CHAPTER-3 - Accounting Principles

Short Questions

Question 1

Accounting statements of a business is important financial information for stakeholders to analyze the company's financial position. Hence, it is crucial to prepare the statement with care using standardized rules, methods and language, which are known as Generally Accepted Accounting Principles (GAAP).

Question 2

The concept of separate legal entity separates the proprietor, managers, employees from the business.

Question 3

At its core, it serves as the basis for mentioning the value of assets in the annual balance sheet so as to indicate that the assets are for a long term basis, and are not meant to be sold in the close future.

Question 4

The basic accounting equation is:

Assets = Liabilities + Capital

Question 5

The characteristics of Accounting Principles are as follows:

- **Accuracy-** Accounting principles are based on predetermined rules and methods so as create accurate and easy to comprehend financial statement of a firm.

- **Dynamic-** Accounting principles are prone to change time and again and adapt new policies to improve and make financial statements more accurate
- **Relevance-** Accounting principles are only useful if they are deemed to be relevant to the various stakeholders.
- **Objectivity-** Accounting principles are based on material evidence and are free from personal judgement or bias of the company/ company's accounting partners.
- **Feasibility**– Accounting principles are feasible as it can be used with ease.

Very Short Questions

Question 1

Answer- Two characteristics of accounting principles are as follows:

(i) Reliability

(ii) Consistency

Question 2

The concept of separate legal entity separates the proprietor from the business.

Question 3

As per the money measurement concept, transactions which have a monetary value are the only ones to be recorded in accounting.

Question 4

According to the going concern concept of accounting, a business is expected to continue to exist for a long term with no intention to wind up or downsize.

Question 5

The life time of the business is divided into intervals of 12 months each so as to ascertain profits and monitor its growth. These intervals are known as accounting periods.

Question 6

Assets are to be recorded at historical cost, i.e. the cost at which it was acquired as per the cost concept of accounting.

Question 7

As per the dual concept of accounting, every transaction effects two accounts, one of which is debited and one of which is credited.

Question 8

As per the matching concept, all expenses and costs paid in an accounting period should be charged against the incomes and revenues of the same period.

Question 9

As per the matching concept, all expenses and costs paid in an accounting period should be charged against the incomes and revenues of the same period. Similarly, depreciation of the current accounting period is charged against the revenue of the same accounting period.

Question 10

As per the accrual concept, revenue should be recorded when earned irrespective of when it is actually received.

Question 11

Convention of full disclosure states that financial information of all significant value should be disclosed.

Question 12

According to the convention of consistency, accounting methods and principles once adopted should be used continuously year after year.

Question 13

All expected losses should be recorded in the books of accounts and all expected gains should be neglected as per the convention of prudence.

Question 14

According to the materiality convention which states that any transaction or item that have an insignificant or negligible effect need not be disclosed or can be written off to the P&L A/c.

Question 15

Convention of full disclosure states that financial information of all significant value should be disclosed.

Question 16

Current assets follow the convention of prudence, according to which current assets are recorded at cost price or realizable value, whichever is lower. Hence, closing stock is valued in such a manner.

Question 17

A business should follow the consistency concept so as to aid comparability of financial information, which is only possible if the methods and policies followed by the company are consistent over the years.

Question 18

In situations of inflation, depreciation will be established on the historical cost of the asset and charged against the incomes at market price, and therefore distorting the accuracy of the net profit.

Question 19

The life time of the business is divided into intervals of 12 months each so as to ascertain profits and monitor its growth.

Higher Order Thinking Skills (HOTS) Questions

Question 1

GAAP is an acronym for General Accepted Accounting Principles.

Question 2

The concept of separate legal entity separates the proprietor from the business, therefore treating them as creditors of the business.

Question 3

A loss of a major customer is material evidence for stakeholders and should be disclosed as per the convention of full disclosure.

