Study Note - 1

ACCOUNTING PROCESS

This Study Note includes

1.1 INTRODUCTION

Business is an economic activity undertaken with the motive of earning profits and to maximize the wealth for the owners. Business cannot run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer demand.

The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well.

As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business. Two basic questions would have to be answered:

(a) What is the result of business operations? This will be answered by finding out whether it has made profit or loss.

(b) What is the position of the resources acquired and used for business purpose? How are these resources financed? Where the funds come from?

The answers to these questions are to be found continuously and the best way to find them is to record all the business activities. Recording of business activities has to be done in a scientific manner so that they reveal correct outcome. The science of book-keeping and accounting provides an effective solution. It is a branch of social science. This study material aims at giving a platform to the students to understand basic principles and concepts, which can be applied to accurately measure performance of business. After studying the various chapters included herein, the student should be able to apply the principles, rules, conventions and practices to different business situations like trading, manufacturing or service.

1.2 DEFINITIONS

Definition of Accounting

Definition by the American Institute of Certified Public Accountants (Year 1961):

"Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof".

Definition by the American Accounting Association (Year 1966):

"The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting".

(a) Objectives of Accounting

(i) Providing Information to the Users for Rational Decision-making

The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors, investors, etc. Various outcomes of business activities such as costs, prices, sales volume, value under ownership, return of investment, etc. are measured in the accounting process. All these accounting measurements are used by stakeholders (owners, investors, creditors/bankers, etc.) in course of business operation. Hence, accounting is identified as 'language of business'.

(ii) Systematic Recording of Transactions

To ensure reliability and precision for the accounting measurements, it is necessary to keep a systematic record of all financial transactions of a business enterprise which is ensured by book-keeping. These financial records are classified, summarized and reposted in the form of accounting measurements to the users of accounting information i.e., stakeholder.

(iii) Ascertainment of Results of above Transactions

'Profit/loss' is a core accounting measurement. It is measured by preparing profit and loss account for a particular period. Various other accounting measurements such as different types of revenue expenses and revenue incomes are considered for preparing this profit and loss account. Difference between these revenue incomes and revenue expenses is known as result of business transactions identified as profit/loss. As this measure is used very frequently by stockholders for rational decision-making, it has become the objective of accounting.

For example, Income Tax Act requires that every business should have an accounting system that can measure taxable income of business and also explain nature and source of every item reported in Income Tax Return.

(iv) Ascertain the Financial Position of Business

'Financial position' is another core accounting measurement. Financial position is identified by preparing a statement of ownership i.e., Assets and Owings i.e., liabilities of the business as on a certain date. This statement is popularly known as balance sheet. Various other accounting measurements such as different types of assets and different types of liabilities as existed at a particular date are considered for preparing the balance sheet. This statement may be used by various stakeholders for financing and investment decision.

(v) To Know the Solvency Position

Balance sheet and profit and loss account prepared as above give useful information to stockholders regarding concerns potential to meet its obligations in the short run as well as in the long run.

- **Providing Information to the Users for Rational Decision-making**
- **Systematic Recording of Transactions**
- **Ascertainment of Results of above Transactions**
- **Ascertain the Financial Position of Business**
- **To Know the Solvency Position**

Function of Accounting

The main functions of accounting are as follows:

(a) **Measurement**: Accounting measures past performance of the business entity and depicts its current financial position.

(b) **Forecasting**: Accounting helps in forecasting future performance and financial position of the enterprise using past data.

(c) **Decision-making**: Accounting provides relevant information to the users of accounts to aid rational decision-making.

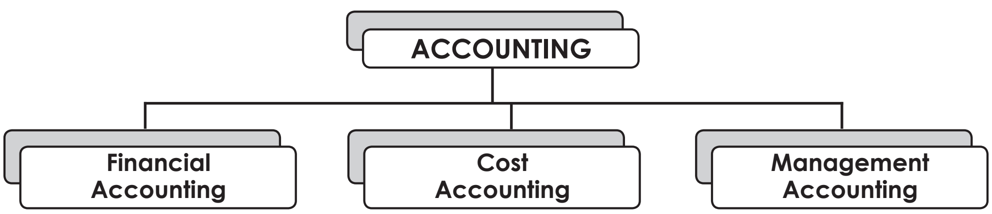
(d) **Comparison & Evaluation**: Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.

(e) **Control**: Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

(f) **Government Regulation and Taxation**: Accounting provides necessary information to the government to exercise control on die entity as well as in collection of tax revenues.

Accounting – Classification

The various sub-fields of the accounting are:



1.	Financial Accounting	Determining the financial results for the period and the state of affairs on the last day the accounting period.	Stewardship Accounting
2.	Cost Accounting	Information generation for Controlling operations with a view to maximizing efficiency and profit.	Control Accounting
3.	Management Accounting	Accounting to assist management in planning and decision making.	Decision Accounting

(a) Financial Accounting

It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least of a financial character, and interpreting the results thereof."

(b) Cost Accounting

According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as "application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making."

(c) Management Accounting

Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions.

Difference between Management Accounting and Financial Accounting

The significant difference between Management Accounting and Financial Accounting are :

Management Accounting	Financial Accounting
1. Management Accounting is primarily based on the data available from Financial Accounting.	1. Financial Accounting is based on the monetary transactions of the enterprise.
2. It provides necessary information to the management to assist them in the process of planning, controlling, performance evaluation and decision making.	2. Its main focus is on recording and classifying monetary transactions in the books of accounts and preparation of financial statements at the end of every accounting period.
3. Reports prepared in Management Accounting are meant for management and as per management requirement.	3. Reports as per Financial Accounting are meant for the management as well as for shareholders and creditors of the concern.
4. Reports may contain both subjective and objective figures.	4. Reports should always be supported by relevant figures and it emphasizes on the objectivity of data.
5. Reports are not subject to statutory audit.	5. Reports are always subject to statutory audit.
6. It evaluates the sectional as well as the entire performance of the business.	6. It ascertains , evaluates and exhibits the financial strength of the whole business.

1.3 BOOK-KEEPING

As defined by Carter, 'Book-keeping is a science and art of correctly recording in books-of accounts all those business transactions that result in transfer of money or money's worth'.

Book-keeping is an activity concerned with recording and classifying financial data related to business operation in order of its occurrence.

Book-keeping is a mechanical task which involves:

- Collection of basic financial information.
- Identification of events and transactions with financial character i.e., economic transactions.
- Measurement of economic transactions in terms of money.

- Recording financial effects of economic transactions in order of its occurrence.
- Classifying effects of economic transactions.
- Preparing organized statement known as trial balance.

The distinction between book-keeping and accounting is given below:

Distinction between Book-keeping and Accounting

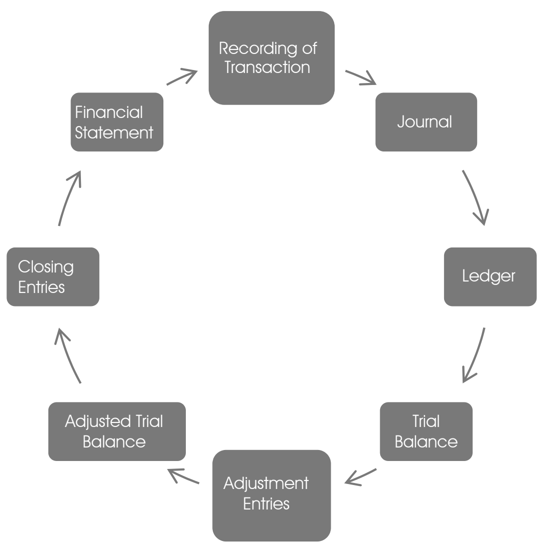
	Book-Keeping		Accounting
1.	Output of book-keeping is an input for accounting.	1.	Output of accounting permit informed judgments and decisions by the user of accounting information.
2.	Purpose of book-keeping is to keep systematic record of transactions and events of financial character in order of its occurrence.	2.	Purpose of accounting is to find results of operating activity of business and to report financial strength of business.
3.	Book-keeping is a foundation of accounting.	3.	Accounting is considered as a language of business.
4.	Book-keeping is carried out by junior staff.	4.	Accounting is done by senior staff with skill of analysis and interpretation.
5.	Objects of book-keeping is to summarize the cumulative effect of all economic transactions of business for a given period by maintaining permanent record of each business transaction with its evidence and financial effects on accounting variable.	5.	Object of accounting is not only bookkeeping but also analyzing and interpreting reported financial information for informed decisions.

