

# Double entry bookkeeping

In this chapter you will learn about the principles of the double entry bookkeeping system and record a variety of business transactions in the General Ledger.



## OBJECTIVES

ON THE COMPLETION OF THE CHAPTER YOU SHOULD BE ABLE TO:

1. Explain the principles of the double entry bookkeeping system.
2. State the rules of debit and credit for each group of accounts.
3. Describe the flow of information through an accounting system.
4. Explain the nature and purpose of journals and their relationship to the ledger.
5. Explain the nature and purpose of a ledger.
6. Record a variety of business transactions in appropriate ledger accounts.
7. Explain the nature and purpose of a Trial Balance.


**OBJECTIVE 1**

Explain the principles of the double entry bookkeeping system

## Principles of the double entry bookkeeping system

Processing transactions in accounting is done by what is called **double entry** recording. As the name suggests there are at least two entries. Some examples of this are:

- *Using cash to buy a motor vehicle*: this transaction will reduce the Bank account and at the same time increase the Motor vehicle account.
- *A debtor paying an account*: this transaction will result in the Bank account increasing and the Debtor's account decreasing.
- *Paying cash to a creditor*: this transaction will result in the Bank account decreasing and the Creditor's account decreasing.

In all these examples there are at least two effects to each transaction. There is a change of resources. One account may increase and another decrease. To record these increases and decreases accountants use a system utilising debits and credits.

An amount is recorded as a **debit** with a corresponding amount being recorded as a **credit**. The rule is that for every debit there must be a corresponding credit. The debit is always recorded on the left-hand side while the credit is on the right-hand side of an account. This means that the monetary value of the debits must equal the monetary value of the credits; that is, \$DEBIT = \$CREDIT. This method of recording is called double entry bookkeeping and provides a self-balancing mechanism. Therefore when recording a transaction it must be decided which accounts are debits and which are credits. This principle can be represented by the accounting equation as:

$$A + E = L + OE + R$$

$$(\text{DEBITS}) = (\text{CREDITS})$$

where

A = assets  
 E = expenses  
 L = liabilities  
 OE = owner's equity  
 R = revenue


**OBJECTIVE 2**

Explain the rules of debits and credits

## Rules of debits and credits

As seen in the previous chapter there is a relationship between assets, liabilities, owner's equity, expenses and revenue. There is a set of rules for recording transactions that affect these elements.

Debits and credits provide the general principles used to record transactions in accounts. Increases in the Assets accounts are shown as debits while increases in the Liabilities and Owner's equity accounts are shown as credits. Because Owner's equity accounts have a credit balance, an increase in Revenue accounts that increases the owner's equity will also have a credit balance. Therefore since expense items decrease owner's equity they normally have a debit balance. Applying these rules should ensure that the accounting equation is maintained.

The debit (DR) and the credit (CR) rules are as follows:

Accounting element	On which side is an increase recorded?	On which side is a decrease recorded?
Assets	Debit side	Credit side
Expenses	Debit side	Credit side
Liabilities	Credit side	Debit side
Owner's equity	Credit side	Debit side
Revenue	Credit side	Debit side

- The debit side is the left-hand side of the account.
- The credit side is the right-hand side of the account.

Remember the terms debit and credit refer only to a particular side of an account.

Do not think of a credit as something good and a debit as something bad. Accountants use the terms debit and credit instead of saying left-hand side and right-hand side.

## Flow of information

The flow of information starts with the source documents of the business. These documents substantiate that the transactions took place. Examples of source documents are sales invoices, purchase invoices, cash register tapes, cheque butts, delivery dockets, receipts and credit notes.

The preparation of journals is the next step in the accounting process. The journals summarise the information from the source documents, which makes processing easier and more convenient. The summarised information is then entered into ledgers. There are seven different types of journals. For the types of transactions that occur most frequently there are six special journals. Those items that do not occur frequently are entered into the General Journal.

The General Ledger account records all transactions relating to a particular item. There is a ledger account for every Asset, Liability, Owner's equity, Revenue and Expense account. The two common formats for the ledger accounts are the columnar format and the T-account format.

