Debits and Credits

(Cheat Sheet)

AccountingCoach

Meaning of Debits and Credits

Debit and *credit* are related to the terms used in Italy 500 years ago to document the double-entry system of accounting. Today, you should memorize the following meanings:

- Debit means left or left side of an account
- Credit means right or right side of an account

To describe an amount recorded on the left side of an account, we say that the amount was debited to the account, or that the amount was a debit (or debit entry) in the account. An amount recorded on the right side of an account is said to be a credit entry, a credit, or that the account was credited.

It is important that you do *not* think that a debit is “good” or “bad”. Similarly, you should *not* think of a credit as being “good” or “bad”.

Account

An account is a record in which the amounts from a company’s transactions are posted (or recorded) in order to sort and store similar amounts. The following are typical account titles: Cash, Accounts Receivable, Accounts Payable, Loans Payable, Sales, Advertising Expense, Rent Expense, Interest Expense, and perhaps hundreds more.

When we use the term *accounts*, we are referring to the *general ledger accounts*. In the past the *general ledger* was a ledger book with paper pages, but today it is likely to be a computer file or database.

A simple listing of the account titles and account numbers that are available for use in a company’s general ledger is known as a *chart of accounts*.

Double-Entry Accounting or Bookkeeping

The double-entry system requires that for every business transaction there must be an amount entered as a debit in one account and the same amount entered as a credit in another account. In other words, every business transaction will involve:

- A minimum of two accounts
- One or more of the accounts must have an amount entered as a *debit*, and
- One or more of the accounts must have an amount entered as a *credit*.

Example #1.
When a company borrows $5,000 from its bank, the company will record a *debit* of $5,000 in the account entitled Cash *and* a *credit* of $5,000 in the account Loans Payable or Notes Payable.

Example #2.
When a company pays $1,000 for a radio advertisement the company will record a *debit* of $1,000 in the account Advertising Expense *and* a *credit* of $1,000 in the account Cash.

It is common for inexpensive, yet sophisticated accounting software (such as QuickBooks by Intuit) to use the double-entry system but prompts you for only one account name or number. For example, if the software prepares a check, it will automatically credit the account Cash when the check is written. Therefore, the software requires that you enter only the account or accounts to be debited.

Accounting Equation May Help You Understand Debits and Credits

The accounting equation is:

Assets = Liabilities + Stockholders' (or Owner's) Equity

Asset accounts, which are on the left side of the equation, will usually have their *balances on the left side of the account*. Since debit means left side, an asset account will likely have a *debit balance*.

Liability accounts, which appear on the right side of the accounting equation, will usually have their *balances on the right side*. Since credit means right side, a liability account will likely have a *credit balance*.

Stockholders' equity accounts, which also appear on the right side of the accounting equation, will usually have their *balances on the right side*. Since credit means right side, a stockholders' equity account will likely have a *credit balance*.

Asset Accounts Will Likely Have Debit Balances

Examples of asset accounts are:

- Cash
- Accounts Receivable
- Inventory
- Prepaid Expenses
- Investments
- Land
- Buildings
- Furniture and Fixtures
- Vehicles, and more

Generally, asset accounts will have *debit balances* and their account balances will be increased with a debit entry. Hence, a credit entry will decrease the asset's normal debit balance.

> Note: There are a few asset accounts that are intended to have credit balances. These are known as contra-asset accounts. Examples are Allowance for Doubtful Accounts (which relates to the debit balance in Accounts Receivable) and Accumulated Depreciation (which relates to the debit balances in the accounts Buildings, Equipment, Vehicles, etc.). These contra-asset accounts will be credited instead of crediting the related asset accounts.

Liability Accounts Will Likely Have Credit Balances

Some examples of liability accounts include:

- Accounts Payable
- Loans Payable (or Notes Payable)
- Interest Payable
- Wages Payable
- Income Taxes Payable
- Accrued Expenses Payable (or Accrued Liabilities)
- Deferred Revenues, and others

Generally, liability accounts are expected to have *credit balances* and their account balances will be increased with a credit entry. To decrease a liability account's balance a debit entry is needed.

Stockholders' (or Owner's) Equity Accounts Will Have Credit Balances

Some examples of stockholders' (or owner's) equity accounts include:

- Common Stock
- Paid-in Capital in Excess of Par
- Retained Earnings
- Accumulated Other Comprehensive Income
- Mary Smith, Capital

Generally, these accounts are expected to have *credit balances* and their account balances will be increased with a credit entry. To decrease one of these accounts a debit entry is needed.

> Note: Treasury Stock and Mary Smith, Drawing are two contra-equity accounts that are intended to have debit balances.

