Financial Accounting
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Lecture – 25
2.7 Tutorial – Entering transactions in Journal I (Part II)

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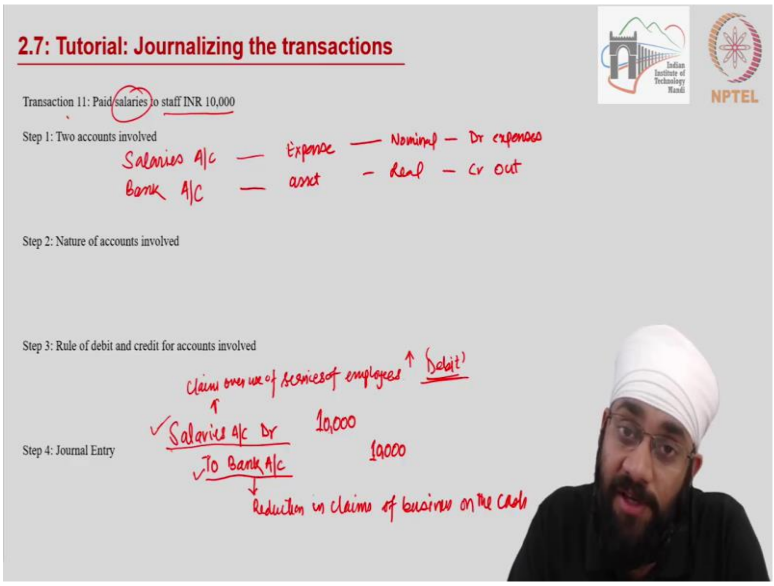

This is a continuation from the previous video, where we looked at about 10 transactions and also compared some of them to make some intuitive sense of how the transactions are written in the book called Journal. In this video we are going to look at another 10 transactions and write journal entries for them.

Transaction 11 is paid salaries to staff. Salaries represent the right of the business over the use of the services of the staff. Salaries account is the first account which is involved. Salaries typically come into your bank account through the company's bank account. So, the salary account and the bank account are the two accounts involved here. Salaries are an expense for the business and it is a nominal account, you debit all expenses. The bank on the other hand is an asset, it is a real account and you credit what goes out. Thus, the journal entry is Salaries A/c (Dr.) 10000, To Bank A/c 10000. Let me use the concepts of claims of business here and again tell you how this transaction is affecting the claims of business. Salaries represent the claim of business over the use of services of the staff, services of employees. When you pay salaries you have an increase in the right. So, in this case rights are going up which means a debit should be given. Debit represents the increase in the claims of the business therefore, the salary account is being credited. Let me again reemphasize that the salaries and the cash being paid for salaries are two different things. Typically, you would confuse yourself by thinking of salaries as an expense, it is going out why are you debiting it? How is it increasing the claim? I want to segregate the two things that are getting mixed up in your mind; the two things are salaries and the cash being paid for the salaries. That is what we have done here two sides of the same coin. What is going out of the business is the bank balance, you are paying or the business is paying through its bank account. So, this represents the reduction in claims of business over on the cash that the business has or the bank balance that the business has. So, usually we mix these two, that is you know in the common parlance that is how things are thought of, but in accounting language that we are learning, there is a double entry system, we look at a transaction from two sides. Here are the two sides – salaries represent the claim of the business; the bank account represents what is going out of the business in this transaction.

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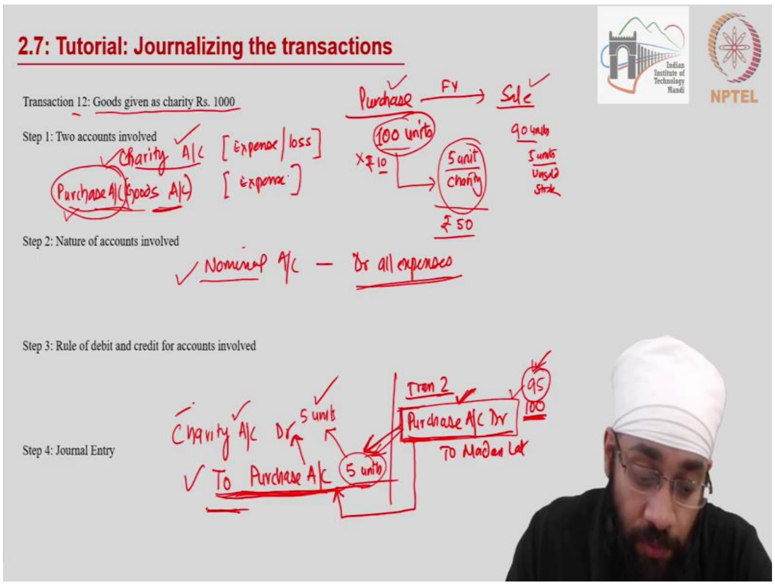

