ACCOUNTANCY

Class XI

CBSE Syllabus

[Strictly according to the latest syllabus of the Central Board of Secondary Education, New Delhi.]

Including :

- Accounting for **Goods and Services Tax (GST)**
- Questions Based on **MISSING INFORMATION**
- Sufficient number of 1 mark questions with their answers at the end of each chapter as per the latest design of the Question Paper.
- High Order Thinking Skills (HOTS) Questions
- Project Work

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Accounting Principles

LEARNING OBJECTIVES

After studying this Chapter, you should be able to understand :

- Meaning of Accounting Principles
- Nature or Characteristics of Accounting Principles
- Need of Accounting Principles
- Kinds of Accounting Principles
  - (I) Accounting Concepts or Assumptions :
    Fundamental Accounting Assumptions as per AS-1
    (1) Going Concern Concept
    (2) Consistency Concept
    (3) Accrual Concept
    Other Accounting Assumptions
    (4) Business Entity Concept
    (5) Money Measurement Concept
    (6) Accounting Period Concept
    (7) Cost Concept
    (8) Dual Aspect Concept
    (9) Revenue Recognition Concept
    (10) Matching Concept
    (11) Objectivity Concept
  - (II) Accounting Conventions :
    Distinction between Concepts and Conventions
    (1) Convention of Full Disclosure
    (2) Convention of Materiality
    (3) Convention of Conservatism

Theory Base of Accounting

Theory base of accounting consists of principles, concepts, conventions, rules and guidelines developed over a period of time to bring uniformity and consistency to the process of accounting in order to enhance its utility to various users of accounting information. In addition, accounting standards issued by The Institute of Chartered Accountants of India (ICAI) also constitute the theory base of accounting.

Meaning of Accounting Principles

Unlike in the past when accounting statements were largely needed by the proprietor, these days the accounting statements are needed by various parties who have vested interest in the business, namely, proprietors, investors, creditors, government and many others. Accounting statements disclose the profitability and solvency of the business to various parties. It is, therefore, necessary that such statements should be prepared according to some standard language and set rules. These rules are usually called 'Generally accepted accounting principles' (GAAP). These principles have been generally accepted by accountants all over the world as general guidelines for preparing the accounting statements. These principles have developed over a course of period from usage, reason, common experiences, historical precedents, statements of individuals, professional bodies and regulation of Government agencies.

Nature or Characteristics (Features) of Accounting Principles :

(*i*) **Accounting principles are Uniform set of Rules :** Accounting principles are uniform set of rules or guidelines developed to ensure uniformity and easy understanding of the accounting information.

(*ii*) **Accounting Principles are Man-Made :** Accounting principles are man made and are derived from experience and reason. They are not laboratory tested and hence they lack universal applicability like the principles of physics, chemistry and other natural sciences.

(*iii*) **Accounting Principles are Flexible :** Accounting principles are not rigid but flexible. They are bound to change with the passage of time in response to the changes in business practices, government policies and needs of the users of accounting information.

(*iv*) **Accounting Principles are Generally Accepted :** Accounting principles are bases and guidelines for accounting and are generally accepted. The general acceptance of an accounting principle depends upon how well it statisfies the following three criteria :

(*a*) **Relevance :** A principle is relevant if it results in information that is useful to the user of the accounting information.

(*b*) **Objectivity :** A principle is objective if it is free from personal bias or judgements of those who furnish the information. Objectivity also implies verifiability which means that there is some way of finding out the truthfulness or correctness of the information reported.

(*c*) **Feasibility :** A principle is feasible if it can be applied without undue complexity or cost.

Need of Accounting Principles :

In order to make the accounting information meaningful to its internal and external users, it is significant that such information is reliable as well as comparable. The comparability of information is required to see how a firm has performed as compared to the other firms and 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 some set rules known as policies, principles and conventions. These rules (usually called GAAP) bring uniformity and consistency to the process of accounting and enhance its utility to different users of accounting information.

Kinds of Accounting Principles :— Accounting principles are described by various terms such as assumptions, conventions, concepts, doctrines, postulates etc. These principles can be classified mainly into two categories :—

(I) Accounting Concepts or Assumptions

(II) Accounting Conventions

(I) **Accounting Concepts or Assumptions :—** In order to make the accounting language convey the same meaning to all people and to make it more meaningful, most of the accountants have agreed on a number of concepts which are usually followed for preparing the financial statements. These concepts provide a foundation for accounting process. No enterprise can prepare its financial statements without considering these basic concepts or assumptions. These concepts guide how transactions should be recorded and reported. Following may be treated as basic concepts or assumptions :—

As per Accounting Standard (AS-1), issued by the Institute of Chartered Accountants of India, there are three fundamental accounting concepts or assumptions:

(1) Going Concern Concept
(2) Consistency Concept
(3) Accrual Concept

Fundamental accounting concepts and assumptions are the assumptions which are presumed to have been followed in preparing the financial statements.

