

Double Entry Bookkeeping

CAF - 01

History

The **history of accounting** or accountancy is thousands of years old.

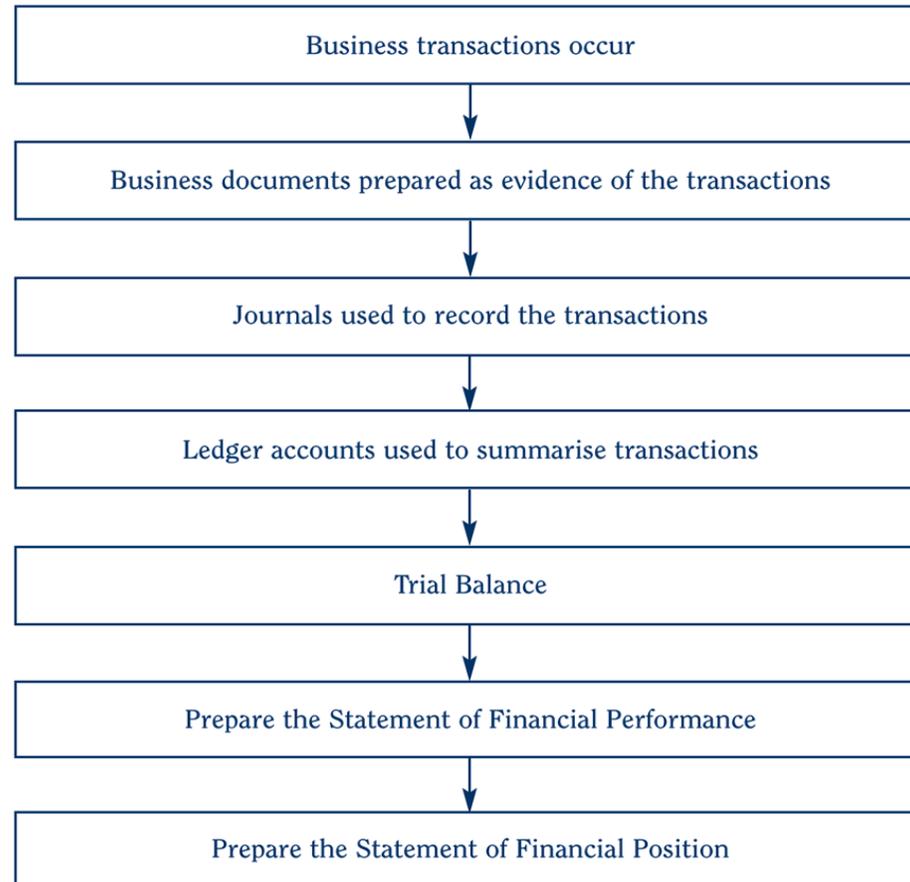
The Italian Luca Pacioli (Italian Mathematicians), recognized as *The Father of accounting and bookkeeping* was the first person to publish a work on double-entry bookkeeping in 1494, and introduced the field in Italy.

