

Theory Base of Accounting

2

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

- identify the need for theory base of accounting;
- explain the nature of Generally Accepted Accounting Principles (GAAP);
- state the meaning and purpose of the basic accounting concepts;
- list the accounting standards issued by Institute of Chartered Accountants of India;
- describe the systems of accounting; and
- describe the basis of accounting.

As 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 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 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

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 Rs.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 Rs. 2 crore; office building Rs. 1 crore; computers Rs.15 lakh; office chairs and tables Rs. 2 lakh; raw material Rs. 33 lakh and finished goods Rs. 4 lakh. Thus, the total assets of the enterprise are valued at Rs. 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 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 Rs. 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 Rs. 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 Rs. 10,000 every year for 5 years from the profit and loss account. In case the continuity assumption is not there, the whole cost (Rs. 50,000 in the present example) will need to be charged from the revenue of the year in which the asset was purchased.

2.2.4 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.

Test Your Understanding - I

Choose the Correct Answer

1. During the life-time of an entity accounting produce financial statements in accordance with which basic accounting concept:
 - (a) Conservation
 - (b) Matching
 - (c) Accounting period
 - (d) None of the above
2. When information about two different enterprises have been prepared presented in a similar manner the information exhibits the characteristic of:
 - (a) Verifiability
 - (b) Relevance
 - (c) Reliability
 - (d) None of the above

3. A concept that a business enterprise will not be sold or liquidated in the near future is known as :
 - (a) Going concern
 - (b) Economic entity
 - (c) Monetary unit
 - (d) None of the above
4. The primary qualities that make accounting information useful for decision-making are :
 - (a) Relevance and freedom from bias
 - (b) Reliability and comparability
 - (c) Comparability and consistency
 - (d) None of the above

2.2.5 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 Rs. 50 lakh by Shiva Enterprise, which is into the business of manufacturing detergent powder. An amount of Rs. 10,000 was spent on transporting the plant to the factory site. In addition, Rs. 15,000 was spent on repairs for bringing the plant into running position and Rs. 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. Rs. 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.

2.2.6 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 Rs. 50,00,000. The amount of money brought in by Ram will result in an increase in the assets (cash) of business by Rs. 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 purchases goods worth Rs. 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 Rs. 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 :

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

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, which has been dealt in detail, in chapter 3.

2.2.7 Revenue Recognition (Realisation) Concept

The concept of *revenue recognition* 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 installments is treated as realised.

2.2.8 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 than 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. You will learn about this aspect in detail in the chapter on financial statement.

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.

2.2.9 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.

2.2.10 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.

2.2.11 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*.

2.2.12 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.

2.2.13 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.

Test Your Understanding - II

Fill in the correct word:

1. Recognition of expenses in the same period as associated revenues is called _____ concept.
2. The accounting concept that refers to the tendency of accountants to resolve uncertainty and doubt in favour of understating assets and revenues and overstating liabilities and expenses is known as _____.
3. Revenue is generally recognised at the point of sale denotes the concept of _____.
4. The _____ concept requires that the same accounting method should be used from one accounting period to the next.
5. The _____ concept requires that accounting transaction should be free from the bias of accountants and others.

2.3 Systems of Accounting

The systems of recording transactions in the book of accounts are generally classified into two types, viz. Double entry system and Single entry system. Double entry system is based on the principle of "Dual Aspect" which states that every transaction has two effects, viz. receiving of a benefit and giving of a benefit. Each transaction, therefore, involves two or more accounts and is recorded at different places in the ledger. The basic principle followed is that every debit must have a corresponding credit. Thus, one account is debited and the other is credited.

Double entry system is a complete system as both the aspects of a transaction are recorded in the book of accounts. The system is accurate and

more reliable as the possibilities of frauds and mis-appropriations are minimised. The arithmetic inaccuracies in records can mostly be checked by preparing the trial balance. The system of double entry can be implemented by big as well as small organisations.

