



The double entry system for expenses and revenues



Specific objectives

After you have studied this chapter you should be able to:

- understand the concept of profit and loss by comparing revenue with expenses
- see the effects of profits and losses on capital and the relationship to the accounting equation
- understand why separate accounts are used for each type of expense and revenue
- record expenses and revenues using the double entry system
- understand the term drawings, be able to record them and recognise the effects of drawings on capital.

8.1 The nature of profit or loss

To an accountant, *profit* means the amount by which *revenues* are greater than *expenses* for a set of transactions. The term *revenues* means the value of goods and services that have been supplied to customers. The term *expenses* means the value of all the assets that have been used up to obtain those revenues.

If, therefore, we had supplied goods and services valued for sale at \$100,000 to customers, and the expenses incurred by us to be able to supply those goods and services amounted to \$70,000, then the result would be a profit, calculated as follows:

	\$
Revenues (goods and services supplied to our customers for the sum of)	100,000
<i>Less Expenses</i> (value of all the assets used up to enable us to supply the above goods and services)	70,000
	<u>30,000</u>
Profit is therefore	<u>30,000</u>

On the other hand, it is possible for expenses to exceed our revenues for a set of transactions. In this case the result is a loss. For instance, a *loss* would be incurred given the following details.

	\$
Revenues – What we have charged our customers in respect of all the goods and services supplied to them	60,000
<i>Less Expenses</i> – Value of all the assets used up to supply these goods and services to our customers	80,000
	<u>(20,000)</u>
Loss is therefore	<u>(20,000)</u>

8.2 The effects of profit or loss on capital

Businesses exist to make profits and so increase their capital. Let us look at the relationship between profits and capital in an example.

On 1 January the assets and liabilities of a firm are:

- **Assets:** Fixtures \$10,000; Inventory \$7,000; Cash at bank \$3,000
- **Liabilities:** Accounts payable \$2,000

The capital is found by the formula:

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

In this case capital works out as:

$$\text{Assets } \$10,000 + \$7,000 + \$3,000 - \text{Liabilities } \$2,000 = \$18,000$$

During January the whole of the \$7,000 inventory is sold for \$11,000 cash. On 31 January the assets and liabilities have become:

$$\begin{aligned} \text{Assets: Fixtures } & \$10,000; \text{ inventory nil; cash at bank } & \$14,000 \\ \text{Liabilities: Accounts Payable} & & \$2,000 \end{aligned}$$

The capital can be calculated:

$$\text{Assets } \$10,000 + \$14,000 - \text{Liabilities } \$2,000 = \$22,000$$

It can be seen that capital has increased from \$18,000 to \$22,000 = \$4,000 increase because the \$7,000 inventory was sold for \$11,000, a profit of \$4,000. Profit, therefore, increases capital:

$$\begin{aligned} \text{Old capital} + \text{Profits} &= \text{New capital} \\ \$18,000 + \$4,000 &= \$22,000 \end{aligned}$$

On the other hand, a loss would reduce the capital so:

$$\text{Old capital} - \text{Loss} = \text{New capital}$$

8.3 Profit or loss and sales

Profit will be made when goods are sold at more than cost price, while the opposite will mean a loss.

8.4 Profit or loss and expenses

In Section 8.1, it was shown that profit was made when the goods were sold for more than the cost price. As well as the cost of the goods, a firm incurs other expenses such as rent, salaries, wages, telephone and internet costs, motor expenses and so on. Every extra \$1 of expenses will mean \$1 less profit.

All expenses could be charged to one Expenses account, but it would then be difficult to identify specific areas of the firm's expenditure, such as the amount spent on motor running costs or rent. To facilitate the need to know different types of expenses, a separate account is opened for each type of expense, for instance:

Rent account	Salaries account	Wages account
Telephone/internet account	Advertising account	Insurance account
Stationery account	Motor expenses account	Postage account

In the same way that separate accounts are opened for each type of expense, separate accounts are also opened for any additional revenue that the business may receive, such as rent received or bank interest received. Again, separate revenue accounts can be opened as follows:

- Rent receivable account
- Commission received account
- Bank interest received account

It is purely a matter of choice in a business as to the nature of each expense or revenue account. For example, an account for postage stamps could be called 'Postage stamp account', 'Postage account' or even 'Communication expenses account'. Also, some businesses amalgamate expenses – for example, 'Printing, stationery and advertising account'. Infrequent or small items of expense are usually put into a 'Sundry expenses account' or 'General expenses account'.