Introduction

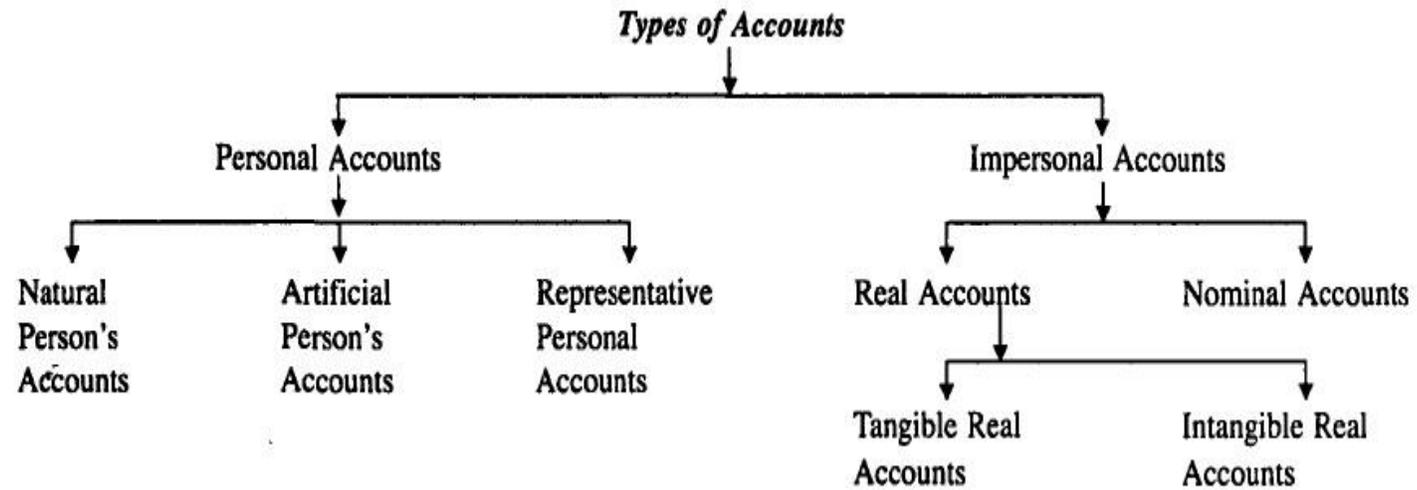
- ▶ Each financial event is called a ***transaction***
- The effect of a transaction is recorded in the accounts by an ***entry***
- Each entry will affect at least two parts of the accounting record to balance the record
- This does not mean that the financial event is recorded twice – rather it is balanced against either costs, increased or reduced liability, changes in inventory, etc.

- ▶ The double-entry system provides checks and balances to ensure that your books are always in balance.
- ▶ In double-entry accounting, every transaction has two journal entries: a debit and a credit. Debits must always equal credits.

Flow of Information



Types of Accounts



Personal Accounts

(a) **Natural Person's Account:** Natural Person's Accounts are meant for recording transactions of business deals with individual persons. For example, Thomas Account, Raman's Account, Nancy Account etc.

(b) **Artificial Persons or Legal Bodies:** An account recording financial transaction of business deals with an artificial persons or legal bodies created by law or otherwise called an Artificial Personal Account. For example, Firm's Account, Limited Companies, Bank Account etc.

(c) **Representative Personal Account:**

An account indirectly representing a person or persons is known as a Representative Personal Account. All accounts recording financial transactions of outstanding expenses and accrued or prepaid incomes are Representative Personal Account. For example, Salaries Outstanding Account is a personal account representing salaries payable to the staff.

Real Accounts

- ▶ Real Account refers to an account recording financial transactions of business connected with assets is known as Real Account or Property Accounts.
- ▶ The Real Accounts may be
Tangible Real Account
and **Intangible Real Account**.

▶ **Tangible Real Account**

refers to an account relates to an asset which can be touched, felt and measured. For example, Building, Goods, Furniture, Machinery etc.

▶ **Intangible Real Account**

refers to an account which relates to an asset which cannot be touched and measured physically. For example, Trade Mark, Goodwill, Patent, Copy Rights etc.

Nominal Accounts

- ▶ Nominal Accounts are recording transactions of business connected with expenses, incomes, profit or losses etc
- ▶ For example, Rent Account, Salaries Account, and Interest Account, etc.

Classify the following under Personal, Real and Nominal accounts:

- ▶ Stock.
- ▶ Prepaid Interest.
- ▶ Building.
- ▶ Insurance.
- ▶ Bank.
- ▶ Capital.
- ▶ Drawing.
- ▶ Fixtures.
- ▶ Machinery.
- ▶ Interest.
- ▶ Salary Prepaid.
- ▶ Loan.
- ▶ Salary.
- ▶ Cash.
- ▶ Salary O/S.
- ▶ Bank Overdraft.
- ▶ Bills Receivable.
- ▶ Goodwill.

Stock	Real Account
Loan	Personal Account
Insurance	Nominal Account
Salary	Nominal Account
Interest	Nominal Account
Bank	Personal Account
Cash	Real Account
Capital	Personal Account
Prepaid Interest	Personal Account
Goodwill	Real Account

Salary Outstanding	Personal Account
Bank overdraft	Personal Account
Salary prepaid	Personal Account
Fixtures	Real Account
Drawings	Personal Account
Bill receivable	Real Account
Machinery	Real Account
Building	Real Account

Double Entry System

The double-entry accounting system recognizes both the debit and credit side of a business transaction.

