

Accounts Theory



CA FOUNDATION
ACCOUNTS

**100% Theory
covered**

100 ME 100

CA HARDIK
MANCHANDA

Q-1 - a] True - False - 12 Marks

Theory

Practical

c] Theory - 4 marks. ✓

Q-6 - b] Theory - 5 marks

10-15

Approx. 45-5 hours

CHAPTER-1 ✓

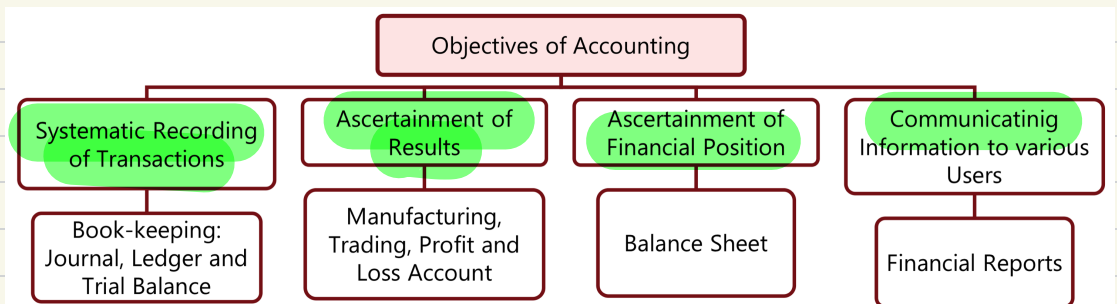
Definition of Accounting

The Committee on Terminology set up by the American Institute of Certified Public Accountants formulated the following definition of accounting in 1961:

“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.”

■ However, the above-mentioned definition does not reflect the present day accounting function. According to the above definition, accounting ends with interpretation of the results of the financial transactions and events but in the modern world, **the importance of communicating the accounting results has increased.**

Thus, accounting may be defined as the *process of recording, classifying, summarising, analysing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.*



Functions of Accounting

The main functions of accounting are as follows: ✓

- (a) **Measurement:** Accounting measures past performance of the business entity and depicts its current financial position. ✓
- (b) **Forecasting:** Accounting helps in forecasting future performance and financial position of the enterprise using past data and analysing trends.
- (c) **Decision-making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.
- (d) **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information, which play an important role in predicting, comparing and evaluating the financial results.
- (e) **Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.
- (f) **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

Difference between Book-keeping & Accounting

S. No.	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 <u>base</u> for <u>accounting</u> .	It is considered as a <u>language</u> of the <u>business</u> .
3.	<u>Financial statements do not form part of this process.</u>	<u>Financial statements are prepared in this process</u> on the basis of book-keeping records.
4. ✓	Managerial decisions <u>cannot be taken</u> with the help of these <u>records</u> .	Management takes decisions on the basis of these records.
5.	There is no <u>sub-field</u> of <u>book-keeping</u> .	It has several <u>sub-fields</u> like financial accounting, management accounting etc.
6. ✓	<u>Financial position of the business cannot be ascertained</u> through book-keeping records.	Financial position of the business is ascertained on the basis of the accounting reports.

Sub-Fields of Accounting

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.

(ii) Management Accounting – It is concerned with internal reporting to the managers of a business unit. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting.

(iii) Cost Accounting – The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as: “the process of accounting for cost which begins with the recording of income and 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 – 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.

Users of Accounting Information

- (i) Investors:** They provide risk capital to the business. They need information to assess whether to buy, hold or sell their investment. Also they are interested to know the ability of the business to survive, prosper and to pay dividend.
- (ii) Employees:** Growth of the employees is directly related to the growth of the organisation and they are interested to know its ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.
- (iii) Lenders:** They are interested to know whether their loan-principal and interest will be paid back when due.
- (iv) Suppliers and Creditors:** They are also interested to know the ability of the enterprise to pay their dues.
- (v) Customers:** Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods.
- (vi) Government and their agencies:** They regulate the functioning of business enterprises for public good, control prices, charge excise duties and taxes, and so they have continued interest in the business enterprise.
- (vii) Public:** The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.
- (viii) Management:** Management as whole is also interested in the accounts for various managerial decisions. On the basis of the accounts, management determines the effects of their various decisions on the functioning of the organisation. This helps them to make further managerial decisions.

