Unit 2

CONCEPTUAL FRAMEWORK OF ACCOUNTING

Contents

Points to recall

The following points are to be recalled before learning conceptual framework of accounting:

- Meaning and definition of Accounting
- Functions of Accounting
- Users of Accounting
- Basic Accounting terminologies

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Learning Objectives

To enable the students to

- Understand the meaning, definition and features of book-keeping
- Evaluate the advantages and limitations of book-keeping
- Understand the accounting concepts and conventions
- Understand the meaning of and need for Accounting Standards

Key terms to know

- Book-keeping
- Accountancy
- Accounting concepts
- Accounting Standards

2.1 Book-keeping-An introduction

The first tstep in the accounting process is identifying and recording of transactions in the books of accounts. This is necessary for any business as the transactions happening in a business entity must be recorded so that the information is available for further analysis.

Book-keeping forms the base for the preparation of financial statements and interpretation which are the important functions of accounting. In a broad sense, accounting includes book-keeping also. In a small business, the entire accounting work may be performed by a single accountant. In a large firm, there may be a separate person or department for book-keeping work.

2.1.1 Meaning of book-keeping

Book-keeping is the process of recording financial transactions in the books of accounts. It is the primary stage in the accounting process. It includes recording the transactions and classifying the same under proper heads. Book-keeping work is of routine nature. Transactions may be recorded in the accounting note books and ledgers or may be recorded in a computer.

2.1.2 Definition of book-keeping

"Book-keeping is an art of recording business dealings in a set of books". - *J.R.Batliboi.*

"Book-keeping is the science and art of recording correctly in the books of account all those business transactions of money or money's worth". -*R.N.Carter*.

2.1.3 Features of book-keeping

Following are the features of book-keeping:

(i) It is the process of recording transactions in the books of accounts.
(ii) Monetary transactions only are recorded in the accounts.
(iii) Book-keeping is the primary stage in the accounting process.
(iv) Book-keeping includes journalising and ledger posting.

2.1.4 Objectives of book-keeping

Following are the objectives of book-keeping:

(i) To have a complete and permanent record of all business transactions in chronological order and under appropriate headings.
(ii) To facilitate ascertainment of the profit or loss of the business during a specific period.
(iii) To facilitate ascertainment of financial position.
(iv) To know the progress of the business.
(v) To find out the tax liabilities.
(vi) To fulfil the legal requirements.

2.1.5 Advantages of Book-keeping

Book-keeping has the following advantages:

(i) Transactions are recorded systematically in chronological order in the book of accounts. Thus, book-keeping provides a permanent and reliable record for all business transactions.
(ii) Book-keeping is useful to get the financial information.
(iii) It helps to have control over various business activities.
(iv) Records provided by business serve as a legal evidence in case of any dispute.
(v) Comparison of financial information over the years is possible. Also comparison of financial information of different business units is facilitated.
(vi) Book-keeping is useful to find out the tax liability.

2.1.6 Limitations of book-keeping

Book-keeping has the following limitations:

(i) Only monetary transactions are recorded in the books of accounts.

(ii) Effects of price level changes are not considered.

(iii) Financial data recorded are historical in nature, i.e., only past data are recorded.

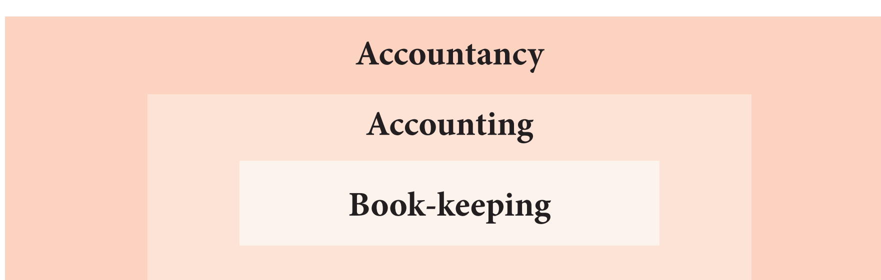
2.2 Book-keeping Vs. Accounting

Following are the differences between book-keeping and accounting:

S. No	Basis of distinction	Book-keeping	Accounting
1	Scope	It is concerned with recording and classifying the business transactions.	It is concerned with recording, classifying, summarising, analysing and interpreting the financial data.
2	Stage	Book-keeping is the primary stage in accounting. It is the base for accounting.	Apart from the primary stage, it includes secondary stage of analysis and interpretation.
3	Nature of job	It is routine and clerical in nature.	It is analytical in nature.
4	Knowledge required	It requires basic knowledge of the principles of journalising and posting.	It requires thorough knowledge of accounting principles, procedures and practices.
5	Skill required	Analytical skill is not required for book-keeping.	It requires analytical skill.

