INDIAN SCHOOL MUSCAT

Senior Section

Department of Commerce and Humanities

Class : XI **Notes-No 3 : Theory Base Of Accounting & Bases of Accounting** **Reference: T.S.Grewal**

ACCOUNTANCY (055)

THEORY BASE OF ACCOUNTING

Accounting principles, concepts and conventions commonly known as Generally Accepted Accounting Principles or GAAPs are the basic rules that define parameters and constraints within which accounting operates. These principles are the theory base of accounting. They have been formulated so that the financial statements are drawn on uniform basis. The Institute of Chartered Accountants of India (ICAI) has issued Accounting Standards to standardize the accounting practices adopted to produce Financial Statements.

MEANING AND NATURE OF ACCOUNTING PRINCIPLES

"Principles of Accounting are the general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice." -The American Institute of Certified Public Accountants

Accounting Principles are the rules of action or conduct adopted by accountants universally while recording accounting transactions. They are the norms or rules which are followed in treating various items of assets, liabilities, expenses, incomes. These principles are classified into two categories:

1. Accounting Concepts: Accounting Concepts are the basic assumptions or fundamental propositions within which accounting operates. They are generally accepted accounting rules based on which transactions are recorded and financial statements are prepared. It is important to follow the accounting concepts because it will enable the users of financial statements to understand them better and in the same manner.

2. Accounting Conventions: Accounting Conventions are the outcome of accounting practices or principles being followed by the enterprises over a period of time. Conventions may undergo a change with time to bring about improvement in the quality of accounting information.

FEATURES OF ACCOUNTING PRINCIPLES

1. Accounting Principles are Man-Made: Accounting Principles are man-made and, therefore, do not stand scrutiny like the principles of natural science. They are the best possible suggestions based on practical experiences.

2. Accounting Principles are Flexible: Accounting Principles are not rigid but flexible. Whenever a situation arises that requires solution, accountants arrive at a reasonable decision which gradually becomes the accepted Accounting Principle. It must be borne in mind that accounting principles are not permanent and change with time.

3. Accounting Principles are Generally Accepted: Accounting Principles are the bases and guide for accounting and are generally accepted. The general acceptance of Accounting Principle usually depends on how it meets the criteria of relevance, objectivity and feasibility.

(i) Relevance: Accounting Principles are relevant if they result in information that is useful to the users of accounting information.

(ii) Objective: Accounting Principles are objective if they are not influenced by the personal bias of the persons preparing the accounting information.

(iii) Feasible: Accounting Principles are feasible if they can be applied without undue complexity and cost.

NECESSITY OF ACCOUNTING PRINCIPLES

Accounting information is better understood if it is prepared following the set of accounting principles uniformly. It means the same Accounting Principles are followed by all entities in preparing their final accounts. Accounting information is meaningful and useful for users of accounting information if the accounting records and financial statements are prepared following generally accepted accounting information in standard forms which are understood.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS OR CONCEPTS

Fundamental Accounting Assumptions or Concepts are the assumptions which are presumed to have been followed in preparing the annual accounts. The entities which do not follow any of the fundamental accounting assumptions should disclose which of these assumptions have not been followed and the reasons for not following them.

The Fundamental Accounting Assumptions are:

1. Going Concern Assumption
2. Consistency Assumption; and
3. Accrual Assumption

1. Going Concern Assumption: According to the Going Concern Concept it is assumed that business shall continue for a foreseeable period and there is no intention to close the business or scale down its operations significantly. It is because of this concept that a distinction is made between a capital expenditure, i.e., expenditure that will render benefit for a long period and revenue expenditure, i.e., one whose benefit will be exhausted quickly, say, within the year. On the basis of this concept, fixed assets are recorded at their original cost and depreciated in a systematic manner without reference to their market value.

Examples: (a) Fixed Assets are recorded at their original cost and they are depreciated in a systematic manner over their expected useful life.
(b) This concept leads to a distinction in Capital Expenditure and Revenue Expenditure.
(c) Companies prepay and accrue expenses because they believe they will continue operations in future.

