# CHAPTER : 1 THEORETICAL FRAMEWORK

**Question 1**

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

**[SM, PYQ Dec 23]**

**Answer**

Accounting is the art of recording, classifying, and summarising 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.

The various sub-fields of accounting are:

(i) Financial Accounting – It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already been occurred. The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet. It primarily helps in determination of the net result for an accounting period and the financial position as on the given date.

(ii) Management Accounting – It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control, and decision- making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting. A very important component of the management accounting is cost accounting which deals with cost ascertainment and cost control.

(iii) Cost Accounting – The process of accounting for cost which begins with the recording of expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.

(iv) Social Responsibility Accounting – The demand for social responsibility accounting stems from increasing social awareness about the undesirable by- products of economic activities., Social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.

(v) Human Resource Accounting – Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

**Question 2**

Who are the users of accounting information?

**[SM]**

**Answer**

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

**Question 3**

Discuss briefly the relationship of accounting with

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

**[SM]**

**Answer**

(i) **Accounting and Economics:** Economics is viewed as a science of rational decision making about the use of scarce resources. It is concerned with the analysis of efficient use of scarce resources for satisfying human wants. This may be viewed either from the perspective of a single firm or of the country as a whole. Accounting is viewed as a system, which provides data to the users to permit informed judgement and decisions. Some non-accounting data are also relevant for decision making. 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. However, there exists a wide gulf between economists' and accountants' concepts of income and capital. Accountants got the ideas of value, income and capital maintenance from economists, but brushed suitably to make them usable in practical circumstances. Accountants developed the valuation, measurement and decision making techniques which may owe to the economic theorems for origin but these are moulded in the work environment and suitably tempered with reference to relevance, verifiability, freedom from bias, timeliness, comparability, reliability and understandability. 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. At the macro-level, accounting provides the database over which the economic decision models have been developed; micro-level data arranged by the accounting system is summed up to get macro-level database. © The Institute of Chartered Accountants of India THEORETICAL FRAMEWORK 1.17 Non-overlapping zones of accounting are not negligible. Development of the systems of recording, classifying and summarising transactions and events, harmonising the systems by uniform rules and communicating the data is essentially a non-overlapping area of accounting.

(ii) **Accounting and Statistics:** 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. In accounts, all values are important individually because they relate to business transactions. As against this, statistics is concerned with the typical value, behaviour or trend over a period of time or the degree of variation over a series of observations. Therefore, wherever a need arises for only broad generalisations or the average of relationships, statistical methods have to be applied in accounting data. Further, in accountancy, the classification of assets and liabilities as well as the heads of income and expenditure has been done as per the needs of financial recording to ascertain financial results of various operations. Other types of classification like the geographical and historical ones and ad hoc classification are done depending on the purpose to make such classification meaningful. Accounting records generally take a short-term view of events and are confined to a year while statistical analysis is more useful if a longer view is taken for the purpose. For example, to fit the trend line a longer period will be required. However, statistical methods do use past accounting records maintained on a consistent basis. The functional relations showing mathematical relations of one variable with one or more other variables are based on statistical work. These relations are used widely in making cost or price estimates for some estimated future values assigned to the given independent variables. For example, given the functional relation of total cost to the price of an input, the effect of changes in future prices on the cost of production can be calculated. 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. 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. Now- a-days multiple discriminate analysis is popularly used to identify symptoms of sickness of a business firm. Therefore, the study and application of statistical methods would add extra edge to the accounting data.

(iii) **Accounting and Law:** 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. Similarly, 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. © The Institute of Chartered Accountants of India THEORETICAL FRAMEWORK 1.19 Banking, insurance and electric supply undertakings may also have to produce financial statements as prescribed by the respective legislations controlling such entities. However, legal prescription about the accounting system is the product of developments in accounting knowledge. That is to say, legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In that way accounting influences law and is also influenced by law.

**Question 4**

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

**[SM, RTP June 23, May 19, MTP Mar 18, Oct 19, Oct 20, Mar 21,Nov 22, Dec 23, April 24, PYQ Nov 18]**

**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.

**Question 5**

What services can a Chartered Accountant provide to the society?

