Basic Accounting Information

GL Account Types – When to Debit or Credit

Software Development
RIMSS Business Systems Technology

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Introduction to Debits and Credits

Under the **double-entry** system every business transaction is recorded in at least two accounts. One account will receive a "debit" entry, meaning the amount will be entered on the *left* side of that account. Another account will receive a "credit" entry, meaning the amount will be entered on the *right* side of that account. The initial challenge with double-entry is to know which account should be debited and which account should be credited.

- A *debit* entry will either increases an asset or expense account, or decreases a liability or equity account.
- A *credit* entry will either increases a liability or equity account, or decreases an asset or expense account.

Debits and Credits vs. Account Types

	Increase	**Decrease**
Asset	Debit	Credit
Liability	Credit	Debit
Income/Revenue	Credit	Debit
Expense	Debit	Credit
Equity/Capital	Credit	Debit

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Debits and Credits in Common Accounting Transactions

The following bullet points note the use of debits and credits in the more common business transactions:

- *Sale for cash:* Debit the cash account | Credit the revenue account
- *Sale on credit:* Debit the accounts receivable account | Credit the revenue account
- *Receive cash in payment of an account receivable:* Debit the cash account | Credit the accounts receivable account
- *Purchase supplies from supplier for cash:* Debit the supplies expense account | Credit the cash account
- *Purchase supplies from supplier on credit:* Debit the supplies expense account | Credit the accounts payable account
- *Purchase inventory from supplier for cash:* Debit the inventory account | Credit the cash account
- *Purchase inventory from supplier on credit:* Debit the inventory account | Credit the accounts payable account
- *Pay employees:* Debit the wages expense and payroll tax accounts | Credit the cash account
- *Take out a loan:* Debit cash account | Credit loans payable account
- *Repay a loan:* Debit loans payable account | Credit cash account

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Debit and Credit Examples

Arnold Corporation sells a product to a customer for $1,000 in cash. This results in revenue of $1,000 and cash of $1,000. Arnold must record an increase of the cash (asset) account with a debit, and an increase of the revenue account with a credit. The entry is:

	Debit	Credit
Cash	1,000	
Revenue		1,000

Arnold Corporation also buys a machine for $15,000 on credit. This results in an addition to the Machinery fixed assets account with a debit, and an increase in the accounts payable (liability) account with a credit. The entry is:

	Debit	Credit
Machinery - Fixed Assets	15,000	
Accounts Payable		15,000

The abbreviation for debit is dr. and the abbreviation for credit is cr.

What Is An Account?

To keep a company's financial data organized, accountants developed a system that sorts transactions into records called **accounts**. When a company's accounting system is set up, the accounts most likely to be affected by the company's transactions are identified and listed out. This list is referred to as the company's **chart of accounts**. Depending on the size of a company and the complexity of its business operations, the chart of accounts may list as few as thirty accounts or as many as thousands. A company has the flexibility of tailoring its chart of accounts to best meet its needs.

Within the chart of accounts the balance sheet accounts are listed first, followed by the income statement accounts. In other words, the accounts are organized in the chart of accounts as follows:

- **Assets**
- **Liabilities**
- **Owner's (Stockholders') Equity**
- **Revenues or Income**
- **Expenses**
- **Gains**
- **Losses**

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Assets and Liabilities

Balance sheet accounts are the assets and liabilities. When we set up your chart of accounts, there will be separate sections and numbering schemes for the assets and liabilities that make up the balance sheet.

A quick reminder: Increase assets with a debit and decrease them with a credit. Increase liabilities with a credit and decrease them with a debit.

Identifying assets

Simply stated, assets are those things of value that your company owns. The cash in your bank account is an asset. So is the company car you drive. Assets are the objects, rights and claims owned by and having value for the firm.

Since your company has a right to the future collection of money, accounts receivable are an asset-probably a major asset, at that. The machinery on your production floor is also an asset. If your firm owns real estate or other tangible property, those are considered assets as well. If you were a bank, the loans you make would be considered assets since they represent a right of future collection.

There may also be intangible assets owned by your company. Patents, the exclusive right to use a trademark, and goodwill from the acquisition of another company are such intangible assets. Their value can be somewhat hazy.

Generally, the value of intangible assets is whatever both parties agree to when the assets are created. In the case of a patent, the value is often linked to its development costs. Goodwill is often the difference between the purchase price of a company and the value of the assets acquired (net of accumulated depreciation).

Identifying liabilities

Think of liabilities as the opposite of assets. These are the obligations of one company to another. Accounts payable are liabilities, since they represent your company's future duty to pay a vendor. So is the loan you took from your bank. If you were a bank, your customer's deposits would be a liability, since they represent future claims against the bank.

We segregate liabilities into short-term and long-term categories on the balance sheet. This division is nothing more than separating those liabilities scheduled for payment within the next accounting period (usually the next twelve months) from those not to be paid until later. We often separate debt like this. It gives readers a clearer picture of how much the company owes and when.

Owners' equity

After the liability section in both the chart of accounts and the balance sheet comes owners' equity. This is the difference between assets and liabilities. Hopefully, it's positive-assets exceed liabilities and we have a positive owners' equity. In this section we'll put in things like

- Partners' capital account
- Stock
- Retained earnings

Another quick reminder: Owners' equity is increased and decreased just like a liability:

- Debits decrease
- Credits increase

Most automated accounting systems require identification of the retained earnings account. Many of them will beep at you if you don't do so.

By the way, retained earnings are the accumulated profits from prior years. At the end of one accounting year, all the income and expense accounts are netted against one another, and a single number (profit or loss for the year) is moved into the retained earnings account. This is what belongs to the company's owners-that's why it's in the owners' equity section. The income and expense accounts go to zero. That's how we're able to begin the new year with a clean slate against which to track income and expense.

The balance sheet, on the other hand, does not get zeroed out at year-end. The balance in each asset, liability, and owners' equity account rolls into the next year. So the ending balance of one year becomes the beginning balance of the next.

Think of the balance sheet as today's snapshot of the assets and liabilities the company has acquired since the first day of business. The income statement, in contrast, is a summation of the income and expenses from the first day of this accounting period (probably from the beginning of this fiscal year).

Income and Expenses

Further down in the chart of accounts (usually after the owners' equity section) come the income and expense accounts. Most companies want to keep track of just where they get income and where it goes, and these accounts tell you.

A final reminder: For income accounts, use credits to increase them and debits to decrease them. For expense accounts, use debits to increase them and credits to decrease them.

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Income accounts

If you have several lines of business, you'll probably want to establish an income account for each. In that way, you can identify exactly where your income is coming from. Adding them together yields total revenue.

Typical income accounts would be

- Sales revenue from product A
- Sales revenue from product B (and so on for each product you want to track)
- Interest income
- Income from sale of assets
- Consulting income

Most companies have only a few income accounts. That's really the way you want it. Too many accounts are a burden for the accounting department and probably don't tell management what it wants to know. Nevertheless, if there's a source of income you want to track, create an account for it in the chart of accounts and use it.

Expense accounts

Most companies have a separate account for each type of expense they incur. Your company probably incurs pretty much the same expenses month after month, so once they are established, the expense accounts won't vary much from month to month. Typical expense accounts include

- Salaries and wages
- Telephone
- Electric utilities
- Repairs
- Maintenance
- Depreciation
- Amortization
- Interest
- Rent