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How Accounts, Debits, and Credits are Used to Record Business Transactions

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Abstract

To keep a company's financial data organized, accountant developed a system that sorts transactions into records called account. An account is an individual record of increase and decrease in a specific asset, liability, or owner's equity/stockholders' equity item. In its simplest form, an account consists of three parts (a) the title of the account, (b) a left side or debiting, and (c) a right side or crediting. The combine of those parts become a form that we called a T-account. T-account need two element that consist of debit and credit that used by accountants when recording transactions in business company. Some transactions are a mixture of increase/decrease effect. The types of accounts that increased with a debit like dividends, expenses, assets, and losses. Then for increased with a credit like gains, income, revenues, liabilities, and stockholders (owner's) equity. So an asset account is increased with a debit and therefore it is decreased with a credit. The other one is the debit/credit system has internal consistency that attempts to describe the effects of a transaction in debit/credit for and it will be something wrong when debits do not equal credits. For now, financial report was computerized systems that challenge any attempt to unbalanced transaction that does not satisfy the condition of debits = credits. The debit/credit rules are built with logical structure.

Keywords : Financial Account, Debit, Credit, Increase/Decrease

1. INTRODUCTION

Accounting is introduced of recording increases and decreases in various accounts. In business transactions, accounting is used to record numbers in two columns where is called debit column and credit column. Historically, this was taught using the debit/credit approach, which we label as the "traditional approach". The traditional approach makes adjustments very straight-forward and facilitates interpretation of accounting policies that require such adjustments. The traditional approach has been taught with the assumption that know to utilize debit/credit is better at interpretation of accounting (Daulay, 2020). Debit is an accounting entry that either increases an asset or expense account, or decreases a liability or equity account and it is positioned to the left column. Then credit is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account and it is positioned to the right column. This case we called as double entry system which provides accuracy in the accounting records and financial statements. This paper will describe between accounts, debits, and credits are used to record business transactions and allow for all the financial elements of a business to appear in a single expanded equation and can be make the transactions become more intuitive and transparent to a broader audience of end-users of transactions in accounts.

2. LITERATURE REVIEW

Actually, accounting classify all accounts into five basic categories assets, liabilities, owners' equity, revenues, and expenses. According Loughran (2011), there are some brief definitions derived :

- Assets are tangible and intangible items that a company holds that have value (e.g., cash, computer systems, patents).

- Liabilities are funds that the business owes to others such as loans, mortgages, and other claims of creditors.
- Owners' Equity (Equity) is the portion of total assets that the owners of the company fully own or have paid for outright.
- Revenues are the net from the company earns from its sales.
- Expenses are the costs the company spends to produce the goods or services that it sells (e.g., office supplies, utilities, advertising).

The trial balance is a compilation of account balances displayed in the same order as the categories listed above (Loughran, 2011). The trial balance displays assets and expenses on the left-side with a balancing right-side for the liabilities, equity, and revenues. Accountants compile the trial balance after recording all the transactions using the two accounting equations. The first traditional accounting equation (Eq 1) is the starting point for introducing the topic of accounting. Accountants refer to the following accounts as permanent, since these accounts are open for more than one accounting period. This equation contains the main components of the balance sheet. The balance sheet reflects the value of assets, liabilities, and owners' equity of an entity at a point in time; therefore, it is static. We typically present this equation in its normal form, which requires the balance of all the assets to appear on the left side while the balance of all liabilities and the owners' equity put in the right side.

Assets = Liabilities + Owners' Equity (1)

The income statement basic equation (Eq 2) reflects the company's financial performance over one period, typically a month or a year. The accountant computes the difference between monthly income and expenses to derive a net income or loss amount. Unlike assets, liabilities, and the owners' equity accounts, revenues and expenses are temporary accounts; following the closeout at the end of each month, the accountant transfers the resulting net income amount to the owners' equity.

Revenues – Expenses = Net Income (2)

Needles et al. (2013), Warren et al. (2015), Weygandt et al. (2018), Williams et al. (2005), Harrison and Horngren (2008), Libby, Libby, and Hodge (2017), and other textbooks begin showing the expanded equation of accounting in some form:

Assets = Liabilities+((Owners' Equity+(Revenues –Expenses)–Distributions to Stockholders)) (3)

As the entity continues its day-to-day operations, the business activities affect their assets and liabilities throughout the accounting period and not just at the end of the month. According to Libby (2017), Debits and credits are used to record transactions in a company's chart of accounts. The five poin of accounts category are :

1. Asset Account
   Assets are items that provide future economic benefit to a company (Nurmadi et al., 2018). For example : cash, accounts receivable, inventory, prepaid expanses, property & equipment, and vehicles.

