Double entry bookkeeping (part 1)

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All accounting entries consist of a matching debit and credit entry. This system, known as double entry bookkeeping has been operated since the 15th century. Recently with the advent of very user friendly internet based accounting systems such as Clear Books the requirement to have a detailed knowledge of debits and credits to carry out company financial administration has been eliminated.

However double entry bookkeeping does remain the underpinning technique for computerised accounting systems and although it is not required there are some circumstances where a knowledge of double entry bookkeeping can help to understand the way the system is working. This article seeks to give an introduction to double entry bookkeeping.

Here is an example of the double entry to account for raising a sales invoice for £100 with no VAT. The example uses Dr to refer to debit and Cr to refer to credit. The debit and credit entries are split into separate columns as well as being labelled in the text.

	Dr	**Cr**
Dr Trade debtors	100	
Cr Sales		100
Being sales invoice raised		

What are the rules used in creating the double entry?

- For each entry total debits and total credits are equal and opposite. You will see that in our example above that both are equal to £100.
- Debits are used to create assets (good things) on the balance sheet (b/s). In the example there is a debit to trade debtors which is a balance sheet account.

- Credits are used to create liabilities (bad things) on the b/s.
- Debits are used to create expenses (bad things) on the profit and loss account (p&l).
- Credits are used to create revenue (good things) on the p&l. In the example there is a credit to sales which is a profit and loss account.
- Debits and credits made to the same account cancel each other out.

Note that debits are good on the balance sheet and bad on the profit and loss account. Credits are bad on the balance sheet and good on the profit and loss account. There is no higher logic to why debits and credits work in this way. The rules just need to be learnt.

Balance sheet: assets and liabilities

Assets (Debits)	Liabilities (Credits)
• Premises • Plant and equipment • Fixtures & fittings • Motor vehicles • Cash • Trade debtors • Investments • Stock • VAT	• Trade creditors • Accruals • Bank loans • Bank overdraft • HMRC (payroll) • HMRC (VAT) • HMRC (Corporation Tax)

Profit and loss account: revenue and expenditure

Revenue (Credits)	Expenditure (Debits)
• Sales • Other income • Interest received	• Wages • Employers NI • Raw materials • Rent • Rates • Utilities • Renewables • Depreciation • Equipment repair • Interest paid • Insurance • Corporation Tax • ......and many many more

Double entry worked examples

Having looked at the principles behind double entry the rest of the article looks at 10 worked double entry examples which cover the core financial transactions.

1A. Sales (invoice basis)

In this example we look at raising a sales invoice for £100 plus £20 VAT and then receiving the cash from the customer. You will see that this requires two double entry transactions. The first one is entered when the sales invoice is raised. The second one is entered when the cash is received from the customer.

Part 1

Firstly we need to identify the things which we expect to be affected. It is a sales invoice - so sales. After we raise the invoice we will have a debtor - so trade debtors. The invoice includes VAT - so the VAT account will be affected.

Making a sale is a good thing. Looking at out rules above therefore we expect there to be some balance sheet debit and some profit and loss credit. Sales is a profit and loss account so that will be a credit, trade debtors is a balance sheet account so it will be a debit. As for VAT we will end up owing the VAT collected to HMRC - so it will be a bad thing on the balance sheet namely a credit.

Now we just construct the amounts - and because they must be equal we only need to know 2 to fill in the third. So our total amount due on the invoice is £120 so that will be the Dr to trade debtors. The VAT charged was £20 and that will be a Cr. From that we know the sales amount must be Cr of £120-£20 = £100

Part 2

Later on we receive the cash from our customer. This will add to our cash balance (a good thing) and reduce our trade debtor asset (a bad thing). Therefore we expect a Dr entry to cash and a Cr entry to trade debtors. The amount will be £120 for both.

1A. Sales

	Dr	**Cr**
Part 1		
Dr Trade debtors	120	
Cr VAT		20
Cr Sales		100
Being sales invoice raised		
Part 2		
Dr Cash	120	
Cr Trade debtors		120
Being cash received from customer		

1B. Sales (cash accounting)

Under cash accounting entries are only made to the system when the cash is received from a customer. Therefore there is only one double entry. We know that the full £120 cash will be received from the customer so our cash which is a balance sheet account will go up by £120. Good things on the balance sheet are debits so we have Dr Cash £120. We state sales excluding VAT. Sales is a good thing on the profit and loss account so that will be Cr Sales £100. VAT is the balance between the two which is a £20 Cr.

	Dr	**Cr**
Dr Cash	120	
Cr VAT		20
Cr Sales		100

	Dr	Cr
Being recognise sale when cash is received		

2A. Purchase (standard accounting)

In this example we look at receiving a purchase invoice for £20 rent plus £4 VAT and then paying the supplier. You will see that this requires two double entry transactions. The first one is entered when the purchase invoice is received. The second one is entered when the cash is paid to the supplier

Part 1

Firstly we need to identify the things which we expect to be affected. It is a purchase invoice - so profit and loss account expenditure of some type in this case rent. After we raise the invoice we will owe the gross amount to our supplier - so trade creditors. The invoice includes VAT - so the VAT account will be affected.

Recording expenditure is a bad thing. Looking at out rules above therefore we expect there to be some balance sheet credit and some profit and loss debit. Rent expenditure is a profit and loss account so that will be a debit. Trade creditors is a balance sheet account so it will be a credit. As for VAT we will end up reclaiming the VAT element from HMRC - so it will be a good thing on the balance sheet namely a debit.

