CHAPTER 2

THEORY BASE OF ACCOUNTING

Learning Objectives

After studying this chapter, students will be able to:

- Describe the meaning of Accounting Assumptions and Accounting Principles.
- Explain the Accounting Standard and IFRS along with their objectives.
- Describe the Bases of Accounting.
- Distinguish between Cash Basis of Accounting and Accrual Basis of Accounting

Main objective of accounting is to provide appropriate, useful and reliable information about the financial performance of the business to its various users to enable them in judicious decision-making. This objective can be achieved only when accounting records are maintained on the basis of uniform rules and principles.

Accounting principles, concepts and conventions are known as Generally Accepted Accounting Principles (GAAP). These principles are the base of Accounting. Generally Accepted Accounting Principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity and consistency in the preparation and the presentation of financial statements.

These principles have evolved over a long period of time on the basis of experiences of the accountants, customs, legal decisions etc., and which are generally accepted by the accounting professionals.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

1. **Going Concern Assumption :**This concept assumes that an enterprise has an indefinite life or existence. It is assumed that the business has neither intention to liquidate nor to scale down its operations significantly.

Relevance :

(*a*) Distinction is made between capital expenditure and revenue expenditure.

(*b*) Classification of assets and liabilities into current and non-current.

(*c*) Depreciation is charged on fixed assets and fixed assets appear in the Balance Sheet at book value, without having reference to their market value.

2. **Consistency Assumption :** According to this assumption, accounting practices once selected and adopted, should be applied consistently year after year. This will ensure a meaningful study of the performance of the business for a number of years.

Consistency of assumption does not mean that particular practices, once adopted, cannot be changed. The only requirement is that when a change is desirable, it should be fully disclosed in the financial statements along with its effect on income statement and Balance Sheet.

Any accounting practice may be changed if the law or Accounting standard requires so, to make the financial information more meaningful and transparent.

Relevance : It helps the management in decision-making by utilizing the comparable financial information.

3. **Accrual Assumption :**Accrual concept applies equally to revenue and expenses. As per this assumption, all revenue and costs are recognized when they are earned or incurred.

It is immaterial, whether the cash is received or paid at the time of transaction or later date *e.g.,* if a credit sale (Credit for two months) for Rs. 15,000 is made on 15th Feb. 2013, then the revenue earned is to be recorded on 15th Feb. 2013, not on the date of cash realized, *i.e.,* after two months. In case of Expenses, if at the end of the year the two months salary is due but not paid, then the expenses of salary will be recorded in the current year in which salary is due, not in the next year in which it will be paid.

Relevance : Earning of a revenue and consumption of a resource (expenses) can be accurately matched to a particular accounting period.

ACCOUNTING PRINCIPLES

1. **Accounting Entity :** An entity has a separate existence from its owner. According to this principle, business is treated as an entity, which is separate and distinct from its owner. Therefore transactions are recorded; analyzed and financial statements are prepared from the business point of view and not of the owner.

   The owner is treated as a creditor (Internal liability) for his investment in the business, as if the firm has borrowed from its owner instead of the outside parties. Interest on capital is treated as expense like any other business expense. His private expenses are treated as drawings leadings to reduction in capital.

2. **Money Measurement Principle :** According to this principle, only those transactions that are measured in money or can be expressed in term of money are recorded in the books of accounts of the enterprises. Non-monetary events like death of any employee/Manager, strikes, disputes etc., are not recorded at all, even though these also affect the business operations significantly.

   Limitation :

1. It ignores qualitative aspect *e.g.,* efficient human resources (Assets), satisfied customers (Assets) and dishonest employee (liabilities).

2. Value of money (currency) is not stable.

   To make accounting records simple, relevant, understandable and homogeneous, facts are expressed in a common unit of measurement-money.

3. **Accounting Period Principle :** According to this principle, the whole indefinite life of an enterprise is divided into parts, known as accounting period.

   Accounting period is defined as interval of time, at the end of which the profit and loss account and balance sheet are prepared, so that the performance is measured at regular intervals and decision can be taken at the appropriate time. Accounting period is usually a period of one year and that year may be financial year or calendar year.

Relevance :

1. This Assumption requires showing the allocation of expenses between Capital and Revenue.

2. Portion of Capital Expenditure that is consumed during the current year is charged to Income statement and rest of the portion *i.e.,* Unconsumed portion is shown as an asset in the Balance Sheet.

3. As per income tax law, tax on income is calculated on annual basis from 1st April to 31st March (Financial Year)

4. Timely action for corrective measures can be taken by the Management.

4. **Full Disclosure Principle :** According to this principle, apart from legal requirements all significant and material information relating to the economic affairs of the entity should be completely disclosed in its financial statements and accompanying notes to accounts.

