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

Lecture – 22
2.6 Entering transactions in Journal (Part-II)

This is a continuation of the previous video in which we did one journal entry. So, I am going to continue with the second journal entry.

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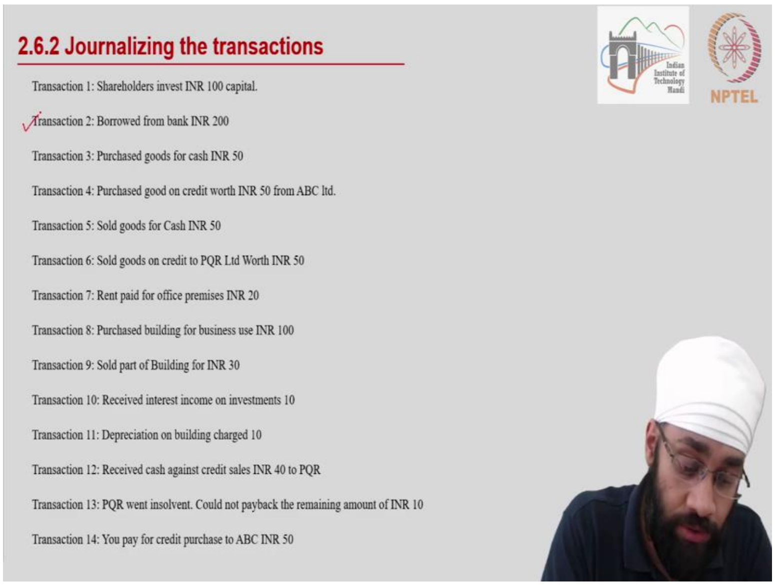

So, we are going to transaction 2; which is borrowed from bank.

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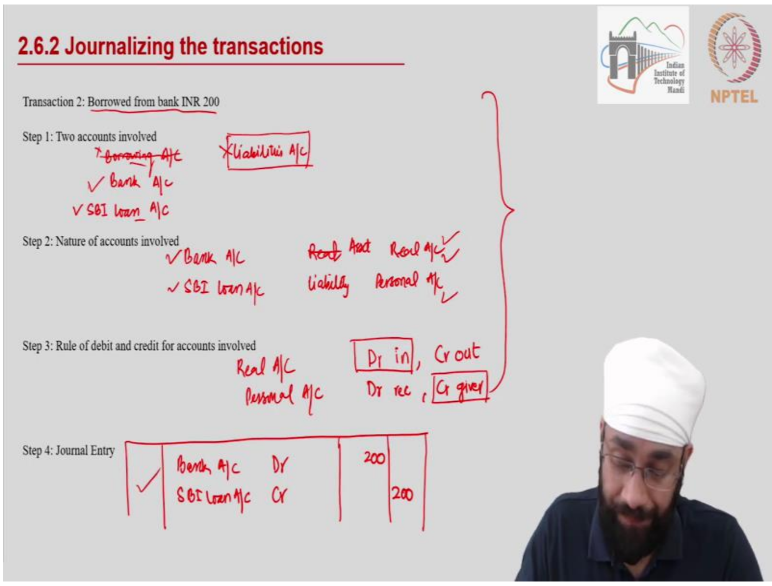

Let us switch to transaction 2; we are going to follow the same process in baby steps-identify the two accounts involved. Let me again populate some options based upon my experience: when you borrow from a bank there is a borrowing account. There is a bank involved so there is a bank account and some people also say this is a loan account as well and then I get this as well that there is a liabilities account. Another quick tip when you have the name of an asset, liability, income or expense you use the name. Do not use the generic term which is the name of a category. There are different types of liabilities. Do you know the name of the liability? If yes, then use the name not the liabilities and in this case, we do know the name. I am going to strike this off right away.

