UNIT- 02
THEORY BASE OF ACCOUNTING

Unit at a glance:

- Introduction
- Meaning of accounting principles
- Features of accounting principles
- Necessity of accounting principles
- Basic accounting concepts
- Basis of accounting
- Nature of accounting standards
- Utility of accounting standards
- International Financial Reporting Standards (IFRS)
- Meaning and benefits of IFRS

"A mode of conduct imposed on an accountant by custom, law and professional body." – Kohler

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Introduction:

To maintain uniformity in recording transactions and preparing financial statements, accountants should follow Generally Accepted Accounting Principles.

Meaning of Accounting Principles:

Accounting principles are the rules of action or conduct adopted by accountants universally while recording accounting transactions.

GAAP refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and presentation of financial statements.

Features of accounting principles:

(1) Accounting principles are manmade.
(2) Accounting principles are flexible in nature
(3) Accounting principles are generally accepted.

Necessity of accounting principles:

Accounting information is meaningful and useful for users if the accounting records and financial statements are prepared following generally accepted accounting information in standard forms which are understood.

Basic accounting concepts

(1) Business entity concepts

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 Rs. 1,00,000 as capital in business. It is treated as liability of business to owner. Similarly if owner withdrew Rs. 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 concept

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.

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(3) Going concern concept

This concept assumes that business shall continue to carry out its operations indefinitely for a long period of time and would not be liquidated in the foreseeable future. It provides the very basis for showing the value of assets in the balance sheet.

An asset may be defined as a bundle of services. For example, a machine purchased for Rs. 2,00,000 and its estimated useful life say 10 years. The cost of machinery is spread on suitable basis over next 10 years for ascertaining the profit or loss for each year. The total cost of the machine is not treated as an expense in the year of purchase itself.

(4) Accounting period concept

Accounting period refers to 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.

(5) 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 Rs. 1,00,000 and spent Rs. 10,000 on its installation. Therefore asset will be recorded in the books of accounts at Rs. 1,10,000.

This concept is historical in nature. For example, if machine purchased for Rs. 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.

(6) Dual aspect concept

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 Rs. 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.**

(7) 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. For example, sales made in March, 2010 and receives amount in April, 2010. Revenue of these sales should be recognised in February month, when the goods sold. For example commission for the March, 2010 even if received in April 2010 will be taken into profit and loss A/c of March, 2010. Similarly if rent for the April, 2010 is received in advance in March, 2010 it will be taken the profit and loss A/c of the financial year of March, 2011.

(8) Matching concept

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, 2010 paid in April, 2010 is recorded in the profit and loss A/c of financial year ending March, 2010 and not in the year when it realized. Similarly we records 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.

(9) Full disclosure concept

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. Company's act 1956 has provided a format for making profit and loss A/c 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.

(10)Consistency concept

This concept states that accounting practices followed by an enterprise should be uniform and consistent over a period of time. For example if an enterprise has adopted straight line method of charging depreciation then it has to be followed year after year. If we adopt written down value method from second year for charging depreciation than the financial information will not be comparable. Consistency eliminates the personal bias helps in achieving the results that are comparable. However consistency does not prohibits the change accounting policies. Necessary changes can be adopted and should be disclosed.

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(11) Conservatism concept (Prudence concept)

This concept takes into consideration all prospective losses but not the prospective profit. It means profit should not be recorded until it 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 etc. This concept ensures that the financial statements provide the real picture of the enterprise.

(12) Materiality concept

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 of repair of building Rs. 4,00,000 is material for enterprise having the sales turnover of Rs.1,50,000 but not material for enterprise having turnover of Rs. 25,00,000. Similarly closure of one plant material but stock eraser and pencils are not shown at the asset side but treated as expenses of that period, whether consumed or not because the amount involved in it are low.

(13) Objectivity 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 Rs. 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.

Basis of Accounting:

(1) Cash basis

Under this entries in the books of accounts are made when cash id received or paid and not when the receipt or payment becomes due. For example, if salary Rs. 7,000 of January 2010 paid in February 2010 it would be recorded in the books of accounts only in February, 2010.

(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 record the effect of transaction is taken into book in the 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.

Accounting Standards (AS):

"A mode of conduct imposed on an accountant by custom, law and a professional body." – By Kohler

Nature of accounting standards:

(1) Accounting standards are guidelines which provide the framework credible financial statement can be produced.
(2) According to change in business environment accounting standards are being changed or revised from time to time
(3) To bring uniformity in accounting practices and to ensure consistency and comparability is the main objective of accounting standards.
(4) Where the alternative accounting practice is available, an enterprise is free to adopt. So accounting standards are flexible.
(5) Accounting standards are amendatory in nature.

Utility of accounting standards:

(1) They provide the norms on the basis of which financial statements should be prepared.
(2) It creates the confidence among the users of accounting information because they are reliable.
(3) It helps accountants to follow the uniform accounting practices and helps auditors in auditing.
(4) It ensures the uniformity in preparation and presentation of financial statements by following the uniform practices.

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International Financial Reporting Standards (IFRS):

To maintain uniformity and use of same or single accounting standards, International Financial Reporting Standards (IFRS) are developed by International Accounting Standards board (IASB).

Objectives of IASB:

(1) To develop the single set of high quality global accounting standards so users of information can make good decisions and the information can be comparable globally.
(2) To promote the use of these high quality standards.
(3) To fulfill the special needs of small and medium size entity by following above objectives.

Meaning of IFRS:

IFRS is a principle based accounting standards. IFRS are a single set of high quality accounting Standards developed by IASB, recommended to be used by the enterprises globally to produce financial statements.

Benefits of IFRS:

(1) Global comparison of financial statements of any companies is possible
(2) Financial statements prepared by using IFRS shall be better understood with financial statements prepared by the country specific accounting standards. So the investors can make better decision about their investments.
(3) Industry can raise or invest their funds by better understanding if financial statements are there with IFRS.
(4) Accountants and auditors are in a position to render their services in countries adopting IFRS.
(5) By implementation of IFRS accountants and auditors can save the time and money.
(6) Firm using IFRS can have better planning and execution. It will help the management to execute their plans globally.

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QUESTIONS

Explain cost concept.

(1) What is mean by accounting standard? What is the main objective of accounting standard?

(2) Explain the following concepts.
  a. Business entity concept
  b. Going concern concept
  c. Revenue recognition concept

(3) Explain the utility of Accounting Standards.

(4) Which principle assumes that a business enterprise will not be liquidated in near future?
  Ans. Going concern concept.

(5) "Closing stock is valued lower than the market price" which concept of accounting is applied here?
  Ans. Conservatism (prudence) concept.

(6) 'An asset may defined as a bundle of services' – explain with an example.

(7) Under which accounting principle, quality of manpower is not recommended in the books of accounts?
  Ans. Money measurement concept.

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