Financial Accounting
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Lecture – 23
2.6 Entering transactions in Journal (Part III)

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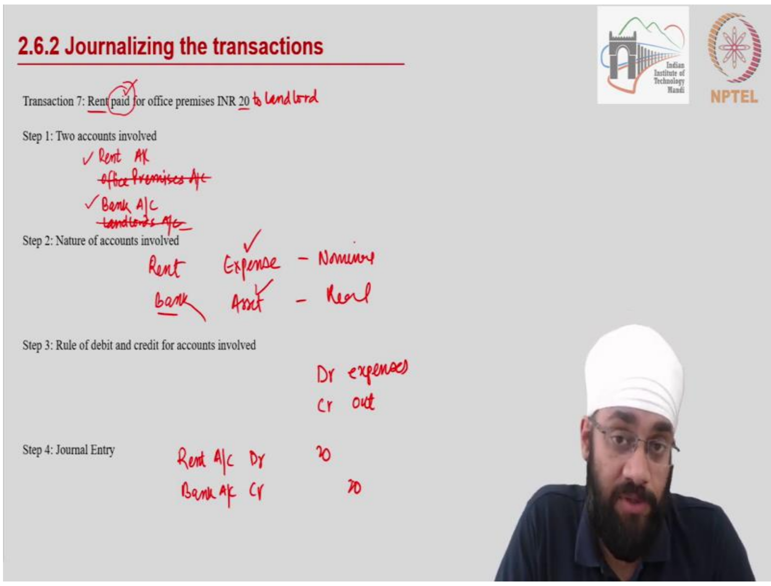

Hi, this is the continuation of the previous video; we are learning how to journalize the transactions. Let us jump on to transaction 7.

Rent paid for office premises is 20 rupees. Let us identify the two accounts involved. So, rent is one obvious option and then, there is office premises, that is the other option and then, you have paid the rent. So, I am going to use a bank account because we have agreed that all transactions are going to be bank based. Possibly you pay this to, let us say, landlord; I am just improvising because maybe you are thinking about this as well; so landlord's account. So, which two accounts should we use? Rent is the name of the expense and as we discussed earlier, the rent account represents our claim on the use of the office premises. So, rent is clearly one account which we should record this transaction into. The other accounts are office premises. Now, an office premises account sounds like you own the office premises; but you do not. You only have the right to use it temporarily based upon the rent you paid. So, the rent account has inherent in itself the message that the rent is being paid for office premises. At best you could say rent for an office premises account; we could do that as well. Thus, I do not want to create a new office premises account because that will be misleading. Then, you have a bank account.

It says rent paid; rent has been paid- it must have gone through the bank account of the company to the bank account of the landlord. So, a bank account is certainly involved. As we have identified two accounts clearly, the landlord’s account is irrelevant now. However, I will still justify why this account is not a viable option. If you create an account for the landlord it means you need to pay, you owe to the landlord. However, you do not owe anything to the landlord, because you have actually paid it. You will owe the landlord again next month; but that has not happened yet. So, the landlord's account will not be created because it will give an impression that this is a liability. But there is none, you just paid this liability already. Thus, rent and bank account; rent is an expense and bank is an asset, that is easy. Expense is a nominal account; asset is a real account. Because a nominal account is an expense, the rule is, debit all expenses. Real account, the bank, goes out: bank balance is going down. So, credit what goes out. Thus, the journal entry is rent account debit and bank account credit, 20 and 20. There you go; that is how you write a journal entry for the rent paid.

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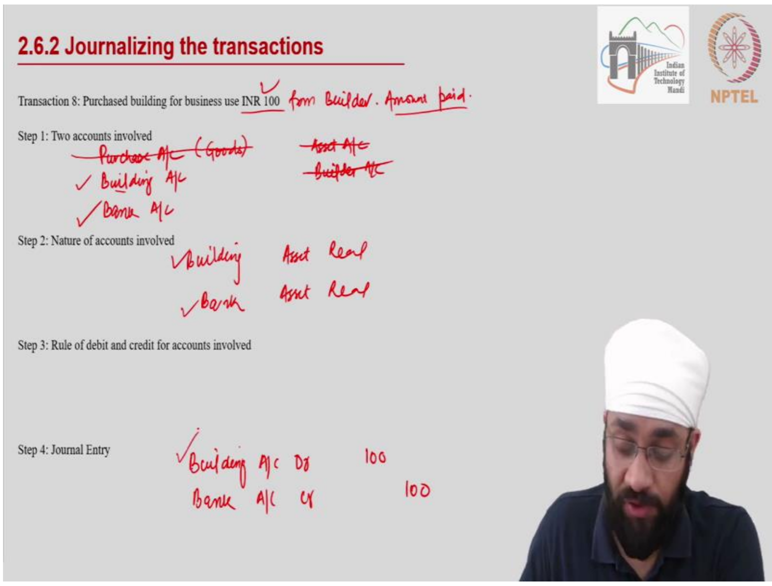

