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

Lecture – 26
2.7 Tutorial – Entering transactions in Journal I (Part III)

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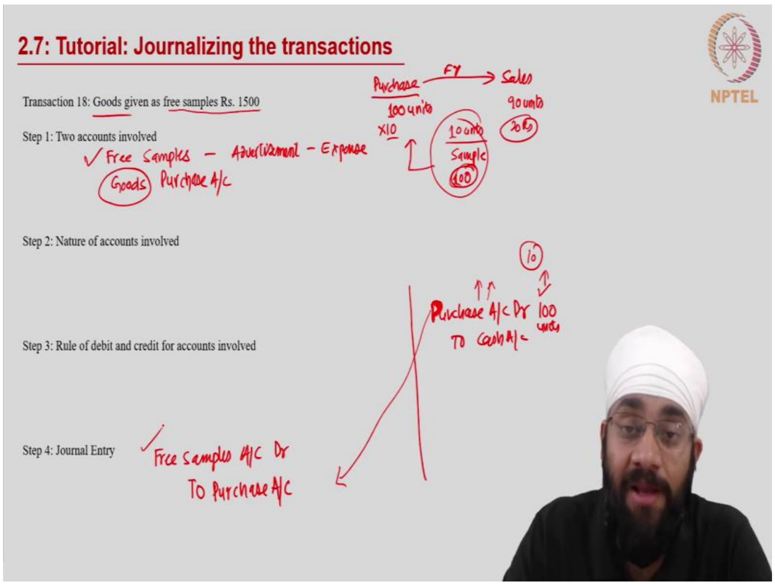

Alright; this is a continuation of the previous video; we are going to look at some more transactions. Let us get started.

Transaction 18: goods given as free samples. Now, you should recall the transaction where goods were given away as charity, this is a similar transaction. So, there is a free samples account possibly. There are goods being given away; so there has to be a goods account. I am going to redraw the same thing, you purchased 100 units and you intend to sell these 100 units in the financial year. However, it turns out in order to sell these goods, you have to give these goods away as free samples for customers to use and then they will decide if they want to purchase these. So, let's say 10 units are given away as samples. So, when you give away the units of goods as free samples, you are not able to sell them. So, only 90 units are available to be resold. What does it mean? Let’s say, the cost per unit purchase was 10. Therefore, for the 10 units given away, 100 rupees you are never going to recover. But you have paid for these and this is kind of an advertisement for the business as well. So, you are going to regard this as an expense.

The value of this expense is going to be equal to the number of units which are given away and the cost of those units which you paid to the vendor when you purchased. So, that is important. You cannot put the value to this expense by saying I was going to sell these at 20 rupee per piece: you cannot do that. What you paid for them is the expense that you should show. Now, free samples are an expense account, nominal account and you would debit all expenses and losses. So, you can write a free samples account debit or you could write advertisement by free samples account as well and you have to credit an account. So, what should be that account? Goods go out of the business. These goods were recorded in the purchase account. So, we have to cancel those goods. When you purchased the goods, you wrote a purchase account debit to the vendor or to cash account you must have paid for. Let us assume you purchase 100 units alright. So, your purchase is going to be considered as an expense during the year when you calculate your profit. However, you cannot show all 100 units as the purchase amount because 10 of these units have been given away as samples. That will still be an expense and will not affect the profit eventually, but the disclosure is not going to be correct. I am invoking the principle of full disclosure. So, you have to segregate the free samples from the purchase account, you have to remove that from here. In order to remove, we give an opposite effect, opposite treatment to the purchase account. Purchase account is credited by the amount of free sample. When you look at the notebook where purchase accounts records are written, you will see 100 units were bought in the beginning and then 10 units were given away. So, 90 units is the actual purchase expense during the year. Remaining 10 is not a purchase expense but is a free sample expense.

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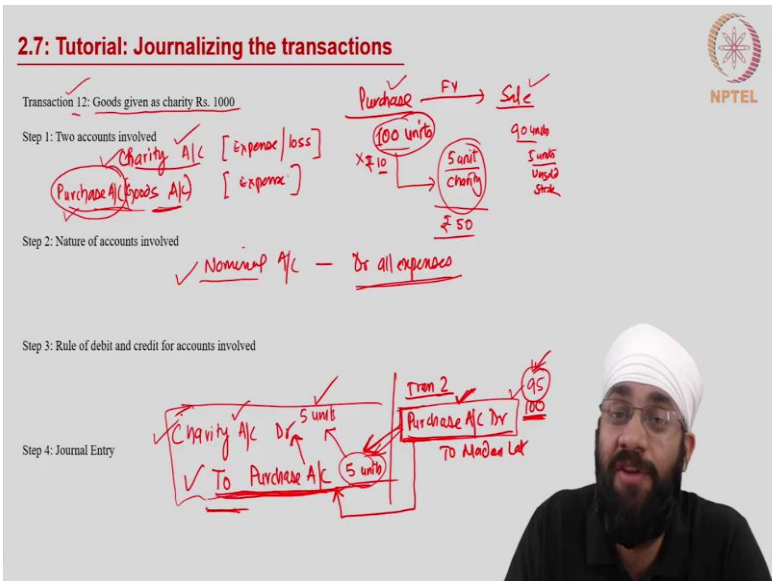

I can also go back to the charity expense transaction just to be clear. Transaction number 12: the journal entry was charity account debit to purchase; a similar logic is used here. Instead of charity, now we have free samples.

