

BASIC ACCOUNTING TERMS

There are certain basic accounting terms which are daily used in the business world. Before recording the transactions in the books, it is essential to understand these terms as these terms have their specific meaning in Accounting. These basic terms are called **accounting terminology** :

(1) **Business Transaction** :— A business transaction is an economic activity of the business that changes its financial position. Whenever any business transaction takes place, it results in a change in the values of some of the assets, liabilities or capital.

The chief features of a transaction are :

- (i) It involves an economic activity. For example, when goods are purchased or sold for cash or on credit or when salaries are paid to employees or when interest is paid on money borrowed from the bank, a business transaction takes place. Social activities are not considered as transactions. For example if X purchases a gift for his friend, it will not be considered as a transaction because it is social engagement.
- (ii) Transactions may be classified into two types — external and internal. External transactions are those which involve economic activities between two independent business entities such as purchase or sale of goods. Internal transactions are those economic activities that take place entirely within one business entity such as depreciation charged on fixed assets.
- (iii) It results in a change in the financial position of the firm — a change in the values of some of the assets, liabilities or capital.
- (iv) The change must be capable of being expressed in terms of money. Loss of goods by fire or the loss due to a customer's inability to pay are transactions because the losses can be measured in terms of money. However, when an efficient manager retires from the firm, the loss to the business may be quite large, but since it cannot be measured in terms of money, it will not be a business transaction.

(2) **Event** :— An event is the consequence or result of a transaction. For example :

Sachin starts a business with a Capital of ₹5,00,000. He purchases goods for ₹4,00,000 for Cash and sells 3/4th of these goods for ₹3,80,000. He also pays ₹20,000 as rent of the godown.

The following results can be drawn from the above :

1. **Transactions are :**

- (a) Investment of ₹5,00,000 in the business.
- (b) Purchasing of goods for ₹4,00,000.
- (c) Making Cash Sales of ₹3,80,000.
- (d) Payment of godown rent ₹20,000.

2. **Events are :**

- (a) Profit of ₹60,000 computed as under :

		₹
Sales		3,80,000
Cost of Purchases : 3/4 of ₹4,00,000		3,00,000
Add : Godown Rent		20,000
		<u>60,000</u>

- (b) Closing Inventory of ₹1,00,000 computed as under :

		₹
1/4 of ₹4,00,000		<u>1,00,000</u>

- (c) Cash balance of ₹4,60,000 computed as under :

		₹
Capital Contribution		5,00,000
Add : Cash Sales		3,80,000
		8,80,000
Less : Cash Purchases		4,00,000
Godown Rent		20,000
		<u>4,20,000</u>
		<u>4,60,000</u>

- (d) Capital of ₹5,60,000 computed as under :

		₹
Initial Capital Contribution		5,00,000
Add : Profit		60,000
		<u>5,60,000</u>

(3) **Voucher** :— A voucher is a document which provides the authorisation to pay and on the basis of which the business transactions are, first of all, recorded in the books of accounts. A separate voucher is prepared for each transaction and it specifies the accounts to be debited or credited. The form of a voucher varies from firm to firm since vouchers are printed separately by different firms in their own names. Vouchers are prepared by accountant and each voucher is numbered and countersigned by an authorised person of the firm.

(4) **Capital** :— It refers to the amount invested by the proprietor in a business enterprise. It is the amount with the help of which goods and assets are purchased in the business. As such, in order to calculate the amount of capital all current assets and fixed assets are added up and external liabilities are deducted out of it.

For example, suppose that the following balances appeared in the books of a firm :— Cash ₹20,000; Machinery ₹50,000; Stock ₹1,00,000; Debtors ₹40,000 and Creditors ₹30,000. In this case the Capital will be :—

Capital = Cash ₹20,000 + Machinery ₹50,000 + Stock ₹1,00,000 + Debtors ₹40,000 – Creditors ₹30,000 = ₹1,80,000.

Capital is also known as Owner's Equity or Net Worth or Net Assets.

(5) **Assets** :— Anything which is in the possession or is the property of a business enterprise including the amounts due to it from others, is called an asset. In other words, anything which will enable a business enterprise to get cash or a benefit in future is an asset. Thus, Cash and Bank balances, Stock, Furniture, Machinery, Land and Building, Bills Receivable, Money owing by Debtors etc. are all assets.

