CHAPTER

2

Generally Accepted Accounting Principles

- Introduction
- Need of Accounting Principles
- Generally Accepted Accounting Principles
- Characteristics of Accounting Principles
  - Objectivity
  - Application
  - Reliability
  - Feasibility
  - Understandability
- Accounting Concepts
  - Separate Entity Concept
  - Money Measurement Concept
  - Dual Aspect Concept
  - Going Concern Concept
  - Cost Concept
  - Accounting Period Concept
  - Periodic Matching of Costs and Revenues Concept
  - Realisation Concept
- Accounting Conventions
  - Conservatism
  - Consistency
  - Materiality
  - Full Disclosure
- Check Your Understanding
- Descriptive Questions
- Interview Questions

2.1 INTRODUCTION

Accounting is the language of business. When we speak in any language, our intention is our ideas are to be understood by others. Language can be understood only when words used by us convey the same meaning to the listener. Both the speaker and listener should mean the same for the words used. Equally, every language has grammar of its own. When we write or speak, we follow the principles of grammar. Similar is the case with accounting.

Most of the activities, be it official, social or personal, are guided by a set of certain rules or conventions. Some of the conventions are as follows:

- In India, we always drive on the left hand side of the road.
- Overtaking the vehicle, either two-wheeler or four-wheeler, is to be made on the right side, alone.
- As a citizen of India, we are guided by certain rules and regulations.
- Also as a citizen, we are supposed to obey the law of this country and so on.

While preparing the accounts, the accountant is often faced with the problem as to how exactly a transaction or event is to be recorded in the books of accounts and shown in the Profit and Loss account and Balance Sheet. There are differences of views on many matters. However, accountants have come to an agreement about some fundamental principles, concepts and conventions. These are always kept in mind when an accounting transaction is recorded.

2.2 NEED OF ACCOUNTING PRINCIPLES

In the olden days, the common form of business has been sole proprietor or partnership firm. It has been sufficient, if they have understood the accounting records. Their financial statements are personal and confidential character, which are not shared as public documents. In the case of joint stock companies, the financial statements are public documents. In modern days, joint stock companies, be it private limited or public limited, has become the normal form of business. There are several parties interested in their financial statements ranging from shareholders, creditors, employees and Government to potential investors. If every business follows its own accounting practices, the final accounts may not be understandable to all such parties in a similar and uniform manner. Unless the accounting transactions are recorded according to certain definite principles, it becomes difficult to maintain uniformity of understanding. Hence, a definite need has been felt to follow uniform accounting principles from the stage of recording the transactions to the stage of preparing financial statements.

Accounting principles are the rules based on assumptions, customs, usages and traditions for recording transactions.

2.3 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Transactions are recorded in accounts, following certain fundamentals, concepts and conventions, which are called as Generally Accepted Accounting Principles.

> **Accounting principles may be defined as those rules of action or conduct, which are adopted by the accountants, universally, while recording the transactions.**

The chief objective behind the accounting principles is that the accounting statements should be both reliable and informative. This objective can be achieved when there is certain common agreement and compliance about the accounting principles.

Every profession has developed its own jargon and vocabulary. Like all other professions, accounting has also developed its own concepts and conventions. These concepts and conventions have been evolved after centuries of experimentation and their use have, now, become accepted principles.

> **"Accounting" is based on a number of rules or conventions, which have evolved over time.**

These principles are known as generally accepted accounting principles.

Generally Accepted Accounting Principles (GAAP) may be defined as those rules of action or conduct, which are derived from experience and practice, and when they prove useful, they are accepted as principles of accounting.

They are, however, not rigid. They are subject to change. They have evolved in order to deal with practical problems experienced by a preparer and a user rather than to reflect some theoretical ideal.

> **Generally Accepted Accounting Principles (GAAP) is a term used to describe, broadly, the body of principles that governs the accounting for financial transactions underlying the preparation of a set of financial statements.**

However, it should be mentioned, at the outset, that an application of many concepts does involve subjective judgment about the selection of methods available for choice, on the part of a person who is preparing the accounts. Depreciation can be provided on fixed assets, either on the basis of straight-line method or written down method. Both the methods are recognised. Same financial data, if different methods are applied, shows different financial results. This means that two different persons using the same source data could produce two entirely different sets of financial statements, with different operational results and financial position. There is no difference of opinion whether depreciation on fixed assets is to be provided or not. Here, the subjective judgment relates to selection of method of depreciation and not providing for depreciation on the fixed assets.