Let us look at transaction 12 now: goods given away as charity. This is something new. This is something which we have not discussed before – goods given away as charity. So, there is a charity account and there has to be a goods account and we know there is no goods account. I will clarify that also. What is charity? You get people walking in, NGOs coming in saying *please donate money or in kind, you could deliver, or you could donate goods*. So, rather than giving out money as donation, this business has given you goods, for example. Let's say this is a furniture trading business. You purchase furniture in trading or manufacturing, you purchase furniture, you sell furniture. You have purchased the furniture. So, let me just draw it out here. You purchased 100 units of furniture and then you intend to sell these. However, during the financial year somebody comes to you and asks if you want to donate. You say *ok, I do not want to donate cash, but if your office, if the office of this NGO or some organization needs some tables and chairs I can supply that.* So, you give them 5 units of furniture, but you do not charge them. So, money is not coming in here. Therefore, you are left with the remaining 95 to be sold and it is possible that you sell only 90 units and remaining 5 units are your closing stock. So, this 5 is charity and this 5 is unsold stock which is also called closing stock. I introduced it to a new term here, we will talk about closing stock more, later. So, we are talking about these 5 units which are being given away as charity. So, when you give away goods as charity the goods go out of the business. So, you have to do something about that and we know the goods which are going out they are going out from which account? Purchase account because purchase account represents the goods that come into the business. Goods come into the business through a purchase account, they go out of the business through a sales account. However, sales are not happening here. Therefore, you are going to use a purchase account to indicate that the goods have been given away. It will become clearer in a few seconds. Therefore, instead of a goods account I am going to use the purchase account, it represents my goods account. Charity is the name of the expense, the goods you are giving away. But the goods were purchased by paying for them in cash. Let us say 100 units were purchased at rupee 10 per unit. Therefore, for 5 units that are given away, you have paid 50 rupees to the vendor from whom you purchased it. So, the value of the goods which are being given away is 50. So, 50 is the charity that you give; it is an expense. It is a loss in a way; however, charity is also thought of as a kind of advertisement for the business. So, you would consider it as an expense. Charity account represents the expense or the loss for the business; expense/ loss for the business and the purchase account, on the other hand, represents your goods. So, you think of these only as goods although we know purchase is also considered an expense account. I can also use this logic to explain to you. Let us move forward with this. As charity is an expense and purchase is also an expense, both the accounts are nominal accounts and in nominal account you debit all expenses. The new expense that you are creating through this transaction, the name of that expense is charity. So, I am going to write charity account debit. Now, typically you pay for expenses and you write a bank account or cash account and if you do not pay you write the name of the vendor because a liability has been created. However, in this case a unique thing is happening which is you are giving away goods. So, instead of paying in cash you are giving away goods from the purchase account, I am going to write To purchase account or purchase account (Cr.). Now, you would say it is also a nominal account and purchase in is an expense, so, you should debit all expenses. However, that is what is unique about this transaction, a slightly more complex transaction where you are not following this rule rather what you are doing is an adjustment. What is the adjustment that you are doing? Well, let me bring here the Journal entry from a purchase transaction.

Let me go back to the purchase transaction.

