

Chapter 2 - Theory Base Of Accounting

Question:1

Why is it necessary for accountants to assume that business entity will remain a going concern?

Solution:

Going Concern Concept assumes that the business entity will continue its operation for an indefinite period of time. It is necessary to assume so, as it helps to bifurcate revenue expenditure (i.e. expenditure related to current year), and capital expenditure (i.e. expenditure whose benefits accrue over a period of time). For example, a machinery that costs Rs 1,00,000, having an expected life of 10 years, will be treated as a capital expenditure, as its benefit can be availed for more than one year; whereas, the per year depreciation of the machinery, say Rs 10,000, will be regarded as a revenue expenditure.

Question:2

When should revenue be recognised? Are there exceptions to the general rule?

Solution:

Revenue should be recognised when sales take place either in cash or credit and/or right to receive income from any source is established. Revenue is **not** recognised, in case, if the income or payment is received in advance or the payment is actually received from the debtors. In a nutshell, revenue will be recognised when the right to receive income is established. For example, Mr. A sold goods in January and received payment in February; then revenue is considered to be recognised in the month of January and not in February. However, if Mr A received cash in advance, i.e. in December and goods are sold in January, then the revenue is recognised in January and **not** in December.

The exceptions to this rule are given below.

1) Hire purchase– When goods are sold on hire-purchase system , the amount received in instalments is treated as revenue.

2) Long term construction contract– The long term projects like construction of dams, highways, etc. have long gestation period. Income is recognised on proportionate basis of work certified and **not** on the completion of contract.

Question:3

What is the basic accounting equation?

Solution:

The basic accounting equation is,

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

It means that all the monetary value of all assets of a firm are equal to the total claims, viz. owners and outsiders.

Question:4

The realisation concept determines when goods sent on credit to customers are to be included in the sales figure for the purpose of computing the profit or loss for the accounting period. Which of the following trends to be used in practice to determine when to include a transaction in the sales figure for the period. When the goods have been:

a. dispatched b. invoiced

c. delivered d. paid for

Give reasons for your answer.

Solution:

According to the realisation concept, revenue is recognised when an obligation to receive the amount arises. When the goods are invoiced, it is treated as the transfer of ownership of goods from the seller to the buyer and hence the revenue is recognised.

Question:5

Complete the following work sheet:

- (i) If a firm believes that some of its debtors may 'default', it should act on this by making sure that all possible losses are recorded in the books. This is an example of the _____ concept.
- (ii) The fact that a business is separate and distinguishable from its owner is best exemplified by the _____ concept.
- (iii) Everything a firm owns, it also owns out to somebody. This co-incidence is explained by the _____ concept.
- (iv) The _____ concept states that if straight line method of depreciation is used in one year, then it should also be used in the next year.
- (v) A firm may hold stock which is heavily in demand. Consequently, the market value of this stock may be increased. Normal accounting procedure is to ignore this because of the _____.
- (vi) If a firm receives an order for goods, it would not be included in the sales figure owing to the _____.
- (vii) The management of a firm is remarkably incompetent, but the firms accountants can not take this into account while preparing book of accounts because of _____ concept.

Solution:

- (i) If a firm believes that some of its debtors may 'default', it should act on this by making sure that all possible losses are recorded in the books. This is an example of the conservatism concept.
- (ii) The fact that a business is separate and distinguishable from its owner is best exemplified by the business entity concept.
- (iii) Everything a firm owns, it also owns out to somebody. This co-incidence is explained by the dual aspect concept.

- (iv) The consistency concept states that if straight line method of depreciation is used in one year, then it should also be used in the next year.
- (v) A firm may hold stock which is heavily in demand. Consequently, the market value of this stock may be increased. Normal accounting procedure is to ignore this because of the conservatism.
- (vi) If a firm receives an order for goods, it would not be included in the sales figure owing to the revenue recognition.
- (vii) The management of a firm is remarkably incompetent, but the firm's accountants cannot take this into account while preparing book of accounts because of money measurement concept.

Question:6

'The accounting concepts and accounting standards are generally referred to as the essence of financial accounting'. Comment.

Solution:

Financial accounting is concerned with the preparation of the financial statements and provides financial information to various accounting users. It is performed according to the basic accounting concepts like Business Entity, Money Measurement, Consistency, Conservatism, etc. These concepts allow various alternatives to treat the same transaction. For example, there are a number of methods available for calculating stock and depreciation, which can be followed by various firms. This leads to wrong interpretation of financial results by external users due to the problem of inconsistency and incomparability of financial results among different business entities. In order to mitigate inconsistency and incomparability and to bring uniformity in preparation of the financial statements, accounting standards are being issued in India by the Institute of Chartered Accountant of India. Accounting standards help in removing ambiguities and inconsistencies. Hence, accounting standards and accounting concepts are referred as the essence of financial accounting.