Limitations of Accounting

- 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, e.g., provision for doubtful debts, method of depreciation adopted, recording certain expenditure as revenue expenditure or capital expenditure, selection of method of valuation of inventories and the list is quite long.
- Financial statements consider those assets which can be expressed in monetary terms. Human resources although the very important asset of the enterprise are not shown in the balance sheet. **There is no generally accepted formula for the valuation of human resources in money terms.**
- **Different accounting policies for the treatment of same item adds to the probability of manipulations.** Though through various laws and Accounting Standards, efforts are made to reduce these options to minimum but certainly could not be reduced to one.

ROLE OF ACCOUNTANT IN THE SOCIETY

- There are only a few types of profession in the world which are held in high esteem in public eyes and there is no denying the fact that the accounting profession is one of them.
- An accountant with his education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever growing society

Areas of Service

- Maintenance of Books of Accounts: An accountant is able to maintain a systematic record of financial transactions in order to establish the net result of the transactions entered into during a period and to state the financial position of the concern as at a particular date.
- Statutory Audit: Every limited company is required to appoint a chartered accountant or a firm of chartered accountants as their auditor who are statutorily required to report each year whether in their opinion the balance sheet shows a true and fair view of the state of affairs on the balance sheet date, and the profit and loss account shows a true and fair view of the profit or loss for the year.
- Internal Audit: It is a management tool whereby an internal auditor thoroughly examines the accounting transactions and also the system, according to which these have been recorded with a view to ensure the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of management.
- Taxation: An accountant can handle taxation matters of a business or a person and he can represent that business or person before the tax authorities and settle the tax liability

- **Management Accounting and Consultancy Services:** Management accountant performs an advisory function. He is largely responsible for internal reporting to the management for planning and controlling current operations, decision-making on special matters and for formulating long-range plans.
- **Financial Advice:** Many people need help and guidance in planning their personal financial affairs. An accountant who knows about finances, taxation and family problems is well placed to give such advice.
- **Other services** : like secretarial work, company formation, etc.

Unit 2 - ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

Rules

old practice

Assumptions

Entity concept:

- Entity concept states that business enterprise is a separate identity apart from its owner.
- Accountants should treat a business as distinct from its owner.
- Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of accounts
- In a way, the entity concept helps to ascertain how much amount of money is due to the owner in form of his capital and share of profits earned. It also helps to perform accounting from the point of view of the business and not that of the owner.
- Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.

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.
- For example; employees of the organization are, no doubt, the assets of the organizations but their measurement in monetary terms is not possible therefore, not included in the books of account of the organisation.

Periodicity concept:

■ 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.

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
- (iii) Matching periodic revenues with expenses for getting correct results of the business operations

Accrual concept:

■ Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

■ Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. The accrual concept relates to measurement of income, identifying assets and liabilities.

■ Example: Mr. J D buys clothing of Rs. 50,000 paying cash Rs. 20,000 and sells at Rs. 60,000 of which customers paid only Rs. 50,000.

His revenue is Rs. 60,000, not 50,000 cash received. Expense (i.e., cost incurred for the revenue) is Rs. 50,000, not Rs. 20,000 cash paid. So the accrual concept based profit is Rs. 10,000 (Revenue – Expenses).

Purch. 1 Lac COYS
80000 - 120.000

Matching concept:

- In this concept, all expenses matched with the revenue of that period should only be taken into consideration.
- In the financial statements of the organisation if any revenue is recognised then expenses related to earn that revenue should also be recognized.
- This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash. This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes.
- It is not necessary that every expense identify every income. Some expenses are directly related to the revenue and some are time bound.

