Summary Sheet

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Theory Base of Accounting

1 Accounting Principles

Suppose, a company has asked Ram and Shyam to prepare the Financial Statements. They may produce different accounting statements which may not be uniform and comparable. So, here arises the need for Accounting Principles.

So, Accounting principles are **the rules and guidelines that companies, and other bodies must follow when they're reporting financial data**. These **rules and guidelines** are regarded as the **base of accounting**.

These accounting rules **and guidelines** are called by different names such as accounting **principles,** accounting **concepts,** accounting **conventions and** accounting **postulates.**

2 Tools for Consistency and Uniformity

In order to maintain uniformity and consistency in accounting records, certain rules or principles have been developed which are generally used.

2.1 Generally Accepted Accounting Principles (GAAP)

- **Generally Accepted Accounting Principles (GAAP)** refers to the rules or guidelines adopted for recording and reporting of business transactions, GAAP is introduced to bring uniformity in the preparation and the presentation of financial statements.
- All accounting principles are known as **GAAP**.

2.2 Accounting Standards

- An accounting standard is **a common set of principles, standards, and procedures that define the basis of financial accounting policies and practices**.
- This has been given by the **Institute of Chartered Accountants of India**.

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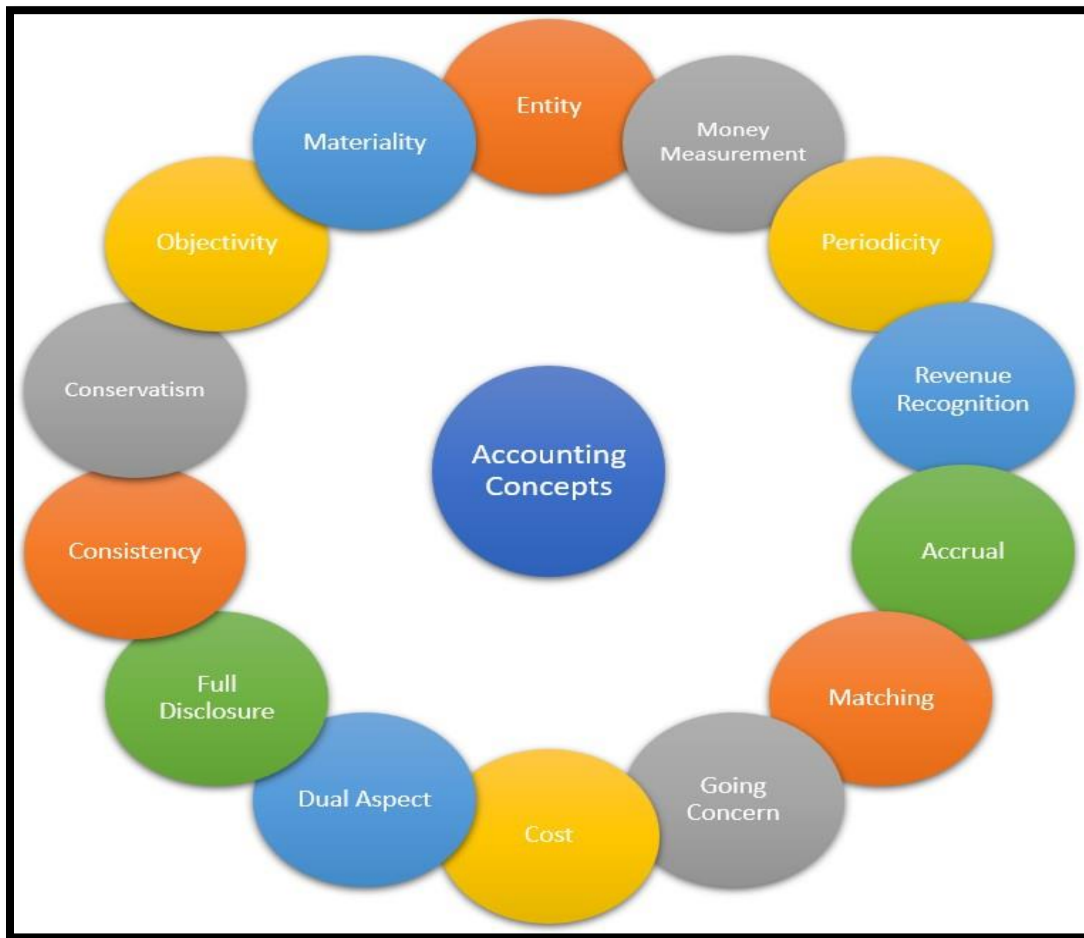
3 Accounting Concepts/Principles

