UNIT 6 CONCEPTS RELATING TO FINAL ACCOUNTS

Structure

6.0 OBJECTIVES

After studying this unit you should be able to:

- explain the concepts underlying the preparation of final accounts
- describe various bases of accounting
- explain the importance of distinction between capital and revenue
- identify correctly whether an expenditure/receipt is of a capital or revenue nature.

6.1 INTRODUCTION

You have learnt about the procedure of recording and posting various business transactions in the appropriate books of account and testing the arithmetical accuracy of these records with the help of a Trial Balance. Having recorded the transactions and tested the accuracy of books of account,' we prepare a summary at the end of the accounting period to ascertain (i) the profit or loss, and (ii) the financial position of the business. The summary is prepared in the form of a Profit and Loss Account (also called Income Statement) and a Balance Sheet (also called Position Statement). These two financial statements are termed as the 'Final Accounts',

Before you can prepare the final accounts properly, it is necessary to understand the basic concepts which guide their preparation, In this unit, you will learn about these concepts and study how each concept influences the measurement of income and the financial position of the business, Clarity on the distinction between capital and revenue is equally relevant for the correct ascertainment of profit or loss and the financial position of the business. Hence, it is important to know whether a particular expenditure or receipt is of a capital nature or of a revenue nature.

6.2 BASIC CONCEPTS RELATING TO FINAL ACCOUNTS

You know that accounting concepts are broad working rules adopted by the accounting profession as guides for recording and reporting the affairs and activities of the business. In Unit 1 you learnt about the concepts to be observed at the recording stage. Let us now discuss the concepts which are to be observed at the reporting stage **i.e.,** at the time of preparing the final accounts. These concepts are:

1 Going Concern Concept
2 Accounting Period Concept
3 Matching Concept
4 Conservatism Concept
5 Consistency Concept
6 Full Disclosure Concept
7 Materiality Concept

Let us take them up one by one.

6.2.1 Going Concern Concept

Normally the business is started with the intention of continuing it indefinitely or at least for the foreseeable future. The investors lend money and the creditors supply goods and services with the expectation that the enterprise would continue for long. Unless there is a strong evidence to the contrary, the enterprise is normally viewed as a going (continuing) concern. Hence, financial statements are prepared on a going concern basis and not on liquidation (closure) basis.

Certain expenses like rent, repairs, etc., give benefit for a short period, say less than one year. But the benefit of some other expenditure like purchase of a building, machinery etc. is spread over a longer period. If the benefit of an expenditure is limited to one accounting year it is fully charged to the Profit and Loss Account of that year. But, if the benefit of an expenditure is available for a number of accounting years, it must be spread over a number of years. Hence, only a portion of such expenditure is charged to the Profit and Loss Account every year. The balance is shown in the Balance Sheet as an asset. Let us take an example, Suppose a firm purchased a delivery van for Rs. 60,000 and its expected life is 10 years. It means the business will use the van for a period of 10 years. So, the accountant has to spread the cost of the van over 10 years. He would charge Rs. 6,000 (1110 of its cost) every year to the Profit and Loss Account in the form of depreciation, and show the balance in the Balance Sheet as an asset. This is based on the assumption that the business will continue for an indefinite period and the asset will be used for its expected life. Thus this concept is regarded as the basic assumption in accounting according to which the fixed assets are valued at historical cost less depreciation and not at its realisable value.

6.2.2 Accounting Period Concept

You know the going concern concept assumes that the business will continue for a long period, almost indefinitely. But, the businessmen cannot postpone the preparation of financial statements indefinitely. Therefore, he prepares them periodically to find out the profit or loss and financial position of the business. This will also enable other interested parties such as owners, investors, creditors, tax authorities to make periodic assessment of its performance. So, the life of the business enterprise is divided into what are called 'accounting periods', Profit and loss and the financial position at the end of each such accounting period is regularly assessed. Conventionally, duration of the accounting period is twelve months. It is called an 'accounting year'. Accounting year cap be a calendar year **i.e.,** January 1 to December 31 or any other period of twelve months, say, April 1 to March 31 or Dewali to Dewali.

