2

ACCOUNTING CONCEPTS

In the previous lesson, you have studied the meaning and nature of business transactions and objectives of financial accounting. In order to maintain uniformity and consistency in preparing and maintaining books of accounts, certain rules or principles have been evolved. These rules/principles are classified as concepts and conventions. These are foundations of preparing and maintaining accounting records. In this lesson we shall learn about various accounting concepts, their meaning and significance.

OBJECTIVES

After studying this lesson, you will be able to :

- explain the term accounting concept;
- explain the meaning and significance of various accounting concepts : Business Entity, Money Measurement, Going Concern, Accounting Period, Cost Concept, Duality Aspect concept, Realisation Concept, Accrual Concept and Matching Concept.

2.1 MEANING AND BUSINESS ENTITY CONCEPT

Let us take an example. In India there is a basic rule to be followed by everyone that one should walk or drive on his/her left hand side of the road. It helps in the smooth flow of traffic. Similarly, there are certain rules that an accountant should follow while recording business transactions and preparing accounts. These may be termed as accounting concept. Thus, this can be said that :

Accounting concept refers to the basic assumptions and rules and principles which work as the basis of recording of business transactions and preparing accounts.

The main objective is to maintain uniformity and consistency in accounting records. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus they are universally accepted rules. Following are the various accounting concepts that have been discussed in the following sections :

- Business entity concept
- Money measurement concept
- Going concern concept
- Accounting period concept
- Accounting cost concept
- Duality aspect concept
- Realisation concept
- Accrual concept
- Matching concept

Business entity concept

This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense. Thus, the accounting records are made in the books of accounts from the point of view of the business unit and not the person owning the business. This concept is the very basis of accounting.

Let us take an example. Suppose Mr. Sahoo started business investing Rs100000. He purchased goods for Rs40000, Furniture for Rs20000 and plant and machinery of Rs30000. Rs10000 remains in hand. These are the assets of the business and not of the owner. According to the business entity concept Rs100000 will be treated by business as capital i.e. a liability of business towards the owner of the business.

Now suppose, he takes away Rs5000 cash or goods worth Rs5000 for his domestic purposes. This withdrawal of cash/goods by the owner from the business is his private expense and not an expense of the business. It is termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct persons. Accordingly, any expenses incurred by owner for himself or his family from business will be considered as expenses and it will be shown as drawings.

Significance

The following points highlight the significance of business entity concept :

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- This concept restraints accountants from recording of owner's private/ personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view
- It is the very basis of accounting concepts, conventions and principles.

INTEXT QUESTIONS 2.1

Fill in the blanks with suitable word/words

(i) The accounting concepts are basic .... of accounting.

(ii) The main objective of accounting concepts is to maintain .... and .... in the accounting record.

(iii) .... concept assumes that business enterprise and its owners are two separate independent entities.

(iv) The goods drawn from business for owner's personal use are called ....

2.2 MONEY MEASUREMENT CONCEPT

This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees.

Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts. For example, sale of goods worth Rs.200000, purchase of raw materials

Rs.100000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts. For example, sincerity, loyality, honesty of employees are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Another aspect of this concept is that the records of the transactions are to be kept not in the physical units but in the monetary unit. For example, at the end of the year 2006, an organisation may have a factory on a piece of land measuring 10 acres, office building containing 50 rooms, 50 personal computers, 50 office chairs and tables, 100 kg of raw materials etc. These are expressed in different units. But for accounting purposes they are to be recorded in money terms i.e. in rupees. In this case, the cost of factory land may be say Rs.12 crore, office building of Rs.10 crore, computers Rs.10 lakhs, office chairs and tables Rs.2 lakhs, raw material Rs.30 lakhs. Thus, the total assets of the organisation are valued at Rs.22 crore and Rs.42 lakhs. Therefore, the transactions which can be expressed in terms of money is recorded in the accounts books, that too in terms of money and not in terms of the quantity.

Significance

The following points highlight the significance of money measurement concept :

- This concept guides accountants what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

INTEXT QUESTIONS 2.2

Put a tick mark (√) against the information that should be recorded in the books of accounts and cross mark (×) against the information that should not be recorded

(i) Health of a managing director

(ii) Purchase of factory building Rs.10 crore

(iii) Rent paid Rs.100000

(iv) Goods worth Rs.10000 given as charity

(v) Delay in supply of raw materials

2.3 GOING CONCERN CONCEPT

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet; For example, a company purchases a plant and machinery of Rs.100000 and its life span is 10 years. According to this concept every year some amount will be shown as expenses and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it will not be proper to charge the amount from the revenues of the year in which the item is acquired. Only a part of the value is shown as expense in the year of purchase and the remaining balance is shown as an asset.

