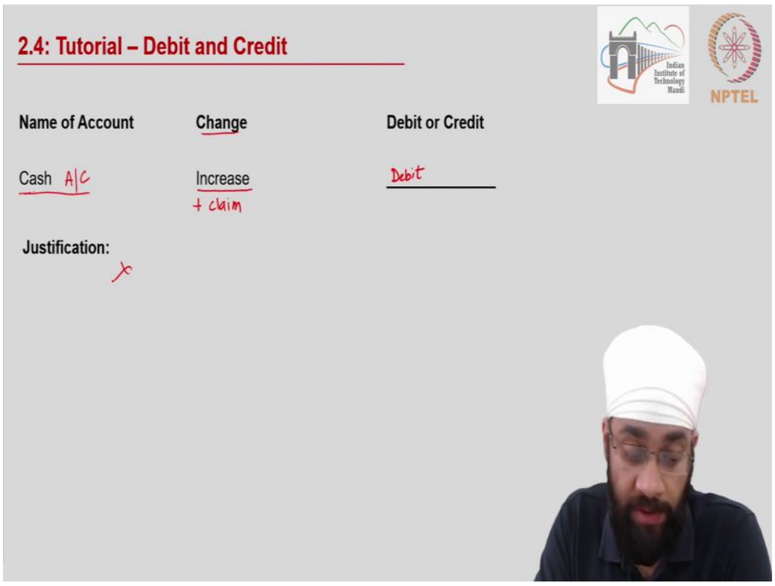
Financial Accounting
Dr. Puran Singh
School of Humanities and Social Sciences
Indian Institute of Technology, Mandi

Lecture – 19
2.4 Tutorial - Debit and Credit

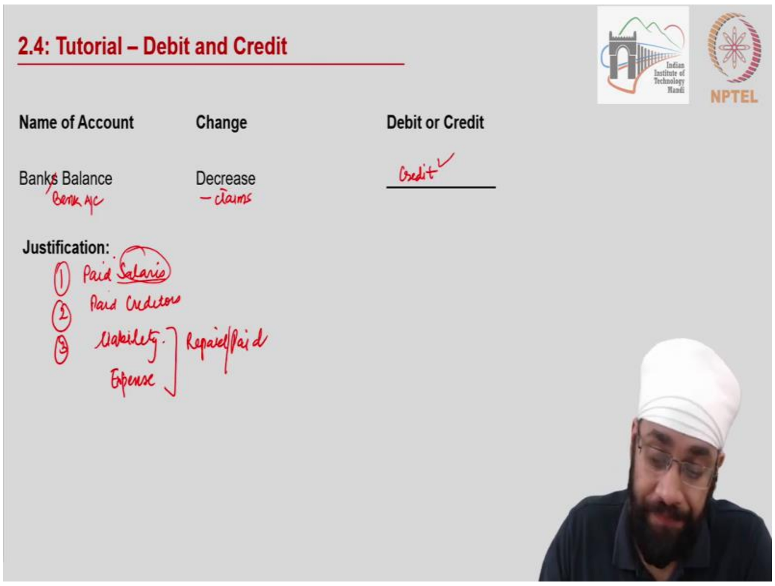
Let us reinforce your learning's from the previous video about Debit and Credit and do a quick tutorial.

(Refer Slide Time: 00:25)



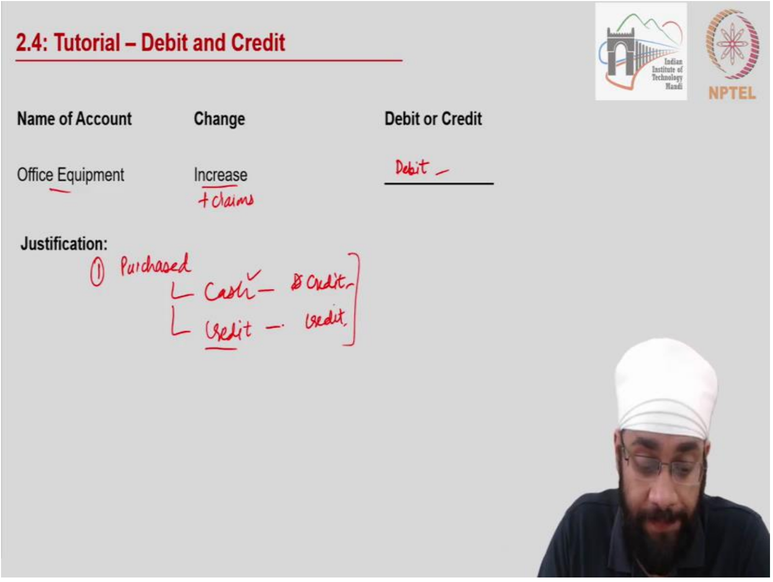
On the slide you see the name of an account. So, we have a cash account here and we have been given the direction of change. This is interpreted as follows. The slide is telling us that due to a transaction, cash account in the business has experienced an increase, meaning more cash has come into your hand. Now, you have to respond by saying whether the cash account should be a debit or credit. Should it be debited or credited? That is how we use these two terms as well. So, let me do this quickly. Now, the cash account is experiencing an increase which means there is an increase in the claim of the business on the new cash that the business has received. Increase in claim is debit right. I do not think any justification is required; this is fairly straightforward.

(Refer Slide Time: 01:37)



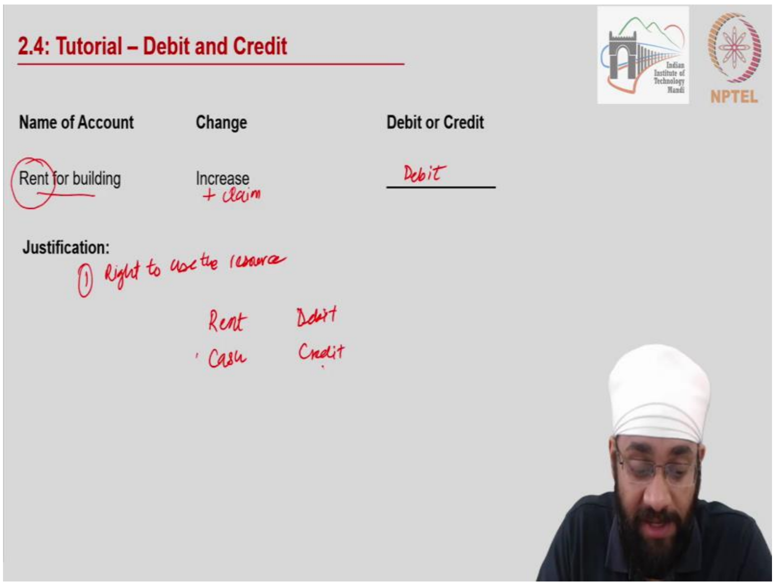
Then you have a bank balance, so you are going to call it let us say bank account. Bank account decreases. Now, when does the bank account decrease? Bank account decreases when you pay salaries, when you pay to creditors, when you pay any other expense or repayment of a liability. So, let me just write those two as well. So, a liability or an expense can be repaid or paid. You pay through your bank account, it could be through cheque or online transfer. So, business' claims on its bank balance are going down. So, decrease in claims and decrease in claim is credit. Remember that there must also be an equal debit. All debits have equal credits. Thus, when you say bank account credit and you are paying, let us say, salaries an equal debit has to be given to the salaries account. But we are only discussing one side of the coin, we are taking baby steps. One by one we are learning what should be debit and what should be credit. And in the following videos, we are going to stitch everything together and look at both sides of the coin.