Single entry system is not a complete system of maintaining records of financial transactions. It does not record two-fold effect of each and every transaction. Instead of maintaining all the accounts, only personal accounts and cash book are maintained under this system. In fact, this is not a system but a lack of system as no uniformity is maintained in the recording of transactions. For some transactions, only one aspect is recorded, for others, both the aspects are recorded. The accounts maintained under this system are incomplete and unsystematic and therefore, not reliable. The system is, however, followed by small business firms as it is very simple and flexible (you will study about them in detail later in this book).

2.4 Basis of Accounting

From the point of view the timing of recognition of revenue and costs, there can be two broad approaches to accounting. These are:

- (i) Cash basis; and
- (ii) Accrual basis.

Under the *cash basis*, entries in the book of accounts are made when cash is received or paid and not when the receipt or payment becomes due. Let us say, for example, if office rent for the month of December 2014, is paid in January 2015, it would be recorded in the book of account only in January 2015.

Similarly sale of goods on credit in the month of January 2015 would not be recorded in January but say in April, when the payment for the same is received. Thus this system is incompatible with the matching principle, which states that the revenue of a period is matched with the cost of the same period. Though simple, this method is inappropriate for most organisations as profit is calculated as a difference between the receipts and disbursement of money for the given period rather than on happening of the transactions.

Under the *accrual basis*, however, revenues and costs are recognised in the period in which they occur rather when they are paid. A distinction is made between the receipt of cash and the right to receive cash and payment of cash and legal obligation to pay cash. Thus, under this system, the monetary effect of a transaction is taken into account in the period in which they are earned rather than in the period in which cash is actually received or paid by the enterprise. This is a more appropriate basis for the calculation of profits as expenses are matched against revenue earned in relation thereto. For example, raw material consumed are matched against the cost of goods sold.

2.5 Accounting Standards

Accounting standards are written policy documents covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in financial statements. Accounting standard is an authoritative statement issued by ICAI, a professional body of accounting in our country. The objective of accounting standard is to bring uniformity in different accounting policies in order to eliminate non comparability of financial statements for enhancing reliability of financial statements. Secondly, the accounting standard provides a set of standard accounting policies, valuation norms and disclosure requirements. In addition to improving credibility of accounting data, accounting standard enhances comparability of financial statements, both intra and inter enterprises. Such comparisons are very effective and widely used for assessment of firms' performance by the users of accounting.

Need for Accounting Standards

Accounting extends information to various users of information. Accounting information can serve the interest of different users only if it possesses uniformity and full disclosure of relevant information. There can be alternate accounting treatment and valuation norms which may be used by any business entity. Accounting standard facilitate the scope of those alternatives which fulfil the basic qualitative characteristics of true and fair financial statement.

Benefits of Accounting Standards

1. Accounting standard helps in eliminating variations in accounting treatment to prepare financial statements.
2. Accounting standard may call for disclosures of certain information which may not be required by law, but such information might be useful for general public, investors and creditors.
3. Accounting standard facilitate comparability between financial statements of inter and intra companies.

Limitations of Accounting Standards

1. Accounting standard makes choice between different alternate accounting treatments difficult to apply.
2. It is rigidly followed and fails to extend flexibility in applying accounting standards.
3. Accounting standard cannot override the statue. The standards are required to be farmed within the ambit of prevailing status.

Applicability of Accounting Standards

Except the purely charitable organisation which does not have any commercial, industrial and business activity, accounting standard is applicable to:

1. Sole proprietorship unit
2. Partnership firm
3. Societies
4. Trusts
5. Hindu undivided family
6. Association of persons
7. Cooperative societies
8. Companies

9. International Financial Reporting System

10. There have been vast changes in the global economic scenario with the emergence of globalisation, liberalisation and privatization. The advent of transnational corporations in search of funds in order to sustain their ongoing operations in addition to fuelling the growth of economy has resulted in raising capital globally, i.e., cutting across international boundaries. Since each country has its own set of rules and regulations for maintaining business records for accounting purposes and financial reporting, it becomes a cumbersome and complex exercise to comply with the existing accounting rules and regulations of the country in case the business enterprise decides to raise its capital needs from foreign country. In order to make economy more dynamic, competitive and to boost confidence amongst international analysts and investors, it is important that the financial statements put forward by the business organisations across the countries are comparable on similar parameters, investor friendly, fair, transparent and decisions worthy. In view of this, a trend towards global convergence of accounting standards is seeking momentum for international financial reporting.

