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B.Com Honours

Semester I

Calicut University

# **Fundamentals of Financial Accounting**

Course Code: COM1MN103 • Module 2 Notes

# 1. Capital vs. Revenue: Receipts and Expenditures

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A fundamental requirement in accounting is the correct classification of financial transactions into capital and revenue categories. If a capital item is mistakenly recorded as a revenue item (or vice versa), the final accounts will show incorrect profits and an inaccurate financial position. This module covers the distinction between capital and revenue receipts, capital and revenue expenditures, deferred revenue expenditures, contingent items, and the sequential steps of the accounting cycle.

## Capital Receipts vs. Revenue Receipts

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Receipts represent inflows of cash or assets into the business. They are classified based on their regularity and impact on liabilities or assets:

Feature	Capital Receipts	Revenue Receipts
<b>Nature</b>	Non-recurring and irregular.	Recurring and regular.
<b>Financial Statement</b>	Recorded in the Balance Sheet.	Recorded in the Trading or Profit & Loss Account.
<b>Impact</b>	Creates a liability (e.g., loans) or reduces a fixed asset (e.g., sale of machinery).	Does not create a liability or reduce fixed assets. Earned from core business.
<b>Examples</b>	Capital introduced by owner, bank loans, sale of plant.	Sales revenue, commission received, rent received on property.

## Expenditures: Capital, Revenue, and Deferred

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Expenditures represent cash outflows or liabilities incurred to acquire assets, goods, or services. Correct classification is essential for calculating periodic profits:

### Capital Expenditure

Incurred to acquire fixed assets, improve their capacity, or extend their useful life. The benefit extends over multiple years (e.g., purchasing machinery, constructing a factory). Recorded as an asset in the Balance Sheet.

### Revenue Expenditure

Incurred in the normal course of business to maintain existing assets or run day-to-day operations. The benefit is fully consumed within the current accounting period (e.g., salaries, rent, repairs). Charged to the P&L Account.

### Deferred Revenue Expenditure

A revenue expenditure that is exceptionally large, yielding benefits over multiple future years (e.g., massive advertising campaign for a new brand). It is written off over 3-5 years.

## Contingent Assets and Contingent Liabilities

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- **Contingent Liability:** A potential liability that may occur depending on the outcome of an uncertain future event (e.g., a pending court case against the firm, guarantees given on behalf of others). They are not recorded in the books but must be disclosed as footnotes to the Balance Sheet.
- **Contingent Asset:** A potential asset that may arise from past events, whose existence will be confirmed by uncertain future events (e.g., a pending lawsuit where the firm might receive damages). Following conservatism, they are neither recorded nor disclosed in footnotes.

## 2. The Accounting Cycle

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The accounting cycle is a collective process of identifying, analyzing, and recording the accounting events of a company. The cycle repeats every fiscal year, executing through the following steps:

### Steps 1 - 4: Recording & Classifying

1. **Identify Transactions:** Analyzing business events and verifying source documents (invoices, receipts).
2. **Journalising:** Recording the transaction chronologically in the primary book (Journal) using debit/credit rules.
3. **Ledger Posting:** Transferring journal entries to individual accounts in the ledger to group transactions.
4. **Trial Balance:** Listing all ledger balances to verify the arithmetical accuracy of the double-entry system.

### Steps 5 - 8: Summarizing & Reporting

1. **Adjustments:** Recording adjusting entries for outstanding expenses, accrued income, and depreciation.
2. **Adjusted Trial Balance:** Re-listing balances to verify accuracy after adjustments.
3. **Financial Statements:** Preparing the Trading Account, P&L Account, and Balance Sheet.
4. **Closing Entries:** Transferring temporary account balances (revenues, expenses) to capital, ready for the next cycle.

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