# Theme: *****Double Entry*****

***Types of Balance Sheet***

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Almaty 2009y.

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**The Essence of Double Entry Principle**

In accounting, the journal should has two ledger that is called double entry accounting. This method was introduce by Mediecci in 12th century at Italy. The father of accounting, Luca Paccioli is the first publisher of double entry accounting system.

Double entry accounting is a method in which each transaction is recorded in two separate accounts, i.e. in one account as a debit and in the other account as a credit. In other words, in double entry principle each transaction that has a value added to the assets account also has a value subtracted from the liabilities account - these transactions are called credits. Conversely, each transaction that has a value added to the liabilities account has a value subtracted from the assets account - these transactions are called debits.

Double entry accounting principle is used more often than the single entry principle, in which each transaction is recorded in only one account. It is used more often since it prevents many errors and promptly alerts the business to possible errors so that they can be corrected on a timely basis. Since credits and debits should always be equal, i.e. according to the essence of accounting basics there must be an equation between debits and credits, if there is ever a discrepancy between the value of the credits and debits, it is an alert to the business that an error has occurred while recording the transaction in the books of the business. Thus, with the double entry accounting principle it is quick and easy to ensure that the accounts are always balanced. Also this principle is useful to record transactions separately and present proper and accurate data to its users for the purpose of decision making relating the entity.

Example 1

Consider the following example of the double entry principle. Cut to the Chase, a hair salon, buys hair brushes in bulk once every quarter, purchase is made on credit, i.e. cash for the purchase made is paid later on after the purchase. The bulk of brushes costs $250. So, every quarter the accountant for Cut to the Chase makes $250 entry in the liabilities account (adding to the value of the liabilities) and a $250 entry in the assets account (adding to the value of the assets). Below you can see how the entries look like;

D Inventory (Assets) $250

Accounts payable (Liabilities) $250

Example 2

The next example is the usage of the acquired brushes in the activities of the Cut to the Chase hair salon. Assume that during the next quarter the company used all the acquired brushes in its activities, i.e. $250 expenses were incurred and assets decreased by $250. The accountant will record a $250 entry in the assets account as a credit and a $250 entry in the equity account as a debit, i.e. expenses as a decrease in equity. Below you can see how the entries look like;

D Expenses (Equity) $250

C Inventory (Assets) $250

As these examples show, the bottom line of double entry principle is that for each entry made in one account (i.e. liabilities or equity), an opposite entry in the same amount of the original entry must be made in the other account (i.e. assets).

**The Accounting Equation**

All accounting entries in the books of account for an organisation have a relationship based on the 'accounting equation':

|  |
| --- |
| Assets = Liabilities + Owner's equity |

Assets

Assets are tangible and intangible items of value which the business owns. Examples of assets are:

* Cash
* Cars
* Buildings
* Machinery
* Furniture
* Debtors (money owed from customers)
* Stock/Inventory

**Liabilities**

Liabilities are those items which are owed by the business to bodies outside of the business. Examples of liabilities are:

* Loans to banks
* Creditors (money owed to suppliers)
* Bank overdrafts

**Owner's Equity**

The simplest way to understand the accounting equation is to understand what makes up “owner's equity”.

By rearranging the accounting equation you can see that Owner's Equity is made up of Assets and Liabilities.

|  |
| --- |
| Owner's Equity = Total Assetsless Total Liabilities |

Owner's Equity can also be expressed as:

|  |
| --- |
| Owner's Equity = Capital invested by owner + Profits (Losses) to date  (also known as 'Retained Earnings') |

Rearranging the equation again, therefore:

|  |
| --- |
| Total Assets - Total Liabilities = Capital + Retained Earnings |

The accounting equation establishes the basis of Double Entry Bookkeeping

**Double Entry Bookkeeping**

All accounting transactions are made up of 2 entries in the accounts: adebit and a credit.

For example, if you purchased a book, your value of books would increase, but your value of cash would decrease by the same value, at the same time. This is double entry bookkeeping.

**Ledger Accounts**

A ledger account is an item in either the Profit & Loss account (which we'll discuss shortly) or the balance sheet. A Ledger account is either a:

* Asset
* Liability
* Equity
* Income
* Expense

The example of purchasing a book, mentioned above, can be shown in the form of ledger "T" accounts as follows:

“Dr” is short form “Cr” is short form for Debit for Credit

**Purchases-Books**

**Dr Cash Cr**

**$20**

**Cash**

**Dr Cr**

**Books $20**

If all transactions are entered into the books in this way, then the sum of all of the debits would equal the sum of all of the credits.