**[SM, RTP June 24, PYQ Nov 20, MTP Mar 22, July 24]**

**Answer**

The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Chartered 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 chartered accountants to the society are briefly mentioned hereunder:

(i) Maintenance of books of accounts;
(ii) Statutory audit;
(iii) Internal Audit;
(iv) Taxation;
(v) Management accounting and consultancy services;
(vi) Financial advice and financial investigations etc.
(vii) Other services like secretarial work, share registration work, company formation receiverships, arbitrations etc.

**Question 6**

Differentiate between Book-keeping and Accounting.

**[PYQ Sep 24]**

**Answer**

The difference between Book keeping and Accounting are as follows:

| S.N. | Book-keeping | Accounting |
|---|---|---|
| 1. | It is a process concerned with recording of transactions. | It is a process concerned with summarising of the recorded transactions. |
| 2. | It constitutes as a base for accounting. | It is considered as a language of the business. |
| 3. | Financial statements do not form part of this process. | Financial statements are prepared in this process on the basis of book-keeping records. |
| 4. | Managerial decisions cannot be taken with the help of these records. | Management takes decisions on the basis of these records. |
| 5. | There is no sub-field of book keeping. | It has several sub-fields like financial accounting, management accounting etc. |
| 6. | Financial position of the business cannot be ascertained through book- keeping records. | Financial position of the business is ascertained on the basis of the accounting reports. |

**Question 7**

Develop the accounting equation from the following information:-

| Particulars | March 31, 2021 (Rs.) | March 31, 2022 (Rs.) |
|---|---|---|
| Capital | 1,00,000 | ? |
| 12% Bank Loan | 1,00,000 | 1,00,000 |
| Trade Payables | 75,000 | 70,000 |
| Fixed Assets | 1,25,000 | 1,10,000 |
| Trade Receivables | 75,000 | 80,000 |
| Inventory | 70,000 | 80,000 |
| Cash and Bank | 5,000 | 6,000 |

Required: Find the profit for the year and the balance sheet as on 31/03/2022.

**[SM]**

**Answer**

For the year ended March 31, 2021: Equity = Capital Rs. 1,00,000
Liabilities = Bank Loan + Trade Payables Rs. 1,00,000 + Rs. 75,000 = Rs. 1,75,000
Assets = Fixed Assets + Trade Receivables + Inventory + Cash & Bank
Rs. 1,25,000 + Rs. 75,000 + Rs. 70,000 + Rs. 5,000 = Rs. 2,75,000
Equity + Liabilities = Assets Rs. 1,00,000 + Rs. 1,75,000 = 2,75,000
For the year ended March 31, 2022: Assets = Rs. 1,10,000 + Rs. 80,000 + Rs. 80,000 + Rs. 6,000 = Rs. 2,76,000
Liabilities = Rs. 1,00,000 + Rs. 70,000 = Rs. 1,70,000
Equity = Assets – Liabilities = Rs. 2,76,000 – Rs. 1,70,000 = Rs. 1,06,000
Profits = New Equity – Old Equity = Rs. 1,06,000 – Rs.1,00,000 = Rs. 6,000

**Question 8**

Write short notes on:

(i) Fundamental accounting assumptions.

**[SM, RTP Nov 19, June 24, Nov 23, May 21, Nov 20]**

(ii) Periodicity concept

**[PYQ May 22]**

(iii) Accounting conventions.

**[RTP Sep 24, Nov 23, June 23, May 20, Nov 20, 19]**

**Answer**

**Fundamental accounting assumptions:** Fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed. The Institute of Chartered Accountants of India issued Accounting Standard (AS) 1 on 'Disclosure of Accounting Policies' according to which the following have been generally accepted as fundamental accounting assumptions:

1. Going concern: The enterprise is normally viewed as a going concern, i.e. as continuing operations for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.
2. Consistency: It is assumed that accounting policies are consistent from one period to another.
3. Accrual: Guidance Note on 'Terms used in Financial Statements' defines accrual basis of accounting as "the method of recording transactions by which revenue, costs, assets and liabilities are reflected in the accounts in the period in which they accrue." The accrual 'basis of accounting' includes considerations relating to deferrals, allocations, depreciation and amortization. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions. Accrual basis is also referred to as mercantile basis of accounting.