1.4 ACCOUNTING CYCLE

When complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be developed as under:



ACCOUNTING CYCLE

(a) Recording of Transaction : As soon as a transaction happens it is at first recorded in subsidiary book.

(b) Journal : The transactions are recorded in Journal chronologically.

(c) Ledger : All journals are posted into ledger chronologically and in a classified manner.

(d) Trial Balance : After taking all the ledger account closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.

(e) Adjustment Entries : All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.

(f) Adjusted Trial Balance : An adjusted Trail Balance may also be prepared.

(g) Closing Entries : All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.

(h) Financial Statements : Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

1.5 BASIC ACCOUNTING TERMS

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting. The aim here is to enable the student to understand with these often used concepts before we embark on accounting procedures and rules. You may note that these terms can be applied to any business activity with the same connotation.

(i) **Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

(ii) **Goods/Services :** These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

(iii) **Profit:** The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

(iv) **Loss:** The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

(v) **Asset:** Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as Intangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc.

Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets – An asset shall be classified as Current when it satisfies any of the following :

(a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded ,

(c) It is due to be realised within 12 months after the Reporting Date, or

(d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

(vi) **Liability:** It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term on non-current liabilities and Short Term or current liabilities.

Current Liabilities – A liability shall be classified as Current when it satisfies any of the following :

(a) It is expected to be settled in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(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 (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

(vii) **Internal Liability :** These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.

(viii) **Working Capital :** In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.

Gross Working capital = Total Current Assets

= Long term internal liabilities plus long term debts plus the current liabilities minus the amount blocked in the fixed assets.

There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept.

Working Capital (Net) = Current Assets – Currents Liabilities.

(ix) **Contingent Liability :** It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.

(x) **Capital :** It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

(xi) **Drawings :** It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

(xii) **Net worth :** It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's equity. A profit making business will result in increase in the owner's equity whereas losses will reduce it.

(xiii) **Non-current Investments :** Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.

(xiv) **Current Investments :** Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.

(xv) **Debtor :** The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

(i) Good debts : The debts which are sure to be realized are called good debts.

(ii) Doubtful Debts : The debts which may or may not be realized are called doubtful debts.

(iii) Bad debts : The debts which cannot be realized at all are called bad debts.

It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

(xvi) **Creditor :** A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

(xvii) **Capital Expenditure :** This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.

(xviii) **Revenue expenditure :** This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g. repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income statement.

(xix) **Balance Sheet :** It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income statement.

(xx) **Profit and Loss Account or Income Statement :** This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) **Trade Discount :** It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be ₹ 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for ₹ 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at ₹12000 only.

(xxii) **Cash Discount :** This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is ₹ 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of ₹ 3000 (20% of ₹ 15000) will be deducted and the cash discount of 2% will be calculated on ₹12000 (₹15000 – ₹ 3000). Hence the cash discount will be ₹ 240 (2% of ₹ 12000) and net payment will be ₹ 11,760 (₹12,000 - ₹ 240)

Illustration 1.

Fill in the blanks:

(a) The cash discount is allowed by ———— to the —————.

(b) Profit means excess of ——— over —————.

(c) Debtor is a person who ——— to others.

(d) In a credit transaction, the buyer is given a ——— facility.

(e) The fixed asset is generally held for —————.

(f) The current liabilities are obligations to be settled in ——— period.

(g) The withdrawal of money by the owner of business is called ————

(h) The amount invested by owners into business is called —————.

(i) Transaction means exchange of money or money's worth for ————.

(j) The net result of an income statement is ———— or ————.

(k) The ——————— shows financial position of the business as on a particular date.

(l) The ————— discount is never entered in the books of accounts.

(m) Vehicles represent ———— expenditure while repairs to vehicle would mean ————— expenditure.

(n) Net worth is excess of —— ——— over ——— ———.

Solution:

(a) creditor, debtor

(b) income, expenditure

(c) Owes

(d) Credit

(e) Longer period

(f) Short

(g) Drawings

(h) Capital

(i) Value

(j) Profit, loss

(k) Balance sheet

(l) Trade

(m) Capital, revenue

(n) Total assets, total liabilities

Illustration 2.

Give one word or a term used to describe the following:-

(a) An exchange of benefit for value

(b) A transaction without immediate cash settlement.

(c) Commodities in which a business deals.

(d) Excess of expenditure over income.

(e) Things of value owned by business to earn future profits.

(f) Amount owed by business to others.

(g) An obligation which may or may not materialise.

(h) An allowance by a creditor to debtor for prompt payment.

(i) Assets like brand value, copy rights, goodwill

Solution:

(a) Transaction, (b) credit transaction, (c) goods, (d) loss, (e) Assets, (f) liability, (g) contingent liability, (h) cash discount, (i) intangible assets

1.6. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board are called Generally Accepted Accounting Principles (GAAP). These are the common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP is to be followed by companies so that investors have a optimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such aspects like revenue recognition, balance sheet item classification and outstanding share measurements.

1.7 ACCOUNTING CONCEPTS AND CONVENTIONS

As seen earlier, the accounting information is published in the form of financial statements. The three basic financial statements are

(i) The Profit & Loss Account that shows net business result i.e. profit or loss for a certain periods

(ii) The Balance Sheet that exhibits the financial strength of the business as on a particular dates

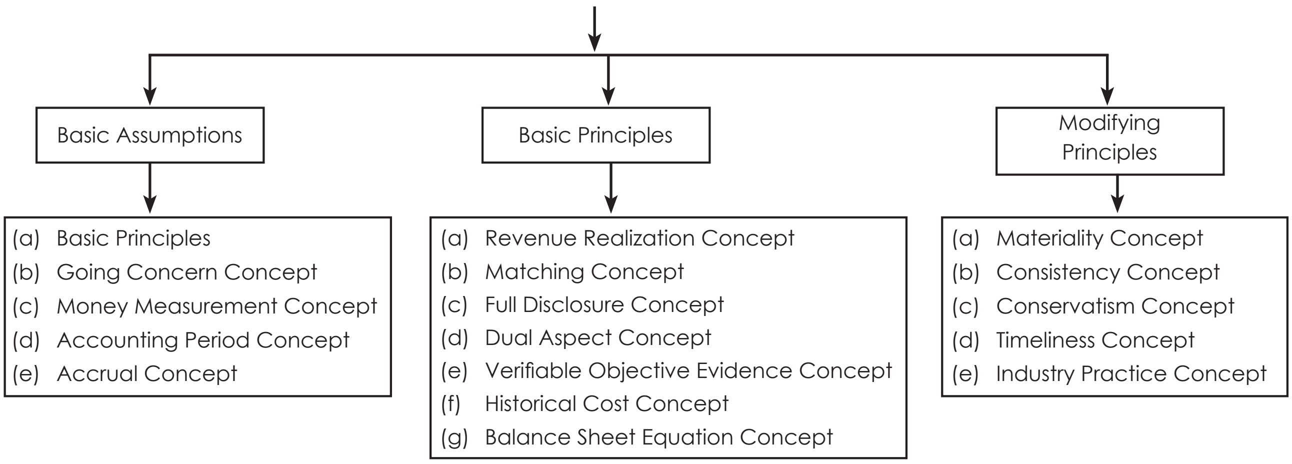
(iii) The Cash Flow Statement that describes the movement of cash from one date to the other.

