

Accounts Theory

Chapter 1 (Unit-1)

Q1) Define accounting. What are the sub-fields of accounting?

Answer: Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof. Various subfields of accounting are listed as:

- Financial Accounting
- Management Accounting
- Cost Accounting
- Social Responsibility Accounting
- Human Resource Accounting.

Q2) Who are the users of accounting information?

Answer: Users of accounts can be listed as Investors, Employees, Lenders, Suppliers and Creditors, Customers, Govt. and their agencies, public and Management.

Q3) Discuss briefly the relationship of accounting with

- (i) Economics (ii) Statistics (iii) Law

Answer:

(i) Accounting & Economics:

- a. Accounting overlaps economics in many respects. It contributed a lot in improving the management decision-making process. But, economic theories influenced the development of the decision-making tools used in accounting
- b. An example may be given to explain the nexus between accounting and economics. Economists think that value of an asset is the present value of all future earnings which can be derived from such assets. Now think about a plant whose working life is more than one hundred years. How can you estimate future stream of earnings? So accountants developed the workable valuation base – the acquisition cost i.e., the price paid to acquire the assets.

(ii) Accounting & Statistics

- a. The use of statistics in accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. But, for decision-making purposes such precision is not necessary and hence, the statistical approximations are sought.
- b. wherever a need arises for only broad generalizations or the average of relationships, statistical methods have to be applied in accounting data.
- c. In accountancy, a number of financial and other ratios are based on statistical methods, which help in averaging them over a period of time. Several accounting and financial calculations are based on statistical formulae.

- d. Statistical methods are helpful in developing accounting data and in their interpretation. For example, time series and cross-sectional comparison of accounting data is based on statistical techniques.

(iii) **Accounting & Law:**

- a. An economic entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. The entity itself is created and controlled by laws. For example, a company is created by the Companies Act and also controlled by Companies Act.
- b. Every country has a set of economic, fiscal and labour laws. Transactions and events are always guided by laws of the land. Very often the accounting system to be followed has been prescribed by the law. For example, the Companies Act has prescribed the format of financial statements for companies
- c. Banking, insurance and electric supply undertakings may also have to produce financial statements as prescribed by the respective legislations controlling such entities.

Q3) Discuss the limitations which must be kept in mind while evaluating the Financial Statements.

Answer: Limitations which must be kept in mind while evaluating the Financial Statements are as follows:

- The factors which may be relevant in assessing the worth of the enterprise don't find place in the accounts as they cannot be measured in terms of money.
- Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date.
- Accounting ignores changes in some money factors like inflation etc.
- There are occasions when accounting principles conflict with each other.
- Certain accounting estimates depend on the sheer personal judgement of the accountant.
- Different accounting policies for the treatment of same item adds to the probability of manipulations

Q4) What services can a Chartered Accountant provide to the society?

Answer: The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Accountants are presently taking active role in company laws and other corporate legislation matters, in taxation laws matters (both direct and indirect) and in general management problems.

Some of the services rendered by accountants to the society are briefly mentioned hereunder:

- Maintenance of Books of Accounts
- Statutory Audit
- Internal Audit
- Taxation
- Management Accounting and Consultancy Services

- Financial Advice
 - Other services like Company Formation, Secretarial work, etc.
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Chapter 1 (Unit-2)

Q1) Write short notes on:

- a. Fundamental accounting assumptions.
- b. Periodicity concept.
- c. Accounting conventions

Answers:

- a. **Fundamental accounting assumptions:** There are three fundamental accounting assumptions: Going Concern; Consistency and Accrual. 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.
- b. **Periodicity concept:** According to this concept, accounts should be prepared after every period not at the end of the life of the entity. This is also called the concept of definite accounting period. Usually, this period is one accounting year. We generally follow from 1st April of a year to 31st March of the immediately following year.
- c. **Accounting conventions:** 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. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

Q2) Distinguish between:

- a. Money measurement concept and matching concept
- b. Going concern and cost concept

Answer:

a. **Distinction between Money measurement concepts and matching concept:**

As per *Money Measurement concept*, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions and events that cannot be expressed in terms of money are not recorded in the business books.

In *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 expenses related to earn that revenue should also be recognized.

b. Distinction between Going concern and cost concept

Going Concern Concept

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, it should be disclosed in the financial statements.

Cost concept

By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity

Q3) Briefly explain the qualitative characteristics of the financial statements.

Answer: Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The following are the important qualitative characteristics of the financial statements:

- a. Understandability
- b. Relevance
- c. Reliability
- d. Comparability

These are the four principal qualitative characteristics. There are other important qualitative characteristics as well, such as:

- e. Materiality
 - f. Faithful Representation
 - g. Substance over Form
 - h. Neutrality
 - i. Prudence
 - j. Full, fair and adequate disclosure
 - k. Completeness
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Chapter 1 (Unit-3)

Q1) Define following terms:

- a. Accrual Basis of Accounting
- b. Amortization
- c. Contingent Asset
- d. Contingent Liability

Answer:

a. *Accrual Basis of Accounting*

The method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts in the period in which they accrue.

b. *Amortization*

The gradual and systematic writing off of an asset or an account over an appropriate period.

c. *Contingent Asset*

An asset the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

d. *Contingent Liability*

An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

Chapter 1 (Unit-5)

Q1) Differentiate between:

- a. Provision and Contingent Liability
- b. Liability and Contingent liability.