**(i) Periodicity concept :** This is also called the concept of definite accounting period. As per going concern' concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business. According to this concept accounts should be prepared after every period & not at the end of the life of the entity. Usually, this period is one calendar year. We generally follow from 1st April of a year to 31st March of the immediately following year. Thus, for performance appraisal it is not necessary to look into the revenue and expenses of an unduly long time-frame. This concept makes the accounting system workable and the term 'accrual' meaningful. If one thinks of indefinite time-frame, nothing will accrue. There cannot be unpaid expenses and non- receipt of revenue. Accrued expenses or accrued revenue is only with reference to a finite time-frame which is called accounting period.

Thus, the periodicity concept facilitates in:

(i) Comparing of financial statements of different periods

(ii) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business

Matching periodic revenues with expenses for getting correct results of the business operations

**(iii) 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.

**Question 9**

Distinguish between:

(i) Money measurement concept and matching concept

**[SM, RTP Nov 23, 19 and May 18,21, MTP Apr 19, Oct 20]**

OR

Explain Money Measurement concept.

**[PYQ May 22, Dec 23]**

(ii) Going concern and cost concept

**[SM, RTP June 23, MTP Mar 18, PYQ May 19]**

**Answer**

**(i) 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 them expenses related to earn that revenue should also be recognized.

(ii) **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 its 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:** It means that 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.

**Question 10**
Briefly explain the qualitative characteristics of the financial statements.

**[SM]**

***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:

**1. Understandability**:
An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business, economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand

**2. Relevance**:
To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

**3. Reliability:**
To be useful, information must also be reliable, Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports

to represent or could reasonably be expected to represent. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

**4. Comparability:**

Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those polices and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist. Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s). The four principal qualitative

**Question 11**

(ii) Explain the following:

(1) Cash Basis of Accounting

(2) Going Concern concept

**[PYQ June 24, RTP Jan 25, Nov 22]**

**Answer**

(i) Cash Basis of Accounting is the method of recording financial transactions, by which revenues and expenditure and assets and liabilities are reflected in the accounts in the period in which the receipts or payments are actually effected/made.

(ii) Going Concern concept states that 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, the financial statements may have to be prepared on a different basis and, if so, the basis used needs to be disclosed.

The valuation of assets of a business entity is dependent on this assumption. Traditionally, accountants follow historical cost in majority of the cases.

**Question 12**

State with reasons whether the following statements are '**True**' or '**False**'.

(1) Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.

(2) Money spent to reduce working expenses is Revenue Expenditure.

(3) Legal fees to acquire property is Capital Expenditure.

(4) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.

(5) Amount spent for replacement of worn out part of machine is Capital Expenditure.

(6) Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.
(7) Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.
(8) Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.

**[SM]**

**Answer**

(1) **False**: Overhaul expenses are incurred to put second-hand machinery in working condition to derive endurable long-term advantage. So it should be capitalised.
(2) **False:** It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. So this is capital expenditure.
(3) **True:** Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure
(4) **False:** Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
(5) **False:** Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
(6) **False:** Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.
(7) **True:** The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.
(8) **True:** Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

**Question 13**

State with reasons whether the following are Capital or Revenue Expenditure:
(1) Expenses incurred in connection with obtaining a license for starting the factory for Rs. 10,000.
(2) Rs. 1,000 paid for removal of Inventory to a new site.
(3) Rings and Pistons of an engine were changed at a cost of Rs. 5,000 to get fuel efficiency.
(4) Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) Rs. 8,000 for installing telephone in the office.
(5) A factory shed was constructed at a cost of Rs. 1,00,000. A sum of Rs. 5,000 had been incurred in the construction of temporary huts for storing building material.

**[SM]**

**Answer**

(1) Money paid Rs. 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.
(2) Rs. 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.
(3) Rs. 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.
(4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.
(5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

**Question 14**

Best Tech Solutions buys and sells computers as a part of its business. It purchased 20 computers for resale to its customers. Cost of each computer is Rs. 20,000. It also purchased a computer costing Rs. 24,000 for its accountant to be able to maintain the accounting records and printing of invoices. Suggest whether above transactions qualify as capital expenditure or revenue expenditure transactions?

**[SM]**

**Answer**

Best Tech Solutions is in the business of buying and selling of computers. Any computers purchased for resale to its customers will qualify as revenue expenditure. Hence, a purchase of 20,000 x 20 = Rs. 4,00,000 will be a part of revenue expenditure.

At the same time, the computer purchased for maintaining the records and invoicing is to be able to operate the business for a longer period of time. Therefore, the purchase of Rs. 24,000 qualifies as a capital expenditure. This amount will be a part of assets in the Balance Sheet.

