

BASIC ACCOUNTING TERMS

There are certain basic accounting terms which are daily used in the business world. Before recording the transaction in the books, it is essential to understand terms as these terms have their specific meaning in accounting. These basic terms called accounting terminology.

Assets

Anything which is the property of an enterprise including the amounts due to it from others, is called an asset.

In other anything which will enable a business enterprise to get cash or benefit in fully assets. Thus, cash and bank balances, stock furniture, machinery, land and building bills receivable, money owing by debtors etc. are all assets.

Fixed Assets: Fixed assets are long-term assets used in the operation of a business and are not intended for sale. They are used for producing goods or providing services.

Examples:

- Land and Building: Property owned by the business where it operates its offices, factories, or stores.
- Plant and Machinery: Equipment used in the manufacturing process, such as assembly line machines or industrial ovens.
- Motor Vehicles: Company-owned cars, trucks, or delivery vans used for business purposes.
- Furniture: Office desks, chairs, cabinets, and other furnishings used within the business premises.

Current Assets: Current assets are short-term assets that are expected to be converted into cash or used up within one year.

Examples:

- Cash and Bank Balances: Money available in the business's bank accounts and cash on hand.
- Stock (Inventory): Goods available for sale, including raw materials, work-in-progress, and finished products.
- Debtors (Accounts Receivable): Money owed to the business by customers for goods or services delivered.
- Bills Receivable: Promissory notes or other financial instruments that are expected to be paid by debtors within a short period.

Tangible Assets: Tangible assets are physical assets that can be seen and touched.

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Examples:

- Land: A physical piece of property owned by the business.
- Plant: The physical infrastructure of a factory or manufacturing facility.
- Furniture: Office or manufacturing furniture that can be physically touched and used.
- Stock: Goods or inventory available for sale, which are physical items.
- Cash: Physical money held by the business.

Intangible Assets: Intangible assets are non-physical assets that cannot be seen or touched but have value to the business.

Examples:

- Goodwill: The value of the business's brand name, customer relationships, and overall reputation.
- Patents: Legal rights granted to an invention, allowing the business to exclusively produce and sell the invention.
- Trademarks: Symbols, names, or logos legally registered to represent the business or its products.
- Copyrights: Exclusive rights to reproduce, publish, and sell creative works such as books, music, and software.

Wasting Assets: Wasting assets are assets that decrease in value due to their consumption or usage over time. They are often associated with natural resources or assets that depreciate.

Examples:

- Mines: Natural resource sites that deplete as minerals or ores are extracted.
- Oil Wells: Sites where oil is drilled, which deplete as oil is extracted.
- Patents: While also an intangible asset, patents can be considered wasting assets if they have a finite legal lifespan and their value diminishes as the patent nears expiration.
- Leasehold Properties: Properties leased by the business, which lose value as the lease term progresses towards expiration.

Liability

What Are Liabilities?

Liabilities are obligations or debts that a business needs to settle in the future. They represent claims against the company's assets by creditors, vendors, or lenders. Essentially, liabilities are what the business owes to others.

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How Liabilities Work

When a business acquires goods, services, or loans but does not pay for them immediately, it incurs a liability. These liabilities must be paid off at some point, either in the short term (within a year) or the long term (over a year).

According to **Finney and Miller**, "liabilities are debts; they are amounts owed to creditors."

Types of Liabilities

1. Long-Term Liabilities

Definition: Debts or obligations that are due for payment over a period longer than one year.

Examples:

- Long-Term Loans: Loans taken from banks or financial institutions that are repaid over several years. Example: A business might take a 5-year loan to buy equipment.
- Debentures: These are a type of long-term loan that a company can use to raise money from the public, with a promise to pay back after a certain period, like 10 years.
- Bonds: Similar to debentures, these are long-term borrowing instruments issued by the company.

Importance: Long-term liabilities are often used to finance significant investments in the business, like buying property, plant, or equipment.

2. Current Liabilities

Definition: Debts or obligations that are due within one year.

