SYNOPSIS

Accounting concepts

Accounting concepts are the foundational principles that guide the recording and reporting of financial transactions. These concepts have been developed over time to ensure consistency and reliability in financial accounting. They are broadly categorized into two groups:

1. Concepts for Recording Transactions

These guide how transactions are entered into the books of accounts:

(i) **Business Entity Concept**: Treats the business as distinct from its owner. Transactions involving the owner are recorded as external dealings.

(ii) **Money Measurement Concept**: Only monetary transactions are recorded, expressed in monetary terms. Non-monetary aspects, like employee skills, are excluded.

(iii) **Historical Cost Concept**: Assets are recorded at their acquisition cost, which includes purchase price, transport, and installation. This ensures objectivity but does not reflect current market values.

(iv) **Objectivity Concept**: Transactions should be recorded with verifiable evidence, ensuring unbiased and reliable entries.

(v) **Conservatism Concept**: Prefers recognizing potential losses over unrealized gains, ensuring prudent financial reporting.

(vi) **Dual Aspect Concept**: Every transaction has a dual effect, maintaining the accounting equation: **Assets = Liabilities + Capital**.

2. Concepts for Reporting Transactions

These guide the preparation of financial statements:

(i) **Going Concern Concept**: Assumes the business will continue to operate indefinitely, allowing asset costs to be spread over their useful life.

(ii) **Accounting Period Concept**: Financial statements are prepared for specific periods (usually a year) to assess performance and financial position.

(iii) **Matching Concept**: Matches expenses incurred with the revenues earned in the same period, ensuring accurate profit calculation.

(iv) **Full Disclosure Concept**: Requires all material and relevant information to be included in financial statements and notes.

(v) **Consistency Concept**: Ensures uniform accounting methods over time to enable comparisons between periods and entities.

(vi) **Materiality Concept**: Focuses on recording only significant information that influences decision-making, while immaterial details are excluded.

These concepts form the foundation of financial accounting, ensuring transparency, consistency, and reliability in financial reporting. While they provide a robust framework, certain limitations, such as the inability to reflect non-monetary elements or current market values, highlight the need for supplemental approaches like inflation accounting and additional qualitative disclosures.

Business entity concept

The **business entity concept** is a fundamental principle of accounting that treats a business as an independent and distinct unit, separate from its owner(s). This concept applies to all types of businesses, such as retail stores, manufacturing units, banks, schools, hospitals, and service organizations. The primary purpose of this concept is to ensure that the financial records focus exclusively on the transactions of the business and not on the personal financial activities of the owner(s).

Key Features of the Business Entity Concept

1. **Separation of Business and Owner(s):** From an accounting perspective, the business is treated as a separate entity from its proprietor(s) or owner(s). This distinction

ensures that only business-related transactions are recorded in the books of accounts. For example:

- The owner's personal expenditures, such as housing, food, or clothing, are not included in the business's accounts unless business funds are used for these expenses.
- If personal expenses are paid from business funds, they are recorded as **drawings** by the owner, reflecting a reduction in the owner's equity rather than as business expenses.

2. **Owner as a Creditor:** The capital invested by the owner in the business is treated as a **liability** from the business's perspective. This is because the business, being a separate entity, owes this amount to the owner. As such, the owner has a claim over the assets of the business, similar to other creditors. This principle highlights the owner's dual role as both a contributor of capital and a separate entity in relation to the business.

3. **Applicability to All Business Forms:**

   - The concept is universally applicable to all types of business organizations, including sole proprietorships, partnerships, and corporations.
   - In the case of corporations, the distinction is clear and legally recognized, as a corporation is considered a separate legal entity.
   - For sole proprietorships and partnerships, the legal separation between the business and its owner(s) does not exist. However, for accounting purposes,

they are treated as distinct entities to ensure proper financial tracking and accurate reporting of profits or losses.

4. **Accurate Profit and Loss Calculation:** By separating the business and personal activities of the owner(s), the concept allows for the precise determination of the business's financial performance. This enables businesses to ascertain their profit or loss without interference from the owner's personal financial matters.

Implications of the Business Entity Concept

1. **Clarity in Financial Records:** By focusing exclusively on business transactions, the concept ensures that financial records provide a clear and accurate representation of the business's performance and financial position. This separation aids in decision-making and financial analysis.

2. **Legal and Financial Accountability:**
    - In corporations, the business entity concept aligns with legal requirements that treat the company as an independent entity, separate from its shareholders or directors.
    - For sole proprietorships and partnerships, although the owner(s) are personally liable for business obligations, accounting records still distinguish between personal and business transactions, ensuring accurate financial reporting.

3. **Transparency in Reporting:** The concept supports the preparation of financial statements that reflect only the business's financial activities, ensuring transparency and

building trust among stakeholders, including investors, creditors, and regulators.

4. **Compliance with Taxation and Regulatory Requirements:** Separate business records help in meeting taxation and regulatory requirements effectively. For instance, business income is distinct from personal income, enabling proper compliance with tax laws.

Challenges in Applying the Business Entity Concept

1. **Difficulty in Sole Proprietorships and Partnerships:** In cases where the legal distinction between the owner and the business does not exist, such as in sole proprietorships and partnerships, maintaining strict separation can be challenging. Owners often mix personal and business finances, leading to complications in accounting.

2. **Complexity in Managing Drawings:** Regular withdrawals by the owner(s) from business funds, if not properly accounted for as drawings, can distort the financial position of the business.

3. **Dependence on Owner's Discipline:** The effectiveness of the business entity concept relies heavily on the owner(s)' discipline in maintaining a clear distinction between personal and business finances.

Business entity concept - a cornerstone of accounting

The business entity concept is a cornerstone of accounting that ensures the financial activities of a business are recorded and reported independently of its owner(s). This distinction enhances the clarity, accuracy, and reliability of financial statements, making them useful for decision-making by stakeholders. While the application of this concept is straightforward in corporations due to their legal recognition as separate entities, it requires greater discipline and adherence in sole proprietorships and partnerships. Ultimately, this concept lays the foundation for transparent and effective financial management, enabling businesses to maintain accountability and meet legal and regulatory requirements.

Money measurement concept

The money measurement concept is a fundamental principle in accounting that states all business transactions and events recorded in the books must be expressed in monetary terms. This principle ensures that diverse transactions are captured in a uniform manner, facilitating meaningful aggregation and interpretation of financial data.

