.g., Capital) and liabilities (e.g., Trade payables) increase on the credit side (cr) and decrease on the debit side (dr) of the account.

GOLDEN RULE

Income (e.g., sales, service fees) increases equity and is credited (cr) to the particular income account.

GOLDEN RULE

Expenses (e.g., wages) decrease equity and are debited (dr) to the particular expense account.

Dr **Capital** **Cr**

				20.1			**R**
				Feb 1	Bank		130 000

Dr **Drawings** **Cr**

20.1			**R**				
Feb 12	Bank		1 000				

Dr **Loan: ABC Bank** **Cr**

				20.1			**R**
				Feb 2	Bank		25 000

Dr **Trade payables** **Cr**

20.1			**R**	**20.1**			**R**
Feb 11	Bank		2 000	Feb 10	Furniture		2 000
28	Balance	c/d	200	21	Advertising expenses		200
			2 200				2 200
				20.1			
				Mar 1	Balance	b/d	200

Dr **Wages** **Cr**

20.1			**R**				
Feb 16	Bank		800				

Dr **Advertising expenses** **Cr**

20.1			**R**				
Feb 21	Trade payables		200				

Dr **Service fees** **Cr**

				20.1			**R**
				Feb 13	Bank		1 000
				18	Trade receivables		8 000
							7 000

COMMENT

- *Note that an item in a ledger account is simply the name of the other ledger account involved in the transaction. This other ledger account is known as the **contra ledger account**.*

4.14 THE TRIAL BALANCE

A trial balance is a list of the balances brought down (b/d) of the accounts in the general ledger on a specific date. The debits must be equal to the credits - this is a possible indication of the correctness of the recording of transactions in the general ledger.

GOLDEN RULE

The balance “brought down” (b/d) must be used to prepare the trial balance.

The following trial balance has been prepared according to the ledger accounts in section 4.12.

FIX-'N-MAT

TRIAL BALANCE AS AT 28 FEBRUARY 20.1

	Dr R	Cr R
Bank	54 200	
Equipment	100 000	
Furniture	2 000	
Trade receivables control	4 000	
Capital		130 000
Drawings	1 000	
Loan: ABC Bank		25 000
Trade payables control		200
Wages	800	
Advertising expenses	200	
Service fees		7 000
	162 200	162 200

GOLDEN RULE

Asset and expense accounts have debit (dr) balances brought down (b/d) and are entered on the debit side of the trial balance.

GOLDEN RULE

Equity (capital), liability and income accounts have credit (cr) balances brought down (b/d) and are entered on the credit side of the trial balance

COMMENTS

- *The trial balance balances.*
- *Note that an account with a debit balance (brought down) is shown on the debit side of the trial balance and an account with a credit balance (brought down) is shown on the credit side.*
- *If we compare the totals of the trial balance with the totals of the columns of the BAE (refer to section 4.6), we note the following:*
- *Capital in the BAE is R129 000. In the trial balance capital, R130 000 (Cr), and drawings, R1 000 (Dr), are shown separately, which also gives a net total of (R130 000 – R1 000) = R129 000.*
- *Income less expenditure = R6 000 profit. If the expenses in the trial balance, namely, wages and advertising expenses with debit balances of R800 and R200 respectively are subtracted from the income, namely, service fees with a credit of R7 000, the net amount is R(7 000 - 1 000) = R6 000 credit, which corresponds to the income in the BAE.*

4.15 PREPARING FINANCIAL STATEMENTS

In this module we deal with statements of financial position, statements of profit or loss and other comprehensive income and statements of changes in equity as well as some of the notes. Statements of cash flows will be dealt with in FAC1601.

As mentioned previously, the trial balance serves as a basis for preparing the statement of profit or loss and other comprehensive income, the statement of changes in equity, and the statement of financial position for an entity. **The trial balance represents a summary of the balances in the general ledger to see if all the debits are equal to the credits.** The statement of profit or loss and other comprehensive income shows the entity's financial result, and the statement of financial position shows its financial position.

4.15.1 The statement of profit or loss and other comprehensive income

We will now use the information from the trial balance in section 4.14 above to prepare a statement of profit or loss and other comprehensive income for Fix-'n-Mat. This statement will be discussed in detail in study unit 15.

FIX-'N-MAT

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE MONTH ENDED 28 FEBRUARY 20.1

	Notes	R
Revenue		7 000
Distribution, administrative and other expenses		(1 000)
Wages		800
Advertisesing expenses		200
Profit for the period		6 000
Other comprehensive income for the period		--
Total comprehensive income for the period		6 000

COMMENTS

- *Note the title. A statement of profit or loss and other comprehensive income is prepared for **a period ended**, not on a certain date.*
- *The profit for the period as determined in the statement of profit or loss and other comprehensive income corresponds to the income/expenditure column in the BAE.*
- *The income and expenditure accounts are called **nominal accounts**.*

GOLDEN RULE

Revenue (consisting of service fees) less expenses result in a profit or a loss.

4.15.2 The statement of changes in equity

This statement shows all the changes in equity that occurred in the financial period. The **purpose of a statement of changes in equity is to reconcile an entity's equity at the beginning of the financial period with its equity at the end of the financial period.** The balance of the equity at the end of the financial period is then shown in the statement of financial position. Equity will be discussed in more detail later.