2. Expense Account
   This thing is related to operational of a business. For example : advertising, utilities, rent, travel, and salaries.

3. Revenue Account
   This kind of thing is related to income from the sale of products and services. For example : sales revenue, service revenue, interest income, and investment income.

4. Liability Account
   Obligations that the company is required to pay. For example : accounts payable, income tax payable, loans payable, and bank fees.

5. Equity Account
These are net asset entries or non-operational assets after liabilities have been paid before). For example : securities, stocks, bonds, mutual funds, real estate, pension and retirement plans, derivative instruments.

According to Spellman W.L (2000) , in order to deepen the development of accounting techniques, it is necessary first of all to provide a complete and analytical framework of the literature review concerning the nature of the accounts. According to the international classification of the nature of accounts: Real accounts: are considered all assets of a firm, which are tangible or intangible, balance sheet account that is carried forward into the next year. Tangible real accounts are related to things that can be touched and felt physically (tool, building, machinery, stock, land).

DEBIT : SOMETHING COMES IN	CREDIT : SOMETHING GOES OUT

Personal accounts is accounts related to individuals, firms, companies (debtors, creditors, banks, outstanding/prepaid accounts, accounts of credit customers, accounts of goods suppliers, capital, drawings) and the other one for natural personal accounts is related to people. And then artificial personal accounts is related to entities created by law (corporations, institutions). Representative personal accounts is related to a certain person or a group directly or indirectly (employees and wageprepaid account).

DEBIT : RECEIVER	CREDIT : GIVER

Nominal account is related to expenses, losses, incomes or gains. According to Spellman W.L (2000), existing by name only is not existed in physical form, but related to any nominal account like money, income statement account (revenue and expense) that were closed at the end of the year.

DEBIT : EXPENSES AND LOSSES	CREDIT : INCOMES AND GAINS

According to Luca Pacioli (1494), the classification above focuses on the material accounts but do not have connection with the accounting equation but it is referred to the initial classification. According to the theoretical of Gino Zappa (Dagnino, G.B., Quattrone, P., 2006), father of the modern Italian business economics, has defined the earnings system, where the original, numerical accounts, represented by the changes of money, is distinguished, and the derived aspect, referred to economic measures, economic accounts, which are distinguished as economic accounts of capital, and earnings economic accounts. The current widespread approach adopted in Italy to identify the nature of the accounts, called capital and earnings system, as it is presented by contemporaneous academics (Melis, A., 2007), it outlines the original (financial) and derivative (economic) accounts (Manni, F., 1996; Manni, F., 2008; Manni, F., Faccia A., 2015; Manni, F., Faccia, A., 2019).

Financial accounts like cash, operating receivables and operating payables are in addition to financial receivables and payables. Financial accounts concerns cash inflows & outflows, as well as increases & decreases of receivables and payables) like cash or bank.

DEBIT : INCREASE OF CASH	CREDIT : DECREASE OF CASH

Assimilated is deferred values, to sum up, operating receivables and payables. And Assumptive is accrued receivables and payables, and funds.

DEBIT : INCREASE OF CREDIT	CREDIT : DECREASE OF CREDIT

OR DECREASE OF DEBIT	**OR INCREASE OF DEBIT**

Economic accounts, on the other hand, include, in addition to multi-annual (that exhaust their usefulness in more than one period) and operating costs and revenues (that exhaust their usefulness in one period), also the equity. Economic accounts aspect to identify the causes of financial transaction, cost, revenues, and equity.

Earnings of the period: costs and revenues of the period

DEBIT : EXPENSE OR REVENUE REDUCTION	**CREDIT : REVENUE OR EXPENSE REDUCTION**

Earnings multi-annual is economic accounts with two-phase operation (multi-year) – multi-annual like material and intangible assets.

DEBIT : DURABLE EXPENSE INCREASE	**CREDIT : DURABLE EXPENSE REDUCTION**

Earnings suspended: costs and revenues of deferred allocation (inventories and deferral, prepaid expenses and unearned revenues)

DEBIT : EXPENSE PAID, BUT STILL NOT ACCRUED	**CREDIT : REVENUE COLLECTED, BUT STILL NOT ACCRUED**

Capital is accounts related to risk.