“Assets are future economic benefits, the rights of which are owned or controlled by an organisation or individual.” — **Finney & Miller**

“Assets are valuable resources owned by a business which are acquired at a measurable money cost.” — **Prof. R.N. Anthony**

According to the above definitions there are three main characteristics of an asset :—

- I. The resources must be valuable.
- II. The resources must be owned by the business.
- III. The resources must be acquired at a measurable money cost.

Assets may be classified into the following categories :—

(i) **Fixed Assets** :— Fixed assets refer to those assets which are held for continued use in the business for the purpose of producing goods or services and are not meant for sale. Examples of fixed assets are long-term investments, Land and Building, Plant and Machinery, Computer, Motor Vehicles, Furniture etc.

Fixed assets are further classified into :

(a) **Tangible Assets** :— Tangible assets are those assets which can be seen and touched. In other words, which have a physical existence such as Land & Building, Plant & Machinery, Computer, Motor Vehicles, Furniture, Stock, Cash etc.

(b) **Intangible Assets** :— Intangible assets are those assets which do not have a physical existence and thus, cannot be seen or felt. Examples of such assets are Goodwill, Patents, Copyright, Trade Marks, Computer Software and Prepaid Expenses. Intangible assets are also valuable assets. For example, with the help of Patents (know-how) businessman is able to produce goods and his goodwill helps in attracting customers easily. Therefore the intangible assets help the firm in earning profits as much as the tangible assets. Hence, both tangible and intangible are valuable assets. Value of intangible assets is based on the benefit and facility available to the business from such assets.

(ii) **Current Assets** :— Current assets are those assets which are meant for sale or which the management would want to convert into cash within one year. As such, these assets are also termed as ‘Short-lived or active assets’. For example, ‘Debtors’

are expected to be converted into cash within a reasonable short period, Stock is continuously sold and Bills receivables are also converted into cash.

According to **The Institute of Certified Public Accountants, U.S.A.** "Current assets include cash and other assets or resources commonly identified as those which are reasonably expected to be realised in cash or sold or consumed during the normal operating cycle of the business."

Although 'Prepaid Expenses' will never be realised in Cash, these are also included in Current Assets, since service or benefit will be available against these without further payment.

Current assets are also known as floating assets or circulating assets as the amount and nature of such assets keeps changing continuously. For example, a businessman purchases goods for cash and these goods are sold to X on Credit, X becomes our Debtor and it means that the stock has been converted into 'Debtors'. Again, if a bill receivable is received from X, it means that the Debtors are converted into 'Bills Receivable' and after some time Bills Receivable will be converted into Cash. It shows that all Current assets are finally converted into Cash.

Current assets are usually shown in the balance sheet in the 'Liquidity Order'. Liquidity is the facility with which the asset may be converted into cash. Those assets which are most difficult to be converted into cash are written last. Following are the Current assets in order of liquidity :— Cash in Hand, Cash at Bank, Bills Receivable, Short Term Investments, Debtors, Stock and Prepaid Expenses.

Out of the above assets, Stock and Investments are shown in the balance sheet at **Cost or realisable value whichever is less.** Bills Receivable and Debtors are shown at the estimated realisable values and the Cash in Hand and Cash at Bank are shown at the actual figure.

(iii) **Liquid Assets** :— Liquid assets are those which are either in the form of cash or can be quickly converted into cash, such as Cash, Bills Receivable, Short Term Investments, Debtors, Accrued Income etc. In other words, if Prepaid Expenses and Closing Stock are excluded from Current Assets, the balance will be Liquid Assets.

(iv) **Wasting Assets** :— Wasting assets are those assets which are consumed through being worked or used, such as mines. As soon as all the minerals have been extracted, the mine becomes valueless. Oil wells have the same characteristics. Wasting assets also include assets which get exhausted with the lapse of time, such as Patents, Trade Marks, Leasehold Properties etc.

(v) **Fictitious or Nominal Assets** :— These are the Assets which cannot be realised in Cash or no further benefit can be derived from these assets. Such assets include Debit balance of P & L A/c and the expenditure not yet written off such as Advertisement Expenses etc. These assets are not really assets but are shown on the Assets side only for the purpose of transferring them to the Profit & Loss Account gradually over a period of time.