8.5 Debit or credit

We have to decide whether expense accounts are to be debited or credited with the amounts involved. Assets involve expenditure by the firm and are shown as debit entries. Expenses also involve expenditure by the firm, and therefore should also be debit entries. Why? Because assets and expenses must ultimately be paid for. This payment involves a credit to the bank account (or cash account) so the original entry in the asset account or in the expense account must be a debit.

An alternative explanation may also be used for expenses. Every expense results in a decrease in an asset or an increase in a liability, and because of the accounting equation this means that the capital is reduced by each expense. The decrease of capital needs a debit entry and, therefore, expense accounts contain debit entries for expenses.

Revenue is the opposite of expenses and, therefore, appears on the opposite side to expenses – that is, revenue accounts appear on the credit side of the books. Pending the periodic calculation of profit, therefore, revenue is collected together in appropriately named accounts, and until it is transferred to the profit calculations it will need to be shown as a credit.

Consider, too, that expenditure of money pays for expenses, which are used up in the short term, or assets, which are used up in the long term – both for the purpose of gaining revenue. Both of these are shown on the debit side of the accounts, while the revenue that has been gained is shown on the credit side of the accounts.

8.6 Effect of transactions

A few illustrations will demonstrate the double entry required.

Example 1: Rent of \$200 is paid in cash. Here the twofold effect is:

- 1 **The total of the expense of rent is increased** – a benefit goes 'in'. As expense entries are shown as debits, and the expense is rent, so the action required is the debiting of the Rent account.
- 2 **The asset of cash is decreased** – money goes 'out'. This means crediting the Cash account to show the decrease of the asset.

Summary: Debit the Rent account with \$200 – 'in';

Credit the Cash account with \$200 – 'out';

Example 2: Motor expenses are paid with a cheque for \$550. The twofold effect is:

1 The total of the motor expenses paid is increased – a benefit is received 'in'.

To increase an expenses account needs a debit, so the action required is to debit the Motor expenses account – 'in'.

2 The asset of money in the bank is decreased – money goes 'out'. This means crediting the Bank account to show the decrease of the asset – 'out'.

Summary: Debit the Motor expenses account with \$550 – 'in'.
Credit the Bank account with \$550 – 'out'.

Example 3: \$260 cash is paid for telephone expenses. The twofold effect is:

1 The total of telephone expenses is increased – a benefit received goes 'in'.

Expenses are shown by a debit entry, therefore, to increase the expense account in question, the action required is to debit the Telephone expenses account.

2 The asset of cash is decreased – money goes 'out'. This needs a credit in the Cash account to decrease the asset.

Summary: Debit the Telephone expenses account with \$260 – 'in'.
Credit the Cash account with \$260 – 'out'.

It is now possible to study the effects of some more transactions showing the results in the form of a table. See Exhibit 8.1.

2017	Increase	Action	Decrease	Action
June 1 Paid for postage stamps by cash \$50	Expense of postage	Debit postage account (<i>in</i>)	Asset of cash	Credit cash account (<i>out</i>)
June 2 Paid for advertising by cheque \$590	Expense of advertising	Debit advertising account (<i>in</i>)	Asset of bank	Credit bank account (<i>out</i>)
June 3 Paid wages in cash \$1,960	Expense of wages	Debit wages account (<i>in</i>)	Asset of cash	Credit cash account (<i>out</i>)
June 4 Paid insurance by cheque \$420	Expense of insurance	Debit insurance account (<i>in</i>)	Asset of bank	Credit bank account (<i>out</i>)

▲ Exhibit 8.1

These examples can now be shown in account form:

Dr	Cash		Cr
	2017		\$
	Jun 1	Postage	50
	Jun 3	Wages	1,960
Dr	Bank		Cr
	2017		\$
	Jun 2	Advertising	590
	Jun 4	Insurance	420
Dr	Advertising		Cr
2017	\$		
Jun 2	Bank	590	

Dr		Insurance	Cr
2017		\$	
Jun 4	Bank	420	
Dr		Postage	Cr
2017		\$	
Jun 1	Cash	50	
Dr		Wages	Cr
2017		\$	
Jun 3	Cash	1,960	

8.7 Drawings

The owner may want to take cash out of the business for his or her private use. This is known as drawings. Money taken out as drawings will reduce capital.

Each amount taken as drawings will be debited to a drawings account and at the end of the year this is transferred to the capital account and will be explained later.

The following example illustrates the entries for drawings.

On 25 August 2017, the proprietor takes \$200 cash out of the business for his own use.