Rationale Behind the Concept

Businesses engage in transactions involving various items measured in different physical units such as kilograms, liters, tons, or meters. If these transactions were recorded in their respective units, combining them would be challenging and would not produce a coherent total. To overcome this, money is adopted as the standard unit of measurement.

All accounting records are maintained in the currency of the country where the business operates. For instance:

- In India, transactions are recorded in **Indian Rupees (₹)**.
- In the USA, they are recorded in **US Dollars ($)**. This common monetary denominator ensures uniformity and comparability in financial records.

Implications of the Money Measurement Concept

1. Inclusion of Monetary Transactions

- Only events and transactions that can be quantified in monetary terms are recorded in the books of accounts. Examples include sales, purchases, payment of salaries, or loss of goods in an accident.
- Non-monetary events, such as the appointment of an accountant or the death of a key employee, are not recorded despite their potential significance. This is because their effects cannot be objectively measured in terms of money.

2. Homogeneity in Financial Reporting

- By using a single unit of measurement, businesses can consolidate and analyze diverse transactions. For example, a company's assets like machinery, land, and inventory can be aggregated into a single monetary value, enabling stakeholders to assess the total worth of the business.

3. Objective Reporting

- Money, as a standard measure, introduces objectivity into accounting, reducing the subjective interpretations that might arise if non-monetary metrics were included.

Limitations of the Concept

1. Exclusion of Non-Monetary Factors

- Important qualitative factors, such as employee morale, management expertise, or brand reputation, are excluded from financial records. These intangible elements, though critical to a business's success, are not captured in monetary terms and hence do not appear in the accounts.

2. **Impact of Inflation**

   - The value of money is not constant over time. Inflation erodes the purchasing power of money, meaning that ₹1 today may hold far less value than ₹1 a decade ago. This limitation leads to discrepancies in financial reporting, as assets and liabilities recorded at historical cost may not reflect their current market value.

3. **Lack of True and Fair View**

   - Because changes in the value of money over time are not reflected in the accounts, the financial data may fail to present an accurate picture of the business's real financial position. For instance, assets purchased decades ago are recorded at their original cost, which can lead to significant undervaluation when compared to their present worth.

Modern Adjustments to the Money Measurement Concept

To address the limitations posed by inflation and price-level changes, businesses and accounting standards have started to adopt additional measures such as **inflation accounting**. This approach involves adjusting financial statements to reflect the impact of changing price levels on reported income, assets, and liabilities. By incorporating these adjustments, businesses can present a more accurate and realistic picture of their financial condition.

Money measurement concept – a measure for consistency, comparability and uniformity

The money measurement concept is essential for ensuring consistency, comparability, and uniformity in financial accounting. It simplifies the aggregation of diverse business transactions by expressing them in monetary terms. However, its limitations, especially the exclusion of non-monetary factors and the disregard for changes in the value of money over time, highlight the need for supplementary approaches like inflation accounting. Despite these challenges, the concept remains a cornerstone of modern accounting, enabling businesses to maintain organized and comprehensible financial records.

Historical Record Concept

The historical record concept is a foundational accounting principle that focuses on the recording of transactions that have already occurred. It ensures that accounting records are based on objective, verifiable events rather than speculative or anticipated activities.

Key Aspects of the Historical Record Concept

1. **Recording Past Transactions:** According to this concept, only **actual transactions** that have taken place are recorded in the books of accounts. Future transactions, which are uncertain and cannot be measured or verified with accuracy, are excluded from the accounting process. For instance, if goods are sold today, the sale is recorded immediately. However, a potential sale projected for the future is not recorded until it materializes.

2. **Chronological Order:** Transactions are recorded in a **systematic, chronological sequence**. This organization

allows for the preparation of a clear historical record, which can be easily referenced or audited. The chronological structure ensures transparency and provides a detailed timeline of the business's financial activities.

3. **Objective and Verifiable Data:** The concept emphasizes that only transactions backed by **objective evidence** are recorded. Examples of such evidence include invoices, receipts, or contracts. This requirement for evidence ensures that the records are unbiased and reliable.

4. **Focus on Factual Reporting:** The historical record concept underscores the importance of recording **facts only**, without assumptions or projections. This approach safeguards the integrity of financial data, making it a dependable resource for decision-making and analysis.

Benefits of the Historical Record Concept

- **Reliability:** By focusing solely on actual transactions, the concept ensures that financial records are based on verified events.

- **Transparency:** The chronological recording of transactions provides a clear and accessible trail of financial activities.

- **Accountability:** Objective and factual data allows for accurate auditing and minimizes the risk of errors or manipulation.

Limitations of the Historical Record Concept

1. **Exclusion of Future Transactions:** By concentrating only on past transactions, the concept excludes future events that could impact financial planning or decision-making.

2. **Impact of Inflation:** The historical record does not account for changes in the value of money over time. Assets recorded at their original cost may not reflect their current market value, leading to discrepancies in financial reporting.

3. **Inflexibility:** This concept does not accommodate adjustments for price-level changes or dynamic market conditions, which may hinder a business's ability to present its true financial position.

Modern Relevance and Updates

To address the limitations of the historical record concept:

- **Fair Value Accounting:** Many organizations adopt fair value accounting methods to provide a more current valuation of assets and liabilities.

- **Inflation Accounting:** Adjustments for inflation are incorporated to reflect the changing value of money, improving the accuracy of financial statements.

- **Supplementary Disclosures:** Businesses often include notes or additional data in their financial statements to provide context and address the impact of future events or price-level changes.

Conclusion

The historical record concept is integral to the discipline of accounting, ensuring that financial data is factual, verifiable, and organized. While it provides a reliable foundation for financial reporting, its limitations, particularly in dynamic economic environments, have led to the development of complementary methods such as fair value and inflation accounting. By balancing historical accuracy with modern adaptations, businesses can present a comprehensive and transparent view of their financial activities.

Objective evidence concept

The objective evidence concept is a fundamental accounting principle that emphasizes the importance of unbiased and verifiable financial records. It ensures that all accounting transactions and measurements are supported by reliable, independent evidence, making financial statements credible and trustworthy.

