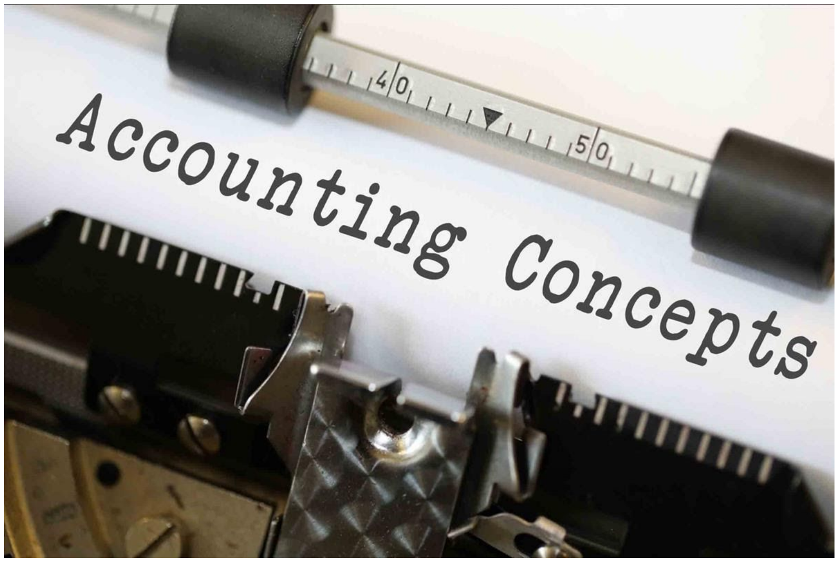
Basic Accounting Concepts

Accounting is both a science and an art. And just like all other streams of science, even in accounting certain rules are followed. Also, accounting is based on certain assumptions as well. We call these the accounting concepts. Let us study them in brief.

Accounting Concepts

Accounting both practical and theory-based is built on some accounting principles. And these accounting principles are built on a few assumptions that we call accounting concepts. These thirteen accounting concepts find wide acceptance across the world by accounting professionals and auditors.



1] Business Entity Concept

This accounting concept separates the business from its owner. As far as accounting is concerned the owner and the business are two separate entities. This will help the accountant identify the business transactions from the personal ones. All forms of business organizations (proprietorship, partnership, company, AOP, etc) must follow this assumption.

So for example, if the owner brings in additional capital into the business, we will treat this as a liability on the balance sheet of the business.

2] Money Measurement Concept

This accounting concept states that only financial transactions will find a place in accounting. So only those business activities that can be expressed in monetary terms will be recorded in accounting. Any other transaction, no matter how significant, will not find a place in the financial accounts.

So for example, if the company underwent a major management overhaul this would have no effect on the accounting records. This concept is actually one of the major drawbacks of accounting.

Do you know Accounting Standards, GAAP and IFRS ?

3] Going Concern Concept

The going concern concept assumes that a business will continue to operate indefinitely. So it assumes that for the foreseeable future the business will not be winding up. This leads to the assumption that the business will not have to sell its assets any time soon and it will meet all its obligations as well.

So it justifies the financial statements as a part of a continuous series of statements. The current statements are tentative and only reflect the financial position of that particular period of time.

4] Accounting Period Concept

Every organization, according to its needs, chooses a specific period of time to complete an accounting cycle. Generally, the time chosen is a year we call the accounting year. The time period is mentioned in the financial statements.

So the indefinite life of an organization is divided into shorter, generally equal time period. This facilitates a comparison of performances and allows stakeholders to get timely information. Also in most cases, it is also a statutory requirement.

5] Cost Concept

This accounting concept states that all assets of the firm are entered into the books of account at their purchase price (cost of acquisition + transport + installation etc). In the subsequent years to, the price remains the same (minus depreciation charged). The market price of the asset is not taken into consideration.

Browse more Topics Under Theory Base Of Accounting

- Basic Accounting Concepts
- Systems and Basis of Accounting
- Accounting Standards, GAAP and IFRS

- Classification of Accounting

6] Dual Aspect Concept

This concept is the basic principle of accounting, it is the heart and soul. It basically is one of the golden rules of accounting – for every credit, there must be a corresponding debit. So every transaction we record must have a two-fold effect, i.e. it will be recorded in two places. This is the core concept of the double-entry system of accounting.