(Refer Slide Time: 03:19)



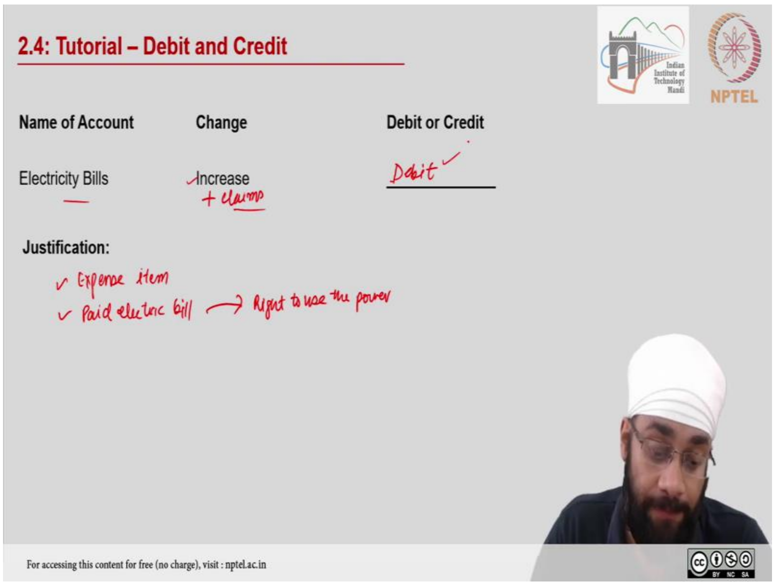
Next step is office equipment; office equipment increases. When does office equipment increase? They increase when you purchase them. So, you purchase them. You could purchase them on cash; you could purchase them on credit right, does not matter. If you purchase them then you know your claims are going up, business’ claims are going up on that particular asset or office equipment in this case and you will write a debit. The opposite of this, the other side of the coin is that you have paid in cash. If you have paid in cash then the cash account should be credit, because your claim on cash goes down. And if you have not paid in cash, then this creditor has a claim on the business. So, there is a new liability that you have. Again, increase in liability is credit, because the creditor has a claim on the business in this case. So, a debit is going to have an equal credit, but I am refraining from going into the other side, but I will start doing it as we move forward.

(Refer Slide Time: 04:33)



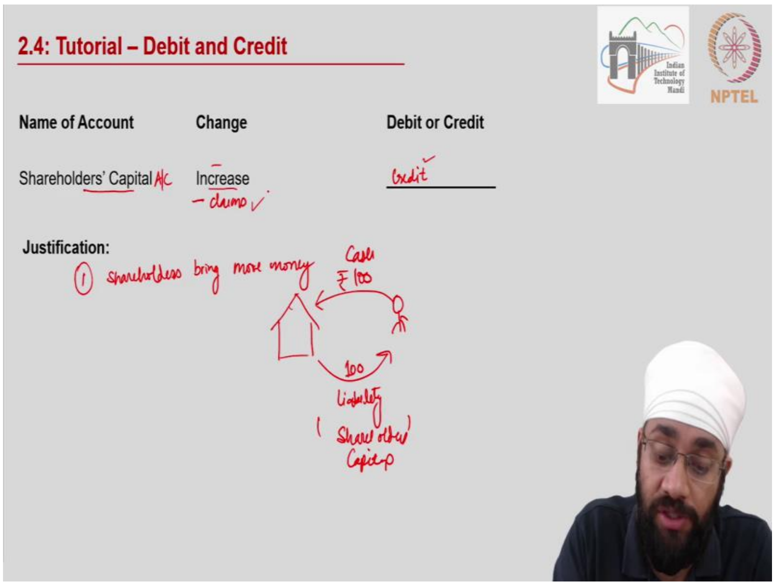
Rent for building. If you remember, when you pay rent it gives you a right to use the resource, to use the property. So, there is an increase in the claim of the business over the use of this asset which is called building here. Please remember rent does not refer to the money that is being paid that is cash, cash account that is separate. Rent represents the right that you buy, the right to use that resource. Therefore, the claim, the right is going up here and you would write a debit. The other side of the coin of the rent being paid is that you are paying cash for it. So, your claim on the cash is going down. Thus, the other side is that you do a credit to the cash account. More than that as we move forward, but I am giving you a preview of what is to come in the next videos as well.

(Refer Slide Time: 05:41)



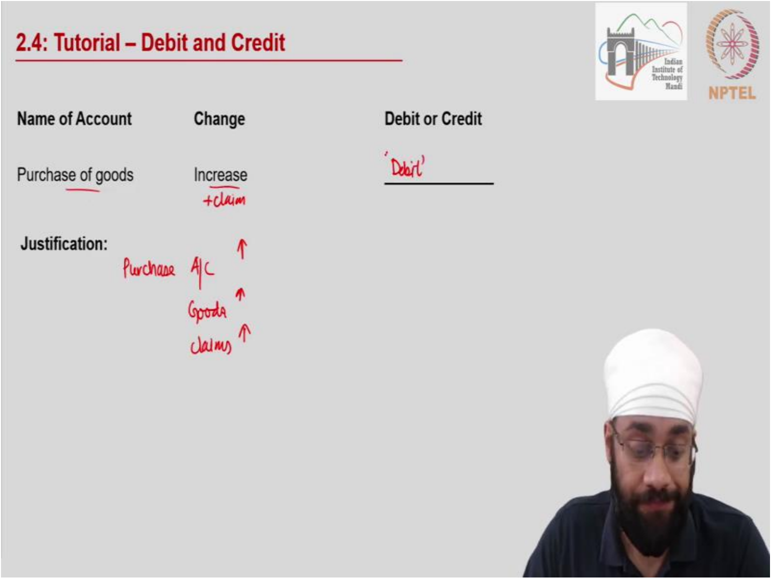
Electricity bills increase. So, electricity bill is an expense item and, let us say, you paid the electricity bill. By paying the bill you earn the right to continue to use the electricity, the power source. So, it refers to an increase in the claims of the business over the use of this service which is supply of electricity. So, you are going to do a debit to indicate that your rights, your claims are going up. Again, the other side of the coin is that you paid money for it which is a cash account. Cash account will see a reduction. Business' claim on its cash will go down, because we have paid that cash to the electricity company to the government and you cannot demand that back. And if you have not paid, the government will demand that money, the supply company will demand the money from you. For now, claims of business go up on the use of the supply of electricity therefore, we write a debit here.

