Financial Accounting
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Lecture – 6
1.5 Tutorial – Key accounting terms

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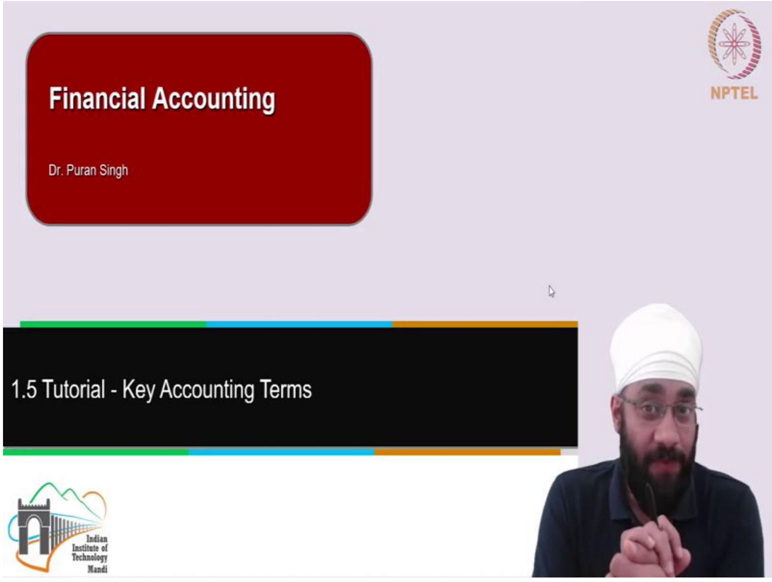

This is a Tutorial. We are going to put to practice the concepts of asset, liability, income, and expenses. It is appropriate to spend some time on consolidating our understanding on what these four terms mean and which of the various transaction items in the business fall into each of these categories.

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So, I am going to look at a list of items one by one, and tell you how to start thinking about categorization. So, we will do this and also do the sub categorization within each of the four terms.

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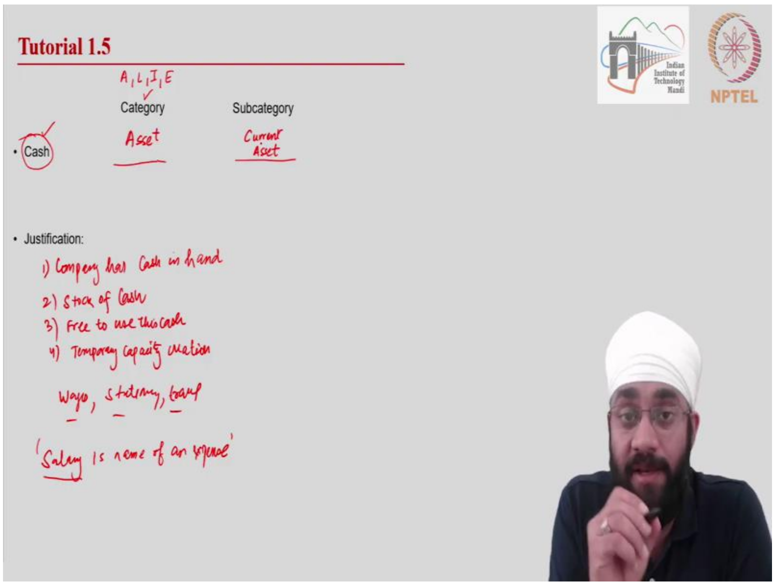

So, this is how the content in the slide is arranged: you have the name of the item, say cash, you have to say which category this belongs to, and by category I mean asset, liability, income or expense, and then which subcategory? So, if it is assets, you have a current asset, noncurrent asset; if you have income, then operating or non-operating. So, likewise we have to answer these two questions here. And then we can make some working notes in order to justify our answer.

So, first of all, cash. The first question is what do we mean by cash? We are referring to a company having cash: cash in hand, in the pocket, in the drawer of the business. you have some cash which belongs to the business- that is the cash we are talking about. This cash is with you. You can call it a stock of cash. This is stock of cash with you. Now, you are free to use this cash as well. Since, it belongs to business you are free to use it for business- not for personal use of the owner of this business. And this cash is going to help you create some temporary capacity. You can use it for temporary capacity creation. What does that mean? That means, you could pay daily wages with it, you could pay for stationary with it, you could pay for travel with it, you could spend on any of these things. You have not yet spent it: it is with you- it is a stock of cash.

So, this stock of cash which is clearly an asset as we have discussed earlier, this is an asset, and it helps you generate capacity in the short run. It is going to help you generate income in the short run. Therefore, it is also going to be a current asset.

So, please do not confuse cash with expenses being paid like salary; now salary is the name of an expense: salary is the name of an expense, salary is not equal to cash. Salary is the name of an expense and an expense is done using the stock of cash that you have. These are two different sides of a coin. You would say salary has come into my account; actually, cash comes into your account, money comes into your account, because you have earned a salary. You will take a while to get used to this way of thinking about things, but the idea is that what you really get is cash and, why you get cash is because of your salary. So, cash here refers to the stock of money with you. And it helps to generate capacity in the short run, helps you generate income in the short run, therefore we call it a current asset. Let us go to another item which is bank balance.