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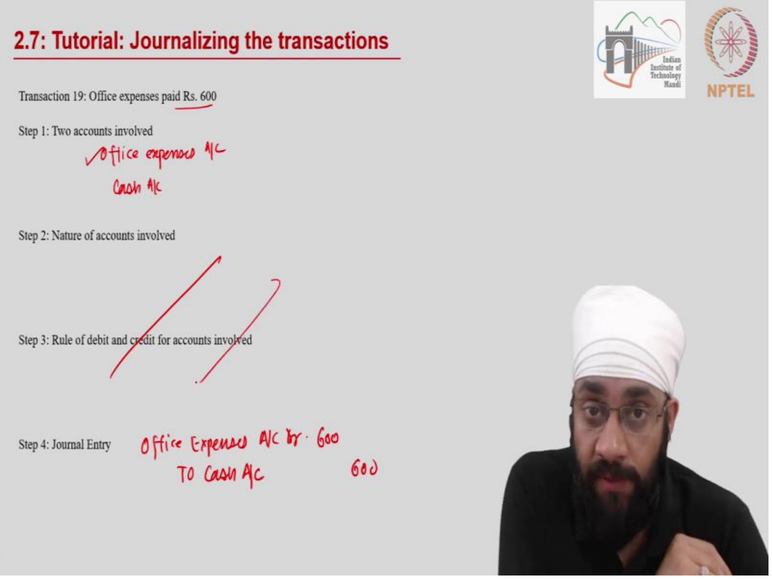

Next transaction is transaction 19: office expenses paid. Simple enough, you have an expense name which is office expenses and you pay them. Let us assume cash account. So, this is an expense you debit all expenses. I am going to directly write Office Expenses A/c (Dr.) and we pay in cash, cash is a real account, debit what comes in, credit what goes out. So, To Cash A/c 600 because cash goes out 600, no need for the rest of the discussion.

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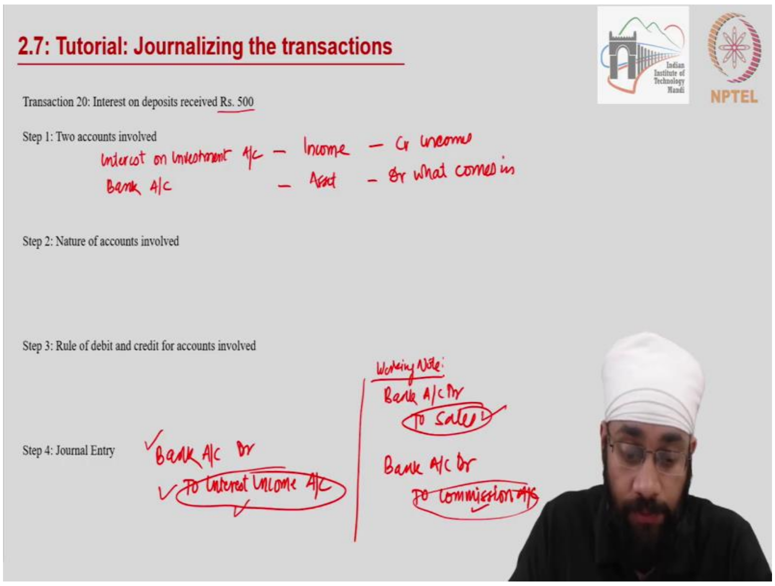

Transaction 20: interest on deposits received 500. So, you are receiving this as an income. The name of the income is interest on investment and typically, you receive all this interest in the bank account. So, interest on the investment account and the bank account. This is an income for you, this is an asset, you credit all incomes and you debit what comes in. So, the journal entry is going to be bank account goes up, Bank A/c (Dr.), To Interest Income A/c. If you remember, I earlier compared the other two income transactions: one of which was sales and the transaction can be Bank A/c (Dr.), To sales. The other transaction was commission. So, let say Bank A/c (Dr.), To Income by way of commission. Notice that this is an income, this is an income, and again, this is also an income. So, any income transaction is going to follow this format. On the debit side, you will have a bank account or cash account or if it is not paid in bank or in cash, you will have to name the person from whom this income has to be received. So, he will become a debtor. The credit account is always going to be the name of the income: either sales, commission, interest income or any other income which you may receive. So, this was just a working note.