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
- Entities need to assess at the time of preparation of financial statements, whether they are likely to continue to operate their business. If the Going Concern assumption is under question, the same information should be communicated to the stakeholders.

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

However, the cost concept creates a lot of distortion too as outlined below:

- (a) In an inflationary situation when prices of all commodities go up on an average, acquisition cost loses its relevance.
- (b) Historical cost-based accounts may lose comparability.
- (c) Many assets do not have acquisition costs.

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.
- When an asset is recorded at its historical cost of Rs. 5,00,000 and even if its current cost is Rs. 15,00,000 such change is not counted unless there is certainty that such change will materialize.
- However, accountants follow a more conservative path. They try to cover all probable losses but do not count any probable gain. That is to say, if accountants anticipate decrease in value they count it, but if there is increase in value they ignore it until it is realised.
- Now-a-days the revaluation of assets has become a widely accepted practice when the change in value is of permanent nature. Accountants adjust such value change through creation of revaluation (capital) reserve.

Dual aspect concept:

This concept is the core of double entry book-keeping. Every transaction or event has two aspects:

- $M \uparrow$ $C \downarrow$ $M \uparrow$ $L \uparrow$ $M \downarrow$ $C \uparrow$ $C \downarrow$ $C \uparrow$
- (1) It increases one Asset and decreases other Asset;
 - (2) It increases an Asset and simultaneously increases Liability;
 - (3) It decreases one Asset, increases another Asset;
 - (4) It decreases one Asset, decreases a Liability.

Conservatism:

- 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.
- The Realisation Concept also states that no change should be counted unless it has materialised. The Conservatism Concept puts a further brake on it. It is not prudent to count unrealised gain but it is desirable to guard against all possible losses.

Consistency:

- In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.
 - But the concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.
- An enterprise should change its accounting policy in any of the following circumstances only:
- a. To bring the books of accounts in accordance with the issued Accounting Standards.
 - b. To comply with the provision of law.
 - c. When under changed circumstances, it is felt that new method will reflect a true and fair picture in the financial statement.

Materiality:

- Materiality principle permits other concepts to be ignored, if the effect is not considered material.
- This principle is an exception to full disclosure principle.
- According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of the accountant but will not be relevant to the users' need should not be disclosed in the financial statements.
- The term materiality is the subjective term. It is on the judgement, common sense and discretion of the accountant that which item is material and which is not.
- The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making the decision etc

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions:

- (i) Going Concern
- (ii) Consistency
- (iii) 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. **However**, if any of the above-mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

Qualitative Characteristics of financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.

👉 The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

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.

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.

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.

Comparability:

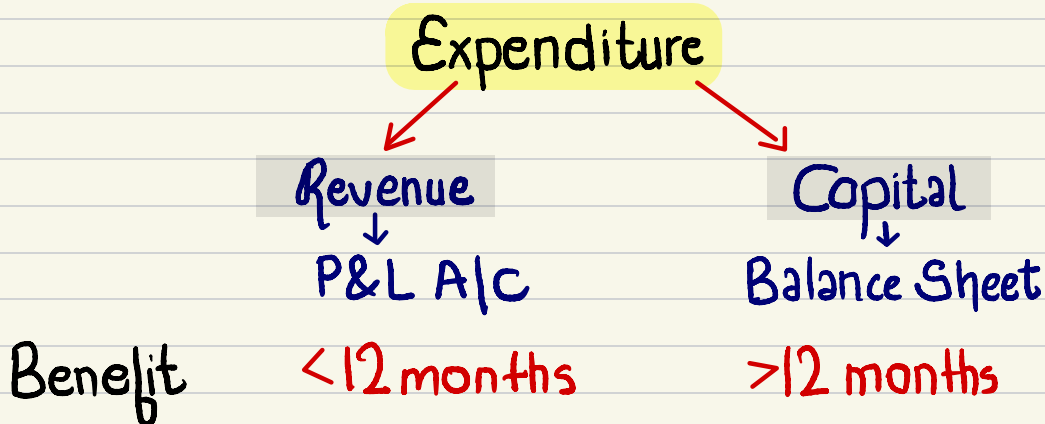
- Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows.
- Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows.
- Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

