

Accounting Concepts

3.1 Introduction

In the previous lesson, you have studied the accounting assumptions like, Business Entity, Money Measurement, Going Concern etc. Besides these assumptions, there are some key concepts in accounting. These concepts or principles (general rules) are accepted and followed by all those who record transactions in the books of accounts. These concepts have been developed over the years. You will study about some of these important concepts in detail in this lesson.

3.2 Objectives

After studying this lesson, you will be able to:

- state the meaning of 'Accounting Concepts';
 - enumerate the four Accounting Concepts viz. matching concept, accrual concept, realisation concept and dual aspect concept;
 - state the meaning of revenue and expense with examples;
 - give examples of revenue and expenses of business;
 - match expenses with revenues of a particular period in a given situation;
 - infer the meaning and significance of matching concept;
 - state the meaning of accrual concept;
 - cite examples of expenditure incurred but not paid at the close of the accounting period;
 - cite examples of income due but not received upto the end of the accounting period;
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- infer that revenues increase capital and expenses decrease it;
- infer the significance of accrual concept;
- state the meaning and significance of realisation concept;
- recognise the dual aspect in every transaction;
- infer that the assets are equal to liabilities;
- explain the meaning and significance of 'Dual Aspect' concept.

3.3 Accounting Concepts

Before you learn the meaning of accounting concepts, examine the following example

Transaction : Atul sold goods for cash Rs.10,000 and on credit Rs.20,000

The above transaction may be recorded in the following two ways :

- I Sales can be recorded only by Rs.10,000 as this amount has been received in cash.
- II Sales can be recorded by Rs.30,000 (Rs.10,000 cash + Rs.20,000 credit)

Which one is correct and why? Recording of the transaction in the second way is correct as it is recorded on the basis of an Accounting Concept (rules). The concept followed in this recording is known as 'Accrual Concept.

Let us now understand the meaning of the accepted term 'Accounting Concept'. Accounting Concepts are the universally accepted rules which guide the actual recording of transactions. These concepts help in understanding the recorded transactions any time after they are recorded. They help in determining the effect of transactions on profits of business. Like Accounting assumptions, concepts have been developed over the years from experience.

The four important accounting concepts are:

- (i) Matching Concept
- (ii) Accrual Concept
- (iii) Realisation Concept
- (iv) Dual Aspect Concept

We shall study these concepts in detail in this lesson:

Matching Concept

Let us examine the following example:

A businessman sold a cotton shirt for Rs.150 (cost Rs.130) on 31st March 1996 i.e. at the end of the accounting year. The amount of cash Rs.100 was received on 31st March 1996 and the balance on 15th April 1996. Now ascertain the profit or loss in this situation as on 31st March 1996.

You may say that he has suffered a loss of Rs.30 as cost Rs.130 minus the amount received on sale Rs.100.

You may also say that he earned a profit of Rs.20 i.e. sales of Rs.150 minus cost Rs.130.

Now which answer is correct and why?

The second answer i.e. a profit of Rs.20 is correct because we can ascertain the correct profit only by applying the matching concept in this situation.

In order to understand the matching concept, let us first learn some important terms.

Revenue

Revenue is an inflow of assets like cash and receivables (right to receive cash) from customers. Revenue is related primarily to the sale of goods or supply of services. By selling goods, either cash is received immediately or the seller gets the right to receive cash from the buyer in future. That is, through sales, an asset, in the form of cash or receivables, is acquired. This is called **revenue**. Let us take some examples of revenue:

- (i) A firm sells goods for Rs.20,000 for cash, the revenue for the firm is Rs.20,000.
 - (ii) A firm sells goods for Rs.50,000 on credit. The revenue for the firm is Rs.50,000.
 - (iii) A business owns a building. A part of the building is let out for rent of Rs.1,200 per month. Every month, the business gets a revenue of Rs.1,200 through rent.
 - (iv) A bank gave an interest of Rs.600 on deposits for 1996 to a firm. This is a revenue for the firm for 1996.
 - (v) You are an agent of Ankur Electronics. You sold goods belonging to this firm. Ankur electronics paid Rs.2,000 as commission to you. The commission, you received, is revenue for you.
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In the above examples, you have observed various sources of revenue like sale of goods for cash or credit, rent, commission and interest received etc.

