CHAPTER 2

Basic Accounting Terms

LEARNING OBJECTIVES

This Chapter would enable you to understand:

Accounting Terms Prescribed in Syllabus:

- ❑ Business Transaction
- ❑ Account
- ❑ Capital
- ❑ Drawings
- ❑ Liabilities (Non-current and Current Liabilities)
- ❑ Assets [Non-current Assets, Current Assets and Fictitious Assets] (Fixed Assets—Tangible Assets and Intangible Assets)
- ❑ Receipts (Capital and Revenue)
- ❑ Expenditure (Capital, Revenue and Deferred Revenue)
- ❑ Expense (Prepaid and Outstanding)
- ❑ Income
- ❑ Profit
- ❑ Gains
- ❑ Losses
- ❑ Purchases
- ❑ Purchases Return
- ❑ Sales
- ❑ Sales Return
- ❑ Revenue from Operations
- ❑ Goods
- ❑ Stock/Inventory
- ❑ Trade Receivables (Debtors and Bills Receivable)
- ❑ Trade Payables (Creditors and Bills Payable)
- ❑ Cost
- ❑ Vouchers
- ❑ Discount—Trade and Cash

Other Important Accounting Terms:

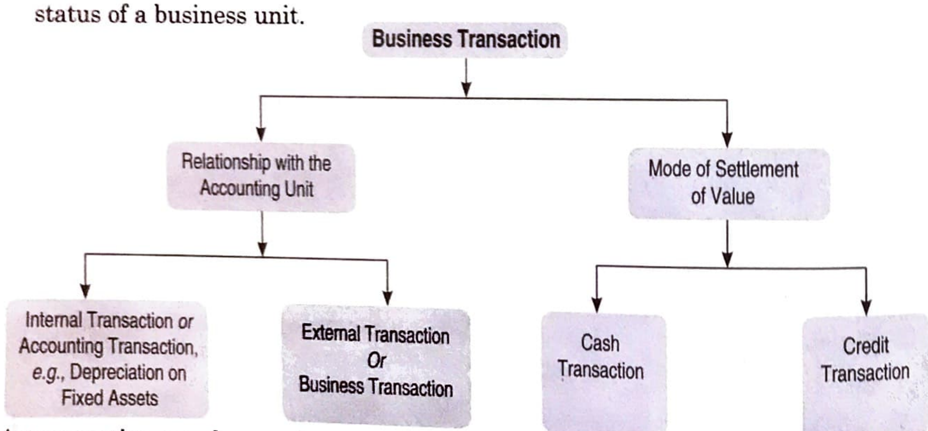
- ❑ Bad Debts
- ❑ Balance Sheet
- ❑ Book Value
- ❑ Books of Account
- ❑ Cost of Goods Sold
- ❑ Credit
- ❑ Debit
- ❑ Depreciation
- ❑ Entity
- ❑ Entry
- ❑ Insolvent
- ❑ Proprietor
- ❑ Rebate
- ❑ Solvent
- ❑ Financial Statements or Final Accounts

In business, various accounting terms are used. It is necessary to understand these terms as they are part of the standard accounting terminology.

1. Business Transaction: The term 'Business Transaction' means a financial transaction or economic event entered into by two parties that initiates the accounting process of recording it in the books of account of an enterprise. It is a financial event expressed in terms of money which brings a change in the financial position of an enterprise. Stating differently, it is an agreement between two parties involving transfer or exchange of goods or services. Examples of business transactions are sales of goods, purchases of goods, receipt from debtors, payment to creditors, purchase or sale of fixed assets, payment of interest, payment of dividend, etc.

Characteristics of a Business Transaction

1. It is concerned with money or money's worth of goods or services.
2. It arises out of the transfer or exchange of goods or services.
3. It brings about a change in the financial position (*i.e.*, in Assets and Liabilities).
4. It has an effect on the accounting equation of any business firm.
5. It has dual aspects or two sides—'Receiving' (Debit) and 'Giving' (Credit) of the benefit. In other words, every transaction has two sides—one is 'Receiving' the benefit and the other is 'Giving' the benefit.
6. After each transaction, the total assets of a business must be equal to its total liabilities and capital. Therefore, *the equality of the Balance Sheet* cannot be disturbed by any transaction.
7. The nature of each transaction is carefully analysed since it affects the financial status of a business unit.



A transaction may be a cash transaction or a credit transaction. When the amount is transacted (paid or received) immediately on entering into a transaction it is a *cash transaction* and when it is promised to pay later, it is a *credit transaction*. Transactions may be external (between a business entity and a second party, for example, goods sold on credit to Z) or internal (does not involve second party, *e.g.*, depreciation charged on machinery).

2. Account: It is a record of transactions (cash and credit) under a particular head of account (say Salaries, Telephone Expenses, Electricity Expenses, etc.) or a particular head (say asset, liability, etc.). It not only shows the amounts of transactions but also shows their effect and direction.

3. Capital: Capital is the amount invested in an enterprise by the proprietor (in case of proprietorship) or by partners (in partnership business). It may be in the form of money or assets having a monetary value. It is a liability of the business towards the proprietor or partners which increases with further investments made in the business and the amount of profit earned. On the other hand, it decreases when it is withdrawn (drawings) or loss is incurred by the business.

In the case of Companies, contributors of capital are many and they are known as **shareholders**.