(Refer Slide Time: 07:01)



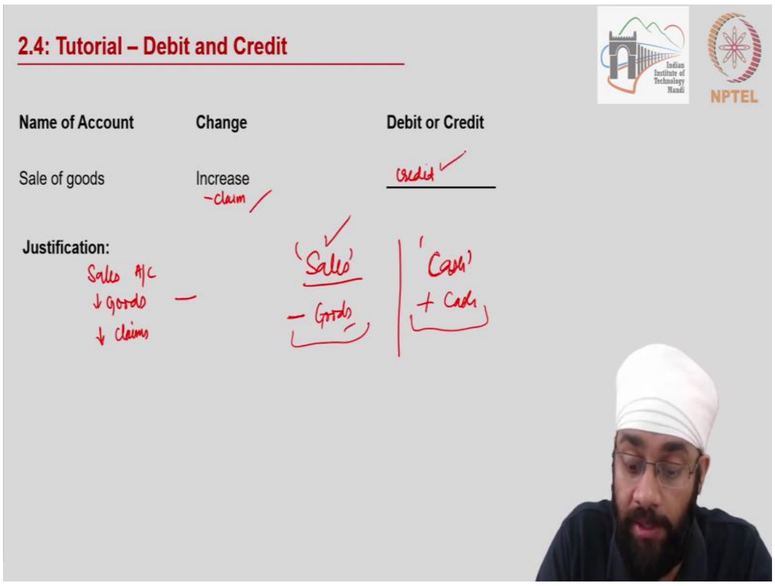
Next step we have shareholders' capital which is increasing. Why is shareholders' capital increasing? Because shareholders brought in more money. When shareholders bring more money into the business what is happening? The business' claims are going down. If you remember this is the shareholder. Shareholder brings in a new hundred rupees into the business. Now, there is a new liability that has been created. Business owes this money back to the owner at whatever point it is due, equal to a 100. This is the cash that owner gives to the business, but in return what is happening is shareholders' capital, the name of the liability is shareholders' capital. And this is what is going up. Shareholders' capital is increasing which means there is a reduction in the claims of the business, because shareholders' claim on the business is going up right. So, any reduction in claim is shown by credit. So, we are going to write shareholders capital account and write the word credit opposite to it. And somebody who knows the accounting language will be able to interpret, will be able to infer that the shareholders brought in more money, more cash into the business. Therefore, the liability of the business towards the shareholder is going up. That represents the reduction in the claims of business and hence, the credit has been written there.

(Refer Slide Time: 08:51)



Then you have the purchase of goods which is increasing. So, you are purchasing the goods; more goods are coming in. So, you have the purchase account. Purchase account which is going up, because goods are coming in. So, goods are going up which means claims of business on these goods are going up.

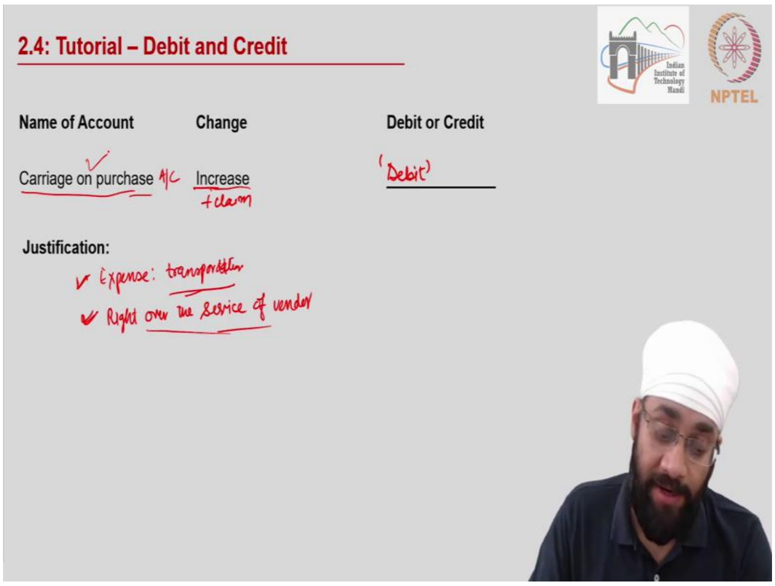
(Refer Slide Time: 09:27)



So, I am going to write a plus claim which means increase in the claims of business which is represented by the word debit and you are done. Sale of goods; again, you are going to have a sales account. When you are selling goods there is a reduction in the right of the business over these goods, because you have sold these goods you have delivered these goods. So, goods are going out. Thus, reduction in the goods, in the claims on the goods is consequently the reduction in the claims of the business. So, I am going to write minus claims and say a credit. Again, remember that sales are typically thought of as an income, as a good thing, as a positive thing, and debit represents the increase in things right.

However, there are two sides to a point. The thing that you are thinking about is cash that you receive against the sales. When I see sales, I mean goods and goods will have to go out, thus, minus goods. Goods will have to go out for you to make this money; this is the cash that comes in. So, do not confuse the two. In accounting language, we learn to segregate the transactions. We see the transactions and we categorize them into two aspects, give and take; what is the debit and what is the credit. That is what the double entry system is. So, in this case we are right now talking about the goods which are going out meaning business' claims are going down. Therefore, we write a credit against the sales account to indicate that goods are being sold.

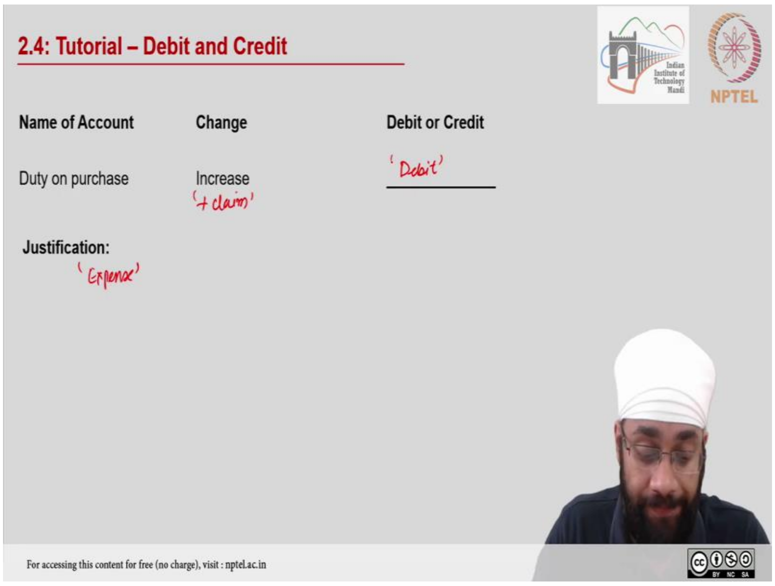
(Refer Slide Time: 11:15)



Then you have a carriage on purchase. Carriage, as I earlier said, is an expense item. It is a transportation cost. So, what is happening here is it is increasing; meaning you paid it in the account, in the carriage on purchase account, you show an increase, because you just paid the carriage. So, by increase we do not mean that earlier the carriage was 100 rupee per kilometer and now it is 200 rupees, not that increase. We are keeping a record for all the transportation costs; there is one more item, there is an addition to that.