   The financial statements should act as means of conveying and not concealing the information. Disclosure of information will result in better understanding and the parties may be able to take sound decisions on the basis of the information provided.

E.g., footnotes such as :

(*1*) Contingent liabilities in respect to a claim of a very big amount against the business are pending in a Court of Law.

(*2*) Change in the method of providing depreciation.

(*3*) Market value of investment.

5. **Materiality Principle :** Disclosure of all material facts is compulsory but it does not imply that even those figures which are irrelevant are to be included in financial statements. According to this principle, only those items or information should be disclosed that have material effect and relevant to the users. So, item having an insignificant effect or being irrelevant to user need not be disclosed separately, these may be merged with other item.

   If the knowledge of any information may affect the user's decision, it is termed as material information.

   It should be noted that an item material for one enterprise may not be material for another enterprise. *e.g.,* an item of expenses Rs. 50,000 is material for an enterprise having turnover of Rs. 100 crore.

6. **Prudence Principle :** According to this principle, profit in anticipation should not be recorded but loss in anticipation should immediately be recorded. The objective of this principle is not to overstate the profit of the enterprise in any case. When different equally acceptable alternative methods are available, the method which having least favourable immediate effect on profit should be adopted, *e.g.,*

   (*1*) Valuation of stock at cost or realizable values, whichever is lower.

   (*2*) Provision for doubtful debts and provision for discount on debtors is made.

7. **Cost Principle :** According to this Principle, an asset is recorded in the books of accounts at its original cost comprising cost of acquisition and all expenditure incurred for making the assets ready to use.

This cost becomes the basis of all subsequent accounting transactions for the asset, since the acquisition cost relates to the past, it is referred to as Historical cost. *Example:* Machinery purchased for Rs. 1,50,000 in cash and Rs. 20,000 was spent on installation of machine then Rs. 1,70,000 be recorded as cost of machine in the books and depreciation will be charged on this cost. If market value of machine due to inflation has gone upto Rs. 2,00,000 then the increased value will not be recorded. This cost is systematically reduced from year after year by charging depreciation and the assets are shown in the balance sheet at book value (cost-depreciation).

8. **Matching Principle :** According to this principle, all expenses incurred by any enterprises during an accounting period are matched with the revenue recognized during the same period.

   The matching principle facilitates to ascertain the amount of profit or loss incurred in a particular period by deducting the related expenses from the revenue recognized that period.

   The following treatment of expenses and revenue are done due to matching principle:

   (*1*) Ascertainment of Prepaid Expenses.

   (*2*) Ascertainment of Income received in advance.

   (*3*) Accounting of closing stock.

   (*4*) Depreciation charged on fixed assets.

9. **Dual Aspect Principle :** According to this principle, every business transaction has two aspects–a debit and a credit of equal amount. In other words, for every debit there is a credit of equal amount in one or more accounts and vice-versa.

   The system of recording transaction based on this principles is called as "Double Entry System".

   Due to this principle, the two sides of Balance Sheet are always equal and the following accounting equation will always hold good at any point of time.

Assets = Liabilities + Capital

Example : Ram started business with cash Rs. 1,00,000. It increases cash in assets side and capital in liabilities side by Rs. 1,00,000.

Assets Rs. 1,00,000 = Liabilities + Capital Rs. 1,00,000

BASES OF ACCOUNTING

There are two bases of ascertaining profit or loss, namely (1) Cash Basis, and (2) Accrual Basis.

1. **Cash Basis of Accounting :** Under this system of accounting transactions are recorded in the books of accounts only on the receipt/ payment of cash. The income is calculated as the excess of actual cash receipts (in respect of sale of goods, service, properties etc.) over actual cash payments (regarding purchase of goods, expenses, rent, electricity, salaries etc.)

   Entry is not recorded when a payment or receipt merely due *i.e.,* outstanding expenses, Accrued income are not treated.

   This method is contrary to the matching principle.

2. **Accrual Basis of Accounting :** Under this system of accounting, revenue and expenses are recorded when they are recognized *i.e.,* Income is recorded as Income when it is accrued (when transaction takes place) irrespective of fact whether cash is received or not. Similarly expenses are recorded when they are incurred or become due and not when the cash is paid for them.

   Under this system, expenses such as outstanding expenses, prepaid expenses, accrued income and received in advance are identified and taken into account.

Under the companies Act 1956, all companies are required to maintain their accounts according to accrual basis of accounting.

