Week 4

Topic: Double Entry Book Keeping

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Meaning- Double Entry Book-Keeping

The double entry system of bookkeeping means that every business transaction will involve two accounts (or more). For example, when a company borrows money from its bank, the company's Cash account will increase and its liability account Loans Payable will increase. This means that for every credit entry, there must always be a corresponding debit entry. Thus, every transaction will be entered twice in the book of one of the two people involved. For example, if Mr. Kokosari pays Mr. Magidun ₦40,000 out of his personal account; he will effect this by crediting Mr. Kokosari cash account and debiting Mr. Madigun's personal account in his (Mr. Kokosari) books. Law of double entry states that for every debit entry, there must be a corresponding credit entry and for every credit entry there must be a corresponding debit entry.

DR Mr. Kokosari's-Cash
Account CR

Mr.
Madigun's 40,000.00

DR Mr. Madigun's
Account CR

	₦	₦
Cash	40,000.00	

The logic behind double entry book-keeping is that we tend to look at accounts as real human beings hence the saying:

- Debit the account that receives
- Credit the account that gives

Debit and Credit

The terms “debit” and “credit” in bookkeeping and accounting simply denote an increase or decrease to the balance of a referenced business account. Using “debit” and “credit” to record increases or decreases of account balances conforms with the underlying occurrence in business transactions. The exchange of financial interests involving two or more business accounts inevitably leads to increases and/or decreases among those accounts. Rules in bookkeeping and accounting dictate that a debit to the accounts of assets, expenses or losses and a credit to the accounts of liabilities, equities, revenue or gains both increase the balance of each of those accounts. A debit decreases the account balance for liabilities, equities, revenue or gains, and a credit decreases the asset, expense or loss account balances.

Double Entry

The fundamental concept of double entry derives from the use of debit and credit to record business transactions. The total debits always equal the total credits. Customarily, in bookkeeping and accounting, the asset, expense and loss accounts are listed on the left side of a bookkeeping sheet, and the liability, equity, revenue and gain accounts are listed on the right side, with the two sides maintaining the same total balance. A debit to one or more accounts must be accompanied by a credit to at least one account, equally increasing or decreasing the balance on each side. Other times, a debit to either side is balanced out by an equal credit to the same side.

An asset represents a present economic resource of a company to which it has a right or other type of access that other individuals or firms do not have. A right or other access is legally enforceable, which means that a company can use economic resource at its discretion, and its use can be precluded or limited by an owner. For an asset to be present, a company must possess a right to it as of the date of the financial statements. An economic resource is something that is scarce and has the ability to produce economic benefit by generating cash inflows or decreasing cash outflows.

Assets can be broadly categorized into short-term (or current) assets, fixed assets, financial investments and intangible assets. Assets are recorded on companies' balance sheets based on the concept of historical cost, which represents the original cost of the asset, adjusted for any improvements or aging. Historical cost is also called the book value.

Current Assets

Current assets are short-term economic resources that are expected to be converted into cash within one year. Current assets include cash and cash equivalents, accounts receivable, inventory, and various prepaid expenses. While cash is easy to value, accountants periodically reassess the recoverability of inventory and accounts receivable. If there is persuasive evidence that collectability of accounts receivable is impaired or that inventory becomes obsolete, companies may write off these assets.

Fixed Assets

Fixed assets are long-term resources, such as plants, equipment and buildings. An adjustment for aging of fixed assets is made based on periodic charges called depreciation, which may or may not reflect the loss of earning power of a fixed asset. Generally accepted accounting principles (GAAP) allow depreciation under two broad methods: the straight-line method assumes that a fixed asset loses its value in proportion to its useful life, while the accelerated method assumes that the asset loses its value faster in its first years of use.

Financial Assets

Financial assets represent investments in the assets and securities of other institutions. Financial assets include stocks, sovereign and corporate bonds, preferred equity, and other hybrid securities. Financial assets are valued depending on how the investment is categorized and the motive behind it.

Intangible Assets

Intangible assets are economic resources that have no physical presence. They include patents, trademarks, copyrights and goodwill. Accounting for intangible assets differs depending on the type of asset, and they can be either amortized or tested for impairment each year.