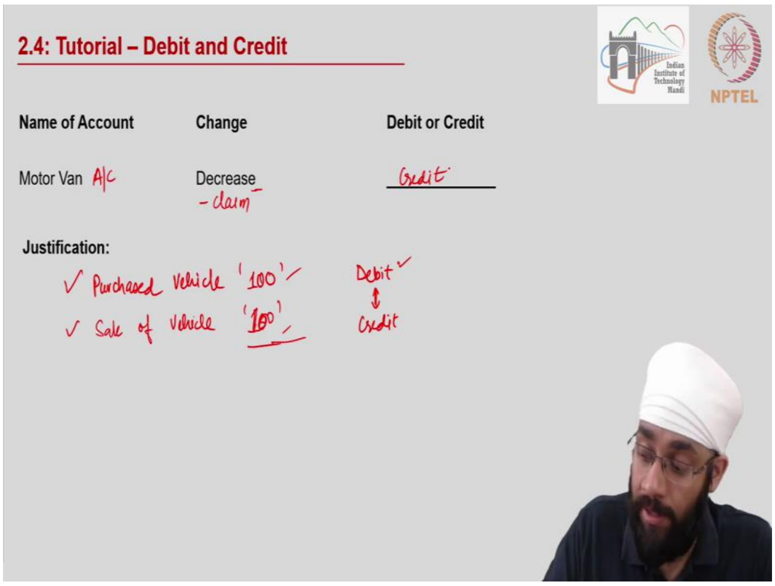
So, when that happens it means you have a right over the use of the transportation service of the vendor or whoever moves the vehicle, a company. So, when you have the right over the use of vehicles, the claim of business is going up. So, you say it debit. You are going to write a carriage on the purchase account, debit. It means that you have a right to use this service of transportation, because you have paid for it. The other side is that you have paid cash for it. So, the business' claims on the cash will go down, but the business' claim on the use of service, right to use the service will go up. And carriage on purchase represents that right, not the cash that is paid.

(Refer Slide Time: 13:09)



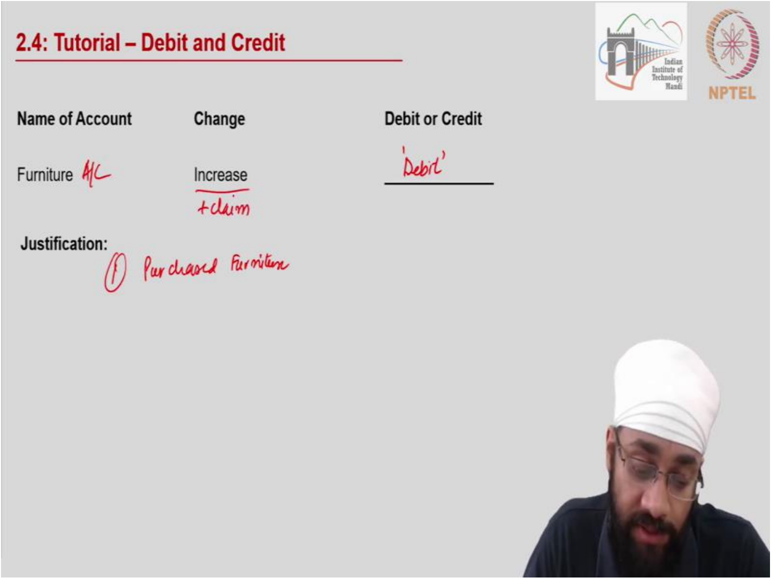
Then you have a duty on purchase, a similar item, again this is an expense. When you pay the expense, you have an increase in the right of the business over the use of a resource or the business has more claim on that service. It is indicated by a debit.

(Refer Slide Time: 13:33)



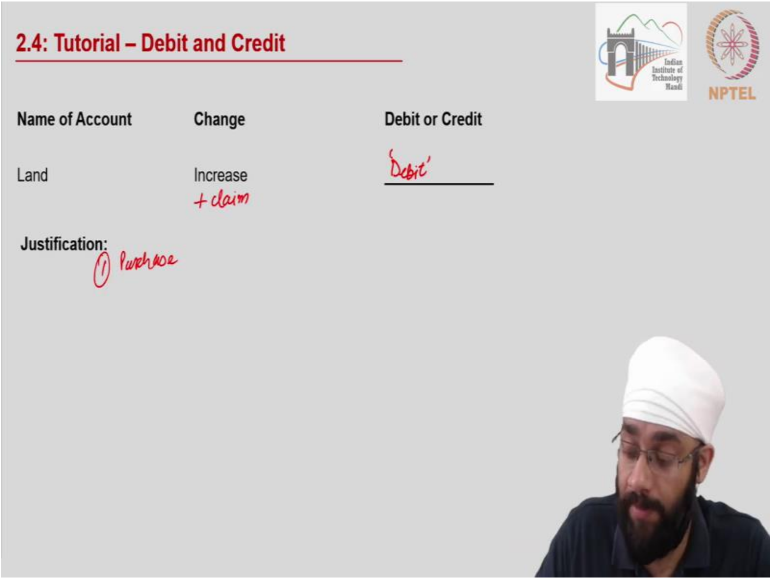
Motor van decrease. Now, what does decrease in vehicle mean? So, this is a motor van account; let us say, you purchased the vehicle for 100. At that time, you would have shown a debit, because paid cash for it and the vehicle is coming into the business. And you have bought the vehicle, you have the right over the vehicle, the registration is in the name of the business possibly. So, you showed a debit at that time. Now, when would there be a credit? Of course, we understand debit and credit are opposite to each other. One represents the increase of the claims of business, the other one represents the decrease. So, when you purchase the vehicle, you show a debit. Now, clearly the opposite of purchase is going to be a sale. So, let us say you sold the vehicle for 50, because over a period of time the value goes down as well. You sell the vehicle for 50, but effectively what is happening is you are reducing the value of the vehicle. And if you want to keep it simple, let us say keep it 100, because then you know this whole question of the value is going down and what price you are selling? Will deal with those advanced questions a little bit later in the course. Let us say that you bought it for 100 and the next day you sell it at 100. Again, not possible. The value of vehicles goes down by 20 - 30 percent immediately after they get out of the showroom. However, this is a hypothetical situation. The second you sell the vehicle your claim on the vehicle goes down, because you would have received cash against it. So, reduction in the claim is shown by a credit.

