rise to income and if the expenses incurred is more than the revenue earned, it gives rise to loss.

Capital and Revenue Items:

The main purpose of accounting is to ascertain the true results of the business in terms of profit and loss during a particular accounting period. The profit or loss of a business can be ascertained by matching business revenues earned against the cost incurred for earning such revenue during the same period. Therefore, a clear understanding of the terms capital and revenue (expenditures and receipts) is necessary for the correct ascertainment of profit or loss.

Types of Expenditure:

The expenditures incurred by an enterprise is divided into three types:

(i) Capital expenditure;

(ii) Revenue expenditure; and

(iii) Deferred Revenue expenditure

Capital Expenditure: Capital expenditure is the expenditure which results in acquisition of an asset or which helps to increase in the earning capacity of a business. The benefit from a capital expenditure is derived over long period of time. For example, amount paid for purchase of land, building, machinery, furniture, motor car, etc. All these assets are used in the business from year to year. Capital expenditures are non-recurring in nature i.e. they are not required to be incurred every year.

Special Features of Capital Expenditures :

(i) Capital expenditure is incurred for acquiring fixed assets.

(ii) This expenditure increases the value of fixed assets.

(iii) These expenditures increase the profit earning capacity of the business.

(iv) These expenditures are non-recurring in nature.

(v) The assets acquired through these expenditures are not meant for sales in the ordinary course of business.

(vi) These expenditures are shown on the assets side of the Balance Sheet.

Examples of Capital expenditure :

(i) Cost of acquisition of permanent asset such as goodwill, land, building, machinery, patents, trade-marks, furniture, designs, patterns, loose tools and other equipments, sport goods, library books, investments, hospital equipments, research equipment etc., etc.

(ii) Cost of installation of fixed assets and of lights, fans etc.

(iii) Cost of additions, expansions, improvements or alterations of fixed assets.

(iv) Cost of development, research and experiments.

(v) Carriage, cartage and freight paid on acquiring assets such as plant and machinery, furniture etc.

(vi) Repairing charges paid on purchase of second hand assets to bring them into working condition.

Accounting Treatment of Capital Expenditure:

Capital expenditure results in increase in fixed assets. Therefore, on acquiring fixed assets, the quantity and value of respective fixed asset increases and hence respective fixed assets account is debited, the rule being *'debit increase in assets'*. While preparing financial statements, these assets are shown on the assets side of the balance sheet.

Revenue Expenditure: The expenditure incurred to meet the day to day expenses of the concern is called revenue expenditure. It is incurred in the normal course of business. The benefit of revenue expenditure is derived in the year of incurring the expenditure. These expenditures are incurred to maintain the earning capacity of existing assets and are recurring in nature. These are required to be incurred every year for earning revenue.

Special Features :

(i) These expenses are of are routine nature.
(ii) These expenses are incurred to meet the day-to-day expenditure.
(iii) These expenses are incurred for maintenance of fixed assets such as repairing of machinery, white-washing of buildings, etc.
(iv) These expenses do not increase the profit earning capacity of the firm.
(v) Current assets acquired through these expenditures are meant for sale.
(vi) Revenue expenses are shown at the debit side of the trading and profit and loss A/c.

Examples of Revenue Expenditure :

(i) Expenses on repairs, renewals, replacements for maintaining the existing fixed assets.
(ii) Purchases of goods for resale and stores for consumption such as bar materials, foods, medicines, etc.
(iii) Salaries, Wages, Rent, Taxes, Light charges, Audit fees etc.
(iv) Depreciation of fixed assets, interest on loans and miscellaneous expenses.

It may be noted that expenditure is a wider term and includes expenses as well.

Distinction between Capital Expenditures and Revenue Expenditures:

Points of Distinction	*Capital Expenditures:*	*Revenue Expenditures*
1. *Meaning*	Expenses incurred in acquiring fixed assets or improving fixed assets are termed as capital expenditure.	Expenses incurred for meeting the day-to-day business expenses are known as Revenue Expenditure.
2. *Purpose*	These are incurred in purchasing of fixed assets.	These are incurred for conducting the business.
3. *Accounting treatment*	These are shown at the assets side of the Balance Sheet.	These are shown on the debit side of trading/profit and loss account.
4. *Capacity*	It helps to increases the earning capacity of the business.	These are incurred for earning profit.
5. *Period of benefit*	The benefit of capital expenditure is received over a a number of years.	The benefit of revenue expenditure is restricted only to the accounting period in which it is incurred.

