chapter 2

Recording transactions

Learning objectives

After you have studied this chapter, you should know that:

- There are two elements to every transaction: an *Item exchanged* and a *Form of settlement.*
- Double entry bookkeeping requires that for each transaction, an entry is made once for the *Item exchanged;* and once for the *Form of settlement.*
- The treatment of the *Item exchanged* is always the opposite of the treatment of the *Form of settlement.*
- Debit means 'place on the left of the account called . . .'.
- Credit means 'place on the right of the account called . . .'.
- The total of the debit must always equal the total of the credit.
- Capital is what the owner contributes to a business.
- Capital does not belong to a business; it belongs to the owner of the business.
- Liabilities are all other items that do not belong to a business, such as loans from banks.
- Debtors are people who owe money to a business.
- Creditors are people who are owed money by a business; the owner of a business is not a creditor of the business; the owner is an investor in the business.
- Expenses are immediately used-up but, they belong to the business and are treated the same way as all other possessions.
- Possessions that last some time are called 'assets'.
- When the *Form of settlement* is given, it is a credit.
- When the *Form of settlement* is received, it is a debit.
- The entry for the *Item exchanged* is always the opposite of the entry for the *Form of settlement.*
- To identify the accounts to debit and credit, you *always* focus upon the *Form of settlement.*

Introduction

In this chapter, you will learn the *Principles of double entry:* how to do double entry bookkeeping. You will learn how double entry is used to record financial transactions. You will also learn how to use T-accounts, the traditional way to make such entries under the double entry system.

Part One The principles of double entry

2.1 The nature of a transaction

In Chapter 1, you saw how various events had each changed two items in the balance sheet. These events are known as 'transactions'. Transaction involves two things: the **Item exchanged** and a **Form of settlement** that is either cash, an **IOU**, or capital. 'IOU' is usually called 'credit,' but 'IOU' is easier to learn to use at this stage of your studies. 'Capital' is what has been invested by the owner in a business. The *Item exchanged* and the *Form of settlement* are the two *'elements of a transaction'*. If there is no *Item exchanged* (i.e. bought or sold), there is no transaction:

- If a businessman asks the price of something, but does not buy it, there is no transaction.
- If a businessman asks the price of something and then buys it, that event is a transaction.

When we enter the data relating to a **transaction** in the accounting records. we need to ensure that the items that were affected by the transaction, *and only those items*, are shown as having changed. Bookkeeping is the first stage in doing so. It can take many forms, but the one that is most used is called **double entry bookkeeping**.

Activity 2.1

What do you think a likely name might be for other forms of bookkeeping? (*Hint:* double beds and _____ beds.)

Double entry bookkeeping is therefore all about recording the financial results of transactions. Examples of transactions include a purchase of a machine, payment of an electricity bill, sale of a sandwich, and interest received from a bank for money deposited.

There is a wide range of possible transactions for any business, and we need a system of book-keeping that is flexible enough to record any of them. We do this by having places where we record each entry. These are called **accounts**. We can add a new account whenever we want and there is no limit to the number of accounts we can have.

What we record in accounts are the two **elements of transactions**.

2.2 The elements of a transaction

As mentioned above, in accounts we record the outcome of transactions involving two elements: the *Item exchanged*, such as a car or a computer; and the *Form of settlement*, such as cash.

So, if you buy a computer with cash, the *Item exchanged* is the computer. You need to create an account called 'computer account'. In that account, you record that you now own a computer, which means that the total value of the account has increased.

You also need an account for the *Form of settlement*, in this case 'cash'. You call that account, 'cash account'. In that account, you record that your cash has been reduced because you used some cash to become the owner of a computer.

Traditionally, each account has a left-hand side and a right-hand side. You can see one for a computer in Exhibit 2.1.

Exhibit 2.1

Computer account

Activity 2.2 What do you think we call this form of account? (*Hint:* what shape do the lines make?)

The amount of each transaction is entered on one of those two sides in the account for the *Form of settlement*; and on the other side in the account for the *Item exchanged*. That is the **double entry**: one entry made in two different accounts for each transaction. When we make these entries, we describe one as a **debit** and the other as a **credit**. Let's see what these terms mean.

2.3 Debit and credit

Debit means *'place on the left of the account called . . .'* and credit means *'place on the right of the account called . . .'*. You can see why we just use the words 'debit' and 'credit', instead of the whole eight-word phrase each time, can't you?

