Financial Accounting
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Lecture – 21
2.6 Entering transactions in Journal (Part-I)

If you are watching this, I take it that you are now well versed with the concept of debit and credit. You know about the three types of accounts; personal, real and nominal, and you also know the rules of debit and credit for these three types of accounts. In this video, we are going to go to the next step which is the first step in the accounting cycle.

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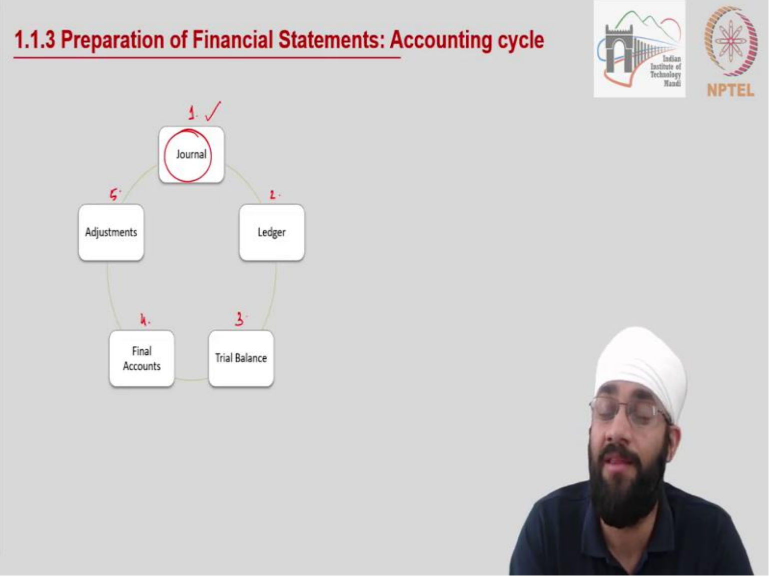

If you remember this slide, we discussed that a transaction has to go through a cycle, a set of books; the first book of accounting is called a journal and any transaction, as it takes place in the business, is recorded in this first book called a journal. Therefore, if you look at a journal of a business, you would see transactions in chronological order.

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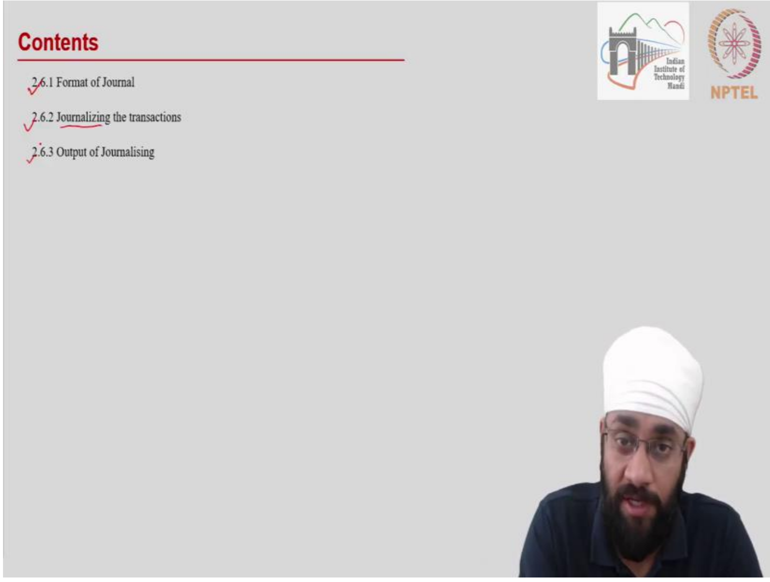

In this video, we are going to look at the format which is used for this book; the process which is used to write the transactions in this book is called journalizing. And finally, we look at the output: what does a journal look like after you have recorded the transactions. So, let us get started.

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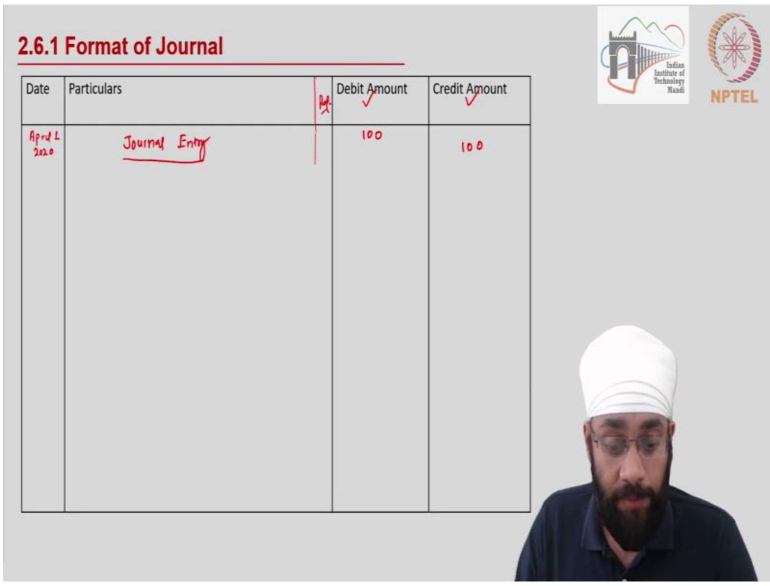

