Financial Accounting
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Lecture – 20
2.5 Rules of debit and credit

In this video, we are going to learn about the Rules of Debit and Credit. You are already familiar with the rules of debit and credit from the previous tutorial. All I am going to do is just relate it for you so that you see it clearly.

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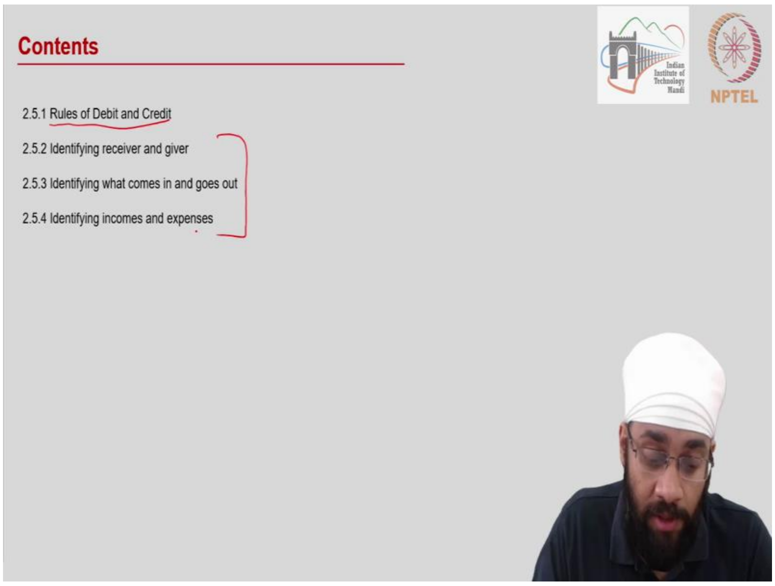

So, the contents of this video are as follows. I will tell you about the rules of debit and credit, and then we will quickly put this rule to practice a little bit more to get a better grasp on the concept of debit and credit.

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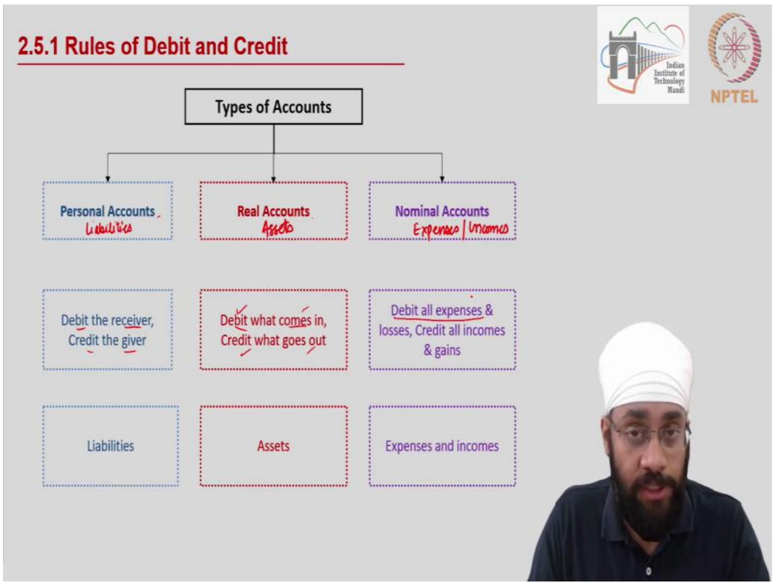

In the earlier videos, we talked about three types of accounts: personal account, real account and nominal accounts. We also said all personal accounts are going to be liabilities, real accounts are going to be assets and nominal accounts are going to be expenses and incomes, and of course losses and gains.. So, we know this and we also understand what is debit and credit: debit increase in the claims of business, credit decrease in the claims of business.Now, we are going to learn the rules of debit and credit, another scientific way, rule of thumb you can just blindly follow a formula if you will. So, here it is. When you have a transaction you figure out which accounts you want to write that transaction in, and then you say is this account a personal account, real account, or nominal account, say, you decide it is a personal account. Now, if this personal account, the person whose account is being written to, if he is a receiver you give him a debit, if he is a giver you give him a credit. **Debit the receiver, credit the giver.** This is the rule which is followed for items which fall into the personal account. Most liabilities are going to be personal accounts, and hence they will follow this rule: debit the receiver, credit the giver.