DEBIT : CAPITAL REFUND (WITHDRAWAL)	**CREDIT : CAPITAL CONTRIBUTION**

3. METHODS

All manufacturing systems are identified by their three key elements. They are inputs, processes and outputs so accounting manufactures outputs in the form of financial statement and financial reports for business decision makers. (Prayogi et al., 2020) It same like a process known as the double-entry bookkeeping system to accurately capture inputs so that manufacture can produce meaningful reports.

Usually in business transaction, it is recorded in the accounting equation under a specific account. There are different accounts are used for each subdivisions of the accounting equation: asset, liabilities, equity, expanses, and revenues. There are some methods to arrange accounts, debits, and credits to record business transactions. They are consists of :

- A way to record the increases and decreases
- In specific account categories, keeping them together in one place
- Collect formal account that includes column for date, item, posting reference, debits and credits
- Separate accounts in another form
- Each form contains all transactions affecting it
- All forms kept together in a ledger (book-like)
- Each page contains one account

Recording transactions is using T accounts according to the rules of debit and credit which is account category for assets, owner's equity (withdrawals and expenses) if increase then will put in debit column and the other side if decrease will put in credit column. Beside that, the account category like liabilities, owner's equity (capital and revenue) if increase then will put in credit column and the other side if decrease will put in credit column. This kind of this will describe below :

Assets		=	Liabilities		+	Owner's Equity							
						Capital		Withdrawals		Revenue		Expenses	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
+	-		-	+		-	+	+	-	-	+	+	-

And the rules for withdrawals and expenses are the opposite of those for capital and revenue

Assets		+	Withdrawals		+	Expenses		=	Liabilities		+	Capital		+	Revenue	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.		Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
+	-		+	-		+	-		-	+		-	+		-	+

The must important for accuracy in financial reports is the debit totals must equal with credit totals which means this ensures the accounting equation is balance.

4. RESULT AND DISCUSSION

4.1 RESULT

There are five steps to analyzing each transaction which is the financial report become accurate and transparent :

1. Determine which accounts are affected. Example: cash, accounts payable, rent expense. A transaction always affects at least two accounts.
2. Determine which categories the accounts belong to: assets, liabilities, capital, withdrawals, revenue, or expenses.
3. Determine whether the accounts increase or decrease. Example: If you receive cash, that account increases.
4. What do the rules of debit and credit say?
5. What does the T account look like?

Business transaction is recorded in the accounting equation which is like asset accounts, liabilities accounts, expense accounts, revenue accounts, and etc. The way to record the increases and decreases in specific account categories is the standard account form which is a formal account that includes columns for date, item, posting reference, debit, and credit. All accounts have a separate form, and affecting. All the business's account forms (which often are referred to as ledger accounts) are then placed in a ledger. Each page of the ledger contains one account. The ledger may be in the form of a bound or a loose-leaf book. If computers are used, the ledger may be part of a computer file. For simplicity's sake, we use the T account form. This form got its name because it looks like the letter T. Generally, T accounts are used for demonstration purposes. Each T account contains three basic parts:

1. Title of account
2. Left side (debit)
3. Right side (credit)

At this point do not associate the definition of debit and credit with the words increase or decrease. The debit or credit as only indicating a position like left or right side in T account. For every debit there must be a credit. For example, if you purchase office supplies with $500 cash, the Office Supplies account is debited by $500 and the Cash account is credited $500.

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

1. *Sale for cash:* Debit the cash account | Credit the revenue account
2. *Sale on credit:* Debit the accounts receivable account | Credit the revenue account

3. *Receive cash in payment of an account receivable:* Debit the cash account | Credit the accounts receivable account
4. *Purchase supplies from supplier for cash:* Debit the supplies expense account | Credit the cash account
5. *Purchase supplies from supplier on credit:* Debit the supplies expense account | Credit the accounts payable account
6. *Purchase inventory from supplier for cash:* Debit the inventory account | Credit the cash account
7. *Purchase inventory from supplier on credit:* Debit the inventory account | Credit the accounts payable account
8. *Pay employees:* Debit the wages expense and payroll tax accounts | Credit the cash account
9. *Take out a loan:* Debit cash account | Credit loans payable account
10. *Repay a loan:* Debit loans payable account | Credit cash account

4.2 DISCUSSION

If company debit a cash account, then this means that the amount of cash on hand *increases*. However, if company debit an accounts payable account, this means that the amount of accounts payable liability *decreases*. These differences arise because debits and credits have different impacts across several broad types of accounts like :

1. *Asset accounts*. A debit increases the balance and a credit decreases the balance.
2. *Liability accounts*. A debit decreases the balance and a credit increases the balance.
3. *Equity accounts*. A debit decreases the balance and a credit increases the balance.

