

## ACCOUNTING TERMS

It will be appropriate to get familiarised with certain basic terms which are used in accounting before proceeding with the technique of recording of business transactions. It is necessary for the readers to go through these basic terms and understand them clearly, since it will be then convenient for them to understand clearly the contents of the chapters which are to follow:

✓ 1. **Assets** The term 'assets' include the resources acquired by a business from the funds made available either by the owners or by others. They are "tangible objects or intangible rights owned by an enterprise and carrying probable future benefits".<sup>1</sup> In other words, property of all kinds owned by a business comes within the category of the term 'assets'.

Assets may be classified into the following categories:

- (i) **Fixed assets** These are assets which are acquired for relatively long period for carrying on the business of the enterprise. They are not meant for resale. The examples of such assets are land, buildings, plant, machinery, etc.
- (ii) **Current assets** These are assets which are acquired with the intention of converting them into cash during the normal business operations of the company. They include "cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business".<sup>2</sup> The essential difference between current assets and fixed assets is that the current assets are held essentially for a short period and they are meant for converting into cash. Examples of such assets are cash, inventories (i.e., stocks of raw material, work-in-progress and finished goods), bills receivable, debtors, etc. These assets are also termed as 'Floating' or 'Circulating' Assets.
- (iii) **Liquid assets** These are assets which are immediately convertible into cash without much loss. As a matter of fact, all current assets excluding prepaid expenses and inventories are included in the definition of liquid assets.
- (iv) **Fictitious assets** These are assets which have no real value but are shown in the books of accounts only for technical reasons. Examples of such assets are preliminary expenses incurred in connection with the establishment of a business or discount allowed on issue of shares by a company, etc.
- (v) **Wasting assets** These are the assets which are exhausted with, or which lose themselves in the goods they produce. Mines and quarries are common examples of such assets. The term is also used for describing such assets which get exhausted with the lapse of time, e.g., copyrights, patents, trademark, etc.

✓ 2. **Liabilities** The term 'Liabilities' is used to denote amounts which a business owes and has to return or account for. They are present obligations whose amounts can be ascertained with substantial accuracy. They can be divided into two categories:

- (i) **Current liabilities** The term 'Current Liabilities' is used to denote liabilities which will be due within a short time (usually one year or less) and that are to be paid out of current assets or by creation of other current liabilities. Creditors for goods, bills payable, outstanding expenses are some of the examples of current liabilities.
- (ii) **Fixed liabilities** Liabilities that will not be due for a comparatively long time (usually more than one year) are termed as 'Fixed Liabilities' or 'Long-term Liabilities'. These liabilities would continue to be treated as Fixed Liabilities if they are renewed rather than paid at maturity.

1&2. *Accounting Terminology* issued by Institute of Chartered Accountants of India (ICAI).

3. **Capital** The term 'Capital' is used to denote the owners' equity in the business. It is a residual claim against the assets of the business after the total liabilities are deducted. Owners' Equity, Proprietorship and Net-Worth are some of the other terms which are also used to denote Capital.

Capital may be classified into the following categories:

- (i) *Fixed Capital* It is the capital invested in or represented by Fixed Assets.
  - (ii) *Circulating Capital* It is the capital in the form of Current or Floating Assets.
  - (iii) *Working Capital* It is the excess of Current Assets over Current Liabilities.
4. **Contingent Asset** An asset, the existence, ownership value of which may be known or determined only on the occurrence or non-occurrence of one more future uncertain events. It usually arises from unexpected events that give rise to possibility of inflow of economic benefits to the business enterprise. For example, a claim that the firm is pursuing the outcome of which is uncertain, is a contingent asset.

A contingent asset is not recognised in the books of an enterprise. It also does not require any disclosure in the financial statements. Such an asset is assessed continuously and when it becomes virtually certain that it will result in inflow to economic benefits to the enterprise, the asset and the related income may be recognised in the financial statements of the firm in which such change occurs.

5. **Contingent Liability** It is an obligation relating to existing condition or situation which may arise in future depending upon the occurrence or non-occurrence of one or more uncertain future events. It is a possible obligation which may or may not arise depending upon the situation.

Following are the examples of contingent liabilities:

- 1. A claim against the enterprise not acknowledged as debt.
- 2. Uncalled liability on shares partly paid.
- 3. Arrears of fixed cumulative dividends.
- 4. Estimated amount of contracts remaining to be executed on capital account and not provided for.

An enterprise should not recognise a contingent liability. However, it may be disclosed as a note to the financial statements. Such liabilities are assessed on a continuing basis to determine whether an outflow of economic resources has become probable, if so to the extent of the probable amount, the liability will have to be recognised in the books and a provision will have to be created.

6. **Provision** An amount written off or retained by way of providing for depreciation or diminution in value of assets or for providing any known liability, the amount of which cannot be determined with substantial accuracy. Examples of a provision are provision for bad and doubtful debts, a provision for discount on debtors, etc.

