Section 4 Accounting Assumptions, Principles and Conventions

1. A	2. C	3. D	4. A	5. D	6. D	7. C	8. B	9. A	10. A
11. D	12. C	13. B	14. D	15. A	16. C	17. A	18. D	19. A	20. C
21. D	22. B	23. C	24. A	25. A	26. C	27. C	28. A	29. B	30. C
31. D									

1. **A**

   Business entity concept states that the owner and the company are two separate entities.

   B is incorrect. There is no business responsibility concept in accounting.

   C is incorrect. Historical cost concept means assets should be recorded at costs of acquisition or production but not at their market values.

   D is incorrect. Going concern concept states that the business is assumed to continue its operation in the foreseeable future.

2. **C**

   Business entity concept states that the owner and the company are two separate entities. Therefore, the owners should not record their own transactions in the company's books.

   A is incorrect. Owners should keep a separate set of financial statements.

   B is incorrect. Owners cannot withdraw the company's assets without paying for them. It would be recorded in the company's books as drawings.

   D is incorrect. Owners can obtain profit from the company, which is the main objective of operating the business.

3. **D**

   (1), (2) and (3) are correct. Business entity concept assumes a business is independent of its owner(s). Only transactions affecting the business should be recorded in the books of the business. Withdrawing assets for private use should be treated as drawings.

4. **A**

   Historical cost concept means assets should be valued at their purchase prices.

5. **D**

   The reason for adopting historical cost concept is to ensure that financial information is objective. Since the original price of an asset is verifiable, it is more objective than the speculated market value.

   C is incorrect. Based on historical cost concept, the data in the financial statements would be less updated.

6. **D**

   Going concern concept states that a business is assumed to continue its operation in the foreseeable future.

7. **C**

(1) is incorrect. Personal assets of owners and of the firm should always be separated in accounting no matter the firm is going to stop operating or not.

(2) is correct. When the business is closing down, accrued revenues and prepaid expenses may not be recognised in the future and thus should not be treated as assets of the firm. Also, accrued expenses should be paid to the creditors at the point of liquidation and unearned revenues should be returned to the payers if services are not rendered at the time. Therefore, accrual concept cannot be applied.

(3) is correct. When the business is going to wind up, it is better to reflect the most updated financial position of the firm so that it is easy for the firm to liquidate. Therefore, market prices should be used to evaluate the assets and the historical cost concept cannot be applied.

8. **B**

If a company closes down and liquidates, assets should be valued at their current market prices.

9. **A**

(1) and (2) are correct. Going concern concept states that a business is assumed to continue to operate in the foreseeable future with no intention to liquidate or curtail significantly the scale of operation.

(3) is incorrect. In line with historical cost concept, assets are valued at historical costs.

10. **A**

Accrual concept states that revenues and expenses should be recognised when they are earned or incurred but not when they are received or paid. As a result, accrual basis should be adopted instead of cash basis.

11. **D**

According to accrual concept, rental expenses from 1 March 2013 to 31 December 2013 should be included in the income statement but rental expenses from 1 January 2014 to 28 February 2014 should be treated as prepaid expenses, which should not be included in the income statement.

The rental expenses for the year ended 31 October 2013
= $9,000 × 10 months
= $90,000

The expenses for ABC Company were overestimated by $18,000 ($108,000 – $90,000 = $18,000). Therefore, the net profit for the year was thus underestimated by $18,000 (i.e. the correct net profit was $18,000 more than the original one.).

12. **C**

Consistency concept states that the accounting policy or measurement method should not change over time unless the new method can reflect a higher accuracy of measurement.

13. **B**

Historical cost concept states that assets should be recorded at their purchase prices. In this case, the change in market price is irrelevant and the value of the car should still be recorded as $30,000 in the financial statements.

14. **D**

Business entity concept states that the company is a separate entity from the owners. Therefore, using company resources to pay for the owner's electricity bill should be regarded as drawings.

15. **A**

Consistency concept requires the company to adopt the same accounting treatment for similar items over time unless changes can give a more accurate view of the company. Manipulation of the figures is avoided as a result.

16. **C**

Accrual concept means that revenues and expenses should be recorded when they are earned or incurred but not when they are received or paid.

17. **A**

Consistency principle states that same method should be used to record the same type of transactions in a firm within an accounting period, and from one accounting period to another.