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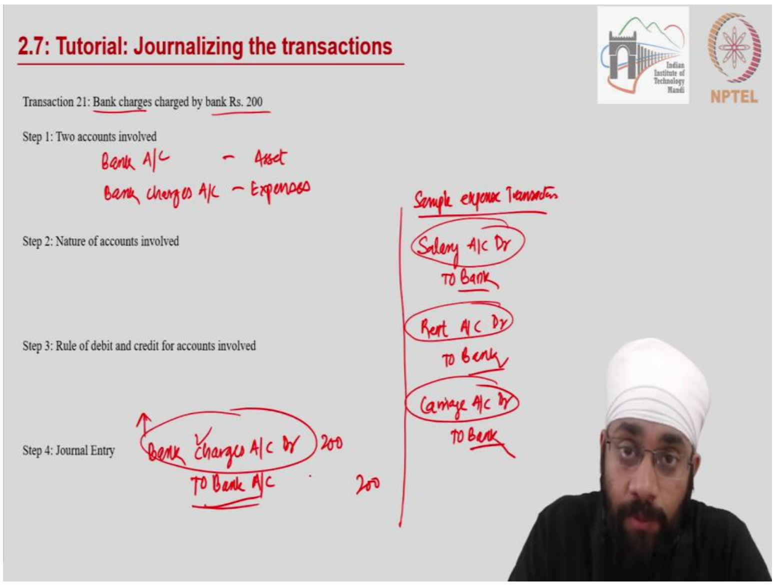

Let us move forward: bank charges charged by the bank. What are bank charges? Bank charges are annual maintenance charges that banks charge you or sometimes if you use your ATM card for more than x number of transactions on the ATM machine, then bank charges you some amount. So, bank charges are different charges that the bank deducts from your bank account from time-to-time and then you get a message. The accounts involved are bank account because the money is being deducted from this and the other is a bank charges account. Bank charges are expenses for business, a bank account is an asset: you debit all expenses so, I am going to debit the expense name which is bank charges account and I am going to write To Bank A/c. This is all automatic, we just get an auto debit, auto deducted message from the bank. So, the amount is 200 and you are done. Now, let me compare this transaction to other expense transactions. When you pay salaries, the transaction is salaries account debit to bank. When you pay rent, the transaction is Rent A/c (Dr.), To Bank A/c. There could be carriage on purchase or transportation cost: Carriage A/c (Dr.), To Bank A/c. So, these are sample expense transactions. In all these transactions, you see To bank, To bank, To bank and To bank because we are assuming that money is being paid through the bank account. So, that is one pattern. The other pattern is in the debit, you always write the name of the expense because you debit all the expense and losses and the way we understand this is the name of the expense really represents our claim on the service. Here bank charges, we have a claim on the service from the bank for the next 1 year. They typically deduct these charges in advance and you pay through the bank. So, that is how all the expense based journal entries are going to be written.

So, try to pick up these trends, these patterns as we move forward and I will keep showing them to you.

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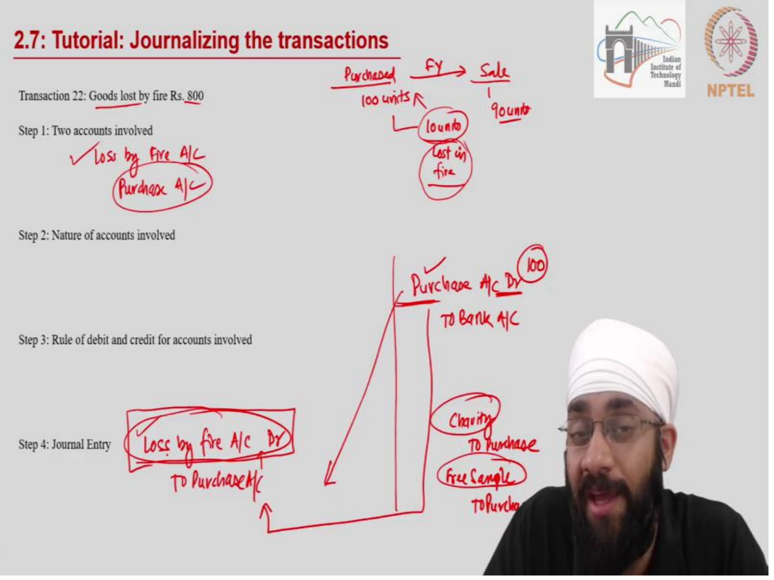

Let us go to transaction 22. This is goods lost by fire 800. This is similar to the charity transaction or goods given away as free samples transactions. So, you purchased goods, let's say 100 units, and you thought you would sell these 100 units. On the way, during the financial year, there was a fire and you lost 10 units. So, this is lost in fire. Earlier, you gave away these 10 units as free samples and you treated that as an expense and you gave away these as charity and treated that as a loss. Here, the losses due to fire. So, in a similar transaction all you have to do is change the name of the expense instead of charity or free sample, you are going to write goods lost in fire. There is loss by fire account, you have to deduct these 10 units from the purchase account. Therefore, the other account involved is the purchase account. You debit all expenses and losses so, you are going to write Loss by Fire A/c (Dr.) and the purchase account again, when you purchase the goods, you would have written this journal entry Purchase A/c (Dr.), To Bank A/c. You would have paid for it as well. So, let say 100 units was the purchase and now, you no longer have those 100 units. You only have 90 units to be resold. Therefore, you have to cancel; you have to take out those 10 units. To cancel that 10 units, you give it the opposite treatment which is you credit the purchase account. So, purchase account credit by 10 units and you reduce the balance in the purchase account. You are saying, again remember the loop, you are leaking those 10 units from the purchase account in a way and then, you are saying hey those 10 units are actually lost and loss is debit. So, that is how we write the transaction for goods lost by fire. Let me compare this transaction to the other transactions like charity. In charity, we said Charity A/c (Dr.), To Purchase A/c. We also had Free Sample A/c (Dr.), To Purchase A/c. So, these three transactions are similar in nature, goods are being taken away from the purchase account. They are not being used for reselling. What are they being used for? Either charity or free sample or lost in fire. That is a trend and that is how all these transactions involving goods being lost or being used for alternative purposes other than sale have to be treated. This is how this transaction is going to be written.