As these statements are meant to be used by different stakeholders, it is necessary that the information contained therein is based on definite principles, concrete concepts and well accepted convention.

Accounting principles are basic guidelines that provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and reported. They assure uniformity and understandability. Accounting concepts lay down the foundation for accounting principles. They are ideas essentially at mental level and are self-evident. These concepts ensure recording of financial facts on sound bases and logical considerations. Accounting conventions are methods or procedures that are widely accepted. When transactions are recorded or interpreted, they follow the conventions. Many times, however, the terms-principles, concepts and conventions are used interchangeably.

Professional Accounting Bodies have published statements of these concepts. Over years, many of these concepts are being challenged as outlived. Yet, no major deviations have been made as yet. Path breaking ideas have emerged and the accounting standards of modern days do require companies to record and report transactions which may not be necessarily based on concepts that are in vogue for long. It is essential to study accounting from the basic levels and understand these concepts in entirety.

Theory Base of Accounting



A. BASIC ASSUMPTIONS

(a) Business Entity Concept

This concept explains that the business is distinct from the proprietor. Thus, the transactions of business only are to be recorded in the books of business.

(b) Going Concern Concept

This concept assumes that the business has a perpetual succession or continued existence.

(c) Money Measurement Concept

According to this concept only those transactions which are expressed in money terms are to be recorded in accounting books.

(d) The Accounting Period Concept

Businesses are living, continuous organisms. The splitting of the continuous stream of business events into time periods is thus somewhat arbitrary. There is no significant change just because one accounting period ends and a new one begins. This results into the most difficult problem of accounting of how to measure the net income for an accounting period. One has to be careful in recognizing revenue and expenses for a particular accounting period. Subsequent section on accounting procedures will explain how one goes about it in practice.

(e) The Accrual Concept

The accrual concept is based on recognition of both cash and credit transactions. In case of a cash transaction, owner's equity is instantly affected as cash either is received or paid. In a credit transaction, however, a mere obligation towards or by the business is created. When credit transactions exist (which is generally the case), revenues are not the same as cash receipts and expenses are not same as cash paid during the period.

Today's accounting systems based on accrual concept are called as Accrual system or mercantile system of accounting.

B. BASIC PRINCIPLES

(a) Realization Concept

This concept speaks about recording of only those transactions which are actually realized. For example Sale or Profit on sales will be taken into account only when money is realized i.e. either cash is received or legal ownership is transferred.

(b) Matching Concept

It is referred to as matching of expenses against incomes. It means that all incomes and expenses relating to the financial period to which the accounts relate should be taken in to account without regard to the date of receipts or payment.

(c) Full Disclosure Concept

As per this concept, all significant information must be disclosed. Accounting data should properly be clarified, summarized, aggregated and explained for the purpose of presenting the financial statements which are useful for the users of accounting information. Practically, this principle emphasizes on the materiality, objectivity and consistency of accounting data which should disclose the true and fair view of the state of affairs of a firm.

(d) Duality Concept

According to this concept every transaction has two aspects i.e. the benefit receiving aspect and benefit giving aspect. These two aspects are to be recorded in the books of accounts.

(e) Verifiable Objective Evidence Concept

Under this principle, accounting data must be verified. In other words, documentary evidence of transactions must be made which are capable of verification by an independent respect. In the absence of such verification, the data which will be available will neither be reliable nor be dependable, i.e., these should be biased data. Verifiability and objectivity express dependability, reliability and trustworthiness that are very useful for the purpose of displaying the accounting data and information to the users.

(f) Historical Cost Concept

Business transactions are always recorded at the actual cost at which they are actually undertaken. The basic advantage is that it avoids an arbitrary value being attached to the transactions. Whenever an asset is bought, it is recorded at its actual cost and the same is used as the basis for all subsequent accounting purposes such as charging depreciation on the use of asset, e.g. if a production equipment is bought for ₹ 1.50 crores, the asset will be shown at the same value in all future periods when disclosing the original cost. It will obviously be reduced by the amount of depreciation, which will be calculated with reference to the actual cost. The actual value of the equipment may rise or fall subsequent to the purchase, but that is considered irrelevant for accounting purpose as per the historical cost concept.

The limitation of this concept is that the balance sheet does not show the market value of the assets owned by the business and accordingly the owner's equity will not reflect the real value. However, on an ongoing basis, the assets are shown at their historical costs as reduced by depreciation.

(g) Balance Sheet Equation Concept

Under this principle, all which has been received by us must be equal to that has been given by us and needless to say that receipts are clarified as debits and giving is clarified as credits. The basic equation, appears as :-

Debit = Credit

Naturally every debit must have a corresponding credit and vice-e-versa. So, we can write the above in the following form –

Expenses + Losses + Assets = Revenues + Gains + Liabilities

And if expenses and losses, and incomes and gains are set off, the equation takes the following form – Asset = Liabilities

or, Asset = Equity + External Liabilities

i.e., the Accounting Equation.

C. MODIFYING PRINCIPLES

(a) The Concept of Materiality

The materiality could be related to information, amount, procedure and nature. Error in description of an asset or wrong classification between capital and revenue would lead to materiality of information. Say, If postal stamps of ₹ 500 remain unused at the end of accounting period, the same may not be considered for recognizing as inventory on account of materiality of amount. Certain accounting treatments depend upon procedures laid down by accounting standards. Some transactions are by nature material irrespective of the amount involved. e.g. audit fees, loan to directors.

(b) Consistency Concept

This Concept says that the Accounting practices should not change or must remain unchanged over a period of several years.

(c) Conservatism Concept

Conservatism concept states that when alternative valuations are possible, One should select the alternative which fairly represents economic substance of transactions but when such choice is not clear select the alternative that is least likely to overstate net assets and net income.

It provides for all known expenses and losses by best estimates if amount is not known with certainty, but does not recognizes revenues and gains on the basis of anticipation.

(d) Timeliness Concept

Under this principle, every transaction must be recorded in proper time. Normally, when the transaction is made, the same must be recorded in the proper books of accounts. In short, transaction should be recorded date-wise in the books. Delay in recording such transaction may lead to manipulation, misplacement of vouchers, misappropriation etc. of cash and goods. This principle is followed particularly while verifying day to day cash balance. Principle of timeliness is also followed by banks, i.e. every bank verifies the cash balance with their cash book and within the day, the same must be completed.

(e) Industry Practice

As that are different types of industries, each industry has its own characteristics and features. There may be seasonal industries also. Every industry follows the principles and assumption of accounting to perform their own activities. Some of them follow the principles, concepts and conventions in a modified way. The accounting practice which has always prevailed in the industry is followed by it. e.g Electric supply companies, Insurance companies maintain their accounts in a specific manner. Insurance companies prepare Revenue Account just to ascertain the profit/loss of the company and not Profit and Loss Account. Similarly, non trading organizations prepare Income and Expenditure Account to find out Surplus or Deficit.