Examples:

- Accounts Payable (Creditors): Money owed to suppliers for products or services bought on credit. Example: A business buys office supplies on credit to be paid in 30 days.
- Short-Term Loans: Loans that need to be repaid within a year. Example: A business takes a 6-month loan to cover immediate expenses.
- Bank Overdraft: When a business withdraws more money from its bank account than it actually has, creating a negative balance.
- Accrued Expenses: Expenses that have been incurred but not yet paid. Example: Utility bills, wages, and rent that are due soon.
- Bills Payable: Bills that the business has to pay in the near future, such as invoices from suppliers.

Importance: Managing current liabilities effectively is crucial for maintaining good cash flow and ensuring the business can meet its short-term obligations.

Why Liabilities Matter

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- **Financial Health Indicator:** By looking at a company's liabilities, you can gauge its financial health. High liabilities might indicate potential risk, while manageable liabilities suggest stability.
- **Creditworthiness:** Lenders and investors look at a company's liabilities to determine its ability to repay debt. A company with lower liabilities is often seen as a safer investment.
- **Cash Flow Management:** Understanding liabilities helps a business manage its cash flow effectively, ensuring it can meet its financial obligations without running into trouble.
- **Operational Efficiency:** Effective management of liabilities ensures smooth business operations, avoiding disruptions that could arise from unpaid bills or unmet loan repayments.

Simple Formula:

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

This formula shows that what the business owes (liabilities) is equal to what it owns (assets) minus what the owners have invested (capital).

Capital

What is Capital?

Capital is the money or assets that the owner invests in the business. It's what the business uses to buy things like goods, equipment, and other assets needed to operate.

Key Points About Capital

- **Owner's Investment:** Capital is the amount of money the business owner puts into the business.
- **Used for Buying Assets:** This money is used to buy things the business needs, like stock, machinery, and buildings.
- **Net Worth of the Business:** Capital shows the net worth of the business, calculated by subtracting what the business owes (liabilities) from what it owns (assets).

How to Calculate Capital

The formula to find out the capital is:

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

Assets: Everything the business owns that has value (cash, stock, buildings, equipment).

Liabilities: Everything the business owes to others (loans, bills, debts).



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Types of Capital

Fixed Capital:

- Long-term use: Used to buy things the business will use for many years.
- Examples: Buildings, machinery, vehicles, furniture.

Working Capital:

- Short-term use: Used for daily business operations.
- Examples: Cash, inventory (goods to sell), money owed by customers.

Why Capital is Important

- Keeps Business Running: Ensures the business can buy what it needs and keep operating smoothly.
- Shows Financial Health: Indicates if the business is financially stable and can handle ups and downs.
- Supports Growth: Provides funds needed to expand the business or start new projects.
- Helps Get Loans: A strong capital base makes it easier to get loans and attract investors.

Simple Example

Imagine you start a business with Rs 50,000 of your own money. You use this money to buy:

- Inventory: Rs 20,000 (goods to sell)
- Equipment: Rs 15,000 (machines, tools)
- Cash: Rs 15,000 (money in the bank)

Now, suppose you also have:

Liabilities: Rs 10,000 (a loan you need to repay)

Using the formula:

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

So, your capital would be: Rs 50,000 (total assets) - Rs 10,000 (total liabilities) = Rs 40,000

This **Rs 40,000** is your capital, representing your net investment in the business after accounting for what you owe.

Expenses:

What Are Expenses?

Expenses are the costs that a business incurs to produce and sell goods and services. These costs are essential for running the business and include things like rent, utilities, wages, and materials.

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Key Points About Expenses

- Costs of Running the Business: Expenses are the necessary costs to keep the business operating.
- Production and Sales: They include everything from making the products to selling them.

Types of Expenses

Expenses can be broadly categorized into different types based on their nature and timing:

1. Operating Expenses

These are the day-to-day costs required to run the business.

Examples:

- Rent: Payment for the space where the business operates.
- Utilities: Costs for electricity, water, internet, etc.
- Wages: Salaries paid to employees.
- Office Supplies: Items like paper, pens, and other materials used in the office.

2. Cost of Goods Sold (COGS)

These are the direct costs associated with producing the goods that the business sells.

