COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | BASIC

Video Transcription: Processing Business Information: Source Document to Ledger Account

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Hi, my name is Don. This video is going to look at how information from business transactions is processed in the accounting system. The video will specifically focus on how information from a source document is recorded via a journal entry.

Remember, the term “recording” describes how the financial information that arises from each business transaction is captured in the accounting records of the business. A more familiar term to describe this process is “bookkeeping”. So how would a business know that a transaction has occurred and that financial information needs to be processed?

Well, each transaction will generate a document which is proof that a transaction has actually happened. The document contains details of the transaction, such as who the business transacted with, the amount of the transaction, what was purchased, sold, provided to or by the business. In other words, the information provided on the document allows the business to identify whether the business’ assets, liabilities and/or equity have been affected and whether the assets/liabilities and/or equity have increased or decreased.

These documents are known as “Source Documents” and are the first stage of the recording or bookkeeping system. In the second stage the information from a source document is entered via a journal entry. So what is a journal entry? A journal entry is an accounting record that indicates the effect of a transaction on the elements of the accounting equation.

Let’s process a journal entry for the following transaction: The source document indicates that on 10 January the business purchased a vehicle from Auto Dealers for R150 000 on credit. This means that the business acquired a vehicle for R150 000 and has an obligation to pay Auto Dealers R150 000.

Thus, the effect on the elements of the accounting equation is as follows: Increase assets by R150 000, being the vehicle acquired and increase liabilities by R150 000, being the amount owed to Auto Dealers. The accounting system, however, uses the terms debit and credit to indicate whether assets, liabilities and/or equity increase or decrease, so the following journal entry will be processed:

- Debit vehicles, which is an asset, by R150 000
- Credit Auto Dealers, which is a liability, by R150 000

Normal bookkeeping practice is to record the debit entry as the first line of any journal entry and the credit entry as the second line. Each journal entry has a brief description that includes sufficient information about the entry to allow anyone who refers to the journal, to know why the journal entry has been prepared. This description is referred to as a “narration”.

Journal entries allow us to record the double entry, that occurs with respect to each transaction, and to ensure that for each transaction, the debit entry equals the credit entry. This ensures that assets equal equity plus liabilities after each transaction (or you could say that the accounting equation balances).

Students often say that they do not understand how to prepare journal entries but what is generally the problem is that students do not understand how the transaction impacts on the accounting equation (in other words, how does the transaction affects assets, liabilities and equity?).

Let's look at a second source document and prepare the journal entry to record this transaction.

On 31 December the financial year end, the business receives an invoice of R3 200 from Windowash for the cleaning of the office windows during December. This amount will be paid in January.

So, the business owes Windowash for cleaning the office windows, thus an increase in a liability of R3 200 is recorded. No other liability or asset has changed so a decrease in equity of R3 200 is recorded. As this is not a transaction with the owner we recognise this decrease in equity as an expense. So the journal entry will be as follows:

- Debit cleaning expense, which is equity with R3 200
- Credit Windowash, which is a liability, with R3 200

The narration will indicate that at the year end the company had received services for which they had not yet paid. So each business transaction has a source document that is proof of the transaction and is used so the effect of each transaction on assets, liabilities and equity is recorded.

Now what happens if the business wants to know how much cash it has in the bank or how much it owes its trade payables? If the business wants to know how much it owes to trade payables, imagine looking through all the journal entries to find those related to trade payables to work out what the business owes – that's not very efficient.

This would be similar to a supermarket piling all of its products together so you have to sift through them all to find what you needed. Shops organise their items by placing similar items together so it is easy for customers to find what they need.

Well, the ledger, which is the third stage of the accounting or bookkeeping system, has a similar role in accounting. You can think of a ledger as a way of organising the information for individual assets, liabilities or equity. The ledger does this by having a separate storage area, known as an account, for each asset, liability and equity item. The business can then record all the transactions that impact on a particular asset, liability or equity item in its own account.

A ledger account is a record of all the debit and credit entries that affect individual asset, liability or equity items

Let's look at the vehicle example again: The ledger will have separate accounts for Vehicles and Auto Dealers. The left hand side of the account will record all the debit entries that affect the item, and the right hand side of the account will record all the credit entries that affect that item.

The information in the journal entry is posted to the ledger. It is important that you remember that the journal entry indicates the effect of a transaction on the elements of the accounting equation.

- So, the first line of the journal entry indicates a debit in the Vehicles account of R150 000 (in other words an increase in an asset).
- The second line of the journal entry indicates a credit in the Auto Dealers account of R150 000 (in other words an increase in a liability).

Finally, in order to complete recording the transaction in the ledger we need to show the "contra", or other account, that has been used. In other words, in the Vehicles ledger account, the contra account is Auto Dealers, and in the Auto Dealers account, the other account is Vehicles.

Once you feel confident with these principles please watch the next video which is on "balancing ledger accounts". I hope this video, in some way, has been of some help to you. Thank you for watching.