1.8 EVENTS AND TRANSACTIONS

Transaction:

Transaction is exchange of an asset and discharge of liabilities with consideration of monetary value.

Events:

While event is anything in general purpose which occur at specific time and particular place.

We can also say that all transactions are events and but all events are not transactions. This is because in order events to be called transaction an event must involve exchange of values.

1.9 VOUCHER

Voucher:

- It is a written instrument that serves to confirm or witness (vouch) for some fact such as a transaction.
- A voucher is a document that shows goods have bought or services have been rendered, authorizes payment, and indicates the ledger account(s) in which these transactions have to be recorded.

Types of Voucher			
Receipt Voucher	Payment Voucher	Non-Cash or Transfer Voucher	Supporting Voucher

(i) Receipt Voucher

Receipt voucher is used to record cash or bank receipt. Receipt vouchers are of two types. i-e.

(a) Cash receipt voucher – it denotes receipt of cash

(b) Bank receipt voucher – it indicates receipt of cheque or demand draft

(ii) Payment Voucher

Payment voucher is used to record a payment of cash or cheque. Payment vouchers are of two types. i.e.

(a) Cash Payment voucher – it denotes payment of cash

(b) Bank Payment voucher – it indicates payment by cheque or demand draft.

(iii) Non Cash Or Transfer Voucher

These vouchers are used for non-cash transactions as documentary evidence. e.g., Goods sent on credit.

(iv) Supporting Vouchers

These vouchers are the documentary evidence of transactions that have happened.

1.10 DOUBLE ENTRY SYSTEM

Double Entry System

It was in 1494 that Luca Pacioli the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System. The use of principles of double entry system made it possible to record not only cash but also all sorts of Mercantile transactions. It had created a profound impact on auditing too, because it enhanced the duties of an auditor to a considerable extent.

Features of Double Entry System

(i) Every transaction has two fold aspects, i.e., one party giving the benefit and the other receiving the benefit.

(ii) Every transaction is divided into two aspects, Debit and Credit.

One account is to be debited and the other account is to be credited.

(iii) Every debit must have its corresponding and equal credit.

Advantages of Double Entry System

(i) Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.

(ii) It ensures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically or at the end of the financial year.

(iii) It prevents and minimizes frauds. Moreover frauds can be detected early.

(iv) Errors can be checked and rectified easily.

(v) The balances of receivables and payables are determined easily, since the personal accounts are maintained.

(vi) The businessman can compare the financial position of the current year with that of the past year/s.

(vii) The businessman can justify the standing of his business in comparison with the previous years purchase, sales, and stocks, incomes and expenses with that of the current year figures.

(viii) Helps in decision making.

(ix) The net operating results can be calculated by preparing the Trading and Profit and Loss A/c for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.

(x) It becomes easy for the Government to decide the tax.

(xi) It helps the Government to decide sickness of business units and extend help accordingly.

(xii) The other stakeholders like suppliers, banks, etc take a proper decision regarding grant of credit or loans.

Limitations of Double Entry System

(i) The system does not disclose all the errors committed in the books accounts.

(ii) The trial balance prepared under this system does not disclose certain types of errors.

(ii) It is costly as it involves maintenance of numbers of books of accounts.

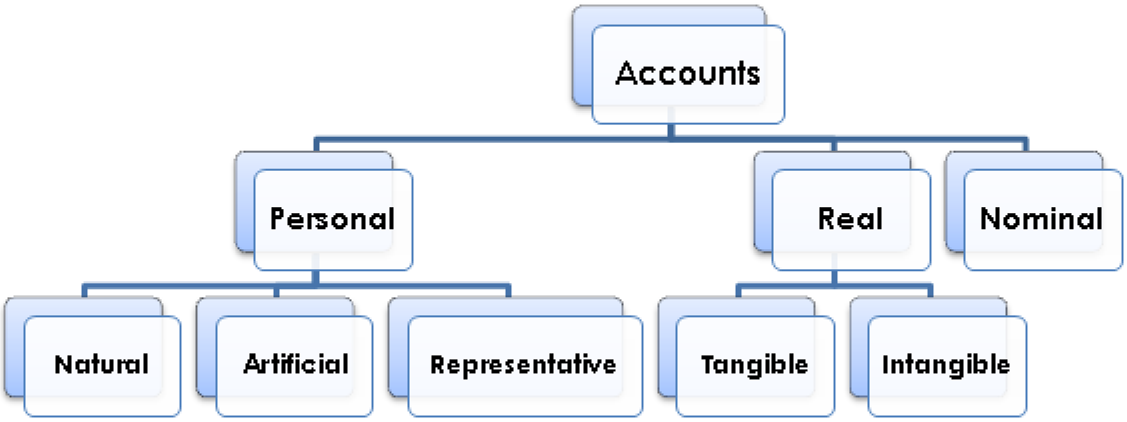
1.11 THE CONCEPTS OF 'ACCOUNT', 'DEBIT' AND 'CREDIT'

The concept of Account

- An account is defined as a summarized record of transactions related to a person or a thing e.g. when the business deals with customers and suppliers, each of the customers and supplier will be a separate account.
- The account is also related to things – both tangible and intangible. e.g. land, building, equipment, brand value, trademarks etc are some of the things. When a business transaction happens, one has to identify the 'account' that will be affected by it and then apply the rules to decide the accounting treatment.
- Typically, an account is expressed as a statement in form of English letter 'T'. It has two sides. The left hand side is called as "Debit' side and the right hand side is called as "Credit' side. The debit is denoted as 'Dr' and the credit by 'Cr'. The convention is to write the Dr and Cr labels on both sides as shown below. Please see the following example:

Dr.	**Cash Account**	**Cr.**
Debit side		**Credit side**

1.12 TYPES OF ACCOUNTS



Let us see what each type of account means.

(1) Personal Account : As the name suggests these are accounts related to persons.

(a) These persons could be natural persons like Suresh's A/c, Anil's a/c, Rani's A/c etc.

(b) The persons could also be artificial persons like companies, bodies corporate or association of persons or partnerships etc. Accordingly, we could have Videocon Industries A/c, Infosys Technologies A/c, Charitable Trust A/c, Ali and Sons trading A/c, ABC Bank A/c, etc.

(c) There could be representative personal accounts as well. Although the individual identity of persons related to these is known, the convention is to reflect them as collective accounts. e.g. when salary is payable to employees, we know how much is payable to each of them, but collectively the account is called as 'Salary Payable A/c'. Similar examples are rent payable, Insurance prepaid, commission pre-received etc. The students should be careful to have clarity on this type and the chances of error are more here.

(2) Real Accounts : These are accounts related to assets or properties or possessions. Depending on their physical existence or otherwise, they are further classified as follows:-

(a) Tangible Real Account – Assets that have physical existence and can be seen, and touched. e.g. Machinery A/c, Stock A/c, Cash A/c, Vehicle A/c, and the like.

(b) Intangible Real Account – These represent possession of properties that have no physical existence but can be measured in terms of money and have value attached to them. e.g. Goodwill A/c, Trade mark A/c, Patents & Copy Rights A/c, Intellectual Property Rights A/c and the like.

(3) Nominal Account : These accounts are related to expenses or losses and incomes or gains e.g. Salary and Wages A/c, Rent of Rates A/c, Travelling Expenses A/c, Commission received A/c, Loss by fire A/c etc.