(6) **Liability** :— It refers to the amount which the firm owes to outsiders (excepting the amount owed to proprietors). In the words of Finney and Miller, "Liabilities are debts, they are amounts owed to Creditors." This can be expressed as:

$$\text{Liabilities} = \text{Assets} - \text{Capital}$$

Thus, when a firm purchases goods on credit from A, the amount owing to A is a liability. Likewise when a bank account is overdrawn, the amount owing to the bank (i.e., bank overdraft) is known as a liability. Likewise the Bills Payable, Creditors, Unpaid Wages are also the examples of liabilities.

Liabilities may be divided into two parts :

(i) **Internal Liabilities** :— All amounts which a business entity has to pay to the proprietor or owners are internal liabilities such as capital and accumulated profits.

(ii) **External Liabilities** :— All amounts which a business entity has to pay to outsiders are known as external liabilities such as creditors, bank overdraft, loans etc.

Liabilities may be further classified as under :—

(i) **Long-term Liabilities** :— These refer to those liabilities which fall due for payment in a relatively long period (normally after more than one year). For example, Long Term Loans and Debentures etc.

(ii) **Current Liabilities** :— Current liabilities refer to those liabilities which are to be paid in near future (normally within one year). For example, Bank Overdraft, Bills Payable, Creditors, Outstanding Expenses and Short Term Loans etc.

(iii) **Contingent Liabilities** :— These are not the actual liabilities on the date of Balance Sheet, but may become payable only on the happening of some specific event. Examples are :—

(I) **Bills Discounted but not matured** :— The firm will become liable to pay the amount of such a Bill only if an acceptor dishonours the bill accepted by him on the due date.

(II) If a suit against the firm is pending in the court, the actual liability in this respect will arise only if the suit is decided against the firm.

(III) If the firm has given a Guarantee for another person, the actual liability in this respect will arise only if the person for whom the guarantee is given fails to meet his obligation.

Treatment in Final Accounts :— Contingent Liabilities are not recorded in the books. These will be stated only outside the Balance Sheet as a footnote.

(7) **Trade Receivables** :— Trade receivables refer to the amount receivable on account of sale of goods or services rendered by the company in the normal course of business.

Trade receivables include both Debtors and Bills Receivables.

Debtors :— The term 'Debtors' represents those persons or firms to whom goods have been sold or services rendered on credit and payment has not been received from them. They still owe some amount to the business. For example, if goods worth ₹50,000 have been sold to Mohan on Credit, he will continue to remain the debtor of the business so long as, he does not make the full payment.

Bill Receivable :— A bill of exchange becomes bill receivable for the person who draws it (drawer) and gets it back, after its acceptance from the drawee. Thus bill receivable is an accounting term for bills of exchange drawn on debtors or received by way of endorsement from them. The amount specified in such a bill is receivable at a future date.

(8) **Trade Payables** :— Trade payables is the amount payable on account of goods purchased or services taken in the normal course of business.

Trade Payables include both 'Creditors' and 'Bills Payables'.

Creditors :— The term 'Creditors' represents those persons or firms from whom goods have been purchased or services procured on credit and payment has not been made to them. Some money is still owing to them. For example, if goods worth ₹50,000 are purchased from Govind on Credit, he will continue to remain the creditor of the firm so long as, the full payment is not made to him.

Bill Payable :— A bill of exchange becomes bill payable for the person who accepts it (drawee) and returns it to the drawer. Thus bills payable is an accounting term for bills of exchange accepted in favour of creditors. The amount specified in such a bill is payable at a future date.

(9) **Purchases** :— The term purchases is used only for the purchase of 'Goods' in which the business deals. In case of a manufacturing concern 'goods' means acquiring of raw material for the purpose of conversion into finished product and then sale. In case of trading concern 'goods' are those things which are purchased for resale. In both the cases the purpose is to make a profit by its resale. For example, if a cloth dealer purchases cloth for sale, the cloth so purchased will be called 'goods'. However, if the same cloth dealer purchases furniture for seating the customers, such furniture will not be termed as goods, but it will be an 'Asset' and a separate account named 'Furniture Account' will be opened for it.

The term purchases includes both cash purchases and credit purchases of goods.

Purchase Returns :— When purchased goods are returned to the suppliers these are known as purchase returns. Such returns are also termed as 'returns outwards'.