18. **D**

According to historical cost concept, assets are recorded at their costs of acquisition. Trade discounts should be deducted. Besides, business entity concept states that a business is separated from its owners. Thus, purchasing assets for the company with personal cheque is regarded as a capital contribution. The correct double entries are as follows:

		$	$
Dr	Office equipment ($5,000 × (1 – 20%))	4,000	
	Cr Capital		4,000

19. **A**

According to accrual concept, revenues and expenses are recognised when they are earned and incurred but not when they are received or paid. Given that BOBO Limited has only provided services to the customer for 7 months (from June to December), the service fee for the remaining 5 months ($600,000 × 5 ÷ 12 = $250,000) should be treated as unearned revenues.

20. **C**

According to historical cost concept, assets are valued at the cost of purchase.
Therefore the valuation of the premises as at 31 January 2013
= $250,000 × (1 – 20%)
= $200,000

21. **D**

According to going concern concept, assets should be valued at the current market price when the company is not going to continue its business in the foreseeable future. Please note that historical cost principle is only applicable when the company is operating in the foreseeable future, i.e. no intention of closing down or curtailing the business.

22. **B**
According to business entity concept, a business is an entity separated from its owners. Only transactions affecting the business should be recorded in the books. Thus no personal transactions should be recorded in the company's accounting record. Thus, purchasing a motor car for a family member by the firm's bank is regarded as taking company's assets for personal use. Drawings account should be debited and bank account should be credited as a result.

23. **C**
According to accrual concept, expenses are recognised when incurred but not when paid. Given that the insurance premium of $72,000 is used for 3 years, only a third of it should be treated as expenses for the current financial year.
Thus, the insurance expenses for the financial year
= $72,000 ÷ 3
= $24,000

24. **A**
At the time when the fixture was brought into the company, its value was $1,000. Based on the historical cost concept which states that assets should be valued at their original cost of purchase rather than their market value, the amount recorded should be $1,000 instead of the current market value of $2,000.

25. **A**
(1) is correct. The concept of consistency means that accounting methods, once adopted, must be applied consistently in future. A change is only allowed if it can reflect a more accurate view of business. In this case, the reason is simply unjustifiable.

(2) is incorrect. It does not violate the concept.

(3) is incorrect. The actual cost of purchase to the business is the net amount after the deduction of trade discount from the listed price, so it does not violate the principle.

26. **C**
According to the accrual concept, expenses are recorded when they are recognised, but not when they are paid. Jack Company rents the office for use in 20X6 and it is the period when the transaction is recognised. Even though Jack Company pays the rent in 20X5, the amount should be expensed in 20X6.

A and B are incorrect. The consistency principle is not applicable to this case. Consistency principle means accounting policies and methods should be the same in an accounting period and from one period to another unless a change can give a better presentation.

27. **C**
According to the historical cost concept, the machine should be recorded at cost incurred when it was bought from other parties. The amount recorded should be the actual cost of the machine, which is $300,000 – $10,000 = $290,000. The trade discount should be deducted.

Market value should not be recorded because of the going concern assumption. It means the value of the machine should be recorded at historical cost on the statement of financial position if the company is expected to continue to operate in the foreseeable future.

28. **A**
The amount of rental expense
= ($360,000 – $10,000) ÷ (2 + 3) × 11
= $770,000

29. **B**

Quick ratio = Liquid current assets ÷ Current liabilities : 1

2.5 : 1 = \$55,000 ÷ Current liabilities : 1

Current liabilities = \$22,000

Working capital
= Current assets – Current liabilities
= \$22,500 + \$55,000 – \$22,000
= \$55,500

30. **C**

Business entity concept means that a firm is regarded as an entity separate from its owners and other entities. Separate books should be kept for the two companies. Business entity concept is violated if the books are combined.

A is incorrect. As the diamond ring is for private use, the transaction should not be recorded in the company's book. Business entity concept is violated. The amount of the diamond ring is irrelevant to the company.

B is incorrect. Matching concept has been violated instead of consistency concept. Matching concept means that the revenue should be matched with the expenses and cost, and dealt with in the profit and loss account in the same year. Providing depreciation is one example of matching concept. In addition, only if the depreciation policy is changed due to unjustifiable reasons will the consistency concept be violated.

D is incorrect. Accrual concept is violated instead of going concern assumption. Accrual concept means that revenues and expenses should be recorded when they are earned or incurred, not when they are received or paid. The amount of expenses prepaid should be treated as a current asset in the books. Going concern assumption is irrelevant to the transaction.

31. **D**

According to going concern assumption, financial statements are prepared under the assumption that the firm has no intention or necessity to liquidate or curtail its scale of operation significantly. As John's company goes bankrupt, the assumption does not hold. Historical cost concept is no longer appropriate. Thus, market value should be used in the valuation. The value of the motor van should be \$38,000.