

Double-Entry Bookkeeping

*The golden rule that keeps every set of accounts **perfectly balanced**.*

Why this matters

Double-entry bookkeeping is the foundation of all accounting. Every financial transaction is recorded in at least two places because money never appears from nowhere or vanishes. It always moves from somewhere to somewhere and double-entry captures both sides every time.

The accounting equation

Everything in bookkeeping rests on one equation:

Assets = Liabilities + Equity

This must always balance. If you record every transaction correctly using double-entry, it will balance automatically: that is the built-in self-check.

Debits and credits — the basics

- Every transaction has two sides: a Debit (Dr) and a Credit (Cr)
- Debits and credits are not 'good' or 'bad' - they simply describe which side of an account is affected
- Total debits must always equal total credits - if they don't, something has been missed
- DEAD CLIC: Debits increase Drawings, Expenses, Assets - Credits increase Capital, Liabilities, Income

Four worked examples

Each transaction below shows the debit and credit entries side by side.

Transaction	Debit (Dr)	Credit (Cr)
Owner puts £5,000 cash into business	Bank account (Asset) £5,000	Owner's capital (Equity) £5,000
Buy office supplies for £200 cash	Supplies expense (P&L) £200	Bank account (Asset) £200
Take out a £10,000 bank loan	Bank account (Asset) £10,000	Loan payable (Liability) £10,000
Earn £800 from a client — cash	Bank account (Asset) £800	Service revenue (Income) £800

KEY RULE TO REMEMBER

After every transaction, check that your debits equal your credits. If they don't balance, you've either missed an entry or recorded an amount incorrectly. This self-checking property is what makes double-entry so powerful.

The Balance Sheet: Assets

*Tangible assets and current assets — **what the business owns and how it's recorded.***

Why this matters

Assets are things that the business owns. On the balance sheet they are split into two groups: non-current (fixed) assets, which the business holds for more than a year and current assets, which will convert to cash within 12 months. Understanding the difference tells you a great deal about how a business is structured.

Tangible (Fixed) Assets

Tangible assets are physical items owned and used by the business over many years to generate income. They appear on the balance sheet at their original cost, then are gradually reduced each year through depreciation because they wear out or become outdated over time.

Examples of tangible assets

Asset type	Examples	Depreciated?
Buildings	Factory, office, warehouse	Yes
Land	Business premises land	No — never depreciates
Machinery	Production equipment, tools	Yes
Vehicles	Delivery vans, company cars	Yes
Computers	Hardware, servers, office tech	Yes

Current assets — listed in reverse liquidity order (how quickly they can become cash)

- 1. Inventory / stock — goods held for sale (slowest to convert to cash)
- 2. Trade debtors — money owed by customers (credit sales not yet paid)
- 3. Prepayments — expenses paid in advance, e.g. insurance or rent
- 4. Bank — money held in the business bank account
- 5. Cash — physical notes and coins (most liquid of all)

KEY RULE TO REMEMBER

Land is the one tangible asset that is never depreciated: it does not wear out. Every other tangible fixed asset is depreciated. The order of current assets matters too: listing them from slowest to most liquid helps readers assess how quickly the business could raise cash in an emergency.

The Balance Sheet: Liabilities

Current and long-term liabilities — and why working capital is the lifeblood of a business

Why this matters

Liabilities are debts and obligations that the business owes to others. They are split by time: current liabilities are due within 12 months; long-term liabilities are due after 12 months. The balance between what a business can access quickly (current assets) and what it owes shortly (current liabilities) is one of the most closely watched measures in finance.

Current liabilities — due within 12 months

- Trade creditors - invoices owed to suppliers for goods or services received
- Bank overdraft - the bank balance has gone into the negative
- Corporation tax payable - tax owed to HMRC on profits earned
- Accruals - expenses incurred but not yet invoiced or paid
- Short-term loan instalments - portions of loans due within the year

Long-term liabilities — due after 12 months

- Bank loans repayable over several years
- Mortgage on business property
- Debentures - long-term bonds issued to investors
- Finance lease obligations
- Pension liabilities - future staff pension commitments

Working capital and the current ratio

Working capital measures short-term financial health. The current ratio tells you how comfortably the business can cover its short-term debts.

Measure	Formula	What it tells you
Working capital	Current Assets – Current Liabilities	Positive = healthy; negative = danger
Current ratio	Current Assets ÷ Current Liabilities	Above 1.5:1 is comfortable; below 1:1 is a warning
Danger zone	Ratio below 1.0:1	Liabilities exceed assets — risk of insolvency

Measure	Formula	What it tells you
IMPORTANT TO KNOW <i>When a business cannot pay its debts as they fall due, it meets the legal definition of insolvency. At that point directors have a duty to act in the interests of creditors, not shareholders. This is why lenders, auditors and investors watch the current ratio so carefully.</i>		

The Balance Sheet: Equity

*Share capital, retained earnings, and reserves — **the owners' stake in the business.***

Why this matters

Equity is the owners' stake in the business i.e. what would be left for them if all assets were sold and all liabilities paid off. It always equals Assets minus Liabilities. Equity grows when the business makes a profit and retains it; it shrinks when a loss is made or dividends are paid out.

