Chapter 2: Theory Base of Accounting

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Short Answers — Questions for Practice — Short Answers

Q1 Why is it necessary for accountants to assume that business entity will remain a going concern?

SOLUTION

The going concern assumption is fundamental to accounting because it determines how assets are valued and costs are allocated across periods.

Basis for asset valuation: Assets are recorded at historical cost and written off gradually over their useful lives (depreciation) only because the business is assumed to continue operating. If liquidation were imminent, assets would need to be shown at their realisable (break-up) value, which is typically much lower.

Justification for deferred costs: Expenses such as prepaid rent, insurance premium or capital expenditure are spread over future periods. This is valid only if the business will survive those future periods to derive benefit from them.

Basis for depreciation: Depreciation allocates the cost of a fixed asset over its estimated useful life. For example, if a computer costing Rs 50,000 is expected to last 5 years, Rs 10,000 is charged each year. This spreading is possible only because the business is assumed to operate for those 5 years.

Without the going concern assumption, every asset would have to be valued at liquidation value each year, making financial statements highly volatile and unsuitable for decision-making.

Answer: The going concern assumption justifies historical cost valuation, depreciation over useful life, and deferral of unexpired costs — all of which become meaningless if liquidation is assumed to be imminent.

Q2 When should revenue be recognised? Are there exceptions to the general rule?

SOLUTION

General rule of revenue recognition: Revenue is recognised when a legal right to receive it arises, i.e., at the point of sale of goods or when a service has been rendered. It is not recognised when the order is received, when goods are dispatched, or when cash is collected.

For time-based income (rent, interest, commission): Revenue is recognised on a time basis. For example, rent for March 2017, even if received in April 2017, is taken into the profit and loss account of the year ending March 31, 2017.

Exceptions to the general rule:

1. Long-term construction contracts: For contracts that span 2–3 years (e.g., construction work), proportionate revenue based on the part of the contract completed by the end of the accounting period is treated as realised, not the full contract amount.

2. Hire-purchase sales: When goods are sold on hire purchase, the amount collected in each instalment is treated as realised at the time of collection, rather than recognising the full sale price upfront.

Answer: Revenue is recognised when the legal right to receive it arises (at the point of sale or service rendered). Exceptions: long-term contracts (proportionate basis) and hire-purchase sales (instalment-collected basis).

Q3 What is the basic accounting equation?

SOLUTION

The basic accounting equation, also called the fundamental accounting equation, is derived from the dual aspect concept:

Assets = Liabilities + Capital

This equation states that the total assets of a business are always equal to the total claims against those assets. These claims are of two types:

1. Claims of owners (proprietors) — called Capital or Owners' Equity.
2. Claims of outsiders (creditors, lenders) — called Liabilities.

Every business transaction affects at least two items in this equation but always maintains its balance (equality). For example:

- Ram starts a business with Rs 50,00,000 cash: Assets (Cash) increase by Rs 50,00,000; Capital increases by Rs 50,00,000. Equation remains balanced.

- Purchase of goods worth Rs 10,00,000 on cash: Assets (Stock) increase; Assets (Cash) decrease by the same amount. Net effect on both sides is zero.

- Purchase of machinery worth Rs 30,00,000 on credit: Assets (Machinery) increase; Liabilities (Creditor) increase by the same amount. Equation remains balanced.

This equation forms the basis of the double entry system of accounting.

Answer: The basic accounting equation is: Assets = Liabilities + Capital. It reflects that every asset is funded either by owners (capital) or outsiders (liabilities), and every transaction keeps the equation balanced.

Q4 The realisation concept determines when goods sent on credit to customers are to be included in the sales figure for the purpose of computing the profit or loss for the accounting period. Which of the following tends to be used in practice to determine when to include a transaction in the sales figure for the period? When the goods have been: (a) dispatched, (b) invoiced, (c) delivered, (d) paid for. Give reasons for your answer.

SOLUTION

The correct answer is (c) delivered.

Reason: Under the revenue recognition (realisation) concept, revenue is recognised when the legal right to receive it arises — that is, when the risks and rewards of ownership have been transferred to the buyer. Delivery of goods to the customer is the point at which:

1. The seller has fulfilled the obligation to supply the goods.
2. The buyer accepts the goods and incurs a legal obligation to pay.
3. A legally enforceable claim (legal right to receive money) arises for the seller.

Why the other options are incorrect:

(a) Dispatched: Goods have left the seller's premises but may not yet have reached the buyer. The buyer has not yet accepted them; the risk of loss in transit may still lie with the seller depending on the contract terms. No legal right has arisen.

