Financial Accounting
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Lecture – 5
1.4 Key accounting terms II

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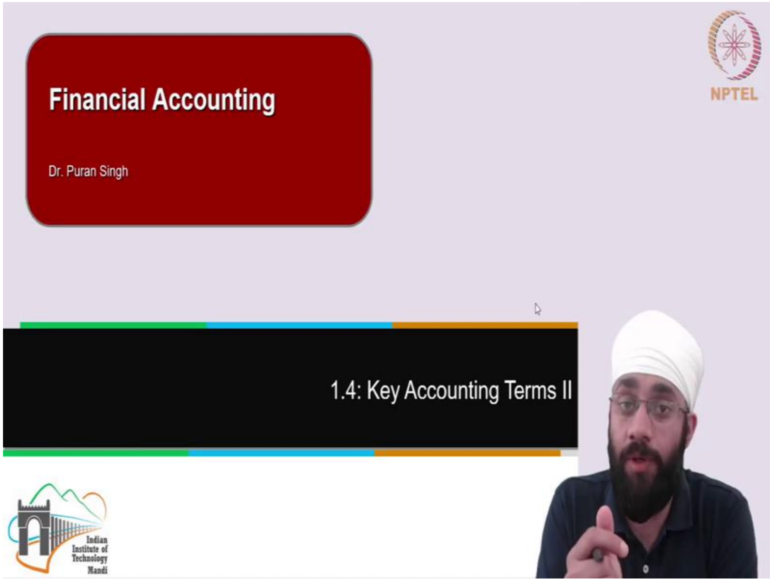

In this video I am going to talk about types of assets, liabilities, incomes and expenses.

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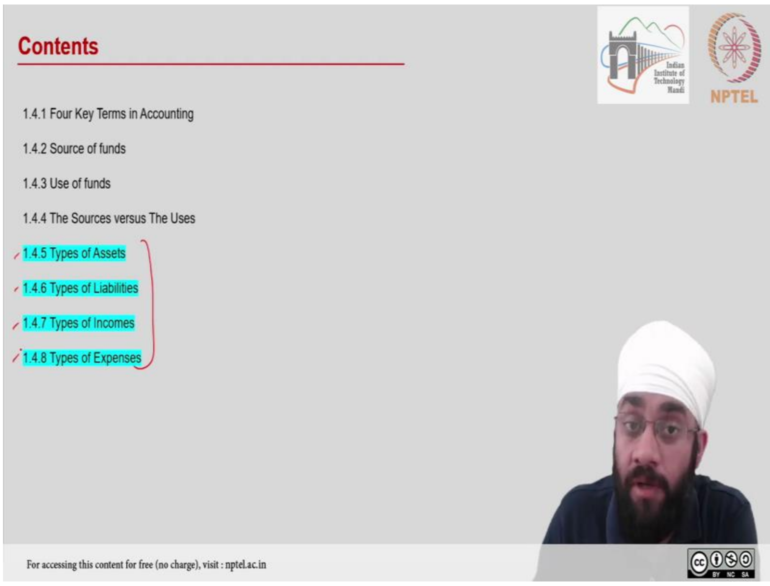

We will build up on our understanding from the previous video and now deep dive into the four terms of accounting.

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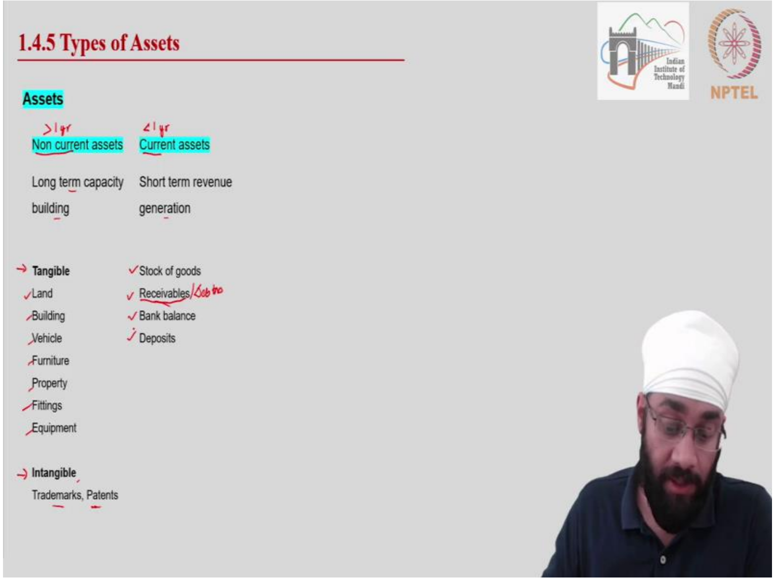

Types of assets: Two types of assets are non-current and current assets. The word current and non-current refer to short term and long term. So, short term is less than 1 year and long term is more than 1 year. Throughout the course whenever we say short term, we are referring to less than 1 year also referred to as current year. And non-current is more than 1 year which is long term. So, try to remember that.

