Unit 2

Principles of double-entry book-keeping

Introduction

The system which forms the basis of most organisations' accounting procedures is called double-entry book-keeping. This unit introduces and explains some of the general principles of double-entry book-keeping and some of the terms you will come across during your book-keeping work.

Objectives

When you have finished this unit, you should be able to:

- define the term *double-entry book-keeping*
- apply basic accounting concepts
- explain what the two entries made in the accounts books represent
- explain the terms *asset* and *liability*
- briefly say what *debit* and *credit* entries are
- draw up a page for recording details in an accounts book.

New terms

Double-entry book-keeping

A system of keeping financial accounts in which each transaction is recorded in the accounts books by making a debit entry and a corresponding credit entry, so that when all the ledgers are added up the totals of all debit entries and credit entries are equal.

Asset

Something of value owned by a business (e.g. property, cash, money in the bank, money owed to the business).

Liability

Something which will cost a business money (e.g. a bank loan that must be repaid, a debt owed to a supplier).

Debit

An entry in the accounts books recording a gain to the organisation – this can be an increase in assets or decrease in liabilities.

Credit

An entry in the accounts books recording a loss to the organisation – this can be a decrease in assets or increase in liabilities.

Account

A record of all transactions of a particular type (e.g. stock), or relating to a particular customer, supplier etc.

Sole Trader

A business owned and managed by one person is known as a sole trader. The owner may employ others to work in the business.

Limited Company

A company owned by shareholders but managed by the Board of Directors, each shareholder will be able to vote to appoint members of the board.

Basic accounting concepts

As mentioned is the Study Guide, accounting has certain basic rules or concepts that are followed so that all book-keepers and users of accounts understand the rules followed when the accounts are drawn up. This unit introduces some of these fundamental concepts accepted and used in all book-keeping and accounting. These concepts must be obeyed and used in the preparation of limited company accounts but are also used by sole traders in order that all accounts have a uniform structure.

Business entity

This concept states that only transactions concerning the business are included in the business accounts. Any private affairs of the owner must be kept separate. For example, the owner should not use the business cheque book to pay a bill for his holidays because this is a personal expense; if he does so, he is drawing money from the business.

Money measurement

The accounts can only include items that can be measured in monetary terms that people can agree on. An example would be including the wages of a skilled workforce as the amount is known, but a value could not be included for those skills so this will not be included even though it might be argued that the skills themselves are an asset to the business.

Duality

This concept is at the heart of double-entry book-keeping. Every transaction has two aspects, for example, if we buy something we receive goods but pay out money; or if we buy on credit, someone else sells. This dual aspect must be recorded. Hence, assets always equal liabilities in a business and the accounting equation

Assets = Liabilities + Capital

is the expression of the duality concept.

Historic cost

This describes the concept of always including items in the accounts at the actual cost of purchase. The main reasons for doing this are that: it is easily understood, it follows the double-entry system and the Inland Revenue recognises it.

Going concern

This is another fundamental accounting concept and means that the accounts are drawn up in the belief that the business is going to continue trading into the foreseeable future. This means that all assets are usually valued at cost, not what they could be sold for, because the business is going to carry on using them. This is important, for example, with buildings, which may have gone up in value since the business bought them. If the business is to continue as a going concern it cannot benefit from this rise in value because it will not be selling the buildings. Equally, assets should not be valued at the ‘break-up’ value, i.e. the value the asset would have if the business was sold off because it had stopped trading.

Materiality

This concept says that if the inclusion or exclusion of an amount or a piece of information in the accounts would mislead users of the accounts then that matter is material, i.e. it refers to the size of the amount involved. A fixed asset is one that is bought and used in the business for many years – for example, desks, computers and large office fittings. Would you, therefore, include a stapler or hole punch – also bought and used for many years? No, because these items only cost a small amount of money. Since the amount is not material you should miss them out of fixed assets and include them in office expenses in the profit and loss account.

However, sometimes the size of a business affects materiality as what is a large amount to a small business may be a relatively immaterial amount to a large business. Most businesses have a fixed asset level, e.g. in some larger businesses nothing costing less than £500 would be regarded as a fixed asset.