Let us go to another entry, where you are purchasing a building. Purchased building for business use, 100. What are the various accounts involved? You have a purchase account; you could argue that there could be a building account, and there is money being paid so clearly a bank account. We agreed that bank payment will be made; so a bank account is involved. The remaining two options are purchase account and building account. We agreed earlier that a purchase account is reserved for purchase of goods which are for resale purposes. You are not doing a real estate business here, although I did not clarify that; but we said, we generally are writing these transactions for a manufacturing or a trading business. So, you purchase goods; building is not goods for you. Therefore, you are left with building. And building is an asset, you could also create an asset account. Asset account, why not that? Because you have the specific name of the asset; whenever you have that, you do not create a generic account, you create a specific account. Name of the asset is building so we do not want to create a generic account. Another possible option could be you purchased the building from, let us say, a vendor or a builder. Can you then propose to have a builder's account? Well again, I will say no because you paid the builder when you purchased the building. The transaction does not say you paid, but I am going to say the amount paid, alright. Typically, when nothing is mentioned, you assume that it is on credit; but when it is explicitly said in cash, you take it in cash. So, I will try to clarify whatever is the case going forward in the transactions. We are assuming that amount has been paid. So, no account for the builder. If the amount was not paid, yes, we could create a builder's account which will be a liability account. Hence, the two accounts involved are the building account and the bank account. Building is an asset; all assets are real accounts. Bank is also an asset and thus, a real account. The rule is debit what comes in, credit what goes out and I am not going to write the rule in this slide and I am gradually going to reduce these steps as well. So, building is coming in, bank balance going out. Thus, the journal entry is building account debit and bank account credit, you write the amounts and you are done. That is how you write a journal entry for purchase of a building or any other asset for that matter.

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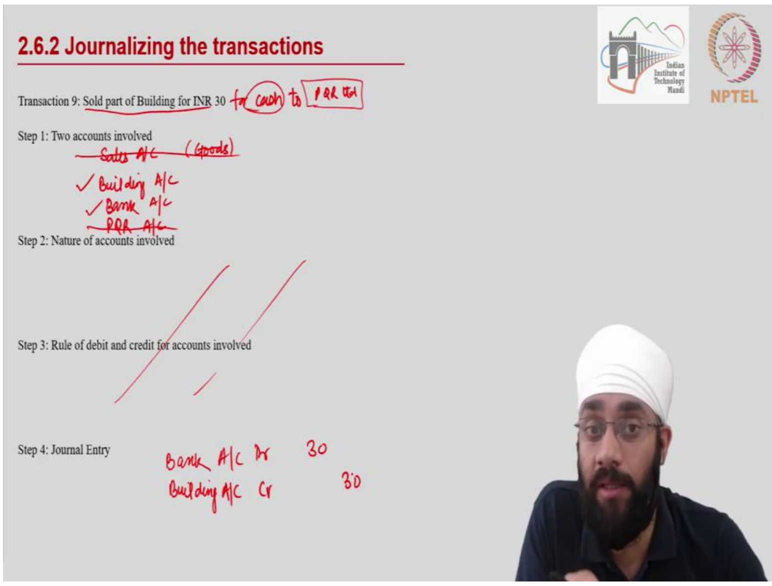