So let us see an example of this in action. Say the business buys an asset worth Rs 10,000/-. So now the Fixed Assets of the company will increase bt 10,000/-. But at the same time, the bank or cash balance will reduce by 10,000/-. And so the transaction will have a dual effect in accounting. And also the Balance Sheet will stay balanced.

7] Realisation Concept

According to the realization accounting concept, revenue is only recognized when it is realized. Now revenue is the cash inflow for a business arising from the sale of goods or services. And we assume this revenue as realized only when it legally arises to be received. So in simpler terms, the profit earned will be recorded when it is actually earned.

What is Systems and Basis of Accounting?

8] Matching Concept

This concept states that the revenue and the expenses of a transaction should be included in the same accounting period. So to determine the income of a period all the revenues and expenses (whether paid or not) must be included.

The matching accounting concept follows the realization concept. First, the revenue is recognized and then we match the costs associated with the revenue. So costs are matched with revenue, the reverse would be an incorrect system.

9] Full Disclosure Concept

This concept states that all relevant information will be disclosed in the accounting statements. A lot of external users depend on these financial statements for their information to make investing decisions. So no information/transactions etc of relevance to anyone of them will be omitted from these statements for the benefit of the company.

10] Consistency Concept

Once the company decides on a certain accounting policy it should not be frequently changed. Unless there is a statutory requirement or it allows better representation of the accounts accounting policies should be consistent for long periods of time. This allows users to make inter-firm and inter-period comparisons. Also, frequent changes in policies may be to manipulate the accounts and this must be prevented.

11] Conservatism Concept

This accounting concept promotes prudence in accounting. It states that profit should not be included until it is realized. However, losses even those not realized but with the remote possibility of occurring should be included in the financial statements. So all losses are recognized – those that have occurred or are even likely to occur. But only realized profits are recognized.

12] Materiality Concept

Materiality states that all material facts must be a part of the accounting process. But immaterial facts, i.e. insignificant information should be left out. The materiality of a transaction will depend on its nature, value and its significance to the external user. If the information can affect a person's investing decision then it is definitely a material fact.

13] Objectivity Concept

Finally, we come to the last accounting concept – objectivity. This concept states the obvious assumption that the accounting transaction recorded should be objective, i.e. free from any bias of the person recording it. So each transaction should be verifiable by supporting documents like vouchers, bills, letters, challans, certificates, invoices etc.

Solved Question for You

Q: According to__________ accounting concepts, while preparing accounts we anticipate losses.

a. Materiality
b. Objectivity
c. Conservatism
d. None of the above

Ans: The correct option is C. Conservatism is the policy of anticipating future losses but not recognizing future gains.

Systems and Basis of Accounting

Accounting is not as one dimensional as it sometimes seems to people. It also has a few systems and types, which allows the accountant to choose the system most suitable for his organization. Here we will look at two systems of accounting – single entry and double entry. And we will also learn about the two bases of accounting – cash basis and accrual basis.

Systems of Accounting

Systems of accounting refer to the two systems of recording the financial transactions in the books of accounts. These two systems are the single entry system and the double or dual entry system. Let us learn about both in brief.

Single Entry System

This system is also known as pure entry system. It does not follow the traditional dual recording format. Instead, in a single entry system, only a Cash Book will be maintained. All cash transactions will be recorded in the Cash Book. No other Ledgers find a place in this system. All transactions of personal nature are simply recorded in a rough book.

As you can notice, this method is not very scientific. So it is rarely used in the modern days. We use the single entry system only to prepare final accounts from records that are incomplete for some reason. Some other salient features of the single entry system are,

- Since only one cash book is kept, personal and business transactions will be recorded together
- Real and Nominal accounts will be ignored by this system
- Profit or Loss can be ascertained but we cannot represent the financial position of the organization
- No trial balance is prepared, so arithmetical accuracy of accounts cannot be verified

Double Entry System

This is the more traditional and conventional system for recording transactions in financial accounting. This is a scientific method which has some rules and principles which must be followed. The basic essence of the double entry system is that every transaction will affect two accounts. This is known as the debit and credit rule – every credit entry, there must be a corresponding debit entry.

