THEORY BASE OF ACCOUNTING

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.**

FUNDAMENTAL ACCOUNTING ASSUMPTIONS :

1. Going Concern Assumption :

This concept assumes that an enterprise has an **indefinite life or existence.** It means that the intentions of the business are to continue for sufficiently longer period of time. It will not be dissolved or liquidated in the immediate future. If a machinery purchased is expected to last (to be used for) next 10 year, then the cost of machinery will be spread over the next 10 year for calculating net profit or loss of each year (Dep. Charged.)

The full cost of the machine would not be treated as expense in the year of purchase itself. **Market value of the asset is irrelevant** and is **not recorded in the balance sheet,** as these assets are not going to be sold in the near future.

Relevance :

(a) Distinction is made between a capital expenditure and revenue expenditure.
(b) Classification of assets and liabilities into short term and long term respectively.
(c) Depreciation charged on fixed assets or fixed assets appears in the balance Sheet at book value, without having reference to their market value.

2. Consistency Assumption :

a. It implies that **accounting practices once selected and adopted, should be applied consistently year after year.**
b. Same Accounting practices will be followed for similar items year after year. This will ensure a meaningful study of the performance of the business for a number of years.
c. When the accounting principles and practices are uniformly/consistently followed from year to year that the result obtained will be comparable.

Consistency 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 financial position (Balance Sheet) of the year in which that change is made.

This assumption is important when alternative accounting practices are equally acceptable. E.g. two methods of charging depreciation, written down value method and Straight line method are equally acceptable. If a firm adopts one method in the previous year and the other method in next year, the result will not be comparable.

3. Accrual Assumption :

Accrual concept applies **equally to revenue and expenses.** As per this assumption, **revenue is recognized when it is accrued/ earned,** that is, when sale is complete or services are rendered. It is immaterial, whether the cash is received or not. E.g. if a credit sale for ϕ 15,000 of two month is made on 15th Feb. 2011, then the revenue earned is to be recorded on 15th Feb. 2011 not on the date of cash realized, i.e, after two months. Similarly, **expenses are recognized in the accounting period in which they facilitate in earning the revenues,** whether the cash is paid for them or not. E.g. if at the end of year the two month 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**

4. Accounting Entity. / Business 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 business transactions are recorded; analyzed and financial statements are prepared from the business point of view and not of the owner.**

i. The owner is treated as a creditor (liability) for his investment in the business, as if the firm has borrowed from its owner instead of the outside parties.
ii. Interest on capital is treated as expense like any other business expense.
iii. His private expenses are treated as drawings leadings to reduction in capital.
iv. **This concept is applicable to all forms of business organizations – sole proprietorship, partnership or a company.**

5. Money Measurement Principle:

According to this principle, only those **transactions that are measured in money or can be translated in term of money are recorded** in the books of accounts of the enterprises.

i. Money means the currency of a country.
ii. Money is a common measuring unit for recording and reporting business transactions.

Example : purchases cost ɸ 15,000 will be recorded in the books of accounts but the good human relationship within organization will not be recorded.

Limitations :

1. it ignores qualitative aspects e.g. efficient human resources (Assets), satisfied customers (Assets) and dishonest employee (liabilities)
2. Self-generated goodwill not recorded.
3. Value of money (currency) is not stable.
4. The facts which cannot be expressed in money cannot be recorded.
5. To make accounting records simple, relevant, understandable and homogeneous, facts are expressed in a common unit of measurement - money.

6. Accounting Period Principle :

According to this principle, the **whole indefinite life of an enterprise is divided into part, 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 the **performance is measured at regular intervals** and decision can be taken at the appropriate time. This interval may be quarterly, half-yearly and one year. Accounting period is usually a period of one year and that year may be financial year or calendar year.

Relevance :

1. As per SEBI and Companies Act Annual reports are to be prepared and submitted to registrar annually.
2. As per income tax law, tax on income is calculated on annual basis from 1st April to 31st March (Financial Year)
3. **Accounting period concept is responsible for the preparation of income statement on accrual basis as distinguished from cash basis of accounting.**

7. 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 statement and accompanying footnotes.**

Disclosure of material information will result in better understanding of users, so, they take good and sound decision from the information. 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.

