Financial Accounting
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Lecture – 40
3.5 Tutorial – Identifying balances (Part 4)

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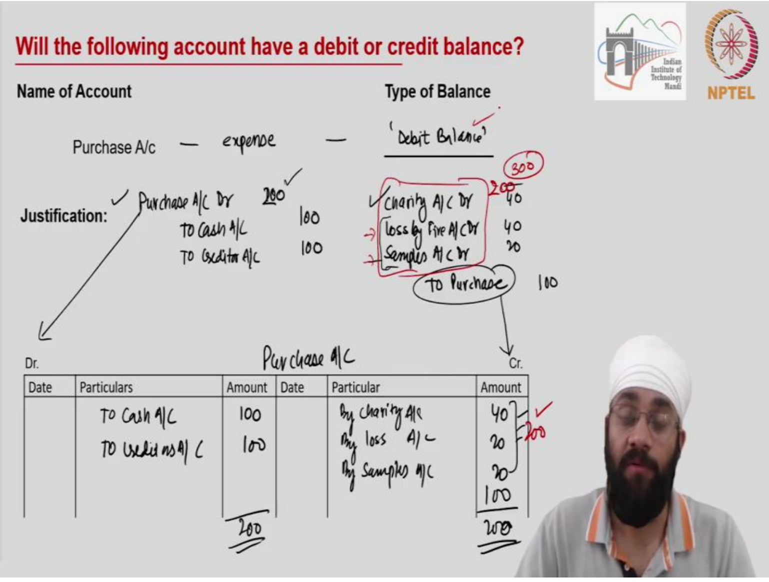

This is a continued video, a tutorial on identifying the type of balances: debit or credit. We are looking at a new account: purchase account. Purchase account is considered to be an expense item and we have learned that all expenses are always going to have a debit balance and we are going to take a minute to justify this. When you purchase, what is the transaction? Well, the transaction is Purchase A/c (Dr.), To Cash or Bank, let us say, 100. This is a cash purchase; you could purchase on credit. When you purchase on credit, you will write the name of the creditor, the vendor that is it. When you do that: let us make this 100 and this becomes 200, I am writing a complex journal entry. Is there any other entry which you would write for purchase? None. It is possible that you lose goods in fire or give away free samples or charity, then that happens you write the journal entry as follows: you write Charity A/c (Dr.), or you can write Loss by Fire A/c (Dr.), or the third one was samples, Free Samples A/c (Dr.), To purchase. Now, let us post these into the purchase account. On the debit side, you are going to show all the purchase transactions: you will write To Cash A/c and To Creditors account 100 each. So, 200 is the total on the debit side. On the credit side, you are going to write this journal entry. Here, purchase is being credited, so, you are going to go here, let me also determine the amounts here. So, let me write 100 here and let us say 40, 40 and 20. So, To Purchase A/c means it is credited. On the credit side I am going to write By charity A/c, By loss A/c, By fire A/c and By free samples A/c. I am just going shorthand here. So, charity is 40, 20 and 20 for samples. Now, you have 200 on the debit side and you have only 100 on the credit side, there is 100 which is remaining. Now, you could argue that you intentionally kept these amounts low; why do not you make them bigger? Well, my counter argument would be let us do that. What is the amount that you want to assign to a charity account? How much charity are you going to do out of the total purchases of 200? If 200 is the value of total purchased goods with you, are you going to give away all of them as charity? Well, no, you will not do that. Even if you do that, let us say, if you give away all 200 as charity, then there is no possibility of losing rest of the goods because there is no goods left now and hence, you do not have anything to give away as samples.

So, you could make this, let us say 200. Even if you make one of these items 200- that is the best you could do- you will have a 200 here and then, there will be no balance. But you will never have a higher amount here, you cannot give away more goods than you have and you could say we could have sold these goods at 300, when you sell the goods at 300, you enter that in the sales account because an income comes in. Here, you only show the purchase amount of the goods which are being given away. Same logic goes for loss by fire samples.

So, there is going to be no case where the amount being given away is going to be more than the amount of the unit, the stock of goods that you already have. Therefore, the purchase account is always going to have a debit balance.

