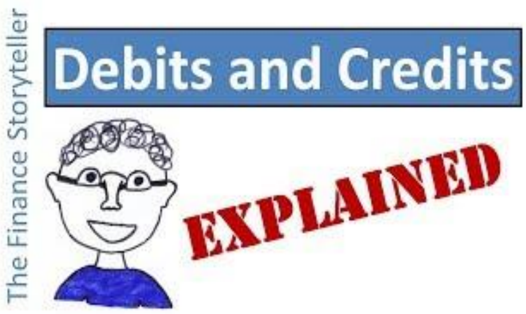
Financial Accounting - 9

By
Dr.Sanjay Banerji
Founder Director/Dean of Amrita School of Business

Debits and Credits - The Language of Accountants



Bala Sir welcomed Vaishali and her team with a broad smile on his face. He said, "Today, we are going to discuss a very important topic - The Language of Accountants. All of you have seen the importance of keeping correct record of all transactions, very carefully for running a business. A real business runs into hundreds of thousands of transactions almost daily. Therefore, the accountants have devised a fool proof system, to ensure that the transactions are recorded faithfully.

However, for reasons best known to them, they created their own code language, using just two words Debit and Credit. This is a kind of shorthand, developed by them (primarily the then Britishers) for recording all business transactions systematically. The primary purpose of all these records were two-fold: 1. To record the facts of the transactions correctly and 2. To uphold the validity of the balance sheet equation. The following table shows how their language works. The accountants' world is full of debits and credits.

Cash + **Non-cash Assets** + **Expenses** =**Liabilities + Shareholders' Equity + Revenue**

The Language of Accountants			
#	**Balance sheet equation item**	**Increase**	**Decrease**
	LHS		
1	**Cash**	**Debit**	**Credit**
2	**Non-cash Assets**	**Debit**	**Credit**
3	**Expenses**	**Debit**	**Credit**
	Balance sheet equation item	**Increase**	**Decrease**
	RHS		
4	**Liabilities**	**Credit**	**Debit**
5	**Shareholders' Equity**	**Credit**	**Debit**
6	**Revenue**	**Credit**	**Debit**

Bala Sir asked every member of the team to spend some time to understand the basic logic behind this language, sort of going behind the common-sense meanings of debit or credit. *The basic logic behind this code is the assurance that if the debits equal credits for every single transaction, the balance sheet equation would be maintained automatically*. We start an accounting year with the assets being equal to the liabilities. We transact our business, and truthfully record all transactions, ensuring that the debits equal credits. We are bound to get a new balance sheet where the assets equal the liabilities. This is the beauty of this mechanism of debits and credits. Hats off to those who devised this wonderful system, even though, it appears slightly confusing to begin with.

The point to note is that the terms debit and credit assume opposite meanings for the left-hand and the right-hand items of the balance sheet equation. Any increase in the LHS item is called 'Debit' abbreviated as Dr. Any increase in the RHS item is called 'Credit' abbreviated as Cr. Conversely, any decrease in the LHS item is called 'Credit'. Any decrease in the RHS item is called 'Debit'. These terms are also used as a verb. You may often hear accountants saying 'Debit cash 10,000'. Essentially, they mean that cash has gone up by 10,000 and record this transaction as 'Dr. Cash 10,000'. Similarly, when some transaction is done involving paying out cash, e.g. paying advance rent of Rs. 12,000, the accountants would ask you to 'Credit cash 12,000' meaning that cash has gone down by 12,000. They would expect you to write this as 'Cr. Cash 12,000' *with a slight indent.* The indent is designed to distinguish all debit entries from all credit entries.

The women were quite nervous, and many of them had started feeling that this was not their cup of tea, and it may be better to engage a professional accountant to keep the books of accounts. Bala Sir, could clearly see the apprehension on their faces, and he wanted to remove their apprehensions. He said, 'Ladies, please don't worry. All of you have learnt English, a foreign language, with its own grammar. In accounting, the only grammar you have to remember is the following:

> ***Any increase on any left-hand side item of the balance sheet equation is termed as a debit. Any increase on any right-hand side item of the equation is termed as a credit. For decreases, the opposite is true.***

Bala Sir said, you may look at debits and credits in another way.

A debit signifies an increase of the LHS or a decrease of the RHS of the balance sheet equation.

Conversely, a credit signifies an increase of the RHS or a decrease of the LHS of the balance sheet equation.

Please recall that the balance sheet equation has 3 items on each side. The LHS has Cash, non-cash assets and expenses while the RHS has Shareholders' equity, liability and revenues. Now, theoretically speaking (and even in reality), all the six elements may go up or down at some point in time. The accountants are in search of a common rule, that would ensure that under all circumstances, we ensure that the balance sheet equation remains valid. In order to do so, they devised a simple rule that while recording any transaction, we must ensure that the debits equal the credits. This would ensure that the balance sheet equation remains valid. If you are not convinced, please see the following table, where we have explored all possible permutations and combinations.

Credit	Increase in RHS	Decrease in LHS
Debit		
Increase in LHS	Increase LHS & increase in RHS	Increase in LHS & decrease in LHS
Decrease in RHS	Decrease in RHS & increase in RHS	Decrease in RHS & decrease in LHS

The above table captures all possible combinations of any change in the balance sheet equation, and if we ensure that debits are equal to credits, the validity of the equation is retained. Therefore, in spite of the potential confusion that the terms debit or credit might create, we should firmly establish in our mind the above definitions: *A debit signifies an increase of the LHS or a decrease of the RHS of the balance sheet equation; and a credit signifies an increase of the RHS or a decrease of the LHS of the balance sheet equation.* This is the *only* meaning in the accounting framework, for these two terms.

Bala Sir was thinking to himself:

> "Unfortunately, however, 'credit cash 10,000' in accounting would always imply that cash was depleted by 10,000, while your professor, in his careless moments, continues to become happy, considering the English language meaning of this phrase – and assuming that he received cash of 10,000. So, in case the women of the SHG ever make similar mistakes, we must understand their situation, and be patient to correct their mistake".

In order to boost their confidence level, Bala Sir devised a simple exercise for them. For each one of the following situations, he asked them to choose between debit and credit. He also gave a hint: just remember the balance sheet equation, especially the LHS items and the RHS items; and remember that LHS items going up means debit and RHS items going up means credit.

He distributed each individual a small slip of paper with the following details, asked them to write their name on top, tick mark the correct entry, and return the slip to him. He gave them 10 minutes for this exercise, followed by a short tea break.

Cash + Non-cash Assets + Expenses = Liabilities + Shareholders' Equity + Revenue

Name:	
Situation	Option
Cash goes down	Debit / Credit
Liability goes up	Debit / Credit
Shareholders' equity goes up	Debit / Credit
Revenue goes up	Debit / Credit
Non-cash goes up	Debit / Credit
Expenses goes up	Debit / Credit
Liability goes down	Debit / Credit
Cash goes up	Debit / Credit
Non-cash goes down	Debit / Credit
Revenue goes down	Debit / Credit
Expenses goes down	Debit / Credit

Serious students, please try this on your own. We shall start the next session with the answers.