It is a liability because under "Business Entity Concept", business is a separate and distinct entity from its owners. Transactions are recorded in the books of account from the point of view of business. Capital is also known as **Owner's Equity** or **Net Worth**. It is always equal to assets *less* liabilities. It can be expressed as:

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

4. Drawings: It is the amount withdrawn or goods taken by the proprietor or partner for personal use. Goods so taken by the proprietor or partner are valued at purchase cost. Drawings reduces the investment (or capital) of the owners. Drawings by the proprietor or partner is debited to Drawings Account. At the time of preparing Balance Sheet, it is deducted from the capital of the proprietor or partner, as the case is.

5. Liabilities: Liabilities mean amount owed (payable) by the business. Liability towards the owners (proprietor or partners) of the business is termed as **internal liability**. On the other hand, liability towards the outsiders, *i.e.*, other than the owners (proprietor or partners) is termed as **external liability**.

External liability arises because of credit transactions or loans taken. Examples of external liability are creditors, bank overdraft, long-term borrowings, and other liabilities.

Liability is further classified into:

(*i*) *Non-current Liability:* Non-current Liability is that liability which is payable after a period of more than a year from the end of the accounting period. Examples of Non-current Liability are long-term loans, debentures, etc.

(*ii*) *Current Liability:* Current Liability is that liability which is payable within 12 months from the end of the accounting period. Examples of Current Liability are creditors, bills payable, short-term loans, etc.

Classification of Liabilities in case of Companies as per Schedule III of the Companies Act, 2013

Liability under Schedule III of the Companies Act, 2013 is classified into:

(*i*) Current Liabilities, and (*ii*) Non-current Liabilities

(*i*) *Current Liabilities:* A liability is a current liability if it satisfies any one of the following criterias:

(*a*) it is expected to be settled in the company's normal *operating cycle*; or

(*b*) it is held primarily for the purpose of being traded; or

(*c*) it is due to be settled within 12 months after the reporting date; or

(*d*) the company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.

(*ii*) *Non-current Liabilities:* Non-current liabilities are those liabilities which are not current liabilities.

Operating Cycle means the time between the acquisition of an asset for processing and its conversion into Cash and Cash Equivalents. If the operating cycle cannot be identified, it is taken to be a period of 12 months.

Company Accounts is part of syllabus for Class XII.

6. *Assets:* Assets are the properties (tangible assets and intangible assets) owned by an entity or enterprise. They are the economic resources of the business. In other words, anything which will enable the firm to get economic benefit in the future, is an asset. Examples of assets are land, building, machinery, furniture, stock, debtors, cash and bank balances, trademarks, copyrights, goodwill, etc.

"*Assets are future economic benefits, the rights, which are owned or controlled by an organisation or individual.*" —**Finney and Miller**

"*Assets are property or legal right owned by an individual or a company to which money value can be attached.*" —**R. Brockington**

"*Assets are valuable resources owned by a business which are acquired at a measurable money cost.*" —**Prof. R.N. Anthony**

What emerges from the above definitions is that an asset should have the following characteristics:

1. It should be owned (*i.e.*, property) by the business.
2. It may be in tangible (physical) form or intangible form.
3. It should have some value attached to it.
4. It should be capable of being measured in money terms.

Assets can be classified into (*i*) Non-current Assets, (*ii*) Current Assets, and (*iii*) Fictitious Assets:

(*i*) *Non-current Assets:* Non-current Assets are those assets which are held by an entity or enterprise not with the purpose to resell but are held either as investment or to facilitate business operations. In other words, those assets are held by the business from a long-term point of view. Examples of non-current assets are Fixed assets, Non-current Investments, Long-term Loans and Advances and Other Non-current Assets.

Fixed Assets: Fixed assets are those non-current assets of an enterprise which are held not to resell but with the purpose to increase its earning capacity. Fixed assets are further classified into:

(*a*) *Tangible Assets:* Tangible Assets are those assets which have physical existence, *i.e.*, they can be seen and touched. Examples of tangible assets are land, building, machinery, computer, furniture, etc.

(*b*) *Intangible Assets:* Intangible Assets are those assets which do not have physical existence, *i.e.*, they cannot be seen and touched. Examples of intangible assets are patents, goodwill, trademarks, Computer Software, etc.

(*ii*) *Current Assets:* Current Assets are those assets which are held by an entity or enterprise with the purpose of converting them into cash within a short period, *i.e.*, one year. For example, goods are purchased with a purpose to resell and earn profit, debtors exist to convert them into cash, *i.e.*, receive the amount from them, bills receivable exist again for receiving cash against it, etc.

Prepaid expenses are also classified as Current Assets although they cannot be converted into cash. They are so classified because a part of the benefit from such expenses is available in the next accounting year.

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

In the case of firms, an example of fictitious asset is Deferred Revenue Expenditure such as Advertisement Expenditure. Discount or Loss on Issue of Debentures is an example of fictitious asset in the case of companies.

Classification of Assets in the case of Companies as per Schedule III of the Companies Act, 2013

Assets, like liabilities, are classified by Schedule III of the Companies Act, 2013 into (*i*) Current Assets, and (*ii*) Non-current Assets. They are defined as follows:

(*i*) *Current Assets:* An asset is a current asset if it satisfies any one of the following criterias:

(*a*) it is expected to be realised in or is intended for sale or consumption in the company's normal operating cycle; or

(*b*) it is held primarily for the purpose of being traded; or

(*c*) it is expected to be realised within 12 months from the reporting date; or

(*d*) it is Cash and Cash Equivalent unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting date.