The next type of account is real accounts, all assets. The rule for writing the transaction is **debit what comes in, credit what goes out**. Now, when you are talking about assets, you are talking about land, building, equipment, vehicles, cash, bank balance, so all these items are either going to come into the business which means you are buying these or you are receiving cash, or you are going to sell off these things, they will go out of the business. Hence the rule debit when an asset is coming in, credit when an asset is going out. Again, all assets are real accounts and this is the rule that we are going to follow.

Nominal accounts: **debit all expenses and losses, and credit all incomes and gains**. So, whenever you are spending on an expense, like spending on rent and salary, we say that it is an increase in the claim of the business, and hence we give it a debit, and the opposite for the credit. So, all of this you already knew, we did this, we have practiced this in the previous videos and all I did was I gave you some thumb rules.

Sometimes you are confused and you need guidance, and this is the guidance that you would use, these are the rules that you would use to write the transactions in the books of accounts. Let us put these to use a little bit more.

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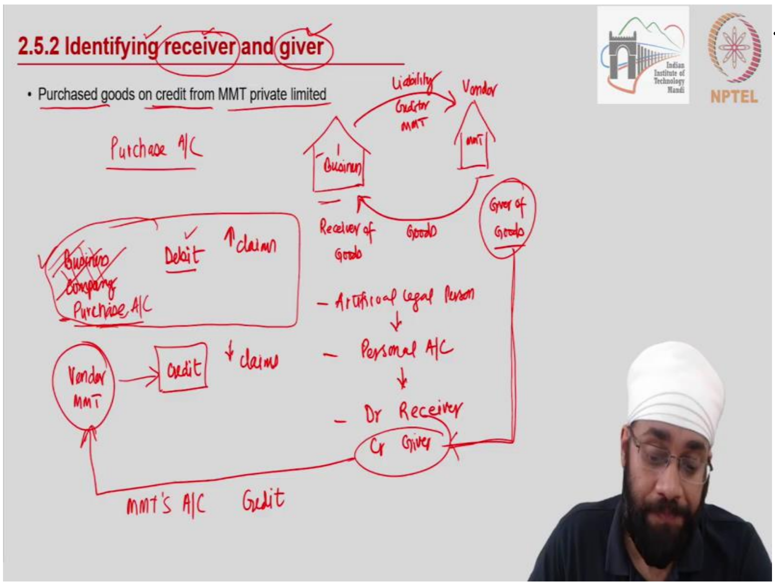

Let us say, this is a transaction, the business purchases goods on credit from a company called MMT private limited. So, what we do here is we have to identify the receiver and the giver, what are the parties involved in this transaction, what is happening, and accordingly how do you use the rule of debit and credit.

So, let us do this. You would maintain a purchase account. The transaction really is happening between two parties: this is the business, and this is your vendor from whom you purchase goods- this is MMT- the vendor. The vendor is supplying goods. And this is on credit; therefore, there is a liability which is being created liability. This is a creditor, MMT is a creditor. So, who is the receiver and who is the giver? You know that is the question. In this case your business is the receiver of goods. And this vendor, on the other hand, is the giver of goods. And since we are talking about two companies, and both of these are artificial legal persons, they fall into personal account right. And the rule for personal account is to debit the receiver and credit the giver. This means the receiver is the business, so we are going to say our business or whatever is the name of our company should write a debit. And the vendor, MMT is the giver of the goods. So, the rule says credit the giver what does it mean now. So, we have to write it like this. We also know that debit means increase in the claims of business, and credit means decrease in the claims of business. So, let us verify if you are able to check everything off using the knowledge that you have gained in the previous sessions. Now the business is going to do a debit to its own account. Please understand that any account that a business prepares are its own accounts. So, what is really happening here is purchase. So, it will have a purchase account. Thus, rather than saying you know my company's purchase account or businesses purchase account or company's purchase account, we simply say purchase account. And whenever you do not prefix anything else here it means that it is this company's own account. Imagine that I am the company, I am the artificial person and if I come to life somehow how am I going to write my transactions, I am going to use a notebook and I am going to write my purchases right, you could simply do that. So, I do not need to write my company's name and then purchase account; I do not need to write that.