Consistency

When a company adopts a certain method of accounting for transactions, that company must then consistently use that method every year. This enables the results of one year to be accurately compared with those of another. If it has a good reason and informs the users of the accounts, the company can adjust the method used but from then on must use the new method consistently.

Prudence

Under the concept of 'prudence' profits are not included until they are sure, but losses are included as soon as they are anticipated. A simple example of this would be if stock is held that costs £50 per item and can be sold for £80 per item, it is included in the stock valuation at £50 because the profit is not certain since the item has not yet been sold. However, if the item of stock is damaged and can only be sold for £30 then it is included in the accounts at £30 as the damage has happened and we know that we cannot get £50 for it. Simply expressed, it is safer to under-estimate than to over-estimate profits.

Accruals

This is sometimes called 'matching' and will be dealt with in some detail in Unit 15. Briefly, it means that costs and the income derived from those costs should be matched in the same accounting period even if the costs have yet to be paid. This ensures that the account will include all income and expenses for that period in order that the profit gives a true and fair view.

ACTIVITY 1

a) Which of these businesses is a going concern?

1. James Smith Ltd has been put up for sale as business is bad.
2. James Bros are going through a bad period but have taken out a bank loan to enable them to carry on trading.

b) Are the following items material to a garage with a turnover of £500,000 per annum and an asset 'cut off point' of £1000?

1. The accountants discover a piece of machinery costing £5,000 has been included in plant repairs instead of fixed assets.
2. There is a new set of spanners in the garage costing £50 and the assistant accountant wants to include them in fixed assets as they will be there for many years.

c) The company premises cost £100,000 but the accountant believes that they would be worth £200,000 if they were sold. The company does not intend to move to new premises in the near future.

1. What value should be included in the accounts?
2. State the concept used to arrive at this decision.

d) John Smith Ltd has certain customers who regularly buy around £1million of goods every year. The manager wants to include a value for these customers as an asset of the business. Name the concept used to decide whether a value can be included.

Compare your answers with ours, at the end of this module.

The two entries

The term *double-entry book-keeping* takes its name from the basic principle that forms the foundation of this system. Each transaction is recorded in the accounts books twice – a double entry. This means that each time an organisation buys something, sells something, pays an employee, or makes any other kind of financial transaction, the transaction is recorded in two places in the organisation's books.

One of these entries must record a *benefit* to the business. This may be in the form of goods or services coming into the business. The other must record some kind of loss or *expense*. So, for example, when an organisation buys something, it gains the benefit of the goods bought, but it loses the benefit of money from its cash or bank balance. When it sells something, it loses goods from stock, but gains money. From this you can see that each transaction can be said to have both a positive and a negative side: something is gained, but something else must be given in exchange.

Assets and liabilities

The terms usually used to describe a business's wealth and its loss of a benefit are asset and liability. You will probably be familiar with these words in their more general sense from your everyday life.

An *asset* is anything of value that the business owns. This includes money in the bank, but also property, goods ready for sale, components ready to be made into goods, money owed by customers, machinery, equipment, motor vehicles and so on.

A *liability* is anything which will eventually cost the business money. Generally, this takes the form of a debt to suppliers, or a loan, both of which must be repaid.

ACTIVITY 2

Tick the appropriate box to say which of the following are assets and which are liabilities.

	Asset	Liability
A car	☐	☐
A bank loan to buy the car	☐	☐
Office furniture	☐	☐
Raw materials	☐	☐
Debt owed for raw materials bought	☐	☐
A building	☐	☐
The mortgage used to buy the building	☐	☐

Compare your answers with ours, at the end of this module.

From the last activity, you probably noticed that there is often a close link between assets and liabilities. If a business buys a car with a loan, the car is an asset, but the borrowed money is at the same time a liability. The office furniture and raw materials purchased represent assets acquired by the business. However, the amount owing to the supplier of goods on credit is a liability, i.e. it represents an amount owing by the business. The building also represents an asset and the debt to the mortgage company is a liability.

Imagine you own a small shop. Make a list of some of the kinds of assets and liabilities you think you may have.

Assets	Liabilities

Your list of the kind of *assets* owned by a small shop could include the following:

- the premises
- fixtures and fittings
- a motor vehicle
- stock
- cash

and the *liabilities* could consist of:

- loans
- money owing to the suppliers of goods and services on credit
- wages owing to employees
- a bank overdraft.

