Bookkeeping Basics: Double Entry Accounting

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The double entry system of accounting has been in use since the 15th Century and it defines just about every bookkeeping process you carry out, whether it's a modern digital system, or a paper book. Here's what you need to know!

Equity is the money put into the business by the shareholders (e.g. 'funds introduced', plus any profits, less any losses or drawings from the business. Another way to think about the accounting equation is: **equity = assets - liabilities**

Within *any business*, at *any time* the **accounting equation** applies:

assets = liabilities + equity

If you were to wind up the business you would sell all the **assets**, e.g. land, livestock, machinery and after you had repaid all the **liabilities** e.g bank loan, suppliers to whom you owe money, etc, what was left would belong to the owners of the business, e.g. a sole trader, or the partners—this is their **equity**.

In double entry bookkeeping every financial transaction you make will have two parts, and these will maintain this balance.

EXAMPLE 1

	ASSETS	= LIABILITIES	+ EQUITY
Margo buys a bull for £1,000 paying in cash.	+ £1,000 (value of bull)	£0 (no change)	£0 (no change)
Net effect:	**£0**	**£0**	**£0**

The accounting equation is maintained.

EXAMPLE 2

	ASSETS	= LIABILITIES	+ EQUITY
Jim buys a digger on credit, it cost £9,500.	+ £9,500 (the digger)	+ £9,500 (owed to dealer)	£0 (no change)
Net effect:	**+ £9,500**	**+£9,500**	**£0**

The accounting equation is maintained.

In each example there are two entries for every transaction (the bull and the cash, or the digger and the debt to the dealer), and these cancel each other out.

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Double-entry bookkeeping in practice

In double-entry bookkeeping you have various different *ledgers* and at least two are involved in every accounting transaction. In accounting software these are often called *accounts*, *nominal accounts*, or *nominals,* and together these are known as the *nominal ledger***.** The nominal accounts you have for your business will be tailored to your needs, for instance different types of livestock sales, or different variable costs or overheads. The nominal accounts you have will generally be grouped together into:

- Sales/income
- Purchases/expenses
- Assets
- Liabilities
- Equity

Every transaction you enter into your bookkeeping software will have two separate entries even though it may only feel like you are recording one single thing. Your system will know that if you've paid for an item with cash then the reduction in your *cash* asset will be the second entry. Similarly if you haven't paid the supplier the system will record *accounts payable* (or *creditors*) as the second entry and when you then pay the supplier the system will create another two transactions—one which reduces the accounts payable, and one which reduces the cash in your bank.

What about income & expenses?

So far we've seen examples where the purchase or sale has been of an asset. This clearly fits into the assets = liabilities + equity equation. But what about income and expenses, like a subsidy payment, or a feed bill?

When the business makes a profit this increases the owner/s equity, part of which is comprised of the accumulated profits (less any losses). So transactions which increase business profits (e.g. sales) will increase the equity, whilst transactions which reduce business profits (e.g. expenses) will reduce the equity.

EXAMPLE	**ASSETS**	**=**	**LIABILITIES**	**+**	**EQUITY**
Fiona receives a vet bill for £1,000 on account.			+ £1,000 (owed to vet)		- £1,000 (the vet bill reduces the profits by £1,000)
Net effect:	**£0**		**+£1,000**		**- £1,000**

The accounting equation is maintained.

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