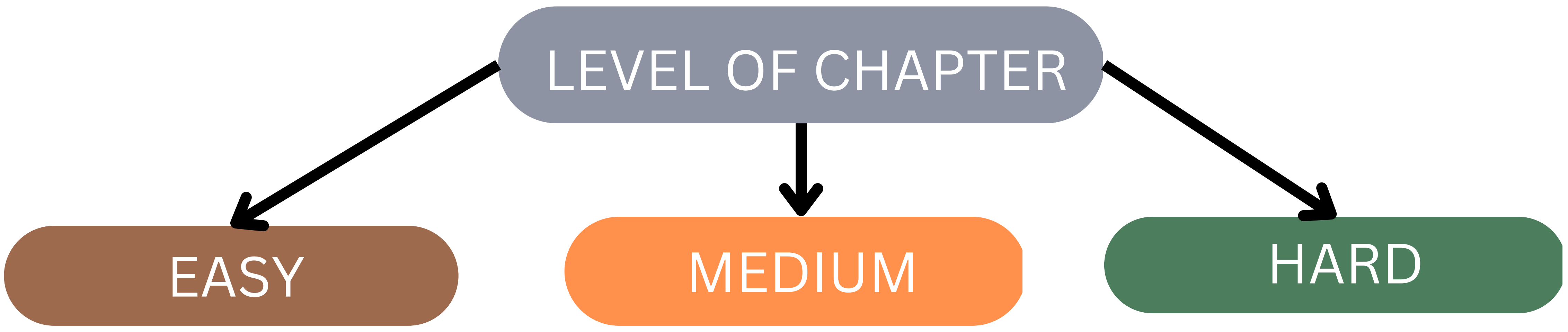
ACCOUNTING PRINCIPLES

3



ACCOUNTING PRINCIPLES

Accounting Principles

Accounting principles are a set of guidelines and rules issued by accounting standards like GAAP and IFRS for the companies to follow while presenting or recording financial transactions in the books of account. This enables companies to present a true and fair view of the financial statements.

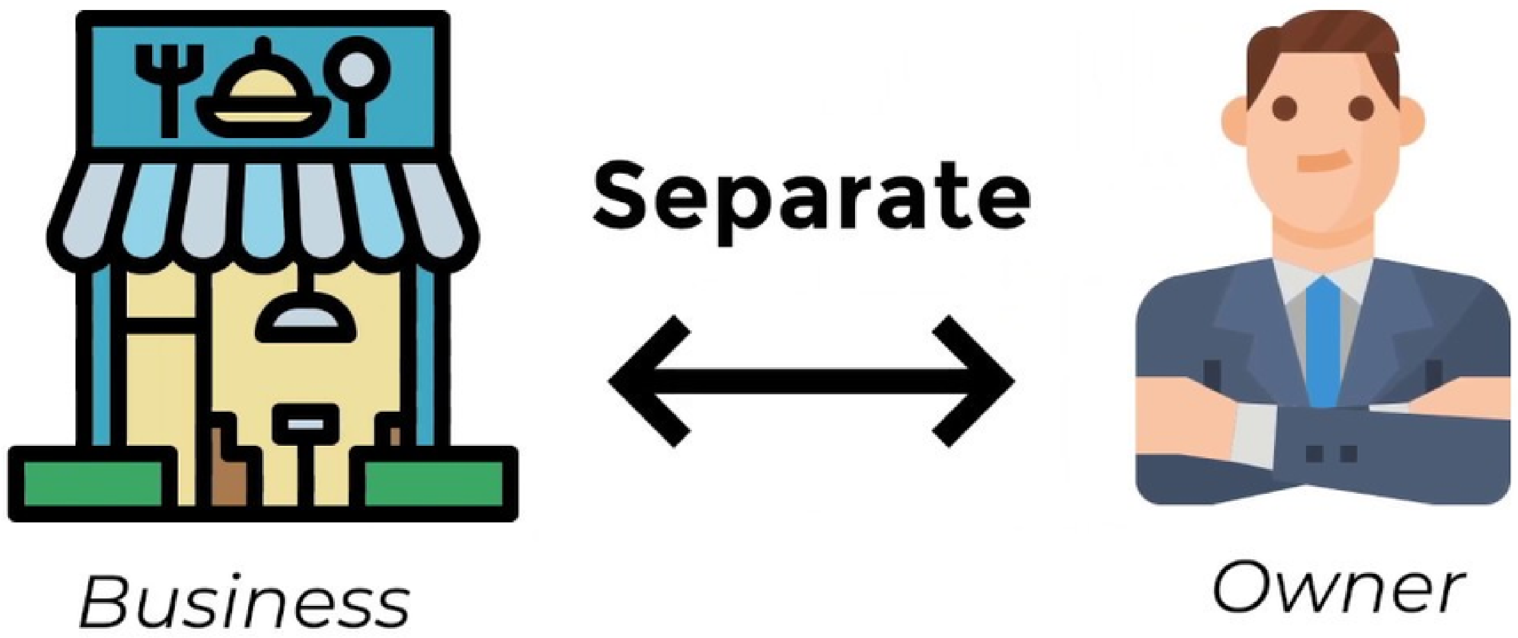
There are accounting rules that an accountant should follow while recording business transactions or recording accounts. They may be termed as accounting concepts. Hence, it can be said that:

