

CBSE Test Paper 05
Ch-2 Theory Base of Accounting

1. Due to which principle, contingent liabilities are shown in the balance sheet?
2. A businessman purchased goods for Rs.30,00,000 and sold 80% of such goods during the accounting year ended 31st March 2013. The market value of the remaining goods was Rs.5,00,000. He valued the closing stock at Rs.6,00,000. Which concept did he violate?
3. Varun Ltd purchased 1500 sq.m land for Rs.4.5 crore to build a factory. At the end of year, the market value of land was Rs.4.05 crore. Varun Ltd treated Rs.45 lakh as loss and recorded the land at ? 4.05 crore. State whether the treatment of company is correct or not, if not which principle is being violated here?
4. Name the basis of accounting, which is recognised under the Companies Act, 2013.
5. What do you understand by accounting conventions?
6. Explain materiality principle.
7. During the financial year, Rajan had cash sales of Rs.4,50,000 and credit sales of Rs.3,00,000. Expenses incurred for the year were Rs.3,50,000 out of which Rs.1,50,000 are still to be paid. Find out Rajan's income following:
 - i. Cash basis of accounting
 - ii. Accrual basis of accounting
8. Briefly explain the 'full disclosure' principle of accounting?
9. Briefly discuss the two accounting systems, used to record financial transactions in the books of accounts.
10. Why is it important to adopt a consistent basis for the preparation of financial statements? Explain.

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Answer

1. Principle of full disclosure says contingent liabilities are shown in balance sheet by way of footnotes.
2. Principle of Conservatism or prudence
3. No, the treatment is not correct as it has violated the principle of cost. According to this principle, a fixed asset is to be recorded in the books at a price at which it was acquired and by showing 45 lakhs as loss is totally wrong.
4. Accrual basis of accounting is recognised under Companies Act, 2013
5. Accounting Conventions are guidelines based on custom, or usage or general agreement, they are followed in preparing the profit and loss account and balance sheet, personal judgement may play crucial role in the adoption of accounting conventions.
6. The materiality principle states that an accounting standard can be ignored if the net impact of doing so has such a small impact on the financial statements that a reader of the financial statements would not be misled. Under generally accepted accounting principles (GAAP), you do not have to implement the provisions of an accounting standard if an item is immaterial. This definition does not provide definitive guidance in distinguishing material information from immaterial information, so it is necessary to exercise judgment in deciding if a transaction is material.

The Securities and Exchange Commission has suggested for presentation purposes that an item representing at least 5% of total assets should be separately disclosed in the balance sheet. However, much smaller items may be considered material. For example, if a minor item would have changed a net profit to a net loss, that item could be considered material, no matter how small it might be. Similarly, a transaction would be considered material if its inclusion in the financial statements would change a ratio sufficiently to bring an entity out of compliance with its lender covenants.

The materiality principle is especially important when deciding whether a transaction should be recorded as part of the closing process, since eliminating some transactions can significantly reduce the amount of time required to issue financial statements. It is useful to discuss with the company's auditors what constitutes a material item, so that there will be no issues with these items when the financial statements are audited.

7. Cash basis refers to a major accounting method that recognizes revenues and expenses at the time cash is received or paid out. This contrasts accrual accounting, which recognizes income at the time the revenue is earned and records expenses when liabilities are incurred regardless of when cash is received or paid.

Cash Basis of Accounting = $4,50,000 - 2,00,000 = \text{Rs. } 2,50,000$

Under the *accrual* basis of accounting (or accrual method of accounting), revenues are reported on the income statement when they are earned. When the revenues are earned but cash is not received, the asset accounts receivable will be recorded.

Accrual Basis of Accounting = $4,50,000 + 3,00,000 - 3,50,000 = \text{Rs. } 4,00,000$

8. According to this principle, there should be reporting of all the significant information relating to the economic affairs of the business and it should be complete and understandable.

The information disclosed should be material and significant, which in turn results in better understanding. Since one of the objectives of accounting information is to communicate accounting information to various users, it is important to provide complete information to them, so that they can take right decisions at the right time on the basis of the financial statements of the business. Whether information should be disclosed or not depends upon whether such information will affect the decision making of the users of accounting information or not.

The Companies Act, 2013 provides disclosures, yet there may be many material information which if disclosed, will make the financial statements more meaningful. Various items which do not find a place in an accounting statement are shown in the balance sheet by way of footnotes. Such as:-

- i. Contingent Liabilities:- For instance, a claim of a very big sum pending in a court

of law against the enterprise should be brought to the notice of the users of the financial statements, otherwise the statement should be misleading.

- ii. If there is a change in the method of valuation of the stock, or for providing depreciation or in making provision for doubtful debts, it should be disclosed in the Balance sheet by way of a footnote.
- iii. The market value of Investments should be given by way of a footnote.

Disclosing of material facts does not mean leaking out the secrets of the business but disclosing sufficient information which is of material interest to the users of the financial statements.

9. Single Entry System

This system is not a complete system of maintaining records of financial transactions. It does not record two-fold effect of each and every transaction.

Only personal accounts and cash book are maintained under this system instead of maintaining all the accounts. No uniformity is maintained under this system while recording transactions.

The single entry system is also known as accounts from incomplete records. 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.

Double Entry System

Double entry system is based on the principle of 'dual aspect' which states that every transaction has two aspects i.e. debit and credit. The basic principle followed is that every debit must have a corresponding credit. Thus, one account is debited and the other is credited. It is a complete system as both the aspects of a transaction are recorded in the books of accounts. The system is accurate and more reliable as the possibilities of frauds and misappropriations are minimised. The system of double entry can be implemented by big as well as small organisations.

- 10. 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 books of accounts, summarising the results thereof and reporting them to the interested parties. For example, a firm can choose any one of the several methods of depreciation, i.e., straight-line method, written down method or any other method. But it is expected that the method once chosen will be followed consistently year after year. Likewise, the method of stock valuation or making provision for likely bad debts should remain consistent with the previous years otherwise the decision taken on the basis of accounts will be misleading.

However, consistency does not prohibit a change in accounting policies. Necessary required changes are fully disclosed by presenting them in the financial statements indicating their probable effects on the results of the business.

Hence, it is important to adopt a consistent basis for the preparation of financial statements.