Question 8 *(ICAI Study Material)*

Are the following expenditures capital in nature?

(i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was ₹ 20,000.

(ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent ₹ 10,000 on account of legal expenses.

(iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent ₹ 40,000 for transportation of such machinery. The year ending is 31st Dec, 2023.

Solution:

(i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus the renovation expense is capital expenditure in nature.

(ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is normal recurring expense of the business. Thus the legal expenses incurred in this case is revenue expenditure in nature.

(iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

Question 9 *(RTP May 2018) / (RTP Nov 2019) / (RTP Nov 2020) / (RTP Nov 2023) (Similar)*

Classify the following expenditures as capital or revenue expenditure:

(i) Amount spent on making a few more exits in a Cinema Hall to comply with Government orders.

(ii) Travelling expenses of the directors for trips abroad for purchase of capital assets.

(iii) Amount spent to reduce working expenses.

(iv) Amount paid for removal of stock to a new site.

(v) Cost of repairs on second-hand car purchased to bring it into working condition.

Solution:

(i) Revenue Expenditure (ii) Capital Expenditure (iii) Revenue Expenditure if short term benefit and Capital Expenditure if long term benefit to entity (iv) Revenue Expenditure (v) Capital Expenditure

Question 10 *(RTP May 2018) (RTP May 2021) / (RTP Nov 2021)*

Classify each of the following transactions into capital or revenue transactions:

a) Complete repaint of existing building.

b) Installation of a new central heating system.

c) Repainting of a delivery van.

d) Providing drainage for a new piece of water-extraction equipment.

e) Legal fees on the acquisition of land.

f) Carriage costs on a replacement part for a piece of machinery.

g) Inauguration expenses of a new manufacturing unit in an existing Business.

Solution:

(a) Revenue Expenditure (b) Capital Expenditure (c) Revenue Expenditure (d) Capital Expenditure (e) Capital Expenditure (f) Revenue Expenditure (g) Revenue Expenditure

Question 11 *(RTP May 2019)*

Classify the following expenditures and receipts as capital or revenue:

(i) ₹ 10,000 spent as import duty on machinery purchased.

(ii) Amount received from debtors during the year.

(iii) Cost of testing whether the equipment is functioning properly.

(iv) Insurance claim received on account of machinery damaged by fire.

Solution

(i) Capital expenditure (ii) Revenue receipt. (iii) Capital expenditure. (iv) Capital receipt.

Question 12 *(RTP May 2020)*

Classify the following expenditures as capital or revenue expenditure.

(i) Money spent to reduce working expenses.

(ii) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land.

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

(iv) Compensation of ₹ 2.5 crores paid to workers, who opted for voluntary retirement.

Solution

(i) Capital expenditure if long term benefit (ii) Revenue expenditure. (iii) Capital expenditure. (iv) Revenue expenditure.

Question 13 *(RTP May 2022)*

Classify the following expenditures as capital or revenue expenditure:

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

(ii) Amount spent on painting the factory

(iii) Payment of wages for building a new office extension.

(iv) Amount paid for removal of stock to a new site.

(v) Rings and Pistons of an engine were changed to get full efficiency

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 1 accounting period.

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

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

(iv) Amount paid for removal of stock to a new site is treated as a Revenue Expenditure because it is not enhancing the value of any asset.

(v) Expenditure 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.

Question 14 *(RTP Nov 2022)*

Classify the following expenditures as capital or revenue expenditure:

(i) Expenses incurred to keep the machine in working condition.

(ii) Registration fees paid at the time of purchase of a building.

(iii) Expenses incurred for advertisement in newspaper.

(iv) Amount spent on renewal fee of patent rights.

(v) Cost of repairs on second-hand car purchased to bring it into working condition.

Solution

(i) Revenue Expenditure. (ii) Capital Expenditure. (iii) Revenue Expenditure. (iv) Revenue Expenditure. (v) Capital Expenditure.

Question 15 *(RTP May 2023)*

Classify the following expenditures as capital or revenue expenditure:

(i) Insurance claim received on account of inventory damaged by fire.

(ii) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land.

(iii) Travelling expenses of the chief financial officer on trips abroad for purchase of special machinery.

(iv) Dividend received from XYZ limited during the year.

Solution

(i) Revenue Receipt. (ii) Revenue Expenditure. (iii) Capital Expenditure. (iv) Revenue Receipt.

Question 16 *(MTP Dec 2022)*

Classify the following expenditures as capital or revenue expenditure:

(i) Amount spent for replacement of a petrol driven engine by CNG kits.

(ii) Travelling expenses of the directors for trips abroad for purchase of capital assets.

(iii) Amount spent to reduce working expenses.

(iv) Insurance claim received on account of inventory damaged by fire.

(v) Expenses incurred on the repairs and white washing for the first time on purchase of an old factory.

Solution

(i) Capital Expenditure. (ii) Capital Expenditure. (iii) Capital Expenditure (assuming long term benefit) (iv) Revenue Expenditure. (v) Capital Expenditure.