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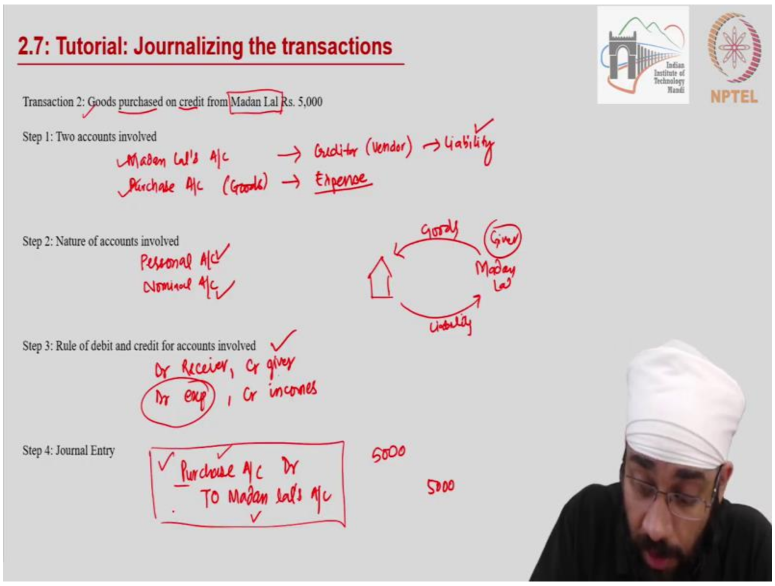

In transaction number 2, where you purchase goods from your vendor and the journal entry is Purchase A/c (Dr.), To your vendor. Let us go to transaction 12 now and write this alongside: Purchase A/c (Dr.), To your vendor whose name is Madan Lal, this was transaction 2. So, let us say you had bought these 100 units from Madan Lal in the beginning and in the purchase account you wrote those 100 units here. Now, you would consider the purchase as an expense. However, all the purchases are not being sold. So, in the purchase account as we have discussed you only consider the units which are being sold during the year. So, 5 units are being given away as charity. So, all we are doing in this transaction here is adjusting the number of units in the purchase account. We are saying that although we purchased these goods we did not resell them, the purpose was different. We gave them away as charity. So, our purchase should be reduced by 5 units. We should not be showing the purchase of 100 units as an expense when we do our profit calculation. We should clearly state that only 95 units were available for resale and 5 units have been given away as charity. So, we are converting 5 units from the purchase account to a new account called charity; think of this as a channel or pipeline. So, from the purchase account you brought 5 units here and then you converted them into charity, that is what is happening. The net effect is in the purchase account you will only have 95 units which is the correct way of showing it. The reason for giving credit to the purchase account is because we had a debit of 100 units to purchase. We created an opposite and canceling transaction for the purchase account by writing To purchase account, by giving a credit to the purchase account. So, the purchase account shows only 95 units. And, then after bringing it here, after canceling it from the purchase account we are then indicating that these 5 units are being given away as charity and that is the actual expense of the business. I think it is getting a little complex, but there are more transactions of similar nature which will clarify these things more. So, let us move forward.

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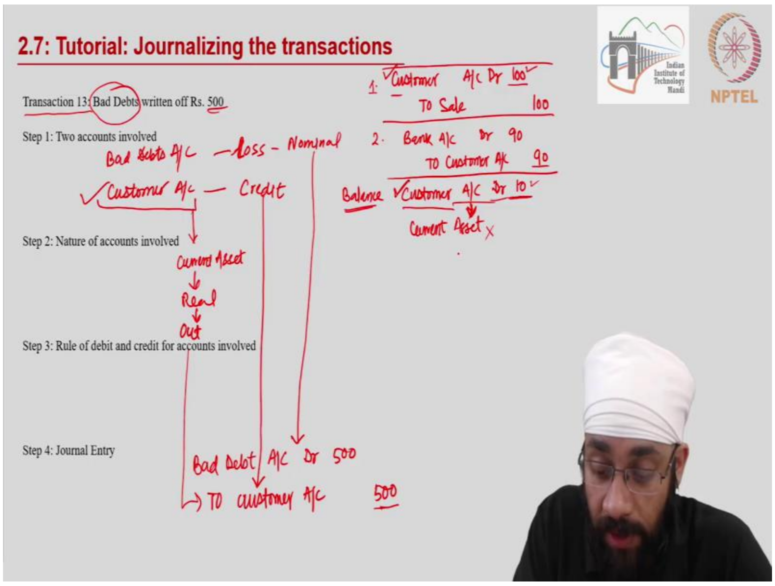

