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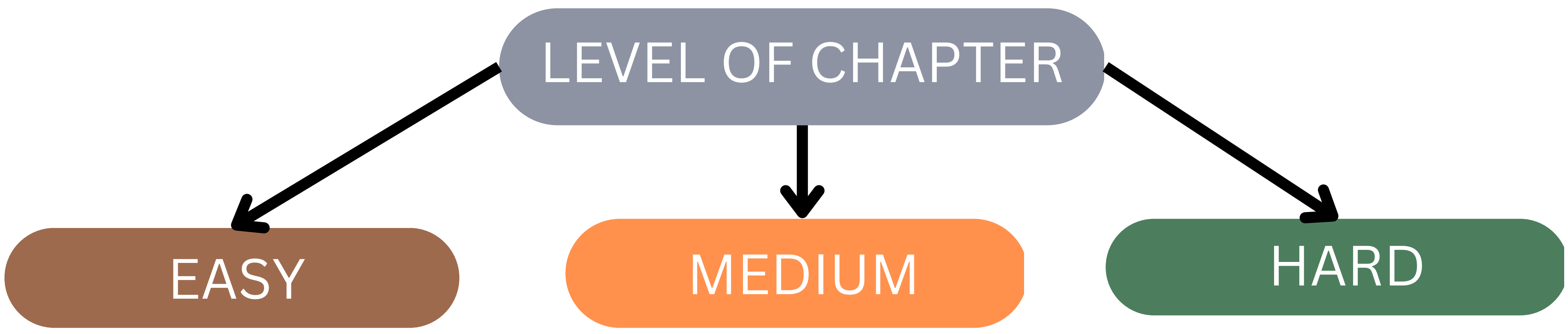
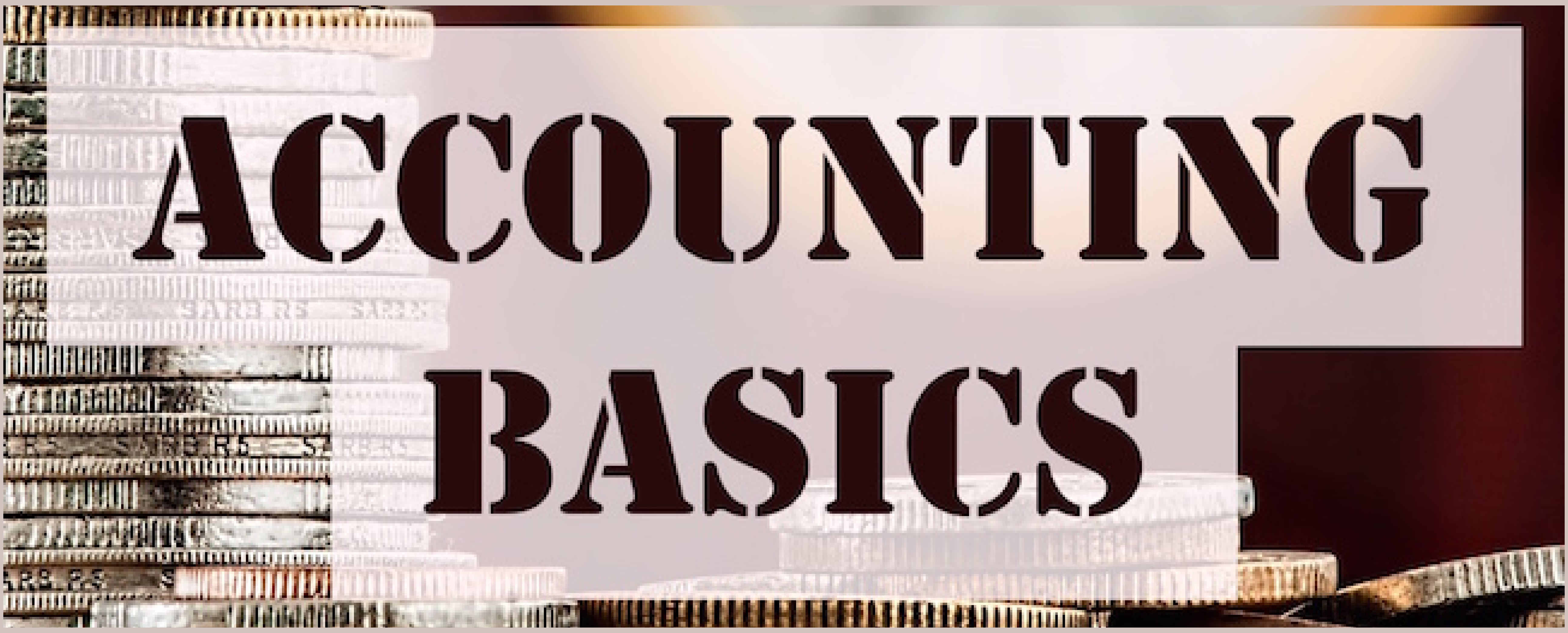
BASICS OF ACCOUNTING