Then you borrow from the bank: the business goes to the bank, you represent the business as the owner or management, you go to the bank and say we want a loan, submit the paperwork, bank processes it and then deposits 200 in the bank account of the business. Thus, certainly the bank account of the business is involved here. So, I am going to check this bank account-number one. Then borrowings and loans essentially indicate the same thing and we do not have any specific account called the borrowing account. Again, borrowing is a generic term. Do you specifically know what the name of the loan is? The loan could be a working capital loan, the loan could be for the purchase of a building so, you can specify that as well.

So, here the typical nomenclature is that you write the name of the bank; you have taken a loan from SBI. So, you are going to say SBI loan account, it represents the borrowing that we have taken. So, again this is a generic term I am going to cross this off. So, you have two accounts: bank account and SBI loan account.

The next step is the nature of accounts involved. So, you have a bank account and SBI loan account. The bank account, as it was in the previous journal entry, is a real account, SBI loan is a liability and hence, we are going to call it a personal account and bank here is an asset thus, it is a real account. How is SBI loan a liability account? I think these discussions we already had and this should be absolutely clear. If you have any doubts whatsoever go back to the previous videos where we discussed in detail how each of these items is called as asset liability income or expense, alright.

Having identified the two types of accounts we have to figure out the rule of debit and credit for these two types of accounts. So, for real account debit what comes in again, I am writing in further shorthand and credit what goes out. Personal account; debit the receiver and credit the giver. These are the two rules. Now, the business is getting money in the bank account. So, bank account being the real account, the new asset is coming in. So, you have to debit the bank account, I am going to write it here. Bank account debit and the other account of course, is SBI loan account. So, SBI loan account is a liability and again, the loan liability represents the bank and bank in this case is the giver of the loan. So, that is how you have to read this. So, credit the giver SBI loan account credit. There you go, you write 200 in front of the debit column debit row and 200 in front of the credit row. The reason I staggered these is because this is how the format of the journal is; if you remember from the first page- maybe I will quickly show it to you.

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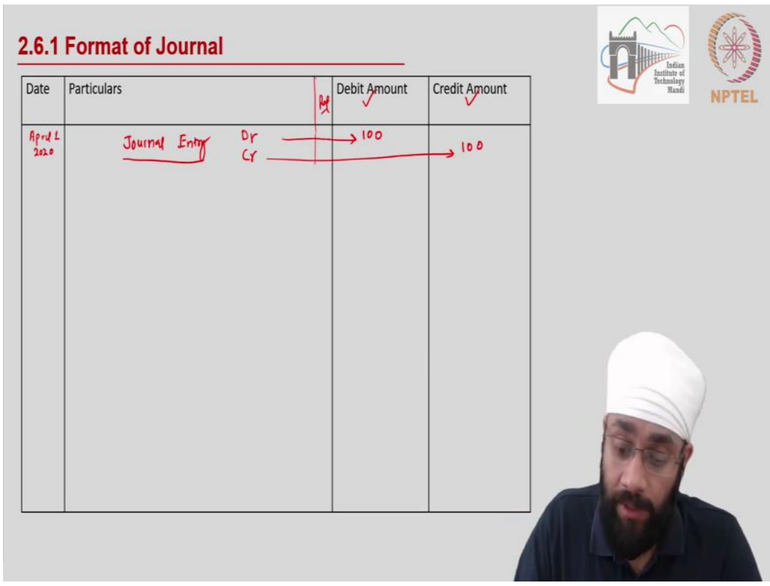

Here, you have a debit amount and you have a credit amount. So, you have to write it like this and since you have a debit item here, credit item here, I am writing it in front of this, writing in front of this.

So, after we go through these transactions, I will show you a final journal on how it should look and then things will become clearer with respect to the presentation of this. You do not have to write all of this, it is only for learning purposes. You eventually write only this journal entry here.