Normally, the final accounts are prepared at the end of each accounting year. The

Profit and Loss Account is prepared for the year so as to ascertain the profit earned or loss incurred during that year, and the Balance Sheet is prepared as on that date. However, for internal management purposes, accounts can be prepared even for shorter periods, say monthly, quarterly or half yearly.

6.2.3 Matching Concept

This is called 'Matching of Costs against Revenues Concept'. To work out profit or loss of an accounting year, it is necessary to bring together all revenues and costs pertaining to that accounting year. In other words, expenses incurred in an accounting year should be matched with the revenues earned during that year. The crux of the problem, therefore, is that appropriate costs must be matched against appropriate revenues. For this purpose, first we have to recognise the inflows (revenues) during an accounting period and the costs incurred in securing those inflows. Then, the sum of the costs should be deducted from the sum of the revenues to arrive at the net result of that period. Let us now understand how to recognise the revenues and costs in relation to an accounting period. For this purpose, the following rules are followed.

The Timing of Revenue Recognition

Revenue is recognised in the period in which it is earned or realised. The revenue recognition is primarily based on realisation principle which clearly states that in identifying revenues with a specific period one must look to the time of various transactions rather than cash inflow. Thus,

i) In case of the sale of goods (or services) revenue is regarded as realised when sales actually take place and not when cash is received. In other words, credit sales are treated as revenue when sales are made and not when money is received from the debtors
ii) Income such as rent, interest, commission, etc. are recognised on a time basis. The revenue from such items is taken to the Profit and Loss Account of the year during which it is earned. Let us assume that the business purchased some government securities on October 1,1987 for Rs. 20,000 carrying interest at 12 per cent. The interest is payable half yearly on April 1 and October 1 every year. The first instalment of interest (Rs. 1,200) is received on April 1,1988. The Profit and Loss Account is being prepared for the year 1987 (January 1,1987 to December 31, 1987). The interest amounting to Rs. 600 earned during October 1 to December 31 must be shown as the income from interest on investments in the Profit and Loss Account for 1987 though the amount has not been received in 1987.

The Timing of Cost Recognition

The matching principle holds that the expenses should be recognised in the same period as the associated revenues. Thus,

i) Cost of goods have to be matched with their sales revenue. This means that while preparing the Profit and Loss Account for a particular year, you should not take the cost of goods produced during that year but consider only the cost of goods that have actually been sold during that year. The cost of goods sold is arrived at by deducting the cost of closing stock from the cost of goods produced. You will learn about it in detail in Unit 7.
ii) Expenses such as salaries, wages, interest, rent, insurance, etc., are recognised on time basis. In other words, they are related to the year in which the service is obtained or the expense is incurred, whether paid immediately or payable at a later date.
iii) Costs like depreciation on fixed assets are also allocated over the periods during which the benefit is derived.

Thus, all revenues earned during an accounting year, whether received or not, and all costs incurred, whether paid or not have to be taken into account while preparing the Profit and Loss Account for the year. Similarly, any amount received or paid during the current year which actually relates to the previous year or the following accounting year, must be eliminated from the current year's revenues and costs. This gives rise to another aspect viz., the accrual basis of accounting about which you will learn later in this unit.

The Matching Concept thus has the following implications for ascertaining of profit or loss during a particular period.

1 We should ensure that costs should relate to the same accounting period as the revenues. For example, when we prepare the Profit and Loss Account for 1986, we shall take into account all those incomes that were earned during 1986, and similarly consider only those costs which were incurred in 1986 only. Any costs or incomes which relate to 1985 or 1987 shall be excluded.
2 We should ensure that all costs incurred during the accounting period (whether paid or not) and all revenues earned during that year (whether received or not) are bully taken into account.
3 We should consider only those costs which relate to the revenue taken into account. That is why we consider only the cost of goods sold, and not the cost of goods produced during that period.

