Double Entry Bookkeeping

Accounting Conventions

Basic principles

Three principles underlie double entry bookkeeping

- the business entity concept
- "duality"
- the accounting equation.

Business entities are regarded as separate from their owners.

- An entity may be legally separated from its owners (eg an incorporated enterprise).
- Businesses which are not legally distinguishable (sole traders and partnerships) are distinct from their proprietors for accounting purposes.

Importance

- Transactions between a business entity and its owners are separately identified and accounted for from the entity's perspective.

Duality

Every transaction has two effects.

The second effect is equal and "opposite" to the first.

Example

(a) A borrows $20,000 from a bank

(b) A buys a motor vehicle for $8,000 cash

(c) A sells goods for $600 on credit.

Solution

(a)	Effect 1: A has $20,000 more cash A owes the bank $20,000
(b)	Effect 1: A has $8,000 less cash A owns a motor vehicle costing $8,000
(c)	Effect 1: A has $600 more sales revenue A is owed $600

Effects are considered from A's perspective and not the parties with which A is transacting.

Question - 1

M is a sole trader. What are the two effects of each of the following transactions?

(i) Introduces $10,000 capital
(ii) Buys a car for $5,000 cash
(iii) Borrows $5,000 from the bank

Solution - 1

(i)	1:	Cash increases by $10,000
	2:	Capital increases by $10,000
(ii)	1:	Cash decreases by $5,000
	2:	Car increases by $5,000
(iii)	1:	Cash increases by $5,000
	2:	Bank loan increases by $5,000

Accounting Equation

- At any point in time

  Net assets (ie Assets – Liabilities) = Equity

- Consequently, the movement (ie change) in net assets over a specified period *must* equal the movement in equity for the same period ie

Closing net assets	–	Opening net assets	=	Capital introduced in period	+ –	Profit Loss	–	Appropriations

Equity

The residual interest in assets after deducting all liabilities.

- Components include
  - Capital – representing investment by the owner(s)
  - Accumulated profits – profits less losses earned and retained. Profits retained are after setting apart (ie "appropriating") amounts due to owners. Eg
    - distributions ("dividends") to shareholders
    - salaries and profit shares to partners
    - drawings by sole traders.

Balance Sheet Equation

- The accounting equation is also known as the balance sheet equation because, re-arranged, it underlies the presentation of the balance sheet.

  Assets = Equity + Liabilities

Question - 2

Show the balance sheet equation at the end of each transaction set out in *Example 1*.

Solution 2

(i) Cash $10,000 = Capital $10,000

(ii)

	$	
Car	5,000	
Cash	5,000	
	10,000	= Capital $10,000

(iii)

	$		$
Car	5,000	Capital	10,000
Cash	10,000	Loan	5,000
	15,000		15,000

The following illustration shows the dual effect and how the accounting equation holds for the preparation of the balance sheet.