

(A) Write short notes on:

Question 1

Materiality

(3 Marks) (Intermediate–Nov. 1994)

Answer

Materiality is primarily related to the qualitative characteristic 'relevance'. If an item is not material, then it is not relevant. Para 17 of AS 1 states that financial statements should disclose all material items. Material items are those the knowledge of which might influence the decisions of the user of the financial statements. Materiality depends on the size of item or error judged in the particular circumstances of its omission or misstatement. From a positive perspective, materiality has to do with the significance of an the item or event to warrant attention in the accounting process. From a negative view point, materiality is critical because otherwise a great deal of time might be spent on trivial matters in the accounting process. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful. The Financial Accounting Standards Board, USA expresses the opinion that "no general standards of materiality can be formulated to take into account all the considerations that enter into an experienced human judgement". Individual judgements are required to assess materiality, or to decide what the appropriate minimum quantitative criteria are to be set for given situations. The Companies Act, 1956 also recognises the need for separate disclosure of material items. Part II of Schedule VI states that any item of expense which exceeds 1% of the total revenue of the company or Rs. 5,000, whichever is higher, should be shown as a separate and distinct item against an appropriate head in the profit and loss account.

Questions 2

Indicate any three areas in respect of which different accounting policies may adopted by different enterprises. Also indicate the requirements with regard to disclosure of accounting policies.

(7 Marks) (Intermediate—May 1995)

2.2 Accounting

Answer

Areas in which different accounting policies may be adopted : The following are three areas in which different accounting policies may be adopted by different enterprises:

- (i) Methods of depreciation, depletion and amortisation.
- (ii) Valuation of inventories.
- (iii) Valuation of Fixed Assets.

(The above three areas are not exhaustive. There are other areas also)

Disclosure requirements of accounting policies :The disclosure requirements as prescribed in Accounting Standard 1 (AS 1) 'Disclosure of Accounting Policies' are as follows :

- (i) All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed at one place and they should form part of the financial statements.
- (ii) Any change in the accounting policies which has a material effect in the current period should be disclosed alongwith the amount, to the extent ascertainable, by which any item in the financial statement is affected. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. However, if a change in accounting policies is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is made.
- (iii) If the fundamental accounting assumptions viz. Going concern, Consistency and Accrual are followed in the preparation of financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Question 3

Entity concept.

(5 Marks) (Intermediate–Nov. 1995)

Answer

The American Accounting Association defines the accounting entity as “an area of economic interest of a particular individual or group”. The accounting entity may be the business unit itself (i.e. sole proprietorship firm, partnership firm, company or government business undertaking), or defined part of a business (i.e. a department) or an amalgamation of related businesses (i.e. a holding company) depending on the users needs. It can also be a non-business group, i.e. person, club, religious bodies or government, which engages in economic activities.

The entity concept has three major implications for accounting:

1. It limits the area to be covered by accounting records and reports. For example, personal transactions of the sole proprietor is not to be recorded in his business accounts as business expenses, they are simply treated as drawings.
2. All transactions are recorded from the point of the entity itself and not from the point of other parties such as owners, managers or customers. For example, when a firm sells goods to customers, this is recorded as sales by the firm and not as purchases by the customers.
3. The entity concept underlines the accounting concept of profits in which a sharp distinction is made between the expenses of operating the business and payment to the owners. All payments to the owners take the form of repayment of capital or loan, or a distribution of profits. They are not treated as business expenses.

Question 4

Elucidate "accounting convention of conservatism." (5 Marks) (Intermediate–of Nov. 1999)

Answer

'Conservatism convention' states that the accountants should not anticipate income and should provide for all possible losses. The underlying principle is that revenues should only be recognised when there is reasonable certainty about their realisation. At the same time provision must be made for all possible liabilities, whether the amount is known with certainty or is based on estimates. Faced with the choice between two methods of valuing an asset, the method which leads to lesser value must be selected. To illustrate, inventories are recorded at the cost or market value, whichever is less or if there is a possibility that a debt may not be realised, a specific amount is set aside from profits as a provision for doubtful debts.

Question 5

Under what circumstances can an enterprise change its accounting policy?

(4 Marks) (PE-II – Nov. 2005)

Answer

A change in accounting policy is made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.