Double Entry Accounting Explained

Most small business users are not accountants and the way a P&L is reported can seem backwards, but it is not, they don't really understand how debits and credits work in a double entry accounting system.

QuickBooks is a double entry accounting system, so named because every entry to an account requires a corresponding and opposite entry to a different account. For instance, recording earnings of $100 would require making two entries: a debit entry of $100 to an account called "Cash" and a credit entry to an account called "Income."

The earliest known written description of double-entry accounting comes from Franciscan friar Luca Pacioli. In deciding which account has to be debited and which account has to be credited, the three *golden rules of accounting* are used.

1. **Personal Account**: Account of parties with whom the business is carried on, personal accounts may be:
   - Account of a natural or physical person, Example: Fred Jones Account, Mary Smith Account
   - Account of artificial or legal persons, Example: ABC, Inc.
   - Representative personal account, Example: O/S Expenses Account, O/S Income Account

   Rules of Accounting: Debit the Receiver
Credit the Giver

2. **Real Account**: Asset accounts that appear in the Balance Sheet. Referred to as Real Account (or Permanent Accounts) as these are owned by businesses and the balances in these accounts, at the end of an accounting period, will be carried over to the next period. Example: Cash Account, Land Account, Building Account, etc.

   Rules of Accounting: Debit what comes in
Credit what goes out

3. **Nominal Account**: Account of expenses and loses which a business incurs and income or gains which a business earns in the course of business. Example: Rent Account, Interest Account.

   Rules of Accounting: Debit all expenses and losses
Credit all income and gains

This is also accomplished using the accounting equation: Equity = Assets − Liabilities. The accounting equation serves as an error detection tool. If at any point the sum of debits for all accounts does not equal the corresponding sum of credits for all accounts, an error has occurred. It follows the sum of debits and the sum of the credits must be equal in value.

Asset, cost of sales, and expense accounts are all increased with a debit and decreased with a credit. Liability, income, and equity accounts are the opposite. They are decreased with a debit and increased with a credit. To add to the confusion, in many settings where accounts that usually have a debit balance are presented along with accounts that usually have a credit balance, debits are represented as positive numbers and credits as negative numbers.

Assets, which include stock, investments, plant, buildings and amounts owed to the entity the accounts relate to are all recorded as DEBIT amounts (think Debtors, the people who owe you money - they are an asset). In dual entry accounting, debit amounts are treated as positive values.

Liabilities, which include amounts of money borrowed from others, bank overdrafts, amounts we owe to suppliers (creditors), are treated as negative values.

When selling to a customer, the amount received is posted as a debit (positive amount) to the Bank Account and as a credit (negative amount) to the Sales Account, the other side of the double entry posting.

A trial balance is an example of this type of report, as is the Chart Of Accounts. So, the way your account balances are showing is quite correct. It is double entry accounting and it does appear to be counter-intuitive to what you would expect, but it is correct.