Acc 2N2 - Basic accounting concepts

SYNOPSIS

Basic accounting concepts

The basic accounting concepts are the fundamental ideas or assumptions underlying the theory and practice of financial accounting. They are broad working rules for all financial accounting activities developed through ages by the accountants. The important ones are listed below under two sub-groups:

(1) Concepts for recording of transactions which are: Business entity, Money measurement, Historical cost, Objectivity, Conservatism, and Dual aspect

(2) Concepts for reporting of transactions which are: Going concern, Accounting period, Matching, Full disclosure, Consistency, and Materiality.

Concepts for recording of transactions

The concepts or assumptions under this group is required while writing the books of accounts of an entity.

Business Entity Concept: The concept of business 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. Keeping this in view, 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. Here, one separate entity (owner) is assumed to be giving money to another distinct entity (business unit). Similarly, 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. 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. 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.

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 such as sale of goods or payment of expenses or receipt of income, etc., are to be recorded in the book of accounts. All such transactions or happenings which cannot be expressed in monetary terms, for example, the appointment of a manager, capabilities of its human resources or creativity of its research department or image of the organisation among people in general do not find a place in the accounting records of a firm. 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, office building containing 10 rooms, 30 personal computers, 30 office chairs and tables, a bank balance of ₹5 lakh, raw material weighing 20-tons, and 100 cartons of finished goods. These assets are expressed in different units, so cannot be added to give any meaningful information about the total worth of business. For accounting purposes, therefore, these are shown in money terms and recorded in rupees and paise. In this case, the cost of factory land may be say ₹2 crore; office building ₹1 crore; computers ₹15 lakh; office chairs and tables ₹2 lakh; raw material ₹33 lakh and finished goods ₹4 lakh. Thus, the total assets of the enterprise are valued at ₹3 crore and 59 lakh. Similarly, all transactions are recorded in rupees and paise as and when they take place. The money measurement assumption is not free from limitations. Due to the changes in prices, the value of money does not remain the same over a period of time. The value of rupee today on account of rise in prices is much less than what it was, say ten years back. Therefore, in the balance sheet, when we add different assets bought at different points of time, say building purchased in 1995 for Rs 2 crore, and plant purchased in 2005 for Rs 1 crore, we are in fact adding heterogeneous values, which cannot be clubbed together. As the change in the value of money is not reflected in the book of accounts, the accounting data does not reflect the true and fair view of the affairs of an enterprise. To some extent an attempt has been made by the name of 'inflation accounting' to redress such issues.

Historical 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. To illustrate, on June 2005, an old plant was purchased for ₹50 lakh by Shiva Enterprise, which is into the business of manufacturing detergent powder. An amount of ₹10,000 was spent on transporting the plant to the factory site. In addition, ₹15,000 was spent on repairs for bringing the plant into running position and ₹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. ₹50,50,000. The concept of cost is **historical** in nature as it is something, which has been paid on the date of acquisition and does not change year after year. For example, if a building has been purchased by a firm for Rs 2.5 crore, the purchase price will remain the same for all years to come, though its market value may change. Adoption of historical cost brings in objectivity in recording as the cost of acquisition is easily verifiable from the purchase documents. The market value basis, on the other hand, is not reliable as the value of an asset may change from time to time, making the comparisons between one period to another rather difficult. However, an important limitation of the historical cost basis is that it does not show the true worth of the business and may lead to hidden profits. During the period of rising prices, the market value or the cost at (which the assets can be replaced are higher than the value at which these are shown in the book of accounts) leading to hidden profits. This issue is resolved to some extent by revaluation reserve.

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. Similarly, receipt for the amount paid for purchase of a machine becomes the documentary evidence for the cost of machine and provides an objective basis for verifying this transaction. One of the reasons for the adoption of 'Historical Cost' as the basis of recording accounting transaction is that adherence to the principle of objectivity is made possible by it. As stated above, the cost actually paid for an asset can be verified from the documents but it is very difficult to ascertain the market value of an asset until it is actually sold. Not only that, the market value may vary from person to person and from place to place, and so 'objectivity' cannot be maintained if such value is adopted for accounting purposes.