Substance over Form:

- If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
- The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentations and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

Most gmp

UNIT - 3 CAPITAL AND REVENUE EXPENDITURES AND RECEIPTS

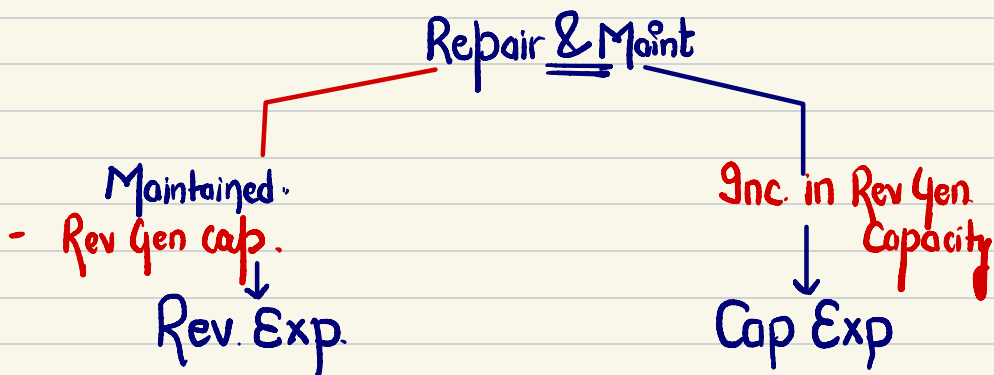


→ Capital Expenditure : 1] Acquisition of Fixed Assets

Tangible

Intangible
Patent. Lease

2] Increase in efficiency / productive capacity



→ Revenue Expenditure: Other than cap. Exp.

⇒ Basic Considerations :

1. Nature of Business.
 2. Recurring nature of exp.
 3. Purpose of exp.
 4. Materiality.
- Recurring - Rev Exp
- Non-Rec- Cap Exp

Key Differences	Capital Expenditure	Revenue Expenditure
Period of benefit	Any expenditure incurred to provide a benefit over a long-term period is capital expenditure.	Any expenditure incurred to provide a benefit during the current period is revenue expenditure.
Enhancement vs Maintenance	Capital expenditure is incurred for the purpose of increasing the capacity of the business. Alternatively, <u>it also includes an expenditure to reduce the costs of the business.</u>	Revenue expenditure is incurred to maintain the earning capacity of the business.
Examples	Purchase of machine, car, furniture, etc.	Repairs and maintenance, salary of accounting staff, etc.

✓ Rent 100,000
Salary 50,000

L8B Acquire Software

Receipts

Capital

Sale of Mach ↓ in Fixed Assets

Loan, issue of sh. Deb. ↑ in Liabilities.

→ Non-Recurring

Revenue

↓
Obtained in the course of normal business activity

Recurring

State with reasons whether the following are Capital or Revenue:

(1) Expenses incurred in connection with obtaining a license for starting the factory for Rs. 10,000. Cap ^{9.A}

(2) Rs. 1,000 paid for removal of Inventory to a new site. Rev

(3) Rings and Pistons of an engine were changed at a cost of Rs. 5,000 to get fuel efficiency. Cap

(4) Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) Rs. 8,000 for installing telephone in the office. Cap

(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. Cap ^{Cap}

(6) 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. Cap

(7) 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. Cap ^{Rev}

(8) Fire insurance, Rs. 1,000 was paid on 1st October, 2021 for one year. Rev Exp ^{Large}

(9) Overhauling expenses of Rs. 25,000 for the engine of a motor car to get better fuel efficiency. Cap

(10) Inauguration expenses of Rs. 25 lacs incurred on the opening of a new manufacturing unit in an existing business. Rev Exp

