CHRISTOPHER MILLER CONSULTING
Excellence in Management Accounting

DOUBLE ENTRY BOOKKEEPING

Double entry bookkeeping is one of the highest achievements of the western intellectual tradition. It wasn't applied at all in Communist countries; it is scarcely applied in third world ones. There is a direct link between its application and economic success. Its importance is under-recognised; it is nothing less than the foundation of first world economic success.

SET OF TWO TRANSACTIONS

Consider an example: a business sells a good for $100 on credit (ie, not a cash sale). It had previously bought the good for $60 and, until sale, held it in inventory.

There is a set of two transactions to be recorded:

- The first records that a Sale has taken place (a Profit and Loss transaction) and a legally enforceable account receivable – a Trade Debtor – has been created (and therefore needs to be reflected in the Balance Sheet):

Debit: Trade Debtors [Balance Sheet]	$100
Credit: Sales [Profit and Loss]	($100)

- The second records that the value of a tangible asset – Inventory – has diminished, which requires adjustment to the Balance Sheet, by an amount to be reflected in Profit and Loss (as the cost of the sale):

Debit: Cost of Goods Sold [Profit and Loss]	$60
Credit: Inventories [Balance Sheet]	($60)

It is possible under single entry bookkeeping to record that the sale and the reduction in inventories are a set. In practice, the second transaction is commonly overlooked. On the other hand, double entry bookkeeping, for the reason I indicate at the third level of benefit below, forces its recognition. To this extent, double entry bookkeeping commonly does contain more information.

BENEFITS AT THREE LEVELS

The benefits of double entry bookkeeping are at three levels.

- Firstly, for every entry, debits must equal credits or, signing credit balances as negative amounts, debits and credits must sum to zero.

  Bookkeepers understand that this protects against clerical errors.

- The second level of benefit is actually more important. Balance Sheet amounts are created which are capable of validation by reference to objective, external evidence.

  In this example, if the customer – the Trade Debtor – can prove that he or she does not owe $100 (and the courts are the final arbiters) then there was not a sale for $100. This level of benefit was missing from Communist bookkeeping, to disastrous effect.

- The third level arises from changes in equity investors' interests being quantified as the net of Profit and Loss items. The corollary is that the business is recognised as having existence separate from its investors.

  In this example, the Profit and Loss items are:

Credit: Sales	($100)
Debit: Cost of Goods Sold	$60
Gives: Increase in Equity (Profit)	($40)

  (The crucial legal decision was from the House of Lords in 1897: *Salomon vs Salomon & Co Limited*. Mr Salomon lent money to his own company on terms preferential to himself. When the company failed, he claimed it back, leaving other creditors unpaid. The House of Lords was forced to make clear, however much they might have thought this sharp practice, that Mr Salomon and Salomon & Co Limited were separate. In fact, the law recognised that the company was legally another person, albeit one with neither a body to kick nor a soul to damn.)