# THEORETICAL FRAMEWORK

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*"One second, One minute, One hour, One day, One week, One month, One year and you are one year older. Make full use of your time."*

## MEANING AND SCOPE OF ACCOUNTING

### MEANING OF ACCOUNTING

1) As per the American Institute of Certified Public Accountants (AICPA) – 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 financial character, and interpreting the results thereof.
2) Accounting also involves analyzing and interpreting financial transactions and communicating the results to the persons interested in such information.
3) As per American Accounting Association- Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounts.
4) Accounting is considered as an 'Information System', as the function of Accounting is to provide quantitative information, primarily financial in nature about the business organization.

## TRANSACTIONS VS EVENTS, FINANCIAL VS NON- FINANCIAL

1. Transactions and Events: In a business or economic scenario.

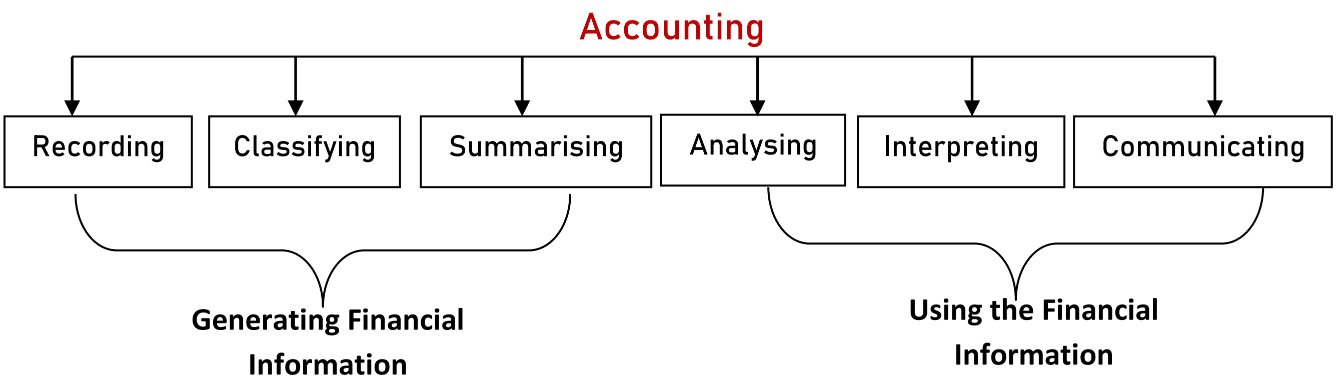
Business Activities

- Transactions – Performance of business Activity
  - Thumb rule: Human Effort is involved.
  - For Eg.: Purchases, Sales, Expenses paid,etc.
- Events – Result of Transactions.
  - Thumb rule: Human Effort not involved. It represents results.
  - Eg:Profits/Closing Stock are results of purchases & Sales
- Both Transaction and Event
  - Thumb rule: Both Human Effort & results from such effort are involved in a single
  - Eg.: Purchase of Fixed Assets on last day of accounting year

**2.** Types of Transactions – 2 Types:

| Types | Financial Transaction | Non – Financial Transaction |
|---|---|---|
| Meaning | When a business transaction involves a transfer of money or moneys' worth, then the transaction is called "Financial Transaction" | When a business transaction does not involve money or money's worth |
| Example | Purchase and Sale of goods, Payment of Expenses, Purchase of Assets, Goods lost by fire etc. | Quarrel between 2 Managers, Death of an employee etc. |
| Types | Cash and Credit Transaction | No such classification |

## ACCOUNTING PROCESS




<u>Processes of Generating Financial Information (3 processes)</u>

### 1. Recording:

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| Meaning | All business transactions which are of financial nature (i.e. expressed in terms of money) are recorded in the books of accounts. |
| Purpose | A businessman cannot keep in his memory all the business activities carried out by 'him. Hence, there is a need for keeping track of such activities in a separate record. |
| Basis of Recording | All transactions must be evidenced by supporting documents like Sales Invoice, Purchase Bill, Receipts, Pay Slip, etc. (These are called Vouchers) |
| Relevant A/cs Book | The Books in which primary entry is made is called "Journal", which is further sub—divided into several Subsidiary Books for Sales, Purchases, Cash & Bank, etc. according to the nature and size of the business. |
| Checkpoint | It is to be noted that Accounts is concerned with only FINANCIAL Transactions. Accounting will not record non—financial transactions in its books. |
| Example | • Salary paid to Manager will be recorded in the books of accounts. <br> • But, good health of the Manager, even if it is of great use to the business, has no financial character and no economic value, and therefore, will not be considered in Accounting. |

## 2. Classifying:

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| Meaning | Classifying involves grouping transactions of a similar nature at one place, such that information will be compressed and presented in useable form. |
| Purpose | While the process of recording ensures that all financial transactions are recorded, one cannot make any observations unless all the transactions are grouped together under different categories. |
| Basis of Recording | Classification is based on the transactions recorded in the Journal / Subsidiary Books. |
| Relevant A/cs Book | The book containing the classified information of transactions is called 'Ledger". Each page in the Ledger is called as "Folio". In each folio (Page No.), an individual Account Head and all transactions relating to that Account Head is recorded / posted. |
| Checkpoint | Ledger can be prepared only after the preparation of Journal / Subsidiary Books |
| Example | • At recording stage, all transactions are normally recorded chronologically (i.e. date—wise).<br>• Assuming a businessman made 10 sale transactions (out of which 6 are on credit), paid telephone charges. Rent etc., received payments from 3 debtors in a week, it is not possible to ascertain the exact position of each item unless they are grouped as "Sales A/c, Telephone Charges A/c, Rent A/c, Debtors A/c etc." |

## 3. Summarizing:

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| Meaning | This involves presentation and preparation of the classified information in a manner useful to the internal and external users of Financial Statements. |
| Accounts Books | It involves preparation of Trial Balance, and Financial Statements there from, viz. (i) Profit and Loss Account (used to find out profits / losses for the business), (ii) Balance Sheet (used to ascertain the financial position), and (ii) Cash Flow Statement (used to determine the factors for increase or decrease in cash & bank balances) |
| Basis | Summarizing is based on the classified transactions presented in Ledger |

Usage of Financial Information (generated through above 3 processes)

## 4. Analysing:

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| Meaning | Analysis involves methodical classification of data given in the Financial Statements. |
| Nature of process | Analysis is concerned with determining the relationship between the items in the Profit and Loss Account and Balance Sheet (i.e. Ratio Analysis). Thus, it provides the basis for interpretation. Further, analysis involves comparing current year figures with the previous year figures |
| Basis | Financial Statements generated above in summarizing. |

## 5. Interpreting:

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| Meaning | Drawing observations from the items in the financial statements and also from relationships determined in analyzing process |
| Purpose | The recorded financial data is analysed and interpreted in the manner that will enable the data users to make a meaningful judgment about the financial condition and profitability of the business operation. |

| | |
|---|---|
| Nature of process | Financial Statements are interpreted to explain what had happened, why it had happened and what is likely to happen under specified conditions. |
| Basis | Financial Statements generated in summarizing process and relationships determined in Analyzing process. |
| Example | Assuming the NP ratio for 2023 is 20% on sales, whereas it was 15% in 2022. After analysing different ratios it was interpreted that the profit has increased mainly due to decrease in expenses & not due to increase in sales. |

### 6. Communicating:

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| Meaning | It is concerned with the transmission of summarised, analysed and interpreted information to the end user to enable them to make rational decisions. |
| Modes | This is done through preparation and distribution of Accounting Reports, which includes Profit and Loss Account and Balance Sheet, additional information in the form of Accounting Ratios, Graphs, Diagrams, Funds Flow Statement, etc. |

## EVOLUTION OF ACCOUNTING AS SOCIAL SCIENCE

Accounting finds its roots as early as around 4000 BC, where Egyptians used some form of accounting for their treasuries. The in-charge of treasuries had to send day wise reports to their superiors known as Wazirs and monthly reports were sent to kings. Babylonia, known as the city of commerce, used accounting for business to identify the losses that took place due to frauds and lack of efficiency. Greece used accounting to divide the revenues received among treasuries, maintaining receipts, payments and balance of government financial transactions. Accounting practices in India could be traced back to a period where, Kautilya, a minister in Chandragupta's kingdom wrote a book named Arthashasthra, which also described how accounting records had to be maintained

In its oldest form, accounting aided the stewards to discharge their stewardship function. The wealthy men employed stewards to manage their property; the stewards in turn rendered an account periodically of their stewardship. This *'Stewardship Accounting' was the root of financial accounting system*.

Social Science study man as a member of society; they concern about social processes and the results and consequences of social relationships. The usefulness of accounting to society as a whole is the fundamental criterion to treat it as a social science.

## OBJECTIVES OF ACCOUNTING

1. To have a systematic record of all business transactions which are of financial nature.
2. To know the result of business operations for a particular period of time. If Revenue / Income exceeds the Expenses, then it is said that the business is running profitably, but if the Expenses exceed the Revenue, then the business is operating at a loss.
3. To know the financial position of the business. This will help answer questions like how much Assets and Liabilities that the business has on any date. The Balance sheet is a statement of assets & liabilities of the business at a particular point of time & helps in ascertaining the financial health of business.
4. To provide information to Users for decision making. Accounting, as the language of business, communicates the financial result of enterprises, to various Users. Accounting aims to meet the information needs of the decision maker and help them in rational decision making.

5. To know the <u>solvency position</u>: Balance sheet also helps to know whether the business is solvent, i.e. ability to meet its liabilities in short run & in long run as and when they fall due.

