Theory Base of Accounting

CBSE · Class 11 · Accountancy — exam notes

Every figure in a set of accounts rests on a shared rulebook so that different businesses can be read and compared with confidence. This chapter explains that rulebook — the fundamental assumptions, GAAP and the basic accounting concepts, the systems and bases of accounting, the role of Accounting Standards and Ind-AS, and the basics of GST.

Key terms & definitions

GAAP (Generally Accepted Accounting Principles)
The common set of accounting rules, conventions and concepts that businesses are expected to follow while preparing financial statements, so that the accounts are reliable, consistent and comparable across firms.

Accounting Concepts
The basic assumptions and conditions that an accountant takes as always true while recording transactions and preparing accounts (for example Business Entity, Going Concern, Dual Aspect).

Accounting Conventions
Customs or practices that have developed over time and are followed while preparing accounts, such as Consistency, Full Disclosure, Conservatism (Prudence) and Materiality.

Business Entity Concept
The business and its owner are treated as two separate persons for accounting. Money the owner puts in is shown as Capital (a liability of the business owed back to the owner), and money taken out for personal use is Drawings.

Going Concern Concept
The assumption that the business will continue to operate for an indefinitely long period and has no intention of closing down, which is why the cost of long-life assets is spread over their useful life through depreciation rather than charged in full in the year of purchase.

Dual Aspect Concept
Every transaction has two equal and opposite effects, so total assets always equal the total of capital and liabilities. This is the foundation of double-entry book-keeping: Assets = Capital + Liabilities.

Accrual Basis of Accounting
A system in which revenue is recorded when it is earned and expenses are recorded when they are incurred, regardless of when the cash is actually received or paid.

Matching Concept
The principle that the expenses of an accounting period must be set against (matched with) the revenues earned in that same period, so that the profit or loss reported is true and fair.

Accounting Standards (AS)
Written, authoritative statements issued by the Institute of Chartered Accountants of India (ICAI) that prescribe the methods of measuring, recording and disclosing specific items, so as to bring uniformity and reliability to financial statements.

Ind-AS (Indian Accounting Standards)
Accounting standards notified by the Ministry of Corporate Affairs that are converged with (largely aligned to) the global IFRS, applied mainly by large and listed companies in India.

IFRS
International Financial Reporting Standards — a single set of high-quality global accounting standards intended to make financial statements comparable across countries.

GST (Goods and Services Tax)
A comprehensive, multi-stage, destination-based indirect tax levied on the supply of goods and services, which replaced many earlier indirect taxes under the principle of 'One Nation, One Tax'.

Why a theory base is needed (meaning and purpose of GAAP)

- Accounting information is used by many outsiders — owners, lenders, investors, tax authorities — who must be able to trust and compare the figures.
- If every business recorded transactions in its own way, the accounts of two firms could not be compared, so a shared rulebook is essential.
- GAAP is this shared rulebook: the body of generally accepted concepts, conventions, principles and standards that guide how accounts are prepared.
- GAAP makes financial statements reliable (free from bias), consistent (same treatment over time) and comparable (across firms and years).
- GAAP is not a single rigid law; it evolves as business practice and Accounting Standards develop.

Fundamental Accounting Assumptions

- Three assumptions are presumed to be followed in every set of accounts unless the firm clearly states otherwise: Going Concern, Consistency and Accrual.
- Going Concern: the business will continue for the foreseeable future; assets are therefore carried at cost less depreciation, not at break-up (sale) value.
- Consistency: the same accounting methods (for example, the same method of depreciation) are followed from one year to the next, so results can be compared.
- Accrual: revenues and costs are recognised when they are earned or incurred, not when cash moves.
- If any of these three is NOT followed, the fact must be disclosed in the accounts.

Basic Accounting Concepts (Part 1) — Entity, Money Measurement, Going Concern, Accounting Period

- Business Entity Concept: the firm is separate from its owner; owner's investment is Capital (a liability of the firm) and personal withdrawals are Drawings.
- Money Measurement Concept: only transactions and events that can be expressed in money are recorded; valuable but non-monetary facts (skill of staff, good location, employee morale) are not entered in the books.
- A further effect of Money Measurement is that money is assumed to have a stable value, so amounts from different years are simply added together (changes in the value of money are ignored).
- Going Concern Concept: the firm is assumed to continue indefinitely, which justifies spreading the cost of fixed assets over their useful life and classifying items as fixed or current.
- Accounting Period Concept: the indefinite life of a business is divided into fixed, equal intervals (usually one year) so that performance and position can be measured and reported regularly; in India the accounting year normally runs 1 April to 31 March.

