

2.2: Describe Principles, Assumptions, and Concepts of Accounting and Their Relationship to Financial Statements

Double-Entry Bookkeeping

The basic components of even the simplest accounting system are *accounts* and a *general ledger*. An **account** is a record showing increases and decreases to assets, liabilities, and equity—the basic components found in the accounting equation. Each of these categories, in turn, includes many individual accounts, all of which a company maintains in its general ledger. A **general ledger** is a comprehensive listing of all of a company's accounts with their individual balances.

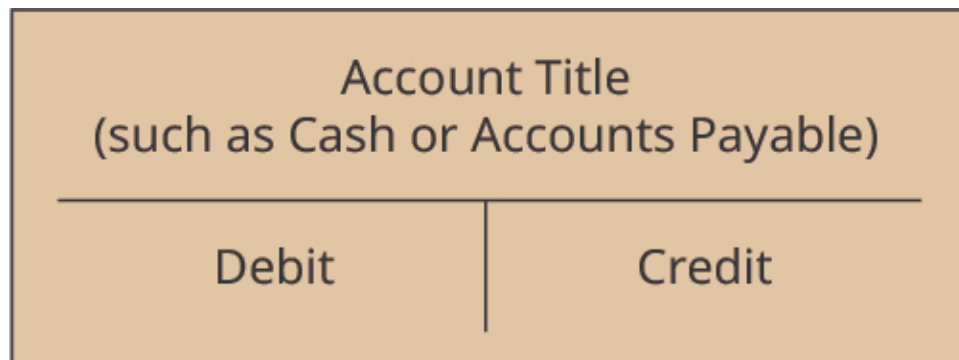
Accounting is based on what we call a **double-entry accounting system**, which requires the following:

- Each time we record a transaction, we must record a change in at least two different accounts. Having two or more accounts change will allow us to keep the accounting equation in balance.
- Not only will at least two accounts change, but there must also be at least one debit and one credit side impacted.
- The sum of the debits must equal the sum of the credits for each transaction.

In order for companies to record the myriad of transactions they have each year, there is a need for a simple but detailed system. Journals are useful tools to meet this need.

Debits and Credits

Each account can be represented visually by splitting the account into left and right sides as shown. This graphic representation of a general ledger account is known as a **T-account**. A T-account is called a “T-account” because it looks like a “T,” as you can see with the T-account shown here.



A **debit** records financial information on the left side of each account. A **credit** records financial information on the right side of an account. One side of each account will increase and the other side will decrease. The **ending account balance** is found by calculating the difference between debits and credits for each account. You will often see the terms *debit* and *credit* represented in shorthand, written as *DR* or *dr* and *CR* or *cr*, respectively. Depending on the account type, the sides that increase and decrease may vary. We can illustrate each account type and its corresponding debit and credit effects in the form of an *expanded accounting equation*.

Assets		=		Liabilities		+		Common Stock		-		Dividends		+		Revenues		-		Expenses	
Debit	Credit			Debit	Credit			Debit	Credit	Debit	Credit	Debit	Credit			Debit	Credit	Debit	Credit	Debit	Credit
Increase	Decrease			Decrease	Increase			Decrease	Increase	Increase	Decrease	Increase	Decrease			Decrease	Increase	Increase	Decrease	Increase	Decrease

As we can see from this expanded accounting equation, Assets accounts increase on the debit side and decrease on the credit side. This is also true of Dividends and Expenses accounts. Liabilities increase on the credit side and decrease on the debit side. This is also true of Common Stock and Revenues accounts. This becomes easier to understand as you become familiar with the *normal balance* of an account.

Normal Balance of an Account

The **normal balance** is the expected balance each account type maintains, which is the side that increases. As assets and expenses increase on the debit side, their normal balance is a debit. Dividends paid to shareholders also have a normal balance that is a debit entry. Since liabilities, equity (such as common stock), and revenues increase with a credit, their “normal” balance is a credit. Table 2.2.1 shows the normal balances and increases for each account type.

Account Normal Balances and Increases

Type of account	Increases with	Normal balance
Asset	Debit	Debit
Liability	Credit	Credit
Common Stock	Credit	Credit
Dividends	Debit	Debit
Revenue	Credit	Credit
Expense	Debit	Debit

Table 2.2.1

When an account produces a balance that is contrary to what the expected normal balance of that account is, this account has an **abnormal balance**. Let’s consider the following example to better understand abnormal balances.

Let’s say there was a credit of \$4,000 and a debit of \$6,000 in the Accounts Payable account. Since Accounts Payable increases on the credit side, one would expect a normal balance on the credit side. However, the difference between the two figures, in this case, would be a debit balance of \$2,000, which is an abnormal balance. This situation could possibly occur with an overpayment to a supplier or an error in recording.

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