Chapter 2

Theory Base of Accounting

2.1 Generally Accepted Accounting Principles

1. **What is theory base of accounting?** **2 Marks**

Ans: The theory base of accounting consists of principles, concepts, rules and guidelines developed over a period of time to bring uniformity and consistency to the process of accounting and enhance its utility to different users of accounting information.

2. **What is the need for theory base of accounting?** **2 Marks**

Ans: Theory base of accounting or accounting principles, rules and guidelines are required (i.e., needed) to make the accounting information reliable as well as comparable, so that it becomes useful to its users.

3. **Expand GAAP.** **1 Mark**

Ans: GAAP = Generally Accepted Accounting Principles.

4. **Give the meaning of generally accepted accounting principles?** **2 Marks**

Ans: Generally accepted accounting principles refers to the rules or guidelines adopted for recording and reporting of business transactions. The purpose is to bring uniformity in the preparation and the presentation of financial statements.

5. **Give the meaning of accounting concepts.** **2 Marks**

Ans: Accounting concepts refers to the necessary assumptions and ideas which are fundamental to accounting practice.

2.2 Basic Accounting Concepts

1. **Business entity concept:** It means in accounting every business undertaking is regarded as a separate unit or entity quite distinct from the owners who own it. In other words, the business and its owners are to be treated as two separate entities. Example: In proprietary concern, the business is different from its owner.

   The accounting records are made in the books of accounts from the point of view of the business unit. Therefore, when owner brings capital or makes drawings, they are entered in the books of accounts of the business.

2. **Money measurement concept:-**It means only those transactions which can be expressed in terms of money (i.e. **monetary** transactions) such as sale of goods for cash, payment of salary etc, are to be recorded in the books of accounts.

   Transactions which cannot be expressed in monetary terms such as appointment of a manager, the retirement of an accountant etc, are not recorded in the books of accounts.

   Thus, according to this concept, transactions are recorded not in the physical units but in monetary unit.

3. **Going concern concept:-** It means in accounting, a business firm is regarded as a going concern. In other words, according to this concept, a business enterprise will continue to operate for a fairly long period of time.

   This concept provides the very basis for showing the value of assets in the balance sheet with proper classification as fixed assets and current assets.

4. **Accounting period concept:** It means, for measuring the financial results of a business, financial statements are prepared for a financial period or accounting period, which is normally a year.

Example: Calendar year, i.e. from 01.01.2016 to 31.12.2016 (or any Calendar year)

Financial year, i.e. from 01.04.2016 to 31.03.2017 (or any Financial year)

In our country, the Companies Act, 2013 and the Income Tax Act require that the income statements should be prepared annually.

5. **Cost concept:-** Cost concept means that an asset (i.e. fixed asset) acquired by a concern is recorded in the books of accounts at its cost or purchase price at the time of acquisition. The cost price includes cost of acquisition, transportation, installation and making the asset ready to use.

In subsequent years, it should appear at its cost price less depreciation written off to date. The market price of the asset is ignored.

6. **Dual aspect concept (Accounting Equation concept):** Every business transaction always results in receiving of some benefit of some value and giving of some other benefit of equal value.

Example: When a business concern sells ₹ 1,000 worth goods for cash, it receives cash of ₹ 1,000 and gives goods worth ₹ 1,000.

Thus, every **business transaction involves 2 aspects of equal value.**

Dual aspect concept means every transaction has a dual or two aspects and should be recorded in two places.

Dual aspect is the basic principle of accounting. It provides the basis for recording business transactions in the books of accounts. In fact, this concept forms **the core of double entry system of accounting.**

The duality principle is commonly expressed in terms of **fundamental accounting equation**, which is as follows:-

Assets = Liabilities + Capital

From the above equation, if follows that,

Liabilities = Assets – Capital, and

Capital = Assets – Liabilities.

7. **Revenue recognition concept or Realization concept:-** The concept of revenue recognition requires that the revenue from a business transaction should be included in the accounting records only when it is realized. And revenue is to be recognized or considered to be realized only when goods or services are transferred to a customer and the customer becomes legally liable to pay for them.

Example: credit sales are treated as revenue (or income) on the day when sales are made (and not when money is received from the buyer)

8. **Matching concept:** It means, to measure the profit or loss of the business for an accounting period, all the expenses incurred should be matched (deducted from) with the revenues (income) earned during that accounting period.

Thus, according to matching concept, all revenues earned during an accounting year, whether received during that year or not, and all costs incurred, whether paid during the year or not, should be taken into account while ascertaining profit or loss for that year.

9. **Accrual Concept:** It means that revenue accrues in the year in which they are earned and not in the year in which they are actually received; and expenses accrue in the year in which they are incurred.

10. **Objectivity concept:** It means, all accounting entries should be based on objective evidence, i.e. supported by verifiable documents such as vouchers, invoices, receipts etc.

    The evidence must be objective, i.e. free from the bias of accountants or others and must be subject to verification by auditors.