Basic Accounting Concepts (Part 2) — Cost, Dual Aspect, Revenue Recognition, Matching

- Cost (Historical Cost) Concept: an asset is recorded at the price actually paid to acquire it, not at its current market value; this keeps records objective and verifiable.
- The Cost Concept fixes the value at which the asset is FIRST recorded — it does not freeze the value forever; book value still falls year by year through depreciation. What the concept prevents is writing the value UP to a higher market price.
- Dual Aspect (Duality) Concept: every transaction affects at least two accounts with equal debit and credit, giving the accounting equation Assets = Capital + Liabilities; this is the basis of double-entry book-keeping.
- Revenue Recognition (Realisation) Concept: revenue is treated as earned at the point the goods are sold or the service is rendered, even if the cash is received later; advance received before the sale is not yet revenue.
- Matching Concept: against the revenue of a period, all expenses incurred to earn that revenue (whether paid or still outstanding) are charged in the same period, so that the period's profit is correctly stated.
- Matching is the reason adjustments such as outstanding expenses, prepaid expenses, accrued income and depreciation are made before finding profit.

Accounting Conventions — Full Disclosure, Consistency, Conservatism, Materiality, Objectivity

- Full Disclosure: all information that is significant to users must be reported clearly in or with the financial statements (for example, pending lawsuits, large loans, change of method), so that nobody is misled.
- Consistency: accounting methods once chosen are followed every year; if a method is changed, the change and its effect must be disclosed.
- Conservatism (Prudence): do not anticipate profits, but provide for all possible losses — for example, value stock at cost or market price, whichever is lower, and create a provision for a doubtful debt.
- Materiality: only items important enough to influence a user's decision need separate, detailed treatment; trivial items may be merged with others (a low-value office item need not have its own ledger account).
- Objectivity (Verifiability): every entry should be supported by documentary evidence — bills, vouchers, receipts — so that the records are free from personal bias and can be checked.

Systems of Accounting — Double Entry and Single Entry

- Double Entry System: records both the debit and the credit aspect of every transaction; it is complete, scientific and accurate, and allows preparation of a Trial Balance to check arithmetical accuracy.
- Single Entry System: an incomplete system that records only some aspects (often only cash and personal accounts); it is used by very small businesses but is not reliable for final accounts.
- Because it captures both aspects, the Double Entry System is the accepted basis for proper accounting.

Basis of Accounting — Cash Basis vs Accrual Basis

- Cash Basis: income and expenses are recorded only when cash is actually received or paid; no entry is made for outstanding or prepaid items, so the profit shown can be misleading.
- Accrual (Mercantile) Basis: income is recorded when earned and expenses when incurred, irrespective of cash movement, so it gives a true and fair profit for the period.
- Accrual Basis records outstanding expenses, prepaid expenses, accrued income and income received in advance; Cash Basis does not.
- Accrual Basis is the recognised basis for formal financial statements and is required under the Companies Act for companies; Cash Basis may be used only for small or non-trading concerns and informal records.
- Accrual Basis is based on the Accrual, Revenue Recognition and Matching concepts.

Accounting Standards (AS) — meaning, objectives and applicability

- Accounting Standards are written, authoritative rules issued in India by the Institute of Chartered Accountants of India (ICAI) on how to measure, treat and disclose specific items.
- Objectives: to bring uniformity in accounting practice, to make financial statements reliable and comparable, to reduce the chances of fraud and manipulation, and to help auditors by setting agreed treatments.
- Standards narrow the range of choices a business has, but a reasonable degree of choice still remains in some areas.
- Applicability: standards apply to general-purpose financial statements; the level of compliance required depends on the size and class of the enterprise, with relaxations for smaller entities.
- Relationship with concepts: concepts give the broad direction (the 'constitution'), while standards give the detailed, mandatory rules (the 'laws') for specific situations — both are needed together.

IFRS and Indian Accounting Standards (Ind-AS)

- IFRS (International Financial Reporting Standards) are a single set of high-quality global standards meant to make accounts comparable across countries.
- India did not adopt IFRS as it is; instead it issued Ind-AS — Indian Accounting Standards that are converged with (substantially aligned to) IFRS but adapted to Indian law and conditions.
- Ind-AS are notified by the Ministry of Corporate Affairs and are applied mainly by large companies and listed companies, in a phased manner based on size.
- Smaller and unlisted entities generally continue to follow the existing Accounting Standards (AS) rather than Ind-AS.