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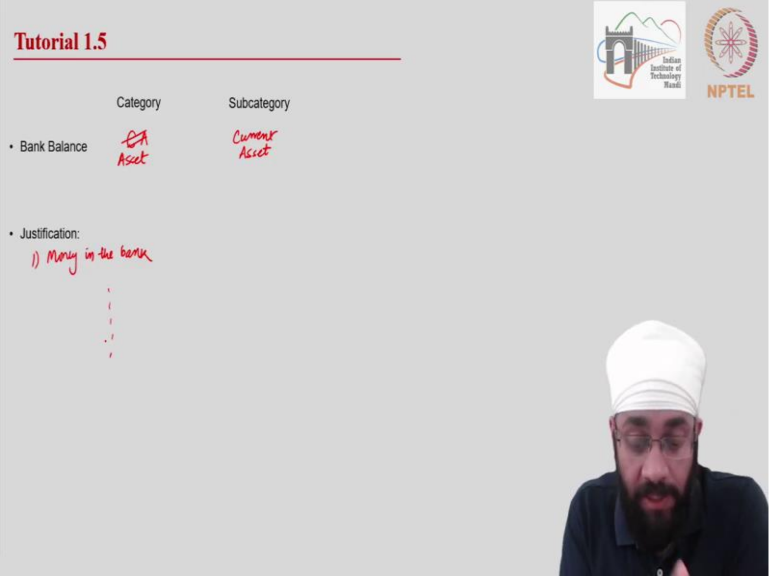

What is a bank balance? Bank balance is money in the bank instead of money in the desk drawer you have money in the bank, in the bank account. And in the bank account, it could be in your you know current account, it could be in your savings account, and FD account whichever type of account as long as it is in the bank you call it bank balance.

So, really the nature of this item is the same as the cash, you cash, you have cash in hand, you have cash in the bank. The cash in hand can be used to pay salaries, wages, travel expenses. Similarly, cash at bank can be used to pay all these people digitally. So, you know bank balance again is an asset, it is an asset; and the subcategory is current asset.

If you have put money in a longer time deposit then it becomes a long-term asset, but businesses typically would not do that unless they are in the investment business. Rest of the justification stays the same, thus, money in the bank is a current asset.

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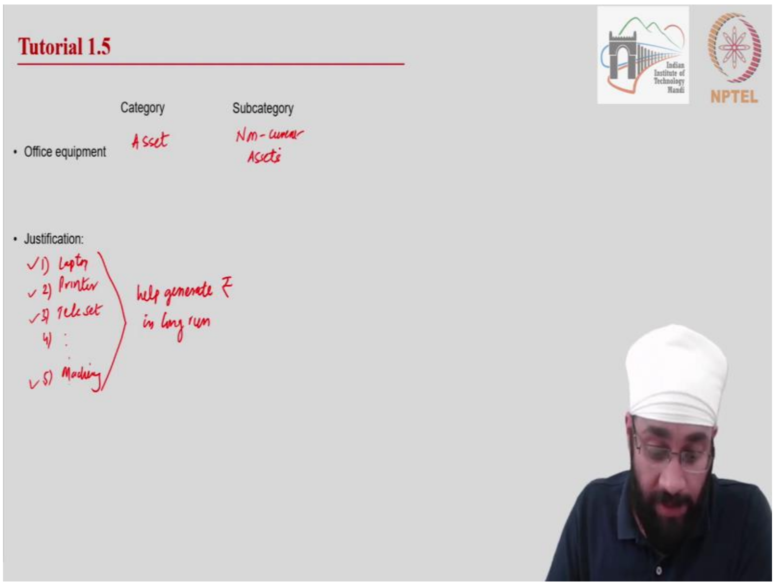

Then you have office equipment. Office equipment can be laptop, printer, telephone set. So, any other different kinds of equipment which are any technical things which you need in an organization to run day-to-day or also to run you know longer period, we have machinery, you can have any other type of machinery as well.

So, all these things are going to help generate revenue. And they help generate revenue in the long run, in the long term, therefore, you are talking about non-current, it is not current; it is not 1 year; it is more than 1 year.

A laptop has a life of 2 to 3 years typically; printer is going to be with you for many years; telephone set; these things do not vanish in 1 year unless there is an accident or something which is exceptional- you do different treatment for that. But all these things have a long-term life, and they help you build capacity, revenue generation capacity, for the long run. You call them assets. And since it is long term, you call them noncurrent assets.

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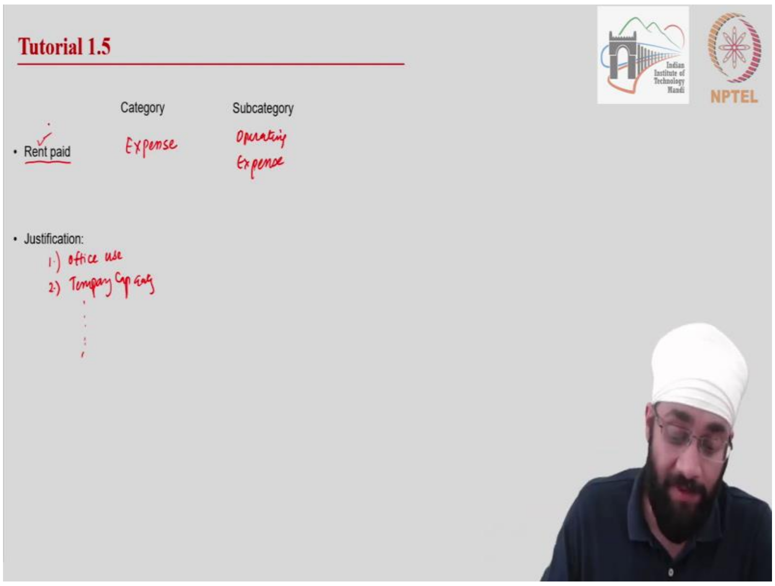

Next item is rent or rent paid. Now, let us understand the nature of this item. What is happening here is you pay rent for the use of let say office building- you use office building, you pay rent. Actually, you pay rent first, and then you use the office building. So, if you are not paying the rent, you do not have a right to use the office building. So, by paying rent essentially what you are buying is the right to use a specific property for which you are paying the rent.

