

Accounting Assumptions

2.1 Introduction

In the previous lesson, you have learnt about recording of business transactions in brief. While recording business transactions some problems arise. For example :

- (i) Which of the transactions are recordable events?
- (ii) Should owner's personal transactions be recorded in the books of business?
- (iii) When should business results be communicated?

The solution of these problems is based on certain postulates i.e. basic assumptions about the environment. Postulates or assumptions guide the recording of transactions in the books of accounts. These are foundations of accounting records. In this lesson the focus will be on some important Accounting Assumption.

2.2 • Objectives

After studying this lesson, you will be able to :

- define 'Accounting Assumption';
 - enumerate the four accounting assumptions viz. business entity, money measurement, going concern and periodicity;
 - explain that business and owner are two different entities with suitable examples;
 - infer the meaning and significance of business entity assumption;
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- illustrate the meaning and significance of money measurement assumption;
- explain the meaning and significance of periodicity assumption;
- state the meaning of going concern assumption;
- identify the need for going concern assumption;
- explain the significance of periodicity assumption with examples.

2.3 Accounting Assumptions

The first lesson focuses on the nature of business transactions. These are monetary in nature. This means that all monetary transactions are recordable events. And hence, non-monetary events and transactions are not recorded anywhere in the books of business. Similarly, owner's personal transactions are not recorded anywhere in the books. For example, Akshay a cloth merchant, goes on a picnic with his family and spends Rs.10,000 there. Since this event does not affect business position, it will not be recorded in the books of business. Everyone, who is recording transactions, accepts these as given truths (taken for granted). Thus, Accounting Assumptions may be defined as : **basic postulates or assumptions which serve the basis of actual recording.**

These assumptions help in solving the difficulties one faces while recording business transactions. These have been derived through reason and are based on experience. These assumptions are taken for a granted to be true statements.

These assumptions are :

- (i) Business Entity Assumption;
- (ii) Money Measurement Assumption;
- (iii) Going Concern Assumption;
- (iv) Periodicity Assumption;

Let us explain:

i) **Business Entity Assumption**

Since you are familiar with the meaning of business transaction, let us begin with some more examples of business transactions :

Example. 1

- (i) Mohini brings cash Rs.2,00,000 as capital to start a new business.
- (ii) She buys goods for cash Rs.1,00,000
- (iii) She sells goods for cash Rs.1,50,000
- (iv) She pays rent of the shop Rs.3,000
- (v) She buys goods on credit from Shyam Rs.20,000
- (vi) She buys furniture on credit from Royal furniture House Rs.5,000
- (viii) She withdraws cash Rs.2,000 from the business for her personal use.

Mohini is the owner of the business. She has invested capital and does all its activities. If you read these transactions carefully, you will find that Mohini is separate (distinct) from Shyam, Purnima and Royal Furniture House is a separate business. In accounting, the same separation (distinction) is assumed between a business and its owners). Accounting treats a business as distinct from the person(s) who owns it; then it becomes possible to record transactions of this fact, the transactions Nos.(i) and (viii) i.e., Mohini brings cash Rs.2,00,000 as capital to start a new business and she withdraws cash Rs.2,000 from the business for her personal use, become business transactions like other ones. Therefore, these are also recorded in the books of business.

Let us take one more example.

Example 2

Hari's ambition was to start a hairdressing saloon. Recently, he has received Rs.3,00,000 on the sale of a part of his property. Accordingly, he makes all necessary arrangements and starts a saloon under the name 'NewWay Hairdressing'. For this new business, he contributes cash Rs.2,00,000 as capital out of Rs.3,00,000.

This example shows that Hari has set apart Rs.2,00,000 for his business activities. He may use the balance of Rs.1,00,000 for his personal or other activities. This separation helps accountant to record business transactions pertaining to or affecting Rs.2,00,000 only. Without such a distinction, the affairs of the business will be all mixed up with the private affairs of the owner and the true picture of the business will not be available. From these examples, it may be said that accounting treats business as a separate or

distinct from its owner(s). This distinction is the basis of recording every transaction between the business and the owner(s) as a business transaction. This is a business entity assumption. It may be defined as, "An accounting postulate which treats business as distinct from the person(s) who owns it."

It guides accountants to treat owner's contribution as a business liability.

Significance

The following points highlight the significance of business entity assumption :

- (i) This assumption helps in ascertaining the true position of business.
- (ii) It guides accountants not to record owner's personal transactions.
- (iii) It specifies the responsibility of accounting.
- (iv) It facilitates recording and reporting business transactions from business point-of-view.
- (v) It serves the basis for accounting concepts, conventions, etc.