Goods and Services Tax (GST) — meaning, characteristics and advantages

- GST is an indirect tax on the supply of goods and services; it replaced many earlier central and state indirect taxes (such as excise duty, service tax and VAT) under the idea of 'One Nation, One Tax'.
- Characteristics: it is comprehensive (covers most goods and services), multi-stage (levied at each stage of the supply chain) and destination-based (the tax goes to the state where the goods or services are finally consumed).
- India follows a dual GST model: for a supply within a state both CGST (collected by the Centre) and SGST/UTGST (collected by the State/UT) are charged, while for a supply between states IGST (collected by the Centre and shared with the consuming state) is charged.
- Input Tax Credit: a registered business can set off the GST paid on its purchases against the GST collected on its sales, so that tax is effectively paid only on the value it adds and the cascading 'tax on tax' is removed.
- Advantages: removes cascading of taxes, creates a common national market, widens the tax base, improves transparency and makes compliance simpler through a single tax.

Formulas & formats

- `Accounting Equation (Dual Aspect): Assets = Capital + Liabilities (also written Capital = Assets − Liabilities).`
- `Effect of Drawings under Business Entity Concept: Closing Capital = Opening Capital + Additional Capital + Profit − Drawings.`
- `Cost / Book value relation: Book Value of Asset = Original (Historical) Cost − Accumulated Depreciation (asset is never written up to market value).`
- `GST on an intra-state supply: Total GST = CGST + SGST (each usually half of the total GST rate); on an inter-state supply: Total GST = IGST.`
- `Net GST payable (Input Tax Credit): GST payable to government = Output GST (on sales) − Input GST (on purchases).`

Important questions & model answers

1 mark **State the three Fundamental Accounting Assumptions.**

- Going Concern, Consistency and Accrual.

1 mark **Which accounting concept treats the owner and the business as separate persons?**

- The Business Entity Concept (also called the Separate Entity Concept).

1 mark **Give the full form of GAAP and of GST.**

- GAAP = Generally Accepted Accounting Principles.
- GST = Goods and Services Tax.

3 marks **Explain the Business Entity Concept with one example.**

- The business is treated as separate and distinct from its owner for accounting purposes.
- Therefore money invested by the owner is recorded as Capital, i.e. a liability of the business owed back to the owner, and money taken out for personal use is recorded as Drawings.
- Example: if a proprietor brings in ₹5,00,000 of personal savings, the firm shows ₹5,00,000 as Capital; if he later withdraws ₹20,000 for household use it is treated as Drawings, not as a business expense.
- This keeps the firm's results free from the owner's personal transactions.

4 marks **Distinguish between the Cash Basis and the Accrual Basis of accounting.**

- Recording: under Cash Basis, income and expenses are recorded only when cash is received or paid; under Accrual Basis, they are recorded when earned or incurred, regardless of cash flow.
- Outstanding / prepaid items: Cash Basis ignores outstanding expenses, prepaid expenses and accrued income; Accrual Basis records all of them.
- True profit: Cash Basis may show a misleading profit, while Accrual Basis gives a true and fair profit for the period.
- Acceptability: Accrual Basis is required for formal financial statements (and for companies under the Companies Act), whereas Cash Basis is suitable only for small or non-trading concerns and informal records.

3 marks **'The Cost Concept means the value of an asset never changes in the books.' Do you agree? Explain.**

- The statement is not fully correct.
- The Cost Concept only fixes the value at which an asset is FIRST recorded — its original purchase price, not its market value.
- After that, the book value falls every year through depreciation (charged under the Matching Concept).
- What the Cost Concept actually prevents is writing the asset UP to a higher market value; it does not freeze the value forever.

4 marks **What are Accounting Standards? State any three of their objectives.**

- Accounting Standards are written, authoritative rules issued in India by the Institute of Chartered Accountants of India (ICAI) that prescribe how specific items are to be measured, treated and disclosed in financial statements.
- Objective 1 — Uniformity: they bring uniformity to accounting practice by laying down agreed treatments.
- Objective 2 — Reliability and comparability: they make financial statements more reliable and comparable across firms and years.
- Objective 3 — Check on manipulation: by codifying methods, they reduce the scope for fraud and window-dressing and assist auditors.
- (Any three objectives are acceptable.)