The concept of Debit and Credit

- In double entry book-keeping, debits and credits (abbreviated Dr and Cr, respectively) are entries made in account ledgers to record changes in value due to business transactions.
- Debit is derived from the latin word **"debitum"**, which means 'what we will receive'. It is the destination, who enjoys the benefit.
- Credit is derived from the latin word **"credre"** which means 'what we will have to pay'. It is the source, who sacrifices for the benefit.
- The source account for the transaction is credited (an entry is made on the right side of the account's ledger) and the destination account is debited (an entry is made on the left).

- Each transaction's debit entries must equal its credit entries.
- The difference between the total debits and total credits in a single account is the account's balance. If debits exceed credits, the account has a debit balance; if credits exceed debits, the account has a credit balance.

1.13 THE ACCOUNITNG PROCESS

There are two approaches for deciding an account is debited or credit.

1. American Approach or Modern Approach ⟷ **Accounting Proces** ⟷ 2. British Approach or Traditional Approach

Mostly followed the British Rule.

A. American approach : In order to understand the rules of debit and credit according to this approach transactions are divided into the following five categories:

(i) Transactions relating to owner, e.g., Capital – These are personal accounts

(ii) Transactions relating to other liabilities, e.g., suppliers of goods – These are mostly personal accounts

(iii) Transactions relating to assets, e.g., land, building, cash, bank, stock-in-trade, bills receivable – These are basically all real accounts

(iv) Transactions relating to expenses, e.g., rent, salary, commission, wages, cartage – These are nominal accounts

(v) Transactions relating to revenues, e.g., interest received, dividend received, sale of goods – These are nominal accounts

To Sum Up

For Assets	Increase in Assets Decrease in Assets	Dr. Cr.
For Liabilities	Decrease in Liabilities Increase in Liabilities	Dr. Cr.
For Capital	Decrease in Capital Increase in Capital	Dr. Cr.
For Incomes	Decrease in Income Increase in Income	Dr. Cr.
For Expense	Increase in Expense Decrease in Expense	Dr. Cr.
For Stock	Increase in Stock Decrease in Stock	Dr. Cr.

B. British Approach or Double Entry System :

When one identifies the account that is getting affected by a transaction and type of that account, the next step is to apply the rules to decide whether the accounting treatment is to debit or credit that account. The Golden Rules will guide us whether the account is to be debited or credited.

These rules are shown below:

Personal Account →	Debit the receiver or who owes to business Credit the giver or to whom business owes
Real Account →	Debit what comes into business Credit what goes out of business
Nominal Account →	Debit all expenses or losses Credit all income or gains

Illustration 3.

Ascertain the debit and credit from the following particulars under Modern Approach.

(a) Started business with capital.

(b) Bought goods for cash.

(c) Sold goods for cash.

(d) Paid salary.

(e) Received Interest on Investment.

(f) Bought goods on credit from Mr. Y

(g) Paid Rent out of Personal cash.

Solution:

	Effect of Transaction	Account	To be debited/Credited
(a)	Increase in Cash	Cash A/c	Debit
	Increase in Capital	Capital A/c	Credit
(b)	Increase in Stock	Purchase A/c	Debit
	Decrease in Cash	Cash A/c	Credit
(c)	Increase in Cash	Cash A/c	Debit
	Decrease in Stock	Sale A/c	Credit
(d)	Increase in Expense	Salary A/c	Debit
	Decrease in Cash	Cash A/c	Credit
(e)	Increase in Cash	Cash A/c	Debit
	Increase in Income	Interest A/c	Credit
(f)	Increase in Stock	Purchase A/c	Debit
	Increase in Liability	Y A/c	Credit
(g)	Increase in Expense	Rent A/c	Debit
	Increase in Liability	Capital A/c	Credit

Illustration 4.

Ascertain the Debit Credit under British Approach or Double Entry System. Take Previous illustration.

Solution:

	Step-I	**Step-II**	**Step-III**	**Step-IV**
(a)	Cash A/c Capital A/c	Real Personal	Comes in Giver	Debit Credit
(b)	Purchase A/c Cash A/c	Nominal Real	Expenses Goes out	Debit Credit
(c)	Cash A/c Sales A/c	Real Nominal	Comes in Incomes	Debit Credit
(d)	Salary A/c Cash A/c	Nominal Real	Expenses Goes out	Debit Credit
(e)	Cash A/c Interest A/c	Real Nominal	Comes in Incomes	Debit Credit
(f)	Purchase A/c Y' A/c	Nominal Personal	Expenses Giver	Debit Credit
(g)	Rent A/c Capital A/c	Nominal Personal	Expenses Giver	Debit Credit

1.14 ACCOUNTING EQUATION

The whole Financial Accounting dependes on Accounting Equation which is also known as Balance Sheet Equation. The basic Accounting Equation is:

Assets = Liabilities + Owner's equity

$$\left.\begin{array}{l}\text{or } A = L + P \\ \text{or } P = A - L \\ \text{or } L = A - P\end{array}\right\} \text{Where A = Assets, L = Liabilities, P = Capital}$$

While trying to do this correlation, please note that incomes or gains will increase owner's equity and expenses or losses will reduce it.

Students are advised to go through the following illustration to understand this equation properly.

Illustration 5.

Prepare an Accounting Equation from the following transactions in the books of Mr. X for January, 2012 :-

1 Invested Capital in the firm ₹ 20,000

2 Purchased goods on credit from Das & Co. for ₹ 2,000

4 Bought plant for cash ₹ 8,000

8 Purchased goods for cash ₹ 4,000

12 Sold goods for cash (cost ₹ 4,000 + Profit ₹ 2,000) ₹ 6,000.

18 Paid to Das & Co. in cash ₹ 1,000

22 Received from B. Banerjee ₹ 300

25 Paid salary ₹ 6,000

30 Received interest ₹ 5,000

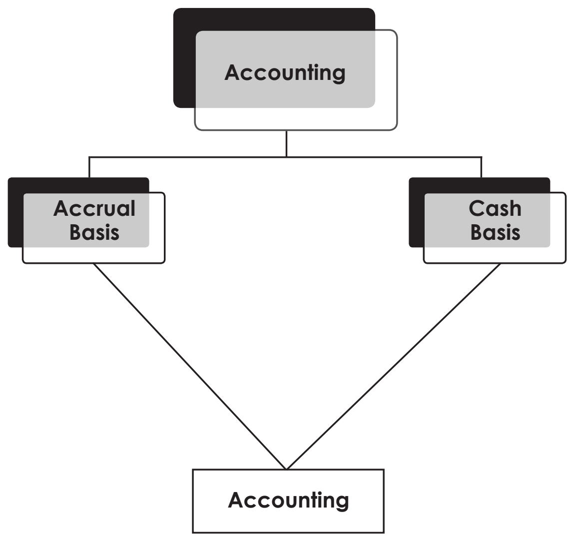
31 Paid wages ₹ 3,000

Solution:

Effect of transaction on Assets, Liabilities and Capital

Date	Transaction	Assets =	Liabilities +	Capital
January, 2013 1	Invested Capital in the firm ₹ 20,000	20,000	-	20,000
2	Purchased goods on credit from Das & Co. ₹ 2,000	+2,000	+2,000	-
	Revised Equation	**22,000=**	**2,000+**	**20,000**
4	Bought Plant for cash ₹ 8,000	+8,000 -8,000	-	-
	Revised Equation	**22,000 =**	**2,000+**	**20,000**
8	Purchased goods for cash ₹ 4,000	+4,000 -4,000	- -	- -
	Revised Equation	**22,000=**	**2,000+**	**20,000**
12	Sold Goods for cash (Cost ₹ 4,000 + Profit ₹ 2,000)	+6,000 -4,000		+2,000
	Revised Equation	**24,000**	**2,000+**	**22,000**
18	Paid to Das & Co. for ₹ 1,000	-1,000	-1,000	
	Revised Equation	**23,000=**	**1,000+**	**22,000**
22	Received from B.Banerjee for ₹ 300	+300 -300		
	Revised Equation	**23,000 =**	**1,000+**	**22,000**
25	Paid salary for ₹ 6,000	- 6,000		-6,000
	Revised Equation	**17,000 =**	**1,000+**	**16,000**
30	Received Interest for ₹ 5,000	+5,000		+5,000
	Revised Equation	**22,000=**	**1,000+**	**21,000**
31	Paid Wages for ₹3,000	-3,000		-3,000
	Revised Equation	**19,000=**	**1,000+**	**18,000**

1.15 ACCRUAL BASIS AND CASH BASIS OF ACCOUNTING



(i) Accrual Basis of Accounting

Accrual Basis of Accounting is a method of recording transactions by which revenue, costs, assets and liabilities are reflected in the accounts for the period in which they accrue. This basis includes consideration relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting.