Slavin and Reynolds have defined revenue in the following words:

“The term revenue describes the sources of inflow of assets received in exchange for services rendered, sale of product, or merchandise, gains from sales or exchange of assets other than stock in trade, and earnings of interest and dividends on investment.”

Expense

Expenses are outflows of cash or usage of assets, for the purpose of generating revenue in a particular period.

The following are some examples of **expenses**:

- (i) Rs.2,500 is paid for the **salary** of a salesman every month. This is an outflow of cash and hence an **expense** for the firm.
- (ii) A firm pays Rs.500 for **postage** for a month. This is an outflow of cash and hence an **expense** for the firm.
- (iii) A firm pays Rs.1,000 as **rent** for the premises for its business. This is an **expense** for the business, as it is an outflow of cash.
- (iv) A firm has purchased machinery for Rs.50,000 on 1st Jan. 1996. The expected life of the machine is 10 years. The usage of the machinery for the year ending 31st Dec. 1996 is Rs.5,000 (Rs. 50,000/10 the life of the machine). The **usage of machine** is an **expense**. Such a usage is called “**depreciation**”.
- (v) Raman pays Rs.200 for carriage. This is an outflow of cash and hence an **expense** for him.

Let us study the following transactions of a business during the year ended 31st Dec. 1996.

- (i) Sales : Cash Rs.20,000 and Credit Rs.10,000.
- (ii) Salaries paid Rs.3,500
- (iii) Commission paid Rs. 500
- (iv) Interest received Rs. 500
- (v) Rent received Rs.1,400 out of which Rs.400 received for the year 1997.

- (vi) Carriage paid Rs.200
- (vii) Postage & Stationery Rs.300
- (viii) Rent paid Rs.2,000, out of which Rs.500 belongs to the year 1995.
- (ix) Goods purchased in the year for cash Rs.15,000 and on credit Rs.5,000
- (x) Depreciation on Machinery Rs.2,000

Let us separate the above transactions under the headings Expenses and Revenue :

Expenses	(Rs.)	Revenue	(Rs.)
1. Salaries	3,500	1. Sales	
2. Commission	500	Cash	20,000
3. Carriage	200	Credit	<u>10,000</u>
			30,000
4. Postage & Stationery	300	2. Interest Received	500
5. Rent paid 2,000		3. Rent Received	1,400
Less for <u>500</u>		Less for <u>400</u>	
1995		1997	
	1,500		1,000
6. Goods Purchased			
Cash 15,000			
Credit <u>5,000</u>			
	20,000		
7. Depreciation	2,000		
	<u>28,000</u>		
Total		Total	<u>31,500</u>

In the above example expenses have been matched with revenues and (Revenue Rs.31,500 minus expenses Rs.28,000). This comparison has resulted in an income of Rs.3,500. If the revenue is more than the expenses, it is called **Profit** or **Income**. If the expenses are more than revenue it is called **Loss**. This is exactly what we do in matching concept.

Meaning and Significance

Under the matching concept, we match the expenses with the revenues for a particular period normally a year, in order to determine the profit or loss

of the period. If revenue exceeds expense, it is called **Profit** or **Income** and in case expense exceeds revenue it becomes **Loss**. This comparison is generally made for a particular period i.e. year (Periodicity Assumption studied in Previous lesson). The **significance** of this is that it guides how the expenses should be compared with revenues for deriving exact profit or loss for a particular period.

Intext Questions 3.1

1. Fill in the blanks with suitable words:
 - (i) Expenses are matched with _____, generated during a period.
 - (ii) Revenue is an inflow of _____ like cash and receivables.
 - (iii) Goods sold for cash is an example of _____
 - (iv) 'Salaries paid' is an example of _____
 - (v) Income is the excess of _____ over _____
2. Ascertain whether the following transactions resulted in revenue or expense for the business.
 - (i) Goods sold for cash Rs.30,000.
 - (ii) Goods sold on credit Rs.50,000.
 - (iii) Salaries paid for the month Rs.2,500.
 - (iv) Bank paid interest Rs.1,000.
 - (v) Commission paid to Salesman Rs.2,000.