Today, accounting is used by everyone and a good understanding of it is beneficial for all, now we will discuss about major concepts of accounting:



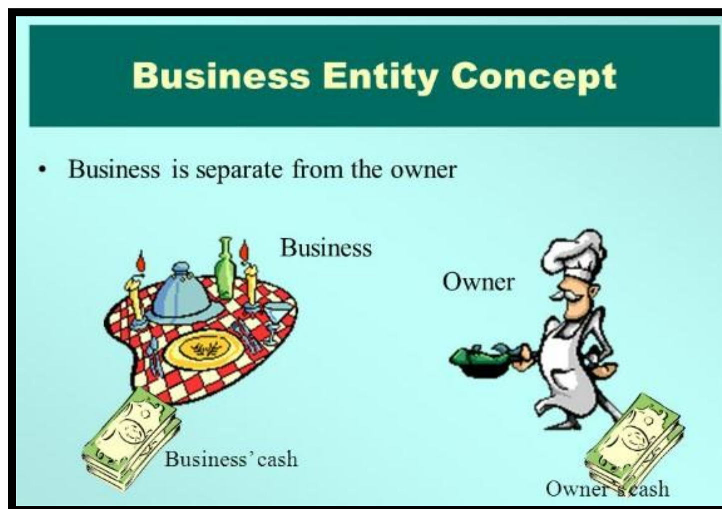
For better conceptual clarity, we will understand each component one by one.

3.1 Entity Concept

The concept of **business entity or entity** assumes that business has a **distinct** and **separate entity from its owners**. It means that for the purposes of accounting, the business and its owners are to be treated as **two separate entities.**

This is a fundamental concept of accounting that business and owner are different**. For Example - If Mr. Ram starts a business, then Ram and business are both separate entities.**

Another important aspect of the entity concept is that the accounting records are made in the book of accounts from the **point of view of the business unit and not that of the owner.**



Case 1 - When a person **brings** in some money as capital into his business, in accounting records, it is treated as **liability of the business to the owner**.

Example for case 1 – Mr. X started business investing Rs 7,00,000 with which he purchased machinery for Rs 5,00,000 and maintained the balance as cash in hand. The financial position of the firm will be:

Liability		Assets	
Capital By Owner	700000	Cash	200000
		Machine	500000

Case 2 - When the owner **withdraws** any money from the business for his personal expenses (drawings), it is treated as **reduction of the owner's capital** and consequently a reduction in the liabilities of the business.

Example for case 2 - Now if Mr. X spends Rs 5,000 to meet his family expenses from the business fund, then it **should not be taken as business expenses,** and it would be charged to his capital account (his investment would be reduced by Rs 5,000). **The financial position of the firm will be:**

Liability		Assets	
Capital By Owner	695000	Cash	195000
		Machine	500000

The personal assets and liabilities of the owner are, therefore, not considered while recording and reporting the assets and liabilities of the business.

Similarly, **personal transactions of the owner are not recorded in the books of the business**, **unless it involves inflow or outflow of business funds.**

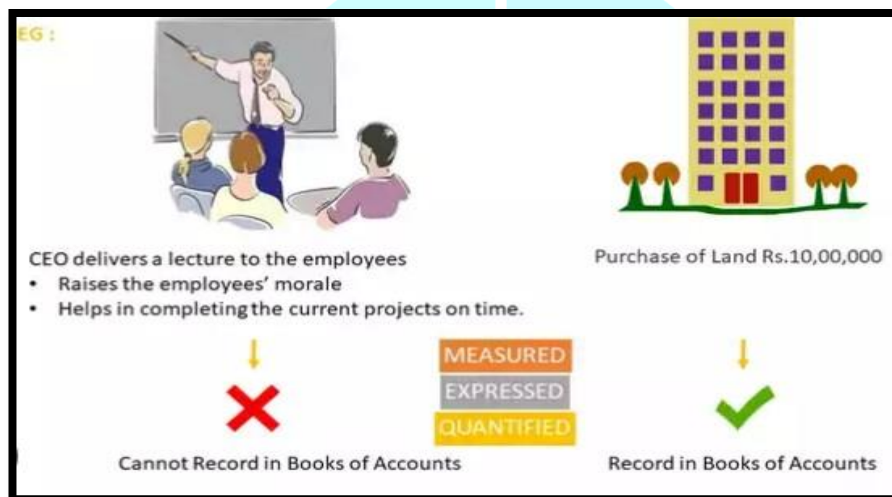
For Example - Now if Mr. X spends Rs 5,000 to meet his family expenses from his own bank account, then it should not be taken recorded in the books, because this Rs.5000 is an individual expenses of Mr. X and its not a business expense.