**Objectives of Accounting**

| Systematic recording of transactions | Ascertainment of results | Ascertainment of financial position | Communicating information to Users |
|---|---|---|---|
| ↓ | ↓ | ↓ | ↓ |
| Book-Keeping, i.e. Journal, Ledger and trial Balance | Manufacturing, Trading, Profit & Loss Account | Balance Sheet | Financial Reports |

## FUNCTIONS OF ACCOUNTING

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| Measurement | Accounting measures the performance of the business entity and depicts its current financial position. |
| Forecasting | Accounting helps in forecasting future performance and financial position of enterprise using past data. |
| Decision-making | Accounting provides relevant information to the Users of accounts to aid rational decision-making. |
| Comparison & Evaluation | Accounting assesses performance achieved in relation to targets and discloses information which plays important role in comparing & evaluating financial results. |
| Control | Accounting identifies weaknesses in the operational system and provides feedback regarding effectiveness of measures to rectify such weaknesses. |
| Government Regulation & Taxation | Accounting provides necessary information to the Government, to exercise control on the entity as well as in collection of tax revenues. |

## BOOK-KEEPING – MEANING AND FEATURES

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| Meaning | It is an activity of recording and classifying the financial data relating to business operations in a significant and orderly manner. |
| Objective | • Complete recording of transactions.<br>• Ascertainment of financial effect on the business. |
| Features | • It is art of scientifically recording the transactions.<br>• Recording of transactions is restricted only to that of particular enterprise<br>• The recordings are made in a given set of books. |
| Advantages | • From Financial Statements, financial information is readily available to Users<br>• Qualitative financial decisions can be taken, since information is reliable<br>• Valuable conclusions can be drawn on comparing books of different years of the same enterprise or comparing books of same period for different enterprises.<br>• Financial accounts of an enterprise are treated as evidence in a Court of Law. |

## BOOK-KEEPING V/S ACCOUNTING

| Basis | Book-Keeping | Accounting |
|---|---|---|
| **Scope** | It is a process concerned with recording of transactions | It is a process concerned with summarising of the recorded transactions. |
| **Stage** | Book-Keeping is the primary stage. It constitutes as the base for accounting. | Accounting is the secondary stage. It constitutes as a language of the business. |
| **Basic Objectives** | To maintain systematic records of financial transactions | To ascertain net results of operations and financial position and to communicate information to the interested parties. |
| **Financial position** | Financial position of the business cannot be ascertained through book-keeping | Financial position of the business is ascertained based on the accounting reports |
| **Financial Statements** | Financial Statements do not form part of this process. | Financial statements are prepared on the basis of book-keeping records. |
| **Managerial decision** | Managerial decision cannot be taken with the help of these records. | Management can take decision on the basis of these records. |
| **Sub-fields** | There are no-sub fields for Book-Keeping | It has several sub-fields such as Financial Accounting, Management ,etc. |

Note: In terms of scope, Book-Keeping < Accounting

## SUB FIELDS OF ACCOUNTING

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|---|---|
| Financial Accounting | It covers the preparation and interpretation of financial statement (i.e. P&L Account and Balance Sheet) and communication thereof, to the user of accounts. It is historical in nature as it records transactions which has already occurred. It primarily helps in determination of the net result for an accounting period and the financial position as on a given date. |
| Management Accounting | It is used for internal reporting to the Management of a business unit. The different ways of grouping information and preparing reports as desired by the Managers for discharging their functions and referred to as Management Accounting. |
| Cost Accounting | It is the process of accounting for cost and determination of overall cost of the product or service. The study of the behavioural pattern of cost will enable to control cost. |
| Social Responsibility Accounting | It is concerned with accounting for social costs incurred by the enterprise and social benefits created. |
| Human Resource Accounting | It seeks to identify, qualify and report investments made in human resources of an organization that are not presently accounted under any conventional accounting practice. |

## USERS OF FINANCIAL INFORMATION

| Users | Purpose |
|---|---|
| Management | For day-to-day decision-making and performance evaluation. |
| Investors | To analyze performance, profitability and financial position.<br>Note: Prospective investors are interested in the track record of the company |
| Lenders | They are interested to know whether their loan-principal and interest will be paid back when due |
| Suppliers | To determine the credit worthiness of the Company. |
| Customers | To know general business viability before entering into long-term contracts and arrangements |
| Employees | To know stability, continuity & growth of the enterprises, and its ability to pay remuneration, retirement & Other benefits & to enhance career opportunities. |
| Government | To ensure prompt collection of Direct and Indirect Tax revenues & to evaluate performance and contribution to social objectives |
| Public at Large | To see whether the enterprise is making a reasonable/ substantial contribution to local economy, e.g. employment opportunities, patronage of local suppliers |

## RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINE

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|---|---|
| Auditing | Auditing process review the Financial Statements, which are the outcome of the accounting process. Thus, Auditor should have a through & sound knowledge of accounting Standards & GAAP of reviewing the Financial statement. |
| Economics | • Economics uses the database provided by Accounting System, for developing decision-models and for rational decision-making on the use of scarce resources.<br>• Economic Theories have influenced the development of decision-making tools used in accounting.<br>• However, there are differences between the Economists' and Accountants concepts of Income, Capital and Valuation of assets |
| Law | • Transactions and events are governed by the laws of the land like The Contract Act, Sale of Goods Act, Negotiable Instruments Act and Taxation Laws.<br>• The entity itself is governed by specific status like Partnership Act, Companies Act, Co-operative Societies Act, which have a bearing on maintenance of account books |
| Mathematics | • Knowledge of arithmetic and algebra is a pre-requisite for accounting computation and measurement, e.g. Depreciation, Use of Interest and annuity tables, lease Rentals, Hire Purchase Installments etc.<br>• Ratios, Graphs & Operation Research Models have been widely used in accounting |
| Management | Management relies on accounting and other data for effective decision-making. Since an accountant plays an active role in management, he understands the data requirements, so the accounting System can be designed to serve management purpose. |

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| Statistics | In accounting many ratios and financial calculations are based on statistical methods, which help in averaging them over a period of time. Thus, Statistics is helpful in development of accounting data and in their interpretation using Pie-charts, Graphs and Trend Curve Diagram etc |

## LIMITATIONS OF ACCOUNTING

1. Accounting involves different assumptions and conventions on which it is based. These assumptions, by themselves become a limitation for accounting. Hence, Accounting is considered only as an art and not as pure science.
2. There are different accounting policies for the treatment of the same item, e.g. Depreciation, Valuation of Stocks, etc. This may not ensure comparability among financial statements of various firms.
3. Certain accounting estimates are based on the personal judgement of the accountant e.g. provision for doubtful debts, capital vs revenue expenditure, writing off intangible assets, etc. This may lead to the possibility of manipulation.
4. The financial position of the business as depicted by accounts is static and not dynamic i.e. it gives the position on a particular day on which it is prepared and does not predict future position.
5. Inflation effect is not considered in the general purpose financial statements i.e. Accounting ignores changes in some money factors
6. The worth of an entity may be assessed by various factors but all cannot be measured in terms of money.
7. Accounting ignores the real assets which cannot be measured in terms of money, i.e., Employees. There is no generally accepted formula for the valuation of Human Resources in terms of money. Financial statements consider those assets which can be expressed in monetary terms.
8. There are occasions when accounting principles conflict with each other.

## ROLE OF ACCOUNTANT IN THE SOCIETY

### Areas of Service

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|---|---|
| Maintenance of Books of Accounts | An accountant is able to maintain a systematic record of financial transactions in order to establish the net result of the transactions entered into during a period and to state the financial position of the concern as at a particular date |
| Statutory Audit | Every limited company is required to appoint a chartered accountant or a firm of chartered accountants as their auditor who are statutorily required to report each year whether in their opinion the balance sheet shows a true & fair view of the state of affairs on balance sheet date, and Profit & Loss A/c shows a true & fair view of profit or loss for the year. |
| Internal Audit | Now-a-days internal auditing has developed as a service to management. The internal auditor constructively contributes in improving the operational efficiency of the business through an independent review and appraisal of all business operations. |

| | |
|---|---|
| Taxation | An accountant can handle taxation matters of a business or a person and he can represent that business or person before the tax authorities and settle the tax liability under the statute prevailing. He can also assist in avoiding or reducing tax burden by proper planning of tax affairs. |
| Management Accounting and Consultancy Services | Accountant provides management consultancy services in the areas of management information system, expenditure control and evaluation of appraisal techniques for new investments and divestments, working capital management, corporate planning etc. |
| Financial Advice | Some of the areas in which accountant can render financial advice are:<br>➢ Investments<br>➢ Business Expansion<br>➢ Insurance<br>➢ Investigations<br>➢ Pension schemes |
| Other Services | Secretarial Work, Share Registration Work, Company Formation, Receiverships, Liquidations, etc |

## Chartered Accountant in Industry

He works with the functional departments and translates the organisation's aims in terms of financial expectations.

A qualified accountant will be able to play an important role in performing important functions of a business relating to accounting, costing and budgetary control, estimating and treasury.

## Chartered Accountant in Public Sector Enterprises

It is the duty of the accountants to prepare the accounts and reports of these public corporations in such a way that they enable the general public to know how far the items appearing in the various types of records and financial statements justify their existence.

## Chartered Accountant in Framing Fiscal Policies

Accountants have a positive role to play in the determination of proper fiscal policies and advancement of trade, commerce and industry. They should develop new techniques and prepare themselves for new fields of service towards their commitment to the concept of the public goods and services.

## Chartered Accountant and Economic Growth

In the present times accountants should conceive their duties as broadly as the conditions might require and do not restrict them to only literal compliance of the law. Their aim should be not to allow any individual to gain at the cost of the nation. Accountants have to accept a positive role and do their best to encourage efficiency in individual business units and encourage those social objectives which form the main foundation of a welfare state.

## MULTIPLE CHOICE QUESTIONS

1) Which of the following is not a subfield of accounting?
   (a) Management accounting.
   (b) Cost accounting.
   (c) Book-keeping
2) Purposes of an accounting system include all the following except
   (a) Interpret and record the effects of business transaction.
   (b) Classify the effects of transactions to facilitate the preparation of reports.
   (c) Dictate the specific types of business enterprise transactions that the enterprises may engage in.
3) Book-keeping is mainly concerned with
   (a) Recording of financial data.
   (b) Designing the systems in recording, classifying & summarizing the recorded data.
   (c) Interpreting the data for internal and external users.
4) All of the following are functions of Accounting except
   (a) Decision making.
   (b) Ledger posting.
   (c) Forecasting.
5) Financial statements are part of
   (a) Accounting.
   (b) Book-keeping.
   (c) Management Accounting.
6) Financial position of the business is ascertained on the basis of
   (a) Records prepared under book-keeping process.
   (b) Trial balance.
   (c) Balance Sheet
7) Users of accounting information include
   (a) Creditors/Suppliers
   (b) Lenders/ Customers
   (c) Both (a) and (b)
8) Financial statements do not consider
   (a) Assets expressed in monetary terms.
   (b) Liabilities expressed in monetary terms.
   (c) Assets and liabilities expressed in non-monetary terms
9) On January 1, Sohan paid rent of ₹ 5,000. This can be classified as
   (a) An event.
   (b) A transaction.
   (c) A transaction as well as an event.
10) On March 31, 2023 after sale of goods worth ₹ 2,000, he is left with the closing inventory of ₹ 10,000. This is
   (a) An event.
   (b) A transaction.
   (c) A transaction as well as an event.
11) Which of the following is not a business transaction?
   (a) Bought a machine of ₹10,000 for business
   (b) Paid towards salaries of employees ₹ 5,000
   (c) Paid son's fees from her personal bank account ₹ 8,000

12) Which qualitative characteristics of accounting information is reflected when accounting information is clearly presented?
    (a) Understandability
    (b) Relevance
    (c) Comparability

ANSWERS MCQs

1. (c) 2. (c) 3. (a) 4. (b) 5. (a) 6. (c) 7. (c) 8. (c) 9. (b) 10. (a) 11. (c) 12. (a)

## TRUE / FALSE

State with reasons whether the following statement is true or false:

1) There is no difference between book keeping and accounting, both are same.
2) Management Accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.
3) Financial accounting is concerned with internal reporting to managers of business unit.
4) Customers of business should not be considered as users of accounts prepared by business. They are not interested to know performance of the business
5) Summarizing is the basic function of accounting. All business transactions of a financial characters evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account.
6) Balance sheet shows the position of the business on the day of its preparation and not on the future date.
7) Objectives of book-keeping are complete recording of transactions & ascertainment of financial effect on the business.
8) Accounting can be viewed as information system which has its input, processing methods & output.
9) Accounting involves communication.