Key Features of the Objective Evidence Concept

1. **Unbiased Accounting Measurements:** Objectivity in accounting refers to the practice of ensuring that financial data is free from personal bias or subjectivity. This means that all transactions are recorded and reported based on verifiable facts rather than opinions or estimates.
2. **Requirement of Supporting Documents:** Each transaction recorded in the books of accounts must be backed by **evidence** in the form of documents such as:
    - Invoices for sales or purchases.
    - Receipts for cash transactions.
    - Bank statements for financial activities.
    - Contracts or agreements for long-term obligations.
    - Cash memos for smaller business expenses.

These documents, collectively known as **vouchers**, form the foundation for making accounting entries. They are also crucial for subsequent verification, particularly during audits.

3. **Independent Verification:** The concept facilitates the independent verification of financial records. Auditors rely on these supporting documents to confirm the authenticity and accuracy of transactions, reducing the likelihood of manipulation or errors in the financial statements.

4. **Treatment of Non-Tangible Items:** Certain items in accounting, such as depreciation or provisions for doubtful debts, lack direct documentary evidence. In such cases, management policy statements or estimates serve as the basis for recording these transactions. For example, depreciation is calculated using established accounting policies, such as the straight-line or reducing balance method. Provisions for doubtful debts are determined based on historical trends and the management's assessment of credit risk.

Significance of the Objective Evidence Concept

1. **Reliability and Transparency:** By requiring verifiable evidence for all transactions, the concept ensures that financial statements are reliable and free from bias. Stakeholders, including investors, creditors, and regulators, can trust the accuracy of the financial data.

2. **Auditability:** The presence of supporting documents simplifies the auditing process. Auditors can cross-check transactions against their corresponding evidence to verify the integrity of financial statements.

3. **Accountability:** The concept holds businesses accountable for their financial activities. It reduces the risk of fraudulent practices and ensures compliance with regulatory standards.

4. **Uniformity and Comparability:** Objective evidence provides a consistent basis for recording transactions, enabling comparisons over time and across businesses.

Limitations of the Objective Evidence Concept

1. **Dependence on Estimates:** For items like depreciation and provisions, reliance on management's judgment introduces a degree of subjectivity, even though these estimates are necessary for financial reporting.

2. **Challenges with Intangible Factors:** Certain business aspects, such as employee morale or brand reputation, cannot be documented or quantified objectively. These elements, though critical, are excluded from financial statements due to the concept's focus on verifiable data.

3. **Outdated Evidence:** Documents like invoices or purchase orders may not reflect current market conditions, especially in cases where the value of assets changes over time.

Modern Updates and Practices

To enhance the application of the objective evidence concept, businesses have adopted several advancements:

1. **Digital Documentation:** Electronic invoices, receipts, and transaction records are increasingly replacing traditional paper-based systems. These digital records are easier to store, retrieve, and verify.

2. **Blockchain Technology:** Blockchain offers a tamper-proof system for recording transactions, ensuring an even higher level of objectivity and reliability in financial data.

3. **Regulatory Frameworks:** International accounting standards, such as IFRS (International Financial Reporting Standards) and GAAP (Generally Accepted Accounting Principles), mandate adherence to the objective evidence concept to ensure global consistency and comparability.

4. **AI-Driven Verification:** Artificial intelligence tools are being used to analyze and verify large volumes of transactional data, further enhancing the reliability of financial records.

Conclusion

The objective evidence concept is crucial for maintaining the integrity of financial accounting. By requiring all transactions to be supported by verifiable evidence, it ensures that financial records are reliable, transparent, and auditable. While certain limitations exist, such as reliance on estimates and the exclusion of intangible factors, modern practices like digital documentation and blockchain technology are helping address these challenges. Ultimately, the concept reinforces trust among stakeholders and provides a solid foundation for informed decision-making.

Cost concept

The Cost Concept, also referred to as the historical cost principle, is a fundamental accounting convention that requires assets to be recorded in the financial statements at their original purchase price. This price reflects the actual amount paid or agreed upon at the time of acquisition, whether in cash or as part of a credit transaction. This principle emphasizes objectivity and consistency by ensuring that financial records are based on verifiable historical data.

For example, if a business purchases machinery for ₹80,000, this amount is recorded in the accounting books as the value of the asset. Even if the market value of the machinery later appreciates to ₹1,00,000 or declines to ₹50,000, it will still be represented in the financial statements at the original cost of ₹80,000. This approach avoids reliance on fluctuating market prices, which may introduce subjectivity and complexity into financial reporting.

However, the Cost Concept does not imply that the asset's value remains unchanged in the books indefinitely. Over time, assets may lose value due to wear and tear, usage, or obsolescence. To account for this reduction, depreciation is systematically applied, which gradually decreases the book value of the asset. Depreciation is typically calculated as a fixed percentage of the original cost and does not consider changes in the market value of the asset. As a result, the asset's depreciated value, rather than its current market value, is reflected in the balance sheet.

This reliance on historical cost presents a limitation of the Cost Concept, as it may not provide an accurate reflection of a company’s current financial position. For instance, during periods of inflation, the purchasing power of money changes, and the recorded values of assets may significantly differ from their actual worth. This discrepancy can hinder stakeholders from making well-informed financial decisions. Nonetheless, historical cost accounting is favored for its simplicity, objectivity, and reliability.

To address these limitations, modern accounting practices have introduced **Inflation Accounting**, which adjusts financial statements to account for the changing purchasing power of money and provides a more realistic view of an organization's financial health. There are two prominent methods of inflation accounting:

1. **Current Purchasing Power (CPP) Method:** This approach updates the value of monetary and non-monetary items in financial statements based on a general price index. By converting values using a price index factor, it maintains consistency with the current economic conditions and the real value of money.

2. **Current Cost Accounting (CCA) Method:** This method values assets and liabilities at their replacement costs rather than their historical costs. It reflects the current expenses required to replace an asset, offering a more accurate representation of the entity's financial standing during periods of inflation.

Inflation accounting mitigates the shortcomings of historical cost accounting by providing financial information that reflects the true economic conditions. This adjustment is particularly useful for businesses operating in highly inflationary environments, as it improves decision-making by stakeholders and presents a clearer picture of financial stability.

Dual aspect concept

The Dual Aspect Concept is a fundamental principle in accounting that underscores the dual nature of every business transaction. According to this concept, every transaction has two corresponding effects: one that reflects what the business receives and another that shows what it gives in return. This idea is encapsulated in the famous dictum: "Every receiver is also a giver, and every giver is also a receiver."