2. Consistency Assumption: According to the Consistency Assumption, accounting practices once selected and adopted, should be applied consistently year after year. The concept helps in better understanding of accounting information and makes it comparable (a qualitative characteristic of accounting information) with that of previous years. Consistency eliminates personal bias and helps in achieving results that are comparable. The concept is particularly important when alternative accounting practices are equally acceptable.

Examples: (a) A method once chosen and applied for charging depreciation (Straight Line Method or Written Down Value Method) should be applied consistently year after year.
(c) If basis of measuring management performance is Net Profit Basis then that will be used consistently instead of Net Sales Basis.

3. Accrual Assumption: According to the Accrual Assumption, a transaction is recorded at the time when it takes place and not when the settlement takes place. The concept is particularly important because it recognises the assets, liabilities, incomes and expenses.as and when transactions relating to it are entered into. Under this concept, profit is regarded as earned at the time the goods or services are sold to a customer, i.e., the legal title is passed to the customer, who, in turn, has an obligation to pay for them.

Examples: (a) Profit is regarded as earned at the time the goods or services are sold or rendered to the customer i.e. the legal title is passed to the customer, who, in turn, has an obligation to pay for them.
(b) Expense is regarded as incurred when the goods or services are purchased or availed and obligation to pay for them is assumed.

. **ACCOUNTING PRINCIPLES**

(1) Accounting Entity or Business Entity Principle: This concept assumes that business has a distinct and separate entity from its owners. Therefore business transactions are recorded in the books of accounts from the business point of view and not owners. For example, If owner bring ₹ 1,00,000 as capital in business. It is treated as liability of business to owner. Similarly if owner withdrew ₹ 5,000 from business for personal use, it is treated as reduction of owner’s capital and consequently reduction in liability of business towards owner.

(2)Money Measurement Principle: This concept states that transactions and events that can be expressed in money terms are recorded in the books of accounts. Non-monetary transactions cannot be recorded in the books like appointment of manager, capabilities of human resources etc. Another aspect is the records of transactions are to be kept not in physical unit but in monetary unit. For example, an organisation has 2 buildings, 15 computers, 20 office tables are not recorded because they are physical unit and not in monetary unit. Limitation of this concept is the value of rupee does not remain same over a period of time. As changes in the value of money is not reflected in books does not reflect fair view of business affairs.
This principle suffers from two major limitations:
(i) Transactions and events that cannot be measured in money terms are not recorded in the books of accounts, howsoever important they may be to the enterprise.
(ii) The value of money is considered to have static value as the transactions are recorded at the value on the transaction date

(3) Accounting Period Principle: According to the Accounting Period Principle, the life of an enterprise is broken into smaller periods so that its performance is measured at regular intervals.
Accounting period refers to a span of time at the end of which financial statements are prepared to know the profits or loss and financial position of business. Information is required to by different users at regular intervals for decision making. For example, bankers require information periodically because they want to ensure safety and returns of their investments. Similarly management requires information at regular interval to assess the performance and funds requirement. Therefore they are prepared at regular interval, normally a period of one year. This interval of time is called accounting period.

(4) Full Disclosure Principle: According to the Principle of Full Disclosure, "there should be complete and understandable reporting on the financial statements of all significant information relating to the economic affairs of the entity."
Apart from legal requirement good accounting practice require all material and significant information must be disclosed. Financial statements are the basic means of communicating financial information to its users for taking useful financial decisions. This concept states that all material and relevant fact and financial performance must be fully disclosed in financial statement of the business. Companies Act 2013 has provided a format for making Profit and Loss Account and Balance Sheet, which needs to be compulsorily adhered to

for preparation of financial statement. Disclosure of material information results in better understanding. For example, the reasons for low turnover should be disclosed.

(5) Materiality Principle: The Materiality Principle refers to the relative importance of an item or an event. According to the American Accounting Association, "an item should be regarded as material if there is a reason to believe that knowledge of it would influence the decision of an informed investor." This concept states that accounting should focus on material fact. Whether the item is material or not shall depend upon nature and amount involved in it. For example, amount spent on repair of building ₹ 2,50,000 is material for enterprise having the sales turnover of ₹ 10,00,000 but not material for enterprise having turnover of ₹ 15,00,00,000. On the other hand, closure of a production plant, even temporarily, say because of an environmental problem is material.