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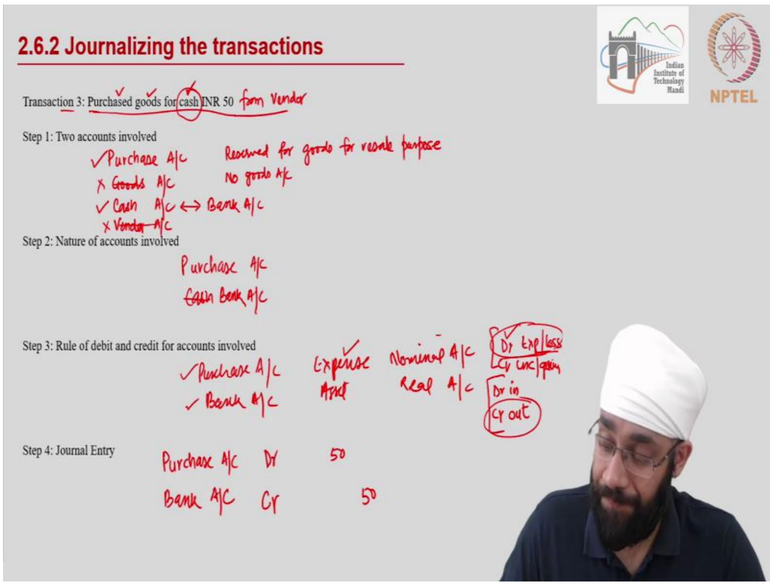

Let us go on to another transaction; purchased goods for cash. Let me identify the accounts. So, we have a purchase account right, there is goods, let me write a goods account, there is cash, let me write a cash account. I do not see anything else; however, you purchase goods from a vendor. So, let me just add that to improvise. I am going to write a vendor account and if you had the name of the vendor for example, ABC Limited I would write that ABC Limited account, accounts involved.

Let me now try to eliminate and identify which two accounts are the correct accounts where the transaction should be written. Let me go from you know bottom to up vendors account. You are purchasing goods for cash number one. When you are purchasing goods for cash, you are paying the vendor in cash. When you pay the vendor in cash you do not need to worry about writing it in a notebook that you have paid this person in cash. You only create a record for the vendor if you have to pay him or any other business, or if you have to receive from him. So, any cash transaction we do not bother to record it in the account of the person with whom the transaction is being done. If it is cash, we just take you to a cash account. So, a cash account is certainly an account, but vendors account I am going to eliminate, because we have paid the vendor- no more liabilities, no more recording. The other two options are purchase account and goods account and I told you that purchase account is reserved for the goods for resale purposes. We do not use a purchase account for purchase of assets: purchase and goods are the same thing and we do not maintain any goods account. There is no goods account; there is unsold stock which becomes a current asset, but its treatment is different; it is not featured here. So, the purchase account is the other account, goods are inherent in the purchase account. What are you purchasing? You are purchasing goods. So, you do not have to worry about these two accounts. We have identified that you have a purchase account and you have a cash account and because we set a rule that all transactions are going to go through the bank, we are going to replace cash with bank account. Although the transaction says purchase goods for cash, cash has been in your bank. Basically cash would reflect that payment is done. So, instead of cash I am going to now write a bank account. What is the nature of these two accounts? The purchase account is an expense and hence a nominal account. On the other hand, a bank account, as we know, is an asset, hence a real account. For a nominal account, the rule is to debit all expenses and losses and current all incomes and gains. For a bank account, a real account, debit what comes in and credit what goes out.

So, these are the two rules that we have to follow. Purchase being an expense has to be debited: debit all expenses and losses. So, I am going to write a purchase account debit and bank account, on the other hand, when you are purchasing you are paying the vendor through your bank account. So, bank balance is going out, it is reducing, that is how you should see it. So, bank account credit, because bank balance is going out. So, these two rules are being used here: you use amount 50 for debtor column and 50 for credit column and you're done. There you have the transaction for purchasing goods in cash.