**Question 15**

State with reasons whether the below items relating to the business of AB td are capital or revenue receipts?

(a) A machine with a book value of Rs. 10 lakh is sold for Rs. 12 lakh.

(b) Premium amounting to Rs. 1 Lakh received on issue of shares

(c) An amount of Rs. 20,000 received from goods sold in cash.

(d) An amount of Rs. 5 lac received on the maturity of fixed deposit from bank. Also, an interest of Rs. 40,000 was received in addition to the maturity amount of the fixed deposits.

**[SM]**

**Answer**

(a) The amount of Rs. 12 lac is a capital receipt. There is a profit on sale of the machine to the extent of Rs. 2 lac (12 – 10)

(b) Premium received on issue of shares is an example of capital receipt.

(c) Amount received from cash sale is a revenue receipt.

(d) Amount received on the maturity of fixed deposit is the recovery of the deposit amount, and is a capital receipt. Interest income is an example of revenue receipt.

**Question 16**

Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the first year ending 31st March, 2022.

(1) Second-hand furniture worth Rs. 9,000 was purchased; repainting of the furniture costs Rs. 1,000. The furniture was installed by own workmen, wages for this being Rs. 200.

(2) Expenses in connection with obtaining a license for running the cinema worth Rs. 20,000. During the course of the year the cinema company was fined Rs. 1,000, for contravening rules. Renewal fee Rs. 2,000 for next year also paid.

(3) Fire insurance, Rs. 1,000 was paid on 1st October, 2021 for one year. © The Institute of Chartered Accountants of India ACCOUNTING 1.68 1.68

(4) Temporary huts were constructed costing Rs. 1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready. Point out how you would classify the above items.

**[SM]**

**Answer**

(1) The total cost of the furniture should be treated as Rs. 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If Rs. 1,000 and Rs. 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts will be credited

to the Furniture Account.
(2) License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of Rs. 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.
(3) Half of the insurance premium pertains to the year beginning on 1st April, 2021. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.
(4) Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

**Question 17**
State with reasons, how you would classify the following items of expenditure:
(1) Overhauling expenses of Rs. 25,000 for the engine of a motor car to get better fuel efficiency.
(2) Inauguration expenses of Rs. 25 lacs incurred on the opening of a new manufacturing unit in an existing business.
(3) Compensation of Rs. 2.5 crores paid to workers, who opted for voluntary retirement.

**[SM]**

***Answer***

(1) Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long-term advantage. So this expenditure should be capitalized
. (2) Inauguration expenses incurred on the opening of a new unit may help to explore more customers This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.
(3)The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

**Question 18**
Classify the following expenditures and receipts as capital or revenue:
(i) Rs. 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.
ii) Amount received from Trade receivables during the year.
(ii) Amount spent on demolition of building to construct a bigger building on the same site.
(iii) Insurance claim received on account of a machinery damaged by fire.

**[SM]**

***Answer***
(i) Capital expenditure.
(ii) Revenue receipt.
(iii) Capital expenditure.
(iv) Capital receipt.

**Question 19**
Are the following expenditures capital in nature?
(i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was Rs. 20,000.
(ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent Rs. 10,000 on account of legal expenses.
(iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent Rs. 40,000 for transportation of such machinery. The year ending is 31st Dec, 2022.

**[SM]**

**Answer**

(i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus, the renovation expense is capital expenditure in nature.

(ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus, the legal expenses incurred in this case is revenue expenditure in nature.

(iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

**Question 20**

What are the basic considerations in distinguishing between capital and revenue expenditures?

**(SM, MTP Apr 19, PYQ July 21, MTP Oct 21, May 24)**

**Answer**

The basic considerations in distinction between capital and revenue expenditures are:

| | |
|---|---|
| (a) | **Nature of business:** For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criterion in separating expenditure between capital and revenue. |
| (b) | **Recurring nature of expenditure**: If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure. |
| (c) | **Purpose of expenses**: Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. |
| (d) | **Effect on revenue generating capacity of business**: The expenses which help to generate income/revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure. |
| (e) | **Materiality of the amount involved**: Relative proportion of the amount involved is another important consideration in distinction between revenue and capital. |

**Question 21**

Define revenue receipts and give examples. How are these receipts treated?. Explain

**[SM, RTP Nov 22, 19 and May 18]**

**Answer**

Receipts which are obtained in course of normal business activities are revenue receipts (e.g,. receipts from sale of goods or services, interest income etc.).

Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

**Question 22**

Classify the following expenditures as capital or revenue expenditure/receipt:

(i) An extension of railway tracks in the factory area.

(ii) Amount spent on painting the factory.

(iii) Payment of wages for building a new office extension
(iv) Premium received on issue of shares
(v) Rings and Pistons of an engine were changed to get full efficiency.
(vi) Legal fees paid to acquire a property

**[RTP Jan 25, May 22]**

**Answer**

(i) Expenses incurred for extension of railway tracks in the factory area should be treated as a Capital Expenditure because it will yield benefit for more than one accounting period.

(ii) Painting of the factory should be treated as a Revenue Expenditure because it has been incurred to maintain the factory building.

(iii) Payment of wages for building a new office extension should be treated as a Capital Expenditure.

(iv) Premium received on issue of shares is an example of capital receipt.

(v) Expenditure incurred for changing Rings and Pistons of an engine is a Revenue Expenditure because, the change of rings and piston will restore the efficiency of the engine only and it will not add anything to the capacity of the engine.

(vi) Legal fees paid to acquire a property is a part of the cost of that property. Hence, it is taken as capital expenditure.

**Question 23**

(b) Classify the following expenditures as capital or revenue receipt or capital or revenue expenditure:
(i) Traveling expenses of the chief executive officer for trips abroad for purchase of capital assets.
(ii) Amount spent on making a few more exists in a Cinema Hall to comply with Government orders.
(iii) Insurance claim received on account of inventory damaged by fire.
(iv) Amount paid for removal of stock to a new site.
(v) Cost of repairs on second-hand car purchased to bring it into working condition.

**[RTP Sep 24, Nov 23, 20, 19, May 18]**

**Answer**

(i) Capital Expenditure.
(ii) Revenue Expenditure.
(iii) Revenue Receipt.
(iv) Revenue Expenditure.
(v) Capital Expenditure.

**Question 24**

Classify the following expenditures as capital or revenue expenditure:
(i) Insurance claim received on account of inventory damaged by fire.
(ii) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land.
(iii) Travelling expenses of the chief financial officer on trips abroad for purchase of special machinery.
(iv) Dividend received from XYZ limited during the year.

**[RTP June 23]**

**Answer**

(i) Revenue expenditure.
(ii) Revenue expenditure.
(iii) Capital expenditure.
(iv) Revenue expenditure.

**Question 25**

Classify the following expenditures as capital or revenue expenditure:

(i) Expenses incurred to keep the machine in working condition.

(ii) Registration fees paid at the time of purchase of a building.

(iii) Expenses incurred for advertisement in newspaper.

(iv) Amount spent on renewal fee of patent rights.

(v) Cost of repairs on second-hand car purchased to bring it into working condition.

**[RTP Nov 22]**

**Answer**

(i) Revenue Expenditure.

(ii) Capital Expenditure.

(iii) Revenue Expenditure.

(iv) Revenue Expenditure.

(v) Capital Expenditure.

**Question 26**

Classify each of the following transactions into capital or revenue transactions:

-- Legal fees on the acquisition of land.

-- Complete repaint of existing building.

-- Repainting of a delivery van.

-- Providing drainage for a new piece of water-extraction equipment.

-- Carriage costs on a replacement part for a piece of machinery.

**[RTP Nov 21]**

**Answer**

-- Legal fees on acquisition of land: capital

-- Complete repaint: revenue

-- Repainting van: revenue.

-- Drainage for new equipment: capital.

-- Carriage costs on replacement part: revenue.

**Question 27**

Classify each of the following transactions into capital or revenue transactions:

-- Inauguration expenses of a new manufacturing unit in an existing Business.

-- Installation of a new central heating system.

-- Repainting of a delivery van.

-- Providing drainage for a new piece of water-extraction equipment.

-- Legal fees on the acquisition of land.

-- Carriage costs on a replacement part for a piece of machinery.

**[RTP May 21]**

**Answer**

-- Inauguration expenses of new unit of existing business: revenue.

-- Installation of new heating system: capital.

-- Repainting van: revenue.

