

Theory Base of Accounting

Kerala · Class 11 · Accountancy — exam notes

Two textile shops in Thrissur can both be profitable, yet their accounts are useless for comparison if each owner follows his own private logic. The theory base fixes that. Accounting CONCEPTS say what a business is and what may be measured; accounting CONVENTIONS say how to apply those concepts consistently. In India these are formalised as Accounting Standards issued by the ICAI and backed by the Companies Act, 2013.

Key terms & definitions

GAAP

Generally Accepted Accounting Principles — the body of concepts, conventions and standards that accountants agree to follow so statements are consistent and comparable.

Business Entity Concept

The business is treated as separate from its owner. Money the owner puts in is capital — a liability of the business towards him.

Money Measurement Concept

Only events measurable in money are recorded. Staff loyalty and a shop's street reputation are real advantages but stay out of the books.

Going Concern Concept

Accounts are prepared assuming the business will continue for the foreseeable future and is not about to be shut down or sold off.

Accounting Period Concept

The indefinite life of a business is cut into fixed periods (usually 1 April to 31 March in India) so results can be reported regularly.

Cost Concept

An asset is recorded at the price actually paid to acquire it, not at market value. Also called the historical cost concept.

Dual Aspect Concept

Every transaction has two effects of equal amount — one debit and one credit — keeping $\text{Assets} = \text{Liabilities} + \text{Capital}$ always true.

Revenue Recognition (Realisation)

Revenue is recognised when goods are delivered or services are rendered, not when the order is received or the cash arrives.

Matching Concept

Expenses of a period must be set against the revenues of that same period, so the profit figure is true for that period.

Accrual Concept

Income and expenses are recorded when they are earned or incurred, regardless of when cash is received or paid.

Conservatism (Prudence)

Provide for all probable losses, but do not record a gain until it is certain. Anticipate no profit; provide for all possible losses.

Materiality

Items significant enough to influence a user's decision must be shown separately; trivial items may be merged or treated simply.

Why a theory base is needed at all

- Without shared rules, two equally honest shopkeepers would produce accounts that cannot be compared.
- The theory base makes statements COMPARABLE across firms and RELIABLE across years.
- It also limits manipulation — an owner cannot simply choose whichever treatment flatters his profit.
- Two families of rules: CONCEPTS (what a business is, what is measured) and CONVENTIONS (how to apply them in practice).

Business Entity Concept

- Owner and business are two different persons in the eyes of accounting.
- When Rajan invests ₹5,00,000 of personal savings into his kirana shop, the shop records CAPITAL of ₹5,00,000 — an amount it owes back to Rajan.
- This is exactly why capital appears on the liabilities side, and why drawings reduce capital instead of being an expense.
- Without this concept, personal and business transactions would mix and profit would be meaningless.

Money Measurement Concept

- Only what can be expressed in rupees is recorded.
- Rajan's honest staff, his customer goodwill on the street and his own management skill are genuine strengths — none of them appear in the books.
- Limitation: money's value itself changes with inflation, so amounts of different years are not strictly comparable.
- This is a leading reason accounting cannot show the full picture of a business.

Going Concern Concept

- Accounts assume the business will continue operating for the foreseeable future.
- This is why a machine costing ₹1,00,000 is spread over its useful life as depreciation instead of being written off at once.
- It also justifies showing assets at cost less depreciation rather than at forced-sale value.
- It is an ASSUMPTION, not a guarantee — it simply means there is no evidence the business is about to close.

Accounting Period Concept

- A business may run for decades, but users cannot wait decades for results.
- Life is divided into equal periods — in India normally the financial year, 1 April to 31 March.
- At the end of each period, a Profit & Loss Account (for the period) and a Balance Sheet (on the closing date) are prepared.
- This concept creates the need for adjustments — outstanding, prepaid, accrued items — so each period carries only its own income and expense.

Cost Concept (Historical Cost)

- An asset enters the books at the amount actually paid for it.
- Land bought in 1995 for ₹2,00,000 stays at ₹2,00,000 even if it is worth ₹50,00,000 today.
- Advantage: the figure is objective and can be verified from the purchase document.
- Limitation: the balance sheet may badly understate the true present worth of the business.

Dual Aspect Concept — the heart of accounting

- Every transaction affects at least two accounts, by equal amounts, on opposite sides.
- If Rajan buys goods worth ₹50,000 on credit: stock (asset) rises ₹50,000 AND creditors (liability) rise ₹50,000.
- This is the source of the accounting equation $\text{Assets} = \text{Liabilities} + \text{Capital}$, and of double-entry bookkeeping itself.
- Because of it, a trial balance can be used to check arithmetical accuracy.

