Financial Accounting

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Lecture – 16
2.2 Tutorial - Types of Accounts (Part I)

In this video we are going to reinforce the concepts that you learnt in the previous video.

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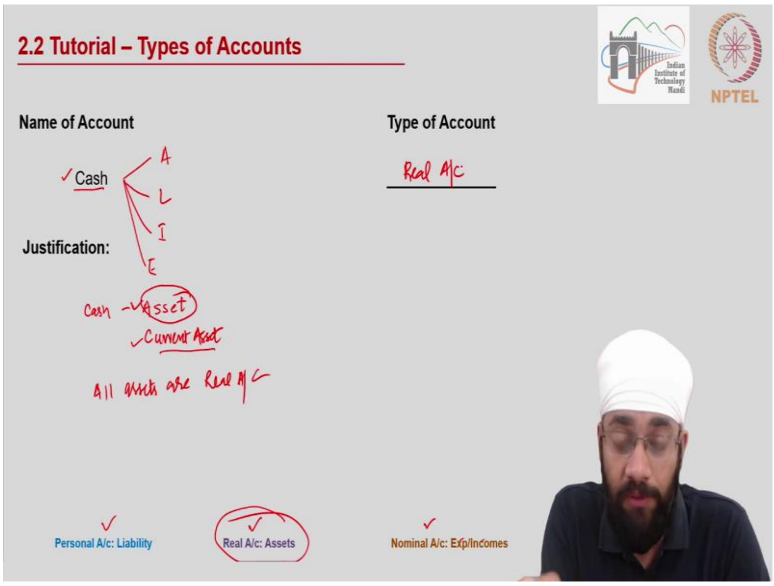

On the screen you see the name of an account. By now, you should very well know what an account is. All we have to do is to identify the type of account. So, we have a cash account written on the slide. We have to figure out which type of account a cash account is; is it a personal account, real account or nominal account? The way to do that is as follows: we identify whether cash is an asset, liability, income or expense and then we have the standard formula or the rule at the bottom of the slide. You have personal accounts for all the liabilities, all the assets are real account, and all expenses and incomes are nominal account.

Now, we very well know that cash is an asset. Cash refers to the stock of cash you have in hand and this can be utilized towards building temporary capacity and therefore, it is also a current asset. So, it is an asset and it is a current asset; but we do not have to go to the second level of categorization- the sub category of cash which is the current asset, because we know the rule for assets: all assets are real accounts.

So, we are using this rule and we are talking about a real account. Let me repeat, the word real does not mean anything in itself, do not refer to the English language meaning of the word real, it is just a nomenclature- anything which is an asset will be categorized into a real account that is it.

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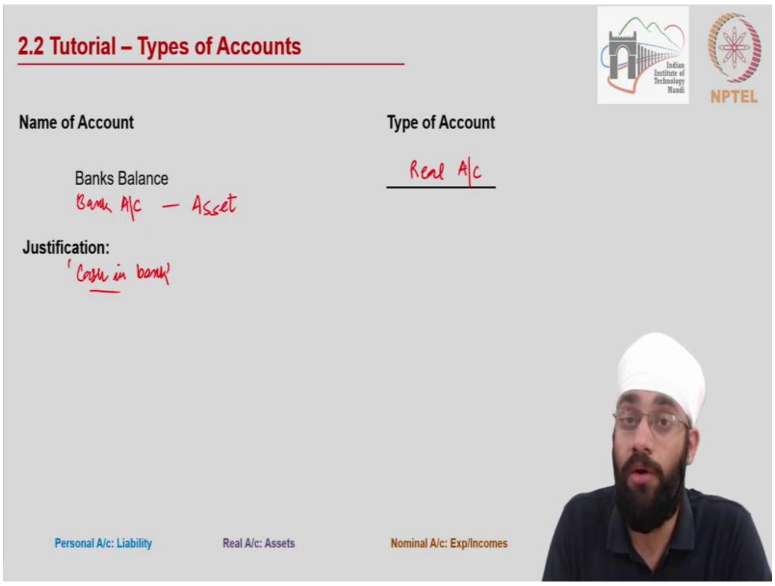

Let us move on to another item, another account, which is bank balance. You can call it bank account, bank account (A/C- short for account, another convention that is used). I hope everybody is familiar with it because in your bank statements, they do write A/C. Bank account, just like a cash account, is cash. So, a cash account is cash in hand, this is cash in the bank account. Similar to the cash in hand, this is an asset, this is a current asset and as we discussed earlier, all assets are a real account. So, I am going to say a real account.

So, in this tutorial we are going to look at about 20, 25 items accounts and identify whether they are real account, personal account or nominal account.

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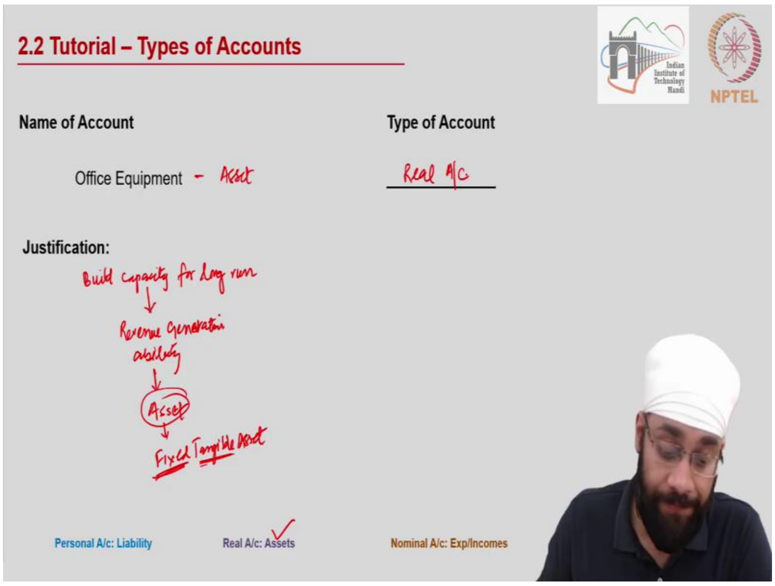

Let us move forward.

