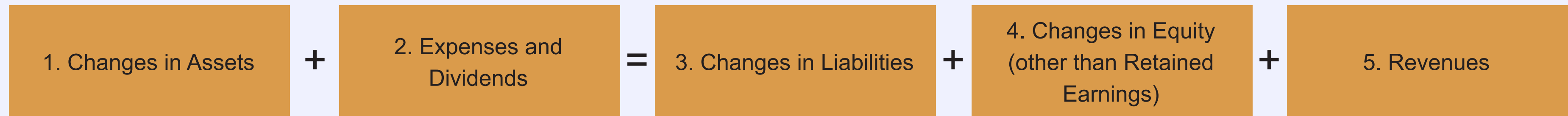
FINANCE AT A GLANCE

Identifying and analyzing transactions : introducing debit and credit

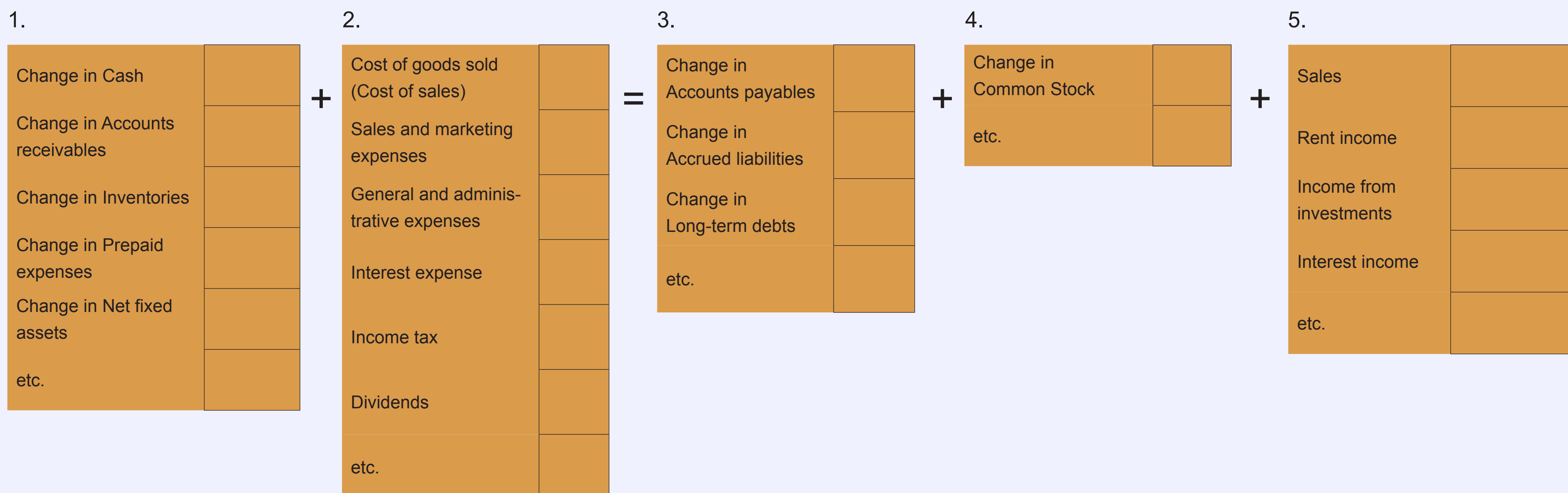
Lesson 39

We looked at transactions in previous lessons for the purpose of showing how their effects on the financial statements conform to the balance sheet-income statement relationship equation, which essentially is based on the balance sheet equation, that we introduced in the very first lesson of this course. In this lesson, we shall use the same equation to start our walk through the accounting cycle. Here we present again the diagram of this equation:



From the diagram of the balance sheet-income statement relationship equation, we can see its resemblance to the balance sheet equation. If the balance sheet equation is to be upheld, then the changes in the assets must equal the changes in the liabilities plus the changes in equity. Notice however that in the Change in Equity, it says “(other than Retained earnings)”. That’s because the Change in Retained earnings is already accounted for by the inclusion of Revenues and Expenses+Dividends. Recall what we discussed in an earlier lesson that the Changes in Retained earnings stem from Revenues earned within a period as well as the Expenses (and Dividends) within the same period. In fact we can say here that “the Retained Earnings is where the balance sheet meets the income statement”. This is an important point to remember at a certain stage in the accounting process. We shall make reference to this point again when we reach that stage.

For now, let us expand the above diagram by displaying the details of each box. For example, under Box 1 - Change in Assets means Change in the various asset types like: Change in Cash, Change in Accounts receivables, etc. Under Box 2 - Expenses and Dividends, we have Cost of goods sold, Sales and marketing expenses, etc.



When we say “Change in Cash”, or “Change in “Accounts payables”, or any of the phrases in the above diagram that starts with “Change in … “, we mean either an increase or a decrease. Accountants, however, do not call these change as “increases” and “decreases”. They call them *debits* and *credits*. In the field of accounting, by convention:

An increase in an Asset	is called a	*debit*
A decrease in an Asset	is called a	*credit*

An increase in a Liability or Equity	is called a	*credit*
A decrease in a Liability or Equity	is called a	*debit*

Just like any Equity, a Change in Retained earnings is a debit if it is a decrease, or a credit if it is an increase. And as we said in Lessons 31 and 32, Expenses and Dividends decrease Retained earnings, and therefore, Expenses and Dividends are called debits. Now, when Expenses (or Dividends) are reversed, as in cases where they are found to be overbooked, or booked by mistake, etc., Retained earnings increases. Therefore reversals of Expenses or Dividends are credits.
Revenues, on the other hand increase Retained earnings, and therefore, are called credits. When Revenues are reversed, Retained earnings decreases, therefore reversals of Revenues are debits.
We summarize these as:

An Expense or a Dividend	is called a	*debit*
A reversal of an Expense or a Dividend	is called a	*credit*

A Revenue	is called a	*credit*
A reversal of a Revenue	is called a	*debit*

In the next few lessons, we will apply these definitions.