Significance

The following points highlight the significance of going concern concept;

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the fixed asset.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- A business is judged for its capacity to earn profits in future.

INTEXT QUESTIONS 2.3

Fill in the blanks by selecting correct words given in the bracket/brackets:

(i) Going concern concept states that every business firm will continue to carry on its activities …………….. (for a definite time period, for an indefinite time period)

(ii) Fixed assets are shown in the books at their …………….. (cost price, market price)

(iii) The concept that a business enterprise will not be closed down in the near future is known as …………….. (going concern concept, money measurement concept)

(iv) On the basis of going concern concept, a business prepares its .... (financial statements, bank statement, cash statement)

(v) .... concept states that business will not be dissolved in near future. (Going concern, Business entity)

2.4 ACCOUNTING PERIOD CONCEPT

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.

Further, this concept assumes that, indefinite life of business is divided into parts. These parts are known as Accounting Period. It may be of one year, six months, three months, one month, etc. But usually one year is taken as one accounting period which may be a calender year or a financial year.

Year that begins from 1^{st} of January and ends on 31^{st} of December, is known as Calendar Year. The year that begins from 1^{st} of April and ends on 31^{st} of March of the following year, is known as financial year.

As per accounting period concept, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent, salaries etc. paid for the period are accounted for and against that period only.

Significance

- It helps in predicting the future prospects of the business.
- It helps in calculating tax on business income calculated for a particular time period.
- It also helps banks, financial institutions, creditors, etc to assess and analyse the performance of business for a particular period.
- It also helps the business firms to distribute their income at regular intervals as dividends.

INTEXT QUESTIONS 2.4

Fill in the blanks with suitable word/words.

(i) Recording of transactions in the books of accounts with a definite period is called ………………. concept.

(ii) The commonly accepted accounting period in India is ……………….

(iii) According to accounting period concept, revenue and expenses are related to a ………………. period.

(iv) If accounting year begins from 1st of January, and ends on 31st of December, it is known as ……………….

(v) If accounting year begins from 1st of April and ends on 31st of March, then accounting year is known as ……………….

2.5 ACCOUNTING COST CONCEPT

Accounting cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them. For example, a machine was purchased by XYZ Limited for Rs.500000, for manufacturing shoes. An amount of Rs.1,000 were spent on transporting the machine to the factory site. In addition, Rs.2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e. Rs.503000. This cost is also known as historical cost. Suppose the market price of the same is now Rs 90000 it will not be shown at this value. Further, it may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The cost concept is also known as historical cost concept. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price.

Significance

- This concept requires asset to be shown at the price it has been acquired, which can be verified from the supporting documents.
- It helps in calculating depreciation on fixed assets.
- The effect of cost concept is that if the business entity does not pay anything for an asset, this item will not be shown in the books of accounts.

Notes

INTEXT QUESTIONS 2.5

Fill in the blanks with suitable word/words

(i) The cost concept states that all fixed assets are recorded in the books of accounts at their ………… price.

(ii) The main objective to adopt historical cost in recording the fixed assets is that the cost of the assets will be easily verifiable from the ………… documents.

(iii) The cost concept does not show the ………… of the business.

(iv) The cost concept is otherwise known as ………… concept.

2.6 DUAL ASPECT CONCEPT

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded.

Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :

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

The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. This claim is also termed as capital or owners equity and that of outsiders, as liabilities or creditors' equity.

The knowledge of dual aspect helps in identifying the two aspects of a transaction which helps in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

Let us analyse some more business transactions in terms of their dual aspect :

1. Capital brought in by the owner of the business

   The two aspects in this transaction are :

   (i) Receipt of cash

   (ii) Increase in Capital (owners equity)

2. Purchase of machinery by cheque

   The two aspects in the transaction are

   (i) Reduction in Bank Balance

   (ii) Owning of Machinery

3. Goods sold for cash

   The two aspects are

   (i) Receipt of cash

   (ii) Delivery of goods to the customer

4. Rent paid in cash to the landlord

   The two aspects are

   (i) Payment of cash

   (ii) Rent (Expenses incurred).

Once the two aspects of a transaction are known, it becomes easy to apply the rules of accounting and maintain the records in the books of accounts properly.

The interpretation of the Dual aspect concept is that every transaction has an equal effect on assets and liabilities in such a way that total assets are always equal to total liabilities of the business.

Significance

- This concept helps accountant in detecting error.
- It encourages the accountant to post each entry in opposite sides of two affected accounts.