(Refer Slide Time: 15:25)



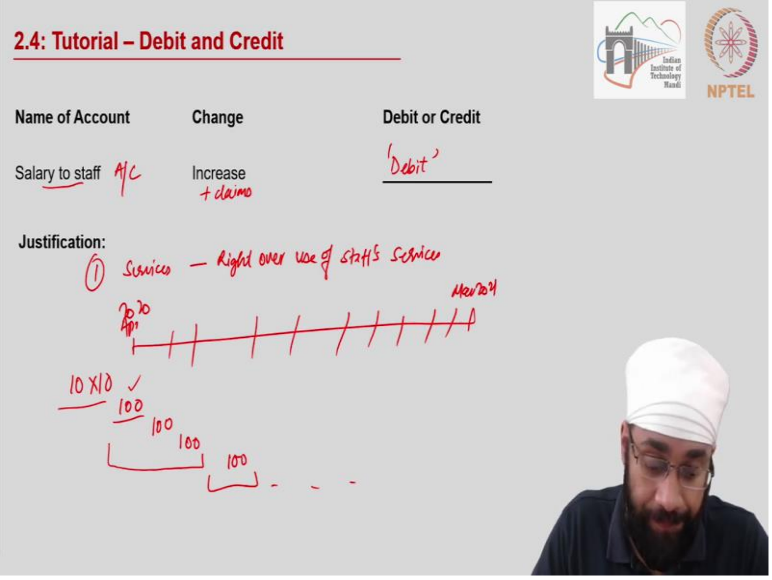
Furniture increase. Your claim on the furniture is going up. Furniture increase means you purchase more furniture, that is the clear explanation. You purchased more furniture. So, in the furniture account you are going to write a debit, because you have paid for it or you will pay for it. And you have an increase in the claim of the business on the use of the furniture.

(Refer Slide Time: 15:55)



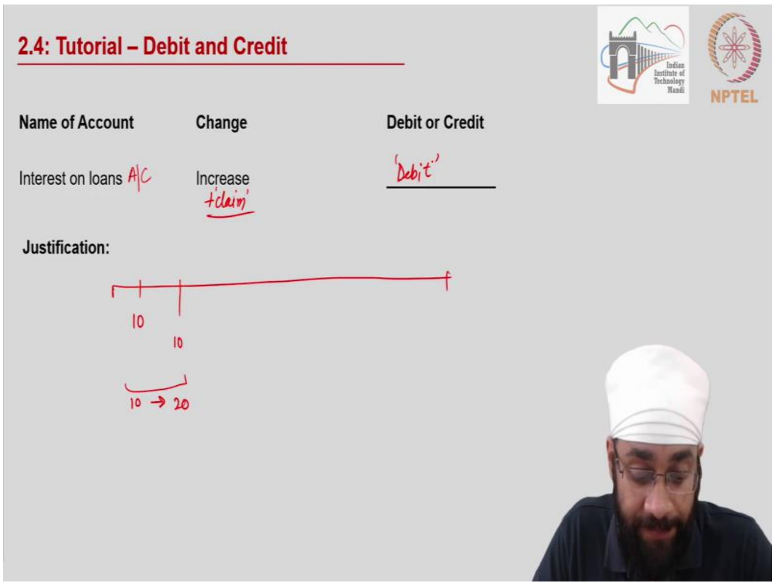
Land increase: again, when land increases, I mean it is not increasing in size but that you bought more land or you added more land to your existing pool of land. So, I am going to quickly write for hints that you purchase more land: that means, you have a claim on more land, your claims are going up in that sense. Any increase in the claim is debit. Salary to staff; salary is being paid for the services.

(Refer Slide Time: 16:23)



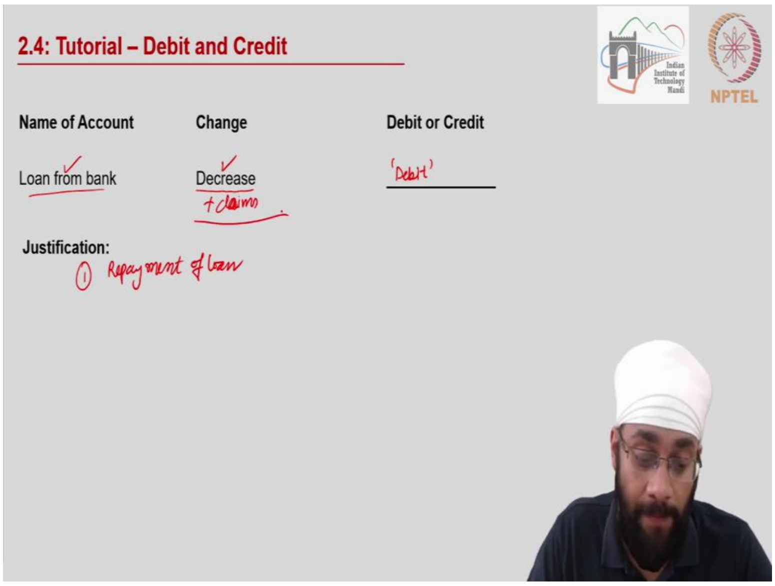
So, the business has right over the use of staff services that is what it means. When the salary has been paid, when you say the salary account is increasing, it does not mean the monthly salary has a 10 percent increment. Let me take a financial year, so April 2020 to March 2021; every month you pay salaries these are the monthly breakdowns. Every month you pay salaries you have 10 employees. Everybody is paid, let us say, 10. So, every month you spend 100 in salaries. So, you pay 100 in the first month, in the salary account you show 100. In the next month you add another 100; this is what I mean by increase. In the following month you add another 100 and the total salaries till data 300. Next month you pay another 100, total salaries are paid till now are 400. So, this is what I mean by increase in salary, whenever you add more to the record or the book where you are maintaining the records for salaries. So, when you do that, you pay more salaries and your claims are going up, because you have a right to use the services of those staff members. And any increase in the claims of business is represented by the word debit.