4 marks **Explain how the Accrual Concept and the Matching Concept together help in finding true profit.**

- Accrual Concept: revenue is recognised when it is earned and expenses when they are incurred, not when cash is received or paid.
- So sales made on credit are counted as income of the period of sale, and expenses still unpaid (outstanding) are counted as costs of the period in which they arose.
- Matching Concept: against the revenue of the period, all expenses incurred to earn that revenue are charged in the same period.
- This requires adjustments such as outstanding expenses, prepaid expenses, accrued income and depreciation.
- Together they ensure that the profit or loss reported for the period is true and fair, neither overstated nor understated.

4 marks **Explain the dual GST model in India and the meaning of CGST, SGST and IGST.**

- India follows a dual GST model in which both the Centre and the States have the power to levy GST on the same supply.
- On a supply WITHIN a state (intra-state), two taxes are charged: CGST (Central GST, collected by the Central Government) and SGST/UTGST (State/UT GST, collected by the State or Union Territory).
- On a supply BETWEEN states (inter-state), a single tax called IGST (Integrated GST) is charged; it is collected by the Centre and the State's share is passed on to the consuming state.
- GST is a destination-based tax, so the revenue ultimately belongs to the state where the goods or services are consumed.
- Because of Input Tax Credit, a business sets off GST paid on purchases against GST collected on sales, removing the cascading 'tax on tax'.

6 marks **Why is a theory base (set of concepts and standards) necessary in accounting? Explain with reference to GAAP.**

- Accounting information is used by many outside parties — owners, banks, investors, suppliers and the government — who must be able to trust and compare the figures.
- If each business followed its own rules, two firms doing identical business could report very different profits, making comparison impossible.
- GAAP (Generally Accepted Accounting Principles) is the common rulebook of concepts, conventions, principles and standards that all firms are expected to follow.
- Reliability: by fixing objective methods (for example, recording assets at cost), GAAP keeps the accounts free from personal bias.
- Consistency: by requiring the same methods over time, GAAP makes one year's results comparable with another's.
- Comparability: by standardising treatment, GAAP lets a user compare different firms on a like-for-like basis.
- Accounting Standards build on GAAP by giving detailed, mandatory rules for specific items, while the basic concepts give the broad direction — both are needed so that financial statements are dependable and decision-useful.

Exam tips

- Learn the three Fundamental Accounting Assumptions (Going Concern, Consistency, Accrual) as a ready-made one-mark answer — and remember that if any one is NOT followed it must be disclosed.
- In 'name/identify the concept' questions, link the keyword in the question: separate owner → Business Entity; only money items → Money Measurement; record when earned → Revenue Recognition/Accrual; match expenses to income → Matching; lower of cost or market → Conservatism.
- Never say the Cost Concept freezes value forever — it only blocks writing the asset UP; depreciation still reduces book value. This nuance is a common trap.
- For 'concept vs standard' questions, write that concepts are broad assumptions (direction) while Accounting Standards are detailed mandatory rules (specific treatment) — and that both apply together.
- For GST, remember the three keywords (comprehensive, multi-stage, destination-based) and the split: intra-state = CGST + SGST, inter-state = IGST.
- Answer point-wise with the concept named first; the marking scheme awards a mark for naming the correct concept and further marks for the explanation and example.

Quick revision

- GAAP = the shared rulebook (concepts + conventions + principles + standards) that makes accounts reliable, consistent and comparable.
- Fundamental Assumptions (must be disclosed if not followed): Going Concern, Consistency, Accrual.
- Basic Concepts: Business Entity, Money Measurement, Going Concern, Accounting Period, Cost, Dual Aspect, Revenue Recognition, Matching.
- Conventions: Full Disclosure, Consistency, Conservatism (Prudence), Materiality, Objectivity.
- Accounting Equation (Dual Aspect): Assets = Capital + Liabilities.
- Cash Basis vs Accrual Basis: Accrual records earned/incurred items (outstanding, prepaid, accrued) and is required for formal accounts; Cash records only actual receipts and payments.
- Accounting Standards: issued by ICAI; objectives = uniformity, reliability, comparability, check on manipulation. Ind-AS = standards converged with global IFRS for large/listed companies.
- GST: comprehensive, multi-stage, destination-based; intra-state = CGST + SGST, inter-state = IGST; Input Tax Credit removes cascading.