Intext Questions 2.1

Fill in the blanks with suitable words:

- (i) The _____ is the basis of recording transactions between the owner and the business as business transactions.
 - (ii) The business entity assumption guides accountants to treat owner's contribution (i.e. capital) as a business _____.
 - (iii) The business entity assumption is applicable to _____ type of business enterprise.
 - (iv) According to business entity assumption, the personal transactions of the owner of a business _____ recorded in the books of the business.
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2.4 Money Measurement Assumption

Suppose, a businessman manufactures shoes. He needs rice. Now he is looking for a person who is having rice and is interested in exchanging

shoes for rice. Exchanging goods for goods is known as barter trade. Many problems come in barter trade, e.g., finding a right customer, bargaining etc. Money has solved most of the problems of barter trade. Gradually, money has been accepted as a medium of business. Barter transactions are not recorded in the books of business.

Let us take another example. On a particular day, a business concern purchases one office table, 60 metres of cloth, and 10 litres of petrol. How will the accountant record all these items? How will the office table, the metres and the litres be added? These items have been measured in different units. If these are brought to a common unit of measurement, their recording and reporting will be easy. Such a common unit of measuring all business transactions in accounting is accepted as money. That's why business transactions are monetary in nature. Therefore, only those transactions which are expressed (measured) in terms of money are recorded in the books of business with their monetary effect. In other words, if a transaction is not measurable in terms of money, it will not be recorded in the books of accounts. This is known as money measurement assumption. Recording transactions at their monetary value has the following advantages:

(i) Universal unit of measurement

Since long, money has been accepted as a medium of business transactions. It serves the purpose of a common and universal unit of measurement of all business transactions.

(ii) Guidance for recording

Money measurement assumption guides accountants what to record and what not to record.

(iii) Facilitates Recording

Transactions expressed in monetary terms can be added, subtracted, etc. easily. It helps in recording business transactions uniformly.

(iv) Utility of financial statements

People can understand things easily if these are expressed in monetary terms.

(v) Facilitates Comparison

User cannot compare one table to 60 metres of cloth. But Rs.1,000 can be easily compared with Rs.500. Thus, money facilitates comparison of business performance.

Intext Questions 2.2

Put a Tick Mark (√) against the information that should be recorded in the books of accounts and cross mark (×) against the information that should not be recorded.

- (i) Health of financial manager.
 - (ii) Purchased machinery costing Rs.1,00,000
 - (iii) Good relations between workers and management
 - (iv) Telephone bill Rs. 700 paid
 - (v) Goods worth Rs.1,000 given as charity
 - (vi) Power-cut during office hour
 - (vii) Delay in supply of raw-materials
 - (viii) Cloth exchanged for petrol
 - (ix) Goods purchased on credit
 - (x) Cash withdrawn by the owner
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2.5 Going concern assumption

A businessman purchases different items. Some items are purchased for sale (known as goods). However, some items are purchased not for sale. Such items are continuously used in doing business activities. Let us take an example. In any stationery shop you might have seen books, note-book and other stationery items. The stationer sells these items at their market price. But, apart from these, there are items like almirah, table, chair, fan, etc. These items are not meant for sale. If you visit the same shop again and again, you will find that these items remain there for a longer period of time. such items are known as fixed assets. While recording, every businessman states fixed assets at the cost price and not at the market price. Why? Because, he assumes that he will continue his business with the help of these assets over a longer period of time. In accounting, this is known as going concern assumption. Suppose, a business concern is planning to spend Rs.5,00,000 on advertisement of goods. In which of the following situations, will it be preferable to incur such a huge amount?

- (i) When the business concern has a limited number of transactions to perform:
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- (ii) When the business concern has a short life span say it is going to close down its activities within 3 to 4 months.
- (iii) When the business concern has a long life and better prospects of growth.

In the first situation, since the business concern has a limited number of transactions, it is not advisable to spend such a huge amount. Similarly, in the second situation the business concern has a short life span i.e., it is going to close down its activities shortly. Therefore, it is not good to spend such a huge amount when the life of business is certainly short. In the third situation, it is better to spend such a huge amount. It means that a business incurs or should incur a huge amount of money only when it is assumed that its activities will continue over a longer period of time and during the course of such long period, the benefits of such expenditure will accrue. This assumption may be stated as : "An accounting assumption which states that a business will have an indefinite life unless it is likely to be sold in the near future."

The following points highlight the need and significance of going concern assumption :

- (i) Financial statements are prepared on the basis of this assumption.
- (ii) It ensures outsiders the continuity of business activities over an indefinite period of time.
- (iii) By viewing a business as an on-going concern, the fluctuating market value of the fixed assets is not taken into consideration.
- (iv) It is because of this assumption that a business is judged for its capacity to earn profits in future.

Intext Questions 2.3

Fill in the blanks by selecting correct words given in the bracket:

- (i) Going concern assumption states that every business is viewed as continuing its operations _____ (for a definite period, definitely, for a short period).
 - (ii) Fixed Assets are shown in the books at their _____ (Cost Price, Sales Price, list Price).
 - (iii) The assumption that a business enterprise will not be sold or closed down in the near future is known as _____ (entity assumption, going concern assumption, money measurement assumption).
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- (iv) On the basis of going concern assumption, a business prepares its _____ (bank statement, cash statement, financial statements).
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2.6 Periodicity Assumption

Before taking up the meaning of periodicity assumption, let us consider the following example : Suppose, you are carrying on your business. You know that the main objective of business is to earn profits. You also know accounting ascertains business profits. If you want to ascertain profits of your business, which of the following situations will you prefer for the ascertainment of your business profits?