3.4 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."

The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of when the cash is received. for example salaries of Rs.10,000 for the month of Dec.'96 paid in Jan'97. This will be taken into Account while determining the income for the

year ending 31st Dec.'96. In the same way expenses are recognised at the time the services are received irrespective of when actual payment for these services is made. For example, Amrit sold goods worth Rs.25,000 to Akhil in December 1996 on a credit for three months. Now if Amrit wants to determine his income for the year ending 31st December, 1996, he will consider the sale of Rs.25,000 to Akhil as a revenue for 1996. When Akhil pays back Rs.25,000 after three months, it will be recorded merely as a collection from a debtor and not as a revenue transaction.

Expenditure incurred —Payment made and yet to be made

According to the accrual concept expenditure incurred during a period is considered whether the payment has been made or is yet to be made at the end of the period.

Let us study the following examples:

- (i) Salaries of Rs.5,000 for the month of December 1996, paid in January, 1997.
- (ii) Rent paid Rs.2,000 in January, 1997 for the month of December, 1996.
- (iii) Wages paid Rs. 1,000 for December 1996 in December.

In each of the above examples, can you make out the amount to be paid on 31st December, 1996? These are :

- (i) Rs. 5,000
- (ii) Rs. 2,000
- (iii) NIL

From the above examples, it is clear that expenses which have become **due and payable** at the end of the accounting period must be recorded as an expense for that period. Salaries and rent for December, 1996 have been paid in January, 1997. but as per the accrual concept these expenses have been considered for the year ending 31st, December 1996, as the payment for these expenses become due in Dec. 1996. Irrespective of the fact that the expenses have been paid or not, we consider all expenses in the year in which they have become due.

Revenue—Received and yet to be received

The accrual concept states that revenue for a period is considered realised at the time of sale of goods or services whether it has been received in cash or yet to be received at the end of the period.

Let us study the following examples:

- (i) A business has let out a part of its premises to another trader on a rent of Rs.1,000 per month. The rent for the month of December 1996 has been received in January 1997.
- (ii) Commission Rs. 500 received in December 1997 for December 1997.
- (iii) Goods sold in December, 1996 for cash Rs.10,000 and on credit Rs.5,000 for three months.

In each of the above examples, it is clear that the revenues which have been earned during a period to be received at the end of the period, must be recorded as a revenue for that period. The revenue though rent and credit sale of goods has been earned in the year ending 31st, December, 1996, but received in cash in 1997, will be considered a revenue for the year 1996 for the determination of income.

Effect of Revenue and Expense on Capital

Let us take an example, Atul sells goods for Rs.10,000. His expenses for selling the goods (including the cost of goods) comes to Rs.8,000. His capital in the business is Rs.50,000. Now, by selling goods for Rs.10,000 he received a revenue of Rs.10,000 and hence his capital will be increased by Rs.10,000 and becomes Rs.60,000. At the same time, he incurred expenses (including the cost of goods) of Rs.8,000 in getting the above revenue. Thus, his capital will be reduced by the amount of expenses i.e. Rs.8,000 and now his capital is Rs.52,000. In other words, revenues increase capital and expenses decrease it.

Thus, the accrual concept of accounting states:

- (i) Revenue is realised at the time of sale *of goods or services irrespective of when the cash* is received.
- (ii) Expenses are recognised at the time of services are received and *utilised in the production of revenue* irrespective of when payment is made.
- (iii) Revenue increases the owner's capital and expenses reduce it.

Intext Questions 3.2

1. Fill in the blanks with suitable words:
 - (i) Accrual concept relates to the determination of _____
 - (ii) Revenue _____ the capital.
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- (iii) Owner's capital is decreased by _____
- (iv) Excess of revenue over expense is called _____
- (v) Loss is the excess of _____ over _____

2. Following are the transactions of Ajay for the years 1996 and 1997. His accounting year ends on 31st December every year. Write the year against each transaction and state whether they will be treated as revenue or expense.