Answer:

a.

	Provision	Contingent Liability
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallize depending on the occurrence or non-occurrence of one or more uncertain future events.
(2)	A provision meets the recognition criteria	A contingent liability fails to meet the same.
(3)	Provision is recognized when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognizes a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability.

- b. A **liability** is defined as the present financial obligation of an enterprise, which arises from past events.
On the other hand, in the case of **contingent liability**, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.
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Chapter 1 (Unit-6)

Q1) Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.

Answer: Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements.

Policies are based on various accounting concepts. There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating, calls for considerate judgement by the management.

Different accounting policies are frequently encountered in the areas like:

- a. Valuation of inventory
- b. Valuation of Investments
- c. Methods of Depreciation

Q2) *“Change in accounting policy may have a material effect on the items of financial statements.”* Explain the statement with the help of an example.

Answer: Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit/loss.

Chapter 1 (Unit -7)

Q1) Define Measurement in brief. Explain the significant elements of measurement.

Answer: Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Three elements of measurement are:

- a. Identification of objects and events to be measured;
- b. Selection of standard or scale to be used;
- c. Evaluation of dimension of measurement standard or scale

Q2) Describe in brief, the alternative measurement bases, for determining the value at which an element can be recognized in the balance sheet or statement of profit and loss.

Answer: There are four generally accepted measurement bases or valuation principles. These are:

a. *Historical Cost:*

It means acquisition price. For example, the businessman paid Rs. 7,00,000 to purchase the machine and spend Rs. 1,00,000 on its installation, its acquisition price including installation charges is Rs. 8,00,000. The historical cost of machine would be Rs. 8,00,000.

According to this base, assets are recorded at an amount of cash or cash equivalent paid at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation

b. *Current Cost:*

Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently

Example: Take that Mr. X purchased a machine on 1st January, 2011 at Rs. 7,00,000. As per historical cost base he has to record it at Rs. 7,00,000 i.e. the acquisition price. As on 1.1.2020, Mr. X found that it would cost Rs.25,00,000 to purchase that machine. So as per current cost base, the machine value is Rs. 25,00,000

c. *Realizable Value:*

As per realizable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.

Suppose, Mr. X found that he can get Rs. 20,00,000 if he would sell the machine purchased, on 1.1.2011 paying Rs. 7,00,000 and which would cost Rs. 25,00,000 in case he would buy it currently. So, the machine should be recorded at Rs. 20,00,000 as per this basis.

d. *Present Value*

As per present value, an asset is carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Chapter 1 (Unit-8)

Q1) Explain the objective of “Accounting Standards” in brief.

Answer: Accounting Standards are selected set of accounting policies or broad guidelines regarding the principles and methods to be chosen out of several alternatives.

The main objective of Accounting Standards is to establish standards which have to be complied with, to ensure that financial statements are prepared in accordance with generally accepted accounting principles. Accounting Standards seek to suggest rules and criteria of accounting measurements. These standards harmonize the diverse accounting policies and practices at present in use in India.

Q2) State the advantages of setting Accounting Standards.

Answer: The main advantage of setting accounting standards is that the adoption and application of accounting standards ensure *uniformity, comparability* and *qualitative improvement* in the preparation and presentation of financial statements. The other advantages are: Reduction in variations; Disclosures beyond that required by law and Facilitates comparison.

Chapter 1 (Unit-9)

Q1) Explain the need of convergence rather adoption of IFRS as Global Standards.

Answer: The Government of India in consultation with the ICAI decided to converge and not to adopt IFRSs issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRSs requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS-converged Indian Accounting Standards (IND AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential.

Q2) What is the significance of issue of Indian Accounting Standards? Explain in brief.

Answer: Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements. The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements.

Other Important Questions

Q1) What do you mean by principal books of accounts?

Answer: Ledger is known as principal books of accounts and it provides full information regarding all the transactions pertaining to any individual account. Ledger contains all set of accounts (viz. personal, real and nominal accounts).

Q2) What are the rules of posting of journal entries into the Ledger?

Answer: Rules regarding posting of entries in the ledger:

- a. Separate account is opened in ledger book for each account and entries from ledger posted to respective account accordingly.
- b. It is a practice to use words 'To' and 'By' while posting transactions in the ledger. The word 'To' is used in the particular column with the accounts written on the debit side while 'By' is used with the accounts written in the particular column of the credit side. These 'To' and 'By' do not have any meanings but are used to the account debited and credited.
- c. The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.

Q3) Is cash book a subsidiary book or a principal book? Explain.

Answer: Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it has also to be treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.

Q4) What are the advantages of a three column cash book?

