

# Chapter 3 Accounting Principles

## Short Questions

### Question 1

Define basic accounting terms.

**Answer-**Accounting statement of a company is required by everyone to understand a company's financial status. Therefore, it is important to structure this statement wisely with some standard language and set rules. These set rules are known as Generally accepted accounting principle. These principles help a company to prepare the various type of statements of both government and private agencies.

### Question 1

Define basic accounting terms.

**Answer-**Accounting statement of a company is required by everyone to understand a company's financial status. Therefore, it is important to structure this statement wisely with some standard language and set rules. These set rules are known as Generally accepted accounting principle. These principles help a company to prepare the various types of statements of both government and private agencies.

### Question 2

Explain the business entity concept with an example.

**Answer-** In this concept, business is treated as a unit separate and distinct from its owners, creditors, managers, and others. In other words, the owner of the business is always considered as distinct and separate from the business he owns.

### Question 3

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

**Answer-** This assumption provides the very basis for showing the value of assets in the balance sheet because we assume that these assets are not going to be sold in the near future.

### Question 4

What is the basic accounting equation?

**Answer-**  $\text{Assets} = \text{Liabilities} + \text{Capital}$

### Question 5

Explain the characteristics of Accounting Principles.

**Answer-** The characteristics of Accounting Principles are.

- - Accounting principles have their own set of rules and guidelines used to develop an accurate and easy to understand the financial statement of a company.
  - These principles are determined from years of experience and reason. They are not laboratory proven, therefore, they are not used universally
  - These principles are not static so they have a chance to change with the passage of time according to new policies and needs of the user.
  - The reception of accounting principles depends upon the following points.

- **Relevance-** It means the principle is relevant only if the accounting information derived is useful to the user
- **Objectivity-** The principle is objective if it is free from personal bias or judgment from those people who furnish the accounting information.
- **Feasibility-** The principle is feasible if it can be applied easily and without the complexity

## Very Short Questions

### Question 1

Give two characteristics of accounting principles.

**Answer-** The two characteristics of accounting principles are

- (i) Man-made
- (ii) Flexible

### Question 2

What is the business entity concept?

**Answer-** Business is treated as an entity separate and distinct from its owners.

### Question 3

What is the money measurement concept?

**Answer-** Only those transactions and events are recorded in accounting which can be expressed in terms of money.

### Question 4

What is going concern concept?

**Answer-** Business will continue to exist for a long time in the future and there is no intention to close it or reduce its size significantly.

### Question 5

What is the accounting period concept?

**Answer-** The entire life of an enterprise is divided into time intervals which are known as accounting periods at the end of which a profit and loss account is prepared to ascertain the profit and a balance sheet is prepared to ascertain the financial position.

### Question 6

What is the cost concept?

**Answer-** Assets are shown in the book at cost of acquisition less depreciation.

### Question 7

What is the dual aspect concept?

**Answer-** Every business transaction is recorded having a dual aspect. One aspect is debited while other is credited.

### Question 8

What is matching concept?

**Answer-** All costs incurred during a particular period should be charged to revenue of the period for determining the net profits.

#### **Question 9**

How does the matching concept apply to depreciation?

**Answer-** In matching concept all costs which are incurred in an accounting period should be charged against the revenue of the period. Hence, depreciation of the current year is charged against the current year's revenue. In other words, the full cost of the asset is not treated as an expense in the year of its purchase itself rather it is spread over its useful life.

#### **Question 10**

What is accrual concept?

**Answer-** Revenue is recorded when sales are made or services are rendered and it is immaterial whether cash is received or not.

#### **Question 11**

What is a convention of full disclosure?

**Answer-** There should be sufficient disclosure of information which is of significant interest to the users of financial statements.

#### **Question 12**

What is the concept of consistency?

**Answer-** Accounting principles and methods once selected and adopted should be applied consistently from one year to another.

#### **Question 13**

What is the convention of prudence or conservatism?

**Answer-** All anticipated losses should be recorded in the books of accounts, but all anticipated or unrealized gains should be ignored.

#### **Question 14**

What is the convention of materiality?

**Answer-** Items having an insignificant effect or being irrelevant to the users of financial statements need not be disclosed.

#### **Question 15**

Which principle states that the financial statements should disclose all significant information?

