BASIC ACCOUNTING CONCEPTS

**Revenue**

Whatever you receive through the sale of your goods and services.

You receive it in the form of cash/cheque/direct bank transaction (card).

You record it in your books as an asset because the money that you have received is yours.

The more you sell, the more revenue you have and the more your business grows over the period of time.

Normally, revenue is of two types: recurring and non-recurring.

Recurring revenue means whatever you receive from the primary course of your business. E.g. you have a stationery shop and whatever you earn by selling your stationery is your recurring revenue.

Non-recurring revenue means whatever money you earn once in a while. E.g. you have a stationery shop and once in a while during Diwali you sell fire crackers, so whatever money you are earning during the Diwali season in your non-recurring revenue.

**Expenditure**

Whatever cost you are incurring in running your stationery shop is called expenditure.

Normally, expenditure/expense is of two types: expired and unexpired.

Expired cost is that which you have already incurred, and it has already given you benefit for incurring that cost. E.g. the electricity bill you have paid for June month.

Unexpired cost is that which you have incurred but you are still benefitting from it. E.g. marketing expenses.

From accounting point of view, there are two types of expenditure: revenue expenditure and capital expenditure.

Revenue expenditure is that cost which you are incurring again and again for your regular revenues. E.g. you are paying your electricity bill every month for running you stationery shop.

Capital expenditure is that cost which you incur once in a while, and it is a huge amount. E.g. renovation of your stationery shop.

Present unexpired cost is the future expired cost

Total cost 5 cr

2010= 1cr

2011= 1cr

2012= 1cr

2013= 1cr

2014= 1cr

**Profit**

Profit is excess of revenue over my costs.

**Gross Profit**

All your revenue minus your expenses.

**Net Profit**

Gross Profit minus your taxes towards the govt.

E.g. whatever you have earned minus your expenses is your profit. But that is your gross profit, after that when you pay taxes to the govt based on your gross profit that is your net profit. So your net profit will be your actual profit.

**Liabilities**

Now you want to set up an additional shop for expanding, but you decide you are not going to take any funding from the general public. You decide to go to a financial institution or a bank to borrow money. You owe that money to the bank it is not yours to keep. You have to pay it back. These are known as your liabilities. Whatever you owe to anyone.

There are two types of liabilities: current and non-current

Current liabilities are the ones which you need to repay within one year. E.g. you got to the wholesaler and buy stationery from him on credit basis and you tell him I will pay you in instalments or you tell him I will pay you at the end of 2 months.

Non-current liabilities are the ones which you need to repay after on year. This may also go on for 5-10 years. E.g. the bank loan you borrowed that you will repay in 5 years. (Long term liabilities)

**Equity**

You invest some money to set up your stationery shop. That is your money. So in accounting terms it is known owner’s fund.

Now you are thinking of buying on more shop to expand your business. You need money for that. But you don’t have enough profits that you can set up the new shop on your own. So now you will ask people for money. When you ask them for money, they will ask for a part in your business. Because they are giving you their money so they want some returns on it and so they will ask for a part in your business. That part in your business is known as equity in accounting terms.

So in other words you own total 100 parts of your business. And then you borrowed money from 5 people and gave them 1 part each, so you gave away a total of 5 parts of your business. So now you own 95 parts of the business. (equity, shares, stocks)

**Assets**

Whatever you own in the business is termed as your asset. So basically, xerox machines, the shop premises, the furniture in it, the billing system in it. These are all your assets. Even the goods that you have in your shop they are known as inventory/stock in accounting terms and even these are your assets.

There are two main types of assets: current and non-current

Current assets are the ones where you will receive money within this year. E.g the stock of stationery items that you have in your shop to sell or inventory that you have to sell, you will sell them in this year itself. You will get the money in this year itself. E.g suppose you are the wholesaler and you decide to sell your goods on credit basis and give the repayment time of 2 months, so basically you will get the money in 2 months, in this accounting year itself.

Non-current assets are the ones where you will receive the money after this year. E.g the xerox machine you have in your shop, that machine will give you revenue for the next 20 years. E.g suppose you decide to invest a part of your profits in a fixed deposit for 5 years, that is an investment. (Long term assets)

**Debtors**

When I sell goods on credit, the person to whom I am selling on credit is known as debtor. He owes me the money.

They are the revenue because they owe you the money they will give you the money and so they are your assets.

**Creditors**

When I purchase goods on credit, the person from whom I am buying on credit is known as the creditor. I owe him the money.