According to the American Institute of Certified Public Accountants (AICPA), the principles, which have substantial authoritative support, become a part of the generally accepted accounting principles.

Accounting principles are divided into two categories:

(i) Accounting Concepts

(ii) Accounting Conventions

2.4 CHARACTERISTICS OF ACCOUNTING PRINCIPLES

Accounting principles are accepted if they possess the following characteristics. The general acceptance of the accounting principles or practices depends upon how well they meet the following criteria:

1. Objectivity

Objectivity connotes reliability and trustworthiness. A principle is objective to the extent when the accounting information is not influenced by personal bias or judgment of those who provide it. This implies that accounting information is prepared and reported in a "neutral" way. In other words, it is not biased towards a particular user group or vested interest. It also implies verifiability, which means that there is some way of ascertaining the correctness of the information reported.

2. Application

Application of the principle must be possible. In case, the principle is only theoretical and has no practical utility or application, then the principle has no value.

3. Reliability

This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant missed out) and capable of being verified (e.g. by a potential investor).

4. Feasibility

A principle is feasible to the extent it can be implemented without much complexity or cost.

5. Understandability

The accounting principle should be simple and easily understandable by all. This implies that the accounting information should be in such a way that it is easily understandable to users — who are generally assumed to have a reasonable knowledge of business and economic activities.

2.5 ACCOUNTING CONCEPTS

The term 'Accounting Concept' refers to assumptions and conditions on which the accounting is based. Basic assumptions of accounting can never be ignored.

Accounting concepts are necessary assumptions or conditions, which form a basis of accounting.

The different accounting concepts are discussed under the following heads:

1. Separate Entity Concept

According to this concept, business is considered as a separate entity, distinct from the persons who own it. This concept is also known as 'Business Entity Concept'. In other words, business is treated as a unit or entity apart from its owner, creditors and others. It may appear strange that a person can sell goods for himself. However, it would make sense once it is understood that the private affairs of the proprietor are to be made separate from the business. Let us take a practical example in our daily life. If the daughters of the proprietor take away the garments they like from their father's boutique shop and these transactions are not recorded with the reasoning that the business and proprietor are not different, what is the consequence? The year-end accounts show shortage of stock as they are not recorded, at all. Manager of the shop may be made accountable for the shortages shown. Business may show reduced profits or even loss due to the fancy habits of the daughters of the proprietor. Remember, the proprietor has more than one daughter and their habits are fancier too! For this reason, capital invested by proprietor/partner of a business is shown as capital, under the liability side. Consumption of garments is treated as personal withdrawal and those transactions may be recorded, at best, at their cost price. In the absence of such treatment, profit would be low and financial position is distorted.

Separate entity concept already exists, legally, in a joint stock company. Even in the sole proprietor and partnership firms, this concept of 'separate entity', though does not legally exist, is presumed to exist for accounting treatment.

This concept has now been extended for various divisions of a firm in order to ascertain the results of each division, separately.

Separate Entity Concept has given birth to the concept of 'Responsibility Accounting' for determining the operational results of each responsibility centre.

2. Money Measurement Concept

Accounting records only those transactions that can be expressed, in terms of money, though quantitative records are kept, additionally. If the events or transactions cannot be expressed in monetary value, however important they are, they are not recorded in accounts. Services of the finance manager and chief executive officer are very valuable and due to their significant contribution, the firm might have turned from its earlier loss making position into a profit-making firm. Their presence in the firm is valuable and their exit may be a serious bolt to its continued success. Though they are assets to the firm, in the real sense, but monetary measurement is not possible so accounting books do not exhibit them. Qualities like workforce skill, morale, market-leadership, brand recognition, quality of management etc cannot be quantified in monetary terms and so not accounted for in books of accounts.

> **The money measurement concept increases the true understanding of the state of affairs of the business.**

For example, if a business has a cash balance of Rs.20,000, plot of land 5,000 square metres, two air-conditioners, 1,000 kg of raw materials, 20 machines and 50 chairs and tables and so on, there is absence of money measurement concept. These different types of assets cannot be added to give useful information. One cannot assess the worth of the firm. But, if the same are expressed in terms of money in accounts – Rs.20,000 cash balance, Rs.2 lakhs of plot, Rs.40,000 of air-conditioners, Rs.2,52,000 of raw materials, Rs.4,60,000 of machines and Rs.2,35,000 of furniture (chairs and tables) – it is possible to add them and use them for any comparison and understanding the financial position of the firm. When the value of the assets is expressed in terms of money, precise information is available with intelligible financial picture and is more useful for any other purpose.

