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Video Transcription: Understanding Debits and Credits

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Hello there, my name is Jacqui and this video is going to focus on debits and credits, the language of accounting.

Our journey into understanding debits and credits should really start in 1494. Don't worry though, we speed up quite quickly after taking a look at history. Luca Pacioli is often referred to as the Father of Accounting. This is because in 1494, he described the double-entry bookkeeping system, and the idea "for every debit entry there must be an equal credit entry" has remained the basis behind record keeping since that date. So, why do we need a record-keeping system? The business will require information about the type and amount of resources it has, as well as information about whether these resources are provided by owners and/or lenders and how efficiently these resources have been used to generate income.

In other words, the business needs to keep a day-to-day record of every transaction that happens in the business, and the system in which we record these transactions has to acknowledge that after every transaction the assets are equal to the equity plus the liabilities. At the same time, the system also has to acknowledge that every transaction has a double impact. This is sometimes referred to as the double-entry principle.

So, what is this double-entry principle? For example, the business pays cash, so bank will decrease but what did the business actually pay for? It could have been for an asset such as inventory, vehicles or equipment or paid to the owner as a dividend, paid to a lender or for electricity that the business has used. The records will also need to indicate whether an asset – inventory, vehicles, equipment – has increased or whether equity through a dividend or an expense or a liability has decreased.

What about a second example? The business receives cash so bank will increase but from whom did the business receive the cash? Was it the owner, a lender, a customer for a sale? The records also need to indicate whether the equity, either through capital or income, or a liability has increased.

Businesses will keep track of a large number of transactions and it is therefore important that they correctly record both legs or entries of every single transaction.

To be able to trace and keep track of whether both legs of the transaction have been reported, the double-entry system refers to one leg of the transaction as a debit entry and the second leg of the transaction as a credit entry. It is important that the business, every now and again, checks that the total of all the debit entries equal the total of all the credit entries. If these two figures are not equal the business reviews the transactions to identify the error. The tool that is used to check that overall the debits are equal to the credits is called a trial balance, and preparing this document is a key step in identifying errors.

We know that after every transaction, the assets are equal to the claim on the assets. In order to ensure that both legs of the transaction are recorded, each transaction must also have an equal debit and credit entry.

So, how are these two requirements mapped? Remember, transaction-by-transaction to create the accounting record-keeping system.

The accounting recording system recognises that a business requires resources and that these resources are provided by the owner and lenders of a business. When the owner contributes resources, the assets increase and the equity increases. So how do we translate this information into accounting speak or debits and credits? An increase in an asset is recorded as a debit entry. Equity also increases. We know by now that each transaction has to have an equal debit and credit entry. This means that when equity increases we show it as a credit entry.

Let's look at another example. If the resources have been provided by lenders, the assets would increase and liabilities would increase. Referring to this transaction in terms of debits and credits, we can see that the assets increase. Remember, we debit the asset. The liabilities have also increased and for each transaction we need an equal debit and credit entry. So an increase in a liability is shown as a credit entry. If an increase in an asset is recorded as a debit entry, then a decrease will be recorded as a credit entry. We have seen that an increase in equity and liabilities is recorded as a credit entry, so a decrease in equity or a liability would therefore be recorded as a debit entry.

You need to think of the terms debit and credit as an instruction to the bookkeeper about how to record the impact on the assets (equity and liabilities) per transaction. The instruction is given in code. For example, using the terms debit and credit instead of the terms increase and decrease. So each bookkeeper is actually a spy in disguise, the James Bond of the accounting world.

Here is something to think about. If a business purchases an asset, the asset would increase and part of the purchase price is paid in cash. Okay so the cash would decrease and the remainder is still being owed. So a liability would increase. What do you think we would debit and credit? Can you see the asset the we're acquiring is being debited, the cash asset we are giving away is being credited and the liability is also being credited. What is interesting about this example is, we have one debit entry and two credit entries. But if we look at what would be happening, the debit for the asset increasing is still going to be equal to the total of the credit entries. So when we say for every debit there must be an equal credit. Remember that we could have more than one debit or more than one credit per transaction but your debits would still equal your credits after each transaction.

Students often ask the question, "What does the term 'debit and credit' actually mean?" It is really important to understand that we can actually only understand the terms debit and credit if we ask, which element are we referring to – asset, equity or liability? Remember with respect to assets, debit refers to an increase and with respect to equity and liabilities a decrease. With respect to assets, credit refers to a decrease and with respect to equity and liabilities, an increase.

Okay so let's look at a few transactions and determine what the instruction to the bookkeeper would actually look like.

In this example, the business purchased a vehicle on credit for R50 000. So we know that the vehicle, an asset, will increase by R50 000. We will represent this as a debit to vehicles of R50 000. We also know that the liabilities or a payable will increase by R50 000. This will be represented as a credit to payables of R50 000.

One of the reasons students get confused with the concepts of debits and credits is because as an individual you may have an account at a bank and every now and again we will receive either a bank statement or an ATM slip. Let's think why this can cause some confusion. The first point to note is that the bank, wherever you have chosen to open an account, records the transactions with you from its point of view. Also when the bank sends you information, your bank statement or bank slip from an ATM, this information is also from their point of view.

So, why is this important? When you deposit money into an account at the bank, the bank owes you this money, in other words, the bank sees you as a liability and when you deposit money into the bank what they owe you increases. Well, we have learnt that when a liability increases it is recorded as a credit entry. So the bank shows a credit entry in their books. When you withdraw money from your account at the bank, the bank owes you less or we can say that their liability decreases.

Well, we know that a decrease in a liability is recorded as a debit entry. So when you withdraw money from your account at the bank, the bank records this as a debit entry. When you deposit money in an account at the bank, you would record this transaction as an asset in your books, you would debit the asset account. Remember, the bank has recorded this transaction as an increase in a liability. In your books the bank is an asset and in the bank's books you are a liability. Well, this makes sense as you are entitled to the cash, this means it is your resource and therefore an asset and the bank has an obligation to give it back to you when requested. Therefore, they have a liability.

Conversely, if you borrowed money from the bank you would credit a liability in your books as this is the amount you need to pay back. The bank would debit an asset account as they expect to receive this amount back from you so it is a resource in their books.

During this video, we have identified that the terms debit and credit are used to indicate either an increase or decrease in assets, equity and liabilities. Well, now that we've become familiar with the language of accounting what we would like to suggest is that you move on to understanding a little bit more about the recording process. We hope you have enjoyed this video and we suggest that you maybe take a look at the video about the recording and the reporting process (see "Recording and Reporting Financial Information"). That video is going to focus on the actual difference between what we call the recording and the reporting of financial information.

Thanks very much and we hope you enjoyed watching.