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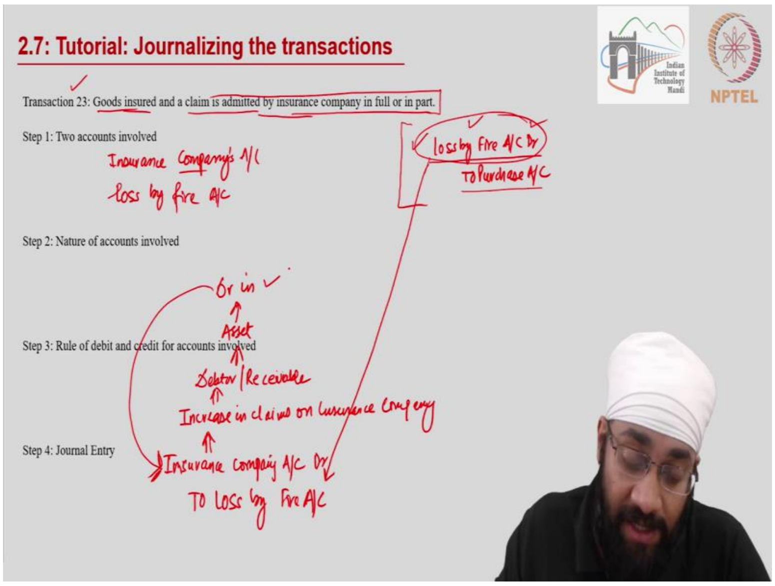

Transaction 23: goods insured and claim is admitted by insurance company in full, in part. This is a continuation of the previous transaction. The goods that you lost in fire, you had fire insurance luckily and the insurance company has admitted that alright fine, we will be reimbursing you for this loss. So, suddenly the insurance company comes into picture. If you have the name of the insurance company, you would write the name: insurance company's account is going to be here. In the previous transaction we said it is a loss, this loss is now going to be made good by the insurance company. So, I am going to use this entry Loss by Fire A/c (Dr.), To Purchase A/c. So, according to this transaction, the insurance company has agreed that the loss by fire that you experienced will take care of that, we will pay you that money, we will not give you the goods so, nothing is going to happen to the purchase account. But you are telling your shareholders, the government, other people, the public that there is a loss by fire; however, we will pay you for that. Therefore, this no longer should be treated as a loss.So, we have to cancel this loss. In order to cancel this loss, you create an opposite transaction, opposite

effect, opposite treatment. As it was being debited earlier, now, you can credit the loss by fire account, you are cancelling its effect. However, instead of this loss by fire, because this whole debit is being cancelled, we have to create another debit and that debit is going to be created against the insurance company, the insurance company's account. What does debit mean? You are giving it a debit. Debit means increase in the claims of business; increase in the claim of business on insurance company because the insurance company has admitted the claim. Insurance company is saying we will pay you for this. So, the insurance company becomes your debtor. You have to recover money from the insurance company. It is a receivable; it becomes a current asset. So, you follow that rule and you say debit what comes in and that is what you are doing, you are saying debit what comes in. So, in this transaction, I took the opposite approach. I showed you intuitively what the effect should be, how we should cancel this effect and then, I wrote the journal entry. And then, I also justified the journal entry using the rules of the three types of accounts.

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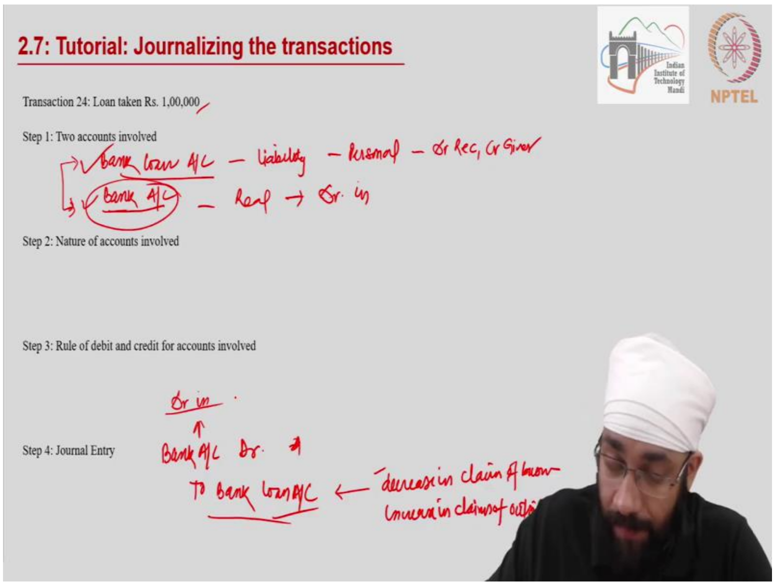