6.2.4 Conservatism Concept

This is also known as Prudence Concept. This concept tries to ensure that all uncertainties and risks inherent in business are adequately provided for, Accountants generally prefer understatement of assets or revenues, and overstatement of liabilities or costs. This is in accordance with the traditional view which states anticipate no profits but anticipate all losses. In other words, you should account for profits only when they are actually realised. But in case of losses, you should take into account even those losses which may be a remote possibility. That is why the closing stock is valued at cost price or market price whichever is lower. Provision for doubtful debts and provision for discounts on debtors are also made according to this concept. This reflects a generally pessimistic attitude of the accountants but it is regarded as the best way of dealing with uncertainty and protecting creditors against an unwarranted distribution of the firm's assets as dividends.

6.2.5 Consistency Concept

The principle of consistency means conformity from period to period with unchanging policies and procedures. It means that accounting method adopted should not be changed from year to year. For example, the principle of valuing closing stock at cost price or market price whichever is lower should be followed year after year. Similarly, if depreciation on fixed assets is provided on straight line basis, it should be followed consistently year after year. Consistency eliminates personal bias and helps in achieving comparable results.

If this principle of consistency is not followed, the accounting information about an enterprise cannot be usefully compared with similar information about other enterprises and so also within the same enterprise for some other period. Consistent use of the same methods and bases from one period to another, enhances the utility of the financial statements.

However, consistency does not prohibit change. Desirable changes are always welcome. But such changes should be completely disclosed while presenting the financial statements.

6.2.6 Full Disclosure Concept

You know the financial statements are the basic means of communicating financial information to all interested parties. These statements are the only source for assessing the performance of the enterprise for investors, lenders, suppliers, and others. Therefore, financial statements and their accompanying footnotes should completely disclose all relevant information of a material nature which relate to the profit and loss and the financial position of the business. This enables the users of the financial statements to make correct assessment about the profitability and financial soundness of the enterprise. It is therefore necessary that the disclosure should be full, fair and adequate.

6.2.7 Materiality Concept

This concept is closely related to the Full Disclosure Concept. Full disclosure does not mean that every thing should be disclosed. It only means that all relevant and material information must be disclosed. Materiality primarily relates to the relevance and reliability of information. An item is considered material if there is a reasonable expectation that the knowledge of it would influence the decision of the users of the financial statements. All such material information should be disclosed through the financial statements and the accompanying notes. For example, commission paid to sole selling agents, if any, should be disclosed separately in the Profit and Loss Account. Similarly, if there is a change in the method or rate of depreciation, this fact must be duly reported in the financial statements.

A strict adherence to accounting principles is not required for items of little significance or of non-material nature. For example, erasers, pencils, scales, etc., are used for a long period, but they are not treated as assets. They are treated as expenses. This does not affect the amount of profit or loss materially.

Similarly, while showing the amounts of various items in the financial statements, they can be **approximated up** to paise. Even if they are shown to the nearest rupee or hundreds, there may not be any material effect. For example, if an amount of **Rs. *1,45,923.28*** is shown as Rs. **1,45,923** or Rs. **1,45,900** *it* does not make much difference for assessment of the performance of the enterprise.

However, there are no specific rules for ascertaining material or non-material items. It is **just** a matter of personal judgment.

Check Your Progress A

1 What is the assumption under Going Concern Concept?

....

....

....

2 What is the significance of an Accounting Period?

....

....

....

3 Name three items of costs.

....

....

....

4 Name three items of revenue.

....

....

....

5 Fill in the blanks.

i) Profit is the excess of revenue over ....
ii) Cost of goods .... is matched with their sales revenue.
iii) Conservatism concept is also known as .... Concept.
iv) Consistency enhances the .... of financial statements.
v) An item is **considered** .... if its **knowledge influences** the **decision** of the users of the financial statements.
vi) Revenue **realisation does** not mean that revenue is **realised** in ....