(Refer Slide Time: 18:05)



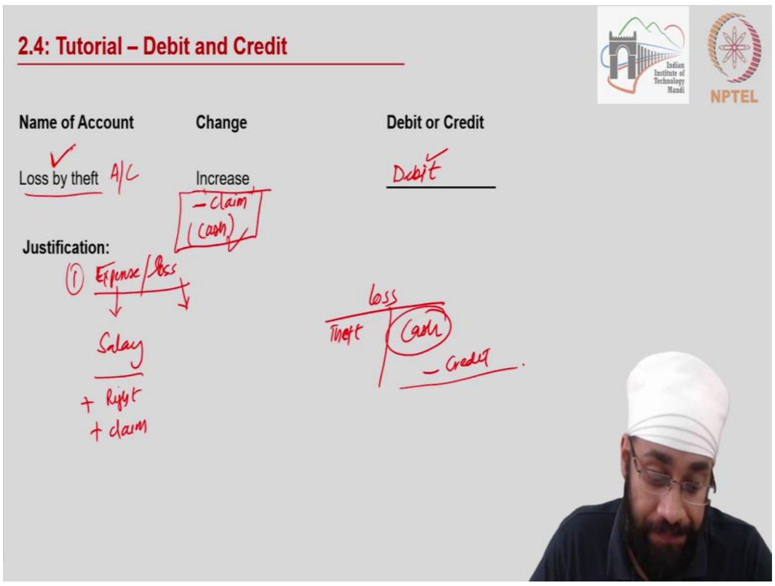
Yeah, interest on loans is increasing. Again, increasing does not mean earlier you are paying 8 percent now you are paying 10 percent which could possibly also be the case and we will deal with that later as an advanced case. But we are saying interest on loan has been paid now. In the interest on the loan account, you just wrote a new item, because every month, let us say, you pay interest. So, when you paid interest for the first month it was 10 and now you paid another 10, the accumulated interest that you have paid is 20. So, from 10 to 20 this is the increase, this is what we mean. So, when we pay the interest on the loan, what is happening is you are paying the rent equivalent to rent paid for office premises. When you pay rent for office premises, you earn the right to use the office premises. And when you pay an interest on loan, you earn the right to use the principal amount of the loan for the business. So, it also represents an increase in the claim of business. As long as you are paying the interest, you are eligible to use the loan. If you stop paying the interest, the bank will stop this service and they will demand repayment of the loan from you or if it is a secured loan which means you have given paperwork or transferred paperwork ownership temporarily to the bank, the bank can sell it off under the contract of the loan. So, this is an increase in the claims of business. All increases in the claims are shown by the word debit.

(Refer Slide Time: 19:47)



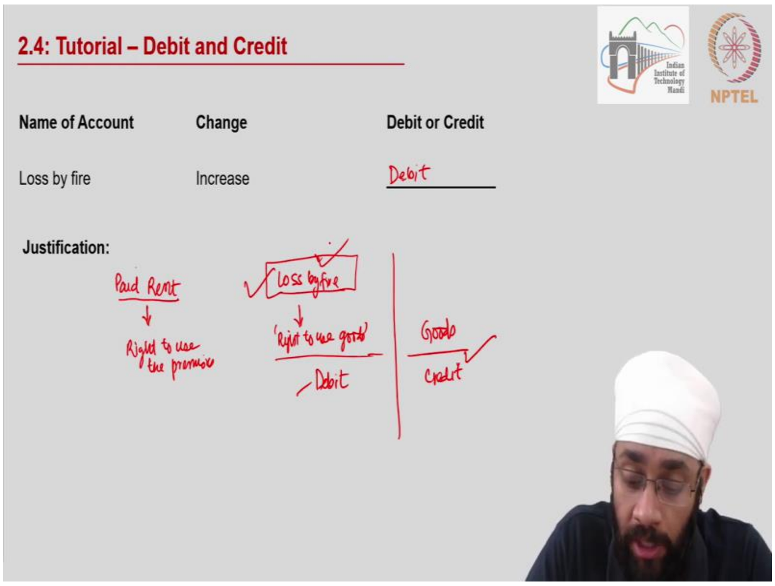
The other is a loan from the bank; it decreases. When does a loan decrease? When you repay it, you have done the repayment of the loan. When you repay the loan, it means the bank no longer can have a claim on your business. Therefore, bank's' claims on the business goes down, which is the alternative of that. The other side of the coin is that business' claims are now going up, because an external party does not have any more claims on the business. So, you have an increase in the claims of business, because the loan is being repaid- it is decreasing. If it was increasing, we would say credit, but it is decreasing so we will say debit. Loan being paid, claims of business are going up.

(Refer Slide Time: 20:41)



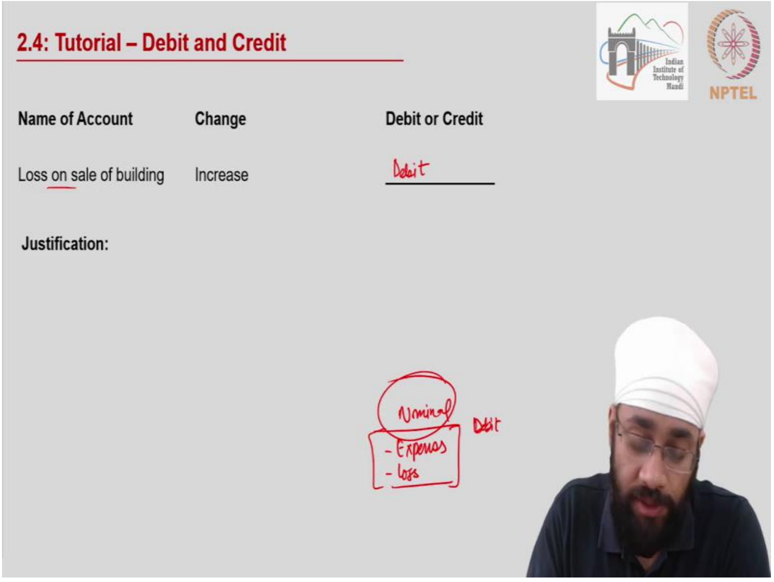
Loss by theft: again, it comes in the category of expense/loss. Loss increases means possibly earlier there was no loss by theft, now there is loss by theft. In the loss by theft account, you will have to write something. So, your claims go down, because you know theft has taken place. If the money has been taken away, your claim on that money goes down. Now, you could argue saying you actually have a legal claim on that and you can file a fir and then legal proceedings can happen, but assuming that everything has now settled and still you were unable to recover this money. That is when the loss is recognized as well. So, it is a reduction in the claims of the business, but you have to think differently about it. This is an exceptional case. Typically, when you spend on salary your right goes up, the right or the claim goes up. However, in case of a loss you are just losing the cash. In case of loss the two sides of the coin are: let us say you lost the cash, but you lost the cash because you know there was a theft loss by theft alright. So, you no longer have the right on the cash which will be represented by a credit reduction in the claims, but an opposite debit has to be shown in the books of accounts as well. To say, what was the cause, why did you lose this cash- there is no obvious reason. I mean you did not buy any right over the use of anything it was just a loss, but an equivalent debit has to be created. Thus, in this case we are going to still make a debit. The decrease in the claim is going to be for the cash. So, the decrease is in terms of cash if this was cash loss. However, in this case a debit has been given to loss by theft, because we do not have any other option, we are not earning any right. So, we just created a dummy account which is loss. We are not earning any right; it is a loss of the right account. So, the account which is being debited is a loss by theft account and what we actually lose is the cash which is going to be the other side of the coin, the other side of the transaction in this case.

