Accounting Concepts

The historical cost concept
It means that assets are normally shown at original cost price, and that this is the basis for valuation of the asset.

The money measurement concept
The money measurement concept in financial reporting is that an item should not be 'recognised' and included in the financial statements unless it has a money value that can be measured reliably and objectively.

For example land can be included in the financial statements because its value can be measured objectively, either at its original cost or at its current market value (which can be determined objectively from a professional valuation).

On the other hand, the value of a skilled and experienced employee is not included in a statement of financial position, partly because the cost or value of an employee to the business cannot be measured objectively.

The business entity concept
A concept used in financial reporting is that a business entity is an entity that is separate from its owners. In other words, the business entity and its owners are different.

For example, suppose that ARD sets up a sole trader business as a builder, and he calls the business 'ARD Builders'. For the purpose of financial reporting, the business (ARD Builders) and ARD, the owner of the business, are different and separate from each other.

The dual aspect concept
This states that there are two aspects of accounting, one represented by the assets of the business and the other by the claims against them. The concept states that these two aspects are always equal to each other. In other words, this is the alternate form of the accounting equation: **Assets = Capital + Liabilities.** Double entry is the name given to the method of recording transactions under the dual aspect concept.

Accounting Year
One of the underlying principles of accounting, the accounting year concept, is that financial statements are prepared at regular intervals of one year. For internal management purposes they may be prepared far more frequently, possibly on a monthly basis or even more frequently.

Going concern Basis
The going concern basis of accounting is that all the items of value owned by a business, such as inventory and property, plant and equipment, should be valued on the assumption that the business will continue in operation for the foreseeable

future. The business will not close down or be forced to close down and sell off all its items (assets). This assumption affects the value of assets and liabilities of an entity, as reported in the financial statements.

For example, if a business entity is not a going concern, and is about to be closed down and liquidated, the value of its assets would be their estimated value in the liquidation process. Assets are valued differently on a going concern basis.

Consistency

It states that when a business has once fixed a method for the accounting treatment of an item, it will enter all similar items that follow in exactly the same way. However, it does not mean that the business has to follow the method until the business closes down. A business can change the method used, but such a change is made with a lot of consideration.

Prudence (conservatism)

The accountant should make certain that assets are not valued too highly. Similarly, liabilities should not be shown at values that are too low The accountant should always exercise caution when dealing with uncertainty while, at the same time, ensuring that the financial statements are neutral – that gains and losses are neither overstated nor understated. It also states that if we can foresee loss it should be recorded immediately but income should not be recorded once it's realized.

The accruals / matching concept

The accruals basis of preparing financial statements, which is also called the 'matching concept', is based on the following assumptions.

- The cost of sales in the income statement (or within profit and loss in the statement of comprehensive income) must be matched with the sales. Sales income and 'matching' expenses must be reported in the same financial period.
- Other expenses should be charged in the period to which they relate, not the period in which they are paid for.
- Income, such as sales, should be reported in the period when the income arises. This might not be the same as the period when the cash is received.

With the accruals basis, financial transactions and other events are recognised in the financial statements when they occur, and not when the cash relating to the transaction is received or paid.

Materiality

Anything that appears in a financial statement should be 'material'. Means It should be of interest to the stakeholders, those people who make use of financial accounting statements. It need not be material to every stakeholder, but it must be material to a stakeholder before it merits inclusion. Do not waste your time in the elaborate recording of trivial items. Example small items of assets should be treated as expenses

Substance over Form

Substance over form states that whenever there is a conflict between legal form of a transaction and its economic reality then we should ignore its legal position and use economic reality of the transaction e.g. Assets bought through financial lease / hire purchase.

Realization

The realization principle is the concept that revenue can only be recognized once the underlying goods or services associated with the revenue have been delivered or rendered, respectively. Thus, revenue can only be recognized after it has been earned.

Capital & Revenue Expenditure

Capital expenditure is incurred when a business spends money either to:
- buy fixed assets, or
- add to the value of an existing fixed asset.

Included in such amounts should be spending on:
- acquiring fixed assets
- bringing them into the business
- legal costs of buying buildings
- carriage inwards on machinery bought
- any other cost needed to get a fixed asset ready for use.