Important Accounting Conventions: (In NCERT Text book, these are treated as 'Accounting concepts')

1. **Convention of materiality (or materiality concept):** It means in accounting, a detailed record is made only of those business transactions which are material (i.e. significant) to the users of accounting information. No detailed record is made of transactions which are not material (i.e. trivial or insignificant)

   Example: According to materiality convention, when a pen worth Rs. 20 is put to use; the entire amount of Rs. 20 is treated as expense immediately, though the pen may be used for a few days.

2. **Convention of conservatism (or conservatism concept):** It means in accounting records and in the financial statements of a business, all prospective losses should be considered and provided for but prospective profits should be ignored. In short, according to this convention, "provide for all possible losses, but anticipate no profits". Valuing closing stock at cost or market price whichever is lower; creating provision for doubtful debts etc. are some of the examples of application of the principle of conservatism.

3. **Convention of consistency (or consistency concept):** It means the accounting policies and practices should remain consistent (i.e. uniform or unchanged) from one accounting year to another.

   Example: when once a particular method of depreciation is adopted for a particular fixed asset, the same method should be followed for that asset year after year.

   According to Indian Accounting Standard, consistency is a fundamental assumption.

   This convention enables a meaningful comparison of the accounting figures of one year with that of another year.

   Note: It should be noted that this convention does not prohibit the introduction of improved technique of accounting.

4. **Convention of full disclosure (or Full disclosure concept):-**It means all material facts relating to accounts must be disclosed in the financial statements with sufficient details.

   Example: In case of sundry debtors, not only the total amount of sundry debtors should be disclosed but also the amount of good and secured debtors, and the amount of doubtful debts should be mentioned.

   The idea behind this convention is to enable the users of financial statements to make proper decisions.

   The **practice of giving notes related to various facts or items** which do not find place in accounting statements is according to this convention

   Example: (a) Market value of investments appearing as 'Note'

   (b) Contingent liability appearing as a 'Note'

6. **State any one basic accounting concept.** **1 Mark**

Ans: Business entity concept

7. **State any two accounting concepts.** **2 Marks**

Ans: (a) Business Entity concept

(b) Money measurement concept

(c) Going concern concept

(d) Cost concept

(e) Matching concept (Any two)

8. **Why it is necessary for accountants to assume that business entity will remain a going concern? 2 Marks**

Ans: It is necessary for accountants to assume that business entity will remain a going concern because it provides the very basis for showing the value of assets in the balance sheet. Further, business has neither the intention nor the necessity to wind up the concern in the near future.

9. **State is the basic accounting equation?** **1 Mark**

Ans: Assets = Liabilities + Capital

10. **When should revenue be recognized? Are there exceptions to the general rule?** **2 Marks**

Ans: Revenue should be recognized only when it is realized. Revenue is considered 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.

There are some exceptions to the general rule of revenue recognition.

Example: (a) Contracts like construction work

(b) Goods sold on hire purchase basis.

11. **What is money measurement concept?** **2 Marks**

Ans: Money measurement concept means only those transactions which can be expressed in terms of money (i.e. monetary transactions) such as sale of goods for cash, payment of salary, etc are to be recorded in the books of accounts.

12. **What is matching concept?** **2 Marks**

Ans: Matching concept means, to measure the profit or loss of the business for an accounting period, all the expenses incurred in an accounting period should be matched with (i.e. deducted from) the revenues (Income) earned during that accounting period.

2.3 Systems of Accounting

13. **State the systems of accounting** **2 Marks**

Ans: (a) Double entry system (b) Single entry system

14. **State any one system of accounting.** **1 Mark**

Ans: Double entry system.

15. **What is double entry system?** **2 Marks**

Ans: The system of recording 2 aspects (i.e. debit & credit) of every transaction in the books of accounts is known as double entry system.

2.4 Basis of Accounting

16. **State two basis of accounting.** **2 Marks**

Ans: **(a) Cash basis:** Entries are made when cash is received or paid

(b) Accrual basis: Revenues or costs are recognized when they occur (Accrue)

17. **State any one basis of accounting.** **1 Mark**

Ans: (1) Cash basis.

2.5 Accounting Standards

18. State any two accounting standards, issued by the Institute of Chartered Accountants of India. 2 Marks

Ans: (a) AS 3. Cash flow statement, (b) AS 6. Depreciation accounting, (c) AS 10. Accounting for fixed assets.

19. Expand ICAI.

Ans: ICAI = Institute of Chartered Accountants of India.

20. Expand ASB.

Ans: ASB = Accounting standards Board

21. State any two accounting standards, issued by the international accounting standards committee. 2 Marks

Ans: (a) IAS-1. Presentation of financial statements, (b) IAS-2. Inventories, (c) IAS-7. Cash flow statement.

21A. Expand IAS. 1 Mark

Ans: IAS = International Accounting Standard

22. Expand IASB. 1 Mark

Ans: IASB = International Accounting Standards Board

2.6 International Financial Reporting Standards

23. Expand IFRS. 1 Mark

Ans: IFRS = International Financial Reporting Standards.

24. State any one benefit of convergence of IAS with IFRS. 1 Mark

Ans: (1) Easy access to global capital markets (2) True and fair valuation.