3. Dual Aspect Concept

This is the basic concept of accounting. As per this concept, for every debit, there is a corresponding credit. In other words, when a transaction is recorded, debit amount has to be equal to the credit amount. This is also known as 'Double Entry Principle'. No transaction is complete without double aspect.

When a new business is started with a capital of Rs. one lakh, the position is expressed as under:

Capital (Equities) = Cash (Assets)

1,00,000 = 1,00,000

> **The term 'Assets' denotes the resources owned by the business, while the term 'Equities' denotes the various claims of the parties against those assets.**

Equities are of two types. They are owner's equity and outsider's equity. Owner's equity (or capital) is the claim of owners against the assets of the business. Outsider's equity (or liabilities) is the claim of the outsiders such as creditors, loan providers and debenture-holders against the assets of the company.

Someone, either owner or outsider, has a claim against the assets of the business. So, the total value of the assets is equal to the total value of capital and liabilities.

Equities = Assets

Capital + Liabilities = Assets

In the above situation, if an outsider (creditor) has supplied machinery for Rs.50,000 on credit, the situation would appear as follows:

Capital Rs.1,00,000 + Creditors Rs.50,000 = Cash Rs.1,00,000 + Machinery Rs.50,000

If the business has acquired an asset, the source could be any one of the following:

(a) New asset is in place of an asset given up; or

(b) Liability has been created for its acquisition; or

(c) There has been profit to purchase; or

(d) The proprietor has contributed more capital to finance.

Similarly, if there is an increase in liability, there must have been an increase in assets. Alternatively, loss would have reduced the capital, to that extent, with a similar reduction in assets.

Thus, at any time

Assets = Capital + Liabilities

Capital = Assets – Liabilities

The above is known as 'Accounting Equation'. This would indicate that the owner's share is always equal to the left out assets, after paying off the outsiders.

The term 'Accounting Equation' is used to denote the relationship of equities to assets.

The above concept establishes the arithmetical accuracy of the accounts and enables detection of the errors in accounting and provides a strict watch on the activities of the employees.

4. Going Concern Concept

The underlying idea of this concept is that the business would continue for a fairly long period to come. Accounting transactions are recorded from this point of view. On account of this concept, accountant does not take into account the market value of the fixed asset (forced value of asset, as if business would be liquidated) for preparing balance sheet. Depreciation is charged on the original cost of the fixed assets on the basis of the expected lives, considering that the business would continue, in future, at least for a reasonable period, at least sufficient to the life of the assets. At the time of preparing the final accounts, we take into consideration the outstanding expenses and prepaid expenses on the presumption that the business will continue in future too.

It is to be noted that the 'Going Concern Concept' does not imply permanent continuation of the enterprise, indefinitely.

It rather presumes that the enterprise will continue in operation long enough that the cost of the fixed assets would be charged over the usual lives of the assets. Moreover, the concept applies to the business, as a whole. Even if a branch or division of the business were closed, ability of the business to continue would not be affected.

5. Cost Concept

Cost concept is closely related to the 'Going Concern Concept'. Cost is the basis for all accounting in respect of fixed assets. If a plot of land is purchased at Rs.1,00,000, it has to be shown at that amount, even though the subsequent market price becomes Rs. 1,50,000. In other words, the subsequent changes in the market price are ignored. Even if the price falls to Rs. 80,000, the fall is equally ignored in respect of fixed assets.

Cost concept brings the advantage of objectivity in the preparation and presentation of financial statements. In the absence of this concept, accounting records would have depended on the subjective views of the persons.

It does not mean that the fixed assets are valued at the historic cost, original price at which they are acquired, for all the years. At the time of purchase, they are recorded at the original cost and later depreciation is charged, based on the original cost. For presentation in the Balance Sheet, depreciation is deducted from the original cost and net value is shown on the assets side. Thus, the fixed asset depreciates during the economic life of the asset and, finally, is sold as scrap.

Cost concept is applied to fixed assets only. Current assets are not affected by this concept.

However, cost concept is largely becoming irrelevant due to continued inflationary tendencies. This is the growing reason for inflation accounting.

6. Accounting Period Concept

According to the 'Going Concern Concept', every business would exist for a longer duration. That longer duration is divided into appropriate segments or periods for studying the results shown by the business for each period.

After each period, it is necessary to 'stop' and 'see back' how things have been going. So, it is necessary to maintain accounts with reference to a specific period.