3.2 Money Measurement Concept

The concept of money measurement states that only those transactions and happenings in an organisation which can be expressed in **terms of money** are recorded**. For Example,** sale of goods or payment of expenses or payment of rent, etc., are recorded in the book of accounts.

All such transactions or happenings which cannot be expressed in monetary terms are not recorded in the books of accounts. **For example**, the appointment of a manager, capabilities of its human resources are not recorded in the books of accounts.

Another important aspect of the concept of money measurement is that the records of the transactions are to be kept **not in the physical units** but in the **monetary unit.**



For example, an organisation may, on a particular day, have a factory on a piece of land measuring 2 acres, an office building containing 30 personal computers and 30 chairs and tables. These assets are expressed in different units, so cannot be added to give any meaningful information about the total worth of business.

So, for accounting purposes, therefore, these are shown in **money terms** and recorded in rupees and paise. In this case, the cost of land let's say its Rs 20 crore; office computers Rs 15 lakh; and 30 chairs and tables worth Rs 3 Lakh.

Thus, if we add, we can conclude that the total assets of the enterprise are valued at Rs 20 crore and 18 lakhs.

3.3 Periodicity Concept

Accounting period refers to the **span of time at the end** of which the financial statements of an enterprise are prepared, to know whether it has earned profits or incurred losses during that period and what exactly is the position of its assets and liabilities at the end of that period. The interval of time is called the **accounting period.** This concept is also known as **Accounting Period Concept.**

The **Companies Act 2013 and the Income Tax Act** require that the income statements should be prepared **annually**.

As per the regulations by **SEBI**, listed companies are required to publish **quarterly** results to ascertain the profitability and financial position at the end of every three months period.

For example, if the reporting period for the current year is set at calendar months (January-December), then the same periods should be used in the next year, so that the results of the two years can be compared on a month-to-month basis.

3.4 Revenue Recognition Concept

The concept of revenue recognition requires that the **revenue** for a business transaction should be included in the accounting records only when it is **realized**. Revenue Realization means when the right to receive it arises. This concept is also known as the **Realization Concept.**

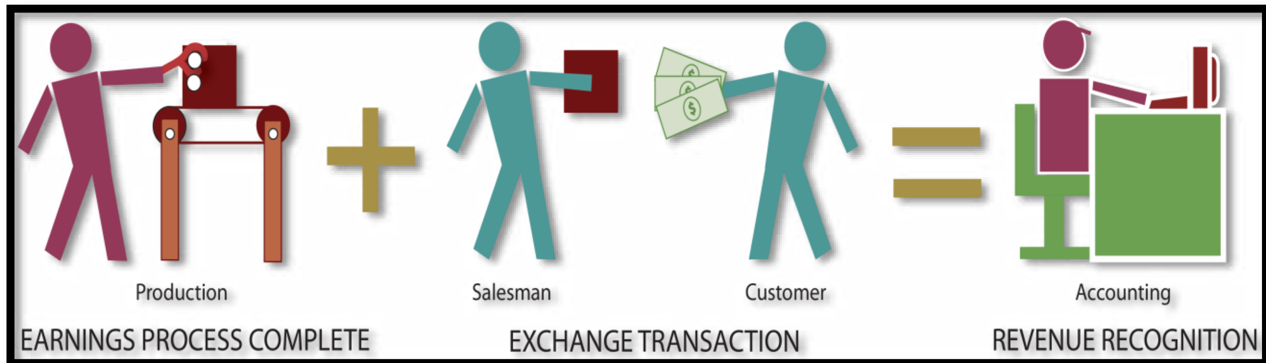
Suppose goods are manufactured in January and goods are delivered in February whereas the payment is made in March.

As per the revenue recognition concept, the revenue will be recognized when the right to receive it arises. So, the revenue will be recognized in February itself.