Circumstances where revenue expenditure becomes capital expenditure:

Following are some of the circumstances under which an expenditure which usually of a revenue nature may be taken as an expenditure of a capital nature :

(a) Repairs: The amount spent on repairs of plant, furniture, building, etc., is taken as a revenue expenditure. However, when some second-hand plant, motor car, etc., is purchased, the expenditure incurred for immediate repairs of such plant, motor car, etc., to make it fit for use will be taken as a capital expenditure.

(b) Wages: The amount spent as wages is usually taken as a revenue expense. However, the amount of wages paid for erection of a new plant or machinery or wages paid to workmen engaged in construction of a fixed asset are taken as capital expenditure.

(c) Legal charges: Legal charges are usually taken as expenditure of a revenue nature, but legal charges incurred in connection with purchase of fixed assets is taken as a part of the cost of the fixed asset and hence treated as capital expenditure.

(d) Carriage/Freight charges: Carriage/Freight charges are generally of a revenue nature, but such charges incurred for a new plant and machinery are taken as expenditure of a capital nature and are added to the cost of the asset.

(e) Raw materials and stores: Amount paid for purchase of Raw materials and stores are usually taken as revenue expenditure, but raw materials and stores utilised in construction of the fixed assets are treated as capital expenditure and taken as a part of the cost of such fixed asset.

Deferred Revenue Expenditure :

The expenditures which are revenue in nature but the benefit of which is likely to accrue over a certain period of time to the entity incurring such expenditure are termed as 'Deferred Revenue Expenditure'. It is termed as 'Deferred' because the revenue recognition of such expenditure is deferred and recognised over the period during which the benefit of such expenditure is likely to accrue. Generally such periods are considered between 3 to 7 years as decided by the entity. Of course, the actual period for recognition of such expenditure as revenue depends on the policy of the entity. In case of such type of expenditure, the portion of the expenditure, which is considered to have been used or consumed in the current year (the year in which the whole amount has been spent), is termed as expense of the current year and is shown in trading and profit and loss account of the current year. The balance of the expenditure is carried forward and written off over the years as decided by the entity. The amount carried forward at the end of each year is shown in the assets side of the balance sheet till the whole amount is completely written off.

For example, a business entity has incurred an expenditure of ₹ 4,00,000 for advertisement in electronic media for launching a new product. The business entity decided to write off the total expenditure of ₹ 4,00,000 equally over four years. Hence, ₹ 4,00,000/4 = ₹ 1,00,000 will be recognised as revenue expenditure every year over four years and will be debited to Profit and Loss Account every year for four years. The balance of the expenditure not written off at the end of each year will be shown on the assets side of the Balance Sheet till the whole amount is completely written off. In this example, at the end of 1st year, ₹ 1,00,000 will be shown on the debit side of the Profit and Loss Account and the balance not written off ₹ (4,00,000 – 1,00,000) = ₹ 3,00,000 will be shown on the assets side of the Balance sheet. In the second year, ₹ 1,00,000 will be shown on the debit side of the Profit and Loss Account and the balance not yet written off ₹ (3,00,000 – 1,00,000) = ₹ 2,00,000 will be shown on the assets side of the Balance sheet. In the third year, ₹ 100,000 will be shown on the debit side of the Profit and Loss Account and the balance not yet written off ₹ (2,00,000 – 1,00,000) = ₹ 1,00,000 will be shown on the assets side of the Balance sheet. In the fourth year, ₹ 1,00,000 will be shown on the debit side of the Profit and Loss Account and nothing will be shown on the assets side of the Balance sheet as the whole amount has been completely written off.

Examples of Deferred Revenue Expenditure :

(a) Heavy expenditure on special advertising campaign or for launching a new product.

(b) Heavy expenditure on Research and Development incurred in a particular year.

(c) Expenses incurred for removal of factory from one place to another place including the cost of dismantling and re-installing of plant and machinery.

Types of Receipts:

Each and every enterprise receives some amount of money every year. The amount received are divided into the following two categories:

(i) Capital receipts; and

(ii) Revenue receipts.

(i) Capital Receipts: Capital receipts are receipts by the business from the owner towards the capital of the firm and also any sum received as any loan and the proceeds of sale of any fixed assets of a business enterprise. They are non-recurring in nature. For example, capital introduced, loan taken, amount realised by sale of assets.

(ii) Revenue Receipts: Revenue receipts are the receipts which are the result of a firm's activity in the accounting period, part of its rewards for offering goods or services to the public. For example; amount received against sales, commission, interest on investment, etc. They are recurring in nature i.e. they are received from year to year. For example, dividend received, discount received, commission received.