So, non-current assets are the ones which help you build capacity in the long run. On the other hand, the current assets help you generate revenue in the short term. They build a temporary capacity for you to generate income in that particular year. In contrast, the long-term asset, the non-current assets are going to help you to build capacity to generate revenue over multiple years.

Examples of non-current assets are land, building, vehicle, furniture, property, fittings and equipment: all of these things help you set up a manufacturing place to produce goods for a longer duration of time, usually more than 1 year.

Also, non-current assets can be of different types and I have one specific category which will be useful: tangible non-current assets and intangible non-current assets. Tangible assets I think it is very fairly clear- all these things you can see, touch, feel they exist they have a physical existence. On the other hand, intangible non-current assets may not have a physical existence. These are the trademarks, patents, intellectual property which give you certain rights or certain advantages in the market using which you will be able to generate a revenue in the long run. These are called intangibles because you cannot see them, but they are assets; they help you build capacity in the long run and they help you generate revenue in the long run.

Short term assets: current assets help you generate revenue in the short run and build temporary capacity like stock of goods. If you have a stock of goods that you deal in, you will be able to sell it and make money. The intention is that you want to produce the goods which you will be able to sell within this year as fast as possible. If it is up to you, you would want to sell everything right now and make as much money as possible. So, with the stock of goods, the intention is to sell it as soon as possible, typically within 1 year and so it gives the temporary capacity to generate revenue: hence, it is a current asset.

Then there are receivables; what are receivables? You sell the goods, but you do not get the money now because as a business policy you decide to attract customers and compete with the competitors by giving some incentive to customers. So, you *say I will sell it to you, pay me after 1 month- I give you a credit period*. So, this money is recoverable and is called receivable or recoverable. This is also called debtors in some cases or recoverables. So, this policy helps you generate revenue, you will be able to sell more if you extend the credit period to your customers. So, the amount of money which is recoverable represents a current asset.

Bank balance and bank deposits: all the money you have in the bank you can put it to use for different purposes. So, it is something fluid to build temporary capacity as and when you need. If you need to buy something quickly, if you need to pay for something on a given day, you can use this money.

So, stock receivables bank and bank deposits give capacity in the short run or give temporary capacity to generate revenue. So, that is how you distinguish between non-current assets and the current assets.

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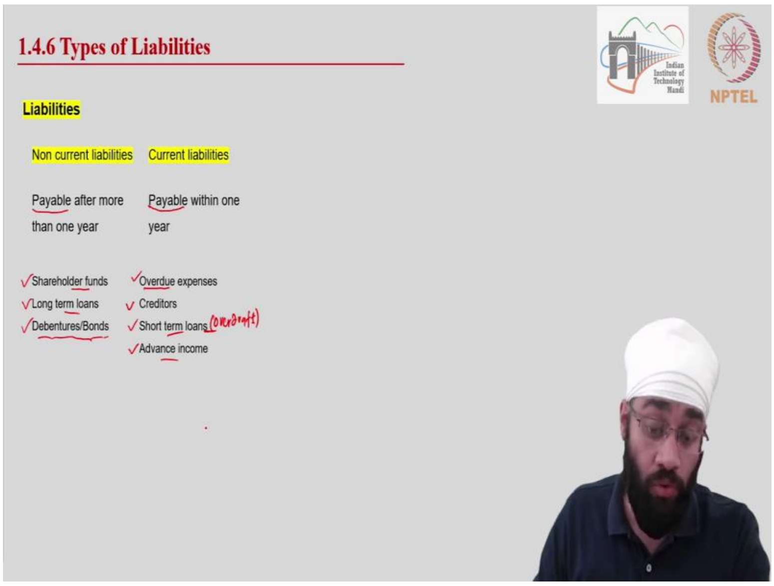

Let us talk about the types of liabilities now. Again, liabilities can be categorized into two: non-current and current liabilities. And now I should not need to repeat what current is and what non-current is: you should have it at your fingertips by now.

So, payable; liabilities are payables- if you have to return the money after 1 year in the longer run you call it non-current liability. If you have to return the money within 1 year you call it current liability, simple as that.

Now, shareholder funds, long term loans, and any debentures and bonds- these are the examples of non-current liabilities. I think now you very well understand shareholder funds- this is the money which is brought in by the investors, the shareholders of the company, long term loans from the banks. Debentures and bonds are fancy terms that refer to the loans taken from the general public instead of the banks. When I say *you* I mean the company, the artificial legal person, the company can raise funds from a bank or raise funds from the public. From the public it can raise an investment or it can raise a loan: when you raise a loan from the public it is called debenture/bond. Bond is a more popular terminology in the international market, in Indian markets debentures are more popular. Overall debenture or bond market is not very active in India as it is in international markets. Anyway, that is non-current liabilities for you.