The Trial Balance shows all the balances of the accounts in the General Ledger. It totals all the balances of the debits and all the balances of the credits thereby showing if errors have been made. The Trial Balance is the basis for the preparation of the financial statements.

The Statement of Financial Performance shows the results of the firm's trading. The statement matches the revenue earned against the expenses incurred and therefore shows if the firm has made a profit or a loss. It shows the financial performance of the business.

The Statement of Financial Position shows the assets, liabilities and owner's equity of the firm. It shows the financial position of the business.

The flow of information starts with raw data, which is gradually transformed into financial statements. These statements provide managers with information to help them make business decisions. Therefore the more

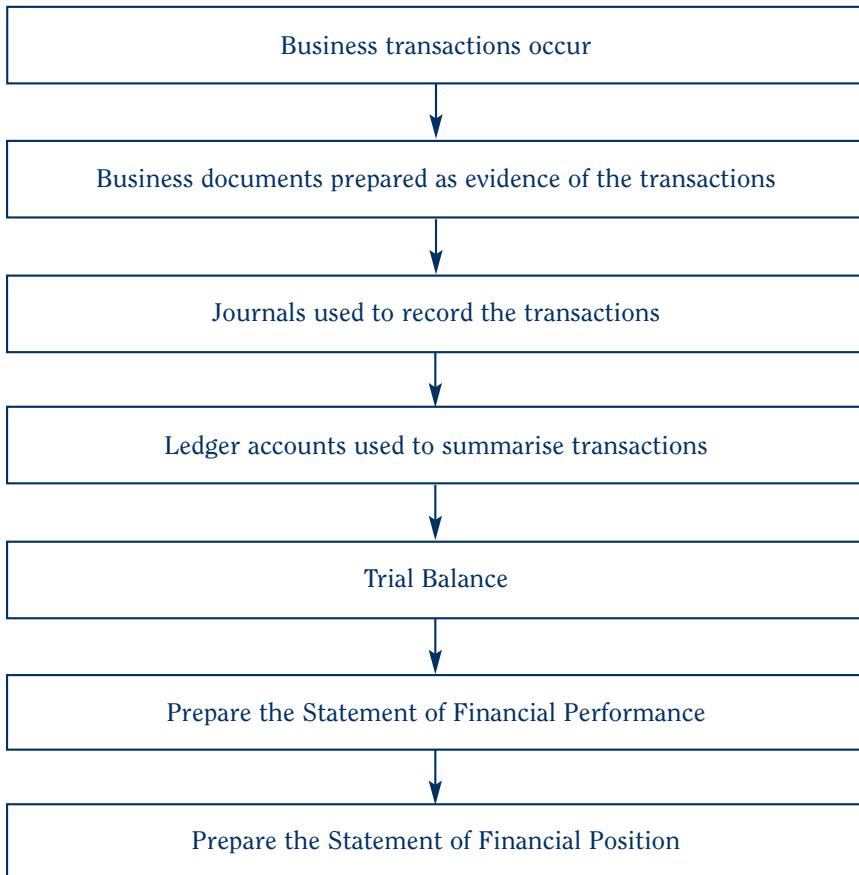


### OBJECTIVE 3

Describe the flow of information through an accounting system

accurate these reports are the greater the chance managers have of making informed decisions.

There are a number of steps that information flows through in an accounting system:



#### OBJECTIVE 4

Explain the nature and purpose of journals and their relationship to the ledger

## Journals and ledgers

A journal summarises information from similar source documents. The information from these source documents is summarised into journals before it is entered into the ledger. Transactions are sorted into like groupings. This allows each group to be recorded in a separate journal. Journals are day books in date order which record the history of the business through its monetary transactions. There are several different kinds of journals. The Cash Receipts Journal and the Cash Payments Journal are often called the cashbooks. The common journals for a trading business are:

1. **Cash Receipts Journal** Records all cash and cheques received. It records all funds coming into the business whether it be cash or in cheque form.

