FINANCE AT A GLANCE

Insights into accounting entries (1)

Lesson 42

In the last two lessons, we saw that in each transaction the debit entry (or the total of the debit entries) equals the credit entry (or the total of the credit entries). Understanding why or how this is so requires some insight, and that will be our topic in this lesson.

We shall use the following definitions in our discussion.

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*

We shall relate these definitions to the balance sheet-income statement relationship equation. We shall use the transactions of Lessons 40 in the explanation.

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

As shown earlier the accounting entries for this transaction are as follows:

Dr	*Sales and marketing expenses*	*2,000*	
Cr	*Cash*		*2,000*

If we situate these entries in the equation, the debit entry goes to Box 2, and the credit entry goes to Box 1.

1. Changes in Assets	+	2. Expenses and Dividends	=	3. Changes in Liabilities	+	4. Changes in Equity (other than Retained Earnings)	+	5. Revenues
Cr Cash (a decrease) - 2,000	+	Dr *Sales and marketing expenses* *2,000*	=	0	+	0	+	0

Observe that the transaction involves only the left side of the equation. All three boxes on the right are not involved, and their values, as far as the transaction is concerned, are zero for each of them, which all add up to zero. *For the equality to be upheld, the left side of the equation must add up to zero as well*. And it does indeed add up to zero (-2000 + 2000 = 0)

The decrease in Cash (which is an asset) is a credit, based on definition 2 above. The Sales and marketing expenses is a debit based on definition 3. Their respective amounts are equal, but have opposite signs, therefore offsetting each other. This transaction shows how debit/s and credit/s that all fall under the left side of the equation are equal to each other.

Transaction 2: 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.

As shown earlier the accounting entries for this transaction are as follows:

Dr	*Long-term debt*	*700,000*	
Cr	*Capital stock*		*700,000*

If we situate these entries in the equation, the debit entry goes to Box 3, and the credit entry goes to Box 4.

1. Changes in Assets	+	2. Expenses and Dividends	=	3. Changes in Liabilities	+	4. Changes in Equity (other than Retained Earnings)	+	5. Revenues
				Dr *Long-term debt* (a decrease)		Cr *Capital stock* (an increase)		
0	+	0	=	- 700,000	+	700,000	+	0

Observe that the transaction involves only the right side of the equation. The two boxes on the left are not involved, and their values, as far as the transaction is concerned, are both zero, which add up to zero. For the equality to be upheld, the right side of the equation must add up to zero as well. And it does indeed add up to zero (-700,000 + 700,000 = 0)

The decrease in Long-term debt (which is a liability) is a debit, based on definition 6 above. The increase in Capital stock (which is an Equity) is a credit based on definition 5. Their respective amounts are equal, but have opposite signs, therefore offsetting each other. This transaction shows how debit/s and credit/s that all fall under the right side of the equation balance each other.

What about transactions that affect both sides of the equation? We shall look into this in the next lesson.