Examples:

- Materials: Raw materials used to make products.
- Labor: Wages paid to workers directly involved in production.
- Manufacturing Supplies: Items needed for the manufacturing process.

3. Non-Operating Expenses

These are expenses not related to the main activities of the business.

Examples:

- Interest: Money paid on loans.
- Taxes: Business taxes owed to the government.

Importance of Expenses

- Profit Calculation: Expenses are subtracted from revenue to calculate profit. Knowing expenses helps determine how much money the business is actually making.
- Budgeting: Understanding expenses is crucial for creating budgets and controlling costs.
- Financial Health: Monitoring expenses ensures the business is spending money wisely and staying financially healthy.

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Simple Example

Imagine you own a bakery. Here are some typical expenses:

Rent: Rs 1,000 per month for the shop.

Ingredients: Rs 500 per month for flour, sugar, and other baking supplies.

Utilities: Rs 200 per month for electricity and water.

Wages: Rs 1,500 per month for employees.

If the bakery earns Rs 5,000 in a month, you calculate the profit like this:

$$\text{Revenue} - \text{Expenses} = \text{Profit}$$

$$\text{Rs } 5000 - (\text{Rs } 1,000 + \text{Rs } 500 + \text{Rs } 200 + \text{Rs } 1,500) = \text{Rs } 1800$$

So, the bakery's profit for the month is Rs 1,800 after paying all expenses.

Income

What is Income?

Income is the profit that a business earns after subtracting all expenses from its revenue. It's the amount of money left over once all the costs of running the business are paid. This is different from revenue, which is the total amount of money received from sales.

Key Points About Income

Revenue vs. Income:

- Revenue: Total money received from selling goods or services.
- Expenses: Costs incurred to produce and sell those goods or services.
- Income: The surplus or profit that remains after all expenses are subtracted from revenue.

Profit Calculation: Income is calculated using the formula:

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

Understanding Revenue and Expenses

Revenue: The total amount of money a business earns from selling its goods or services.

- Examples: Sales from products, service fees, rental income.

Expenses: The costs incurred to generate revenue.

- Examples: Cost of materials, wages, rent, utilities.

How Income is Calculated

To calculate income, you subtract the total expenses from the total revenue. The remaining amount is the income or profit.

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Let's use a simple example to illustrate:

Revenue: Imagine a small business that sells handmade candles. In one month, the total revenue from sales is ₹10,00,000.

Expenses: The costs incurred to produce and sell these candles include:

- Materials: ₹3,00,000 (wax, wicks, containers, etc.)
- Wages: ₹2,00,000 (paying employees)
- Rent: ₹1,00,000 (shop space)
- Utilities: ₹50,000 (electricity, water)
- Other Expenses: ₹50,000 (advertising, shipping, etc.)

Total expenses for the month are = ₹3,00,000 + ₹2,00,000 + ₹1,00,000 + ₹50,000 + ₹50,000 = ₹7,00,000

Income Calculation: Subtract the total expenses from the total revenue to find the income.

Income = ₹10,00,000 - ₹7,00,000 = ₹3,00,000

So, the business has an income (or profit) of ₹3,00,000 for the month.

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 two categories :

(i) capital expenditure and (ii) revenue expenditure.

Capital expenditure is like big investments that help the business grow over time, while **revenue expenditure** is all about the everyday costs of doing business. Understanding the difference helps in managing money wisely and making the right decisions for the business.

a) **Capital expenditure:** any expenditure which is incurred in acquiring or increasing the value of a fixed assets 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 over a long period and hence written in assets.

b) **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 expenditure are debited to trading and profit and loss account. Such expenditure does not result in an increase in earning capacity. It also does not bring into existence an asset of an enduring nature.

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Debtors and Receivables

When a business sells goods to someone on credit, meaning they don't get paid immediately but later, those people or companies become debtors. The money they owe is called accounts receivable or receivables. Here's a simpler breakdown:

Debtors: These are the people or companies who haven't paid for the goods they bought on credit yet.