Need for IFRS

1. The important economic decisions are made on the basis of financial statements. In order to avoid manipulations of figures in the financial accounts, there is a need for consistent way of deciding which elements require recognition and measurement and how information is presented in the financial statements. Hence, IFRS helps to prevent material manipulation or errors in financial statements.
2. IFRS helps in global harmonisation. Unless accounting activities are regulated, different countries will apply different set of accounting rules and regulations are prevalent in each country. This will restrict uniformity

and comparability of financial statements. Hence, IFRS promotes global standards for each of business growth.

3. It facilitates global investment. The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investments and achieves substantial benefits for all capital market stakeholders.

To uniform accounting policies and procedures almost all countries have agreed to apply IFRS. But the name of this IFRS has been converged as Ind AS. In substance, Ind AS is not different from IFRS. Ind AS is accounting standard notified by ministry of corporate affairs and has wide range of convergence as compared to existing accounting standards.

The list of Ind AS and existing standards for comparative analysis is given below:

Ind-As	Title	AS	Title
1	Presentation of Financial Statements	1 —	Disclosure of accounting policies Framework for preparation and presentation of financial statements
2	Inventories	2	Valuation of inventories
7	Cash Flow Statements	3	Cash flow statements
8	Accounting Policies, Changes in Accounting Estimates and Errors	5	Net profit or loss for the period, prior period items and changes in accounting policies
10	Events after the Balance Sheet Date	4	Contingencies and events occurring after the balance sheet date
11	Construction Contracts	7	Construction contracts
12	Income Taxes	22	Accounting for taxes on income
16	Property, Plant and Equipment	10	Accounting for fixed assets
17	Leases	6	Depreciation accounting
18	Revenue	19	Leases
19	Employee Benefits	9	Revenue recognition
20	Accounting for Government Grants and Disclosure of Government Assistance	15	Employee Benefits
21	The Effects of Changes in Foreign Exchange Rates	12	Accounting for government grants
23	Borrowing Costs	11	The effects of changes in foreign exchange rates
24	Related Party Disclosures	16	Borrowing Costs
		18	Related Party Disclosures

27	Consolidated and Separate Financial Statements	21	Consolidated Financial Statements
28	Investments in Associates	23	Accounting for Investment in Associates in CFS
29	Financial Reporting in Hyperinflationary Economics	---	
31	Interests in Joint Ventures	27	Financial reporting of interest in joint venture
32	Financial Instruments: Presentation	31	Financial instrument: Presentation
33	Earnings Per Share	20	Earnings Per Share
34	Interim Financial Reporting	25	Interim Financial reporting
36	Impairment of assets	28	Impairment of Asset
37	Provisions, contingent liabilities and contingent assets	29	Provisions, contingent liabilities and contingent assets
38	Intangible assets	30	Intangible assets
39	Financial instruments: Recognition and measurement	13	Financial instruments: Recognition and measurement
40	Investment property	13	Accounting for investments
101	First time adoption of international financial reporting standards	13	Accounting for investments
102	Share-based payments	---	
103	Business combinations	---	G.N. on employee share based payment
104	Insurance Contracts	14	Accounting for amalgamations
105	Non-current Assets held for Sale and Discontinued Operations	24	Discontinuing Operation
106	Exploration for and Evaluation of Mineral Resources	---	
107	Financial Instruments: Disclosures	32	Financial Instrument : Disclosure
108	Operating Segments	17	Segment Reporting