Accounting treatments:

While preparing final accounts all revenue items and the portion of deferred revenue expenditure chargeable to the current year are taken to Trading/ Profit and Loss Account while Capital receipts and Capital payments are considered while preparing the Balance Sheet.

Distinction between Capital Receipts and Revenue Receipts

Points of Distinction	*Capital Receipts*	*Revenue Receipts*
1. *Meaning*	The amount received in the form of capital introduced, loans taken and sale proceeds of the fixed assets is known as Capital Receipts.	The amount received mainly by selling of goods and services is known as Revenue Receipts.
2. *Nature*	These receipts non-recurring nature.	These receipts are recurring in nature.
3. *Presentation in final account*	These receipts are shown in the Liabilities side of Balance Sheet or shown as deduction from fixed assets.	These receipts give rise to income and hence they are shown on the credit of either Trading account or Profit and Loss account.

BAD DEBTS & PROVISION FOR BAD DEBTS

Introduction:

It is a common feature for every business to sell goods on credit. The person to whom goods have been sold on credit are known as *'Debtor'* and the total of all the debtors is termed as *'Sundry Debtors'*. *'Sundry Debtors'* are also termed as *'Book Debts'*. The total debtors of a firm may be classified into: Good debts, Bad debts and Doubtful Debts.

(i) *Good debts* : Good debts are those debts which will be recovered in full. In other words, that portion of sundry debtors which will be recovered in full is termed as *'Good Debtors'*.

(ii) *Bad Debts* : Sometimes due to the financial difficulty, death or insolvency or dishonesty of a Debtor, full amount due from them may not be recovered from such person/persons. When the business firm finds that a particular amount due from a particular debtor cannot be recovered either in full or in part, the unrecoverable portion is termed as *'Bad Debts'*.

When the business entity feels that a particular amount cannot be recovered from a particular debtor, it is meaningless to carry forward the balance in the account of such debtor in the ledger every year. The balance standing to the debit of that account is cancelled. The process of cancellations of balance in the account of a debtor is called ***'writing off' bad debts***. This is done by recording the following journal entry:

Bad debts A/c Dr.
 To Debtors A/c (Individually)
(Being bad debts written off)

In examination problems where the name of the debtor is not given, the entry for 'writing off' bad debts will be as under:

Bad debts A/c Dr.
 To Sundry Debtors A/c
(Being bad debts written off)

The amount of bad debts occurring in a particular year and written off during that year before the preparation of trial balance is termed *'bad debts written off during the year'*. *Bad debts written off* during the year means that the entry for writing off bad debt has been passed. Therefore, for such bad debts no further entry for writing off bad debts is required to be passed. Amount of Sundry Debtors shown in the trial balance in such cases is after deduction of bad debts. In such a case bad debts is not required to be deducted further from Sundry Debtors in the balance sheet.

The amount of bad debts occurring in a particular year which has not been written off during that year before the preparation of trial balance is termed as '*Bad debts to be written off*'. Therefore, entry for writing off such bad debts is required to be passed. Amount of Sundry Debtors shown in such cases is before the deduction of bad debts. In such a case, bad debts is required to be deducted further from Sundry Debtors in the balance sheet.

(iii) *Doubtful Debts* : Sometimes a firm may be in doubt about the possibility of realisation of the amount from some of its debtors. Such debtors are termed as doubtful debts.

It is common for every business to find that some of the amount due from debtors may not be realised but this will be known to the business only in the future when the effort will be put on to realise the amount from the debtors. As the amount of actual loss on account of bad debts of current year would be known only in the future when the amount is realised from Debtors, a provision is created to cover any possible loss arising on account of bad debts likely to occur in future. Such provision is termed as ***Provision for bad debts.***

Need for creating Provision for Doubtful Debts:

As credit sales are made in a particular year during which debtors are created, the profit on such sales is included in the Trading and Profit and Loss Account of that year as revenues are ascertained on the basis of accrual assumption. Doubtful Debts is a business loss arising from credit sales; so it is logical that such a loss is charged against the revenue earned through credit sales of that year according to the matching principle. Moreover, on the basis of the modifying principle of conservatism and according to the principle of revenue recognition, expected loss must be taken into account during that year while ascertaining net profit.

Hence, it is not only fair but also logical that doubtful debts being a business loss in connection with credit sales must be provided for out of the revenue earned during the period so that the Profit and Loss Account of the following year is not burdened with the loss of earlier years.