**Difference between a Contingent Liability, a Provision and a Liability** This can be understood with the following example:

A lawsuit has been filed against a firm claiming damages of ₹1,00,000. The firm feels that the case against the firm may or may not be dismissed by the court. Such a liability is a contingent liability and may be disclosed by way of a note to the financial statements. However, if the firm feels that it may be required to pay the damages of around ₹20,000 in the suit in all probabilities, the provision to the extent of ₹20,000 for the lawsuit will be created. Finally if the court fixes the damages payable of ₹25,000 against the firm, a liability of ₹25,000 will be recognised in the books of the firm.

## CHAPTER THREE

**7. Transaction and Event** Every economic activity is performed through transactions and events. A transaction may be a business, performance of an act or an agreement. While an event is the happening, consequence or result of a transaction.

For example, A starts business with a capital of ₹1,00,000. He makes cash purchases of ₹80,000 and makes cash sales of ₹90,000 of goods costing ₹60,000. He also pays ₹10,000 as rent of the godown.

The following results can be drawn from the above:

1. **Economic Activity:** Starting of business

2. **Transactions are:**

- Investment of ₹1,00,000 in the business.
- Purchasing of goods for ₹80,000.
- Making cash sales of ₹90,000.
- Payment of godown rent ₹10,000.

3. **Events are:**

- Profit of ₹20,000, computed as under

		₹
	Sales	90,000
	Cost of Purchases	60,000
	Godown Rent	10,000
<b>Add:</b>		<u>70,000</u>
		20,000

- Cash balance of ₹1,00,000, computed as under:

	Capital introduced	1,00,000
<b>Add:</b>	Cash sales	90,000
		<u>1,90,000</u>
<b>Less:</b>	Cash Purchases	80,000
	Godown Rent	10,000
		<u>90,000</u>
		1,00,000

- Closing Inventory of ₹20,000 computed as under:

	Goods Purchased	80,000
<b>Less:</b>	Cost of Goods Sold	60,000
		<u>20,000</u>

- Capital of ₹1,20,000 computed as under:

	Initial capital introduced	1,00,000
<b>Add:</b>	Profit made	20,000
		<u>1,20,000</u>

**8. Revenue** The term 'Revenue' means income of a recurring nature from any source. The source may be sale of goods, performance of services for a customer or a client, the rental of a property, the lending of money and any other business or professional activity carried on for the purpose of earning income.

**9. Expenditure** The term includes incurring a liability disbursement of cases or transfer of property for the purpose of obtaining assets goods or services. It may be of three types:

- Capital expenditure** An expenditure incurred for obtaining a long-term advantage for the business.
- Revenue expenditure** An expenditure where benefits expire within a year or which has been incurred merely to maintain the business or keep the assets in good working condition.
- Deferred expenditure** An expenditure or liability for which payment has been made or incurred but which is carried forward on the presumption that it will be

of benefit over a subsequent period or periods. This is also referred to as deferred revenue expenditure.

10. **Expense** The term 'Expense' denotes the cost of services and things used for generating revenue.

An 'Expense' is to be distinguished from a Loss. An Expense is supposed to bring some benefit to the firm, whereas a Loss brings no benefit to the firm, *e.g.*, loss by theft, loss by fire, etc.

The terms 8 to 10 discussed above have been explained in detail later in a separate chapter, "Capital and Revenue".

11. **Goods** The term 'Goods' means the property in which the business deals. In other words, 'Goods' are properties for resale. For example, if a furniture dealer purchases furniture for sale, the furniture so purchased will come within the definition of the term 'Goods'. However, if the furniture has been purchased by a furniture dealer for using it in his business, such furniture will come within the definition of the term 'Fixed Assets'.

12. **Debtor** The person who owes money to the business is called a 'Debtor'.

13. **Creditor** A person who has a claim for money against the business is termed as 'Creditor'.

14. **Bill of Exchange** It is a document in writing directing a certain person to pay a certain sum of money to the order of a certain person or to the bearer of the instrument. For example, if *A*, a creditor by a document in writing asks his debtor *B* to pay a sum of ₹10,000 (owed by *B* on account of purchase of certain goods) after 3 months, such a document is termed as 'Bill of Exchange'.

The document will be termed as 'Bill Receivable' for *A* (*i.e.*, the person entitled to get the payment) and a 'Bill Payable' for *B* (*i.e.*, the person who is liable to pay the money under the document).

15. **Accounts Receivable** The term includes both Debtors and Bills Receivable

16. **Accounts Payable** The term included both Creditors and Bills Payable.

17. **Discount** An allowance or a deduction allowed from an amount due is termed as 'Discount'. It may be of three types:

- (i) *Trade discount* A deduction allowed to the buyers from the gross or catalogue price is termed as 'Trade Discount'.
- (ii) *Quantity discount* A deduction allowed to the buyers from the gross catalogue price on making bulk purchases is termed as 'Quantity Discount'.
- (iii) *Cash discount* A discount allowed to a debtor on prompt payment of cash is termed as 'Cash Discount'.

Trade or quantity discount is not taken into account while recording accounting transactions. The transactions are recorded at 'net' while cash discount is recorded in the books of account.

