Appendix 1 revision notes

Double-entry – the basics

Theory and practice of double-entry bookkeeping
Double-entry bookkeeping is a convention, the main objectives of which are to have a permanent record of transactions, and to show the effect of each transaction and the combined effect of all the transactions upon the financial position of the entity.
The fundamental idea of double-entry bookkeeping is that all transactions of a business entity shall be recorded twice in the entity's business records. It is based on the principle that every financial transaction involves the simultaneous receiving and giving of value, and is therefore recorded twice. Transactions involve both services and goods. There are other accounting entries that do not result directly from invoice or cash transactions but which also result in double-entry records being created. These accounting adjustment entries relate, for example, to accounting for depreciation, bad debts, and doubtful debts.
Debits and credits
There is sometimes confusion in the use of the terms of debit and credit used in bookkeeping when they are compared to the same terms that have been used on bank statements. Bank statements traditionall refer to a receipt of cash as a credit, whereas a receipt of cash in bookkeeping terms is referred to as a debit.
Double-entry bookkeeping data are recorded as transactions that are described as 'debits' and 'credits'. Debits and credits represent certain types of account in both the balance sheet: assets and liabilities, and the profit and loss account: costs and sales.
All business transactions, either goods or services, ultimately end up with cash (or cash equivalents, such as cheques, bank transfers, etc.) changing hands. All these transactions will involve a document being raised, as a record of the transaction and an indication of the amount of cash that will change hands, namely an invoice. A purchase invoice records a purchase from a third party and so it represents an account to be payable at some time. A sales invoice records a sale to a third party and so it represents an account to be receivable at some time.
The meaning of a debit and a credit may most usefully be remembered using the following rules, applying to entries reflected in the accounts of a business entity:

Transaction		**Accounting entries**	
CASH RECEIPT	=	DEBIT CASH	and credit something else
CASH PAYMENT	=	CREDIT CASH	and debit something else
PURCHASE INVOICE	=	CREDIT PAYABLES	and debit something else
SALES INVOICE	=	DEBIT RECEIVABLES	and credit something else

These are definitions within the convention of double-entry bookkeeping, which may be usefull remembered as a basis for establishing whether all further subsequent transactions are either debits or credits.
An elementary method of representing and clarifying double-entry is known as the T account.
Accounting adjustments
Adjusting accounting entries, such as those relating to closing stock valuations, are made to the accounts prior to preparation of the profit and loss account and balance sheet.
There are five main accounting adjustments that are usually made post-trial balance and prior to preparation of the profit and loss account and balance sheet:

- closing stocks
- accruals – charges not yet received
- prepayments – payments in advance (and income accrued)
- depreciation
- bad and doubtful debts

Books of account and the ledgers in action

Double-entry bookkeeping operates to record the detail of transactions that may be represented in accounts to provide some clarity in seeing how each entry has been made and the interrelation of the entries. In practice, accounting records are kept along the same lines but in books of account and ledgers rather than T accounts on a piece of paper. The old fashioned manually prepared ledgers maintained by companies have long since been superceded b computerised accounting systems.

The original books of account, and subsidiary ledgers: cash book (receipts and payments); purchase invoice daybook and purchase ledger (or accounts payable); sales invoice daybook and sales ledger (or accounts receivable), hold the details of transactions that are reflected in the general ledger.

General ledger

The main ledger held within the accounting records of a company is called the general ledger, or nominal ledger, in which the results of all transactions made by the company are recorded either in summary or in detail.

In smaller businesses, wages and salaries data are usually recorded in the cash books and subsequentl posted to the general ledger. In larger companies, wages and salaries usually have their own ledgers and control accounts in the general ledger.

The general ledger is set up to include all accounts whether they are assets, liabilities, sales (or revenues), or costs (or expenses). The detail of every transaction finds its way to the general ledger, or is posted to it (to use the technical term), in much the same way as in T accounts. The general ledger may be said to be the collection of every T account within the entity.

The cash accounts, payables and receivables accounts in the general ledger are referred to as control accounts because they provide the control over the same transactions that are also represented in some further detail, and which must agree in total, in what are termed the books of account and subsidiary ledgers; the cash book, accounts payable (purchase ledger), and accounts receivable (sales ledger).

Cash book

Within the general ledger one account or more will be established to represent cash transactions (including cheques, drafts, bank transfers, etc.). These entries are posted to the general ledger from the analysis of entries made into the cash book. The cash book is a book of original entry maintained to show the detail of all receipts and payments made by the entity. The cash book records the dates, values and unique references of all receipts and payments, and what they are for, for example, payment of salaries, receipts from receivables, purchase of fixed assets, etc., and in theory should match exactl with the regular statements issued by the entity's bank. In practice, the cash book is prepared partl from company internally-generated cash payment information and available information relating to cash receipts. Some transactions may appear in the bank account without prior notification, for example bank charges, and so the cash book may also be partly prepared from the bank statement.

There may always be differences in the balances between the cash book and the bank statement because cheques may have been issued but not yet presented to the bank and cash may have been received into the bank account not yet recorded in the cash book. A regular bank reconciliation, that identifies the differences between the cash book and the bank statement, is a necessary function of the finance department.

Each payment and each receipt is posted from the cash book to the cash account in the general ledger as a credit or debit to cash. The opposite entry, either debit or credit, is posted at the same time to its relevant account in the general ledger, for example, payables, printing and stationery expenses, receivables, etc.