These two words 'debit' and 'credit' are central to understanding double entry bookkeeping. Every time you record a transaction, you *debit* one account, and you *credit* another account. This is why we call this form of bookkeeping, 'double entry'. The amount you *debit* will always be equal to the amount you *credit*.

Debit ALWAYS *equals* Credit

Activity 2.3 Why do you think debit always equals credit?

Let's now look at what guides you in making these 'double entries': the *Principles of double entry bookkeeping*.

2.4 The principles of double entry bookkeeping

When recording a transaction, you need to decide which account to *debit* and which account to *credit* for each entry. In order to do so, there are three things that are always true:

1. A *Form of settlement* given is always a credit.
2. A *Form of settlement* received is always a debit.
3. The entry for the *Item exchanged* is always the opposite to the entry for the *Form of settlement*.

These are what ensure you make the correct entries *every* time.

Now that you know what an account is, what *debit* and *credit* mean, and the principles to follow, let's see what happens when we record the elements of a transaction.

If you remember these principles, you will *always* know which account to *debit* and which account to *credit*.

2.5 Recording the elements of a transaction

The amount of each transaction is entered in the accounts of the two elements of the transaction: on one side in the account for the *Form of settlement,* and on the other side in the account for the *Item exchanged*.

So, imagine that you entered into a transaction worth £100. After the entries for the transaction have been made, the two accounts would *either* look like this:

Exhibit 2.2

Item exchanged account			Form of settlement account	
£100				£100

or like this:

Exhibit 2.3

Item exchanged account			Form of settlement account	
	£100		£100	

These are the only two possibilities. **The *Form of settlement* will tell you which of these to use:**

- If you *purchased* something for cash, you would record the entries as in Exhibit 2.2: the *Form of settlement* was given, so it must be credit; the *Item exchanged* must be debit.
- If you *sold* something for cash, you would record the entries as in Exhibit 2.3: the form of settlement was received, so it must be debit; the *Item exchanged* must be a credit.

Do you see how the *Form of settlement* guides you in how to make these entries?

***Always* use the *Form of settlement* to guide you in what to *debit* and what to *credit*.**

This is straightforward when cash is involved. And it is the same when it is not. When you purchase goods that you will pay for later, you have given the seller an IOU, i.e. a promise to pay later. So, you must credit the *Form of settlement* and debit the goods account. What account do you use to record this **IOU**?

2.6 When the form of settlement is an IOU

An IOU is a 'debt'. A **'debt'** is created whenever a seller agrees to wait for the payment until sometime in the future. In the accounts of the seller, whenever a new debt is created, it is the *Form of Settlement* in the transaction.

Let's assume that the *Form of settlement* in both Exhibit 2.2 and Exhibit 2.3 is an IOU:

- In Exhibit 2.2 (a purchase): a *Form of settlement* has been given, so it is a credit. That is, the debt *due to the seller* is a credit.
- In the case of Exhibit 2.3 (a sale): a *Form of settlement* has been received so it is a debit. That is, the debt *due from the customer* must be a debit.

Activity 2.4

Describe the two entries in Exhibit 2.2 using 'debit' and 'credit'; and give an example of a transaction that fits this description.

Whenever a debt is repaid, it is the *Item exchanged*. This is because you pay a debt using a *Form of settlement*.

2.7 Balance

Once you have made some transactions, you may want to find out how much an account is worth. For example, how much a debtor owes you, or how much you owe someone else. You do this by calculating the difference between the totals of the debits and the total of the credits entered in that account. We call that difference, the **balance**. In Exhibit 2.2, the *Item exchanged* account has £100 more on the debit side: it has a 'debit balance' of £100; and the *Form of settlement* account has £100 more on the credit side: it has a 'credit balance' of £100.

Let's now use the *Principles of double entry bookkeeping* to see what happens when you have a list of balances and want to know what your business is worth. We'll use an example that involves 'capital'. Capital is a *Form of settlement*.

2.8 Drawing-up a list of what a business is worth

Imagine you have been in business for a few months but, you have not kept any proper records of your transactions. You have decided to end that business and start a new one by transferring everything to the new business. You now also want to start using double entry bookkeeping.

