

CHAPTER 2

Theory Base of Accounting

CBSE Class 11 · Financial Accounting Part I ·
Chapter 2

CBSE · Accountancy · Class 11

WHAT THIS CHAPTER DOES

A Understand why accounting needs a common theory base (GAAP).

B Learn the 13 accounting concepts and apply each to a situation.

Boards prep that builds confidence, not anxiety.

TODAY'S MISSION

Today's mission

1

Understand why accounting needs a common theory base (GAAP).

2

Learn the 13 accounting concepts and apply each to a situation.

3

Derive the accounting equation $\text{Assets} = \text{Liabilities} + \text{Capital}$ from dual aspect.

4

Distinguish the cash basis from the accrual basis and meet Accounting Standards / IFRS.

WHY THIS MATTERS

Why this chapter matters

- 1 These concepts are the silent rules behind every journal entry, balance sheet and adjustment for the next two years.
- 2 Examiners love 'which concept applies/violated here?' — direct 1-mark MCQs plus a 3-4 mark short answer in almost every paper.
- 3 GAAP is what makes one company's accounts comparable with another's — it is the universal grammar of business.

TOPIC

A

Why a theory base? GAAP

THEOREM · LOAD-BEARING RESULT

Generally Accepted Accounting Principles (GAAP)

GAAP are the common rules, concepts, conventions and standards that guide HOW accounting is done, so that financial statements are UNIFORM, RELIABLE and COMPARABLE across firms and over time.

STATEMENT

Accounting principles are the body of doctrines associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of

WHY THIS MATTERS

- If every accountant recorded transactions their own way, no two sets of accounts could be compared and no outsider could trust them
- GAAP imposes a shared rulebook, so a bank, investor or government reads every firm's accounts on the same basis.

WATCH OUT FOR

NOTE Accounting principles are split into CONCEPTS (basic assumptions, e.g. entity, dual aspect) and CONVENTIONS (customs/practices, e.g. conservatism, materiality, consistency, full disclosure). They are not rigid laws of nature — they are generally-accepted, man-made and can evolve.

TOPIC

B

The opening concepts

TOPIC

Who, what and how long

BUSINESS ENTITY CONCEPT

The BUSINESS ENTITY concept treats the business as a SEPARATE accounting person, distinct from its owner. The books record only the business's own dealings, never the owner's private life. So when the owner puts money into the firm it is CAPITAL — a liability the

MONEY MEASUREMENT CONCEPT

The MONEY MEASUREMENT concept says only those transactions and events that can be expressed in terms of MONEY are recorded in the books. Money is the common unit that lets us add a building, a debt and a sale together. The flip side is a real limitation:

GOING CONCERN CONCEPT

The GOING CONCERN concept assumes the business will continue to operate for the FORESEEABLE FUTURE and has no intention or necessity to close down or sell off its assets. It does not claim the firm is immortal — only that, for now, it will keep running. This assumption justifies showing assets at COST

ACCOUNTING PERIOD CONCEPT

The ACCOUNTING PERIOD concept divides the otherwise endless life of a business into smaller, equal time intervals — usually one year (1 April to 31 March in India) — so that performance can be measured and reported regularly. Without it, the owner, bank and

TOPIC

C

Cost and the dual aspect

THEOREM · LOAD-BEARING RESULT

The cost (historical cost) concept



Under the COST concept, an asset is recorded in the books at the PRICE ACTUALLY PAID to acquire it (its historical cost), NOT at its current market value. This cost then becomes the basis for charging depreciation over the asset's useful life.

STATEMENT

Every transaction is recorded at the cost actually incurred. The market value of an asset may change from day to day, but its book value remains based on the original acquisition cost (less

WHY THIS MATTERS

- Historical cost is a FACT supported by a voucher — objective and verifiable
- Market value is an opinion that changes daily and differs from person to person
- Recording at cost keeps the accounts reliable and free from the bias of guessing current values

WATCH OUT FOR

NOTE A building bought years ago for ₹5,00,000 stays in the books at cost (less depreciation) even if its market value has risen to ₹20,00,000. The cost concept works hand-in-hand with going concern (assets at cost because the firm will keep using them, not sell them).

WORKED EXAMPLE

Every transaction has two equal sides → the accounting equation

- 1** The DUAL ASPECT concept: every transaction affects TWO items by an EQUAL amount — one debit and one credit — so total debits always equal total credits. This is the basis of the double-entry system.
- 2** It gives the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Capital}$ (equivalently, $\text{Capital} = \text{Assets} - \text{Liabilities}$). Both sides must always stay equal.
- 3** (1) Owner invests ₹1,00,000 cash → Assets: Cash 1,00,000 = Capital 1,00,000. Equation balances.
- 4** (2) Buys goods for ₹20,000 cash → Goods +20,000 and Cash -20,000; total assets unchanged at 1,00,000 = Capital 1,00,000.
- 5** (3) Borrows a ₹50,000 loan → Cash +50,000 (asset) and Loan +50,000 (liability). Now Assets 1,50,000 = Liabilities 50,000 + Capital 1,00,000.

