Double Entry – The Cornerstone of Financial Accounting

A Method to help Prepare Double Entries

By Mr. Conor Foley, B. Comm., MAcc., ACA, Dip IFR, on behalf of the CPA Examinations Team for Foundation Level Financial Accounting, January 2023.

Introduction:

Double entry is the cornerstone of accounting. Luca Pacioli (c1447 – 1517), the Italian mathematician was the first person to publish information on the double entry system. Pacioli credits Benedetto Cotrugli with producing the double entry method approximately 35 years before Pacioli published his book. It is interesting to note that despite all the inventions in technology, the majority of the core accounting principles in use today date back to medieval times and highlight how successful the double entry process that was developed then still is today. Pacioli is famously quoted as saying that 'a person should not go to sleep at night until the debits equal the credits'. How many of us have had a late night trying to manage this!

There are many methods developed to help students understand and improve on preparing double entries. In this article, I am going to outline one method which I have found to be useful to students in understanding and achieving success in preparing double entries.

Background:

The conceptual framework outlines five main elements that are necessary in preparing financial statements. These five elements are as follows:

- Assets;
- Liabilities;
- Equity;
- Income; and
- Expenses.

The conceptual framework defines these elements as follows:

Assets A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

For example, if a company purchases a motor car for one of its sale representatives. Then the car is controlled/owned by the company as a result of the past event of purchasing it. The company expects it to result in future economic benefits flowing to the company by allowing the sales representative to use it to make sales for the company. Therefore, the motor car fits the definition of an asset and is accounted for as a non-current asset in the statement of financial position.

Liability A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

If a company takes out a loan from a bank to help purchase the motor car. Therefore, the company has an obligation to the bank to pay back for the loan as it owes the bank for the amount of the loan it received to help finance the purchase of the car. The company have to pay back the bank in monthly instalments so that is an outflow of resources. This is why the bank loan meets the definition of a liability and is included in the statement of financial position.

Equity The residual interest in the assets of an entity after deducting all its liabilities.

Equity is effectively the accounting equation i.e., Assets – Liabilities = Equity.

Income Income is defined as encompassing both revenue and gains

Expenses Expenses include losses as well as expenses that arise in the course of ordinary activities of the company

Examples of Assets

Typical assets include:

Bank	Cash	Trade Receivables
Prepayments	Inventory	Property, Plant & Equipment
Intangible Assets	Goodwill	Investments

Examples of Liabilities
Typical liabilities include:

Trade Payables	Bank Loans	Taxes owing i.e., Vat/Corporation tax etc.
	Accruals	Debentures/Long Term Loans

Examples of Equities
Typical items to be included in the equity section include:

Ordinary Share Capital	Share Premium	Preference Share Capital
Retained Earnings	Revaluation Surplus	

Examples of Income
Typical income items include:

Revenue	Deposit Interest Received	Profit on Disposal of Assets
Rental Income		

Examples of Expenses
Typical expense items include:

Purchases	Accountancy Fees	Rent & Rates
Insurance	Wages & Salaries	Light & Heat
Marketing	Distribution Costs	Administrative Expenses
Telephone & Internet		

Double Entry Method:
This double entry method follows a 3 step process i.e.

Step 1: Identify key words to establish which one of the 5 elements the item in question is i.e.

Is it?

An Asset;
A Liability;
Equity;
Income; or
Expense

Step 2: Once you have identified which one of the 5 elements it is, then decide is the level increasing or decreasing.

Step 3: Once you identify whether the element is increasing or decreasing, then one has to know the following:

Increase in an Asset	**Debit**
Increase in a Liability	**Credit**
Increase in Equity	**Credit**
Increase in Income	**Credit**
Increase in Expense	**Debit**

Obviously, if it is the opposite, then the opposite debit or credit applies i.e., if an Asset is decreasing, then it will be a Credit in the Double Entry.

Example 1:
A company makes a sale amounting to €200 which it lodges to the bank account.