Solution

1) False: Book-keeping and accounting are different from each other. Accounting is a broad subject. It calls for a greater understanding of records obtained from book-keeping and an ability to analyse and interpret the information provided by book-keeping records. Book-keeping is the recording phase while accounting is concerned with the summarizing phase of an accounting system.
2) False: Financial accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.
3) False: Management accounting is concerned with internal reporting to managers of a business unit.
4) False: Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods
5) False: Recording is the basic function of accounting. Summarising is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements.
6) True: Balance Sheet is a statement of financial position of an enterprise at a given date.
7) True: Book-keeping is concerned with complete recording and combined effect of transactions made during the accounting period.
8) True: Accounting is a processing system whose input is financial transaction and output is financial statement communicating various information to various interested groups.
9) True: Accounting starts only when there is a communication of business transactions to the accounting department. It also communicates the results obtained from arranging of data to interested parties like investors, creditors, employees etc.

# ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

| | Item | Descriptions |
|---|---|---|
| 1. | Accounting Assumptions | (a) "Assumptions" refers to the Fundamental conditions based on which the entire accounting process is carried out.<br>(b) In accounting there are 3 fundamental Accounting Assumptions.<br>(c) For e.g. when a person started a particular business, we assume that the person started the business for continuing it to earn profits and not for closing it. |
| 2. | Accounting Principles | (a) Accounting Principles refers to the set of doctrines associated with the theory and procedures of accounting.<br>(b) They serve as an explanation of currently practices and as a guide for selection of conventions or procedures where alternatives exist.<br>(c) Accounting principles should be- (i) based on real assumptions, (ii) simpler and easily understandable, (iii) consistently followed, (iv) informational to the Users, and (v) able to reflect future predictions. |
| 3. | Accounting Concepts | (a) "Concept" means any idea or notion, which has universal application.<br>(b) Accounting Concepts are the basic conditions which lay down the foundation for formulating the accounting principles.<br>(c) They are clearly defined and supported by reasoning. Certain concepts are perceived, assumed & accepted in accounting to provide a unifying structure and internal logic to accounting process |
| 4. | Accounting Conventions | (a) Accounting Conventions are the general procedures emerging out of usage and practice of accounting principles.<br>(b) Conventions may not have universal application.<br>(c) Denote circumstances or traditions which guide the accountants while preparing the accounting statements.<br>(d) Further, certain conventions may be changed over a period by Accounting Bodies like ICAI, to improve quality of financial statement.<br>(e) Eg: In India, pedestrians walk on the left side and vehicles go on the right side of the road. This is traditionally accepted practice, and everybody follows it |
| Concepts Vs Conventions:<br>(a) Concepts are clearly defined & supported by reasoning while conventions may not be clearly defined.<br>(b) Concepts support the principles whereas Conventions may contradict the principles | | |

Note: Above terms Concepts, Principles & Conventions are sometimes used interchangeably

# LIST OF ACCOUNTING ASSUMPTIONS / CONCEPTS / CONVENTIONS

1. Fundamental Accounting Assumptions: Only 3- (a) Going concern, (b) Consistency and (c) Accrual. (They are also considered as part of accounting concepts)
2. Accounting Concepts:

| | |
|---|---|
| 1. Business Entity | 6. Going Concern |
| 2. Money Measurement | 7. Cost |
| 3. Accounting Period/Periodicity | 8. Realization |
| 4. Accrual | 9. Dual Aspect |
| 5. Matching | 10. Consistency |

3. Accounting Conventions: (a)Consistency (b)Full Disclosure (c)Conservatism (d)Materiality

# FUNDAMENTAL ACCOUNTING ASSUMPTIONS

## 1. Going Concern:

(a) The enterprise is normally viewed as Going Concern, i.e. Continuity in operation for the foreseeable future (endlessly)

(b) It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of reducing substantially its level of operations.

For Example: When we invest in shares of Reliance Company, we normally assume that the Company's operations will be continued. We do not expect the company to be closed.

Exception to Assumption: Joint Venture (Which is created for specific purpose/ period)

(c) Going concern is also considered as one of the accounting concepts.

(d) Based on Going Concern assumption becomes inappropriate (i.e. if the enterprise cannot be taken as a going concern) then assets should be valued at their Net Realizable Value. i.e. if the business is to be closed, then the assets must be valued at Market Values and not at cost.

## 2. Consistency:

(a) Meaning: Accounting principles followed by the entity shall be consistent. i.e., the same over a period of time. Frequent changes in accounting policies will distort comparison.

Example: If one year, a particular payment is treated as expense, then the assumption is that the subsequent years also it shall be treated only as an expense.

(b) Consistency is also considered as one of the accounting concepts.

(c) Exception: As per Consistency Concept, a change in an accounting policy should be made only-

- If the adoption of a different accounting policy is required by Statute, or
- For compliance with an Accounting Standard, or
- If it is considered that the change would result in a more appropriate presentation of the Financial Statement of the enterprises.

## 3. Accrual:

(a) Revenue and Costs are "accrued". i.e, recognized as they are earned or incurred and recorded in the financial Statement of the period to which they relate and not when money received or paid.

Example: If a sale for ₹ 10,000 is made on credit to a person in 2022 but the settlement is received in 2023. In this case ₹ 10,000 shall be treated as income in 2022 (in the year of accrual) and not in 2023. (year of receipt)

(b) Accrual is also treated as one of the Accounting Concepts.

Disclosure Requirements

| If the above assumptions are followed in preparing accounts | If the above assumptions are not followed |
|---|---|
| Separate disclosure is not required, since their acceptance and use are assumed | Disclosure is necessary, specifying that the general accounting assumptions are not followed. |

# ACCOUNTING CONCEPTS & CONVENTIONS

## BUSINESS ENTITY

1. Meaning: The business enterprise is a separate identity and distinct from that of its Owners or Managers. The Owner of the business and the business as such is treated as two different persons.
2. Impact of above concept: All transactions are classified into – (a) Business Transactions, and (b) Personal Transactions. Business transactions are recorded in the books of accounts of the business. Owner's Personal transactions are recorded in his personal book of accounts and not in the books of the business.
3. Example:
   (a) Mr. A is an owner of a CA firm "M/s A & Co." The profits arising from M/s A & Co. belong to Mr. A only. However, for accounting purpose, Mr. A is a different person and M/s A & Co. is a different person.
   (b) Accounting will be done only for the transactions in which M/s A & Co. is involved and not for A's personal transactions.

## MONEY MEASUREMENT

1. Meaning: Accounting data must be quantified so that data can be aggregated and hence summarized; hence, all transactions and events should be measured in terms of money. Transactions are recorded in books of account, in the ruling currency of the country where the books of accounts are prepared.

2. Common unit: A common measuring unit in terms of money helps to (a) quantify data, and (b) enable determination of profit/loss and financial position. For Example the Rupee is the common unit of measurement for economic events and transactions in India. It is the legal tender used as the medium of exchange in market transactions.

3. Criticism of Money Measurement:
   (a) Value of Money erodes over a period of time. Future Cash Flows have a lower value than the Present Cash Flows. Hence money by itself is not a meaning full measurement base.
   Example: One kg of Onion in 2022 was ₹ 40; But the same one kg of onion in 2023 is ₹ 80. This implies that the real value of money has gone down.
   (b) Exchange value of a currency (e.g. Rupee) in relation to other currency is not constant over a time period. Hence, money does not provide a stable measurement yardstick.
   (c) Many material transactions and events are not recorded in the books of accounts just because they cannot be measured in terms of money. E.g. appointment of new Chairman for the company.

4. Impact on Accounting:
   (a) As per Money Measurement Concept, only those transactions which are capable of being measured in terms of money are recorded in the books of accounts, that too in the ruling currency of the country. E.g. in Rupees in India, in Dollars in USA, in Pounds in UK.
   (b) Transactions which are not in monetary terms, even if they affect the results of the business materially, are not recorded in the books of accounts.

Note: Entity & Money Measurement Concepts are basic concepts on which the other procedural concepts depend.

## PERIODICITY OR ACCOUNTING PERIOD

1. Need: As per the Going Concern Assumption, the enterprise has an indefinite life. However, it is necessary to sub-divide such indefinite period into smaller time units for (a) measurement of performance; (b) understanding the financial position of the enterprise and (c) control over operations. Such smaller and usable time-frame for reporting purpose is called Accounting Period.
2. Meaning:
   (a) Hence, during the life-time of an entity, Financial Statement can be prepared in periodic intervals of time. The economic life of an enterprise is split into the periodic interval (being a financial year).
   (b) As per Periodicity Concept, the financial Statements should be prepared after every accounting/ financial period, and not at the end of the life of the entity.
   (c) Generally a period of 12 months (i.e. one year) is considered as the accounting period by most enterprises. In the corporate sector, Interim Financial Reporting is also prevalent. The length is also determined by the statute in certain cases.
   Note: Normally the term "Financial Year" refers to the period for which the accounts are prepared. it is usually taken as the period from 1st April to 31st March of the next year.
3. Periodically Concept facilitates in-
   (a) Comparison of financial statements of different periods.
   (b) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business.
   (c) Matching periodic revenue with expenses for getting correct result of the business operations.

## ACCRUAL

1. Meaning: "Accrual" means recognition of revenue as they are earned and the cost as they are incurred and not when money is received or paid. This concept relates to measurement of income, identifying assets and liabilities.
2. Method: Under Accrual Concept, all transactions and events are recognized on mercantile basis, i.e., as they are earned or incurred, and recorded in the financial statement of the period to which they relate, and not when cash is actually received or paid.
3. As per Accrual Concept, Profits = Revenue Less Expenses
   (a) Revenue = Gross Inflow of Cash, Receivables and other consideration arising in the course of ordinary activities of an enterprise from sale of goods, from rendering services, and from the use by others of enterprise's resources yielding interest, royalties and dividends.
   (b) Expenses = Cost relating to the operations of an accounting period, or to the revenue earned during the period, or the benefits of which do not extend beyond that period.

## MATCHING

1. Meaning:
   (a) The performance of a business entity is measured with reference to a specific accounting period.
   (b) Hence, to determine the profits for a particular period, Revenue earned in that period should be matched with the expenses incurred for earning such revenue.

2. Impact of Matching Concept: As per Matching Concept
   Periodic Profit = Periodic Revenue – Matched Expenses
   From the revenue of an accounting period such expenses are deducted which are expended to generate the revenue to determine profit of that period.

3. Nature of Income / Expenses

| Particular | Income | Expenses |
|---|---|---|
| Inclusions | Sales/Service rendered but money not received (Outstanding Income/Accrued Income) | Services received/ purchases made but money not paid (Outstanding Expenses /Sundry Creditors) |
| Exclusions | Advances received before sale/service is not income (Income received in advance) | Advance paid before purchases made/services received (Prepaid Expenses/Expenses paid in advance) |

4. Impact: The Accrual Concept, together with Periodicity and Matching concepts, give rise to the recognition of (a) Prepaid Expenses (b) Outstanding Expenses (c) Income Receivable and (d) Income Received in advance.

## COST

1. Meaning: As per Cost Concept, Value of asset as shown in balance sheet must be its Historical Cost, i.e. Acquisition Cost. This is the conventionally adopted measurement base for valuation of assets.