- (i) Since going concern assumption assumes the continuity of business operations over an indefinite period of time, you would prefer to wait till the end of such an indefinite period. And only at the end of indefinite period you will ascertain your business profits.
- (ii) You will follow going concern assumption. But, for the ascertainment of business profits, you divide indefinite period into small periods. And at the end of this small period you calculate your business profits regularly.

Now in both the situations, the second one is better. Because second situation helps in taking many types of business decisions, e.g.,

- (i) It is worth continuing in the business
- (ii) If the profits are encouraging, should the business be expanded?
- (iii) If the profits are less than the expectation, what timely corrective action should be taken so that expected profits are earned in future?

Profit, in its ultimate sense, means the income earned at the end of the business. Periodical ascertainment of profit earned during that period is more important. Hence the necessity to assess the profit earned after a fixed time period arises. Therefore, transactions are recorded in the books of accounts on the assumption that profit out of those transactions is to be ascertained for a specified period. This is known as Periodical Assumption of Accounting. In periodicity Assumption, indefinite life of business is divided into parts. These parts are known as accounting periods. It may be of one year, half-yearly, monthly etc. Normally *one year is taken as a accounting period*. If accounting year begins from 1st of January and ends on 31st of December, then accounting year resembles calendar year. If accounting year begins from 1st of April and ends on 31st of March, then accounting year resembles financial year. According to Periodicity Assumption, transactions

are recorded in the books of accounts with a *specific period in view*. Hence, goods purchased and sold during a period, rent paid for the period are accounted for against that period only. The Periodicity Assumption assumes that expenses and revenues are identified with a specific accounting period, usually a year. Thus, profits are calculated on yearly basis. The assumption of accounting period is so important that even the Government charges tax on business income calculated for a year. Even outside parties dealing with a business, e.g., banks, financial institutions, etc. like to know the profits of a business for a particular period. This is possible only if the profits are calculated with this assumption of Periodicity.

Intext Questions 2.4

1. Fill in the blanks with suitable words:
 - (i) Recording of transactions in the books of accounts with a definite period in view is called _____ assumption.
 - (ii) Periodical ascertainment of profits helps in judging the _____ of a business unit.
 - (iii) The commonly accepted accounting period is _____
 - (iv) According to the Periodicity Assumption, revenues and expenses are related to a _____ period.

 2. Write the name of Accounting Assumption against the given statements:
 - (i) Only monetary transactions are recorded in books of Accounts _____
 - (ii) Transactions are assumed to be for a specific period normally one year _____
 - (iii) Business is separate and distinct from its owner _____
 - (iv) Business is looked upon as a continuing entity. _____
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2.7 What You Have Learnt

- (i) Accounting assumptions are the (basic) postulates which serve the basis of recording actual business transactions.
 - (ii) The four important accounting assumptions are Business Entity, Money measurement, Going concern and Periodicity.
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- (iii) Accounting treats business as distinct and separate from its owner. This is known as Business entity Assumption.
- (iv) Transactions, expressed in terms of money, are recorded in the books of accounts with their monetary effect.
- (v) Going Concern Assumption assumes that a business will have an indefinite life unless it is likely to be sold or closed down in the near future.
- (vi) Transactions are recorded in the books of accounts on the assumption that profits are to be ascertained for a specified period. This is known as Periodicity Assumption of Accounting.

2.8 Terminal Questions

1. Answer the following questions in one sentence :
 - i) Name the four accounting assumptions.
 - ii) Write the meaning of accounting assumption.
2. Give the meaning and any two points of the significance of Business Entity Assumption (about 30-50 words)
3. State the meaning and significance of money measurement assumption (about 40 words)
4. Give any four points which highlights the need and significance of Going Concern Assumption.
5. Illustrate the necessity of having Accounting Assumptions.
6. Explain in about 80 words the meaning and significance of periodicity assumption

2.9 Answers to Intext Questions

- 2.1 (i) Business entity Assumption
 - (ii) Liability
 - (iii) every
 - (iv) are not
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- 2.2. (i) × (ii) √ (iii) × (iv) √ (v) ×
(vi) × (vii) × (viii) × (ix) √ (x) √

- 2.3 (i) indefinitely
(ii) cost price
(iii) Going Concern Assumption
(iv) Financial statements.

- 2.4 1. (i) Periodicity
(ii) Performance
(iii) One year
2. (i) Money measurement Assumption
(ii) Periodicity Assumption
(iii) Business Entity Assumption
(iv) Going Concern Assumption
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