Disclosure of all material facts is compulsory but is does not imply that even those figures which are irrelevant are to be included in financial statements

8. Materiality Principle :

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 effect the decision of a user of account, 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 ϕ 50,000 is material for an enterprise having turnover of ϕ 1,50,000 but it is not material for an enterprise having turnover of ϕ 100 crore.
The nature of transaction should be taken into consideration for materiality of information. E.g. a difference of ϕ 200 in the valuation of stock may be immaterial but the difference of ϕ 50 in cash could be termed as material.

9. Prudence/ conservatism 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 profit of the enterprise in no case overstated.

When there are 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 debtor is made.
3. Ignore provision for discount on creditors.

10. Cost or Historical Cost Principle :

According to this Principle, **an assets 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 ` 1,50,000 in cash and ` 5,000 was spent for installation of machine and ` 15,000 spent on carriage of machine. Then the cost of machine ` 1,70,000 will be in the books and depreciation will be charged on this cost. If market value of machine due to inflation has gone up to ` 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-dep.). This principle brings **objectivity into the accounts.**

11. Matching Principle :

According to this principle, **all expenses incurred by any enterprise during an accounting period are matched with the revenue recognized during the same period.**
The matching principle facilitates to ascertain the amount of profit / 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 :

- Ascertainment of Prepaid Expenses
- Ascertainment of income received in advance.
- Accounting of closing stock.
- Depreciation charged on fixed assets.

12. 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 principle 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.

Total Assets = External Liabilities + Capital

Example :

Ram started business with cash ` 1,00,000. It increase cash in assets side and capital in liabilities side by ` 1,00,000.

Total assets ` 1,00,000 = External liabilities + Capital ` 1,00,000 + ` 1,00,000 = ` 1,00,0000

Double Entry System :

Concept :

According to this system every business transaction affects at least two accounts in opposite directions. e.g. **if machinery is purchased for cash, machinery is increased whereas the cash is decreased.** The amount of every transaction is written twice, once as a debit and again as a credit. The person or the account receiving a benefit is debited and the person or the account who gives something to the business is credited.

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 is recorded in the books of accounts on the receipt/ payment of cash. 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 take 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 these system outstanding expenses, prepaid expenses, accrued income and income received in advance are identified. 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**
Recording of transactions	Both cash and credit transactions are recorded	Only cash transactions are recorded
Profit or Loss	Corrected profit or loss is ascertained due the complete of record of transactions.	Correct profit of loss is not ascertained because it records only cash transaction
distinction between capital and revenue item	This method makes a distinction between capital and revenue nature	This method does not make a distinction between capital item and revenue nature item
Legal position	This basis is recognized under the companies Act 1956	This basis is not recognized under the companies Act 1956

Accounting Standard : Concept and Objectives -

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 period. As a result, the financial statements become inconsistence and incomparable.

As result it was felt that certain minimum standards should be universally applicable, so that the accounting statements have the qualitative characteristics of reliability, 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 prepare and submit a draft accounting standard to the Council ICAI. The Council ICAI issue the draft for the comments of the Govt., industry and professionals etc. After due consideration fo comments received, the **Council ICAI** notify it for its use in financial statements.
Concept of Accounting Standard: Accounting standards are written statements, issued from time to time by institutions of accounting professional, specifying uniform rules or practices for drawing the financial statements.

Objectives of Accounting Standard :

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 statement-accounts prepared by using accounting standard are reliable for various users, because these standard create a sense of confidence among the users.
3. To prevent frauds and manipulation- by codifying the accounting methods and practice.
4. To help auditors- accounting standard provide uniformity in accounting practice, so it help auditors to audit the books of accounts.

IFRS- International Financial Reporting Standard :

Concept - this term refers to the financial standard issued by International Accounting Standard Board (IASB). Numbers of IFRS issued so far is 8. GAAP is being replaced by the use of IFRS.

Applicability of IFRS in India :

Govt. of India opted for a stage implementation:

stages	Date of implementation	To be adopted by
1st stage	1st April 2011	companies that are listed in Nifty/SENSEX/Over seas/or net worth of over ` 1,000 crores.

2nd stage	1st April 2012	Insurance companies
3rd stage	1st April 2013	Listed companies with net worth of over ` 500 crore. Banks and large Non-Banking Finance Companies (NBFC)
4th stage	1st April 2014	Listed companies over ` 500 crore, NBFC with net worth of over ` 500 crore. Urban co-opera tive Bank with net worth of over ` 200 crore

Note : The following organizations won't be required to adopt IFRS :

1. Unlisted companies with a net worth under 500 crore and ;
2. Urban co-operative Bank with a net worth of under 200 crore.
3. Rural co-operative Bank.