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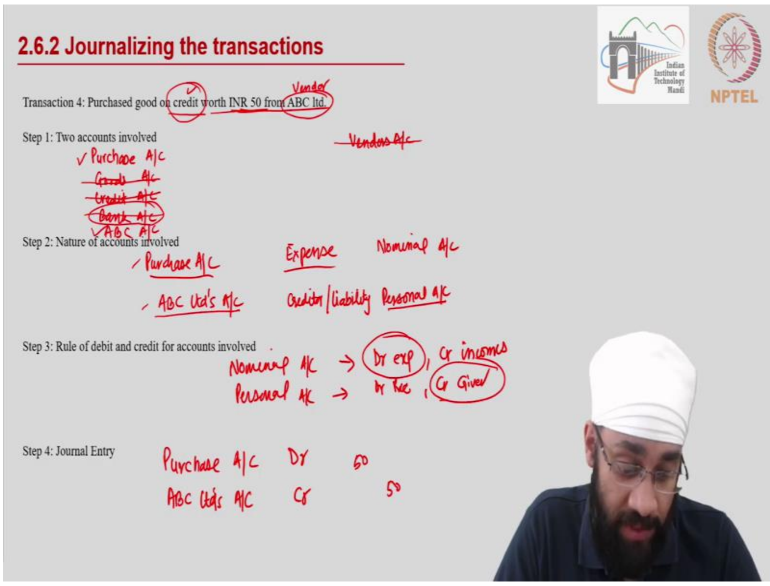

Transaction 4; you purchase goods on credit. Now, you do not pay and you are buying it from ABC. ABC Limited is our vendor now. So, step 1: what are the two accounts involved? We will have a lot of options here. Again, purchase account is involved, goods account could be involved, there is a credit there should be a credit account that is involved, and then you know 50 this money might have been exchanged. So, bank through bank or transaction through bank. So, I am writing a bank account and finally, you have an ABC account. There could possibly be a vendors account. I am writing all possible options that you might think of and now I am going to eliminate some of these to arrive at the final two. Vendors account; vendor is a generic name. When we have a specific name we do not need a generic name. The specific name of the vendor is ABC Limited. So, I am going to strike this off. You do not need to maintain a vendor account, you maintain an ABC Limited account if you have to.

Let me then pick goods. We discussed in the previous transaction that the purchase account is reserved for the purchase of goods. So, when you say purchase account it is a goods account. So, you do not need to maintain a goods account separately. So, we strike it off. Then there is a credit account. Now, we have never discussed a credit account. We have not seen a credit account in the balance sheet or income statement of Reliance Industries Limited either. So, there is nothing like a credit account. Now, if you were trying to say that we have purchased goods from somebody and there is a liability then that is a creditors account, but again creditor is a generic term, the vendor is the creditor. Vendor is also a generic term: finally, you have the name of the vendor which is ABC Limited. So, use that name ABC is your vendor, is your creditor, is your supplier. So, everything has been included in an account which you call ABC Limited’s account: this account represents all the things that you wanted to represent from the liability side. Thus, now you have a purchase account, certainly, because you are purchasing goods. The only thing which is now left is bank account. Should a bank account be involved or not? When you are purchasing goods on credit you are not paying to the person. So, bank account is not getting affected. So, let me cross the bank account as well. So, there you go, you have the two accounts; purchase account and ABC Limited’s account ok. There is a book we are going to write about all the purchase transactions of the ABC Limited’s transactions.

What is the nature of these accounts? Purchase is considered an expense therefore; it is going to be a nominal account. ABC Limited on the other hand is your creditor is your creditor, it is a liability. All liabilities are personal account. What is the rule for nominal account and for personal account? For nominal accounts the rule is debit all expenses and credit all incomes and for personal accounts the rule is debit the receiver and credit the giver.

Now, let us see, purchase is an expense. Purchase being an expense will be debited. So, you write a purchase account debit and on the other hand ABC Limited being a personal account and being a giver of the goods to the business will be credited. So, we are going to write ABC Limited’s account credit and amount is 50 and 50 here, done that is it. That is how you record a transaction which is on credit which is not on cash.