Other Accounting Concepts :

(4) Business Entity Concept
(5) Money Measurement Concept
(6) Accounting Period Concept
(7) Cost Concept or Historical Cost Concept
(8) Dual Aspect Concept
(9) Revenue Recognition Concept
(10) Matching Concept
(11) Objectivity Concept

(1) **Going Concern Concept :—** As per this concept it is assumed that the business will continue to exist for a long period in the future. The transactions are recorded in the books of the business on the assumption that it is a continuing enterprise. It is on this concept that we record fixed assets at their original cost and depreciation is charged on these assets without reference to their market value. For example, if a machinery is purchased which would last, say, for the next 10 years, the cost of this machinery will be spread over the next 10 years for calculating the net profit or loss of each year. Because of the concept of going concern the full cost of the machine would not be treated as an expense in the year of its purchase itself. The market value of the fixed assets is irrelevant and is not recorded in the balance sheet, as these assets are not going to be sold in the near future.

It is also because of the going concern concept that outside parties enter into long-term contracts with the enterprise, give loans and purchase the debentures and shares of the enterprise. Another example of this concept is that prepaid expenses, which have no realisable value are shown as assets in the balance sheet, because the benefit of such expenses will be received in future. Also without this concept, the classification of current and fixed assets and short and long term liabilities cannot be made and such classification would be difficult to justify.

(2) **Consistency Concept :—** This concept states that accounting principles and methods should remain consistent from one year to another. These should not be changed from year to year, in order to enable the management to compare the Profit & Loss Account and Balance Sheet of the different periods and draw important conclusions about the working of the enterprise. If a firm adopts different accounting principles in two accounting periods, the profits of current period will not be comparable with the profits of the preceding period. For example, a firm can choose any one of the several methods of depreciation, *i.e.,* straight line method, written down value 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 decisions taken on the basis of accounts will be misleading.

But the consistency concept should not be taken to mean that it does not allow a firm to change the accounting methods according to the changed circumstances of the business. Otherwise, the accounting will become non-flexible and the improved techniques of accounting will not be used. As such, if the accountant feels that change in a particular method will lead to the better disclosure of the profits and the financial position of the business, the changed method may be adopted. However, the nature and effect of the change of method and justification for the change, must be stated clearly by way of footnotes to enable the users of the financial statements to be aware of the change.

(3) **Accrual Concept :—** In accounting, accrual basis is used for recording of transactions. It provides more appropriate information about the performance of business enterprise as compared to cash basis. Accrual concept applies equally to revenues and expenses. In accrual concept revenue is recorded when sales are made or services are rendered and it is immaterial whether cash is received or not. Similary, according to this concept, expenses are recorded in the accounting period in which they assist in earning the revenues whether the cash is paid for them or not. Thus, to ascertain true profit or loss for an accounting period and to show the true financial position of the enterprise at the end of the accounting period all expenses and incomes relating to the accounting period are recorded whether actual cash has been paid or received or not. Accrual concept is often described as matching concept.

The significance of these fundamental assumptions is that they need not be specifically stated in the financial statements and the users of financial statements can take for granted that these assumptions have been followed while preparing financial statements.

However, if any of the above mentioned fundamental accounting assumption is not followed, then this fact should be specifically disclosed.

Other Accounting Concepts :

(4) **Business Entity Concept :—** According to this concept, business is treated as a unit separate and distinct from its owners, creditors, managers and others. In other words, the owner of a business is always considered as distinct and separate from the business he owns. Business unit should have a completely separate set of books and we have to record business transactions from firm's point of view and not from the point of view of the proprietor. The proprietor is treated as a creditor of the business to the extent of capital invested by him in the business. The capital is treated as a liability of the firm because it is assumed that the firm has borrowed funds from its own proprietors instead of borrowing it from outside parties[1]. It is for this reason that we also allow interest on capital and treat it as an expense of the business. Interest on capital reduces the profits of the firm and at the same time it increases the capital of the proprietor. Similarly, the amount withdrawn by the proprietor from the business for his personal use is treated as his drawings. Likewise, goods used from the stock of the business for business purposes are treated as the expenditure of the business but similar goods used by the proprietor for his personal use are treated as his drawings.

Because of the concept of separate entity, the proprietor's house, his personal investment in securities, his personal car and personal income and expenditure are kept separate from the accounts of the business entity. Also, if the proprietor has some other business entity doing another business, the records of that business should also be kept separate. In the absence of the concept of separate entity, the net profits and financial position of a business entity cannot be known. The concept of separate entity is applicable to all forms of business organisations, *i.e.*, sole proprietorship, partnership or a company.

(5) **Money Measurement Concept :—** Only those transactions and events are recorded in accounting which are capable of being expressed in terms of money. An event, even though it may be very important for the business, will not be recorded in the books of the business unless its effect can be measured in terms of money with a fair degree of accuracy. For example, accounting does not record a quarrel between the production manager and sales manager; it does not report that a strike is beginning and it does not reveal that a competitor has placed a better product in the market. These facts or happenings cannot be expressed in money terms and thus are not recorded in the books.