Provision for Doubtful Debts – How Created:

Since doubtful debt can only be estimated, a provision is created on estimated basis. This is calculated at a certain percentage on the amount of Debtors at the end of the year. The percentage is fixed on the basis of past experience in connection with the realisability of debtors. ***The provision so created is called 'Provision for Doubtful Debts' or 'Provision for Bad Debts' or 'Provision for Bad and Doubtful Debts'***. All these three terms are used interchangeably. Sometimes the term 'Reserve' is used in place of the 'Provision'. It is not proper to use the term Reserve in place of 'Provisions'. The Provision for Doubtful Debts created for the first time in a particular year is carried forward

			49,300	
		Less: Provision for Doubtful Debt	2,000	47,300

Provision for Discount on Debtors :

In order to encourage the debtors to make prompt payment or to make payment within a specified date, it is a normal practice to allow some rebate to those debtors from whom the payment is received within a fixed time. Such discount allowed is called Cash Discount. Cash Discount, thus allowed, is an expense of the business and is, therefore, debited to the Profit & Loss Account. Since there will be some debtors who will make early payment in the next accounting year and will be allowed such discount, a provision for allowing such discount is created in the current year itself because the revenue has been recognised in this year. The following entry is passed for creating a provision for discount on debtors:

Profit & Loss A/c Dr.

To Provision for Discount on Debtors A/c

(Being provision for discount created on good Debtors)

Note : *It should be kept in mind that the provision for discount is calculated on good debtors. Here good debtors means debtors left after deducting further bad debts and additional discount allowed as given in adjustments and the provision for doubtful debts required to be made at the end of the current year. In other words; Good Debtors = Sundry Debtors appearing in the trial balance – (Further bad debts + Additional discount allowed to debtors + New provision for doubtful debts).*

While preparing the final accounts, Provision for Discount on Debtors will be shown as deduction from the Sundry Debtors on the assets side of the Balance Sheet

Accounting Treatment : Accounting Treatment of Provision for Discount on Debtors can be discussed under the following two heads:

(I) ***Where the balance in the Provision for Discount on Debtors Account does not exist :*** Where the balance in the Provision for Discount on Debtors Account does not exist, the total amount of Discount allowed is transferred to Profit and Loss Account. The following journal entry will be passed:

(i) *When Discount is Allowed to Debtors*

Discount Allowed A/c Dr.

To Debtor's A/c

(ii) *For transfer of Discount Allowed:*

Profit and Loss A/c Dr.

To Discount Allowed A/c

(iii) *For creation of Provision for Discount on Debtors:*

Profit and Loss A/c Dr.

To Provision for Discount on Debtors A/c

(Being the Provision for debtors created @ ....% on ₹..............)

Outstanding Expenses

Outstanding expenses are those expenses which have been incurred during the current accounting period and are due to be paid, however, the payment is not made. Such an item **is to be treated as payable** by the business.

Examples – Outstanding salary, outstanding rent, outstanding subscription, outstanding wages, etc. Outstanding expenses are **recorded in books of finance at the end of an accounting period** to show the true numbers of a business.

The outstanding expense is a **personal account** and is treated as a liability for the business. It is also shown on the liability side of a balance sheet.

Example and Simplification

Company-A has a rent obligation of 10,000/month that is paid on every 10th, the company has paid for 11 months and one month is unpaid until the end of the period.

The amount for 1 month which remains unpaid is termed as "outstanding expense" for Company A.

At the end of the period, this "**expense due but not paid**" impacts the financials of the business. As per **accrual accounting**, it is supposed to be **journalized**.

