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Theoretical Framework of Financial Accounting

Financial accounting is based on a set of principles, concepts, and conventions that ensure financial statements are prepared consistently, accurately, and fairly. These guidelines help users understand and compare financial information.

1. Entity Concept (Business Entity Concept)

The business is treated as a separate entity from its owner(s).
Personal and business transactions are recorded separately.
This ensures accurate measurement of business performance.

Example:
If the owner invests ₹50,000 in the business, it is recorded as capital, not as business income.

2. Money Measurement Concept

Only transactions that can be measured in monetary terms are recorded.
Non-monetary items like employee skills, customer loyalty, or management quality are not recorded.

Example:
Purchase of machinery for ₹2,00,000 is recorded, but employee honesty is not.

3. Going Concern Concept

It assumes that the business will continue operating for the foreseeable future.
Assets are valued based on continued use rather than immediate sale.

Example:
A machine purchased for long-term production is depreciated over its useful life instead of being valued at its selling price.

4. Cost Concept (Historical Cost Concept)

Assets are recorded at their original purchase cost.
Changes in market value are generally ignored until the asset is sold.

Example:
Land purchased for ₹5,00,000 remains recorded at ₹5,00,000 even if its market value increases to ₹8,00,000.

5. Realisation Concept (Revenue Recognition)

Revenue is recognized when it is earned, not necessarily when cash is received.
This ensures that income is recorded in the correct accounting period.

Example:
Goods sold on credit are recorded as sales immediately, even if payment is received later.

6. Accrual Concept
Income and expenses are recorded when they are earned or incurred, regardless of when cash is received or paid.
This provides a more accurate picture of financial performance.

Example:
Salary for March paid in April is recorded as an expense in March.

7. Periodicity Concept (Accounting Period Concept)
The life of a business is divided into fixed accounting periods (such as monthly, quarterly, or yearly).
Financial statements are prepared at the end of each period.

Example:
A company prepares financial statements every year ending on 31st March.

8. Consistency Concept
The same accounting methods should be used from one period to another.
This improves comparability of financial statements.

Example:
If straight-line depreciation is used this year, it should continue in future years unless there is a valid reason to change.

9. Prudence (Conservatism) Concept
Anticipate expected losses but do not recognize expected profits before they are realized.
This prevents overstatement of assets and income.

Example:
A provision is created for doubtful debts, but expected future profits are not recorded.

10. Materiality Concept
Only information that is significant enough to influence users' decisions needs separate disclosure.
Small or insignificant items may be grouped together.

Example:
A calculator costing ₹500 may be treated as an expense instead of being recorded as an asset.

11. Full Disclosure Concept
Financial statements should disclose all important information that may affect users' decisions.
This includes notes, accounting policies, and contingent liabilities.

Example:
A pending lawsuit against the company is disclosed in the notes to the financial statements.

Summary Table

Concept/Convention	Meaning
Entity	Business is separate from its owner.
Money Measurement	Only monetary transactions are recorded.
Going Concern	Business will continue operating in the future.
Cost	Assets are recorded at original purchase cost.
Realisation	Revenue is recognized when earned.
Accrual	Income and expenses are recorded when they occur.
Periodicity	Business life is divided into accounting periods.
Consistency	Same accounting methods are used each year.
Prudence (Conservatism)	Record expected losses, not anticipated profits.
Materiality	Only significant information requires separate reporting.
Full Disclosure	All relevant financial information should be disclosed.

Exam Tip

A simple way to remember these concepts is the mnemonic:

E – Entity
M – Money Measurement
G – Going Concern
C – Cost
R – Realisation
A – Accrual
P – Periodicity
C – Consistency
P – Prudence
M – Materiality
F – Full Disclosure

These principles form the foundation of financial accounting and help ensure that financial statements are reliable, comparable, and useful for decision-making.