CHAPTER	
1	**Accounting : An Introduction**

Unit : 2 **Accounting Concepts, Principles and Conventions**

[1] (a) According to the conservatism concept of accounting, the accountant should provide for all possible losses but not anticipated incomes. Bad debts is a loss to the company which may arise in future therefore, a provision for bad and doubtful debts is made.

[2] (b) As per cost concept, the value of an asset is to be determined on the basis of historical cost i.e. the cost of acquisition. Therefore, recording of Fixed Assets at cost adheres to the principle of cost concept.

[3] (c) As per Accounting Standard-1 (AS-1), the fundamental accounting assumptions are:

- Going Concern - Consistency - Accrual

These are presumed to be followed during preparation of any financial statements and a special disclosure is required if any of them is not followed.

[4] (d) If it can be said that the fixed assets are sold at book value itself then there will be no change in total assets as furniture will be sold so it is removed from Balance Sheet but Cash/Bank will flow in.

Journal Entry: Cash A/c Dr.

To Furniture A/c

[5] (b) Accounting Equation is presented as follows:

Equities + Liabilities = Assets

Since, the liability side and asset side of the equation has to tally, hence it can be observed that it is based on Dual Aspect Concept. This concept is the core of double entry book-keeping and states that every transaction or event has two aspects, one debit and equal and opposite credit.

[6] (b) Entity concept states that business enterprise is a separate identity apart from its owner. Accountants should treat a business as distinct form its owners. Business transactions are recorded in the business books of accounts and owners transactions in his personal books of accounts.

[7] (d) According to the entity concept the owner should treat his personal expenses separate from those of the business. If this is not followed it means violation of entity concept. This concept states that enterprise is liable to the owner for capital investment made by the owner.

[8] (b) Two primary qualitative characteristics of financial statements "Relevance and Reliability". Information at first should be relevant and reliable and only then other characteristics will matter. If this characteristic is missing then even if information is understandable, material, etc. it will be not of any importance and use in ultimate decision-making.

[9] (a) When we have to receive something from any other person it becomes an Asset for the receiving person.

Liability will be one when something is due to be paid to an outsider. Expense is the outflow of economic resources to earn the specified revenue.

Capital is the sum provided by the owner for investment purposes in a business.

[10] (a) Machinery should be valued at ₹ 11,00,000 on 31.3.06 and not for ₹ 12,00,000. This entails adherence of Cost Concept.

If the machinery is valued at ₹ 12,00,000 on 31.3.06 it will mean violation of cost concept. Cost concept means that assets should be recorded at their buying cost or historical cost and not on their market value existing at the date of balance sheet.

[11] (d) Net Profit = Closing Capital + Drawings – Capital Introduced – Opening Capital

= 1,25,000 + 35,000 – 25,000 – 90,000

= 45,000

Therefore, the amount of Profit added to Capital is ₹ 45,000.

[12] (b) GAAP's mean Generally Accepted Accounting Principles. The term GAAP is used to describe rules developed for the preparation of the financial statements and are called concepts, conventions, postulates, principles, etc. These GAAP's are back bone of the accounting information system. GAAP's and Accounting Standards together are known as the theory base of accounting.

[13] (b) Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice. Accounting conventions need not have any universal application.

Therefore answer is Accounting Convention.

[14] (c) Double Entry Principle based on dual aspect concept means that a transaction has two aspects, a debit aspect and an equal and opposite credit aspect. It is for this reason that trial balance and ultimately the balance sheet, tally up.

[15] (b) The Concept of **Conservatism** states that the accountant should not anticipate income and should provide for all possible losses. This clearly shows that no inference of profit should be made and all possible losses should be incorporated.

[16] (c) Amortization of intangible assets means charging a reasonable portion of the asset on a product basis to the revenues of that year. This is done as per the Matching Concept.

Matching Concept states that all expenses matched with the revenue of that period should only be taken into consideration. Amortization is treated an expense of that particular year.

In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

[17] (d) "Dividends can only be paid out of the profits which have been realized in cash."