Answer: The advantages of three column Cash Book are that –

- a. The Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. Also the chances of error are reduced.
- b. The information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Bank Account

Q5) Briefly explain the following terms:

- a. Materiality
- b. Conservatism
- c. Extraordinary item
- d. Floating Charge
- e. Accrual Basis of Accounting

Answer:

- a. Materiality refers to all relatively important and relevant items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.
- b. Conservatism states that the accountant should not anticipate any future income however they should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value.
- c. Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.
- d. Floating charge is a general charge on some or all assets of an enterprise which are not attached to specific assets and are given as security against a debt.
- e. The method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts in the period in which they accrue.

Q6) "The cost of Property, Plant and Equipment comprises of any cost directly attributable to bring the asset to the location and condition necessary for it to be capable of operating in a manner intended by the enterprise". Give any five examples of such 'directly attributable costs'.

Answer: Cost of Property, Plant and Equipment comprise of any cost directly attributable to bring the asset to the location and condition necessary for it to be capable of operating in a manner intended by the enterprise. Examples of directly attributable costs are:

- a. Cost of employee benefits arising directly from acquisition or construction of an item of property, plant and equipment.
- b. Cost of site preparation
- c. Initial delivery and handling costs
- d. Installation and assembly costs
- e. Cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling the items produced while testing (such as samples produced while testing)
- f. Professional fees e.g., engineers hired for helping in installation of a machine
- g. Transportation cost
- h. Trial run expenses

Thus, all the expenses which are necessary for asset to bring it in condition and location for desired use will become part of cost of the asset.

Q7) Explain Cash and Mercantile system of accounting

Answer: Cash and mercantile system:

Cash system of accounting is a system by which a transaction is recognized only if cash is received or paid. In cash system of accounting, entries are made only when cash is received or paid, no entry being made when a payment or receipt is merely due. Cash system is normally followed by professionals, educational institutions or non-profit making organizations.

On the other hand, *Mercantile system* of accounting is a system of classifying and summarizing transactions into assets, liabilities, equity (owner's fund), costs, revenues and recording thereof. A transaction is recognized when either a liability is created/ impaired and an asset is created /impaired. A record is made on the basis of amounts having become due for payment or receipt irrespective of the fact whether payment is made or received actually. Mercantile system of accounting is generally accepted accounting system by business entities

Important Questions (Already discussed during practical classes)

Q8) Discuss the rules if there is no Partnership Agreement.

Answer: As per the Indian Partnership Act, 1932, in the absence of any agreement among the partners,

- a. No partner has the right to a salary,
- b. No interest is to be allowed on capital,
- c. No interest is to be charged on the drawings,
- d. Interest at the rate of 6% p.a. is to be allowed on a partner's loan to the firm, and
- e. Profits and losses are to be shared equally

Q9) Periodic Inventory System Vs Perpetual Inventory System

S. No.	Periodic Inventory System	Perpetual Inventory System
1.	This system is based on physical verification.	It is based on book records.
2.	This system provides information about inventory and cost of goods sold at a particular date.	It provides continuous information about inventory and cost of sales.
3.	This system determines inventory and takes cost of goods sold as residual figure.	It directly determines cost of goods sold and computes inventory as balancing figure.
4.	Cost of goods sold includes loss of goods as goods not in inventory are assumed to be sold.	Closing inventory includes loss of goods as all unsold goods are assumed to be in Inventory.
5.	Under this method, inventory control is not possible.	Inventory control can be exercised under this system.
6.	This system is simple and less expensive.	It is costlier method.
7.	Periodic system requires closure of business for counting of inventory.	Inventory can be determined without affecting the operations of the business.

Q10) Discuss the factors taken into consideration for calculation of depreciation.

Answer: Following factors are taken into consideration for calculation of depreciation.

- a. **Cost of Asset:** Cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof for the purpose of increase in efficiency.
- b. **Estimated useful life of the asset** - Useful Life' is either (i) the period over which a depreciable asset is expected to be used by the enterprise or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise. Determination of the useful life is a matter of estimation and is normally based on various factors including experience with similar type of assets. Several other factors like estimated working hours, production capacity, repairs and renewals, etc. are also taken into consideration on demanding situation.
- c. **Estimated Residual value:** If such value is considered as insignificant, it is normally regarded as nil. On the other hand, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of asset.

Q11) What is petty cash book? Write it's any two advantages.

Answer: In a business house a number of small payments, such as for taxi fare, cartage, etc., have to be made. If all these payments are recorded in the cash book, it will become unnecessarily heavy. Also, the main cashier will be overburdened with work. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making small payments. of-course he will be reimbursed for the payments made.

Imprest system of petty cash is followed, under this system a fixed sum of money is given to petty cashier for meeting expenses for a prescribed period.

Advantages of Petty cash book are:

- a. Saving of time of the chief cashier
- b. Saving in labour in writing up the cash book and posting into the ledger
- c. Control over small payments

YouTube Channel: <https://www.youtube.com/channel/UCuNVVDzXhLPN7ypU91a7fkQ>

Telegram Group: <https://t.me/targetcafoundation>