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

Going Concern Concept assumes that a business entity will continue its operation for an indefinite period. It is necessary to assume as such because it helps to divide revenue expenditure (i.e. expenditure related to the current year), and capital expenditure (i.e. expenditure whose benefits accrue over a period).

For example, a piece of machinery that costs Rs 2, 00,000, having an expected life of 10 years, will be treated as a capital expenditure. As its benefit can be availed for more than one year; whereas, the per year depreciation of the machinery, say Rs 20,000, will be regarded as revenue expenditure.

2. What is the basic accounting equation?

The basic accounting equation can be written as,

Assets = Liabilities + Capital

It means that all the monetary value of all assets of a firm are equal to the total claims, namely, the owners and outsiders.

3. When should revenue be recognized? Are there exceptions to the general rule?

Revenue is recognised whenever sales take place either in cash or credit and/or when the right to receive income from any source is established. However, revenue is not recognised in the case, if the income or payment is received in advance or the payment is actually received from the debtors.

In brief, revenue will be recognised when the right to receive income is established.

For example, Mr B sold goods in January and received payment in February; then revenue is considered to be recognised in January and not in February. However, if Mr B received cash in advance, i.e. in December and goods are sold in January, then the revenue is recognised in January and not in December.

The exceptions to this rule are given below.

1) Hire purchase: When goods are sold on the hire-purchase system, the amount received in instalments is treated as revenue.

2) Long term construction contract: Some of the long term projects like construction of dams, highways, etc. have a long gestation period. Income is recognised on a proportionate basis of work certified and not on the completion of the contract.

4. Complete the following work sheet:

(i) If a firm believes that some of its borrowers may 'default', it should act on this by making sure that all possible losses are documented 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 company owns, it also owns out to someone. This co-incidence is elucidated 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.

Answer:

(i) conservatism

(ii) business entity

(iii) dual aspect

(iv) consistency

(v) Conservatism

(vi) revenue recognition.

(vii) measurement

5. The realization 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 trends 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.

According to the realization concept, revenue is recognized when an obligation to receive the amount arises. When the goods are invoiced, it is treated as the transfer of ownership of goods from the seller to the buyer and hence the revenue is recognized.

Long Answers

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

Financial accounting deals with the preparation of the financial statements and makes financial information available to various accounting users. It is created with reference to the basic accounting concepts like Business Entity, Money Measurement, Consistency, Conservatism, etc. These concepts permit different alternatives to treat the same transaction. For example, there are a few methods available for calculating stock and depreciation, which can be followed by various firms.

This leads to a wrong interpretation of financial results by external users due to the problem of inconsistency and incomparability of financial results among different business entities. In order to mitigate discrepancy and incomparability and to bring uniformity in the preparation of the financial statements, accounting standards are being issued in India by the Institute of Chartered Accountant of India. Accounting standards help in removing uncertainties and discrepancies. Hence, accounting standards and accounting concepts are referred to as the essence of financial accounting.

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

According to the Conservatism Principle, profits should not be recorded; however, all losses should be recorded (irrespective of whether they occurred or not). It states that profits should not be recorded until they get recognized; however, all possible losses must be recorded even though they may happen rarely. For example, the stock is valued at cost or market price, whichever is lower in amount. If the market price is lower than the cost price, then loss should be accounted; whereas, if the market price is more cost price, then this profit should not be recorded until unless that stock has been sold. There are many such provisions that are maintained based on the conservatism principle like, provision for discount to debtors, provision for doubtful bad debts, etc. This principle is based on common sense and depicts negativity. This also helps the business to deal with uncertainty and unforeseen conditions.

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

Financial statements are created to provide information about growth or decline of business activities over a period of time or for comparison of the results which can be intra-firm (comparison within the same organisation) or inter-firm comparisons (comparison between different firms). Comparisons can be performed if accounting policies are uniform and consistent.

According to the Consistency Principle, accounting practices once designated should be continued over a long period and should not be changed frequently. It helps in getting a better understanding of the financial statements and thus make comparisons relatively easy.

For example, if a firm is following FIFO method for recording stock for one year, and suddenly switches over to the weighted average method the next year, then it is not possible to compare the results of this year with that of the previous years. Although consistency does not avert change in the accounting policies, if change in the policies is vital for better presentation and a better understanding of the financial results, then the firm must undertake a change in its accounting policies and must fully reveal all the pertinent information, reasons and effects of those variations in the financial statements.

4. 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?

According to Money Measurement Concept, only those events that can be expressed in monetary terms should be recorded in the books of accounts. For example, 12 television sets of Rs 5,000 each are purchased then this event is recorded in the books with a total amount of Rs 60,000. Money acts as a common denomination for all the transactions and helps in expressing different units of measurement into a common unit, for example, rupees. Thus, money measurement concept helps in enabling consistency for maintaining accounting records.

It is seen that adhering to the money measurement concept makes it harder to compare the monetary values of one period with that of the other. It is due to the fact that the money measurement concept ignores the changes in the purchasing power of the money, i.e. it is concerned with the nominal value of money and not the real value. For e.g. what Rs 1 could buy 10 years back cannot buy on today’s date; hence, the nominal value of money makes comparison difficult.

In fact, the real value of money would be a more appropriate measure as it considers the price level (inflation), which depicts the changes in profits, incomes, expenses, assets and liabilities of the business.

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

Matching Concept states that all expenses incurred during the year, whether it is paid or not, and all revenues earned during the year, whether it is received or not, should be taken into account while determining the profit for that year. In other words, expenses incurred in a period should be set off against its revenues earned in the same accounting period for defining profit or loss. For example, insurance premium paid for a year is Rs 1200, on September 01 and if accounts are closed on March 31, every year, then the insurance premium of the current year will be ascertained for seven months (i.e. from September to March) and will be calculated as,

Rs 1200 − Rs 700 = Rs 500

Thus, according to the matching concept, the expense of Rs 700 will be taken into account and not Rs 1200 for determining profit, as the benefit of only Rs 700 is availed in the current accounting period.

All business entities follow the matching concept primarily to determine the true profit or loss during an accounting period. It is quite possible that in the same accounting period, the business may either pay for or receive payments that may or may not belong to the same accounting period. This leads to an imbalance in determining profit or loss, which may not reveal the true efficiency of the business and its activities in the concerned accounting period.

Similarly, there may be various expenditures like the purchase of buildings, machinery etc. Such expenditures are capital in nature and their benefits can only be availed over a long period. In such cases, depreciation of such assets is treated as an expense and it should be taken into account for calculating profit or loss of the concerned year. Thus, it is very important for any business entity to follow the matching concept.