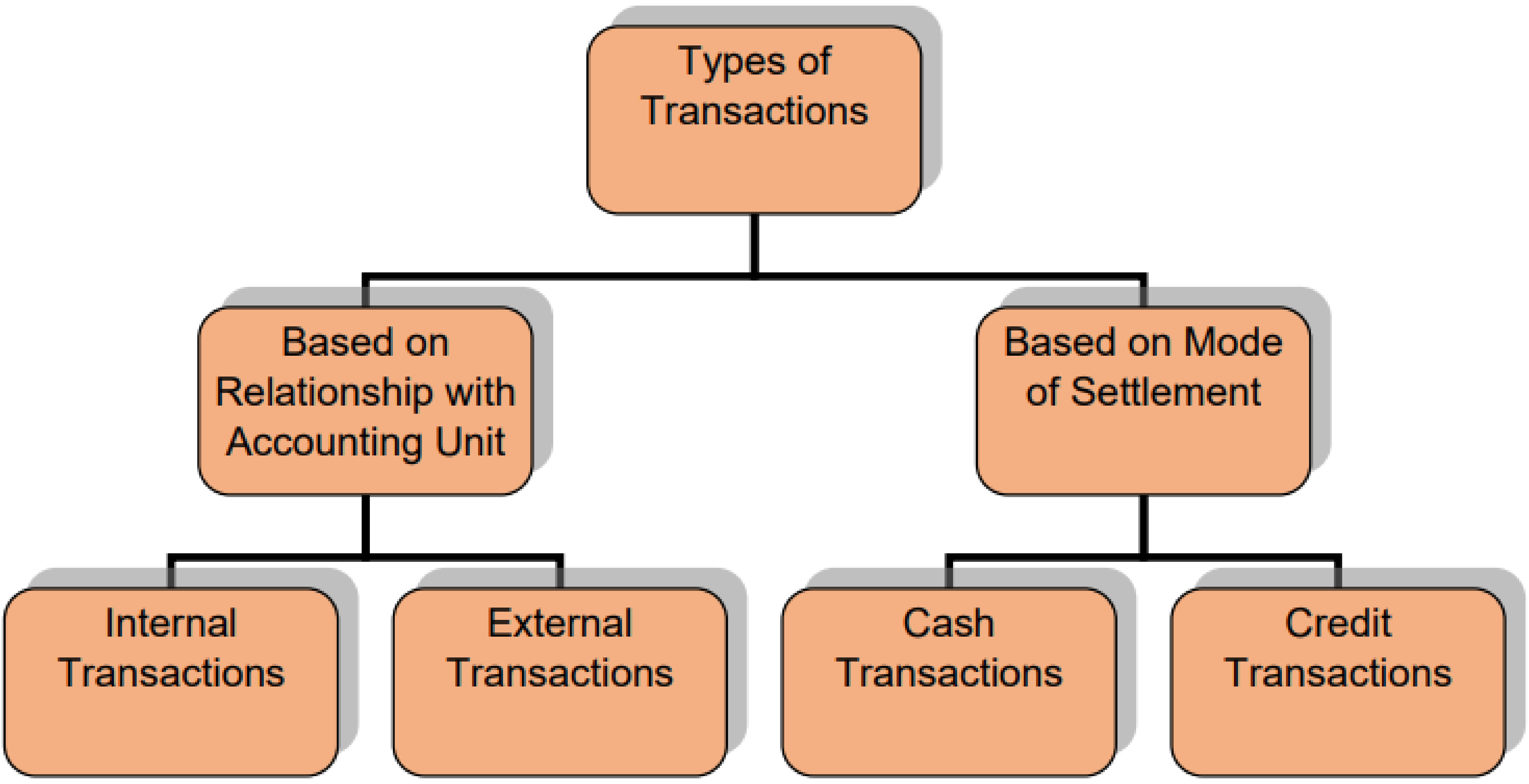


Understanding Basic Accounting Terms

Business Transaction:

o Transaction: It is an event which involves transfer of money, goods and services and can be classified into cash or credit transactions. Cash transaction is the one where cash receipt or payment is involved and a credit transaction is one where cash is not involved immediately but will be paid or received later.

Business Transaction: It is a financial transaction or an economic event expressed in terms of money which brings in a change in the financial position of an enterprise. It involves transfer and exchange of goods or services such as purchase/sale of goods and services, wages paid to workers, rent paid, dividend received, lending and borrowing money.



o Characteristics:
Following are the characteristics of a Business Transaction:

i. Money or money's worth: It is basically concerned with money or money's worth received from of sale of goods or provision of services.

ii. Exchange of goods or services: It arises out of exchange of goods or services.

iii. Change in financial position: It affects the financial statements of an enterprise and therefore, is responsible for change in its financial position.

iv. Accounting equation: It affects the accounting equation of any business firm.

v. Dual Aspects: Every business transaction has 2 sides, one is receiving side and the other is giving side and therefore, it is said to have a dual aspect for every transaction.

vi. Equality of Balance Sheet: Since, every transaction has dual aspect affecting the two sides namely, Receiving and Giving simultaneously, it helps in maintaining the equality of Balance Sheet.

Account: It is a record of both cash and credit transactions maintained under a particular head which shows the transactions and the effect of such transactions in the books of accounts.

Capital: It is the amount invested by the proprietor (in case of proprietorship business) and by partners (in case of partnership business) into the business. If the business earns profit or proprietor/partners invests additional amount, the amount of capital increases in the business. On the other hand, if the business incurs losses or amount is withdrawn, the amount of capital decreases. Capital is also known as Owner's Equity or Net Worth which is computed as excess of Assets over Liabilities as follows:

Assets - Liabilities = Capital

Drawings: It is the amount of cash or goods withdrawn from the business by the proprietor (in case of proprietorship business) or by partners (in case of partnership business) for their personal use. Such an amount reduces the amount of investments or capital of the owners in the business and therefore, is shown as a deduction from the capital of the proprietor or partner while preparing the Balance Sheet.

LIABILITIES

Liability is a legal obligation of an individual or a business entity towards creditors arising out of some transactions.