Effect	Action
1 Capital is decreased by \$200	Debit the drawings account \$200
2 Cash is decreased by \$200	Credit the cash account \$200

Dr		Drawings	Cr
2017		\$	
Aug 25	Cash	200	
Dr		Cash	Cr
		2017	\$
		Aug 25	Drawings 200

Sometimes goods are taken for private use. These are also known as drawings. Entries for such transactions will be described in Chapter 27 Section 27.9.

8.8 Revenues and double entry

We have just looked at instances of expenses being recorded. There will also be the need to record revenues. We will now look at an example.

Example: On 5 June 2017 it is decided that part of a firm's premises are not needed at the moment. The firm lets someone else use the surplus space and receives rent of \$740 by cheque. Here the twofold effect is:

- 1 **The asset of the bank is increased** – money comes 'in'. This means debiting the bank account to show the increase of the asset.
- 2 **The total of the revenue of rent received is increased** – the benefit comes 'out' of rent received so the action required is the crediting of the Rent received account.

Summary: Debit the Bank account with \$740 – 'in'.

Credit the Rent received account with \$740 – 'out'.

This will therefore appear as:

Dr		Bank	Cr
2017		\$	
Jun 5	Rent received	740	
Dr	Rent Received		Cr
		2017	\$
		Jun 5	Bank 740



Summary

- The calculation of profit is achieved by comparing revenues with expenses incurred in running the business.
- A loss occurs when the expenses incurred are more than the revenue earned.
- If a business makes a profit, that profit belongs to the owner of the business and consequently their capital is increased by that amount.
- It is important to record expenses in separate expense accounts to enable the business to identify various areas of expense such as motor expenses, stationery, etc.
- Different types of revenue should also be recorded in separate accounts to provide information of the income received.
- The procedure for recording expenses and revenue in the various accounts uses the double entry system.
- 'Drawings' are recorded in a separate account. They are then deducted from the owner's capital account and are never an expense of the business.

Exercise 8 Exercises

1 Complete the following table, showing the accounts to be debited and those to be credited.

- (a) Paid rates by cheque.
- (b) Paid staff by cash.
- (c) Rent received by cheque.
- (d) Received by cheque refund of insurance previously paid.
- (e) Paid general expenses by cash.

Account to be debited	Account to be credited

2 Complete the following table.

- (a) Paid rent by cash.
- (b) Paid for goods by cash.
- (c) Received by cheque a refund of rates already paid.
- (d) Paid general expenses by cheque.
- (e) Received commissions in cash.
- (f) Goods returned by us to T. Jones.
- (g) Goods sold for cash.
- (h) Bought office fixtures by cheque.
- (i) Paid staff in cash.
- (j) Took cash out of business for private use.

Account to be debited	Account to be credited

PART 1 INTRODUCTION TO PRINCIPLES OF ACCOUNTING

Q.12 Complete the following table, showing the accounts to be debited and those to be credited.

- (1) Paid insurance by cheque.
- (2) Paid motor expenses by cash.
- (3) Rent received in cash.
- (4) Paid rates by cheque.
- (5) Received refund of rates by cheque.
- (6) Paid for stationery expenses by cash.
- (7) Paid staff by cash.
- (8) Sold surplus stationery receiving proceeds by cheque.
- (9) Received sales commission by cheque.
- (10) Bought motor van by cheque.

Account to be debited	Account to be credited

Q.13 The following table should be completed.

- (1) Sold surplus stationery, receiving proceeds in cash.
- (2) Paid staff by cheque.
- (3) Rent received for premises sublet, by cheque.
- (4) Goods returned to us by B. Roberts.
- (5) Commission received by us previously in error, we now refund this by cheque.
- (6) Bought machinery by cheque.
- (7) Paid lighting expenses in cash.
- (8) Insurance rebate received by cheque.
- (9) Buildings bought by cheque.
- (10) Building repairs paid in cash.

Account to be debited	Account to be credited

Q.14 Enter the following transactions in the necessary accounts in double entry.

2017

- Jan 1 Started business with \$20,000 in the bank.
- Jan 2 U. Surer lent us \$10,000, giving us the money by cheque.
- Jan 3 Bought goods on credit, \$2,960 from T. Parkin.
- Jan 5 Bought motor van by cheque \$7,500.
- Jan 6 Cash sales \$1,050.
- Jan 7 Paid motor expenses in cash \$150.
- Jan 8 Paid wages in cash \$780.
- Jan 10 Bought goods on credit from C. Moore \$850.
- Jan 12 Paid insurance by cheque \$220.
- Jan 25 Received commission in cash \$1,500.
- Jan 31 Paid electricity bill by cheque \$370.