Let us go to another transaction loan taken 100000. So, a bank loan is being taken although it does not say bank loan. I am assuming a bank loan; it could be a personal loan as well. There is a bank loan account and the money goes into your bank so, there is a bank account. This is a bank deposit account; this is a bank loan account. Loan is being taken which is a liability and any liability is a type of personal account. The loan represents the liability that the business has towards the bank. So, the bank has claims on the business. The rule is you debit the receiver and you credit the giver. The bank is the giver so, you are going to write To Bank Loan account.

On the other hand, your bank account, your deposit account, this is a real account, this is an asset and you debit what comes in. By way of loan, money has been deposited in your bank account. So, you would certainly say bank account coming in, bank balance coming in so, Bank A/c (Dr.). Understand that this bank account is not bank's account; it is your bank account in which the money is deposited. Do not get confused because in both the transaction, both the accounts involved have bank written in it. So, do not get confused there. Bank A/c (Dr.) 100000, To Bank Loan A/c: this is a liability being created. When liability is created; that means, businesses' claims are going down, somebody else's claims are going up on the business. So, decrease in claims of business or increase in the claims of an outsider: bank is the outsider here. So, any decrease in the claim of business is shown by way of credit. So, it is being credited here. On the other hand, debit what comes, using the rule of the real account we have written this transaction.

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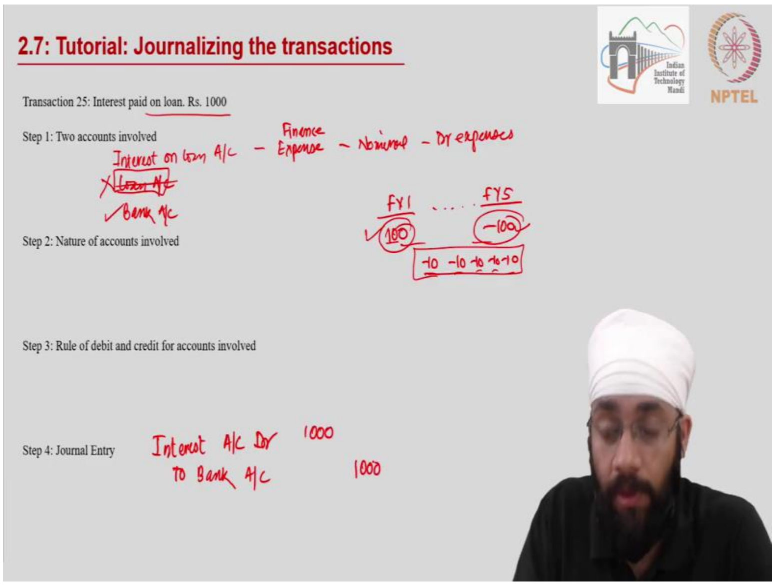

Transaction 25: interest paid on loan. You had taken a loan and now, you have to pay interest on it. So, interest on loan account: maybe there is a loan account involved here, we are doing this for the first time. I am just you know going through the whole drill. You are paying it so, let us assume it is going to be paid through a bank account. So, interest on loan is an expense and if you remember the financial statements, we call it a finance expense. All the interests that you pay on all the loans are clubbed into one head in the financial statement which is called finance expenses or finance costs. As this is an expense, this is a nominal account, can you debit all expenses? Therefore, I am going to write interest, you could write interest on loan, or

you could write interest expenses or interest account debit and you are going to credit in another account. Which account? Loan account? If you write anything in the loan account, that would mean the loan has gone up or gone down, but that is not the case. You are only paying interest. The way loans typically work are: you pay some simple interest. Example, you take a loan at the beginning of the year, let me just draw it out in financial year 1, you take a loan of 100. And then, you have to pay back this loan in financial year 5. Five years from now in full and during the 5 years, you are going to pay an interest of 10, interest of 10, 10, 10 and 10 for 5 years and finally, you pay 100. I am not talking about EMI's here; I am saying one lump sum amount is taken as a loan and then, you repay it. Therefore, the interest which is being paid is not the EMI. Interest which is being paid is separate from the principal which has to be repaid. Even in the EMI's that you pay; the EMI has two parts. Some proportion of the EMI goes towards paying the interest while the other portion goes towards paying the principal; this transaction is a simpler case. You are only writing a transaction for paying the interest on the loan. Therefore, a loan account is not involved here. You are paying it through the bank, the bank is an asset that goes out, bank account is given a credit and you are done.