(Refer Slide Time: 23:35)



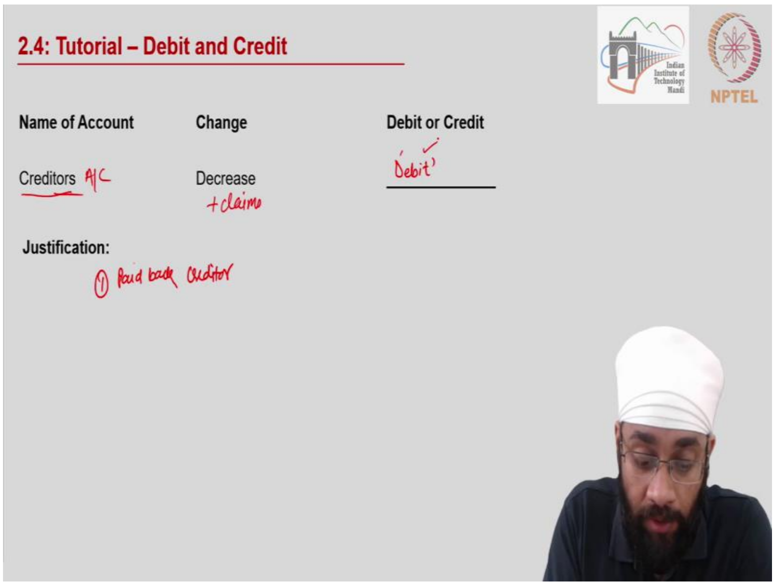
Same, for loss by fire. Let me explain it again, because it is slightly complicated. Typically, in case of an expense, for example, rent when you pay rent you earn a right to use; right to use the premises or whatever property and you pay cash for it. However, in this case what is happening is, you have a loss due to fire, and let us say your goods have been burned. So, what you lose is the right to use the goods, let us say, your stock has been put to fire. So, the right to use the goods goes away, it vanishes is what we are saying. And it vanishes, because you lost the goods by fire. When you paid rent you earned a right to use the property, but when the goods were lost in fire you did not get any right whatsoever. So, there is nothing, no increase in the rights of the business, but since all credits have to have an equal debit, you create a dummy account which is called loss by fire account and you show a debit and you show an equal credit for it; so, debit. And equal credit for it, because you lost the goods. So, goods show a credit and loss by fire shows a debit: an equal debit and credit. So, understand that loss by fire is kind of a dummy account to show that we did not earn any right. Typically, we would say this right has been earned and let us give it a debit, but no right has been earned. But in order to record this in the books of accounts, we have to create a dummy account which is called loss by fire.

(Refer Slide Time: 25:39)



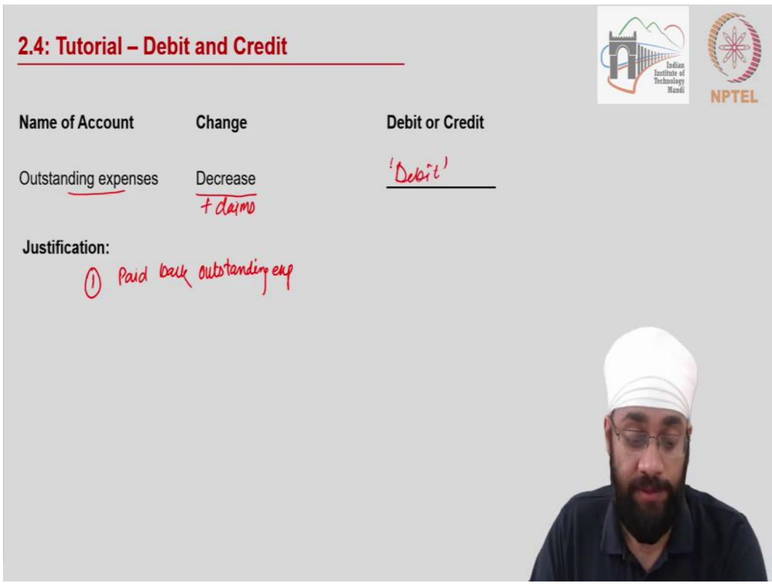
Same, loss on sale of building you sold the building and you sold it at a lower price compared to the cost at which you bought it. It is also a loss. Again, all losses are recorded in a dummy expense account: it does not necessarily give you right, but you have to show a debit for the equal credit. So, again, you show a debit here. And remember the rule that all expenses and losses are nominal accounts. And we are going to learn the rules of debit and credit where we will see all expenses and losses are going to be debit as well. So, just wait for that.

(Refer Slide Time: 26:25)



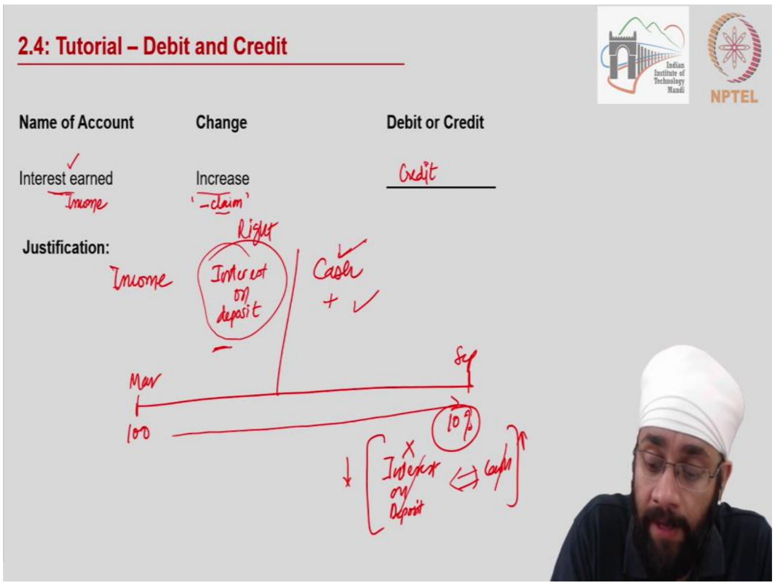
Creditors are decreasing. When creditors decrease it means you paid back the creditors; you paid back the vendors. When you pay back the vendors they can no longer ask you for money. So, vendors' claims on business go down which means business' claims go up. So, an increase in the claims of business is always shown by a debit. So, the creditors account will show a debit when you pay back the creditors.