2.3 Relationship among Book-keeping, Accounting and Accountancy

Book-keeping is part of Accounting. It is the primary stage in accounting. It is the process of recording transactions in the books of accounts. Accounting is part of Accountancy. Accounting is the process of reording, classifying, analysing and interpreting of financial data. Accountancy is the systematic knowledge of accounting process and contains the standards, principles, policies and procedures to be followed in accounting.



2.4 Accounting Principles

Accounting principles are the basic norms and assumptions developed and established as the basis for accounting system. These principles are adopted by the accountants universally. These accounting principles provide uniformity and consistency in the accounting methods and process. Such accounting principles are known as Generally Accepted Accounting Principles (GAAP).

Accounting principles provide the basic framework within which the accounting records and accounting reports are to be prepared. Accounting standards have been issued by national and international regulatory authorities to ensure uniformity of accounting procedure and accounting results. These accounting standards and GAAPs provide the theoretical base of accounting. Accounting principles may be accounting concepts or accounting conventions. Accounting concepts are the basic assumptions whereas conventions are the guidelines based upon practice or usage.

Accounting concepts are the basic assumptions or conditions upon which accounting has been laid. Accounting concepts are the results of broad consensus. The word concept means a notion or abstraction which is generally accepted. Accounting concepts provide unifying structure to the accounting process and accounting reports.

The word convention refers to traditions or usage. The accounting conventions are the usage or practices which are followed as a guide to the preparation of accounting statements.

The utility of these accounting conventions have been recognised by regulatory authorities of accountancy in making financial statements more realistic, reliable, and useful to all concerned parties.

The important accounting concepts and conventions are discussed below:

(i) Business entity concept

This concept implies that a business unit is separate and distinct from the owner or owners, that is, the persons who supply capital to it.

Based on this concept, accounts are prepared from the point of view of the business and not from the owner's point of view. Hence, the business is liable to the owner for the capital contributed by him/her.

According to this concept, only business transactions are recorded in the books of accounts. Personal transactions of the owners are not recorded. But, their transactions with the business such as capital contributed to the business or cash withdrawn from the business for the personal use will be recorded in the books of accounts. It implies that the business itself owns assets and owes liabilities.

(ii) Money measurement concept

This concept implies that only those transactions, which can be expressed in terms of money, are recorded in the accounts. Since, money serves as the medium of exchange transactions expressed in money are recorded and the ruling currency of a country is the measuring unit for accounting.

Transactions which do not involve money will not be recorded in the books of accounts. For example, working conditions in the work place, strike by employees, efficiency of the management, etc. will not be recorded in the books, as they cannot be expressed in terms of money.

It helps in understanding of the state of affairs of the business as money serves as a common measure by means of which heterogeneous facts about the business are recorded. For example, if a business has 5 computers, 2 tables and 3 chairs, the assets cannot be added to give useful information, unless, they are expressed in monetary terms ₹ 1,00,000 for computers, ₹ 10,000 for tables and ₹ 1,500 for chairs.

(iii) Going concern concept

It is the basic assumption that business is a going concern and will continue its operations for a foreseeable future. Going concern concept influences accounting practices in relation to valuation of assets and liabilities, depreciation of the fixed assets, treatment of outstanding and prepaid expenses and accrued and unearned revenues. For example, assets are generally valued at historical cost. Any increase or decrease in the value of assets in the short period is ignored.

(iv) Cost concept

An asset is recorded in the books on the basis of the historical cost, that is, the acquisition cost. Cost of acquisition will be the base for all further accounting. It does not mean that the asset will always be shown at cost. It is recorded at cost at the time of its purchase, but is systematically reduced in its book value by charging depreciation.

The cost concept has the following limitations:

a) In an inflationary situation, when prices of commodities increase, valuing the assets at historical cost may not represent the true position of the business.

b) The results of business units established at different dates are not comparable if assets are recorded on historical basis.

c) Assets which do not have acquisition cost such as human resources are not recognised under this concept.

(v) Dual aspect concept

Dual Aspect Concept

According to this concept, every transaction or event has two aspects, i.e., dual effect.

For example, when Arun starts a business with cash ₹ 5,00,000, on the one hand, the business gets cash of ₹ 5,00,000 and on the other hand, a liability arises, that is, the business has to pay Arun a sum of ₹ 5,00,000.

This is the concept which recognises the fact that for every debit, there is a corresponding and equal credit. This is the basis of the entire system of double entry book-keeping.

From this concept arises the basic accounting equation, that is,

Capital + Liabilities = Assets

(vi) Periodicity concept

This concept deals with preparing accounts for a particular period. As the proprietors, investors, creditors, employees and the government are interested in knowing the performance of the business unit periodically, it becomes necessary to select a particular period, normally one year for measuring performance. Hence, financial statements are prepared after every accounting period and not at the end of its life.