Balancing the double entries

Another important principle of double-entry book-keeping is that the two entries should balance: they must record equal amounts of money. For example, if a shoe repairer pays £10 by cheque for glue to repair shoes, this represents a gain of £10 worth of glue, but a loss of £10 from the bank.

ACTIVITY 3

See if you can work out the two sides of each of the following transactions, and for each say how assets or liabilities are increased or decreased.

1. A manufacturing firm uses cash to buy components to make a product.

2. The firm pays its electricity bill by cheque.

3. The firm pays by cheque an employee's wages which were owing.

4. A customer returns a product for a refund of cash.

Compare your answers with ours, at the end of this module.

Credit and debit entries

The two types of entries that are made in the accounts books are called *credit* and *debit* entries. You will need to learn to distinguish between the two in all kinds of situations, and be able to work out which entry should be recorded as a debit and which as a credit. You will get the chance to practise this throughout the course, and will learn more about it later in this unit.

Simply, a *debit* is something that brings *benefit into* the business. It may be the gain of an asset or the loss of a liability. A debit may be money paid into the bank, or goods received from a supplier, or something less obvious, like the removal of a debt. Each of these must be recorded as a debit entry in the accounts. A debit generally increases the assets of the business. This may mean an increase in wealth, though not necessarily in terms of money.

A *credit* is something that represents movement of *benefits out* of the business. It may be the gain of a liability or the loss of an asset. An obvious example is money moved out of the bank account. Credits also include stock moved out (when it is sold, for example), or a debt incurred or any other movement of goods or services from the business. A credit reduces the assets of the business or increases its liabilities.

As all transactions must be recorded as two balancing entries, there must be a debit entry and a credit entry for each, and the two must record equal amounts of money. You can see that because the two are always balanced, it may appear that the business never earns any money. In fact, of course, businesses do make money – or they should do – and their total worth should increase. We will look at this in a later unit.

Introducing the accounts books

We have seen that transactions must be recorded in the form of two balancing entries, a debit and a credit; now we have to think about where and how these entries are made.

Financial accounting records are kept in a series of books called the accounts books. You will come across several other terms – ledgers, cash books, journals and day books – used for the accounts books. These are explained later in this unit. Some organisations will keep a full set of accounts books, but a small business may keep a smaller set, or, if all their business uses cash and cheques, they may keep only a single book in which all transactions are recorded. We will look at an example of a simple business like this at the end of this module.

The accounts books hold a series of *accounts*. An account is a record of all transactions of a particular type, or relating to a particular customer, supplier, type of expenditure or purchase. For example, a typical accounting system will have separate accounts for each of the following (and more):

- cash
- movement of money into and out of the bank
- buying stationery, printing
- buying electricity

- sales to customers
- purchase of goods for stock (to be resold later)
- an account for each customer who buys on credit
- an account for each supplier who supplies goods on credit
- wages and salaries
- VAT
- accountancy charges
- fixtures, fittings and equipment purchased
- motor vehicles purchased
- expenses for motor vehicles
- loans.

Later in this module you will learn how the different kinds of account are usually distributed amongst the various accounts books and why they are kept in different books.

You will probably already be familiar with the term *account* from your everyday life. You may have accounts at banks and/or building societies, and when you receive an electricity or phone bill, or a bill from a credit card company, it will probably have the title 'Statement of account'. This shows that you can hold an account either with a positive amount of money (a deposit account at a bank, for example), or a negative amount (you owe money to the credit card company). The term *account* is used because the bank, electricity board and so on have an account for you as a customer in their books. Later in the course, you will learn how statements are drawn up to show the state of a customer account or supplier account of this type.

List any companies, banks, shops and so on with which you hold an account:

ACTIVITY 4

Using the brief definitions given earlier in this unit, see if you can work out which of the two parts of the transactions listed in the last activity should be recorded as debit entries and which as credit entries. Mark each as Dr for a debit or Cr for a credit entry.

