Financial Accounting
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Lecture – 4
1.4 Key accounting terms I

In this video, I am going to talk about 4 Key Accounting terms. These 4 terms are really alphabets of the accounting language. If you know the alphabets a, b, c, you can write sentences. And if you know these four terms, then you can converse or you can write in the language of accounting. So, let us get started.

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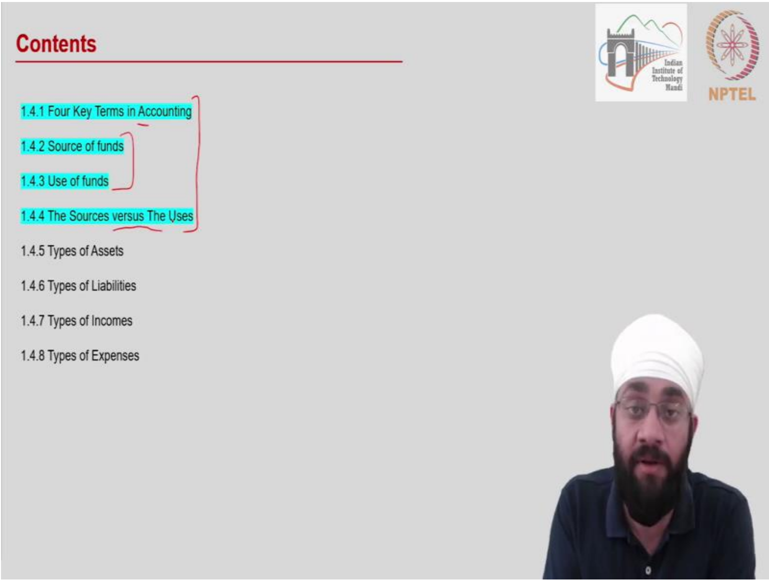

The video is divided into two parts. In this video, I am going to take up the first half 4 topics, and then the remaining 4 are going to be taken up in the following video part 2. So, I will talk about the 4 terms, I name them, and then I will try to explain to you what those terms mean in these two sessions. And then I will establish the relationship between the 4 terms. Let us get onto it.

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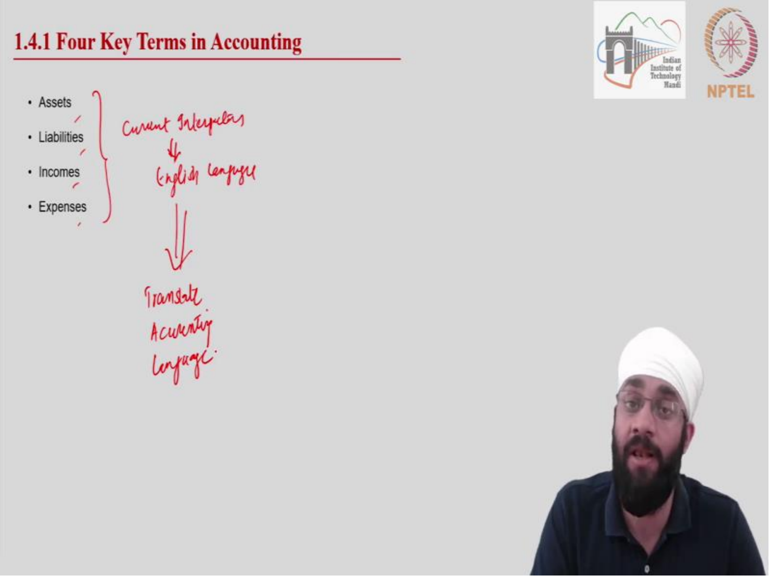

The four terms are assets, liabilities, incomes and expenses. These terms are not something you have not heard of; I am sure everybody has come across these terms. However, our interpretation of these terms is as per English language. All we need to do now is to translate it into the language of accounting: that is what we are going to do in this video.

We will say asset, liability, income, expense, is not what you think they are. Let us agree on the definition of these four terms. And, whenever we are looking at financial reports of a company or we are conversing about financial results of a company, we should always refer to these words having certain specific meanings as per the language of accounting.