6.3 BASES OF ACCOUNTING

The accounts are prepared by the business either on cash **basis** or **on** accrual basis. **In** the **Cash System** accounting entries are made on the basis of dash received or cash paid. In other words, no entry is made when an income is earned or an expenditure is incurred. It will be recorded in books only when the amount involved is actually received or paid. Thus, the incomes earned but not yet received (accrued income) or the expenses incurred but not yet paid (outstanding expenses) are completely ignored while preparing the final accounts. For example, rent for the month of December, 1987 paid in January 1988 will be taken to the Profit and Loss Account of 1988 even though the expenditure relates to 1987. This leads to incorrect ascertainment of profit or loss of the business. But it is not true of the accounts maintained on accrual basis, Under the Accrual System (also called Mercantile System of Accounting) the financial effect of transactions is recorded in the books as and when they occur and not when the amount involved is received or paid by the business. This system attempts to relate the revenues and expenses to the accounting period during which they are actually earned or incurred. Thus, rent for the month of December, 1987 paid in January, 1988 will be taken into the Profit and Loss Account of 1987 and not of 1988. This is more logical because the benefit of expenditure is enjoyed in the year 1987 and not in 1988.

The main difference between accrual basis of accounting and cash basis of accounting is the timing of recognition of revenues, gains, expenses and losses. The objective of accrual accounting is to account for the effect of transaclions and events to the extent their financial effect are recognisable and measurable in the periods in whcih they occur. The adjustments made in the final accounts in respect of outstanding expenses, prepaid expenses, income received in advance, income earned but not yet received, etc. are in fact based on accrual accounting. You will learn about these adjustments in Unit 8.

Sometimes the businessman adopts a combination of both the above systems. In that case it is called Mixed or Hybrid System. For example, he may consider incomes on cash basis and expenses on accrual basis. This is considered most conservative. In practice most enterprises adopt the accrual basis of accounting.

6.4 DISTINCTION BETWEEN CAPITAL AND REVENUE

You know that a firm prepares Profit and Loss Account for ascertaining the net result of business operations and the Balance Sheet for determining the financial position of the business. These are prepared with the help of Trial Balance which shows the final position of all ledger accounts'. All items appearing in the Trial Balance are transferred either to the Profit and Loss Account or to the Balance Sheet. As per rules, the items of revenue nature are taken to the Profit and Loss Account and the items of capital nature are shown in the Balance Sheet. In other words whether an item appearing in the Trial Balance is to be taken to the Profit and Loss Account or the Balance Sheet depends upon the capital and revenue nature of the item. If any item is wrongly classified i.e., if an item of revenue nature is treated as a capital item or vice versa, the Profit and Loss Account will not reveal the correct amount of profit and the Balance Sheet will not reflect the true and fair view of the affairs of the business. It is therefore necessary to determine correctly whether an item is of capital nature or of a revenue nature and record it in the books accordingly. There are certain rules governing the allocation of expenditures and receipts between capital and revenue which should be clearly understood..

6.4.1 Capital and Revenue Expenditures

You incur expenditure on various items every day. You buy food items, stationery, cosmetics; utensils, furniture, etc. Some of them are consumables and some are durables. The benefit of expenditure on consumables like stationery, cosmetics, etc. is derived over a short period. But in case of durables like furniture, utensils, etc., the benefit spreads over a number of years. Same is true of business also. In business you incur expenditure on two types of items: (i) routine items like stationery, and (ii) fixed assets like machinery, building, furniture, etc., whose benefit is available over a number of years. In accounting terminology the first category of expenditure is called revenue expenditure and the second one is called capital expenditure.

Let us now study the exact nature of capital and revenue expenditures.

Capital Expenditure: As stated above, when the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure. The following expenditures are usually treated as capital expenditures.