This concept helps the business in distribution of income to the owners and comparing and evaluating performance of different periods.

(vii) Matching concept

According to this concept, revenues during an accounting period are matched with expenses incurred during that period to earn the revenue during that period. This concept is based on accrual concept and periodicity concept. Periodicity concept fixes the time frame for measuring performance and determining financial status.

All expenses paid during the period are not considered, but only the expenses related to the accounting period are considered.

On the basis of this concept, adjustments are made for outstanding and prepaid expenses and accrued and unearned revenues. Also due provisions are made for depreciation of the fixed assets, bad debt, etc., relating to the accounting period. Thus, it matches the revenues earned during an accounting period with the expenses incurred during that period to earn the revenues before sharing any profit or loss.

(viii) Realisation concept

According to realisation concept, any change in value of an asset is to be recorded only when the business realises it. When assets are recorded at historical value, any change in value is to be accounted only when it realises.

(ix) Objective evidence concept

Objective evidence concept requires that all accounting transactions recorded should be based on objective evidence. The objective evidence includes documentary evidence like cash receipts, invoices, etc. It ensures authenticity, accuracy and reliability of transactions entered in the books of accounts.

(x) Accrual concept

According to accrual concept, the effects of the transactions are recognised on mercantile basis, i.e., when they occur and not when cash is paid or received. Revenue is recognised when it is earned and expenses are recognised when they are incurred. All expenses and revenues related to the accounting period are to be considered irrespective of the fact that whether revenues are received in cash or not and whether expenses are paid in cash or not. For example, i) Credit sale is recognised as sale though the amount has not been received immediately. ii) Rent for the month of March-2018 has not been paid and if the accounting period is 1.4.2017 to 31.3.2018, it will still be recorded as an expense for the accounting year 2017-2018 because it had become due.

(xi) Convention of consistency

The consistency convention implies that the accounting policies must be followed consistently from one accounting period to another. The results of different years will be comparable only when same accounting policies are followed from year to year. For example, if a firm follows the straight line method of charging depreciation since its purchase or construction, the method should be followed without any change. However, it does not mean that changes are not possible.

ACCOUNTING PRINCIPLES

Business entity	Owner and business are two di erent entities
Money measurement	Only monetary transactions are recorded
Going concern	Business will continue for a foreseeable future
Co	Assets are recorded at co price
Dual aspect	Every transaction has two aspects – debit aspect and credit aspect
Periodicity	Accounts are closed at the end of accounting period. It is generally one year
Matching	Expenses relating to a particular period are to be matched with revenues relating to that period.
Realisation	Revenue should be recorded only when it is realised.
Objective evidence	Every transaction mu have a supporting evidence
Accrual	Transaction is recorded when it is entered into and not when settlement takes place.
Consistency	Accounting rules and practices should be continuously observed
Full disclosure	Accounts mu disclose full and fair information
Materiality	Relatively important and significant monetary items are to be recorded and disclosed in the financial atements
Conservatism	While recording transactions, only the prospective losses and not the prospective incomes should be considered

Change in accounting policy can be incorporated in the following circumstances:

(a) To comply with the provisions of law

(b) To comply with accounting standards issued and

(c) To reflect true and fair view of state of affairs of the business.

(xii) Convention of full disclosure

It implies that the accounts must be prepared honestly and all material information should be disclosed in the accounting statement. This is important because the management is different from the owners in most of the organisations.

The disclosure should be full, fair and adequate so that the users of the financial statements can make correct assessment about the financial position and performance of the business unit.

(xiii) Convention of materiality

According to this convention, financial statements should disclose all material items which might influence the decisions of the users of financial statements. Hence, any item which is not significant and is not relevant to the users need not be disclosed in the financial statements.

This principle is basically an exception to the full disclosure principle. The term materiality is subjective in nature. Materiality depends on the amount involved in the transaction, size of the business, nature of information, requirements of the person making decision, etc. An item material to one person may be immaterial to another person.

(xiv) Convention of conservatism or prudence

It is a policy of caution or playing safe. While recording the business transactions one has to anticipate no income but provide for all possible losses.

For example, the closing stock in the factory is valued at ₹ 35,000 at cost price and ₹ 25,000 at its realisable price. But while recording in the books the value of ₹ 25,000 will be considered being the lower of the two. According to realisation concept, any increase in value is not to be accounted unless it has materialised. The conservatism convention puts further restriction on it. Any unrealised gain is not to be anticipated but provision can be made against all possible losses.

DO YOU KNOW?

Going concern concept, Convention of consistency and Accrual concept are considered as fundamental accounting assumptions.