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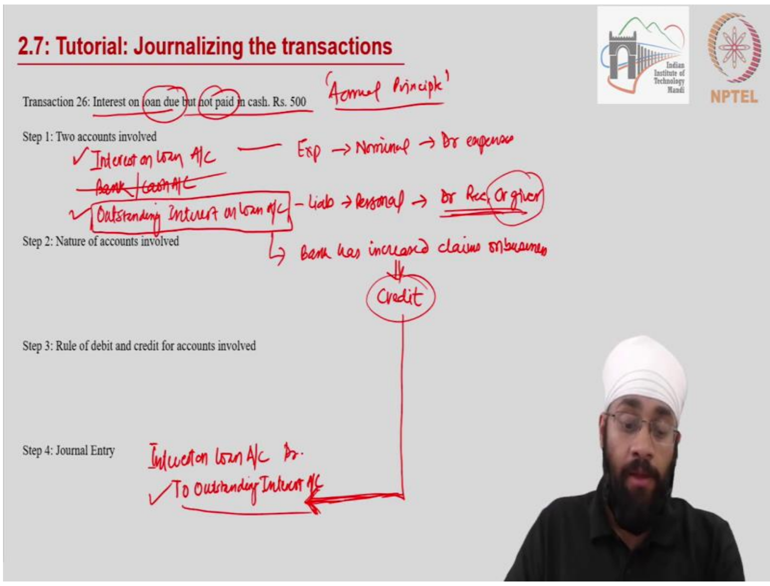

Interest on loan due, but has not been paid in cash: this is interesting. Now, interest on loan; we are using accrual principle here. I mean invoking another Generally Accepted Accounting Principle (GAAP). Interest on loan has become due whenever it becomes due, it has accrued, that is the nomenclature. So, interest on account should be recognized as an expense first of all. The other part was that you pay for it. When you pay for it, you pay through a cash account or bank account, but not paid. So, you are not paying for it. If you do not pay, it becomes overdue. When it becomes overdue, it becomes a liability. The name of the liability is outstanding expense and we have the name of the expense which is interest outstanding, interest on loan account. Interest on loan is an expense, is a nominal account and you debit all expenses, here we go. So, we are going to debit interest on a loan account or interest account as we wrote in the previous entry and this outstanding interest is a liability. It represents the bank's claims. So, it is a liability. Liabilities are personal accounts and the rule is debit the receiver and credit the giver right. In this case, the interest on the loan is the expense, but you are not paying for it. Thus, the claims of the banks are going up on the business. So, in this case, the bank is not a receiver or giver in this case. Giver in the sense the bank was a giver of the loan. However, the way to think about this transaction is that the bank has increased claims on business. Therefore, it is going to be represented through a credit. The credit is given to the outstanding interest account. In a way bank is the giver, in the sense that the interest on loan which the business could not pay back, the bank has borne that for now. Bank also sources the money from depositors and has to pay back to them. If you do not repay the bank on the loans you have taken, then the bank will have to pay those expenses anyways. In that sense, the bank is the giver, it is giving you a leeway, it is paying on your behalf to the lenders that the bank further has and hence, it is a liability. But in a more intuitive way, you can say the claims of outsiders on the business are going up. So, business' claims are going down. We show that by way of giving a credit to the outstanding interest, a new liability which is being created.

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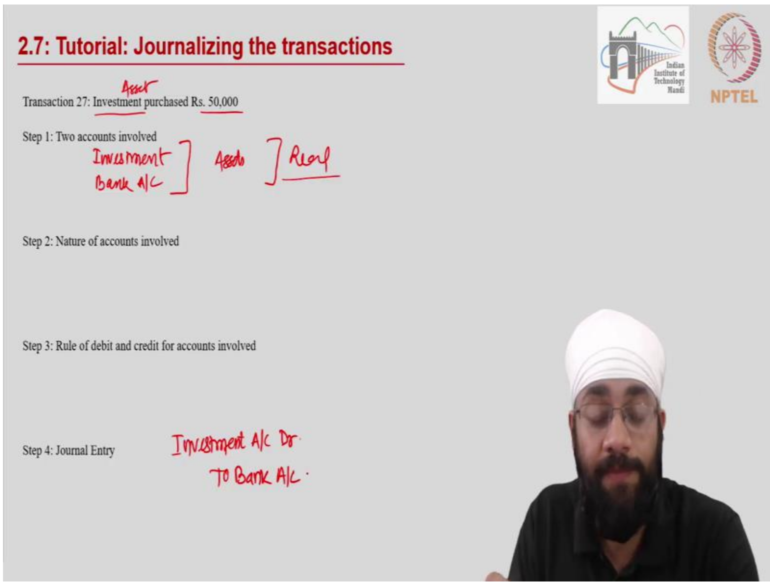

Let us go to the next transaction: investment purchased 50000. Now, investment is an asset clearly you have investment and you are purchasing it and you pay for it so, bank account. Both of these are assets, both of these are real accounts. One thing is coming in, another thing is going out. What is coming in is investment so, the investment account is debit and you are paying for it. So, bank account is credit.