The specific period is normally one year. This time interval is called 'accounting period'.

At the end of each accounting year, Profit and Loss Account and Balance Sheet are prepared. Profit and Loss Accounts shows the financial results, while Balance Sheet shows the financial position. When making comparison, the accounting period should be similar. In other words, results of one year cannot be compared with the results of another period where the period has been only six months. Suitable adjustments are to be made before comparison of results of different periods for proper evaluation and conclusion.

7. Matching Concept—Periodic Matching of Costs and Revenues Concept

This concept is also known as 'Matching Concept'. The main motto of every business is to make maximum profits, at the earliest. Hence, every one tries to find out the cost and revenue during a particular accounting period and compare the financial results with preceding year to find out whether the business is progressing or going down. Unless the costs are associated properly with the revenues of the corresponding period, misleading results would appear. It is necessary to match the revenues with the costs of that particular period to know the profit or loss during that period. For example, if a salesman is to be paid commission for the sales made, for comparison of sales, it is immaterial whether the commission is paid or not. If sales are made in the month of March (year 2006-07) and commission, in cash, is paid in the subsequent month, April (year 2007-08), it is necessary to make provision for the commission in the year 2006-07 for proper comparison of the net profits.

Efforts and accomplishments are to be matched for proper presentation of operational results.

Excess of accomplishments over efforts is called profits. On account of this concept, adjustments for prepaid expenses, outstanding expenses, accrued income and unearned income have to be made, while preparing the accounts, at the end of the year, for proper comparison of profits of different years.

Matching concept requires suitable adjustment for deferred expenditure. What is meant by deferred expenditure? Deferred expenditure is that amount of expenditure that has been incurred but not charged to profit and loss account and postponed for charging against a future period. The argument is the benefit of the expenditure would last over the future period. Deferred expenditure is amortized on the basis of this matching concept. Relying on this concept, the deferred expenditure would be charged against the future incomes of the business. The classical example is Research & Development expenditure. Benefit of R & D expenditure would last for a considerable period. So, it is appropriate to charge the expenditure over the future period, spread in installments. The underlying idea is that the benefit of income should bear the share of expenditure as future income is the consequence of the expenditure incurred, in the past. So, the expenditure is matched to the income period.

8. Realisation Concept

According to this concept, profit is recognised as and when realised. Now, the important issue is, what the actual point of sale is and when profit is deemed to have been accrued?

Sale is deemed to have taken place, when the title to the property or goods passes from the seller to the buyer.

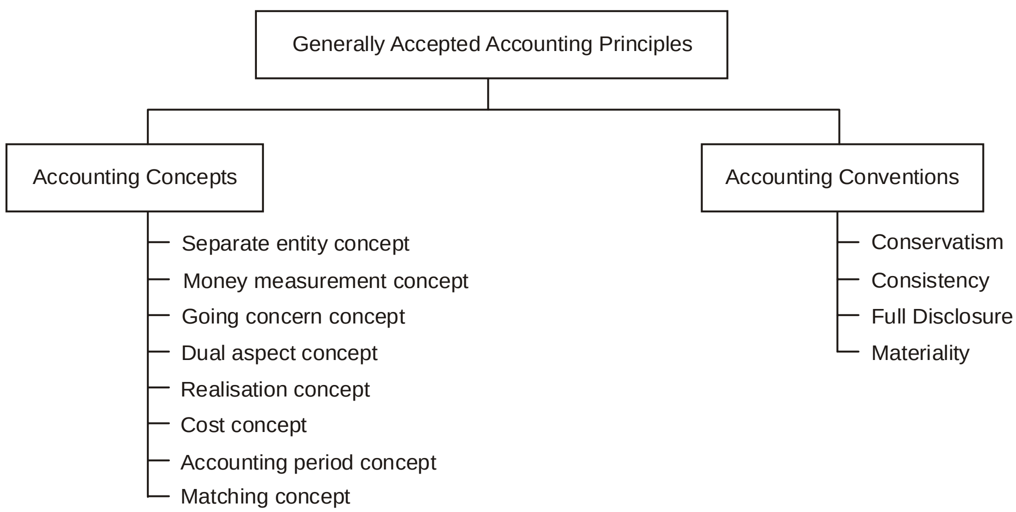
To make the point clear, let us take a small example. Radhi & Co, a boutique shop owner has placed an order with Dheera & Co for supply of ready-made garments. On receiving the order, Dheera & Co has purchased the required cloth, engaged labour and started manufacturing too. As per the terms of the agreement, Dheera & Co has received advance too from Radhi & Co, before execution of the order. Now, the issue is what is the actual time of sale? Is it at the time of receiving the order, time of receiving the advance, placing the order for supply of cloth and engaging the labour? The actual time of sale is when the goods are delivered by Dheera & Co to Radhi & Co. Till such time, no profit can be recognised.

