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Double entry bookkeeping (part 2)

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This article follows on from the previous article - [Double entry bookkeeping part 1](#).

The following topics are covered in this article:

- An introduction to the chart of accounts.
- Transferring the double entry transactions documented in Part 1 to a trial balance.
- Using the trial balance to produce a profit and loss account and balance sheet.
- Common mistakes to avoid.
- How double entry bookkeeping is sometimes abused to produce so called creative accounting.

Chart of accounts

The chart of accounts provides the skeleton for the accounts. For computerised systems it tends to be based on a code system. The accounts are placed in code order and by appropriate coding similar accounts can be grouped together. At the highest level all the profit and loss accounts will be grouped together as will all the balance sheet accounts. So for instance if a coding system from 0 to 10000 was used then 0 to 4999 could be reserved for balance sheet accounts and 5000 to 10000 for profit and loss accounts.

It is very important to correctly classify the account codes between profit and loss and balance sheet otherwise when balances are extracted to prepare the financial statements errors will occur. Fortunately modern web based accounting software such as Clear Books automatically classify the account codes correctly for you.

Trial balance

To produce accounts from the double entry items there is an intermediate stage known as the trial balance. At this stage all the debit entries and credit entries are summed up for each account.

The table below shows the trial balance based upon the double entry items which were documented in part 1 of the article. Note that the total of debits and credits must balance (that is the "balance" part of trial balance).

Code	Heading	Reference from Part 1	Dr	Cr
1000	Fixtures and fittings	3	60	
1001	Fixtures and fittings depreciation	4		20
2000	Prepayments	5	10	
2010	Trade debtors	1	120	120
2020	Cash	1,2,3,7,8	120 ₍₁₎ +200 ₍₇₎	24 ₍₂₎ +72 ₍₃₎ +20 ₍₈₎
3000	Trade creditors	2,3	24+72	24+72
3010	Accruals	6		6
3020	VAT control	1,2,3	4+12	20
4000	<u>Bank loan</u>	7,8	16	200
5000	Sales	1		100
6000	Rent	2	20	10
6100	Utilities	6	6	
7000	Interest paid	8	4	
8000	Depreciation	4	20	
	Total		688	688

Once the debits and credits are summed up for each account they are netted off to leave a single net Dr or Cr balance for each account. If the Dr and Cr entries are exactly equal there will be a nil balance on the account.

Code	Heading	Reference from Part 1	Dr	Cr
1000	Fixtures and fittings	3	60	
1001	Fixtures and fittings depreciation	4		20
2000	Prepayments	5	10	
2010	Trade debtors	1		
2020	Cash	1,2,3,7,8	204	
3000	Trade creditors	2,3		
3010	Accruals	6		6
3020	VAT control	1,2,3		4
4000	<u>Bank loan</u>	7,8		184
5000	Sales	1		100
6000	Rent	2	10	
6100	Utilities	6	6	
7000	Interest paid	8	4	
8000	Depreciation	4	20	
	Total		314	314

Extract balances to generate profit and loss account and balance sheet

The key here is to make sure that accounts are correctly extracted to either the profit and loss account or balance sheet. The profit and loss accounts are those numbered 5000 and higher. They are also indicated above by the line between bank loan and sales - everything below the line is a profit and loss account and everything above the line is a balance sheet account.

As well as adding all the balances above the profit and loss balance calculated from the profit and loss statement is added to the bottom part of the balance sheet as retained profit.

Profit and loss statement		£
Sales		100
Admin expenses (rent + utilities)		(16)
Depreciation		(20)
Interest		<u>(4)</u>
Profit before tax		60
Balance sheet		£ £
Assets and liabilities		
Fixtures & Fittings (60-20)	40	
Cash	204	
Prepayments	<u>10</u>	
Accruals	(6)	
VAT creditor	(4)	
Bank loan	<u>(184)</u>	
		<u>(194)</u>
Net Assets		60
Capital and reserves		
Retained Profit		60

The first check is to make sure the top half and the bottom half of the balance sheet balance. They do. The next check is to ensure that all the balances in the profit and loss are really profit and loss accounts and likewise with the balance sheet. In this case they are so we can rely upon our profit figure of £60 and our net assets of £60.

