**Chapter – 3**
# THEORY BASE OF ACCOUNTING

**Generally Accepted Accounting Principles:**
Generally Accepted Accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financialstatements. These principles are also referred to as concepts and conventions. From the practicality view point, the various terms such as principles, postulates, conventions modifying principles, assumptions, etc. have been used interchangeably and are referred to as basic accounting concepts, in the present book.

**Basic Accounting Concepts:**

The basic accounting concepts are referred to as the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are broad working rules for all accounting activities and developed by the accounting profession. The important concepts have been listed as below:

| Assumptions | Concepts or principles |
|---|---|
| i. Going concern;<br>ii. Consistency;<br>iii. Accrual Assumption | i. Business entity;<br>ii. Money measurement;<br>iii. Accounting period; iv. Cost<br>v. Dual aspect (or Duality);<br>vi. Revenue recognition (Realisation);<br>vii. Matching;<br>viii. Full disclosure;<br>ix. Conservatism (Prudence);<br>x. Materiality; xi. Objectivity ( Verifiable ) |

**Fundamental Accounting Assumptions**

**1 Going Concern Assumption :** The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely (for a fairly long period of time) and would not be liquidated in the near future.

**2 Consistency Assumption :** This concepts states that accounting policies and practices followed by enterprises should be uniform and consistent one the period of time so that results are compassable. Comparability results when the same accounting principles are consistently being applied by different enterprises for the period under comparison, or the same firm for a number of periods

**3 Accrual Assumption**
As per Accrual assumption, all revenues and costs are recognized when they are earned or incurred. It is immaterial, whether the cash is received or paid at the time of a transaction or on a later date. e.g., if a credit sale (Credit for two months) for ` 15,000 is made on 15th Feb. 2019, then the revenue earned is to be recorded on 15th Feb. 2019, not on the date when cash is realized,
i.e., after two months. In case of expenses, if at the end of the year, salary for two months is due but not paid, then the expenses of salary will be recorded in the current year in which the salary is due, not in the next year when it will be paid.

**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 and analysed, and the financial statements are prepared from the point of view of business and not the owner. The owner is treated as a creditor (Internal liability) for his investment in the business, i.e. to the extent of capital invested by him. Interest on capital is treated as an expense like any other business expense. His private expenses are treated as drawings leading 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 terms of money are recorded in the books of accounts of the enterprise. 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.

3. **Accounting Period Principle:** According to this principle, the life of an enterprise is divided into smaller periods so that its performance can be measured at regular intervals. These smaller periods are called accounting periods. Accounting period is defined as the interval of time, at the end of which the profit and loss account and the balance sheet are prepared, so that the performance is measured at regular intervals and decisions can be taken at the appropriate time. Accounting period is usually a period of one year.

**Relevance:**

1. This Assumption requires the allocation of expenses between capital and revenue.
2. Portion of capital expenditure that is consumed during the current year is charged to the Income Statement and the remaining portion i.e., the unconsumed portion is shown as an asset in the Balance Sheet.
3. As per the income tax law, tax on income is calculated on annual basis from 1st April to 31st March (Financial Year).
4. Timely decision for corrective measures can be taken by the management by using these financial statements.

4. **Full Disclosure Principle:** According to this principle, apart from legal requirements, all significant and material information related to the economic affairs of the entity should be completely disclosed in its financial statements and the accompanying notes to accounts. The financial statements should act as a 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 the financial statements. According to this principle, only those items or information should be disclosed that have a material effect and are relevant to the users. So, an item having an insignificant effect or being irrelevant to user need not be disclosed separately, it may be merged with another item. If the knowledge about any information is likely to 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 expense of ` 50,000 is immaterial for an enterprise having sales of ` 100 crores but it is material for an enterprise with sales of ` 10,00,000.

6. **Prudence Principle:** According to this principle, prospective profit should not be recorded but all prospective losses should immediately be recorded. The objective of this principle is not to overstate the profit of the enterprise in any case i.e., do not anticipate any profits but anticipate for all possible losses. This concept ensures that a realistic picture of the company is portrayed. When different equally acceptable alternative methods are available, the method having the least favourable immediate effect on profit should be adopted. e.g.,

1. Valuation of stock at cost or realizable value, whichever is lower.
2. Provision for doubtful debts and provision for discount on debtors is made.
3.

7. **Cost Principle:** According to this Principle, an asset is recorded in the books of accounts at its original cost comprising of the cost of acquisition and all the 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 the historical cost.
e.g., Machinery was purchased for ` 1,50,000 in cash and ` 20,000 was spent on the installation of machine, then ` 1,70,000 will be recorded as the cost of machine in the books and depreciation will be charged on this cost. If the market value of the machine goes up to ` 2,00,000 due to inflation, then the increased value will not be recorded. This cost is systematically reduced 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 an enterprise during an accounting period are matched with the revenues recognized during the same period.
The matching principle facilitates the ascertainment of the amount of profit earned or loss incurred in a particular period by deducting the related expenses from the revenue recognized in that period.

The following treatment of expenses and revenues 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 transactions on the basis of this principle is known as ―Double Entry System‖. Due to this principle, the two sides of the Balance Sheet are always equal and the following accounting equation will always hold good at any point of time.
Assets = Liabilities + Capital
e.g., Ram started business with cash ` 1,00,000. It increases cash in assets side and capital in liabilities- side by ` 1,00,000.
Assets (` 1,00,000) = Liabilities + Capital (` 1,00,000)

10. **Revenue Recognition (Realisation) Concept:** Revenue is the gross in-flow of cash arising from the sale of goods and services by an enterprise and use by others of the enterprise resources yielding interest royalties and dividends. The concept of revenue recognition requires that the revenue for a business transaction should be considered realised when a legal right toreceive it arises.

**11 Objectivity Concept (verifiable Concept ):** The concept of objectivity requires that accounting transaction should be recorded in an objective manner, free from the bias of accountants and others. This can be possible when each of the transaction is supported by verifiable documents or vouchers

**Concept of Accounting Standards**
Accounting standards are written statements, issued from time-to-time by institutions of accounting professionals, specifying uniform rules and 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 reliability of the financial statements:** Statements 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 standards issued by International Accounting Standards Board (IASB). It is the process of improving the financial reporting internationally to help the participants in the various capital markets of the world and other users.

**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.