TOPIC

D

Income, costs and the period

TOPIC

When to count revenue and costs

REVENUE RECOGNITION (REALISATION)

The REVENUE RECOGNITION (realisation) concept fixes the MOMENT at which revenue is treated as earned. Revenue is recognised when it is REALISED — generally when goods are delivered or the service is rendered and a legal right to payment arises

MATCHING CONCEPT

The MATCHING concept says that to find the correct profit of a period, the EXPENSES of that period must be set against the REVENUES of the SAME period. So once we decide which revenues belong to a year, we charge against them every cost that helped earn them — cost of goods sold, salaries

FULL DISCLOSURE

The FULL DISCLOSURE convention requires that the financial statements honestly disclose ALL material information that is significant to the users of the accounts — nothing important should be hidden or suppressed. Beyond the face of the accounts, important facts are shown through notes, footnotes and

OBJECTIVITY / VERIFIABILITY

The OBJECTIVITY (verifiability) concept requires that accounting entries be based on FACTUAL, unbiased evidence that can be VERIFIED by an independent person — typically a source document or voucher such as an invoice, receipt or bill. Entries

TOPIC

E

The conventions of prudence and proportion

TOPIC

Be cautious, be consistent, be sensible

CONSISTENCY

The CONSISTENCY convention requires that accounting POLICIES once adopted be applied UNIFORMLY from one period to the next, so the results of different years can be compared meaningfully. For example, if a firm charges depreciation by the straight-line method this year, it should

CONSERVATISM (PRUDENCE)

The CONSERVATISM (prudence) convention follows the golden rule: 'anticipate NO profit, but provide for ALL possible losses.' Profits are not recorded until actually realised, but a foreseeable loss is provided for the moment it is anticipated — so accounts err on the side

MATERIALITY

The MATERIALITY convention says that only information which is MATERIAL — that is, important enough to influence the decision of a user — needs to be recorded and disclosed separately; trivial, insignificant items may be treated in the simplest convenient way. What is material is a matter of

FUNDAMENTAL ASSUMPTIONS RECAP

Three concepts are singled out as the FUNDAMENTAL ACCOUNTING ASSUMPTIONS, and they are presumed to be followed unless a clear statement says otherwise: GOING CONCERN (the business will continue for the foreseeable future),

TOPIC

F

Systems and basis of accounting

TOPIC

How records are kept and when items are recognised

SYSTEMS: DOUBLE ENTRY VS SINGLE ENTRY

There are two SYSTEMS of recording. The DOUBLE-ENTRY system records BOTH aspects (debit and credit) of every transaction, flowing directly from the dual aspect concept; it is scientific, complete, self-balancing through the trial balance, and is the standard system used

CASH BASIS OF ACCOUNTING

Under the CASH BASIS, revenue is recorded ONLY when cash is actually RECEIVED and an expense ONLY when cash is actually PAID. Credit transactions, outstanding expenses and prepaid expenses are completely ignored until cash changes hands. This basis is simple and is

ACCRUAL BASIS OF ACCOUNTING

Under the ACCRUAL (mercantile) basis, revenue is recorded when it is EARNED and expenses when they are INCURRED, REGARDLESS of when cash is received or paid. Credit sales are revenue now, outstanding expenses are charged now, and prepaid

ACCOUNTING STANDARDS & IFRS

ACCOUNTING STANDARDS are written policy documents issued by a recognised body — in India by the Institute of Chartered Accountants of India (ICAI) — that lay down uniform rules for recognising, measuring, presenting and disclosing items, so accounts are comparable and free

TRY IT · SOLVE BEFORE YOU PEEK

Name the concept (60-second self-check)

Work it out before you flip the answer.

SOLUTION

TOPIC

Business entity concept

TRAP → TRUTH

- × **MISTAKE** The business and its owner are the same person, so the owner's personal expenses can be put through the business books.
- ✓ **CORRECT** Under the BUSINESS ENTITY concept the business is treated as a SEPARATE legal-accounting person, DISTINCT from its owner. The business's books record only the business's transactions. When the owner invests money it is CAPITAL (a liability the business owes back); when the owner takes money for personal use it is DRAWINGS (not a business expense). The owner's private rent, groceries or car never enter the business accounts.