18. **Commission** Commission may be termed as remuneration payable to an employee for his services to the firm or to the agent for purchasing or selling goods, collection of debtors on behalf of the firm, etc. The commission is computed as a percentage of the amount involved. The commission earned is considered as an income while commission allowed is considered as an expense for the business.

Following are examples of persons to whom commission may be allowed:

- (1) Selling or buying agents.
- (2) Brokers and bankers.
- (3) Property dealers for helping in renting out or purchase or sale of properties.
- (4) Import-export agent in foreign trade.

19. **Merchandise Cost** It is the same as cost of goods sold. It is computed as follows:

	Opening Inventory	.....
Add:	Net Purchases ( <i>i.e.</i> , purchases <i>less</i> returns)	.....
	Direct Expenses ( <i>i.e.</i> , expenses incurred for acquiring the goods and making them fit for sale)	.....
Less:	Closing Inventory	.....
	Cost of goods sold	.....

20. **Gross Profit** It is the excess of the selling price over the cost of goods sold (without deducting any expenses incurred in selling the goods).

21. **Net Profit/Income** It is the profit left after deducting all business expenses from the Gross Profit made by the business.

**ILLUSTRATION 3.1.** Find out merchandise cost, gross profit and net income from the following transactions:

	₹
Purchases (3,000 articles)	25,000
Freight	1,000
Local Taxes	1,000
Salaries	2,500
Shop Rent	500
Godown Rent	500
Electric Charges	600
Municipal Taxes	200
Stationery	250
Furniture (Estimated life 5 years)	12,000
Sales (2,700 articles)	32,000

**SOLUTION:**

(i) <b>Merchandise Cost</b>	₹
Purchases	25,000
Freight	1,000
Local Taxes	1,000
Cost of 3,000 articles	27,000
Less: Closing Inventory (300 articles)	2,700
	24,300

(ii) **Gross Profit**

$$\begin{aligned} \text{Sales} - \text{Merchandise Cost} \\ = ₹32,000 - 24,300 = ₹7,700 \end{aligned}$$

(iii) **Net Income**

$$\begin{aligned} \text{Gross Profit} - \text{All Other Expenses} \\ = ₹7,700 - 6,950^* = ₹750 \end{aligned}$$

\*Includes ₹2,400 as depreciation on Furniture and all other expenses.

22. **Drawings** The withdrawal of goods or cash from the business by the owner for personal use is called 'Drawings'.

23. **Entry** Recording of a transaction in any book of account is called an 'Entry'.

24. **Insolvent** A person who is not in a position to pay his debts in full. It means that the liabilities of such a person are more than his assets.

25. **Solvent** A person who is in a position to pay his debts as they become due.
26. **Bad Debts** The amount lost from a debtor on account of his inability to pay his debts.
27. **Net Assets** The excess of the book value of assets (other than fictitious assets) of an enterprise over its liabilities. This is also referred to as *Net Worth* or *Shareholders' Funds*.
28. **Working Capital** The funds available for day-to-day operations of an enterprise. Also represented by the excess of current assets over current liabilities including short-term loans.

### KEY TERMS

1. **Asset:** A tangible object or an intangible right owned by an enterprise and carrying probable future benefits.
2. **Capital:** Owners' equity in the business.
3. **Capital Expenditure:** An expenditure incurred for the purpose of obtaining a long-term advantages for the business.
4. **Goods:** The property in which the business deals.
5. **Liability:** An amount which business owes and has to return or account for.
6. **Revenue:** An income of a recurring nature from any source.
7. **Revenue Expenditure:** An expenditure whose benefit expires within a year or which is incurred merely to maintain the business or keeping the assets in good working condition.

### TEST QUESTIONS

#### Objective Type

##### 1. State whether each of the following statements is 'True' or 'False':

- (i) The term 'Asset' means a property or possession of the business with the help of which the work of the concern is carried on.
- (ii) Wasting Assets are those assets which are meant to be converted into cash in the ordinary course of the firm's business.
- (iii) A 'Revenue' denotes the expenditure incurred by the business in earning income.
- (iv) A 'Liability' denotes the value in terms of money which the business owes.
- (v) Floating Assets are assets those whose value change constantly.
- (vi) Circulating Capital is represented by Fixed Assets.
- (vii) The terms 'Loss' and 'Expense' have synonymous meaning.
- (viii) Goodwill is a current Asset.

[Ans. (i) True; (ii) False; (iii) False; (iv) True; (v) True; (vi) False; (vii) False; (viii) False]

##### 2. Fill in the blanks:

- (i) A person who owes money to the firm is a .....
- (ii) A person who is entitled to get money from the firm is termed as .....
- (iii) All those things which a firm purchases for resale are called .....
- (iv) Drawings denote the withdrawal of cash or goods by the owner for .....
- (v) The assets used for long-term use in the business are termed as .....
- (vi) The excess of Current Assets over Current Liabilities is termed as .....

[Ans. (i) debtor; (ii) creditor; (iii) goods; (iv) his personal use;  
(v) fixed assets; (vi) working capital]

##### 3. Choose the correct answer:

- (i) Furniture for a cloth dealer is a
  - (a) Fixed Asset
  - (b) Current Asset
  - (c) Wasting Assets