FINANCIAL ACCOUNTING

UNIT-1

PART-IV

ACCOUNTING PRINCIPLES

Obviously, if each business organisation conveys its information in its own way, we will have a babel of unusable financial data.

Personal systems of accounting may have worked in the days when most companies were owned by sole proprietors or partners, but they do not anymore, in this era of joint stock companies.

These companies have thousands of stakeholders who have invested millions, and they need a uniform, standardised system of accounting by which companies can be compared on the basis of their performance and value.

Therefore, accounting principles based on certain concepts, convention, and tradition have been evolved by accounting authorities and regulators and are followed internationally.

These principles, which serve as the rules for accounting for financial transactions and preparing financial statements, are known as the "Generally Accepted Accounting Principles," or GAAP.

The application of the principles by accountants ensures that financial statements are both informative and reliable.

It ensures that common practices and conventions are followed, and that the common rules and procedures are complied with. This observance of accounting principles has helped developed a widely understood grammar and vocabulary for recording financial statements.

However, it should be said that just as there may be variations in the usage of a language by two people living in two continents, there may be minor differences in the application of accounting rules and procedures depending on the accountant.

ACCOUNTING CONCEPTS AND CONVENTIONS

There are some concepts and conventions which are followed in accounting for a long time. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus, are universally accepted rules and are termed as 'Generally Accepted Accounting Principle' or GAAP. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts.

ACCOUNTING CONCEPTS

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Accounting Concepts are the foundation to lay an organized accounting system in an organization. Accounting concepts are very vital for every company as this helps to remain in sync with the industries as for using the same accounting concept. All these also help in better comparison. The concepts give the management a better view and help manage the accounting system with an even tone of management.

Concepts are those basic assumptions and condition which form the basis upon which the accountancy has been laid.

- Business entity concept
- Money measurement concept
- Going concern concept
- Accounting period concept
- Accounting cost concept
- Dual aspect concept
- Matching concept
- Realisation concept
- Accrual concept

(1) Business entity concept

This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense.

Let us take an example, Ms. Sakshi started business by investing Rs. 2,00,000. She purchased goods for Rs. 20,000, Furniture for Rs. 10,000, Plant and Machinery of Rs. 50,000 and Rs. 10,000 remained in hand. These are the assets of the business and not of the owner. According to the business entity concept Rs. 2,00,000 will be treated by business as capital i.e., a liability of business towards the owner of the business.

Now suppose she takes away from business Rs. 5,000 in cash and goods worth Rs. 5,000 for her domestic purposes. This withdrawal of cash & goods by the owner from the business are her private expenses and not the expenses of the business. These are termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct entities. Accordingly, any expense incurred by owner for himself/herself or for his/her family from business will not be considered as an expense but it will be treated as drawings. Since business and its owners according to this concept are treated as separate entities therefore, the transactions between these two are recorded in the books of accounts.

Significance

The following points highlight the significance of business entity concept:

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- This concept restraints accountants from recording of owner's private/ personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view.
- It is the very basis of accounting concepts, conventions and principles.

(2) Money measurement concept

This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees. Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts. For example, sale of goods worth Rs.200000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts.

For example, sincerity, loyalty is not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Significance

The following points highlight the significance of money measurement concept:

- This concept guides accountants what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

(3) Going concern concept

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet.

Significance

The following points highlight the significance of going concern concept:

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the fixed assets.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- Because of this concept business can be judged for its capacity to earn profits in future.

(4) Accounting period concept

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.

(5) Accounting cost concept

It states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them.

(6) Dual aspect concept

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts.

This concept assumes that every transaction has a dual effect, i.e., it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation:

Assets = Liabilities + Capital

(7) Matching concept

The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept.

Therefore, the matching concept implies that all revenues earned during an accounting year, whether received/not received during that year and all cost incurred, whether paid/not paid during the year should be taken into account while ascertaining profit or loss for that year.

Significance

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.
- It is very helpful for the investors/shareholders to know the exact amount of profit or loss of the business.

(8) Realisation concept

This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not. In other words, it can be said that: Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.

The concept of realisation states that revenue is realized at the time when goods or services are actually delivered.

Let us study the following examples:

A Jeweller received an order to supply gold ornaments worth Rs.500000. They supplied ornaments worth Rs.200000 up to the year ending 31st December 2005 and rest of the ornaments were supplied in January 2006. The revenue for the year 2005 for a Jeweller is Rs.200000. Mere getting an order is not considered as revenue until the goods have been delivered.

Bansal sold goods for Rs.1,00,000 for cash in 2006 and the goods have been delivered during the same year.

The revenue for Bansal for year 2005 is Rs.1,00,000.

(9) 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. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate.

Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses. The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of the fact when the cash is received.

ACCOUNTING CONVENTIONS

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity.

Accounting conventions are the basic guidelines that are used to help the companies to determine how to record the business transactions which are not fully addressed by the accounting standards. These procedures and principles are though not legally binding but these are generally accepted by the accounting bodies. Basically, these are designed to promote the consistency and help the accountants to overcome the practical problems which can arise while preparing the financial statements.

Conventions denote customs or traditions or usages which are in use since long. To be clear, these are nothing but unwritten laws.

The accountants have to adopt the usage or customs, which are used as a guide in the preparation of accounting reports and statements. These conventions are also known as doctrine.

- Consistency
- Full Disclosure
- Materiality
- Conservatism

(1) Convention of consistency

The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable.

(2) Convention of full disclosure

Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information. Let us relate it to the business.

The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc.

The shareholder would like to know profitability of the firm while the creditor would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statement discloses all relevant information in full, fair and adequate manner.

(3) Convention of materiality

The convention of materiality states that, to make financial statements meaningful, only material fact i.e., important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Material fact means the information of which will influence the decision of its user.

(4) Convention of conservatism

This convention is based on the principle that "Anticipate no profit, but provide for all possible losses". It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit.

The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.