Office equipment- now office equipment helps you build capacity for the long run. What do we mean by capacity? Capacity refers to revenue generation ability or capacity. So, the office equipment is going to exist for more than 1 year and it is going to help make revenue over a long period of time which means this is an asset and within assets this is a fixed asset: this is a fixed tangible asset. The world fixed, I am introducing this for the first time, means something which is immovable in a way. It is another word for tangible assets. So, tangible assets are what you already know. Equipment is an asset and we know that all assets are categorized into real accounts and when we go to the next videos, it will become clearer as to why we are categorizing these accounts into personal, real, and nominals. There are the rules using which we are going to write these transactions into a book called journal. So, that is why we are learning these.

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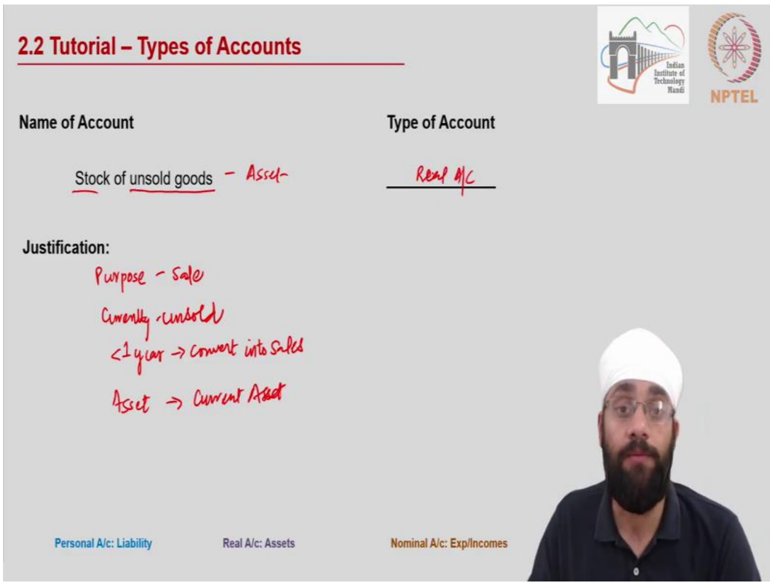

Next is the stock of unsold goods. Stock means it is with us, we have accumulated it. The purpose is to sell it. However, right now it is currently unsold. But the intention is to sell it as soon as possible. So, in less than 1 year you want to convert this into sales, that is the idea. Anything which is going to help you generate revenue in the short run, anything which builds capacity in the short run and I have said it building capacity refers to converting things into sale, making more money as soon as possible through revenues, is an asset. Therefore, unsold stock is also an asset, let me write it here as well. This is an asset and since it helps build temporary capacity; this is a current asset and it does not matter whether it is current asset or non-current asset, it is going to be a real account; all assets are real account that is the rule.

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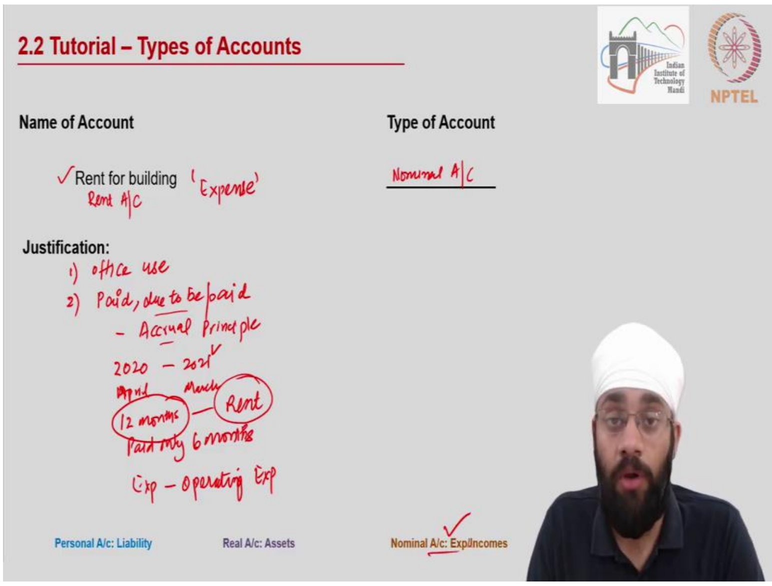

Next up you have rent for the building. What does this mean? Building is being used for the office purposes; number 1 that is the assumption. So, let us say this is an office and second, we are going to say rent has been paid or it is due to be paid. If you remember the accrual concept or accrual principle, we consider all the expenses during a given period of time does not matter whether we have paid it in cash or not. So, accrual principle means due to be paid. For example, the financial year 2020 to 2021, starts in April and ends in March: there are 12 months. So, out of the 12 months at the end of 2021, even if you had paid for only 6 months still you are going to show total rent for 12 months because you have used the office building for the full year, does not matter how much you have paid. So, you are going to show rent for the full year because you have to match the expenses of this financial year to the incomes of this financial year and whether or not you have paid rent, if you have use the office building, then the rent has become due to be paid and therefore, you should show this rent. So, I just explained the nature of this transaction or this account. So, we are going to call this rent account and it is going to help you generate revenue in the short run, it is an expense of the business. It is an expense of the business and also if you want to further categorize it this is an operating expense because this is for the primary purpose of the business: you have to generate revenue and for that you are using an office building. Now, all expenses and losses are nominal accounts, that rule is clear. So, this is a nominal account, the third type of account- you can see the rule on the slide.