So, what it helps you build is a temporary capacity. So, you can use the office for a certain period of time. And then if you do not pay rent, you do not have the right. So, temporarily you build the capacity to generate revenue, to have your operations. Therefore, as you are spending money, it becomes an item of expense. And within the expense category, the subcategory is operating expense because you are using this rent space for the operations of the business- at least that is the assumption. And maybe the name rent will not make it operating or non-operating. If you have a building which you use as a personal guesthouse and you are paying rent on that, that is not an operating expense for the business. So, you do have to look into the purpose for which various expenses are being made. So, in this case, we typically assume that you know rent will be paid for the office building.

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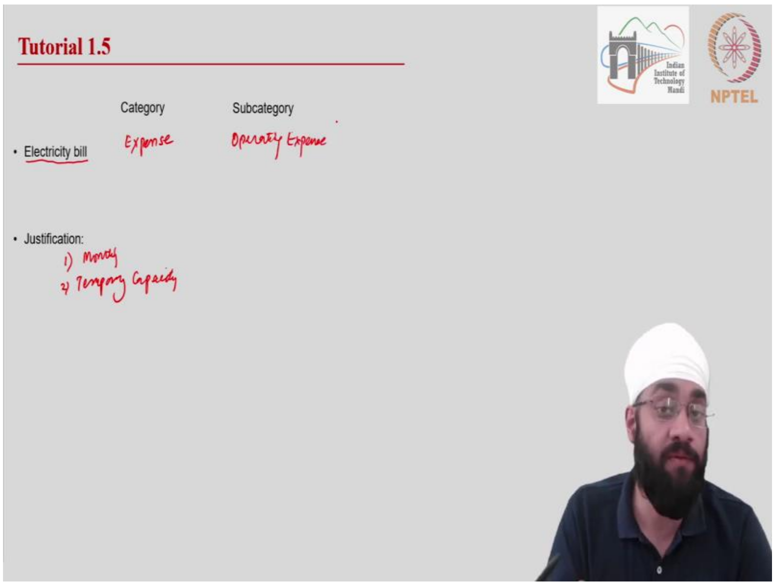

Let us move forward. You have an electricity bill. Electricity bill is paid you know to whosoever is a supplier of the power to you. And then you pay it monthly, it can be quarterly. in some cases industrial units and so on. So, again it helps you build temporary capacity. You do not pay the bill, you will not have the power in your factory, the manufacturing will not happen, it is an ongoing thing. And you are spending money on it. So, clearly this is an expense item, and operating expense item assuming that you are using the electricity for business purposes.

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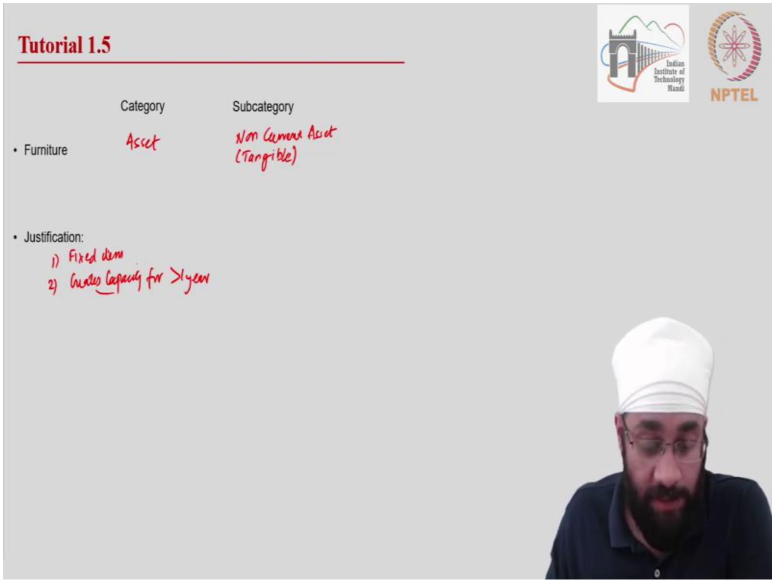

Then you have furniture. Furniture, well, it is a fixed item. It helps you generate capacity, creates capacity for more than 1 year right; it has a life of more than 1 year. So, it is going to help you to generate revenue in the long run as well. When that happens, it is called an asset. And since it has a longer time period – it helps you generate capacity in the long run, you call it a noncurrent asset. And actually, within noncurrent assets, there is a category of tangible. You can see this asset; this is a tangible asset. So, there you go- furniture is an asset and a noncurrent asset.

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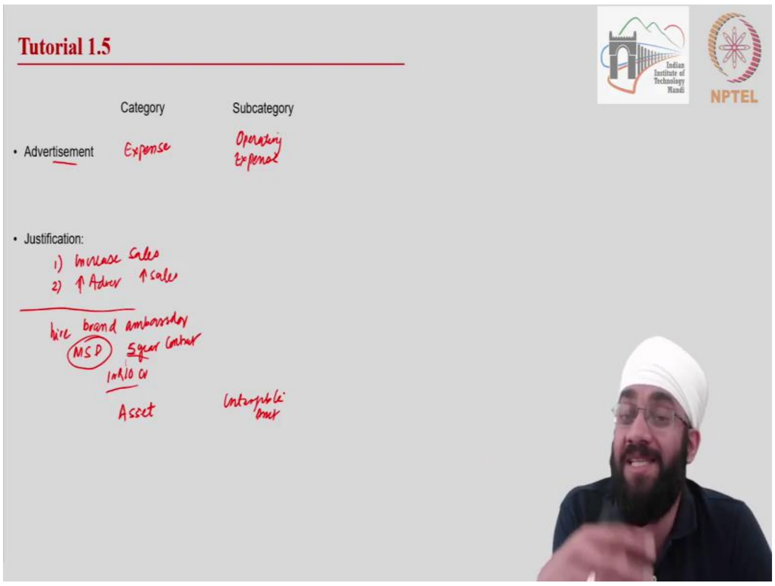

Next item is an advertisement. Now, advertisements are done to help the sales of the business. So, you are trying to increase the sales, you are trying to bring in more and more revenue. And typically, if you do not advertise, you do not make that money. Or the more you advertise, the more sales. So, there is a short term relationship between these two. You spend money on advertising, you can make more money in sales. So, this is clearly an expense item, expense item. And this is an operating expense, because it is helping you to generate revenues; primary activity of business to generate revenue from primary sources.