Next step is, bad debts written off. We have discussed earlier what bad debts are, but let me quickly take you through this journey. So, first of all you sell goods to a customer. So, the transaction is a customer's account debit; customers account debit to sale. So, let us say this was 100 and this was 100. Now, the customer is your debtor. So, it is the asset account which we are talking about here. Then the customer pays you back. So, when a customer pays you back you write Bank A/c (Dr.), To Customer A/c. So, let us say he paid you 90 and after this you realize that there is new information that the customer has gone insolvent. He has gone out of business and he is not going to be able to pay you the rest of the money. He has already paid you 90. The effect of the sample transaction 1 and 2 here is as follows. You gave a debit to the customer by 100 which meant the customer owed you 100. Then you gave a credit to the customer of 90, which means you deducted 90 out of this 100. Therefore, the remaining balance in the customer account is 10, this is the balance. As this is a debit balance, 10 represents the value of the asset which is remaining. So, 10 is what is to be recovered. Transaction 13 says it is now a bad debt. So, this money is not going to be recovered. If for sure this money is not going to be recovered, then you have to write it off; meaning you have to remove it from the books of accounts, you should not show this balance as an asset. Right now this is appearing as a current asset. You expect to recover this money, but new information says you cannot recover it and now I am invoking the principle of conservatism which says report your losses. Report your losses as soon as you know about these, be conservative about these things, do not inflate your profit. So, if you have new information now you have to cancel this asset. How do you cancel this asset? You create an opposite transaction; there is a debit balance of the customer account, you give it a credit by the same amount. So, you are going to say To customer account. So, you are giving a credit to the customer’s account by doing that, you are canceling the debit which was left over, the amount here is 500 that is why I am writing it as 500. The question is what should be the other account which is involved. You are cancelling an asset. You expected to recover this money, now you are not going to recover this money, it is clearly a loss for the business. So, you have to write the name of the loss. Name of the loss is bad debt; Bad Debt A/c (Dr.) 500. If we were to go in a step-by-step I would first write a bad debt account, this is one of the accounts; the other account is the customer from whom this money was expected to be recovered. So, as you want to cancel a customer's account, you will create a credit transaction in the customer's account and that is what is done here and bad debt is a loss that you are recognizing in the business. And, all losses are nominal accounts and you debit all expenses and losses that is what has been done here. That is how you would do it step by step. But, I want you to understand why customer’s account is being credited. Because in this case this customer account was a current asset, and now it is no longer a current asset. It is a real account. The asset is going out, so, debit what comes in and credit what goes out, you could use that logic as well. However, you need some explanation to see in this way.

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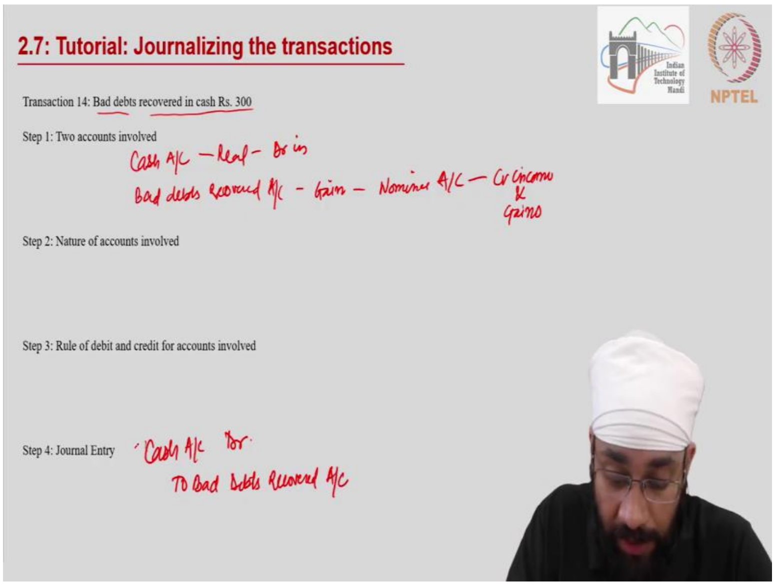

