Financial Accounting
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Lecture – 18
2.3 Debit and Credit

In this video, we are going to discuss the two key terms in accounting- the building blocks for the double entry system. We are going to learn about Debit and Credit. Most of you must be familiar with these two terms, but possibly you have not been able to figure out what these two terms mean. So, let me demystify these two words and how these two words are going to be interpreted and used in the language of accounting.

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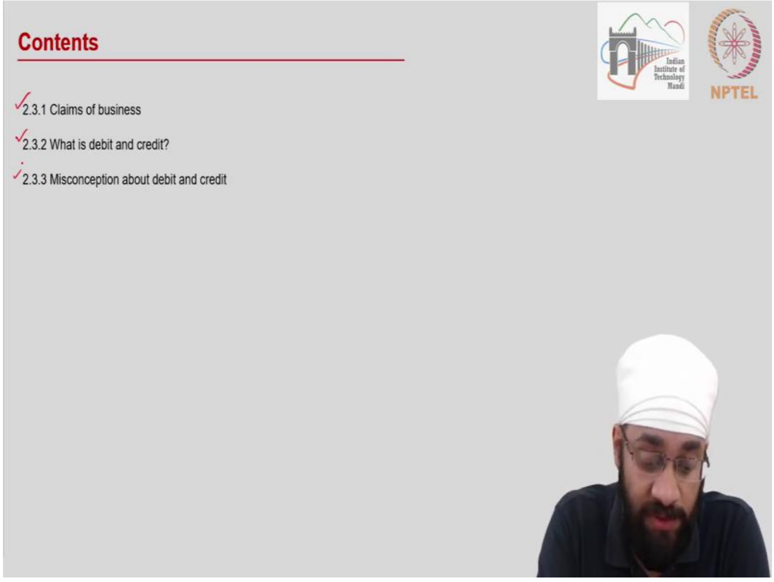

There are three short topics that we will go over. We are going to talk about the concept of claims of business over something and then I am going to introduce you to the two words, debit and credit, and I am going to clarify a misconception or a confusion about these two words.

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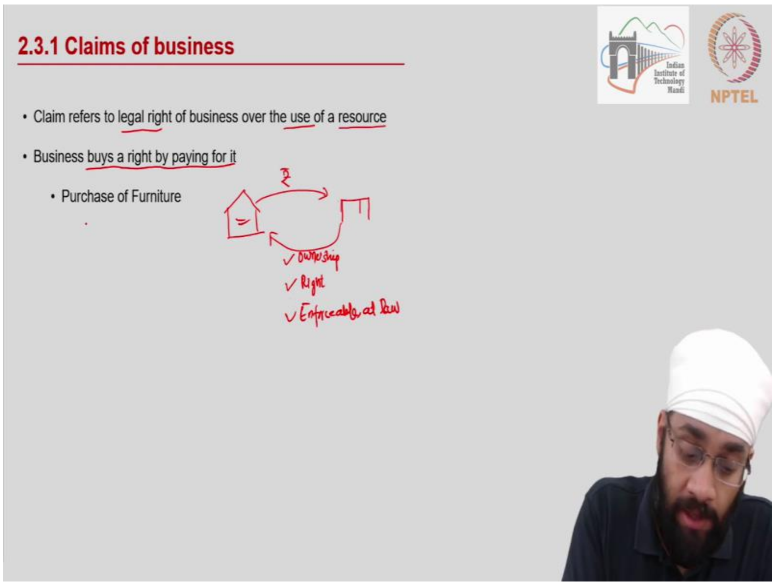

The claim refers to the legal right of a business over the use of a resource. Now, we need to understand this very clearly, because I am going to use this logic, this reasoning when we analyze various business transactions and when we learn how to record the transactions in the books of accounts. So please pay attention here.

A business buys a right to use a resource by paying for it. For example, purchase of furniture: when a business purchases furniture, say a table- I will draw a table - it purchases a table and it pays for it. In return of the money paid, it gets the ownership of the asset; anything that it wants to buy. So, what this ownership really gives is a right to place this piece of furniture anywhere in your premises. And when you place this furniture in your premises nobody else should be able to or, nobody else should come to your premise and then remove this furniture from your premise or start using it for their own personal purposes. If they do that then you have the right to go to the police and you can file a complaint and the police will enforce your right. So, you have a right which is enforceable by law. When the police come, they will go to the person who has stolen your furniture and they will ask them to bring it back or they will bring it back and then they will punish this person, because they stole from your premises. So, when we talk about a claim, we are talking about this ownership or the right over the use of a resource. Right really means that you have a legally enforceable right on that resource. You could enforce the legal machinery of a country or a geography to have the right to use that particular resource for which you have paid. So that is the understanding, that is the depth that we want to go into in order to understand and interpret the term *claims of business* correctly.