Revenue Accounts Will Have Credit Balances

Examples of revenue accounts include:

- Sales
- Service Fees Earned
- Fee Revenues
- Interest Income

Revenue accounts will have *credit balances* and their account balances will be increased with a credit entry. Revenue accounts have credit balances because revenues increase stockholders' (or owner's) equity.

> Note: The account Sales Discounts and the account Sales Returns and Allowances are known as contra-revenue accounts since they have debit balances. These accounts are debited because they cause a decrease in the expected credit balances of the stockholders' (or owner's) equity accounts.

Expense Accounts Will Have Debit Balances

Examples of expense accounts include:

- Salaries Expense
- Rent Expense
- Utilities Expense
- Repairs and Maintenance Expense
- Advertising Expense
- Depreciation Expense
- Interest Expense
- Income Tax Expense

The general ledger accounts for expenses will have *debit balances* and will almost always be debited. Expenses have debit balances because they will decrease the normal credit balances of stockholders' (owner's) equity.

The Accounts for Revenues and Expenses are Temporary Accounts

At the end of each year, the income statement accounts (revenues, expenses, gains, losses) are closed to a stockholders' (owner's) equity account. As a result, these accounts will begin each accounting year with zero balances. This is the reason that the *income statement accounts* are known as *temporary accounts*. (The *balance sheet accounts* are known as *permanent accounts*, since their balances are not closed at the end of an accounting year. Instead, these account balances are carried forward to the next accounting year.)

Learning Which Accounts to Debit and Credit

Since many business transactions involve cash, a good place to begin learning debits and credits is with the general ledger account Cash. Since Cash is an asset account:

- *Cash will be debited when cash is received.* (Recall that a debit will increase an asset account's balance.)
- *Cash will be credited when cash is paid out.* (Recall that a credit will decrease an asset account's balance.)

In our earlier examples, a company borrowed money from its bank. The account Cash has to be *debited* because the company is receiving $5,000 of cash from its bank. Because of double-entry accounting, another account will be *credited* for $5,000. In this case, the company should *credit* Loans Payable or Notes Payable. This credit makes sense because the balance in a liability account needs to be increased.

In our other example, when a company pays a bill, the asset account Cash needs to be *credited* for $1,000 in order to reduce this asset's normal debit balance. Therefore, another account will need to be debited. Since the payment was for advertising, the account Advertising Expense will be *debited*. (Recall that expenses are almost always debited. Also recall that expenses are debited since they decrease the normal credit balance in the equity accounts.)

If a company makes a cash sale of $500, the company will *debit* Cash for $500 because the company is receiving cash and needs to increase the balance in the asset account Cash. The double-entry system requires that another account will need a credit entered. In this situation, the account to be credited is Sales. (Recall that revenue accounts are almost always credited. Also recall that revenue accounts are credited since they *increase* the normal credit balance in the equity accounts.)

When a company makes a payment of $5,200 to repay its $5,000 loan plus $200 of interest, the company should:

- *credit* Cash for $5,200 since the asset Cash is decreasing
- *debit* Loans Payable for $5,000 since the liability Loans Payable is decreasing
- *debit* Interest Expense for $200 since expenses are nearly always debited.

In this example, we see that the credit of $5,200 = the debits of $5,200 ($5,000 + $200).

If a company buys a new machine at a cost of $20,000 by writing a check for $12,000 and promising to pay $8,000 in six months, the company will *debit* the asset Machinery for $20,000; *credit* Cash for $12,000; and *credit* Loans Payable or Notes Payable for $8,000.

Additional Tips for Accounts to be Debited and Credited

You might think of the acronym DEAL when learning which accounts will be increased with a debit entry. Use the first letter from the following four types of accounts to spell D-E-A-L:
Dividends
Expenses
Assets
Losses

You could think of the acronym GIRLS when learning which accounts will be increased with a credit entry. Use the first letter from the following five types of accounts to spell G-I-R-L-S:
Gains
Income
Revenues
Liabilities
Stockholders' (or owner's Equity)

Trial Balance

If each transaction has its debits equal to credits, and there are no math errors in calculating the account balances, then the accounts are in balance. A *trial balance* is an internal report that lists all of the account balances in the respective debit or credit column. The amounts in each column should sum up to the same total. (Today's popular accounting software has been programmed to require debits to be equal to credits and the account balances will be computed without error. Hence, the trial balance should never indicate a difference.)

A balanced trial balance does not guarantee that the records are free of errors. For example, an entry could be completely omitted or could be entered twice and the trial balance will be in balance. Also, the monthly rent payment could be coded incorrectly as a debit to an asset account instead of a debit to Rent Expense and the trial balance will be in balance.