Financial Accounting
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Lecture – 37
3.5 Tutorial - Identifying balances (Part 1)

Hi, this is a tutorial. In this video, we are going to look at a list of account names and then, we are going to try and justify why those accounts will always have a debit balance or a credit balance.

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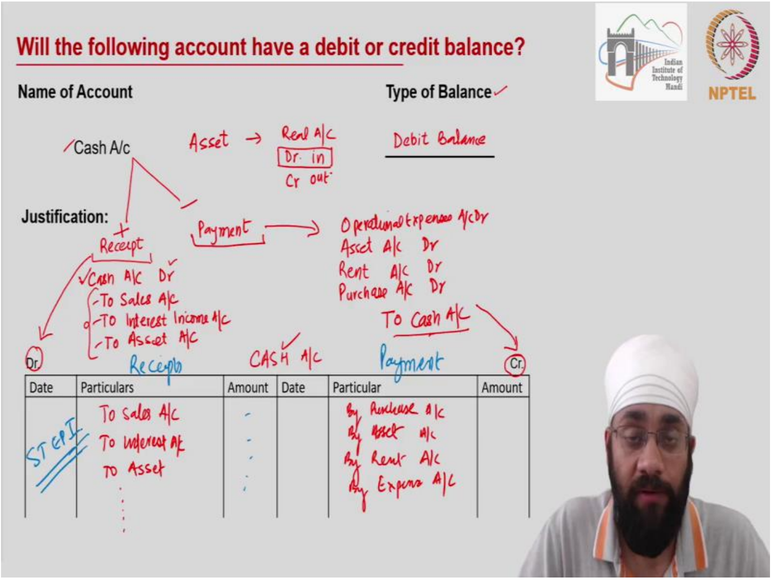

The format of the slide is arranged as follows. We have an account of interest, cash account. The question that we have to answer is: Will a cash account have a debit balance or a credit balance? And then, we have to do our working notes in this open area on the slide and I have an account format on the slide, just in case I need to illustrate the ideas that I am trying to convey to you.

So, let us get started. We have a cash account and a cash account is an asset and the rule that we learnt, the pattern that we saw from the previous video, is that all assets are going to have a debit balance. With this understanding, let us try to question this notion and try to object to it and say why would this happen, why cannot cash account, if this is the cash account, why can this not have a credit balance?

For justification let us do some discussion here. In any transaction where cash is involved, cash is going to be used either to pay for something, like for purchasing something or for an expense, or cash is going to be received for providing some service or as an income which is being received. So, there are only two ways in which cash moves: one-cash goes up, the other- cash goes down. When cash goes up, you say you have a receipt of cash and when cash goes down, you have a payment of cash. Whenever you have a receipt, cash is an asset, hence, a real account and whenever cash comes in, we say debit what comes in and credit what goes out. Therefore, whenever cash comes in, the journal entry is going to be cash account debit. When a cash account is debited in this transaction where you are receiving the cash, the other account involved is going to be credited. Let us say cash is coming in because you are selling the goods, so a sales account. So, a sales account is an income and income is nominal, credit all incomes and gains. Hence, sales account is credit. If the cash being received is not due to sales, but due to, let us say, interest income earned on the bank deposit, then what is going to happen? In that case, again, cash is coming in so, you will write cash account debit and instead of sales account, you would say To Interest Income A/c. Now, let us say, another source of income could be you sell off an asset: you sell off a furniture or a building or land and cash comes into the business. What is the journal entry? Again, cash is coming in, you will debit the cash account and you are going to credit the asset account which is being sold because asset is also real account and credit what goes out, asset is going out, cash is coming in. Likewise, you take any transaction in which cash is coming in, cash is going to be debit and the other account is going to be credit. Now, if this is true and we have established this to be true using the principles of the double entry system, when you prepare the cash account, all these transactions which are receipts, which are reasons for cash coming into the business, are going to be written on the debit side. All receipts go to the debit side because in all the transactions involving receipts, the cash account is debited. So, you go to the debit side of the cash account and you are going to write all the accounts due to which cash is coming in. So, you write To Sales, To Interest Earned, To any asset which is being sold, or To any other type of income which is going to be written here.

Now, let us look at the payment side. For the payment side, whenever cash goes out, the entry is going to be reversed which means that you are going to write To Cash A/c. Now, cash can go out of the business if you are purchasing goods. So, the purchase account is going to be debit and the cash account is going to be credit. You could also pay rent for the building. So, rent account is going to be debit, To Cash A/c. You could purchase an asset. So, Asset A/c (Dr.), To Cash A/c. You could pay transportation cost, you could pay any other operational or non-operational expenses: entry will be (non)operational expenses account debit. So, the bottom line in all the payments is that the cash account is going to be credited. Therefore, all the payment transactions are going to appear on the credit side of the cash account. So, you can write By Purchase A/c, By Asset A/c, By Rent A/c, By any other expense expenses account.

Now, this is the pattern of the cash account: you have all the receipts on this side and all the payments on this side and we are talking about cash in hand, we are not talking about the bank balance here. Cash in hand means you have some money in, say, your drawer, in the desk drawer, in the business, and you are going to spend that money. You can only spend the money which you have, you cannot spend more, there is no overdraft facility available. Therefore, it means that money has to first come into the business. So, this is always step I, you have to first bring money into the business. We missed one major receipt of cash which could be capital brought in, but typically we say capital goes into the bank.

Anyways the point is first receipts, first cash comes into the business, business receives cash and then, payments are made. If you do not have cash, you cannot make the payments. So, intuitively, logically, you would not be able to spend more than the cash that you have and if you look into the journal entries that you have in any business, you will see that you will never be able to transact and hence, we will never write a journal entry of cash being paid if you do not have cash.

Transaction will only take place when you have cash in hand and when you transact, and this is the first step, first the cash will come in and then, you pay the cash. I cannot emphasize it more. So, there you go cash, and the asset account is always going to have a debit balance.