So, I have this understanding whenever I write a purchase account, rent account, salaries account, what I mean is my company's salaries which are being paid to employees, my company's rent which is being paid and so on. So, we do not need to mention business or company's name here at all. So, this purchase account represents the business in that sense. However, since this is a business' purchase account and business is receiving it we have given it a debit, although that is not the correct logic. I will come to that in a bit. So, on the other hand, you have the vendor, the vendor is the giver of the goods, and debit the receiver, and credit the giver. Using this rule, we are going to give credit to the vendor. So, the outcome of the objective of the slide was to identify a receiver and giver. We said receiver is the business and giver is the MMT company. It gives goods. We credit the giver and vendors account MMT's account.

The outcome is going to be MMTs account is going to be credited, because it is a giver. I am not commenting on the first half of the you know transaction where you know there is no longer a receiver, but a purchase account and purchase account is not a personal account. So, I am going to reserve that for the following slides to be discussed.

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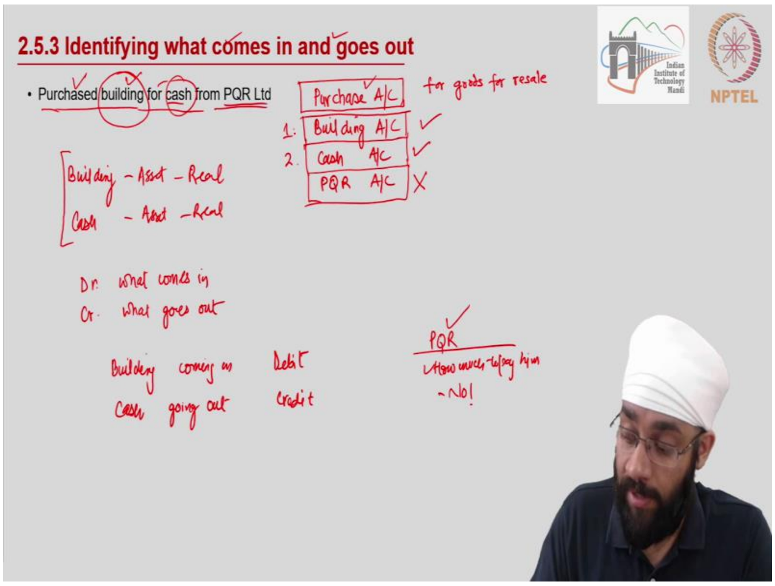

Let us look at another transaction where the building is being purchased for cash from PQR. Now, we have to again identify who are the parties involved, how would this business record its transaction. So, clearly there is something called purchase, you could create a purchase account. There is a building being purchased. So, you could also think about creating a building account, cash is involved. So, you could create a cash account. And PQR is the person from whom the building is being bought. So, you could create PQR accounts. There are four possible accounts or records that you would want to maintain. Which account should you actually maintain for this transaction is the question. So, you are purchasing now, purchase account- this is the first option we have discussed that purchase account is a dedicated account for the goods that are going to be resold. So, the goods for resale purpose, all those goods are going to be recorded in purchase, purchase account. You do not want to mix the purchase of assets with purchase of goods. So, in this notebook where you write purchases, you will only write purchase of goods which are to be resold.

Next option is buildings account. Now, what is building? Building account means you have a notebook wherein you write about building, you purchased building, you sold building, you did something to renovate building, etc., all of that is going to be written here. In this transaction, you are purchasing the building right; you are not purchasing goods, you are purchasing building. So, building account is the account which you should certainly create. You should have a page or have a notebook where you write about updates on the building.