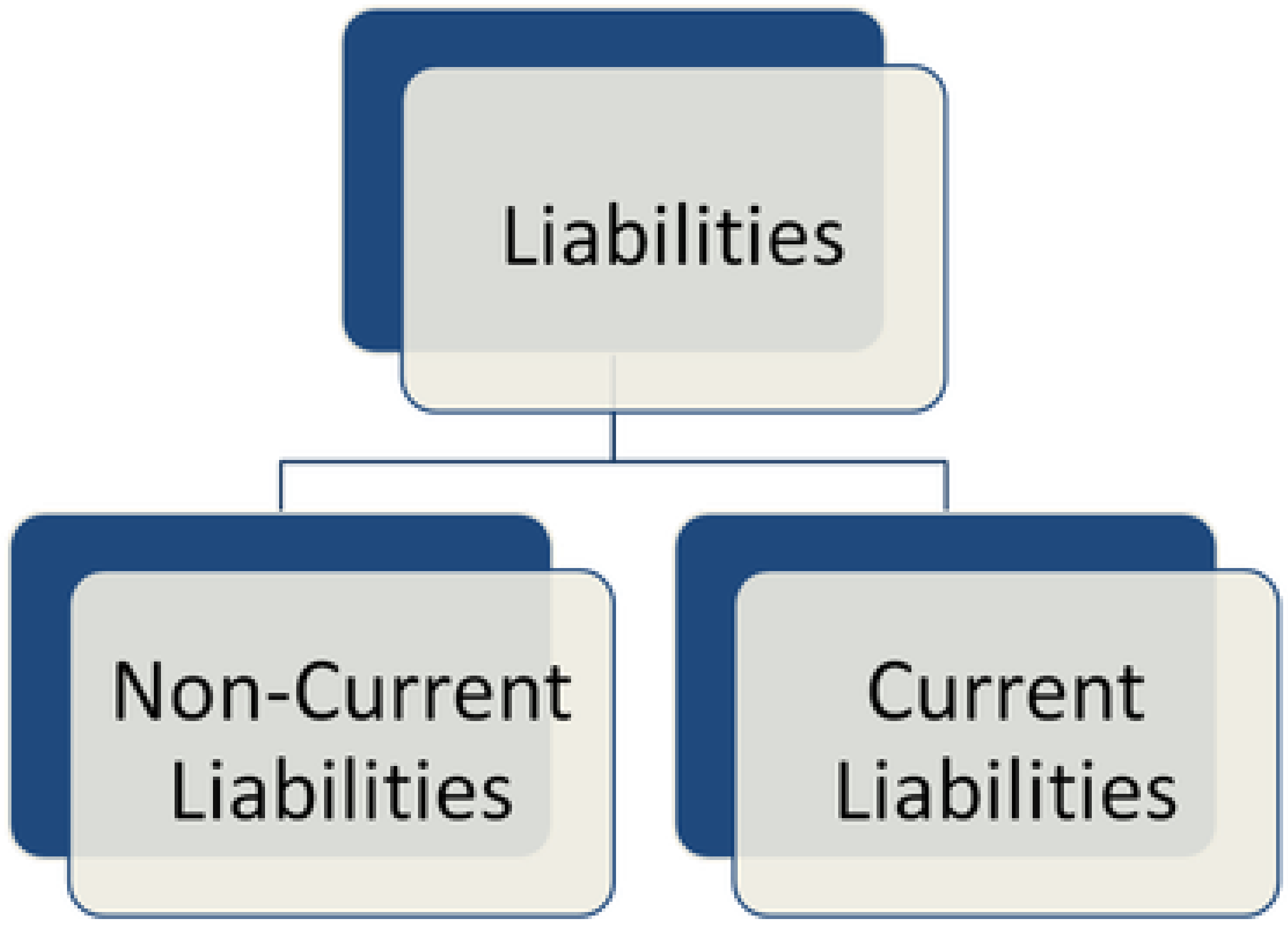
TYPES OF LIABILITIES

CURRENT LIABILITIES: Current Liabilities are those liabilities which are normally due and payable within one year

Long-term Liabilities are those liabilities which don't due immediately but become due after a year or more. **LONG TERM LIABILITIES**

CONTINGENT LIABILITES: Contingent Liabilities are liabilities are payable on the occurrence of some event or contingency.

Liabilities: It refers to the financial obligations or debt which a business owes to others, i.e. amount business is liable to pay others such as loans from banks, other persons or creditors for goods supplied. These liabilities are classified as Internal or External Liabilities where, internal liability is the liability towards owners of the business and external liability is the liability towards the outsiders (i.e., other than owners). It is further classified as follows:



o Non-Current or Long term Liabilities: These are the loans which are payable after a period of more than a year from the end of the accounting period. Examples include, long-term loans, debentures, etc.

o Current or Short term Liabilities: These are the obligations which are payable within a period of 12 months from the end of the accounting period. Examples include, bills payable, short-term loans, etc.

Assets: These are the properties owned by the business which are used to carry out the business operations and earn operating revenue for the business. It can be classified into Non-Current, Current and Fictitious Assets which are explained as follows:

o **Non-Current assets:** These are used for carrying out normal business operations and are held in the business not for the purpose of reselling it but to increase the earning capacity of the business. These are further classified as Fixed Assets, Non-Current Investments, Long term Loans and Advances and Other Non-Current Assets.