Date	Received from	Receipt number	Discount allowed \$	Accounts receivable \$	Cash sales \$	GST payable \$	Bank \$

Diagram illustrating the Cash Receipts Journal structure with arrows pointing to labels:

- Receipt date (points to Date)
- Why receipt was issued (points to Received from)
- Receipt number (points to Receipt number)
- Payments received (points to Accounts receivable and Cash sales)
- Record GST sales (points to GST payable)
- Amount received (points to Bank)

2. Cash Payments Journal Records all payments by cash or cheque.

Date	Paid to	Cheque number	Discount received \$	Accounts payable \$	Cash purchases \$	GST received \$	Other \$	Bank \$

Diagram illustrating the Cash Payments Journal structure with arrows pointing to labels:

- Cheque date (points to Date)
- Reason for writing cheque (points to Paid to)
- Cheque number (points to Cheque number)
- Record payment to creditor and discount received (points to Accounts payable and Discount received)
- Record GST purchases (points to Cash purchases and GST received)
- Cheque amount (points to Bank)

3. Sales Journal Records all sales of trading stock, that is, inventories, on credit. The invoice that is sent out will contain all the necessary information.

Date	Sold to	Invoice number	Sales amount \$	GST payable \$	Total \$

Diagram illustrating the Sales Journal structure with arrows pointing to labels:

- Date of invoice (points to Date)
- Customer's name (points to Sold to)
- Invoice number (points to Invoice number)
- Value of goods sold (points to Sales amount)
- GST charged (points to GST payable)
- Total value of invoice (points to Total)

4. **Sales Returns and Allowances Journal** Records the returns of credit sales, that is, those returns originally recorded in the Sales Journal.

Date	Returned to	Credit note number	Amount \$	GST payable \$	Total \$

↑ Date of invoice      ↑ Customer's name      ↑ Credit note number      ↑ Value of goods      ↑ GST charged      ↑ Total value of invoice

5. **Purchases Journal** Records all the purchases of inventory on credit. The information for the Purchases Journal is obtained from invoices the supplier has given.

Date	Purchased from	Invoice number	Purchases \$	GST receivable \$	Total \$	Withholding tax payable \$

↑ Date of invoice      ↑ Supplier's name      ↑ Invoice number      ↑ Purchase value of goods      ↑ GST on purchase      ↑ Total value      ↑ If **no** ABN, 48.5% withheld


6. **Purchases Returns and Allowances Journal** Records the return of credit purchases or allowances that were previously purchased on credit. Information for this journal is obtained from a credit note received from a supplier.

Date	Returned from	Credit note number	Amount \$	GST receivable \$	Total \$	Withholding tax payable \$


↑ Date of invoice      ↑ Supplier's name      ↑ Credit note number      ↑ Value of goods returned      ↑ GST on returns      ↑ Total value      ↑ Reversal of withholding tax

7. **General Journal** Records any transaction that is not recorded in one of the specialised journals. A small business may in fact record all its entries in a General Journal.


Date	Details	Debit \$	Credit \$	Balance \$



Date of transaction



Amount to be debited



Amount to be credited

Typical transactions and their appropriate journals are:

Transaction	Journal
(a) Cash sale	Cash Receipts Journal
(b) Cash payment	Cash Payments Journal
(c) Credit sales	Sales Journal
(d) Credit purchase	Purchases Journal
(e) Credit sales return	Sales Returns and Allowances Journal
(f) Credit purchase return	Purchases Returns and Allowances Journal
(g) Starting of the business	General Journal

A service business would not have a Sales Journal, Sales Returns and Allowances Journal, Purchases Journal or a Purchases Returns and Allowances Journal because there are no goods to be accounted for.

A journal has a number of functions, including:

- categorising similar items together;
- providing a permanent record of the transaction;
- classifying items into debit and credit; and
- assisting in posting transactions to the ledger.

Journals are set up so as to eliminate excessive detail from the ledger. Because the journals summarise the transactions it means that information is entered into the ledgers in a summarised format. Each special journal is set up for a particular purpose; for example, a cash sale uses the Cash Receipts Journal. However, if an entry cannot be placed into a special journal, perhaps because it occurs infrequently, then it is entered into the General Journal.

What type of transactions will go into the following journals?