Here is a typical format of a journal wherein you have four columns: you mention the date of the transaction. For example, a transaction took place on April 1st 2020, thus, you write an entry here, which we call a journal entry. Then you write an amount, let us say, here and an amount in the credit column. And we know that there are two sides to any transactions, a debit side and the credit side. We write the debit amount in this column and the credit amount in the other column. There can be another column in this journal which can be a reference or a ledger folio number, which is something accountants should bother about; as a manager, as somebody who wants to be able to read the financial statements, we do not necessarily need to get into those nitty-gritties. We need to understand the flow, the process, and the principles around it, rather than the minute details of recording the transactions. So, this is the format of the journal.

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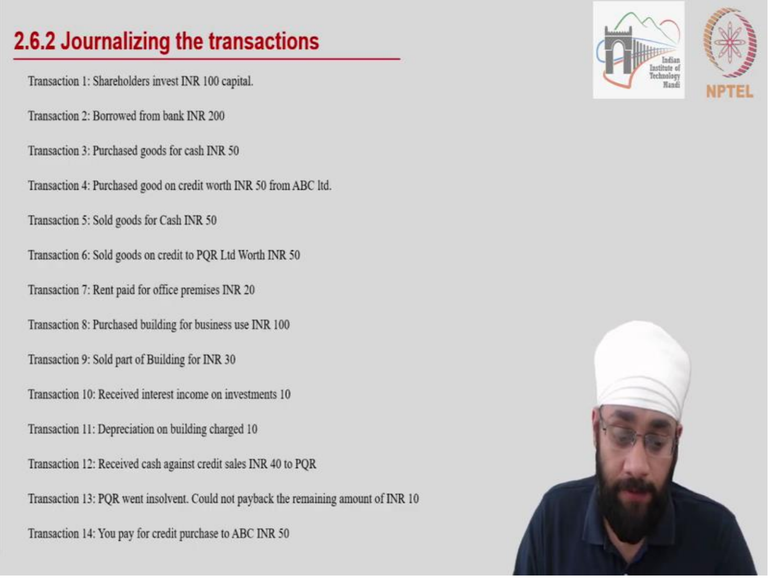

Now let us look at a list of transactions. I have about 14 transactions on the screen and these transactions simulate different kinds of transactions which would happen in a business. We are going to take each transaction one by one and write a journal entry.

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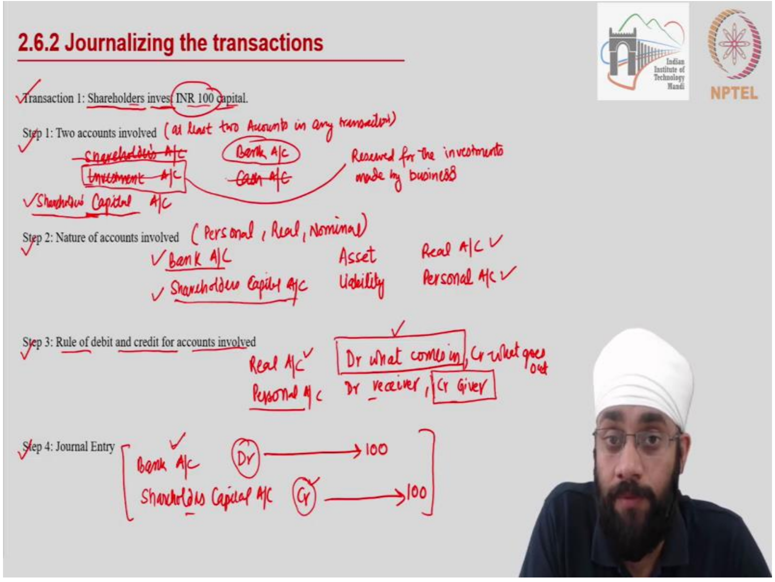

Let us take transaction 1. So, we are going to follow four steps in order to arrive at the journal entry. And as I explained, journal entries are what you write in the book called journal. So, there is a way to write this entry and that is what we are going to learn now. Transaction 1 says, shareholders invest INR 100 as capital into the business. So, business, let us say, started and investment is coming in: shareholders are putting in money.