So, there you go. One clarification that I want to make here is that in some cases advertisements are an expense, but a different kind of item, and let me make that case. So, let’s say you hire a brand ambassador, say you get MS Dhoni to advertise for your company. And there is a 5-years contract that you have, and you are going to pay this person 10 crore rupees for 5 years. Now, this kind of transaction is a 5 year transaction that is going to help you generate revenue not in the short term, but in the long term. The money is huge as well. So, in such cases, you are going to call it an asset. You are going to call it an asset, because this is going to help you generate revenue in the long run, and you can call it an intangible asset as well.

So, in advertisements when there is a contract for longer duration, you can call it an asset because it helps you to travel in the longer run. Also, if you are purchasing things like display boards which have longer than 1 year life, they will also be categorized as assets and not as an expense. I hope that makes sense.

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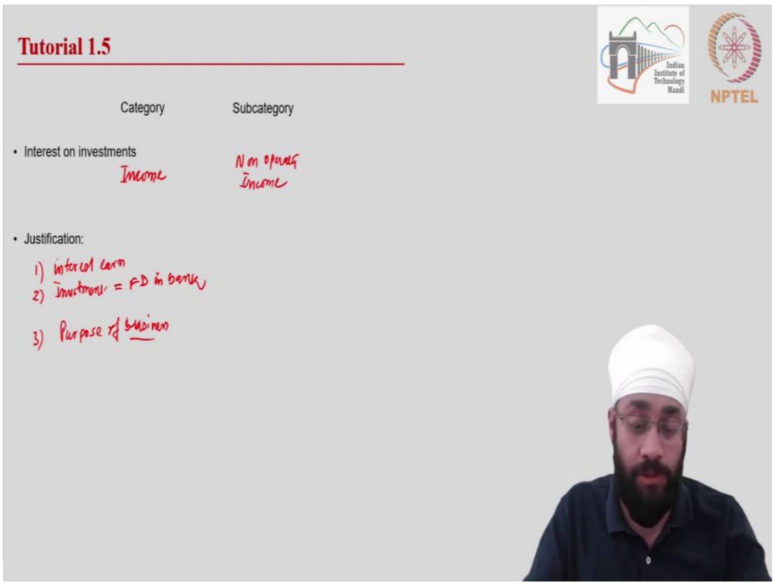

Then you have interest on the investments. What does it mean? This is the interest that the company earns. And what do you mean by investment? The investment can be in let’s say a fixed deposit in the bank. So, when you receive money, it is as an income.There are only two types of sources; either it is an income or a liability. It is clearly not a liability, you do not have to repay it; it is an investment that you made in the bank, and they are paying you back. So, it is an income. The question is if this is an operating income or non-operating income? The purpose of business, what was the purpose of business? Was the purpose of business to deposit money in the bank and make interest on it? No, it was to manufacture or trade with some goods and services. So, this is secondary to the objective of the business. Therefore, call it a non-operating income. It is not regular for the business to do this; or even if it is regular, it is not primary- that is really the criteria.

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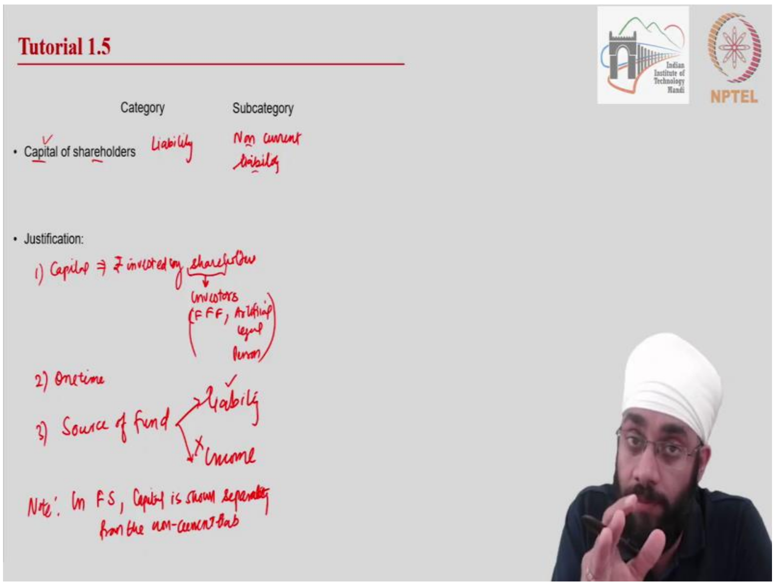

Then you have capital of shareholders ok. Let me clarify what capital is. Capital refers to the amount of investment, amount invested by these shareholders alright. Who are the shareholders? Shareholders are simply the people who gave money to investors. Who can be an investor? Investors can be your friend, family, fools- it can be any other artificial legal person as well, any company A can invest in company B that is also possible. So, capital refers to the money invested by shareholders, so that is the capital of shareholders. Now, it should make sense. What is this capital of shareholders? This is a one time thing or a long-term thing, you invest once. From a company's point of view, you are not going out every day to raise capital to ask people to invest in you. You do not do that. You have money for the next 5 years and now you set it up. Then after 5 years you see again, you need to raise more money, so you talk to more people.