THEORY QUESTIONS

Question 1 *(RTP Questions)*

a) Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.
b) Discuss the limitations which must be kept in mind while evaluating the Financial Statements. *(CA Foundation Nov 2018) (4 Marks)*
c) Define revenue receipts and give examples. How are these receipts treated? Explain.
d) Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the helo of an example.
e) State the advantages of setting Accounting Standards
f) Distinguish between Money measurement concept and matching concept.
g) Explain Cash and Mercantile system of accounting.
h) Differentiate between Liability and Contingent Liability
i) Write short notes on
   (i) Fundamental Accounting Assumptions.
   (ii) Accounting conventions
   (iii) Measurement
   (iv) Going Concern Concept

Solution

a) Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts. There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating, calls for considerate judgement by the management. Different accounting policies are frequently encountered in the areas like valuation of inventory and investments etc.

b) Limitations which must be kept in mind while evaluating the Financial Statements are as follows:
- The factors which may be relevant in assessing the worth of the enterprise don't find place in the accounts as they cannot be measured in terms of money.
- Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date.
- Accounting ignores changes in some money factors like inflation etc.
- There are occasions when accounting principles conflict with each other.
- Certain accounting estimates depend on the sheer personal judgement of the accountant.
- Different accounting policies for treatment of same item add to the probability of manipulations.

c) Receipts which are obtained in course of normal business activities are revenue receipts (e.g. receipts from sale of goods or services, interest income etc.). Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

d) Change in accounting policy may have a material effect on the items of financial statements. For example, cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items

e) The main advantage of setting accounting standards is that the adoption and application of accounting standards ensure uniformity, comparability and qualitative improvement in the preparation and presentation of financial statements. The other advantages are: Reduction in variations; Disclosures beyond that required by law and ease in comparison

f) Distinction between Money measurement concept and matching concept

As per Money Measurement concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions and events that cannot be expressed in terms of money are not recorded in the business books.

In Matching concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

g) Cash and mercantile system:

Cash system of accounting is a system by which a transaction is recognized only if cash is received or paid. In cash system of accounting, entries are made only when cash is received or paid, no entry being made when a payment or receipt is merely due. Cash system is normally followed by professionals, educational institutions or non-profit making organizations.

On the other hand, mercantile system of accounting is a system of classifying and summarizing transactions into assets, liabilities, equity (owner's fund), costs, revenues and recording thereof. A transaction is recognized when either a liability is created/ impaired and an asset is created /impaired. A record is made on the basis of amounts having become due for payment or receipt irrespective of the fact whether payment is made or received actually. Mercantile system of accounting is generally accepted accounting system by business entities

h) A liability is defined as the present financial obligation of an enterprise, which arises from past events. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

i)

(i) Fundamental Accounting Assumptions: Fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

a. Going Concern: The enterprise is normally viewed as a going concern, i.e., as continuing operations for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

b. Consistency: It is assumed that accounting policies are consistent from one period to another.

c. Accrual: Revenues and costs are accrued, i.e. recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

(ii) Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

(iii) Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Any measurement discipline deals with three basic elements of measurement viz., identification of objects and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards or scale. Kohler defined measurement as the assignment of a system of ordinal or cardinal numbers to the results of a scheme of inquiry or apparatus of observations in accordance with logical or mathematical rules.
Three important elements of measurement are:
(1) Identification of objects and events to be measured;
(2) Selection of standard or scale to be used;
(3) Evaluation of dimension of measurement standard or scale.

(iv) Going Concern concept: The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Question 2 *(CA Foundation May 2019) (4 Marks) / (RTP May 2023)*

Distinguish between Going Concern concept and Cost concept.

Solution

Going Concern concept: The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Cost concept: By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity. It is highly objective and free from all bias.

Question 3 *(CA Foundation May 18) / (Nov 19) / (Dec 22) (4 Marks) / (RTP May 20) / (Nov 23)*

Distinguish between Provision and Contingent Liability.

Solution

Provision	Contingent Liability
Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.
A provision meets the recognition criteria. Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation	A contingent liability fails to meet the same. Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability

Question 4 *(CA Foundation Nov 2020) (4 Marks)*

What services can a Chartered Accountant provide to the society?

Solution

The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Chartered Accountants are presently taking active role in company laws and other corporate legislation matters, in taxation laws matters (both direct and indirect) and in general management problems.

a) Some of the services rendered by chartered accountants to the society are briefly mentioned hereunder: Maintenance of books of accounts;
b) Statutory audit;
c) Internal Audit;
d) Taxation;
e) Management accounting and consultancy services;
f) Financial advice and financial investigations etc.
g) Other services like secretarial work, share registration work, company formation receiverships, arbitrations etc

Question 5 *(CA Foundation July 2021) (4 Marks)*

Discuss the basic considerations in distinguishing between capital and revenue expenditure.

Solution

The basic considerations in distinction between capital and revenue expenditures are:

(a) Nature of business: For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criterion in separating expenditure between capital and revenue.
(b) Recurring nature of expenditure: If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting

year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.

(c) Purpose of expenses: Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.

(d) Effect on revenue generating capacity of business: The expenses which help to generate income/revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.

(e) Materiality of the amount involved: Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.

Question 6 *(CA Foundation June 2022) (4 Marks)*

Briefly explain the following Concepts of Accounting:

(i) Money Measurement Concept
(ii) Periodicity Concept.

Solution

Money Measurement concept: As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions and events that cannot be expressed in terms of money are not recorded in the business books.

Periodicity concept: According to this concept, accounts should be prepared after every period not at the end of the life of the entity. This is also called the concept of definite accounting period. Usually, this period is one accounting year. We generally follow from 1st April of a year to 31st March of the immediately following year.