INTEXT QUESTIONS 2.6

Write the two aspects (effects) of the following transactions.

S.No.	Transaction	Ist aspect	IInd aspect
(i)	Owner brings cash in business		
(ii)	Goods purchased for cash		
(iii)	Goods sold for cash		
(iv)	Furniture purchased for cash		
(v)	Received cash from Sharma		
(vi)	Purchased machine from Rama on credit		
(vii)	Paid to Ram		
(viii)	Salaries Paid		
(ix)	Rent Paid		
(x)	Rent Received		

2.7 REALISATION CONCEPT

This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not.

In other words, it can be said that :

> Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.

Let us study the following examples :

(i) N.P. Jeweller received an order to supply gold ornaments worth Rs.500000. They supplied ornaments worth Rs.200000 up to the year ending 31^{st} December 2005 and rest of the ornaments were supplied in January 2006.

(ii) Bansal sold goods for Rs.1,00,000 for cash in 2006 and the goods have been delivered during the same year.

(iii) Akshay sold goods on credit for Rs.50,000 during the year ending 31^{st} December 2005. The goods have been delivered in 2005 but the payment was received in March 2006.

Now, let us analyse the above examples to ascertain the correct amount of revenue realised for the year ending 31^{st} December 2005.

(i) The revenue for the year 2005 for N.P. Jeweller is Rs.200000. Mere getting an order is not considered as revenue until the goods have been delivered.

(ii) The revenue for Bansal for year 2005 is Rs.1,00,000 as the goods have been delivered in the year 2005. Cash has also been received in the same year.

(iii) Akshay's revenue for the year 2005 is Rs.50,000, because the goods have been delivered to the customer in the year 2005. Revenue became due in the year 2005 itself. In the above examples, revenue is realised when the goods are delivered to the customers.

> The concept of realisation states that revenue is realized at the time when goods or services are actually delivered.

In short, the realisation occurs when the goods and services have been sold either for cash or on credit. It also refers to inflow of assets in the form of receivables.

Significance

- It helps in making the accounting information more objective.
- It provides that the transactions should be recorded only when goods are delivered to the buyer.

INTEXT QUESTIONS 2.7

Ascertain the amount of current revenue realized for the year ending 31^{st} December 2006

(i) An order, to supply goods for Rs.20,00,000 is received in the year 2006. The goods have been supplied only for Rs.10,00,000 in 2006.

(ii) What will be the revenue (i) if the payment of Rs.6,00,000 is received in cash in 2006 and the balance payment of Rs.4,00,000 received in 2007.

(iii) What will be the revenue if the goods have been sold on credit and the payment of Rs.1500000 is received in the year 2007, while all the goods of Rs.20,00,000 are supplied in the year 2006.

(iv) What will be the revenue if an advance payment of Rs.100,000 is received in the year 2006 and the balance received in the year 2007.

2.8 ACCRUAL CONCEPT

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses.

The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of the fact when the cash is received. For example, a firm sells goods for Rs 55000 on 25th March 2005 and the payment is not received until 10th April 2005, the amount is due and payable to the firm on the date of sale i.e. 25th March 2005. It must be included in the revenue for the year ending 31st March 2005. Similarly, expenses are recognised at the time services provided, irrespective of the fact when actual payment for these services are made. For example, if the firm received goods costing Rs.20000 on 29th March 2005 but the payment is made on 2nd April 2005 the accrual concept requires that expenses must be recorded for the year ending 31st March 2005 although no payment has been made until 31st March 2005 though the service has been received and the person to whom the payment should have been made is shown as creditor.

In brief, accrual concept requires that revenue is recognised when realised and expenses are recognised when they become due and payable without regard to the time of cash receipt or cash payment.

Significance

- It helps in knowing actual expenses and actual income during a particular time period.
- It helps in calculating the net profit of the business.

INTEXT QUESTIONS 2.8

Fill in the blanks with suitable word/words :

(i) Accrual concept relates to the determination of ....

(ii) Goods of Rs.50000 are sold on 25th March 2006 but payment is received on 10th April 2006. It will be a revenue for the year ending ....

(iii) Accrual concept requires revenue is recognised when .... and expenses are recognised when they become ....

2.9 MATCHING CONCEPT

The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept.

Let us study the following transactions of a business during the month of December, 2006

(i) Sale : cash Rs.2000 and credit Rs.1000

(ii) Salaries Paid Rs.350

(iii) Commission Paid Rs.150

(iv) Interest Received Rs.50

(v) Rent received Rs.140, out of which Rs.40 received for the year 2007

(vi) Carriage paid Rs.20

(vii) Postage Rs.30

(viii) Rent paid Rs.200, out of which Rs.50 belong to the year 2005

(ix) Goods purchased in the year for cash Rs.1500 and on credit Rs.500

(x) Depreciation on machine Rs.200

Let us record the above transactions under the heading of Expenses and Revenue.