(a) Cash Payments Journal \_\_\_\_\_

(b) Credit Purchases Journal \_\_\_\_\_

(c) General Journal \_\_\_\_\_

(d) Cash Receipts Journal \_\_\_\_\_

**ACTIVITY**

**1**


**OBJECTIVE 5**

Explain the nature and purpose of ledger accounts

## Ledger accounts

Ledger accounts record all transactions relating to a particular account. Information is transferred or posted to the General Ledger from the journals. The General Ledger will show all the changes to the particular account. An account is kept for every asset, liability, owner's equity, revenue and expense.

Ledger accounts can be in a columnar format or a T format.

### Columnar format

The columnar format is generally used in preference to the T account. In practice, a columnar account is used because it offers the advantage of having the balance calculated after each entry has been recorded. This means that there is a running balance and it is easy to see what the current balance is. Most if not all computer accounting packages use the columnar format, shown below.

ACCOUNT NAME					
Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$

Annotations:

- Shows when the transaction took place (points to Date column)
- The name of the account is shown (points to ACCOUNT NAME header)
- Balance of the account after the transaction has been recorded. The balance can be either a debit or a credit (points to Balance column)
- Shows the other account affected by the transaction (points to Particulars column)
- Shows the amount in dollar terms (points to Debit and Credit columns)

For example, suppose that on 1 July 200X ET commenced a child-minding business by depositing \$10 000 into a bank account. The Bank account ledger would be as shown below. Because this transaction also affects the Capital account, a ledger account for that account also needs to be set up. However, in this example, only the Bank account will be illustrated.

BANK					
Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
1 July	Capital		10000		10 000 DR

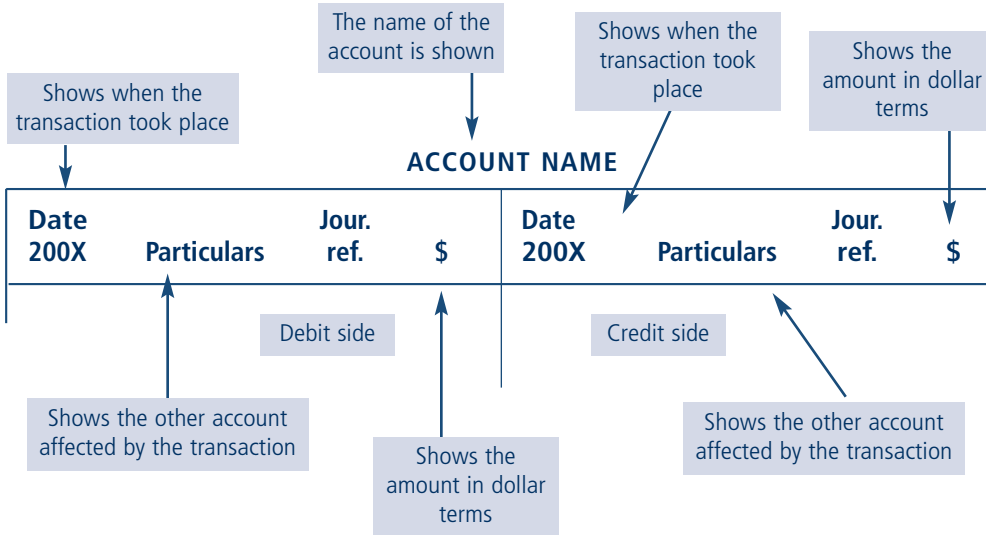
Annotations:

- Shows when the transaction took place (points to Date column)
- The name of the account is shown (points to BANK header)
- Balance of the account after the transaction has been recorded. The balance can be either a debit or a credit (points to Balance column)
- Shows the other account affected by the transaction (points to Particulars column)
- Shows the amount in dollar terms (points to Debit and Credit columns)