Let us move to transaction 14. Suddenly what has happened is bad debts have been recovered. You have earlier written off the bad debts, but suddenly the customer comes up and says *hey, I made some money and I can pay you 300. Do you want to take the money?* Of course, you want to take the money. So, a cash account is involved because you receive cash from the customer. Cash account is a real account coming in, it is an asset; debit what comes in. So, cash account debit. Now, what should be the other account? You have bad debts recovered. Bad debts recovered account is a gain. You recovered the money. This is a nominal account; all incomes and gains are nominal and you credit all incomes and gains. Therefore, you are going to write to a bad debts recovered account. So, cash has been received, you write Cash A/c (Dr.), To Bad Debts Recovered A/c.

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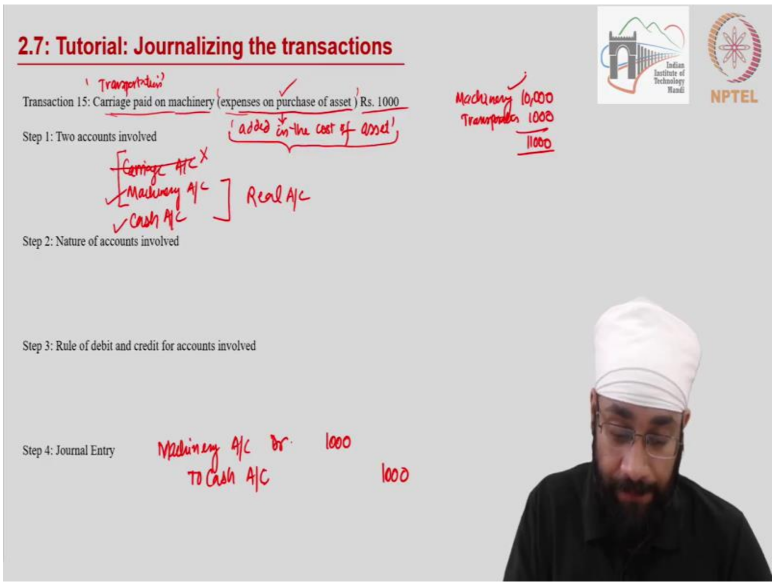

Let us do our transaction number 15- carriage paid on machinery and expenses. This is an expense on purchase of an asset, the amount is 1000. Carriage is simply transportation; you purchase the machinery and now you have to bring it to your site, the plant where the machinery will be operated. So, you have to pay some transportation costs. The reason this text -expenses on purchase of asset- has been given here is that any expenses on the purchase of the asset like shipping cost, installation all etc., all of that is added to the cost of machinery or asset. So, until the time the asset is ready to be used all the expenses are added to the cost of the asset. For example, people who own cars when you go to the showroom, they tell you a showroom price and then there is an on-road price which also includes insurance that you have to pay, you have to get the registration as well and some accessories have to be installed in the car. So, there is a price which is in the showroom and then there is an on-road price in fact, there is another ex-showroom price as well. But the idea is that there is an additional cost. When your friend asks you what the price of the car is, you quote the final price right. On-road this is how much it cost me because that also went out of my pocket when I bought the car. So, all the expenses have to be added to arrive at the final expense. There is similar logic here as well. So, carriage being paid is an expense. Let me write a carriage account. The other account involved is a machinery account with just being paid on machinery and you are paying it in cash. So, a cash account. You are paying it in cash, certainly cash is involved, out of these two we have to identify one, and I just mentioned that we do not consider this as a separate expense. We add this cost to the cost of the asset that is it. So, if the machinery was bought for 10000, now its value is going to be 11000 because you paid transportation on it; any expenses, pre-installation is added to the cost. Therefore, not the carriage account, but the machinery account is going to be involved. Both these accounts represent assets and hence are real accounts- what is coming in is machinery. So, you write Machinery A/c (Dr.) and you are paying cash for it. So, To cash account or Cash A/c (cr.) 1000. Typically you would be given the value of machinery as well. So, you can write the amount as 11000 instead alright.