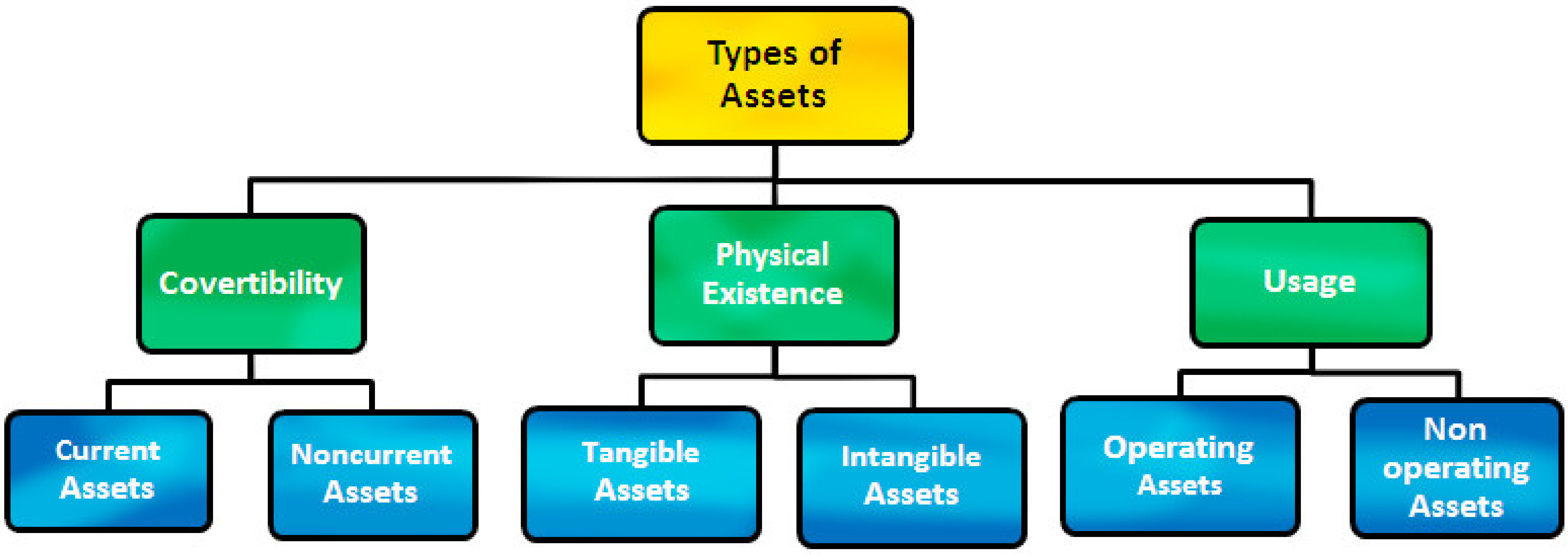
Fixed Assets: These are those assets which are not held in the business for reselling but are held for a long term to increase the earning capacity of the business. They are further classified as follows:

a. **Tangible:** Assets which have physical existence and can be seen and touched are termed as Tangible Assets. It includes land, building, furniture, etc.

b. **Intangible:** Assets which do not have physical existence and cannot be seen and touched are termed as Intangible Assets. It includes patents, goodwill, etc.

o **Current Asset:** These are those assets which are held on short term basis for the purpose of converting them into cash within a year such as debtors, stocks, etc. Prepaid expenses are also classified as current assets because although they cannot be converted into cash, because a part of their benefit is available for next accounting year.

o **Fictitious Assets:** These are those assets which are neither tangible nor intangible. These are the losses not written off in the year in which they are incurred but in more than one accounting period.



