

Basic Accounting Terms

The Accounting Terms prescribed in the Syllabus are discussed hereunder:

1. Event. *Event is a business event that impacts the Ledger account balances.*

'Event' means happening or occurrence as a result of transaction or transactions and which brings change in the financial position of the entity. Some examples of event are: inventory, gross profit, and net profit, etc.

2. Transaction. *It is exchange of money, goods and/or services by an entity.*

'Transaction' is a financial event entered into by the entity having monetary impact on the financial statements and recorded in the books of account. It brings change in the financial position of an enterprise. Some examples of transactions are: sale of goods, purchase of goods, receipts from debtors, payments to creditors, purchase or sale of fixed assets, payment of dividend, etc.

Characteristics of a Transaction

- (i) It is for a financial value, *i.e.*, for an amount.
- (ii) It is supported by a source voucher (document) *e.g.*, sale invoice, purchase bills, receipts, debit note, credit note, etc.
- (iii) It has two fold effect in accounting.
- (iv) It brings change in the financial position (assets and liabilities) of the entity.

A transaction is a *cash transaction* if the amount is transacted immediately on entering into a transaction. It is a *credit transaction* if it is settled at a later date.

If a transaction is settled partly in cash immediately and partly later, part of transaction for which cash is received is cash transaction and other part is credit transaction.

3. Vouchers.

Source Voucher. *An evidence of transaction having taken place.*

Voucher is a document which establishes that a transaction has taken place. It is an evidence on the basis of which an entry is recorded in the books of account. Some examples of vouchers are: Cash Memo, Invoice or Bill, Receipt, Debit/Credit Notes, etc. They are also known as **Source Vouchers**.

Accounting Voucher. *It is prepared on the basis of source vouchers showing account or accounts that are debited and credited.*

Based on the source vouchers, an accounting voucher is prepared which shows the accounts debited and credited.

4. **Trade Debtor.** *A person or entity who owes amount to the business against credit sale of goods and/or services.*

Trade Debtor is a person or entity who owes amount to the enterprise on account of credit sale of goods and/or services. Stating differently, Trade Debtor is a person or entity to whom goods and/or services are sold on credit.

5. **Trade Creditor.** *A person or entity to whom amount is owed against credit purchase of goods and/or services.*

Trade Creditor is a person or entity to whom the enterprise owes an amount for credit purchase of goods and/or services. Stating differently, Trade Creditor is a person or entity from whom goods and/or services are purchased on credit.

6. **Purchases.** *It is purchase of goods to be sold in the ordinary course of business.*

The term 'Purchases' means purchase of goods for resale or for manufacture of goods, *i.e.*, raw material. The term 'Purchases' includes both cash and credit purchase. Goods purchased against cash are called **cash purchases** while goods purchased on credit, *i.e.*, to be paid at a later date, are called **credit purchases**.

Purchases Return. *It is return of goods purchased for resale.*

Goods purchased may be returned due to any reason, say, they are not as per specifications or are defective. Goods returned are known as **Purchases Return** or **Returns Outward**.

7. **Sales.** *It is sale of goods in the ordinary course of business.*

The term 'Sales' means sale of goods dealt in by the enterprise. The term 'Sales' includes both cash and credit sales. When goods are sold against cash, they are known as **cash sales** but if goods are sold and payment is to be received at a later date, it is known as **credit sales**.

Sales Return. *It is return of goods sold.*

Goods sold when returned by the purchaser are termed as **Sales Return** or **Returns Inward**.

8. **Assets.** *Economic resources of the entity which give cash or benefit in future.*

Assets are property or legal rights owned by an entity to which money value can be attached. In other words, anything which will enable the entity to get cash or benefit in the future is an asset. Money owed by debtors, stock of goods, cash, furniture, machines, building, patents, etc., are some examples of assets.

Assets can be classified as:

- (i) **Fixed Assets.** *Assets owned by the entity or enterprise which are not for resale.*

Fixed Assets are the assets held by an enterprise not for sale but with the purpose to increase the earning capacity of the business. Fixed assets are further classified into Tangible Fixed Assets and Intangible Fixed Assets.

- (a) **Tangible Fixed Assets.** Tangible Fixed Assets have physical existence, *i.e.*, they can be seen and touched. Examples of tangible fixed assets are land, building, plant and machinery, computer, etc.