Now we just construct the amounts - and because they must be equal we only need to know 2 to fill in the third. So our total amount due on the invoice is £24 so that will be the Cr to trade creditors. The VAT charged was £4 and that will be a Dr. From that we know the expenditure amount must be Dr of £24-£4 = £20

Part 2

Later on we pay our supplier. This will reduce our cash balance (a bad thing) and reduce our trade creditor liability (a good thing). As both these are balance sheet accounts we expect a Dr entry to trade creditors and a Cr entry to cash. The amount will be £24 for both.

	Dr	Cr
Part 1		
Dr Rent (could be any expenditure account)	20	
Dr VAT	4	
Cr Trade creditors		24
Being recognise expenditure when invoice is received		
Part 2		
Dr Trade creditors	24	
Cr Cash		24
Being pay supplier		

2B. Purchase (cash accounting)

Under cash accounting an expenditure entry is only made to the system when the cash is paid to a supplier (an invoice may well be received from the supplier to document purchase and to supply payment information but it is not posted onto the accounting system). There is only one double entry. We know that the full £24 cash will be paid to the supplier so our cash which is a balance sheet account will go down by £24. Bad things on the balance sheet are credits so we have Cr Cash £24. We state expenditure excluding VAT. Expenditure is a bad thing on the profit and loss account so that will be Dr Rent expenditure £20. VAT is the balance between the two which is a £4 Dr.

	Dr	Cr
Dr Rent expense	20	
Dr VAT	4	
Cr Cash		24
Being recognise expense when cash is paid		

3. Buy fixed asset

This is another transaction which requires two double entry items.

Part 1

Firstly we receive an invoice from our supplier. This will be recorded as a trade creditor on the balance sheet at the full VAT inclusive amount. Owing money is a bad thing which means that for a balance sheet account we will expect a Cr entry. The amount will be £72 as we owe the amount including VAT. The fixed asset is stated on the balance sheet at the purchase price excluding VAT. As having an asset is a good thing and it is a balance sheet amount then we know the entry must be a £60 debit. The VAT is the balance between these two entries being Dr £12

Part 2

Subsequently we will pay our supplier. Cash which is a balance sheet account will go down (a bad thing) so we expect a £72 Cr to cash. Trade creditors which is a balance sheet account will be reduced which is a good thing so we expect a £72 Dr to trade creditors.

	Dr	Cr
Part 1		
Dr Fixed asset - fixtures and fittings	60	
Dr VAT	12	
Cr Trade creditor		72
Being asset recognised at purchase price net of VAT when invoice is received from supplier		
Part 2		
Dr Trade creditors	72	
Cr Cash		72
Being pay supplier		

4. Depreciate fixed asset

Depreciation is used to ensure that the cost of a fixed asset is recognised in the profit and loss account over its useful life. In this case we are taking our £60 cost fixed asset and depreciating it equally over 3 years of its useful life. The depreciation charge for one year is £60/3 = £20.

The depreciation charge to the P&L is a bad thing so it will be a debit. The entry to the balance sheet which decreases the value of the asset is also a bad thing but as a balance sheet entry it is a credit.

	Dr	Cr
Dr Depreciation charge (profit and loss account)	20	

	Dr	Cr
Cr Accumulated depreciation (balance sheet)		20
Being one year charge on £60 asset with 3 years of useful life		

5. Prepayment

A prepayment entry is made to account for the situation where an expenditure invoice is received which relates to future periods. In the example below we have previously received and entered an annual rent invoice for £20. Looking at the invoice we can see that £10 is for future periods. If no adjusting entry is made then too much expenditure will be included in the profit and loss account potentially distorting profit.

So to make the adjustment we need to reduce the expenditure in the profit and loss account. That means we need to make a good entry there which means it will be a credit. Therefore the other entry to the prepayment account must be a debit.

	Dr	Cr
Dr Prepayments	10	
Cr Rent expense		10
Being of the £20 annual rent invoiced above 6 months is for future period		

6. Accrual

Accruals are similar in concept to prepayments. Whereas prepayments are used when too much expenditure could be included in the profit and loss account accruals are used when not enough expenditure would be included. In this example we have not received our electricity bill for 3 months. We know the usual cost is £2 per month therefore we should be adding 3 x £2 = £6 of expenditure to the profit and loss account for electricity cost.

Expenditure on the profit and loss is a bad thing so we expect that there will be a £6 Dr entry. Our Dr and Cr entries must balance so we have a £6 Cr entry to accruals.

	Dr	Cr
Dr Utilities	6	
Cr Accruals		6
Being electricity cost is £2 per month and a bill has not been received for 3 months		

7. Take out bank loan

This entry will affect our cash account and our bank loan creditor. They are both balance sheet accounts. An increase in cash is a good thing so that will be a Dr entry. An increase in the loan creditor is a bad thing hence a Cr entry.

	Dr	Cr
Dr Cash	200	
Cr Bank loan		200
Being obtain £200 bank loan		

8. Make a repayment toward the bank loan

The repayment includes some amount paying off the capital of the loan and some paying interest. For a £20 repayment we know that our balance sheet cash balance will go down by £20. This is a bad thing on the balance sheet so it will be a Cr entry. Of the £20 cash repaid £4 represents interest charges. Interest paid is a bad thing on the profit and loss account and therefore a Dr entry will be required. This leaves £16 which is repaying the outstanding loan. The loan is a balance sheet creditor and it is being reduced which is a good thing therefore that is a debit entry.

	Dr	Cr
Dr Bank loan	16	
Dr Interest	4	
Cr Cash		20
Being make a £20 loan repayment where £4 is interest payment and £16 is repayment of capital		

Next time...

In the next article, Double Entry Part 2, we use the double entry we created here to create a profit and loss account and balance sheet. We also look at what can go wrong in creating the financial statements from the double entry items and how double entry can be used unscrupulously for “creative accounting”.

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