1 Any expenditure which results in the acquisition of fixed assets such as land, buildings, plant and machinery, furniture and fixtures, office equipment, copyright, etc. You should note that such capital expenditure includes not only the purchase price of the fixed asset but also the expenses incurred in connection with their acquisition. Thus, the brokerage or commission paid in connection with the acquisition of an asset, the freight and cartage paid for transportation of machinery, the expenses incurred on its installation, the legal fees and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.
2 Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, or (c) improvement in its revenue earning capacity. Improvement in the revenue earning capacity can be in the form of (i) increased production capacity, (ii) reduced cost of production, or (iii) increased sales of the firm. Thus, cost of making additions to buildings and the amount spent on renovation of the old machinery are also regarded as capital expenditures. If you buy a second hand machinery and incur heavy expenditure on reconditioning it, such expenditure is also to be treated as capital expenditure. Similarly, expenditure on structural improvements or alterations to existing fixed assets whereby their revenue earning capacity is increased, is also treated as capital expenditure.
3 Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.
4 Cost of experiments which ultimately result in the acquisition of a patent. The cost of experiments which are not successful is not to be treated as capital expenditure. It is treated as a deferred revenue expenditure which is written off within two to three years.
5 Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.

Revenue Expenditure: When the benefit of an expenditure is not likely to be available for more than one year, it is treated as revenue expenditure. So all expenses which are incurred during the regular course of business are regarded as revenue expenditures. The examples of such expenses are:

1 Expenses incurred in day-to-day conduct of the business such as wages, salaries, rent, postage, stationery, insurance, electricity, etc.
2 Expenditure incurred for buying goods for resale or raw materials for manufacturing.
3 Expenditure incurred for maintaining the fixed assets such as repairs and renewals of building, machinery, eta.
4 Depreciation on fixed assets. This can also be termed as revenue loss.
5 Interest on loans borrowed for running the business. You should note that any interest on loan paid during the initial period before production commences, is not treated as revenue expenditure. It is treated as capital expenditure.
6 Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages, etc.

6.4.2 Deferred Revenue Expenditure

Sometimes, certain expenditure which is normally treated as revenue may be unusually heavy and its benefit is likely to be available for more than one year. In such a situation, it is considered appropriate to spread the cost of the expenditure over a number of accounting years. Hence, it is capitalised and only a portion of the total amount spent is charged to the Profit and Loss Account of the current year. The balance is shown as an asset which will be written off during the subsequent accounting years. Such expenditure is called a Deferred Revenue Expenditure because its charge to Profit and Loss Account has been deferred to future years. Some examples of such expenditure are:

1 Expenditure incurred on advertising campaign to introduce a new product in the market.
2 Expenditure incurred on formation of a new company (preliminary expenses)
3 Brokerage charges, underwriting commission paid and other expenses incurred in connection with the issue of shares and debentures.
4 Cost of shifting the plant and machinery to a new site which may involve dismantling, removing and re-erection of the plant and machinery.

Let us take the case of expenditure on advertising campaign. It is not a routine advertisement and the amount involved is unusually heavy. Its benefit will not completely exhaust in one accounting year but will continue over two to three years. Hence, it is not proper to charge such expenditure to the Profit and Loss Account of one year. It is better to distribute it carefully over three years. So, in the first year we may charge one-third of the amount spent to the Profit and Loss Account and show the balance in the Balance Sheet as an asset. In the second year again we may charge a similar amount to the Profit and Loss Account and show the balance as an asset. In the third year, we may charge this balance to the Profit and Loss Account. Every expenditure which is regarded as deferred revenue is treated in this way in the final accounts.

Look at Illustration 1 and note how each expenditure has been treated and why.

