



# A GUIDE TO DOUBLE ENTRY BOOKKEEPING

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PROJECT LEAD FOR THE FINANCIAL EDUCATION FOR FUTURE  
ENTREPRENEURS (FEFE) PROJECT





# **A Guide to Double Entry Bookkeeping: Objectives**

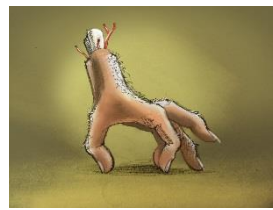
**By the end of this course you will be able to:**

- **Explain the 3 key principles of double entry bookkeeping**
- **Explain the rules of debits and credits for recording transactions**
- **Identify the correct double entry bookkeeping required for simple cash and credit transactions**
- **Identify the correct accounting required under both the perpetual and periodic inventory systems**
- **Identify which elements of financial statements typically have debit balances and which typically have credit balances at the end of a period**



# **A Guide to Double Entry Bookkeeping: Contents**

- **The 3 key principles**
- **The general ledger and ‘T accounts’**
- **Debits and credits**
- **Accounting for cash transactions**
- **Accounting for credit transactions**
- **Accounting for inventory using the perpetual and periodic inventory systems**
- **Preparing financial statements**



# Double Entry Bookkeeping: 3 Key Principles

Double entry bookkeeping is based on 3 key principles:

1. The 'accounting equation' principle:

After every transaction is recorded the accounting equation is in balance:

$$\text{Assets} = \text{Liabilities} + \text{Equity, or,}$$
$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

2. The 'dual effect' principle:

There are two effects for every transaction – a debit and credit.

3. The 'separate entity' principle:

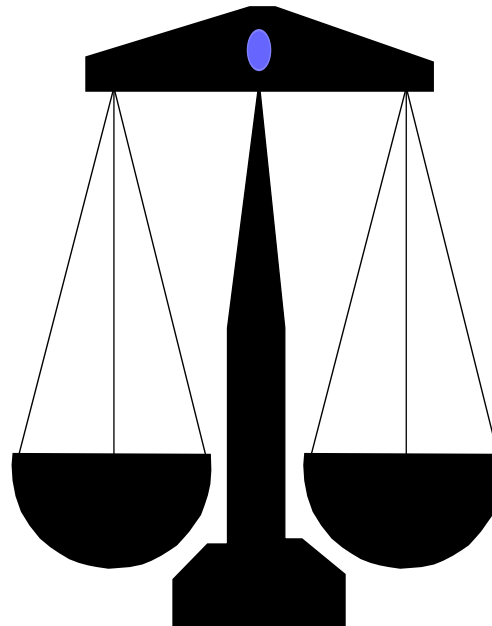
The business is treated as a separate entity distinct from its owners.



# The Accounting Equation

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY}$$

$$\text{ASSETS} - \text{LIABILITIES} = \text{EQUITY}$$





# The Accounting Equation Illustrated

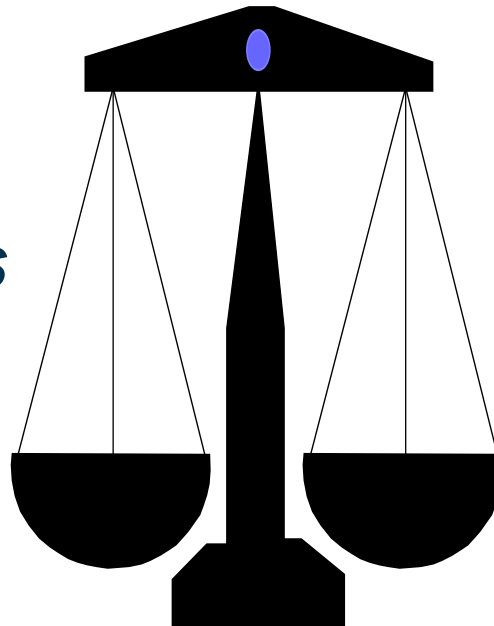
**ASSETS = LIABILITIES + EQUITY**

**£100,000**

**£90,000**

**£10,000**

*What resources  
do we control?*



*Where did the  
money  
come from?*



# The General Ledger

- The ‘general ledger’ (or ‘nominal ledger’) is the name of the book in which transactions are recorded
- The ledger is divided into sections called ‘accounts’
- Double-entry bookkeeping involves recording in the accounts the *dual effect* of each business transaction
- Each transaction requires a ‘debit’ entry to be made in one account and a corresponding ‘credit’ entry to be made to another account



# **‘T Accounts’**

- **‘Accounts’ are used to record the detailed increases and decreases for each item in the financial statements**
- **The simplest form of ‘account’ has 3 parts:**
  - 1. The title**
  - 2. Space for recording increases in the amount of the item**
  - 3. Space for recording decreases in the amount of the item**
- **This simplified form of account is known as a ‘T account’ (sometimes shortened to ‘T a/c’)**