Receipts, Expenditure, Income, Expense, Profit, Gains and Losses

Receipts: It is the amount which is received or receivable for selling goods, services or assets. These receipts are further classified as follows:

o Revenue Receipts: The amount that has been received or is receivable by the business in its normal course either from sale of goods or by providing services. It will also include the amounts that are received from investment of business resources say interest received from investment in fixed deposits. Such amounts from normal course of business are recorded in the Profit and Loss Account (in case of profit-making enterprises) and in the Income and Expenditure Account (in case of an NPO).

o Capital Receipts: The amount received or receivable against the transactions which are not revenue in nature like sale of an asset, investment, etc. Such amounts are shown in the Balance Sheet of the business entity.

Expenditure: It is the amount spent or liability incurred for acquiring assets, goods or services. These expenditures are further classified as follows:

o Revenue Expenditure: It is that expenditure the benefit of which is consumed or exhausted within the accounting period. These are the amounts spent for the purposes which are directly related to the business of the entity like cost of goods sold, rent, electricity, etc. They are shown in the Trading or Profit and Loss Account (in case of profit-making enterprises) and in the Income and Expenditure Account (in case of an NPO).

o Capital Expenditure: It is the amount incurred to acquire tangible or intangible assets or the amount spent on improving the existing assets which increase the earning capacity of the business. These amounts spent are shown in the Balance Sheet of the entity.

o Deferred Revenue Expenditure: This is a revenue expenditure in nature which is written off or charged in more than one accounting period. Such treatment is given to those items, the benefits of which are estimated to accrue in more than one financial year. These include the large expenditure amounts like advertising expenses, research expenses, etc. that will give benefit for more than one accounting period.

Income: It is the profit earned during an accounting period which is calculated as the difference between the Revenue and Expenses. In other words, excess of Revenue over expenses is termed as Income.

Expense: It is the cost incurred for generating revenue or a monetary measure of inputs or resources consumed. It is actually the value of business that has expired during the accounting year. It includes amount spent as cash payments for salaries, wages or amounts that are written off during an accounting period like depreciation, bad debts or decline in the value of any investment or cost of goods sold. It is charged to the Trading Account or Profit and Loss Account. It is necessary to understand the following expenses:

o Prepaid Expenses:
It is the amount of expense which is paid in advance and the benefit of which will be available in the following year or years and therefore, are shown as assets in the Balance Sheet of the business.

o Outstanding Expenses: It is an expense that has been incurred but has not been paid during the current accounting year. Since, the amount is payable, it is a liability for the business and is therefore, shown as a liability in the Balance Sheet.

Profit: It is the income earned by the business from its Operating Activities which are carried out by the enterprise to earn profits. These activities can be either sale of goods or provision of services. This profit is further divided into gross and net profit:
o Gross Profit: It is the difference between revenue from sales and/or services rendered and its direct cost.
o Net Profit: It is the profit after deducting total expenses from total revenue of the enterprise. In case if the total expenses are more than the total revenue, such difference is termed as Net Loss.

Gain: It is the increase in the owners' equity resulting from something other than the day to day earning that is of irregular or non-recurring nature. It is the profit from non-operating transactions but which is incidental to it such as gain on sale of land, machinery or investments.

Loss: Loss refers to the excess of expenses over its related revenues for a period which decreases the owners' equity. It is a broad term and includes loss incurred in its operating activities, money or money's worth lost against which the firm receives no benefit, or any loss from events of non-recurring nature.

Purchases, Purchases Return, Sales, Sales Return, Revenue from Operations, Goods and Stock/Inventory

Purchases: It refers to the amount of goods which are bought for resale or the amount of raw materials that are used in the production process. It includes both cash and credit purchases of goods.

Purchases Return: When goods are returned to the suppliers for any reason, it is called as purchases return or returns outward.

Sales: Sales refers to the amount of goods sold that have already been bought or manufactured by the business. It includes both cash and credit sales of goods.

Sales Return: When goods are returned from the customers for any reason, it is called sales return or return inward.

Revenue from Operations: Revenue means the income generated from the sale of goods (in case of a non-financial enterprise) and the earnings from interest, dividend and commission (in case of a financial enterprise). In other words, it is revenue earned by an enterprise from its operating activities.