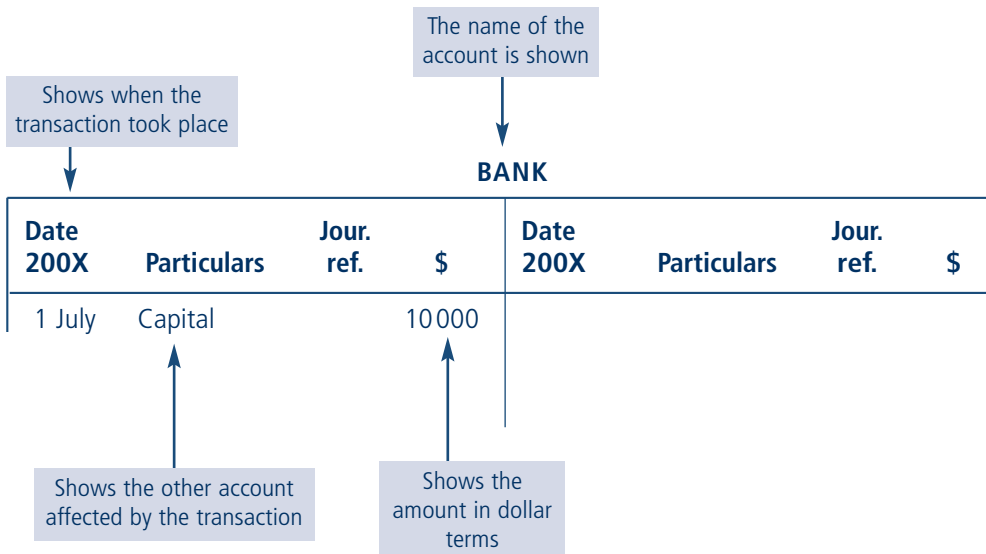


## T-account format

The other format is the T account. As the name suggests, the account looks like a large ‘T’. The left side of the T account shows debits and the right side shows credits.



The same example as that above will be used, that is, on 1 July 200X ET commenced a child-minding business by depositing \$10 000 into a bank account. The Bank account ledger using the T-account format would be as shown below. Because this transaction also affects the Capital account, a ledger account for that account also needs to be set up. However, in this example only the Bank account will be illustrated.



A difference between the T account and the columnar account is that the T account does not have a column to show the balance at the end of each transaction. This may lead to confusion when looking at an account. As a result of this a balancing procedure needs to be adopted at the end of an accounting period to calculate the balance of each account.


**OBJECTIVE 6**

Record a variety of business transactions in appropriate ledger accounts

## Recording transactions in ledger accounts

To illustrate how transactions are recorded in columnar ledger accounts look at the transactions in the example below.

### Illustrative example 1

- 1 July 200X: ET commenced a child-minding business by depositing \$10 000 into a bank account.
- 2 July: ET bought equipment for \$4000 cash.
- 3 July: ET bought supplies for \$2000 cash from DL Company.
- 4 July: Received \$100 for enrolments of two children.

#### BANK

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
1 July	Capital		10 000		10 000 DR
2 July	Equipment			4 000	6 000 DR
3 July	Supplies			2 000	4 000 DR
4 July	Revenue		100		4 100 DR

#### CAPITAL

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
1 July	Bank			10 000	10 000 CR

#### EQUIPMENT

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
2 July	Bank		4 000		4 000 DR

**SUPPLIES**

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
3 July	Bank		2 000		2 000 DR

**REVENUE**

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
4 July	Bank			100	100 CR

Note that for each debit there is a corresponding credit. For example, the transaction on 2 July affects two accounts, namely the Bank account and the Equipment account. An entry of \$4000 on the debit side is made in the Equipment account (increasing this asset) while a credit entry is also made in the Bank account for \$4000 (decreasing this asset).

In addition, each transaction is cross-referenced thereby making it easier to see where the corresponding entry is recorded. For example, for the transaction on 2 July in the Equipment account it can be seen that the corresponding account is the Bank account.

**Illustrative example 2**

Using the same figures as in Illustrative example 1, record the transactions using T accounts:

- 1 July 200X: ET commenced a child-minding business by depositing \$10 000 into a bank account.
- 2 July: ET bought equipment for \$4000 cash.
- 3 July: ET bought supplies for \$2000 cash from DL Company.
- 4 July: Received \$100 for enrolments of two children.