It should be remembered that money is the only measurement which enables various things of diverse nature to be added up together and dealt with. For example, a business, on a particular day has ₹50,000 in cash, 5,000 kilograms of raw materials, 10,000 kilograms of finished goods, 5 Machines, 100 Chairs and 20 Fans. All these things cannot be added up unless expressed in terms of money. In order to make a record of these items, these will have to be expressed in monetary terms such as, cash ₹50,000; raw materials ₹2,50,000; finished goods ₹5,00,000; Machines ₹20,00,000; Chairs ₹50,000 and Fans ₹80,000. As such, to make accounting records relevant, simple, understandable and homogeneous, they are expressed in a common unit of measurement, *i.e.*, money.

(1) "In one sense, capital itself may be regarded as liability — the amount due from the business to its proprietors." **— Rowland**

(6) **Accounting Period Concept :—** As the business is intended to continue indefinitely for a long period, the true results of the business operations can be ascertained only when the business is completely wound up. But ascertainment of profit after a very long period will be of little use to the proprietors, managers, investors and others because it will be too late to take corrective steps at that time. The users of the financial statements need to know the results of the business at frequent intervals. Thus, the entire life of the firm is divided into time-intervals for the measurement of the profits of the business. Twelve month period is usually adopted for this purpose. According to the amended income tax law, a business has compulsorily to adopt financial year beginning on 1st April and ending on 31st March in the next calendar year, as its accounting period. Apart from this, companies whose shares are listed on the stock exchange are required to publish quarterly results to depict the profitability and financial position at the end of three months period.

(7) **Cost Concept or Historical Cost Concept :—** According to this concept, an asset is ordinarily recorded in the books of accounts at the price at which it was acquired. This cost becomes the basis of all subsequent accounting for the asset. Since the acquisition cost relates to the past, it is referred to as historical cost. This cost is the basis of valuation of the assets in the financial statements. For example, if a business entity purchases a building for ₹20,00,000, it would be recorded in the books at this figure. Subsequent increase or decrease in the market value of the building would not be recorded in the books of accounts. If two years later the market value of the building shoots up to ₹60,00,000, the increased value will not be ordinarily* recorded in the books of accounts.

However, the cost concept or historical cost concept does not mean that assets will be continuously shown at their acquisition price for as long as the business entity owns them. Their cost is systematically reduced from year to year by charging depreciation and the assets are shown in the balance sheet at cost less depreciation.

The **justification** for the historical cost concept lies in the following arguments :

(*i*) This cost is objectively verifiable because the cost recorded in the books is derived from an actual transaction and is not arbitrarily determined.

(*ii*) It is justified by the going concern concept which assumes that the enterprise will continue its activities indefinitely and thus there is no need of using the current values or liquidation values.

(*iii*) Market values or current values of assets are difficult to be determined. The valuation by one expert will not be the same as that of another.

(*iv*) Market values of the assets may change from time to time and it will be extremely difficult to keep track of up and down of the market price.

The drawbacks of the historical cost concept are :

(*i*) Assets for which nothing is paid will not be recorded. Thus a favourable location, brand name and reputation of the business, knowledge and technological skill built inside the enterprise will remain unrecorded though these are valuable assets.

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* The word ordinarily is used since there are certain situations in which the changed values are recorded in the books of accounts to reflect the market values, e.g., in case of inventories and investments.

(*ii*) During periods of inflation, the figure of net profit disclosed by profit and loss account will be seriously distorted because depreciation based on historical costs will be charged against revenues at current prices.

(*iii*) Information based upon historical cost may not be useful to management, investors, creditors etc.

(8) **Dual Aspect Concept :—** According to this concept, every business transaction is recorded as having a dual aspect. In other words, every transaction affects atleast two accounts. If one account is debited, any other account must be credited. The system of recording transactions based on this principle is called as 'Double Entry System'. It is because of this concept that the two sides of the Balance Sheet are always equal and the following accounting equations will always hold good at any point of time :—

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

OR

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

Whenever a transaction is to be recorded, it has to be recorded in two or more accounts to balance the equation. If a transaction affects (increases or decreases) the one side of the equation, it will also affect (increase or decrease) the other side of the equation or increase one account and decrease another account on the same side of the equation. Equation remains balanced whenever a transaction takes place. For example, *X* commences business with ₹20 Lakh in cash and takes a loan of ₹5 Lakh from the bank, and these ₹25 Lakh are used in buying some assets, say, plant and machinery. The equation will be as follows :—

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

$$₹25 \text{ Lakh} = ₹5 \text{ Lakh} + ₹20 \text{ Lakh}$$

(9) **Revenue Recognition (Realisation) Concept :—** Revenue means the amount which is added to the capital as a result of business operations. Revenue is earned by sale of goods or by providing a service. Concept of revenue recognition determines the time or the particular period in which the revenue is realised. Revenue is deemed to be realised when the title or the ownership of the goods has been transferred to the purchaser and when he has legally become liable to pay the amount. It should be remembered that revenue recognition is not related with the receipt of cash. For example, if a firm gets an order of goods on 1st January, supplies the goods on 20th January and receives the cash on 1st April, the revenue will be deemed to have been earned on 20th January, as the ownership of goods was transferred on that day.

Revenues in case of incomes such as rent, interest, commission etc. is recognised on a time basis. For example, rent for the month of March 2015, even if received in April 2015 will be treated as revenue of the financial year ending March 31, 2015. Similarly if commission for April 2015 is received in advance in March 2015, it will be treated as revenue of the financial year commencing April 2015.