(*ii*) *Non-current Assets:* Non-current Assets are those assets which are not current assets.

Operating Cycle means the time between the acquisition of an asset for processing and its conversion into Cash and Cash Equivalents. If the operating cycle cannot be identified, it is taken to be a period of 12 months.

7. *Receipts:* Receipt is the amount received or receivable for selling assets, goods or services. Receipts are further categorised into revenue receipts and capital receipts.

Revenue Receipts: It is the amount received or receivable in the normal course of business say against sale of goods or rendering of services or investment of business resources say in fixed deposit. They are shown in the Profit and Loss Account, in the case of enterprises and in Income and Expenditure Account in the case of Not-For-Profit Organisations. Examples of revenue receipts are: amount received or receivable against sale of goods or rendering of services, interest on fixed deposits or investments, etc.

Capital Receipts: It is the amount received or receivable against transactions which are not revenue in nature. They are shown in the Balance Sheet of the entity. For example, amount received or receivable from sale of machinery, building, furniture, investment, loan taken, etc.

8. Expenditure: Expenditure is the amount spent or liability incurred for acquiring assets, goods or services. Expenditure may be categorised into:

(*i*) *Capital Expenditure:* It is an expenditure incurred to acquire assets or improving the existing assets which will increase the earning capacity of the business, *i.e.*, will give benefit of enduring nature to the business. It may be incurred to acquire tangible asset or intangible asset. They are shown in the Balance Sheet of the entity. Examples of capital expenditure are purchase of machinery to manufacture goods, purchase of furniture or computers to carry on business.

Capital Expenditure is shown on the assets side of the Balance Sheet.

(*ii*) *Revenue Expenditure:* Revenue Expenditure is the expenditure incurred, the benefit of which is consumed or exhausted within the accounting period. It has direct relationship with revenue or with the accounting period, *e.g.*, cost of goods sold, salaries, rent, electricity expenses, etc.

Revenue Expenditure is shown on the debit side of the Trading Account or Profit and Loss Account, in the case of proprietorship or partnership enterprises and in the Expenses part of the Statement of Profit and Loss, in the case of companies. It is shown on the debit side of the Income and Expenditure Account in the case of Not-for-Profit Organisations.

(*iii*) *Deferred Revenue Expenditure:* Deferred Revenue Expenditure is a revenue expenditure in nature but is written off (charged) in more than one accounting period because it is estimated that benefit of such expenditure will accrue in more than one financial year. For example, large advertising expenditure that will give benefit for more than one accounting period is a Deferred Revenue Expenditure.

Revenue: Revenue is gross inflow of cash, receivables or other consideration arising in the course of ordinary activities of the enterprise from the sale of goods, from rendering of services and from the use by others of enterprise resources yielding interest, dividends, etc. Thus, revenue is the amount received or receivable by the enterprise from its operating activities. Examples of revenue are receipts from sale of goods, rent, commission, etc.

Revenue differs from income. Amount received against sale of goods and/or services rendered is revenue and cost of sale of goods and/or services is an expense. The difference between revenue and expense is income.

Income = Revenue – Expense

9. Expense: Expense is the cost incurred for generating revenue. According to **R.N. Anthony**, "*Expense is a monetary measure of inputs or resources consumed.*" It is a value which has expired during the accounting period. It may be

(*i*) cash payment such as salaries, wages, rent, etc.

(*ii*) writing off a part of fixed assets (*i.e.*, depreciation).

(*iii*) an amount written off out of a current asset (say bad debts).

(*iv*) decline in the value of assets (say investments).

(*v*) cost of goods sold.

An expense is charged (debited) to Trading Account or Profit and Loss Account.

Prepaid Expense: It is an expense that has been paid in advance and the benefit of which will be available in the following year or years. For example, insurance premium of ₹ 50,000 has been paid for one year beginning 1st October, 2017. The financial year ends on 31st March, 2018. It means premium for six months, *i.e.*, 1st April, 2018 to 30th September, 2018 amounting to ₹ 25,000 is paid in advance. Thus, the amount of premium paid in advance (₹ 25,000) is Prepaid Expense. It will be accounted as an expense in the financial year ending 31st March, 2019. In the Balance Sheet as at 31st March, 2018, it will be shown as a Current Asset.

Outstanding Expense: It is an expense that has been incurred but has not been paid. For example, an audit has been conducted by a firm of chartered accountants against which audit fee of ₹ 60,000 is payable. It means a liability of ₹ 60,000 has been incurred, which is yet to be paid. It is termed as **Outstanding Expense**. It is debited to the Profit and Loss Account and also shown under the head Current Liabilities in the Balance Sheet.

10. Income: Income is the profit earned during an accounting period. In other words, the difference between revenue and expense is termed as **Income**. It is a broader term than the term 'profit' and includes profit from activities other than its Operating Activities. 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:

Income = Revenue – Expense

11. Profit: Profit means income earned by the business from its Operating Activities, *i.e.*, the activities carried out by the enterprise to earn profit. For example, profit earned from sale of goods and/or rendering of services.

Profit is further divided into gross profit and net profit.

Gross Profit: Gross Profit is the difference between revenue from sales and/or services rendered and its direct cost.