2. Significance/Merits:
   (a) Historical Cost is objective and free from bias.
   (b) Historical cost is easier to ascertain than Current Cost, Present Value etc.
   (c) Historical Cost represents an actual figure/out flow of resources for acquiring the asset and does not reflect a hypothetical or notional figure.

3. Criticism: Historical Cost is criticized on the following grounds-
   (a) Historical Cost does not reflect the true value of the assets particularly in an inflationary situation.
   (b) Financial Statement prepared on the basis of cost concept loses comparability.
   (c) Many assets (like Human Resources) do not have acquisition costs. Cost Concept fails to recognize such assets.

Note: Due to the above criticism, other measurement bases like Current Costs, Net Realizable Value, Present Value etc. are suggested.

## REALISATION

1. Meaning: As per Realisation Concept, An asset is recorded at its Historical Cost and any change in its value should only be recognized when it is realized, i.e. at the time of its actual sale/disposal.
2. Concept: It emphasized that there is no certainty of income until a sale has been made and hence increase in value of the assets should not be taken into account unless it is actually realised.
3. Criticism: However, Realisation concept is criticized by arguing that if the value of an asset has been permanently changed, Profit or loss arising out of such change be considered to reflect true and fair financial position of the enterprise. Otherwise, accounting will become distorted and meaningless.

4. Revaluation: So, fixed assets may be revalued periodically. However, selective revaluation of an asset may lead to unrepresentative or misleading amounts being reported in financial statements. Hence revaluation of assets should be done on a systematic basis. for example, all machineries shall be revalued rather than a single machinery.

| |
|---|
| Fair Value: Thus, the Realisation Concept is slowly being replaced by the recognition of assets at their fair market value (Fair value accounting concept). However, Accountants follow a more conservative path. They try to cover all probable losses but do not count probable gains. |

## DUAL ASPECT

1. Meaning: The Dual aspect concept is the core of double entry book-keeping
2. Basis: As per this concept, every transaction or event has two aspects, which have to be recorded in the books and the amounts of both the aspects are equal.
3. The possible combinations of the effect of each transaction is as under-

| 1st Aspect | 2nd Aspect | Example |
|---|---|---|
| Increase in one asset | Decrease in another asset | Purchase of Machine by cash |
| Increase in asset | Increase in liability | Purchase of Machine on credit |
| Decrease in asset | Decrease in liability | Payment of Cash to Creditors |
| Increase in one liability | Decrease in another liability | Creditors paid from bank Overdraft |

4. Significance: This concept give rise to the accounting equation: "CAPITAL + LIABILITIES + ASSETS". This equation can take many forms and some forms are given below

| | | |
|---|---|---|
| Equity (i.e. Capital) + Liabilities | = | Assets |
| Equity + Long term liabilities + Current liabilities | = | Fixed Assets + Current Assets |
| Equity + Long Term Liabilities | = | Fixed Assets + (Current Assets – Current Liabilities) |
| Equity + Long Term Liabilities | = | Fixed Assets + Working Capital |
| Equity | = | Fixed Assets + Working Capital– Long Term Liabilities |
| Note: Closing Capital = Opening capital ( ±) Profits/ (Losses) during the year (+) Additional Capital (-) Drawings (+) Interest on capital (-) Interest on drawings | | |

Note: Capital is otherwise called Equity. Both the sides of equations shall always tally.

## FULL DISCLOSURE

1. Meaning: As per this concept all the events and transactions which are relevant shall be disclosed in the books of accounts and the financial statement. The events may relate to the current or the subsequent accounting periods.
2. Purpose: The users of the financial statements must be aware of all relevant events and transactions to understand real position of the business.
3. Disclosure: It means that a statement describing the event/ transaction (including the amount involved) should be added to the financial statements as a note therein. (Disclosure is not same as accounting. Accounting means Accounting Entries will be passed, whereas in disclosure a mere statement is given Journal Entry not passed.)
   Example: The legal suit filed against a company for violation of copyrights shall be disclosed as part of the financial statements though it cannot be measured accurately.

## CONSERVATISM

1. Meaning:
   (a) Conservatism or Prudence demands that unrealized profits and gain should not be recognized in the accounts. However, provision should be made for all actual and possible losses.
   (b) The accountants should not anticipate income but should provide all possible losses.

2. Application of Conservatism Convention:
   (a) Choice among different methods of valuation: If there is a choice between two methods of valuing an asset, the Accountant should choose a method which leads to the lesser value, e.g. Current Assets are valued at Cost or NRV, whichever is lower
   (b) This concept prohibits Window Dressing. (It means manipulating the financial statements to make them attractive viz. inflating the profits, suppressing expenses, treating revenue expenditure as Capital expenditure etc.)

3. Advantages: This Concept has led to the following qualitative characteristics of Financial Statements – (a) Prudence, (b) Neutrality, and (c) Faithful representation of alternative values.

## MATERIALITY

1. Meaning: As per Materiality Concept, all items having significant economic effect on the business should be disclosed in the financial statement.
2. Material items refer to the items in the financial statements the knowledge of which might influence the decision of the users of financial statement.
3. Factors: Materiality depends on the size and nature of the items or error, judged in the particular circumstances of its misstatement.
4. Advantage: Materiality provides a threshold or cut-off point for classifying the amounts into assets or expenses
5. Exception: This principle is an exception to the full disclosure principle.

## SUBSTANCE OVER LEGAL FORM

1. Meaning: The accounting treatment and presentation in financial statements of transactions and events, should be governed by their substance and not merely by the legal form.

2. For Example:
   (a) Sale of Land & Buildings without Registration: If the Firm has sold its land and Building, received consideration and handed over the possession to the buyer, it should be recorded as sale of land and building this recognition cannot be postponed for mere procedural formality pending e.g registration of sale deed.
   (b) Hire Purchase-Considered as Sale: In case of an asset required on hire purchase, ownership is not transferred till last installment is paid. However, asset is shown in the books of the hire purchaser.

## BASIS OF ACCOUNTING

1. Meaning: "Basis of Accounting" refers to the stage at which incomes and expenses are recorded in the books of accounts.

2. Types: There are 3 basis of Accounting- (a) Cash Basis (b) Accrual Basis and (c) Hybrid Basis.

| Cash Basis | Accrual Basis<br>(Otherwise called as Mercantile Basis) |
|---|---|
| Profit = Cash received in normal course of business (-) Cash paid in normal course of business | Profit = Revenue (earned) (-) Expenses (incurred) |
| Cash Receipts of any year may relate to (a) previous year (b) current year or (c) future years. No distinction is drawn for calculating profits/surplus | When cash and revenue flow at different times, it is treated as under<br>(a) Cash received before revenue is earned<br>= Income Received in Advance = Liability.<br>(b) Cash received after revenue is earned<br>= Income Receivable = Assets |
| Cash payments of any year may relate to – (a) previous years, (b) current year or (c) future years. No distinction is drawn for calculating profits/surplus | When cash and expense are recognized at different times, it is treated as under-<br>(a) Cash paid before expense is incurred= Prepaid expenses = Assets.<br>(b) Cash paid after expense is incurred = Payables / Outstanding Liabilities = Liability |
| Companies Act, 2013 does not permit the use of cash basis of accounting | Companies Act 2013 specifically requires the use of accrual basis of accounting |

Hybrid System or Modified Accrual System: In this method, the revenue is recognized on cash basis and expenses are recognized on Accrual Basis.

## QUALITATIVE CHARACTERSTICS OF FINANCIAL STATEMENTS

Financial Statements are prepared to ascertain the operating results and the financial position of the business. They should have the following features:

| | |
|---|---|
| Relevance | Information must be relevant to the decision-making needs of the users |
| Reliability | Information in financial statements must be reliable, i.e. (a) free from material error and bias, and (b) can be depended upon by the user to faithfully represent the correct position |
| Understandability | Financial statements must be understandable to users. However, the required information should not be excluded, just because it may be complex or difficult for the users to understand. |
| Comparability | Information in financial statements should be comparable (both for inter-firm and intra-firm comparison). This is possible only when consistency concept is applied and accounting policies and changes therein are adequately disclosed |

| | |
|---|---|
| Materiality | All material information should be disclosed in the financial statements. Information is material if its misstatement (i.e. Omission/erroneous) could influence the economic decision of users. |
| Faithful Representation | Information must faithfully represent the transactions & events which it represents. It should represent the balance of assets and liabilities which can be used for analysis in good faith |
| Substance over from | The financial statement should reflect the substance of the transaction than the mere legal form thereof. |
| Neutrality | Information in financial statement must be free from bias, i.e. it should not influence the decision or judgment of the user, in order to achieve a pre-determined results or outcome. |
| Prudence | Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty. Hence assets and incomes should not be over-stated, and liabilities and expenses should not be under-stated. |
| Disclosure | All material items must be fully, fairly and adequately disclosed in the financial statements. Fullness implies nothing material should be omitted. Fairness implies true and fair view of financial statements. Adequacy implies disclosure of proper details and in a sensible manner. |
| Completeness | Information in financial statements must be complete within the limitations set by materiality & cost. An omission can cause information to be misleading, unreliable and irrelevant |

## MULTIPLE CHOICE QUESTIONS

1) All the following items are classified as fundamental accounting assumptions except
   (a) Consistency.
   (b) Business entity.
   (c) Going concern.

2) Two primary qualitative characteristics of financial statements are
   (a) Understandability and materiality.
   (b) Relevance and reliability.
   (c) Neutrality and understandability.

3) Kanika Enterprises follows written down value method of depreciating machinery year after year due to
   (a) Comparability.
   (b) Convenience.
   (c) Consistency.

4) A purchased a car for ₹ 5,00,000, making a down payment of ₹ 1,00,000 and signing a ₹ 4,00,000 bill payable due in 60 days. As a result of this transaction
   (a) Total assets increased by ₹ 5,00,000.
   (b) Total liabilities increased by ₹ 4,00,000.
   (c) Total assets increased by ₹ 4,00,000 with corresponding increase in liabilities by ₹ 4,00,000

5) Mohan purchased goods for ₹15,00,000 and sold 4/5th of the goods amounting ₹18,00,000 and met expenses amounting ₹ 2,50,000 during the year, 2023. He counted net profit as ₹ 3,50,000. Which of the accounting concept was followed by him?
   (a) Entity.
   (b) Periodicity.
   (c) Matching.

6) A businessman purchased goods for ₹ 25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2023. The market value of the remaining goods was ₹ 4,00,000. He valued the closing Inventory at cost. He violated the concept of
   (a) Money measurement.
   (b) Conservatism.
   (c) Cost.

7) Capital brought in by the proprietor is an example of
   (a) Increase in asset and increase in liability.
   (b) Increase in liability and decrease in asset.
   (c) Increase in asset and decrease in liability.

8) During the life-time of an entity, accounting provides financial statements in accordance with which basic accounting concept:
   (a) Conservatism
   (b) Matching
   (c) Accounting period

9) A concept that a business enterprise will not be liquidated in the near future is known as :
   (a) Going concern
   (b) Economic entity
   (c) Monetary unit

10) Assets are held in the business for the purpose of
    (a) Resale.
    (b) Conversion into cash.
    (c) Earning revenue.