This is the example of accounts, debits, and credits are used to record business transactions which will describe below :

Tjandra Corporation sells a product to a customer for Rp 10.000.000 in cash. This results in revenue of Rp 10.000.000 and cash of Rp 10.000.000. Tjandra 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	10.000.000	
Revenue		10.000.000

Then Tjandra Corporation also buys a machine for Rp 100.000.000 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 – Fix Assets	100.000.000	
Accounts Payable		100.000.000

Accountants and bookkeepers often use T-accounts as a visual aid to see the effect of a transaction or journal entry on the two (or more) accounts involved. It will begin with two T-accounts : cash and notes payable.

Cash (asset account)

Debit	Credit
Increases an asset	Decreases an asset
Received Rp.	Paid Rp.

Notes Payable (liability account)

Debit	Credit
Decreases a liability	Increases a liability
Repaid loan	Borrowed more

For example to use of these T-accounts with two transactions :

1. On March 6, 2022 Tjandra Corp borrows Rp 300.000.000 from bank. As a result, Tjandra Corp's asset cash must be increased by Rp 300.000.000 and its liability notes payable must be increased by Rp 300.000.000. To increase the asset cash the account needs to be debited. To increase the Tjandra Corp liability notes payable this account needs to be credited. After entering the debits and credits the T-accounts look like this:

Cash (asset account)

Debit		Credit	
Increases an asset		Decreases an asset	
Received Rp.		Paid Rp.	
March 6, 2022 ENTRY	**300.000.000**		

Notes Payable (liability account)

Debit		Credit	
Decreases a liability		Increases a liability	
Repaid loan		Borrowed more	
		300.000.000	**ENTRY March 6, 2022**

2. On March 7, 2022 Tjandra Corp repays Rp 100.000.000 of the bank loan. As a result, Tjandra Corp's asset cash must be decreased by Rp 100.000.000 and its liability notes payable must be decreased by Rp 100.000.000. To reduce the asset cash the account will need to be credited for Rp 100.000.000. To decrease the liability notes payable that account will need to be debited for Rp 100.000.000. The T-accounts now look like this:

Cash (asset account)

Debit		Credit	
Increases an asset		Decreases an asset	
Received Rp.		Paid Rp.	
March 6, 2022 ENTRY	**300.000.000**	**100.000.000**	**ENTRY March 7, 2022**
March 7, 2022 BALANCE	**200.000.000**		

Notes Payable (liability account)

Another way to visualize business transactions is to write a general journal entry. Each general journal entry lists the date, the account title(s) to be debited and the corresponding amount(s) followed by the account title(s) to be credited and the corresponding amount(s). The accounts to be credited are indented. Let's illustrate the general journal entries for the two transactions that were shown in the T-accounts above.

Date	Account Name	Debit	Credit
March 6, 2022	**Cash**	**300.000.000**	
	Notes Payable		**300.000.000**

Date	Account Name	Debit	Credit
March 7, 2022	**Notes Payable**	**100.000.000**	
	Cash		**100.000.000**

This is the example of financial report for applying the each transaction in general journal of accounting that includes accounts category, debits and credits :

A - March 28: Tjandra Corp invests $12.000 cash and $400 of office equipment in the business. (A debit of $12.000 to Cash and a debit of $400 to Office Equipment for a credit of $12.400 to Tjandra Corp, Capital)

B - March. 29: Law practice bought office equipment for cash, $1000.

C - March. 30: Bought more office equipment on account, $600.

D - April. 1 : Provided legal services for cash, $4.000.

E - April. 3 : Provided legal services on account, $6.000.

F - April. 5 : Received $900 cash from clients for services rendered previously on account.

G - April. 8 : Paid salaries expense, $1.400.

H - April. 10 : Paid rent expense, $800.

I - April. 12 : Received a bill for advertising expense (to be paid next month), $400.

J - April. 15: Tjandra withdrew cash for personal use, $200.