	Account	Dr or CR
1. A manufacturing firm buys components to make a product:		
– cash leaves the company	Cash	________
– a stock of components comes into the company	Stock	________
2. The firm pays its electricity bill by cheque:		
– the firm gains electricity	Light & heat	________
– money moves out of the bank account	Bank	________
3. The firm pays an employee's wages by cheque:		
– the firm gains the employee's work	Wages	________
– money moves out of the bank account	Bank	________
4. A customer returns a product for a refund of cash:		
– the firm refunds cash	Cash	________
– the firm gains stock	Stock	________

Compare your answers with ours, at the end of the module.

You will have many more opportunities to practise working out which entries should be debits and which should be credits.

The layout of accounts

Traditionally, accounts in a double-entry book-keeping system are laid out following these rules:

- each account has a page to itself; there is never more than one account on a page (an account may run over several pages if there are many transactions)
- in the UK, debit entries are recorded on the left-hand side of the page
- in the UK, credit entries are recorded on the right-hand side of the page
- the title of the account is written across the top of the page and the account reference number is also shown, e.g. in the top right-hand corner
- each side, debit and credit, is sub-divided to give spaces to record the date, some details of the transaction, and the amount of money involved
- each account should have a reference column (also called a folio column). Although this is not used much in this course, you should know that it is simply used as a cross-reference for each double-entry which is made.

Here is an example of a blank ledger page in an accounting book. You will become very familiar with this layout as you progress through the course.

Account number here

Account name here

Debit side **Credit side**

Date	Details	Ref	£	Date	Details	Ref	£

Practise drawing up this layout on your own paper. You will need to use a lot of accounting paper during your work on the course, and you can either draw it up yourself following this layout or you can buy pre-printed paper from a stationery shop.

In some accounts, you will find that most or all entries appear on the same side – all are credits or all are debits. In others, there will be roughly equal numbers of credits and debits.

Here is an example of an account showing the purchase of stationery for use in a business.

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Expenses: Stationery

Dr **Cr**

Date	Details	Ref	£	Date	Details	Ref	£
9/3	HC Papers Ltd		178.20				
10/3	Lincote & Sons		49.50				
11/3	HC Papers Ltd		102.35				

The '17' which appears in the top right-hand corner is the account's reference number.

ACTIVITY 5

How do you think the assets and liabilities of the business are affected by the transactions listed in the stationery account, Ref 17, above?

Compare your answer with ours, at the end of this module.

As you can see, all the entries in the stationery account are debits. This is because stationery comes into the business when it is bought, but there is no movement of stationery out of the business in exchange for money, i.e. it isn't resold. Although all the entries recorded in this account are debits, there will of course be credit entries to balance them elsewhere in the accounts. These will show either the movement of money out of the cash account to pay for the goods, or a debt owed to the supplier. Although all the entries shown here are debit entries, there are circumstances in which a credit entry might be made in an expense account like this. If, for example, some stationery were to be returned to the suppliers for a refund, perhaps because it was found to be damaged, there should then be a credit entry in this account to show the movement of stationery out of the business.

In other accounts, you will see entries on both the credit and debit side. A good example is the bank account. This will show money coming into and leaving the business:

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Bank account

Dr Receipts **Payments Cr**

Date	Details	Ref	£	Date	Details	Ref	£
9/4	Opening balance	b/f*	2000.00				
10/4	Invoice 77178		451.11				
10/4	Sales (from cash)		265.79	10/3	Bowes & Lynn		479.90
11/4	Invoice 77186		391.12	20/3	J Wilson & Co		975.81
				1/4	Willis & Sons		195.40
				30/4	HC Papers Ltd		280.55
				30/4	Rent		415.65
				30/4	Lincote & Sons		49.50

* b/f = brought forward

You can see that money coming in is always a debit, recorded on the left-hand side. Money going out is always a credit, recorded on the right-hand side.

Your bank statement, as compared with the business's account above, is written from the bank's point of view. So when you pay money in, it is a credit and a liability as far as the bank is concerned as it then owes you the money you have deposited. When you take money out, it is a debit because the bank is discharging its responsibility to repay the money you have loaned to it.

You will have many chances to practise making debit and credit entries later in this module and throughout the course.

Summary

In this unit you have learned that the basic principle of double-entry book-keeping is that each transaction is recorded in the form of two balancing entries: a debit entry and a credit entry. You should now also be able to:

- explain what a debit is and what a credit is
- explain the terms *asset* and *liability*
- draw up an account following the standard layout
- make simple entries in an account to record a transaction.