There are few exceptions to this rule of revenue recognition :

(*i*) In case of sales on instalment basis, the amount collected in instalments is treated as realised.

(*ii*) In case of long-term construction projects, it is difficult to postpone the revenue till the completion of full contract. In such cases, that proportionate part of revenue which is equal to the part of contract completed by the end of the year is recognised as realised.

(*iii*) In case of mining, revenue is recognised in the accounting period when production is made even though a sale has not been made.

(10) **Matching Concept :—** This concept is very important for correct determination of net profit. According to this concept, in determining the net profit from business operations, all costs which are applicable to revenue of the period should be charged against that revenue. Accordingly, for matching costs with revenue, first revenues should be recognised and then costs incurred for generating that revenue should be recognised. Following points must be considered while matching costs with revenue :—

1. When an item of revenue is included in the profit and loss account, all expenses incurred on it, whether paid or not, should be shown as expenses in the profit and loss account. On the basis of this principle, outstanding expenses, though not paid in cash are shown in the profit and loss account.
2. When some expense, say insurance premium is paid partly for the next year also, the part relating to next year will be shown as an expense only next year and not this year. This means that, that part of the insurance premium against which benefit will be derived or revenue will be earned in future should be shown in the balance sheet as an asset and the rest is treated as an expense during the current year.
3. Cost of the goods remaining unsold at the end of the year together with the expenses incurred on it must be carried forward to the next year, as these goods will be sold only during the next period. As such, the closing stock is carried over to the next period as opening stock.
4. Similarly, incomes receivable must be added in revenues and incomes received in advance must be deducted from revenues.

(11) **Objectivity Concept :—** This concept requires that accounting transaction should be recorded in an objective manner, free from the personal bias of either management or the accountant who prepares the accounts. It is possible only when each transaction is supported by verifiable documents and vouchers such as cash memos, invoices, sales bill, pay-in slip, correspondence, agreements etc. For example, when the goods are purchased for cash, the transaction must be supported by cash receipt for money paid and if the goods are purchased on credit, the transaction must be supported by a copy of invoice or delivery challan. The cash receipt or invoice become the documentary evidence of the transaction and provide an objective basis for verifying the transaction. Objectivity is one of the reasons for adopting the 'Historical Cost' as the basis of recording accounting transaction because cost actually paid for an asset (*i.e.* historical cost) can be verified from the documents. On the contrary, if assets are recorded on their market value, the objectivity cannot be adhered to because the market value may differ from person to person and from place to place.

(2) **Accounting Conventions :—** An accounting convention may be defined as a custom or generally accepted practice which is adopted either by general agreement or

common consent among accountants. Accounting conventions differ from concepts in respect to the following :

Basis of Distinction	Accounting Concepts	Accounting Conventions
1. Legal Position	Accounting concepts have legal acceptance.	Accounting conventions are guidelines based upon custom, or usage or general agreement.
2. Recording Vs Financial Statements	Accounts concepts are the basic assumptions on the basis of which transactions are recorded and accounts are maintained.	Accounting conventions are followed in preparing the profit and loss account and balance sheet.
3. Significance	These are the uniform set of rules usally followed in recording the transactions.	These are not so important as accounting concepts.
4. Role of Personal	There is no role of personal judgment or individual bias in following the accounting concepts.	Personal judgment may play a crucial role in the adoption of accounting conventions.
5. Uniform adoption	There is uniform adoption of accounting concepts in different enterprises.	There is no uniformity in the adoption of accounting conventions in various enterprises.

Following are the main accounting conventions :

(1) Convention of Full Disclosure
(2) Convention of Materiality
(3) Convention of Conservatism (Prudence)

(1) **Convention of full disclosure :—** This Convention requires that all significant information relating to the economic affairs of the enterprise should be completely disclosed. In other words, there should be a sufficient disclosure of information which is of material interest to the users of the financial statements such as proprietors, present and potential creditors, investors and others. The principle is so important that the Companies Act makes ample provisions for the disclosure of essential information in the financial statements of a Company. The proforma and contents of Balance Sheet and Profit and Loss Account are prescribed by Companies Act. Various items or facts which do not find place in accounting statements 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 statements would be misleading.

(*ii*) If there is a change in the method of valuation of 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*) 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.

(2) **Convention of Materiality :—** This Convention is an exception to the convention of full disclosure. According to this convention, items having an insignificant effect or being irrelevant to the user need not be disclosed. These unimportant items are either left out or merged with other items, otherwise accounting statements will be unnecessarily overburdened. **American Accounting Association** (AAA) defines the term materiality as under :—

"An item should be regarded as material if there is reason to believe that knowledge of it would influence decision of informed investor."

According to **Kohler :—**

> "Materiality is the characteristics attaching to a statement, fact, or item whereby its disclosure or the method of giving its expression would be likely to influence the judgment of a reasonable person."

It should be noted that what is material for one concern may be immaterial for another. For instance, the cost of small tools may be material for a small repair workshop, but the same figure may be immaterial for Escorts Limited. Similarly, the nature of the transaction should also be taken into consideration. A difference of ₹500 in the valuation of stock may be regarded as immaterial, but the difference of ₹500 in cash could be termed material. Thus, the accountant should judge the importance of each transaction to determine its materiality.