(6) Conservatism or Prudence Principle: The Prudence Principle is many a times described using the phrase "Do not anticipate a profit, but provide for all possible losses." In other words, it takes into consideration all prospective losses but not the prospective profits. The application of this concept ensures that the financial statements present a realistic picture of the state of affairs of the enterprise and do not paint a better picture than what actually it is

This concept takes into consideration all prospective losses but not the prospective profit. It means profit should not be recorded until it is realised but all losses, even those which have remote possibility are to be recorded in the books. For example, valuing closing stock at cost or market value whichever is lower, creating provision for doubtful debts and discount on debtors in anticipation of bad debts and discount etc. This concept ensures that the financial statements provide the real picture of the enterprise.

(7) Cost Concept or Historical Cost Concept: According to this concept all assets are recorded in the books of accounts at the purchase price which includes the purchase price, cost of acquisition, transportation and installation. For example, if an asset purchased for ₹ 1,00,000 and spent ₹ 10,000 on its installation. Therefore asset will be recorded in the books of accounts at ₹ 1,10,000. This concept is historical in nature. For example, if machine purchased for ₹ 75,000, the purchase or acquisition price will remain same for all years to come, though its market value may change. The main limitation of this concept is that it does not show the true value of asset and may lead to hidden profits. The market value of an asset may change with the passage of time but for accounting purposes it continues to be shown in the books of accounts at its book value (i.e., 'cost at which it was purchased minus depreciation provided up-to-date).

(8) Matching Concept or Matching Principle: The matching concept states that expense incurred in an accounting period should be matched with revenues during that period. It follows from this that revenue and expenses incurred to earn these revenues must belong to the same accounting period. For example, salary for the month of March, 2019 paid in April, 2019 is recorded in the Profit and Loss Account of financial year ending March, 2019 and not in the year when it realized. Similarly we record cost of goods sold and not the goods purchased or produced. So the cost of unsold goods should be deducted from the cost of goods produced or purchased. According to the Matching Concept, cost incurred to earn revenue is recognized as expense in the period when related revenue is recognized as earned. Since the accounts are usually prepared on accrual basis, the expenses incurred in an accounting period are matched with the revenues recognized in that period. Therefore as per this concept, adjustments are made for all outstanding expenses and prepaid expenses.

(9) Dual Aspect or Duality Principle: According to the Dual Aspect Concept, every transaction entered into by an enterprise has two aspects, a debit and a credit of equal amount. Simply stated, for every debit there is a credit of equal amount in one or more accounts. It is also true vice versa.

This concept provides the very basis for recording the transaction in the books of accounts. It states that every transaction entered in the books has two aspects. For example, Man as started business with cash ₹ 50,000. In this transaction asset (cash) increases and liability (capital of owner) also increases. This principle is also known as duality principle. This principle is commonly expressed in fundamental accounting equation given below. Assets = Liabilities + Capital. This equation states that assets of business are always equal to the claims of owners and outsiders.

(10) Revenue Recognition Concept (Realisation Concept) According to this principle revenue is considered to have been realised when a transaction has been entered and obligation to receive the amount has been established. In other words when we receive right to receive revenue than it is called revenue is realised. Suppose an enterprise has received an advance in February, 2018, for the sales to be made in May 2018, upon sales having been made because the legal obligation to receive the amount is established in May, 2018. Suppose an enterprise sells goods in February, 2018 and receives the amount in April, 2018, then revenue of this sales should be recognized in February, 2018 i.e. when the goods are sold because the legal obligation to receive the amount has been established (upon sales) in February, 2018.

(11) Verifiable Objective Concept: This concept states that accounting should be free from personal bias. This can be possible when every transaction is supported by verifiable documents. For example, purchase of machinery for ₹ 30,000 should be supported by the voucher and should be recorded in the books of accounts. Similarly other supporting documents are cash memo, invoices, receipts provides the basis for accounting and auditing.