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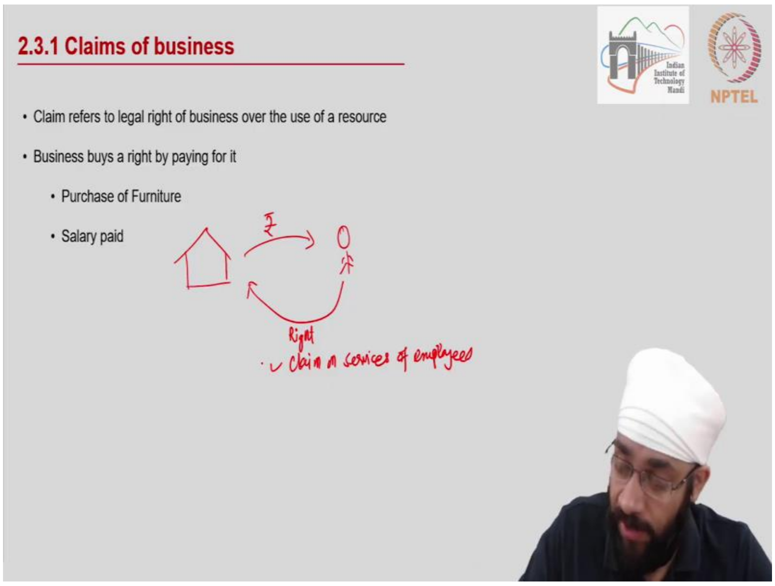

Let me take another example, salary paid. When you pay the salary, what is the claim that business has purchased or what is the right that it has acquired? When you pay a salary, in return what do you get? You do not get ownership of people. Instead, you get a right, you get a claim to the services of the staff, services of the employees. You cannot buy people of course; slave trade is not allowed anymore. So, the business has a claim over the services of the employee. Now if you pay to an employee and the employee is not working for you; you can sue the employee, you can drag him to the court and the court will help enforce your claim and the person will have to either pay you for the damages, for the revenue lost or will work for you for the duration for which salary was paid to this person. This is a different case; in case of furniture, you were in physical possession of the furniture. You had claim on the furniture, but when you pay salary to employee you really have a claim on their time, on their services that you want from them. Please understand that claims are not only on the tangible things, physical resources, but you can have a claim on the services also. You can have a right to use the services of somebody, because you bind them by a contract and you pay a remuneration to them.

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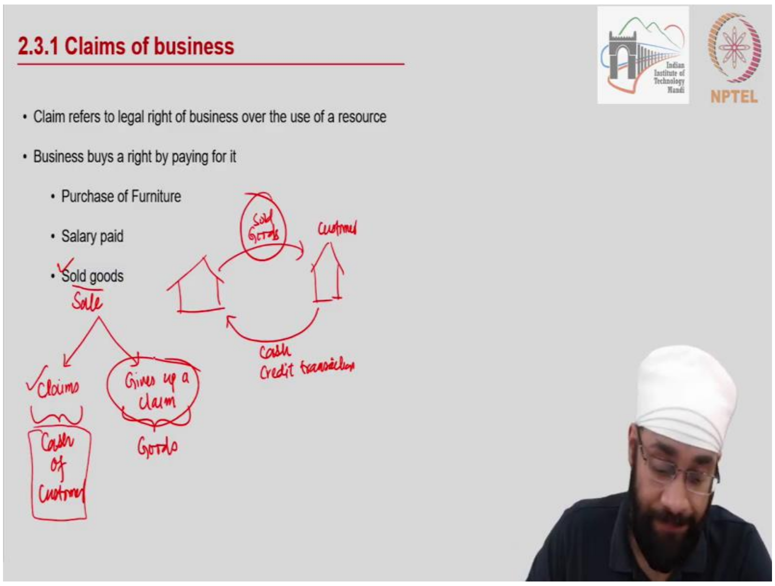

So, another aspect of claims of business. Sold goods; when you sell goods what is happening? Again, let me draw a business here and there is another business, let us say this is a business-to-business transaction. You are selling goods. So, goods are being sold to the customer. Customer is another business here, and in return what is happening is; you are either going to get cash or this is going to be a credit transaction; however, we are more interested in what is happening here. So when a sale is happening, what claim do you create for the business now? Is there a right that business is creating for itself? So, when a sale is happening two things are taking place; 1) the business generates a claim, the business generates a right; and, 2) the business gives up a claim. We are giving up the claim on the goods. Correct? We are giving up the goods, we are delivering the goods to the customer and we are expecting a payment in return. So, what are you expecting? You are expecting cash. Your claims on the cash, whose cash? Cash of customer. Thus, when the business sells goods to some customer, the business creates or generates a claim on the customer's resources, customer's cash that you want to have. But you are giving up your claim on the goods because you are selling it off to the customer. So, now I am not talking about claims being generated, but claims being sort of relinquished. You are giving up the claim on that and in return you are getting a claim on something as an equivalent resource and as per the money measurement principle of accounting, everything has to be expressed in money. Give up goods, an equivalent amount of money has to come into business. So, business gives up a claim, generates another claim.