(b) Invoiced: Raising an invoice is an administrative act. If goods have not been delivered, a right to payment has not arisen. However, in practice, invoicing often coincides with delivery, which is why (b) is sometimes treated as equivalent — but delivery is the underlying trigger.

(d) Paid for: Waiting until cash is received ignores credit sales entirely and would violate the matching and accrual concepts. Most businesses sell on credit; recognising revenue only when cash is received would severely understate sales in any credit-based business.

Answer: Revenue is recognised at the point of delivery (c), when the legal right to receive payment arises. Dispatch lacks buyer acceptance; invoicing is administrative; cash receipt ignores credit sales and violates the matching concept.

Q5 Complete the following worksheet: (i) 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 ___ concept. (ii) The fact that a business is separate and distinguishable from its owner is best exemplified by the ___ concept. (iii) Everything a firm owns, it also owns out to somebody. This co-incidence is explained by the ___ concept. (iv) 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. (v) A firm may hold stock which is heavily in demand. Consequently, the market value of this stock may be increased. Normal accounting procedure is to ignore this because of the ___. (vi) If a firm receives an order for goods, it would not be included in the sales figure owing to the ___. (vii) The management of a firm is remarkably incompetent, but the firm's accountants cannot take this into account while preparing book of accounts because of ___ concept.

SOLUTION

(i) Conservatism (Prudence) concept.
Reason: The conservatism concept requires that all possible losses must be recorded (e.g., creating a provision for doubtful debts) even if they are not yet certain, whereas anticipated gains are not recorded until realised.

(ii) Business Entity concept.
Reason: The business entity concept treats the business and its owner as two separate and distinct entities for accounting purposes, regardless of the legal form of ownership.

(iii) Dual Aspect concept.
Reason: The dual aspect (duality) concept states that every asset of the business is owned by or owes to someone — either the owner (capital) or outside parties (liabilities). This is expressed as: Assets = Liabilities + Capital.

(iv) Consistency concept.
Reason: The consistency concept requires that the same accounting method (e.g., straight line method of depreciation) must be applied uniformly from one accounting period to the next to enable meaningful comparisons.

(v) Conservatism (Prudence) concept.
Reason: Under conservatism, unrealised gains (increase in market value of stock not yet sold) are not recognised in the books. Stock is valued at cost or net realisable value, whichever is lower.

(vi) Revenue Recognition (Realisation) concept.
Reason: Merely receiving an order does not create a legal right to receive payment. Revenue is recognised only when goods are delivered or services are rendered, not when an order is placed.

(vii) Money Measurement concept.
Reason: The money measurement concept requires that only those facts and transactions that can be expressed in monetary terms are recorded. The incompetence of management is a qualitative factor that cannot be measured in money and hence finds no place in the accounting records.

Answer: (i) Conservatism, (ii) Business Entity, (iii) Dual Aspect, (iv) Consistency, (v) Conservatism, (vi) Revenue Recognition (Realisation), (vii) Money Measurement.

Long Answers — Questions for Practice — Long Answers

Q1 'The accounting concepts and accounting standards are generally referred to as the essence of financial accounting'. Comment.

SOLUTION

The statement is well-founded. Accounting concepts and accounting standards together form the theoretical and regulatory foundation that makes financial accounting meaningful, reliable, and comparable.

Role of Accounting Concepts (GAAP):

Accounting concepts are the fundamental assumptions and guidelines that govern the recording and reporting of financial transactions. Key concepts and their relevance:

1. Business Entity concept: Ensures that personal and business transactions are not mixed, giving a true picture of business performance.

2. Going Concern concept: Justifies valuation of assets at historical cost and spreading of costs over future periods, rather than liquidation values.

3. Matching concept: Ensures that revenues and the expenses incurred to earn them belong to the same accounting period, giving a fair measure of profit.

4. Conservatism concept: Prevents overstatement of profits, protecting creditors and investors from misleading information.

5. Consistency concept: Enables meaningful inter-period and inter-firm comparisons by requiring uniform application of accounting methods.

6. Full Disclosure concept: Ensures all material facts are disclosed so that users can make informed decisions.

Without these concepts, each accountant could record the same transaction differently, making financial statements incomparable and unreliable.

Role of Accounting Standards:

Accounting standards are authoritative written statements issued by the Institute of Chartered Accountants of India (ICAI). They specify the recognition, measurement, presentation, and disclosure of accounting transactions. Their role:

1. Eliminate variations: Reduce the number of permissible accounting treatments so that similar transactions are recorded similarly across enterprises.