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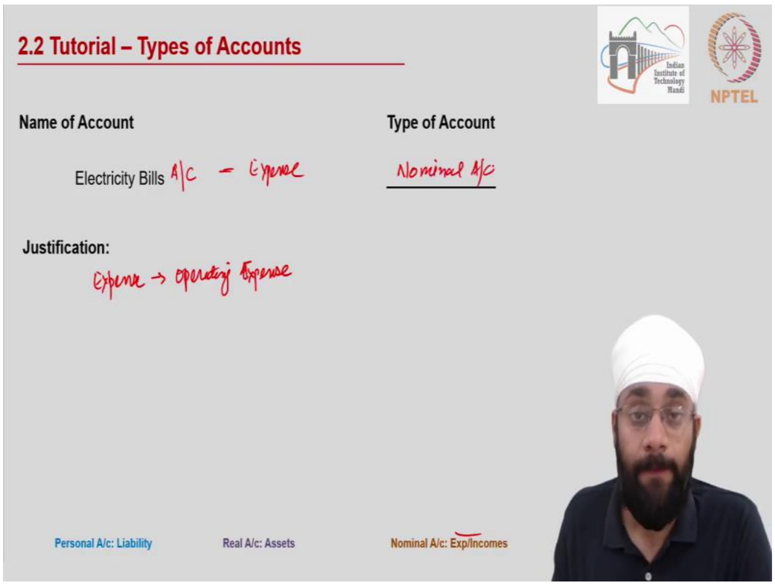

Next up you have electricity bills. So, let me just call it an electricity bills account. All the bills that you are going to pay for use of electricity can be clubbed here. Clearly, this is also an expense item and you can further categorize this as an operating expense. Again, the idea is that this is going to help you generate revenue in the short run, help you maintain your operations effectively in the short run, this is an expense item, as we said, and all expenses are nominal account.

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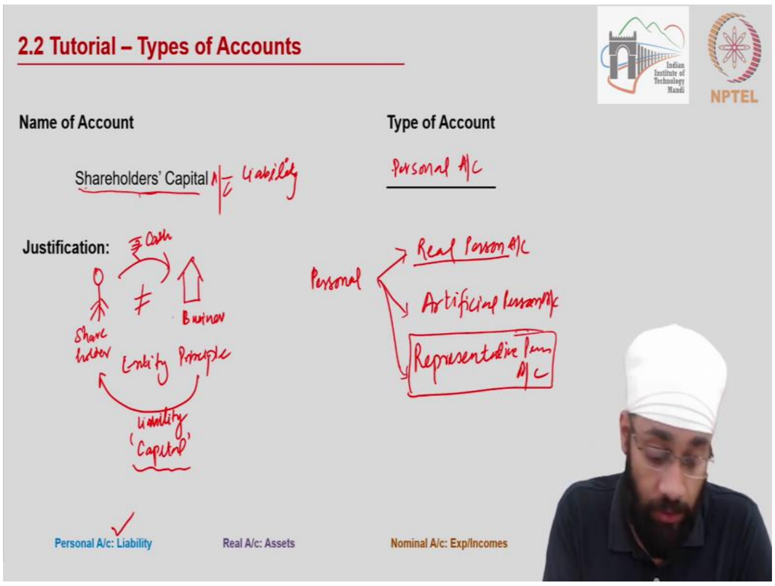

Next item is shareholders' capital. Now, the shareholder brings money to the business. So, let us say this is business and this is shareholder- this is the investor. Investors bring in money to the business and if you remember, according to entity principle, these two are separate: owner and business should not be mixed, they are not equal, they are not the same. So, businesses should treat the owner as a separate entity. If the owner is supplying this capital to the business, then the business owes back to the owner. So, if this money is being supplied by the shareholders to the business; let us say this is cash balance or bank balance, then in return the business owes to the shareholder: business has a liability towards the owner of the business and the name of the liability is capital; shareholders' capital is the name of the liability. This is the entity principle that we have discussed earlier. Now, based upon this we can say that shareholders capital is a liability and all liabilities, as the rule says, are personal accounts. I am going to write here, personal account here. Within the personal account there are 3 categories. So, the personal account can be a real or a natural person account, or an artificial person account or a representative person account. In this case, the shareholders capital is a representative personal account. You could also say this is a real person that you owe to. However, we are not writing the name of the person here, we are just clubbing everything under shareholders' capital. The capital account represents all these shareholders of the business. So, the most accurate categorization of this would be representative personal account. The account of shareholders' capital account represents the claims that the shareholders have on the business, it is the liability of the business towards the shareholders. To conclude shareholders capital is going to be treated as a personal account, because it is a liability and that is the thumb rule to go with.

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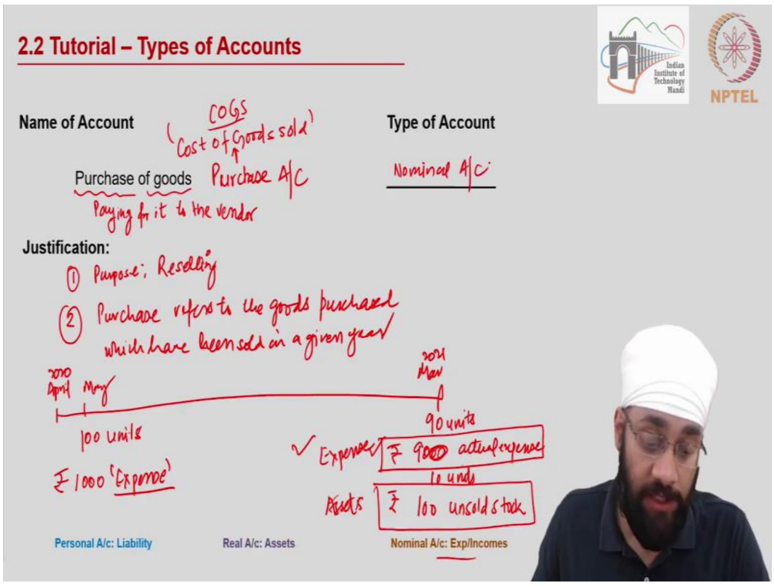