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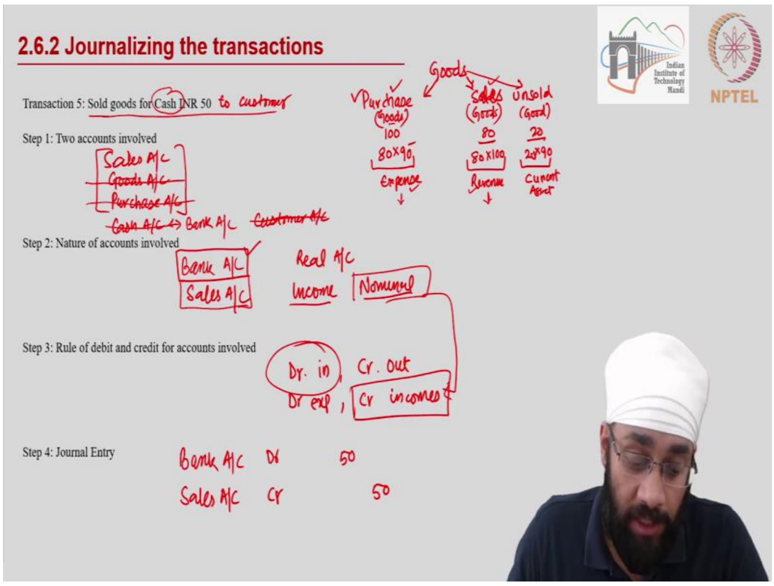

Let us look at one more transaction; sold goods for cash. Now, you are selling the goods-the two accounts involved clearly could be a sales account and goods are being sold so you could say goods account and then you might wonder *hey goods account was represented by the purchase account. So, maybe purchase account is involved.* Thus, we will write a purchase account here and then there is cash account and possibly there is a customer, you sold goods for cash to the customer. So, there will be a customer account.

Now, pay attention to these three items. We said when we purchase goods, goods are going to be purchased and then goods are going to be sold and finally, there will be goods which will be unsold right.

All the goods that are purchased are written in the purchase account, then all the goods which are sold are included in the sales account, and finally, all the goods that are unsold go to an unsold stock account which is a different kind of account opened at the end of the year you just have this record.

Goods unsold are converted into a current asset- this becomes a current asset later on. I have explained this earlier as well: say 100 units are purchased and then you are able to sell only 80 out of these. So, 20 are remaining. So, the selling price of the 80 units sold is 100, so 80x100 becomes your revenue. These 80 units were purchased at 90 rupees, which is your expense for the year. Thus, your cost price for the 80 units that are sold is 80x90. Finally, the value of 20 units which is unsold is to be calculated at the cost price which is 90. Thus, 20x90 becomes the current asset, this is the unsold stock. You have to understand this dynamic here, because this is going to be used as we move forward.

So, in this transaction what is happening is you are selling some goods for cash.. You must have purchased these goods earlier and we saw that. So, the goods account is of two types then: purchase account and sale account, expense and income account, revenue account. There is no separate goods account to be maintained, there is no purchase account which is getting affected in this transaction. Although the goods are the same, you maintain separate records and as we move forward it will become clearer as to why we keep purchase and sale separate despite both representing the same goods. Then you have the cash account. We agreed that we will do all the transactions through the bank. So, I am going to exchange, replace the cash account with the bank account and cross it off and you have a customer account. Now, you sold goods to a customer, he paid you cash, well, you do not have to bother recording transactions in his account. Therefore, you have a bank account and you have a sales account. These are the two accounts which are involved in this transaction. Bank is a real account, I think we have done this over and over, sales being an income is a nominal account. For a real account your rule is- debit what comes in and credit what goes out. For a nominal account the rule is- debit all expenses and losses and credit all incomes. The bank here is going up, because you are selling goods, cash is coming into your bank account. So, a bank account is coming in so, debit what comes in. The journal entry is going to be bank account debited and, on the other hand, you have sales which is an income and it is a nominal account, the rule is credit all incomes and gains. So, we are going to write a sales account as credit, the amount is 50 and 50 for both debit and credit. There you go, that is how you generalize the transactions relating to sales of goods in cash.