- (i) Goods sold for Rs.25,000 in April 1996 ()
 - (ii) Commission paid Rs.2,000 in Jan. 1997 for the sale in November 1996 ()
 - (iii) Rent paid Rs.2,500 in Dec. 1996 as an advance for Jan. 1997 ()
 - (iv) Interest of Rs. 600 became due for 1996 but paid by the bank in April 1997 ()
 - (v) Repair charges of Rs.1,200 paid on goods sold in 1996 as per sales agreement ()
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3.5 Realisation Concept

This concept states as to when revenue should be recorded in the books of accounts. It says that revenue should be recorded when it has been realised. Revenue is said to have been realised when *cash has been received* or *right to receive cash has been established on the sale of goods or services or both*.

Let us study the following examples:

- (i) V.K.Jewellers received an order to supply ornaments worth Rs.1,00,000. They have supplied ornaments worth Rs.20,000 upto the year ending 31st December 1996 and rest of the ornaments were supplied in 1997.
 - (ii) Rekha sold goods for Rs.50,000 for cash in 1996 and the goods have also been delivered in the same year.
 - (iii) Vikram sold goods on credit for Rs.25,000 during the year ending 31st December 1996, the goods have been delivered in 1996, but the payment was received in March 1997.
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Now you can analyse the above examples to ascertain the correct amount of revenue realised for the year ending 31st December 1996.

- (i) The revenue for the year 1996 for V.K.Jewellers is Rs.20,000 because mere getting an order will not be considered as revenue until the goods have been delivered.
- (ii) The revenue for Rekha for 1996 is Rs.50,000 as the goods have been delivered in 1996 and cash has also been received in the same year.
- (iii) Vikram's revenue for the year 1996 is Rs.25,000 as the goods have been delivered to the customer in 1996 and the revenue became due in 1996 while received in 1997.

According to the realisation concept, revenue is to be recorded only on its *realisation* and not before. Realisation does not refer to *realisation in cash only*, it refers to inflow of assets in the form of receivables also.

In the above examples, revenue is realised when the goods are delivered to the customers. The concept of realisation says that revenue is realised at the time when *goods or services are actually delivered or provided*.

The significance of this concept is that it helps in making the accounting information more objective. It guides that the recording of transactions should be based upon performance and not on mere promise. Thus, the realisation concept is helpful in relating revenue to accounting periods.

Intext Questions 3.3

Ascertain the amount of correct revenue realised for the year ending 31st December 1996.

- (i) An order, to supply goods for Rs.2,00,000 is received in 1996. The goods have been supplied only for Rs.1,50,000 in 1996.
 - (ii) What will be the revenue in (i) if the payment of Rs.1,00,000 is received in cash in 1996 and the balance payment of Rs.50,000 is received in 1997.
 - (iii) What will be the revenue in (i) if the goods have been sold on credit and the payment of Rs.1,50,000 is received in 1997, while all the goods of Rs.2,00,000 supplied in 1996.
 - (iv) What will be the revenue if an advance payment of Rs.50,000 is received in 1996 and the balance recovered in 1997.
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3.6 Dual aspect concept

Dual means two. It signifies that every transaction in accounting has two aspects. For example in the transaction goods purchased for cash, the two aspects are 'giving of cash' and 'receiving of goods. Similarly each transaction in accounting has two aspects.

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

1. Purchased machinery for cash

The two aspects in this transaction are :

- (i) Cash paid
- (ii) Machinery acquired

2. Goods sold for cash

The two aspects are :

- (i) Cash received
- (ii) Delivery of goods

3. Owner brings cash in business

This is a transaction between owner and this business. The two aspects are :

- (i) Cash received
- (ii) Owner's capital or liability towards the owner

4. Sold goods to Krishna on Credit

The two aspects are :

- (i) Delivery of goods
- (ii) Krishna - money is due from him. (In accounting language such a person is called 'debtor')

5. Furniture purchased on credit from Rama

The aspects of this transaction are

- (i) Furniture received
- (ii) Rama — Money is due to him (In accounting language such a person is called a 'creditor').

