FINANCE AT A GLANCE

Analyzing transactions : making *debit* and *credit* entries (1)

Lesson 40

Now, were ready to analyze transactions and write the accounting entries (debit and credits) based on our analysis.
The definitions of debit and credit (from the previous lesson) are being repeated here, and numbered 1 through 8 in order to facilitate making references to them as we analyze transactions.

1. An increase in an Asset	is called a	*debit*
2. A decrease in an Asset	is called a	*credit*
3. An Expense or a Dividend	is called a	*debit*
4. A reversal of an Expense or a Dividend	is called a	*credit*

5. An increase in a Liability or Equity	is called a	*credit*
6. A decrease in a Liability or Equity	is called a	*debit*
7. A Revenue	is called a	*credit*
8. A reversal of a Revenue	is called a	*debit*

In the analyzing transactions, we shall use the word ***account*** to mean not just the bank accounts in which the business entity lodges its cash, but also to refer to any of the items of the balance sheet (Cash, Accounts receivables, Accounts payables, Common stock, etc.) and of the income statement (Sales, Cost of goods sold, Salaries, Income taxes, etc.).
The short forms for the words debit and credit are “Dr” and “Cr” respectively. We shall use these short forms from here on.
Also, in writing accounting transactions, the credit entry/ies is/are indented vis-avis the debit entry/ies, as shown in the last column of the table below.

The transactions that we shall analyze in this lesson are as follows:

Transaction 1: January 5, 2010
The Company President spends $2,000 cash to entertain the Company's most important client.

Transaction 2: January 10, 2010
The bank from which the Company owes $700,000 in Long-term debt is invited to be a shareholder of the Company using the amount of what is owed to it as capital.

Here’s how we analyse these transactions.
Under the column “Applicable Definition”, you will see a number that refers to one of the eight definitions of debit and credit as displayed above. Using the relevant definition, plus the information under the columns “Account Type” and “Type of Change”, you will readily see why the entry is a debit or a credit.

Trans-action	Analysis	Account Affected	Account Type	Type of Change	Applicable Definition	Accounting Entries
1	The expense of $2,000 incurred in entertaining a client falls under *Sales and marketing expenses*. Such expense involves a disbursement of *Cash* (a reduction in the Cash balance).	Sales and marketing expenses Cash	Expense Asset	 decrease	3 2	Dr Sales and marketing expenses 2,000 Cr Cash 2,000
2	Of the Company's *Long-term debt*, $700,000 ceases to exist as such. Long-term debt decreases. The $700,000 that ceases to be a debt becomes an increase in *Capital Stock.*	Long-term debt Capital Stock	Liability Equity	decrease increase	6 5	Dr Long-term debt 700,000 Cr Capital stock 700,000

An important observation from the analysis: *In each transaction, <u>the debit entry equals the credit entry.</u>*

We shall analyze more transactions in the next lesson.