Capital expenditure not only consists of the cost of purchasing a fixed asset, but also includes other costs necessary to get the fixed asset operational.

Revenue Expenditure which is not spent on increasing the value of fixed assets, but on running the business on a day-to-day basis, is known as **revenue expenditure**. The difference between revenue expenditure and capital expenditure can be seen clearly with the total cost of using a van for a business. Buying a van is capital expenditure. The van will be in use for several years and is, therefore, a fixed asset. Paying for petrol to use in the van is revenue expenditure. This is because the expenditure is used up in a short time and does not add to the value of fixed assets.

1 If expenditure is directly incurred in bringing a fixed asset into use for the first time, it is capital expenditure.

2 If expenditure improves a fixed asset (by making it superior to what it was when it was first owned by the organization, e.g. building an extension to a warehouse), it is capital expenditure.

3 All other expenditures are revenue expenditure.

Differences between capital and revenue expenditure

Expenditure	Type of Expenditure
1 Buying van	Capital
2 Petrol costs for van	Revenue
3 Repairs to van	Revenue
4 Putting extra headlights on van	Capital
5 Buying machinery	Capital
6 Electricity costs of using machinery	Revenue
7 We spent $1,500 on machinery: $1,000 was for an item (improvement) added to the machine; and $500 was for repairs	Capital $1,000 Revenue $500
8 Painting outside of new building	Capital
9 Three years later – repainting outside of building in (8)	Revenue

Examples of Capital expenditures

1. Acquiring fixed, and in some cases, intangible assets.
2. Repairing an existing asset so as to improve its useful life.
3. Upgrading an existing asset if its results in a superior performance
4. Preparing an asset to be used in business
5. Restoring property or adapting it to a new or different use.
6. Starting or acquiring a new business.
7. Paint on a new building
8. Head Lights on vehicle for better visibility.
9. Training cost.

Examples of Revenue expenditures:
1. Salaries and wages
2. Heat and Lighting
3.Repair and maintenance
4.Insurance
5. Paint on an old building.

Incorrect treatment of expenditure
If one of the following occurs:
1 capital expenditure is incorrectly treated as revenue expenditure, or
2 revenue expenditure is incorrectly treated as capital expenditure,
then both the balance sheet figures and trading and profit and loss account figures will be incorrect.

This means that the net profit figure will also be incorrect and, if the expenditure affects items in the trading account part of that statement, the gross profit figure will also be incorrect.

Capital and revenue receipts
when an item of capital expenditure is sold, the receipt is called a capital receipt. Suppose a van is bought for $5,000, and sold five years later for $750. The $5,000 was treated as capital expenditure. The $750 received is treated as a capital receipt and credited to the fixed asset account in the General Ledger.

Revenue receipts are sales and other revenue items that are added to gross profit, such as rent receivable and commissions receivable.

Capital receipts A capital receipt is a receipt which is derived from sale or purchase of capital assets like plant and machinery, furniture, investment (long term) etc which shall not be occurring all the time. Capital receipts refer to incoming cash flows (receipts) originating from one of the following sources:

• Cash from the sale of fixed assets (either or intangible) (Can also include a payment associated with an insurance claim from a damaged fixed asset).
• Cash from the sale of shares in the business
• Cash from the issuance of a debt instrument

REVENUE RECEIPT

a revenue receipt is something which is carried out from daily activities like sale of goods or purchase of goods etc. A revenue receipts shall be repetitive in nature and shall be shown (credited) in the profit and loss account.

Receipt which is recurring (received again and again) by nature and which are available for meeting all day to day expenses (revenue expenditure) of a business concern are known an Revenue receipts, e.g. sale proceeds of goods interest received, commissions received, rent received, dividend received etc.

DISTINCTION BETWEEN CAPITAL RECEIPT AND REVENUE RECEIPT

The main differentiate between revenue receipts and capital receipts is that revenue receipts are recurring in nature, which the company can expect to receive year after year, whereas capital receipts are a kind of one time income. E.g. the salary you receive is your revenue receipt and the income you receive by selling your home is capital receipt.

