3.1. BASICS TERMS OF ACCOUNTING

Following are the some important terminologies of accounting which are very useful for all those who are going to deal in accounting. For better understanding of this subject the clear meaning of the following terms will be very helpful.

1) **Assets:** Assets are things of value used by the business in its operations. These are economic resources of an enterprise that can be usefully expressed in monetary terms.

   Assets = Liabilities + Capital

   According to Finny and Miller, "Assets are future economic benefits, the rights, which are owned or controlled by an organization or individual".

   Classification of Assets

   i) **Fixed Assets:** Fixed assets refer to those assets which are held for the purposes of providing or producing goods or services and those that are not held for resale in the normal course of business. Fixed assets may be classified as under:

      a) **Tangible Fixed Assets:** It refers to those fixed assets which can be seen and touched. **For example,** land and building, plant and machinery, furniture and fixture.

      b) **Intangible Fixed Assets:** It refers to those fixed assets which cannot be seen and touched. **For example,** goodwill, patent, trademarks, copyrights.

   ii) **Current Assets:** Current assets are those assets which are held:

      a) In the form of cash,
      b) For their conversion into cash,
      c) For their consumption in the production of goods or rendering of services in the course of business.
      d) On a short-term basis.

      For example, cash in hand, cash at bank, stock of finished goods, debtors, bills receivables, stock of raw materials, and stock of work-in-progress.

   iii) **Fictitious Assets:** Fictitious assets are those assets, which do not have physical form. They do not have any real value. Actually, they are not the real assets but they are called assets on legal and technical ground. These assets are the revenue expenditure of capital nature which is also termed as **deferred revenue expenditure.** The example of these assets is loss on issue of shares, advertising suspense and preliminary expenses etc. Fictitious assets do not have real value, so they are written off in the future.

2) **Liabilities:** Liabilities means the amount which the firm owes to outsiders, that is excepting the proprietors. These are the obligations or debts that the enterprise must pay in money or services at sometime in the future.

According to Finny and Miller, "Liabilities are debts, they are amounts owed to creditors."

Thus, the claims of those who are not owners are called liabilities. This can be expressed as:

Liabilities = Assets – Capital

Classification of Liabilities

i) **Current Liabilities/Short-Term Liabilities:** Current liabilities refer to those liabilities which fall due for payment in a relatively short period, (normally, a period of not more than 12 months from the date of the balance sheet). **For example,** bills payable, trade creditors, outstanding expenses, bank overdraft.

ii) **Long-Term Liabilities:** Long-term liabilities refer to those liabilities which do not fall due for payment in a relatively short period (normally a period of not more than 12 months from the date of balance sheet). **For example,** long-term loans, debentures, etc.

3) **Capital:** Capital is the investment made by the owner for use in the firm. For the business, capital is a liability towards the owner. It is also known as **Owner's Equity** or **Proprietorship** or **Net Worth**. Owner's equity means owner's claim against the assets. This can be expressed as:

Capital = Assets – Liabilities

Classification of Capital

i) **Fixed Capital:** Permanent of fixed working capital is the minimum amount which is required to ensure effective utilization of fixed facilities and for maintaining the circulation of current assets. There is always a minimum level of current assets, which is continuously required by the enterprise to carry out its normal business operations. **For example,** every firm has to maintain a minimum level of raw materials, work-in-process, finished goods and cash balance. This minimum level of current assets is called permanent or fixed working capital as this part of capital is permanently blocked in current assets. As the business grows the requirements of permanent working capital also increase due to the increase in current assets. The permanent working capital can further be classified as regular working capital and reserve working capital required ensuring circulation of current assets from cash to inventories, from inventories to receivables and from receivables to cash and so on.

ii) **Floating Capital:** assets purchased with the intension of sales, such as stock, and investments and so on.

iii) **Working Capital:** Working Capital refers to the cash a business requires for day-to-day operations, or, more specifically, for financing the conversion of raw materials into finished goods, which the company sells for payment. Among the most important items of working capital are levels of inventory, debtors and creditors. These items are looked at for signs of a company's efficiency and financial strength.

Working capital, in general practice, refers to the excess of current assets over current liabilities.

The better a company manages its working capital, the less the company needs to borrow. Even companies with cash surpluses need to manage working capital to ensure that those surpluses are invested in ways that will generate suitable returns for investors.

4) **Proprietor:** Proprietor is an individual or groups of persons who undertake the risk of the business are known as 'proprietor'. They invest their funds into the business as capital. Proprietors are adventurous persons who make arrangement of land, labor, capital and organization.

5) **Drawings:** Amount or goods withdrawn by the proprietor for his private or personal use is termed as 'drawing'. The cost of using business assets for private or domestic use is also drawing. Use of business car for domestic use or use of business premises for residential purpose is also drawing. Certain examples of drawings are as under:
   i) Amount withdrawn by proprietor for personal use.
   ii) Goods taken by the proprietor for domestic use.
   iii) Purchasing pocket transistor for proprietor's son.
   iv) Using business vehicles for business use.
   v) Using business premises for residential purpose.

6) **Revenues:** Revenues are the amounts, a business earns by selling its product or providing services to customers.

7) **Income:** Income is the difference between revenue and expense.

   Classification of Income

   Income can be classified into two categories:

   i) **Capital Income:** The term 'capital income' means an income which does not pertain to the running of the business proper. **For example,** if a building costing ₹10,000 purchased by a business for its use is sold for ₹15,000, ₹5,000 will be taken as capital income or profit.

   ii) **Revenue Income:** Revenue income means an income which arises out of and in the course of the regular business transactions of a business. **For example,** in the course of running the business, the profit is made of sale of goods; income is received from letting on the business property, etc. All such incomes are revenue incomes or profits.