(ii) Cash Basis of Accounting

Cash Basis of Accounting is a method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts for the period in which actual receipts or actual payments are made.

Distinction between Accrual Basis of Accounting and Cash Basis of Accounting

Basis of Distinction	Accrual Basis of Accounting	Cash Basis of Accounting
1. Prepaid/Outstanding Expenses/ accrued/unaccrued Income in Balance Sheet.	Under this, there may be prepaid/outstanding expenses and accrued/unaccrued incomes in the Balance Sheet.	Under this, there is no prepaid/outstanding expenses or accrued/ unaccrued incomes.
2. Higher/lower Income in case of prepaid expenses and accrued income	Income Statement will show a relatively higher income	Income Statement will show lower income.
3. Higher/lower income incase of outstanding expenses and unaccrued income	Income Statement will show a relatively lower income.	Income Statement will show higher income.
4. Availability of options to an accountant to manipulate the accounts by way of choosing the most suitable method out of several alternative methods of accounting e.g. FIFO/LIFO/SLM/WDV	Under this, an accountant has options.	Under this an accountant has no option to make a choice as such.

Hybrid or Mixed Basis

Under the hybrid system of accounting, incomes are recognised as in Cash Basis Accounting i.e. when they are received in cash and expenses are recognised on accrual basis i.e. during the accounting period in which they arise irrespective of when they are paid.

Illustration 6.

Mr. Anil Roy, a junior lawyer, provides the following particulars for the year ended 31st December, 2013:

	₹
Fees received in cash in 2013	60,000
Salary paid to Staff in 2013	8,000
Rent of office in 2013	14,000
Magazine and Journal for 2013	1,000
Travelling and Conveyance paid in 2013	3,000
Membership Fees paid in 2013	1,600
Office Expenses paid in 2013	10,000

Additional Information:-

Fees include ₹ 3,000 in respect of 2012and fees not yet received is ₹ 7,000.

Office rent includes ₹ 4,000 for previous year and rent of ₹ 2,000 not yet paid.

Membership fees is paid for 2 years.

Compute his net income for the year 2013, under – (a) Cash Basis, (b) Accrual Basis and (c) Mixed or Hybrid Basis.

Solution:

(i)

Mr. Anil Roy

Statement of Income (Cash Basis)

For the year ended 31st December, 2013

Particulars	Amount (₹)	Amount (₹)
Fees received		60,000
Less :		
Salary	8,000	
Office Rent	14,000	
Magazine & Journal	1,000	
Travelling & Conveyance	3,000	
Membership Fees	1,600	
Office Expenses	10,000	37,600
Net Income		22,400

(ii)

Mr. Anil Roy

Statement of Income (Accrual Basis)

For the year ended 31st December, 2013

Particulars		Amount (₹)	Amount (₹)
Fees received		60,000	
Add: Accrued fees for 2013		7,000	
		67,000	
Less: Fees for 2012 received in 2013		3,000	64,000
Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
	16,000		
Less: Rent for 2012 paid in 2013	4,000	12,000	
Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance fee paid for 2014 (½ x 1600)	800	800	
Office Expenses		10,000	34,800
Net Income			29,200

(iii)

Mr. Anil Roy
Statement of Income (Mixed or Hybrid Basis)
For the year ended 31st December, 2013

Particulars	Amount (₹)	Amount (₹)	Amount (₹)
Fees received			60,000
Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
	16,000		
Less: Fees for 2012	4,000	12,000	
Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance	800	800	
Office Expenses		10,000	34,800
Net Income			25,200

1.16 CAPITAL AND REVENUE TRANSACTIONS

There are 2 types of Transaction

1. Capital

2. Revenue

The concepts of capital and revenue are of fundamental importance to the correct determination of accounting profit for a period and recognition of business assets at the end of that period.

- **Capital Transactions:**

  Transactions having long-term effect are known as capital transactions.

- **Revenue Transactions:**

  Transactions having short-term effect are known as revenue transactions.

- **Capital Expenditure**

  Capital expenditure can be defined as expenditure incurred on the purchase, alteration or improvement of fixed assets. For example, the purchase of a car to be use to deliver goods is capital expenditure. Included in capital expenditure are such costs as:

  - Delivery of fixed assets;
  - Installation of fixed assets;
  - Improvement (but not repair) of fixed assets;
  - Legal costs of buying property;
  - Demolition costs;
  - Architects fees;

- **Revenue Expenditures**

  Revenue expenditure is expenditure incurred in the running / management of the business. For example, the cost of petrol or diesel for cars is revenue expenditure. Other revenue expenditure:

  - Maintenance of Fixed Assets;
  - Administration of the business;
  - Selling and distribution expenses.

Capitalized Expenditure

Expenditure connected with the purchase of fixed asset are called capitalized expenditure e.g. wages paid for the installation of machinery.

The Treatments of Capital and Revenue Expenditures

Capital expenditures are shown in the Balance Sheet Assets Side while Revenue Expenditures are shown in the Trading and Profit And Loss Account debit side.

Revenue Receipts

Amount received against revenue income are called revenue receipt.

Capital Receipts

Amount received against capital income are called capital receipts.

Capital Profits

Capital profit which is earned on the sale of the fixed assets.

Revenue Profit

The profit which is earned during the ordinary course of business is called revenue profit.

Capital Loss

The loss suffered by a company on the sale of fixed assets.

Revenue Loss

The loss suffered by the business in the ordinary course of business is called revenue loss.

Rules for Determining Capital Expenditure

An expenditure can be recognised as capital if it is incurred for the following purposes :

- An expenditure incurred for the purpose of acquiring long term assets (useful life is at least more than one accounting period) for use in business to earn profits and not meant for resale, will be treated as a capital expenditure. For example, if a second hand motor car dealer buys a piece of furniture with a view to use it in business; it will be a capital expenditure. But if he buys second hand motor cars, for re-sale, then it will be a revenue expenditure because he deals in second hand motor cars.
- When an expenditure is incurred to improve the present condition of a machine or putting an old asset into working condition, it is recognised as a capital expenditure. The expenditure is capitalised and added to the cost of the asset. Likewise, any expenditure incurred to put an asset into working condition is also a capital expenditure.
- For example, if one buys a machine for ₹ 5,00,000 and pays ₹ 20,000 as transportation charges and ₹ 40,000 as installation charges, the total cost of the machine comes upto ₹ 5,60,000. Similarly, if a building is purchased for ₹ 1,00,000 and ₹ 5,000 is spent on registration and stamp duty, the capital expenditure on the building stands at ₹ 1,05,000.
- If an expenditure is incurred, to increase earning capacity of a business will be considered as of capital nature. For example, expenditure incurred for shifting ‘the ‘factory for easy supply of raw materials. Here, the cost of such shifting will be a capital expenditure.