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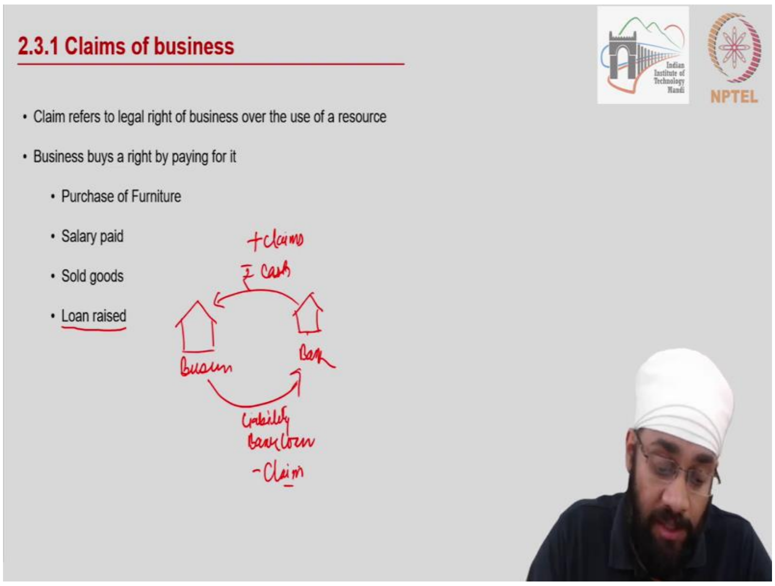

Loan raised: when a loan is being raised what is happening. So, again this is a business; this is a bank. So, when a business is raising a loan from the bank; bank gives money and the business now has a liability. The liability is called a bank loan. In this transaction the bank has a claim on the business, rather than the business having a claim on a resource, the bank has a claim on the business. So, the business is relinquishing some claims towards the bank, but of course, there are two sides to it; business has increased in the claims in terms of the cash that the business receives. The bank deposits money in the bank account of the business. So, business' claims on this cash go up; however, bank's claim on the business also goes up. In other words, business' claims are going down because an external party has claims on the business. If you do not repay the loan then the bank can sue the business and then legal machinery can be used to recover money from the business. So, claims of the business are going down on the other hand. Thus, there are always going to be two sides, because it is a transaction, it is a give and take. It is also a double entry system. Equal give equal take, because everything is expressed in terms of money.

We will get there, these are all the building blocks of the double entry system and I am slowly introducing to the dynamics of how we think about all these things and the ecosystem in which these transactions are created.

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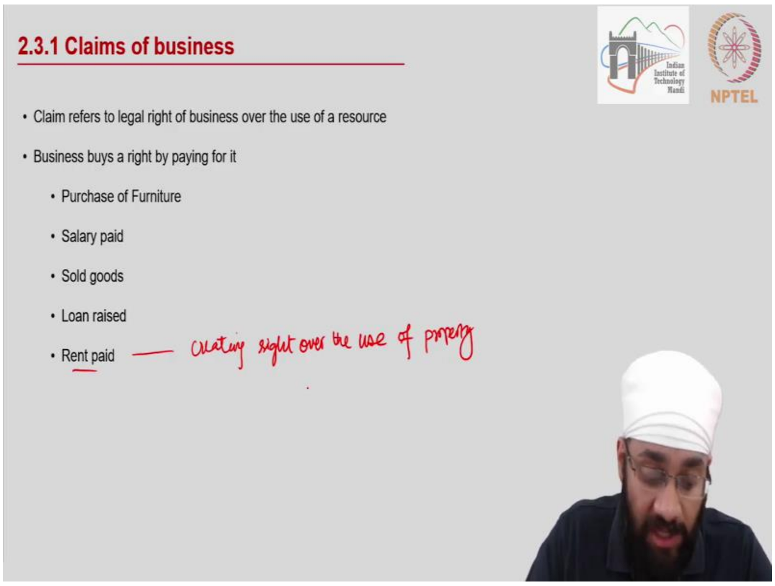

Moving forward- another couple of items. Rent paid; when you pay the rent to the landlord, you are creating, earning a right over the use of the property for which you are paying the rent. You pay the rent, so they claim on the cash that you pay to the landlord; thus, your claim on the cash goes down but in return the claim that you have bought for that cash is the right over the use of the property for which you are paying. So, that is how we think about claims in the business.

