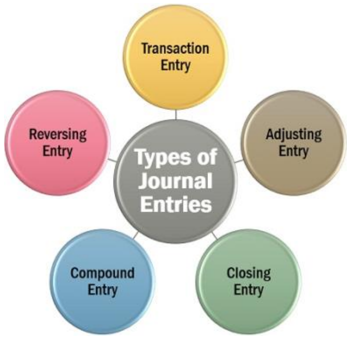
Financial accounting -10

Journal Entries I

By
Dr.Sanjay Banerji
Founder Director/Dean of Amrita School of Business

Dear Friends,



Welcome back to the study of Financial Accounting. In this session, we shall introduce you to one more important accounting convention for recording all business transactions in a book. This book is given a special name by the accountants – a journal, similar to a diary that maintains daily records of important events. In this case, all business transactions qualify to be an event to be recorded, and the process of recording is called making journal entries or simply 'journal entries'.

Bala Sir welcomed the SHG members, to continue the exercises on Debits and Credits and to introduce 'Journal Entries'. He reproduced the crucial Table for convenience as under:

The Language of Accountants			
#	**Balance sheet equation item**	**Increase**	**Decrease**
	LHS		
1	**Cash**	**Debit**	**Credit**
2	**Non-cash Assets**	**Debit**	**Credit**
3	**Expenses**	**Debit**	**Credit**
	Balance sheet equation item	**Increase**	**Decrease**
	RHS		
4	**Liabilities**	**Credit**	**Debit**
5	**Shareholders' Equity**	**Credit**	**Debit**
6	**Revenue**	**Credit**	**Debit**

Next, he provided the correct answers to the practice exercise questions:

Answer	
Situation	Option
Cash goes down	~~Debit /~~ Credit
Liability goes up	~~Debit /~~ Credit
Shareholders' equity goes up	~~Debit /~~ Credit
Revenue goes up	~~Debit /~~ Credit
Non-cash goes up	Debit ~~/ Credit~~
Expenses goes up	Debit ~~/ Credit~~
Liability goes down	Debit ~~/ Credit~~
Cash goes up	Debit ~~/ Credit~~
Non-cash goes down	~~Debit /~~ Credit
Revenue goes down	Debit ~~/ Credit~~
Expenses goes down	~~Debit /~~ Credit

Resuming the session, Bala Sir congratulated them, as most of them had done the exercise correctly. For those who made a few mistakes, Bala Sir reassured them, not to worry. He admitted that even after so many years, any moment he tries to decide upon Debit / Credit mechanically, he would make a mistake. Therefore, he forces his own mind to decide in the following manner mentally:

1. Is this a LHS item or RHS item in the balance sheet equation? (Remember - LHS up means debit, RHS up means credit)
2. Is this going up or going down? If going down, the rules reverse
3. Decide

This is why we had said earlier that the balance sheet equation plays a very important role in accounting. After the exercise, most of the women felt better, though a few still had some doubts. Bala Sir took up a few more examples, that the ladies were quite familiar.

Journal Entry

Next, Bala Sir told the ladies that he was going to introduce one more important accounting convention for recording all business transactions in a book. This book is given a special name by the accountants – a **journal**, similar to a diary that maintains daily records of important events. In this case, all business transactions qualify to be an event to be recorded, and the process of recording is called making journal entries or simply 'journal entries'.
He asked them to recall the first transaction for starting the business. We put Rs. 60,000 in the bank in the name of APS. Remember that we are recording all transactions on behalf of APS. For APS cash went up by 60,000. We shall record this as Dr. Cash 60,000. This is simply a shorthand method of recording the fact that Cash went up by Rs. 60,000. But simultaneously, you recall that APS became liable to the owners for the same amount. We called this liability – Shareholders' equity. This liability went up by the same amount – 60,000. This item appears on the right-hand side. Therefore, increases are entered as credits. Therefore, we also record as Cr. Shareholders' equity 60,000. This happened on October 1, 2021. So, the full journal entry for this transaction would look like this:

#	*Date*	*Description*	*Debit*	*Credit*
1	Oct. 1, 2021	Promoters' contribution	Dr Cash 60,000	
				Cr Shareholders' equity 60,000

This journal entry is a *shorthand method* adopted by the accountants to say that on 1st October 2021, the promoters brought in cash amount of Rs. 60,000 to start the business in the name of APS, and simultaneously, APS became liable to the shareholders for the same amount. It is a very strict rule followed by all accountants. Please note that debit (Dr) entries are noted first, and the credit entries are noted below *with an indent*. Please also note that the debits and credits must be equal, thereby maintaining the balance sheet equation. *Before the transaction* APS had no asset and no liability. *After* the transaction, it had an asset (Cash) of 60,000 and a liability of 60,000. *As and when further transactions occur, if we diligently follow this principle of double entry, ensuring the debits equal the credits, our balance sheet equation is maintained.*

Every journal entry has the following structure:

Date Brief transaction description Debit (Account name) Amount

Credit (Account name) Amount

Every entry must have:

- A serial number known as the transaction number – it helps in future references
- The date when this transaction happened
- A brief description of the transaction
- A debit entry including the account name and the amount
- A credit entry including the account name and the amount, *with an indent.*

Bala Sir continued:
The accountants developed these universal rules, followed all over the world, keeping in mind the importance of maintaining the integrity of the balance sheet equation at all times. In summary:

1. The integrity of the balance sheet equation must be maintained while recording each and every transaction. This is realised through the *double entry system*, for each transaction, at least two entries (debit and credit) must be made, for retaining the balance.
2. We have also seen that the date of the transaction plays an important role. For example, on the day, a business takes some loan from a bank with interest, it has no interest payable, but as days pass, interest starts accruing and a liability arises. Therefore, we must also keep record of the date of the transaction.
3. We have also seen that we need to keep track of different accounts, like cash for example. We need to assign appropriate names for different accounts, and keep track of all changes in each of these accounts.

In order to ensuring that these requirements are fulfilled, accountants have developed a system of recording all transactions using journal entries and T accounts.
We have already seen the journal entries for the first transaction, when the ladies brought in Rs. 6000 each to start APS. Now we shall see the corresponding T Accounts.

A T-account looks like this:

Name	
Debit	Credit

For the first transaction, we make the following entries into the respective T Accounts:

Cash	
Debit	Credit
60,000 (1)	

Shareholders' Equity	
Debit	Credit
	60,000 (1)

Please note that we created a T-account for each item – Cash and Shareholders' Equity. The respective amounts are noted under the appropriate column – Debit or Credit. The corresponding transaction number is noted within bracket, for ease of traceability.
This was quite understandable, felt the ladies. Bala Sir also felt relieved, and suggested that they would take up (on the next session) the journal entries and T-Accounts for all the transactions of APS, they had in the month of October.