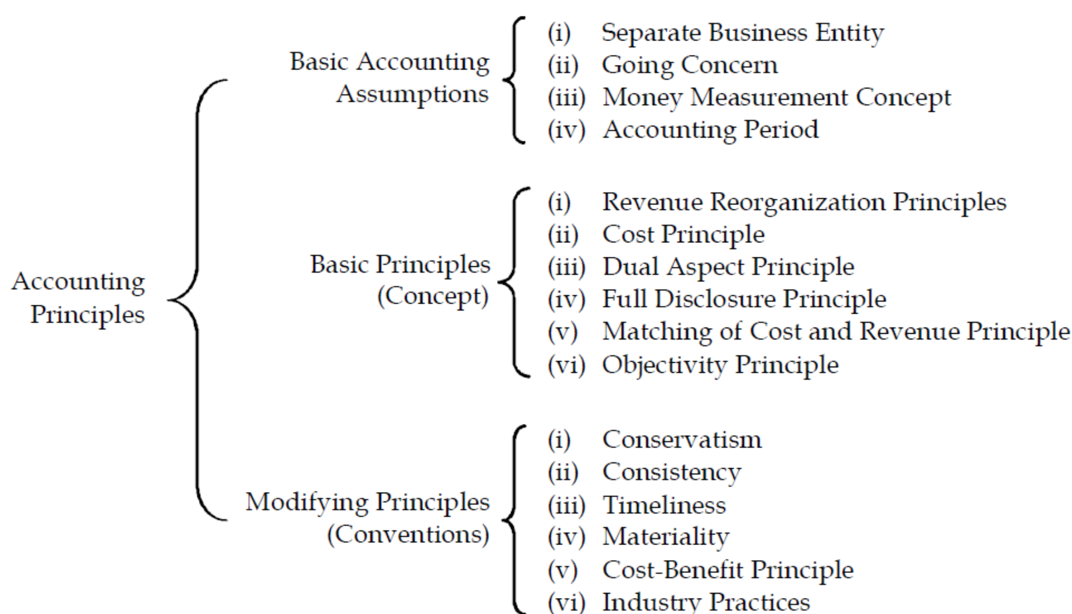
Financial Accounting and Management

UNIT 1

Accounting Principles

Accounting principles are those rules of actions on the basis of which the transactions of the business are recorded, classified, and summarized. If the financial statements are not prepared on the basis of these principles, there will be low acceptability and difficulty to understand them, and the comparison will be impossible and unreliable. These common concepts and conventions of accounting have become the basic accounting concepts and conventions as these are commonly accepted by the body of the professional accountants all over the world to prepare the financial statements, Therefore, they are termed as Generally Accepted Accounting Principles (GAAP). Accounting principles are broadly classified into three categories, these are:

- Basic Assumptions
- Basic Principles (Concepts)
- Modifying Principles (Conventions)



Basic Accounting Assumptions

1. ***Separate Business Entity:*** As per this assumption, business is considered a separate entity from its owner(s). This assumption helps in keeping the business transactions strictly free from the effect of personal affairs of the owner. For instance, when a person starts the business with cash of 2,00,000 then this amount increases the balance of cash from the point of business and on the other hand the owner is treated as a liability, and this is shown in the liability side of the balance sheet as owner's capital. For this transaction this journal entry is passed:

Cash A/c	Dr.	2,00,000	
To Owner's Capital A/c			2,00,000

2. ***Going Concern Concept:*** As per International Accounting Standards, it is a fundamental accounting assumption underlying the preparation of financial statements. Under this assumption, “the enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. Under this all assets are shown at cost price and not at market price and depreciation is provided on cost price in order to calculate true profit. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the sale of its operations.” Under this assumption the assets of the business are valued by the accountants on the basis of going concern concept, historical cost and expected life of the assets.
3. ***Money Measurement Concept:*** Money is medium to value quantities. As per this assumption, only those transactions of the business are recorded in the accounting which can be measured in money. Those transactions/activities of the business which cannot be measured in money are not recorded in accounting.
4. ***Accounting Period Assumption:*** As per the going concern concept, the income of the business can be measured at the time of the liquidation of the business or at the time when business is sold. But it is very difficult to wait such a long period that is also not definite. Generally, this segment of time is one year either calendar year or a financial year. Sometimes it may be less than twelve months i.e., quarterly, half yearly, etc. Reports made for less than twelve months are called interim reports and are less reliable than annual reports. At the end of each segment (period) profit and loss account and balance sheet are prepared.

Basic Accounting Principles (Concepts)

1. Revenue Recognition Principle

It is also called revenue realization principle which means profit should be considered only when realised. As per this principle the revenue is recorded in accounting when the sales have taken place. If there is expectation that will be a particular transaction there in future, that is not recorded in accounting. Revenue/sales is considered to be made when title of ownership of goods passes from the seller to buyer and the buyer become legally liable to pay. However, this principle has some exemptions which are as follows:

1. In the case of sales made on the basis of hire purchase system where ownership is not transferred at the time of sales while it is transferred at time of final payment. Herewith, sales are presumed to the extent of instalment received.
2. In the case of contract accounts, if the contract is for long period revenue cannot be realized until the contract is not completed. Here, only a part of total revenue is treated as realized.

2. Cost Principle

This principle is closely related to the going concern concept. As per this principle every transaction of the business should be recorded at its historical cost and not at its market price. At the time of recording of the transactions, their market price is not considered. Sometimes its market price may be less than or more than its actual cost, but its actual cost is recorded in accounts because of cost principle. Under this principle the historical cost of a transaction becomes the base cost for the subsequent years. On the basis of this cost, the depreciation is

charged on the assets and the balance is shown in the balance sheet. All the fixed assets and current assets are recorded at historical cost. Thus, we observe that the balance sheet prepared on the basis of historical cost does not give us actual results for those applicable of fixed assets and current assets. Due to the changing in the price level changes, the financial statements become irrelevant for the users. This led to the inflation accounting to came into existence.

