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Theory Base of Accounting

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.

Money Measurement Concept The concept of money measurement states that only those transactions and happenings in an organization 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 cannot 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 organization 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 organization 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 cannot 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 cannot 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.

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.