CHAPTER 3
ACCOUNTING PRINCIPLE

Theory Base of Accounting-Theory base of accounting consists of principles, concepts, conventions, rules and guidelines developed over a period of time to bring uniformity and consistency to the process of accounting.

Meaning of Accounting Principles Unlike in the past when accounting statements were largely needed by the proprietor, these days the accounting statements are needed by various parties who have vested interest in the business, namely, proprietors, investors, creditors, government and many others. Accounting statements disclose the profitability and solvency of the business to various parties. It is, therefore, necessary that such statements should be prepared according to some standard language and set rules. These rules are usually called 'Generally accepted accounting principles' (GAAP).

These principles have been generally accepted by accountants all over the world as general guidelines for preparing the accounting statements. These principles have developed over a course of period from usage, reason, common experiences, historical precedents, statements of individuals, professional bodies and regulation of Government agencies.

Nature or Characteristics (Features) of Accounting Principles:

- **(i) Accounting principles are Uniform set of Rule-** Accounting principles are uniform set of rules or guidelines developed to ensure uniformity and easy understanding of the accounting information.
- **(ii) Accounting Principles are Man-Made**- Accounting principles are man made and are derived from experience and reason. They are not laboratory tested and hence they lack universal applicability like the principles of physics, chemistry and other natural sciences.
- **(iii) Accounting Principles are Flexible-**Accounting principles are not rigid but flexible. They are bound to change with the passage of time in response to the changes in business practices, government policies and needs of the users of accounting information.
- **(iv) Accounting Principles are Generally Accepted** -Accounting principles are bases and guidelines for accounting and are generally accepted. The general acceptance of an accounting principle depends upon how well it satisfies the following three criteria

- **(a) Relevance**- A principle is relevant if it results in information that is useful to the user of the accounting information
- **(b) Objectivity-** A principle is objective if it is free from personal bias or judgements of those who furnish the information. Objectivity also implies verifiability which means that there is some way of finding out the truthfulness or correctness of the information reported.
- **(c) Feasibility**- A principle is feasible if it can be applied without undue complexity or cost.

Need of Accounting Principles

In order to make the accounting information meaningful to its internal and external users, it is significant that such information is reliable as well as comparable. The comparability of information is required to see how a firm has performed as compared to the other firms and how it has performed as compared to the previous years. This becomes possible only if the information provided by the financial statements is based on some set rules known as policies, principles and conventions. These rules (usually called GAAP bring uniformity and consistency to the process of accounting and enhance its utility to differences of accounting information.

Kinds of Accounting Principles-Accounting principles are described by various terms such as assumptions, conventions, concepts, doctrines, postulates etc. These principles can be classified mainly into two categories-

(1) Accounting Concepts or Assumptions

(2) Accounting Conventions

(1)**Accounting Concepts or Assumptions** - In order to make the accounting language convey the same meaning to all people and to make it more meaningful, most of the accountants have agreed on a number of concepts which are usually followed for preparing the financial statements. These concepts provide a foundation for accounting process. No enterprise can prepare its financial statements without considering these basic concepts or assumptions. These concepts guide how transactions should be recorded and reported. Following may be treated as basic concepts or assumptions:

As per Accounting Standard (AS-1), issued by the Institute of Chartered Accountants of India, there are three fundamental accounting concepts or assumptions:

- **i.** Going Concern Concept
- **ii.** Consistency Concept
- **iii.** Accrual Concept

Fundamental accounting concepts and assumptions are the assumptions which are presumed to have been followed in preparing the financial statements.

Other Accounting Concepts:

- **i.** Business Entity Concept
- **ii.** Money Measurement Concept
- **iii.** Accounting Period Concept
- **iv.** Cost Concept or Historical Cost Concept
- **v.** Dual Aspect Concept
- **vi.** Revenue Recognition Concept
- **vii.** Matching Concept
- **viii.** Objectivity Concept

(1)Going Concern Concept - As per this concept is assumed that the business will continue to exist for a long period in the future. The transactions are recorded in the books of the business on the assumption that it is a continuing enterprise. It is on this concept that we record fixed assets at their original cost and depreciation is charged on these assets without reference to their market value.

It is also because of the going concern concept that outside parties enter into long-term contracts with the enterprise, give loans and purchase the debentures and shares of the enterprise.

(2) Consistency Concept - This concept states that accounting principles and methods should remain consistent from one year to another. These should not be changed from year to year, in order to enable the management to compare the Profit & Loss Account and Balance Sheet of the different periods and draw important conclusions about the working of the enterprise. If a firm adopts different accounting principles in two accounting periods, the profits of current period will not be comparable with the profits of the preceding period.

(3) Accrual Concept- In accounting, accrual basis is used for recording of transactions. It provides more appropriate information about the performance of business enterprise as compared to cash basis. Accrual concept applies equally to revenues and expenses. In accrual concept revenue is recorded when sales are made or services are rendered and it is immaterial whether cash is received or not. Similarly, according to this concept, expenses are recorded in the accounting period in which they assist in earning the revenue whether the cash is paid for them or not. Thus, to ascertain true profit or loss for an accounting period and to show the true financial position of the enterprise at the end of the accounting period all expenses and incomes relating to the accounting period are recorded whether actual cash has been paid or received or not. Accrual concept is often described as matching concept.