Current liabilities are any expenses that you have not paid, but they have become due or have become overdue. So, whenever you have passed the deadline and you have to pay these expenses, it is called a current liability and you have to pay it within a year. For example, telephone bill; I use the telephone services and a bill comes, the due date is 30th of the month. If you do not pay it on the 30th of the month, it goes to next month - they send you a reminder, it becomes a short-term liability for you to pay it back quickly.

You can take a short term loan from the bank, it gives you a facility called overdraft. Again, when I say *you* I mean the company, the business not you. So, you can use the overdraft facility; it means that companies or businesses which have a good reputation with the bank for a long period of time, the bank can extend a facility where if you have 10,000 rupees in the bank account, the bank will allow you to withdraw 20,000 rupees instead. That means you will have a negative balance of 10,000 rupees in the bank account. And overdraft policy may vary from bank to bank; but the bank can say you can bring this money back into your account within 1 month. If you delay it more than 1 month, then we will charge interest otherwise this facility is free of cost. And only because you are a good customer and we know that you sell every month and money comes into your account, we will extend you overdraft facility. So, this is again a short-term liability that you have to pay within a month or 2 or a few months.

Advance income: if your customers give you money and you have not delivered them goods and services yet, this is also a short-term liability. Why do we call it liability? Because if you do not deliver the goods and services, then the money is going to be returned, you will be liable to return this money back. So, till the time you deliver those goods and services this money is going to be called a liability. As soon as you deliver the goods you have discharged your duty you have a right over this advance income and can start calling it regular income instead. So, that is the categorization of liabilities into non-current and current.

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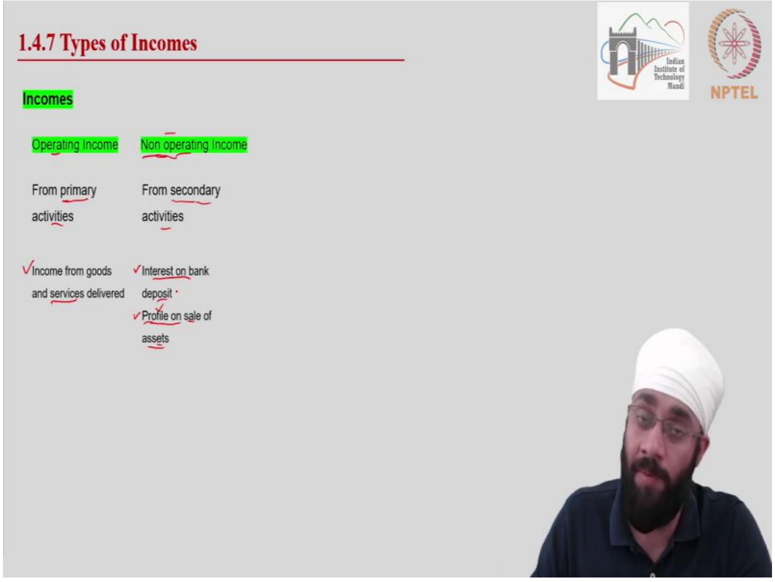

Let us go to incomes; now incomes, of course, are regular- there is no noncurrent and current income in that sense, but there is a different categorization for it. We have something called an operating income and a non-operating income. What do we mean? By operating we mean any income coming from the primary activities of the business and non operating is the income which comes from the secondary activities of the business.

What is primary and what is secondary activity? I talked about memorandum of association when I was discussing the artificial legal person, the company. The company has something called MOA and AOA where it is written that the company is being registered by the promoter for the purpose which is x y z. So, when you make money through that x y z purpose, which is mentioned in your memorandum of association, you call it a primary income- primary activity. Whenever you do something additional to it you call it secondary activity. Let me give you an example of this. For any given business, the goods that the business sells- either it manufactures the goods or buys the goods from somebody and sells it further- any income coming from that is a primary income. That is why the promoters established that company and if it is a services company then the services that are being provided. So, for any business, the primary income or the operating income comes from the sale of goods and services.

Non operating income, on the other hand, can come from many different sources- for example, interest on bank deposits. It means that you have put money in the bank account and the bank pays every 6 months some 3- 4 percent interest on that which is an income for you. But you did not set up the business to put money in the bank account and earn interest- that is not a primary activity. It is a resultant activity: it is a side activity due to which you are getting money. Therefore, we call it non-operating income.

Similarly, profit on sale of assets. What are assets? Assets are things you purchase to build capacity in your business to generate revenue in the long run. You bought land; now if you sell the land and make some profit this is an income, it is the additional money that you make. However, it is a non operating income; why? Because you did not set up the business to buy the land and sell the land and make profit on it- that is not your primary activity. The land was of no use because you have used it for 10 years and now the plan or the business is different- you are moving to another geography, for example.So, now, you can sell up the land the profit that you make that is non operating profit. However, if you are in the business of buying and selling the land then that is a primary activity. Also, if you are a bank and you are in the business of taking deposits and giving the loans then the interest that you earn at that time will be from a primary activity.