MEANING OF ACCOUNTING STANDARDS

The Accounting Standards are a set of guidelines, i.e., Generally Accepted Accounting Principles, issued by the accounting body of the country such as The Institute of Chartered Accountants of India, that are followed for preparation and presentation of Financial Statements. They are accounting rules and procedures relating to measurement, valuation and disclosure issued by the Council of the Institute of Chartered Accountants of India.

NATURE OF ACCOUNTING STANDARDS

Following points highlight the nature of Accounting Standards:

1. Accounting Standards are **guidelines** providing the framework so that credible Financial Statements can be produced.
2. The objective of setting Accounting Standards is to bring **uniformity** in accounting practices and to ensure transparency, consistency and comparability.
3. Accounting Standards are prepared keeping in view the **business environment and laws** of the country.
4. Accounting Standards are mandatory in nature.
5. Accounting Standards have also been made **flexible** in the sense that where alternative accounting practices are acceptable, an enterprise is free to adopt any of the practices, with a suitable disclosure.

10. UTILITY OF ACCOUNTING STANDARDS

Accounting Standards serve the following purposes:

1. Accounting Standards provide the **norms** on the basis of which financial statements should be prepared.
2. Accounting Standards ensure **uniformity** in the preparation and presentation of financial statements by removing the effect of diverse accounting practices. The application of Accounting Standards make financial statements more meaningful and comparable.
3. Accounting Standards **create a sense of confidence** among the users of accounting information. Accounting information created by applying Accounting Standards is considered reliable by users of such information.
4. Accounting Standards **help auditors** in auditing the accounts. They help accountants to follow uniform practices and policies.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Meaning: IFRS are a set of accounting standards developed by the International Accounting Standards Board (lASB) the international accounting standard- setting body. IASB places emphasis on developing standards based on sound and clearly stated principles, from which interpretation is necessary. Therefore, IFRS are referred to as principles-based accounting standards. This contrasts with sets of standards, like Indian Accounting Standards, which contain significantly more application guidance. These standards are often referred to as rule-based accounting standards.

Bases of Accounting:

(1) Cash Basis: Under this entries in the books of accounts are made when cash is received or paid and not when the receipt or payment becomes due. For example, if salary ₹ 7,000 of January 2010 paid in February 2010 it would be recorded in the books of accounts only in February, 2010. Here the transactions are recorded when cash is transacted, whether received or paid. It means revenue is recognized on receipt of cash. Likewise, expenses are recorded as incurred when the have been paid.

(2) Accrual Basis: Under this however, revenues and costs are recognized in the period in which they occur rather when they are paid. It means it records the effect of transaction into book when they are earned rather than in the period in which cash is actually received or paid by the enterprise. It is more appropriate basis for calculation of profits as expenses are matched against revenue earned in the relation thereto. For example, raw materials consumed are matched against the cost of goods sold for the accounting period.

Difference between Cash Basis and Accrual Basis of Accounting

	Basis	Accrual Basis	Cash Basis
1	Nature of Transactions	Both Cash & Credit transactions are recorded	Cash transactions are recorded
2	Prepaid/ Outstanding Expenses, Accrued Income/ Income received in advance	They are accounted for in the Profit & Loss A/c and shown in the Balance Sheet.	They are not adjusted
3	Profit/Loss	Correct profit or Loss is ascertained because it records both cash and credit transactions	Correct profit or Loss is not ascertained because it records only cash transactions.
4	Technical Knowledge	Requires technical knowledge as many adjustments like Prepaid/ Outstanding Expenses, Accrued Income/ Income received in advance are required to be made.	Does not require much of technical knowledge as is required for Accrual Basis of Accounting.
5	Legal Position	Recognised by the Companies Act, 2013	Not recognized by the Companies Act, 2013
6	Acceptability	More acceptable in business as it reveals correct income and expenses besides assets and liabilities.	Not acceptable in business as it does not reveal correct income and expenses besides assets and liabilities.

7	Reliability	More reliable as it records both Cash & Credit transactions and thus reveals correct income and expenses besides assets and liabilities.	Less reliable as it records only cash transactions and as a result does not reveal correct income and expenses besides assets and liabilities.
8	Suitability	Suitable for businesses as it requires information that is complex	Suitable for Not-for-Profit Organisations and Professionals, since they require less information.

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