So, clearly this is a source, this is a source of funds. There are two types of sources; it can either be a liability or it can be an income. Well, it is not an income, because income comes by way of selling goods and services. This is a liability because these investors who have invested money in your company, they would want a return, they would expect the principle to be paid back at some point in time if not in 2 years then in 5 years or long run or when the company closes down.

Income, on the other hand, is a regular feature; and nobody is asking you to repay that income that is not the case. Therefore, clearly, this is a liability. And within liabilities this is a noncurrent liability right. Based upon the discussion we have had; you classify it as a noncurrent liability. And, actually you will see when we put a note here when you go into the financial statements. In the financial statements of the companies, this capital is actually shown further apart from the noncurrent liabilities. In the financial statements capital is shown separately from the other noncurrent liabilities. And the reason for that is the shareholders are insiders of the business; they are the ones who are possibly running the business. They are different from the other sources of funds or other liabilities which is bank or an artificial person that does not participate necessarily in regular functioning of the business. So, there is a distinction. When we go to financial statements, do not be surprised that the capital or the shareholders' funds are shown separately from the noncurrent liability, but understand that they are liability in the long run for the company.

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You have a bank loan, and we just discussed the same nature, the only difference is that the bank is external to the business. So, a bank loan is also a liability. And the category is noncurrent liability. What is the justification? Well, this is a source of funds. This is a long-term fund and you have to repay it; that is a definition of a liability.

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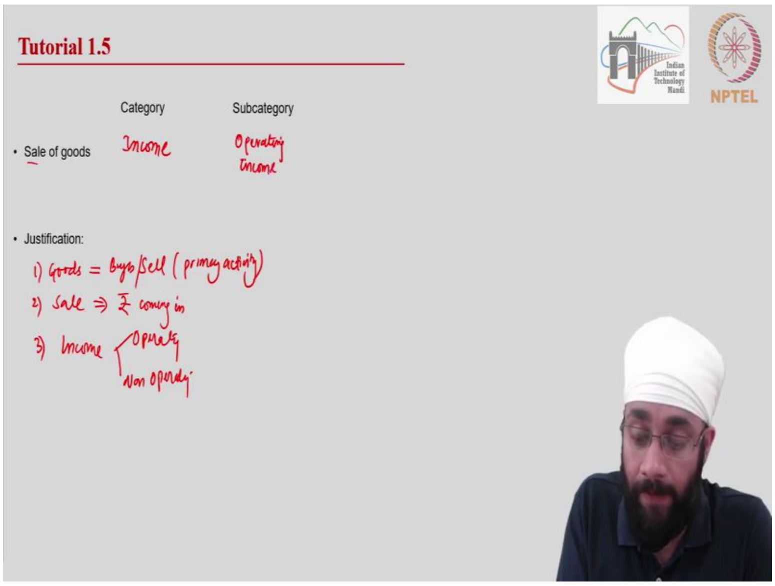

Then you have a sale of goods. So, what do we mean by sale of goods? Sale of goods, refers to things that you buy and sell regularly in the business. This is your primary activity; primary activity in the business. This is for what we have set up the business. Now, when you sell the goods, you get money. You have a sale means, you have money which is coming in the wallet income. So, it is an income.

Now, what kind of income is it? Is it an operating income or non-operating income that is the next question? Now, clearly you set up the business to sell goods or services, therefore, it is an operating income; it is a primary income (Refer Time: 20:31).

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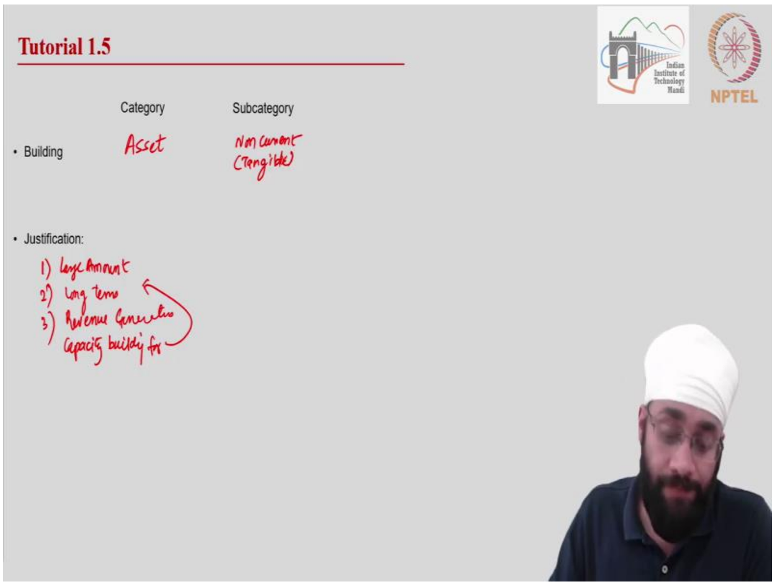

Next is building. What is a building? You are purchasing this building; it is a large amount first of all. Second – it is a long-term spending; it is a long-term benefit that you are expecting. So, revenue generation or your building capacity for the long term. When that happens, you call it an asset, it is an asset; it is also a tangible asset, but first of all it is a noncurrent asset and it is a tangible asset.

In fact, any such item, and we will see if there are more, any physical assets that you purchase that stays with you for a longer duration of time, and helps you to generate revenue year after year, is called an asset.