(3) **Convention of Conservatism or Prudence :—** According to this convention, all anticipated losses should be recorded in the books of accounts, but all anticipated or unrealized gains should be ignored. In other words, conservatism is the policy of playing safe. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty. Likewise, when there are different alternatives for recording a transaction, the one having least favourable immediate effect on profits or capital should be adopted. Following are the examples of the application of the principle of conservatism :—

(*i*) Closing stock is valued at cost price or realisable value whichever is less.
(*ii*) Provision for doubtful debts is created in anticipation of actual bad-debts.
(*iii*) Joint life insurance policy is shown only at surrender value as against the amount paid.
(*iv*) Provision for a pending law suit against the firm, which may either be decided in its favour.

Effect of Convention of Conservatism :— The convention of conservatism should be used very cautiously, otherwise it will have two effects :

(*i*) Profit & Loss Account will disclose lower profits in comparison to the actual profits.
(*ii*) Balance Sheet will disclose understatement of assets and overstatement of liabilities in comparison to the actual values.

The above mentioned effects will result in creation of secret reserves which is in direct conflict with the convention of full disclosure.

SHORT ANSWER QUESTIONS

1. What do you mean by Accounting Concepts?

2. ''Revenue earned and cost of earning that revenue should be properly identified for a period.'' Explain this statement.

3. What are Accounting Concepts? Explain any two of them.

4. Explain the business entity concept with example. *(Delhi 2016)*

5. ''Capital is a liability for the business.'' Explain this statement with the principle applied. *(Chandigarh 2017)*

Ans. Explain 'Business Entity Concept'.

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

Ans. 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 near future.

7. What is the basic accounting equation?

Ans. Assets = Liabilities + Capital

8. Explain the meaning and significance of 'money measurement concept'. *(Delhi 2016)*

9. Discuss the principle based on the premise "do not anticipate profits but provide for all losses." *(Chandigarh 2017)*

Ans. Discuss the Convention of prudence.

10. Explain any two of the following Concepts :
Money Measurement Concept *(Delhi 2017, 2018)*
Business Entity Concept *(Delhi 2018)*
Matching Concept *(Delhi 2016; KVS 2016)*

11. Explain the following :
(*i*) Dual Aspect Concept
(*ii*) Accrual Concept *(Delhi 2018)*
(*iii*) Going Concern Concept
(*iv*) Cost Concept
(*v*) Accounting Period Concept *(Delhi 2015, 2017)*

12. Explain the meaning of any three of the following terms :
(*i*) Full Disclosure *(Delhi 2017) (KVS 2016)*
(*ii*) Consistency *(Delhi 2014, 2015)*
(*iii*) Materiality *(Delhi 2017) (KVS 2016)*
(*iv*) Conservatism *(Chandigarh 2019)*

13. ''Every transaction has debit and credit aspects.'' Explain.

VERY SHORT ANSWER QUESTIONS
(Questions Carrying 1 Mark)

1. Give two characteristics of accounting principles.

Ans. (*i*) Accounting principles are man made.
(*ii*) Accounting principles are flexible.

2. What is business entity Concept?

Ans. Business is treated as an entity separate and distinct from its owners.

3. What is money measurement Concept?

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

4. What is going concern concept? *(KVS 2019)*

Ans. 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.

5. What is accounting period concept?

Ans. 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.

6. What is cost concept?

Ans. Assets are shown in the books at cost of acquisition less depreciation.

7. What is dual aspect concept? *(KVS 2019)*

Ans. Every business transaction is recorded having a dual aspect. One aspect is debited while other is credited.

8. What is matching concept?

Ans. All costs incurred during a particular period should be charged to revenue of that period for determining the net profits.

9. How does the matching concept apply to depreciation?

Ans. According to matching concept, all costs which are incurred in an accounting period should be charged against the revenue of that period. Hence depreciation of current year is charged against the current year's revenue. In other words, 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.

10. What is accrual concept?

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

11. What is convention of full disclosure?

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

12. What is concept of consistency?

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

13. What is convention of prudence or conservatism?

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

14. What is convention of materiality?

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

15. Which principle states that the financial statements should disclose all significant informations?

Ans. Convention of Full Disclosure.

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

Ans. Convention of Prudence or Conservatism.

17. Why should a business follow the consistency Concept?

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

18. State one limitation of historical cost. *(KVS 2014)*

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

19. Why the entire life of business is divided into time intervals? *(Delhi 2019)*

Ans. To ascertain the amount of profit earned or loss suffered by the business.

20. Under which principle, resignation by a Marketing Manager is not recorded in books of accounts? *(Chandigarh, 2018)*

Ans. Money Measurement Concept.

21. Name and explain the accounting concept under which it becomes necessary for business concerns to take their unsold stock at the end of the year to the next year. *(I.S.C. Specimen Question Paper, 2019)*

Ans. Unsold Stock is carried forward to the next year as per matching concept.

22. Why capital of owner is shown on the liabilities side of balance sheet? *(Delhi 2019)*

Ans. Due to separate entity concept.