The Realisation concept states that any change in value of an asset is to be recorded only when the business realizes it. The change is not to be counted unless there is certainty that such change will materialize.

Therefore, holding gains in relation to stocks should not be used for payment of dividends because these have not been realized in cash.

[18] (d) As per the going concern concept it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations. If any such intention or need exists, the financial statements may have to be prepared on a different basis. It requires the assets to be brought down to their realizable values.

Therefore, if going concern is lost "Land held as investment would be valued at its realizable value".

[19] (a) Accounting Equation as per the dual aspect concept is:

Assets = Capital + Liabilities

When Ram starts business:

A	=	C + L
Cash	=	Capital + Liability
90,000	=	90,000 + Nil

When goods are bought on Credit:

A	=	C + L
Cash + Goods	=	Capital + Creditors
90,000 + 23,000	=	90,000 + 23,000
1,13,000	=	90,000 + 23,000

[20] (c) Window dressing means beautification of accounts and showing a more rosy picture than what actually is. This is mainly done with the intention of attracting more and more investments from the outsiders.

It is not a measure of tax avoidance or showing losses. It just aims at beautification with the objective of gaining more investments.

[21] (c) The Accounting Equation: Assets = Liabilities + Owners Equity

This is represented through the position statement i.e. Balance Sheet.

<u>Format of Balance Sheet</u>

Capital	Assets
Liabilities	

[22] (c) The journal entries for the transactions are as follows:

Car A/c	Dr.	10,000	
To Cash A/c			3,000
To Vendors A/c			7,000

As a result of above, the Asset side increase by 7,000 with corresponding increase in liabilities.

[23] (c) According to the Periodicity Concept, the accounts should be prepared after every period and not at the end of the life of the entity. This period can be any arbitrary point of time but usually this period is one calendar year. This concept makes the accounting system workable and the term 'accrual' meaningful.

[24] (d) According to Matching Concept, all expenses of one period should be matched with the revenues of that period itself. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash. This leads to adjustment of certain items like prepaid and outstanding expenses, unearned and accrued incomes.

[25] (d) **Same as Ans. 6 and 7**

[26] (c) According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item should not be disclosed in the financial statements.

Materiality principle permits other concepts to be ignored, if the effect is not considered material. This principle is an exception to full disclosure.

Omission of paise and showing the round figures, is due to this concept only.

[27] (d) As per the money measurement concept, only those transaction, which can be measured in terms of money are recorded in financial statements.

Any transaction which is not convertible in monetary terms, will not be recorded in financial statements even if it effects the results of the business materially.

Therefore, non-monetary transactions are not recorded in books of accounts.

[28] (b) Prepaid Expense means that expense which has been paid in advance. The journal entry for recording it is:

Prepaid Expense A/c Dr.
To Expense A/c

This shows that the amount of prepaid expense is deducted from the relevant expense and it is shown as an asset on the asset side of balance sheet. Prepaid expense is a representative personal account.

[29] (c) As per AS-1 issued by ICAI, the three fundamental accounting assumptions are:

(i) Going Concern
(ii) Consistency
(iii) Accrual

These require a mention in the financial statements if they are not followed. Therefore, conservatism is not a fundamental accounting assumption.

[30] (b) The concept of going concern treats the life of the business as indefinite i.e. the business life will consist of many accounting periods. Those assets benefit of which is received in one accounting year itself are current assets and those whose benefit extends to more than one accounting period are called fixed assets. Existence of more than one accounting period is supported by going concern concept only.

[31] (b) The obligations of an enterprise other than owner's fund are known as liabilities and also known as external equities. It is that amount which is payable to outsiders.

[32] (c) As per money measurement concept, only those transactions, which can be measured in terms of money are recorded in books of account. This concept requires that those transactions that are capable of being measured in terms of money can only be recorded in books of accounts.

[33] (c) Effect on fixed assets will be that they will increase by ₹ 6,60,000.