Next option is a cash account. Now, is the cash account being affected? Are you paying cash for it? When you purchased a building you paid in cash, so certainly the cash account is getting affected. So, you have to consider this. And finally, PQR. Now, what is happening is you buy a building from PQR, and you pay him cash. Do you want to maintain a PQR account? If you maintain a PQR account, you would maintain it because you want to know how much do I owe him, how much to pay him or how much to receive from him. In this case since you are purchasing the building from him the relevant question is do you have to pay something to PQR for the building? The answer is, no- because you already paid in cash. So, if you have already paid in cash why do you need to maintain a record? It is a waste of effort, you do not need to record, because there is no record, you paid in cash. So, whenever you pay in cash you do not worry about the vendor because you do not owe anything more to the vendor, in the vendor's account you are only going to write whatever is due to them which you have not paid. So, in this case, PQR is going to be excluded. So, we have arrived at two accounts where this transaction should be recorded: building and cash. Now, building is an asset and hence a real account, cash is also an asset, and hence a real account as well.

What is the rule of debit and credit for the real account? The rule for debit and credit is, debit what comes in, and credit what goes out. Both the items are assets, since you are purchasing the building, you would say building is coming in and hence you should write a debit for it. On the other hand, cash is being paid, so cash is going out. So, you should write a credit in the cash account. There you go, that is how you identify what comes in, what goes out and also how to identify which accounts you should write the debit and credit into alright.

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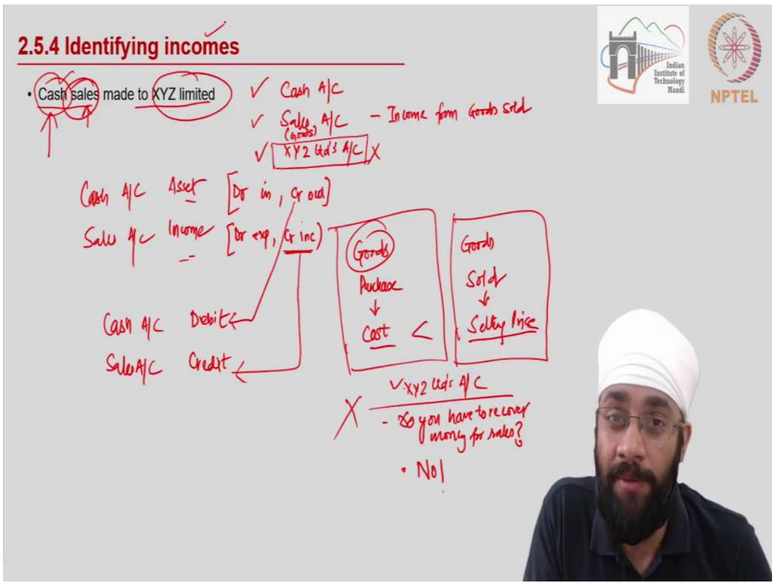

One more transaction where we will try to identify the income. Cash sales made to XYZ. Let us look at possible accounts where we may want to record this transaction, cash first of all. So, one possibility is where we write this in the cash record, then you have sales which are being made. So, you have a sales account, then you have XYZ limited your customer XYZ limited's account, three possibilities where you could write this transaction. First of all cash sales are being made. So, cash is certainly coming in. So, you do want to record in the cash account, so that you know what is the cash in the balance, and what is the balance according to my notebook. The second account is a sales account; sale account refers to the income from goods sold alright. So, sales are certainly being made- cash would be coming in because you are selling the goods, goods are going out of the business. So, a sales account is actually a goods account. We do not write it as a goods account, because we like to maintain separate sales: understand that goods are purchased and goods are sold, maybe I should clarify it here. So, goods are first purchased, and then they are sold alright. So, we could maintain one single account which would be a goods account, but we do not do that. Why? Because purchases have a cost price and the sales have a selling price that is how you make profit- selling price. So, these two prices are different, the cost price is typically lower than the selling price. So, we like to maintain different records for goods that are purchased, and goods that are sold, so that we can calculate our profit. More on that later in the course. So in this transaction sale is certainly an account which you should consider recording.