For instance, when a business purchases machinery for ₹8,000, it acquires an asset (machinery) while simultaneously reducing another asset (cash). Similarly, if goods worth ₹500 are bought on credit, the business gains an asset (inventory of goods) but also incurs a liability (creditors). These examples highlight the two-fold effect of transactions: the receiving aspect and the giving aspect.

The Dual Aspect Concept forms the foundation of the **Double Entry System of Bookkeeping**, which ensures that every transaction is recorded in a way that captures both its effects. This system maintains balance within the accounting records, making it possible to prepare accurate financial statements.

Accounting Equation

The concept also gives rise to the Accounting Equation, a representation of the financial position of a business at any given time. It states:

$$\text{Assets} = \text{Liabilities} + \text{Equity (Capital)}$$

- **Assets**: Resources or property owned by the business.
- **Liabilities**: Claims of outsiders, such as creditors and banks, against the business.
- **Equity (Capital)**: Claims of the owners against the business.

This equation highlights that all assets are funded either by the owners (equity) or by external parties (liabilities). Regardless of the number or nature of transactions, the accounting equation always remains in balance.

Practical Illustration

1. **Initial Capital Contribution:** Suppose Mr. Gyan Chand starts a business by contributing ₹50,000 in cash. The business receives cash (an asset), and the contribution is recorded as capital (a liability to the business, as per the business entity concept).

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

$$₹50{,}000(\text{Cash}) = ₹0 + ₹50{,}000(\text{Capital})$$

2. **Purchase of Goods on Credit:** If the business buys goods worth ₹5,000 on credit from Mr. Chakravarty, the inventory (asset) increases while creditors (liability) also increase.

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

$$₹50{,}000 + ₹5{,}000\ (Cash + Stock)$$

$$= ₹5{,}000(Creditors) + ₹50{,}000(Capital)$$

3. **Furniture Purchase with Cash:** The purchase of furniture for ₹10,000 reduces cash while increasing furniture (asset).

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

$$₹40{,}000 + ₹5{,}000 + ₹10{,}000 \begin{pmatrix} Cash + Stock \\ + Furniture \end{pmatrix}$$

$$= ₹5{,}000(Creditors) + ₹50{,}000(Capital)$$

Balance Sheet Representation

The above transactions can be summarized in a Balance Sheet, which is a statement of assets and liabilities that reflects the equality of the accounting equation.

Capital and Liabilities	₹	**Assets**	₹

Capital and Liabilities	₹	**Assets**	₹
Capital	50,000	Stock of goods	5,000
Creditors (Mr. Chakravarty)	5,000	Furniture	10,000
		Cash	40,000
Total	55,000	**Total**	55,000

The equality between total assets and total liabilities (including capital) is maintained, irrespective of the number of transactions. This balance results from the dual effect of every transaction on the business's financial position.

Significance of the Dual Aspect Concept

1. **Ensures Accuracy:** By recording both aspects of every transaction, it guarantees that financial records are complete and accurate.

2. **Maintains Balance:** The accounting equation remains consistent, ensuring the integrity of financial statements.

3. **Facilitates Financial Reporting:** It enables the preparation of reliable balance sheets, providing insights into the financial health of a business.

4. **Enhances Decision-Making:** Accurate records based on dual aspects allow better analysis and decision-making for stakeholders.

In conclusion, the Dual Aspect Concept is integral to the structure of modern accounting, ensuring that all financial transactions are recorded in a balanced and systematic manner. It not only upholds the accuracy of financial records but also lays the groundwork for more complex accounting practices.

Going concern concept

The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely, i.e. for a fairly long period of time and would not be liquidated in the foreseeable future. This is an important assumption of accounting as it provides the very basis for showing the value of assets in the balance sheet. An asset may be defined as a bundle of services. When we purchase an asset, for example, a personal computer, for a sum of ₹50,000, what we are buying really is the services of the computer that we shall be getting over its estimated life span, say 5 years. It will not be fair to charge the whole amount of ₹50,000, from the revenue of the year in which the asset is purchased. Instead, that part of the asset which has been consumed or used during a period should be charged from the revenue of that period. The assumption regarding continuity of business allows us to charge from the revenues of a period only that part of the asset which has been consumed or used to earn that revenue in that period and carry forward the remaining amount to the next years, over the estimated life of the asset. Thus, we may charge ₹10,000 every year for 5 years from the profit and loss account. In case the continuity assumption is not there, the whole cost (₹50,000 in the present example) will need to be charged from the revenue of the year in which the asset was purchased.

Accounting period concept

Accounting period refers to the span of time at the end of which the financial statements of an enterprise are prepared, to know whether it has earned profits or incurred losses during that period and what exactly is the position of its assets and liabilities at the end of that period. Such information is required by different users at regular interval for various purposes, as no firm can wait for long to know its financial results as various decisions are to be taken at regular intervals on the basis of such information. The financial statements are, therefore, prepared at regular interval, normally after a period of one year, so that timely information is made available to the users. This interval of time is called accounting period. The Companies Act 2013 and the Income Tax Act require that the income statements should be prepared annually. However, in case of certain situations, preparation of interim financial statements become necessary. For example, at the time of retirement of a partner, the accounting period can be different from twelve months period. Apart from these companies whose shares are listed on the stock exchange, are required to publish quarterly results to ascertain the profitability and financial position at the end of every three months period.

Matching concept

The process of ascertaining the amount of profit earned or the loss incurred during a particular period involves deduction of related expenses from the revenue earned during that period. The matching concept emphasises exactly on this aspect. It states that expenses incurred in an accounting period should be matched with revenues during that period. It follows from this that the revenue and expenses incurred to earn these revenues must belong to the same accounting period. As already stated, revenue is recognised when a sale is complete or service is rendered rather when cash is received. Similarly, an expense is recognised not when cash is paid but when an asset or service has been used to generate revenue. For example, expenses such as salaries, rent, insurance are recognised on the basis of period to which they relate and not when these are paid. Similarly, costs like depreciation of fixed asset is divided over the periods during which the asset is used. Let us also understand how cost of goods are matched with their sales revenue. While ascertaining the profit or loss of an accounting year, we should not take the cost of all the goods produced or purchased during that period but consider only the cost of goods that have been sold during that year. For this purpose, the cost of unsold goods should be deducted from the cost of the goods produced or purchased. The matching concept, thus, implies that all revenues earned during an accounting year, whether received during that year, or not and all costs incurred, whether paid during the year, or not should be taken into account while ascertaining profit or loss for that year.