The journal of transactions above :

	1	2	3	4	5	
Date	**Accounts Affected**	**Category**	**(decrease /increase)**	**Rules of Dr. and Cr.**	**Appereance of T Accounts**	
	Cash				Cash 111	
28-Mar		Asset	↑	Dr.	12.000	
29-Mar		Asset	↓	Dr.		1000
1-Apr		Asset	↑	Dr.	4.000	
5-Apr		Asset	↑	Dr.	1.800	
8-Apr		Asset	↓	Cr.		1400
10-Apr		Asset	↓	Cr.		800
15-Apr		Asset	↓	Cr.		200
	Office Equipment				Office Equipment 121	
28-Mar		Asset	↑	Dr.	400	
29-Mar		Asset	↑	Dr.	1000	
30-Mar		Asset	↑	Dr.	600	
	Tjandra Corp, Capital				Tjandra Corp, Capital 311	
28-Mar		Capital	↑	Cr.		12.400
	Accounts Payable				Accounts Payable 211	
30-Mar		Liability	↑	Cr.		600
12-Apr		Liability	↑	Cr.		400
	Legal Fees				Legal Fees 411	
1-Apr		Revenue	↑	Cr.		4000
3-Apr		Revenue	↑	Cr.		6000
	Accounts Receiveable				Accounts Receiveable 112	
3-Apr		Asset	↑	Dr.	6000	
5-Apr		Asset	↓	Cr.		1.800
	Salaries Expenses				Salaries Expenses 511	
8-Apr		Expense	↑	Dr.	1.400	
	Rent Expenses				Rent Expenses 512	
10-Apr		Expense	↑	Dr.	800	
	Advertising Expenses				Advertising Expenses 513	
12-Apr		Expense	↑	Dr.	400	
	Tjandra Corp, Withdrawals				Tjandra Corp, Withdrawals 312	
15-Apr		Capital	↑	Cr.	200	

5. CONCLUSSION

The rules of debit and credit only tell us on which left or right side, whether the debit or credit represents increases or decreases depends on the account category: assets, liabilities, capital, and so on. Think of a business transaction as an exchange: You get something and you give or part with something.

A transaction that involves more than one debit or more than one credit is called a compound entry that consists of assets, withdrawals, and expenses increase when you put amounts on the left, or debit, side of these accounts. The accounting system is balanced if liability, capital, and revenue increase when there are amounts on the right, or credit, side of these accounts whether the increase side of any accounts will represent its normal balance.

There should be called a footings that is used to obtain the totals of each side of every T account if it has more than one entry. The footings are used to find the ending balance. The ending balances are used to prepare a trial balance. The trial balance is not a financial statement, although it is used to prepare financial statements because all the accounts with their balances in the same order as they appear in the chart of accounts.

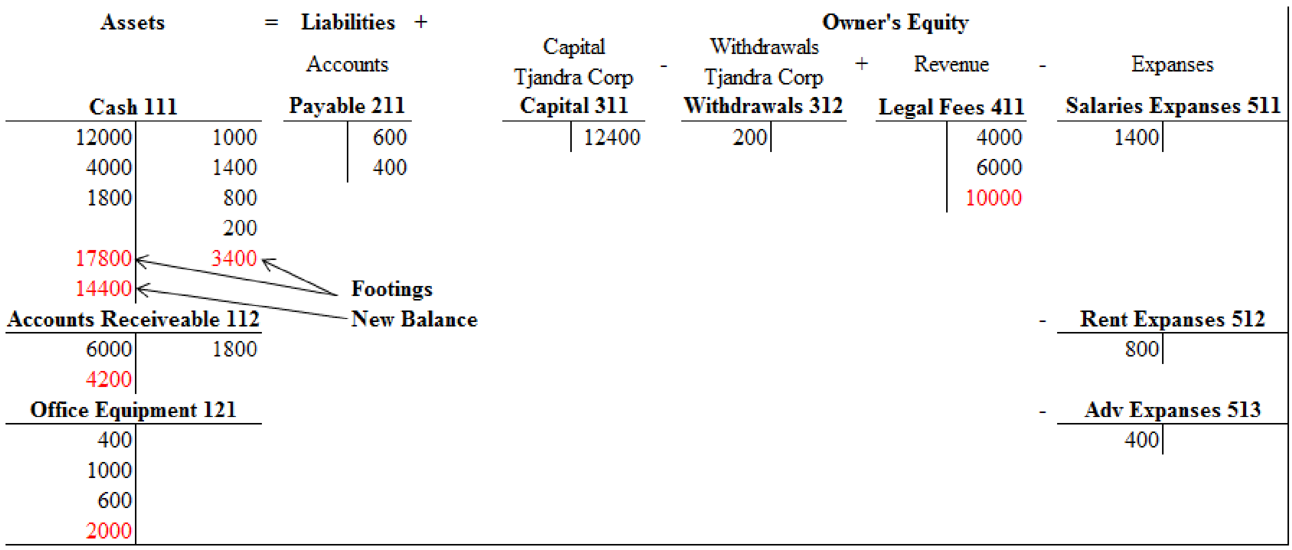
The trial balance is a list of ending balances which are used to prepare the three financial reports that consists of no debits or credits. The inside columns are used to subtotal numbers which is revenue and expense is put on the income statement and beside that withdrawals and either net income or net loss is put on the owner's equity. The balance sheet consists of assets, liabilities, and the new amount for ending capital. Because the trial balance has debit or credits, not the financial reports.