What is a 'Liability'

A liability is a company's financial debt or obligations that arise during the course of its business operations. Liabilities are settled over time through the transfer of economic benefits including money, goods or services. Recorded on the right side of the balance sheet, liabilities include loans, accounts payable, mortgages, deferred revenues and accrued expenses.

Liabilities are a vital aspect of a company because they are used to finance operations and pay for large expansions. They can also make transactions between businesses more efficient. For example, in most cases, if a wine supplier sells a case of wine to a restaurant, it does not demand payment when it delivers the goods. Rather, it invoices the restaurant for the purchase to streamline the drop off and make paying easier for the restaurant. The outstanding money that the restaurant owes to its wine supplier is considered a liability. In contrast, the wine supplier considers the money he is owed to be an asset.

Other Definitions of Liability

Generally, liability refers to the state of being responsible for something, and this term can refer to any money or service owed to another party. Tax liability, for example, can refer to the property taxes that a homeowner owes to the municipal government or the income tax he owes to the federal government. Liability may also refer to the legal liability of a business or individual. For example, many businesses take out liability insurance in case a customer or employee sues them for negligence.

Current Versus Long-Term Liabilities

Businesses sort their liabilities into two categories: current and long-term. Current liabilities are debts payable within one year, while long-term liabilities are debts payable over a longer period. For example, if a business takes out a mortgage payable over a 15-year period, that is a long-term liability. However, the mortgage payments that are due during the current year are considered the current portion of long-term debt and are recorded in the short-term liabilities section of the balance sheet.

Ideally, analysts want to see that a company can pay current liabilities, which are due within a year, with cash. Some examples of short-term liabilities include payroll expenses and accounts payable, which includes money owed to vendors, monthly utilities, and similar expenses. In contrast, analysts want to see that long-term liabilities can be paid with assets derived from future earnings or financing transactions. Debt is not the only long-term liability companies incur. Items like rent, deferred taxes, payroll and pension obligations can also be listed under long-term liabilities.

The Relationship between Liabilities and Assets

Assets are the things a company owns, and they include tangible items such as buildings, machinery, and equipment as well as intangible items such as accounts receivable, patents or intellectual property. If a business subtracts its liabilities from its assets, the difference is its owner's or stockholders' equity. This relationship can be expressed as assets – liabilities = owner's equity. However, in most cases, this equation is commonly presented as liabilities + equity = assets.

What is the Difference between an Expense and a Liability?

An expense is the cost of operations that a company incurs to generate revenue. Unlike assets and liabilities, expenses are related to revenue, and both are listed on a company's income statement. In short, expenses are used to calculate net income. The equation to calculate net income is revenues minus expenses. For example, if a company has more expenses than revenues for the past three years, it may signal weak financial stability because it has been losing money for those years.

Expenses and liabilities should not be confused with each other. One is listed on a company's balance sheet, and the other is listed on the company's income statement. Expenses are the costs of a company's operation, while liabilities are the obligations and debts a company owes.

Meaning of ledger

A ledger is a book that holds the record of transactions made by a company or business.Until now, the ledger has been referred to as one book, and in a business of a small size, all ledger account could be contained in a small volume. However, in a business of any size, it is needed for a ledger to be subdivided into accounts, so that we can have separate accounts for each transaction.This in essence means that at the end of a particular period all transactions recorded in the journal will now be transferred to the ledger. The sales ledger may be divided into a number of books, each containing an account for each person or firm with whom we have business transactions.

The ledger account is practically divided into two parts: The left hand part is known as the debit side, while the right hand side is known as the credit side. Each side contains the date, particulars, folio number and the amount columns. The date column refers to the date of transaction. Folio column refers to the page number of the journal from where the double entry is completed.

Classification of Ledger

A ledger is classified into two. They include

- Personal ledger; and
- Impersonal ledger

The diagram below illustrates the classification of ledger.

Ledger Account

Personal impersonal

Debtors Creditors real nominal

- **Personal ledger**: These are accounts in which persons or organization transactions are recorded. It consists of debtors and creditors.

- **Impersonal ledger**: This is an account that relates to assets, liabilities, income and expenses; it is divided into nominal and real account.