Next transaction is about the sale of the building. You purchased the building and now, you are selling part of the building. So, there could be a sales account, there could be a building account. You sold the building, again let me clarify, for cash, say, to PQR limited; we sold it to PQR limited. So, a sale account, building account, possibly cash, but we have agreed on bank. So, I am going to write a bank account; all cash transactions go through the bank and there could possibly be a PQR account, these are all the possibilities. Now, the sales account is reserved for goods, we are not in the business of buying and selling buildings so we will not record this in the sales account first of all. Second is building; clearly building when it was bought in the previous transaction you see, building came in, now building is going out; so we should record this in the building account. So, building account clearly is the correct option. Then, you have a bank account and PQR. Well, I clarified that this is a cash transaction; when it is a cash transaction, you do not create a record for PQR because he has already paid you. If you create an account that we have sold the building to him somebody in the accounting domain would read that PQR has to pay you. But he does not, they have already paid you. Therefore, do not create a PQR account, only create a bank account; there you go. So, building and bank, both are real accounts; debit what comes in, credit what goes out. Cutting the two steps here, going directly to the journal entry and I write debit what comes in. So, what comes in is the bank balance because you are selling the building. Bank account debit 30 and building, the asset, goes out; credit what goes out 30, and done.

That is how you write a journal entry for the sale of a building or any other asset.

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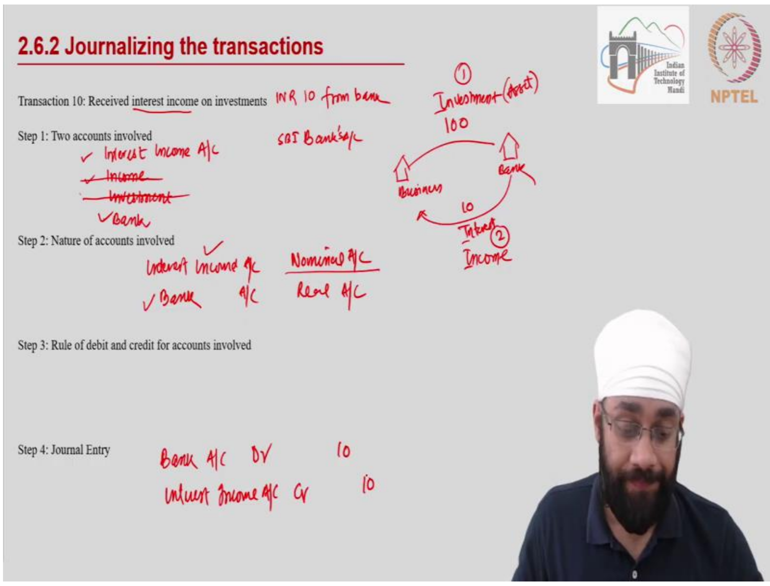

Let us go to transaction number 10.

Received interest income on investment and the amount is, say, INR 10. You are receiving interest income. First of all, there is interest, the other account is income and there is investment and this money would come into our bank account, we agreed on all transactions through the bank. And then, you could say this is being received from the bank. So, there should be a bank account as well. This is actually SBI bank; SBI bank's account and this is your bank account in the bank SBI.

So, the first option is an interest account. Should we have an interest account or should we have an income account? We said wherever you have the name of a specific item, you should use the name. The name of the income is interest; so it is better that we create an interest account and you could say interest income account, because there could be an interest expenses account as well, the two are different things. Maybe I will just strike it off and I will say interest income account, it gives me all the things at the same place.

The next option is investment. Now, investment is something different. What happens is; the business is going to deposit money in the bank. Let me say this is a bank, this is business. So, business deposits 100. So, this is an investment we do-an FD. And then, the bank returns the interest; interest is being paid. These two are separate transactions, do not mix the two. When investment happens, then you consider it as an investment and investment is an asset which is already considered when the investment happened. At this time, in this transaction, you are receiving interest and this is an income. This is a separate entry, a separate transaction. So, do not worry about investment. We are receiving interest due to investment that is fine, but there is no transaction happening about the investment. So, there you go.; you have a bank account and interest income account.

Let me now clarify the interest income account. This is an income clearly and hence, the nominal account; the other one is the bank, which we have done so many times, the real account. Let me skip the rules and directly get to the journal entry. Bank is coming in-real account; debit what comes in. Bank balance is coming in because you are receiving this money. So, bank account is debited. On the other hand, you have a nominal account: debit all expenses and losses and credit all incomes and gains. This is an income, so credit all incomes. Interest income account credited. Let us say 10 is the amount and you are done. That is how you write an entry for interest income or any other type of income as well.