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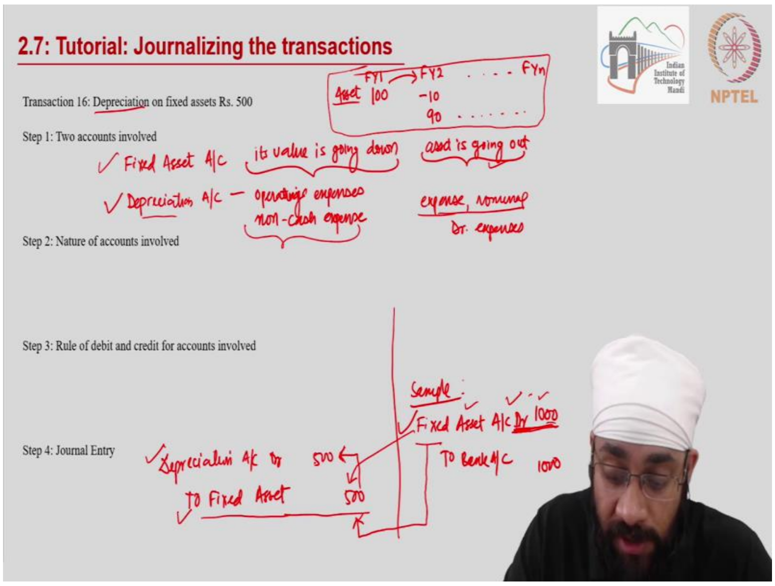

Let us move forward depreciation on fixed assets. I have explained the concept of depreciation before. It is a reduction in the value of fixed assets over a period of time say financial year 1, financial year 2 and so on till financial year n. You purchase an asset, let us say, fixed asset for 100. You use it for 1 year, its value goes down by 10, the new book value is 90. Like this the reduction in the value of the asset every year. So, what are the accounts involved? Now, the fixed asset if we had the name of the asset, we would write that. Fixed asset account is certainly involved because its value is going down due to depreciation which means that an asset is going out of the business or the value of the asset, we know asset is going out of the business equal to value of the depreciation. The other account involved is Depreciation. Depreciation is regarded as an expense; it is an operating expense of the business. Let me clarify this as well. I think I have done that before, this is an operating expense of the business, while doing the calculation of profit for the year, you deduct depreciation. Also, depreciation does not involve cash; this is a non-cash expense, and accounting is done on accrual basis not cash basis. If you are thinking if it is not a cash transaction why are we recording this in the books of accounts then I am invoking the principle of money measurement here. Generally

Accepted Accounting Principle: anything which can be expressed in terms of money can be recorded in the books of accounts. So, the question is can you measure depreciation in money, monetary terms? Yes, you can. In fact, there are rules around it, there is an accounting standard, I think accounting standard 6, that talks about the depreciation rates for different types of assets. So, there are rules around how to measure depreciation in monetary value. So, this is done, depreciation being an expense you are going to debit it, this is a nominal account. The transaction is going to be a fixed asset going out credit. So, you are going to write To Fixed Asset and you have depreciation as an expense, you debit all expenses. So, you are going to write Depreciation A/c (Dr.) 500. Now, I want to do another working note here, just to make it more intuitive. You would have purchased the fixed asset before. When you purchase the fixed asset what is the journal entry? You debit the fixed asset account; this is a sample. Fixed asset account is debit and you pay for it. To Bank A/c, alright. Let us say this is 1000 and this is 1000. I do not have space, otherwise, I would stagger it and write it towards the right-hand side. When you purchase a fixed asset you give it a debit. You say the claim of the business on the fixed asset is worth 1000, is going up and it is worth 1000. Now, depreciation is being charged and fixed assets are being given credit. Now, these are counter transactions; this transaction is cancelling this transaction, this credit is cancelling this debit. However, debit was equal to 1000; credit was equal to 500 only. Therefore, there is a debit balance; there is a balance in the fixed asset equal to 500, meaning the value of the fixed asset went down from 1000 to 500 now. So, if you look at the notebook where you maintain records for the fixed asset you will see it was purchased at 1000, minus 500, the value currently is 500. So, this is going to be summarized in the notebook or in the journal where you write transactions for fixed assets. This is the net effect of the transaction. Another thing that I want to indicate to you is that you are really leaking the value of this asset here and then you are transferring this value into depreciation. See, what I am saying here is that the value of the fixed asset is shown as an expense in this year, some value. So, 50 percent of the value let say is going into expense. Likewise, every year you spend the value of the fixed asset in terms of depreciation. You actually pay for the asset right in the beginning when you purchase the fixed asset. However, you show it as an expense in smaller parts every year you know for the duration of the life of the fixed asset. More on depreciation will you know will be done more discussion will be done in some of the future videos, but for now this is sufficient.