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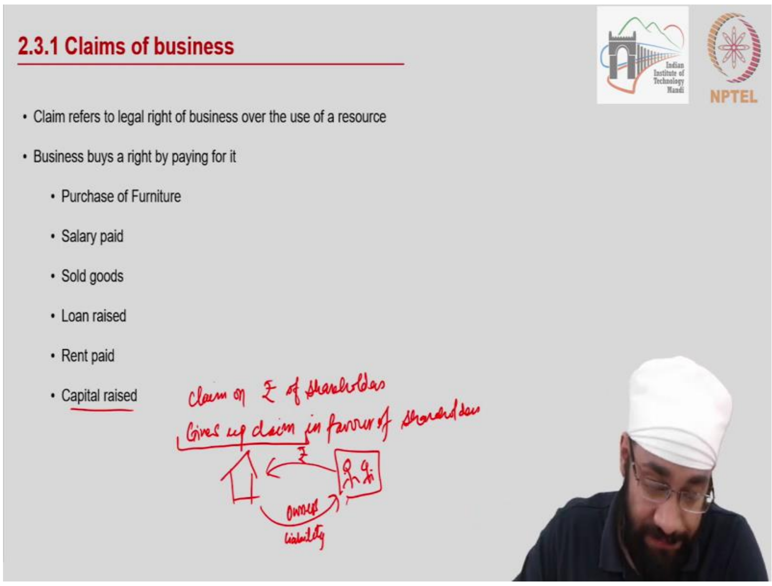

Another example of this is capital raised, when shareholders invest money in the business, what really happens is, the business creates a claim. You have a claim on the money of the shareholders; however, if you give up the claim, the business gives up the claim in favor of shareholders as well. Now, what claim is being given up? Well, when a business gets money from the shareholders, you get claims on the cash. But if you do not repay this capital to the owners of the business then the business owes to these people. So, there is a liability that the business has towards the owners and that is what the business entity concept states as well. Owner is separate. Owner is treated as somebody who is lending his or her resources to the business. When business raises capital, business is giving a right to the owner that it can demand from the business a repayment at whatever point is stipulated or whenever business comes to an end and the owner can reinforce that right as well.

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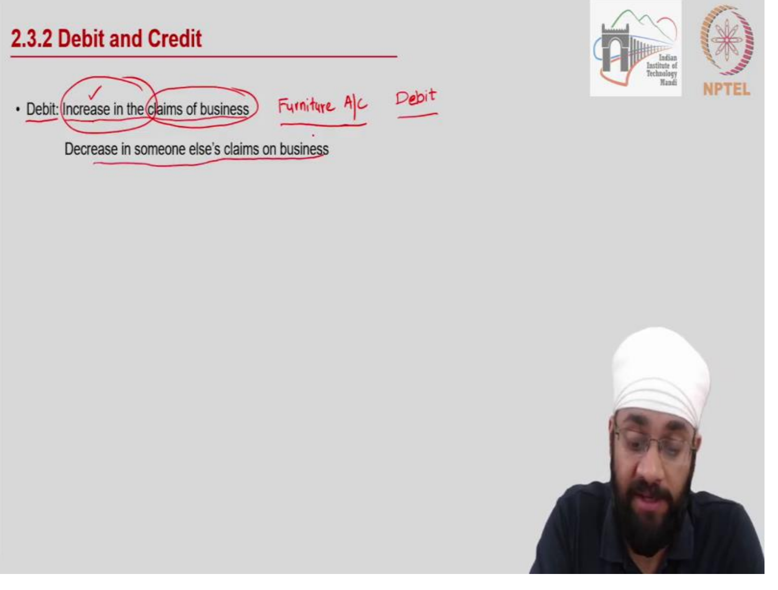

So, now let me introduce you to the two terms debit and credit. Now you very well understand what is meant by claims of a business and how a claim can be created or how a claim can be reduced as well. At this point in time, you are very well equipped to handle these two terms; debit and credit.

The word debit is used to indicate an increase in the claims of the business. And what is the claim of the business? It is the right of the business over a resource. The business typically buys this by paying for it now or by paying for it in future.

So, whenever there is an increase in claim rather than saying *hey claims are increasing*, we say, *hey debit in the claims*. So, if the claim of the business is going up, let us say, on an item called furniture; we are going to say furniture account- and we have also learned about the you know types of accounts I am going to put that to use as well shortly- but furniture account is the record of furniture account is simply a record. Now, the furniture account is going to show a debit. We are going to write a debit against it to indicate that the business has purchased furniture and paid for it. By purchasing the furniture the business has seen an increase in its claim on the furniture, that is what is meant by the word debit. The word debit basically translates or condenses this English sentence into one word. When you say debit, I know it means that the claim of business has gone up. Alternatively, you could also think about decreasing someone else's claim on the business, but I will address this shortly.