-- Drainage for new equipment: capital.

-- Legal fees on acquisition of land: capital

-- Carriage costs on replacement part: revenue

**Question 28**
Classify the following expenditures as capital or revenue expenditure:
(i) Money spent to reduce working expenses.
(ii) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land.
(iii) Rings and Pistons of an engine were changed at a cost of Rs. 5,000 to get fuel efficiency.
(iv) Compensation of Rs. 2.5 crores paid to workers, who opted for voluntary retirement.

**[RTP May 20]**

**Answer**
(i) Capital expenditure.
(ii) Revenue expenditure.
(iii) Capital expenditure.
(iv) Revenue expenditure

**Question 29**
Differentiate between:
(i) Provision and Contingent Liability.
(ii) Liability and Contingent liability.

**(SM, MTP Nov 21)**

**Answer**
1. Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation. On the other hand, 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 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.

**Question 30**
Write short notes on the following: Contingent Asset and Contingent Liability.

**[RTP Sep 24]**

**Answer**
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.
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.

**Question 31**
Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.

**[SM, RTP May 19]**

**OR**

Define accounting policy. What are the conditions under which a company can change its accounting policy?

**[PYQ June 24]**

**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 valuation of inventory and investments etc.

**Conditions under which change takes place:**

A change in accounting policies shall be made in the following conditions:

(a) It is required by some statute or for compliance with an Accounting Standard

(b) Change would result in more appropriate presentation of financial statement

**Question 32**

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:

(1) Identification of objects and events to be measured;

(2) Selection of standard or scale to be used;

(3) Evaluation of dimension of measurement standard or scale

**Question 33**

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**

Alternative measurement bases are:

(i) Historical Cost; (ii) Current cost (iii) Realisable (Settlement) Value and (iv) Present Value. Refer para 6.6 for details.

**Question 34**

Explain the objective of "Accounting Standards" in brief.

**(SM, MTP May 20, May 22, April 23, RTP Jan 25)**

**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 Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) formulates Accounting Standards to be established by the Council of the ICAI. 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

**Question 35**

State the advantages of setting Accounting Standards.

**[SM, RTP June 24, Nov 18, 21 and May 20, MTP Mar 19, May 22]**

**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:

(a) Reduction in variations;

(b) Disclosures beyond that required by law and

(c) Facilitates comparison.

**Question 36**

Distinguish between fundamental accounting assumption and accounting policies.

**[RTP Jan 25, May 22]**

**Answer**

| Fundamental Accounting Assumption | Accounting Policies |
|---|---|
| There are three fundamental accounting assumptions viz. Going Concern, Consistency and Accrual. | There is no single list of accounting policies which are applied in all circumstances. As a result, there may be different accounting policies adopted by different enterprises. |
| No disclosures is required if all the fundamental assumptions have been followed. | Disclosure is required if a particular accounting policy has been followed. |
| If fundamental accounting assumption is not followed, it is to be disclosed in the financial statements together with the reasons. | If the policy is changed in subsequent year, the effect of such change should be disclosed in the financial statements. |
| There is no option to choose fundamental accounting assumptions. | The firm has an option to select a particular policy. |

**Question 37**

Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the help of an example.

**[SM, RTP Jan 25, May 21, May18, MTP Oct 18, April 21, Nov 22, May 23, May 24]**

**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, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. 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.

The examples in this regard may be given as follows:

Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads.

**Question 38**

Explain Cash and Mercantile system of accounting.

**[RTP Sep 24, Nov 20,21,22,18, MTP Mar 19, May 22, Nov 23, Aug 24]**

**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.

**Question 39**

Differentiate between provision and contingent liability.

**[RTP May 20, Nov 23, PYQ May 18, Nov 19, 22, MTP June 24]**

**Answer**

| | 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 crystallise 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<br>(a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and<br>(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 recognises a provision in the balance sheet. | If the management estimates, that it is less likely that any economic benefit will outflow from the firm to settle the obligation, it discloses the obligation as a contingent liability. |

**Question 40**

(c) Explain the followings:

(i) Accrual Basis of Accounting

(ii) Amortisation

(iii) Contingent Assets

(iv) Contingent Liabilities

**[PYQ Dec 21]**

**Answer**

1. 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.

2. Amortisation

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

3. 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.

4. 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.