Account Name	
Left Side	Right Side
Debit Side	Credit Side
Debit	Credit



double-entry accounting

A system used to analyze and record a transaction.



debit

An entry on the left side of an account.



credit

An entry on the right side of an account.

▶ Newton' Third Law of Motion

For every action there is an equal and opposite reaction

▶ Accounting rules

For every Debit there is an equal and opposite Credit recorded in the accounting records

How to Apply Double Entry?

When analyzing
business transactions,
you should

Apply the rules of debit
and credit.

Complete the entry in
T-account form.

Debits and Credits

Debit = Left

Credit = Right

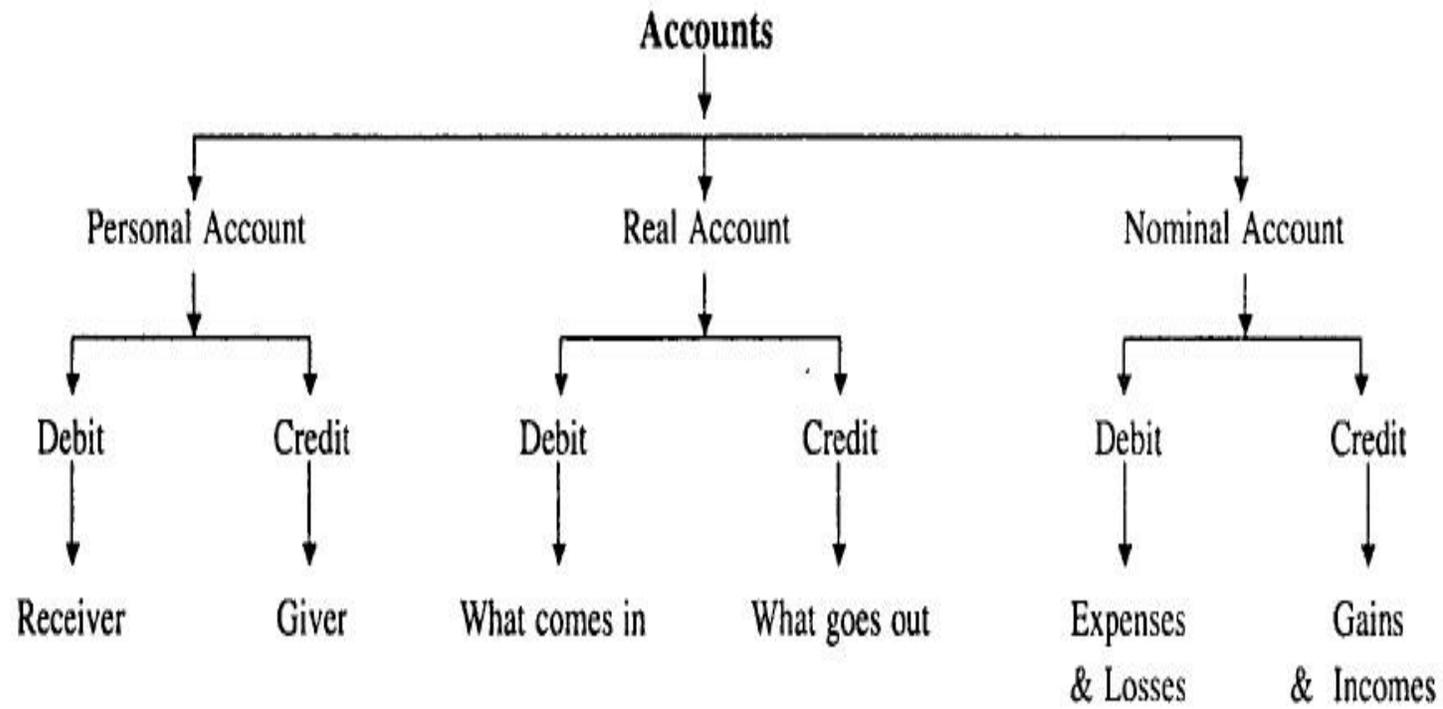
Assets		=	Liabilities		+	Equity	
Debit	Credit		Debit	Credit		Debit	Credit
+	-		-	+		-	+

In every transaction, the total dollar value of all debits equals the total dollar value of all credits.