Illustration 1

State whether the following items of expenditure would be treated as (a) capital expenditure, (b) revenue expenditure, or (c) deferred revenue expenditure:

i) Carriage on goods purchased Rs. 25
ii) Rs. 2,000 spent on repairs of machinery
iii) Rs. 5,000 spent on white washing
iv) Rs. 8,000 paid for import duty and cartage on the purchase of machinery from West Germany
v) Rs. 25,000 spent on issue of equity shares
vi) Rs. 14,000 spent on spreading new tiles on factory floors
vii) Rs. 4,000 spent on dismantling, transportation and reinstalling plant and machinery to new site
viii) Rs. 60,000 spent on construction of railway siding
ix) Rs. 20,000 spent on some major alterations to a theatre which made it more comfortable and attractive.
x) A second hand machine was bought for Rs. 10,000 and an amount of Rs. 6,000 was spent on its overhauling.

Solution:

i) It is a revenue expenditure as it relates to the goods for resale.
ii) It is a revenue expenditure as it relates to the maintenance of a fixed asset.
iii) Same as no. (ii).
iv) It is a capital expenditure as it is spent in connection with the purchase of a fixed assets.
v) It would be treated as deferred revenue expenditure. It is a heavy amount incurred in connection with raising of capital for the company and so capitalised. Even under the Indian Companies Act and the Indian Income Tax Act this expenditure is allowed to be written off over a number of years.
vi) It is a revenue expenditure so it is treated as a sort of repairs not leading to any increase in the earning capacity of a fixed asset.
vii) Normally expenditure on transportation etc. is revenue in nature. But this expenditure has been incurred on shifting to new site which is non-recurring in nature and involves a heavy amount. Hence it shall be treated as a deferred revenue expenditure.
viii) It is a capital expenditure as it is incurred on the construction of railway siding, a fixed asset.
ix) It is a capital expenditure as the alterations made the theatre more comfortable and attractive which is likely to increase its collections.

x) It is a capital expenditure as it is incurred on making the newly bought second hand machinery operational.

6.4.3 Capital and Revenue Receipts

Receipts refer to amounts received by a business **i.e.,** cash inflows. Receipts may be classified **as** Capital Receipts and Revenue Receipts. It is necessary to note this distinction clearly because only the revenue receipts are taken to the Profit and Loss Account and not the capital receipts.

Capital Receipts: Capital receipts are the amounts received in the **form** of (a) additional capital introduced in **the** business, (b) loans received, and (c) sale proceeds of **fixed** assets. You are aware that a loan taken by the business is repayable sooner or later. Similarly, additional capital received represents an increase in the proprietor's claim over the business assets. Thus **these** two items represent increase in **liabilities** of the business and obviously are not incomes or revenues. These are capital receipts and should be treated as such. The sale proceeds of a fixed asset are also treated as a capital receipt because the amount receivedis not revenue earned in the normal course of business. The capital receipts increase the liabilities or reduce the assets. They do not affect the profit or loss.

Revenue Receipts: Revenue receipts are the amounts received in the normal and regular course of business. They take the form of (a) sale proceeds of goods, and (b) incomes such as interest earned, commission earned, rent received, etc. These receipts are on account of goods sold or some services rendered by the business and as such they are not repayable. All revenue receipts are treated as incomes and shown on the credit side of the Profit and Loss Account.

Check Your Progress B

1 Choose one of the alternatives given within brackets and fill in the blanks.

i) Proper allocation of expenditure between capital and revenue is necessary for the ascertainment of .... (Profit or **Loss/Cash** in hand)
ii) **All** items of revenue nature are shown in the .... (Profit and Lass **Account/Balance** Sheet)
iii) Any expenditure where the benefit is spread over a number of years is .... expenditure **(capital/deferred** revenue)
iv) **When** a revenue expenditure is **capitalised,** it is called .... expenditure **(capital/deferred** revenue)
v) Any expenditure incurred in acquiring a right like goodwill or patent is treated as .... expenditure **(capital/revenue)**

2 State whether the following statements are True or False

i)	Every expenditure of large amount is capital expenditure.	....
ii)	An expenditure incurred on acquisition of a fixed asset is a capital expenditure.	....
iii)	Cartage paid on the new machine is a revenue expenditure.	....
iv)	Depreciation on fixed assets is a capital expenditure.	....
v)	Cost of goods purchased for resale is a **revenue** expenditure.	....
vi)	Heavy expenditure on advertising campaign is a deferred revenue expenditure.	....
vii)	Money received from the sale of goods is a capital receipt.	....
viii)	Expenditure is not the same thing as payment.	....