Time of transfer of property is material as that point determines the time of recognition of Profit.

However, there are two exceptions to the above rule:

(A) In case of hire purchase sale, ownership of goods passes from the seller to the buyer only when the last installment is paid. This is from the legal view point. However, sales are presumed to have been made to the extent of the installment received and installment outstanding (i.e. installment is due, but not received). In other words, profit is recognised by the seller on installments received and due, without waiting for the receipt of last installment. The later is accounting view-point for recognition of profits. Reason is simple. Otherwise, there would be no profit, till the last installment period.

(B) In case of contract accounts, the contractor may be liable to pay only when the whole work is completed as per the terms of the contract. However, profit is recognised on the completed work, certified by the proper agency, year after year, for the purpose of accounting.



2.6 ACCOUNTING CONVENTIONS

By Accounting Conventions, we mean usages and customs of accounting. Customs or usage is a practice, which is in vogue, since long. We mostly use these conventions in preparing the final accounts, as they are useful for better understanding.

Accounting conventions are the customs and traditions, which guide us in preparing accounting statements.

Types of Accounting Conventions

1. Conservatism

'Playing safe' is the main idea underlying this convention. In the initial stages of accounting, not actual profits, but, even anticipated profits have been recorded. But, the anticipated profits have not materialised. This has shaken the confidence in accounting.

In consequence, Accounting has started to follow the rule "anticipate no profit and provide for all possible losses". For example, closing stock is valued at cost price or market price, whichever is lower. The effect of the above is that in case, market price comes down, then the 'anticipated loss' is to be provided for. But, if the market price goes up, then the 'anticipated profits' is to be ignored. When lower of the two is taken into account for valuation of closing stock, no anticipated profit is booked, but all possible loss is taken care of.

This concept emphasises that profit should never be overstated or anticipated.

> **Concept of conservatism is otherwise known as 'Prudence'. Conservative concept, more than any other, has given rise to the idea that accountants are pessimistic and boring people!!**

Basically, the concept says that whenever there are two equally acceptable methods, the one, which is more conservative, will be accepted. When a judgment is based on general estimates, if there is a dilemma as to which is correct, the most conservative estimate will be accepted. When there is a probability of getting profit or loss, profit will be ignored, but loss will be taken into account.

If an optimistic view of profits is taken, then dividends may be paid out of profits that have not been earned.

Critics point out that conservation to an excess degree results in the creation of secret reserve. Even, prudence does not justify the creation of secret reserves. Creation of secret reserves is not allowed. If allowed, it provides an opportunity to the management to cover their inefficiencies from the secret reserves so created. So, Creation of secret reserves is also quite contrary to the doctrine of disclosure. 'Conservatism Concept' needs to be applied with more caution so that operational results are not distorted. This concept, principally, applies to the current assets.

2. Consistency

Consistency is a fundamental assumption of accounting. It is presumed, unless otherwise stated, Accounting Practices are unchanged, year after year. If the accounting practices are changed, the fact is to be mentioned and its impact is to be quantified.

If closing stock is valued at cost or market price, whichever is lower, the same principle is to be applied, every year. Similarly, if the fixed assets are depreciated according to the diminishing balance method, the same method is to be consistently followed. Following diminishing balance method for one year and straight-line method for the next year would distort the results. It does not mean ignoring change for betterment. The important point is departure for better techniques are allowed, but the effect of change has to be arrived at and specified. Otherwise, comparison would give misleading results. So, if the valuation of closing stock is changed from the earlier stated one (cost or market price, whichever is lower) to the valuation based on the market price alone, then in the year of change, the change has to be stated and, equally, the impact of change, in terms of profits, is to be quantified in 'Notes to Accounts'.

Once a firm has chosen a particular method of accounting, it should adhere to that method in the future, so as to allow for the most meaningful comparisons on a year-by-year basis.

However, consistency does not mean inflexibility. However, when there are compelling reasons for a change, that change should be reported. If adoption of a change results in inflating or deflating the profit figures and financial position, compared to the previous year, a suitable note about the impact of change on operational results and financial position has to be given in the 'Notes to the Accounts' of the financial statements.

Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change.