OBJECTIVE TYPE QUESTIONS

(A) Fill in the blanks :—

(*i*) Concept of .... requires that the same accounting methods should be used from one accounting period to the next. *(Chandigarh, 2017)*

(*ii*) Recognition of cost in the same period as associated revenues is called .... concept.

(*iii*) Personal transactions are distinguished from business transactions in accordance with the concept of ....

(*iv*) 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 .... convention. *(KVS 2018)*

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

(*vi*) Everything a firm owns, it also owes out to somebody. This co-incidence is explained by the .... concept. *(Chandigarh, 2017)*

(*vii*) The .... concept states that if straight line method of depreciation is used in one year, then it should also be used in the next year. *(KVS 2018)*

(*viii*) 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 ....

(*ix*) The management of a firm is remarkably incompetent, but the firm's accountant cannot take this into account while preparing books of accounts because of .... concept. *(KVS 2018)*

[**Ans.** (*i*) Consistency (*ii*) Matching (*iii*) Business Entity
(*iv*) Prudence (*v*) Business Entity (*vi*) Dual Aspect
(*vii*) Consistency (*viii*) Convention of Prudence
(*ix*) Money Measurement]

(B) Mention whether the following are true or false :—

(*i*) Convention of Prudence results in understatement of profits and assets and overstatement of liabilities.

(*ii*) Business entity concept is not applicable to sole trading concerns and partnership concerns.

(*iii*) Only those facts and events are recorded in accounting which are capable of being expressed in terms of money.

(*iv*) All items or facts whether material or immaterial are recorded in accounting.

(*v*) Assets will be equal to capital if there are no liabilities.

(*vi*) Revenues are matched with expenses in accordance with going concern assumption.

(*vii*) Entire life of the firm is divided into time intervals for the measurement of profits in accordance with 'Going Concern Assumption'.

(*viii*) Materiality principle is an exception to the 'Full Disclosure Convention'.

(*ix*) If a firm adopts different accounting principles in two accounting periods it conflicts with the concept of consistency.

(*x*) The essence of convention of prudence is to anticipate no profit and provide for all possible losses.

[**Ans. :** True : (*i*); (*iii*); (*v*); (*viii*); (*ix*); (*x*)
False : (*ii*); (*iv*); (*vi*); (*vii*)]

(C) Choose the best Alternate

1. Accounting Principles are :
   (A) Made by Government (B) Made by man
   (C) Made by Law (D) None of the above

2. Accounting principles mean :
   (A) The rules which are adopted while recording the accounting transactions
   (B) The rules which are adopted while preparing Profit & Loss Account
   (C) The rules which are adopted while preparing balance sheet
   (D) The rules which are adopted while preparing Director's Report

3. Various names of accounting principles are :
   (A) Assumptions (B) Conventions
   (C) Concepts (D) All of the above

4. According to Business Entity Concept :
   (A) Business is treated as a separate unit from its owner
   (B) Business is not treated as a separate unit from its owner
   (C) Personal transactions of owner are not distinguished from business transactions
   (D) None of the above

5. According to Money Measurement Concept only those transactions are recorded in accounting :
   (A) Which are capable of being expressed in terms of money
   (B) Which cannot be expressed in terms of money
   (C) both of the above transactions
   (D) None of the above

6. As per Going Concern Concept business will continue to exist :
   (A) For a limited period (B) For 10 years
   (C) For 25 years (D) For a long period in the future

7. As per Income Tax Act, accounting period is :
   (A) From 1st January to 31st December
   (B) From 1st April to 31st March
   (C) From 1st July to 30th June
   (D) From Diwali to Diwali

8. As per Cost Concept, an asset is recorded in the books
   (A) At market value
   (B) At going concern value
   (C) At the price at which it was acquired
   (D) At liquidation value

9. As per Dual Aspect Concept :
   (A) Assets = Liabilities – Capital
   (B) Assets = Capital – Liabilities
   (C) Assets = Liabilities + Capital
   (D) Capital = Assets + Liabilities

10. Accounting Period concept means :
(A) A period of 12 months (B) A period of 6 months
(C) Indefinite period (D) Period fixed by management

11. According to Dual Aspect Concept, the system of recording transactions is called :
(A) Double Account System (B) Double Entry System
(C) Double Book System (D) All of the above

12. As per Revenue Recognition Concept, revenue is deemed to be realised :
(A) When purchase order is received from the purchaser
(B) When goods are delivered to the purchaser
(C) When the title of the goods has been transferred to the purchaser
(D) When cash is received from the purchaser

13. Cost concept means :
(A) Sale of goods at cost price
(B) Sale of goods at market price
(C) Sale of goods at cost plus percentage of cost
(D) Recording of asset in the books at cost price

14. According to Objectivity Concept :
(A) There should be proper vouchers for checking every transaction
(B) There should be proper vouchers for checking every cash transaction
(C) There should be proper vouchers for checking every purchase-sale transaction
(D) There is no need of vouchers for checking of transactions

15. According to Convention of Full Disclosure
(A) All secrets of the business must be disclosed
(B) All significant information should be completely disclosed
(C) All accounts should be maintained honestly
(D) All accounts should be prepared quickly