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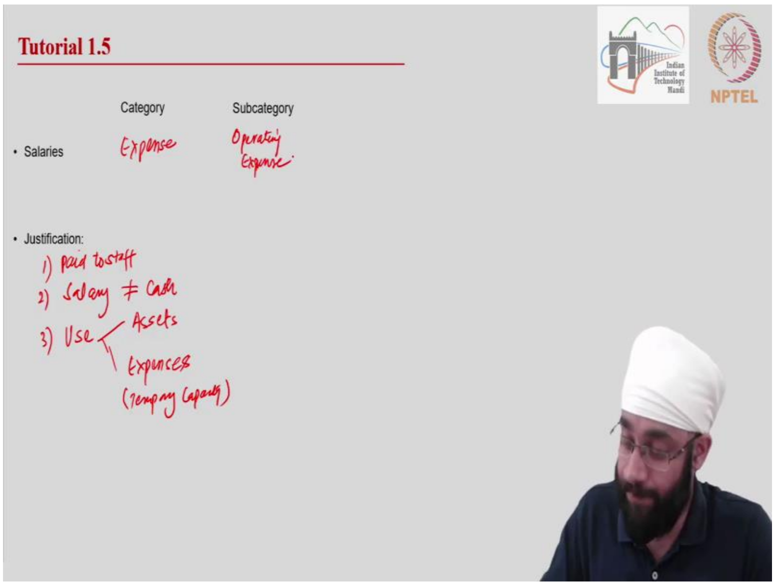

Then you have salaries. What are salaries? Salaries are paid to the staff. Now, we are calling it salary, and this is not equal to cash. What do I mean by that? Earlier we discussed an item called cash in hand which is cash in your drawer. Salary is the name of an expense, it is not the name of the cash. Please understand that. Cash is different; the salary is different.

The salary is paid in cash. You could also pay salary through bank balance; you could also pay salary by giving goods to these employees as well. I am trying to say that salary is not equal to cash, do not think of these two things and synonyms. So, salary is the name of an expense. And for that expense you have to spend from the cash in the drawer, you take out cash from the drawer, you give it to the person, and then you say salary has been paid using the stock of cash which I had. So, the stock of cash now reduces, and there is an expense item that is salary. So, salary clearly is a use of funds. And there are two types of uses of funds. You could use funds on buying assets or you could use funds to spend on expenses. You pay a salary for a month; you get services for a month. You do not pay a salary, people leave. It is a temporary capacity that you are generating.

So, temporary capacity means it is an expense item. And you hire people to work on the main objective of the business. So, it is an operating expense for the business.

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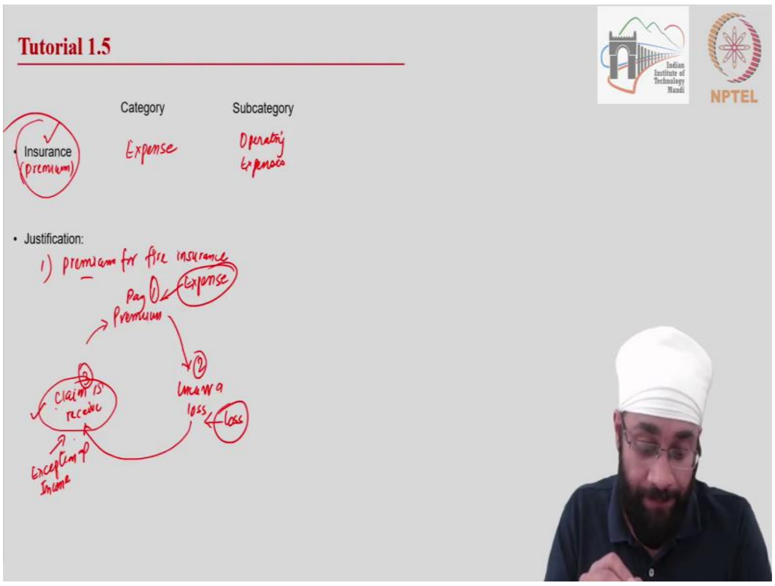

Insurance, what do we mean by insurance? You pay a premium. You can have a premium for let say fire insurance, you can have theft insurance, you can have some other kinds of insurance. But we are not talking about life insurance here. A company may pay for a health insurance premium which is also an expense by the way. So, we are talking about a company paying insurance to secure its assets such as buildings, stock and everything. So, you are paying a premium using the cash or the bank balance.

So, insurance really should mean insurance premium being paid. You should also understand the cycle of insurance as a product. So, you pay the premium. You pay a premium, let me write pay: you pay the premium, and then you incur a loss meaning you paid for theft insurance and then theft happens, that event happens. And when you have this loss, the insurance company pays your claim. Claim is received. So, the business is going to receive the claim from an insurance company. So, there are three different steps. It is not necessarily a cycle, but step 1, step 2, step 3, and then again you pay an insurance premium to ensure that next year also, you have this insurance cover. So, this claim that you received from insurance is not what we are talking about. You are talking about the premium that you pay. So, this is an expense item.

When you incur a loss, you call it *loss*. And you still can categorize it under the expense, but this becomes a non-operating loss at that time. And finally, when a claim is received, it is an exceptional item, exceptional item because it is neither a liability nor an income. So, it is an exceptional income, and hence you categorize this specific item under non-operating income.

So, basically it is compensating you for a loss. So, treatment is very different for that. Going back to the main item here, we are talking about insurance premiums. This item is an expense, and the subcategory is that it is an operating expense. You need it to make sure that your losses are covered whenever that happens.