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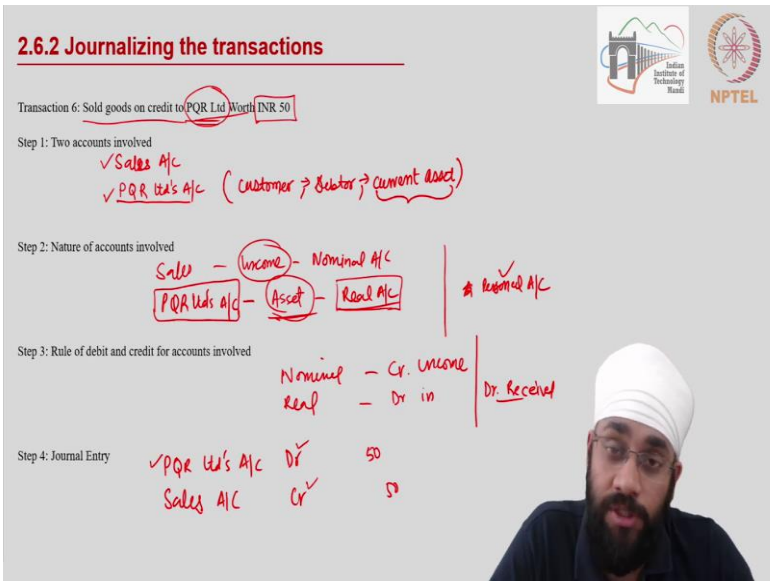

Let me take another transaction of sales, where you do sales on credit. When you sell goods on credit and I am going to put out less options now, be more refined in my approach. I know that whenever you sell goods, a sales account is involved, this represents the goods that are being sold and these goods are being sold on credit, you are not getting cash. So, the bank account is not involved and the goods are being sold to a customer whose name I know, it is PQR Limited. I am going to write the name of the customer using only PQR Limited's account and the value of the goods is 50. So, this is how your thought process is expected to evolve.

You should be able to identify the accounts involved very quickly with clarity. So, sales are happening and PQR is a customer we are writing in the PQR's account, because he has not paid us money. Therefore, we are not writing bank account or cash account at all. Now, are sales an income? Yes, hence, it is a nominal account and PQR Limited's account now, is your debtor. Let me spend a little bit of time here, this is your customer, this is going to become your debtor and you know debtor is a current asset. So, a current asset is being generated- PQR. Although PQR is an individual, he owes the money to the business. The business transferred the possession of goods to his customer now, the customer is liable to pay back to the business. If the customer does not then business can sue the customer and take help of legal machinery as we said. So, this is a current asset, you expect to recover this money within the next one year. PQR Limited becomes an asset, it is a debtor and hence it is a real account.

So, people get confused calling this a real account, because this is PQR, this is a person who is involved here. We could also use that logic, but let me complete it using this logic, because we treat PQR Limited as a debtor, as a customer has a recoverable amount. So, we treat him as a real account as an asset. The rules for nominal account is you debit all expenses and losses and credit income. So, I am going to only write this rule credit income, because I know there is this income and second is real account for real account, the new asset is being generated the new asset is coming into the business. So, debit what comes in there you go.

So, we are going to write PQR Limited account debit and sales account as credit 50 for both debit and credit. So, one thing you should notice is that we typically write debit in the first line and credit account in the second, that is a convention that is followed wherever you look. You have the account being debited you know first followed by the account being credited. Now, let me clarify the other doubt where you say this is a personal account, this is an artificial you know legal person so this is a personal account. If you call it a personal account then the rule for a personal account is debit the receiver and credit the giver. PQR is the receiver of the goods. So, I am going to debit the receiver. So, even using this logic you will debit the PQR.

So, you arrive at the same conclusion; however, I suggest that you always treat your debtors as assets and then a real account, that is easier to follow, keeps things clean, only the liabilities should be considered as a personal account. Again, you will not be violating any rule, because you still get the same conclusion and you know the logic is logical as well to consider it a personal account sometimes, but follow one method if it is an asset, treat it as a real account. Let me stop here. There are more transactions that we will take up in the next video, which is a continuation of this one.