Conservatism Concept: The concept of conservatism (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. If the profits ascertained are more than the actual, it may lead to distribution of dividend out of capital, which is not fair as it will lead to reduction in the capital of the enterprise. 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. To illustrate, valuing closing stock at cost or market value whichever is lower; creating provision for doubtful debts, discount on debtors; writing of intangible assets like goodwill, patents, etc. from the book of accounts are some of the examples of the application of the principle of conservatism. Thus, if market value of the goods purchased has fallen down, the stock will be shown at cost price in the books but if the market value has gone up, the gain is not to be recorded until the stock is sold. This approach of providing for the losses but not recognising the gains until realised is called conservatism approach. This may be reflecting a generally pessimist attitude adopted by the accountants but is an important way of dealing with uncertainty and protecting the interests of creditors against an unwanted distribution of firm's assets. However, deliberate attempt to underestimate the value of assets should be discouraged as it will lead to hidden profits, called secret reserves. The concept of **revenue recognition or realization** is an offshoot of the conservatism. The revenue recognition concept requires that the revenue for a business transaction should be included in the accounting records only when it is realised. Here arises two questions in mind. First, is termed as revenue and the other, when the revenue is realised. Let us take the first one first. Revenue is the gross inflow of cash arising from (i) the sale of goods and services by an enterprise; and (ii) use by others of the enterprise's resources yielding interest, royalties and dividends. Secondly, revenue is assumed to be realised when a legal right to receive it arises, i.e. the point of time when goods have been sold or service has been rendered. Thus, credit sales are treated as revenue on the day sales are made and not when money is received from the buyer. As for the income such as rent, commission, interest, etc. these are recognised on a time basis. For example, rent for the month of March 2017, even if received in April 2017, will be taken into the profit and loss account of the financial year ending March 31, 2017 and not into financial year beginning with April 2017. Similarly, if interest for April 2017 is received in advance in March 2017, it will be taken to the profit and loss account of the financial year ending March 2018. There are some exceptions to this general rule of revenue recognition. 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 realised. Similarly, when goods are sold on hire purchase, the amount collected in instalments is treated as realised.

Dual Aspect Concept: Dual aspect 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. This can be explained with the help of an example. Ram started business by investing in a sum of ₹50,00,000. The amount of money brought in by Ram will result in an increase in the assets (cash) of business by ₹50,00,000. At the same time, the owner's equity or capital will also increase by an equal amount. It may be seen that the two items that got affected by this transaction are cash and capital account. Let us take another example to understand this point further. Suppose the firm purchase goods worth ₹10,00,000 on cash. This will increase an asset (stock of goods) on the one hand and reduce another asset (cash) on the other. Similarly, if the firm purchases a machine worth ₹30,00,000 on credit from Reliable Industries. This will increase an asset (machinery) on the one hand and a liability (creditor) on the other. This type of dual effect takes place in case of all business transactions and is also known as duality principle. The duality principle is commonly expressed in terms of fundamental Accounting Equation, which is as follows:

$$\boxed{\text{Assets} = \text{Liabilities} + \text{Capital}}$$

In other words, the equation states that the assets of a business are always equal to the claims of owners and the outsiders. The claims also called equity of owners is termed as Capital (owners' equity) and that of outsiders, as Liabilities (creditors equity). The two-fold effect of each transaction affects in such a manner that the equality of both sides of equation is maintained. The two-fold effect in respect of all transactions must be duly recorded in the book of accounts of the business. In fact, this concept forms the core of Double Entry System of accounting.

Concepts for reporting of transactions

The concepts or assumptions under this group is required while preparing the financial reports of an entity.

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 is an important assumption of accounting as 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. When we purchase an asset, for example, a personal computer, for a sum of ₹50,000, what we are buying really is the services of the computer that we shall be getting over its estimated life span, say 5 years. It will not be fair to charge the whole amount of ₹50,000, from the revenue of the year in which the asset is purchased. Instead, that part of the asset which has been consumed or used during a period should be charged from the revenue of that period. The assumption regarding continuity of business allows us to charge from the revenues of a period only that part of the asset which has been consumed or used to earn that revenue in that period and carry forward the remaining amount to the next years, over the estimated life of the asset. Thus, we may charge ₹10,000 every year for 5 years from the profit and loss account. In case the continuity assumption is not there, the whole cost (₹50,000 in the present example) will need to be charged from the revenue of the year in which the asset was purchased.