Revenue Recognition, Matching and Accrual

- REVENUE RECOGNITION: revenue is earned when goods are DELIVERED or the service is RENDERED — not when the order is placed and not when cash arrives.
- Worked case: a paint maker gets an order on 15 June, delivers on 20 June, receives a cheque on 25 June which clears on 27 June. Revenue of ₹50,000 is recognised on 20 JUNE, the date of delivery.
- MATCHING: once revenue is fixed to a period, all expenses incurred to earn it belong to that same period — including unpaid (outstanding) expenses.
- ACCRUAL: record income when earned and expenses when incurred, regardless of cash movement. This is why outstanding and prepaid adjustments exist.
- Accrual is the opposite of cash-basis accounting, where nothing is recorded until money moves.

Conventions: Consistency and Full Disclosure

- **CONSISTENCY:** once a method is chosen — say straight-line depreciation — it is followed year after year.
- A firm changing methods every year could show whatever profit it liked, so comparison across years would be worthless.
- A change IS allowed when it gives a better presentation, but it must be disclosed along with its effect.
- **FULL DISCLOSURE:** every material fact that affects a user's judgement must be shown — in the statements themselves or in notes.
- Example: a pending court case that may cost the business money must be disclosed even though the amount is not yet certain.

Conventions: Materiality and Conservatism

- **MATERIALITY:** an item matters if knowing it would change a user's decision. A ₹50 stapler is written off as expense rather than treated as an asset and depreciated.
- What is material depends on size — ₹10,000 is trivial for a large company but significant for a small shop.
- **CONSERVATISM (PRUDENCE):** anticipate no profit, but provide for all possible losses.
- If a debtor owing ₹30,000 looks unlikely to pay, create a provision for doubtful debts NOW; but do not record a rise in the value of land until it is actually sold.
- This is why closing stock is valued at cost OR net realisable value, WHICHEVER IS LOWER.

Accounting Standards in India

- Accounting Standards (AS) are issued by the INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA (ICAI).
- They convert broad concepts into specific, enforceable rules for particular items such as depreciation, inventory and revenue.
- The Companies Act, 2013 gives them legal force for companies.
- Ind AS are India's standards converged with IFRS, applied to larger companies.
- In any annual report, the section headed 'Significant Accounting Policies' is where the firm states which methods it chose.

Three traps students fall into

- Accrual does NOT mean 'record only when cash is received' — that is the cash basis, and it is the opposite.
- Conservatism does NOT permit deliberately understating profit to save tax. It means not overstating profit when the outcome is uncertain.
- Going concern does NOT guarantee the business will never close. It is only a default assumption in the absence of evidence to the contrary.

Formulas & formats

- Dual Aspect Concept expressed as the accounting equation:
$$\text{Assets} = \text{Liabilities} + \text{Capital}$$
- Conservatism applied to stock valuation:
$$\text{Closing Stock} = \text{Cost OR Net Realisable Value, whichever is LOWER}$$
- Accrual adjustments:
$$\begin{aligned} \text{Income earned} &= \text{Income received} + \text{Income accrued (not yet received)} - \text{Income received in advance} \\ \text{Expense for year} &= \text{Expense paid} + \text{Outstanding expense} - \text{Prepaid expense} \end{aligned}$$
- Matching Concept:
$$\text{Profit of a period} = \text{Revenue EARNED in the period} - \text{Expenses INCURRED to earn it}$$
- Indian accounting year (Accounting Period Concept):
1 April → 31 March

Important questions & model answers

3 marks What is meant by the Business Entity Concept? Give one implication.

- The Business Entity Concept treats the business as an entity separate and distinct from its owner.
- Transactions are recorded from the point of view of the business, not the proprietor.
- Implication: money brought in by the owner is shown as CAPITAL, a liability of the business towards him, and money taken out is DRAWINGS which reduces capital — not a business expense.

3 marks Explain the Money Measurement Concept and state one limitation arising from it.

- The Money Measurement Concept states that only those transactions and events which can be expressed in terms of money are recorded in the books.
- Consequently, valuable but non-monetary facts — the skill of employees, the efficiency of management, customer goodwill — find no place in the accounts.
- Limitation: the financial statements therefore give an incomplete picture of the business; and because the value of money itself changes with inflation, figures of different years are not strictly comparable.

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

- RECOGNITION: Under the cash basis, income and expense are recorded only when cash is actually received or paid. Under the accrual basis, they are recorded when earned or incurred.
- OUTSTANDING / PREPAID: The cash basis ignores outstanding and prepaid items; the accrual basis adjusts for both.
- PROFIT: The cash basis may show a misleading profit for the period; the accrual basis gives a truer profit because of the matching concept.
- ACCEPTANCE: The accrual basis is required under the Companies Act, 2013; the cash basis is used only by some small concerns and professionals.

4 marks Indian Paints receives an order on 15 June to supply paint worth ₹50,000. Goods are delivered on 20 June. The customer's cheque is issued on 25 June and clears on 27 June. On which date should revenue be recognised, and why?

- Revenue should be recognised on 20 JUNE — the date the goods were delivered.
- Under the Revenue Recognition (Realisation) Concept, revenue is earned when the goods are transferred to the buyer and the risks and rewards of ownership pass to him.
- The order date (15 June) is only a promise — no goods have moved, so nothing is earned.
- The cheque dates (25 and 27 June) concern collection of cash, not the earning of revenue; under the accrual concept cash movement does not decide recognition.
- Therefore ₹50,000 is credited to Sales in JUNE, and the amount is shown as a debtor until the cheque clears.