6.5 LET US SUM UP

Summary is prepared at the end of an accounting period in the form of Profit and Loss **Account** and Balance Sheet to ascertain the profit or loss **and** the financial **position of** the business. These **are** called final accounts. There are seven **accounting** concepts **which** are to be observed while preparing the final **accounts.** The going concern concept implies that the firm is a continuing unit. Hence expenditure on long term assets could be spread over a number of years. According to the Matching Concept, appropriate costs have to be matched against the appropriate revenues for the accounting period. The concept of conservatism implies that while calculating the profit of an accounting period, all possible losses should be taken into account while only those incomes should be included which have actually arisen and not just expected. According to consistency concept the accounting methods followed from period to period should be the same so as to ensure meaningful comparisons. The full disclosure and the materiality concepts signify that the financial statements should disclose all material infofmation so that the users can draw rational conclusions about the enterprise.

There are two bases of accounting viz., cash basis and accrual basis. The accrual basis is considered more logical because it takes into account all expenses incurred (whether paid or not) and all incomes earned (whether received or not) during the accounting period and thus ensures correct ascertainment of profit or loss.

It is also important to distinguish between capital and revenue otherwise the ascertainment of profit or loss and the financial position of the business will be incorrect. There are certain rules which guide us to determine whether a particular expenditure or receipt is of a capital nature or of a revenue nature.

6.6 KEY WORDS

Accrual Accounting: Accounting based on accrual system which takes into account all expenses incurred (whether paid or not) and all incomes earned (whether received or not) during an accounting period.

Accounting Year: A period of twelve months at the end of which the financial results are generally ascertained.

Balance Sheet: A statement prepared for ascertaining the financial position of the business as at the end of the accounting period.

Capital Expenditure: An expenditure which results in the acquisition of a fixed asset, or addition to a fixed asset, or an improvement in the earning capacity of the business.

Capital Receipt: Receipt in the form of additions to capital, liabilities or sale prqceeds of a fixed asset.

Deferred Revenue **Expenditure: A** revenue expenditure which involves a heavy amount and the benefit of which is likely to spread over two-three years.

Final Accounts: Financial statements prepared at the end of the accounting period for ascertaining the profit or loss and the financial position of the business. They include Profit and Loss Account and the Balance Sheet.

Revenue Expenditure: An expenditure the benefit of which is limited to one year.

Revenue Receipt: Receipts on account of goods sold or services provided.

6.7 SOME USEFUL BOOKS

Maheshwari, S.N., 1986. ***Introduction to Accounting,*** Vikas Publishing House: New Delhi. (Chapters 8,9,12).

Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting***, R.R. Chand & Co.: New Delhi. (Chapter 2).

William Pickles, 1982. ***Accountancy,*** E.L.B.S. and Pitman: London. (Chapter 8).

Gupta, R.L. and M. Radhaswamy, 1986. ***Advanced Accountancy,*** Sultan Chand & Sons: New Delhi. (Chapters 2,11).

Shukla, M.C. and T.S. Grewal, 1987. ***Advanced Accounts,*** S. Chand & Company: New Delhi. (Chapter 2).