11) Revenue from sale of products, is generally, realized in the period in which
    (a) Cash is collected.
    (b) Sale is made.
    (c) Products are manufactured.

12) The concept of conservatism when applied to the balance sheet results in
    (a) Understatement of assets.
    (b) Overstatement of assets.
    (c) Overstatement of capital.

13) Decrease in the amount of trade payables results in
    (a) Increase in cash.
    (b) Decrease in bank overdraft account.
    (c) Decrease in assets.

14) The determination of expenses for an accounting period is based on the principle of
    (a) Objectivity.
    (b) Materiality.
    (c) Matching.

15) Economic life of an enterprise is split into the periodic interval to measure its performance is as per
    (a) Entity.
    (b) Matching.
    (c) Periodicity.

16) If an individual asset is increased, there will be a corresponding
    (a) Increase of another asset or increase of capital.
    (b) Decrease of another asset or increase of liability.
    (c) Decrease of specific liability or decrease of capital.

17) Purchase of machinery for cash
    (a) Decreases total assets.
    (b) Increases total assets.
    (c) Retains total assets unchanged.

18) Consider the following data pertaining to Alpha Ltd:

| | |
|---|---|
| Cost of machinery purchased on 1st April, 2022 | 10,00,000 |
| Installation charges | 1,00,000 |
| Market value as on 31st March, 2023 | 12,00,000 |

While finalizing the annual accounts, if the company values the machinery at ₹ 12,00,000. Which of the following concepts is violated by the Alpha Ltd.?
    (a) Cost.
    (b) Matching.
    (c) Accrual.

## ANSWERS MCQs

1. (b) 2. (b) 3. (c) 4. (c) 5. (c) 6. (b) 7. (a) 8. (c) 9. (a) 10. (c) 11. (b) 12. (a) 13. (c) 14. (c) 15. (c) 16. (b) 17. (c) 18. (a)

## TRUE / FALSE

State with reasons whether the following statement is true or false:

1) The concept helps in keeping business affairs free from the influence of the personal affairs of the owner is known as the matching concept.
2) Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.
3) Accrual means recognition as money is received or paid and not of revenue and costs as they are earned or incurred.
4) The Conservatism Concept states that no change should be counted unless it has materialized.
5) The concept of consistency implies non-flexibility as not to allow the introduction of improved method of accounting.
6) The materiality depends only upon the amount of the item and not upon the size of the business, nature and level of information, level of the person making the decision etc.
7) Accrual basis of accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.
8) The financial statements are not prepared on the assumption that an enterprise is a going concern and will continue its operation for the foreseeable future. *(Dec 2022)*
9) A concern proposes to discontinue its business from December 2020 and decides to dispose of all its plants within a period of 3 months. The Balance Sheet as on 31$^{st}$ December 2020 should continue to indicate the plants at its historical costs as the assets will be disposed off after the Balance Sheet date. *(Nov 2020)*
10) As per the concept of conservatism, the accountant should provide for all possible losses, but should not anticipate income. *(June 2023)*
11) Revenues are matched with expenses in accordance with the matching principle.
12) The financial statement must also disclose the relevant and reliable information in accordance with the Full Disclosure Principle.
13) The concept of conservatism when applied to the balance sheet results in understatement of assets.
14) Accrual concept implies accounting on cash basis.
15) Accounting principle is general rule followed in preparation of Financial Statements.
16) In double entry accounting, all business transaction are recorded as having dual aspect.
17) Transactions and events are guides by generally accepted accounting principles
18) The value of human resources is generally shown as assets in the Balance Sheet.
19) The results and position disclosed by final accounts are not exact.

## Solution

1) False: Under 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.
2) True: Since the owner invested capital, he has claim on the profits of the enterprise.
3) False: Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
4) False: The Realisation Concept also states that no change should be counted unless it has materialised.

5) False: The concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.
6) False: As per materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements
7) False: Cash Basis of Accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.
8) False: 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.
9) False: If the fundamental accounting assumption of going concern is not followed, then the assets and liabilities should be stated at realizable value not historical cost.
10) True: Concept of conservation states that all the accountants should not anticipate income and should provide for all possible losses.
11) True: The matching concept involves that the revenue earned in an accounting year is matched with the expenses incurred during the same period to generate that revenue.
12) True: The financial statement must also disclose the relevant and reliable information
13) True: Conservatism states that the accountant/entity should not anticipate any future income. However they should provide for all possible / probable losses. Use of this concept leads to understatement of income & assets.
14) False: Accrual concept implies accounting done on due or accrual basis. It involves the recognition of revenues and costs as they accrue irrespective of the actual receipts or payments.
15) True: Accounting principles suggests the rules of action, which are universally accepted by the accountants for the recording of accounting transactions.
16) True: In double entry book-keeping system, every transaction has a dual aspect or a twofold effect in accounting where one account is debited by an amount and the other is credited by the same.
17) True: Every country adopts some generally accepted accounting principles and the transactions and events are guided by those principles.
18) False: The value of human resources cannot be measured in monetary terms, thus it will not be shown in the balance sheet.
19) True: They are prepared on the basis of assumptions, conventions, concepts and personal judgements of the person who prepare them.

# CAPITAL & REVENUE EXPENDITURE AND RECEIPTS

## CAPITAL EXPENDITURE VS REVENUE EXPENDITURE

| Particulars | Capital Expenditure | Revenue Expenditure |
|---|---|---|
| Meaning | It is expenditure incurred for the purpose of-<br>(a) Purchase/ Creation / Improvement of Fixed Assets<br>(b) Expenses necessary for the above purchase / Creation<br>(c) Increasing the earning capacity of business. | It is an expenditure, the benefit of which is immediately (normally within one year) exhausted in the process of earning revenue. |
| Period of benefit | Any expenditure incurred to provide a benefit over a long-term period is capital expenditure. | Any expenditure incurred to provide benefit during the current period is revenue expenditure. |
| Enhancement vs Maintenance | Capital expenditure is incurred for the purpose of increasing the capacity of the business. Alternatively, it also includes an expenditure to reduce the costs of the business | Revenue expenditure is incurred to maintain the earning capacity of the business. |
| Examples | Purchase of machine, car, furniture, etc. | Repairs and maintenance, salary of accounting staff, etc. |
| Treatment in Financial Statement | Capital Expenditure is shown as asset in Balance Sheet. Only depreciation portion is debited to P&L A/c. | Expenditure is charged fully in the Profit and Loss Account. |

## CRITERIA / CONSIDERATIONS FOR CAPITAL VS REVENUE

Whether an expenditure is Capital or Revenue in nature, depends upon the following factors-

| Factor | Capital Expenditure if..... | Revenue Expenditure if....... |
|---|---|---|
| Nature of Business | Expenditure relates to purchase of a Fixed Asset (e.g. Furniture purchased by a trader). | Expenditure relates to purchase of a Current Asset (e.g. Furniture purchased by a trader dealing in furniture). |
| Recurring Nature | Expenditure is incurred infrequently, or once in 2-5years (e.g. purchase of assets.) | Expenditure is incurred frequently / regularly, in the normal course of business (e.g. Salary, Rent, etc.) |
| Purpose of Expenses | Expenditure is for acquiring / creating capital assets or increasing their productive capacity. | Expenditure is for maintaining the capital assets. |
| Period of Benefit | Expenditure helps to generate revenue over more than one accounting period | Expenditure helps to generate income / revenue in the current period only. |
| Materiality | Expenditure is material / significant. | Expenditure is not material, i.e. insignificant. |

## EXAMPLES FOR CAPITAL AND REVENUE EXPENDITURES

| Capital Expenditure | Revenue Expenditure |
|---|---|
| 1. Purchase of Fixed Asset (Land, Building, etc.)<br>2. Purchase of Second hand Asset (e.g. Vehicle, Furniture, etc.)<br>3. Overhaul Expenses to put secondhand machinery in working condition.<br>4. Repairing & Painting of Old Building purchased recently by the Firm.<br>5. Expenditure incurred to reduce working expenses / operating expenses which generate long term benefits to the entity<br>6. Legal Fee paid to acquire new property.<br>7. Licence Fee paid by Cinema Theatre to commence its business.<br>8. Cost of constructing Temporary Huts which were necessary for Factory Building Construction, which were demolished when the Factory was ready. | 1. Expenditure for replacement of worn—out part of an existing asset.<br>2. Regular Advertisement Expenses in respect of products and services.<br>3. Expenditure on removal of stock to new site.<br>4. Legal Fees incurred to file suit against a Customer from whom money is due. |

## CAPITAL VS REVENUE RECIEPTS

| Particulars | Capital Receipt | Revenue Receipt |
|---|---|---|
| Meaning | Capital Receipts refer to receipts other than Revenue Receipts. | Revenue Receipts are moneys received in course of normal business activities and are recurring in nature. |
| Example | Capital contribution by Owner, Issue of Shares /Debentures, Sale Proceeds of Fixed Assets, etc. | Sales, Interest and Other Income Received, Bad Debts Recovered, etc. |
| Purpose | Capital Receipts relate to specific purpose, e.g. Capital Contribution for commencing business or expanding business, Loans taken for acquiring Fixed Assets, etc. | Revenue Receipts relate to general business purpose and are not specifically identifiable to any purpose as such. |
| Effect on Profit | Capital Receipts do not affect profit. | Revenue Receipts have a direct impact on the profits. |
| Disclosure | They are shown as Liability or Reduction from the Asset in the Balance Sheet. | They are shown on the Credit Side of the Profit and Loss Account. |

**Question 1** *(ICAI Study Material)*

State with reasons whether the following statements are 'True' or 'False'.

(1) Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.
(2) Money spent to reduce working expenses is Revenue Expenditure.
(3) Legal fees to acquire property is Capital Expenditure.
(4) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.

(5) Amount spent for replacement of worn out part of machine is Capital Expenditure.
(6) Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.
(7) Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.
(8) Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.

Solution:
(1) False: Overhaul expenses are incurred to put second-hand machinery in working condition to derive endurable long-term advantage. So it should be capitalised.
(2) False: It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. So this is capital expenditure.
(3) True: Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.
(4) False: Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
(5) False: Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
(6) False: Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are part of the cost of building. Accordingly, these are capital expenditure.
(7) True: Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.
(8) True: Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised

**Question 2** *(ICAI Study Material)*

State with reasons whether the following are Capital or Revenue Expenditure:
(1) Expenses incurred in connection with obtaining a license for starting the factory for ₹ 10,000.
(2) ₹ 1,000 paid for removal of Inventory to a new site.
(3) Rings and Pistons of an engine were changed at a cost of ₹ 5,000 to get fuel efficiency.
(4) Money paid to Mahanagar Telephone Nigam Ltd. ₹ 8,000 for installing telephone in the office.
(5) A factory shed was constructed at a cost of ₹ 1,00,000. A sum of ₹ 5,000 had been incurred in the construction of temporary huts for storing building material.

Solution:
(1) Money paid ₹ 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.
(2) ₹ 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.