2. Enhance comparability: Both intra-enterprise (across periods) and inter-enterprise comparisons become meaningful.

3. Mandate disclosure: Require disclosure of information that may not be legally required but is important to users such as investors, creditors, and government.

4. Improve credibility: Financial statements prepared in conformity with accounting standards carry greater credibility with users.

Conclusion: Accounting concepts provide the philosophical base, while accounting standards translate those concepts into specific, enforceable guidelines. Together they ensure that financial statements present a true and fair view of the financial position and performance of an enterprise, making them the very essence of financial accounting.

Answer: Accounting concepts (business entity, going concern, matching, etc.) provide the philosophical foundation for uniform recording, while accounting standards (ICAI) translate these into specific enforceable rules — together ensuring true, fair, comparable, and credible financial statements.

Q2 Why is it important to adopt a consistent basis for the preparation of financial statements? Explain.

SOLUTION

Consistency in financial statements means applying the same accounting policies and methods from one accounting period to the next and across different enterprises. Its importance arises from the following:

1. Enables inter-period comparison:
Investors and management compare the current year's financial results with those of previous years to assess growth, profitability, and efficiency. If accounting policies change every year — for example, if the method of depreciation changes from straight line to written down value — the profit figures of two years are not comparable. Consistency ensures that such comparisons are meaningful.

2. Enables inter-firm comparison:
Creditors, investors, and analysts often compare the financial results of two different firms operating in the same industry. This comparison is valid only when both firms follow the same accounting methods. If one firm values stock on FIFO basis and another on LIFO basis, comparing their profits would be misleading. Consistency makes inter-firm comparisons reliable.

3. Eliminates personal bias:
If an accountant were free to choose a different method each year, results could be manipulated to show higher or lower profit as desired. Consistency eliminates such subjective bias and ensures objectivity.

4. Builds user confidence:
When users know that the same policies have been consistently applied, they can rely on the financial statements for decision-making — whether for investing, lending, or regulatory purposes.

5. Consistency does not mean rigidity:
The consistency concept does not prohibit a change in accounting policy if a change is required by law, an accounting standard, or if the new method gives a more accurate picture. However, any such change must be fully disclosed in the financial statements along with its effect on the

financial results, so that users can adjust their comparisons accordingly.

Example: If a firm changes its method of valuation of stock from FIFO to weighted average, the effect of this change on the profit must be disclosed in the notes to the financial statements.

Answer: Consistency is vital because it enables meaningful inter-period and inter-firm comparisons, eliminates personal bias, and builds user confidence. Changes in policy are permitted but must be fully disclosed along with their financial effect.

Q3 Discuss the concept based on the premise 'do not anticipate profits but provide for all losses'.

SOLUTION

The concept described by the premise 'do not anticipate profits but provide for all losses' is the Conservatism (Prudence) concept.

Meaning of the concept:
The conservatism concept provides guidance for recording transactions in the book of accounts and is based on the policy of playing safe. It requires that:
- Profits should not be recorded until actually realised.
- All losses, even those with a remote possibility, must be provided for immediately.

Application — 'Do not anticipate profits':

1. Stock valuation: If the market value of closing stock has risen above its cost price, the gain is not recorded until the stock is actually sold. Stock is shown at cost price (not market value) in such a case.

2. Revenue recognition: An order received from a customer is not treated as revenue; revenue is recognised only when goods are actually delivered and the right to receive payment has arisen.

3. Capital profits: Gains on revaluation of assets (e.g., market value of land rising above book value) are not credited to the profit and loss account.

Application — 'Provide for all losses':

1. Provision for doubtful debts: If some debtors are likely to default, a provision is created in the books even before the debts actually become bad.

2. Stock valuation at lower of cost or market value: If market value of stock falls below cost, the stock is written down to market value to recognise the loss immediately.

3. Writing off intangible assets: Goodwill, patents, and other intangible assets are written off over a period even if their economic value has not necessarily declined.

4. Provision for discount on debtors: A provision may be made for probable discount to be allowed to debtors who pay within the discount period.

Rationale and limitation:
The concept protects creditors against an unwarranted distribution of firm assets by preventing overstatement of profits. However, deliberate understatement of assets and profits leads to

secret reserves, which is also not desirable as it gives a misleading picture of the firm's financial position.

Answer: The Conservatism (Prudence) concept: do not record unrealised gains (e.g., rise in stock market value, advance orders) but immediately provide for all anticipated losses (provision for bad debts, stock written down to NRV, writing off intangibles). Prevents profit overstatement; excess caution creating secret reserves is also discouraged.