- Preliminary expenses incurred before the commencement of business is considered capital expenditure. For example, legal charges paid for drafting the memorandum and articles of association of a company or brokerage paid to brokers, or commission paid to underwriters for raising capital.
- Thus, one useful way of recognising an expenditure as capital is to see that the business will own something which qualifies as an asset at the end of the accounting period.

Some examples of capital expenditure:

(i) Purchase of land, building, machinery or furniture; (ii) Cost of leasehold land and building; (iii) Cost of purchased goodwill; (iv) Preliminary expenditures; (v) Cost of additions or extensions to existing assets; (vi) Cost of overhauling second-hand machines; (vii) Expenditure on putting an asset into working condition; and (viii) Cost incurred for increasing the earning capacity of a business.

Rules for Determining Revenue Expenditure

Any expenditure which cannot be recognised as capital expenditure can be termed as revenue expenditure. A revenue expenditure temporarily influences only the profit earning capacity of the business. An expenditure is recognised as revenue when it is incurred for the following purposes :

Expenditure for day-to-day conduct of the business, the benefits of which last less than one year. Examples are wages of workmen, interest on borrowed capital, rent, selling expenses, and so on.

Expenditure on consumable items, on goods and services for resale either in their original or improved form. Examples are purchases of raw materials, office stationery, and the like. At the end of the year, there may be some revenue items (stock, stationery, etc.) still in hand. These are generally passed over to the next year though they were acquired in the previous year.

Expenditures incurred for maintaining fixed assets in working order. For example, repairs, renewals and depreciation.

Some examples of revenue expenditure

(i) Salaries and wages paid to the employees;

(ii) Rent and rates for the factory or office premises;

(iii) Depreciation on plant and machinery;

(iv) Consumable stores;

(v) Inventory of raw materials, work-in-progress and finished goods;

(vi) Insurance premium;

(vii) Taxes and legal expenses; and

(viii) Miscellaneous expenses.

Deferred Revenue Expenditures

Deferred revenue expenditures represent certain types of assets whose usefulness does not expire in the year of their occurrence but generally expires in the near future. These type of expenditures are carried forward and are written off in future accounting periods. Sometimes, we make some revenue expenditure but it eventually becomes a capital asset (generally of an intangible nature). If one undertake substantial repairs to the existing building, the deterioration of the premises may be avoided. We may engage our own employees to do that work and pay them at prevailing wage-rate, which is of a revenue nature. If this expenditure is treated as a revenue expenditure and the current year's-profit is charged with these expenses, we are making the current year to absorb the entire expenses, though the benefit of which will be enjoyed for a number of accounting years. To overcome this difficulty, the entire expenditure is capitalised and is added to the asset account. Another example is an insurance policy. A business can pay insurance premium in advance, say, for a 3 year period. The right does not expire in the accounting period in which it is paid but will expire within a fairly short period of time (3 years). Only a portion of the total premium paid should be treated as a revenue expenditure (portion pertaining to the current period) and the balance should be carried forward as an asset to be written off in subsequent years.

AS 26 - Intangible Asset does not accept this view. Para 56 states, "Expenditure incurred to provide future economic benefit to an enterprise that can be recognized as an expense when it is incurred. e.g. expenditure incurred on Scientific Research is recognized as an expense when it is incurred". In short, the whole amount of expenditure is treated as expense for the current year only and will not proportionately be transferred as deferred charge.

Illustration 8.

State whether the following are capital, revenue or deferred revenue expenditure.

(i) Carriage of ₹ 7,500 spent on machinery purchased and installed.

(ii) Heavy advertising costs of ₹ 20,000 spent on the launching of a company's new product.

(iii) ₹ 200 paid for servicing the company vehicle, including ₹ 50 paid for changing the oil.

(iv) Construction of basement costing ₹ 1,95,000 at the factory premises.

Solution :

(i) Carriage of ₹ 7,500 paid for machinery purchased and installed should be treated as a Capital Expenditure.

(ii) Advertising expenses for launching a new product of the company should be treated as a Revenue Expenditure. (As per AS-26)

(iii) ₹ 200 paid for servicing and oil change should be treated as a Revenue Expenditure.

(iv) Construction cost of basement should be treated as a Capital Expenditure.

Illustration 9.

State whether the following are capital or revenue expenditure.

(i) Paid a bill of ₹ 10,000 of Mr. Kumar, who was engaged as the erection engineer to set up a new automatic machine costing ₹ 20,000 at the new factory site.

(ii) Incurred ₹ 26,000 expenditure on varied advertisement campaigns under taken yearly, on a regular basis, during the peak festival season.

(iii) In accordance with the long-term plan of providing a well- equipped Labour Welfare Centre, spent ₹ 90,000 being the budgeted allocation for the year.

Solution :

(i) Expenses incurred for erecting a new machine should be treated as a Capital Expenditure.

(ii) Advertisement expenses during peak festival season should be treated as a Revenue Expenditure.

(iii) Expenses incurred for Labour Welfare Centre should be treated as a Capital Expenditure.

Illustration 10.

Classify the following items as capital or revenue expenditure :

(i) An extension of railway tracks in the factory area;

(ii) Wages paid to machine operators;

(iii) Installation costs of new production machine;

(iv) Materials for extension to foremen's offices in the factory;

(v) Rent paid for the factory;

(vi) Payment for computer time to operate a new stores control system,

(vii) Wages paid to own employees for building the foremen's offices.

Give reasons for your classification.

Solution :

(i) Expenses incurred for extension of railway tracks in the factory area should be treated as a Capital Expenditure because it will yield benefit for more than one accounting period.

(ii) Wages paid to machine operators should be treated as a Revenue Expenditure as it will yield benefit for the current period only.

(iii) Installation costs of new production machine should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

(iv) Materials for extension to foremen's offices in the factory should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

(v) Rent paid for the factory should be treated as a Revenue Expenditure because it will benefit only the current period.

(vi) Payment for computer time to operate a new stores control system should be treated as Revenue Expenditure because it has been incurred to carry on the normal business.

(vii) Wages paid for building foremen's offices should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

Illustration 11.

For each of the cases numbered below, indicate whether the income/expenditure is capital or revenue.

(i) Payment of wages to one's own employees for building a new office extension.

(ii) Regular hiring of computer time for the preparation of the firm's accounts.

(iii) The purchase of a new computer for use in the business.

(iv) The use of motor vehicle, hired for five years, but paid at every six months.

Solution :

(i) Payment of wages for building a new office extension should be treated as a Capital Expenditure.

(ii) Computer hire charges should be treated as a Revenue Expenditure.

(iii) Purchase of computer for use in the business should be treated as a Capital Expenditure.

(iv) Hire charges of motor vehicle should be treated as a Revenue Expenditure.

Illustration 12.

State with reasons whether the following are capital or revenue expenditure :

(i) Freight and cartage on the new machine ₹ 150, and erection charges ₹ 500.

(ii) Fixtures of the book value of ₹ 2,500 sold off at ₹ 1,600 and new fixtures of the value of ₹ 4,000 were acquired. Cartage on purchase ₹ 100.

(iii) A sum of ₹ 400 was spent on painting the factory.

(iv) ₹ 8,200 spent on repairs before using a second hand car purchased recently, to put it in usable condition.

Solution :

(i) Freight and cartage totaling ₹ 650 should be treated as a Capital Expenditure because it will benefit the business for more than one accounting year.