Accounting Period 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. Such information is required by different users at regular interval for various purposes, as no firm can wait for long to know its financial results as various decisions are to be taken at regular intervals on the basis of such information. The financial statements are, therefore, prepared at regular interval, normally after a period of one year, so that timely information is made available to the users. This interval of time is called accounting period. The Companies Act 2013 and the Income Tax Act require that the income statements should be prepared annually. However, in case of certain situations, preparation of interim financial statements become necessary. For example, at the time of retirement of a partner, the accounting period can be different from twelve months period. Apart from these companies whose shares are listed on the stock exchange, are required to publish quarterly results to ascertain the profitability and financial position at the end of every three months period.

Matching Concept: The process of ascertaining the amount of profit earned or the loss incurred during a particular period involves deduction of related expenses from the revenue earned during that period. The matching concept emphasises exactly on this aspect. It 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. As already stated, revenue is recognised when a sale is complete or service is rendered rather when cash is received. Similarly, an expense is recognised not when cash is paid but when an asset or service has been used to generate revenue. For example, expenses such as salaries, rent, insurance are recognised on the basis of period to which they relate and not when these are paid. Similarly, costs like depreciation of fixed asset is divided over the periods during which the asset is used. Let us also understand how cost of goods are matched with their sales revenue. While ascertaining the profit or loss of an accounting year, we should not take the cost of all the goods produced or purchased during that period but consider only the cost of goods that have been sold during that year. For this purpose, the cost of unsold goods should be deducted from the cost of the goods produced or purchased. The matching concept, thus, implies that 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.

Full Disclosure Concept: Information provided by financial statements are used by different groups of people such as investors, lenders, suppliers and others in taking various financial decisions. In the corporate form of organisation, there is a distinction between those managing the affairs of the enterprise and those owning it. Financial statements, however, are the only or basic means of communicating financial information to all interested parties. It becomes all the more important, therefore, that the financial statements makes a full, fair and adequate disclosure of all information which is relevant for taking financial decisions. 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 is to enable the users to make correct assessment about the profitability and financial soundness of the enterprise and help them to take informed decisions. To ensure proper disclosure of material accounting information, the Indian Companies Act 1956 has provided a format for the preparation of profit and loss account and balance sheet of a company, which needs to be compulsorily adhered to, for the preparation of these statements. The regulatory bodies like SEBI, also mandates complete disclosures to be made by the companies, to give a true and fair view of profitability and the state of affairs.

Consistency Concept: The accounting information provided by the financial statements would be useful in drawing conclusions regarding the working of an enterprise only when it allows comparisons over a period of time as well as with the working of other enterprises. Thus, both inter-firm and inter-period comparisons are required to be made. This can be possible only when accounting policies and practices followed by enterprises are uniform and are consistent over the period of time.

To illustrate, 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. Consistency eliminates personal bias and helps in achieving results that are comparable. Also, the comparison between the financial results of two enterprises would be meaningful only if same kind of accounting methods and policies are adopted in the preparation of financial statements. However, consistency does not prohibit change in accounting policies. Necessary required changes are fully disclosed by presenting them in the financial statements indicating their probable effects on the financial results of business.

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 question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Any fact would be considered as material if it is reasonably believed that its knowledge would influence the decision of informed user of financial statements. For example, money spent on creation of additional capacity of a theatre would be a material fact as it is going to increase the future earning capacity of the enterprise. Similarly, information about any change in the method of depreciation adopted or any liability which is likely to arise in the near future would be significant information. All such information about material facts should be disclosed through the financial statements and the accompanying notes so that users can take informed decisions. In certain cases, when the amount involved is very small, strict adherence to accounting principles is not required. For example, stock of erasers, pencils, scales, etc. are not shown as assets, whatever amount of stationery is bought in an accounting period is treated as the expense of that period, whether consumed or not. The amount spent is treated as revenue expenditure and taken to the profit and loss account of the year in which the expenditure is incurred.