Entry:

Assets A/c	Dr.	6,60,000	
To Cash A/c			1,20,000
To Bills Payable A/c			5,40,000

[34] (a) By Valuing the machinery at ₹ 12,00,000 i.e. at market price, the company has violated the cost concept. As per the cost concept, the value of an asset is to be determined on the basis of historical cost, i.e. the acquisition cost.

[35] (a) Whenever proprietor/partner withdraws some amount for personal expenses it is debited to drawings account in the books of business.

Drawings A/c	Dr.	2,000	
To Cash A/c			2,000

[36] (a) Estimated selling price less estimated cost of sales is known as Net Realizable Value. This is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs are necessary to make a sale.

[37] (a) Unpaid expenses at the end of any period are accounted for as outstanding expenses or outstanding liabilities of the business as per the accrual concept.

Expenses A/c Dr.
 To Outstanding Expenses A/c.

[38] (c) Cost incurred to acquire an asset is shown in the balance sheet due to the cost concept, which states that assets should be recorded in balance sheet at their historical or acquisition cost.

[39] (c) Entry for receiving cash from debtors is:

Cash A/c	Dr.	50,000	
To Debtors A/c			50,000

Since, both the above items are current asset elements, there will be no change in current asset position due to this transaction.

[40] (c) Proprietor (owner) is treated as creditor of business due to entity concept or separate entity concept. As per this concept the business and the owner are two distinct and separate entities and thus all transactions of proprietor with the business should also be recorded.

[41] (a) Conservatism states that the accountant should not anticipate income and should provide for all possible losses. Discount is a possible expense which shall be provided for according to the concept of conservatism.

[42] (b) The three fundamental accounting assumptions are Going Concerns, Consistency, Accrual.

[43] (a) Conservatism states that the incomes shall not be anticipated and all possible losses should be provided for. Bad debt is a possible loss and hence provision shall be made on it as per the concept of conservatism.

[44] (c) Under accrual concept, the effects of transactions and other events are recognized on mercantile basis i.e. when they occur (and not when cash is received or paid) and they are recorded in accounting records and reported in financial statements of the period to which they relate.

Outstanding expenses refers to expenses which are related to the current period but are not paid and hence should be included in Profit and Loss A/c at the year end as per the concept of accrual.

[45] (b) Conservatism states that the accountant should not anticipate income and should provide for all possible losses. Therefore, the main objective of conservatism is to anticipate losses but not profits.

[46] (b) As per the concept of Disclosure, the financial statements must disclose all the reliable and relevant information about the business enterprise, to the management and also to their external users for which they are meant, which in turn will help them to take a reasonable and rational decision. Contingent liabilities are not recorded in the financial statements but should be shown as a foot note as per the concept of disclosure.

[47] (c) Dual Aspect Concept is the core of double entry book keeping. Every transaction or event has two aspects:

(1) Increase in one asset and decrease in other asset.
(2) Increase in asset simultaneously increases liability.
(3) Decrease in one asset, increase in another asset.
(4) Decrease in one asset, decrease in liability.
Dual aspect applies in a similar way in case of liabilities.

Hence, decrease in one asset and decrease in another asset does not satisfies the dual aspect concept.

[48] (b) Conservatism states that the accountant should not anticipate income and should provide for all possible losses. The golden rule of “Lower of Cost or Market Value” has originated from this concept.

[49] (c) The Owner of the enterprise pays the interest on drawings according to the Entity concept. According to this concept, business enterprise is a separate identity a part from its owner. The proprietor is treated as a creditor of the company. Therefore, when he withdraws money for his personal use from the business, it is treated as loan from the business to the proprietor, that is why he pays interest on drawings.

[50] (c) The Realisation concept will play a role when the value of inventory is reduced below cost price because the concept states that any change in the value of asset is to be recorded only when the business realises it.

[51] (b) The Cost concept basically recognises historical cost or the acquisition cost of the asset. The value of an asset is to be determined on the basis of historical cost.

[52] (a) **Same as Ans. 1**

[53] (b) As per the accrual concept, revenue and cost should be recognized as they are earned or incurred and not as money is paid or received.