16. Convention of Consistency means :
(A) All the firms in the same industry should use identical accounting principles and procedures
(B) All principles and procedures of accounting are utilised
(C) Accounting principles and methods should remain consistent from one year to another
(D) All of the above

17. Convention of conservatism takes into account :
(A) All future profits and losses
(B) All future profits and not losses
(C) All future losses and not profits
(D) Neither profits nor losses of the future

18. According to Convention of Conservatism closing stock is valued at :
(A) At cost Price
(B) At Realisable value

(C) Cost price or realisable value whichever is less
(D) At Real value

19. According to Convention of Conservatism :
(A) Provision is made for bad and doubtful debts
(B) Depreciation is charged on assets
(C) Recording is made of outstanding expenses
(D) All of the above

20. The concept that a business enterprise will not be sold or liquidated in the near future is known as :
(A) Business Entity Concept
(B) Money Measurement Concept
(C) Matching Concept
(D) Going Concern Concept

21. According to which Concept even the proprietor of the business is treated as a creditor of the business :
(A) Going concern Concept (B) Cost Concept
(C) Business Entity Concept (D) Accounting Period Concept

22. Due to which concept qualitative transactions are not recorded in the books :
(A) Business Entity Concept (B) Money Measurement Concept
(C) Historical cost concept (D) Dual Aspect Concept

23. Accrual concept is based on :
(A) Matching Concept (B) Dual Aspect concept
(C) Cost concept (D) Going concern concept

24. Cost price or realisable value, whichever is less, is used for the valuation of :
(A) Current Assets (B) Closing stock
(C) Fixed Assets (D) All Assets

25. According to which of the following, a business is considered to run for indefinite period :
(A) Business Entity Concept (B) Money Measurement Concept
(C) Historical cost concept (D) Going concern concept

26. Due to which of the following window dressing is prohibited :
(A) Convention of Consistency
(B) Accounting Period Concept
(C) Convention of full Disclosure
(D) Money Measurement Concept

27. According to which concept the same accounting methods should be used each year :
(A) Prudence (B) Full Disclosure
(C) Materiality (D) Consistency

28. Everything a firm owns, it also owes out to somebody. This is explained by which concept) :
(A) Dual Aspect (B) Going Concern
(C) Money Measurement (D) Accounting Period

29. The .... convention states that the method of providing depreciation adopted in one year should be adopted each year :

(A) Full Disclosure (B) Consistency
(C) Prudence (D) Materiality

30. Due to which of the following, contingent liabilities are shown in the Balance Sheet :

(A) Dual Aspect Concept (B) Convention of Full Disclosure
(C) Convention of Materiality (D) Going Concern Concept

31. The cost of a small calculator is accounted as an expense and not shown as an asset in a financial statements of a business entity due to................

(A) Materiality Convention (B) Matching concept
(C) Periodicity concept (D) Convention of full disclosure

32. According to the Cost Concept

(A) Assets are recorded at lower of cost and market value.
(B) Assets are recorded by estimating the market value at the time of purchase.
(C) Assets are recorded at the value paid for acquiring it.
(D) Assets are not recorded

33. Providing depreciation on fixed asset is in accordance with which of the following principles/concepts.

(*i*) Going concern (*ii*) Matching Concept (*iii*) Materiality

(A) (*i*) & (*ii*) (B) (*ii*) & (*iii*)
(C) (*i*) & (*iii*) (D) All the three

34. The owner of the firm records his medical expenses in the firms' income statement. Indicate the principle that is violated.

(A) Cost Concept (B) Prudence
(C) Full disclosure (D) Entity concept

35. M/s Future Ltd. has invested ₹10,000 in the shares of Relicam Industries Ltd. Current market value of these shares is ₹10,500. Accountant of Future Ltd. wants to show ₹10,500 as value of investment in the books of accounts, which accounting convention restricts him from doing so?

(A) Full disclosure (B) Consistency
(C) Conservatism (D) Materiality

36. Which of these is not a fundamental accounting assumption?

(A) Going concern (B) Consistency
(C) Accrual (D) Materiality

37. Omission of paise and showing the round figures in financial statements is based on........

(A) Conservatism convention (B) Consistency concept
(C) Materiality convention (D) Money measurement concept

38. Income is measured on the basis of :

(A) Matching Concept (B) Consistency Concept
(C) Cost Concept (D) None of the above

[**Ans.**

1. (B)	2. (A)	3. (D)	4. (A)	5. (A)
6. (D)	7. (B)	8. (C)	9. (C)	10. (A)
11. (B)	12. (C)	13. (D)	14. (A)	15. (B)
16. (C)	17. (C)	18. (C)	19. (A)	20. (D)
21. (C)	22. (B)	23. (A)	24. (B)	25. (D)
26. (C)	27. (D)	28. (A)	29. (B)	30. (B)
31. (A)	32. (C)	33. (A)	34. (D)	35. (C)
36. (D)	37. (C)	38. (A)]		