(ii) Loss on sale of fixtures ₹ (2,500 – 1,600) = ₹ 900 should be treated as a Capital Loss. The cost of new fixtures and carriage thereon should be treated as a Capital Expenditure because the fixture will be used for a long period. So ₹ (4,000+1,000)the cost of new fixture will be ₹ 4,100.

(iii) Painting of the factory should be treated as a Revenue Expenditure because it has been incurred to maintain the factory building.

(iii) Repairing cost of second hand car should be treated as a Capital Expenditure because it will benefit the business for more than one accounting year.

Illustration 13.

State the nature (capital or revenue) of the following expenditure which were incurred by Vedanta & Co. during the year ended 30th June, 2013 :

(i) ₹ 350 was spent on repairing a second hand machine which was purchased on 8th May, 2013 and ₹ 200 was paid on carriage and freight in connection with its acquisition.

(ii) A sum of ₹ 30,000 was paid as compensation to two employees who were retrenched.

(iii) ₹ 150 was paid in connection with carriage on goods purchased.

(iv) ₹ 20,000 customs duty is paid on import of a machinery for modernisation of the factory production during the current year and ₹ 6,000 is paid on import duty for purchase of raw materials.

(v) ₹ 18,000 interest had accrued during the year on term loan obtained and utilised for the construction of factory building and purchase of machineries; however, the production has not commenced till the last date of the accounting year.

Solution :

(i) Repairing and carriage totaling ₹ 550 for second hand machine should be treated as a Capital Expenditure.

(ii) Compensation paid to employees shall be treated as a Revenue Expenditure.

(iii) Carriage paid for goods purchased should be treated as a Revenue Expenditure.

(iv) Customs duty paid on import of machinery to be treated as a Capital Expenditure. However, import duty paid for raw materials should be treated as a Revenue Expenditure.

(v) Interest paid during pre-construction period to be treated as a Capital Expenditure.

Illustration 14.

State with reasons whether the following items relating to Parvati Sugar Mill Ltd. are capital or revenue :

(i) ₹ 50,000 received from issue of shares including ₹ 10,000 by way of premium.

(ii) Purchased agricultural land for the mill for ₹ 60,000 and ₹ 500 was paid for land revenue.

(iii) ₹ 5,000 paid as contribution to PWD for improving roads of sugar producing area.

(iv) ₹ 40,000 paid for excise duty on sugar manufactured.

(v) ₹ 70,000 spent for constructing railway siding.

Solution :

(i) ₹ 40,000 (50,000 – ₹ 10,000) received from issue of shares will be treated as a Capital Receipt. The premium of ₹ 10,000 should be treated as a Capital Profit.

(ii) Cost of land ₹ 60,000 to be treated as Capital Expenditure and land revenue of ₹ 500 to be treated as Revenue Expenditure.

(iii) Contribution paid to PWD should be treated as a Revenue Expenditure.

(iv) Excise duty of ₹ 40,000 should be treated as a Revenue Expenditure.

(v) ₹ 70,000 spent for constructing railway siding to be treated as a Capital Expenditure.

Illustration 15.

State with reasons whether the following are Capital Expenditure or Revenue Expenditure :

(i) Expenses incurred in connection with obtaining a licence for starting the factory were ₹ 10,000.

(ii) ₹ 1,000 paid for removal of stock to a new site.

(iii) Rings and Pistons of an engine were changed at a cost of ₹ 5,000 to get full efficiency.

(iv) ₹ 2,000 spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the Plaintiff. The suit was not successful.

(v) ₹ 10,000 were spent on advertising the introduction of a new product in the market, the benefit of which will be effective during four years.

(vi) A factory shed was constructed at a cost of ₹ 1,00,000. A sum of ₹ 5,000 had been incurred for the construction of the temporary huts for storing building materials.

Solution :

(i) ₹ 10,000 incurred in connection with obtaining a license for starting the factory is a Capital Expenditure. It is incurred for acquiring a right to carry on business for a long period.

(ii) ₹ 1,000 incurred for removal of stock to a new site is treated as a Revenue Expenditure because it is not enhancing the value of the asset and it is also required for starting the business on the new site.

(iii) ₹ 5,000 incurred for changing Rings and Pistons of an engine is a Revenue Expenditure because, the change of rings and piston will restore the efficiency of the engine only and it will not add anything to the capacity of the engine.

(iv) ₹ 2,000 incurred for defending the title to the firm's assets is a Revenue Expenditure.

(v) ₹ 10,000 incurred on advertising is to be treated as a Revenue Expenditure (As per AS-26).

(vi) Cost of construction of Factory shed of ₹ 1,00,000 is a Capital Expenditure, similarly cost of construction of small huts for storing building materials is also a Capital Expenditure.

Illustration 16.

State clearly how you would deal with the following in the books of a Company :

(i) The redecoration expenses ₹ 6,000.

(ii) The installation of a new Coffee-making Machine for ₹ 10,000.

(iii) The building of an extension of the club dressing room for ₹ 15,000.

(iv) The purchase of Snacks & food stuff ₹ 2,000.

(v) The purchase of V.C.R. and T.V. for the use in the club lounge for ₹ 15,000.

Solution :

(i) The redecoration expenses of ₹ 6,000 shall be treated as a Deferred Revenue Expenditure.

(ii) The installation of a new Coffee - Making Machine is a Capital Expenditure because it is the acquisition of an asset.

(iii) ₹ 15,000 spent for the extension of club dressing room is a Capital Expenditure because it creates an asset of a permanent nature.

(iv) The purchase of snacks & food stuff of ₹ 2,000 is a Revenue Expenditure.

(v) The purchase of V.C.R. and T.V. for ₹ 15,000 is a Capital Expenditure, because it is the acquisition of assets.

1.17 ACCOUNTING STANDARDS

Comparative Statement of AS & IND AS (Subject- Wise)

SL.No.	Accounting Standards (AS)	IND AS No.	Name of IND AS
			I. **Standards on Presentation**
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 3	Ind AS 7	Statement of Cash Flows
3	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
4	AS 4	Ind AS 10	Events after the Reporting Period
5	AS 25	Ind AS 34	Interim Financial Reporting
6	**No Corresponding Standard**	Ind AS 29	Financial Reporting in Hyperinflationary Economies
			II. **Standards on Consolidation**
7	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
8	AS 23	Ind AS 28	Investments in Associates
9	AS 27	Ind AS 31	Interests in Joint Ventures
10	AS 14	Ind AS 103	Business Combinations
			III. **Standards on Revenue**
11	AS 2	Ind AS 2	Inventories
12	AS 7	Ind AS 11	Construction Contracts
13	AS 9	Ind AS 18	Revenue
14	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
15	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
			IV. **Standards on Liabilities and Provisions**
16	AS 15	Ind AS 19	Employee Benefits
17	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
18	**Guidance Note**	Ind AS 102	Share-based Payment
19	**No Corresponding Standard**	Ind AS 104	Insurance Contracts
			V. **Standards on Disclosures**
20	AS 18	Ind AS 24	Related Party Disclosures
21	AS 20	Ind AS 33	Earnings Per Shares
22	AS 17	Ind AS 108	Operating Segments
			VI. **Standards on Assets**
23	AS 16	Ind AS 23	Borrowing Costs
24	AS 28	Ind AS 36	Impairments of Assets
25	AS 26	Ind AS 38	Intangible Assets
26	**No Corresponding Standard**	Ind AS 40	Investment Property
27	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment
28	AS 19	Ind AS 17	Leases
29	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
30	**Guidance Note**	Ind AS 106	Exploration for and Evaluation of mineral Resources
			VII. **Standards on Taxes**