Difference between accrual basis of accounting and cash basis of accounting

Basis	*Accrual Basis of Accounting*	*Cash Basis of Accounting*
1. Recording of transactions	Both cash and credit transactions are recorded.	Only cash transactions are recorded.
2. Profit or Loss	Profit or Loss is ascertained correctly due to complete record of transactions.	Correct profit/loss is not ascertained because it records only cash transactions
3. Distinction between Capital and Revenue	This method makes a distinction between capital and and revenue items.	This method does not make a distinction between capital and revenue nature items.
4. Legal position	This basis is recognized under the companies Act 1956	This basis is not recognized under the companies Act. 1956.

ACCOUNTING STANDARDS : CONCEPT AND OBJECTIONS

The accounting principles or GAAP in the form of concepts and conventions have been developed to bring comparability and uniformity in the financial statements. But GAAP also allow a large number of alternative treatments for the same item. Different organizations may adopt different accounting policies for the same transaction or an organization may follow different accounting policies for the same item over different accounting periods. As a result, the financial statements become inconsistence and incomparable.

So it was felt that certain minimum standards should be universally applicable, so that the accounting statements have the qualitative characteristics of realiability, relevance, understandability and comparability.

International Accounting Standard Committee (IASC) was set up in 1973. (Now renamed as International financial Reporting Committee IFRC). The Institute of Chartered Accountants of India (ICAI) and the Institute of Cost and Works Accountants of India (ICWAI) are members of this committee. ICAI set up the Accounting Standard Board (ASB) in 1977 to identify the areas in which uniformity in accounting required. ASB prepares and submits a draft accounting standard to the Council of ICAI. The Council of ICAI issues the draft for the comments to the Govt., industry and professionals etc. After due

consideration on comments received, the Council of ICAI notifies it for its use in financial statements.

Concept of Accounting Standards

Accounting standards are written statements, issued from time-to-time by institutions of accounting professionals, specifying uniform rules or practices for drawing the financial statements.

Objectives of Accounting Standards

1. Accounting standards are required to bring **uniformity in accounting practices** and policies by proposing standard treatment in preparation of financial statements.
2. *To* **improve realiability of the financial statement :**Accounts prepared by using accounting standards are reliable for various users, because these standards create a sense of confidence among the users.
3. **To prevent frauds and manipulation** by codifying the accounting methods and practices.
4. **To Help Auditors :** Accounting standards provide uniformity in accounting practices, so it helps auditors to audit the books of accounts.

IFRS International Financial Reporting Standards

This term refers to the financial standard issued by International Accounting standards Board (IASB). It is the process of improving the financial reporting Internationally to help participants in the various capital markets of the world and other users. Numbers of IFRS issued so far is 9.

IFRS Based financial Statements

Following financial statements are produced under IFRS:

1. Statement of financial position: The elements of this statement are

   (a) Assets (b) Liability C. Equity

2. Comprehensive Income statement: The elements of this statement are

   (a) Revenue (b) Expense

3. Statement of changes in Equity
4. Statement of Cash flow
5. Notes and significant accounting policies

Main difference between IFRS and IAS (Indian Accounting Standards)

1. IFRS are principle based while IAS are rule based.
2. IFRS are based on Fair Value while IAS are based on Historical Cost.

QUESTIONS

1. Consider the following data pertaining to Ananya Ltd:

Particulars	*Rs.*
Cost of Machinery purchased on 1st April, 2012	5,00,000
Installation charges	50,000
Market value as on 31st march, 2013	8,00,000

While preparing the annual accounts, if the company values the machinery at Rs. 8,00,000 which principle is being violated by Ananya Ltd.?

Ans. Historical cost concept.

2. Accounting to which concept, all expenses incurred to earn revenue of a particular period should be charged against that revenue to determine the net income?

Ans. Matching concept

3. A business purchased goods for Rs. 2,00,000 and sold 75% of such goods during accounting year ended 31st March, 2013. The market value of remaining goods was Rs. 48,000. He valued closing stock at cost. Name the concept being violated in this situation.

Ans. Prudence or conservatism

4. Under which concept, Owner of business is treated as creditor to the extent of his capital?

Ans. Business entity concept

5. Financial statements of an entity are prepared at regular intervals in accordance with which accounting concept?

Ans. Accounting period concept

6. According to which concept, each accounting transaction has at least two effects?

Ans. Dual aspect concept

7. According to which convention, depreciation is being charged as per one particular method year after year?

Ans. Consistency

8. Which accounting convention takes into account all prospective losses but leaves all prospective Profits?

Ans. Conservatism/prudence

9. Name the concept under which the skills or quality of the management team is not disclosed in the financial statements.

Ans. Money measurement concept

10. Name the concept under which assets are recorded in books at the cost incurred for acquisition of such assets.

Ans. Historical cost concept

11. Name the concept under which advance received from the supplier is not taken as income or Sale.

Ans. Revenue recognition concept

12. Under which basis of accounting only cash transactions are recorded in the books?

Ans. Cash basis of accounting.