Once the trial balance is complete, the first statement to make is the income statement, which is made up of only revenue and expenses. Remember that there are no debits or credits on financial statements. All we are taking are the ending balances of each title from the trial balance. For the income statement, put fees as the revenue and then the expense put in the inside column. Total operating expenses are subtracted from the fees like a net income or a net loss.

The second one is to prepare the statement of owner's equity, which shows the calculation of a new figure for capital. The third one is the balance sheet, which consist of asset, liability, and the new figure for capital.

Summery of the Tjandra Corp's transaction above :

Assets		= Liabilities +		Owner's Equity							
		Accounts		Capital Tjandra Corp		- Withdrawals Tjandra Corp		+ Revenue		- Expanses	
Cash 111		**Payable 211**		**Capital 311**		**Withdrawals 312**		**Legal Fees 411**		**Salaries Expanses 511**	
12000	1000		600		12400	200			4000	1400	
4000	1400		400						6000		
1800	800										
	200										
Accounts Receiveable 112										- **Rent Expanses 512**	
6000	1800									800	
Office Equipment 121										- **Adv Expanses 513**	
400										400	
1000											
600											



Then put in trial balances or the list of the ending balances of all the accounts in a ledger so the total debits should equal total credits which list in the same one.

Tjandra Corp
Trial Balance
30-Apr-22

	Dr	Cr
Cash	14400 00	
Accounts Receiveable	4200 00	
Office Equipment	2000 00	
Accounts Payable		1000 00
Tjandra Corp, Capital		12400 00
Tjandra Corp,Withdrawals	200 00	
Legal Fees		10000 00
Salaries Expense	1400 00	
Rent Expense	800 00	
Advertising Expense	400 00	
Totals	23400 00	23400 00

When a trial balance is complete, the total of debits must equal to all credits. Beside trial balance there is income statement: once the trial balance is complete, the first report to make is the income statement, which is made up of only revenue and expense. The other one is statement of wwner's equity: the second report to prepare is the statement of owner's equity, which shows how to calculate a new figure for capital and the last one is balance sheet: the third report is the balance sheet, which lists out each asset, liability, and the new figure for capital. Next financial report is income statement, statement of owner's equity, and the last one is balance sheet that will illustrate below of this :

Tjandra Corp
INCOME STATEMENT
FOR MONTH ENDED APRIL 30, 2022

	Dr						Cr					
Revenue :												
Legal Fees							1	0	0	0	0	00
Operating Expense												
Salaries Expense		1	4	0	0	00						
Rent Expense			8	0	0	00						
Advertising Expense			4	0	0	00						
Total Operating Expense								2	6	0	0	00
Net Income								7	4	0	0	00

Tjandra Corp
STATEMENT OF OWNER'S EQUITY
FOR MONTH ENDED APRIL 30, 2022

	Dr						Cr					
Tjandra Corp, Capital												
APRIL 1, 2022							1	2	4	0	0	00
Net Income for April		7	4	0	0	00						
Less Withdrawals												
for April			2	0	0	00						
Increase in Capital								7	2	0	0	00
Tjandra Corp, Capital												
APRIL 1, 2022							1	9	6	0	0	00

Tjandra Corp
BALANCE SHEET
APRIL 30, 2022

	Dr							Cr					
Assets							Liabilities and Owner's Equity						
Cash	1	4	4	0	0	00	Liabilities						
Accts. Receiveable		4	2	0	0	00	Accts. Payable		1	0	0	0	00
Office Equipment		2	0	0	0	00	Owner's Equity						
							Tjandra Corp, Capital	1	9	6	0	0	00
							Total Liab. And						
Total Assets	2	0	6	0	0	00	Owner's Equity	2	0	6	0	0	00

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