**THEORY BASE OF ACCOUNTING-CHAPTER-2**

**A s discussed in the previous chapter, accounting is concerned with the recording, classifying and summarising of financial transactions and events and interpreting the results thereof. It aims at providing information about the financial performance of a firm to its various users such as owners, managers employees, investors, creditors, suppliers of goods and services and tax authorities and help them in taking important decisions. The investors, for example, may be interested in knowing the extent of profit or loss earned by the firm during a given period and compare it with the performance of other similar enterprises. The suppliers of credit, say a banker, may, in addition, be interested in liquidity position of the enterprise. All these people look forward to accounting for appropriate, useful and reliable information. For making the accounting information meaningful to its internal and external users, it is important that such information is reliable as well as comparable. The comparability of information is required both to make inter-firm comparisons, i.e. to see how a firm has performed as compared to the other firms, as well as to make inter-period comparison, i.e. how it has performed as compared to the previous years. This becomes possible only if the information provided by the financial statements is based on consistent accounting policies, principles and practices. Such consistency is required throughout the process of identifying the events and Theory Base of Accounting 2 2020-21 24 Accountancy transactions to be accounted for, measuring them, communicating them in the book of accounts, summarising the results thereof and reporting them to the interested parties. This calls for developing a proper theory base of accounting. The importance of accounting theory need not be over-emphasised as no discipline can develop without a sound theoretical base. 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. Apart from these, the Institute of Chartered Accountants of India, (ICAI), which is the regulatory body for standardisation of accounting policies in the country has issued Accounting Standards which are expected to be uniformly adhered to, in order to bring consistency in the accounting practices. These are discussed in the sections to follow. 2.1**

**Generally Accepted Accounting Principles In order to maintain uniformity and consistency in accounting records, certain rules or principles have been developed which are generally accepted by the accounting profession.**

**These rules are called by different names such as principles, concepts, conventions, postulates, assumptions and modifying principles. The term ‘principle’ has been defined by AICPA as ‘A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice’. The word ‘generally’ means ‘in a general manner’, i.e., pertaining to many persons or cases or occasions. Thus, Generally Accepted Accounting Principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements. For example, one of the important rule is to record all transactions on the basis of historical cost, which is verifiable from the documents such as cash receipt for the money paid. This brings in objectivity in the process of recording and makes the accounting statements more acceptable to various users. The Generally Accepted Accounting Principles have evolved over a long period of time on the basis of past experiences, usages or customs, statements by individuals and professional bodies and regulations by government agencies and have general acceptability among most accounting professionals. However, the principles of accounting are not static in nature. These are constantly influenced by changes in the legal, social and economic environment as well as the needs of the users. These principles are also referred as concepts and conventions. The term concept refers to the necessary assumptions and ideas which are fundamental to accounting practice, and the term convention connotes customs or traditions as a guide to the preparation of accounting statements. In practice, the same rules or guidelines have been described by one author as a concept, by another 2020-21**

**Theory Base of Accounting 25 as a postulate and still by another as convention. This at times becomes confusing to the learners. Instead of going into the semantics of these terms, it is important to concentrate on the practicability of their usage. From the practicability view point, it is observed that the various terms such as principles, postulates, conventions, modifying principles, assumptions, etc. have been used interchangeably and are referred to as Basic Accounting Concepts in the present chapter. 2.2**

**Basic Accounting Concepts The basic accounting concepts are referred to as the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are broad working rules for all accounting activities and developed by the accounting profession.**

**The important concepts have been listed as below:**

**• Business entity;**

**• Money measurement;**

**• Going concern;**

**• Accounting period; •**

**Cost •**

**Dual aspect (or Duality);**

**• Revenue recognition (Realisation);**

**• Matching;**

**• Full disclosure;**

**• Consistency;**

**• Conservatism (Prudence);**

**• Materiality;**

**• Objectivity.**

**2.2.1 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. 2.2.2 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 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 2020-21 26 Accountancy can not 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 can not 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 ` 2 crore, and plant purchased in 2005 for ` 1 crore, we are in fact adding heterogeneous values, which can not 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. 2.2.3 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 2020-21 Theory Base of Accounting 27 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.**