"The term accounting concepts refer to basic rules, assumptions, and principles which act as a primary standard for recording business transactions and maintaining books of accounts".

Following are the different accounting concepts that are widely used all around the world and hence are termed as universally accepted accounting rules.

Business Entity Concept

This concept assumes that the organization and business owners are two independent entities. Hence, the business translation and personal transaction of its owner are different. For example, when the business owner invests his money in the business, it is recorded as a 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 a business expense. Thus, the accounting transactions are recorded in the books of accounts from the organization's point of view and not the person owning the business.



Accrual Concept

The term accrual means something is due, especially an amount of money that is yet to be paid or received at the end of the accounting period. It implies that revenue is realized at the time of sale through cash or not whereas expenses are recognized when they become payable whether cash is paid or not. Therefore, both the transactions are recorded in the accounting period in which they relate.

In the accounting system, the accrual concept tells that the business revenue is realized at the time goods and services are sold irrespective of the fact when cash is received for the same.
Similarly, expenses are recognized at the time services are provided, irrespective of the fact that cash paid for these services are made.

Accounting Cost Concept

The accounting cost concept states all the business assets should be written down in the book of accounts at the price assets are purchased, including the cost of acquisition, and installation. The assets are not recorded at their market price. It implies that the fixed assets like plant and machinery, building, furniture, etc are recorded at their purchase price.
For example, a machine was purchased by ABC Limited for Rs.10,00,000, for manufacturing bottles. An amount of Rs.2,000 was spent on transporting the machine to the factory site. Also, Rs.2000 was additionally spent on its installation. Hence, the total amount at which the machine will be recorded in the books of accounts would be the total of all these items i.e. Rs.10, 040, 00. This cost is also termed as historical cost.

Dual Aspect

The dual aspect is the basic principle of accounting. It provides the basis for recording business transactions in the books of accounts. This concept assumes that every transaction recorded in the books of accountants is based on dual concepts. This implies that the transaction that is recorded affects two accounts on their respective opposite sides. Hence, the transaction should be recorded at dual places. It implies that both aspects of the transaction should be recorded in the books of account. For example, goods purchased in exchange for cash have two aspects such as paying cash and receiving goods. Therefore, both the aspects should be registered in the books of accounts. The duality of the transaction is commonly expressed in the terms of the following equation given below:

Assets = Liabilities + Capital

The dual concept implies that every transaction has a similar effect on assets and liabilities in such a way that the value of total assets is always equal to the value of total liabilities.