It is most important that the balance on the cash book, the net of all receipts and payments, at all times equals the balance of the cash book represented in the cash account within the general ledger, and that all the opposite entries have also been posted to their relevant accounts.

Purchase ledger

The purchase ledger (or accounts payable) represents all accounts payable by the entity. Within the general ledger one account or more (control accounts) will be established to represent payables transactions, the purchases by the entity for which invoices have been rendered by suppliers, or vendors. All supplier invoices are recorded in a purchase ledger and analysed into the various items of expense by allocating them to a specific general ledger account. These entries are debited to the appropriate general ledger accounts from the analysis of invoices made in the purchase ledger. The totals of these entries are credited to the account(s) representing accounts payable in the general ledger.

The purchase ledger is maintained to show the detail of all invoices received from suppliers. In addition to its function of posting the totals of invoices to the accounts payable account in the general ledger, and the analysis of what the invoices represent to the appropriate accounts in the general ledger, each invoice is analysed and grouped by supplier.

Payments made to suppliers from the cash book that have been credited to the cash account and debited to the payables account in the general ledger are also recorded in detail by amount, date and supplier within the purchase ledger. In this way it can be seen that the total balances at any one time of all accounts in the purchase ledger equals the balance on the payables account in the general ledger.

Sales ledger

The sales ledger (or accounts receivable) represents all accounts receivable by the entity. Within the general ledger one account or more will be established (control accounts) to represent receivables transactions, the sales by the entity for which invoices have been issued to customers. All customer invoices are recorded in a sales ledger and analysed into the various items of sale or revenue by allocating them to a specific general ledger account. These entries are credited to the appropriate general ledger accounts from the analysis of invoices made in the sales ledger. The totals of these entries are debited to the account(s) representing accounts receivable in the general ledger.

The sales ledger is maintained to show the detail of all invoices issued to customers. The totals of customer invoices are posted to the accounts receivable account in the general ledger. The analysis of what the invoices represent are posted to the appropriate accounts in the general ledger. The sales ledger may also enable each invoice to be analysed and grouped by customer.

Receipts from customers from the cash book that have been debited to the cash account and credited to the receivables account in the general ledger are also recorded in detail by amount, date and customer within the sales ledger. In this way the total balances at any one time of all accounts in the sales ledger equals the balance on the receivables account in the general ledger.

The trial balance

The balances on the individual accounts recorded within the general ledger may be summarised in a trial balance, the total of the debit balances being equal to the total of the credit balances.

How do we know which items in the trial balance are balance sheet items and which are profit and loss items? Well, if an item is not a cost (expense) or a sales (revenue) item, then it must be an asset or a liability. The expenses and revenues must appear in the profit and loss account and the assets and liabilities must appear in the balance sheet.

Profit and loss account

The profit and loss account of an entity shows the profit or loss generated by the entity during an accounting period by deducting all expenses from all revenues.

Within the trial balance we may extract the balances on the costs (expenses) and sales (revenues) accounts in order to construct the profit and loss account. The total sum of these accounts will then result in a balance which is profit or a loss, and which may be inserted back into a re-stated trial balance in summary form in place of all the individual profit and loss items that comprise that balance.

Balance sheet

The balance sheet of an entity discloses the assets (debit balances) and liabilities, and shareholders capital (credit balances), and gains (credits) or losses (debits) as at a given date.

A gain, or profit is a credit balance, and loss is a debit balance. The revised trial balance, that includes the net balance of profit or loss, then forms the basis for the balance sheet. The balance sheet may then be constructed by rearranging the balances into an established format.

Cash flow statement

The cash flow statement is a report on the detail of the movement within the cash account in the trial balance, starting with the opening balance and adding the receipts and deducting the payments during the accounting period, resulting in the closing balance.

Accrual accounting and cash accounting

Profit does not necessarily equal cash. Cash flow includes cash items other than those associated with trading, for example receipt of shareholders' capital, and expenditure on fixed assets. Also, trading or operational transactions are not all converted into cash within the accounting period; they may be held as accounts payable, stocks, and accounts receivable, until a subsequent accounting period.

The accruals concept, or matching concept, requires that revenue and costs are:

- recognised as they are earned or incurred
- matched with one another
- dealt with in the profit and loss account of the period to which they relate, irrespective of the period of receipt or payment

Accruals
It may be that an expense has been incurred within an accounting period, for which an invoice may or may not have been received. Such charges must be matched to the accounting period to which they relate and therefore an estimate of the cost (an accrual) must be made and included as an accounting adjusting entry in the accounts for that period.

Prepayment
It may be that an expense has been incurred within an accounting period that related to future period(s). As with accruals, these costs are not necessarily related to sales and cannot be matched with sales. Such charges must also be matched to the period to which they relate and therefore the proportion of the charges that relate to future periods (a prepayment) must be calculated and included as an adjustment in the accounts for that period.

Accounting periods

The accounting period chosen a by a business is the period of time covered by its accounting statements.

Different time periods may be chosen for internal reporting within the financial year, for example thirteen periods of four weeks, twelve periods using a four, four, five week quarter basis, or twelve calendar periods.

Once an accounting period basis has been chosen then consistency must be maintained. This is an example of both the periodicity concept and the consistency concept.