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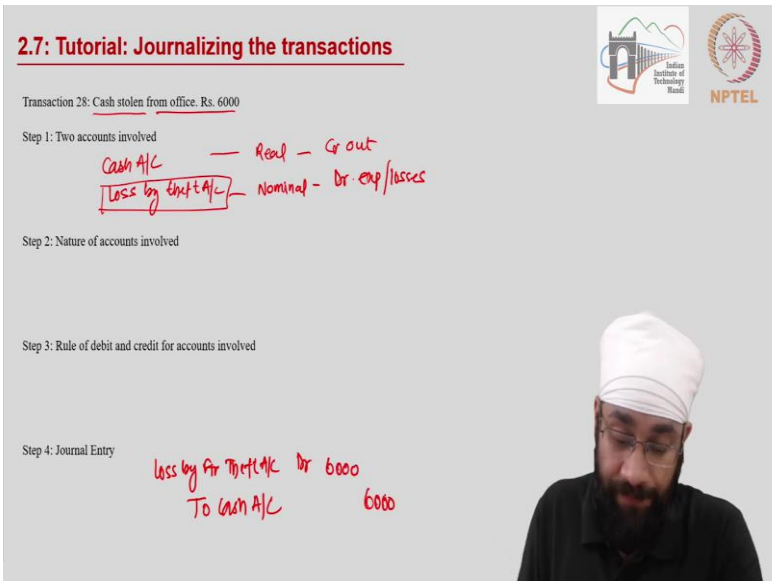

Cash stolen from office is 6000 alright. So, you have a cash account which is reducing because you lost the cash. Of course, there is loss by theft; loss by theft account. So, cash is a real account because it is an asset, it is going out. Credit what goes out; so you are going to write To Cash A/c. On the other hand, you have a loss by theft, this is a loss; all expenses and losses are nominal accounts and you debit all expenses or losses. So, I am going to write Loss by Theft A/c (Dr.) 6000, To Cash 6000. There you go.

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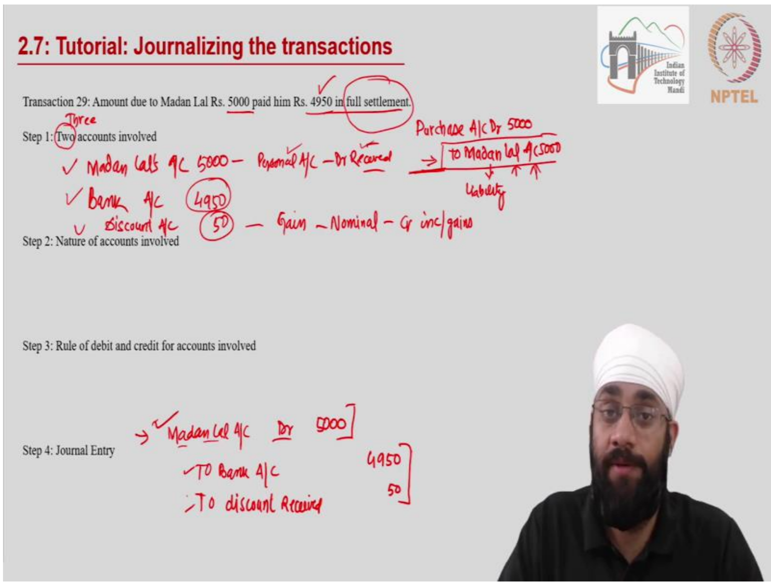

Transaction 29: amount due to Madan Lal 5000, paid him 4950 in full settlement. You would have bought things from Mr. Madan Lal. At that time, the journal entry was Purchase A/c (Dr.) 5000, To Madan Lal's A/c 5000. So, you had a credit to Madan Lal, this was a liability. Now, you are paying this person 4950. So, Madan Lal's account is involved, and because you are paying a person, you are either giving him a cheque or depositing it in his account. So, it is going to go from your bank account. These are the two accounts involved. What are you paying to this person is 4950, what was due to this person is 5000. Now, what about the remaining 50? The remaining 50 you are not paying to him and he has agreed to it. It is a full settlement. You spoke with him on the phone and said *hey, can you let go off the 50 rupees I can pay you right away*, he agreed to it so, said fine. So, what is this 50? This 50 is a discount, this 50 is an incentive that Madan Lal extended to you in order to motivate you to pay right now. So, we are going to say that there is a new account involved here which is called a discount account. Now, for the first time in the discussions till now, we do not have two accounts, but we have three accounts involved and it is possible. I said in the beginning that at least two accounts have involved, but there can be more accounts involved as well. So, let us look at this transaction and how this is going to work out. Now, Madan Lal was given a credit in the beginning. You have paid him in full settlement so, he cannot come back later and say pay me the rest of the money because he is giving you a discount. Thus, one thing that you need to do for sure is to cancel this credit. To cancel this credit, you are going to give this a debit. So, you are going to write Madan Lal account debit by 5000, full 5000 here. You gave a credit to Madan Lal; you gave a debit to Madan Lal debit equal to credit. Nothing to be paid or recovered from the Madan