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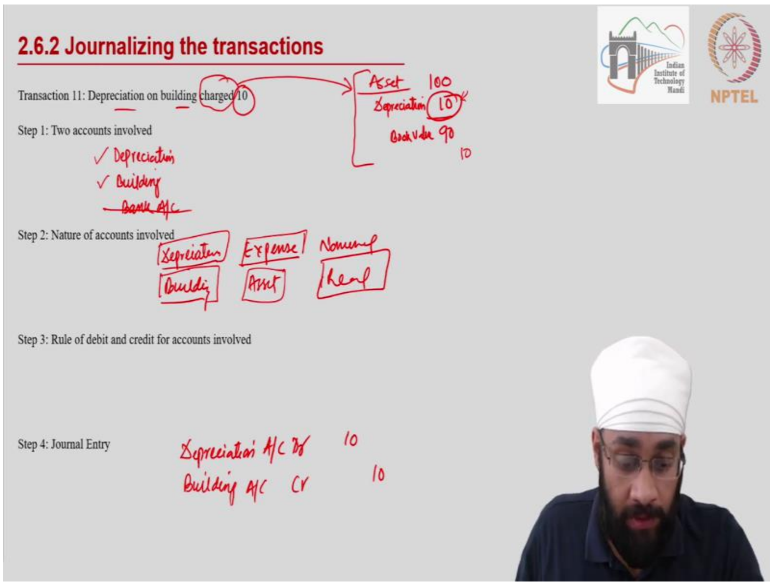

Next step is depreciation on the building. I think we have briefly touched upon depreciation before. I will clarify it again. You have an asset; you purchase an asset. Its value is 100, you use it for a year. When you use it for a year, its value goes down because there is wear and tear, reduction in the efficiency of the asset and so on. So, when you reduce the value by a certain rate, the reduction is called depreciation and then you have a new book value. This is the depreciation that we are talking about. Depreciation of building charged. The word charged means you know this process. At the end of every year, you have to charge depreciation. So, you know when you charge depreciation, you do not pay this money to anybody; you just reduce the value of the asset. Now, why do you do that? Because of the matching principle. The matching principle says the revenues of the current year should be matched with the expenses of the current year. Now, the allowable expenses, the expenses which are allowed to be included for this purpose also include the use of assets for that one year. If you remember, an asset builds long-term capacity for you, but long-term essentially is the sum of short-terms. So, a long-term asset contributes to revenue generation a little by little every year. So, in the first year, if you purchase this asset then depreciation of 10 means that in the first year this asset contributed 10. Thus, 10 rupees is an expense for the first year and then 10 rupees for the next year and so on. So, a part of the value of the asset is converted into an expense every year. So, for now, only that much is sufficient; as we move forward, we are going to talk more about depreciation.

What are these two accounts involved here? Depreciation, then there is this building and as there is an amount mentioned, let me just write a bank account here and then, I will neglect it, of course: I mentioned that there is no cash being received or paid. So, the bank does not get affected, the only thing which is happening is the value of building is going down and depreciation is a new expense, non cash expense; you are not paying it to anybody, but you are allowed to show it as an expense during the calculation of profit. So, the two accounts involved are depreciation and building. Depreciation, being an expense, is a nominal account and building being an asset is a real account. Again, I am skipping the rules to be quicker through this and you should also try to do it this way. So, depreciation is a new expense. Debit all expenses and losses- depreciation account debit. Building is an asset; debit what comes in, credit what goes out. Building is going out in the way that its value is reducing, you have used part of the asset in this year to generate the revenue. So, that asset is not coming back, that value of asset is now gone towards revenue generation. So, we are going to write building goes out; building account credit and the amount is 10. That is how you record depreciation for any asset on which depreciation is charged.

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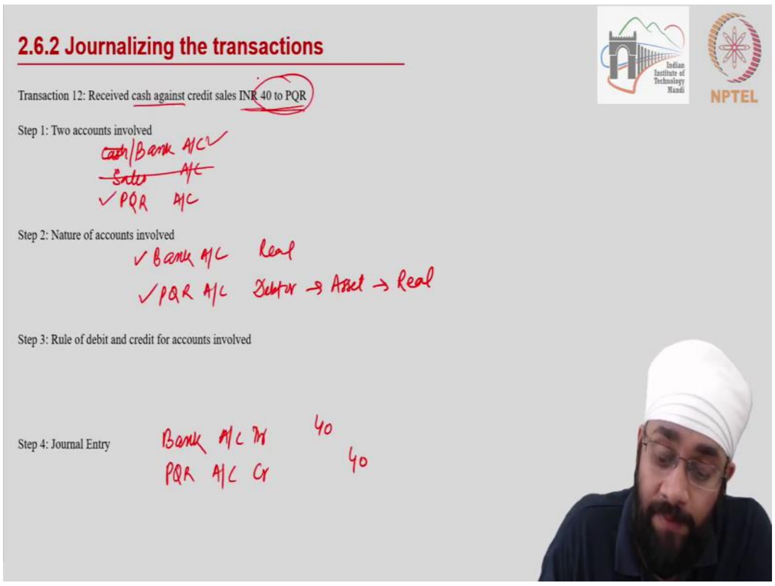