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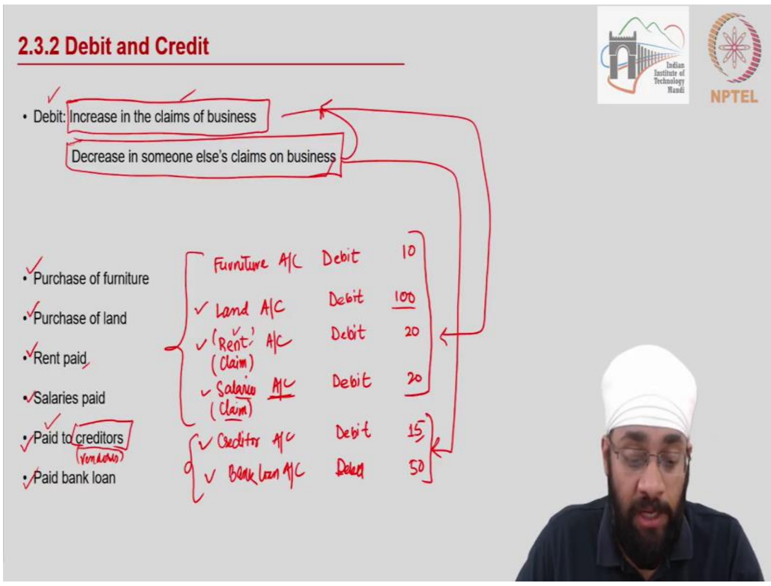

Let us look at some examples here. So, as I said purchase of furniture, you would say furniture account debit. When you purchase the land the businesses claim on that land goes up. Business has the legal right over the use of this resource which is called land. How are you going to reflect this in the books of accounts? You are keeping a record for the land that the business owns and you are going to call this an account. So, the land account is going to show a debit. You are going to write a debit against it and you are going to say well the value of land is 100. The value of furniture was 10 for example ok. So, the value of the claim is 100 in case of purchase of land. When business purchases land, businesses rights over the land go up and there is a value which is assigned to this claim, to this right which is equal to the value of the land or the value which is paid by the business to whosoever earlier owned this land alright.

Next, rent paid; there is going to be a rent account that will be maintained every month if you are paying rent. You will maintain a separate, let us say, notebook writing how much rent was paid. When a business pays rent, as we discussed earlier, the business does not own this property for which the rent is being paid. By paying rent you earn the right to use the property for the duration for which rent is paid. So if rent is being paid for the next 6 months, we are paying advance rent. We have earned the right, the business will earn the right to use this property for the 6 months. So, whenever you pay rent, salaries etc. you earn the right over the use of a resource, you do not own the resource. There are some resources you can own, but there are other resources which you can only hire. Therefore, when you pay the rent, you are going to say- my claim on the use of this building has gone up. Please understand that the claim is represented by this word called rent. The word rent represents the claim. The word rent does not represent the cash which is being paid. That is separate. Business's cash is going down because you are paying the cash to the landlord in this case. So, for the cash account you would say your claim is going down. Since, the topic of discussion is rent account, the rent represents the claim on the use of the property and your claim is going up, so you are going to write a debit here for whatever is the amount of rent.

Again, do you understand that when you pay rent there are two sides of this coin; you are paying the cash, we are not talking about cash here right now; on the other side of the coin, you have the right that you got. What is that right called? That right is called rent. The rent represents that. This is very important to understand and you will get a hang of it as we discuss more such items. Salaries paid- again you pay in cash. Your claim on cash goes down; however, what you have bought is the right, the claim over the use of services of the employees and the name for that is salaries. So, salaries account, in the record, in the notebook where you write all the transactions relating to salaries, you are going to write a debit. You are going to say, *my claim on the services of my staff members has gone up and I am going to write a debit*. And the value of this claim is 20, because that is the money I have paid to these people.

Then you have- paid to creditors.

Now the first part of the slide was an increase in the claim of business. And in all these scenarios, we have discussed the increase in the claim of business. Now, we are going to talk about the opposite of the same which is decrease in someone else’s claim on the business. That can also be shown as the debit. So, businesses claim going up is equivalent to somebody else’s claims on business going down as well.

Let us look at these couple of examples. Creditors, as we know, are our vendors, suppliers from whom you had bought the goods and you have to pay to them. You have not paid them that is why they are called your creditors. Thus, creditors again are the vendors to whom payments need to be made. So, you now make the payment. The transaction says- paid to creditors. So, when you pay to creditors in the book where you are maintaining a record for it; creditors account, you are going to say debit. Debit by whatever amount you have paid to them. Since you have paid them 15 rupees here, their claims on the businesses no longer exist, because you have paid for those claims. The claims were only valid if you did not pay them and then they can go to the court of law and then force you to pay, but when you pay them that claim automatically reduces. So, even the reduction in somebody else’s claim on the business, when it goes down, you say debit. Because the opposite of it is true; when somebody else’s claim goes down business’ claims are going up naturally. It’s a zero sum game in that sense.