Revenue is the gross inflow of cash arising from -

1. The sale of goods and services by an enterprise; and
2. Use by others of the enterprise's resources yielding interest, royalties and dividends.

Revenue is assumed to be realized when a legal right to receive it arises, i.e. the point of time when goods have been sold or service has been rendered.



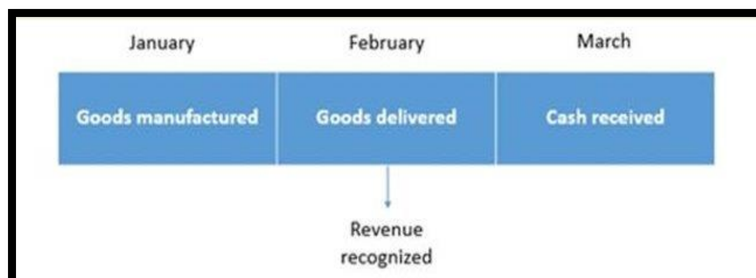
Example 1 (In case of credit sale)

Suppose Mr. Ram produced some goods in the month of January and then Mr. Ram sells goods worth Rs 1 lakh to Mr. Shyam on 28th Feb. So, he has sold/delivered his goods on 28th February But Mr. Shyam gives payment to Mr. Ram on 15th March.

Now in the books of account the sale of goods will be recognized on which date?

As per Revenue Recognition concept, the sale will be recorded on 28th Feb. As, the right to receive payment arises at the time of sale of goods that is on 28th Feb.

So, we can conclude that credit sales are treated as revenue on the day sales are made and not when money is received from the buyer.



Example 2 (In case of Rent agreement)

Suppose Mr. Ram receives rent for the month of March, on 1st April, it will be taken into the profit and loss account of the financial year ending **March 31** and not into financial year beginning with April 2017, because the right to receive the rent is in March only.

3.4.1 Exceptions- Revenue Recognition Concept

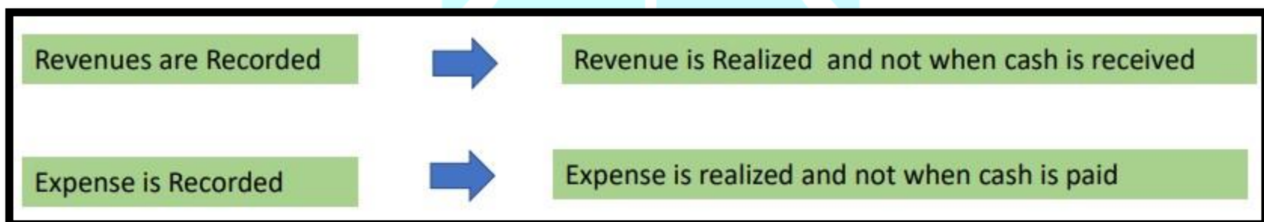
In case of contracts like **construction work, which take long time, say 2-3 years to complete**, proportionate amount of revenue, based on the part of contract completed by the end of the period is treated as realized.

Example:

- In the case **of Long-Term Contract** to build a Dam, the revenue will be recognized on proportionate basis. So, if after 1 year **, 10% of dam is completed and total revenue is 20 lakh, then 2 lakh (10% of 20 Lakh) will be realized.**
- In the case of selling of an item on **installment**, the amount collected in installments is treated as realized. So, if there are 12 monthly equal installments of Rs 1,500. **Then, 1,500 will be realized every month for respective 12 months**.

3.5 Accrual Concept

Accrual concept states that **revenues are to be recorded when the revenue is realized and not when the cash is received.** Also, expenses need to be recorded when expenses are realized and not when cash is paid.



For example - You have taken a building on rent and you have used that building for march. So, even if you give rent in May or April. **The expense will be recognized in March only.**

Revenue Recognition Concept only considered about the revenues. But, Accrual Concept applies both to Revenues and Expenses that revenues and Expense are to be recorded when they occur and not when cash is received or paid. So, we can say that **Revenue Recognition concept is the subset of Accrual concept.**

Accrual concept works in sync with Periodicity Concept. In Accrual concept, transactions are to be recorded when the transaction is realized and not when cash is received. So, Accrual Concept can be applied only when there are proper periods is defined.

Example: Mr. J D buys clothing of 50,000 paying cash 20,000 and sells at 60,000 of which customers paid only 50,000. What shall be the revenue and cost recognized as per Accrual concept?

