Subject : Accountancy	Topic : Theory Base of Accounting, Accounting Standards and IFRS	Date of Study Material : 8/5/2018 Study Material
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CHAPTER 3. THEORY BASE OF ACCOUNTING, ACCOUNTING STANDARDS AND IFRS

FUNDAMENTAL ACCOUNTING ASSUMPTIONS-GAAP:

Accounting principles, concepts and conventions are commonly known as Generally Accepted Accounting Principles
(GAAP). They are basic rules and guidelines to prepare financial statements.
"Principles of Accounting are the general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice."

FEATURES OF ACCOUNTING PRINCIPLES

1. Man-made: best possible suggestions based on experiences
2. Flexible: Not rigid, not permanent, changes with time
3. Generally Accepted: they are relevant, objective & feasible

ACCOUNTING PRINCIPLES/ CONCEPTS/ CONVENTIONS

1. Business Entity
2. Money Measurement
3. Going Concern
4. Accounting Period
5. Cost Concept
6. Dual Aspect
7. Revenue Recognition
8. Matching
9. Full Disclosure
10. Consistency
11. Conservatism
12. Materiality
13. Objectivity
14. Accrual

1. BUSINESS ENTITY/ ACCOUNTING ENTITY:

Business is treated as being separate and distinct from its owners. Transactions are recorded from the business point of view. Capital of owner is a liability of business towards the owner.

2. MONEY MEASUREMENT:

Transactions that can be measured in terms of money only are recorded in the books of account

3. GOING CONCERN

It is assumed that the business shall continue for a foreseeable and that there is no intention to close the business or reduce its operations significantly.

4. ACCOUNTING PERIOD

The life of an organisation is divided into accounting periods (usually 1 year) to measure its performance at regular intervals.

Financial Statements are prepared at the end of an accounting period.

5. COST CONCEPT/HISTORICAL COST PRINCIPLE

An asset is recorded in the books of accounts at the price paid to acquire it. Change in its market value from time to time is not considered.

6. DUAL ASPECT/DUALITY

Every transaction has two aspects- a Debit and credit of equal amount. Double Entry Book Keeping is based on this fundamental principle.

7. REVENUE RECOGNITION

Revenue is considered to have been realised (earned) when a transaction has been entered into and the claim to receive the amount has been established.

E.g.: Goods are sold on credit in February 2018 and cash is received in April 2018. Sales revenue is recognised as earned in February 2018 when the goods are sold.

8. MATCHING

The revenue earned during an accounting period is matched with the expenditure incurred to earn that revenue. It is not relevant when the money is received or paid. Therefore adjustments are made for outstanding expenses, prepaid expenses, Accrued income and unearned income (income received in advance)

9. FULL DISCLOSURE

"There should be complete and understandable reporting on the financial statements of all significant information relating to the economic affairs of the entity".

All material and significant information is to be disclosed for better understanding.

10. CONSISTENCY

Accounting practices once selected and adopted, should be applied consistently year after year.

It helps comparison of information of various years.

11. CONSERVATISM/ PRUDENCE

" Do not anticipate a profit, but provide for all possible losses"

It considers all possible losses, but not possible profits.

Financial statements are to present a realistic or true picture of the affairs of the business.

12. MATERIALITY

It refers to the relative importance of an item or event.

"An item should be regarded as material if there is a reason to believe that knowledge of it would influence the decision of an informed investor."

Whether an item is material or not will depend on its nature and amount; An item material for one entity may not be material for another. Only significant item for the entity should be disclosed.

E.g.: A calculator is not treated as Fixed Asset though it can be used for more than 1 year.

13. OBJECTIVITY/VERIFIABLE OBJECTIVE

Accounting should be free from personal bias (prejudice).

Transactions should be evidenced and supported by source documents such as cash memo, invoices, sales bills etc.

14. ACCRUAL

A transaction is recorded when it has been taken place. It is not relevant whether cash is paid or received or not.

Profit is regarded as earned when goods are sold or services are rendered.

Expenses are regarded as incurred when goods are purchased or services are availed.

ACCOUNTING STANDARDS

Accounting Standards are a set of guidelines, i.e. Generally Accepted Accounting Principles, that are followed for preparation and presentation of Financial Statements.

They are accounting rules and procedures relating to measurement, recognition, treatment, presentation and disclosure of accounting transactions in the financial statements.

" Accounting Standards are a code of conduct imposed on an accountant by custom, law and a professional body" - Kohler

ACCOUNTING STANDARDS- NATURE

1. They are guideline to prepare Financial Statements
2. They ensure uniformity, transparency, consistency & comparability
3. They are subject to change as per law of the country
4. They are mandatory
5. They are flexible where alternatives are available

ACCOUNTING STANDARDS- OBJECTIVES

1. Minimise the diverse accounting policies and practices
2. Promote better understanding of financial statements
3. Understand significant accounting policies
4. Facilitate comparison
5. Enhance reliability of financial statements

INTERNATIONAL FINANCIAL REPORTING STANDARDS- IFRS

International Financial reporting Standards-IFRS are a set of accounting standards developed by International Accounting Standards Board (IASB).IFRS are the principles-based accounting standards.

NEED OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Accounting is the language of business. Therefore a single set of accounting standards is needed to unify the accounting practices worldwide and to understand and compare worldwide financial information. It facilitates investment and economic decisions, increase market efficiency and reduce cost of capital. Therefore International Financial reporting Standards are developed.