Then you have- paid bank loan. Bank has claims on the business. If you do not pay back the loan, the bank can come and recover that money from you through legal means. But you are paying back the bank loan. The bank loan account represents the bank's claim on the business that goes down. Therefore, business’ claims go up. So, you are going to write a debit here by the amount of the bank loan, whatever that amount is.

So, these two items represent decrease in the claims of somebody else on business and the remaining transactions which we discussed earlier represent the increase in the claims of business by way of business paying for these resources.

So, that was debit for you. We have understood that increase in claims of business by either business buying those resources or increase in the claims of business because somebody else’s claims on businesses is going down; both of these are represented by the word debit.

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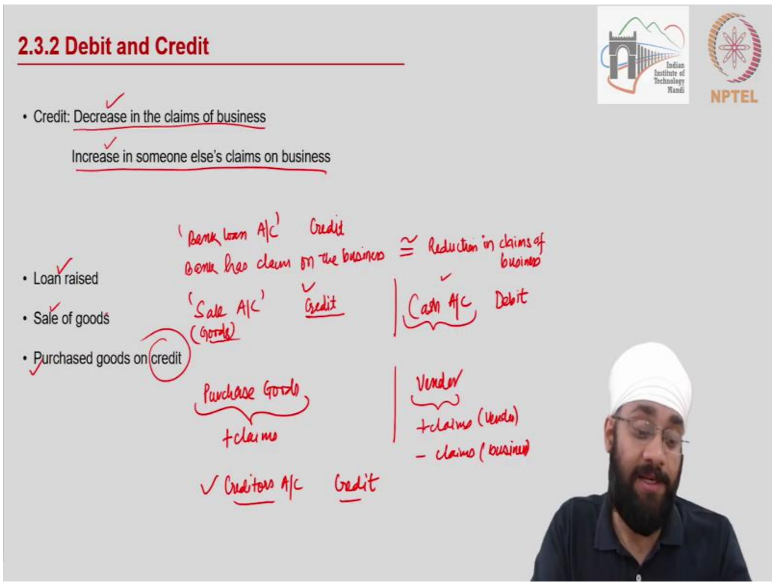

Let us go to the other word which is credit. What is credit? Now credit refers to decrease. It is the opposite of debit. So, I hope it will make sense, because you have understood the word debit now, opposite of that is credit.

We will take some examples now. So, decrease in the claims of business is represented by credit. Let us look at these items one by one. Loans raised; when you raise the loan, the bank has a claim on the business. Now, anybody having a claim on the business is equivalent to reduction in claims of business because if the business does not pay back the loan, the bank can use the legal machinery to recover the money. So, in this case when a new loan is raised from the bank, a liability gets created. The name of the liability is bank loan and you create a record for it and you start calling it bank loan account and you are going to write credit against it. Opposite to this, which will indicate that a new bank loan has been taken and the bank has a claim on our business, because if we do not pay back, the bank can recover the money from us through legal channels.

Then- sale of goods. What is happening here is when you sell the goods you are giving up the claim on the goods, because you will get money in exchange for it, but we are only looking at one side of the coin right now. So, a sales account refers to the goods that you had in the business. That you had bought earlier. When you purchase the goods, you have created your claims on the goods. Now you are selling the goods, you are giving up your claims on the goods that you are selling. So, you are going to write credit here, whenever you sell, you are going to write credit.

Now, the point where people get confused is, *hey sales is my income you know, money is coming in it should lead to you know some positive sign*. It should be debit.

Please understand- the two sides of the coin right. Sales goods are going out, sales money is coming into the business. These two are different aspects of the same coin. Sale represents the goods that are going out of the business. The claims of business on the goods are going down. The claim of business is going up on the cash, the money that you receive in exchange for the sale. That is the difference. That is the accounting language. That is the code we have to understand. Every transaction is going to be split into two;- what is the give and what is the take; what is the debit and what is the credit. Those are the two sides. That is why we call it a double entry system as well.

So, the sale account is going to show credit. You can show the other side of the coin, which is the cash account. The cash in the business that is going to experience an increase, because you receive money in exchange for the goods given up. So, this is the give and this is the take, I mean what is being received and what is going out of the business.

Next step is purchase goods on credit. You are purchasing goods from the vendor, but you are not paying to the vendor. So, when you purchase goods you will pay for it or assuming that you paid for it, the claims are going up here. However, the other side of the coin is that now there is your vendor, you have to pay him. And you have not paid him, it is on credit. Credit means you have not paid him. So, the vendor now has an increase in his claims as well, but when vendors have increased their claims on the business; that means, the business' claims are going down. So, this is with reference to the vendor; this is with reference to our business. We are always thinking from the point of view of our company, our business. So, the vendor has claims on our business, so we are going to write creditors account credit. And we are indicating that this creditor has a claim on the business.

