

# Rules of Debits and Credits

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Accounting is the language of business.

The accounting process involves recording transactions (economic events) during the accounting period. The results are then communicated to internal and external users.

Debits and credits are the tools used in recording transactions. Though the terms have other definitions, for accounting purposes debit means left and credit means right. Debit is abbreviated as dr. Credit is abbreviated as cr. Debit refers to the left side of an account and credit refers to the right side of the account.

The rules of debits and credits form the framework of the accounting process. The rules have existed since 1494. That is when an Italian monk and mathematician, Lucia Pacioli, created the double entry accounting system. The rules of debits and credits are an integral part of this double entry system. For each transaction, the debits and credits are always equal.

These rules work to keep the accounting equation (Assets = Liabilities + Stockholders' Equity) in balance.

This module looks at the rules. The next module covers some examples. Let's start by considering the accounting equation.

Assets equal Liabilities plus Stockholders' Equity. Since assets are listed first, let's begin with them.

Assets are economic resources owned by the business, also referred to as 'things of value'. Examples include cash, accounts receivable, merchandise inventory, supplies, prepaid expenses, land, buildings, equipment, and vehicles.

Assets are increased with a debit and decreased with a credit. The normal account balance is a debit.

What is a normal account balance? The debits and credits are posted from the journal to the ledger (the separate location of each of a company's accounts). The normal account balance reflects the increase to the account. For example, the asset cash is increased with a debit and has a normal debit balance. If the cash account has a credit balance (abnormal balance), accountants first check to see if an error has been made. If there is no error, they next check to see why the account has an abnormal balance. For cash, that means the account is overdrawn. This would require immediate action to keep checks from bouncing and fees from being incurred. An abnormal balance (credit balance) in the asset Accounts Receivable may indicate that a customer has overpaid or prepaid.

Next, consider liabilities. These rules are the opposite of the asset rules because liabilities are on the opposite side of the equal sign in the accounting equation.

Liabilities are amounts owed by the business (debts). Examples include accounts payable, notes payable, salaries payable, unearned revenue, sales tax payable, accrued expenses payable, mortgage payable, and bonds payable.

To keep the accounting equation in balance, liability accounts must be increased with a credit and decreased with a debit. The normal account balance is a credit. An abnormal balance in Accounts Payable (a liability account with a normal credit balance) may signal an error or that the company has overpaid a creditor (generally referred to as a vendor).

As with liabilities, stockholders' equity is located to the right of the equal sign. Stockholders' equity consists of several accounts. Some of these are increased with credits and others are increased with debits. Let's take a closer look.

Equity is the last part of the accounting equation. It is the difference between assets and liabilities and represents the residual interest of the owners (net assets). This section differs for sole proprietorships, partnerships, and corporations. Corporations use the title Stockholders' Equity. Stockholders' equity consists of several accounts. These include common stock, retained earnings, revenues, expenses, dividends, and gains/losses (Gains and losses will be covered in later chapters.)

Let's look at how these accounts affect stockholders' equity.

SE Account	Affect on SE	Increase
<b>Common Stock</b>	Increases SE	Cr
<b>Retained Earnings</b>	Increase SE	Cr
<b>Revenues</b>	Increase SE	Cr
<b>Expenses</b>	Decrease SE	Dr
<b>Dividends</b>	Decrease SE	Dr

Common Stock is a positive element of stockholders' equity and is increased with a credit (remember that it keeps the equation in balance). Debits decrease Common Stock. The normal account balance is a credit. Additional stock accounts will be covered in later chapters.

Retained Earnings is also a positive element of stockholders' equity and is increased with a credit (remember that it keeps the equation in balance). Debits decrease Retained Earnings. The normal account balance is a credit.

Common Stock and Retained Earnings both appear on the Balance Sheet. Common Stock represents the stock issued to the owners of the corporation (stockholders or shareholders). Retained Earnings represents earnings of a corporation less dividends. This balance carries forward each accounting period, beginning on the first day of the corporation's existence. Retained Earnings also appears on the Statement of Retained Earnings.

In addition to Common Stock and Retained Earnings, stockholders' equity is affected by revenues, expenses and dividends. Revenues are a positive element of stockholders' equity and are increased with a credit (remember that it keeps the equation in balance). Debits decrease revenues. The normal account balance is a credit.

Revenues appear on the Income Statement. They are the result of the earnings from providing services or selling goods. The revenue recognition principle requires revenues to be recorded in the accounting period in which they are earned.

Expenses are increased with debits and decreased with credits. The normal account balance is a debit.

Expenses also appear on the Income Statement. They are amounts incurred to produce revenue during the accounting period. The matching principle requires expenses to be recorded (matched to revenues) in the period in which they are incurred to generate revenues

Dividends are increased with a debit and decreased with a credit. The normal account balance is a debit.

Dividends are distributions to stockholders and represent overall decreases to stockholders' equity. Dividends appear on the Statement of Retained Earnings (they are not part of net income).

These items make for a busy stockholders' equity section. Let's analyze equity by using the accounting equation,  $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ .

Common Stock, Retained Earnings, and Revenues represent overall increases to stockholders' equity and are thus increased with credits and decreased with debits (same rules as liabilities because they are on the same side of the equal sign in the equation).

Expenses and Dividends represent overall decreases to stockholders' equity and are thus increased with debits and decreased with credits (the opposite rules as liabilities because they work to decrease stockholders' equity).

The primary accounts are Assets, Liabilities, Common Stock, Retained Earnings, Revenues, Expenses and Dividends. One way to remember the rules of debits and credits is with the acronym **DEAD**. **D**ebits increase **E**xpenses, **A**ssets, and **D**ividends.

Use the acronym **CRIL** to remember the rules for accounts that increase with a credit. **C**redits increase **R**evenues, **I**ntestments (Common Stock and Retained Earnings) and **L**iabilitys.

The rules of debits and credits keep the accounting equation in balance and are used to record accounting transactions in the journal. Normal account balances reflect the increase to the account. Abnormal account balances need to be investigated.