(3) ₹ 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.
(4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.
(5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

## Question 3 *(ICAI Study Material)*

Best Tech Solutions buys and sells computers as a part of its business. It purchased 20 computers for resale to its customers. Cost of each computer is ₹ 20,000. It also purchased a computer costing ₹24,000 for its accountant to be able to maintain the accounting records and printing of invoices. Suggest whether above transactions qualify as capital expenditure or revenue expenditure transactions?

Solution:

Best Tech Solutions is in the business of buying and selling of computers. Any computers purchased for resale to its customers will qualify as revenue expenditure. Hence, a purchase of 20,000 x 20 = ₹4,00,000 will be a part of revenue expenditure. At the same time, the computer purchased for maintaining the records and invoicing is to be able to operate the business for a longer period of time. Therefore, the purchase of ₹24,000 qualifies as a capital expenditure. This amount will be a part of assets in the Balance Sheet.

## Question 4 *(ICAI Study Material)*

State with reasons whether the below items relating to the business of AB Ltd are capital or revenue receipts?

(a) A machine with a book value of ₹ 10 lakh is sold for ₹ 12 lakh.
(b) Premium amounting to ₹ 1 Lakh received on issue of shares.
(c) An amount of ₹ 20,000 received from goods sold in cash.
(d) An amount of ₹ 5 lac received on the maturity of fixed deposit from bank. Also, an interest of ₹40,000 was received in addition to the maturity amount of the fixed deposits.

Solution:

(a) The amount of ₹ 12 lac is a capital receipt. There is a profit on sale of the machine to the extent of ₹ 2 lac (12 – 10)
(b) Premium received on issue of shares is an example of capital receipt.
(c) Amount received from cash sale is a revenue receipt.
(d) Amount received on the maturity of fixed deposit is the recovery of the deposit amount and is a capital receipt. Interest income is an example of revenue receipt.

## Question 5 *(ICAI Study Material)*

Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the first year ending 31st March, 2023.

a) Second-hand furniture worth ₹ 9,000 was purchased; repainting of the furniture costs ₹ 1,000. The furniture was installed by own workmen, wages for this being ₹ 200.

b) Expenses in connection with obtaining a license for running the cinema worth ₹ 20,000. During the course of the year the cinema company was fined ₹ 1,000, for contravening rules. Renewal fee ₹ 2,000 for next year also paid.
c) Fire insurance, ₹ 1,000 was paid on 1st October, 2022 for one year.
d) Temporary huts were constructed costing ₹ 1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready.

Point out how you would classify the above items.

Solution:

a) The total cost of the furniture should be treated as ₹ 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use.
b) License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of ₹ 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.
c) Half of the insurance premium pertains to the year beginning on 1st April, 2023. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.
d) Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

## Question 6 *(ICAI Study Material)*

State with reasons, how you would classify the following items of expenditure:

1) Overhauling expenses of ₹ 25,000 for the engine of motor car to get better fuel efficiency.
2) Inauguration expenses of ₹ 25 lacs incurred on the opening of a new manufacturing unit in an existing business.
3) Compensation of ₹ 2.5 crores paid to workers, who opted for voluntary retirement.

Solution:

1) Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long-term advantage. So this expenditure should be capitalised.
2) Inauguration expenses incurred on the opening of a new unit may help to explore more customers This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.
3) The amount paid to workers on voluntary retirement is in nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

## Question 7 *(ICAI Study Material)*

Classify the following expenditures and receipts as capital or revenue:

(i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.
(ii) Amount received from Trade receivables during the year.
(iii) Amount spent on demolition of building to construct a bigger building on the same site.
(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 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.

## MULTIPLE CHOICE QUESTIONS

1) Money spent ₹ 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is
   (a) Capital expenditures
   (b) Revenue expenditures
   (c) Prepaid revenue expenditures

2) Amount of ₹ 5,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is
   (a) Capital expenditures
   (b) Revenue expenditures
   (c) Prepaid revenue expenditures

3) Entrance fee of ₹ 2,000 received by Ram and Shyam Social Club is
   (a) Capital receipt
   (b) Revenue receipt
   (c) Capital expenditures

4) Subsidy of ₹ 40,000 received from government for working capital by a manufacturing concern is
   (a) Capital receipt
   (b) Revenue receipt
   (c) Capital expenditures

5) Insurance claim received on account of machinery damaged completely by fire is
   (a) Capital receipt
   (b) Revenue receipt
   (c) Capital expenditures

6) Interest on investments received from UTI is
   (a) Capital receipt
   (b) Revenue receipt
   (c) Capital expenditures

7) Amount received from IDBI as a medium term loan for augmenting working capital is
   (a) Capital expenditures
   (b) Revenue expenditures
   (c) Capital receipt

8) Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which
   (a) The sale is made.
   (b) The cash is collected.
   (c) The products are manufactured.

9) If repair cost is ₹ 25,000, whitewash expenses are ₹ 5,000, (both these expenses relate to presently used building) cost of extension of building is ₹ 2,50,000 and cost of improvement in electrical wiring system is ₹ 19,000; the amount to be expensed is
   (a) ₹ 2,99,000.
   (b) ₹ 44,000.
   (c) ₹ 30,000.

### ANSWERS MCQs

1. (a) 2. (b) 3. (a) 4. (b) 5. (a) 6. (b) 7. (c) 8. (a) 9. (c)

## TRUE / FALSE

State with reasons whether the following statement is true or false:

1) The nature of business is not an important criteria in separating an expenditure between capital and revenue.
2) Expenditure incurred for major repair of the asset so as to increase its productive capacity is Revenue in nature.
3) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.
4) Amount spent for replacement of worn out part of a machine is Capital Expenditure. *(June 2022)*
5) Legal fees to acquire property is Capital Expenditure.
6) Amount spent for the construction of temporary huts, which were necessary for construction of the cinema house and were demolished when the cinema house was ready, is Capital Expenditure. *(May 2019)*
7) Wages paid for erection of machinery are debited to Profit and Loss account.
8) Amount paid for acquiring goodwill is revenue expenditure.
9) Overhead expenses of second hand machinery purchased are revenue expenditure.
10) Motor repairs charges including replacement of certain worn out parts incurred before using a second hand car purchased recently is a capital expenditure.
11) An expenditure intended to benefit beyond the current period is revenue expenditure.
12) Expenditure which results in acquisition of a permanent asset of enduring benefit to the business is capital expenditure.
13) Wages paid to workers to produce a tool to be captively consumed is capital expenditure.
14) Expenses incurred on white-washing of factory building after every 6 months are revenue expenditure.
15) Temporary shed put up at project site to house materials is a capital expenditure.
16) Heavy advertising to introduce a new product is a capital expenditure.
17) Expenditure on renovation of a theatre which has increased the seating capacity by 10% is revenue expenditure.
18) Travelling expenses of ₹ 80,000 paid to a technician for the installation of a new machine is debited to Profit and Loss Account.
19) Amount paid to Management company for consultancy to reduce the working expenses is capital expenditure if the reduced working expenses will generate long term benefits to the entity.
20) Expenses in connection with obtaining a license for running the Cinema Hall is Revenue Expenditure *(May 2018) / (June 2023)*
21) Overhauling expenses for the engine of motor car to get better fuel efficiency is revenue expenditure. *(Nov 2018)*
22) M/s. XYZ & Co. runs a café. They renovated some of the old cabins. Because of this renovation some space was made free & number of cabins was increased from 15 to 18. The total expenditure incurred was ₹ 30,000 and was treated as a revenue expenditure. *(Nov 2019)*
23) Insurance claim received on account of plant and machinery completely damaged by fire is a capital receipt. *(Nov 2020)*
24) Subsidy received from the government for working capital by a manufacturing concern is a revenue receipt. *(Jan 2021)*
25) Any amount spent to minimize the working expenses is revenue expenditure. *(Dec 2021)*
26) Expenses incurred on the repairs for the first time on purchase of an old building are capital expenditure. *(Dec 2021)*
27) Sale of office furniture should be credited to Sales A/c.

## Solution

1) False: The nature of business is a very important criteria in separating an expenditure between capital and revenue. For example- 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.
2) False: Expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.
3) False: Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
4) False: Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
5) True: Legal fee paid to acquire any property is a part of cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.
6) True: Since temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised
7) False: - It is a capital expenditure and hence should be debited to Machinery A/c.
8) False: - It is a capital expenditure since it involves acquisition of an intangible asset, which is a fixed asset.
9) False: - Such expenses are incurred to derive long-term benefits of enduring nature. So it is a capital expenditure.
10) True: - As these charges were incurred to derive a long-term benefit.
11) False: - Revenue expenditure is that expenditure which benefits the period in which it is incurred i.e. current period.
12) True: - Because it will generate enduring benefits and help to generate revenue for more than one accounting period.
13) True: - Wages paid to workers for creating an asset to be used in business is capital expenditure.
14) True: - As they are incurred in the normal maintenance course of the asset.
15) True: - Because it is incidental to the main construction and the expenditure on it is a part of construction cost.
16) False: - Since it does not create any property of tangible or intangible nature
17) False: It is a capital expenditure as it has contributed to the revenue earning capacity of the business over more than one accounting period.
18) False: It is a capital expenditure since it has been incurred to put the asset in working condition.
19) True: Amount paid to management company for consultancy to reduce the working expenses is capital expenditure as this expenditure will generate long-term benefit to the entity.
20) False: The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalized. Such expenses are not revenue and amortized over a period of time.
21) False: Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long-term advantage. So this expenditure should be capitalised.

22) False: 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.
23) True: Insurance claim received on account of plant and machinery completely damaged by fire is a capital receipt as it is not obtained in course of normal business activities.
24) True: Subsidy received from the government for working capital by a manufacturing concern is a revenue receipt because it has no effect on improvement of future capability of business in revenue generation.
25) False: It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. So this is capital expenditure.
26) True: Repairs for the first time of an old building are incurred to put the building in usable condition. This is a part of the cost of building. Accordingly, this is a capital expenditure.
27) False: It should be credited to Furniture A/c because it is a capital receipt.

# CONTINGENT ASSETS AND CONTINGENT LIABILITIES

## GLOSSARY OF SIGNIFICANT TERMS

| | |
|---|---|
| Contingency | A situation, which has not actually occurred but which is expected to happen in the near future. |
| Liability | Obligation to pay for any expenses / losses i.e. It represents outflow of business resources. Present financial obligation of an enterprise which arises from past events. |
| Probable | Chance of occurrence of an event is 50%. i.e. an event is more likely to happen |
| Possible | Chance of occurrence of an event is < 50% i.e. an event may or may not happen. It cannot be determined. |
| Present Obligation | An obligation which is probable i.e. it is more than likely that such obligation exists on the date of balance sheet is called "Present Obligation" |
| Possible Obligation | An obligation which is not probable i.e. on the balance date, it is not likely that such obligation may arise in future |

## PROVISIONS

| | |
|---|---|
| Meaning | A Provision is "a Present Obligation, as a result of past events, which leads to probable outflow of resources embodying economic benefits and a reliable estimate of the amount of the obligation can be made" |
| Features | (a) Provision is a present liability of a certain / uncertain amount.<br>(b) Provision can be reasonably measured using a substantial degree of estimation. |
| Treatment | Provision should be recognized in the Books of Account. |
| Impact on Profits | Provision represents liability for expense/loss; So, Provision reduces the profit. |
| Journal Entry | Debit - Profit and Loss A/c Dr.<br>Credit - To Provisions for Liabilities A/c |
| Reasoning | Debit Aspect: Provision is an expense / loss, which reduces the profits of the enterprise Hence, Profit and Loss A/c is debited. (Debit all expenses and losses)<br>Credit Aspect: Provision is a liability payable in future. Hence, it is credited |
| Balance Sheet | Provision is either shown (a) on the liabilities side (or) (b) on the assets side - as a deduction from the relevant asset. |
| Examples | (a) Provision for Guarantees Given, when the original debtor becomes insolvent.<br>(b) Provision for Warranties<br>(c) Provision for Discount on Debtors<br>(d) Provision for Bad and Doubtful Debts |

## CONTINGENT LIABILITY

A Possible Obligation
That arises from past events and the existence of which will be confirmed only by the occurrence or non—occurrence of one or more uncertain future events not wholly within the control of the enterprise

Or

Present Obligation
That arises from past events but is not recognized because —
- it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or

reliable estimate of the amount of obligation cannot be made.