British System

Accounts	Rules
Personal	<ul style="list-style-type: none">• Debit the receiver• Credit the giver
Real	<ul style="list-style-type: none">• Debit what comes in• Credit what goes out
Nominal	<ul style="list-style-type: none">• Debit all expenses and losses• Credit all incomes and gains

Accounts



American System

Journal Entry Debit / Credit Chart		
Account Type	Debits	Credits
Income	Decrease	Increase
Expense	Increase	Decrease
Equity	Decrease	Increase
Asset	Increase	Decrease
Liability	Decrease	Increase

RULES OF DEBIT AND CREDIT



	Debit	Credit
Balance Sheet	Assets	Liabilities
Profit & Loss	Expenses	Income

Debit	Credit
+	-
-	+
-	+
+	-
-	+

double-entry accounting

*requires that every
business transaction
be recorded in
at least two accounts*

Accounting Equation

Assets = Liabilities + Equity

Assets		=	Liabilities		+	Equity	
Debits	Credits		Debits	Credits		Debits	Credits
							
Increase	Decrease		Decrease	Increase		Decrease	Increase

Journal Entries

The general journal (journal for short) is a book of prime entry that is used to record transactions that are not recorded in any other book of original entry.

- ▶ The journal might be used to provide a record and explanation of:
 - ▶ postings from books of prime entry (explained in chapter 5);
 - ▶ year-end adjustments (chapters 6 to 9);
 - ▶ correction of errors (chapter 11) or
 - ▶ any other adjustment.

General Journal Format

Illustration:

	Debit	Credit
Name of the account with the debit entry	X	
Name of the account with the credit entry		X
Narrative explaining or describing the transaction		

Example

Salary paid

Interest received

Machinery purchased for cash

Building sold

Outstanding salary

Received cash from Ramesh

Proprietor introduced capital

Dividend received

Commission paid

Furniture purchased for cash

<i>Transactions</i>	<i>Accounts Involved</i>	<i>Types of Accounts</i>	<i>Rules of Debit and Credit</i>
(1) Salaries	Salary A/c Cash A/c	Nominal Real	Debit all expenses and losses Credit what goes out
(2) Interest received	Cash A/c Interest A/c	Real Nominal	Debit what comes in Credit all incomes and gains
(3) Machinery Purchase	Machinery A/c Cash A/c	Real Real	Debit what comes in Credit what goes out
(4) Building Sold	Cash A/c Building A/c	Real Real	Debit what comes in Credit what goes out
(5) Outstanding Salary	Salary A/c Outstanding Salary A/c } }	Nominal Personal	Debit all expenses and losses Credit the giver
(6) Received cash Cash from Remesh } }	Cash A/c Ramesh A/c	Real Personal	Debit what comes in Credit the giver
(7) Capital introduced	Cash A/c Capital A/c	Real Personal	Debit what comes in Credit the giver
(8) Dividend received	Cash A/c Dividend A/c	Real Nominal	Debit what comes in Credit all incomes and gains
(9) Commission paid	Commission A/c Cash A/c	Nominal Real	Debit all expenses and losses Credit what goes out
(10) Furniture purchased	Furniture A/c Cash A/c	Real Real	Debit what comes in Credit what goes out

General Ledger

- ▶ The general ledger is a document which contains all of the individual accounts which are used to record the double entries of a business. It may have physical form as a book or it may be a software application.
- ▶ Usually a business will organise its general ledger into the specific accounts which it uses.

Chart of Accounts

- ▶ This is a list of accounts created by a business to be used to organise its financial transactions into identified categories of assets, liabilities, income and expenses.
- ▶ A company might have complete freedom in designing its chart of accounts (within the boundaries set by the rules of accounting).
- ▶ In some countries, the government might issue a generic chart of accounts from which a business selects those codes that are appropriate to its needs.
- ▶ The aim of the chart is to ensure that all transactions are recognised in accordance with the requirements of the business.