Net Profit: Net Profit is the profit after deducting total expenses from total revenue of the enterprise. In case total expenses are more than the total revenue, it is Net Loss.

12. Gain: Gain is the increase in owner's equity resulting from something other than the day to day earning from irregular or non-recurring nature. Stating differently, it is a profit that arises from transactions which are not the Operating Activities of the business but are incidental to it such as gain on sale of land, machinery or investments.

13. Loss: Loss is excess of expenses of a period over its revenues. It decreases the owner's equity. It is a broad term and includes loss incurred in its operating (business) activities, money or money's worth lost against which the firm receives no benefit, *e.g.*, cash or goods lost in theft and loss arising from events of non-recurring nature, *e.g.*, loss on sale of fixed assets.

14. Purchases: The term 'Purchases' is used for an account to record purchases of goods or raw materials for resale or for producing products which are also to be sold. The term 'purchases' includes both cash and credit purchases of goods. Goods purchased for cash are termed as **Cash Purchases** and goods purchased on credit are termed as **Credit Purchases.**

15. Purchases Return: Goods purchased may be returned to the seller for any reason, say, they are defective. Goods so returned are known as **Purchases Return** or **Returns Outward.**

16. Sales: The term 'Sales' is associated with or used for sale of goods. These goods may be purchased for resale or manufactured by the enterprise. The term 'Sales' includes both cash and credit sales. When goods are sold for cash, they are termed as **Cash Sales** and when sold on credit, they are termed as **Credit Sales.**

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

18. Revenue from Operations: Revenue from Operations means revenue earned by an enterprise (firm or company) from its operating activities. The term is defined in Schedule III of the Companies Act, 2013, a format in which Balance Sheet and Statement of Profit and Loss (Profit and Loss Account) is prepared. Examples of Revenue from Operations are sale of goods (Net Sales, *i.e.,* Sales – Sales Return), sale of services, (for non-financial enterprises) and interest earned, dividend received (financial enterprises).

19. Goods: Goods are the physical items of trade that are purchased to be sold. The term applies to all the items making up the sales or purchases of a business. Stating differently, they are the Stock-in-Trade of an enterprise, purchased or manufactured with the purpose of selling. For an enterprise dealing in home appliances such as TV, Fridge, AC, etc., are goods and for a Stationer, Stationery is goods.

20. Stock/Inventory: Stock (Inventory) is a tangible asset held by an enterprise for the purpose of sale in the ordinary course of business or for the purpose of using it in the production of goods meant for sale. Stock (Inventory) may be: (*i*) Opening Stock (Inventory) or (*ii*) Closing Stock (Inventory).

(*i*) *Opening Stock* (Inventory) is the stock-in-hand in the beginning of the accounting year. In other words, it is stock-in-hand at the end of the previous accounting year.

(*ii*) *Closing Stock* (Inventory) is the stock-in-hand at the end of the current accounting period.

Stock *or* Inventory may be of the following kinds:

(*i*) *Stock or Inventory of Goods:* Stock, Goods or Inventory in the case of a trading concern comprises stock (Inventory) of goods remaining unsold. In the case of manufacturing concern, it comprises processed goods manufactured for the purpose of sale. It is valued at cost or net realisable value, whichever is lower.

(*ii*) *Stock or Inventory of Raw Material:* It comprises the stock of raw material used for manufacturing of goods lying unused. For example, stock of cloth to be used for stitching shirts. It is valued at cost or net realisable value, whichever is lower.

(*iii*) *Work-in-Progress:* It is a stock that is in the process of being finished, *i.e.,* they are partly finished goods. It is valued at an aggregate of cost of raw material used, cost of labour, other production cost, *i.e.,* power, fuel, etc.

Stock or Inventory is shown in the Balance Sheet as a *Current Asset.* It is valued on the basis of *"cost or net realisable value (market price), whichever is lower"* principle.

21. Trade Receivables: It is the amount receivable for sale of goods and/or services rendered in the ordinary course of business. Stating differently, it is the amount due from the customers of the enterprise.

Trade Receivables is a sum total of debtors and bills receivable.

Debtor: Debtor is a person or an entity who owes amount to the enterprise against credit sales of goods and/or services rendered. Goods when sold to a person on credit that person is called a **Debtor** because he owes that much amount to the enterprise.

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

Trade Receivables as defined in Schedule III of the Companies Act, 2013

Trade Receivables are the amounts receivable by the enterprise against goods sold and services rendered in the normal course of business.

22. Trade Payables: It is the amount payable for purchase of goods and/or services taken in the ordinary course of business. Stating differently, it is the amount due to the seller of goods by the enterprise.

Trade Payables is the sum total of creditors and bills payable.

Creditor: Creditor is a person or an enterprise to whom an enterprise owes amount against credit purchases of goods and/or services taken. For example, Mohan is a creditor of a firm when goods are purchased from him on credit.

Bill Payable: Bill Payable means a Bill of Exchange accepted by the person or enterprise, the amount of which will be payable on the specified date.

Trade Payables as defined in Schedule III of the Companies Act, 2013

Trade Payables are the amounts payable by the enterprise against goods purchased and services taken in the normal course of business.

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

24. Voucher: Voucher is an evidence of a business transaction. Examples of voucher are Cash Memo, Invoice or Bill, Receipt, Debit/Credit Notes, etc.

25. Discount: It is the reduction in the price of goods or from the amount to be paid to a customer by the enterprise. Discount allowed may be Trade Discount or Cash Discount.