In other words, business' claims are going down, because somebody else has claims on the business. So, the two rules or two interpretations of the credit are to summarize as follows;- decrease in the claims of business, that is credit, or increase in someone else's claim on business also refers to decrease in businesses claims on its resources right. So, that is the explanation of the two words debit and credit.

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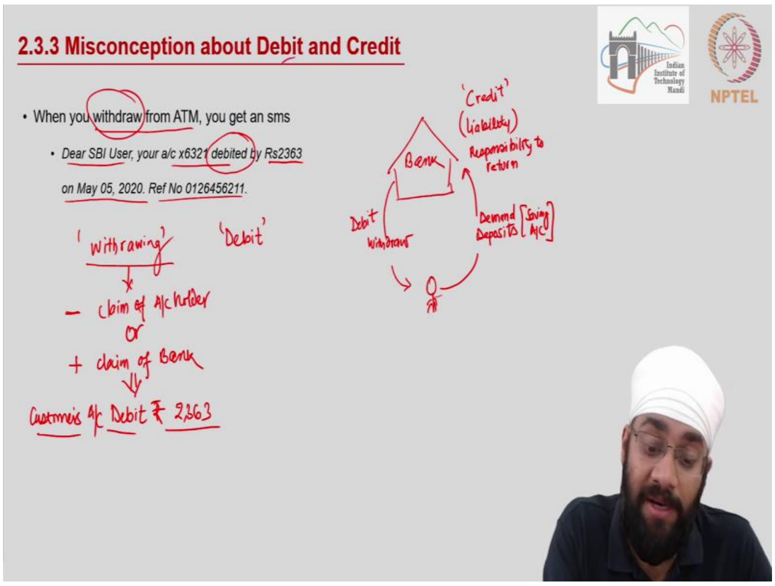

And now let me clarify one misconception or a confusion about debit and credit. All of us have bank accounts, I hope we do. And when you deposit the money in the bank account or withdraw from a bank or ATM or pay through digital channels, you get a sms. The sms has typically you know this text. When you are withdrawing, it says, *dear user, your account is debited by this amount on this day*, say may 5th , and ref number, along with whatever details required; but the key item is that your account is debited and you are withdrawing.

I am withdrawing the money and it is saying. So, when you withdraw the money, it says your account has been debited. What does it mean? Now, whenever a business prepares its records, its books of accounts, it writes in books of accounts from its own perspective. Here, the business is a bank. The bank writes in its books of accounts from its own perspective. When a customer gives money to the business, deposits in the bank, the bank has the responsibility to refund, to return this money when the customer demands it and hence it is called demand deposit as well. This is simple, it is your savings account.

What does your savings account mean? You have your money; you go to the ATM and withdraw it. You go to the bank and say *give me all my money*. They will have to give it if you go in the official working hours. Demand deposit; this is a kind of liability for the bank. This is a liability and also a source. And we have discussed that all sources are typically a liability. So, the bank has a liability towards you, when you deposit money in the bank. On the other hand; on when you withdraw from your savings account then the bank is relieved. Bank says, *alright I do not owe this person any more. I have paid back my liability to this person*. Now, when you deposit money in the bank, liability gets created. So, the bank says *hey, my claims are going down because you know the account holders' claims on the bank go up*. When an account holder deposits money in the bank, the bank is responsible to maintain that money. Therefore, when you deposit money in the bank account, the bank says, *a credit*. When you withdraw money from the bank account then bank is relieved and bank says, *now we do not owe this person 10,000 rupees because he has withdrawn this money*; that means, this person’s, this account holder’s claims on the bank are going down. Alternatively, the bank's claims are going up on its own resources. So, they write a debit.

Bank is maintaining the records of lakhs of account holders and whenever an account holder withdraws the money it means that the claim of the account holder goes down; negative. The other alternative is also true, which means the claim of the bank is going up, and when the claim of the bank is going up, the bank will show it by writing a debit. Where does it write debit? Against your name, against the account holder’s name. So, it will say, the customer's account is debit by whatever, this 2 2 3 6 3, amount. It gives it a debit. So, the bank is writing from its own point of view. You are thinking, it says debit which means negative, but you are saying debit is increase in the claims, how is that possible? So, I am clarifying that confusion. When you receive a sms, the bank has written in its own books, for its own reference, and it has sent you a copy of the email. So, the bank is telling itself that the customer’s claims have gone down, so my claims have gone up. And when you read it, you think *hey my claims are going up or my claims are going down*. So, the only adjustment you need to make is when you read that sms, think from the bank's point of view.

If you are a bank, you are writing a debit because the bank's claims are going up because the bank has paid back to its customer. So, that is how you should interpret the debit and credit used by the bank.