(Refer Slide Time: 27:03)



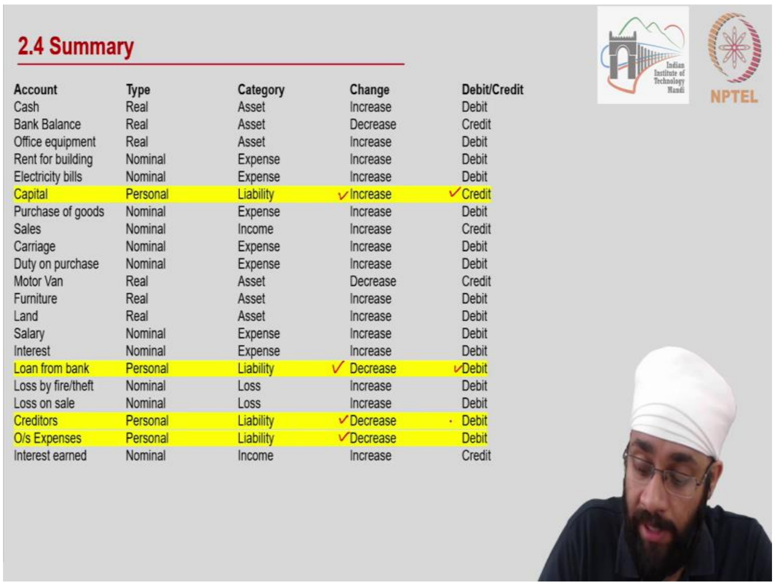
Outstanding expenses: again, it is another liability. It is decreasing means you are paying back. You paid back the outstanding expenses. Outstanding expenses which were overdue, you did not pay those in time, they became a liability, and now you have paid them. When you pay them, people to whom these expenses were due, cannot come back to business and claim any more. So, their claims go down meaning business' claims go up. So, an increase in the claims of business is shown by a debit always.

(Refer Slide Time: 27:45)



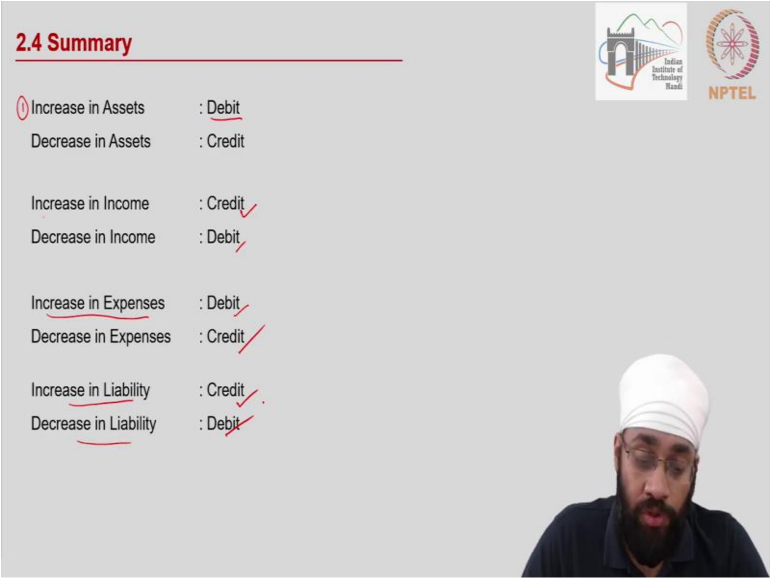
Interest earned: interest earned on deposits that you have in the bank account. When interest earned is going up, what is happening? You are receiving an income it is a non-operating income, but you are receiving an income and you receive cash for it. The income's name is interest and the other side of the coin is the cash. So, you are going to get cash, in exchange for the other side of the coin. In exchange for receiving this cash what you have done is you have forgone, you have given up your right on the interest on the bank deposit right. So, you do not have a right anymore. You do not have a right on the interest on the deposit, because that interest just has just been paid to you. So, again you have to think a little bit slowly about it, the two sides of the coin, you deposited money in the bank account. Now, you deserve to receive interest. So, interest on deposit, this is the right. And now, the bank has paid you in cash. So, this right has been redeemed by you. You already got cash for it. When you got cash for it this right goes down, you do not have this right of receiving the interest anymore. So, think a little bit differently here, interest earned is an income. When you receive the income in cash you are giving up your claim on that income going forward, at least for the duration for which services have been rendered. So, you put money. Let me illustrate it little bit more. Let us say from March to September, 6 months period you deposited 100 and you deserve an interest of 10 percent for the 6 months. Now, during this time; you have increase in the claim, interest on the deposit. Now, bank pays you interest on the money deposited by you. Now, this right goes down. Now, this right has been cancelled because the bank has paid you the cash. So, your claim is going down, because you have been paid cash for it is what I mean. In order to show that you have earned the income, we are saying your right on this income is going down. So, you are going to say credit. Again, the other side of the coin is that you have received cash, your claims go up there.

(Refer Slide Time: 30:47)



So, let us summarize the learnings from this tutorial. I have the accounts that we discussed in the first column then, type of account and category of these terms from the previous couple of videos and tutorials. So, this we already knew. The new thing is when it changes what happens? So, cash being an asset when it increases you show it by debit, bank balance being an asset when it decreases you show it by a credit. So, what are the key learnings from this tutorial? Here you go. So, when assets increase, it is shown by debit. And whenever the assets decrease, it is shown by a credit. That is the learning from this slide. Next step you have incomes. So, sale is an income whenever income increases, you have a credit. Interest earned is an income whenever income increases, you have a credit. Then you have expenses. Whenever expenses increase, you have a debit. Expenses increase debit. So, whenever expenses are increasing, you write it as a debit. And finally, the liability: liability goes up, it is shown by a credit. Whenever liability goes down, it is shown by a debit. This leads us to the following learning.

(Refer Slide Time: 32:37)



Any increase in assets is debit; any decrease in asset is of course, opposite.

So, you only need to remember you know one of these two. Any increase in income is credit and opposite as debit. Any increase in expenses is a debit and decrease is credit. And finally, increase in liability is a credit and decrease in liability is shown by a debit. So, there you go. Now, you know different types of accounts: personal, real, nominal. You already knew assets, liabilities, incomes and expenses.

(Refer Slide Time: 33:19)

So, this is how we are building up assets, liability, incomes and expenses and we also learn the sub categorization of this. And after that we learn the types of accounts which are personal, real and nominal. And then we learned about debit and credit and how increase or decrease in asset, liability, income, expenses will be shown by debit and credit. That is it, for this tutorial. I see you in the next video.