Next step is the purchase of goods. Now, why do you purchase goods? The purpose is reselling right, this is important and tell you why. The goods which are purchased in the business you do not intend to keep with you for more than 1 year. The idea is to as soon as possible dispose off, sell off these goods, which gives rise to the understanding that the stock is not supposed to build a long run capacity but to build short term capacity. Now, when you purchase the goods, what is happening is you are paying for it - purchase for goods account is called purchase account- you are paying for it to the vendor. Now, when you purchase you have possession of the goods and in return you are paying to the vendor. Now, we should note that purchase refers to the goods purchased which have been sold as well which have been sold in a given year. Now, let me give you more details on that. This is a timeline let us say at the beginning of the year which is April 2020, and this is March 2021. In the beginning of the year let us say April and May, in May you purchase 100 units. The idea is that you are going to sell them, let us say you are a trader; you purchase things and then you sell them further. So, these 100 units are available to you for selling and let us say 10 rupees is the cost price per unit of this good. So, 1000 is the money that you have spent. Thus, your total cost is 1000 and let us say you have paid all of this. It turns out at the end of the year you are able to sell only 90 units. Thus, you are able to sell only 90 units and 10 units are remaining in the stock. The expenses for the current year should only be counted; should only be equal to the units which have been sold. In this case, I am assuming no profit, no loss for example, at this time. So, if 10 rupee is the cost, then for 90 units 900 is the actual expense during this year. At the end of the year when you are preparing your financial statements you are going to show only 900 as the expense, remaining 10 units what happens to them? Thus, goods worth 100 are going to be unsold stock. So, this part becomes an asset, we know what is unsold stock and this part becomes the expense because it has helped you generate a revenue in the current period. So, whatever is going to help you generate revenue in the next 1 year you classify that as a current asset, but if something has already helped you to generate revenue in this financial year you have to match the cost of it to the revenue that is generated using this item. So, the expense is 900. Effectively what I want to explain is that purchase is an expense item. However, it is possible that all of the goods that you purchase may not be sold during the year, so, only the cost of the goods which are sold- another nomenclature Cost of Goods which are Sold (COGS in short)- purchase account has the Cost of Goods Sold; there can be other things which could be added to it, but purchase forms a part of the cost of the goods which are sold during the year. Let me wrap it up. It is an expense and all expenses are nominal.

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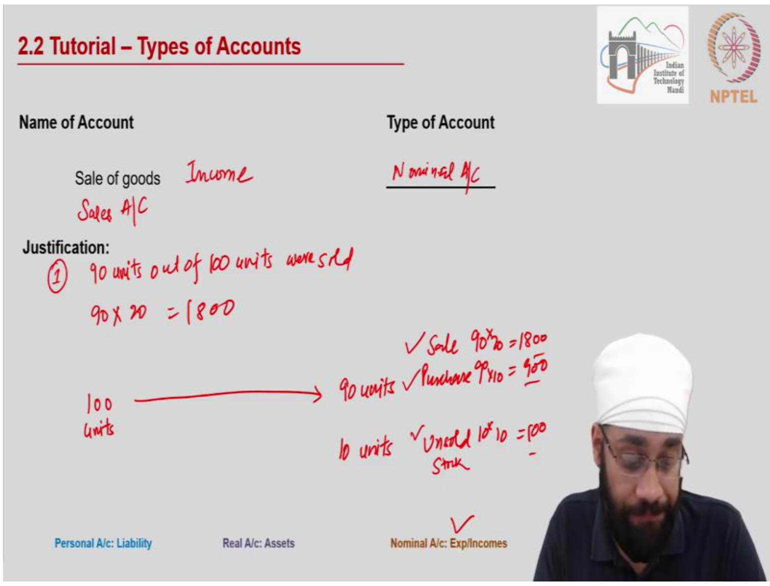

Let us move forward. Now, you have a sale of goods. Sale of goods is goods that you had purchased and sold now. So, if I go back to the previous discussion, you sold 90 units. Let us assume that 90 units out of 100 units were sold. And you are selling them at a profit. Let us say 90 units times 20. So, you made this much money. This is the income that you generate during this financial year. So, the sale of goods is an income, you represent it by a sales account- all the goods that are sold are included here. Remember from the previous slide you had bought 100 units in the beginning right. And, then at the end of the year you sold 90 units and 10 units are unsold. What are we doing now? We are saying the sale of 90 units at 20 per unit is equal to 1800, this is my income. And the purchase of 90 units at 10 equals 900. This was my expense and the 10 units unsold, 10 units into 10; 100 is my stock. So, you see how these things are, how we are arriving at these 3 accounts. So, the sale account is going to show 1800, the purchase account is going to show 900 and unsold stock is going to let me write stock here; it is going to show 100 as a balance in this account. So, for the purpose of a sales account, which is an income, we are going to call it a nominal account because sale refers to income.

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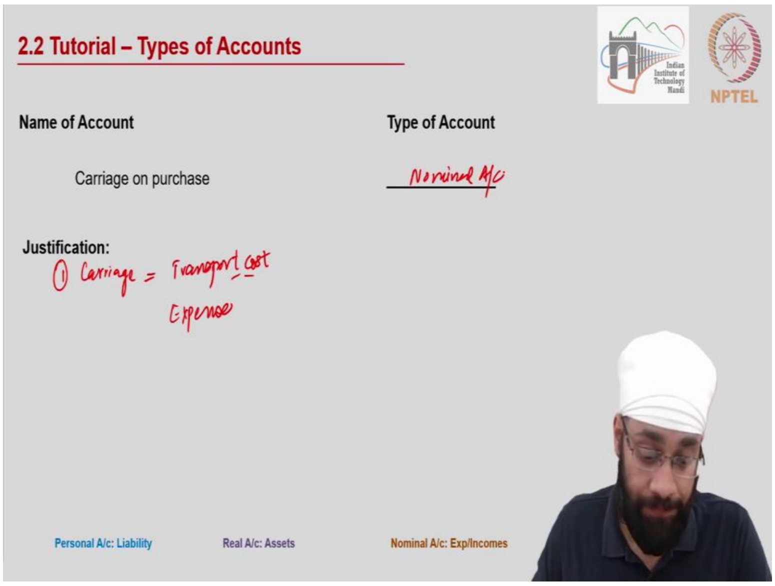

Then, we have a carriage on purchase. Couple of slides back when we were talking about purchase of goods, I mentioned that there is a concept of cost of goods which are sold (COGS) and I said purchase is one component of it. There can be other expenses that you have to do in order to purchase goods and then bring them to your place and then convert them into finished products, if these were raw material. All the expenses that go into getting the product ready to be sold are clubbed into the cost of goods sold. Carriage on purchase is another item under that. These things will clarify themselves as we move forward. We will have a more elaborate discussion on the cost of goods sold in one of the following videos.