Q4 What is matching concept? Why should a business concern follow this concept? Discuss.

SOLUTION

Meaning of Matching Concept:

The matching concept states that expenses incurred in an accounting period should be matched with the revenues earned during that same period. In other words, to ascertain the true profit or loss of an accounting period, only those revenues and the costs incurred to earn those revenues — both belonging to the same period — must be taken into account.

Key implications:

1. Revenue is recognised when earned, not when cash is received. For example, credit sales made in March 2017 are revenue of 2016-17 even if cash is received in April 2017.

2. Expenses are recognised when incurred, not when paid. For example, salaries for March 2017 payable in April 2017 are still an expense of 2016-17.

3. Pre-paid expenses (e.g., insurance paid in advance) are not treated as expense of the current year; only the portion relating to the current period is charged to the profit and loss account.

4. Depreciation: The cost of a fixed asset is not charged entirely in the year of purchase. It is spread over the asset's useful life to match the cost with the revenue generated by the asset each year.

5. Cost of goods: While ascertaining profit, the cost of unsold goods (closing stock) is not treated as an expense of the current year. Only the cost of goods actually sold is matched against the sales revenue of that year.

Why should a business concern follow the matching concept?

1. Accurate profit measurement: Without matching, profit figures would be distorted. Charging all costs in one year regardless of when the related revenue arises would overstate losses in some periods and overstate profits in others.

2. True and fair view: The matching concept ensures that the profit and loss account gives a true and fair view of the operating results of the business for the accounting period.

3. Basis for informed decisions: Management, investors, creditors, and tax authorities rely on profit figures to make decisions. Accurate, properly matched profit figures lead to better decisions.

4. Consistency with accrual basis: The matching concept is an integral part of the accrual basis of accounting, which is required by law (Companies Act) and accounting standards for most organisations.

5. Prevents manipulation: By mandating that revenue and related costs must belong to the same period, the concept prevents deliberate shifting of income or expenses across periods to inflate or deflate reported profits.

Answer: Matching concept: expenses of a period must be matched with revenues of the same period. A business must follow it to ensure accurate profit measurement, true and fair presentation, basis for sound decisions, and conformity with the accrual basis of accounting.

Q5 What is the money measurement concept? Which one factor can make it difficult to compare the monetary values of one year with the monetary values of another year?

SOLUTION

Money Measurement Concept:

The money measurement concept states that only those transactions and events in an organisation that can be expressed in monetary terms are to be recorded in the book of accounts. Transactions or events that cannot be expressed in terms of money — such as the appointment of a manager, the capability of the human resources, the creativity of the research department, or the goodwill of a firm — do not find a place in the accounting records.

The second aspect of this concept is that records must be maintained in monetary units (rupees and paise), not in physical units. Different assets of a firm — land (acres), computers (numbers), raw material (tons) — cannot be added together in physical units to give a meaningful total. By expressing all items in money terms, the accounting system enables aggregation and reporting of a meaningful total (e.g., total assets of the enterprise).

Example from the textbook: A firm has a factory on 2 acres, 10 office rooms, 30 computers, raw material weighing 20 tons, and cash of Rs 5 lakh. These cannot be added in physical units. In money terms: factory land Rs 2 crore, office building Rs 1 crore, computers Rs 15 lakh, etc. — giving a total that can be meaningfully reported.

Factor that makes comparison difficult — Changes in price level (Inflation):

The most significant limitation of the money measurement concept, and the factor that makes inter-period comparison of monetary values difficult, is the change in the purchasing power of money over time (inflation or deflation).

Due to rising prices, the value of the rupee today is lower than what it was ten years ago. Therefore, when we add assets purchased at different points in time — for example, a building bought in 1995 for Rs 2 crore and a plant bought in 2005 for Rs 1 crore — we are in effect adding rupees of different purchasing powers. This makes the total figure of Rs 3 crore economically meaningless as a measure of current worth.

As a result, balance sheets prepared under the historical cost convention do not reflect the true and current value of assets, and profit figures may be overstated (hidden profits) during periods

of inflation because depreciation is charged on historical cost, not on replacement cost.

This limitation is not corrected by conventional accounting; it is a fundamental shortcoming of the money measurement concept.

Answer: Money measurement concept: only monetarily expressible transactions are recorded, in monetary units. The key factor making inter-period comparison difficult is inflation — changes in the price level alter the purchasing power of money, so rupees of different years are not equivalent, distorting historical cost-based comparisons.