6.8 ANSWERS TO CHECK YOUR PROGRESS

A 5 i) costs ii) sold iii) prudence iv) utility v) material vi) cash
B 1 i) profit or loss ii) Profit and Loss Account iii) capital iv) deferred revenue v) capital
2 i) False ii) True iii) False iv) False v) True vi) True vii) False viii) True

6.9 TERMINAL QUESTIONS/EXERCISES

Questions

1 What do you understand by matching costs against revenue? Explain the main implications of the Matching Concept.
2 Distinguish between cash basis and accrual basis of accounting. Why do you consider accrual basis more rational?
3 Write notes on the following concepts

i) Going Concern Concept
ii) Conservatism
iii) Consistency
iv) Full Disclosure
v) Materiality

4 Why is distinction between capital and revenue important? Give examples to show how wrong classification can affect the ascertainment of profit.
5 What is deferred revenue expenditure? Give three examples.

Exercises

1 Ascertain the profit to the business for the month of June, 1988 for which the following information is available.

	Rs.
Sales	80,000
Cost of goods produced	70,000
Cost of goods sold	60,000
Salaries for June	10,000
Rent for June paid in July	1,000
Sundry Expenses	600

Hint: Match costs against revenues
(Answer: Rs. 8,400)

2 State with reasons whether the following expenditure is of capital or revenue nature

i) Rs. 3,00,000 spent on constructing an additional hall.
ii) Rs. 600 spent on carriage of goods.
iii) A second-hand machine was bought for Rs. 10,000 and Rs. 900 were spent on its carriage and installation.
iv) Rs. 800 were paid as wages to own workers for manufacturing loose tools for use in the factory.
v) A sum of Rs. 800 spent on legal charges for recovering dues from debtors.
vi) Rs. 2,000 were paid to an architect for drawing up the plans for the proposed building.

(Answer: i) capital ii) revenue iii) capital (including carriage, etc.) iv) capital v) revenue vi) capital).

3 State whether the following expenditures are capital or revenue. Give reasons in each case.

i) Rs. 15,000 paid as brokerage in connection with the purchase of land.
ii) Rs. 60,000 spent on uniforms to staff

iii) Rs. 2,00,000 incurred in developing a new area for tea plantation
iv) Rs. 600 spent on transportation of stock to new site
v) Rs. 20,000 spent on experimenting a new product which was not **successful**
vi) A sum of Rs. 25,000 spent on overhauling the machinery. It increased the life of the machinery by three years

(Answer: i) capital ii) revenue iii) capital iv) deferred revenue v) deferred revenue vi) capital

Note: These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University. These are for your practice only.

UNIT 7 FINAL ACCOUNTS I

Structure

7.0 OBJECTIVES

After studying this unit you will be able *to:*

- explain the purpose of preparing final accounts
- prepare a trial balance from a given list of balances
- prepare trading and profit and loss account
- prepare balance sheet
- prepare manufacturing account and calculate cost of goods produced
- prevent the final accounts in vertical form.

7.1 INTRODUCTION

In Unit 6 you have learnt about the concepts which guide the preparation of final accounts. You know that the final accounts are primarily prepared for ascertaining the operational result and the financial position of the business. They consist of (i) Profit and Loss Account, and (ii) Balance Sheet. The Profit and Loss Account reveals the profit earned or loss incurred (operational result) during the accounting year and the Balance Sheet indicates the financial position as at the end of the year. In this unit you will learn about the basic framework of final accounts including their presentation in vertical form.

7.2 FINAL ACCOUNTS AND TRIAL BALANCE

You how final accounts are prepared with the help of a Trial Balance which shows all the ledger balances as at the end of an accounting period. Generally, when you are asked to prepare final accounts you are given a properly prepared Trial Balance and you have no difficulty in identifying the items of incomes, expenses, assets, and liabilities. But, sometimes you may not be given a proper Trial Balance, You may simply be asked to prepare the final accounts from the list of closing balances extracted from the books of some firm. In such a situation, it will be helpful if you first prepare the Trial Balance and then the final accounts. Hence it is important that you should know how to prepare the Trial Balance from a given list of balances.

Normally when a Trial Balance is to be prepared, you have full details of ledger accounts with you. You can easily ascertain whether a particular account has a debit