Sample Chart of Accounts

Chart of Accounts		
Account #	Account Name	Account Type
101	Cash	Asset
102	Accounts Receivable	Asset
103	Office Furniture	Asset
104	Computer	Asset
105	Office Supplies	Asset
201	Accounts Payable	Liability
202	Rent Payable	Liability
203	Salaries Payable	Liability
204	Note Payable	Liability
205	Payroll Taxes Payable	Liability
301	John Doe, Capital	Owner's Equity
302	John Doe, Drawing	Owner's Equity
401	Consulting Revenue	Revenue
501	Office Supplies Expense	Expense
502	Rent Expense	Expense
503	Utilities Expense	Expense
504	Payroll Expense	Expense

T - Account

The T account gets its name from being shaped like a T.

Account Name	
Left Side	Right Side
Debit Side	Credit Side
Debit	Credit



T-account

A visual representation of a ledger account. The T account is a tool used to analyze transactions.

Year End Exercise

- ▶ **Step 1:** Perform double entry as necessary to capture the year-end adjustments in the general ledger accounts.
- ▶ **Step 2:** Perform double entry to transfer all incomes statements amounts to a profit or loss general ledger account.

- ▶ **Step 3:** Close off this account
- ▶ **Step 4:** Transfer the balance on this account to capital.
- ▶ **Step 5:** Transfer the balance on the drawings account to capital and close off the capital account.

Trail Balance

- ▶ A trial balance is a list of all the debit balances and all the credit balances on the accounts in the main ledger. A trial balance is 'extracted' from the main ledger simply by listing the balances on every account.
- ▶ The normal method of presentation is to present the balances in two columns, one for debit balances and one for credit balances.
- ▶ Debit balances are assets, expenses or drawings.
- ▶ Credit balances are liabilities, income or equity (capital including share capital and reserve accounts in the case of a company).

Purpose

- ▶ It is a starting point for producing a statement of comprehensive income and a statement of financial position at the end of an accounting period.
- ▶ It is a useful means of checking for errors in the accounting system. Errors must have occurred if the total of debit balances and total of credit balances on the main ledger accounts are not equal.

Preparing accounts from trail balance

- ▶ A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts.

- ▶ **Year end adjustments:**
 - ▶ Depreciation expense (to reflect the use of non-current assets);
 - ▶ Accruals and prepayments;
 - ▶ Bad and doubtful debts; and
 - ▶ Inventory.

- ▶ **Further adjustments:**
 - ▶ Missed items
 - ▶ Incorrect items

LIMITATIONS OF A TRIAL BALANCE

- **A trial balance does not prove that all transactions have been recorded or that the ledger is correct.**
- **Numerous errors may exist even though the trial balance columns agree.**
- **The trial balance may balance even when:**
 - * **a transaction is not journalized,**
 - * **a correct journal entry is not posted,**
 - * **a journal entry is posted twice,**
 - * **incorrect accounts are used in journalizing or posting,**
 - * **offsetting errors are made in recording the amount of the transaction.**

Make and complete accounts using the following information.

- ▶ Jan 1 - Started Business with PKR 30,000 in bank
- ▶ Jan 5 - Bought stock of goods paying PKR 2,770 cheque
- ▶ Jan 7 - Bought a van, PKR 4,800 cheque
- ▶ Jan 9 - Sold goods for PKR 680 cash
- ▶ Jan 10 - Bought desk & chair for the office for PKR 110 cash
- ▶ Jan 15 - Sold goods for PKR 500 cheque
- ▶ Jan 22 - Paid PKR 92 cash for motor expenses
- ▶ Jan 29 Sold goods for PKR 325 cash
- ▶ Jan 30 - Bought more goods, paid PKR 1090 cheque

Bank Account					
Jan-01	Capital	30,000	Jan-05	Purchases	2,770
Jan-15	Sales	500	Jan-07	S/H Van	4,800
			Jan-27	Computer Equipment	2,100
			Jan-30	Purchases	1,090
Capital Account					
			Jan-01	Bank	30,000
Purchases Account					
Jan-05	Bank	2,770			
Jan-30	Bank	1,090			
Van Account					
Jan-07	Bank	4,800			
Cash Account					
Jan-09	Sales	680	Jan-10	Office Furniture	110
Jan-29	Sales	325	Jan-22	Motor Expenses	92
Sales Account					
			Jan-09	Cash	680
			Jan-15	Bank	500
			Jan-29	Cash	325
Office Furniture Account					
Jan-10	Cash	110			
Motor Expenses Account					
Jan-22	Cash	92			
Computer Equipment Account					
Jan-27	Bank	2,100			