Profit for the year	= ₹	1,20,000 – ₹ 60,000
	= ₹	60,000
(–) Expenses incurred	₹	20,000
Profits	₹	40,000

[54] (c) As per accrual concept, Sales – G.P. = Revenue is not correct.

[55] (b) If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements. However, if any of the fundamental accounting assumption is not followed then this fact should be specially disclosed.

[56] (a) Period for which subscription paid = July 1,09 to 30 June 10 Duration of year = 01.04.09 to 31.03.10.

So subscription for 3 months i.e. (April 2010 to June 2010) is prepaid.

So prepaid premium = 3 × 100 p.m = ₹ 300.

[57] (b) According to the matching concept all expenses matched with the revenues of that period should only be taken into consideration. In the financial statements of the organisation if any revenue is recognised then expense related to earn that revenue should also be recognized. This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash.

Revenue – Expenses = Profit

[58] (d) Prudence refers to the judgement about the possible future losses which are to be guarded as well as gains which are uncertain. As per this concept, closing stock be valued at cost or net realizable value whichever is less.

[59] (b) According to the materiality concept all the items having significant economic effect on the business of the enterprice should be disclosed in the financial statements and all insignificant items should be ignored.

Although staplers, calculators etc are the assets of the company and are to be used for a long time still since there amount is too small they are not recorded in the Balance Sheet.

Such items are ignored as per the concept of materiality.

[60] (c) Entity concept states that business enterprise is a separate identity apart from its owner.

It means that the enterprise is liable to the owner for capital investment made by the owner.

[61] (a) According to the concept of consistency, in order to achieve comparibility of financial statements, accounting policies are followed consistently from one period to another.

In the given Question Company XYZ Ltd. consistently follows the written down value of depreciation, hence it has applied the concept of consistency.

[62] (c) As per the cost concept, the value of an asset shall be determined on the basis of historical cost i.e. the acquisition cost and not the market value.

The value at which the machinery will be shown in the Balance Sheet will be –

Acquisition Cost

Less: Deprecation

Therefore amount to be showed in the Balance Sheet will be –

₹ 10,00,000 + 2,00,000 + 1,00,000 =	13,00,000
(-) depreciation	1,50,000
	₹ 11,50,000

[63] (d) As per the concept of money measurement only those items can be shown in the Balance Sheet which can be expressed in terms of money.

Human Resource, although is an asset for the business enterprise still cant be recorded in the books as it cant be expressed in terms of money.

[64] (c) Concept of conservation states that the accountant should not anticipate income and should provide for all possible losses.

[65] (d) According to dual aspect concept, every transaction has two aspects, one debit and the other credit.

In other words, every debit has an equal and opposite credit.

Accounting equation is also supported by this concept i.e. Assets = Capital + Liabilities.

[66] (b) Consistency concept requires that same accounting policies should be followed year by year which have been followed once. When same accounting policies are followed only then the financial statements of one accounting period become comparable with that of another accounting period.

[67] (c) **Consistency** concept requires that same accounting policies should be followed year by year which have been followed once and similar items in a set of accounts should be given similar accounting treatment.

[68] (d) According to matching concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization, if any revenue is recognized, then expense related to earn that revenue should also be recognised.

[69] (d) **Entity Concept** states that business enterprise is a separate identity apart from its owner. Business transactions are recorded in business books of accounts and owner's transactions in his personal books of accounts.
Hence, proprietor's personal travelling expenses are not to be charged in business accounts due to entity concept.

[70] (a) Journal Entry for starting business with cash is —

Cash A/c	Dr. 5,50,000	
To Capital A/c		5,50,000

This results in increase in both assets (cash) and capital by 5,50,000.
Journal entry for purchasing goods on credit from Mohan is —

Purchases A/c	Dr.1,50,000	
To Mohan A/c		1,50,000

This will result in increase in liabilities (creditors) as well as assets (stock) by 1,50,000.
Thus, accounting equation will be —
7,00,000 = 5,50,000 + 1,50,000.

[71] (b) In Order to achieve comparability of financial statements the same accounting policies should be followed over time due to the concept of **consistency**.