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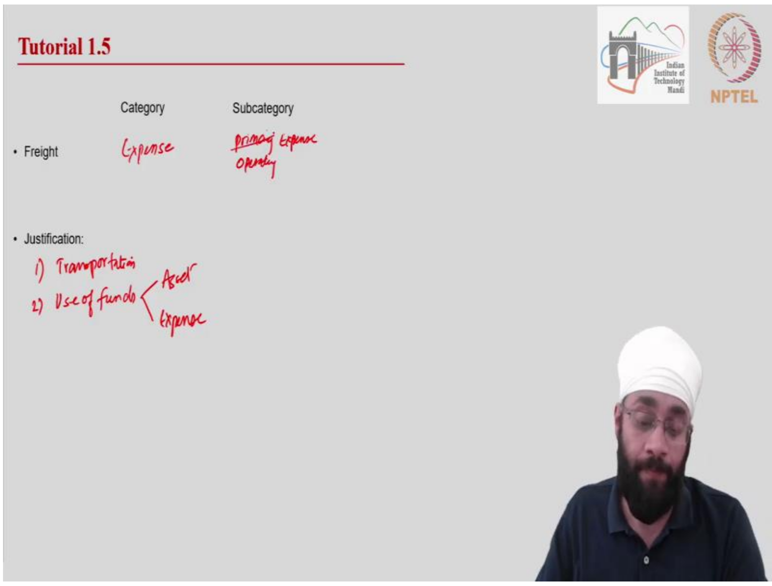

Let us move forward. You have freight. What is freight? Freight is transportation. You might be transporting your goods from the factory to the retail outlet, to the wholesaler and so on. Clearly, this is an expense, this is an use of funds. Use of funds can have two nomenclatures: asset or expense. Clearly, it is not an asset; you pay for transportation, it is an expense and it can be an operating expense.

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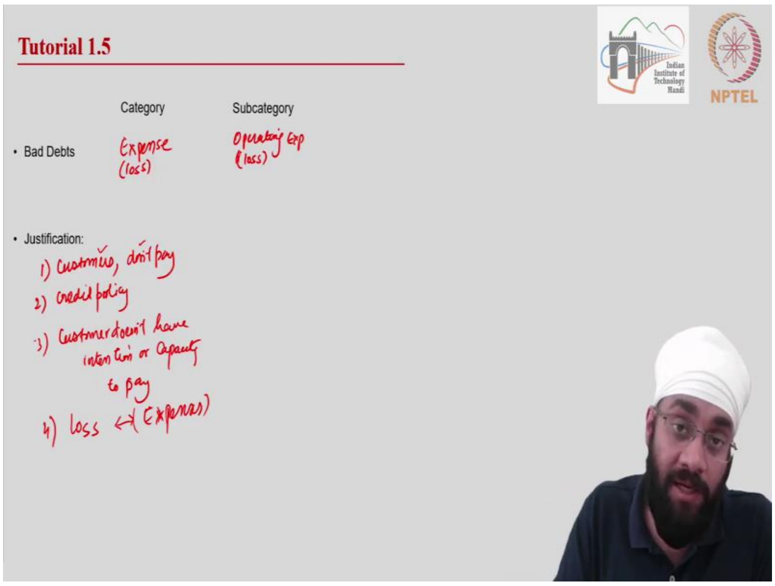

Bad debts, what are bad debts? You have customers. The customers buy things from you, and they do not pay because you have a credit policy. Even in a college canteen, the vendor has a register where you have lists of people and what they eat every day, and then at the end of the month he says this is your bill please pay; that is the credit policy-you want to increase your sales.

So, due to the credit policy, there are customers who have not paid back and now it appears that they do not have an intention or capacity to pay. So, let's say a customer does not have intention or capacity to pay; when this happens, then the debt that you gave to this customer turns out to be bad. When you are fairly certain, that customer is not going to pay; at that point in time you start calling it as unrecoverable amount as in bad debt. It is a loss. It is a loss that we have. And losses are categorized broadly under expenses. We can categorize expenses and losses in the same bucket. So, let me first write it as an expense, as an expense, but as a loss in bracket. Is it an operating loss or a non-operating loss? It is clearly an operating loss, we will call it operating expense, but the real nature is loss. It is operating because you have to boost your sales, we have to do promotion; credit policy is one of the ways of promoting your sales. So, it was done with the intention to help sales. So, it is an operating expense called bad debt-debt given by the company to its customers.

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Repairs: repairs meaning money that you pay to repair the equipment on the business or general maintenance and so on; clearly use of funds. The use of funds has two types: asset or expense. Repairs are not an asset. I think we do not need to spend more time on it. This is an expense and this is an operating expense.

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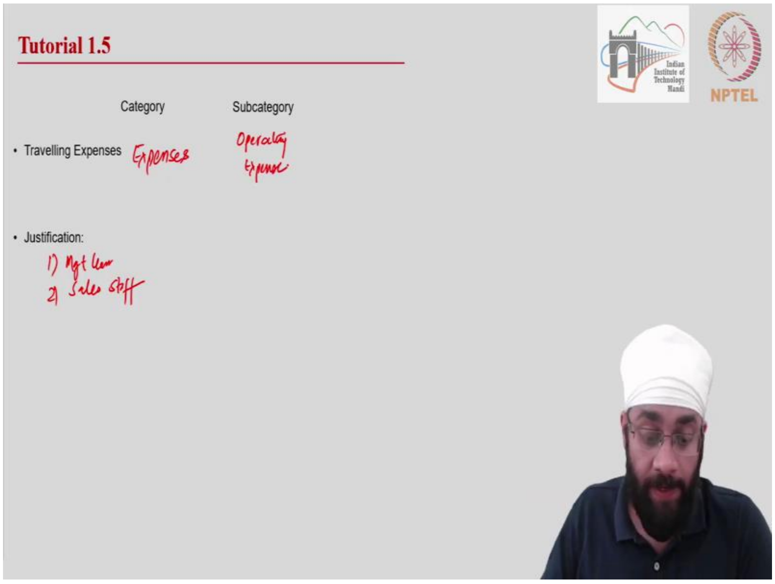

Then we have travelling expenses. Now, whose travelling expenses are we talking about? Travelling expenses of the management team, it can be you know sales staff as well. So, while sales staff travel for business purposes, these are expenses: it is use of funds, but it is not for building any asset. It is an expense item; and it is an operating expense item.