**Answer-** Convention of full disclosure.

#### **Question 16**

'Closing stock is valued at lower of cost or realisable value'. Which principle of accounting is applied here?

**Answer-** Convention of Prudence or Conservatism.

#### **Question 17**

Why should a business follow the consistency concept?

**Answer-** One of the qualitative characteristics of accounting information is comparability i.e., the financial statements must be comparable from year to year. It is possible only when accounting principles remain not changed and followed consistently year after year.

### **Question 18**

State one limitation of historical cost.

**Answer-** During periods of inflation, the figure for net profit will be distorted because depreciation based on historical cost will be charged against revenues at current prices.

### **Question 19**

Why the entire life of a business is divided into time intervals?

**Answer-** To ascertain the amount of profit earned or loss suffered by the business.

## **Higher Order Thinking Skills (HOTS) Questions**

### **Question 1**

What is meant by GAAP?

**Answer-** GAAP stands for General Accepted Accounting Principles.

### **Question 2**

The proprietor of the business is treated as a creditor to the extent of his capital under which concept?

**Answer-** The concept is a business entity concept.

### **Question 3**

A customer of X Ltd. has discontinued his business. He used to purchase 30% of the total goods produced by X Ltd. Is it relevant information in your opinion and should be disclosed by X Ltd.

**Answer-** Yes, the information is of material interest to the users of financial statements and must be disclosed as per the convention of full disclosure.

### **Question 4**

X Ltd. gets a contract of ₹100 crores to build a shopping mall to be completed in 3 years. The management of the company wants to ascertain profit or loss on this contract only when the contract is completed. Is the management justified?

**Answer-** No, the management is not justified. Although the true profit and loss can be ascertained only after the completion of the contract, it will be divided into time intervals of twelve months for the ascertainment of profit as per accounting period concept.

### **Question 5**

Under which principle the calibre or quality of the management is not disclosed in the balance sheet.

**Answer-** Under the principle money measurement concept the calibre or quality of the management is not disclosed in the balance sheet.

### **Question 6**

Which accounting principle states that all anticipated losses should be recorded but all anticipated profits should be ignored?

**Answer-** Convention of Prudence states that all anticipated losses should be recorded but all anticipated profits should be ignored.

### **Question 7**

According to which concept depreciation is to be charged as per one particular method year after year?

**Answer-** According to the concept of consistency the depreciation is to be charged as per one particular method year after year.

### **Question 8**

Why the full cost of an asset is not treated as an expense in the year of its purchase?

**Answer-** Because of going concern concept, it is assumed that the business will continue to exist for a long period in the future. Hence, the cost of the asset is spread over its useful life and only the current year's depreciation is treated as an expense.

### **Question 9**

During the year the company purchased ballpoint pens of ₹500. These were issued to employees and were still in use at the end of the year. Which accounting concept you would follow in dealing with this item?

**Answer-** Materiality convention will be followed in dealing with this item. As per the concept, items having an insignificant effect or being irrelevant to the users of financial statements need not be disclosed. Hence, it will be treated as an expense and will be debited to the stationery account.

### **Question 10**

A debtor who owes ₹2 lakhs to the company is rumoured to be declared insolvent. Will you disclose the information in the books?

**Answer-** Yes, as per the convention of conservatism, all anticipated losses should be recorded. But all anticipated gains should be ignored. Hence, provision for doubtful debts should be created in anticipation of actual bad debts.

### **Question 11**

Goods withdrawn by the proprietor for his personal use has not been recorded in the books of accounts. Which accounting concept has been violated?

**Answer-** The business entity concept will be violated.

### **Question 12**

In a business provision for doubtful debts is created @5% on debtors every year. Name two accounting principles followed in this process.

**Answer-** The two accounting principles followed in this process are consistency and prudence.

### **Question 13**

A firm has stationery stock amounting ₹400 as at the end of the financial year. Accountant of the firm has written it off to profit and loss account. Is he right in doing so?

**Answer-** Yes, the accountant is right because he has followed the materiality convention according to which the items having insignificant effect may not be disclosed or may be written

off.

## Value-Based Questions

### Question 1

Why the closing stock is valued at cost price or realisable value whichever is less?