Let me go to the next transaction which is- received cash against credit sales 40 to PQR. If you remember in one of the earlier transactions you had sold goods on credit to PQR, now you are recovering that money. So, let us see which accounts are involved. So, a cash account is involved or let me say a bank account is involved. There is a sale, so a sales account and now there is PQR- so PQR account is involved. Let me do the identification of correct accounts.

The money has been received; thus, a bank account is involved. Sales account- right now there is no sale happening, only collection is happening. Sale happened earlier; when sale happens, you wrote it in the sales account. At this point in time, no sale is happening-only money is being received. So, you do not write anything in the sales account. But PQR is the one who is paying you this money back. So, you should certainly write in the account of PQR. So, the PQR account is the other account.

So, two accounts involved are bank account and PQR account; bank being a real account and PQR being your customer, he was your debtor and we said all debtors assets should be treated as real accounts as well. So, this is a debtor. Hence, an asset should be treated as a real account. Debit what comes in, credit what goes out. He is paying you the money. So, bank account coming in, bank balance coming in. So, bank account debit and the PQR who was an asset to you earlier is no longer an asset because he has paid. So, that asset is going out; you are converting one asset into the other asset. I am going to write PQR account credit 40 and 40. There you go, that is how you write the transaction for receiving the cash from the customer.

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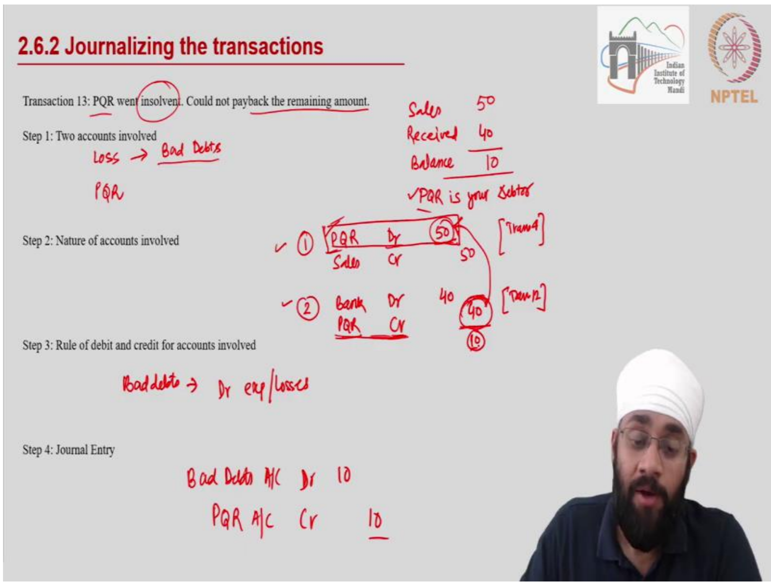

Only two transactions left- PQR went insolvent. What is insolvent? Insolvent you are not able to meet your expenses, your liabilities and you are closing down. When that happens, you cannot recover the amount from that customer. So, PQR was your customer. Now, he cannot pay you. How much was remaining. 40 has been recovered; how much was the sale? That is the question.