4 marks State the Conservatism (Prudence) convention. Give two examples of its application.

- Conservatism requires that all probable losses be provided for, while gains are recognised only when they are actually realised — 'anticipate no profit, provide for all possible losses'.
- Example 1: Closing stock is valued at cost or net realisable value, WHICHEVER IS LOWER, so an expected fall in value is recognised at once.
- Example 2: A provision for doubtful debts is created against debtors who may not pay, even though the loss has not yet occurred.
- Purpose: to ensure profit and assets are not overstated, so users are not misled into over-optimism.
- It does NOT permit deliberate understatement of profit — creating secret reserves is a misuse of the convention.

3 marks Why is the Consistency convention important? Is a change of method ever permitted?

- Consistency requires that the same accounting methods be followed from one period to the next.
- It makes the results of different years COMPARABLE, so a genuine improvement or decline can be identified rather than being produced by a change of method.
- Without it, a firm could switch depreciation methods each year to report whatever profit suited it.
- A change IS permitted when the new method gives a better and truer presentation — but the change and its monetary effect must be fully disclosed.

3 marks Explain the Going Concern Concept and state one effect it has on the treatment of fixed assets.

- The Going Concern Concept assumes the business will continue its operations for the foreseeable future and has no intention or necessity of closing down.
- Effect: a fixed asset is not shown at the price it would fetch if sold today. Its cost is spread over its useful life through depreciation.
- So a machine costing ₹1,00,000 with a ten-year life is charged at ₹10,000 a year rather than written off immediately.
- It also justifies classifying assets and liabilities as current and non-current.

3 marks What is the Matching Concept? Show how it applies to an outstanding expense.

- The Matching Concept requires that the expenses of a period be matched against the revenues of that same period to arrive at correct profit.
- An outstanding expense is one that relates to the current year but has not yet been paid — for example, December's rent paid in April.
- Because the benefit was consumed this year, the expense must be charged to this year's Profit & Loss Account and simultaneously shown as a current liability in the Balance Sheet.
- Ignoring it would overstate this year's profit and understate liabilities.

2 marks Define Materiality with an example.

- Materiality means that an item should be disclosed separately if knowledge of it could influence the decision of a user of the accounts.
- Items too small to affect judgement may be treated in a simplified way.
- Example: a stapler costing ₹50 is charged fully as an expense rather than capitalised as an asset and depreciated over its life.
- Materiality is relative — ₹10,000 may be immaterial for a large company but highly material for a small shop.

3 marks Who issues Accounting Standards in India, and what purpose do they serve?

- Accounting Standards in India are issued by the Institute of Chartered Accountants of India (ICAI).
- They translate broad accounting concepts and conventions into definite rules for specific items such as depreciation, inventory valuation and revenue recognition.
- Purpose: to reduce the number of permitted alternatives, improve comparability between firms, and ensure a true and fair view.
- They are given legal backing for companies by the Companies Act, 2013. Ind AS are the Indian standards converged with IFRS, applicable to larger companies.

Exam tips

- Learn which items are CONCEPTS and which are CONVENTIONS — a question may ask for one group specifically, and listing from the wrong group earns nothing.
- For every concept, memorise one crisp example. Examiners award the example mark separately from the definition mark.
- Revenue-recognition questions almost always give you an order date, a delivery date and a payment date. The answer is the DELIVERY date — say so explicitly and give the reason.
- When explaining conservatism, quote the phrase 'anticipate no profit, provide for all possible losses' — it is the expected wording.
- In 'distinguish between cash basis and accrual basis', answer with a named basis for each difference (recognition, outstanding/prepaid, profit, legal acceptance).
- Do not confuse the Cost Concept with the Matching Concept — cost is about the VALUE at which an asset is recorded; matching is about the PERIOD to which an expense belongs.
- Write 'Institute of Chartered Accountants of India (ICAI)' in full at least once; the abbreviation alone may not secure the mark.

Quick revision

- CONCEPTS: Business Entity · Money Measurement · Going Concern · Accounting Period · Cost · Dual Aspect · Revenue Recognition · Matching · Accrual · Objectivity.
- CONVENTIONS: Consistency · Full Disclosure · Materiality · Conservatism.
- Business entity → capital is a liability, drawings reduce capital.
- Dual aspect → Assets = Liabilities + Capital → double entry → trial balance.
- Revenue is earned on DELIVERY, not on order and not on cash receipt.
- Accrual: record when earned/incurred, not when cash moves — this creates outstanding and prepaid adjustments.
- Conservatism → closing stock at cost or NRV, whichever is LOWER; provision for doubtful debts.
- Consistency allows a change of method only if it is better AND disclosed.
- Accounting Standards are issued by ICAI and backed by the Companies Act, 2013.