Full disclosure concept

Information provided by financial statements are used by different groups of people such as investors, lenders, suppliers and others in taking various financial decisions. In the corporate form of organisation, there is a distinction between those managing the affairs of the enterprise and those owning it. Financial statements, however, are the only or basic means of communicating financial information to all interested parties. It becomes all the more important, therefore, that the financial statements makes a full, fair and adequate disclosure of all information which is relevant for taking financial decisions. The principle of full disclosure requires that all material and relevant facts concerning financial performance of an enterprise must be fully and completely disclosed in the financial statements and their accompanying footnotes. This is to enable the users to make correct assessment about the profitability and financial soundness of the enterprise and help them to take informed decisions. To ensure proper disclosure of material accounting information, the Indian Companies Act 1956 has provided a format for the preparation of profit and loss account and balance sheet of a company, which needs to be compulsorily adhered to, for the preparation of these statements. The regulatory bodies like SEBI, also mandates complete disclosures to be made by the companies, to give a true and fair view of profitability and the state of affairs.

Consistency concept

The accounting information provided by the financial statements would be useful in drawing conclusions regarding the working of an enterprise only when it allows comparisons over a period of time as well as with the working of other enterprises. Thus, both inter-firm and inter-period comparisons are required to be made. This can be possible only when accounting policies and practices followed by enterprises are uniform and are consistent over the period of time.

To illustrate, an investor wants to know the financial performance of an enterprise in the current year as compared to that in the previous year. He may compare this year's net profit with that in the last year. But, if the accounting policies adopted, say with respect to depreciation in the two years are different, the profit figures will not be comparable. Because the method adopted for the valuation of stock in the past two years is inconsistent. It is, therefore, important that the concept of consistency is followed in preparation of financial statements so that the results of two accounting periods are comparable. Consistency eliminates personal bias and helps in achieving results that are comparable. Also, the comparison between the financial results of two enterprises would be meaningful only if same kind of accounting methods and policies are adopted in the preparation of financial statements. However, consistency does not prohibit change in accounting policies. Necessary required changes are fully disclosed by presenting them in the financial statements indicating their probable effects on the financial results of business.

Materiality concept

The concept of materiality requires that accounting should focus on material facts. Efforts should not be wasted in recording and presenting facts, which are immaterial in the determination of income. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Any fact would be considered as material if it is reasonably believed that its knowledge would influence the decision of informed user of financial statements. For example, money spent on creation of additional capacity of a theatre would be a material fact as it is going to increase the future earning capacity of the enterprise. Similarly, information about any change in the method of depreciation adopted or any liability which is likely to arise in the near future would be significant information. All such information about material facts should be disclosed through the financial statements and the accompanying notes so that users can take informed decisions. In certain cases, when the amount involved is very small, strict adherence to accounting principles is not required. For example, stock of erasers, pencils, scales, etc. are not shown as assets, whatever amount of stationery is bought in an accounting period is treated as the expense of that period, whether consumed or not. The amount spent is treated as revenue expenditure and taken to the profit and loss account of the year in which the expenditure is incurred.

Accounting theory

Theory is the organised set of principles. The accounting theory^[1] consists of principles, concepts, rules and guidelines developed over a period of time to bring uniformity and consistency to the process of accounting and enhance its utility to different users of accounting information.

Need for the theory: For making the accounting information meaningful to its internal and external users, it is important that such information is reliable as well as comparable. The comparability of information is required both to make inter-firm comparisons, i.e. to see how a firm has performed as compared to the other firms, as well as to make inter-period comparison, i.e. how it has performed as compared to the previous years. This becomes possible only if the information provided by the financial statements is based on consistent accounting policies, principles and practices. Such consistency is required throughout the process of identifying the events and transactions to be accounted for, measuring them, communicating them in the book of accounts, summarising the results thereof and reporting them to the interested parties. This calls for developing a proper theory base of accounting.

Principle: The term 'principle' has been defined by AICPA as 'A general law or rule adopted or professed as **a guide to action**, a settled ground or basis of conduct or practice'. The word 'generally' means 'in a general manner', i.e., pertaining to many

[1] Also referred to as the theory base of accounting.

persons or cases or occasions. These principles are also referred as concepts and conventions. The term **concept** refers to the necessary assumptions and ideas which are fundamental to accounting practice, and the term **convention** connotes customs or traditions as a guide to the preparation of accounting statements. In practice, the same rules or guidelines have been described by one author as a concept, by another as a postulate and still by another as convention. This at times becomes confusing to the learners. So, attempts have been made by accounting professional bodies to standardise these principles as accounting standards.

GAAP: Generally Accepted Accounting Principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements. For example, one of the important rule is to record all transactions on the basis of historical cost, which is verifiable from the documents such as cash receipt for the money paid. This brings in objectivity in the process of recording and makes the accounting statements more acceptable to various users.

Dynamic nature of GAAP: The Generally Accepted Accounting Principles have evolved over a long period of time on the basis of past experiences, usages or customs, statements by individuals and professional bodies and regulations by government agencies and have general acceptability among most accounting professionals. However, the principles of accounting are not static in nature. These are constantly influenced by changes in the legal, social and economic environment as well as the needs of the users.

Principle setting body: In India, the Institute of Chartered Accountants of India and the Institute of Cost Accountants of India has compiled the standards of financial as well as cost accounting as the optimum practices. These are also referred to as GAAP especially in global context to refer the accounting standards and practices of a country such as Indian GAAP or US GAAP.

Accounting standards

Accounting standards rationalise the norms adopted in respect of identification, measurement and communication of transactions. The accounting process suffers from the limitation of subjectivity attached by the accountant in selection of accounting policies – norms set by an accountant in respect of identification, measurement, and communication of transactions. Flexibility, rather broadness, of GAAPs leaves much to the acumen of the accountant in deciding about the recording or the reporting of a transaction. An accountant has to apply his personal judgment, for example, in deciding the materiality of a transaction to be recorded separately, say a separate ledger, or to be recorded in group, say in a general ledger. Similar thing happens in reporting the transactions too. Whether a sale of a segment to be reported separately or as a part of total sales only. Thus, with the advent of industrialisation and globalisation, a need was felt to standardise these policies so that the financial results produced by one accountant does not variegate much from the results produced by another accountant. Professional accounting bodies throughout the world keep on evolving standard accounting policies by adopting and prescribing the best accounting practices with regard to recording and reporting of accounting transactions. Institute of Chartered Accountants of India has standardised several accounting conventions named as Accounting Standards (AS) which has been given statutory recognition from time to time. Similarly, Institute of Cost Accountants of India has standardised conventions with respect to cost accounting known as Cost Accounting Standards (CAS) which need to be applied by the entities while reporting their financial statements and cost records. Globally, International Accounting Standard Board (IASB), a non-profit international organisation of which different professional accounting bodies of several countries are members including Institute of Chartered Accountants of India and Institute of Cost Accountants of India pronounces standards known as International Financial Reporting Standards (IFRS).