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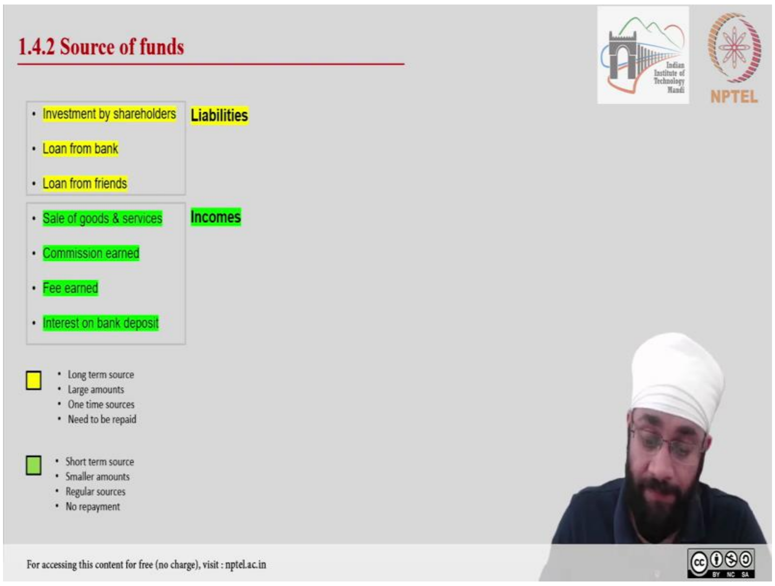

In order to explain these four terms, let us begin with a more understandable way of explaining these items.

Sources of funds for a business: where does money come from- where do the funds come in from? And I have a list for you, you can get your shareholders to invest money, that is one source; you can go to the bank or go to a friend, or family, or, fools as they say three Fs, and get funds for yourself – these are some of the sources of money for a business. You could sell goods and services whichever business you are in, and you know you make some money from there. And there can be some other peripheral additional sources of income, you make some commission on a small new assignment you pick up in the business, you make some fee via way of some consulting assignment, or you put money in the bank and you have interest that you get. These are some representative items which bring in money to the business; there can be more of course.

Now, the first items, investment and loans have a specific nature. What is the nature? These things are long term sources. What do we mean by long term? In accounting, we define long term as typically more than 1 year. So, if a shareholder is investing money, they are at least going to stay invested for 1 year and more. The time horizon is larger. The amounts are also bigger. While starting a business, promoters are looking for not thousands but lakhs of money and thus, these loans and investment by shareholders are kind of one time.

Now, you would argue saying one can take multiple bank loans – yes one can, but such things happen once in a while if not only one time. So, typically these resources are either once in the lifetime of the company or once in a few years. But not many times in a given year because you need to repay the loans and return the investment by shareholders. In the case of public companies, you do not need to pay back the money ever because the shareholders can just sell their shares to somebody else who would buy it and so on. Again, that is divergent, I do not want to go that way. But what I am trying to say is that the first three items, the investments and loans, are long term sources, are one time sources, are large amounts and you need to repay these to the people who have given these funds to you.

The second set of items which you see on the screen are sale, commission, fee and interest- what is their nature? These are short term sources. Now, what do I mean by short term? I mean sale of goods and services you are going to sell it and you are going to make money; if you do not sell, you do not make money. And these are regular sources. You keep on selling. You want to sell as much as possible. So, these are recurring sources of funds to you. And then these can be smaller amounts, typically like you sell one item, how much does it cost? Unless you are in, say, a car business in which case also the amount that you make on sale of 1 car is small in comparison to the investment required to start the car business. So please think of the sales amount in relative terms of the investment as well. And, then you do not need to repay these sources. All you need to do is to exchange some goods or services for these sales. If you earn a commission, you have to provide a service. If you make a fee, you provide some consulting, similarly, interest on bank you have to lock your money in the bank. So, these four items are short term sources and recurring sources: regularly you get money and you do not have to repay this money back. You just give something in return for exchange. So, these are the differences between the nature of the two types of items on the slide, and all the items are sources of funds.