Note: Possible Obligation is always a Contingent Liability, whereas Present Obligation becomes a Contingent Liability if the recognition criteria of Provision are not satisfied.

| Elements | | Cases | | | | |
|---|---|---|---|---|---|---|
| 1. | Possible obligation | X | X | X | X | √ |
| 2. | Present obligation from past events | √ | √ | √ | √ | NA |
| 3. | Expected outflow | √ | √ | X | X | NA |
| 4. | Measurability<br>(using substantial degree of estimation) | √ | X | √ | X | NA |
| 5. | Whether: Provision(P) or Contingent Liability (CL) | P | CL | CL | CL | CL |

## FEATURES OF CONTINGENT LIABILITY

| | |
|---|---|
| 1. Recognition | An Enterprise should <u>NOT RECOGNISE</u> a Contingent Liability. |
| 2. Disclosure | A Contingent Liability should be <u>DISCLOSED in the notes to accounts</u> unless possibility of outflow of a resource embodying economic benefits is remote. |
| 3. Periodical Review | Contingent Liability should be periodically reviewed. On such review, if the character of the Contingent Liability is found to be changed and there is a probable outflow of resources, then it will be recognized as Provision and treated accordingly. |
| 4. Impact | Contingent Liability will NOT AFFECT the profits of the concern, as it is not accounted in Books. |
| 5. Examples | • Claims against the business, not acknowledged as debts<br>• Guarantees given, if the principal debtor is solvent<br>• Uncalled Liability on Partly Paid shares<br>• Arrears of Fixed Cumulative dividends<br>• Liability on Bills Discounted |

## CONTINGENT ASSETS

| | |
|---|---|
| 1. Meaning | A Contingent Asset is a POSSIBLE ASSET that arises from past events, existence of which will be confirmed only by occurrence / non-occurrence of one or more uncertain future events, not wholly within the control of the enterprise. |

| | |
|---|---|
| 2. Treatment | An enterprise SHOULD NOT RECOGNISE a Contingent Asset due to CONSERVATISM Convention. Because this may result in recognition of income that may never be realized. |
| 3. Impact | Contingent Assets will not affect the profits of the enterprise as it is not accounted in the books. |
| 4. Certainty | If the realisation of income is certain, then it is not a Contingent Asset and the same shall be recognized in the Financial Statements. |
| 5. Disclosure | Contingent Assets should not be disclosed in the Financial Statements but may be disclosed in the Report of the Approving Authority. |
| 6. Examples | • Unplanned or unexpected events leading to possibility of inflow of economic benefits<br>• Expected Gain from a legal suit.<br>• Insurance claims for damage of a property |

## PRINCIPLES BEHIND PROVISIONS, CONTINGENT LIABILITIES AND ASSETS

| Nature | Principle |
|---|---|
| 1. Provision | Matching Concept, Conservatism Convention |
| 2. Contingent Liability | Full Disclosure Concept |
| 3. Contingent Asset | Conservatism Convention |

## MULTIPLE CHOICE QUESTIONS

1) Contingent asset usually arises from unplanned or unexpected events that give rise to
   (a) The possibility of an inflow of economic benefits to the business entity.
   (b) The possibility of an outflow of economic benefits to the business entity.
   (c) Either (a) or (b).

2) If an inflow of economic benefits is probable then a contingent asset is disclosed
   (a) In the financial statements.
   (b) In the report of approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).
   (c) In the cash flow statement.

3) In the case of __________, 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.
   (a) Liability
   (b) Provision
   (c) Contingent liabilities

4) Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as _______.
   (a) Provision.
   (b) Liability.
   (c) Contingent liability.

5) In the financial statements, contingent liability is
   (a) Recognised.
   (b) Not recognised.
   (c) Adjusted.

ANSWERS MCQs

1. (a) 2. (b) 3. (c) 4. (a) 5. (b)

## TRUE / FALSE

State with reasons whether the following statement is true or false:

1) A contingent liability need not be disclosed in the financial statements.
2) A Provision fails to meet the recognition criteria.
3) A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent liability. *(June 2022)*
4) When it is probable that the firm will need to pay off the obligation, this gives rise to Contingent liability.
5) Present financial obligation of an enterprise, which arises from past event is termed as contingent liability.

## Solution

1) False: A Contingent liability is required to be disclosed unless possibility of outflow of a resource embodying economic benefits is remote.
2) False: A contingent liability fails to meet the recognition criteria.
3) False: A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset
4) False: When it is probable that the firm will need to pay off the obligation, this gives rise to provision.
5) False: Present Financial obligation of an enterprise, which arises from past events is termed as liability

# ACCOUNTING POLICIES

## MEANING

1. Accounting Policies refer to – (a) The specific accounting principles and (b) the methods of applying those principles adopted by the enterprises in the preparation and presentation of financial statements.
2. Example: Inventory is valued at Cost or Net Realizable Value, whichever is lower. This is a principle. Cost can be determined either by First in First Out (FIFO) method or Weighted Average Cost (WAC) or other suitable methods.
3. Need for disclosure: Accounting Policies should be disclosed in the Financial Statements due to the following reasons-
   (a) To promote better understanding of financial Statements
   (b) To provide meaningful Inter-Firm Comparison.
   (c) To ensure compliance with Law, for example In case of Companies, disclosure is mandatory.

## CHOICE OF ACCOUNTING POLICIES

1. Alternative accounting policies: The different circumstances in which enterprises operate and the situation of diverse and complex economic activities of the company has given rise to acceptability of alternative accounting principles & methods of applying those principles.
2. Decision Making: The choice of the alternatives principles & methods calls for considerable judgment by the management of the enterprises.
3. Reduction in alternatives: Various statements issued by ICAI, together with the measures of Governments, other regulatory agencies, etc. has reduced the number of acceptable policies can at best be reduced, not eliminated, as different enterprises operate in differing circumstances.
4. Illustration List of areas of alternative accounting policies.
   (a) Conversion or translation of foreign Currency items.
   (b) Treatment of – (i) Expenditure during construction.
   (c) Valuation of – (i) Inventories, (ii) Investments.

Note: Generally Companies disclose these accounting policies in the Notes of Accounting.

## PRINCIPLES FOR SELECTION OF ACCOUNTING POLICIES

1. True and Fair View: Primary consideration in the selection of Accounting Policies is that financial statements prepared & presented should represent a true & fair view as under-

| | |
|---|---|
| Balance sheet | Of the State of Affairs of the enterprises as on a certain date. |
| Profit & Loss Account | Of the Profit or Loss for the period ended on that date. |

2. Factors: To select & apply accounting policy, the following points are considered (Secondary Consideration)

| | | |
|---|---|---|
| (a) Prudence | (b) Substance over form | (c) Materiality |

3. Change in Accounting Policies: Accounting policies have to be consistent from year to year. However, change in accounting policies can be made in the following situations-
   (a) If the adoption of a different accounting policy is required by Statute, or
   (b) For compliance with an Accounting Standard, or
   (c) If it is considered that the change would result in a more appropriate presentation of the financial Statements.

## DISCLOSURE OF ACCOUNTING POLICIES

1. Disclosure of Accounting Policies: All significant accounting policies adopted in the preparation and presentation of financial statement should be disclosed to facilitate better understanding of the financial statements.
2. Place of Disclosure: Disclosures should form part of the financial Statements. It should be disclosed at one place, instead of being scattered over several statements.
3. Change in Accounting Policies: Change in an accounting policy should be disclosed-
   (a) When such change has a material effect in the current period and
   (b) When such change is reasonably expected to have a material effect in later periods.
4. Manner of Disclosure of change in accounting policies:

| Effect in Current Period | Expected Effect in later periods |
|---|---|
| • Impact of change on Profit/Loss & Balance Sheet items in the current period should be quantified, to the extent ascertainable.<br>• Where quantification is not possible, either wholly or in part, the fact should be disclosed | • The fact of such change, and<br>• The fact that it is likely to have effect in later periods.<br>Should be appropriately disclosed in the period in which the change is adopted |

Case:

"Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the help of an example.

Answer

Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. 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 like assets, liabilities, profit/loss.

Examples in this regard may be given as follows: "Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads."

## MULTIPLE CHOICE QUESTIONS

1) A change in accounting policy is justified
   (a) To comply with accounting standard and law.
   (b) To ensure more appropriate presentation of the financial statement of enterprise.
   (c) All of the above.

2) Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or net realizable value. Which accounting principle is followed in adopting the above policy?
   (a) Materiality.
   (b) Prudence.
   (c) Substance over form.

3) The areas wherein different accounting policies can be adopted are
   (a) Providing depreciation.
   (b) Valuation of inventories.
   (c) Both the options

4) Selection of an inappropriate accounting policy decision may
   (a) Overstate the performance and financial position of a business entity.
   (b) Understate/overstate the performance and financial position of a business entity.
   (c) Overstate the performance of a business entity.

5) Accounting policies refer to specific accounting
   (a) Principles.
   (b) Methods of applying those principles.
   (c) Both (a) and (b).

ANSWERS MCQs

1. (c) 2. (b) 3. (b) 4. (b) 5. (c)

## TRUE / FALSE

State with reasons whether the following statement is true or false:

1) There is a single list of accounting policies, which are applicable to all enterprises in all circumstances.
2) Selection of accounting policy doesn't impact financial performance and financial position of the business.
3) A change in accounting policies should be made as and when business like to show result as per their choice.
4) Choosing FIFO or weighted average method for inventory valuation is selection of accounting policy.
5) Selection of an inappropriate accounting policy decision will overstate the performance and financial position of a business entity every time.

### Solution

1) False: There cannot be single list of accounting policies, which are applicable to all enterprises in all circumstances. There would always be different policies chosen by different industries under different circumstances.
2) False: Accounting policy has big impact on value of items goes under financial statements, hence it impacts financial performance and financial position of the business.

3) False: A change in accounting policies should be made in the following conditions:
   (a) It is required by some statute or for compliance with an Accounting Standard.
   (b) Change would result in more appropriate presentation of financial statement.
4) True: An enterprise may adopt FIFO or weighted average method for inventory valuation and the method selected for valuation is called an accounting policy.
5) False: It could understate/overstate the performance and financial position of a business entity.