- (b) **Intangible Fixed Assets.** Intangible Fixed Assets do not have physical existence, *i.e.*, they cannot be seen and touched. Examples of intangible fixed assets are goodwill, trademarks, patents, computer softwares, etc.

(ii) **Current Assets.** *Assets that are held by the entity or enterprise for resale or conversion into cash in a short time.*

Current Assets are assets held for short-term with a purpose to sell or convert them into cash. Examples of current assets are unsold goods (Closing Stock or Inventory), debtors, bills receivable, bank balance, etc.

(iii) **Liquid Assets.** *Current Assets that can be realised, i.e., converted into cash in a short period.*

Liquid Assets are part of the current assets that can be realised (converted) into cash in a short period. Examples are cash in hand, bank balance, fixed deposits, etc.

(iv) **Wasting Assets.** *Assets which have limited life and decrease in value by extraction.*

The term 'Wasting Assets' is associated with natural resources such as coal, oil, etc. Wasting Assets are assets having limited life and decrease in value over time with consumption. These assets cannot be recycled for generating additional revenue.

(v) **Fictitious Assets.** *An asset coming into existence by an accounting entry.*

Fictitious Assets are either accumulated losses or Deferred Revenue Expenses (e.g., Advertisement Suspense) not yet written off till the date of Balance Sheet.

9. Liabilities. *Claims of amounts against the entity or enterprise.*

Liabilities mean the amount which the enterprise owes. It may be towards the outsiders or the proprietors.

Liabilities can be categorised into:

(i) **Internal Liabilities.** *Liability towards owners or proprietors.*

It is a claim of the owners or proprietors against the assets of the enterprise termed as **Capital** and shown as liability of the enterprise.

(ii) **External Liabilities.** *Liabilities towards outsiders.*

External Liabilities are those liabilities which arise from the credit transactions or loans taken. For example, creditors, bank overdraft, bills payable, outstanding liabilities, etc.

External liabilities can be further classified into the following:

(a) **Long-Term or Non-Current Liabilities.** These are liabilities which are payable after a period of 12 months from the end of the financial year. For example, long-term loans, debentures, Public deposits, etc.

(b) **Current Liabilities.** These are liabilities which are payable within a period of 12 months from the end of the financial year. For example, creditors, bank overdrafts, bills payable, short-term loans, etc.

(iii) **Contingent Liabilities.** *A liability that crystallises upon happening of an event.*

Contingent Liabilities are those liabilities of the enterprise in which obligation to pay arises on happening of a future event. Thus, contingent liability may or may not be payable. An example of contingent liability is a legal case against the enterprise for compensation. If the court ruling is against the enterprise, it becomes payable and if the court ruling is in favour of the enterprise, it is not payable.

10. Goods Traded in. *Items that are purchased with the purpose to sell.*

Goods Traded are the goods purchased with the purpose of reselling. In other words, they are the products in which an enterprise is dealing or trading in. For example, for an enterprise trading in home appliances, T.V., fridge, washing machines, A.C., etc., are goods. Similarly, for a stationer, stationery is goods, whereas for others, it is an item of expense (not purchases).

11. Stock (Inventory). *Goods remaining unsold or unused in manufacturing as on a particular date.*

Stock (inventory) is the tangible property held by an enterprise for resale in the ordinary course of business or for the purpose of using it in the production of goods meant for sale to be rendered. Stock may be *opening stock* or *closing stock*. The closing stock of one period becomes the opening stock of the next period.

In case of a trading concern, it comprises closing stock in hand or the amount of goods which are lying unsold at the end of an accounting period of the goods traded in.

Stock in the case of a manufacturing concern is of raw materials, work-in-progress and finished goods. They are discussed hereunder:

- (i) **Raw Materials.** Raw Material is a material or substance used in production or manufacturing of goods. After the manufacturing process, the form or shape of raw materials is often changed to suit a particular requirement. It should be kept in mind that a raw material shall be goods traded in for the dealer of raw material commodity. For example, paper is goods traded in for a paper dealer. It is a raw material for a notebook manufacturer who produces notebooks after carrying out further processes like ruling, sizing and binding.
- (ii) **Work-in-Progress (i.e., Semi-finished Goods).** Work-in-Progress means raw material that has entered into the production process but is not yet a finished product. Work-in-Progress (WIP), therefore, means all materials and partly finished products that are at various stages of the production process to be a finished product. Continuing with the example in raw material, a copy manufacturer has completed the ruling process on paper but it is yet to be sized and bound. The ruled paper is Work-in-Progress.
- (iii) **Finished Goods.** Finished goods mean the goods which have undergone the complete process of manufacturing and are ready for sale but are yet to be sold. Continuing the above example, a notebook manufacturer has completed the manufacturing process, i.e., notebooks are ready for sale. The stock of notebooks ready for sale is the stock of finished goods.