FIX-’N-MAT

STATEMENT OF CHANGES IN EQUITY FOR THE MONTH ENDED 28 FEBRUARY 20.1

	Capital
	R
Balance at 1 February 20.1	130 000
Total comprehensive income for the period	6 000
Drawings	(1 000)
Balance at 28 February 20.1	135 000

GOLDEN RULE

A profit increases equity and a loss decreases equity.

COMMENTS

- *Note that a statement of changes in equity is prepared for a **period ended** and not on a specific date.*
- *The equity at the end of the month corresponds to the net total in the BAE in section 4.6.*

GOLDEN RULE

The balance at the end of the period on an entity’s statement of changes in equity must be the same as the “capital” reflected in its statement of financial position.

4.15.3 The statement of financial position

Before we prepare a statement of financial position, please refer to sections 2.4 and 2.5 and the statement of financial position for Fix-'n-Mat that we compiled in section 4.7.

We will now show the statement of financial position of Fix-'n-Mat in narrative form and in compliance with IFRS.

FIX-'N-MAT

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20.1

ASSET	**Note**	**R**
Non-current assets	3	102 000
Property, plant and equipment		102 000
Current assets		58 200
Trade and other receivables		4 000
Cash and cash equivalents (bank)		54 200
Total assets		160 200
EQUITY AND LIABILITIES		
Total equity		135 000
Capital		135 000
Total liabilities		25 200
Non-current liabilities		25 000
Long-term borrowings		25 000
Current liabilities		200
Trade and other payables		200
TOTAL EQUITY AND LIABILITIES		160 200

COMMENTS

- *Refer to section 4.15.4 for the calculation of property, plant and equipment.*
- *The amount for total assets, that is, R160 200 corresponds to the total as shown in the BAE in section 4.6.*
- *The total equity and liabilities of R160 200 corresponds to the total as shown in the BAE in section 4.6.*
- *Words and figures between brackets are for explanatory purposes only and do not form part of a financial statement.*

GOLDEN RULE

- Assets, at this stage, are grouped into non-current and current assets.
- Non-current assets do not change often and are used in ordinary business or production or to render services.
- Current assets change after every operating transaction, in other words, very often.
- Equity (the interest of the owner(s) in the entity) at this stage, consisting of capital only.
- Liabilities, at this stage, consisting of non-current and current liabilities.
- Non-current liabilities are to be paid after 12 months and do not change often. Current liabilities are short term, change often and must be repaid within 12 months.

4.15.4 Notes

Additional information on items appearing in the financial statements of an entity is given in notes to the financial statements. These explanatory notes are shown after the statement of cash flows.

We do not deal with statements of cash flows in this module and will therefore show the notes after a statement of profit or loss and other comprehensive income.

Note number 1 is used to reveal the accounting policies of the business. Now let us prepare the notes of Fix-'n-Mat.

FIX ’N MAT

NOTES FOR THE MONTH ENDED 28 FEBRUARY 20.1

(1) Accounting policy:

The financial statements were prepared on the historical cost basis and comply with International Financial Reporting Standards.

(2) Revenue represents fees earned for services rendered to clients.

(3)

Property, plant and equipment	**Equipment**	**Furniture**	**Total**
	R	**R**	**R**
Carrying amount: Beginning of period			
Cost	–	–	–
Accumulated depreciation	–	–	–
Additions	100 000	2 000	102 000
Depreciation	–	–	–
Carrying amount: End of period	100 000	2 000	102 000
Cost	100 000	2 000	102 000
Accumulated depreciation	–	–	–

No depreciation was written off in this financial period. This note, together with the methods of writing off depreciation will be discussed in detail in study unit 11.

4.16 SUMMARY

We began by explaining the financial position (statement of financial position) and the financial performance (statement of profit or loss and other comprehensive income) of an entity and then went back to how an entity enters into a transaction to set the accounting process in motion.

4.17 REVISION EXERCISES AND SOLUTIONS

4.17.1 REVISION EXERCISE 1

Please attempt **4.17.1_REVISION EXERCISE 1** under the heading **"CONTENT"**. The answer will be provided at a later stage.

4.17.2 REVISION EXERCISE 2

Please attempt 4.17.2_Revision EXERCISE 2 under the heading **"CONTENT"**. The answer will be provided at a later stage.

4.17.3 REVISION EXERCISE 3

Please attempt 4.17.3_REVISION EXERCISE 3 under the heading **"CONTENT"**. The answer will be provided at a later stage.

4.17.4 REVISION EXERCISE 4

Please attempt 4.17.4_REVISION EXERCISE 4 under the heading **"CONTENT"**. The answer will be provided at a later stage.

4.17.5 REVISION EXERCISE 5

Please attempt 4.17.5_REVISION EXERCISE 5 under the heading **"CONTENT"**. The answer will be provided at a later stage.

SELF-ASSESSMENT

Now that you have studied this study unit, can you prepare

	• ledger accounts? • a trial balance? • a basic statement of profit or loss and other comprehensive income? • a statement of changes in equity? • a basic statement of financial position? • certain notes to the financial statements of an entity?