# ACCOUNTING AS A MEASUREMENT DISCIPLINE - VALUATION PRINCIPLES, ACCOUNTING ESTIMATES

## ELEMENTS OF MEASUREMENT DISCIPLINE

Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Measurement is the process of determining money value at which an element can be recognized in the balance sheet or statement of profit & loss.

The 3 elements of Measurement discipline and how accounting satisfies these elements are as under-

| Elements / Conditions | Does Accounting satisfy the condition? |
|---|---|
| 1. Identification of objects or events to be measured | Financial transactions & events are measured in accounting. Non-financial transactions, however significant are not considered |
| 2. Selection of Standard or Scale to be used. | The ruling currency of the country is used as the basis of money measurement, in accounting, however:<br>(a) Money is not a stable scale having universal applicability.<br>(b) Exchange rates between different currencies are not constant. |
| 3. Evaluation of dimension of measurement standard | Money as a valuation base loses its value over period time. Hence, it is not stable in the dimension. |

Conclusion: However, Accounting is not an exact measurement discipline because accounting measures information mostly in money terms which is (a) not a stable scale. (b) Not having universal applicability and (c) not stable in dimension for comparison over time

## MEASUREMENT BASES (OR VALUATION PRINCIPLES) IN ACCOUNTING

The measurement bases or valuation principles used in accounting are-

| Base | Valuation Rule for | |
|---|---|---|
| | Assets | Liabilities |
| 1. Historical cost | Cash or Cash equivalent paid at the time of acquisition | Proceeds received in exchange for the obligation or the amount of cash/ cash equivalent expected to be paid to satisfy it in the normal course of business |
| 2. Current Cost (PURCHASE ANGLE) | Cash and cash equivalent which is to be paid if same or an equivalent asset was acquired currently | Undiscounted amounts of cash and cash equivalent that would be required to settle the obligation currently |
| 3. Realisable Value (SALE ANGLE) | Cash or cash equivalent that could currently be obtained by selling the assets in an orderly disposal | Undiscounted amounts of cash & cash equivalent that would be required to settle obligation in normal course of business |
| 4. Present Value | Present Discounted Value of cash inflows expected to be derived from such assets over its useful life | Present Discounted value of cash outflows expected to be required to settle the liabilities in the normal course of business |

Note: Different measurement bases are used according to suitability (i.e. the situational need) to depict the true and fair view of the financial position of the reporting entity.

Example:

Mohan purchased a machinery amounting ₹ 10,00,000 on 1st April, 2005. On 31st March, 2023, similar machinery could be purchased for ₹ 20,00,000 but the realizable value of the machinery (purchased on 1.4.2005) was estimated at ₹ 15,00,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹ 12,00,000.

1) The current cost of the machinery is (a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 15,00,000.
2) The present value of machinery is (a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 12,00,000.
3) The historical cost of machinery is (a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 15,00,000.
4) The realizable value of machinery is (a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 15,00,000.

## ACCOUNTING ESTIMATES

(a) Meaning: "Accounting Estimate" means an approximation of the amount of an item in the absence of a precise means of measurement.

As a result of uncertainties inherent in business activities, many financial statement items cannot be measured with precisions but can only be estimated. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

(b) Example:

- Estimate of bad debts
- Useful life and Residual value of depreciable assets
- Estimates of inventory obsolescence

(c) Change in Accounting Estimate: Change can occur in the following scenarios:

- As a result of new information
- As a result of more experience
- As a result of subsequent development

## MULTIPLE CHOICE QUESTIONS

1) Measurement discipline deals with
   (a) Identification of objects and events.
   (b) Selection of scale.
   (c) Both (a) and (b)
2) All of the following are valuation principles except
   (a) Historical cost.
   (b) Present value.
   (c) Future value.
3) Book value of machinery on 31st March, 2023 ₹10,00,000 Market value as on 31st March, 2023 if sold ₹ 11,00,000 As on 31st March, 2023, if the company values the machinery at ₹ 11,00,000, which of the following valuation principle is being followed?
   (a) Historical Cost.
   (b) Present Value.
   (c) Realisable Value.

### ANSWERS MCQs

1. (c) 2. (c) 3. (c)

## TRUE / FALSE

State with reasons whether the following statement is true or false:

1) There are four generally accepted measurement bases. (i) Historical Cost; (ii) Current Cost; (iii) Realizable Value; (iv) Future Value.
2) Historical Cost means price paid at time acquisition.
3) As per future value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.
4) At Present value, liabilities are carried at the value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
5) ABC purchased machinery amounting 10 Lakhs on 1st April, 2001. On 31st Mar, 23, similar machinery could be purchased for 20 Lakhs. Historical cost of machine is 20 Lakhs.
6) ABC purchased a machinery amounting 10 Lakhs on 1st April, 2001. On 31st Mar, 23, similar machinery could be purchased for ₹ 20 Lakhs. Current cost of machine is ₹ 20 Lakhs
7) Change in accounting estimate has to be given retrospective effect.
8) Current cost gives an alternative measurement base.

### Solution

1) False: There are four generally accepted measurement bases. (i) Historical Cost; (ii) Current Cost; (iii) Realizable Value; (iv) Present Value.
2) True: Historical cost means the acquisition price.
3) False: At Realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.
4) False: Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
5) False: Historical cost is ₹10,00,000.
6) True: Since similar machine is purchased at 20,00,000, the current cost of machine is ₹ 20,00,000
7) False: Change in accounting estimate has not to be given retrospective effect.
8) True: Generally the value of an asset is determined on the basis of cost of acquisition. Current cost is also an alternative measurement base which means Cash and cash equivalent which is to be paid if same or an equivalent asset was acquired currently.

## ACCOUNTING STANDARDS

| | |
|---|---|
| Meaning | Accounting standards are written policy documents issued by expert accounting body or by government or other regulatory body (e.g. MCA issuing AS for corporates in consultation with NACAS) covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. |
| Issues dealt by AS | ➢ Recognition of events and transactions in financial statements.<br>➢ Measurement of these transactions and events.<br>➢ Presentation of these transactions & events in the financial statements in a manner that is meaningful and understandable to the reader.<br>➢ The disclosure requirements which should be there to enable public at large, the stakeholders and potential investors in particular, to get an insight in to what these financial statements are trying to reflect and thereby facilitating them to take prudent & informed business decisions. |
| Objectives | ➢ The primary objective is to establish standards which have to be complied with to ensure that the financial statements are prepared in accordance with generally accepted accounting principles.<br>➢ To provide a standard for the diverse accounting policies and principles.<br>➢ To eliminate the non-comparability of financial statements.<br>➢ To increase/improve the reliability of the financial statements.<br>➢ To provide standards which are transparent for users. |
| Benefits | ➢ Standardization of alternative accounting treatment (Reduce/eliminate the confusing variations in the accounting treatments used to prepare the financial statements)<br>➢ Requirement for additional disclosures. (disclosures which are not statutorily required)<br>➢ Comparability of financial statements. |
| Limitations | ➢ Difficulties in making choice between different treatments.<br>➢ Lack of flexibilities<br>➢ Restricted scope (accounting standards cannot override the statute) |
| Formulation of AS | ICAI has constituted the Accounting Standard Board (ASB) in 1977. ASB is responsible for setting accounting standards. Although ASB is a body constituted by council of ICAI, it is independent in the formulation of AS & council of ICAI is not empowered to make any modifications in the draft AS formulated by ASB without consulting with the ASB. |
| Process | ➢ Identification of area (where standardization is required)<br>➢ Constitution of study groups (for research)<br>➢ Preparation of draft and its circulation<br>➢ Ascertainment of views of different bodies (like SEBI, CBDT, C&AG)<br>➢ Finalization of exposure draft<br>➢ Comments reviewed on exposure draft (public comments)<br>➢ Modification of the draft<br>➢ Issue of AS<br>• For Non Corporate Entities by ICAI<br>• For Corporate Entities by Central Government of India |

## OVERVIEW OF ACCOUNTING STANDARDS (AS) IN INDIA

| AS | AS TITLE | AS | AS TITLE |
|---|---|---|---|
| 1 | Disclosure of Accounting Policies | 16 | Borrowing Costs |
| 2 | Valuation of Inventories | 17 | Segment Reporting |
| 3 | Cash Flow Statements | 18 | Related Party Disclosures |
| 4 | Events Occurring after Balance Sheet Date | 19 | Leases |
| 5 | Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies | 20 | Earnings Per Share |
| 6 | Depreciation Accounting -Withdrawn- | 21 | Consolidated Financial Statements (CFS) |
| 7 | Construction Contracts | 22 | Accounting for Taxes on Income |
| 8 | -Withdrawn- | 23 | Accounting for Investment in Associates in CFS |
| 9 | Revenue Recognition | 24 | Discontinuing Operations |
| 10 | Accounting for fixed assets<br>Property, Plant & Equipment | 25 | Interims Financial Reporting |
| 11 | Effects of changes in Foreign Exchange Rates | 26 | Intangible assets |
| 12 | Accounting for Government Grants | 27 | Financial Reporting of Interest in Joint Ventures |
| 13 | Accounting for Investments | 28 | Impairment of assets |
| 14 | Accounting for Amalgamation | 29 | Provisions, Contingent Liabilities and Contingent Assets |
| 15 | Employee Benefits | | |

## MULTIPLE CHOICE QUESTIONS

1) Accounting Standards for Non-Corporate entities in India are issued by
   (a) Central Govt.
   (b) State Govt.
   (c) Institute of Chartered Accountants of India.

2) Accounting Standards
   (a) Harmonise accounting policies.
   (b) Eliminate the non-comparability of financial statements.
   (c) Both the above.

3) It is essential to standardize the accounting principles and policies in order to ensure
   (a) Transparency.
   (b) Consistency.
   (c) Both the above.

### ANSWERS MCQs

1. (c) 2. (c) 3. (c)

## TRUE / FALSE

State with reasons whether the following statement is true or false:

1) Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.
2) Accounting standards can override the statute.
3) Difficulties in making choice between different treatments is one of the benefits of accounting standards.
4) Requirements for additional disclosures is limitation of accounting standards.
5) ASB stands for Accounting standardization benchmarking.
6) There are no limitation to accounting standards.
7) Accounting Standards for non-corporate entities in India are issued by the Central Government. *(Jan 2021)*

### Solution

1) True: Accounting standards are documents covering recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.
2) False: Accounting standards can never override the statute. The standards are required to be framed within the ambit of prevailing statutes.
3) False: Difficulties in making choice between different treatments is one of the limitation of accounting standard.
4) False: Benefits of accounting standards are:
   - Standardization of alternative accounting treatments
   - Comparability of financial statements
   - Requirements for additional disclosures
5) False: ASB stands for Accounting standard Board.
6) False: Limitations of accounting standards ▪ Difficulties in making choice between different treatments ▪ Restricted scope
7) False: Accounting Standards for non-corporate entities in India are issued by the Institute of Chartered Accountants of India (ICAI).

# 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 help 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. | A contingent liability fails to meet the same. |
| 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 | 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.