Example: If a store sells a TV to someone on credit, that person becomes a debtor until they pay for it.

Receivables: This is the total amount of money owed to the business from all the people or companies who bought goods on credit.

Example: If the store sold TVs, refrigerators, and microwaves on credit, the total amount owed for all these items is the receivables.

Creditors and Payables

When a business buys goods from someone on credit, meaning they don't pay immediately but later, those people or companies become creditors. The money the business owes them is called accounts payable or payables. Here's a simpler breakdown:

Creditors: These are the people or companies that the business owes money to because they bought goods on credit.

Example: If a store buys TVs from a supplier on credit, that supplier becomes a creditor until the store pays for them.

Payables: This is the total amount of money the business owes to all the people or companies from whom they bought goods on credit.

Example: If the store bought TVs, refrigerators, and microwaves on credit, the total amount owed for all these items is the payables.

Goods

Goods are basically the things that a business buys to either sell directly to customers or to use in making products that will be sold.

Definition: Goods are anything that a business buys with the intention of selling them to customers or using them to make products that will be sold later.

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- If you walk into a grocery store, the food items like fruits, vegetables, and canned goods are all examples of goods that the store intends to sell directly to customers.
- In a factory that makes furniture, the wood, screws, and varnish used to make the furniture are considered goods because they are used to produce the final product that will be sold to customers.

Different types of goods:

1. Consumer Goods:

Consumer goods are products purchased by individuals for personal use or consumption. These goods are typically categorized based on their durability and frequency of purchase.

- Durable Goods: These are long-lasting consumer goods that are not consumed quickly and are used over an extended period. Examples include appliances, furniture, and electronics.
- Non-durable Goods: Non-durable goods are consumed quickly or have a short lifespan. Examples include food, beverages, toiletries, and clothing.

2. Industrial Goods:

Industrial goods are products purchased by businesses for use in production or operations. These goods are often classified based on their purpose and how they contribute to the production process.

- Raw Materials: Raw materials are unprocessed materials used in manufacturing or production processes. Examples include wood, steel, cotton, and oil.
- Intermediate Goods: Intermediate goods are partially processed materials or components used to produce finished goods. They are not sold directly to consumers but are used in the production process. Examples include steel rods used to make cars or computer chips used in electronics manufacturing.
- Capital Goods: Capital goods are long-term assets used by businesses to produce other goods or services. These goods are used repeatedly in the production process and include machinery, equipment, vehicles, and buildings.

Cost

Cost refers to the resources, typically money or its equivalent, that a business gives up in exchange for acquiring goods or services. Here's a simpler breakdown:

Definition: Cost is the amount of money or resources spent on acquiring or producing something, whether it's a product, service, or any other activity.



Examples:

When you go shopping and buy groceries, the money you spend on those groceries is the cost.

For a business, the cost of producing a product includes expenses like purchasing raw materials, paying for labor, and covering overhead costs like rent and utilities.

Types of Costs

Fixed Costs:

Fixed costs are expenses that remain constant regardless of the level of production or sales. These costs do not change with the volume of output and typically include items like rent, insurance premiums, salaries of permanent employees, and depreciation of fixed assets.

- **Example:** Monthly rent for office space remains the same whether the business produces 100 units of a product or 1,000 units.

Variable Costs:

Variable costs are expenses that change in direct proportion to the level of production or sales. These costs fluctuate as production levels vary and include items like raw materials, direct labor, and sales commissions.

- **Example:** The cost of raw materials increases as the business produces more units of a product.

Direct Costs:

Direct costs are expenses directly attributable to the production of a specific product or service. These costs can be easily traced to a particular product or department and include items like raw materials, labor, and direct overhead costs.

- **Example:** The cost of fabric, buttons, and thread for manufacturing a shirt is a direct cost for a clothing manufacturer.

Indirect Costs:

Indirect costs are expenses that cannot be directly attributed to a specific product or service but contribute to overall operations. These costs are typically incurred for multiple products or departments and include items like rent, utilities, and administrative salaries.

- **Example:** The salary of the human resources department staff is an indirect cost that supports the entire organization.

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