(10) **Sales** :— Sales means transfer of ownership of goods or services to customers for a price. For example, If Tarun sells a Computer to Varun, the ownership of Computer will be transferred from Tarun to Varun and Tarun is entitled to receive the agreed price of Computer from Varun. The term 'sales' is used only for the sales of those goods which are purchased for resale purposes. It also includes revenues from services provided to customers. The term 'sales' is never used for the sale of assets. For example, if a cloth dealer sells cloth, it will be termed as sales, but if the same cloth dealer sells old furniture or a typewriter, it will not be termed as sales.

The term sales includes both Cash and Credit sales.

Sales Returns :— Some customers might return the goods sold to them. These are termed as sales returns or 'returns inwards'.

(11) **Goods** :— Goods include all those things which are purchased for resale or which are used for producing the finished products which are also meant to be sold. Thus, for a furniture dealer purchase of chairs and tables is termed as goods, while for others it is furniture and is termed as an asset. Similarly, for a stationery trader, stationery is goods, whereas for others it is expense.

(12) **Stock or Stock-in-trade** :— The term 'stock' includes the value of those goods which are purchased for reselling and which are lying unsold at the end of accounting period. The Stock may be of two types:—

(i) Opening Stock, (ii) Closing Stock.

The term 'Opening Stock' means the value of goods lying unsold at the beginning of the accounting period whereas the term 'Closing Stock' means the value of goods lying unsold at the end of the accounting period.

(13) **Inventory** :— In case of a manufacturer, there can be opening and closing inventory of four types :—

(i) **Inventory of Raw Material** :— It includes inventory of raw materials purchased for using them in the products manufactured but still lying unused. For example, the value of cotton in case of cloth mills is the inventory of raw material.

(ii) **Inventory of Work-in-progress** :— It is also termed as inventory of partly finished goods. It means goods in semi-finished form. Such goods need further processing for converting into finished products. For the valuation of work in progress, the value of raw materials used in it, the cost of labour, power, fuel and other expenses on proportionate basis are included. In case of cloth mills the value of threads and the unfinished cloth will be the inventory of work in progress.

(iii) **Inventory of Finished Goods** :— It includes the stock of those goods which have been completely processed and are ready for sale but are lying unsold at the end of the accounting period. In case of cloth mills the value of finished cloth will be the value of inventory of finished goods.

(iv) **Inventory of Stock-in-trade** : It includes the value of those goods which are purchased for reselling.

Calculation of Closing Inventory :— To ascertain the value of the closing inventory, a complete list of all the items in the godown together with their quantities is prepared. Also the separate lists should be prepared for raw materials, semi-finished goods, finished goods and stock-in-trade.

Care should be taken that the following goods are not included in the list of inventory :—

- I. Goods which have been sold but remain undelivered.
- II. Goods purchased and received but which have not been recorded in the purchase book.

Following goods should be included in the list of inventories :—

- I. Goods sent to the customers on sale or return basis.
- II. Goods sent to the agents for sale but remain lying with them as unsold.

It should always be kept in mind that inventory is valued at cost price or realisable value, whichever is less.

Distinction between Stock and Inventory :

Stock refers only to the value of those goods which are purchased for reselling and which are lying unsold at the end of the accounting period. Whereas the Inventory is a wide term which includes stock also. Thus the Inventory includes the following :

- (i) Inventory of Raw Material
- (ii) Inventory of Semi-Finished Goods
- (iii) Inventory of Finished Goods
- (iv) Inventory of Stock

(14) **Profit** :— It is the excess of total revenues over total expenses of a business enterprise for an accounting period. Profit increases the investment of the owners.

(15) **Loss** :— The term conveys two different meanings. First, it conveys the result of the business for a period when total expenses exceed the total revenues. For example, if revenues are ₹2,00,000 and expenses are ₹2,40,000, the loss will be ₹40,000. Second, it refers to some fact or activity against which firm receives no benefit. For example, loss due to fire, theft, accident etc. It may be noted that losses differ from expenses. Expenses are incurred to generate revenues whereas losses do not. For example, the theft of an asset is a loss but its depreciation is an expense.

(16) **Expenses** :— Expense is the cost incurred in producing and selling the goods and services. According to **Finney and Miller**, “Expense is the cost of use of things or services for the purpose of generating revenue”.