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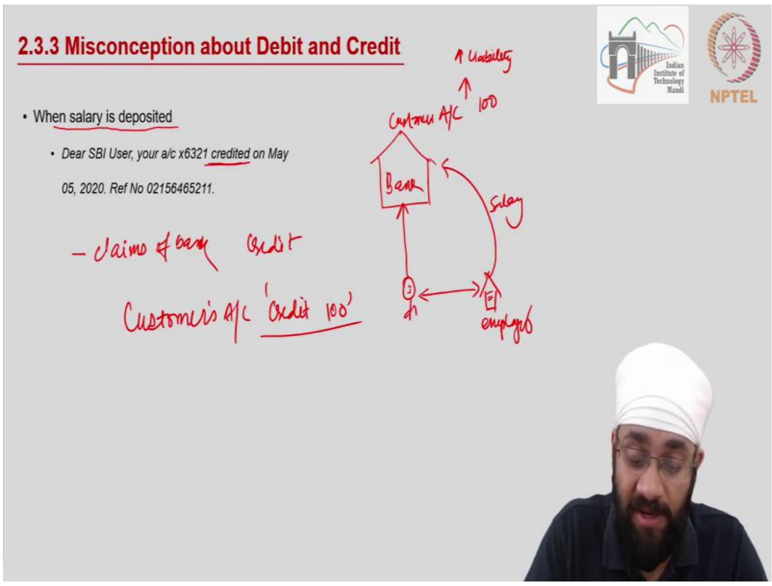

The opposite of this is when your salary is deposited in your bank account, it says, this salary has been credited in your bank account. What does this mean? As I just explained, when salary is deposited into your bank account, this is your bank, this is you, and let us say this is your company, this is your employer. You work for a month and then you also have a bank account. After working for a month your employer deposits your salary. So, the salary is deposited on your behalf. For banks it does not matter where the money came from. Of course, it matters for the taxation purposes. What I am saying is, for the bank the money is coming into your account. So, this customer’s account has gone up by whatever amount of salary that has been deposited and when more money has been deposited there is more liability that the bank has. When a bank has more liability, bank’s claims go down. You have more claims on the bank, because you can ask the bank for more money. My employer just deposited my salary, so I can ask for more money from the bank. So, in that case bank’s claims go down and reduction in claims reduction in claims of bank are shown by a bank as a credit. They say the customer's account is showing a credit of 100, because more money has been deposited. We have more liability towards this person. This person has more claims on our bank. So, let us write a credit there alright. So, I hope you now understand the concepts, the terminology which is debit and credit.

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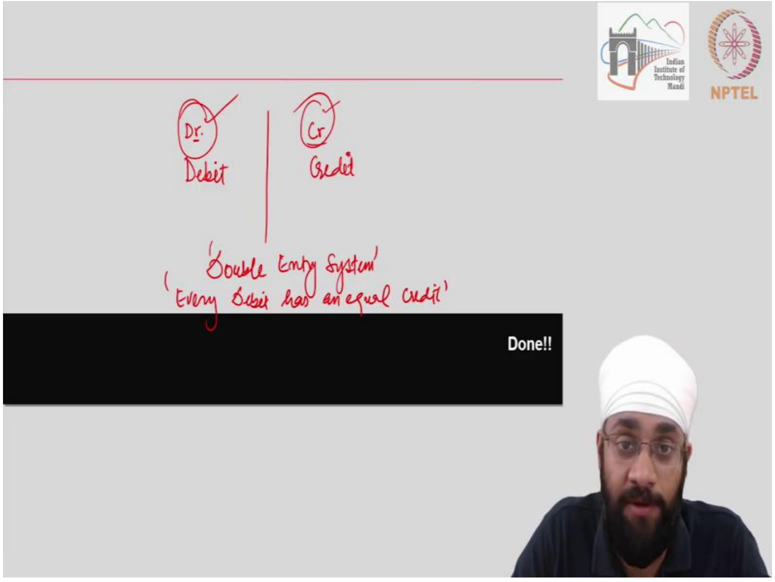

These are the two crucial words which you are going to see or hear over the next few videos lot of time. We use these two words to write the transactions in the books of accounts. Understand that debit and credit are the two sides of the same coin and this is the basis of the double entry system that we are learning. We are into the building blocks. So, debit and credit make an important component of the double entry system. I said these are two sides of the same coin, every debit has an equal credit.

This is another saying, not a saying but it is a scientific truth based upon which the double entry system runs. Debit is also represented by a short form which is Dr. and credit is represented by Cr. You must have also seen this in the sms that you receive from the. Now, you would say credit has C and r, so you can use C and r, but debit does not have D and r. So, why do we use r. It is just a convention. This is how it has been practiced for long, I am just following that. So, Dr. stands for debit Cr. stands for credit. Going forward we are going to be using these short forms for debit and credit. Again, remember debit and credit are two sides of the same coin and every debit is going to have an equal credit. I will see you in the next video.