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Stationary: you spend on office stationery- pens, notebooks, registers and so on. These are small items that help to run the business. You need such administrative expenses. So, you call them expenses, and you call them operating expenses. I do not think your justification is required here. But if you are thinking about stationary like a stapler that would run for 5 years, should we call it an asset? No, because as we move forward in the course, we will talk about generally accepted accounting principles where one principle directs that do not bother about small ticket items, do not make those as an asset. Stapler is what 100 rupees; please keep it as an expense item. So, materiality principle is what we are talking about here. So, we will discuss that in another video, but stationery an expense operating expense.

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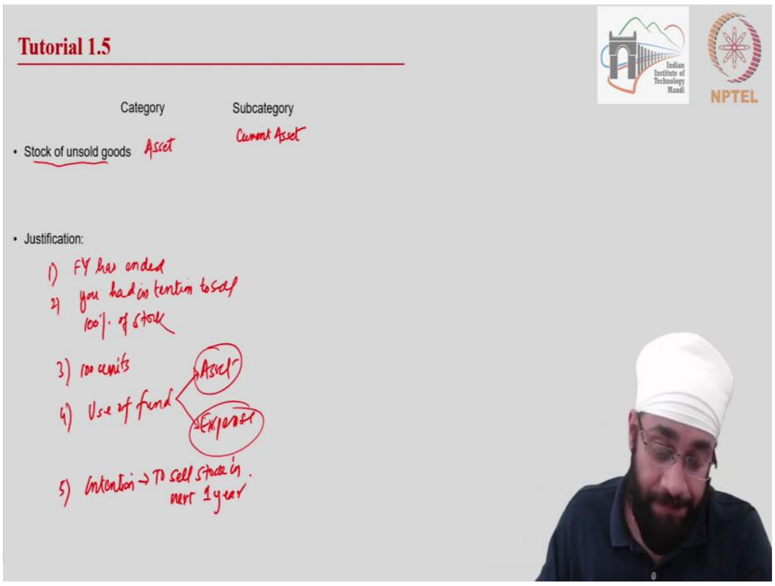

Stock of unsold goods. What are unsold goods? It means the financial year has ended, and you had intention to sell say 100 percent of your stock that you manufacture but you could not sell it in that year. At the end of the year say 100 units are unsold in the stock. What do you do with that, what is that? Now, money has already been spent on this. So, this is a use of funds. Use of funds has two types: one is asset, the other is expense. What is an expense? When you generate temporary capacity within 1 year, you will generate sales. Clearly, you could not do that in this case. And now you hope that you will be able to send the stock in the next year, so it goes beyond 1 year. So, you will help generate revenue by selling this stock in the next year. So, it becomes more than 1 year, or it becomes a non-expense item right now. So, it is part of the asset group.

Now, in the asset group, you have current and noncurrent assets. We call it a current asset. Why do we call it a current asset? Because you intend to sell, the intention is to sell the stock in the next 1 year. So, within 1 year, you want to convert this into cash into revenue. So, temporary capacity building, because it will not sell it earlier. So, it is not an expense, but an asset and a current asset.

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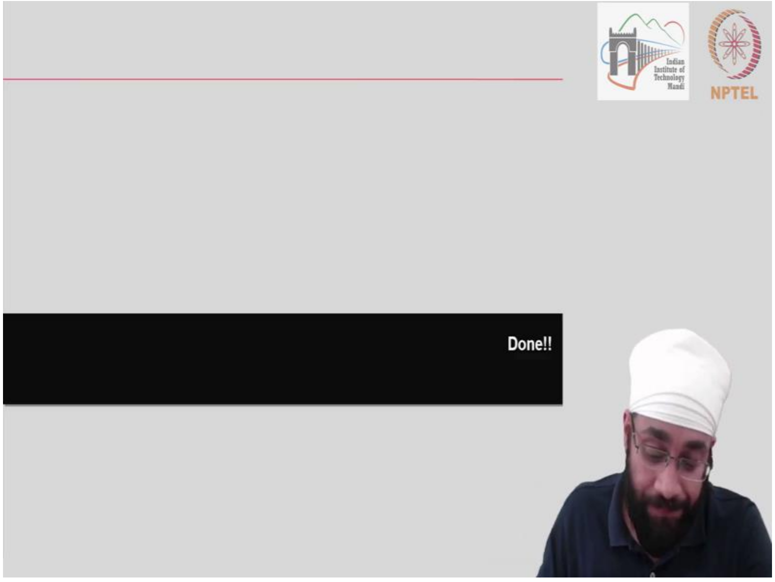

There you go. So, we picked up some items withdrawn from the regular business transactions. And in this tutorial, we try to categorize those into asset, liability, income, expense and their respective subcategories. There are a number of other items that will pop up from time to time, and I will clarify it as and when such items come up for discussion.

I hope through this tutorial you understand the four key accounting terms with more clarity. I am sure you may have more questions and you can go ahead and ask those questions on the communication channels for this course, and I will be happy to provide you responses and clarifications on those.

I will see you in the next video.