(11) Compensation of Rs. 2.5 crores paid to workers, who opted for voluntary retirement. Rev Exp

(12) Rs. 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets. - Cap

(13) Amount spent on demolition of building to construct a bigger building on the same site. - Cap

(14) 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. - Cap

(15) 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. - Rev Exp

(16) 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. - Cap Exp

(18) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land - Rev Exp

(19) Amount spent for replacement of worn-out part of machine is Capital Expenditure - Rev Exp

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

(21) Premium amounting to Rs. 1 Lakh received on issue of shares. - Cap Rec

(22) An amount of Rs. 20,000 received from goods sold in cash. - Rev Rec - Cap Rec

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

(24) Amount received from Trade receivables during the year. - Rev Rec

(25) Insurance claim received on account of a machinery damaged by fire. - Cap Rec

FD - Fixed Asset

Imp

UNIT - 4 CONTINGENT ASSETS AND CONTINGENT LIABILITIES

CONTINGENT ASSET

- A contingent asset may be defined as a **possible asset** that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more **uncertain future events** not **wholly within the control of the enterprise**.
- For example, a claim that an enterprise is pursuing through legal process, where the outcome is **uncertain**, is a contingent asset.
Recognise X
Disclose X
- As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset.
- A contingent asset need not be disclosed in the financial statements. A contingent asset is usually disclosed in the report of the approving authority (Director's Report)

CONTINGENT LIABILITIES

The term 'Contingent liability' can be defined as

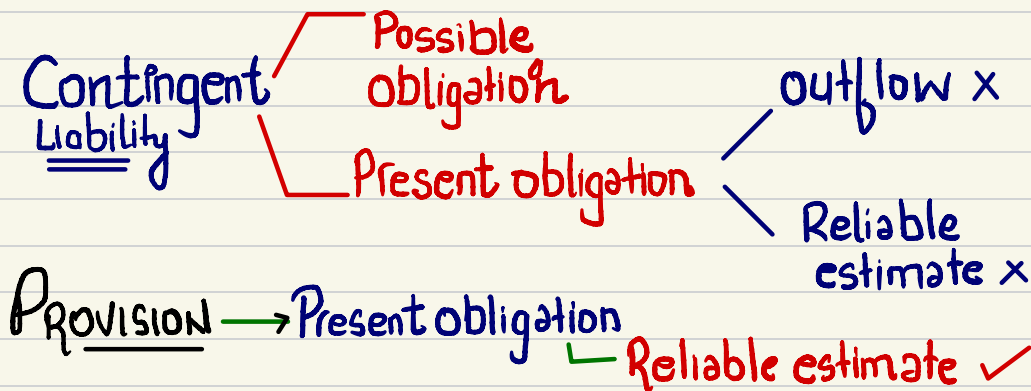
- “(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) a present obligation that arises from past events but is not recognised because:
- (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) a **reliable estimate** of the amount of the obligation cannot be made.”

An enterprise should not recognise a contingent liability in balance sheet, however it is required to be disclosed in the notes to accounts, unless possibility of outflow of a resource embodying economic benefits is remote.

Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc.

DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

- A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises.
- 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.



DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

	Provision	Contingent liability
✓ (1)	Provision is a <u>present liability</u> of uncertain amount, which can be <u>measured reliably</u> by using a substantial degree of estimation.	A Contingent liability is a <u>possible obligation</u> that may or may not crystallise depending on the <u>occurrence</u> or non-occurrence of one or <u>more uncertain future events</u> .
(2)	A provision <u>meets the recognition criteria</u> . ✓	A contingent liability <u>fails to meet the same</u> .
(3)	Provision is recognised when (a) an <u>enterprise has a present obligation</u> arising from past events; an <u>outflow of resources</u> embodying economic benefits is <u>probable</u> , and (b) a <u>reliable estimate</u> can be made of the amount of the obligation.	Contingent liability includes <u>present obligations</u> that <u>do not meet the recognition criteria</u> because either it is not probable that settlement of those obligations will require outflow of economic benefits, <u>or the amount cannot be reliably estimated</u> .
(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 the firm to settle the obligation, it <u>discloses the obligation as a contingent liability</u> .