- **Answer:** As per accrual concept, the Revenue Recognized will be 60,000 and Cost Recognized will be 50,000. As, the total cost incurred whether paid or not is Rs 50,000. Similarly, whether the sales amount is received or not, the right to receive 60,000 arises. So, 60,000 will be recognized as Revenue.
- **Explanation:** Cost will not be 20,000 because it is just the cash paid, so actual cost realized is 50,000. Also, Revenue will not be 50,000 because it is just the cash paid, so actual revenue realized will be 60,000.

3.6 Matching Concept

Matching Concept states that expenses incurred in an accounting period should be **matched** with revenues during that period. It follows from this that the revenue and expenses incurred to earn these revenues must belong to the **same accounting period.** Only those costs/expenses shall be considered which have been used to generate revenue.

Matching Concept works in sync with Accrual Concept and Periodicity Concept. This means that matching concept can only work when Accrual concept and Periodicity concept is being applied. As, we have to match the cost with the expenses within a specific period. The period is defined under the periodicity concept. And to include expenses and revenues as and when they are realized is done as per the Accrual concept.

For Example- Mr. P K started cloth business. He purchased 10,000 pcs. garments @ Rs 100 per piece and sold 8,000 pcs.@ 150 per piece during the accounting period of 12 months 1st January to 31st December 2015. He paid shop rent @ Rs 3,000 per month for 11 months and paid Rs 7,00,000 to the suppliers of garments and received Rs 10,00,000 from the customers.

Solution: In these three tables, we are trying to calculate profit of the business:

As, in first table, accrual concept is not applied. As actual revenue is 12 lakh and not 10 lakh. Similarly, in second table, the cost of garments is taken into consideration as per accrual concept but not as per matching concept. As, according to matching concept, the only cost of garments must be matched that has accounted for revenue. So, the correct would be Rs 8 lakh and not 10 lakhs.

However, table 3 is the correct depiction as it is following accrual and matching concept.

Revenues	10,00,000
Cost of Garments	7,00000
Cost of Rent	33000
Profit	9,67,000

Revenues	12,00000
Cost of Garments	10,00000
Cost of Rent	36000
Profit	1,64000

Revenues	12,00,000
Cost of Garments	8,00000
Cost of Rent	36000
Profit	3,64000

3.7 Going Concern Concept

The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely, i.e. for a fairly long period of time and would not be liquidated in the foreseeable future.

This concept is **a fundamental principle of accounting**. So, this means that the company will continue to trade indefinitely and will not be liquidated in the near future. This is the general meaning. But the underneath meaning of going concern is discussed below:

Example 1: Suppose Mr. X purchased a machine for his business paying Rs 5,00,000 out of Rs 7,00,000 invested by him. He also paid transportation expenses and installation charges amounting to Rs 70,000. If he is still willing to continue the business, his financial position will be as follows:

Balance Sheet

Liability	₹	Assets	₹
Capital	7,00,000	Machinery	5,70,000
		Cash	1,30,000
	7,00,000		7,00,000

Now if he decides to back out and desires to sell the machine, it may fetch more than or less than 5,70,000. So, his financial position should be different.

So, going concern Concept **ignores increase/ decrease in the value of assets in the short-run** as assets are assets are kept for generating benefit in future, not for immediate sale.

Example 2: Suppose a company purchases a computer for 50,000.

Case 1- What will be its impact when going concern concept is assumed:

In this case, the company will generate revenue using this computer for next 5 years. So, the company will charge 10,000 every year for next 5 years as expense in the profit and loss account.

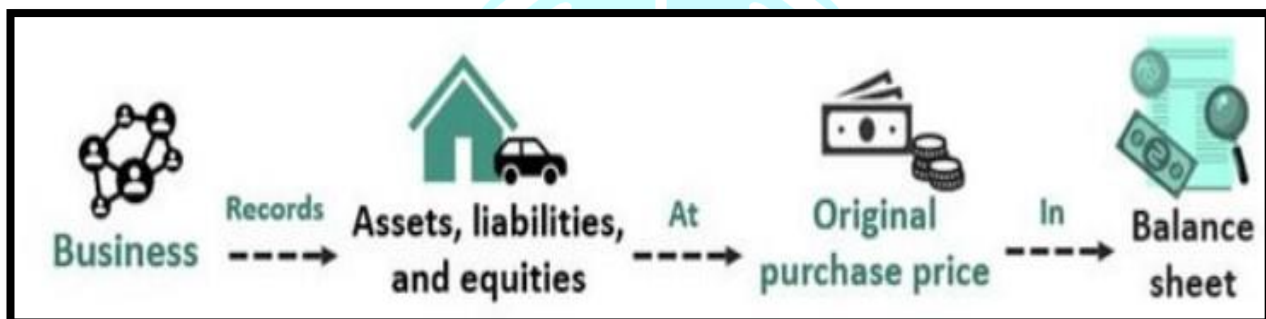
Case 2- What will be its impact when going concern concept is not assumed :

In this case, the company may charge 50,000 in a single year.