Trade Discount: Trade Discount is the reduction in prices by the seller to the purchaser of goods when they buy goods of certain quantity or value. Sales are recorded at net value, *i.e.*, Sales – Trade Discount. Similarly, purchases are recorded by the purchaser at net value, *i.e.*, Purchases – Trade Discount.

Cash Discount: Cash Discount is the discount allowed for timely payment of due amount. It is an expense for the party allowing the discount and income for the party receiving cash discount. It is recorded in the books of account of both the parties.

The accounting terms discussed above have been prescribed in the syllabus. We are discussing below some other important accounting terms as well.

26. Bad Debts: Bad Debt is the amount owed to the business that is written off because it has become irrecoverable. It is a loss for the business and is, thus, debited to Profit and Loss Account.

27. Balance Sheet: It is a statement of the financial position of an individual or enterprise at a given date, which exhibits its assets, liabilities, capital, reserves and other account balances at their respective book values.

28. Book Value: This is the amount at which an item appears in the books of account or financial statements.

29. Books of Account: The records or books in which financial transactions of an entity are recorded and maintained. They include Cash Book, Bank Book, Journal and Ledger.

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

31. 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. It has been derived from an Italian word 'Credito'.

32. 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. It has been derived from an Italian word 'Debito'.

33. Depreciation: Depreciation is a fall in the value of an asset because of usage or with efflux of time or obsolescence or accident. It is an allocation of cost of fixed asset in each accounting year during its estimated useful life.

34. Entity: An *Entity* means an economic unit which performs economic activities (*e.g.*, Reliance Industries, Bajaj Auto, Maruti, TISCO). A business entity means an enterprise established in accordance with law to engage in business activities. These include proprietorship firms, partnership firms, corporations, companies, etc. An accounting system is always devised for a specific business entity (also called **Accounting Entity**).

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

36. Insolvent: Insolvent is a person or enterprise which is not in a position to pay its debts.

37. Proprietor: The person who makes the investment and bears all the risks associated with the business is called **proprietor**.

38. Rebate: It is reduction in price allowed by the seller of goods after the goods have been sold. Stating differently, rebate is offered and allowed on sales completed in the past. It is allowed for the reasons other than for which trade discount and cash discount are allowed. For example, discount allowed because of poor quality of goods.

39. Solvent: Solvent is a person or enterprise which is in a position to pay its debts.

40. Financial Statements or Final Accounts: They are Trading Account, Profit and Loss Account (Statement of Profit and Loss, in the case of Companies) and Balance Sheet prepared at the end of accounting process.

Illustration.

Mr. Prem commenced business of trading in electronic goods with an initial capital of ₹ 15,00,000. Out of the said ₹ 15,00,000, he paid ₹ 10,00,000 towards purchase of electronic goods. He further spent ₹ 2,00,000 on furnishing the shop and ₹ 35,000 for purchase of computer and printer. ₹ 10,000 is yet to be paid to supplier of computer.

He sold goods costing ₹ 5,00,000 for ₹ 7,00,000 in cash and goods costing ₹ 2,50,000 for ₹ 3,10,000 on credit. Goods sold on credit for ₹ 25,000 were returned being defective. These goods (costing ₹ 20,000) were returned to the supplier. Looking into the response, he decided to trade in home appliances also and further invested ₹ 5,00,000.

He purchased electronic goods and home appliances for ₹ 8,00,000 out of which purchases of ₹ 2,00,000 were on credit.

Due to an earthquake, 2 LCD Televisions costing ₹ 50,000 were completely destroyed. Mr. Prem received an insurance claim of ₹ 30,000.

A customer purchased goods costing ₹ 2,25,000 for ₹ 3,00,000 and was allowed discount of ₹ 15,000. He was further allowed discount of ₹ 5,000 for payment within agreed time.

He paid salary to Shyam of ₹ 55,000; ₹ 5,000 were yet to be paid. He insured the goods and paid insurance premium of ₹ 10,000. Out of this, ₹ 5,000 are for the next year. Mr. Prem withdrew ₹ 30,000 during the year for his personal use.

You are required to answer the following questions on the basis of the above:

(*i*) What is the amount of capital invested in the business by Mr. Prem?
(*ii*) What is the amount invested by Mr. Prem in fixed assets?
(*iii*) What is the amount of total purchases?
(*iv*) What is the amount of long-term liabilities?
(*v*) What is the amount of current liabilities?
(*vi*) What is the amount of prepaid expenses?
(*vii*) What is the amount of outstanding expenses?

(*viii*) What is the income earned by Mr. Prem?
(*ix*) How much profit is earned by Mr. Prem?
(*x*) What is the amount due from debtors?
(*xi*) What is the amount due to creditors?
(*xii*) What is the value of Closing Stock?
(*xiii*) What is the value of net purchases?
(*xiv*) What is the amount of Trade Discount allowed?
(*xv*) Has Mr. Prem allowed Cash Discount? If yes, what is the amount?
(*xvi*) What is the amount of Drawings?
(*xvii*) What is the amount of Sales Return?
(*xviii*) What is the amount of Purchases Return?