Q.15 The following are the transactions of C. Little for the month of May 2017. You are required to enter the transactions in the appropriate accounts using the double entry system.

2017

- May 1 Started business with \$12,000 in the bank.
- May 2 Purchased goods \$1,750 on credit from M. Mills.
- May 3 Bought fixtures and fittings \$1,500 paying by cheque.
- May 5 Sold goods for cash \$1,300.
- May 6 Bought goods on credit \$1,140 from S. Wong.
- May 10 Paid rent in cash \$250.
- May 12 Bought stationery \$87, paying by cash.
- May 18 Goods returned by us to M. Mills \$230.
- May 21 Let off part of the premises receiving rent by cheque \$100.
- May 23 Sold goods on credit to M. Brown for \$770.
- May 24 Bought a motor van paying by cheque \$3,000.
- May 30 Paid wages for the month in cash \$648.
- May 31 The proprietor, C. Little, took cash for himself amounting to \$200.

Write up the following transactions in the books of J. Blake for March 2017.

2017

- March 1 Started in business with \$15,000 capital in cash.
- March 2 Paid \$14,000 of the cash into a bank account for the business.
- March 2 Bought goods on credit from J. Paul for \$592.
- March 4 Paid for rent of premises by cash, \$250, and bought a motor van for \$3,000, paying by cheque.
- March 5 Bought goods, paying by cheque \$2,100.
- March 9 Sold goods to E. Ford for \$323 and received a cheque.
- March 11 Paid for printing of stationery, \$45, by cash.
- March 14 Cash sales \$490.
- March 18 Goods returned by us to J. Paul, \$67.
- March 19 Bought goods from J. Paul on credit, \$720.
- March 21 Paid for advertising, \$60, by cheque.
- March 24 Sold goods for cash, \$500.
- March 25 Paid the following expenses by cheque: wages \$540, motor expenses \$110, stationery \$82.
- March 28 Paid J. Paul \$1,245 by cheque.
- March 31 Sold goods for cash \$526.

Enter the following transactions in double entry.

2017

- July 1 Started business with \$8,000 in the bank.
- July 2 Bought stationery by cheque \$30.
- July 3 Bought goods on credit from I. Walsh \$900.
- July 4 Sold goods for cash \$180.
- July 5 Paid insurance by cash \$40.
- July 7 Bought machinery on credit from H. Morgan \$500.
- July 8 Paid for machinery expenses by cheque \$50.
- July 10 Sold goods on credit to D. Small \$320.
- July 11 Returned goods to I. Walsh \$70.
- July 14 Paid wages in cash \$70.
- July 17 Paid rent by cheque \$100.
- July 20 Received cheque \$200 from D. Small.
- July 21 Paid H. Morgan by cheque \$500.
- July 23 Bought stationery on credit from Express Ltd \$80.

- July 25 Sold goods on credit to N. Thomas \$230.
- July 28 Received rent \$20 in cash for part of premises sublet.
- July 31 Paid Express Ltd by cheque \$80.

Write up the following transactions in the records of D. DaSilva.

2017

- Mar 1 Started business with \$3,000 in the bank and \$2,000 cash.
- Mar 2 Bought goods on credit from: T. Small \$250; C. Todd \$190; V Ryan \$180.
- Mar 3 Bought goods for cash \$230.
- Mar 4 Paid rent in cash \$100.
- Mar 5 Bought stationery paying by cheque \$49.
- Mar 6 Sold goods on credit to: C. Crooks \$140; R. Rogers \$100; B. Grant \$240.
- Mar 7 Paid wages in cash \$600.
- Mar 10 We returned goods to C. Todd \$60.
- Mar 11 Paid rent in cash \$100.
- Mar 13 R. Rogers returns goods to us \$20.
- Mar 15 Sold goods on credit to: J. Burns \$90; J. Smart \$130; N. Thorn \$170.
- Mar 16 Paid rates by cheque \$130.
- Mar 18 Paid insurance in cash \$120.
- Mar 19 Paid rent by cheque \$100.
- Mar 20 Bought motor van on credit from C. White \$6,000.
- Mar 21 Paid motor expenses in cash \$60.
- Mar 22 Cash sales \$886.
- Mar 23 Paid wages in cash \$900.
- Mar 24 Received part of amount owing from B. Grant by cheque \$200.
- Mar 28 Received refund of rates \$10 by cheque.
- Mar 28 Paid following by cheque: T. Small \$250; C. Todd \$130; C. White \$600.