Expenses		Amount Rs	Revenue		Amount Rs
1. Salaries		350	1. Sales		
2. Commission		150	Cash	2000	
3. Carriage		20	Credit	1000	3000
4. Postage		30	2. Interest received		50
5. Rent paid	200		3. Rent received	140	
Less for 2005	(50)	150	Less for 2007	(40)	100
6. Goods purchased					
Cash	1500				
Credit	500	2000			
7. Depreciation on machine		200			
Total		2900	Total		3150

In the above example expenses have been matched with revenue i.e (Revenue Rs.3150-Expenses Rs.2900) This comparison has resulted in profit of Rs.250. If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept.

Therefore, the matching concept implies that all revenues earned during an accounting year, whether received/not received during that year and all cost incurred, whether paid/not paid during the year should be taken into account while ascertaining profit or loss for that year.

Significance

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.
- It is very helpful for the investors/shareholders to know the exact amount of profit or loss of the business.

Notes

INTEXT QUESTIONS 2.9

Fill in the blanks with suitable word/words :

(i) Expenses are matched with ……...……. generated during a period.

(ii) Goods sold for cash is an example of ……...…….

(iii) Salaries paid is an example of ……...…….

(iv) Income is the excess of ……...……. over ……...…….

(v) ……...……. concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period

(vi) ……...……. concept states how the expenses should be compared with revenues for ascertaining exact profit or loss for a particular period

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WHAT YOU HAVE LEARNT

- Accounting concept refers to the basic assumptions which serve the basis of recording actual business transactions.
- The important accounting concepts are business entity, money measurement, going concern, accounting period, cost concept, duality aspect concept, realisation concept, accrual concept, and matching concept.
- Business entity concept assumes that for accounting purposes, the business enterprise and its owner(s) are two separate entities.
- Money measurement concept assumes that all business transactions must be recorded in the books of accounts in terms of money.
- Going concern concept states that a business firm will continue to carry on activities for an indefinite period of time.
- Accounting period concept states that all the business transactions are recorded in the books of accounts on the assumption that profits of transactions is to be ascertained for a specified time period.
- Accounting cost concept states that all assets are recorded in the books of accounts at their cost price.
- Dual aspect concept states that every transaction has a dual effect.

- Realisation concept states that revenue from any business transaction should be included in the accounting records only when it is realised
- Matching concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period

TERMINAL QUESTIONS

1. Explain meaning and significance of going concern concept.
2. What do you mean by business entity concept?
3. State meaning and significance of money measurement concept.
4. Write short notes on the following
   (a) Cost concept
   (b) Accrual concept
   (c) Matching concept
   (d) Accounting period concept
5. What do you mean by accounting concept? Explain any four accounting concepts.

ANSWERS TO INTEXT QUESTIONS

Intext Questions 2.1

(i) rules (ii) uniformity and consistency
(iii) Business entity concept (iv) drawings

Intext Question 2.2

(i) × (ii) √ (iii) √ (iv) √ (v) ×

Intext Question 2.3

(i) for an indefinite time period (ii) cost price
(iii) going concern concept (iv) financial statements
(v) Going concern

Intext Question 2.4

(i) accounting period (ii) one year
(iii) particular (iv) calender year
(v) financial year

Intext Question 2.5

(i) purchase
(ii) supporting
(iii) true net worth
(iv) historical cost

Intext Question 2.6

(i) Owner's capital, cash
(ii) Goods received, cash
(iii) Cash received, goods sold
(iv) Furniture, cash
(v) Cash, Sharma
(vi) Machine, Rama
(vii) Ram, cash
(viii) Salaries, cash
(ix) Rent, cash
(x) Cash, rent

Intext Question 2.7

(i) Rs.10,00,000
(ii) Rs.10,00000
(iii) Rs.20,00000
(iv) Rs.1,00,000

Intext Question 2.8

(i) income
(ii) 31st March, 2006
(iii) realised, due

Intext Question 2.9

(i) revenue
(ii) revenue
(iii) expense
(iv) revenue, expenses
(v) matching
(vi) matching

Activity

In our country business concerns are not following the same accounting period every year. Enquire from various sources and list various such periods prevailing in our country. One for example is given

1. Year ending 31st March (financial year)
2. ....
3. ....
4. ....
5. ....