8) **Expenses:** Expenses are the costs incurred by a business in the process of earning revenue.

Expenses are cost incurred by the business in the process of earning revenues. Generating income is the foremost objective of every business. The firm has to use certain goods and services to produce articles, sold by it. Payment for these goods and services is called 'expense'. Cost of raw material for the manufacture of goods or the cost of goods purchased for sale, expenses incurred in manufacturing or acquiring goods, such as wages, carriage, freight and amount spent for selling and distributing goods such as salaries, rent, advertising and insurance etc. are known as 'expense' in accounting terminology.

According to Finney and Miller, "Expense is the cost of use of things or services for the purpose of generating revenue. Expenses are voluntarily incurred to generate income".

9) **Expenditure:** Payment of cash or cash-equivalent for goods or services, or a charge against available funds in settlement of an obligation as evidenced by an invoice, receipt, voucher, or other such document. See also revenue expenditure, capital expenditure.

Classification of Expenditure

i) **Capital Expenditure:** Capital expenditure is the expenditure which is incurred for the following purposes:
   a) Acquiring or bringing into existence an asset or advantage of an enduring benefits,
   b) Extending or improving a fixed asset,
   c) Substantial replacement of an existing fixed asset.

   Capital expenditure is incurred to bring improvements in the following areas:
   a) Productivity,
   b) Earning capacity.

   It is the expenditure which normally yields benefits extending beyond the current accounting period (or of enduring nature).

ii) **Revenue Expenditure:** Revenue expenditure is the expenditure which is incurred for maintaining the following areas:
   a) Productivity,
   b) Earning capacity.

   It is the expenditure which normally yields benefits in the current accounting period.

iii) **Deferred Revenue Expenditure:** Deferred revenue expenditure is the expenditure which yields benefits extending beyond the current accounting period but for relatively a shorter period than the period for which a capital expenditure is expected to yield benefits. Such expenditures are normally for a period of 3 to 5 years.

   Some of the examples of deferred revenue expenditure are as follows:
   a) Heavy advertising campaign,
   b) Research and development expenditure.

10) **Losses:** Losses are unwanted burden which the business is forced to bear. Loss of goods due to theft or fire, or flood or storm or accidents is termed as 'loss in accounting'. Losses are different from expenses in the sense that expenses are voluntarily incurred to generate income where losses are forced to bear.

11) **Purchases:** Purchases are the total amount of goods procured by business on credit and for cash, for use or sale.

12) **Purchases Return:** Purchases return is the part of the purchases of goods, which is returned to the seller. This return may be due to unnecessary, excessive and defective supply of goods. In order to calculate net purchases, purchase return is deducted from purchases. Purchases returns are also known as **Returns Outward**, because it is the return of goods outside the business.

13) **Sales:** Sales are total revenues of goods sold or services provided to customers.

14) **Sales Return:** Sales return is that part of sales of goods which is actually returned to us by purchasers. This return may also be due to excessive, unnecessary and defective supply of goods or violation of terms of agreement. Sales return, also known as **Returns Inward**, is deducted from sales, in order to calculate net sales.

15) **Stock Inventory:** Stock Inventory is a measure of something on hand-goods, spares and other items in a business.

16) **Debtors (Accounts Receivable):** Debtors are persons and/or other entities that owe to an enterprise an amount for receiving goods and services on credit.

17) **Creditors (Accounts Payable):** Creditors are persons and/or other entities that have to be paid by an enterprise goods and services on credit.

18) **Solvent:** Solvent are those persons and firms who are capable of meeting their liabilities out of their own resources. Solvent firms have sufficient funds and assets to meet proprietors' and creditors' claim. Solvency shows the financial soundness of the business.

19) **Insolvent:** Insolvent are all those business firms who have been suffering losses for the last many years and are not even capable of meeting their liabilities out of their assets are financially unsound. Only the court can declare the business firm as insolvent if it is satisfied that the continuation of the firm will be against the interest of the public or creditors. No firm can declare itself as insolvent.

20) **Transactions:** Transactions are those activities of a business, which involve transfer of money or goods or services between two persons or two accounts. **For example,** purchase of goods, sale of goods, borrowing from bank, lending of money, salaries paid, rent paid, commission received and dividend received. Transactions are of two types, namely, cash and credit transactions.

i) **Cash Transaction:** Cash transaction is the one where cash receipt or payment is involved in the transaction. **For example,** when Ram buys goods from Karan and paying the price of goods by cash immediately, it is a cash transaction.

ii) **Credit Transaction:** Credit transaction is the one where cash is not involved immediately but will be paid or received later. In the above example, if Ram, does not pay cash immediately but promises to pay later, it is credit transaction.

21) **Vouchers:** Accounting transaction must be supported by documents. These documentary proofs in support of the transactions are termed as vouchers. It may be a receipt, cash memo, invoice, wages bill, salaries bill, deeds or any document as an evidence of transaction having taken place.

22) **Invoice:** Invoice is a business document which is prepared when one sell goods to another. The statement is prepared by the seller of goods. It contains the information relating to name and address of the seller and the buyer, the date of sale and the clear description of goods with quantity and price.

23) **Receipt:** Receipt is an acknowledgement for cash received. It is issued to the party paying cash. Receipts form the basis for entries in cash book.

24) **Account:** Account is a summary of relevant business transactions at one place relating to a person, asset, expense or revenue named in the heading. An account is a brief history of financial transactions of a particular person or item. An account has two sides called **debit side and credit side.**