The first step is to write down a list of everything belonging to the old business and everything the old business owes. Here is the list you prepared:

Exhibit 2.4

		£
1	Cash	600
2	Cash in US dollars' worth	200
3	Cash in the bank	1,200
4	Cash in the bank in euros worth	430
5	Computer	500
6	Mobile phone	240
7	Sales register	320
8	Printer	150
9	Printing supplies	40
10	Goods for sale	18,000
11	Amount due by Fred Palmer	300
12	Amount due by Winnie Woo	370
13	Loan from bank	10,000

Activity 2.5

If you now enter these items in T-accounts of the new business, what do you think the *Form of settlement* will be for each one?

You are exchanging all of these items shown in Exhibit 2.4. That is, you are giving them to the new business and it will give you something in return for each of them. In each case, the *Form of settlement* account will be one called **capital account**. You, the business owner, have transferred all these items from your old business into your new business. They are now all possessions of your new business. We use a capital account to record what the business owner has put into the business.

Once the business is active, making purchases and sales, we add any profits to that account, subtract any losses from it, and also subtract any items taken out of the business for the owner's own personal use. We call the balance on that account, **capital**. It is what the business is worth to the owner on the date when the balance is calculated. In other words, it is what the owner has invested in the business at that point in time.

'Capital' at any point in time is equal to the amount the owner has invested in the business plus any profits, less any losses, less everything taken out of the business by the owner, such as cash or goods.

Activity 2.6

What do you think the balance on the capital account will be once you have entered each of these 13 items into the correct accounts?

It is important to remember: it is the transactions of the business that you are recording. The business is *not* you. When you begin a business, you give it many things. It settles each of those transactions by giving you capital. The only exceptions are debts owing to someone else. When you give the new business a debt that you owe someone else, that transaction is settled by you giving the business back some of the capital it has given you. When you give back capital the business receives it and enters receipt of this *Form of settlement* as a debit.

Let's now look at how you make these 'double entries'.

2.9 Making double entries

You need to decide which account to debit and which account to credit for each entry. In order to do so, we consider the *Form of settlement*.

Activity 2.7

What is the entry to the capital account when it has decreased?
Is it a debit or a credit?

Let's see what the double entries are for the first four items you are transferring into the new business from your list in Exhibit 2.4. In each case, these things being transferred to the new business are the *Item exchanged*. You give them to the business and it settles each of these transactions using the *Form of settlement*, capital.

Exhibit 2.5

Item Exchanged	Debit	Credit
1 Cash	Cash account	Capital account
2 Cash in US dollars	Cash in US dollars account	Capital account
3 Cash in the bank	Cash in the bank account	Capital account
4 Cash in the bank in euros	Cash in the bank in euros account	Capital account

In each case, the *Form of settlement* (capital) is given to you by the business. That is why it is a credit. Do you see how the debit is always to a cash account? (You have four accounts in which 'cash' is kept: one for cash; one for cash held at your bank; one for cash in US dollars; and one for cash in euros.) These four entries are all debits because the *Form of settlement* is a credit.

What do you think the credit entry will be for items 5 to 12? Let's see:

Exhibit 2.6

Item Exchanged	Debit	Credit
5 Computer	Computer account	Capital account
6 Mobile phone	Mobile phone account	Capital account
7 Sales register	Sales register account	Capital account
8 Printer	Printer account	Capital account
9 Printing supplies	Printing supplies account	Capital account
10 Goods for sale	Goods for sale account	Capital account
11 Amount due by Fred Palmer	Amount due by Fred Palmer account	Capital account
12 Amount due by Winnie Woo	Amount due by Winnie Woo account	Capital account

Capital given is always a credit.

Activity 2.8

What does the fact that capital is credited for each of these items tell you about the debits?

Items 5 to 12 confirm to you that **any increase in something that belongs to the business is a debit.** You should remember that in accounting we call all these items that belong to the business 'assets'.

Activity 2.9

Look carefully at the wording of the debit entry for items 11 and 12. What is being debited, the amount due, or the people who owe the business these amounts? *(Hint:* these are entries for the 'item' exchanged.)

Think back to items 1 and 2 ('cash' and 'cash in US dollars'). They are both items of **cash** but they each have their own account *because they are different types of cash* – you cannot spend the US dollars in a shop unless you are in the United States but, you can spend cash that is in your local currency in any shop in your country. For this reason, you need two accounts to record these different types of cash.

Similarly, items 11 and 12 are both **debts** owed by other people that have been transferred from the old business but *they are debts of different people* so each of them must have its own account. By including the identity of the person who owes you the money in the name of the account, you know who is in debt to you. We call a person who owes you money a 'debtor'.