3. Materiality

'Materiality' refers to the relative importance of an item or event. This convention emphasises that all material facts should be recorded in accounting. Accountant should attach importance to material details and ignore insignificant details. While sending a statement of account to the debtor, the exact amount receivable from the concerned debtor is to be shown. However, when the summary of debtors is presented to the top management, the individual debtors are rounded to the nearest thousand. Here, management is not interested to know the minute details to the last rupee. The Companies Act permits preparation of financial statements to the nearest rupee. Similarly, even the income-tax payable is rounded to the nearest rupee.

The question what constitutes a 'material detail' is left to the discretion of the accountants. An accountant should make an objective distinction between material and immaterial information.

Materiality is defined in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" in the following terms:

"Information is material, if its omission or misstatement could influence the economic decision taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have, if it is to be useful".

Those who make accounting decisions continually confront the need to make judgments regarding materiality. Is this item large enough for users of the information to be influenced by it?

The accountant should regard an item material, if he has reason to believe that the knowledge of it would influence the decision. In other words, if the knowledge of information would have a bearing on the decision, then that information is material and is to be provided.

4. Full Disclosure

The Convention of 'Disclosure' means that all material facts must be disclosed in the financial statements. For example, in case of sundry debtors not only the total amount of sundry debtors should be disclosed, but also the amount of good and secured debtors, the amount of good, but unsecured debtors and amount of doubtful debts should be stated. Full disclosure does not mean disclosure of each and every piece of information.

> **Whether the information is required to be disclosed or not depends on the materiality of information. Materiality depends on the amount involved in relation to the group involved or profits.**

The financial statements should be honestly prepared and sufficiently disclose information, which is of material interest to the present and potential creditors and investors.

According to section 211 of the Companies Act, not only the financial statements must disclose a true and fair view of the affairs of the company, but also should be prepared in the prescribed form as per the requirements of the Act.

Appending notes to accounts and providing information in the notes is a sufficient disclosure of information. 'Notes to Accounts' is provided below the balance sheet. Generally, information relating to contingent liabilities, market value of investments and other information required to be disclosed is mentioned in notes and providing information in this manner is considered sufficient compliance of law.

Check your Understanding

(A) State whether the following statements are True or False

1. The chief objective behind the accounting principles is that the accounting statements should be both reliable and informative.
2. The term 'Accounting Concept' refers to assumptions and conditions on which accounting is based.
3. Financial statements of a Sole Proprietor or Partnership firm are open documents, available for inspection to the public.
4. Accounting principles may be defined as those rules of action or conduct, which are adopted by the accountants, universally, while recording the transactions in books of accounts.
5. Disclosure of contingent liabilities in the notes to accounts, not showing in the main accounts, does not comply disclosure convention.
6. Accounting concepts and accounting conventions convey the same.
7. Dual aspect is the basic concept of accounting.
8. The term 'accounting equation' is used to denote the relationship of equities to assets.
9. Equities are of two types—owner's equity and outsider's equity.
10. According to the 'Going Concern Concept', business would continue to run, indefinitely, beyond foreseeable future.
11. Cost concept is applicable to fixed assets as well as current assets.
12. Accounting conventions are the customs and traditions, which guide us in preparing accounting statements.

13. Conservatism concept emphasises that profit should never be overstated or anticipated.
14. Accountants follow the rule “anticipate no profit and provide for all possible losses”.
15. The concept of ‘Conservatism’ is otherwise known as ‘Prudence’.
16. If closing stock is valued, for a number of years, at cost or market price, whichever is lower, the same principle cannot be changed at all in later years.
17. The question what constitutes a material detail is left to the subjective judgment of the accountants.

Answers

1. True 2. True 3. False 4. True 5. False 6. False 7. True 8. True 9. True 10. False 11. False 12. True 13. True 14. True 15. True 16. False 17. True

(B) Pick up the most appropriate

1. Conservatism convention is applied for the valuation of
   (i) Current assets (ii) Fixed assets
   (iii) Current assets and fixed assets (iv) none
2. Cost concept is applied for the valuation of
   (i) Current assets (ii) Fixed assets
   (iii) Current assets and fixed assets (iv) none
3. The convention of conservatism, when applied to balance sheet, results in
   (i) understatement of liabilities (ii) overstatement of liabilities
   (iii) understatement of assets (iv) overstatement of assets
4. A manager asks the accountant to record the bitter relationship between the production manager and marketing manager, which has resulted in reduced profits. Accountant answers that this aspect cannot be recorded in accounts due to the following:
   (i) consistency convention (ii) money measurement concept
   (iii) separate entity concept (iv) disclosure convention
5. Proprietor inquires whether air-conditioner purchased for his residence can be accounted for in the accounts books of the business and he receives the reply from the accountant that such recording is a violation of
   (i) cost concept (ii) separate entity concept
   (iii) materiality (iv) realisation concept