Lal that is the net effect of this transaction number 1. Second you are paying 4950 to him so, certainly bank account, bank balance is going out, real account. So, a credit has to be given to the bank account the amount being paid is 4950. Now, you have a discount which you are receiving. So, this discount which is being given to you, this is a gain not an income, but a gain. Gain is a nominal account and you credit all incomes and gains. So, you credit the gain, name of the gain is discount received; discount received which is 50 and when you do this, you have total of the credit as 5000 and total of debit as the 5000. All debits must have an equal credit is another rule that I shared: rule of double entry system. The double entry system states that all debits will always have an equal credit. It can be split across multiple accounts, but debits must equal credit, which is double entry system. Let me also justify the debit given to Madan Lal through the proper process that we follow. Madan Lal is our creditor you are paying to him it is a liability so, it is a personal account, personal account you debit the receiver. You are paying Madan Lal, he is the receiver so; you gave him a debit and then, bank and discount I have already explained. So, I have explained this transaction both ways, intuitively by looking at the earlier transaction and I have said we have to cancel this effect. The second way was we just looked at the personal account, the rule followed and accordingly the transaction was written.

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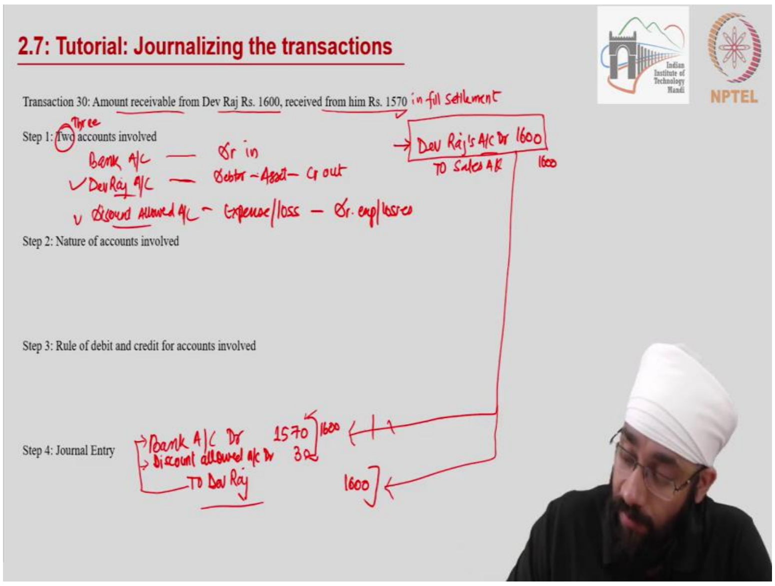

Let us go to the final transaction. In this case, you had to recover the amount from Mr. Dev Raj who was a customer and you have received from him 1570 in full settlement; full settlement- let me add that as well. When you sold goods to him, what was the journal entry? When you sold your journal, entry was Dev Raj’s account debit 1600, To sales account 1600. In this case, Dev Raj became your debtor. It became your asset; you had to recover money from him because he did not pay you in cash. Now, the amount receivable 1600 has been received from him and you have allowed him a discount of 30. You have received 1570 in full settlement. First of all you have received the money so, bank account is involved and money is coming into the business, you debit what comes in so, I am going to quickly write bank account debit and the amount is going to be 1570 because that is the money you received. You are receiving it from Dev Raj. So, Dev Raj's account is also involved and Dev Raj was your debtor; hence, an asset and therefore, you debit what comes in, credit what goes out. Now, Dev Raj earlier was your asset, he paid you no longer he is your asset. So, an asset is going out, the name is Dev Raj so, we are going to give a credit to Dev Raj to the total amount of 1600. He owes you 1600 and he has paid 1570 so, it is clearly a balance of 30 rupees that has to be accounted for. What is this balance? Just like in the previous transaction where your vendor, your creditor gave you a discount, you have given a discount to Dev Raj. So, the third account involved is a discount given which is called a discount allowed account. There are three accounts involved in this transaction. Discount allowed means you wanted your customer, your debtor to pay you as soon as possible. So, you incentivize, then you said pay me 30 less, but pay me right away and he did that. So, this 30 helps you generate a revenue, this is an expense, this is a short term loss that you bear in order to recover the money. So, this is going to be treated as an expense or a loss and the nominal account debit all expenses and losses. So, you will write here discount allowed. Discount allowed account also gets a debit. So, the total of debit is 1600, total credit is 1600;the double entry system survives this transaction as well. And if you want to look at it intuitively, you had Dev Raj as your debtor in the notebook where you wrote Dev Raj's transaction, you said 1600 to be recovered from him. And now, after this transaction you said 1600 not to be recovered from him. So, 1600 cancelled, you do not have to recover from him and now you have recovered 1570 against it and you have allowed a 30-rupee discount for it.

So, here you go, we have gone through a range of transactions, different types of transactions, some a bit more complex and also, we have looked at transactions which involved more than two accounts. There we followed different methods of writing the journal entries, we used the you know scientific method where we looked at the type of account, the rule for debit and credit for that account and wrote the journal entry. We also referenced our journal entries to some past journal entries to see the trends. We also intuitively reached conclusions or we tried to reduce the net effect of different transactions saying earlier this was the transaction. And, now we are creating an opposite effect by writing this transaction. I hope through this tutorial, you have been able to get a better grasp or better hold on how to write journal entries.

So, that is it for this video. I will see you in the following video.