Carriage on purchase- let me define carriage. Carriage is equal to the transportation expenses or cost. So, clearly it is a cost. You are transporting goods that you purchased to your godown, or to your factory, or to retail outlets, it's clearly an expense. All expenses are nominal, there you go.

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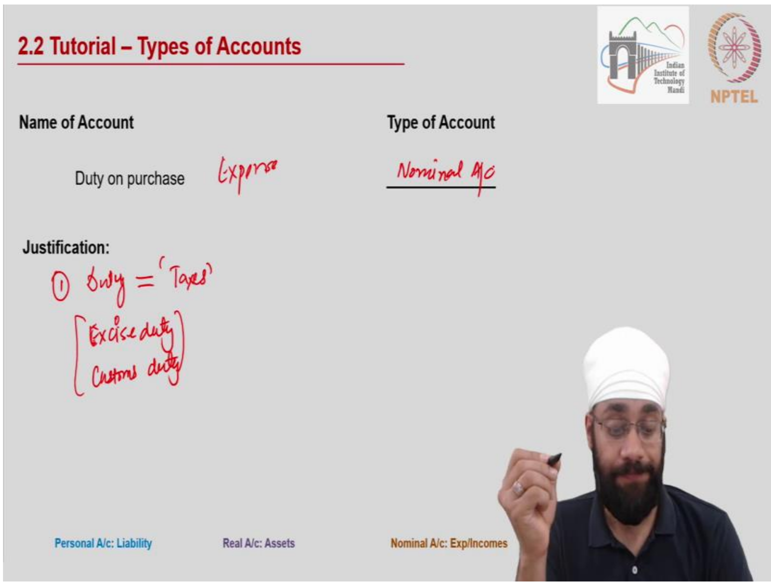

Then, you have duty on purchase. What is a duty? There are different kinds of duties that are charged in India. Duties are basically taxes as we understand them in the common parlance. There is an excise duty which is charged on anything which is produced, manufactured on Indian land. So, excise duty means, if you are manufacturing goods then you have to pay a certain percentage, depending upon what kind of goods you are manufacturing, to the government on it. Similarly, there could be customs duty which is charged on importing goods from other countries unlike excise duty which is charged on manufacturing things. When you import those then you have to pay customs duty and it can be clubbed under duty which can have many other duties which are applicable to the region where you are working or specific to the industry that you are talking about. But broadly these are the two kinds of duties which are generally levied. Clearly this is a tax, this is an expense that you have to pay on as a percentage of whatever you purchase. As this is an expense and we know that all expenses are nominal account, so it is a nominal account. There you go.

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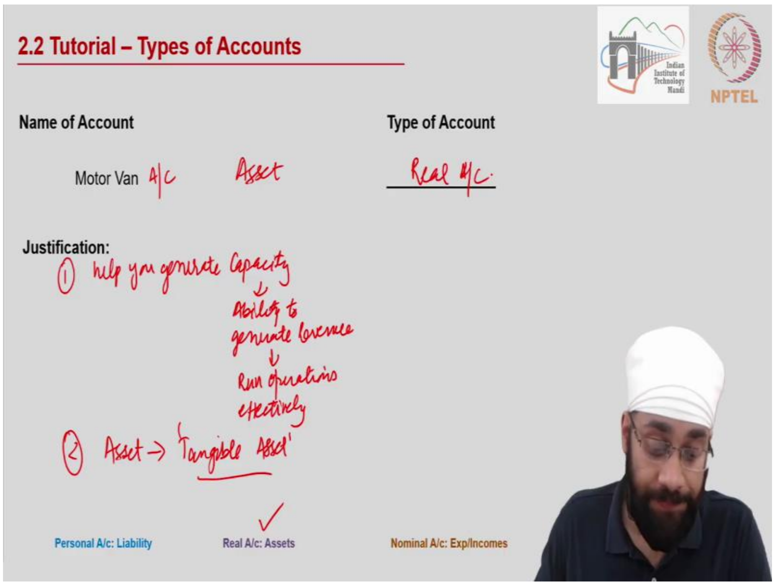

Motor van: all vehicles basically. Motor van account, it is going to help you generate or create capacity and you know when I say capacity, I defined this earlier as well, it means the ability to generate revenue. How do you generate revenue? By running the operations efficiently and effectively. Motor van is not directly going to help you generate revenue, but it is going to help your staff move around or maybe use this van for transporting goods. So, in that sense it helps you in the operations of the business and hence generate revenue for you and in the long run. It is going to be with you in the long run. So, a motor van is an asset and also it's a tangible asset, something that you can see, but does not matter which type of asset it is, as long as this is an asset, it is going to be categorized as a real account that is it.

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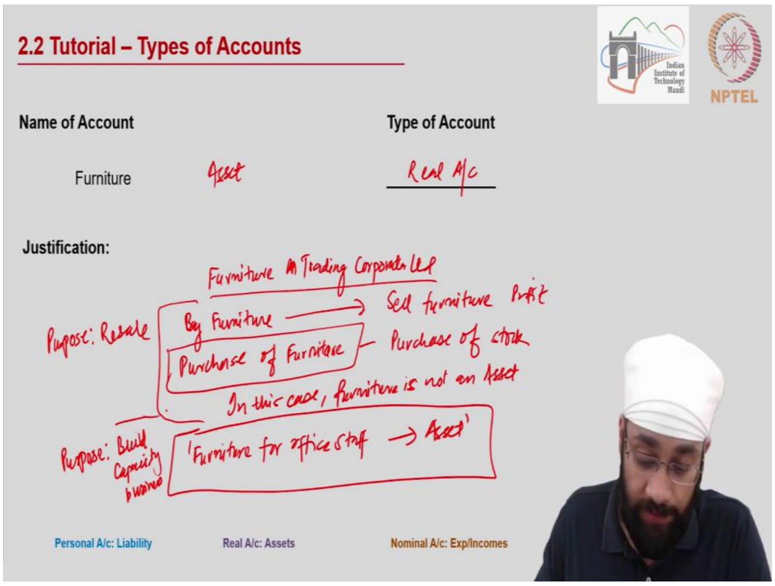