206-230

Lunch Break

UNIT - 5 ACCOUNTING POLICIES

MEANING OF ACCOUNTING POLICIES

■ 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.

■ The areas wherein different accounting policies are frequently encountered can be given as follows:

- (1) Valuation of Inventories;
- (2) Valuation of Investments.

■ Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy.

SELECTION OF ACCOUNTING POLICIES

■ Selection of inappropriate accounting policy may lead to understatement or overstatement of performance and financial position.

■ Thus, accounting policy should be selected with due care after considering its effect on the financial performance of the business enterprise from the angle of various users of accounts.

■ Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality.

CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should 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

■ 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, this 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.

UNIT - 6 ACCOUNTING AS A MEASUREMENT DISCIPLINE

Q) 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.

1 2 3 4
10,000 10,000 10,000 10,000

Disc. value
@ 10%.

Q) 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.

Q) 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.

Q) Limitations of Accounting Standards?

There are some limitations of accounting standards:

(i) Difficulties in making choice between different treatments: Alternative solutions to certain accounting problems may each have arguments to recommend them.

Therefore, the choice between different alternative accounting treatments may become difficult.

(ii) Restricted scope: Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

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

L **ledger**

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).

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

Answer: Rules regarding posting of entries in the ledger:

- Separate account is opened in ledger book for each account and entries from Journal posted to respective account accordingly.
- 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.
- The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.

Q) 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.

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

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

- 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.
- 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

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.

Q) "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. Transportation cost
- 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

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.

Q) 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

Q) 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,

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

Imp

Q) Periodic Inventory System Vs Perpetual Inventory System

S. No.	Periodic Inventory System <u>Physical</u>	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, <u>inventory control is not possible</u> .	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.

Periodic System :

$$\text{op stock} + \text{Purchase} - \text{cl. stock} = \text{COGS}$$

Goods av. for sale

Bal. fig.

Perpetual

$$\text{opst} + \text{Purch} - \text{COGS} = \text{Closing St}$$

Bal fig

Q) 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

Q) What is petty cash book? Write its 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

ADVANTAGES OF JOURNAL

In journal, transactions recorded on the basis of double entry system, fetch the following advantages:

1. As transactions are recorded in chronological order, one can get complete information about the business transactions on timely basis.
2. Entries recorded in the journal are supported by a note termed as narration, which is a precise explanation of the transaction for the proper understanding of the entry. One can know about the transactions through these narrations.
3. Journal forms the basis for posting the entries in the ledger and reduces the chances of error.

Q) What are the advantages of Double Entry System?

According to double entry system, every transaction has two-fold aspects, debit and credit and both the aspects are to be recorded in the book of accounts.

The advantages of double entry system are as follows:

- (i) By the use of this system the accuracy of the accounting work can be established, through the device of the trial balance.
- (ii) The profit earned or loss incurred during a period can be ascertained together with details.
- (iii) The financial position of the entity or the institution concerned can be ascertained at the end of each period, through preparation of the financial statements.
- (iv) The system permits accounts to be kept in as much details as necessary and, therefore provides significant information for the purpose of control and reporting.
- (v) Result of one year may be compared with those of previous years and reasons for the change may be ascertained.

OBJECTIVES OF PREPARING THE TRIAL BALANCE

The preparation of trial balance has the following objectives:

- (i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books of accounts.
- (ii) Financial statements are normally prepared on the basis of agreed trial balance; otherwise the financial statements will not give true and fair picture of the financial transactions.
- (iii) The trial balance serves as a summary of what is contained in the ledger; the ledger may have to be seen only when details are required in respect of an account.