Solution:

(*i*) Capital invested by Mr. Prem in the business is ₹ 20,00,000 (*i.e.*, ₹ 15,00,000 + ₹ 5,00,000).
(*ii*) Mr. Prem has invested ₹ 2,35,000 (*i.e.*, ₹ 2,00,000 + ₹ 35,000) in the fixed assets.
(*iii*) Purchases made by Mr. Prem are ₹ 18,00,000 (*i.e.*, ₹ 10,00,000 + ₹ 8,00,000) during the year.
(*iv*) Long-term liabilities of Mr. Prem are nil.
(*v*) Current liabilities of Mr. Prem are ₹ 1,95,000 [₹ 10,000 (Computer and Printer) + ₹ 2,00,000 (Purchases) + ₹ 5,000 (Salaries) – ₹ 20,000 (Purchases Return)].
(*vi*) Amount of prepaid expenses is ₹ 5,000 being insurance premium.
(*vii*) Outstanding expenses are ₹ 5,000 being salary payable.
(*viii*) Income earned by Mr. Prem is ₹ 1,75,000 [₹ 12,70,000 (Sales) – ₹ 10,95,000 (Expenses)].
(*ix*) Profit earned by Mr. Prem is ₹ 1,75,000 as he has no income from non-operating activities.
(*x*) Amount due from debtors is ₹ 2,85,000.
(*xi*) Amount due to creditors is ₹ 1,80,000.
(*xii*) The value of Closing Stock is ₹ 7,75,000.
[₹ 10,00,000 + ₹ 20,000 + ₹ 8,00,000 – ₹ 5,00,000 – ₹ 2,50,000 – ₹ 20,000 – ₹ 50,000 – ₹ 2,25,000 = ₹ 7,75,000].
(*xiii*) The amount of net purchases is ₹ 17,80,000.
(*xiv*) The amount of Trade Discount allowed is ₹ 15,000.
(*xv*) Yes, Mr. Prem has allowed cash discount and the amount is ₹ 5,000.
(*xvi*) The amount of Drawings is ₹ 30,000.
(*xvii*) The amount of Sales Return is ₹ 25,000.
(*xviii*) The amount of Purchases Return is ₹ 20,000.

QUESTIONS

Multiple Choice Questions (MCQs)

1. *Select the correct alternative:*

(*i*) Capital is
(*a*) internal liability. (*b*) external liability.
(*c*) internal as well as external liability. (*d*) None of these.

(*ii*) Goods taken by the proprietor for personal use is
(*a*) Sale. (*b*) Drawings.
(*c*) Purchase. (*d*) None of these.

(*iii*) Amount received or receivable against sale of goods is
(*a*) revenue receipt.
(*b*) capital receipt.
(*c*) sometimes revenue receipt and sometimes capital receipt.
(*d*) None of these.

(*iv*) Amount paid or payable against purchase of goods is
(*a*) revenue expenditure. (*b*) capital expenditure.
(*c*) Both (*a*) and (*b*). (*d*) None of these.

(*v*) Goodwill is a/an
(*a*) Tangible Asset. (*b*) Intangible Asset.
(*c*) Current Asset. (*d*) Fictitious Asset.

(*vi*) Expenditure of revenue nature that gives benefit for more than one accounting period is categorised as
(*a*) Capital Expenditure. (*b*) Revenue Expenditure.
(*c*) Deferred Revenue Expenditure. (*d*) None of these.

(*vii*) A person who owes money to a firm against goods sold is called a
(*a*) creditor. (*b*) debtor.
(*c*) Both (*a*) and (*b*) (*d*) None of these.

(*viii*) A person to whom money is owed by a firm for purchase of goods is called a
(*a*) creditor. (*b*) debtor.
(*c*) Both (*a*) and (*b*) (*d*) None of these.

(*ix*) Purchase refers to the purchase of
(*a*) goods for resale. (*b*) stationery for office use.
(*c*) assets for the factory. (*d*) None of the above.

(*x*) A liability arises because of
(*a*) cash transactions. (*b*) credit transactions.
(*c*) cash as well as credit transactions. (*d*) None of these.

(*xi*) The amount invested by the proprietor in a business is called
(*a*) capital. (*b*) cash.
(*c*) revenues. (*d*) loan.

(*xii*) Stock is valued at
(*a*) Cost or Net Realisable Value (Market Value), whichever is lower.
(*b*) Cost or Net Realisable Value (Market Value), whichever is higher.
(*c*) Cost.
(*d*) Net Realisable Value (Market Value).

(*xiii*) Bank overdraft is
(*a*) short-term liability. (*b*) long-term liability.
(*c*) contingent liability. (*d*) None of these.

(*xiv*) Which of the following is not a business transaction?
(*a*) Bought furniture of ₹ 25,000 for business.
(*b*) Paid for salaries of employees, ₹ 20,000.
(*c*) Cash withdrawn from personal bank account, ₹ 10,000 for domestic use.
(*d*) All of the above.

(*xv*) Which of the following is not a fixed asset?
(*a*) Building (*b*) Plant and Machinery
(*c*) Balance with bank (*d*) Goodwill

(*xvi*) Which of the following is not a long-term liability?
(*a*) Creditors (*b*) Term-loan
(*c*) Debentures (*d*) Capital

(*xvii*) Which of the following are goods?
(*a*) Machines manufactured for sale.
(*b*) Furniture purchased for sale.
(*c*) Books and stationery purchased by a book seller.
(*d*) All of the above.