**Question 41**

Classify the following expenditures as capital or revenue expenditure:

(i) Amount spent on making a few more exists in a Cinema Hall to comply with Government orders.

(ii) Travelling expenses of the directors for trips abroad for purchase of capital assets.

(iii) Amount spent to reduce working expenses.

(iv) Amount paid for removal of stock to a new site.

(v) Cost of repairs on second-hand car purchased to bring it into working condition.

**(MTP May 20, Nov 22, Dec 23, Aug 24, RTP June 24)**

**Answer**

(i) Revenue Expenditure

(ii) Capital Expenditure.

(iii) Revenue Expenditure.

(iv) Revenue Expenditure.

(v) Capital Expenditure

**Question 42**

Define the following terms:

(i) Capital Commitment

(ii) Expired Cost

(iii) Floating Charge

(iv) Obsolescence

**[PYQ Jan 21]**

**Answer**

(i) Capital commitment: Future liability for capital expenditure in respect of which contracts have been made.

(ii) Expired cost: The portion of the expenditure from which no further benefit is expected. Also termed as expense.

(iii) Floating charge: A general charge on some or all assets of an enterprise which are not attached to the specific assets and are given as security against a debt.

(iv) Obsolescence: Diminution in the value of an asset by reason of its becoming out-of-date or less useful due to technological changes, improvement in production methods, change in market demand for the product or service output of the asset, legal or other restrictions.

**Question 43**

Briefly explain the following terms:

(i) Materiality

(ii) Conservatism

(iii) Extraordinary item

(iv) Floating Charge

**[PYQ June 23]**

**Answer**

(b) (i) 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.

(ii) 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.

(iii) 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.
(iv) 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.

**Question 44**
Briefly explain the following terms.
(i) Conversion Cost
(ii) Diminishing Balance Method
(iii) Money Measurement Concept
(iv) Realisation Concept

**[PYQ Dec 23]**

**Answer**
(i) Conversion Cost: Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes costs which are specifically attributable to units of production, i.e., direct labour, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the direct cost or absorption costing method.
(ii) Diminishing Balance Method: It is a method under which the periodic charge for depreciation of an asset is computed by applying a fixed percentage to its historical cost or substituted amount less accumulated depreciation (net book value). This is also referred to as written down value method.
(iii) Money measurement concept: As per this concept, only those transactions, which can be measured in terms of money are recorded. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms.
(iv) Realisation concept: It closely follows the cost concept. Any change in value of an asset is to be recorded only when the business realises it.

**Question 45**
Write short notes on Measurement.

**[RTP May 20]**

**Answer**
Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Any measurement discipline deals with three basic elements of measurement viz., identification of objects and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards or scale.
Kohler defined measurement as the assignment of a system of ordinal or cardinal numbers to the results of a scheme of inquiry or apparatus of observations in accordance with logical or mathematical rules.
Three important elements of measurement are:
(1) Identification of objects and events to be measured;
(2) Selection of standard or scale to be used;
(3) Evaluation of dimension of measurement standard or scale.
(iv) Advantages of Subsidiary Books
The use of subsidiary books affords the undermentioned advantages :
(i) Division of work
(ii) Specialisation and efficiency
(iii) Saving of the time
(iv) Availability of information's
(v) Facility in checking

**Question 46**
Write short notes on the following:
Tangible Assets vs. Intangible Assets.

**[RTP June 24]**

**Answer**
Distinction between Tangible and Intangible Assets

| Tangible Assets | Intangible Assets |
|---|---|
| Tangible Assets are assets that have a physical substance i.e., they can be seen and touched, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. | Intangible Assets are identifiable assets that do NOT have a physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. |
| Tangible Assets have a finite life based on expected usage. | Intangible Assets have a finite life based on contractual terms. In some cases, intangible assets could also have an indefinite life e.g. purchased goodwill. |
| Useful life is based on expected usage, with no presumption laid down for the same. | Useful life of Intangible Assets is presumed not to exceed 10 years unless evidence exists to the contrary. |
| Tangible Assets are depreciated over the useful life. In other words, writing off the value of tangible assets on an annual basis is known as depreciation. | Intangible Assets are amortised over the useful life. In other words, writing off the value of intangible assets on an annual basis is known as amortisation. |
| Examples include Property, Machinery, Vehicles etc. | Examples include software, streaming rights, landing rights, trademarks, patents etc. |