3.8 Cost Concept

The cost concept requires that all assets are recorded in the book of accounts at their **purchase price**, which includes cost of acquisition, transportation, installation and making the asset ready to use. **For example**, you bought a machine at Rs 1 Lakh, transportation was Rs 10,000 and Installation was another 10,000. In this case the total cost would be 1,20,000 (1,00,000+10,000+10,000).

Hidden Profit: Sometimes the value of an asset may increase over a period of time, but we still record the old value leading to hidden profits which are not shown in my Financial Statements. **For Example,** If the building is purchased for 1 crore, though it's value is increasing, but as per cost concept, it will be recorded as 1 crore only. So, here arises the hidden profit.



Example 1: Suppose, a machine is bought in 1990 at 5 crores. At present the value of the machinery is different. So, as per Cost concept, the purchase price will remain the same for all years to come, though its market value may change.

Example 2: To illustrate, on June 2005, an old plant was purchased for Rs 50 lakh by Shiva Enterprise, which is into the business of manufacturing detergent powder. An amount of Rs 10,000 was spent on transporting the plant to the factory site. In addition, Rs 15,000 was spent on repairs for bringing the plant into running position and Rs 25,000 on its installation. **The total amount at which the plant will be recorded in the books of account would be the sum of all these, i.e., Rs 50,50,000**.

3.9 Dual Aspect Concept

Dual aspect concept is the **foundation** or basic principle of accounting. It provides the very basis for recording business transactions into the book of accounts. This concept states that every transaction has a **dual or two-fold effect** and should therefore be recorded **at two places**. In other words, at least two accounts will be involved in recording a transaction.

Example 1: Mr. X started business investing Rs. 7,00,000 and business kept the same as cash in hand. The financial position of the will be as follows:

Liability		Assets	
Capital By Owner	700000	Cash	700000

Capital Account

Cash Account

Two Accounts are getting impacted here

Example 2: Mr. X started business investing Rs. 7,00,000 with which he purchased machinery for Rs 5,00,000 and maintained the balance in hand. The financial position of the will be as follows:

Liability		Assets	
Capital By Owner	700000	Cash	200000
		Machinery	500000

Cash Account

Machinery Account

Two Accounts are getting impacted here

Example 3: Mr. X started business investing Rs. 7,00,000 with which he purchased machinery for Rs 5,00,000 and maintained the balance in hand. Then he took a loan of 2 lakh and bought a truck. The financial position of the will be as follows:

Liability		Assets	
Capital By Owner	700000	Cash	200000
Loan	200000	Machinery	500000
		Truck	200000

Loan Account

Truck Account

Two Accounts are getting impacted here

The duality principle is commonly expressed in terms of fundamental Accounting Equation, which is as follows: **Assets = Liabilities + Capital**

This can be understood with the below images, that in all the above cases we can see that **Assets = Liabilities + Capital.**

Liability		Assets	
Capital By Owner	700000	Cash	700000

Liability		Assets	
Capital By Owner	700000	Cash	200000
		Machinery	500000

Liability		Assets	
Capital By Owner	700000	Cash	200000
Loan	200000	Machinery	500000
		Truck	200000

Note: Accounting Equation will be discussed in the further chapters.

3.9.1 Various scenarios happening in Balance Sheet:

1) Two different assets will get increased and decrease by same amount – **Overall Assets remains same.**
2) Two different liabilities will get increased and decrease by same amount – **Overall Liability remains same.**
3) One Asset and one liability will increase by same amount or both will decrease by same amount – **Both Assets and Liability will increase or decrease.**

The above cases can be understood below,

Let's assume that the business has total assets (cash) worth Rs 7 lakh and capital worth Rs 7 lakhs. So, we can see that both assets and liabilities is same.