In Exhibit 2.7, we have entered the debt owed to us by Winnie Woo (Item 12) into her account.

Exhibit 2.7

Amount due by Winnie Woo

£370	

You can see that the debit side of Winnie Woo's account (£370) is a higher amount than the credit side (£0). The account has a debit balance, so Winnie Woo is a debtor. **When a person's account has a debit balance, that person is a debtor.**

Activity 2.10 What do you think we call someone whose account has a credit balance?

Now let's look at the final item in your list: Loan from bank. What does this mean? Does it mean that you have £10,000 in the bank? Or, does it mean that you owe the bank £10,000?

It means that you owe the bank £10,000. So, this is an amount your old business owes the bank. **It is not a possession of the business.** The loan is the *Item exchanged*. It is being transferred into the new business and the *Form of settlement* is *capital*, just as it was with all the other items in Exhibit 2.4. But the business is not giving capital in exchange for the loan. It is receiving it so, the entry for the *Form of settlement* (capital) is a debit.

And, this loan is not a possession of the business, so it is treated in the opposite way to a possession of the business. That is, it is a credit.

The double entries for item 13 therefore go in the opposite direction to those for the 12 items that did belong to the business. It has reduced your investment in the new business, so you must settle this transaction with capital. Because the business receives the *Form of settlement* (capital), it is a debit, and the entry for the *Item exchanged* is a credit.

Exhibit 2.8

Item exchanged	Debit	Credit
13 Loan from bank	Capital account	Loan from bank account

As you learnt in Activity 2.10, we call a person or an organisation that we owe money a **creditor**. The credit side of their account is a higher amount than the debit side. You can confirm this by looking at the 'Loan from bank' account in Exhibit 2.9: the credit side (£10,000) is higher than the debit side (£0).

Exhibit 2.9

Loan from bank account

	£10,000

All items that do *not* belong to the business are called **liabilities**. These are things the business *must* pay to its *creditors*. **The only exception is capital.** It is *not* a liability because it belongs to the owners of the business and the business does not have to pay its owners back what they have invested.

So far, you have only seen a few entries in **T-accounts**. Let's now look at two of these accounts with the amounts from Exhibit 2.4 entered on the correct side and then look at what happens when we make a new transaction involving those two accounts.

2.10 Making double entries into existing accounts

Exhibit 2.10 shows you the entries for the printing supplies and the cash from Exhibit 2.4 in their T-accounts.

Exhibit 2.10

Printing supplies account	
£40	

Cash account	
£600	

Now, let's imagine that you decide you need some more printing supplies for your new business. You go to a shop and pay £50 in cash for what you need. What would the double entries be?

The *Form of settlement* is cash. It has been given, so it is a credit. The *Item exchanged* is printing supplies (e.g. toner, ink, paper, etc.). It must be the opposite: a debit.

Debit Printing supplies account	Credit Cash account

Let's now look at those two accounts with the amount of the purchase entered.

Exhibit 2.11

Printing supplies account	
£40	
50	

Cash account	
£600	**£50**

What are the balances on these two accounts?

The balance – the difference between the total of the debits and the total of the credits – on the Printing supplies account has now increased from £40 to £90. At the same time, the balance on the Cash account has reduced from £600 to £550. The total belonging to the business has not changed. You have simply entered a transaction where printing supplies were exchanged for cash: the supplier gave them to you, and you gave the supplier cash.

What would the double entries be if you now sold some of your goods? Let's see.

2.11 Recording a sale

Let's assume an old friend contacts you asking to buy some of your goods. You decide to sell him the goods at the same price as they cost you to purchase them. They cost you £60. You give him the goods and he gives you £60 in cash.

In Exhibit 2.11, you prepared the two T-accounts. Once you had entered the items from Exhibit 2.4 and the purchase of printing supplies for £50, they looked like this:

Goods for sale account	
£18,000	

Cash account	
£600	£50

The double entries for this sale transaction would be:

Debit Cash account	Credit Goods for sale account

The *Form of settlement* (cash) has been received, so it must be debited. The *Item exchanged* ('Goods for sale') must be the opposite, so you must credit the Goods for sale account. The two accounts now contain:

Goods for sale account

£18,000	**£60**

Cash account

£600	£50
60	

Your Cash has increased and your Goods for sale have decreased. Your accounts continue 'in balance'. That is, the total of all the debits in all your accounts equals the total of all the credits in all your accounts.