TOPIC

Conservatism / prudence

TRAP → TRUTH

- × **MISTAKE** Conservatism means recording all profits and all losses as soon as they are foreseen.
- ✓ **CORRECT CONSERVATISM** (prudence) is asymmetric: 'anticipate no profit, but provide for all possible losses'. You do NOT record an expected/unrealised PROFIT until it is actually earned, but you DO provide for a foreseeable LOSS the moment it is anticipated. Classic applications: valuing closing stock at the LOWER of cost or market value, and creating a provision for doubtful debts. It deliberately understates rather than overstates, to avoid a rosy, misleading picture.

TOPIC

Accrual vs cash basis

TRAP → TRUTH

- × **MISTAKE** Under the accrual basis you record revenue and expenses only when cash is actually received or paid.
- ✓ **CORRECT** That is the CASH basis. Under the ACCRUAL basis, revenue is recorded when it is EARNED and expenses when they are INCURRED — regardless of when cash actually moves. So credit sales count as revenue now even if cash comes later, and outstanding rent is an expense of this year even if unpaid. Accrual gives a truer profit; the cash basis only follows the cash. CBSE accounting follows the accrual basis.

TOPIC

Matching concept

TRAP → TRUTH

× **MISTAKE** The matching concept means total cash received should equal total cash paid in a period.

✓ **CORRECT** The MATCHING concept means the EXPENSES of a period must be matched against (set against) the REVENUES of the SAME period to compute correct profit — it has nothing to do with cash equality. So if goods are sold this year, the cost of those goods, plus the rent, salaries and depreciation that helped earn that revenue, must all be charged in the SAME year — including outstanding expenses and excluding prepaid ones. Match cost to the revenue it helped earn, not cash in to cash out.

TOPIC

Money measurement concept

TRAP → TRUTH

- × **MISTAKE** All important facts about a business are recorded in its accounts.
- ✓ **CORRECT** Under the MONEY MEASUREMENT concept, ONLY those transactions and events that can be expressed in MONEY are recorded. Crucial qualitative facts — the skill and honesty of staff, good management, customer loyalty, employee morale, a strike or a change in market taste — are NOT recorded because they cannot be measured in rupees. This is a known LIMITATION of accounting, and it also assumes the value of money is stable (ignoring inflation).

TOPIC

Cost / historical cost concept

TRAP → TRUTH

× **MISTAKE** Assets are shown in the balance sheet at their current market value.

✓ **CORRECT** Under the COST (historical cost) concept, an asset is recorded at the PRICE ACTUALLY PAID to acquire it (its cost), NOT at market value. This recorded cost becomes the basis for charging depreciation over its life. So a building bought years ago for ₹5,00,000 stays in the books at cost (less depreciation), even if its market value has risen to ₹20,00,000. Historical cost is objective and verifiable; market value is subjective and changes daily.

TOPIC

Going concern concept

TRAP → TRUTH

- × **MISTAKE** Going concern means the business will surely last forever / will never close.
- ✓ **CORRECT** GOING CONCERN does NOT promise the business is immortal. It is the ASSUMPTION that the business will continue to operate for the FORESEEABLE FUTURE and has no intention or need to shut down or sell off its assets. This is WHY assets are shown at cost (not break-up/sale value) and why expenses like prepaid insurance are carried forward. If a firm were about to close, this assumption would not hold and assets would instead be valued at their realisable (sale) value.

TOPPER TEMPLATE · MARK-BY-MARK

3-4 mark: 'Explain the dual aspect concept and derive the accounting equation.'

- 1 STATE THE CONCEPT**
1 m
Open: 'The DUAL ASPECT concept states that every transaction has TWO aspects — a debit and a credit of equal amount — so the total of all debits always equals the total of all credits.' This is the foundation of the double-entry system.
- 2 GIVE THE EQUATION**
1 m
State the resulting equation: 'Assets = Liabilities + Capital', or equivalently 'Capital = Assets – Liabilities'. Note that both sides are ALWAYS equal because every transaction affects two items keeping the equation balanced.
- 3 PROVE WITH A WORKED EXAMPLE (MARK-RICH PART)**
2 m
Illustrate: owner invests ₹1,00,000 → Cash (asset) ₹1,00,000 = Capital ₹1,00,000. Buys goods ₹20,000 cash → Goods +20,000, Cash –20,000 (assets reshuffle, total unchanged). Borrows ₹50,000 loan → Cash +50,000 (asset) = Loan +50,000 (liability). Show the equation balancing after each step. Examiners reward the demonstrated balancing, not just the statement.

TOPPER TEMPLATE · MARK-BY-MARK

3-4 mark: 'Distinguish between the cash basis and accrual basis of accounting.'