LIMITATIONS OF TRIAL BALANCE

One should note that the agreement of **Trial Balance is not a conclusive proof of accuracy**. In other words, in spite of the agreement of the trial balance some errors may remain. These may be of the following types:

- (i) Transaction has not been entered at all in the journal.
- (ii) A wrong amount has been written in both columns of the journal.
- (iii) A wrong account has been mentioned in the journal.
- (iv) An entry has not at all been posted in the ledger.
- (v) Entry is posted twice in the ledger.

Advantages of Subsidiary Books

The use of subsidiary books affords the undermentioned advantages:

- (i) **Division of work:** Since in the place of one journal there will be so many subsidiary books, the accounting work may be divided amongst a number of clerks.
- (ii) **Specialisation and efficiency:** When the same work is allotted to a particular person over a period of time, he acquires full knowledge of it and becomes efficient in handling it. Thus the accounting work will be done efficiently.
- (iii) **Saving of the time:** Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to the work being completed quickly.
- (iv) **Availability of information:** Since a separate register or book is kept for each class of transactions, the information relating to each class of transaction be available at one place.
- (v) **Facility in checking:** When the trial balance does not agree, the location of the error or errors is facilitated by the existence of separate books. Even the commission of errors and frauds will be checked by the use of various subsidiary books.

Importance of BRS

- (i) Bank reconciliation will bring out any errors that may have been committed either in the cash book or in the pass book;
- (ii) Any undue delay in the clearance of cheques will be shown up by the reconciliation;
- (iii) A regular reconciliation discourages the accountant of the bank from embezzlement of funds. There have been many cases when the cashiers merely made entries in the cash book but never deposited the cash in the bank; they were able to get away with it only because of lack of reconciliation.
- (iv) It helps in finding out the actual or true position of the bank balance by incorporating the effect of any uncleared funds as well.
- (v) It will ensure accounting of all the financial transactions incurred by the company during a particular financial year

Difference between Statement of Affairs & Balance Sheet

Basis	Statement of affairs	Balance sheet
Source	It is prepared on the basis of transactions <u>partly recorded</u> under the double entry book keeping and partly under the single entry. Most of the assets are recorded based on the estimates, assumptions, information gathered from <u>memory</u> rather from the <u>records</u> .	It is based on <u>transactions recorded</u> strictly on the basis of double entry book keeping; each item in the <u>balance sheet</u> can be verified from the <u>relevant subsidiary books</u> , ledger and <u>documentary evidences</u> .
Capital	In this statement, capital is merely a balancing figure	Capital is derived from the capital account in the ledger and therefore the total of
	being excess of assets over liabilities. Hence assets need not be equal to liabilities.	assets side will always be equal to the total of liabilities side.
Omission	Since this statement is prepared from incomplete records, it is very difficult, to identify and record those assets and liabilities, if omitted from the books.	There is <u>no possibility of omission</u> of any item of asset and liability since all items are <u>properly recorded</u> . Moreover, it is easy to locate the missing items since the balance sheet will not agree.
Basis of Valuation ✓	The valuation of assets is generally done in an arbitrary manner; therefore, <u>no method of valuation is disclosed</u> .	The valuation of assets is done on <u>scientific basis</u> , fixed assets are shown at the original costs <u>less depreciation</u> till date. Any change in the <u>method of valuation</u> is <u>properly disclosed</u> .
Objective	The objective of <u>preparing</u> this statement is to identify the <u>capital figures in the beginning and at the end of the accounting period</u> respectively.	The objective of preparing the balance sheet is to ascertain the financial position on a particular date.

Types of Preference Shares

1) Cumulative Preference Shares: A cumulative preference share is one that carries the right to a fixed amount of dividend or dividend at a fixed rate. Such a dividend is payable even out of future profit if current year's profits are insufficient for the purpose.

2) Non-cumulative Preference Shares: A non-cumulative preference share carries with it the right to a fixed amount of dividend. In case no dividend is declared in a year due to any reason, the right to receive such dividend for that year expires.