Step 1, the first step is to identify the accounts involved. What are the two accounts involved? One learning that you should have by now is that, there are at least two accounts involved in any transaction. So, we need to identify what are the accounts that are involved in this transaction. So, how do we do it? So, we look at the transaction, it says shareholder. So, shareholders' account is one possible account. Then there is investment. Investment account is another possibility. There is capital, so a capital account is another possibility and this money is coming in, so the money will go to a bank account or it could come in cash as well. In my experience, these are different kinds of accounts which students come up with, when asked what possibly is involved in this transaction. Now I am going to run through these and try to tell you which are the two accounts which you should consider in writing this transaction.

Number one, let us decide whether this money is coming into the bank account or cash account. And I am going to make a blanket rule here, we are going to say transactions are happening through the bank: all transactions happen through the bank, because we are in the digital age. Hence, mostly bank or cheque, that is the mode of transaction. So, we are going to ignore cash for the purpose of this exercise. It is possible to have a transaction in cash; but for simplicity we will assume a bank account. Now, shareholders deposit money in the bank account of the company. So, certainly a bank account is involved. So, I am going to pick this account as one. I now need to identify just one more account. And I said there are at least two accounts involved; but there can be three, four, five as well; but in these simple transactions there are only two accounts involved.

Then the other options were shareholders' account, investment account, and capital account. And from our experience and the discussion that we have had till now in various videos, we have seen that capital is one account which is certainly shown in the balance sheet. We have gone through the balance sheet of Reliance Industries Limited as well. We have seen capital account and not only capital, it is called shareholders' capital account. They also call it equity and so on but shareholders' capital account can be clubbed because shareholders' transaction with the business is only going to be of this nature, they invest money, they get a return. So, I am going to cancel this and combine these two to say shareholders' capital account.

Now the last option left is an investment account. The term investment account is reserved for the investments made by the business. So, instead of shareholders' money that is coming into business and being called an investment; when business invests in outside opportunities, we should call that as investment. Again, I am invoking the entity principle, the business, the company should decide. From a company's point of view, this money is capital; it is investment from the point of view of the shareholder. Shareholder is investing his money in the business; but the business is receiving cash in the bank account against the capital- the shareholders' capital that is a liability which is getting created. Therefore, investment is not an account which is involved here.

So, we have arrived at two accounts; bank account and shareholders' capital account. So, step 1 is done, step 2 is to identify the nature of the account. And by nature, I mean, you have to identify whether these accounts are personal, real, or nominal account. Now we are going to use our understanding from the previous videos. Bank account, as we know, is an asset, is a current asset and all assets are real account. Shareholders' capital on the other hand is a liability and all liabilities as we understand are personal account, there you go. So, we are done with step 2 as well.

Let us now go to step 3. Step 3 says, what is the rule of debit and credit for the accounts involved? Well, the two accounts involved are real and personal. So, for real account, the rule is debit what comes in and credit what goes out. And the other account involved is a personal account; the rule for that is, debit the receiver and credit the giver. Step 3 done. Step 4 is to write the journal entry. How do we write a journal entry? We are going to write about the claims of business going up or down as a result of this transaction. Therefore, as a result of this transaction, assets i.e., the bank account and shareholders' capital are the two accounts which are getting affected; one of these accounts is going to be debited, the other one is going to be credited.

We look at these one by one. So, bank account first of all, I write bank account- bank account is a real account and debit what comes in. Bank is coming in such that you have more balance into the bank account; therefore this rule applies, debit what comes in. Bank balance is coming in, so I am going to write bank account debit. On the other hand, I have a personal account in which the rule is debit the receiver and credit the giver. Now, shareholders' capital is the other account: it is a representative personal account- the account represents the shareholders who are the givers of capital. So, you credit the giver. Thus, I am going to write shareholders' capital account credit and the amount is 100; we are going to write 100 here and 100 here opposite to debit, opposite to credit. You do not have to draw the arrows, but I am just trying to indicate.

There you go, that is a journal entry. We are entering this transaction in a specific language of accounting using some scientific methods, scientific tools, or the rules that we learnt recently and this is the outcome.

Rather than writing in plain English which says, shareholders invest money in the business; we say bank account debit and shareholders capital account credit. It means the business' claims on bank are going up, because money is coming into the bank account and shareholders' claims on the business are going up as well, because it says credit. Credit means business' claims are going down; which means somebody else's claim on the business is going up; that someone is a shareholder. So, that is how you journalize the transactions in the book or the first book of accounting which is called a journal. Let me stop here, I will continue the rest of the transactions in the next video.