The double entry system is the one widely used and recognized in the accounting world. Some salient features of this system are,

- All three types of accounts are maintained in this system – real, nominal and personal
- The arithmetic accuracy of the financial records are verified by preparing the trial balance
- The system does not have many modifications.
- It allows for the preparation of the balance sheet which will reflect the financial position of the organization
- Easy to detect frauds and errors in this double entry system

Basis of Accounting

This deals with the timing of the revenue recognition, i.e. when should the revenue be recognized in the books of accounts. There are two approaches to this dilemma – cash basis of accounting and accrual basis of accounting. Let us take a brief look at both.

Cash Basis of Accounting

This is the simpler, uncomplicated approach. Under the cash system of accounting an income will only be recorded when it comes in. So an income will be earned when it is received in cash by the organization. And similarly, the expenses will also be recorded only when they are actually made.

So take for example the organization pays the salary of its employees for the month of June on the 3rd of July. This salary expense will thus be recorded in July, although the expense is for the period of June. Similarly, say the organization made a credit sale on 5th August. They received the payment on 11th October, so this sale will be recorded on this date.

Accrual Basis of Accounting

Accrual basis is the more logical and scientific approach to accounting. This is the method most organizations chose to adopt, as it gives a more fair representation of the financial position of the company.

In the accrual system, the revenues and expenses are recognized in the time period in which they occur, not when the money actually comes in. So the income will be recorded if it is earned irrespective of whether the payment has come in or not. And the expense is recorded when it becomes due, irrespective of whether it has been paid.

So in accrual system, all incomes and expenses – cash items and non-cash items (like prepaid/outstanding expenses and accrued/advance income) will be taken into account. And the final accounts will be a true representation of the organization's financial position.

Solved Example for You

Q: State the differences between single entry and dual entry systems.

Ans:

Single Entry System	Double Entry System

It is fairly simple and uncomplicated in nature.	It is a more scientific and complex approach to accounting.
It is an incomplete recording of transactions	It is a complete record of the transactions
In this system, it is difficult to identify errors and possible frauds	Much easier to spot errors or detect fraud under this system.
Only two types of accounts are kept – personal and cash	All three types of accounts have to be maintained – Personal, Nominal and Real
This system is not suitable for tax purposes	System allows for easy determination of taxes
Does not allow for an ascertainment of the financial position of the organization at the end of the accounting period.	By using this system the financial position of the organization can be determined with accuracy

Accounting Standards, GAAP and IFRS

To keep uniformity and consistency in the accounts some rules and regulations have to be followed. We call these principles of accounting. Every accounting body has their own such rules, standards, principles etc. These are regarded and accepted by the accounting professionals. Here we will look at a few such principles – AS, GAAP and IFRS.

Generally Accepted Accounting Principles (GAAP)

GAAP stands for Generally Accepted Accounting Principles. These are some commonly followed practices of accounting that have found some level of global acceptance. These accounting principles specify certain definitions, the accounting treatment for confusing entries, and even some industry-specific rules and procedures.

The purpose of GAAP is to ensure some basic level of consistency in accounting statement of all different organizations. It enables external users of the financial statements to easily decipher and understand the accounts of a company. GAAP will also allow intra-firm and inter-firm comparisons, which help these users take investment decisions.

Another purpose of imposing GAAP is to ensure that the representation of the financial statement is true and fair. These principles will ensure that the management is not manipulating accounts to suit their purposes. If GAAP rules are being religiously followed then there is a certain level of certainty in the fairness of the financial statements.

However, there are no universal code or accounting standards. GAAP is not universal. The details and specifications of GAAP will vary according to different geographic locations, industries, accounting body etc. Like for example, in USA GAAP rules have been modified by the Financial Accounting Standards Board (FASB). Accordingly many countries and accounting bodies modify the GAAP rules to suit their industries and economies.

