Revision Notes

Chapter-2 Theory Base of Accounting

Learning Objectives

After studying this chapter, students should be able to:

- Describe the meaning of Accounting Assumptions and Accounting Principles.
- Explain the Accounting Standards 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 to make judicious decisions. 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 commonly known as Generally Accepted Accounting Principles (GAAP). These principles are the base of Accounting.
Generally Accepted Accounting Principles (GAAP) refer 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 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 does not have an intention to liquidate or to scale down its operations significantly.
   Relevance:
   1. Distinction is made between capital expenditure and revenue expenditure.
   2. Classification of assets and liabilities into current and non-current.
   3. 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 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 as they can compare the financial information of current year with that or previous years.
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 transaction or on a later date e.g., if a credit sale (Credit for two months) for Rs. 15,000 is made on 15th Feb. 2016, then the revenue earned is to be recorded on 15th Feb. 2016, 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.
   Relevance: Earning of 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 and analyzed, 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 reductions 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.

Limitations:

1. It ignores the qualitative aspect e.g., efficient human resources (Assets), satisfied customers (Assets) and dishonest employees (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, which is not stable.

3. **Accounting Period Principle:** According to this principle, the life of an enterprise is divided into smaller periods so that its peformance 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 other 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 Rs. 50,000 is immaterial for an enterprise having a turnover of Rs. 100 crore but it is material for an enterprise having a turnover of Rs. 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 and 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 favorable 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.

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. Example: Machinery was purchased for Rs. 1,50,000 in cash and Rs. 20,000 was spent on the installation of machine, then Rs. 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 Rs. 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
   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, services, properties etc.) over actual cash payments (regarding purchase of goods, expenses, rent, electricity,

salaries etc.)

Entry is not recorded when a payment or receipt is merely due i.e., outstanding expenses, accrued incomes are not treated.

This method is contradictory 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 the 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 income received in advance are identified and taken into account.

   Under the Companies' amendments Act 2013, 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	Profit or Loss is ascertained correctly due to complete record of transactions.	Correct profit/loss is not ascertained because it records only cash transactions.
Distinction between Capital and Revenue items	This method makes a distinction between capital and revenue items.	This method does not make a distinction between capital and revenue items.
Legal position	This basis is recognized under the companies Act.	This basis is not recognized under the companies Act.

Accounting Standards : Concept and Objections

The accounting principles or GAAP have been developed in the form of concepts and conventions to bring comparability and uniformity in the financial statements. But GAAP also allow a large number of alternative treatments for the same items. 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 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 is required. ASB prepares and submits a draft accounting standard to the Council of ICAI. The Council of ICAI issues the draft for the comments by the Govt., industry and professionals etc. After due consideration on the comments received, the Council of ICAI notifies it for its use in the financial statements.

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.