Now, if the business purchases Machinery worth Rs 5 lakhs for Cash. This will reduce the cash by 5 lakhs and will increase the Machinery by 5 lakhs. So, here there will be no change in the total amount of assets. This can be seen in table 1 below.

Later, to purchase a truck, he took a loan for Rs 2 lakhs. So, this will increase the asset (truck) by 2 lakhs and Loan (liability) by 2 lakhs. So, here the total assets and total liabilities are increased by the same amount. This can be seen in table 3 below.

Now, he infuses Rs 2 lakh in capital to pay back the loan of 2 lakh. So, the loan will become 0 and the capital will increase by 2 lakhs. So, total liabilities remains the same. This can be seen in Table 2.

3

Liability		Assets	
Capital By Owner	700000	Cash	700000

1

Liability		Assets	
Capital By Owner	700000	Cash	200000
		Machinery	500000

2

Liability		Assets	
Capital By Owner	900000	Cash	200000
Loan	0	Machinery	500000
		Truck	200000

3

Liability		Assets	
Capital By Owner	700000	Cash	200000
Loan	200000	Machinery	500000
		Truck	200000

- Sometimes we combine a transaction in such a way that even more than two assets/liabilities get affected. This can be understood with the following example:

Liability		Assets	
Capital By Owner	700000	Cash	200000
Loan	200000	Machinery	500000
		Truck	200000

The business buys land worth 5 lakh. 1 lakh is paid in cash and rest is financed through Loan

Liability		Assets	
Capital By Owner	700000	Cash	100000
Loan	200000	Machinery	500000
Loan for Land	400000	Truck	200000
		Land	500000

3.9.2 Examples:

Question: Refer to the following balance sheet, and show how the adjustments will effect the balance sheet:

Balance Sheet			
Liabilities	**₹**	**Assets**	**₹**
Capital	1,50,000	Machinery	2,00,000
Bank Loan	75,000	Cash	1,00,000
Other Loan	75,000		
	3,00,000		3,00,000

1. A new machine is purchased paying ` 50,000 in cash.

2. A new machine is purchased for ` 50,000 on credit, cash is to be paid later.

3. Cash paid to repay bank loan to the extent of ` 50,000.

4. Raised bank loan of ` 50,000 to pay off other loan.

Solution:

Now considering the above balance sheet, we will see how the transactions will affect the balance sheet.

In the first transaction, machine is purchased for cash. So, Cash will reduce by 50,000 and Machine will increase by 50,000. This can be depicted as:

Impact of Transaction 1 – Two diff Assets Inc. and Dec. by same amount

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

In the second transaction, machine is purchased on credit. So, Machinery will increase by 50,000 and Creditors will increase by 50,000. This can be depicted as:

Impact of Transaction 2 - One Asset Inc. and One liability increases by same amount			
Liabilities	**₹**	**Assets**	**₹**
Capital	1,50,000	Machinery	2,50,000
Creditors for machinery	50,000	Cash	1,00,000
Bank Loan	75,000		
Other Loan	75,000		
	3,50,000		3,50,000

In the third transaction, cash is paid for bank loan. So, Cash will decrease by 50,000 and Bank loan will decrease by 50,000. This can be depicted as:

Impact of Transaction 3 - One Asset Dec. and One liability decreases by same amount			
Liabilities	**₹**	**Assets**	**₹**
Capital	1,50,000	Machinery	2,00,000
Bank Loan	25,000	Cash	50,000
Other Loan	75,000		
	2,50,000		2,50,000

In the fourth transaction, bank loan is raised to pay other loans. So, Bank Loan will increase by 50,000 and Other loan will decrease by 50,000. This can be depicted as:

Impact of Transaction 4 - Two different liabilities increase and decrease by same amount			
Liabilities	**₹**	**Assets**	**₹**
Capital	1,50,000	Machinery	2,00,000
Bank Loan	1,25,000	Cash	1,00,000
Other Loan	25,000		
	3,00,000		3,00,000

3.10 Full Disclosure Concept

The principle of **full disclosure** requires that all **material** and **relevant facts** concerning financial performance of an enterprise must be **fully** and **completely disclosed** in the **financial statements and their accompanying footnotes**.

This helps the users to make correct assessment about the **profitability** and **financial soundness of the enterprise** and help them to take informed decisions.

For Example- Company should disclose the **anticipated** losses from the lawsuit in the footnotes of their financial statement, even though the loss has not been confirmed or finalized yet.