HIGHER ORDER THINKING SKILLS (HOTS) QUESTIONS

1. What is meant by GAAP?
2. Proprietor of the business is treated as creditor to the extent of his capital under which Concept?
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 a relevant information in your opinion and should be disclosed by *X* Ltd.
4. *X* Ltd. gets a contract of ₹100 crore to build a Shopping-Mal 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?
5. Under which principle the calibre or quality of the management is not disclosed in the balance sheet?
6. Which accounting principle states that all anticipated losses should be recorded but all anticipated profits should be ignored?
7. According to which concept, depreciation is to be charged as per one particular method year after year? *(KVS 2017)*
8. Why the full cost of an asset is not treated as an expense in the year of its purchase?
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?
10. A debtor who owes ₹ two lac to the Company is rumoured to be declared insolvent. Will you disclose this information in the books?
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?
12. In a business provision for doubtful debts is created @5% on debtors every year. Name the two accounting principles followed in this process.
13. A firm has stationery stock amounting to ₹400 as at the end of financial year. Accountant of the firm has written it off to Profit & Loss Account. Is he right in doing so?
14. Why closing stock is valued at cost price or realisable value whichever is less?

15. Do you think that the Convention of conservatism results in creation of secret reserves?

16. Identify the values involved in the assumption of going concern. *(KVS 2014)*

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

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

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

20. 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?

21. *R* Ltd. purchased 500 Sq. Metre Land for ₹1.5 crore to build a factory. At the end of 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?

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

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

24. Mohan, the owner of a business receives an order for 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?

25. Land and Buildings are shown at ₹10 Lac in the Balance Sheet of the business owned by Mr. Yuvraj. However, as per the certificate of Govt. approved valuer the realisable value of Land and Building is ₹200 Lac. Mr. Yuvraj wants to show the Land and Building at this value in his books. Can he do so?

26. Shyam purchased a building for ₹20 lakh. After a period of five years, the depreciation charged on the building amounted to ₹3 lakh. However, due to boom in the property market, the current market value of the building is ₹28 lakh. State the value at which building should be recorded in the books of accounts. Also, give reasons for the same. *(Chandigarh 2018)*

27. "Materiality convention is an exception of the full disclosure concept." Do you agree with the above statement? Give reason in support of your answer. *(Delhi 2019)*

28. Describe the relevance of accounting concepts/principles in accounting. Name the concept/assumption related to the following statements :

(*a*) The cost of stationery is accounted as an expense and not shown as an asset in financial statements.

(*b*) Provision for discount on creditors is not created.

(*c*) The owner of the business shows his capital as a liability and not shown as an asset. *(Delhi 2019)*

ANSWER TO HIGHER ORDER THINKING SKILLS (HOTS) QUESTIONS

1. Generally Accepted Accounting Principles.
2. Business Entity Concept.
3. Yes. The information is of material interest to the users of financial statements and must be disclosed as per the Convention of full disclosure.
4. No, the management is not justified. Although the true profit or 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.
5. Money Measurement Concept.
6. Convention of Prudence.
7. Concept of Consistency.
8. 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 expense.
9. Materiality Convention will be followed in dealing with this item. As per this 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 expense and will be debited to Stationery Account.
10. Yes. As per 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.
11. Business Entity Concept.
12. Consistency and Prudence.
13. 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 in other words, may be written off.
14. Closing stock is valued at lower of cost price or realisable value according to the Convention of conservatism or prudence.
15. Yes Convention of conservatism will have two effects : (*i*) Profit and Loss Account discloses lower profits in comparison to the actual profits. (*ii*) Balance Sheet will disclose understatement of assets and overstatement of liabilities. These two effects result in creation of secret reserves.
16. (*i*) It is because of this concept that a distinction is made between capital expenditure 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.

17. Fixed assets are not shown in the books at market value because : (*i*) as per historical concept, we record fixed assets at original cost, and (*ii*) as per going concern concept, the assets are not going to be sold in the near future. Hence, the market value is irrelevant.
18. Entire life of the business enterprise is divided into time intervals of twelve months for the ascertainment of profit.
19. Convention of conservatism or prudence.
20. The Company has violated the convention of full disclosure. Loss of Plant and Machinery is a material information and should have been disclosed.
21. 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.
22. 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.
23. 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 and the company should disclose the change in its financial statements along with its impact on profit or loss.
24. 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 recognised as earned only when cost incurred to earn that revenue is also recognised as expense in that period.
25. No. Accounts are maintained on the concept of historical costs (i.e., the original cost). According to this concept, an asset is recorded in the books of accounts at the price at which it was acquired.
26. Building will be shown in the books at ₹17 Lakh.
    This is because of Historical Cost Concept according to which assets are shown in the books at cost less depreciation.
27. Yes, materiality convention is an exception to the concept of full disclosure. According to the materiality convention, items having an insignificant effect or being irrelevant to the user need not be disclosed due to unnecessarily overburdened while full disclosure concept states that there should be a sufficient disclosure/complete disclosure of informations.
28. In order to make the accounting information meaningful to its internal and external users, it is significant that such information is reliable as well as comparable. This becomes possible only if the information provided by the financial statements is based on some set of rules known as accounting concepts/principles.
    Name of the concept is as follows :
    (*a*) Materiality
    (*b*) Conservation or prudence.
    (*c*) Business entity concept.