Next up is furniture. Furniture is similar to a motor van: it has a longer life, it is going to help you build capacity for revenue generation in the long run. It is an asset and it is going to be categorized into a real account. Now, let me do one sort of thought experiment or one variation of it. Till now we have thought of furniture as an asset. Now, what if you are in furniture trading businesses: let us say furniture trading corporation limited, this is your company. Your job or your business is to buy the furniture and then you have your cost and you have some profit and then you sell the furniture, and you make a profit on it alright. If this was your business, then purchase of furniture is going to be treated differently. When I say treated differently, you are going to think about the purchase of furniture as the purchase of stock because you want to sell it. So, whenever we say stock of goods, we are referring to the goods which we want to resell. Now, the purchase of furniture would be the purchase of stock of furniture which we want to resell here. Therefore, in this case, the furniture is not an asset; furniture is considered a stock item here and not an asset- this is very important. If you were in any other business and you are buying furniture for office use, then you would consider that as an asset. Within the furniture trading corporation you buy furniture; furniture for office staff. Now, this furniture can be called an asset. But you know it is entirely different from the previous category of furniture where, the purpose the purpose was resale and here the purpose is not resale- the purpose is to build capacity in the business and I keep on saying capacity, I am referring to revenue generation you are not going to resell it is going to help you run operations efficiently, effectively and hence you call it an asset.

So, be mindful that you know of this distinction that you may need to make from time to time, from place to place.

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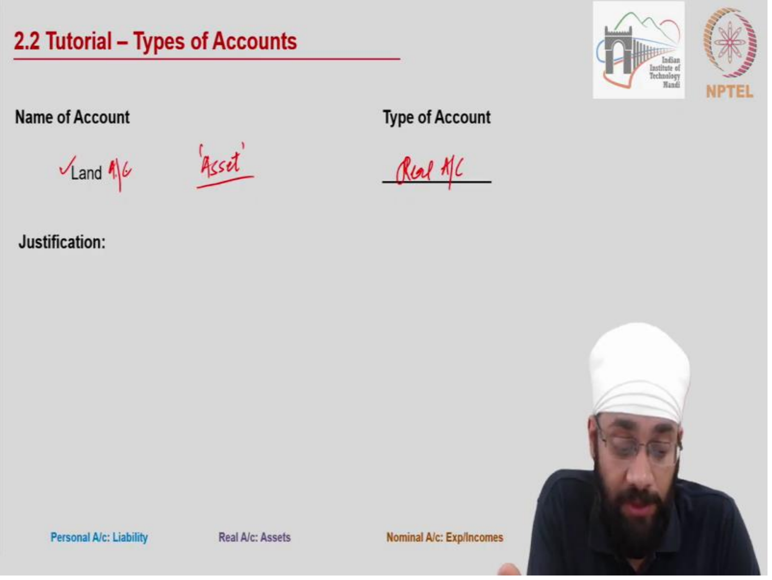

Next up is land. Land clearly we know is an immovable asset, a fixed asset or a tangible asset. All assets are real account. Again, if you are in the real estate business, the different pieces of land that you own and you want to resell those, you will consider that as a stock. But, if you bought land to construct your office; the real estate office at the top of it then you would call it an asset. So, rather than going by the name of a particular account or a particular item please understand what is the purpose behind purchase of that item, how is it going to contribute to the business? Is it an asset or is it a stock in trade for the specific type of business that we are talking about?

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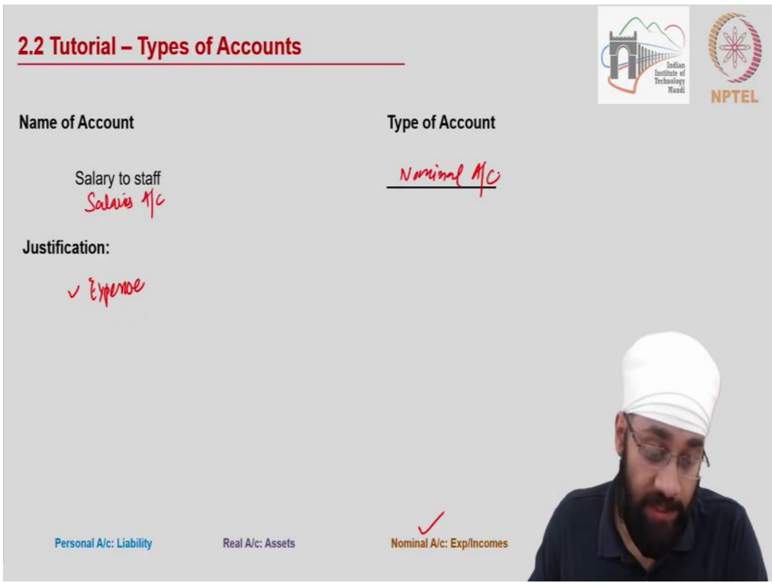

Next you have give salary to staff, now we are going to call it a salary account. Salaries to staff are paid on a monthly basis for the services they render to the business. This is an expense item because it helps you build capacity in the short run: you pay salaries, you have access to the services of the people. So, all expenses are nominal account, thus, salaries are nominal account.