Prepare the double entry for the transaction.

Solution:
Follow the 3-step process by identifying two key words in the transaction details.

The two key words are Sales and Bank.

Deal with the Bank side first.

Step 1: Which of the 5 elements is Bank? Bank is usually an asset.
Step 2: Is the bank balance increasing or decreasing? By lodging money to the bank account, the bank balance is increasing and therefore, the asset is increasing.
Step 3: An increasing asset is a debit. Therefore, we will Debit Bank as one part of the double entry.

Now deal with the Sales side:

Step 1: Which of the 5 elements are Sales? Sales are part of Revenue which is part of Income.
Step 2: Is the sales increasing or decreasing? In this case we have made a new sale so the level of sales is increasing and therefore, the income is increasing.
Step 3: An increasing income is a credit. Therefore, we will Credit Revenue as the other part of the double entry.

Overall, the double entry is as follows:

Debit	Bank	€200	
Credit	Revenue		€200

Remember the total of the debits has to equal the total of the credits.

Example 2:
A company purchase on credit from a supplier goods worth €400.

Prepare the double entry for the transaction.

Solution:
Follow the 3-step process by identifying two key words in the transaction details.

The two key words are purchases and on credit from a supplier i.e., Purchases and Trade Payables. Remember Trade Payables are purchases on credit.

Deal with the Purchases side first.

Step 1: Which of the 5 elements are Purchases? Purchases are usually an expense.

Step 2: Is the purchases level increasing or decreasing? In this example we have made a new purchase so the level of purchases is increasing and therefore, the expense is increasing.

Step 3: An increasing expense is a debit. Therefore, we will Debit Purchases as one part of the double entry.

Now deal with the Trade Payable side:

Step 1: Which of the 5 elements are Trade Payables? Trade Payables are part of Liabilities as you owe money to a supplier which fits the definition of a liability.

Step 2: Is the trade payables increasing or decreasing? In this case we owe money to a trade payable and therefore, the level of trade payables is increasing and therefore, the liability is increasing.

Step 3: An increasing liability is a credit. Therefore, we will Credit Trade Payables as the other part of the double entry.

Overall, the double entry is as follows:

Debit	Purchases	€400	
Credit	Trade Payables		€400

Sometimes, there may be more that one debit and one credit entry in relation to a transaction i.e.

Example 3:
A company set up a business by introducing cash of €20,000 and a car worth €10,000 into the new business.

Prepare the double entry for the transaction.

Solution:
Follow the 3-step process by identifying key words in the transaction details.

The key words are introducing i.e., capital/equity introduced, cash and car.

Deal with the Cash side first.

Step 1: Which of the 5 elements is Cash? Cash is an asset as it is worth something which fits the definition of an asset.

Step 2: Is the cash level increasing or decreasing? In this example we have received cash so the level of cash is increasing and therefore, the asset is increasing.

Step 3: An increasing asset is a debit. Therefore, we will Debit Cash as one part of the double entry.

Now deal with the Car side:

Step 1: Which of the 5 elements is a Car? Car is an asset as it is worth something which fits the definition of an asset.

Step 2: Is the level of cars in the business increasing or decreasing? In this example we had no car before we started the business but we do have a car now so the level of cars is increasing and therefore, the asset is increasing.

Step 3: An increasing asset is a debit. Therefore, we will Debit Cars as part of Property, Plant & Equipment (PPE) as one part of the double entry.

Now deal with the introducing side:

Step 1: Which of the 5 elements are when something is introduced into a business? Capital/Equity introduced is part of the Equity section.

Step 2: Is the equity introduced increasing or decreasing? In this case we introduced cash and a car into the business therefore, the level of equity in the business is increasing.

Step 3: An increasing equity is a credit. Therefore, we will Credit Equity as the other part of the double entry.