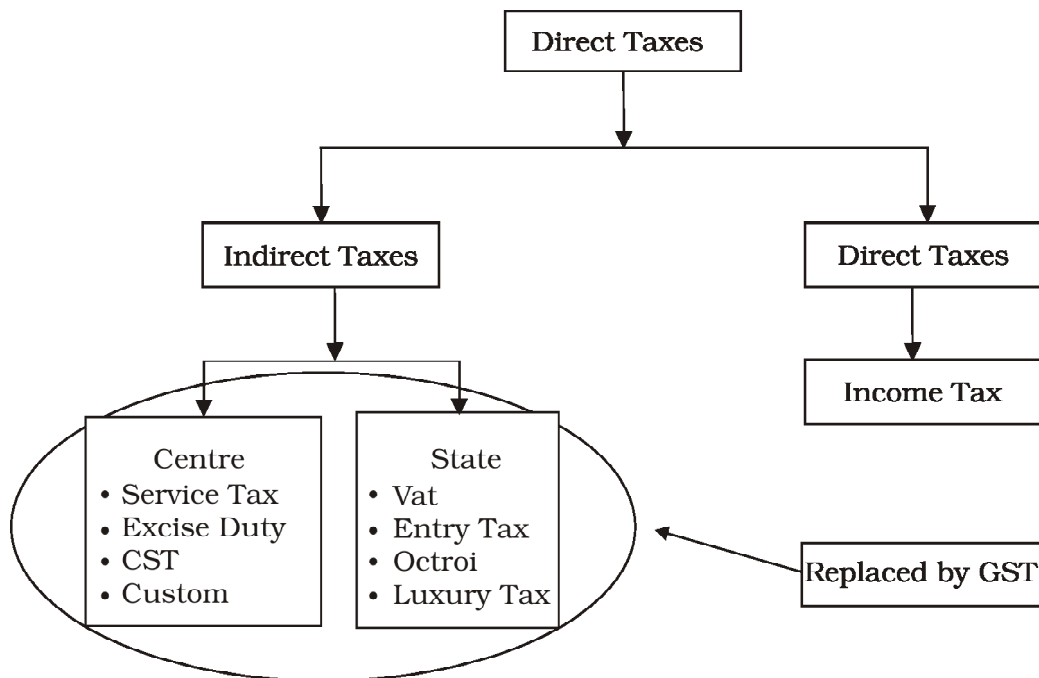
Goods and Services Tax (One Country One Tax)

GST is a destination based tax on consumption of goods and services. It is proposed to be levied at all stages right from manufacture up to final consumption with credit of taxes paid at previous stages available as setoff. In a nutshell, only value addition will be taxed and burden of tax is to be borne by the final consumer. The concept of destination based tax on consumption implies has the tax would accrue to the taxing authority which has jurisdiction over the place of consumption which is also termed as place of supply.

GST has a dual aspect with the Centre and States simultaneously levying on a common tax base. There are three main components of GST which are CGST, SGST, CGST means Central Goods and Services Tax. Taxes collected under CGST will constitute the revenues of the Central Government. The present central taxes like central excise duty, additional excise duty, special excise duty, central sales tax etc., will be subsumed under CGST. SGST means State Good and Services Tax. A collection of SGST is the revenue of the State Government. With GST all state taxes like VAT, entertainment tax, luxury tax, entry tax etc, will be merged with GST. For example, Ramesh a dealer in Punjab sell goods to Seema in Punjab worth Rs. 10,000. If the GST rate is 18%, i.e., 9% CGST and 9% SGST, Rs. 900 will go to Central Government and 900 will go to Punjab Government.

IGST means Integrated Goods and Services Tax. Revenue collected under IGST is divided between Central and State Government as per the rates specified by the Government. IGST is charged on transfer of goods and services from one state to another. Import of goods and services are also covered under IGST. For example, if the goods are transferred from Madhya Pradesh to Rajasthan then this transaction will attract IGST. Lets extend the above example to understand SGST. If Ramesh in Madhya Pradesh sell goods to Anand in Rajasthan worth Rs. 1,000,000. Applicable GST late is 18% i.e., 9% CGST and 9% SGST. In this case, the dealer will charge 18,000 as IGST and will go the Central Government.