- | | |
|---|--|
| <p>1 STATE THE BASIS OF DISTINCTION</p> <p>1 m</p> | <p>Open each difference with a labelled BASIS (Recognition of revenue, Recognition of expense, Outstanding/prepaid items, Profit shown, Acceptability). Examiners award marks per labelled basis, not per loose sentence.</p> |
| <p>2 TWO-COLUMN CONTRAST (MARK-RICH PART)</p> <p>2 m</p> | <p>CASH BASIS — records revenue only when cash is RECEIVED and expense only when cash is PAID; ignores outstanding and prepaid items; gives an incomplete profit. ACCRUAL BASIS — records revenue when EARNED and expense when INCURRED regardless of cash; adjusts for outstanding and prepaid; gives a true and fair profit.</p> |
| <p>3 CLOSE WITH THE VERDICT + WHICH CBSE USES</p> <p>1 m</p> | <p>End: 'The accrual basis is recognised by the Companies Act and gives a truer picture, so it is the basis used in standard financial accounting; the cash basis is used only by very small concerns and professionals.' A clean closing line cements the mark.</p> |

TOPPER TEMPLATE · MARK-BY-MARK

3 mark: 'Explain the conservatism / matching / revenue recognition concept with an example'

1 NAME + DEFINE THE CONCEPT PRECISELY

1 m

Name the concept and give its one-line rule. E.g. CONSERVATISM: 'anticipate no profit but provide for all possible losses.' MATCHING: 'expenses of a period are set against the revenues of the same period.' REVENUE RECOGNITION: 'revenue is recorded when it is earned/realised, normally when goods are delivered or services rendered, not when cash is received.'

2 STATE WHY THE RULE EXISTS

1 m

Give the rationale: conservatism avoids an over-optimistic, misleading profit; matching produces a correct period profit; revenue recognition prevents counting unearned income. One sentence on the purpose earns this mark.

3 ANCHOR WITH A TEXTBOOK EXAMPLE

1 m

Close with the standard example. Conservatism → closing stock at lower of cost or market value; provision for doubtful debts. Matching → charging this year's outstanding rent and depreciation against this year's sales. Revenue recognition → sale recorded on delivery, not on advance receipt. The example secures the application mark.

PYQ PATTERNS









Top PYQ patterns to drill

#1	Explain the BUSINESS ENTITY concept / MONEY MEASUREMENT concept / GOING CONCERN concept (any one, with an example). (3-4 marks)	Most papers
#2	Explain the DUAL ASPECT concept and show how it gives the accounting equation Assets = Liabilities + Capital. (3-4 marks)	Most papers
#3	Distinguish between CASH BASIS and ACCRUAL BASIS of accounting. (3-4 marks)	Frequent
#4	Explain the MATCHING concept / REVENUE RECOGNITION (realisation) concept / CONSERVATISM (prudence) concept. (3 marks)	Frequent
#5	1-mark MCQ: identify which concept applies to a given situation (closing stock at lower of cost or market value = conservatism; recording owner's drawings separately = entity; ignoring employee skill = money measurement). (1 marks)	Almost every paper

MARKS DISTRIBUTION

10-year marks distribution

10-YEAR PYQ MARKS DISTRIBUTION

GAAP / need for accounting principles		12%
Business entity, money measurement, going concern (the 'opening' concepts)		22%
Dual aspect concept + accounting equation		20%
Revenue recognition (realisation) and matching concept		18%
Conservatism / prudence, consistency, materiality, full disclosure		18%
Fundamental accounting assumptions (going concern, consistency, accrual)		14%
Cash basis vs accrual basis of accounting		16%
Accounting Standards / IFRS — meaning and need		10%

RECAP · MEMORISE THESE

Recap

1 GAAP & concepts — GAAP = the shared rulebook. 13 concepts: entity, money measurement, going concern, accounting period, cost, dual aspect, revenue recognition, matching, full disclosure, consistency, conservatism,

2 The equation — Dual aspect → $\text{Assets} = \text{Liabilities} + \text{Capital}$, always balanced. Three fundamental assumptions = going concern, consistency, accrual.

3 Traps to avoid — Accrual ≠ cash basis. Assets at COST not market value. Conservatism = anticipate no profit, provide all losses. Matching ≠ cash equality. Business is SEPARATE from owner.

WHAT'S NEXT

What's next

- Chapter 3 — Recording of Transactions I: applying these concepts through the journal and the double-entry rules of debit and credit.
- Sit the 15-MCQ Quick Drill under a 20-min timer, focusing on 'which concept applies' questions.
- Then attempt the school-pattern mini paper — 30 marks, 60 minutes.

You now know the rules of the game.

Every journal entry from here on will obey these concepts — you'll see why, not just how.

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