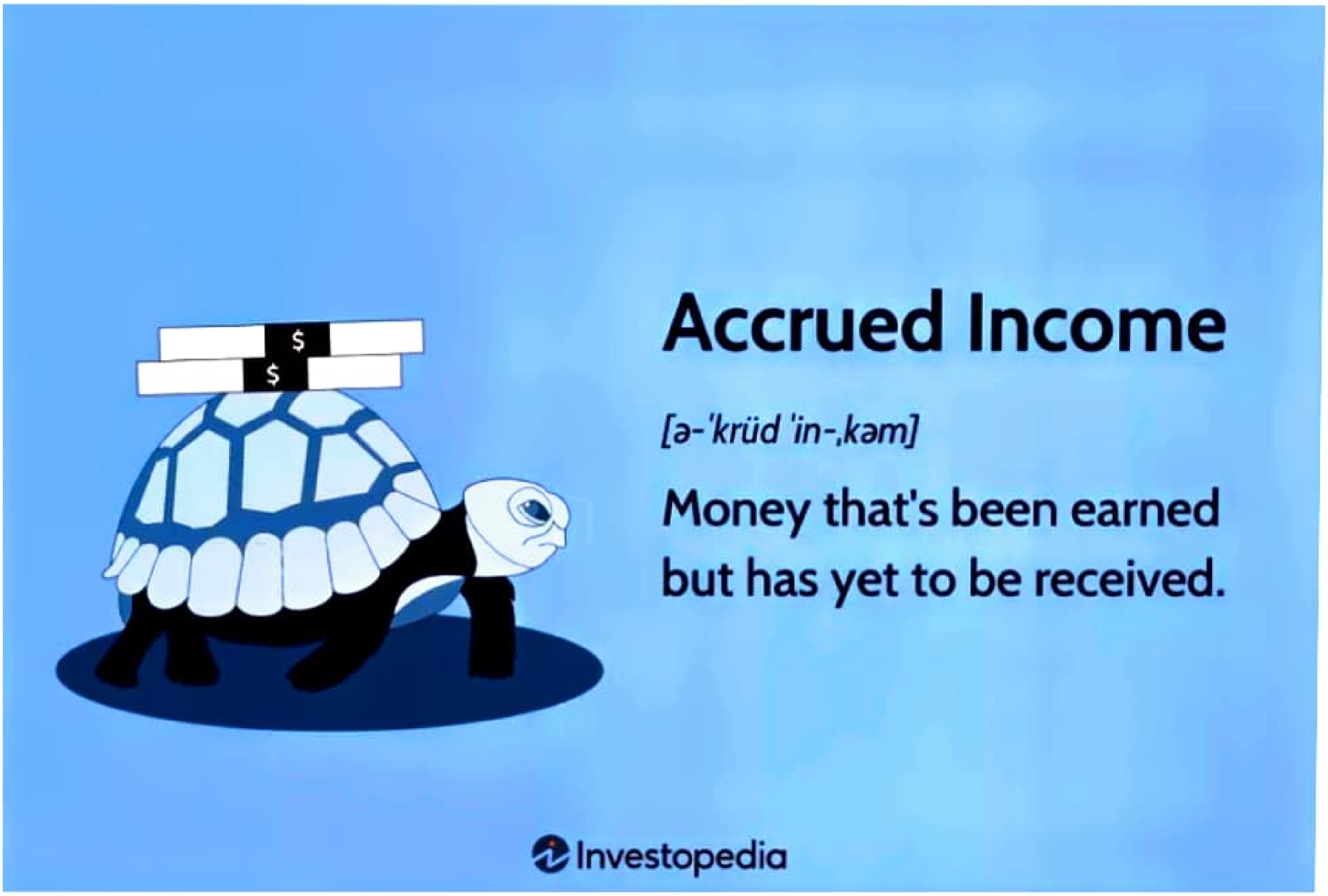
Outstanding Expenses in a Nutshell
Expenses are the amounts paid for goods or services purchased. According to the accrual concept of accounting, transactions are recorded in the books of accounts at the time of their occurrence and not when the actual cash/bank is received or paid.

Payments are not necessarily made and received immediately, they may be late or in advance. Outstanding expenses, **prepaid expenses**, **accrued income** & **income received in advance** are all a result of delayed payments/receipts.

What Is a Prepaid Expense?

A prepaid expense is an expense that has been paid for in advance but not yet incurred. In business, a prepaid expense is recorded as an asset on the balance sheet that results from a business making advanced payments for goods or services to be received in the future.

Prepaid expenses are initially recorded as assets, but their value is expensed over time onto the income statement. Unlike conventional expenses, the business will receive something of value from the prepaid expense over the course of several accounting periods.



Investopedia / Crea Taylor

What Is Accrued Income?

Accrued income is the money a company has earned in the ordinary course of business but has yet to be received, and for which the invoice is yet to be billed to the customer.

> Accrued Income is the income the company has earned in the ordinary course of business after selling the goods or after the provision of the services to the third party but the payment for which has not been received and is shown as an asset in the balance sheet of the company.

Accrued Income is the income earned by the company or an individual during the accounting year but not received in that same accounting period.

It can be any income for which the company gave goods and services to the customer, but customer payment is pending. Sometimes this income can also be applied to revenue generated for which a bill is not issued by the entity yet. Also, it has not been paid yet.

Accrued Income Journal Entries

It is current assets for any business and impact a Balance sheet and Profit & Loss A/c. For this, an accountant needs to pass the journal entry that debits accrued Income A/c and credit Income A/c.