Accounting Standards (AS)

Accounting standards are the rules, regulations, directives etc that are issued by accounting and governing bodies of the world. The intention is to make sure all companies and organizations follow the same rules for accounting and have the same format for their financial statements.

These accounting standards are implemented in the whole country. So this means the entire national economy can implement the same standards and can adopt similar accounting terminology. So all organizations and business units have a uniform, precise and correct financial statements and records.

Indian Accounting Standards (IAS) are issued by the Institute Of Chartered Accountants of India (ICAI). These Accounting Standards are named as well as numbered similarly to the IFRS. They are based on and adapted from the GAAP with modifications necessary for the Indian economy.

These standards deal with conflicting accounting issues, detailing the accounting treatment, rules, and directives. They are detailed and informative to avoid any confusion or uncertainty. In total there are some 32 Indian Accounting Standards. Let us take a look at some of the important ones.

AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements

AS 7	Construction Accounting
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 15	Employee Benefits
AS 20	Earnings per Share
AS 26	Intangible Assets
AS 28	Impairment of Assets

International Financial Reporting Standards (IFRS)

IFRS

International Financial Reporting Standards

The name in itself is pretty self-explanatory. The IFRS is an international framework for accounting records and financial statements. These are developed by the independent accounting body based out of London known as the International Accounting Standards Boards (IASB).

As we know many countries around the world follow their own versions of the GAAP. The USA, Canada, Australia, UK all have their own GAAPs. India has the Indian Accounting Standards. There is a clear lack of uniformity. Also, it poses a problem for Multi-National Companies having branches in many countries. Hence the IFRS was developed, so all nations could adopt one global accounting standard.

Currently around 120 countries globally have started following the IFRS. Soon many more are to follow. As a result, all companies across the world will report their accounts and financial statements following the same rules and regulations. This will lead to uniformity, ease of comparison, less confusion and better compatibility among nations. It is hoped that eventually, all countries of the world (including the USA) will merge with the IFRS.

However, this will not be an easy process. The efforts to converge US GAAP and the IFRS have been ongoing since 2002 but has had limited success. Currently, this convergence process is on hold. In reality, we may never see a full convergence. But instead, all accounting board around the world are working towards reducing the points of difference with their GAAP and the IFRS. Even today the EU country has adopted almost all of the IFRS rules and the US GAAP is also on its way to do the same.

Currently, India has not yet adopted the IFRS for its domestic or international companies. However, keeping with the global trends this is soon on the cards in the future.

Solved Example for You

Q: Accounts must be honestly prepared & they must disclose all material information is know as ____________.

a. Disclosure Concept
b. Entity Concept
c. Materiality Concept
d. None of the above

Ans: The correct option is A. The full disclosure principle states that you should include in the financial statements all information required that would affect a users understanding of such statements.

Classification of Accounting

We can classify the financial accounts under two types of accounts, one is the Traditional Approach and another one is the Modern Approach. Let us deal here with the traditional approach.

Classification and Types of Accounts

We record business transactions in accounts. Thus, an account is an individual and a formal record of a person, firm, company, asset, liability, goods, incomes and expenses. We need to prepare one account for each type of asset, liability, income or expense.

Hence, we record all the transactions related to a particular item in its account. For example, all-cash transactions whether receipts or payments will be recorded in the Cash A/c. After this, we will calculate the balance of Cash A/c.

However, here the classification of accounts is important. We can classify the accounts as per the traditional classification under the following heads:

I. Personal Accounts

We further classify these as:

1. Natural Personal Accounts
2. Artificial Personal Accounts
3. Representative Personal Accounts

Let us study these accounts in detail.

1. Natural Personal Accounts: Natural Persons are human beings. Therefore, we include the accounts belonging to them under this head. For instance, Debtors, Creditors, Capital A/c, Drawings A/c, etc.
2. Artificial Personal Accounts: Artificial persons are not human beings but can act and work like humans. They have a separate identity in the eyes of law and are capable to enter into agreements. These include H.U.F, partnership firms, insurance companies, co-operative societies, companies, municipal

corporations, hospitals, banks, government bodies, etc. For example, Bank of Baroda, Oriental Insurance Co,

3. Representative Personal Accounts: These accounts represent the accounts of natural or artificial persons. When the expenses become outstanding or pre-paid and incomes become accrued or unearned, they fall under this category. For example, Outstanding Salary A/c, Pre-paid Rent A/c, Accrued Interest A/c, Unearned Brokerage A/c, etc.