**Balance Sheet**

**Balance Sheet** is one of the three main **Financial Statements**. It reflects structure of the company's assets and financing sources used to finance these assets as of particular date (i.e. as of year end).

Referring to the Accounting Equation, where:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Assets** | **=** | **Liabilities** | **+** | **Equity** |

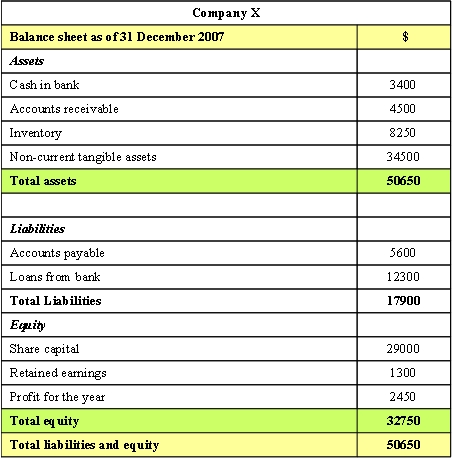
Balance Sheet reflects the same principle, i.e. one side of the **Balance Sheet** represents **Assets** and the other side - **Liabilities** and **Equity**. The must be a balance between the total value of the Assets and the total value of Liabilities and Equity.

**Assets** are properties (can be material, immaterial, monetary) owned by the entity, i.e. any physical thing (tangible) or right (intangible) that has a monetary value. Assets usually are divided into **Current Assets** (cash and other assets that may reasonably be expected to realized in cash or sold or used within period less or equal to one year. Examples: inventory, cash, accounts receivable, prepaid expenses) and **Long-term Assets** (used by the entity for a period longer that one year. Examples: long-term investments, fixed assets, intangible long-term assets).

**Liabilities** are debts owned to outsiders, i.e. creditors. Divided into **Current Liabilities**, which are due within one year (accounts payable, salaries payable, taxes payable, interest payable) and **Long-term Liabilities** which are due after one year

**Equity** includes amounts invested in a business by owners, special kind of liability residual claim against assets of business after total liabilities are deducted. Includes **Share Capital** (financial means invested by the shareholders), **Retained Earnings** – net income retained in the business.

Below there is an example of **the Balance Sheet**:



You can see that total value of the **Assets** ($50650) equals to the total value of **Liabilities** ($17900) and **Equity** ($32750).

**Trial Balance**

A trial balance is a list of all of the ledger accounts of a business and the balance of each. Debits are shown as positive numbers and credits as negative numbers. The trial balance should therefore always equal zero.

If the journal entries are error-free and were posted properly to the general ledger, the total of all of the debit balances should equal the total of all of the credit balances. If the debits do not equal the credits, then an error has occurred somewhere in the process. The total of the accounts on the debit and credit side is referred to as the trial balance.

The more often that the trial balance is calculated during the accounting cycle, the easier it is to isolate any errors; more frequent trial balance calculations narrow the time frame in which an error might have occurred, resulting in fewer transactions through which to search.

**Interpreting Balance Sheet**

**1. ASSETS DEBIT balance = positive amount. CREDIT balance = negative amount**

**Cash** Always review the status of your cash. A cash deficit should rarely

occur. Cash represents the liquidity of your fund and its ability to pay its expenses. It is very important to make sure your cash remains

positive.

**Petty Cash** Periodically review the level of your petty cash fund. Remember that

petty cash is quite vulnerable to loss through fraud or error. Can you reduce the size of the fund without affecting efficiency?

**Receivables** When you review your receivables balance, make sure your

receivables are realistically valued. If you have anything more than a negligible amount in receivables, you should have an allowance for uncollectibles. It should have a credit balance, offsetting the debits to receivables. If you do not have an allowance for uncollectibles. your receivables are probably not worth what your balance sheet shows. Receivables should show a realistic expectation of future cash.

If your receivables balance is growing it could mean the following:

1. Your business is growing in size. Check if the other numbers, such as supplies expense, are growing also.
2. Receivables are increasing in relation to your other assets. Perhaps your customer types are changing. Be careful not to let receivables get out of proportion. You can't pay vendors or staff with receivables!
3. Your customers are paying more slowly and your receivables are staying on the books longer than before. You might need to speed up collection or you might need to extend credit less readily.

If your receivables balance is getting smaller, it could mean the following:

1.. Business is falling off. You have fewer customers and thus fewer people asking to be invoiced. Check your customer base. Has your customer mix changed? Is your product or service still needed?