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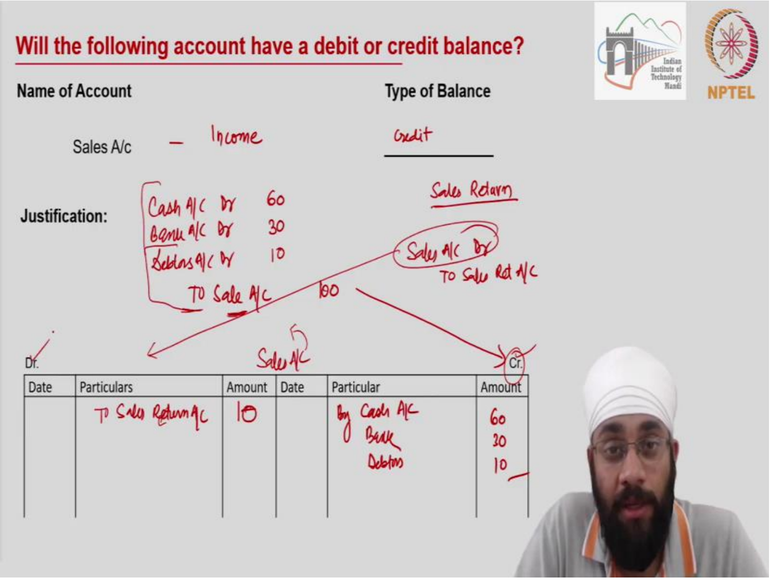

The exact reverse of the purchase account is a sales account. Sales is considered an income and all incomes have always a credit balance. What is the journal entry when you sell goods? You get cash. So, you write Cash A/c (Dr.), or Bank A/c (Dr.) or if you do not receive cash or bank, you could at best get debtors then, Debtors A/c (Dr.) and then, the credit account is going to be sales. Sales account, let us say, you sold 100 rupees worth of goods, you received 60 in cash, you received 30 through bank account payment and the remaining 10 are to be recovered from the customer. When you prepare a sales account, you are going to write on the credit side so, let us say, By cash account, you can write By Bank account and By debtors account and all the amounts are going to be here. You have everything on the credit side, there is no journal entry where you write on the debit side except for one which could be the possibility of sales return. Sales return means the sold goods to the customer and tare returned by the customer. You had a policy, you said within 1 month any problems guaranteed you come and you return the goods, money back guarantee. So, if that happens, then you could just reverse this transaction. Let us say you know some of the customers or maybe all of the customers come back and say we do not want these goods. So, the journal entry is going to be that you reverse this transaction. So, you have a Sales A/c (Dr.), to cancel the returns and you are going to have To Sales Return A/c. This is a new account which is opened, you have not seen this before. So, in this transaction, you go to the debit side and you are going to write To Sales Return A/c.

Now, even if this happens, the customer cannot return you more goods than the goods that you sold to him. So, this amount again is going to be smaller. This is going to be at best equal to the amount that you sold. So, there you go, you will never have a debit balance. The amount on the credit side is always going to be higher than the amount on the debit side.

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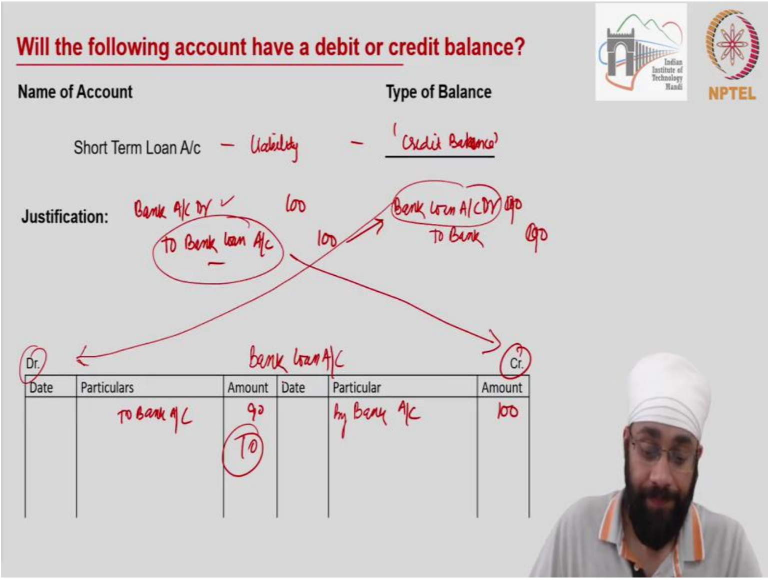

Short-term loan: short-term loan is a current liability. All liabilities have a credit balance. What is the journal entry for when you take a short-term loan? When you receive a loan, it comes into your bank account. So, bank account is debit and you have a new liability called bank loan: you could call it a short term loan as well. So, 100 rupees come into bank loan and there is a new liability called bank loan account.