6. Rent paid in cash to the landlord

The two aspects are :

- (i) Cash paid
 - (ii) Rent - an expense
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7. Commission received in cash

The two aspects of this transaction are :

- (i) Cash received
- (ii) Commission - revenue

The knowledge of Dual aspect concept helps in identifying the two aspects of a transaction. Once the two aspects of a transaction are known, it becomes easy to apply the rules and keep the records in the books of accounts. An implication of the 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.

Assets = Liabilities

Intext Questions 3.4

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 (a debtor)		
(vi)	Purchased Machinery from Rama on credit		
(vii)	Paid to Rahul		
(viii)	Salaries paid		

3.7 What You Have Learnt

1. Accounting concepts are universally accepted rules for recording business transactions.
2. Revenue means sources of inflow of assets like cash or receivables received in sale of goods and services rendered.
3. Expenses are outflows of cash or usage of assets, for the purpose of generating revenue in a particular period.
4. Excess of revenue over expense is called **profit** or **income**.
5. Excess of expense over revenue is called **loss**.
6. Under matching concept, expenses for a period are matched with the revenues of the same period for proper determination of income.
7. Accrual concept assumes that revenue is realised at the time of sale of goods or services irrespective of when cash is received.
8. Accrual concept also assumes that expenses are recognised at the time the services are received and utilized in the generation of revenue irrespective of the payment made.
9. Revenue increases capital and expenses decrease it.
10. According to realisation concept, a revenue is realised when cash has been received or right to receive cash has been established.
11. Every transaction in accounting has two aspects.
12. According to Dual Aspect Concept, every transaction has an equal impact on assets and liabilities in such a way that assets are always equal to total liabilities.

3.8 Terminal Questions

1. Answer the following questions in one sentence:
 - a) What is matched with what under matching concept?
 - b) Name the concept that states that with every subsequent transaction, the totals of assets and liabilities remain equal.
 - c) When is revenue realised under realisation concept?
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2. Explain the term revenue and expense by giving examples in about 50 words.
 3. Give the meaning of matching concept and explain its significance in about 50 words.
 4. State the meaning of accrual concept with examples in accounting in about 50 words.
 5. Explain with a suitable example the meaning of realisation concept in about 50 words.
 6. Explain the meaning and significance of Dual Aspect concept with examples (about 50 words).
 7. M/s Krishna Cotton Mills has the following transactions. State whether these are related to revenue, expense or neither revenue nor expense.
 - (i) Introduced capital in the business 4,00,000
 - (ii) Bought raw cotton for cash 1,00,000
 - (iii) Sold cloth for cash 3,00,000
 - (iv) Machinery purchased from M/s Gupta & Co. 2,00,000
 - (v) Salaries paid to workers 3,000
 - (vi) Bought furniture for office use 10,000
 - (vii) Land purchased for cash 2,00,000
 - (viii) Sales to M/s Khanna & Co. on credit 4,00,000
 - (ix) Cash received from M/s Khanna & Co. 3,00,000
 - (x) Rent received 5,000
 - (xi) Bank paid interest on our deposits 3,000
 - (xii) Wages paid to workers 1,000
 - (xiii) Loan taken from bank 3,00,000
 - (xiv) Commission received 10,000
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3.9 Answers to Intext Questions

- 3.1 1. (i) Revenues (ii) Assets
(iii) Revenue (iv) Expenses
(v) Revenue, Expense
2. Revenue — (i), (ii), (iv)
Expense — (iii), (v)
- 3.2 1. (i) Income (ii) Increases (iii) Expenses
(iv) Income/Profit (v) Expense, Revenue
2. (i) 1996 (Revenue) (ii) 1996 (expense)
(iii) 1997 (expense) (iv) 1996 (Revenue)
(v) 1996 (expense)
- 3.3. (i) Rs.1,50,000 (ii) Rs. 1,50,000
(iii) Rs.2,00,000 (vi) Rs. 1,50,000
- 3.4 (i) Owner's Capital, Cash
(ii) Goods received, Cash
(iii) Cash received, Goods sold
(iv) Furniture, Cash
(v) Cash, Sharma
(vi) Machinery, Raja
(vii) Cash, Rahul
(viii) Salaries, Cash
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