12. Profit. *Excess of revenue over expenses.*

Profit is categorised into:

- (i) **Gross Profit.** *Excess of sales over cost of goods sold.*

Gross Profit = Sales – Cost of Goods Sold*

In other words, Gross Profit means excess of Revenue over Cost of Goods sold.

*Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses – Closing Stock.

(ii) **Net Profit.** *Excess of total revenue over direct and indirect expenses.*

Net Profit is the profit earned after allowing for all expenses direct and indirect, in case expenses are more than the revenue, it is *Net Loss*.

13. **Loss.** *Excess of expenses over total revenue.*

Loss is excess of expenses of a period over revenues for that period. It decreases the owner's equity, *i.e.*, capital. It also refers to money or money's worth lost (or cost incurred) against which the enterprise receives no benefit, *e.g.*, cash or goods lost in theft, loss on sale of fixed assets, etc.

14. **Expense.** *Amount spent to purchase and sell goods and/or services.*

Expense is the amount spent to purchase and sell goods and/or services. Examples of expense are payment of salaries, wages, rent, etc.

15. **Revenue.** *Amount received or receivable against sale of goods and/or services.*

Revenue is the gross inflow of cash, receivables or other consideration earned by the enterprise from the sale of goods and/or services in its ordinary course of business. Examples of revenue are amount received or receivable from sale of goods, rent, commission, etc.

Revenue is the gross inflow of cash, receivables or other consideration arising in the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.

— Accounting Standard 9 issued by ICAI

16. **Income.** *Excess of total revenue over total expense.*

Income is the profit earned during a period of time. It is the difference between revenue and expense. For example, goods costing ₹ 15,000 are sold for ₹ 21,000, the cost of goods sold, *i.e.*, ₹ 15,000 is expense, the sale of goods, *i.e.*, ₹ 21,000 is revenue and the difference, *i.e.*, ₹ 6,000 is income. It can, therefore, be expressed as:

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

Income increases owner's equity.

17. **Drawings.** *Amount, goods or asset taken by the proprietor for personal use.*

It is the amount of goods or asset which the proprietor or a partner withdraws (takes) for his personal use. Drawings reduces capital of the owners.

18. **Capital.** *Claim of the owners or proprietor.*

Capital is the amount which the proprietor has invested in the business, increased by profit (decreased by loss) and claims from the firm. For the firm, it is a liability towards the owner. Capital is shown as a liability because for accounting purpose, owner is separate from the business. Capital is also known as **owner's equity**. It is always equal to assets less liabilities. This can be expressed as:

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

Other Important Terms

The following Accounting Terms are not prescribed in the Syllabus but are important to understand:

1. Cost.

It is the amount of expenditure incurred on or attributable to a specified article or product or activity.

2. Gain. *Profit earned from transactions incidental to business.*

It is a profit that arises from transactions which are incidental to business such as sale of investment or fixed asset at a price that is higher than its book value.

3. Expenditure. *Amount incurred and includes both capital and revenue expenditure.*

Expenditure is the amount spent or liability incurred for the value received. An expenditure may be categorised into:

(i) Capital Expenditure. *Amount spent on acquiring fixed assets.*

Capital Expenditure is the amount spent on purchasing assets which will give benefits over a number of accounting periods. It means expenditure incurred on acquiring fixed assets or for their improvement. Examples are: purchase of machinery to manufacture goods, purchase of furniture or computers to conduct business. Capital expenditure is shown on the assets side of the Balance Sheet.

(ii) Revenue Expenditure. *Cost that is charged as expense.*

Revenue Expenditure is the amount spent to purchase goods and/or services that are consumed during the accounting period. Revenue expenditure does not increase the earning capacity but maintains it in the current year.

4. Discount. *Reduction in the price of goods or in amount.*

Discount is reduction in the prices of goods or amount due by the seller of goods and/or services.