Following are included in the term Expenses :—

- I. Cost of goods sold.
- II. Amount paid for Rent, Commission, Salary, Advertisement etc.
- III. Decline in the value of an asset caused by the use of such asset for business purpose or depreciation is also an expense.

(17) **Expenditure** :— Any disbursement of cash or transfer of property or incurring a liability for the purpose of acquiring assets, goods or services is called expenditure. It means that any type of payment for the receipt of a benefit is termed as expenditure. Expenditure may be classified into two categories : (i) Capital expenditure and (ii) Revenue expenditure.

(i) **Capital Expenditure** :— Any expenditure which is incurred in acquiring or increasing the value of a fixed asset is termed as capital expenditure. As such, the amount spent on the purchase or erection of Building, Plant, Furniture etc. is capital expenditure. Such expenditure yields benefit over a long period and hence written in Assets.

(ii) **Revenue Expenditure** :— Any expenditure, the full benefit of which is received during one accounting period is termed as revenue expenditure. As such, all the revenue expenditures are debited to Trading and Profit & Loss Account. Such expenditure does not result in an increase in the earning capacity of the business but only helps in maintaining the existing earning capacity. It also does not bring into existence an asset of an enduring nature.

(18) **Revenue** :— Revenue in accounting means the income of a recurring (regular) nature from any source. It consists of the amount received from sale of goods and from service provided to customers. It also includes receipt of rent, commission, dividend, interest etc. Revenue is related with the day-to-day affairs of the business and should also be regular in nature. As such, the amount of capital introduced by the proprietor or borrowing loan is not revenue.

(19) **Income** :— ‘Income’ is different from ‘revenue’. Amount received from sale of goods is called ‘Revenue’ and the cost of goods sold is called ‘Expense’. Surplus of revenue over expenses is called ‘Income.’ For example, the goods costing ₹4,00,000 are sold for ₹5,00,000. The sale amounting to ₹5,00,000 is the revenue, the cost

amounting to ₹4,00,000 is expense and the difference between the two *i.e.* ₹1,00,000 is the income. It can thus, be expressed as :

$$\text{Income} = \text{Revenue} - \text{Expense}$$

(20) **Drawing** :— Any cash or value of goods withdrawn by the owner for personal use or any private payments made out of business funds are called drawings.

Other Important Accounting Terms :

21. **Entry** : When a transaction or event is recorded in the books of accounts, it is called 'entry'.
22. **Bad Debts** : It is the amount that has become irrecoverable from a debtor. It is a business loss and is debited to Profit & Loss Account as an expense.
23. **Insolvent** : A person or an enterprise which is not in a position to pay its debts is called insolvent.
24. **Solvent** : A person or an enterprise which is in a position to pay its debts is called solvent.
25. **Stores** : The term 'stores' is used to denote materials held by an enterprise for the purpose of consumption in the business and not for resale. Examples are lubricants, spare parts of machinery, packing materials etc.
26. **Entity** : An entity or business entity means an economic unit which is formed for earning income by providing service or selling goods (for example L.G. Electronics, Wipro, Maruti Suzuki etc.)
27. **Turnover** : Turnover means total sales made in a particular period.
28. **Livestock** : Domestic animals, such as cattle or horses are known as livestock.
29. **Investments** : Investment refers to deployment of funds in the shares or debentures of Companies with the intention of earning a return.
30. **Goods & Service Tax (GST)** : All indirect taxes like Excise Duty, Sales Tax, VAT, Service Tax etc. have been merged into a single tax known as GST. GST is paid at the time of purchase and GST is collected at the time of sale.

ESSAY TYPE QUESTIONS

1. What is a business transaction? What are its characteristics?
2. Define Assets. Explain the types of assets.
3. What is 'Stock'? Explain its types. How is it valued?

SHORT ANSWER QUESTIONS

1. Give any three examples of revenues.

Ans. (i) Amount received from sale of goods;
 (ii) Amount received from providing service to customers;
 (iii) Receipts of commission, interest, rent etc.

2. Distinguish between debtors and creditors.

Ans. Debtors are the persons who owe an amount to the enterprise for the goods sold or service provided to them on credit whereas creditors are the persons who are to be paid an amount by the enterprise for buying from them goods or services on credit.