(*xviii*) Which of the following is an asset?
(*a*) Machinery (*b*) Purchases
(*c*) Sales Return (*d*) Interest Received

(*xix*) Which of the following is a liability?
(*a*) Furniture (*b*) Rent Payable
(*c*) Interest Received (*d*) Stock

(*xx*) Which of the following is revenue?
(*a*) Purchases (*b*) Purchases Return
(*c*) Sales (*d*) Salary Payable

(*xxi*) Which of the following is not an expense?
(*a*) Furniture (*b*) Salary
(*c*) Rent (*d*) Electricity Expenses

(*xxii*) Which of the following is a business transaction?
(*a*) Goods purchased on credit.
(*b*) An employee being dismissed.
(*c*) Proprietor purchasing a car for own use.
(*d*) Sale of personal asset by the proprietor.

(*xxiii*) The nature of capital is
(*a*) an asset. (*b*) a liability.
(*c*) an income. (*d*) an expense.

(*xxiv*) Sale is recognised as revenue
(*a*) when the contract for sale is entered into.
(*b*) at the point of sale or performance of service.
(*c*) after the expiry of credit period allowed to debtors.
(*d*) after the money collected from the customers.

(*xxv*) The nature of accrued income is
(*a*) revenue. (*b*) liability.
(*c*) expenses. (*d*) asset.

(*xxvi*) Trade Discount allowed
(*a*) is shown separately in the books of account.
(*b*) is not shown separately in the books of account.
(*c*) can be shown either separately or deducted from purchase cost.
(*d*) None of the above.

(*xxvii*) Which of the following transaction is not of financial character?
(*a*) Purchase of asset on credit
(*b*) Purchase of asset for cash
(*c*) Withdrawing of money by proprietor from business
(*d*) Strike by employees. (*KVS 2015*)

(*xxviii*) Purchase refers to the buying of
(*a*) Stationery for office use. (*b*) Assets for the factory.
(*c*) Goods for resale. (*d*) Investment. (*KVS 2015*)

(*xxix*) Revenue from Operations refers to
(*a*) Revenue earned from Operating Activities.
(*b*) Revenue earned from activities that are not Operating Activities.
(*c*) Both (*a*) and (*b*).
(*d*) None of the above.

(*xxx*) Out of the following assets, which one is not an intangible asset?
(*a*) Machinery (*b*) Patents
(*c*) Goodwill (*d*) Trade Mark

[(*i*) (*a*); (*ii*) (*b*); (*iii*) (*a*); (*iv*) (*a*); (*v*) (*b*); (*vi*) (*c*); (*vii*) (*b*); (*viii*) (*a*); (*ix*) (*a*); (*x*) (*b*); (*xi*) (*a*); (*xii*) (*a*); (*xiii*) (*a*); (*xiv*) (*c*); (*xv*) (*c*); (*xvi*) (*a*); (*xvii*) (*d*); (*xviii*) (*a*); (*xix*) (*b*); (*xx*) (*c*); (*xxi*) (*a*); (*xxii*) (*a*); (*xxiii*) (*b*); (*xxiv*) (*b*); (*xxv*) (*d*); (*xxvi*) (*b*); (*xxvii*) (*d*); (*xxviii*) (*c*); (*xxix*) (*a*); (*xxx*) (*a*).]

2. *Determine, if the following are Assets, Liabilities, Capital, Revenue from Operations, Revenues, Expenses or none:*
(a) Machinery, (b) Purchases, (c) Stock, (d) Creditors, (e) Capital, (f) Salary paid to a clerk, (g) Sales, (h) Furniture, (i) Interest received and (j) Rent paid.
[*(a) Asset; (b) Expense; (c) Asset; (d) Liability; (e) Capital; (f) Expense; (g) Revenue from Operations; (h) Asset; (i) Revenue; (j) Expense*]

Very Short Answer Type Questions

Q. 1. What is meant by Cash Transaction?
Ans. Cash transaction is a financial transaction or event that is settled immediately in cash.

Q. 2. What is meant by Credit Transaction?
Ans. Credit transaction is a financial transaction or event that is not settled immediately, *i.e.*, is agreed to be settled later.

Q. 3. Briefly explain Expenditure.
Ans. Expenditure is the amount spent or liability incurred for acquiring assets, goods or services.

Q. 4. What are Assets?
Ans. Asset is a property (land, machine, goods, premises, etc.) or legal rights (patents, copyrights, etc.) owned by an individual or business which can be measured in money terms.

Q. 5. What are Fixed Assets?
Ans. Fixed Assets are the assets which are acquired not with a purpose to resell but with a purpose to increase the earning capacity of the business.

Q. 6. What is meant by Tangible Assets? *(MSE Chandigarh 2015)*
Ans. Tangible Assets are the assets which have physical existence, *i.e.*, they can be seen and touched such as Land, Building, Plant and Machinery and Computers.

Q. 7. Briefly explain Intangible Assets.
Ans. Intangible Assets are the assets which do not have a physical existence, *i.e.*, they cannot be seen or touched such as Computer Software and Goodwill.

Q. 8. Briefly explain the term 'Goods'. *(MSE Chandigarh 2012)*
Ans. Goods are the physical items of trade.

Q. 9. Define the term 'Purchase'. *(KVS 2016)*
Ans. The term 'Purchase' is used for purchase of goods for resale or for producing the finished products which are also to be sold. The term 'purchase' includes both cash and credit purchases of goods. Goods purchased for cash are termed as **Cash Purchases** and goods purchased on credit are termed as **Credit Purchases**.