Accounting as an Information System

II. Impersonal Accounts

Impersonal Accounts are further classified as:

1. Real Accounts
2. Nominal Accounts

Let us now understand these accounts in detail.

1. Real Accounts: These are the accounts of all the assets and liabilities of the organization. We do not close these accounts at the end of the accounting year and appear in the Balance Sheet. Thus, we carry forward the balances of these accounts to the

next accounting year. Therefore, we can also say that these are permanent accounts. We can further classify these into:

2. Tangible Real Account: It consists of assets, properties or possessions that can be touched, seen and measured. For example, Plant A/c, Furniture and Fixtures A/c, Cash A/c, etc.
3. Intangible Real Account: It consists of assets or possessions that cannot be touched, seen and measured but possess a monetary value and thus can be purchased and sold also. For example, Goodwill, Patents, Copyrights, etc.
4. Nominal Accounts: Nominal Accounts are the accounts relating to the expenses, losses, incomes, and gains. These are temporary accounts and thus we need to transfer their balances to Trading and Profit and Loss A/c at the end of the accounting year. Therefore, these accounts have no balance to be carried forward next year as they are closed.

Rules for Debit and Credit for all types of accounts:

Personal Account:

Debit the Receiver

Credit the Giver

Real Account:

Debit what comes in

Credit what goes out

Nominal Account:

Debit all expenses and losses

Credit all incomes and gains

Representative Personal Account:

Debit the Debtor

Credit the Creditor

Merits and Demerits of Accounting

Solved Example on Types of Accounts

Analyze the following transactions and state the types of accounts that need to be debited and credited.

1. Suryani commenced business with cash ₹ 1, 00,000.
2. Purchased machinery for cash ₹ 10,000
3. Purchased goods from Romil on credit ₹ 50,000
4. Sold goods for cash ₹ 10000
5. Paid wages to Jaimin ₹ 15,000
6. Paid to Romil ₹ 25000
7. Wages to be paid to Raj is outstanding ₹ 5000
8. Brokerage earned but not received ₹ 2000
9. Deposited ₹ 15000 into the bank.
10. Suryani withdrew cash for personal use ₹ 10000

Ans:

Analysis of transactions

Transaction	Accounts	Nature of Accounts	Reason for Effect on Accounts	Debited or Credited

1.	Cash A/c Capital A/c	Real A/c Personal A/c	Cash is coming in Suryani is the giver	Debit Credit
2.	Machinery A/c Cash A/c	Real A/c Real A/c	Machinery is coming in Cash is going out	Debit Credit
3.	Purchases A/c Romil's A/c	Real A/c Personal A/c	Goods are coming in Romil is the giver	Debit Credit
4.	Cash A/c Sales A/c	Real A/c Real A/c	Cash is coming in Goods are going out	Debit Credit
5.	Wages A/c Cash A/c	Nominal A/c Real A/c	Wages are an expense Cash is going out	Debit Credit
6.	Romil's A/c Cash A/c	Personal A/c Real A/c	Romil is the receiver Cash is going out	Debit Credit
7.	Wages A/c Wages Outstanding A/c	Nominal A/c Representative Personal A/c	Wages is an expense Wages is payable to Raj and thus he is our creditor.	Debit Credit

8.	Accrued Brokerage A/c Brokerage A/c	Representative Personal A/c Nominal A/c	Brokerage is receivable from the client, so the client is our debtor Brokerage is an income	Debit Credit
9.	Bank A/c Cash A/c	Personal A/c Real A/c	The bank is receiving the amount Cash is going out	Debit Credit
10.	Drawings A/c Cash A/c	Personal A/c Real A/c	Suryani is the receiver Cash is going out	Debit Credit