Accounting standards in India is issued by the Institute of Chartered Accountants of India.

These standards relate to the maintenance of books of financial accounts and preparation of final reports (profit and loss account and balance sheet). As of now following accounting standards have been issued.

Framework for the Preparation and Presentation of Financial Statements

AS 1 - Disclosure of Accounting Policies

AS 2 - Valuation of Inventories

AS 3 - Cash Flow Statements

AS 4 - Contingencies and Events Occurring After the Balance Sheet Date

AS 5 - Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 7 - Construction Contracts

AS 9 - Revenue Recognition

AS 10 - Property, Plant and Equipment

AS 11 - The Effects of Changes in Foreign Exchange Rates

AS 12 - Accounting for Government Grants

AS 13 - Accounting for Investments

AS 14 - Accounting for Amalgamations

AS 15 - Employee Benefits

AS 16 - Borrowing Costs

AS 17 - Segment Reporting

AS 18 - Related Party Disclosures

AS 19 - Leases

AS 20 - Earnings per Share (EPS)

AS 21 - Consolidated Financial Statements

AS 22 - Accounting for Taxes on Income

AS 23 - Accounting for Investments in Associates in Consolidated Financial Statements

AS 24 - Discontinuing Operations

AS 25 - Interim Financial Reporting

AS 26 - Intangible Assets

AS 27 - Financial Reporting of Interests in Joint Ventures

AS 28 - Impairment of Assets

AS 29 - Provisions, Contingent Liabilities and Contingent Assets

Cost accounting standards in India is issued by the Institute of Cost Accountants of India.

Cost accounting standards in India is issued by the Institute of Cost Accountants of India. These standards relate to maintenance of cost record and statements. As of now following cost accounting standards have been issued.

CAS 1 - Classification of Cost

CAS 2 - Capacity Determination

CAS 3 - Production and Operation Overheads

CAS 4 - Cost of Production for Captive Consumption

CAS 5 - Determination of Average (Equalized) Cost of Transportation

CAS 6 - Material Cost

CAS 7 - Employee Cost

CAS 8 - Cost of Utilities

CAS 9 - Packing Material Cost

CAS 10 - Direct Expenses

CAS 11 - Administrative Overheads

CAS 12 - Repairs and Maintenance Cost

CAS 13 - Cost of Service Cost Centre

CAS 14 - Pollution Control Cost

CAS 15 - Selling and Distribution Overheads

CAS 16 - Depreciation and Amortisation

CAS 17 - Interest and Financing Charges

CAS 18 - Research and Development Costs

CAS 19 - Joint Costs

CAS 20 - Royalty and Technical Know-How Fee

CAS 21 - Quality Control

CAS 22 - Manufacturing Cost

CAS 23 - Overburden Removal Cost

CAS 24 - Treatment of Revenue in Cost Statements

IFRS is issued by International Accounting Standard Board.

International Accounting Standard Board (IASB) which is a non-profit international organisation of which different professional accounting bodies of several countries are members. Institute of Chartered Accountants of India and Institute of Cost Accountants of India are member of IASB. Prior to IFRS, International Accounting Standard (IAS) was issued by IASB. One may find several IAS along with the IFRS.

IFRS 1 - First-time Adoption of International Financial Reporting Standards

IFRS 2 - Share-based Payment

IFRS 3 - Business Combinations

IFRS 4 - Insurance Contracts

IFRS 5 - Non-current Assets Held for Sale and Discontinued Operations

IFRS 6 - Exploration for and Evaluation of Mineral Resources

IFRS 7 - Financial Instruments: Disclosures

IFRS 8 - Operating Segments

IFRS 9 - Financial Instruments

IFRS 10 - Consolidated Financial Statements

IFRS 11 - Joint Arrangements

IFRS 12 - Disclosure of Interests in Other Entities

IFRS 13 - Fair Value Measurement

IFRS 14 - Regulatory Deferral Accounts

IFRS 15 - Revenue from Contracts with Customers

IFRS 16 - Leases

IFRS 17 - Insurance Contracts

IAS 1 - Presentation of Financial Statements

IAS 2 - Inventories

IAS 7 - Statement of Cash Flows

IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors

IAS 10 - Events after the Reporting Period

IAS 11 - Construction Contracts

IAS 12 - Income Taxes

IAS 16 - Property, Plant and Equipment

IAS 17 - Leases

IAS 18 - Revenue

IAS 19 - Employee Benefits

IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance

IAS 21 - The Effects of Changes in Foreign Exchange Rates

IAS 23 - Borrowing Costs

IAS 24 - Related Party Disclosures

IAS 26 - Accounting and Reporting by Retirement Benefit Plans

IAS 27 - Separate Financial Statements

IAS 28 - Investments in Associates and Joint Ventures

IAS 29 - Financial Reporting in Hyperinflationary Economies

IAS 32 - Financial Instruments: Presentation

IAS 33 - Earnings per Share

IAS 34 - Interim Financial Reporting

IAS 36 - Impairment of Assets

IAS 37 - Provisions, Contingent Liabilities and Contingent Assets

IAS 38 - Intangible Assets

IAS 39 - Financial Instruments: Recognition and Measurement

IAS 40 - Investment Property

IAS 41 - Agriculture

Guidance note & Interpretation document

Apart from the standards issued by the accounting bodies there are several guidance notes and interpretation documents has been issued which is a helpful guide in following the standards.

Accounting standard for a corporate entity in India

Section 129(1) of the Companies Act 2013 provides that the financial statements shall (a) give a true and fair view of the state of affairs of the company or companies; (b) comply with the accounting standards notified under section 133; and (c) shall be in the form or forms as may be provided for different class or classes of companies in Schedule III (Division I, II & III). Proviso to section 129(1) adds that the items contained in such financial statements shall be in accordance with the accounting standards.