Answers

1. (i) 2. (ii) 3. (iii) 4. (ii) 5. (ii)

(C) Match the following

1.	Accounting period consists of	Capital
2.	The qualitative aspect of the business is not recorded in the books of accounts according to the basic assumption of	Separate entity concept

3.	Treatment of capital in the books of the firm as liability observes the accounting assumption of	12 months
4.	A sale is recorded as soon as agreement is made, which is a violation	Money measurement
5.	.... of accounting can never be ignored	Materiality
6.	Disclosing important information in accounting observes the principles of	Realisation concept
7.	Assets – Liabilities =	Basic assumptions

Answers

1. 12 months 2. Money measurement 3. Separate entity concept 4. Realisation concept 5. Basic assumptions 6. Materiality 8. Capital

(D) Point out the incorrect equation

(a) Assets = Liabilities + Capital (b) Assets = Capital + Liabilities
(c) Liabilities = Assets + Capital (d) Capital = Assets – Liabilities

Ans. (c)

Descriptive Questions

1. What is meant by "Generally Accepted Accounting Principles"? Describe the characteristics the Accounting Principles should have for uniform acceptance. **(2.3)**
2. Explain the need of 'Accounting Principles'. Discuss briefly the Accounting Concepts and Conventions. Name any three each in both the categories and detail. **(2.2, 2.5 and 2.6)**
3. What do you understand by the term "Accounting Concepts"? Detail the Accounting Concepts. **(2.5)**
4. Explain the meaning of the term "Accounting Convention" and give a detailed presentation about the accounting conventions. **(2.6)**
5. Write about accounting principles and explain their importance in recording the financial transactions. **(2.2 and 2.3)**
6. What is meant by 'Generally Accepted Accounting Principles'? Describe characteristics of the accounting principles. **(2.2 and 2.4)**

Interview Questions

Q.1. Complete the following sentences:

business entity - dual aspect - business entity - realisation - going concern - prudence - consistency - cost - accruals - money measurement - materiality - prudence

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 (1) .... convention in operation.

The fact that a business is separate and distinguishable from its owner is best exemplified by the (2) .... concept.

Everything a firm owns, it also owes out to somebody. This co-incidence is explained by the (3) .... concept.

If a cashier buys a cash book to record accounts of the firm, he would not try to account for every single sheet of paper in the book because of the (4) .... convention.

The (5) .... convention states that if (say) the straight-line method of depreciation is used in one year, then it should also be used next year.

A firm may hold stock, which is heavily in demand. Consequently the market value of this stock may be increasing. Normal accounting procedure is to ignore this because of the (6) .... concept.

If we receive an order for goods, we would not include the value of it in our sales figures (yet) owing to the (7) .... concept.

A business makes a loss for the second year running, but the (8) .... concept tells us that it will carry on trading unless we are notified to the contrary.

Profit calculation is based on expenses incurred during the period rather than those paid. This statement effectively describes the (9) .... concept.

The management of "Sharma & Co" are remarkably incompetent, but the firm's accountants cannot take this into account when preparing the books because of the (10) .... concept.

The research and development section of "Kishore Ltd" however is doing so well that they anticipate a huge jump in sales next year. The accountants cannot increase the book value of the patents held though, because of the (11) .... convention.

The book-keeper for "Dheera Tiles" would only be concerned with the total value of her drawings, not with how she had spent it because of the .... concept.

Ans. 1. prudence 2. business entity 3. dual aspect 4. materiality 5. consistency 6. cost 7. realisation 8. going concern 9. accruals 10. money measurement 11. prudence 12. business entity

Q.2. The first years' profit of Cherry Bicycles was reported as Rs. 25,600. After this figure was reported, it became known that shop equipment with a cost price of Rs. 6,000 had been entered in full as an expense. The equipment was estimated to last for five years, after which it would be worthless. Fill the gaps in the following:

The amount that should have been charged as an expense to this year is (i) Rs. .... , giving a corrected profit figure of (ii) Rs. .... The relevant concept that should be applied here is the (iii) .... concept.