The last option is XYZ limited which is the customer to whom you have sold. Do you want to write into XYZ limited's account? What are you going to write? He is a customer. So, you would write if you have to recover money from him for the sales. According to this transaction no, why? Because this is cash, he has already paid you. So, why do you want to bother writing in his you know account his record that you maintain? So, we just want to ignore it- you do not need to write in the account of the customer. You just need to be bothered about the cash account and sales account alright. Cash is an asset; sale is an income. The rule for assets is different, for incomes is different. Rule for assets is debit what comes in and credit what goes out. I am just using shorthand for this; for incomes you have to debit all expenses and losses, and credit all incomes and gains. Going by the rule, I am going to say cash account debit because it is coming into the business. On the other hand, you have a sales account which is an income account and credit all incomes, and I am going to say credit. So, I am utilizing this rule here and this rule here. There you go, that is how you identify income and you decide if it is to be debited or credited.

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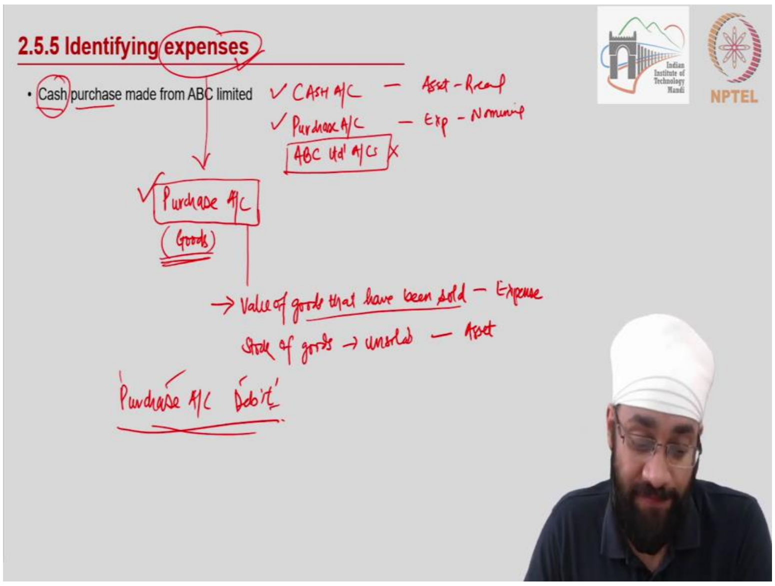

Last transaction, we have to identify expenses here, you do cash purchases, you have cash account, you are doing purchases, you say purchase account, and you are doing the purchases from ABC limited, so ABC limited's account.

Now, as discussed in the last two transactions, whenever you do cash purchases or sales do not worry about the party with whom the transaction is being done, because you do not have to recover from him, you do not have to pay him. So, the only two accounts which you should be bothered about are these two cash and purchase. Cash is an asset and hence real account; purchase is an expense and hence a nominal account. We have to identify expense. And, the expense in this slide is the purchase account. And if you are thinking- how a purchase is an expense account, it is supposed to be a goods account; goods are supposed to be assets for us. Well, I clarified this in an earlier video that purchase refers to the value of goods that have been sold. So, we are not referring to unsold. The stock; the stock of goods is typically unsold alright. So, this is an expense, and the unsold goods are an asset, a current asset. So, in this case, purchase refers to the value of goods that have already been sold, and hence they are treated as an expense. All expenses are debit, so write a purchase account ,you will write a debit against the purchase account, there you go. So, we had to identify the expense, we did that and we have also gone another step ahead and said we should debit it because the rule says so.

That was a quick discussion on what are the rules of debit and credit, and how you identify which accounts are involved in a transaction. In the next video, we are going to go to the first book of the entry, which is a journal. Now you have all the equipment, all the tools that you need, all the concepts that you need to learn in order to write the transactions in the books of accounts. So, the building blocks are over. And starting with the next video, we are going to actually pick up the first book of accounts and take a bunch of transactions and use the rules of debit and credit and write the transaction as it is written in the business.