**Answer-** Closing stock is valued at lower cost price or realisation value according to the convention of conservation of conservatism or prudence.

### Question 2

What is the value involved in adopting the convention of conservatism or prudence?

**Answer-** According to the convention of conservatism, all anticipated losses should be recorded in the books of accounts but all anticipated gains should be ignored. The values involved in following this principle are (i) following the policy of playing safe and (ii) transparency.

### Question 3

Do you think that the convention of conservatism results in the creation of secret reserves?

**Answer-** Yes, the convention of conservatism will have two effects:

- (i) Profit and loss account discloses lower profits in comparison to the actual profits.
- (ii) The balance sheet will disclose the understatement of assets and overstatement of liabilities. These two effects result in the creation of secret reserves.

### Question 4

What value is involved in following the concept of a separate entity?

**Answer-** In the absence of the concept of a separate entity, the net profits and financial position of a business entity cannot be known.

### Question 5

Identify the values involved in the assumption of ongoing concern.

**Answer-** The values involved in the assumption of ongoing concern are

- (i) It is because of this concept that a distinction is made between capital and revenue expenditure
- (ii) It is because of this concept that full cost of an asset is not treated as an expense in the year of purchase itself and the cost is spread over the useful life of the asset by charging depreciation on a suitable basis.
- (iii) It is because of this concept that outside parties purchase shares and debentures of the enterprise.

### Question 6

Why fixed assets are not shown in the books at market value?

**Answer-** Fixed assets are not shown in the books at market value because

- (i) As per the historical concept, we record fixed assets at original cost
- (ii) As per going concern concept, the assets are not going to be sold in the near future. Hence, the market value is irrelevant.

### Question 7

Why the entire life of the business enterprise is divided into time intervals?

**Answer-** Entire life of the business is divided into time intervals of twelve months for the ascertainment of profits.

### Question 8

A company purchased goods for ₹5,00,000 and sold 80% of such goods during the year. The market value of the remaining goods was ₹90,000. The company valued the closing stock at cost. Which principle is being violated?

**Answer-** The principle of a convention of conservatism or prudence is violated.

### Question 9

On 25th March 2017, a fire broke out in the premises of Kamal Ltd. and destroyed a part of its plant and machinery. On account of this, a sharp decline in production for the next six months is expected. The company did not disclose this fact in its annual report for the year ended 31st March 2017. What is your opinion about this omission?

**Answer-** The company has violated the convention of full disclosure. Loss of plant and machinery is material information and should have been disclosed.

### Question 10

R Ltd. purchased 500sq. Meter land for ₹1.5 crores to build a factory. At the end of the year, the market value of land was ₹1.35 crore. R Ltd. treated ₹15 lakh as loss and recorded the land at ₹1,35 crore. Is it a correct treatment?

**Answer-** No, it is not a correct treatment. According to cost concept, a fixed asset is recorded in the books at a price it was acquired.

### Question 11

Raja Ltd. purchased securities for ₹50lakh. At the end of the year, the market value of such securities was ₹40 lakh. While preparing the financial statement, the company valued the securities at cost i.e at ₹50 lakh. Is it a correct treatment?

**Answer-** No, it is not a correct treatment. The company has violated the convention of prudence according to which current assets are valued at cost price or realisable value whichever is less.

### Question 12

A company has been charging depreciation @10% on original cost method. It now wants to change the method from the original cost to diminishing balance method, the rate of depreciation being 15% p.a. Can it do so?

**Answer-** Yes, the method and the rate of depreciation can be changed but the change in method will be treated as a change in accounting policy. The company should disclose the change in its financial statements along with its impact on profit or loss.

### Question 13

Mohan the owner of a business receives an order for the supply of goods worth ₹2,00,000. He has also received ₹25,000 against this order. Mohan wants to record it as a sale. Is Mohan correct in doing so?

**Answer-** No, he will not be correct in recording it as sales because the goods have not been delivered as yet and hence the sale is not completed. Mohan has not earned the revenue so far.

Under the matching concept, revenue is recognized as earned only when the cost incurred to earn that revenue is also recognized as an expense in that period.

**Question 14**

Identify the value involved in full disclosure principle.

**Answer-** The value involved in the full disclosure principle are

- (i) Reliability
- (ii) Transparency
- (iii) Honesty