[72] (d) The Concept which makes a distinction between the receipt of cash and the right to receive the cash is accrual concept.
It says that income should be recorded in the books when right to receive is generated whether it has been actually realised or not.

[73] (d) As per the conservatism concept the stock should be valued at cost or market price whichever is lower.
The cost of remaining stock is ₹ 9,00,000 whereas its market value is ₹ 6,00,000/-
Hence, this valuation is in accordance with conservatism.

[74] (a) As per the Basic Accounting equation:
Equity + Liabilities = Total Assets
Where, net profit is a part of equity, thus.
(Owners Equity + Profits) + Liability (if any) = Total Assets
(90,000 + 60,000) + Nil = **1,50,000**

[75](b) If nothing has been written about the fundamental accounting assumptions in the financial statements, then it is assumed that they have already been followed in the preparation of financial statements. However, if any of the fundamental accounting assumption is not followed then this fact should be specially disclosed.

[76](c) Proprietor (owner) is treated as creditor due to entity concept or separate entity concept. As per this concept the business and owner are two distinct and separate entities and thus all transactions of proprietor with the business should also be recorded.

[77](d) Matching principle demands than revenue and the expenses incurred to earn the revenue should be properly matched. At the end of the year inventory of all the stock is prepared and is valued at cost. The credit to the trading account has the effect of reducing the debit side of trading account to the extent goods remain unsold, these will be sold or used up next year and the cost will therefore, be properly debited to the next year's trading account. It justified the principle that as per matching concept if some expenses has been incurred but against it sale will take place in the next year or income will be received next year, then it should be carry forward as asset.

[78] (c) According to accrual concept, expenses should be recorded in the period in which obligation to pay has arisen, not in the period the cash have been paid while income should be recorded in the period in which right to receive has been established. As per matching concept, all expenses matched with the revenue of that period should only be taken into consideration. Periodicity concept fixes up the time- frame for which the performance is to be measured and financial position is to be appraised. Thus **accrual, matching and periodicity** concept work together for income measurement and recognition of assets and liabilities.

[79] (d) **Conservatism** states that the accountant should not anticipate income and should provide for all possible losses. Since, advance received is not the income of the current period, and Mr. Gyan received advance and showed it as his income, hence he has violated **conservatism** concept.

[80] (b) According to the concept of conservatism, the current assets i.e. closing stock is valued at cost or market price whichever is lower.
Thus, in the given question, goods are valued at cost i.e.7,50,000 or market price i.e. 5,00,000 whichever is lower i.e. 5,00,000 according to concept of **conservatism.**

[81] (a) The going concern, cost and realization concepts gives the valuation criteria for valuation of assets and liabilities.

[82] (b)

	(₹)
Reported Profit	1,47,000
Add: Cost of an asset treated as expenses	23,000
Less: Profit anticipated on sale of car	12,000
Less: Salary payable	7,000
Correct profit to be reported in books	(₹) 1,51,000

[83] (a) Going concern concept states that business will carry on in future. Neither is there a need nor a desire to close the business. Due to this only receivables and payables are created at end of the year to be collected/settled in future.

[84] (d) Cost of goods sold = ₹ 20,00,000 × 4/5
= ₹ 16,00,000
G.P. = Sales – Cost of goods sold
= ₹ 22,00,000 – 16,00,000
= ₹ 6,00,000
N.P. = G.P. – Expenses
= ₹ 6,00,000 – 2,50,000
= ₹ 3,50,000 (Correct Profit)

If the trader is counting his profit as ₹ 1,50,000, it shows he has violated the accrual concept as he is regarding only cash sale as his sale.

Wrong Calculation:

GP = Sale – Cost
= 20,00,000 – 16,00,000
(only Cash Sale)
= 4,00,000
NP = GP – Exp.
= 4,00,000 – 2,50,000
= 1,50,000 (Incorrect Profit)

[85] (a) GP = Sales - Cost of goods sold
= 21,00,000 - (20,00,000 × 4/5)
= 21,00,000 - 16,00,000
= 5,00,000
NP = GP - Expenses
= 5,00,000 - 3,00,000
= 2,00,000/-

The trader counted his profit as ₹ 2,00,000/- which shows that he followed matching concept.