# 'T Accounts' Illustrated

## Title of account

**Left hand side =  
Debit side**

**An entry to Debit side:  
The account is 'debited'  
(‘Dr.’ for short)**

**Right hand side =  
Credit side**

**An entry to the Credit side:  
The account is 'credited'  
(‘Cr.’ for short)**



# Debits and Credits


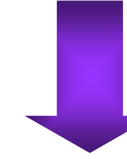


- An entry on the **DEBIT SIDE** (the left hand side):
  - an *increase* in an asset or expense or
  - a *decrease* in a liability, equity or income
- An entry on the **CREDIT SIDE** (the right hand side):
  - an *increase* in a liability, equity or income or
  - a *decrease* in an asset or expense
- For every debit there must be an equal credit, so each transaction must be entered *twice!*



# Rules of Debits and Credits

Accounting Equation:

	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Equity</b>	
<b>Statement of Financial Position</b>	 <b>Debit</b> +	 <b>Credit</b> -	 <b>Debit</b> -	 <b>Credit</b> +	 <b>Debit</b> -	 <b>Credit</b> +

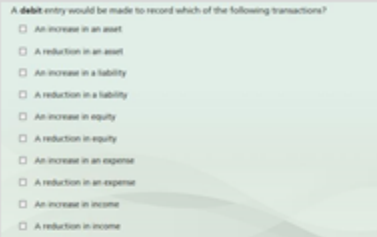
	<b>Expenses</b>	<b>Income</b>		
<b>Statement of Profit or Loss</b>	 <b>Debit</b> +	 <b>Credit</b> -	 <b>Debit</b> -	 <b>Credit</b> +



# The 'DEAD CLIC' Mnemonic

- If we add 'Drawings and Dividends' (which are reductions in Equity) ...
- ... and use 'Capital and Reserves' which is another name for Equity...
- ... we can use the DEAD CLIC mnemonic to remember how to record an increase in the balance of an individual account...

DEBIT	CREDIT
EXPENSES	LIABILITIES
ASSETS	INCOME
DRAWINGS (OR DIVIDENDS)	CAPITAL AND RESERVES (EQUITY)



## Debits and Credits

*Quiz - 2 questions*

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# Recording Cash Transactions

**For cash transactions, it is easiest to consider the impact on cash first and the other half of the double entry second:**

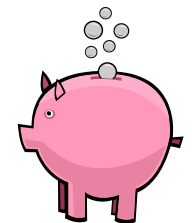
- **An increase in cash (e.g. borrowing money, issuing shares, or the receipt of cash from customers) is recorded as a debit to the cash account**
- **A reduction in cash (i.e. payments made) is recorded as a credit to the cash account**





# Debits and Credits and Cash Transactions

- Recording an increase in cash as a debit and a reduction in cash as a credit can initially seem a bit confusing as this is the opposite of how ‘debits’ and ‘credits’ affect your bank account:
  - Debits are for payments!?
  - Credits are for receipts!?
- But this is because bank account ‘debits’ and ‘credits’ are from the bank’s perspective....
- From the bank’s point of view, the money in a customer’s bank account represents a liability of the bank to its customer....





# Debits and Credits and Your Bank Account



## A Customer's Bank Account

Money going out = a debit

The bank's liability to the customer reduces

Money going in = a credit

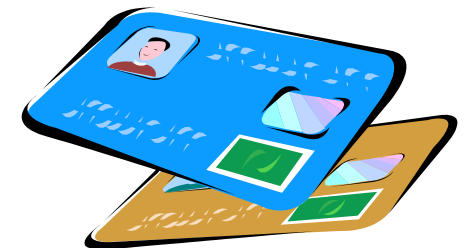
The bank's liability to the customer increases





# Recording Credit Transactions

- **Credit transactions are non-cash transactions**
- **Credit purchases involve an increase in a liability: trade payables. For example, the purchase of inventory on credit is recorded as follows:**
  - **Dr Inventory**
  - **Cr Trade payables**
- **Credit sales involve an increase in an asset: trade receivables. For example, the sale of goods on credit will be recorded as follows:**
  - **Dr Trade receivables**
  - **Cr Revenue**





## Cash and Credit Transactions

*Quiz - 10 questions*

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# Accounting for Inventory using the Perpetual and Periodic Inventory Systems

There are 2 alternative systems for recording inventory in double-entry bookkeeping:

## 1. The perpetual inventory system:

- Under the perpetual inventory system an 'Inventory account' is maintained which is updated for all purchases and sales
- There is a separate 'Cost of Sales account'

## 2. The periodic inventory system:

- Under the periodic inventory system there is no 'Inventory account' and no 'Cost of Sales account'
- Instead, purchases are recorded in a 'Purchases account' and at the end of the period inventory is counted and valued
- Cost of sales is calculated as follows:  
$$\text{Opening inventory} + \text{Purchases} - \text{Closing inventory}$$



# The Perpetual Inventory System

**Example:** A new business buys 5 units of inventory for £20 each for cash. 4 units are sold in the period for £30 each on credit.