So, depending upon what is the purpose of the business you decide whether an income is operating income or a non operating income.

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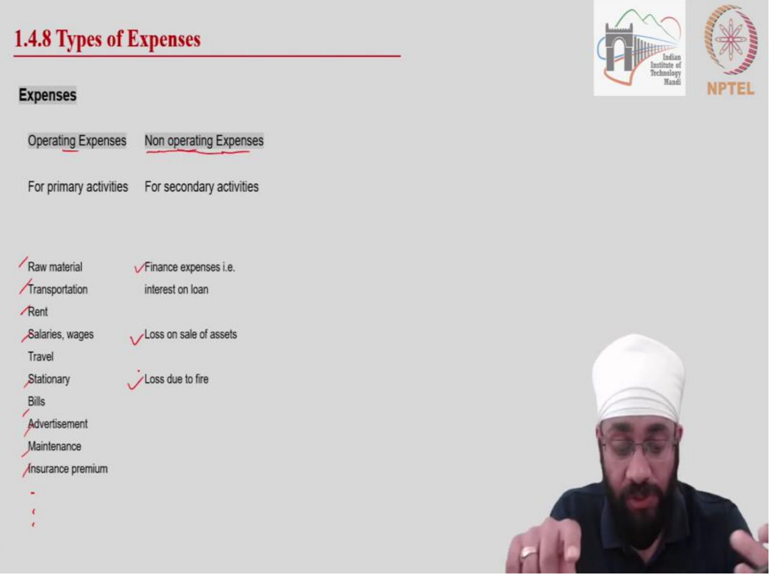

Let us move on to the types of expenses. Similar to income, we have two categories of expenses: operating expenses and non-operating expenses. Again, operating means the expenses which you incur for the primary activity of business and non-operating you know very well now. Let us look at some examples: you purchase raw material you have to spend on transporting the material, rent, salaries- all these expenses are regular in a typical manufacturing business where to produce goods you need to spend and the list can be very long.

On the other hand, non-operating expenses are typically finance expenses. If you have taken a loan and on that loan you have to pay the interest that is an expense of the business, but that is not an operating expense. The convention is that all the finance costs- the interest on any loans- will be called a non-operating expense. You could very well run the business without taking the loan. It is a strategic decision to take the loan, it is not primary to the business. Infosys for example, is a no debt company. They have not taken any long-term loans from banks. So, it is all about strategy and resources that you have. You do not set up a business to take loans alright. So, that is why we are calling it a non operating expense. You could have a loss on sale of assets; you could have a loss due to fire or any other loss which is not primary to business. You did not lose because expenses are more, incomes are less, but you lost because an asset caught fire, or theft, embezzlement of the money happened in the business; all of that is non-operating expense.

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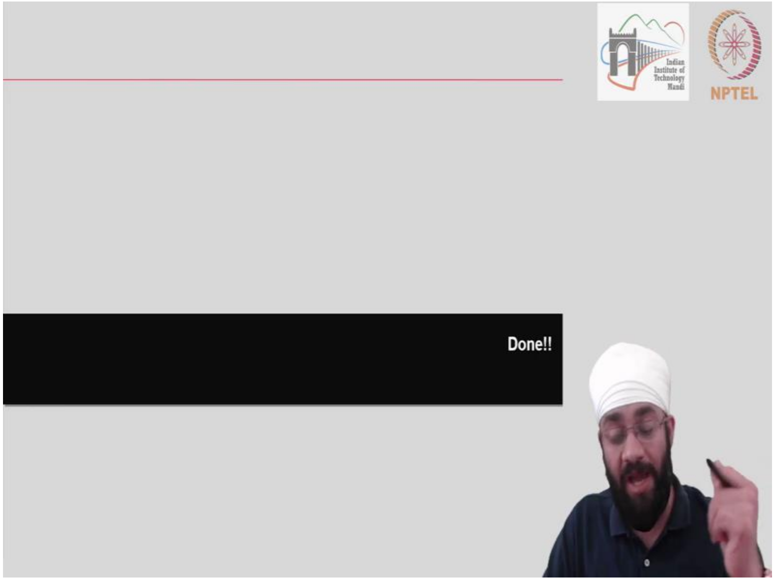

So, there you go, now you should have a fair idea of the four key terms in financial accounting: assets, liabilities, income, and expenses. We have discussed in detail with examples. Any transaction in the business can be dragged and dropped into one of these four categories.

We are going to make use of these four terms in preparing the financial statements, reading the financial statements and everything else in this course. See you in the next video.