**BANK**

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
1 July	Capital		10 000	2 July	Equipment		4 000
4 July	Revenue		100	3 July	Supplies		2 000

**CAPITAL**

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
				1 July	Bank		10 000

**SUPPLIES**

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
3 July	Bank		2 000				

**EQUIPMENT**

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
2 July	Bank		4 000				

**REVENUE**

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
				4 July	Bank		100

Note that like the columnar format, the T format also has for each debit a corresponding credit. For example, the transaction on 2 July affects two accounts, namely the Bank account and the Equipment account. An entry of \$4000 on the debit side is made in the Equipment account while a credit entry is also made in the Bank account for \$4000.

In addition, each transaction is cross-referenced thereby making it easier to see where the corresponding entry is recorded. For example, for the transaction on 2 July in the Equipment account it can be seen that the corresponding account is the Bank account.

As you would expect, both formats show the same details and both formats apply the same accounting principles.

**ACTIVITY****2**

The following information relates to Tom's Lawn Mowing Service:

- 1 July: Tom commenced the business by borrowing \$15 000 from the ANZZ Bank.
- 2 July: Tom purchased a \$10 000 van for cash.
- 3 July: Tom buys two lawn mowers for \$400 each for cash.
- 31 July: Revenue earned for the month totalled \$2000.
- 31 July: Petrol costs for the month totalled \$200.
- 31 July: Tom withdrew \$1000 for his wages for the month.

Post the transactions to the General Ledger using (a) the columnar format and (b) the T-account format.

On 1 July 2000 a goods and services tax (GST) of 10 per cent came into effect in Australia. GST is covered in further detail in Chapter 5. This broad-based tax is applied to a wide variety of goods and services and needs to be recorded in the accounting process.

Illustrative example 3 deals with an account that includes GST.

### Illustrative example 3

On 12 June 200X Nick Payer bought office equipment for \$10 000 on credit. Record this transaction in the General Ledger, remembering to include the GST component.

#### EQUIPMENT

Date 200X	Details	Debit \$	Credit \$	Balance \$
4 June	Creditor	10 000		10 000

#### GST RECEIVABLE

Date 200X	Details	Debit \$	Credit \$	Balance \$
4 June	Creditor	1 000		1 000

#### CREDITOR

Date 200X	Details	Debit \$	Credit \$	Balance \$
4 June	Equipment/GST receivable		11 000	11 000

Notice the effect of the GST: first, a new account has been set up to record the GST amount and second, the 10 per cent is added to the Creditor's account because that is who collected the GST.

## Trial Balance

After the General Journal entries have been posted to the General Ledger accounts, the next step is to record all the account balances in the **Trial Balance**. All the debit account balances and all the credit account balances from the General Ledger are listed to see if the total in each of the columns is equal. If it is, it shows that double entry accounting principles have been correctly applied. A Trial Balance is simply a list of the closing balances of each General Ledger account.

An example of a Trial Balance is as follows:



#### OBJECTIVE 7

Explain the nature and purpose of a Trial Balance

**BOSS INC.**  
**TRIAL BALANCE**  
**As at 30 June 200X**

	\$ DR	\$ CR
Bank	4 100	
Capital		10 000
Supplies	2 000	
Equipment	4 000	
Fees		100
	10 100	10 100

Because the total of the debit column equals the total of the credit column it is assumed that the transactions have been correctly posted. However, this may not always be true because there may be errors hidden in the recording process. Therefore procedures need to be in place to prevent these errors from happening.

If the Trial Balance does not balance this indicates that an error has been made in recording the details in the General Ledger or an error has been made when preparing the Trial Balance.

The Trial Balance is able to be prepared at any time throughout the accounting period. It is not just prepared at the end of an accounting period. In fact, the more often it is prepared, the easier it is to find errors. Two examples of errors are:

- arithmetic error; and
- recording only half of an entry.

The Trial Balance is a useful tool to check the accuracy of the recording process. If an error is detected then the next stage in the accounting cycle will not be carried out until the error is amended. The Trial Balance highlights errors before the accounting reports are prepared.