I owe them the money I have to pay them the money and so they are my liabilities.

**Stock/Inventory**

Whatever goods you have in your shop is termed as inventory. You will sell them you will make money from them and so they are your assets.

**Bank Overdraft**

I have my shop’s bank account, and I keep on withdrawing money even after my own money in the bank account is finished, so basically, I am using the bank’s money. And so, I owe them. So, this withdrawing money again and again is known as bank overdraft. (Bank o/d) So this is your liabilities.

**Investments**

I am putting my money somewhere to gain returns. Short term investments where in you will get returns within the year. Medium term investments where you will get the returns within 5 years. Long term investments where you will get the returns after 5 years and above.

**Depreciation**

It is the fall in the value of asset over a period of time. Because of regular use, wear and tear. So at the end of 10 years when you sell your car you sell it at a loss. And you can never sell any used machine or asset at a profit. Except in case of land, property, flats, houses. There are two methods of depreciation: straight line method and diminishing vale method.

Straight line method: I have a machine worth 10 lacs. And it depreciates every year at the rate of 10% p.a.

2010= 10 lac \* 10%

2011= 10 lac \* 10%

2012= 10 lac \* 10%

2013= 10 lac \* 10%

2014= 10 lac \* 10%

This method is not really practical.

Diminishing value method: I have a machine worth 10 lacs. And it depreciates every year at the rate of 10% p.a.

2010= 10 lac \* 10% = 1 lac (Residual Value= 10 lac – 1 lac = 9 lac)

2011= 9 lac\* 10%= 90,000 (Residual Value= 9 lac – 90,000 = 8,10,000)

2012= 8,10,000\* 10%

2013= 7,29,000\* 10%

2014=

This method is more practical.

**Users of accounting information.**

Internal users

You as a business owner

Employees

Creditors

Management

External users

Govt

Banks

Investors

Consumers

**Uses of accounting information.**

They give the business owner information about my assets, liabilities, revenues, expenses, profits, taxes.

They are giving an overview of my revenue to the creditors, banks, etc. to people from whom I have borrowed money.

Evaluating alternatives, expansion, modernization, I want to set up a green project.

Removing of sick units in my business. I have three shops, A, B and C. I look at my books and I understand that shop B is not giving me profits. So I decide to shut down that shop.

Planning and budgeting. I want to set up a new shop next year but I don’t have the money. So I will plan control my budgets to save money for the new shop.

Controlling your revenue and expenses. You need to first know how much is your revenue and expenses, you need to know where are my revenues coming from and where is my money going for expenses and then you can control these.

Coordinating the running of my business. I need to look at my books to understand how better I can run my business.

**Limitations of accounting information.**

So accounting principles are not compulsory. Why? It is on me to decide whether or not I want to get my books audited. Otherwise, if I maintain my books in such a manner that a layman can understand my revenue, expenses and profits, then also it is absolutely fine. If the govt can understand what my profits for tax computation it are then also is fine.

Accounting principles are such that I can record only the monetary aspects of my business. cannot record non-monetary aspects even though they may be very important to my business.

This is not compulsory. You can come up with your own alternatives. As long as your books clearly reflect where the money is coming from, where the money is going, what is your business about, how are you running your business. Then you can adopt any alternative you want.

Accounting books do not reflect inflation. 5 years back I record my fuel expenses to be 95rs per litre. But today petrol is 100rs per litre. So basically, if I want to calculate my profits in today’s time taking the figures of 5 years back, I won’t be able to. Also, when we do future projections about revenues, you know we calculate this year I will earn 10 lac profits, next year I will earn 20 lac profits. But I am not taking into account the inflation that will happen for one year. I am assuming that today’s inflation rate will be next year’s inflation rate as well. So that is why when future revenue projections are done, they are always based on assumptions.

Conservatism concept said that you should record your inventory at the correct acquisition cost or the market value whichever is lower. You cost of inventory is being recorded at a lower value which is not correct. So what will happen you will reflect a higher profit even if it is not the case. So conservatism concept does not always work.

Judgements and estimates. It is not compulsory for businesses to follow the diminishing value method of depreciation. They can follow any of the two. But what happens is when you follow the straight-line method, you are not reflecting the correct value of the asset. But in case of diminishing value method, you reflect the correct value of the asset. It is based on the owner’s judgements and estimates on which method he/she wants to follow. So the books may not always reflect the correct position.