The other entry could be when you repay the bank loan. When you repay the bank loan, you will say Bank Loan A/c (Dr.). You are going to cancel this, you pay let us say all the amount and you are going to pay through the bank. So, bank account. The exact opposite entry or you could pay less let us say you only pay 90 and 10 is pending. If you look at a bank loan account, this first entry where bank loan is being credited is going to be written here so, you we are going to write by bank account 100 and this transaction is going to be written here debit side we are going to write to bank account so, 90. So, the credit side total is higher than the debit side total. 10 is the balance in the loan account. Even if you pay the full loan, there is no balance in the account, but you will never have a debit balance in the bank account.

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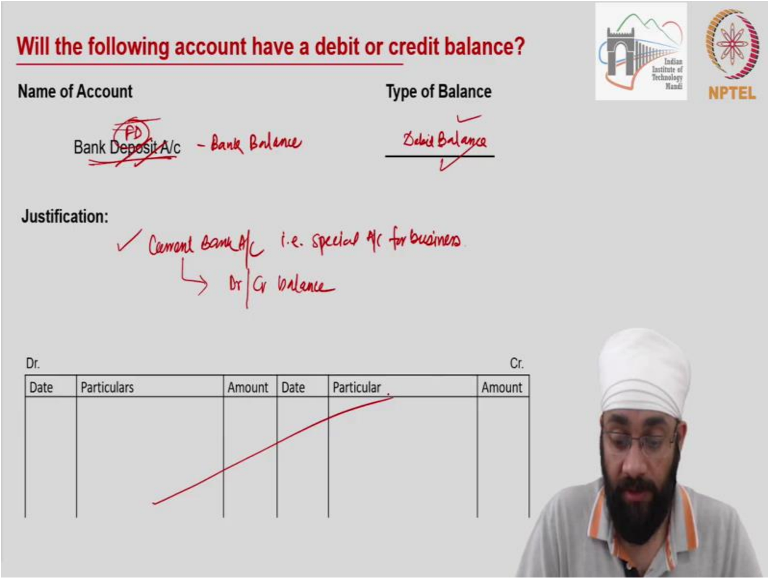

Let us look at a bank deposit account. Bank deposit is actually equal to bank balance account. I should rather call it bank balance account, but you could also think of it as a fixed deposit account in which case a fixed deposit will never have a credit balance. Fixed deposit is a term deposit and it will always have a debit balance. If, and only if, it is a current bank account, there is something called a current bank account, the case might be different. Current bank account is a business bank account; this is a special account for businesses. So, the banks extend the overdraft facility to only the current bank account. For bank deposits or fixed deposit accounts, this facility is not available. Savings account that we have, we do not have an overdraft facility. So, in this case, I will say debit balance only, but if we were talking about a current bank account, then we could say it could have a debit or credit balance. I do not think this is required because we have discussed this already. Cash account with the similar example and the bank balance in the current account has been discussed in the previous video.

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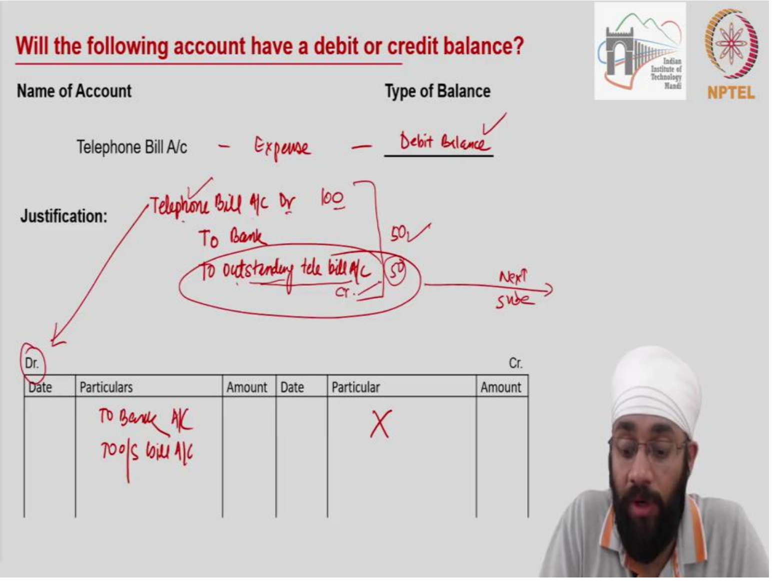