**ACTIVITY****3**

From the following accounts, draw up a Trial Balance:

(a)		\$
	Cash	1 000
	Accounts receivable	1 000
	Accounts payable	2 000
	Expenses	2 000
	Revenue	2 000
(b)		\$
	Cash	2 000
	Motor vehicle	2 000
	Building	9 000
	Revenue	9 500
	Accounts payable	1 000
	Capital	2 500

## SUMMARY

Processing transactions in accounting is done by double entry recording. Debits and credits provide the general principles used to record transactions in accounts. Every transaction affects at least two accounts. The total amount debited must equal the total amount credited.

Information flows through various stages within an accounting system. The starting point is the source documents. These are used to prepare journals, and the information in the journals is then recorded in the General Ledger accounts. These accounts can be in either the columnar or T-account format. The balances of the accounts in the General Ledger are placed in a Trial Balance. The Trial Balance is the basis for the preparation of the financial statements.

## Solutions to activities

- |  |  |
|--|--|
| 1. Cash Payments Journal<br>Credit Purchases Journal<br>General Journal<br><br>Cash Receipts Journal | Records all payments by cash or cheque<br>Records all the purchases of inventory on credit<br>Transactions not recorded in one of the specialised journals<br>Cash sales |
|--|--|

2. (a) **BANK**

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
1 July	Loan		15 000		15 000 DR
2 July	Van			10 000	5 000 DR
3 July	Equipment			800	4 200 DR
31 July	Petrol			200	4 000 DR
31 July	Wages			1 000	3 000 DR
31 July	Revenue		2 000		5 000 DR

### LOAN—ANZZ

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
1 July	Bank			15 000	15 000 CR

## VAN

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
2 July	Bank		10 000		10 000 DR

## WAGES

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
3 July	Bank		1 000		1 000 DR

## REVENUE

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
31 July	Bank			2 000	2 000 CR

## PETROL

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
31 July	Bank			2 000	2 000 CR

## EQUIPMENT—LAWNMOWERS

Date 200X	Particulars	Journal reference	Debit \$	Credit \$	Balance \$
31 July	Bank			2 000	2 000 CR

(b)

## BANK

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
1 July	Loan		15 000	2 July	Van		10 000
31 July	Revenue		2 000	3 July	Equipment		800
				31 July	Petrol		200
				31 July	Wages		1 000

## LOAN—ANZZ

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
				1 July	Bank		15 000



## VAN

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
2 July	Bank		10 000				

## EQUIPMENT

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
3 July	Bank		800				

## REVENUE

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
				31 July	Bank		2 000

## WAGES

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
31 July	Bank		1 000				

## PETROL

Date 200X	Particulars	Jour. ref.	\$	Date 200X	Particulars	Jour. ref.	\$
31 July	Bank		200				

3. (a)		\$		\$
	Cash	1 000		
	Accounts receivable	1 000		
	Accounts payable		2 000	
	Expenses	2 000		
	Revenue		2 000	
		<u>4 000</u>		<u>4 000</u>
(b)		\$		\$
	Cash	2 000		
	Vehicle	2 000		
	Building	9 000		
	Revenue		9 500	
	Accounts payable		1 000	
	Capital		2 500	
		<u>13 000</u>		<u>13 000</u>

## Exercises

1. Why does an increase in a Revenue account have a credit balance?
2. What are the two formats that a ledger account can take?
3. When and why is the General Journal used?
4. Which ledger format do most people use? Why?
5. Why is a Trial Balance drawn up? What does it show?
6. List and briefly explain the steps in the flow of information through an accounting system.
7. From the following accounts, draw up a Trial Balance:

(a)	\$
Cash	2 000
Accounts receivable	2 000
Accounts payable	4 000
Expenses	2 000
Revenue	2 000

(b)	\$
Cash	1 000
Vehicle	1 000
Building	9 000
Revenue	7 500
Accounts payable	1 000
Capital	2 500

8. What information is recorded in a ledger account?
9. What additional information does a columnar account provide over a T account?
10. 'A Trial Balance will always identify all the errors that have been made.' Do you agree with this statement? Why?
11. What column is included in the following journals to allow for the GST?
  - (a) Cash Payments Journal
  - (b) Cash Receipts Journal
  - (c) Purchases Journal