2.5 Accounting Standards (AS)

Student activity

Think: In your school, there are some basic rules to be followed by every student. What are they? What will happen if there is no such rule?

Accounting Standards provide the framework and norms to be followed in accounting so that the financial statements of different enterprises become comparable. It is necessary to standardise the accounting principles to ensure consistency, comparability, adequacy and reliability of financial reporting.

In the words of Kohler, "*Accounting standards are codes of conduct imposed by customs, law or professional bodies for the benefit of public accountants and accountants generally*"

Thus, Accounting Standards are written policy documents issued by the expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions and events in the financial statements.

2.5.1 Need for accounting standards

The need for accounting standards is as follows:

(i) To promote better understanding of financial statements

(ii) To help accountants to follow uniform procedures and practices

(iii) To facilitate meaningful comparison of financial statements of two or more entities.

(iv) To enhance reliability of financial statements

(v) To meet the legal requirements effectively

2.6 International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are issued by the International Accounting Standard Board (IASB). IFRS is a set of International Accounting Standards stating how particular types of transactions and other events should be reported in financial statements. IFRS are issued to develop Accounting Standards that would be acceptable worldwide and to improve financial reporting internationally.

2.7 Accounting Standards in India

In India, Standards of Accounting is issued by the Institute of Chartered Accountants of India (ICAI). The Council of the Institute of Chartered Accountants of India constituted Accounting Standards Board (ASB) on 21st April, 1977 recognising the need for Accounting Standards in India. ASB formulates Accounting Standards so that such standards may be established by the Council of the Institute in India. The ASB will consider the applicable law, custom, usage, business environment and the International Accounting Standards while framing Accounting Standards (AS) in India.

Due to globalisation, the accounts prepared in India must be compatible with accounts prepared in other countries. This has resulted in the existing AS being converged with the IFRS. This convergence has resulted in what is known as Ind AS. Ind AS are basically the International Accounting Standards which have been modified in accordance with Indian accounting practices, customs and traditions. Presently, all big companies have to follow Ind AS rules, but smaller business units are allowed to continue using AS. In future, it is expected that all business entities in India will migrate to Ind AS.

Student activity

Visit *icai.org*. Refer under Resources, Accounting Standards and Ind AS.

Points to remember

- There are established accounting principles available which are to be applied in the preparation of accounting records and financial statements.
- The Accounting Standards are designed to ensure uniformity in the accounting methods and practices.

Self-examination questions

I Multiple choice questions

Choose the correct answer

1. The business is liable to the proprietor of the business in respect of capital introduced by the person according to
   (a) Money measurement concept
   (b) Cost concept
   (c) Business entity concept
   (d) Dual aspect concept
2. The concept which assumes that a business will last indefinitely is
   (a) Business Entity
   (b) Going concern
   (c) Periodicity
   (d) Conservatism
3. GAAPs are:
   (a) Generally Accepted Accounting Policies
   (b) Generally Accepted Accounting Principles
   (c) Generally Accepted Accounting Provisions
   (d) None of these
4. The rule of stock valuation 'cost price or realisable value' whichever is lower is based on the accounting principle of:
   (a) Materiality
   (b) Money measurement
   (c) Conservatism
   (d) Accrual
5. In India, Accounting Standards are issued by
   (a) Reserve Bank of India
   (b) The Cost and Management Accountants of India
   (c) Supreme Court of India
   (d) The Institute of Chartered Accountants of India

Answer

1 (c)	2 (b)	3 (b)	4 (c)	5 (d)

II Very short answer questions

1. Define book-keeping.
2. What is meant by accounting concepts?
3. Briefly explain about realisation concept.
4. What is "Full Disclosure Principle" of accounting.
5. Write a brief note on 'Consistency' assumption.

III Short answer questions

1. What is matching concept? Why should a business concern follow this concept?
2. "Only monetary transactions are recorded in accounting". Explain the statement.
3. "Business units last indefinitely". Mention and explain the concept on which the statement is based.
4. Write a brief note on Accounting Standards.

CASE STUDY

Magesh started a new trading business. He buys and sells packing materials. He wants to be honest in doing his business. He has plans to establish his business in the future. He has little accounting knowledge but has excellent business skills. At the end of his first year of trading, he wanted to value his closing stock. He finds some of the goods are damaged. If he wants to sell them, then he has to spend some amount for making them in a saleable condition. He also takes some money from his business bank account for his personal use. But, he forgot to record that.

Now, discuss on the following points

- Does every businessman need accounting knowledge?
- Identify some of the accounting concepts in this case study.
- How should his closing stock be valued?
- Is it possible for him to compare his business results with that of his competitors?

To explore further

Is it possible to compare the accounting records of an Indian company with that of an International company? Do all the countries follow the same accounting practices?

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