Q. 10. What are the main classes of Liabilities?
Ans. Non-current Liabilities and Current Liabilities.

Q. 11. Give **any two** examples of Current Assets. *(KVS 2007)*
Ans. Stock-in-Trade (Inventories) and Cash in Hand.

Q. 12. Name **three** Current Liabilities.
Ans. Creditors, Bills Payable and Outstanding Expenses.

Q. 13. Name **two** Long-term Liabilities.
Ans. Long-term loans and Debentures.

Q. 14. Explain Capital briefly.
Ans. Capital is the amount invested by the proprietor or the partner in the business.

Q. 15. Who is a Debtor?
Ans. Debtor is a person who owes amount to the business on account of credit sales of goods and/or services in the normal course of business.

Q. 16. Who is a Creditor?
Ans. Creditor is the person to whom an amount is owed on account of credit purchases of goods and/or services in the normal course of business.

Q. 17. What is meant by Revenue from Operations?
Ans. Revenue from Operations means revenue earned by the enterprise from its Operating Activities such as Net Sales (Sales – Sales Return), services rendered, sale of scrap, etc.

Q. 18. What is an Income?
Ans. Income is profit earned during the accounting period, *i.e.*, revenue *minus* expenses.

Q. 19. Define Drawings with example. *(Delhi 2012)*
Ans. Drawings is the amount of money or value of goods which the proprietor or partner withdraws for personal use. For example, withdrawal of cash by the proprietor for personal use.

Q. 20. Define Voucher. *(MSE Chandigarh 2012)*
Ans. Voucher is an evidence of a business transaction.

Q. 21. Define Merchandise. *(MSE Chandigarh 2012)*
Ans. Merchandise means goods for resale.

Q. 22. A firm earns a revenue of ₹ 21,000 and the expenses to earn this revenue are ₹ 15,000. Calculate its income. *(Delhi 2009)*
Ans. Income = Revenue – Expense = ₹ 21,000 – ₹ 15,000 = ₹ 6,000.

Q. 23. A firm has received a large order to supply goods. Will it be recorded in the books of account of the firm? Give reason. *(MSE Chandigarh 2015)*
Ans. *No*, it will not be recorded in the books of account because it is not a transaction.

Short Answer Type Questions

1. Distinguish between Loss and Expense.
2. What are Vouchers?
3. Distinguish between Opening Stock and Closing Stock.
4. Explain the meaning of **any three** of the following terms:
(*i*) Assets; (*ii*) Capital; (*iii*) Goods; (*iv*) Drawings and (*v*) Debtors. *(Delhi 2007)*
5. Explain the following terms:
(*i*) Revenue; (*ii*) Debtors; (*iii*) Fictitious Assets and (*iv*) Working Capital. *(MSE Chandigarh 2007)*
[**Hint:** The difference between the Current Assets and Current Liabilities is known as **Working Capital.**]
6. Explain the meaning of **any three** of the following terms:
(*i*) Liability; (*ii*) Stock; (*iii*) Business Transaction and (*iv*) Drawings. *(Delhi 2008)*

7. Explain and give example of each of the following accounting terms:
   (*i*) Expenses; (*ii*) Drawings and (*iii*) Gain. (*KVS 2010*)
8. Define the following basic accounting terms with example:
   (*i*) Revenue; (*ii*) Drawings and (*iii*) Profit. (*Delhi 2010*)
9. Explain the following terms with example:
   (*i*) Sales and (*ii*) Cost. (*Delhi 2011*)
10. Write a note on types of assets with one example of each. (*KVS 2015*)

PRACTICAL PROBLEM

1. Mr. Gopal started business for buying and selling of readymade garments with ₹ 8,00,000 as an initial investment. Out of this he paid ₹ 4,00,000 for the purchase of garments and ₹ 50,000 for furniture and ₹ 50,000 for computers and the remaining amount was deposited into the bank. He sold some of the ladies and kids garments for ₹ 3,00,000 for cash and some garments for ₹ 1,50,000 on credit to Mr. Rajesh.

   Subsequently, he bought men's garments of ₹ 2,00,000 from Mr. Satish. In the first week of the next month, a fire broke out in his office and stock of garments worth ₹ 1,00,000 was destroyed. Later on, some garments which cost ₹ 1,20,000 were sold for ₹ 1,30,000. Expenses paid during the same period were ₹ 15,000. Mr. Gopal withdrew ₹ 20,000 from business for his domestic use.

   From the above, answer the following:
   (*i*) What is the amount of capital with which Mr. Gopal started the business?
   (*ii*) What fixed assets did he buy?
   (*iii*) What is the value of the goods purchased?
   (*iv*) Who is the creditor and state the amount payable to him?
   (*v*) Who is the debtor and what is the amount receivable from him?
   (*vi*) What is the total amount of expenses?
   (*vii*) What is the amount of drawings of Mr. Gopal?

   [(*i*) *₹ 8,00,000;* (*ii*) *Furniture ₹ 50,000 and Computer ₹ 50,000;* (*iii*) *₹ 4,00,000 + ₹ 2,00,000 = ₹ 6,00,000;* (*iv*) *Mr. Satish—₹ 2,00,000;* (*v*) *Mr. Rajesh—₹ 1,50,000;* (*vi*) *₹ 6,15,000;* (*vii*) *₹ 20,000.*]