How constructing the profit and loss statement and balance sheet can go wrong

In this example we look at what happens if accounts are not correctly allocated to the profit and loss account or balance sheet.

Code	Heading	Reference from Part 1	Dr	Cr
1000	Fixtures and fittings	3	60	
1001	Fixtures and fittings depreciation	4		20
2000	Prepayments	5	10	
2010	Trade debtors	1		
2020	Cash	1,2,3,7,8	204	
3000	Trade creditors	2,3		
3010	Accruals	6		6
3020	VAT control	1,2,3		4
4000	Bank loan	7,8		184
5000	<u>Sales</u>	1		100

Code	Heading	Reference from Part 1	Dr	Cr
6000	Rent	2	10	
6100	Utilities	6	6	
7000	Interest paid	8	4	
8000	Depreciation	4	20	
	Total		314	314

In the trial balance above the line separating profit and loss accounts from balance sheet accounts has been moved down so that sales is now included as a balance sheet account in error.

Extracting the profit and loss statement and balance sheet gives the following.

Profit and loss statement		£
Admin expenses (rent + utilities)		(16)
Depreciation		(20)
Interest		<u>(4)</u>
Loss before tax		(40)
Balance sheet		£
		£
Assets and liabilities		
Fixtures & Fittings (60-20)	40	
Cash	204	
Prepayments	<u>10</u>	
		254
Accruals	(6)	
VAT creditor	(4)	
Bank loan	(184)	
Sales	<u>(100)</u>	
		<u>(294)</u>
Net Assets		(40)
Capital and reserves		
Retained Profit		(40)

Looking firstly at the balance sheet we can see that it balances so the financial statements have passed that test. On the next review as to whether accounts have been correctly allocated we can see that sales has ended up on the balance sheet which is incorrect.

This has meant that a £100 “good” credit entry on the profit and loss account has been turned into a £100 “bad” credit entry on the balance sheet. Therefore both profit and net assets have been incorrectly reduced. In the case of profit a £60 profit now shows as a £40 loss. Instead of £60 net assets there now appears to be £40 net liability.

This is a good example of how the financial statements can be incorrect even though the balance sheet balances.

“Creative” accounting

The previous example looked at what happened when a credit that should have been in the profit and loss account ended up in the balance sheet. Due to the nature of double entry accounting the reported financial position significantly worsened. This is because a credit entry produces a good effect on the profit and loss account and a bad effect on the balance sheet.

For a company wanting to improve their reported financial position the opposite effect is required. You will recall that debit entries are bad on the profit and loss and good on the balance sheet. So to improve the financial position then the business will want to move debit balances from the profit and loss account to the balance sheet. How is that justified?

Well for example let's look at a company developing a software platform which it expects to help in the running of its business (not for resale). The platform is being developed internally by the technical team. The usual way to deal with staff wages would be for them to be treated as an expense as a Dr to the profit and loss account. This would have the effect of reducing the profit by the amount of those wages.

However perhaps it could be argued that an asset has been created which can be used in the servicing of the business - rather like a fixed asset but created from internal resources. If this was the case the Dr entry could be moved from the profit and loss account where it depressed profits to the balance sheet where it will be seen as an asset!

The simple example considers a company which has made £100 of sales and paid £50 of wages to develop software for use in the business.

Standard accounting

	Trial Balance	Dr	Cr
Intellectual property asset			
<u>Cash</u>		50	
Sales			100
Wages		50	
	Profit and loss statement		£
Sales			100
Wages			<u>(50)</u>
Profit			50
	Balance Sheet	£	£
Net Assets			
Cash			50
Capital and reserves			
Retained profit			50

Aggressive accounting

	Trial Balance	Dr	Cr
Intellectual property asset		50	
<u>Cash</u>		50	
Sales			100
Wages			
	Profit and loss statement		£
Sales			100
Wages			<u>0</u>
Profit			100
	Balance Sheet	£	£

Net Assets		
Intellectual property	50	
Cash	<u>50</u>	
		100
Capital and reserves		
Retained profit		100

As you can see the aggressive accounting doubled the reported profitability and net assets.

In reality there are a lot of rules and regulations about this type of transaction as well as auditors who police the rules for larger companies. All the same there are still considerable pressures and temptations for some companies to indulge in aggressive accounting.

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