Goods: These are the physical items of trade that are purchased to be sold and includes all the items making up the sales or purchases of a business. In other words, it is actually Stock-in-trade of an enterprise, purchased or manufactured with the purpose of selling.

Stock/Inventory: Stock or Inventory is a tangible asset that is held by the business for the purpose of sale in normal course of business or for the purpose of using it in production of goods meant for sale. It includes goods unsold on a particular date. It may be opening or closing stock. The goods unsold in the beginning of the accounting period is called opening stock, whereas the goods unsold at the end of the accounting period is called closing stock.

Trade Receivables, Trade Payables, Cost, Vouchers, Trade Discount and Cash Discount

Trade Receivables: It is the amount that is receivable for sale of goods and/or services rendered in the ordinary course of business. It is a sum total of debtors and bills receivable.

o Debtor: Includes a person who receives a benefit without paying money immediately but liable to pay in future within a particular period of time. He owes an amount to business against credit sale of goods/services rendered.

o Bills Receivable: It is the amount of Bill of Exchange accepted by a debtor specifying the amount of which will be received on the specified date from him by the business.

Trade Payables: It is the amount payable for purchase of goods and/or services taken in the ordinary course of business. In other words, it is the sum total of creditors and bills payable.

o Creditor: A creditor is a person who gives a benefit without receiving money immediately but to claim it in future. It is to whom our business owes an amount against credit purchases of goods/services.

o Bills Payable: It is the amount of Bill of Exchange accepted by the person or enterprise, the amount of which will be payable on the specified date.

Cost: It is the amount incurred on or attributable to a specified item or activity in the business.

Vouchers: A voucher is a written document in support of a particular transaction. It includes, cash memo as given by the seller for cash purchase, invoice given for credit purchase and received receipt for making cash payment.

Discount: It is the amount of reduction in the price of goods and/or services or a reduction in the total amount payable for such goods or services. Such discount is further classified as Trade Discount and Cash Discount:

o Trade Discount: It is a reduction in the prices of the goods allowed by the seller to the buyer for buying goods of certain quantity or value. When such discount is allowed, Purchases and Sales are recorded in the books at their net value i.e., Purchases – Trade Discount and Sales – Trade Discount respectively.

o Cash Discount: It is allowed for timely payment of the amount. Such amount is recorded in the books for which it is treated as an expense by the party allowing such discount and income by the party receiving such discount.

Other Important Terms

Bad Debts: It is the amount receivable by the business which becomes irrecoverable and is therefore, treated as a loss by the business and debited to the Profit and Loss Account.

Balance Sheet: It is a statement of financial position of a business on a particular date, which shows the assets, liabilities, capital reserves and other account balances at their respective book values.

Book Value: It is the value at which the items (assets, liabilities, etc.) appear in the books of accounts or financial statements.

Books of Account: It is the records or books in which all the financial transactions of an entity are recorded and maintained. It includes journal, ledger, cash book and bank book.

Cost of Goods Sold: It is the cost attributable to the production of goods sold and/or services rendered.

Debit: It is the left side of an account and is derived from an Italian word 'Debito'. In case where an account is to be debited, the entry is posted to the debit side of an account and it is said that the account is debited.

Credit: It is the right side of an account and is derived from an Italian word 'Credito'. In case where an account is to be credited, the entry is posted to the credit side of an account and it is said that the account is credited.

Depreciation: It is a fall in the value of an asset on account of usage or passage of time or obsolescence. It is allocation of cost of the fixed asset in each accounting year during its expected useful life.

Entity: It is an economic unit which carries out various economic activities and is established in accordance with the law in force. It includes proprietorship, partnership firms, corporations, companies, etc.

Entry: It is a transaction or an event which is recorded in the books of account.

Insolvent: It is the state of a person/entity where he is unable to pay its debts.

Proprietor: A person who owns a business and contributes capital to the business to earn profit is called proprietor.

Rebate: It is a reduction in the price of the goods after the goods have been sold and is offered for reasons other than that which may have been for allowing trade discounts (say, bad quality products delivered). It is offered and allowed on sales completed in the past.

Solvent: It is the state where a person/entity is in position to pay of its debts.