Basic Accounting Terms

LEARNING OBJECTIVES

After studying this Chapter, you should be able to understand :

1. Business Transaction and its Main Features
2. Event
3. Account
4. Meaning of Capital
5. Meaning of Drawings
6. Meaning of Liability
7. Meaning, Definition and Types of Assets
8. Receipts
9. Meaning of Expenditure
10. Meaning of Expenses
11. Meaning of Income
12. Meaning of Profit
13. Meaning of Gain
14. Meaning of Loss
15. Meaning of Purchases
16. Meaning of Sales
17. Stock and its Types
18. Meaning of Trade Receivables (Debtors and Bills Receivables)
19. Meaning of Trade Payables (Creditors and Bills Payables)
20. Meaning of Goods
21. Meaning of Cost
22. Meaning of Voucher
23. Discount and its Types

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	3,20,000
		60,000

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

	₹
1/4 of ₹4,00,000	1,00,000

(*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	4,20,000
			4,60,000

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

	₹
Initial Capital Contribution	5,00,000
Add : Profit	60,000
	5,60,000

(3) **Account** :— In actual practice, the individual transactions of like nature are recorded, added and subtracted at one place. Such place is customarily termed as an 'Account'. Prior to understanding the meaning of debit and credit, it is essential to understand the meaning and form of an Account.

An account is a record of all business transactions relating to a particular person or item. In accounting we keep a separate record of each individual, asset, liability, expense or income. The place where such a record is maintained is termed as an 'Account'. Such as the Account of Ghanshyam, the Account of Ram, the Account of Machinery, the Account of Salary, the Account of rent and likewise. All transactions entered into with Ghanshyam will be recorded in the Account of Ghanshyam and similarly, all transactions relating to Ram will be recorded in the Account of Ram. According to Carter :

"An Account is a ledger record in a summarised form, of all the transactions that have taken place with the particular person or things specified." — **Carter**

All accounts are divided into two sides. The left side of an account is arbitrarily or traditionally called Debit side and the right side of an account is called Credit side. In the abbreviated form, Debit is written as Dr. and Credit is written as Cr. For example, the transactions relating to cash are recorded in an account, entitled 'Cash Account' and its format will be as given below :—

Debit (Dr.) CASH ACCOUNT Credit (Cr.)

	₹		₹

The above account resembles English capital letter 'T'. As such, it is often called 'T' shape account. An Account is abbreviated as A/c.

(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.

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

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) **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.

(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 :

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

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 into two parts as under :—

(*i*) **Non-Current 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.

(7) **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*) **Non-Current Assets** :— Non-Current 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 non-current assets are long-term investments and fixed assets such as Land and Building, Plant and Machinery, Computer, Motor Vehicles, Furniture etc.

Fixed Assets are futher 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*) **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.

(8) **Capital Receipts and Revenue Receipts** :— It is also necessary to make a proper distinction between capital receipts and revenue receipts because the revenue receipts are shown on the credit side of Trading and Profit & Loss Account whereas the capital receipts are shown in the Balance Sheet either as increase in liabilities or as reduction in the value of the assets.

Capital Receipts :

Examples of capital receipts are :

(*i*) Amount received from the sale of fixed assets or investments.
(*ii*) Capital contributed by proprietors, partners or money obtained from issue of shares and debentures in case of company.
(*iii*) Amount received by way of loans.

Revenue Receipts :

(*i*) Money obtained from sale of goods.
(*ii*) Commission and fees received for services rendered.
(*iii*) Interest and dividend received on investments.

(9) **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 three categories : (*i*) Capital expenditure, (*ii*) Revenue expenditure and (*iii*) Deferred 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.

Distinction between Capital Expenditure and Revenue Expenditure :—

I. Capital expenditure is incurred for the acquisition or erection of a fixed asset, whereas revenue expenditure is incurred for the day to day running of the business.

II. Capital expenditure is incurred for the purpose of increasing the earning capacity of the business, whereas revenue expenditure is incurred for maintenance of earning capacity *i.e.*, for keeping the assets in an efficient working order.

III. Capital expenditure yields benefit normally over a long period, whereas revenue expenditure yields benefit for a maximum period of one year.