India is a federal country where both the Centre and the States have been assigned the powers to levy and collect taxes through appropriate legislation. Both the levels of government have distinct responsibilities to perform according to the division of powers prescribed in the Constitution for which they need to rise resources. A dual GST will, therefore, be in keeping with the Constitutional requirement of fiscal federalism. Hence, Centre will levy and administer CGST & IGST while respective states will levy and administer SGST. The Constitution of India has been amended for this purpose.



Characteristics of Goods and Services Tax

1. GST is a common law and procedure throughout the country under single administration.
2. GST is a destination based tax and levied at a single point at the time of consumption of goods and services by the end consumer.
3. GST is a comprehensive levy and collection on both goods and services at the same rate with benefit of input tax credit or subtraction of value.
4. Minimum number of rates of tax does not exceed two.
5. There is no scope for levy of cess, resale tax, additional tax, turnover tax etc.
6. There is no multiple levy of tax on goods and services, such as sales tax, entry tax, octroi, entertainment tax or luxury tax etc.

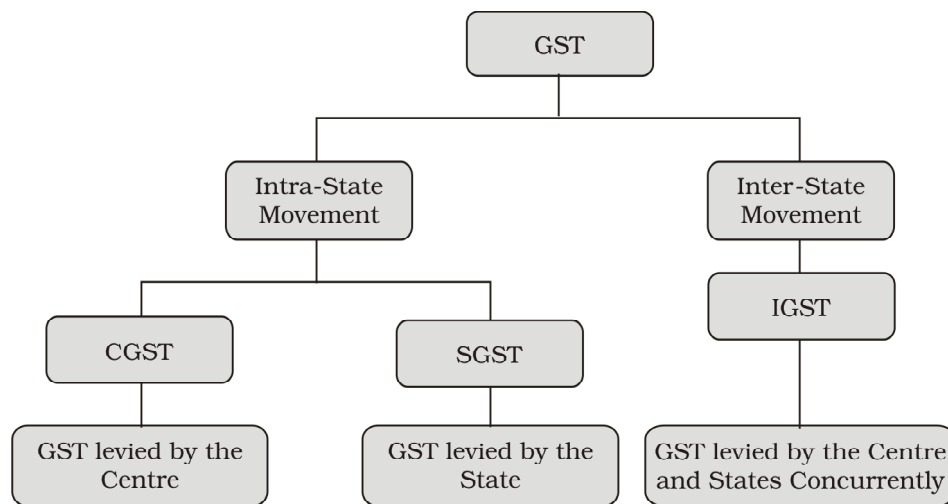
Do it yourself

State how the GST rates will be applicable if CGST is 9%, SGST is 9% and IGST 18% in each of the following situations:

1. Goods worth Rs. 10,000 is sold by a Manufacturer 1 in Maharashtra to a Dealer A in Maharashtra.
2. Dealer A sell goods worth Rs. 25,000 to Dealer B in Gujarat.
3. Dealer B sell goods to Sunita in Gujarat worth Rs. 30,000.
4. Sunita sell goods to Ravindra in Rajasthan worth Rs. 65,000.

Advantages

1. Introduction of GST has resulted in the abolition of multiple types of taxes in goods and services.
2. GST widens the tax base and increased revenue to Centre and State thereby reducing administrative cost for the Government.
3. GST has reduced compliance cost and increases voluntary compliance.
4. GST has affected rates of tax to the maximum of two floor rates.
5. GST has removed the cascading effect on taxation.
6. GST will result in enhancing manufacturing and distribution system affecting the cost of production of goods and services and consequently the demand and production of goods and services will increase.
7. It will eventually promote economic efficiency and sustainable long term economic growth as GST is neutral to business processes, business models, organisational structure and geographical location.
8. GST would help to extend competitive edge in international market for goods and services produced in the country leading to increased exports.