Ans. (i) 1,200 (ii) 30,400 (iii) going concern

Q.3. The chairman of Sandhya Components Ltd reports a profit of Rs. 78,000 for the year. This includes an amount of Rs. 5,000 relating to an order just received. Fill the gaps:

The real profit is (i) Rs. .... because we should apply the (ii) .... concept.

Ans. (i) Rs. 73,000 (ii) Realisation

Q.4. During the year, Radhi has taken home some garments from her boutique, in order to wear it herself. She has included the cost of this stock (Rs. 1,200) as a business expense when calculating the profits as Rs. 28,800. Fill the gaps:

The (i) .... concept applies here and the profit figure should be (ii) Rs. ....

Ans. (i) Business/separate entity (ii) Rs. 30,000

Q.5. Link the following:

1.	Based on assumptions and conditions	Money measurement concept
2.	Expressed in terms of money	Accounting concept
3.	Based on customs and traditions	Double entry principle
4.	Playing safe	Accounting convention
5.	Dual aspect concept	Accounting equation
6.	Equities = Assets	Materiality
7.	Reduction of capital	Cost concept
8.	Fixed assets	Conservatism
9.	Small and ignorable amount	Loss incurred by the firm

Ans. 1. Accounting concept 2. Money measurement concept 3. Accounting convention 4. Conservatism 5. Double entry principle 6. Accounting equation 7. Loss incurred by the firm 8. Cost Concept 9. Materiality

Q.6. A public limited company has been providing depreciation on its fixed assets by written down value method, since long. Now, the company wants to change the method of providing depreciation from WDV method to Straight line method. Is the change of method allowed and if so, how?

Ans. The company can change the method of providing depreciation from WDV method to straight line method. If it decides to change the method of providing depreciation, it has to quantify the effect of change on its operational results. In other words, it has to specify by what amount its profit has been increased or reduced by the changed method. This information has to be, specifically, quantified and stated in 'Notes to Accounts'.

Q.7. What is meant by 'Notes to Accounts'?

Ans. 'Notes to Accounts' are additional information provided below the financial statements. The notes give further details on the numbers given in the accounts. Matters, which have bearing on the financial results, are stated with their impact, quantified, wherever possible in 'Notes to Accounts'. This would enable the reader to understand the financial results and position in a proper perspective.

Q.8. What is the significance of 'Notes to Accounts'?

Ans. One has to read the financial statements along with the notes to accounts. In other words, notes to accounts are an integral part of financial statements. Investors who rely on the main body of the accounts and ignore the notes are likely to find themselves misled. The accounts are not complete without the Notes to Accounts.

Q.9. A private limited company has been valuing its closing stock, adopting the principle of 'cost or market price, whichever is lower', all the years. All the years, the cost has been lower. In the current year, the market price is lower than the cost. If the company values the stock on the basis of market price, changing from the earlier cost to market price, what accounting principle is violated? Do you feel any need to state in 'Notes to Accounts', if so, in what way?

Ans. There is no violation of any accounting principle. The company has been adopting the principle of 'cost or market price, whichever is lower' for valuation of closing stock. The principle of consistency is followed. There is no inconsistency here as the shift from cost price to market price is merely the application of the principle. Only the circumstances have changed. The application is followed, consistently.

Nothing is to be stated in 'Notes to Accounts'.

Q.10. Often we hear, 'Playing Safe' is the practice of accountants. What does it mean?

Ans. The accounting convention – convention of conservatism is also called 'Playing Safe'. According to this accounting policy, accounts should take into consideration all possible losses but not prospective profits. For this reason, providing for all losses and not accounting for profits is termed as 'Playing safe'.

The principle of conservatism is, generally, applied when there are two acceptable methods. The method that is more conservative is adopted. Similarly, when a judgment is based on estimates and there is a dilemma as to which one is correct, the most conservative one is accepted. For this reason, accountants are termed, at times, as pessimists.

Q.11. In one of the annual general meetings, a shareholder has raised the issue that some of the expenses are clubbed with other expenses. A reply has been given that some small amounts of expenditure, whose heads are not significant and important are clubbed. The management has stated that the financial statements disclose all the items which are '……….'. To which accounting principle, the reply is referred to? Explain the significance of the concept, discussed.

Ans. The reference is related to the convention of "Materiality". Materiality is a relative phenomenon. An item material for one concern may not be material to another concern or for another year. So, clubbing of insignificant items of expenditure is not a material.

An accountant should be able to make an objective distinction between material and immaterial information.

If there is sufficient disclosure and materiality is followed, there is no violation of any accounting principle.

❍ ❍ ❍