The equity equation

Equity = Assets – Liabilities.

This is always true and it is what keeps the balance sheet balanced. Every correctly recorded transaction maintains this equality automatically.

Components of equity

Component	What it is
Share capital	Money paid in by shareholders when shares were first issued
Share premium	Any amount paid above the nominal (face) value of shares
Retained earnings	Cumulative profits kept inside the business rather than paid out
General reserve	Unallocated retained profit set aside for future use
Revaluation reserve	Gain arising when a fixed asset is revalued upward (see Lesson 6)
Capital redemption reserve	Created when a company buys back its own shares

Reserves — what they are and are not

- Reserves sit within equity — they are part of the owners' stake, not a pot of cash
- They show that profits have been retained rather than distributed
- Large reserves are a sign of financial strength
- Revaluation reserves and capital redemption reserves are not distributable as dividends
- Only retained earnings and general reserves can be paid out to shareholders

COMMON CONFUSION

Students often think 'reserves' means the business has cash sitting in a special bank account. It does not. A reserve simply means that a portion of profit has been labelled and kept in; the cash may well have been spent on assets or used in the business. The reserve is a category within equity, not a location for money.

Depreciation of Tangible Assets

*Spreading the cost of an asset over its useful life — **matching the expense to the periods that benefit.***

Why this matters

Depreciation is the process of spreading the cost of a tangible asset across its useful life. Rather than recording the full cost as an expense in year one, a portion is charged each year. This follows the matching concept - expenses should be matched to the periods that benefit from them.

The three inputs you need

- Cost - what the business paid for the asset, including delivery and installation
- Residual value - the estimated proceeds when the asset is eventually sold or scrapped
- Useful life - how many years the business expects to use the asset

The two main methods

Worked example throughout: van costing £20,000, residual value £2,000, useful life 5 years.

Method	Formula	Annual charge	Best suited to
Straight-line	$(\text{Cost} - \text{Residual Value}) \div \text{Useful Life}$	£3,600 every year	Assets that wear evenly — furniture, machinery
Reducing balance	Opening book value × Rate %	Falls each year (e.g. 25% = £5,000 yr1, £3,750 yr2...)	Assets losing value fast — vehicles, computers

The double entry — recorded each year

The same entry is posted every year for the life of the asset.

Account	Debit (Dr)	Credit (Cr)
Depreciation expense (P&L — reduces profit)	£3,600	
Accumulated depreciation (balance sheet deduction)		£3,600

TWO THINGS DEPRECIATION IS NOT

Depreciation is not a cash payment - no money leaves the bank when it is recorded. It is a book entry only. It also does not reflect market value. An asset's net book value (cost minus accumulated depreciation) and what someone would pay for it in the open market are two entirely different things.

Dividends

*How profits are distributed to shareholders — **and why dividends never touch the P&L.***

Why this matters

Dividends are payments made to shareholders as a reward for investing in the company. They come out of distributable profits — retained earnings. A dividend is not an expense: it never appears on the profit and loss account. Instead it reduces retained earnings in equity directly, and reduces cash on the assets side — keeping the balance sheet balanced.

Stage 1: Declaration

When the board formally declares a dividend, a legal obligation is created. No cash has left the business yet.

Account	Debit (Dr)	Credit (Cr)
Retained earnings (equity)	£20,000	
Dividends payable (current liability)		£20,000

Stage 2: Payment

When the dividend is paid out, cash leaves the bank and the liability is cleared.

Account	Debit (Dr)	Credit (Cr)
Dividends payable (current liability)	£20,000	
Bank account (asset)		£20,000

Types of dividend

- Interim dividend — paid mid-year from current year profits
- Final dividend — approved at the AGM, based on the full-year result
- Preference dividend — fixed payment to preference shareholders, paid before ordinary dividends
- Special dividend — a one-off payment, often following an asset sale

What can and cannot be distributed

- Retained earnings — yes, distributable as dividends
- General reserve — yes, distributable
- Share capital — no, this is the shareholders' invested money, not profit
- Revaluation reserve — no, the gain is unrealised (asset not yet sold)
- Capital redemption reserve — no, legally ring-fenced

THE MOST IMPORTANT RULE

Dividends are not an expense. They do not reduce taxable profit. They reduce retained earnings in equity directly. If you see a dividend appearing on a profit and loss account, that is an error. The net effect of declaring and paying a dividend is simply: retained earnings down, bank down — by the same amount.