Revenue Receipt		Capital Receipt	
1.	It has short term effect. The benefit is enjoyed within one accounting period.	1.	It has long term effect. The benefit is enjoyed for many years in future.
2.	It occurs repeatedly. Its recurring and regular	2.	It doesn't occur repeatedly. Its non recurring and irregular
3.	It is shown in profit and loss account on the credit side.	3.	It is shown in the Balance Sheet on the liability side.
4.	It does not produce capital receipt	4.	Capital receipt, when invested, produces revenue receipt e.g. when capital is invested by the owner business gets revenue receipt (i.e. sale proceeds of goods etc).
5.	This does not increase or decrease the value of asset or liability	5.	The capital receipt decreases the value of asset or increases the value of liability e.g. sale of a fixed asset, loan from bank etc.
6.	Sometimes, expenses of capital nature are to be incurred for revenue receipt, e.g. purchase of shares of a company is capital expenditure but dividend received on shares is a revenue receipt.	6.	Sometimes expenses of revenue nature are to be incurred for such receipt e.g. on obtaining loan (a capital receipt) interest is paid until its repayment.

Joint expenditure

Sometimes one item of expenditure will need to be divided between capital and revenue expenditure

Exercises

Ex. 1 For the business of J Charles, wholesale chemist, classifies the following between 'capital 'and 'revenue' expenditure:

(*a*) Purchase of an extra van.
(*b*) Cost of rebuilding warehouse wall which had fallen down.
(*c*) Building extension to the warehouse.
(*d*) Painting extension to warehouse when it is first built.
(*e*) Repainting extension to warehouse three years later than that done in (*d*).
(f) Carriage costs on bricks for new warehouse extension.
(*g*) Carriage costs on purchases.
(*h*) Carriage costs on sales.
(*i*) Legal costs of collecting debts.
(*j*) Legal charges on acquiring new premises for office.
(*k*) Fire insurance premium.
(*l*) Costs of erecting new machine.

Ex. 2 For the business of H Ward, a food merchant, classifies the following between 'capital' and 'revenue' expenditure:

(*a*) Repairs to meat slicer.
(*b*) New tyre for van.
(*c*) Additional shop counter.
(*d*) Renewing sign writing on shop.
(*e*) Fitting partitions in shop.
(f) Roof repairs.
(*g*) Installing thief detection equipment.
(*h*) Wages of shop assistant.
(*i*) Carriage on returns outwards.
(*j*) New cash register.
(*k*) Repairs to office safe.
(*l*) Installing extra toilet.

Ex. 3 The following costs were incurred by Napa Ltd during the financial year ended 30 June 2017:

(*1*) Interest on loan to purchase microcomputer.
(*2*) Cost of software for use with the microcomputer.
(*3*) Cost of customizing the software for use in Napa Ltd's business.
(*4*) Cost of paper used by the computer printer.
(*5*) Wages of computer operators.
(*6*) Cost of ribbons used by the computer printer.
(*7*) Cost of adding extra memory to the microcomputer.
(*8*) Cost of floppy disks used during the year.
(*9*) Costs of adding a manufacturer's upgrade to the microcomputer equipment.
(*10*) Cost of adding air conditioning to the computer room.

Required:
Classify each of the above as capital expenditure or revenue expenditure.

Ex. 4 Classify the following items as either revenue or capital expenditure:

(*a*) An extension to an office building costing $24,000.
(*b*) The cost of replacement valves on all the labeling machines in a canning factory.
(*c*) Repairs to the warehouse roof.
(*d*) Annual service costs for a courier firm's fleet of vans.
(*e*) Replacement of rubber treads on a printing press with a plastic one that has resulted in the useful economic life of the printing press being extended by three years.
(f) A new bicycle purchased by a newsagent for use by the newspaper delivery boy.
(*g*) Repairs to a refrigeration system of a meat wholesaler.
(*h*) Repainting of the interior of a bar/restaurant which has greatly improved the potential for finding a buyer for the bar/restaurant as a going concern.
(*i*) Wages paid to employees who worked on the construction of their company's new office building.