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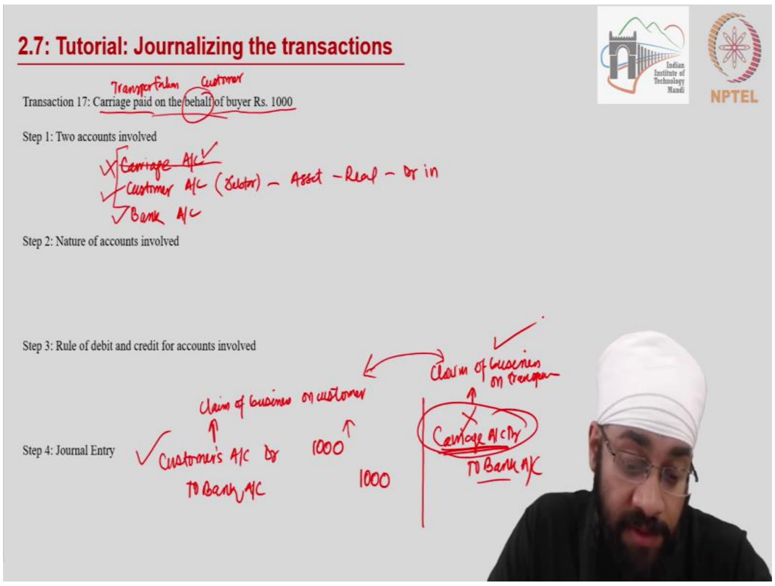

Let us move forward. Carriage paid on behalf of the buyer, what does it mean? Carriage again is a transportation cost. There is a buyer, your customer, you would have sold him some goods and when you deliver the goods you would have paid for transportation, but the customer should have paid for the transaction. So, now you have to recover this money from the customer; that is what is happening in this transaction. So, there are two- three accounts involved. There is a carriage account which is a transportation cost, there is a customer which is involved, customer's account and you paid for the carriage. So, I am going to use a bank account. I clearly paid for it. So, a bank account is involved which means there is going to be only one out of these two accounts. Should this be a carriage account or a customer account? Carriage account means it is an expense account. Whenever you start an expense account you are going to take that expense to the calculation of profit finally. So, if you open a carriage account it would mean that the business has an expense named carriage. However, this is not a business expense, this is a customer's expense. You paid it on the customer's behalf and you will recover it from him. So, you should certainly not open a carriage account, otherwise it will show as a business expense. What you should rather do is, you should *say I have to recover this money from the customer*. So, you should use the customer's account, make the customer a debtor- you have to recover money from him, make him a receivable. Therefore, if this person is going to become a debtor this will become an asset for you and hence the real account. So, debit what comes in, a new customer, a new debtor is being created. So, I am going to write the customer's account or the buyer's account: Customer's A/c (Dr.) and if I had the name of the customer, I would write his name, To Bank A/c. There you go. If it was a business transaction you would write Carriage A/c (Dr.), To Bank A/c. Customer would not come into picture and this carriage account will be taken to the calculation of profit- matching principle. We have to match expenses of the current year but, this expense is not a business expense. Therefore, we are not writing a carriage here, instead we are paying the money on behalf of the customer. So, we are creating a recoverable. We are creating a claim of the business on the customer, we have to recover from him. This would have been a claim of business on the transportation service, we could use that service. So, we just exchanged it, that is not the case. If this was a business expense, we would write this. Let me stop here and there are more journal entries on the other side. I will see you in the next video.