5. Trade Discount. *Reduction in price of goods by the seller.*

Trade Discount is discount allowed by the seller of goods for goods being purchased in quantity. It is not accounted under a separate head but sale is accounted at net value. Similarly, purchases is recorded at net amount, *i.e.*, net of trade discount by the purchaser of goods.

6. Cash Discount. *Reduction in the amount due.*

Cash Discount means discount allowed by the seller for making timely payment. It is debited/credited to a separate head of account.

7. Rebate. *Discount allowed for reasons other than for which Trade Discount is allowed.*

It is reduction in price allowed by the seller of goods after the goods have been sold. It is allowed for the reasons other than for which trade discount and cash discount are allowed. For example, discount because of poor quality of goods.

8. Account. *A summarised record of similar transactions.*

Account is a summarised record of relevant transactions at one place relating to a particular head. It records not only the amount of transactions but also their effect and direction. For example, a Cash Account will show all cash received and paid. A Fixed Asset Account will show purchases, sales and depreciation of fixed assets.

9. Books of Account. *Books in which transactions are entered.*

Books of Account means a system of records, which records and explains the financial transactions of a business. When we refer to books of account, it means Journal and Ledger in which transactions are recorded.

10. Entry.

A transaction and event when recorded in the books of account is known as an **Entry**.

11. Debit.

An account has two parts, *i.e.*, debit and credit. The left side is the debit side while the right side is the credit side. If an account is to be debited, then the entry is posted to the debit side of the account. In such an event, it is said that the account is debited. The term 'Debit' is derived from an Italian word 'Debito'.

12. Credit.

Credit is the right side of an account. If an account is to be credited, then the entry is posted to the credit side of the account. In such an event, it is said that the account is credited. The term 'Credit' is derived from an Italian word 'Credito'.

13. Proprietor. *A person owning business and investing therein.*

The person who owns and makes investment and bears all the risks connected with the business is called the **Proprietor**.

14. Receivables. *Amounts owed to the firm.*

'Receivables' means amount due from others against sale of goods and/or services. It includes debtors, bills receivables, advances, etc.

15. Payables. *Amounts owed by the firm.*

'Payables' means amount payable by the enterprise to others and includes amount payable to creditors, lenders, employees or government towards taxes, etc.

16. Bill of Exchange. *An unconditional order in writing.*

A Bill of Exchange is an unconditional order in writing given by the creditor to the debtor and accepted by him (debtor) to pay on demand or after a certain period, a certain sum of money to or to the order of a specified person or to the bearer.

17. Bill Receivable.

Bill Receivable means a bill of exchange accepted by a debtor, the amount of which will be received on the specified date.

18. Bill Payable.

Bill Payable means a bill of exchange, the amount of which will be payable on the specified date.

19. Depreciation. *Decrease in book value of assets due to its wear and tear.*

Depreciation is decrease in the value of an asset because of usage or with passage of time or obsolescence or accident.

20. Cost of Goods Sold. *Cost of goods attributable to goods sold.*

Cost of Goods Sold is the direct cost of the goods and/or services sold.

21. Bad Debts. *Amount not recoverable.*

Bad Debt is the amount that has become irrecoverable. It is a business loss and is debited to Profit and Loss Account.

22. Insolvent. *A person or entity unable to pay his/its debts.*

Insolvent is a person or entity whose assets are not adequate to pay its debts.

23. Solvent. *A person or entity in position to pay his/its liabilities.*

Solvent is a person or enterprise whose assets are sufficient to pay its debts.

24. Book Value. *Value of an asset in the books of account.*

It is the amount at which an item exists in the books of account.

25. Investments. *Asset purchased or amount placed in bank to earn income.*

Investment means placement of funds with the expectation to earn return. Commonly, it refers to shares and debentures, mutual funds, bonds issued by the financial institutions and by the government. Investments are not expected to be sold within a year.

26. Balance Sheet. *A statement showing assets, liabilities and capital.*

It is a statement of the financial position at a given date, which shows its assets, liabilities, capital, reserves and other account balances at their book values.

27. Entity. *An economic entity.*

An entity means an economic unit that performs economic activities (e.g., Bajaj Auto, Maruti, TISCO). An entity may be a business entity or non-business entity. Business entity means a specifically identifiable business enterprise like ITC Ltd.