3. Dual Aspect Principle

This is the basic principle of accounting. As per this principle every financial transaction of the business has dual effect and recorded at two places. Therefore, it is called double entry system. On the basis of this principle, it is said that every debit must have an equivalent credit and every credit must have an equivalent debit because every transaction of the business has two aspects. For instance, if Mr. Aditya Raj started a business for cash 2,00,000 there will be two aspects of this transaction. In one aspect cash is coming into business while in the other aspect the business has to pay this amount to Mr. Aditya Raj. Because Mr. Aditya Raj has given the amount to the business.

4. Full Disclosure Principle

As per this principal, the financial statements should disclose true and fair view so that these may provide accurate and sufficient information to the users of financial statements. Disclosure principle means to give all the information relating to the economic activities of the business to the owner, creditors, and investors.

5. Matching of Cost and Revenue Principle

As per the going concern concept, the accurate profit/loss of the business can be determined at the time of liquidation of the business or sale of the business. But it will generate a lot of problems. Therefore, the economic life of the business is divided into different segments in order to determine the profit/loss of the business. Generally, a segment of the economic life of the business becomes of a year. To compute the operational profits/loss of the business in a year, it is necessary to find the expenses and revenues relating to the period. Then all the revenues of that period are matched with all the expenses/costs incurred to earn that revenue. This matching is called the principle of matching of cost and revenue. The result of this match becomes as follows:

$$\text{Profit} = \text{Revenue} - \text{Expenses}$$

Herewith the matching means an appropriate association between the revenues of a period and expenses/costs of that period. In other words, the incomes/loss of the business can be determined if the revenues (incomes) of a period are compared (matched) with the expenditure of that period. For the recognition of the revenues/expenses the accurate system of accounting is adopted. Therefore, a proper adjustment is also made in the accounts for the outstanding expenses, prepaid expenses, accrued incomes and unaccrued incomes. At the time of reorganization of the revenue/ expenses, the following points are kept in mind:

1. The expenses which are being spent to earn revenue must be of the same period for which profit is being computed.
2. Revenues/expenses of a period must be computed on the basis of accrual accounting system.

3. If some revenues are received in advance, they must be treated as the income of that period in which goods are supplied/services are rendered.

6. Objectivity Principle

It is also known as objective evidence concept. As per this principle the transactions which are recorded in accounting must be on the objective and factual basis. There should be a voucher or documentary evidence behind each entry in the accounting. The entry must be free from personal bias and based on the rational approach. If the entries are made without evidence, it will lose the confidence of the several users of the financial statements about their reliability. For the auditing of the financial statements, there is also a need of objective evidence.

The Modifying Accounting Principles (Conventions)

Basic accounting assumptions and principles provide us the various rules to prepare the financial statements. If these financial statements are relevant and reliable, they will give much useful information to the various users of the financial statements. In order to prepare the true and fair financial statements, there is a need to modify the accounting assumptions and principles. These modified accounting principles are as follows:

1. Conservation (Prudence)

As per the law of conservatism, at the time of preparing the financial statements, all the possible losses must be kept in mind and all anticipated profits/gains should be left out. In other words, the accounts must follow the policy of playing safe. Likewise, stock-in-trade is valued at ‘market price or cost whichever is least’, provision for bad and doubtful debt, provision for depreciation on fixed assets, etc., are maintained. This principle is being criticized nowadays on the ground that it goes against the principle of disclosure.

2. Consistency

In order to enable the management to do the comparison of the results of the several years of the business, whatever accounting policy is adopted in a year, must be adopted in the coming years. There should be uniformity in accounting process, rules & methods. As a result, biasness of accountant is removed. According to Kohlar there are three forms of consistency:

a) Vertical Consistency is used in the different financial statements of the business on the same date. For instance, depreciation on fixed assets is used in the income statement and the balance sheet on the same date.
b) Horizontal Consistency enables the comparison of the profit or performance of a business in a year with the performance of another year for example the depreciation methods.
c) Third Dimensional Consistency refers to the same principles or practices of accounting adopted by the different firms in an industry.

3. Timeliness

Accounting information given in the financial statements must be reliable and relevant. In order to be relevant, this information must be supplied in time. If late and obsolete information is provided, it will hamper the management and the users of the financial statements to take appropriate, timely and rational decision.

4. Materiality

Herewith, the materiality means that only that information should be disclosed and attached with financial statements which influence the decisions of shareholders, investors, and creditors, etc. and the other insignificant details must be ignored. Moreover, an item of information may be material for one purpose while that may be immaterial for other. This is a subjective matter. For example, the cost of the component may be very much significant for small businessman while it may be insignificant for a large businessman. In one more example, the Companies Act permits to ignore the paise at the time of preparation of financial statements while for the income tax purpose the income is rounded off to the nearest ten.

5. Cost-Benefit Principle

As per this principle the cost of using an accounting principle should not exceed its benefits. It does not mean that to curtail the costs, no information or a little information should be given to the users of the financial statements.

6. Industry Practice

Different accounting principle/practice is adopted in the different industries. At the time of preparing the financial reports and presenting the accounting information the prevailing accounting practices in a particular industry should be kept in mind. For example, disclosing of investments and stock at the cost or market price whichever is lower. Thus, we see that the prevailing accounting practices in an industry play an important role in adopting the accounting practices.