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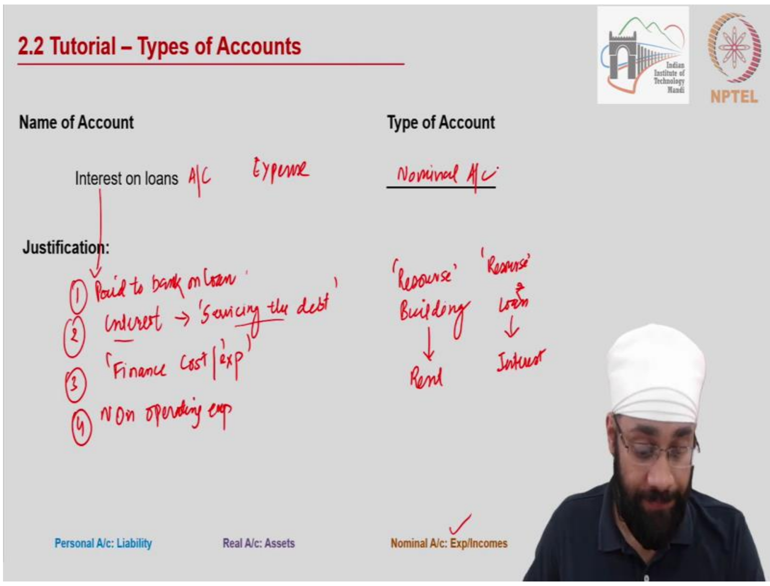

Next up is interest on loans. This is interest on the loan account. Let us say a bank loan that was taken sometimes back, you pay the interest on it. By paying interest what you are doing essentially is servicing the debt. When I say servicing the debt, I mean you have to pay rent on the loan that you have taken. So, consider this, you take a building on rent, you take a building for office use, and you pay rent on it alright. What is a building? Building is essentially a resource. And another kind of resource would be that you take a loan, money, from the bank, you take a building from a landlord and you take another resource called money from a landlord who is called bank. And, you have to pay rent on it. But this rent has a specific name which is interest. That is how we think about interest in accounting. So, you are paying interest, you are servicing the debt, you are servicing the creditors who have given you a resource you have to provide them a return- that is called servicing the debt. Interest paid on loans, we have discussed this earlier, this is a finance cost or finance expense; this is shown separately in the income statement of a public company or a private company. There is a specific head called finance cost, you could go back to the statements of Reliance industries limited and you will see an item called a finance cost. This includes all the interest expenses that are to be paid on the loans that the company has taken. Since, this is an expense and also, we have discussed that this is a non-operating expense, this is not an operating expense; however, this is an expense does not matter what kind of expense and all expenses are nominal accounts. Then you have the loan that you have taken from the bank.

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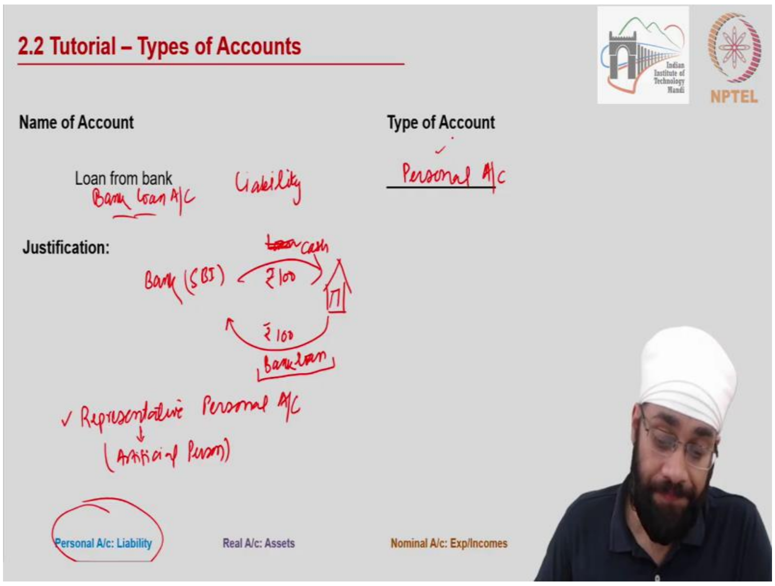

Now, there is a bank let us say, State Bank of India and the business takes a loan. So, there is a loan. Let us say a loan worth 100 has been given. So, when the loan has been given effectively what the business gets is, I should say cashier or the bank balance effectively. And, in return the business now owes to the bank and there is a liability which has been created worth the same amount and this liabilities name is bank loan. This is the transaction that is taking place. So, this bank loan account; loan from bank is called bank loan account. This bank loan represents the liability that the business has towards the State Bank of India. So, the bank loan is a representative; a representative personal account it represents, it represents an artificial person: bank is an artificial person, bank is a company in itself, it is an organization, it is an artificial legal person, it has an identity of its own. Loan from the bank, therefore, is a liability and all liabilities, as the rule says are called personal accounts. So, one more time, the personal accounts refer to any account where you record the liabilities of business towards a real person, an artificial person, or a representative of real persons or artificial persons. In this case, a bank loan represents the bank. It represents the liability that the business has towards the bank therefore, we categorize this as a personal account.

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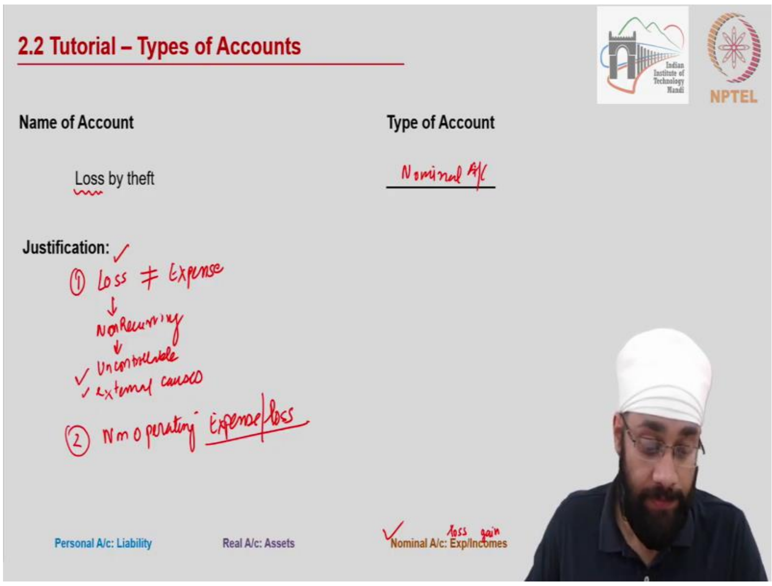

Next, you have loss by theft. Clearly the name itself says- loss and in the rule for nominal account, there is expense or loss, income or gain: the two are treated as synonyms. However, there is a difference in what is a loss and what is an expense and I will clarify that. Loss, typically, is not the same as an expense. Loss is non-recurring in nature What is non-recurring? Recurring means repetition is a regular feature. When we say non-recurring, I mean it is not in your control, sometimes uncontrollable; uncontrollable and also this happens due to external causes. So, you have loss by theft - you did not plan for it, loss by fire- you did not plan for it, embezzlement of cash- you did not plan for it, and these are not typical expenses of business, but you anyways lost cash in the process. So, such items are called losses. Nominal account says all expenses fall into it. So, loss by theft number, one it is a loss, second it is a non-operating expense. Although, it is not an expense, we will say loss is a non-operating item in nature. It is not primary to the business, it just happens sometimes in the business. Anyways, it comes under the expense/loss category which is the nominal account that is important.