Telephone bill: telephone bill is an expense. All expenses have a debit balance. Let me justify this. When you pay any expense, the journal entry is the name of the expense: Telephone Bill A/c (Dr.), To bank or To cash, whichever mode you are opting for. That is it, there is no other journal entry. However, if you do not pay, there is another journal entry. If you do not pay, then instead of a bank account, you will say outstanding; Outstanding Telephone Bill A/c that is it. So, it is being debited, you go to the debit side. You can write bank if you have paid it and you will write outstanding bill account if you have not paid it. There is no posting on the other side. It is always going to have a debit balance. So, all expenses again are going to have a debit balance.

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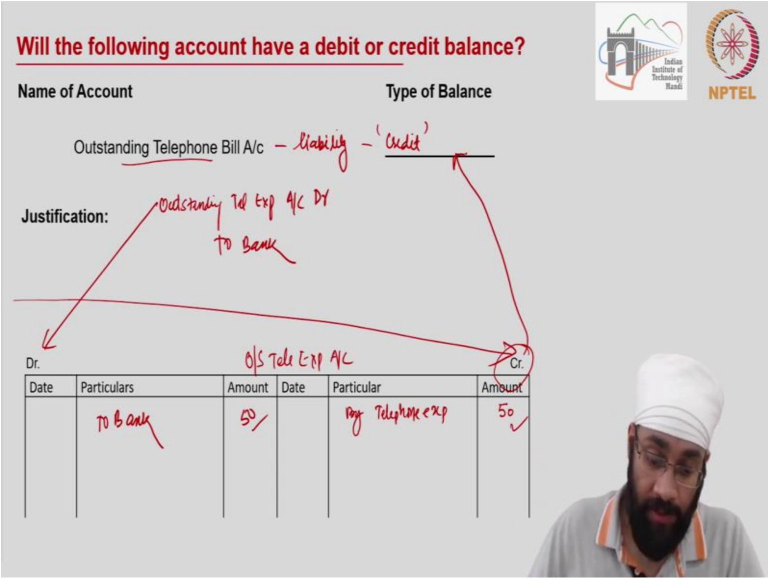

Then you have an outstanding telephone bill account. This is different from the previous one. This is a liability. This is not an expense; this is an outstanding expense and all outstanding expenses are actually liabilities and liabilities have a credit balance. So, do not get confused between telephone expenses account and outstanding telephone expenses account because these are two different things. So, when do you record a transaction in the outstanding telephone bill? Well, you just looked at it in the previous journal entry here. You have Telephone Bill A/c (Dr.), To Outstanding Telephone Bill. If I were to post this entry, let me take this 50 paid, 50 unpaid. Now, this outstanding telephone expenses account is being prepared and I am going to take this to the next slide and post it to the credit side. So, we are posting on the credit side, it is coming from the previous slide and we are going to write By telephone expenses, which you did not pay. How much did you not pay? 50 only, remaining 50 were paid. So, only this 50 should be written. Although, the telephone bill account says debit of 100, but the outstanding expenses account is credited with only 50 rupees. So, we are going to write By telephone expenses 50 and there you go, this is the outstanding telephone expenses account.

The other journal entry which could be posted here is when you actually pay the outstanding expenses: the journal entry is going to be outstanding telephone expenses A/c (Dr.), and you are going to pay in cash or through bank and you can write that.

So, this is being debited. It will come here To bank or To cash 50 and there will be a nil balance, there will be no balance, but there will not be a debit balance. Till the time you do not pay this, there will always be a credit balance; all liabilities always have a credit balance in their account.