Question:7

Why is it important to adopt a consistent basis for the preparation of financial statements? Explain.

Solution:

Financial statements are drawn to provide information about growth or decline of business activities over a period of time or comparison of the results, i.e. intra-firm (comparison within the same organisation) or inter-firm comparisons (comparison between different firms). Comparisons can be performed only when the accounting policies are uniform and consistent.

According to the Consistency Principle, accounting practices once selected should be continued over a period of time (i.e. years after years) and should **not** be changed very frequently. These help in a better understanding of the financial statements and thus make comparisons easy. For example, if a firm is following FIFO method for recording stock, and switches over to the weighted average method, then the results of this year **cannot** be compared to that of the previous years. Although consistency does **not** prevent change in the accounting policies, but if change in the policies is essential for better presentation and better understanding of the financial results, then the firm must undertake change in its accounting policies and must fully disclose all the relevant information, reasons and effects of those changes in the financial statements.

Question:8

Discuss the concept-based on the premise 'do not anticipate profits but provide for all losses'.

Solution:

According to the Conservatism Principle, profits should **not** be anticipated; however, all losses should be accounted (irrespective whether they occurred or not). It states that profits should **not** be recorded until they get recognised; however, all possible losses even though they may happen rarely, should be provided. For example, stock is valued at cost or market price, whichever is lower. If the market price is lower than the cost price, loss should be accounted; whereas, if the former is more than the latter, then this profit should **not** be recorded until unless the stock is sold. There are numerous provisions that are maintained based on the conservatism principle like, provision for discount to debtors, provision for doubtful bad debts, etc. This principle is based on the common sense and depicts pessimism. This also helps the business to deal uncertainty and unforeseen conditions.

Question:9

What is matching concept? Why should a business concern follow this concept? Discuss?

Solution:

Matching Concept states that all expenses incurred during the year, whether paid or **not**, and all revenues earned during the year, whether received or **not**, should be taken into account while determining the profit of that year. In other words, expenses incurred in a period should be set off against its revenues earned in the same accounting period for ascertaining profit or loss. For example, insurance premium paid for a year is Rs1200 on July 01 and if accounts are closed on March 31, every year, then the insurance premium of the current year will be ascertained for nine months (i.e. from July to March) and will be calculated as,

$$\text{Rs } 1200 - \text{Rs } 900 = \text{Rs } 300$$

Thus, according to the matching concept, the expense of Rs 900 will be taken into account and **not** Rs 1200 for determining profit, as the benefit of only Rs 900 is availed in the current accounting period.

The business entities follow this concept mainly to ascertain the true profit or loss during an accounting period. It is possible that in the same accounting period, the business may either pay or receive payments that may or may **not** belong to the same accounting period. This leads to either overcasting or undercasting of the profit or loss, which may **not** reveal the true efficiency of the business and its activities in the concerned accounting period. Similarly, there may be various expenditures like, purchase of machinery, buildings, etc. These expenditures are capital in nature and their benefits can be availed over a period of time. In such cases, only the depreciation of such assets is treated as an expense and should be taken into account for calculating profit or loss of the concerned year. Thus, it is very necessary for any business entity to follow the matching concept.

Question:10

What is the money measurement concept? Which one factor can make it difficult to compare the monetary values of one year with the monetary values of another year?

Solution:

Money Measurement Concept states that only those events that can be expressed in monetary terms are recorded in the books of accounts. For example, 12 television sets of Rs10,000 each are purchased and this event is recorded in the books with a total amount of Rs 1,20,000. Money acts a common denomination for all the transactions and helps in expressing different measurement units into a common unit, for example rupees. Thus, money measurement concept enables consistency in maintaining accounting records. But on the other hand, the adherence to the money measurement concept makes it difficult to compare the monetary values of one period with that of another. It is because of the fact that the money measurement concept ignores the changes in the purchasing power of the money, i.e. only the nominal value of money is concerned with and **not** the real value. What Rs 1 could buy 10 years back **cannot** buy today; hence, the nominal value of money makes comparison difficult. In fact, the real value of money would be a more appropriate measure as it considers the price level (inflation), which depicts the changes in profits, expenses, incomes, assets and liabilities of the business.