Section 133 empowers the Central government to prescribe the standards of accounting or any addendum thereto recommended by the Institute of Chartered Accountants of India in consultation with the National Financial Reporting Authority. Accordingly, the Central government has prescribed the Companies (Indian Accounting Standards) Rules 2015 effective from 1 April 2015 adopting several accounting standards. Prior to this the Companies (Accounting Standards) Rules 2006 regulated the standards for accounting for companies and is still applicable to companies to whom the Companies (Indian Accounting Standards) Rules 2015 is not mandatory.

The financial statements (i.e. Balance sheet, Profit and loss account, Cash flow statement and other statements and explanatory notes) of a company are to be prepared in terms of Schedule III of the Companies Act 2013. Division I of the Schedule provides the format for a company whose financial statements are required to be prepared in compliance with Companies (Accounting Standards) Rules 2006. Division II of the Schedule provides the format for a company whose financial statements are required to be prepared in compliance with the

Companies (Indian Accounting Standards) Rules 2015. Division III of the Schedule provides the format for a Non-banking Financial Company (NBFC) whose financial statements are required to be prepared in compliance with the Companies (Indian Accounting Standards) Rules 2015.

Ind AS

Companies (Indian Accounting Standards) Rules 2015 made under the Companies Act 2013 recognises following accounting standards for preparation and presentation of financial statements popularly known as IndAS:

Framework for the Preparation and Presentation of Financial Statements

Ind AS 101 - First-time Adoption of Indian Accounting Standards

Ind AS 102 - Share based Payment

Ind AS 103 - Business Combinations

Ind AS 104 - Insurance Contracts

Ind AS 105 - Non current Assets Held for Sale and Discontinued Operations

Ind AS 106 - Exploration for and Evaluation of Mineral Resources

Ind AS 107 - Financial Instruments: Disclosures

Ind AS 108 - Operating Segments

Ind AS 109 - Financial Instruments

Ind AS 110 - Consolidated Financial Statements

Ind AS 111 - Joint Agreements

Ind AS 112 - Disclosure of interest in other entities

Ind AS 113 - Fair vlaue measurement

Ind AS 114 - Regulatory deferral account

Ind AS 115 - Revenue from contracts with customers

Ind AS 116 - Leases

Ind AS 1 - Presentation of Financial Statements

Ind AS 2 - Inventories

Ind AS 7 - Statement of Cash Flows

Ind AS 8 - Accounting Policies, Changes in Accounting Estimates and Errors

Ind AS 10 - Events after the Reporting Period

Ind AS 12 - Income Taxes

Ind AS 16 - Property, Plant and Equipment

Ind AS 19 - Employee Benefits

Ind AS 20 - Accounting for Government Grants and Disclosure of Government Assistance

Ind AS 21 - The Effects of Changes in Foreign Exchange Rates

Ind AS 23 - Borrowing Costs

Ind AS 24 - Related Party Disclosures

Ind AS 27 - Consolidated and Separate Financial Statements

Ind AS 28 - Investments in Associates

Ind AS 29 - Financial Reporting in Hyperinflationary Economies

Ind AS 32 - Financial Instruments: Presentation

Ind AS 33 - Earnings per Share

Ind AS 34 - Interim Financial Reporting

Ind AS 36 - Impairment of Assets

Ind AS 37 - Provisions, Contingent Liabilities and Contingent Assets

Ind AS 38 - Intangible Assets

Ind AS 40 - Investment Property

Ind AS 41 - Agriculture

Applicability of Ind AS

Ind AS shall be shall be applicable to:

a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India;

b) companies having net worth of rupees two hundred and fifty crore or more, not covered above;

c) holding, subsidiary, joint venture or associate companies of companies of the abovesaid companies.

Companies Act 2013 Sec 2(57) says that net worth means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

Any other company may voluntarily comply with the Indian Accounting Standards (Ind AS) for preparation of its financial statements. Once a company starts following the Indian Accounting Standards (Ind AS) either voluntarily or mandatorily, it shall be required to follow the Indian Accounting Standards (Ind AS) for all the subsequent financial statements.

The insurance companies, banking companies and non-banking finance companies shall, however, not be required to apply Indian Accounting Standards (Ind AS) for preparation of their financial statements either voluntarily or mandatorily.

Accounting standards under Companies (Accounting Standards) Rules 2006

Every company which does not comply with Ind AS are required to comply with the following Accounting Standards (AS) annexed Companies (Accounting Standards) Rules 2006 to in the manner specified below for preparation of General Purpose Financial Statements. A Small and Medium Sized Company (SMC) shall, however, be exempted from the application of accounting standards. General Purpose Financial Statements include balance sheet, statement of profit and loss, cash flow statement (wherever applicable), and other statements and explanatory notes which form part thereof.

AS 1 Disclosure of Accounting Policies

AS 2 Valuation of Inventories

AS 3 Cash Flow Statements

AS 4 Contingencies and Events Occurring After the Balance Sheet Date

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 15 Employee Benefits

AS 16 Borrowing Costs

AS 17 Segment Reporting

AS 18 Related Party Disclosures

AS 19 Leases

AS 20 Earnings Per Share

AS 21 Consolidated Financial Statements

AS 22 Accounting for Taxes on Income

AS 23 Accounting for Investments in Associates in Consolidated Financial Statements

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AS 26 Intangible Assets

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AS 29 Provisions, Contingent Liabilities and Contingent Assets

Systems of accounting

The systems of recording transactions in the book of accounts are generally classified into two types viz. Double entry system and Single entry system.

Double entry system is based on the principle of "Dual Aspect" which states that every transaction has two effects, viz. receiving of a benefit and giving of a benefit. Each transaction, therefore, involves two or more accounts and is recorded at different places in the ledger. The basic principle followed is that every debit must have a corresponding credit. Thus, one account is debited and the other is credited. Double entry system is a complete system as both the aspects of a transaction are recorded in the book of accounts. The system is accurate and more reliable as the possibilities of frauds and mis-appropriations are minimised. The arithmetic inaccuracies in records can mostly be checked by preparing the trial balance. The system of double entry can be implemented by big as well as small organisations.