Test your Understanding-III

State the applicability of GST rate under given situation if:

1. Amrit Raj is a manufacturing unit for cotton trousers where customers give fabric to convert into trouser.
2. Dress materials are sold by length. They include up to 3 pieces. These can be plain or embroidered (can be further worked upon).
3. Old cotton *dhoti* is used for cleaning purpose. It is a used product recycled for cleaning purpose. There was no VAT applicable on old *dhoti*.

Key Terms Introduced in the Chapter

- Cost
- Matching
- Materiality
- Objectivity
- Consistency
- Dual aspect
- Conservatism (Prudence)
- Going concern
- Comparability
- Full disclosure
- Generally accepted
- Revenue Recognition
- Operating guidelines
- Accounting period
- Money measurement
- Accounting concept
- Accounting Principles (GAAP)
- GAAP
- GST

Summary with Reference to Learning Objectives

1. *Generally Accepted Accounting Principles (GAAP)* : Generally Accepted Accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financial statements. These principles are also referred to as concepts and conventions. From the practicality view point, 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 book.
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 of accounting activities.
3. *Business Entity* : This concept assumes that business has distinct and separate entity from its owners. Thus, for the purpose of accounting, business and its owners are to be treated as two separate entities.
4. *Money Measurement* : The concept of money measurement states that only those transactions and happenings in an organisation, which can be expressed in terms of money are to be recorded in the book of accounts. Also, the records of the transactions are to be kept not in the physical units but in the monetary units.
5. *Going Concern* : The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely (for a fairly long period of time) and would not be liquidated in the near future.
6. *Accounting Period* : 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.
7. *Cost Concept* : The cost concept requires that all assets are recorded in the book of accounts at their cost price, which includes cost of acquisition, transportation, installation and making the asset ready for the use.
8. *Dual Aspect* : This concept states that every transaction has a dual or two-fold effect on various accounts and should therefore be recorded at two places. The duality principle is commonly expressed in terms of fundamental accounting equation, which is :

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

9. *Revenue Recognition* : Revenue is the gross in-flow of cash arising from the sale of goods and services by an enterprise and use by others of the enterprise resources yielding interest royalties and dividends. The concept of revenue recognition requires that the revenue for a business transaction should be considered realised when a legal right to receive it arises.

10. *Matching* : The concept of matching emphasises 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 revenue must belong to the same accounting period.
11. *Full Disclosure* : This concept 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.
12. *Consistency* : This concepts states that accounting policies and practices followed by enterprises should be uniform and consistent one the period of time so that results are composable. Comparability results when the same accounting principles are consistently being applied by different enterprises for the period under comparison, or the same firm for a number of periods.
13. *Conservatism* : This concept requires that business transactions should be recorded in such a manner that profits are not overstated. All anticipated losses should be accounted for but all unrealised gains should be ignored.
14. *Materiality* : This concept states that accounting should focus on material facts. If the item is likely to influence the decision of a reasonably prudent investor or creditor, it should be regarded as material, and shown in the financial statements.
15. *Objectivity* : According to this concept, accounting transactions should be recorded in the manner so that it is free from the bias of accountants and others.
16. *Systems of Accounting* : There are two systems of recording business transactions, viz. double entry system and single entry system. Under double entry system every transaction has two-fold effects where as single entry system is known as incomplete records.
17. *Basis of Accounting* : The two broad approach of accounting are cash basis and accrual basis. Under cash basis transactions are recorded only when cash are received or paid. Whereas under accrual basis, revenues or costs are recognises when they occur rather than when they are paid.
18. *Accounting Standards* : Accounting standards are written statements of uniform accounting rules and guidelines in practice for preparing the uniform and consistent financial statements. These standards cannot over ride the provisions of applicable laws, customs, usages and business environment in the country.
19. *GST* is a destination tax on the consumption of goods and services levied at all stages right from manufacturing up to the final consumption with credit of taxes paid at previous stages.