Under the perpetual inventory system, the bookkeeping will be as follows:

**1. The purchases of inventory:**

<b>Dr Inventory</b>	<b>£100 (5 units x £20)</b>
<b>Cr Cash</b>	<b>£100</b>

**2. The income from the sale of inventory:**

<b>Dr Trade receivables</b>	<b>£120 (4 units x £30)</b>
<b>Cr Revenue</b>	<b>£120</b>

**3. The cost of goods sold expense relating to the sales:**

<b>Dr Cost of sales</b>	<b>£80 (4 units x £20)</b>
<b>Cr Inventory</b>	<b>£80</b>

The balance on the Inventory account at the end of the period will be £20 (£100 - £80) which is the amount recorded in the Statement of Financial Position.



# The Perpetual Inventory System: Gross Profit

**Example:** A new business buys 5 units of inventory for £20 each for cash. 4 units are sold in the period for £30 each on credit.

Under the perpetual inventory system, the gross profit is determined simply by deducting the balance on the cost of sales account from revenue:

Revenue	£120
Less: Cost of sales	<u>(£80)</u>
Gross profit	£40



# The Periodic Inventory System

**Example: A new business buys 5 units of inventory for £20 each for cash. 4 units are sold in the period for £30 each on credit.**

**Under the periodic inventory system, the bookkeeping will be as follows:**

**1. The purchases of inventory:**

<b>Dr Purchases</b>	<b>£100 (5 units x £20)</b>
<b>Cr Cash</b>	<b>£100</b>

**2. The income from the sale of inventory:**

<b>Dr Trade receivables</b>	<b>£120 (4 units x £30)</b>
<b>Cr Revenue</b>	<b>£120</b>

**At the period-end, inventory will be counted and valued. In this example, the amount of inventory will be £20 (1 unit costing £20).**

**There will be a period-end adjustment to record the inventory:**

<b>Dr Closing inventory (SFP) £20</b>
<b>Cr Closing inventory (SPL) £20</b>



# The Periodic Inventory System: Gross Profit

**Example:** A new business buys 5 units of inventory for £20 each for cash. 4 units are sold in the period for £30 each on credit.

Under the periodic inventory system, the gross profit is also determined by deducting the cost of sales from revenue, but this time, cost of sales has to be calculated as opening inventory (from the Trial Balance) + purchases (from the Trial Balance) – closing inventory:

Revenue		£120
Less: Cost of sales		
Opening inventory	£0	
Add: Purchases	<u>£100</u>	
	£100	
Less: Closing inventory	<u>(£20)</u>	
Cost of sales		<u>(£80)</u>
Gross profit		£40

Which of the following are features of a perpetual inventory system?  
(Choose all that apply)

- A purchases account is maintained
- A cost of sales account is maintained
- Inventory is counted and valued at the end of the period
- An inventory account is maintained

## Perpetual and Periodic Inventory Systems

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# Preparing Financial Statements

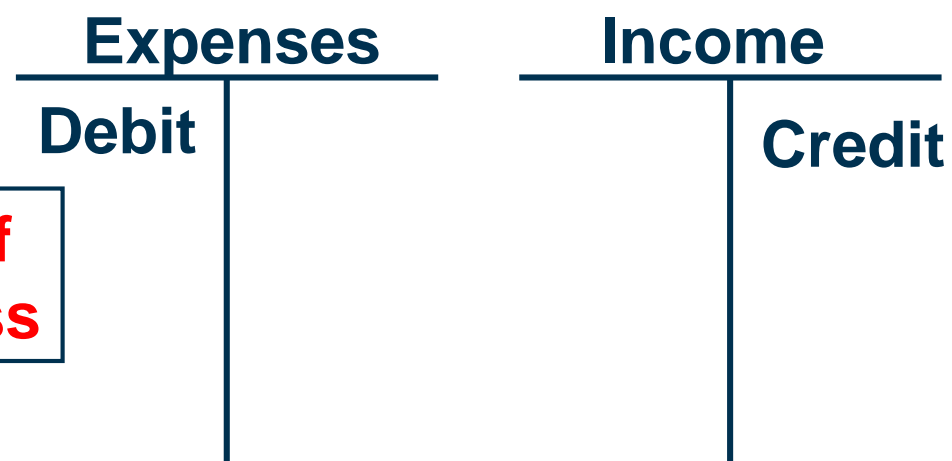
- **At the end of a period, the individual ‘T accounts’ provide the basis for the preparation of the financial statements**
- **The process is as follows:**
  1. **The individual ‘T accounts’ in the general ledger are ‘balanced off’. Some of these accounts will have debit balances and some will have credit balances.**
  2. **The balances are recorded in a ‘Trial Balance’ which is a listing of all debit and credit balances from the individual ‘T accounts’**
  3. **The Trial Balance then provides the information required for the preparation of the financial statements**



# Typical 'T Account' Balances



**Statement of  
Financial  
Position**



**Statement of  
Profit or Loss**



# The 'DEAD CLIC' Mnemonic

- We can again use the DEAD CLIC mnemonic to remember which accounts typically have debit balances and which typically have credit balances...

<b>DEBIT</b>	<b>CREDIT</b>
<b>EXPENSES</b>	<b>LIABILITIES</b>
<b>ASSETS</b>	<b>INCOME</b>
<b>DRAWINGS (OR DIVIDENDS)</b>	<b>CAPITAL AND RESERVES (EQUITY)</b>



## Debit and Credit Balances

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