Question 4

The management is wrong in doing so. Actual profits can be calculated only after completion of the project but, according to the accounting period concept, the life time of the business is divided into intervals of 12 months each so as to ascertain profits and monitor its growth.

Question 5

The quality of the management is not disclosed in the balance sheet as per the money measurement principle.

Question 6

All expected losses should be recorded in the books of accounts and all expected gains should be neglected as per the convention of prudence.

Question 7

As per the concept of consistency, depreciation must be calculated according to one specific method year after year.

Question 8

This done so because of the going concern concept, according to which the full cost of an asset is not charged to only the year of purchase, but is spread across years it serves to be useful by charging suitable depreciation annually

Question 9

According to the materiality convention which states that any transaction or item that have an insignificant or negligible effect need not be disclosed or can be written off to the P&L A/c, therefore, the pens can be treated as an expense under stationery A/c, and can be debited from the P&L A/c.

Question 10

According to the convention of conservatism, all expected losses should be recorded and disclosed. Therefore, a provision for bad and doubtful debts to be created to account for anticipated bad debts.

Question 11

The concept of separate legal entity of the business is being violated.

Question 12

The accounting principles followed are:

i. Principle of Consistency
ii. Principle of Prudence

Question 13

The accountant is right in doing so, as according to the materiality convention which states that any transaction or item that have an insignificant or negligible effect need not be disclosed or can be written off to the P&L A/c.

Value-Based Questions

Question 1

Current assets follow the convention of prudence, according to which current assets are recorded at cost price or realizable value, whichever is lower. Hence, closing stock is valued in such a manner.

Question 2

All expected losses should be recorded in the books of accounts and all expected gains should be neglected, as per the convention of conservatism. Hence, the values involved in following this principle are:

(i) Transparency
(ii) Being prepared for future uncertainties

Question 3

Creation of secret reserves is a possibility because the convention of conservatism will have the following effects:

(i) Discloser of profit and loss seem to be lower than actual profits.

(ii)There may be an undervaluation of assets and an overvaluation of liabilities in the balance sheet.

Question 4

The profits, growth and financial position of the company cannot be ascertained without the existence of the separate legal entity concept.

Question 5

The assumption of ongoing concern has the following values involved:

(i) A distinction between capital and revenue expenditure is possible.

(ii) The full cost of an asset is not charged to only the year of purchase, but is spread across years it serves to be useful by charging suitable depreciation annually.

(iii) External individuals and institutions buy shares and debentures of the company.

Question 6

Due to the following reasons, fixed assets are not shown at market value:

(i) Going concern concept- Since fixed assets are not acquired with the intention of being sold anytime soon, hence the market value is irrelevant.

(ii) Historical cost concept- Fixed assets are to be recorded at cost price and not market value.

Question 7

The life time of the business is divided into intervals of 12 months each so as to ascertain profits and monitor its growth.

Question 8

Current assets follow the convention of prudence, according to which current assets are recorded at cost price or realizable value, whichever is lower.
Hence, the company will be violating the convention in doing so.

Question 9

Loss in production due to fire is material evidence and should have been disclosed as per the convention of full disclosure.

The company is violating the convention of full disclosure by not disclosing the above.

Question 10

A fixed asset should be recorded at historical cost, i.e. it should be recorded at the price it was purchased for according to the cost concept.

Hence, the statement is incorrect.

Question 11

Current assets follow the convention of prudence, according to which current assets are recorded at cost price or realizable value, whichever is lower.
Hence, the company will be violating the convention in doing so.

Question 12

The company can do so.
The change in the method of charging depreciation and the rate will be considered as a change in company policy and all changes should be completely disclosed.

Question 13

Mohan is wrong in doing so.
As per the matching concept of accounting, revenue will be recognized only when earned. In this case, Mohan has still not delivered the goods, hence has not earned it. Therefore, he cannot record it as a sale until transfer of ownership of the goods.

Question 14

The full disclosure principle has the following values:

(i) Honesty

(ii) Reliability

(iii) Transparency