3) Participating Preference Shares: Notwithstanding the right to a fixed dividend, this category of preference share confers on the holder the right to participate in the surplus profits, if any, after the equity shareholders have been paid dividend at a stipulated rate.

4) Non-participating Preference Shares: A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares.' Unless otherwise specified, the preference shares are generally non-participating.

5) Redeemable Preference Shares: These are shares that a company may issue on the condition that the company will repay after the fixed period

6) Non-redeemable Preference Shares: The preference shares, which do not carry with them the arrangement regarding redemption, are called Non-redeemable Preference Shares.

7) Convertible Preference Shares: These shares give the right to the holder to get them converted into equity shares at their option according to the terms and conditions of their issue.

8) Non-convertible Preference Shares: When the holder of a preference share has not been conferred the right to get his holding converted into equity share, it is called Non-convertible Preference Shares.

DISTINCTION BETWEEN DEBENTURES AND SHARES

Debentures	Shares
1. Debenture holders are the creditors of the company.	1. Shareholders are the owners of the company.
2. Debenture holders have <u>no voting rights</u> and consequently do not pose any threat to the existing control of the company.	2. <u>Shareholders have voting rights</u> and consequently control the total affairs of the company.
3. Debenture interest is generally paid at a <u>pre-determined fixed rate</u> . It is payable, whether <u>there is any profit or not</u> . Debentures rank ahead of all types of shares for payment of the interest due on them.	3. Dividend on <u>equity shares</u> is paid at a <u>variable rate</u> which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4. Interest on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4. <u>Dividends are appropriation of profit</u> and these are <u>not deductible</u> in determining taxable profit of the company.
5. There are <u>different kinds of debentures</u> , such as Secured/ Unsecured; Redeemable/ Irredeemable; Registered / Bearer; Convertible/ Non-convertible, etc.	5. There are only two kinds of shares— <u>Equity Shares and Preference Shares</u> .
6. In the Company's Balance Sheet, Debentures are shown under "Long Term Borrowings".	6. In the Company's Balance Sheet, shares are shown under "Shareholder's Fund" detailed in 'Share Capital' of Notes to Accounts.
7. Debentures <u>can be converted into other debentures or shares</u> as per the terms of issue of debentures.	7. <u>Shares cannot be converted into other shares</u> in any circumstances.
8. Debentures cannot be forfeited for non-payment of call moneys.	8. Shares can be forfeited for non-payment of allotment and call moneys.
9. At maturity, <u>debenture holders get back their money</u> as per the terms and conditions of redemption.	9. <u>Equity shareholders cannot get back their money before the liquidation</u> of the company (however, preference shareholders can get back their money before liquidation).
10. At the time of <u>liquidation</u> , debenture holders are <u>paid-off before the shareholders</u> .	10. At the time of liquidation shareholders are <u>paid at last</u> , after paying debenture holders, Trade payable, etc.

Types of Debentures

1) Security

(a) Secured Debentures: These debentures are secured by a charge upon some or all assets of the company. There are two types of charges:

- (i) Fixed charge; and
- (ii) Floating charge.

👉 A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders.

👉 A floating charge generally covers all the assets of the company including future one.

(b) Unsecured or "Naked" Debentures: These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date.

2) Convertibility

(a) Convertible Debentures: These are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible. In future, these debenture holders get a chance to become the shareholders of the company.

(b) Non-Convertible Debentures: These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.

3) Permanence

a) Redeemable Debentures: These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.

b) Irredeemable Debentures: These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation

4) Negotiability

(a) Registered Debentures: These debentures are payable to a registered holder whose name, address and particulars of holding is recorded in the Register of Debenture holders. They are not easily transferable.

(b) Bearer Debentures: These debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures.

5) Priority

(a) First Mortgage Debentures: These debentures are payable first out of the property charged.

(b) Second Mortgage Debentures: These debentures are payable after satisfying the first mortgage debentures.