Now, can we give names to these two categories of funds? And when we do that, the first category is called liability, and the second category is called income. The money comes into the business from two sources, one is liability, the second is income. And suddenly all of you are thinking, *hey, liability means you have to pay it back.* Yes, you have to pay it back, but you have to pay it back because you got that money into the business in the first place. Again, please think differently about these terms- you are learning a new language. So, you need to empty your cup first. Do not associate the existing meanings of liabilities and incomes in your mind. Try to learn this new language where liability is a source of income, it is a good thing as well, but it comes with a condition – you have to pay it back- there is a commitment of interest that you may have to pay on it. So, there you go- two terms liabilities and incomes, both sources of funds, and now I have clarified what these two terms mean.

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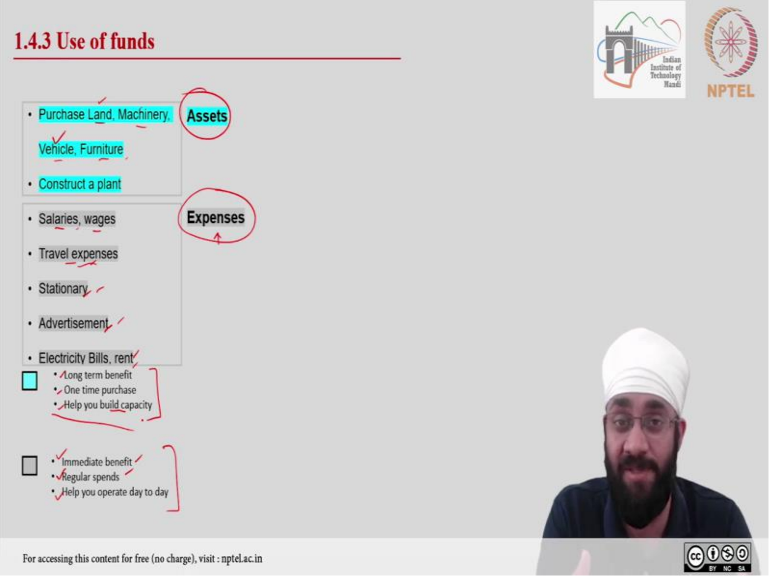

Let us talk about the use of funds. You use the funds in the business to purchase land, machinery, vehicles, all the resources which you need to manufacture the goods or to operate the business. If you are manufacturing, you have to set up a plant, you have to buy various equipment to run the plant as well, you have to hire people, and you have to pay them salaries and wages. You might have to travel for business purposes, you might require stationary, advertisement, electricity, rent, you name it. I am sure anybody could come up with tens of items where their funds can be used in a business.

Again, we are going to repeat the same exercise. Let us look at these items differently; can we categorize them based upon their nature, recurrence, sizes and so on? Here we can categorize again into two parts: the first category typically gives you a long term benefit- land, machinery, furniture, everything is going to help you for more than 1 year. Again, the long term is more than 1 year and, short term is less than 1 year in accounting. So, you get long term benefit. And you purchase these items one time, you do not continue purchasing land. Well, if you are in the business of land, then it is a different case; I am talking about a regular manufacturing business, let us say furniture manufacturing business. So, we are talking about purchasing land once, setting up machinery once, buying delivery vehicles, furniture for your staff and so on. At best you may buy these things after a few years, but not very regularly. And all these things help you build capacity in your business.

What is capacity? Capacity implies that if you are manufacturing then capacity to manufacture more; if you are in services business, then capacity to provide more services. So, these things are helping you build capacity, you are not getting these things to sell off.

The other category that we have on the slide comprises of salaries, travel expenses, stationary, advertisement, electricity bills. All these provide some immediate benefit. You take services from people and pay them salaries monthly, or wages daily- blue collar versus white collar distinction. Then you have travel expenses. You travel, you pay the money- immediate payment. And if you have to travel again, you have to pay the money again.

Now, if you do not want to spend on travel, you can buy a vehicle. But when you buy a vehicle, it becomes a different nature of item. Advertisement, electricity bill, all these things are regular items of spending, and they help in day-to-day operations of the business- that is how these two categories are different.

The first category is called assets and the second category is called expenses. Both assets and expenses are the uses of funds: you spend money on both of these. Expenses help you run day-to-day operations in a business. On the other hand, assets help you build capacity for the long run to ensure smooth functioning of your organization, production of goods, and creation of services.