2. The amount of business you are doing is staying the same. But more customers are paying in cash.

1. You are collecting your receivables quickly. This is good!

**Inventory** Inventory consists of items that you will sell, or the raw materials for making those items. Because you are going to sell it, it represents future cash for your organization. Inventory items are very vulnerable to "shrinkage" - meaning deterioration, becoming outdated, and theft. You should have a tracking method and periodically you should physically count the inventory items. The value of your inventory should appear on your balance sheet and you should be able to document that the value shown on the balance sheet is correct.

**Prepaid Items** Prepaid items such as maintenance agreements are important assets because they represent something you have already paid for. You need to check that you are receiving the appropriate value. For example, if you have a maintenance agreement as an asset on your balance sheet, you should check if you really are receiving the service you paid for.

Amounts in prepaid expense balances are generally transferred to expense over the term of the related maintenance agreement, insurance policy, etc. There should be zero balances in the prepaid accounts once the agreements have expired.

**2. LIABILITIES A CREDIT balance shows there is a liability. A DEBIT balance shows a liability is negative (often meaning it has been overpaid).**

**Sales Tax** If you sell items that are subject to state sales tax, the sales tax should be paid monthly. The Office of the Treasurer processes the payments and remits sales tax to the state of Ohio, based on the amounts you tell them are owed. You should review the balance sheet each month to make sure the payment is being made. Otherwise you might be misled into thinking that all the cash on the balance sheet is yours to use, whereas in reality some of it belongs to the state.

**Salaries In** the OSU General Ledger, Salaries Payable or "Accrued Salaries

**Payable** Payable" occur only at year-end and only for bi-weekly Classified

Civil Service employees and Nine-month Faculty (faculty who work three of the four quarters of the year, but are paid over 12 months).

Since Nine-month Faculty are usually paid from general funds only bi-weekly employees are discussed here.

At the end of the fiscal year, bi-weekly classified employees have almost always worked a portion of a pay period. The university owes these employees money for their work, but of course payment does not occur at the end of the year. Instead it occurs at the next appropriate paycheck run. Nevertheless the fact that the money is owed must be recorded in the university's books as a liability.

Although this liability is only a "paper entry" and is reversed at the beginning of the next fiscal year, you should verify that the amount recorded as a liability to your fund is the appropriate amount.

**Deferred** Deferred revenue represents prepayments received from your

**Revenue** customers. Since you owe your customers the goods or services that you will provide in the future, you cannot claim to fully "own" the cash they have paid to you. The liability "deferred revenue" shows a record of the cash you have received but for which you have not yet provided the corresponding goods or services.

When you provide the goods or services to the customer, amounts in deferred revenue should be transferred to revenues. There should be zero dollars in deferred revenue once all the goods or services have been provided.

You should track your deferred revenue for the following reasons:

1. To see how much of your cash is potentially refundable to others.
2. To ensure that all balances are "current" (represent only amounts for goods or services not yet provided to customers).

**3. EQUITY CREDIT balance shows positive equity. DEBIT balance shows negative equity.**

**Equity** The equity, net worth or fund balance of your fund represents the assets the fund owns, less any liabilities owed to others.

Equity also represents the cumulative effect of all revenues, expenses and transfers posted to the fund since its inception.

It is an important measure of the value of your fund. Equity should always be positive.

**Equity "with"** Because the cash on your balance sheet does not take into **Encumbrances** accountany encumbrances, your equity (assets minus liabilities) does not take them into account either. Consequently, the balance sheet gives you an additional figure labeled "equity with encumbrances," meaning "equity with encumbrances subtracted." When this figure is positive it shows a credit balance, following the same pattern as equity.

The balance sheet gives you this view of your equity so that you can see what equity would be if all the cash that is currently committed were already spent. As you review this figure, bear in mind the following:

1. Some commitments are firmer than others. For example, a salary commitment for a Classified Civil Service employee will certainly be used, unless the person leaves or reduces work hours. On the other hand, if you have a blanket purchase order, you might have established it for a maximum amount, planning to spend that amount only if absolutely necessary. The first encumbrance is "firm," the second less so. Consequently, you must know your operation well in order to interpret "equity with encumbrances."
2. Depending on the type of fund, monies are received at different points during the year. For example, Endowment Income and Expense funds receive the major portion of their funding in July. Earnings funds, on the other hand, usually receive revenues at regular intervals during the year. Thus an Endowment Income and Expense fund that has negative "equity with encumbrances" in the early part of the fiscal year is probably of concern, whereas an Earnings fund can begin the year with negative "equity less encumbrances" because it will earn money during the year to offset the commitment