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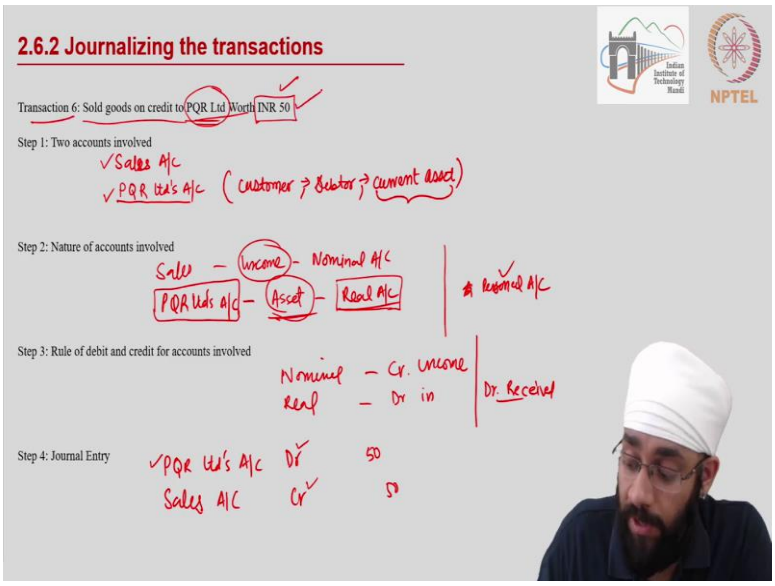

So, I will go back and look for the sale here- you sold goods on credit transaction- 50 rupees worth of goods were sold to this person here. So, 50 rupees of sales was made and this is the balance. 10 rupees has to be recovered from this PQR. Now he is not paying you and when that happens, you have a loss; you have to recognize a loss. The name of the loss is bad debts. Understand that PQR is your debtor. When he cannot pay you he becomes a bad debtor. And the collective term for all the debtors who cannot pay you is bad debts- it is a loss. So, that is the first account which is involved. The other account involved of course, is the PQR because he cannot pay you, so you have to adjust his account. So, this is an exceptional transaction, where you have to use more logic than the scientific method that we have learnt here. So, in the previous transactions, what happened was you first sold goods to PQR. When you sold the goods to PQR in the first step, the journal entry was PQR debit, 50, and sales credit, 50. This was the first journal entry. Then PQR paid back. So you wrote a journal entry: bank debit, 40, and PQR credit, 40. This is transaction 4 and this is transaction 12; the previous transaction. So, refer to transaction 4 and 12. If you look carefully at these journal entries, PQR is an asset to you as a debtor, it was valued 50 debit, increase in the claims of the business on PQR and then, PQR paid to you 40. So, given a credit so businesses claim on PQR you know go down. So, 40 was credit. Now, the net effect is that there is still a 10 to be recovered from the PQR. So, the 10 to be recovered in the PQR has to be cancelled out. In order to cancel it out, you need to do another credit of the remaining 10. So, I am going to write PQR account credit by 10 and this is happening because there is a loss. All losses are debited so bad debts account debit 10. Debit all expenses and losses that is what we are following for the bad debts and PQR is being credited because there was a balancing PQR account and you have to cancel it, you have to give additional 10 rupees worth of credit because he is not going to pay you. You cannot show this person as a debtor anymore in the books of account. All debits have equal credits. In the same account- PQRs account, if you do another credit, debits cancel the credits in that sense. So, you give a credit; that means, debits are equal to credit- nothing to be recovered from the PQR anymore because it has been declared that he cannot pay any more.

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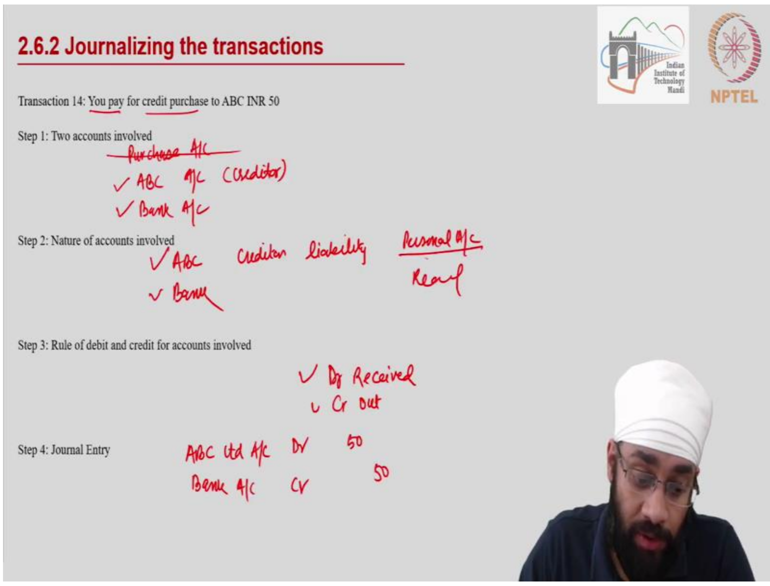

Let us go to the final transaction which is you pay for credit purchases to ABC limited. You also did a credit purchase and you are going to pay for it. So, when you pay for it, you have the following possible account options; purchase account, we have ABC account and you have a bank account; which accounts are involved?