Activity 2.11

Confirm that the total of all the debit balances of the accounts listed in Exhibits 2.5 and 2.6 is the same as the total of all the credit balances. Why is this?

Remember the Principles of double entry bookkeeping:

1. A *Form of settlement* given is always a credit.
2. A *Form of settlement* received is always a debit.
3. The entry for the *Item exchanged* is always the opposite to the entry for the *Form of settlement*.

These principles are all you need to know so that you *always* select the correct account to debit and the correct account to credit for any transaction. Apply them correctly to the *Form of settlement* and your debits and credits should always be in the correct account.

The examples above will guide you if you ever forget the principles.

Activity 2.12

What are the double entries if you repay a loan by paying the creditor in cash?

You can also be guided by the item received. Whenever something is received that belongs to the business, it is a debit. When something received does not belong to the business, like a loan from a bank, it is always a credit. This is very useful to know when you are recording adjustments to accounts. We will do that later in this book. When recording transactions, if you always use the principles, you should always make the correct decisions on the debits and credits.

So far, we have not mentioned expenses. Let's look at how they are recorded in double entry.

2.12 Expenses and double entry

When you incur an expense, *it belongs to the business* in the same way that a computer, a machine, or a building belongs to the business. The difference is that an expense is used-up immediately whereas a computer is used for a long time. (We call possessions that you keep for some time **assets**. We call possessions that are used-up immediately 'expenses'.)

For example, if you pay an electricity bill for £120 by cash, the *Item exchanged* is electricity. Cash was the *Form of settlement* and it was given, so must be a credit. The *Item exchanged* (the expense) must be the opposite, so you debit electricity. You will learn later that expenses are always debits.

2.13 Purchases accounts and Sales accounts

Instead of recording purchases and sales in an account for the *Item exchanged*, many businesses use accounts for purchases and accounts for sales. In that case, **if you purchase something to sell in your shop, you make the entry in the 'Purchases account'.** When you **sell it, you make the entry in the 'Sales account'.**

The purchases and the sales are kept apart. This is done because the balances on both these accounts are needed when you prepare an **Income Statement**, the report accountants produce that shows how profitable the business has been.

Purchases are possessions so, when they increase, the entry is a debit.

Sales are also possessions (that you have exchanged for money or a debt). When your possessions decrease (as they do when you make a sale), the entry is a credit.

2.14 Finally

You now know all you need to know about debits and credits. You will use this knowledge a lot during the rest of this book. If you ever get confused and cannot remember the *Principles of double entry* or how to record an entry, return to this chapter. You will soon know again how to do double entry.

Remember:

Always start by looking at the *Form of settlement*.

Remember:

When a *Form of settlement* is given, it is a credit.

Remember:

When a *Form of settlement* is received, it is a debit.

Remember:

The entry for the *Item exchanged* is always the opposite.

Remember:

The amount of the debit always equals the amount of the credit.

Part Two Some worked examples

Before showing you how a series of transactions are recorded, we'll first look at what else needs to be included when an entry is made in an account.

2.15 Completing the entry in an account

So far you have learnt how to decide which account to debit and which account to credit. You know where to enter the value of each transaction. Now, we shall add the other items that also need to be included when you make an entry:

- the date
- the name of the other account in which the transaction is being entered.

When you make your first entry in an account, you need to enter the year, month and day, plus the name of the other account involved in the transaction. Let's assume that you transferred all the items into the new business on 1 January 2019. To make the entries for Item 1 in Exhibit 2.4, you need to create an account for Cash and an account for Capital. Here is how the entries would look after you have made them.

Exhibit 2.12

Cash Account

2019			£	
January	1	Capital	600	

Capital Account

	2019			£
	January	1	Cash	600

You only enter the year when you make the first entry on each side. So, if on the same day you used £10 of the cash to buy some stamps, the entries would be made as shown in Exhibit 2.13.

Exhibit 2.13

Cash Account

2019			£	2019			£
January	1	Capital	600	January	1	Stamps	10

Stamps Account

2019			£	
January	1	Cash	10	

The year only appears once on each side of the account, no matter how many entries are made. Now we'll go through some worked examples.

2.16 Worked examples

1 Imagine that the owner of a new business has invested £10,000 in cash in the business on 1 August 2019. The result of this transaction is entered in the two accounts as follows. First, a debit entry is made in the Cash account. The entry includes the name of the other account involved. In this case, it is the Capital account:

Cash

2019			£	
Aug	1	Capital	10,000	