Single entry system is not a complete system of maintaining records of financial transactions. It does not record two-fold effect of each and every transaction. Instead of maintaining all the accounts, only personal accounts and cash book are maintained under this system. In fact, this is not a system but a lack of system as no uniformity is maintained in the recording of transactions. For some transactions, only one aspect is recorded, for others, both the aspects are recorded. The accounts maintained under this system are incomplete and unsystematic and therefore, not reliable. The system is, however, followed by small business firms as it is very simple and flexible.

Basis of Accounting

From the point of view the timing of recognition of revenue and costs, there can be two broad approaches to accounting. These are: (1) Cash basis; and (2) Accrual basis.

Cash basis

Under the cash basis, entries in the book of accounts are made when cash is received or paid and not when the receipt or payment becomes due. Let us say, for example, if office rent for the month of December 2014, is paid in January 2015, it would be recorded in the book of account only in January 2015. Similarly, sale of goods on credit in the month of January 2015 would not be recorded in January but say in April, when the payment for the same is received. Thus, this system is incompatible with the matching principle, which states that the revenue of a period is matched with the cost of the same period. Though simple, this method is inappropriate for most organisations as profit is calculated as a difference between the receipts and disbursement of money for the given period rather than on happening of the transactions.

Accrual basis

Matching of cost with revenue has led to the development of accrual basis of accounting. From the matching principle it is learnt that revenue and cost during an accounting period need to be matched irrespective of the period of realisation or payment. This led to the development of accrual basis of accounting. Prior to this, accounts were maintained on cash basis.

In the cash basis of accounting, entries are made on the basis of dash received or cash paid. In other words, no entry is made when an income is earned or an expenditure is incurred. It will be recorded in books only when the amount involved is actually received or paid. Thus, the incomes earned but not yet received (accrued income) or the expenses incurred but not yet paid (outstanding expenses) are completely ignored while preparing the final accounts.

For example, rent for the month of December, 1987 paid in January 1988 will be taken to the Profit and Loss Account of 1988 even though the expenditure relates to 1987. This leads to incorrect ascertainment of profit or loss of the business. But it is not true of the accounts maintained on accrual basis.

Under the accrual basis (also called Mercantile System of Accounting) the financial effect of transactions is recorded in the books as and when they occur and not when the amount involved is received or paid by the business. This system attempts to relate the revenues and expenses to the accounting period during which they are actually earned or incurred. Thus, rent for the month of December, 1987 paid in January, 1988 will be taken into the Profit and Loss Account of 1987 and not of 1988. This is more logical because the benefit of expenditure is enjoyed in the year 1987 and not in 1988.

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

Mixed or Hybrid System

Sometimes the businessman adopts a combination of both the above systems. In that case it is called Mixed or Hybrid System. For example, he may consider income on cash basis and expenses on accrual basis. This is considered most conservative. The hybrid system is mostly in vogue in business enterprises wherein the accrual basis of accounting remains an ideal.

Capital and revenue

Accrual basis of accounting led to the distinction between transaction which impacts during one accounting period (revenue) and those that impacts over more periods (capital).

Capital expenditure

When the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure.

The following expenditures are usually treated as capital expenditures:

(1) Any expenditure which results in the acquisition of fixed assets such as land, budlings, plant and machinery, furniture and fixtures, office equipment, copyright, etc. You should note that such capital expenditure includes not only the purchase price of the fixed asset but also the expenses incurred in connection with their acquisition. Thus, the brokerage or commission paid in connection with the acquisition of an asset, the freight and cartage paid for transportation of machinery, the expenses incurred on its installation, the legal fees and registration charges

incurred in connection with purchase of land and buildings are also treated as capital expenditure.

(2) Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, or (c) improvement in its revenue earning capacity. Improvement in the revenue earning capacity can be in the form of (i) increased production capacity, (ii) reduced cost of production, or (iii) increased sales of the firm. Thus, cost of making additions to buildings and the amount spent on renovation of the old machinery are also regarded as capital expenditures. If you buy a second-hand machinery and incur heavy expenditure on reconditioning it, such expenditure is also to be treated as capital expenditure. Similarly, expenditure on structural improvements or alteration to existing fixed assets whereby their revenue earning capacity is increased, is also treated as capital expenditure.

(3) Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.

(4) Cost of experiments which ultimately result in the acquisition of a patent. The cost of experiments which are not successful is not to be treated as capital expenditure. It is treated as a deferred revenue expenditure which is written off within two to three years.

(5) Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.

Revenue expenditure

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

(1) Expenses incurred in day-to-day conduct of the business such as wages, salaries, rent, postage, stationery, insurance, electricity, etc.

(2) Expenditure incurred for buying goods for resale or raw materials for manufacturing.

(3) Expenditure incurred for maintaining the fixed assets such as repairs and renewals of building, machinery, eta.

(4) Depreciation on fixed assets. This can also be termed as revenue loss.

(5) Interest on loans borrowed for running the business. You should note that any interest on loan paid during the initial period before production commences, is not treated as revenue expenditure. It is treated as capital expenditure.

(6) Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages, etc.

Deferred revenue expenditure

One more feature to be required for treating the expenditure as of capital nature is that it is not consumed in the generation of income. This feature helps in distinguishing capital expenditure from the deferred revenue expenditure. So, deferred revenue expenditure is a revenue expenditure of heavy amount whose benefit is likely to be available for more than one year. It is considered appropriate to spread the cost of the heavy expenditure over a number of accounting years. Hence, it is capitalised and only a portion of the total amount spent is charged to the Profit and Loss Account of the current year. The balance is shown as an asset which will be written off during the subsequent amounting years. Such expenditure is called a deferred revenue expenditure because its charge to profit and loss account has been deferred to future years. Following are the example of deferred revenue expenditure:

(1) Expenditure incurred on advertising campaign to introduce a new product in the market.

(2) Expenditure incurred on formation of a new company (preliminary expenses)

(3) Brokerage charges, underwriting commission paid and other expenses incurred in connection with the issue of shares and debentures.

(4) Cost of shifting the plant and machinery to a new site which may involve dismantling, removing and re-erection of the plant and machinery.

Capital receipts

Capital receipts are the amounts received in the form of (a) additional capital introduced in the business, (b) loans received, and (c) sale proceeds of fixed assets. First two items represent increase in liabilities of the business and obviously are not incomes or revenues. These are capital receipts and should be treated as such. The sale proceeds of a fixed asset are also treated as a capital receipt because the amount received is not revenue earned in the normal course of business. The capital receipts increase the liabilities or reduce the assets. They do not affect the profit or loss.

Revenue receipts

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