3. Distinguish between profit and gain.

Ans. Profit is the excess of revenues over expenses during an accounting period. It is the result of business transactions which are of regular nature whereas gain arises from events or transactions which are incidental to business such as sale of a fixed asset or winning a lottery prize.

4. What are Current Assets?

Ans. Current Assets include Cash and other assets which are expected to be converted into Cash within a short period (normally within one year).

5. What are Current Liabilities?

Ans. Current liabilities refer to those liabilities which are to be paid in near future (normally within one year).

6. Give two examples of Current Assets.

Ans. (i) Cash; (ii) Inventory

7. Give two examples of Tangible Assets.

Ans. (i) Land and Building; (ii) Inventory

8. Give two examples of Intangible Assets.

Ans. (i) Goodwill; (ii) Prepaid Expenses.

9. Give two examples of Current Liabilities.

Ans. (i) Creditors; (ii) Bills Payable

10. Distinguish between non-current assets and current assets.

Ans. Non-current assets refer to those assets which are held for continued use in the business and are not meant for resale whereas current assets are either meant for sale or which are expected to be converted into cash within one year.

11. Distinguish between revenue expenditure and capital expenditure.

Ans. If the benefit of an expenditure is exhausted within a year, it is treated as revenue expenditure (also called expense). On the other hand, if the benefit of an expenditure lasts for more than a year it is treated as capital expenditure (also called an asset). (Delhi 2016)

12. Distinguish between expenses and expenditure.

Ans. Expense is the cost incurred in producing and selling the goods and services. Thus it includes cost of goods sold and amount paid for salaries, rent, commission etc. On the other hand, expenditure is a wider term which includes expenses also. Expenditure is the amount spent for acquiring assets, goods and services.

13. Distinguish between expenses and losses.

Ans. If the benefit of an expenditure is exhausted within a year it is called expense whereas excess of expenses of a period over its related revenues is termed as loss.

14. Give two characteristics of a business transaction.

Ans. (i) It results in a change in the financial position of the firm, i.e. a change in the values of some of the assets, liabilities or capital.

(ii) The change must be capable of being expressed in terms of money.

5. Current assets do not include :
- (A) Debtors (B) Motor Car
(C) Bank Balance (D) Prepaid Expenses
6. Tangible Assets do not include :
- (A) Goodwill (B) Furniture
(C) Stock (D) Cash
7. Which of the following will be treated as drawings :
- (A) Withdrawing money for payment of salary to employees
(B) Withdrawing money for payment to creditors
(C) Withdrawing money from business for private expenses
(D) Withdrawing money for purchase of asset
8. Main feature of business transaction is :
- (A) It involves an economic activity
(B) It results in a change in the financial position of the firm
(C) Change must be capable of being expressed in terms of money
(D) All of the above
9. Current Liabilities do not include :
- (A) Bills Payable (B) Creditors
(C) Outstanding Exp. (D) Debentures
10. Purchases refers to the buying of
- (A) Stationery for office use (B) Assets for the factory
(C) Goods of resale (D) Investment
11. The term sales is used only for the sales of and is never used for the sale of
- (A) Assets, Investments (B) Assets, Goods
(C) Intangible Assets, Goods (D) Goods, Assets
12. Out of the following assets which one is NOT an intangible asset?
- (A) Patents (B) Investments
(C) Goodwill (D) Trademark
- (CA-CPT June, 2013)
13. At the end of financial year, during which sale of goods was worth ₹5,00,000, the closing stock is valued at ₹20,000. This is
- (A) An event
(B) A transaction
(C) Both an event as well as transaction
(D) None of (A) and (B)
14. Which of the following is the Capital expenditure?
- (A) Wages paid for repair of building
(B) Wages paid for white washing of building
(C) Wages paid for construction of building
(D) Wages paid for cleaning of building
15. Consider the following items :
- | | |
|----------------------|----------------------------------|
| 1. Prepaid Salary | 2. Accrued Interest (Receivable) |
| 3. Loan (Short term) | 4. Bank Overdraft |

1.14

EVOLUTION OF ACCOUNTING AND BASIC ACCOUNTING TERMS

Current Liability would include :

(A) 1, 2, 3, 4

(B) 2, 3, 4

(C) 4, 3, 1

(D) 3, 4

(CA-CPT, June 2013)