Well, clearly you are paying for the purchases, you are not doing the purchases. So, I am going to cross the purchase account. You are paying through the bank and you are going to pay to ABC- ABC is your creditor. Being your creditor, ABC is a liability and hence, is a personal account and we know bank is a real account. As ABC is a personal account, the rule is debit the receiver; the business is paying the money to ABC, thus, ABC is the receiver. So, debit ABC's account- ABC limited account debit and bank is an asset and credit what goes out; the bank balances going out, it is reducing. So, bank account credit 50 and 50 amount. There you go, we have learnt how to journalize the transactions in the book of first entry called journal. We took a step-by-step approach in which we identify the accounts in which the entry should be made. We identified the nature of these accounts as personal, real, or nominal. Then we use the rule of debit and credit for personal, real, and nominal accounts to write the journal entry.

Once get more versed with it, you do not have to go through these steps. You can just look at the transaction and write the journal entry, that is how it happens. So, let us go to the next section which is the output of journalizing. I told you that you do not have to go through this step in the actual book, the journal, the way the journal entries appear are as follows here.

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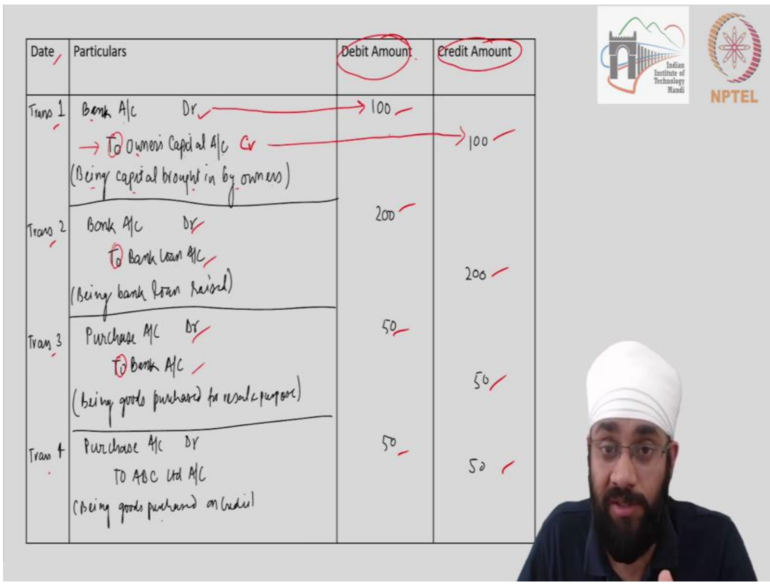

In the date column, you write the date. In this example, we did not have date, but transaction numbers. So, I have just written transaction 1, 2, 3, 4, and so on. In the particulars column you write the journal entry. You have bank account debit and you have owner's capital account credit. There is another convention that is followed- the account which is credited you write a *To* in front of that and press a tab in computer language. So, you write bank account debit to owner's capital, but if you write owner's capital account and credit that is also fine, does not matter as long as you understand what these things mean. Then, there is a short description of the transaction that the capital is brought in by the owners of the business, just for referencing, and there is a debit amount column. Against the debit account, you write the amount; against the credit, you write the amount and you will notice that all debits will have equal credit; 100 and 100; 200, 200; 50, 50 and so on. This is how a journal is going to look like. Transaction 2, you have debit account, credit account; do not be worried about this. I just showed this because in different textbooks, you have different formats; this is a convention that is followed. So, you could deviate from it as well. So, bank account debit, owner's capital account credit- that is an easier way to learn as well. But *To* is also fine, I will mix these two conventions in the future session that we have.