IV. Capital expenditure is written in the balance sheet, whereas revenue expenditure is written in Trading or Profit & Loss Account.

(*iii*) **Deferred Revenue Expenditure** :— There are certain expenditures which are revenue in nature but the benefit of which is likely to be derived over a number of years. Such expenditures are termed as 'Deferred Revenue Expenditures'. The benefit of such an expenditure generally lasts between 3 to 7 years. As such, the whole of such expenditure is not debited to the Profit and Loss Account of the current year but spread over the years for which the benefit is likely to last. Thus, only a part of such expenditure is taken to Profit & Loss Account every year and the unwritten off portion is allowed to stand on the assets side of the Balance Sheet. For example, a firm spent a huge amount of ₹2,00,000 on advertising to introduce a new product in the market and it is estimated that its benefit will last for 4 years. In this case, ₹50,000 will be charged to the P & L A/c of each year for four consecutive years.

₹50,000 will be debited to P & L A/c of each year and the balance will be treated as an asset and shown on the Assets side of the Balance Sheet. As such, the amounts shown on the Assets side will be ₹1,50,000 in the first year, ₹1,00,000 in the second year and ₹50,000 in the third year.

(10) **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.

(11) **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 :

Income = Revenue – Expense

(12) **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.

(13) **Gain** :— It is a monetary benefit, profit or advantage resulting from events or transactions which are incidental to business such as sale of fixed assets, winning a court case or appreciation in the value of an asset. For example, if a building costing ₹10,00,000 is sold for ₹12,00,000; ₹2,00,000 will be the gain on sale of building.

(14) **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.

(15) **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'.

(16) **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'.

(17) **Stock or Inventory** :— The term 'stock' includes the value of those goods 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.

Types of Stocks :— In case of a manufacturer, there can be opening and closing stocks of three types :—

(*i*) **Stock of Raw Material** :— It includes stock 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 stock of raw material.

(*ii*) **Stock of Work-in-progress** :— It is also termed as stock 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 stock of work in progress.

(*iii*) **Stock 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 finished goods.

Calculation of Closing Stock :— To ascertain the value of the closing stock, 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 and finished goods in the stores. Preparation of such lists is called 'stock taking'.

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

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 stocks :—

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 stock is valued at cost price or realisable value, whichever is less.

(18) **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.

(19) **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 'Sundry 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 ₹20,000 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.

(20) **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.

(21) **Cost** :— Cost can be termed as the amount of resources given up in exchange for some goods or services. The resources given up are money or money's equivalent expressed in terms of money. The Chartered Institute of Management Accountants (CIMA), London has defined the term cost as follows "Cost is the amount of expenditure (actual or notional) incurred on, or attributable to a specified thing or activity." The specific thing or activity may be a product, service or any activity.

For example, cost of Machinery will include purchase price, freight and installation expenses etc. Further, the expenditure incurred may be actual or notional. The amount spent on the purchase of raw materials is the actual expenditure whereas notional expenditure is one which does not involve any cash outlay. Notional expenditure is conceptual and deemed to have been incurred, e.g. rent of owned factory, interest on owned capital etc.

(22) **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.

(23) **Discount** :— It is a rebate or an allowance given by the seller to the buyer. It is of two types :

(*i*) **Trade Discount** :— When discount is allowed by a seller to its customers at a fixed percentage on the list or catalogue price of the goods it is called trade discount. It is not recorded in the books of accounts as it is deducted in the invoice or cash memo itself from the gross value of goods.

(*ii*) **Cash Discount** :— When discount is allowed to the customers for making prompt payment it is called cash discount. For example, if a seller allows 2% discount for payment within a week it will be called cash discount. It is always recorded in the books of accounts.

Other Important Accounting Terms :

(24) **Entry :** When a transaction or event is recorded in the books of accounts, it is called 'entry'.

(25) **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.

(26) **Insolvent :** A person or an enterprise which is not in a position to pay its debts is called insolvent.

(27) **Solvent :** A person or an enterprise which is in a position to pay its debts is called solvent.

(28) **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.

(29) **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.