[86] (c) The correct figure of profit will be:

		₹
Profit (as Shown)		6,00,000
Add:	Purchase of Car treated as vehicle exp.	1,30,000
Less:	Expenses unrecorded (10,000/- × 2)	(20,000)

[87] (c) Accounting Equation based on dual aspect concept is:
Assets = Capital + Liabilities and thereby
Capital = Assets – Liabilities.

[88] (d) Trader purchased 100 mobiles and sold 90 mobiles i.e. stock left with him is of 10 mobiles. The cost of these 10 mobiles is 10 × 10,000 each = ₹ 1,00,000 but market value is ₹ 90,000/- As per the golden rule of stock valuation i.e. "Lower of cost or market value", the closing stock should have been valued at ₹ 90,000. Since, the trader valued it at cost, he has violated the concept of Prudence i.e. conservatism concept.

[89] (c) Cost of goods sold = 18,00,000 × $\frac{4}{5}$
= 14,40,000
Gross Profit = Sales – COGS
= 21,60,000 – 14,40,000
= 7,20,000
Net Profit = Gross Profit – Expenses
= 7,20,000 – 3,00,000
= 4,20,000

The concept followed by Sohan is matching concept as he has matched the revenue of the period with the cost incurred to earn that revenue. Accordingly, he has counted ₹ 3,60,000 as his closing stock.

[90] (b) Cost of goods sold = 25,00,000 × 70%
= 17,50,000
∴ Closing stock = 25,00,000 – 17,50,000
= 7,50,000

Market value of goods is ₹ 5,00,000 hence, according to LCM rule i.e. Lower of cost or market value, the valuation should be done at ₹ 5,00,000.
This is in accordance with conservatism concept.

[91] (b) The golden rule of current asset valuation i.e. "lower of cost or market value" has originated from **conservatism** concept. Accordingly, losses even if anticipated are immediately brought to books but anticipated profits are never accounted for.

[92] (a) The convention of conservatism when applied to Balance Sheet, results in understatement of assets. Conservatism essentially leads to understatement of income and wealth.

[93] (b) Capital = Assets – Liabilities
= 8,50,000 – 75,000
Closing Capital = 7,75,000

Closing Capital	7,75,000
Add: Drawings	1,20,000
	8,95,000
Less: Opening Capital	5,00,000
Profit during the year	3,95,000

[94] (c) As per the concept of conservatism, the golden rule of stock valuation is "Lower of Cost or Market Value" i.e., LCM.
Stock left, costs ₹ 6,00,000 but its market value is only ₹ 5,50,000 hence it should be valued at market value.

[95] (d) Opening stock + Purchases - Closing stock = Cost of goods sold
A + B - C = D
∴ A + B = C + D

[96] (c) If an asset is increased, then there will be either a corresponding decrease in asset or an increase in liability.

[97] (b) Consistency principle requires that same accounting methods should be followed from one accounting period to next. It is provided by AS-1 Consistency helps in achieving comparability of statements.

[98] (a) Guarantee given in respect of a third party is a contingent liability and is shown as a foot note to the balance sheet as per the disclosure concept.

[99] (c) As per concept of conservatism or prudence inventory should be valued at cost or net realisable value whichever is lower. Accordingly inventory should have been valued at ₹ 80,000 and not ₹ 1,00,000.
Hence, conservatism stands violated.

[100] (c) Economic life of entity is split into periodic intervals as per periodicity concept.

[101] (b) As per AS-1, the fundamental accounting assumptions are going concern, consistency and accrual. Hence, prudence is not a fundamental accounting assumption.

[102] (b) There are three fundamental accounting assumptions and shown below:
(a) Going Concern
(b) Consistency
(c) Accrual

If nothing has been given about the fundamental accounting assumptions in financial statements then it is assumed that they have already been followed in preparation of financial statements.