Questions for Practice

Short Answers

1. Why is it necessary for accountants to assume that business entity will remain a going concern?
2. When should revenue be recognised? Are there exceptions to the general rule?
3. What is the basic accounting equation?
4. The realisation concept determines when goods sent on credit to customers are to be included in the sales figure for the purpose of computing the profit or loss for the accounting period. Which of the following tends to be used in practice to determine

when to include a transaction in the sales figure for the period. When the goods have been:

- a. dispatched b. invoiced c. delivered d. paid for

Give reasons for your answer.

5. Complete the following work sheet:
 - (i) If a firm believes that some of its debtors may 'default', it should act on this by making sure that all possible losses are recorded in the books. This is an example of the _____ concept.
 - (ii) The fact that a business is separate and distinguishable from its owner is best exemplified by the _____ concept.
 - (iii) Everything a firm owns, it also owns out to somebody. This co-incidence is explained by the _____ concept.
 - (iv) The _____ concept states that if straight line method of depreciation is used in one year, then it should also be used in the next year.
 - (v) A firm may hold stock which is heavily in demand. Consequently, the market value of this stock may be increased. Normal accounting procedure is to ignore this because of the _____.
 - (vi) If a firm receives an order for goods, it would not be included in the sales figure owing to the _____.
 - (vii) The management of a firm is remarkably incompetent, but the firms accountants can not take this into account while preparing book of accounts because of _____ concept.

Long Answers

1. 'The accounting concepts and accounting standards are generally referred to as the essence of financial accounting'. Comment.
2. Why is it important to adopt a consistent basis for the preparation of financial statements? Explain.
3. Discuss the concept-based on the premise 'do not anticipate profits but provide for all losses'.
4. What is matching concept? Why should a business concern follow this concept? Discuss.
5. What is the money measurement concept? Which one factor can make it difficult to compare the monetary values of one year with the monetary values of another year?

Project Work

Activity 1

Ruchica's father is the sole proprietor of 'Friends Gifts', a firm engaged in the sale of gift items. In the process of preparing financial statements, the accountant of the firm Mr. Goyal fell ill and had to proceed on leave. Ruchica's father was urgently in need of the statements as these had to be submitted to the bank, in pursuance of a loan of Rs. 5 lakh applied for the expansion of the business of the firm. Ruchica who is studying Accounting in her school, volunteered to complete the work. On scrutinising the accounts, the banker found that the value of building bought a few years back for Rs. 7 lakh has been shown in the books at Rs. 20 lakh, which is its present market value. Similarly, as compared to the last year, the method of valuation of stock was changed, resulting in value of goods to be

about 15 per cent higher. Also, the whole amount of Rs. 70,000 spent on purchase of personal computer (expected life 5 years) during the year had been charged to the profits of the current year. The banker did not rely on the financial data provided by Ruchica. Advise Ruchica for the mistakes committed by her in the preparation of financial statements in the context of basic concepts in accounting.

Activity 2

A customer has filed a suit against a trader who has supplied poor quality goods to him. It is known that the court judgment will be in favour of the customer and the trader will be required to pay the damages. However, the amount of legal damages is not known with certainty. The accounting year has already been ended and the books are now finalised to ascertain true profit or loss. The accountant of the trader has advised him not to consider the expected loss on account of payment of legal damages because the amount is not certain and the final judgment of the court is not yet out. Do you think the accountant is right in his approach.

Checklist to Test Your Understanding

Test Your Understanding - I

1. (c)
2. (d)
3. (a)
4. (b)

Test Your Understanding - II

1. Matching
2. Conservatism
3. Revenue Realisation
4. Consistency
5. Objectivity

Test Your Understanding - III

1. 18%
2. Dress material sale value net exceeded Rs. 100 @ 5% and exceeding Rs. 1,000 @ 12%
3. 5%