3.11 Consistency

Consistency Concept states that business should maintain the **same accounting methods** throughout the accounting periods, so that users of the financial statements or information are able to make meaningful conclusions from the data.

If the business keeps on changing accounting methods, it will create confusion and the financial statements will not be comparable across accounting periods. For calculating depreciation there are different methods, so, the method adopted must be applied consistently, otherwise the comparison cannot be made.

Consistency eliminates personal bias and **helps in achieving results that are comparable.**

For Example, an investor wants to know the financial performance of an enterprise in the current year as compared to that in the previous year. He may compare this year's net profit with that in the last year. But, if the accounting policies adopted, say with respect to depreciation in the two years are different, the profit figures will not be comparable. Because the method adopted for the valuation of stock in the past two years is inconsistent. It is, therefore, important that the concept of consistency is followed in preparation of financial statements so that the results of two accounting periods are comparable.

Notes: We will discuss about depreciation and methods of depreciation later in the course.

3.12 Conservation Concept

The concept of conservatism or conservation (also called '**prudence'**) provides guidance for recording transactions in the book of accounts and is based on the **policy of playing safe.** The concept states that a **conscious approach should be adopted in ascertaining income so that profits of the enterprise are not overstated**.

Losses shall be recognized immediately but not recognizing the gains until realized is called **conservatism approach**.

When there are many alternative values of an asset, **an accountant should choose the method which leads to the lesser value.**

The concept of conservatism requires that **profits should not to be recorded until realised but all losses, even those which may have a remote possibility, are to be provided for in the books of account.**

For Example- Suppose an asset owned by an entity was bought for Rs 120 but can now be bought for Rs 50. Then the company must immediately write down the value of the asset to Rs 50, i.e., the lower the market cost.

But if the inventory was bought for Rs 120 and now costs the company Rs 150, it must still be shown as Rs 120 on the books. The gain is only recorded when the inventory or the asset is sold.

3.13 Materiality Concept

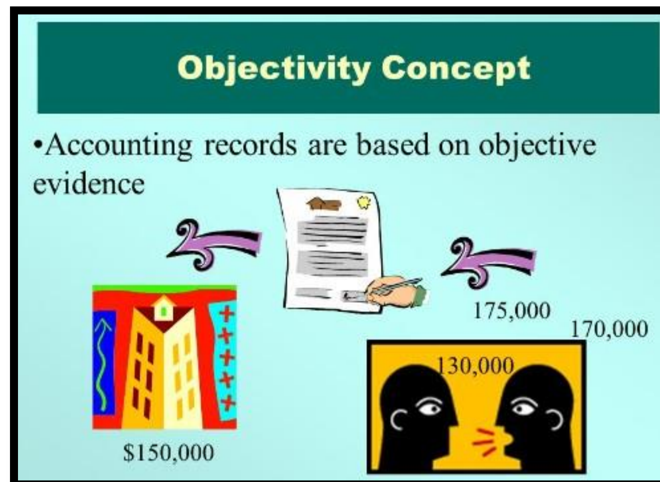
The concept of materiality requires that accounting should **focus on material facts.** Efforts should not be wasted in recording and presenting facts, which are immaterial in the determination of income. The materiality of a fact **depends on its nature and the amount involved.**

Example-

- Information about huge expenditure on training is material fact.
- However, Information about planning a picnic for employees is immaterial information.

3.14 Objectivity 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.**



For example, the transaction for the purchase of materials may be supported by the cash receipt for the money paid, if the same is purchased on cash or copy of invoice and delivery challan, if the same is purchased on credit.

4 Fundamental Accounting Assumptions

These are three fundamental accounting assumptions which are **always** assumed to be true

- Going Concern
- Consistency
- Accrual

These assumptions cannot be tweaked.

These assumptions have been explained earlier in the chapter.

Why are all concepts not assumed to be true?

Remember these are guidelines and not something legal binding. So there can be some variation by various companies.

But these 3 - **Going Concern, Consistency and Accrual are always assumed to be true and adhered to.**

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For Example, If the value of land was Rs 5 lakh as per cost concept. But the value has been increased to 50 lakhs. Now it depends upon the company whether they want to follow the cost concept completely. As at some point the value will be changed.

So, remember the Fundamental Accounting Assumptions are always followed. But all other concepts are just guidelines, and they can be used by companies as per there requirements.