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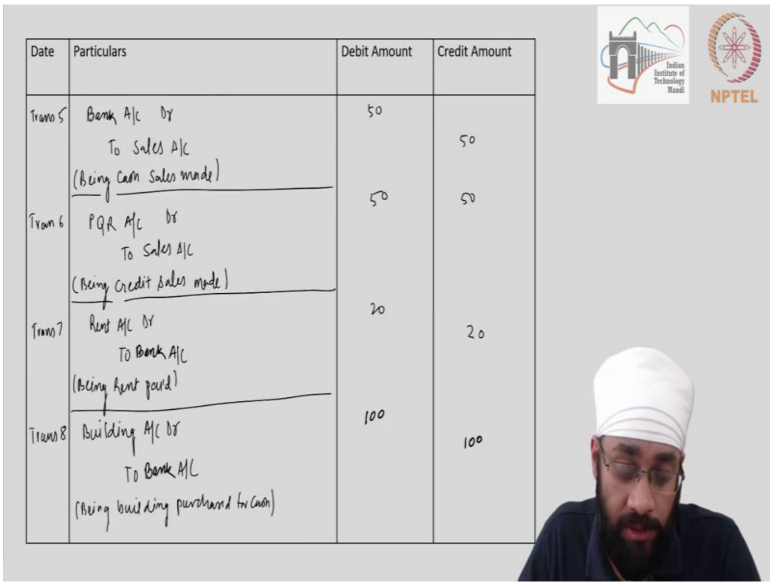

Date	Particulars	Debit Amount	Credit Amount
Trans 5	Bank A/c Dr	50	
	To Sales A/c		50
	(Being cash sales made)		
Trans 6	PQR A/c Dr	50	50
	To Sales A/c		
	(Being credit sales made)		
Trans 7	Rent A/c Dr	20	
	To Bank A/c		20
	(Being Rent paid)		
Trans 8	Building A/c Dr	100	
	To Bank A/c		100
	(Being building purchased for cash)		

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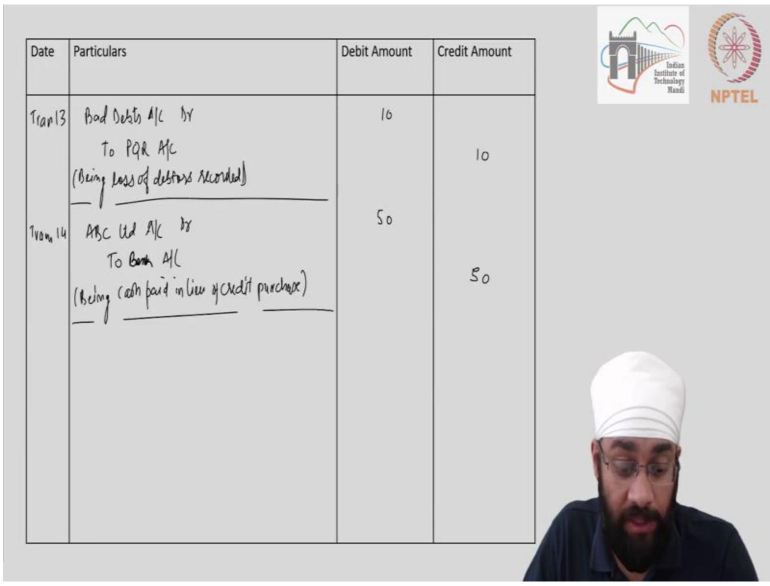

Date	Particulars	Debit Amount	Credit Amount
Tran 13	Bad Debts A/c Dr	10	
	To PQR A/c		10
	(Being loss of debtors recorded)		
Tran 14	ABC Ltd A/c Dr	50	
	To Bank A/c		50
	(Being cash paid in lieu of credit purchase)		

So, all these fourteen transactions have been listed, this is how they are going to be finally presented. Now, understand that all this process is automated, there is software to do this. My intention of walking you through these rules and the process of writing the entry is that when you look at the balance sheet or income statement, when you have to sign off on any of these statements for your company, you should know how these numbers are arrived at.

In my experience, I have seen accountants making mistakes. I have seen chartered accountants also making mistakes somewhere and it is handy to know your stuff about journalizing, about recording the transactions. So, that you know just for the betterment of everybody, for the security of everybody, if you know these terms you can identify those mistakes wherever they are.

Alright, let me stop here. I will see you in the next video; wherein, we will look at more journal entries in a faster and quicker manner. We may not be necessarily going through these steps but directly arriving at the journal entry. We will also take up more complicated transactions.

I will see you in the next video.