Going concern concept

The Going concept in accounting states that a business activities will be carried by any firm for an unlimited duration This simply means that every business has continuity of life. Hence, it will not be dissolved shortly. This is an important assumption of accounting as it provides a base for representing the asset value in the balance sheet.

For example, the plant and machinery was purchased by a company of Rs. 10 lakhs and its life span is 10 years. According to the Going concept, every year some amount of assets purchased by the business will be represented as an expense and the balance amount will be shown as an asset in the books of accounts. Thus, if an amount is incurred on an item that will be used in business for several years ahead, it will not be proper to charge the amount from the revenues of that particular year in which the item was purchased Only a part of the purchase value is shown as an expense in the year of purchase and the remaining balance is shown as an asset in the balance sheet.

Money Measurement Concept

The money measurement concept assumes that the business transactions are made in terms of money i.e. in the currency of a country. In India, such transactions are made in terms of the rupee. Hence, as per the money measurement concept, transactions that can be expressed in terms of money should be recorded in books of accounts. For example, the sale of goods worth Rs. 10000, purchase of raw material Rs. 5000, rent paid Rs.2000 are expressed in terms of money, hence these transactions can be recorded in the books of accounts.

Accounting Period Concepts

Accounting period concepts state that all the transactions recorded in the books of account should be based on the assumption that profit on these transactions is to be ascertained for a specific period. Hence this concept says that the balance sheet and profit and loss account of a business should be prepared at regular intervals. This is important for different purposes like calculation of profit and loss, tax calculation, ascertaining financial position, etc. Also, this concept assumes that business indefinite life is divided into two parts. These parts are termed accounting periods. It can be one month, three months, six months, etc. Usually, one year is considered as one accounting period which may be a calendar year or financial year.

The year that begins on January 1 and ends on January 31 is termed as calendar year whereas the year that begins on April 1 and ends on March 31 is termed as financial year.

Realization Concept

The term realization concept states that revenue earned from any business transaction should be included in the accounting records only when it is realized. The term realization implies the creation of a legal right to receive money. Hence, it should be noted that selling goods is considered as realization whereas receiving order is not considered as realization.

In other words, the revenue concept states that revenue is realized when cash is received or the right to receive cash on the sale of goods or services or both have been created.

Matching Concepts

The Matching concept states that revenue and expenses incurred to earn the revenue must belong to the same accounting period. Hence, once revenue is realized, the next step is to assign the relevant accounting period. For example, if you pay a commission to a salesperson for the sale that you record in March. The commission should also be recorded in the same month.

The matching concept implies that all the revenue earned during an accounting year whether received or not during that year or all the expenses incurred whether paid or not during that year should be considered while determining the profit and loss of the business for that year. This enables the investors or shareholders to know the exact profit and loss of the business.

Accounting conventions

Accounting conventions are certain restrictions for the business transactions that are complicated and are unclear. Although accounting conventions are not generally or legally binding, these generally accepted principles maintain consistency in financial statements. While standardized financial reporting processes, the accounting conventions consider comparison, full disclosure of transaction, relevance, and application in financial statements.

Four important types of accounting conventions are:

Conservatism:

It tells the accountants to err on the side of caution when providing the estimates for the assets and liabilities, which means that when there are two values of a transaction available, then the always lower one should be referred to.

Consistency:

A company is forced to apply the similar accounting principles across the different accounting cycles. Once this chooses a method it is urged to stick with it in the future also, unless it finds a good reason to perform it in another way. In the absence of these accounting conventions, the ability of investors to compare and assess how the company performs becomes more challenging.

Full Disclosure:

Information that is considered potentially significant and relevant is to be completely disclosed, regardless of whether it is detrimental to the company.

Materiality:

Similar to full disclosure, this convention also bound organizations to put down their cards on the table, meaning they need to totally disclose all the material facts about the company. The aim behind this materiality convention is that any information that could influence the person's decision by considering the financial statement must be included.