Overall, the double entry is as follows:

Debit	Cash	€20,000	
Debit	Car (PPE)	€10,000	
Credit	Equity		€30,000

Example 4 – Falley Limited

1. Falley Limited set up a new business by introducing €75,000 cash and a car worth €20,000
2. Falley Limited lodged €60,000 of the cash into a bank account
3. Falley Limited purchased office equipment costing €3,000 by cheque
4. Falley Limited purchased goods which would be sold on subsequently from Jolene Limited on credit amounting to €10,000
5. Falley Limited paid water charges and rent to Limerick Corporation of €2,000 and €1,500 respectively by cheque
6. Dick Falley, the owner paid himself a wage of €900 in cash
7. Falley Limited sold, the goods purchased in No. 4 above for 200% of what they paid for the goods, to Jemini Limited on credit
8. Jemini Limited returned 5% of the goods to Falley Limited as they were defective. As a result, Falley Limited sued Jolene Limited. Jolene Limited agreed to give a 10% discount on the original purchase amount provided they were paid immediately with a cheque. Falley Limited agreed to this. Falley Limited incurred legal fees of €500 which they paid in cash.
9. Falley Limited took out a three-year bank loan for €20,000 which was lodged to the bank account.
10. Falley Limited sold the original car for €20,000 cash and purchased a jeep for €35,000. They used the €20,000 cash received from the sale of the car plus a cheque for €15,000 to pay for the jeep.

Solution:

Using the 3-step rule, one should arrive at the following solution:

Journal Entry No.	Dr./Cr.	Account Type	Amount - € Dr.	Amount - € Cr.
1	Dr.	Cash	75,000	
	Cr.	Capital/Equity		75,000
	Being capital introduced of €75,000 cash			
	Dr.	Car	20,000	
	Cr.	Capital/Equity		20,000
	Being capital introduced of a car worth €20,000			
2	Dr.	Bank	60,000	
	Cr.	Cash		60,000
	Being €60,000 of the cash lodged to a bank account			
3	Dr.	Office Equipment	3,000	
	Cr.	Bank		3,000
	Being office equipment purchased by cheque for €3,000			

Journal Entry No.	Dr./Cr.	Account Type	Amount - € Dr.	Amount - € Cr.
4	Dr.	Purchases	10,000	
	Cr.	Trade Payable - Jolene Limited		10,000
	Being purchases of €10,000 from Trade Payable Jolene Limited			
5	Dr.	Water Charges	2,000	
	Dr.	Rent	1,500	
	Cr.	Bank		2,000
	Cr.	Bank		1,500
	Being water charges of €2,000 and rent of €1,500 paid by cheque			
6	Dr.	Wages	900	
	Cr.	Cash		900
	Being wages of €900 paid to Dick Falley by cash			
7	Dr.	Trade Receivable - Jemini Limited	20,000	
	Cr.	Sales		20,000
	Being sales of €20,000 to Trade Receivable - Jemini Limited on credit			
8	Dr.	Sales Returns	1,000	
	Cr.	Trade Receivable - Jemini Limited		1,000
	Being Sales Returns by Trade Receivable - Jemini Limited of 5% of original amount sold to them			
	Dr.	Trade Payable - Jolene Limited	9,000	
	Dr.	Trade Payable - Jolene Limited	1,000	
	Cr.	Discount Received		1,000
	Cr.	Bank		9,000
	Being a discount received of €1,000 from Trade Payable - Jolene Limited and a payment of €9,000 by cheque to them in full payment of what was owed to them			
	Dr.	Legal Fees	500	
	Cr.	Cash		500
	Being legal fees of €500 paid in cash			
9	Dr.	Bank	20,000	
	Cr.	Bank Loan		20,000
	Being bank loan of €20,000 lodged to the bank account			
10	Dr.	Cash	20,000	
	Dr.	Car	35,000	
	Cr.	Car		20,000
	Cr.	Cash		20,000
	Cr.	Bank		15,000
	Being car sold for €20,000 cash and a jeep purchased for €35,000 which was paid for by €20,000 cash and a cheque for €15,000			