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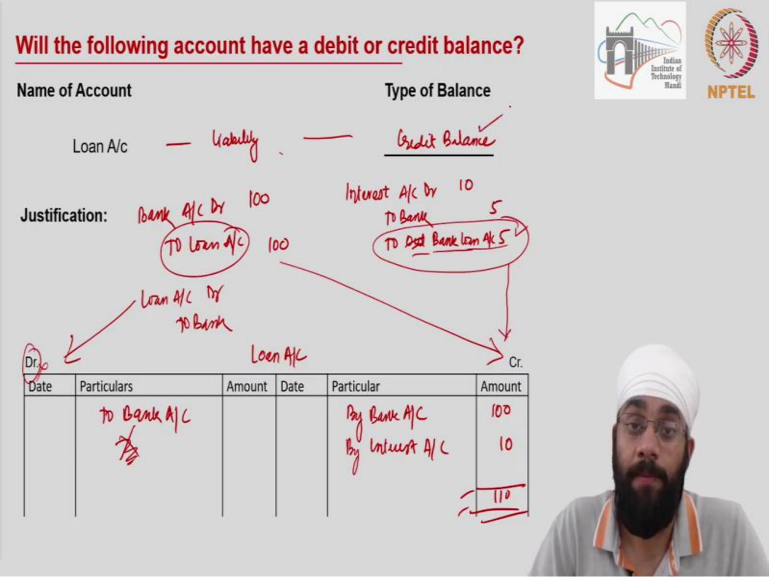

Let us look at a loan account. Loan is also a liability and we just discussed all liabilities will always have a credit balance. When you take the loan, the journal entry is Bank A/c (Dr.), money comes into your account, To Loan A/c and we actually just did a discussion on short term loan. So, these both are the same things. Short term loan or long term loan, both are liabilities, same transactions. You could repay these loans in installments or in one lump sum. It is also possible that you do not pay the interest on the loan and it gets added to the principle that is one interesting transaction as well, but none of that is going to affect the fact that the bank loan account or liability account will always have a credit balance. Let me just articulate this as well. So, this is a loan account, it has been credited. So, it will go to the credit side, we are going to write By Bank A/c. Let us say this is 100 and 100 so, we will write 100. There can be an interest account debit let us say this was 10 and you paid 5 out of this and remaining are added to the bank loan account. So, if they are added to the bank loan account, then we are going to write a bank loan account and 5 or if not added, then they could become outstanding expense in which case again it is a liability so, instead of bank loan, you would say outstanding interest account. I think we did one practice problem where we said the interest will be added to the principal. So, let us just take that. In this case, bank loan account is being credited. Again, we are going to write here By Interest, you have not paid the interest. Now, the loan has gone up to 110. Nothing is coming on the opposite side unless you pay the loan. When you pay the loan, then you have Loan A/c (Dr.), To Bank A/c. Now, you will have a transaction here. Let me remove this and you will say To Bank A/c and you are going to pay 100 or 110 at the most but not more than that. So, you will never have a debit balance in a loan account. Therefore, all liabilities are going to have a credit balance.

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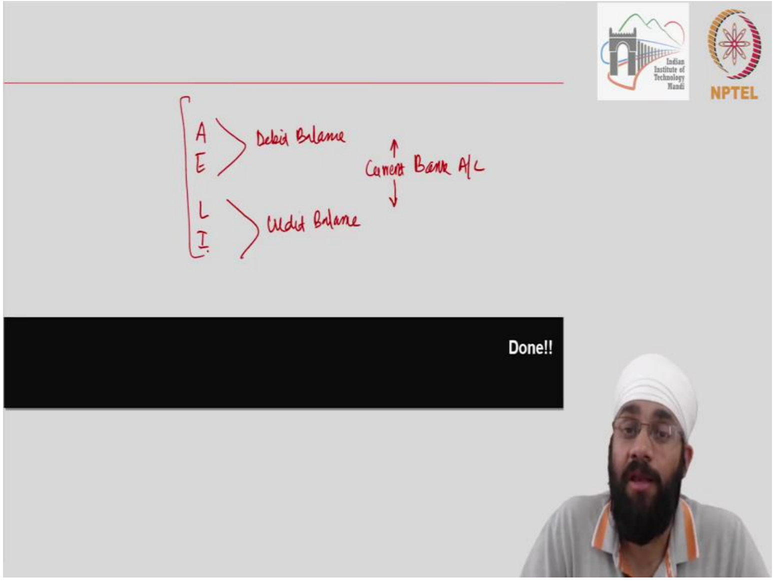

So, we have gone through a bunch of accounts and we looked at what could be the various possible transactions in this account and if there are any conditions under which our learning is going to be violated, the rules are going to be violated. The learning is that assets and expenses are going to have a debit balance and the liabilities and incomes are going to have a credit balance. The only exception that we have seen is the current bank account. Current bank account is a special account given to businesses and it could have either a debit balance or a credit balance. But other than that, this rule is going to stay.

Alright, this is the end of the tutorial. I will see you in the next video.