Now, stationary, advertisement, all these also help in production of goods and services, but a difference in the nature is that they give immediate benefit. These things do not result in building capacity. They only help in the short term, but the assets help in the long run. One more time, please empty your cup, you have to think about assets and liabilities, and incomes and expenses in a very different light.

I understand that asset is a generic term, you think of your personality as an asset, your communication ability as an asset, but unfortunately all of that has no place in the language of accounting. We think of assets as uses of funds in order to build more capacity into business for the long run.

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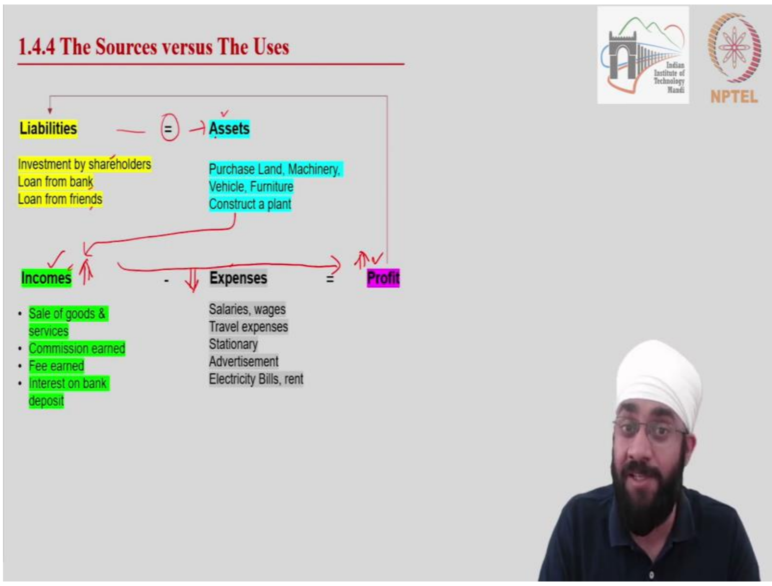

So, these are the four terms and now let me use these four key terms of accounting, the sources and uses, and try to illustrate how business functions; how these four terms make up the whole process of transacting in the business. Now, you begin business and you bring in some money from the shareholders or, you take loans. And this money is with you for a longer duration of time. You have to pay, but it is with you for a longer duration. If you have money for the longer duration, what do you do? You buy things like land, machinery which will help you build capacity for the business. So, use all the liabilities, the funds coming from liabilities, to build assets. You cannot buy more than the funds that you have in the form of liabilities and you can use these funds to buy assets of an equal value that is how you see this equal to sign. You bring in sources, and you have only those sources to spend on building the assets: that is how there is an equal sign between assets and liability.

You got the money, you developed the capacity. Now, what do you do? Now, you manufacture and you sell. So, I am going to sell and what is going to happen, I am going to make money. So, I make money, I call it income. In order to make money, I have to spend money; I have to hire people, pay for rent, and other things. So, I am going to pay all the expenses. So, you generate income, you pay expenses out of this income. And you get a resulting item called profit. Whatever is left in addition to the expenses out of the money that you make (income) is called profit.

After making this profit, what do you do with this profit? Who does this profit belong to? Well, this profit belongs to the people who put money into the business. Who are those people? Those people are the people who supplied the funds; the sources of liabilities they get a right to take the profit. Now, they can decide to use the profit or they can decide to use the profit into business.

So, you can buy more assets. If you can buy more assets, you have more capacity. If you have more capacity, you can make more money. When you make more money, you make more profit. More profit means more liabilities. And then you can generate more capacity, and then you can have even more income and then even more profit and so on. This is how you grow a business.

You are trying to maximize your incomes, minimize your expenses, and hence maximize your profit, so that this profit can be channeled back into the business to generate more assets. So, that is how businesses work and that is how these four terms encompass all types of transactions that take place in a business on a day-to-day basis or in the long run.

Whatever transaction, name a transaction, and I will say as a result of this transaction either an asset is being created, a liability is being created, an expense being made, or an income is being generated. Therefore, it means that in the financial reports of a company all they are going to do is to categorize various transactions into these four and show it to you.

And now you know the alphabets in the accounting language, you know what are assets, liabilities, income and expenses. And when you look at the financial statements which you will in the future videos, you will know what the assets, liabilities, incomes and expenses mean.

Great, so I will see you in the next video.