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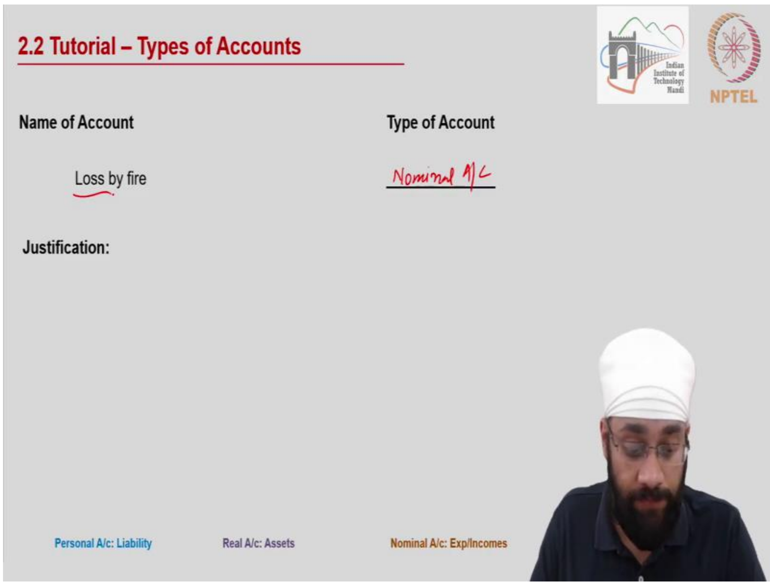

So, any expenses or losses are going to be treated as a nominal account. Loss by fire- same, I am not going to explain this. So, this is a nominal account, this is non-operating expense/loss.

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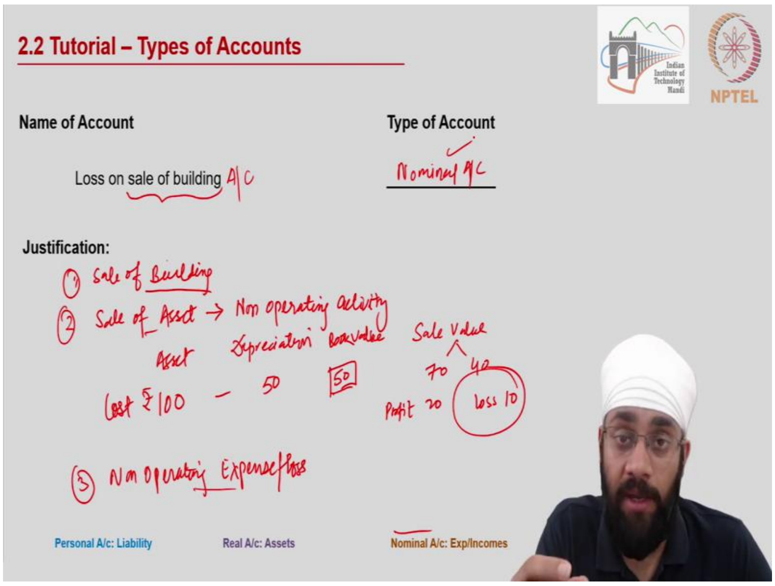

Loss on sale of building: what is the loss on sale of building? Now, the building was purchased. You are a typical, regular, trading business, manufacturing business, you do not buy and sell buildings, you need to understand that. Therefore, the building that you have is an asset which you have. Now, you have sold the asset. Whenever you sell the asset, it is not a primary activity of a business. So, this is a non-operating activity- this is not the revenue that you generate by selling the asset: you did not set up the business to earn that revenue. You bought assets to build capacity, to help run operations, to help buy and sell other goods and services that you wanted to and then make money in that process. But if you start selling your assets it is not going to count as an operating activity- number one! However, in the course of the business you may have to sell an asset because of various reasons: the technology is obsolete, you have to buy new machinery, there is some fault in the machinery that you have as an asset, you want to do that, or maybe you are moving the place of business as in this case. It is a building being sold; you will be selling the building because you are moving your operations from this area. So, whenever you do that, you purchased asset at some value. So, asset was purchased at let us say 100, cost price- historical price. We have discussed this earlier in the cost principle of accounting where we say all assets are shown at their historical value at their cost value. So, rupees 100 is for what you bought this asset and then there is a depreciation that is charged. Reduction in the value of this asset, let us say, 50 is the depreciation till date, it has been 5 years that you bought this building and now you are selling it off. So, 100 minus 50; 50 is the book value, current value in the books of accounts. And, now you are selling it; so, the sale value right now is 70, you are able to sell it at a higher price or possibly you could sell it at 40. So, if you are selling at 70, you make a profit of 20, and if you sell it at 40 you make a loss of 10 compared to this 50. So, I just want to explain this transaction and the dynamics around this type of transaction. The account that we are now talking about is the loss that you face when you sell the building. Loss on sale of building account, since it is a loss- you clearly know this is going to go into nominal account, but more than that we need to also understand the nature of this account. So, this is a non-operating expense/loss, this is not a primary activity of the business. In case of loss by fire, I said it was an unplanned externally caused event, you know something which you could not do anything about. In this case, you could decide to not sell the building. Even if you have to sell the building for some controllable causes possibly, the point is that it is not a regular loss of the business, regular expense of the business; it is a once in a few years kind of thing. So, it is a non-operating expense and all expenses are nominal. So, let me stop here and there are some other items which we need to look at. I will continue that in the next video.