The significance of these fundamental assumptions is that they need not be specifically stated in the financial statements and the users of financial statements can take for granted that these assumptions have been followed while preparing financial statements.

However, if any of the above mentioned fundamental accounting assumption is not followed, then this fact should be specifically disclosed.

Other Accounting Concepts

(4) Business Entity Concept-According to this concept, business is treated as a unit separate and distinct from its owners, creditors, managers and others. In other words, the owner of a business is always considered as distinct and separate from the business he owns. Business unit should have a completely separate set of books and we have to record business transactions from firm's point of view and not from the point of view of the proprietor. The proprietor is treated as a creditor of the business to the extent of capital invested by him in the business. The capital is treated as a liability of the firm because it is assumed that the firm has borrowed funds from its own proprietors instead of borrowing it from outside parties. It is for this reason that we also allow interest on capital and treat it as an expense of the business. Interest on capital reduces the profits of the firm and at the same time it increases the capital of the proprietor. Similarly, the amount withdrawn by the proprietor from the business for his personal use is treated as his drawings. Likewise, goods used from the stock of the business for business purposes are treated as the expenditure of the business but similar goods used by the proprietor for his personal use are treated as his drawings.

(5) Money Measurement Concept: Only those transactions and events are recorded in accounting which are capable of being expressed in terms of money. An event, even though it may be very important for the business, will not be recorded in the books of the business unless its effect can be measured in terms of money with a fair degree of accuracy.

(6) Accounting Period Concept - As the business is intended to continue indefinitely for a long period, the true results of the business operations can be ascertained only when the business is completely wound up. But ascertainment of profit after a very long period will be of little use to the proprietors, managers, investors and others because it will be too late to take corrective steps at that time. The users of the financial statements need to know the results of the business at frequent intervals. Thus, the entire life of the firm is divided into time-intervals for the measurement of the profits of the business. Twelve month period is usually adopted for this purpose. According to the amended income tax law, a business has compulsorily to adopt financial year beginning on 1st April and ending on 31st March in the next calendar year, as its accounting period.

(7)Cost Concept or Historical Cost Concept:- According to this concept, an asset is ordinarily recorded in the books of accounts at the price at which it was acquired. This cost becomes the basis of all subsequent accounting for the asset. Since the acquisition cost relates to the past, it is referred to as historical cost. This cost is the basis of valuation of the assets in the financial statements.

(8) Dual Aspect Concept - According to this concept, every business transaction is recorded as having a dual aspect. In other words, every transaction affects atleast two accounts. If one account is debited, any other account must be credited. The system of recording transactions based on this principle is called as 'Double Entry System'. It is because of this concept that the two sides of the Balance Sheet are always equal and the following accounting equations will always hold good at any point of time-

Assets =Liabilities + Capital

Or

Capital = Assets - Liabilities

(9) Revenue Recognition (Realisation) Concept - Revenue means the amount which is added to the capital as a result of business operations. Revenue is earned by sale of goods or by providing a service. Concept of revenue recognition determines the time or the particular period in which the revenue is realised. Revenue is deemed to be realised when the title or the ownership of the goods has been transferred to the purchaser and when he has legally become liable to pay the amount. It should be remembered that revenue recognition is not related with the receipt of cash.

(10) Full Disclosure Principle: The full disclosure principle requires that financial statements make complete, adequate and fair disclosure of all information which is relevant and significant to the users of accounting service viz investors, lenders, creditors, researchers, government and regulatory agencies.

Thus, the users can analyse and interpret the financial statements to suit their objectives.

(11) Materiality Principle: The principle of materiality requires the accounting of material facts in the books of accounts and accountants need not present facts which are immaterial while determining the income of the enterprise.

(i) Money spent on the extension of size of shop is a material fact as it will increase the future earning capacity of the business.
(ii) A variation in the value of closing stock by Rs.200 is not significant but a variation in the cash balance of the same amount is a significant and material fact.

(12) Principle of Conservatism or Prudence According to principle of conservatism, if the management anticipate loss, provision should be made for loss but if it anticipates profit, it should not be recorded in the book of accounts unless and until it is realized.

This principle is used in thefollowing circumstances:

i. Valuation of closing stock at cost or market price which ever is less.
ii. Creation of provision for Doubtful Debt.

(13) Matching Concept or Matching Principle: According to Matching Concept, expenses incurred in an accounting period should be matched with revenues earned during that period. Thus, the expenses and revenues must belong to same accounting period to determine the correct profit of the accounting period.

Following points should be taken care of

i. We know that revenue is recognized when sales is made or service is rendered rather than when cash is received. Similarly, expense isrecognized when a goods or service has been used to generate the revenue irrespective of the fact whether expenses is paid or not.
ii. The expenses such as salary, rent, insurance, etc are recognized on the basis of period to which they relate and not when they are paid e.g., Salary for the year ending 31st. March, 2010 are paid in April, 2010 butit will be treated as an expense of March, 2010.

iii. If machinery is purchased whose useful life is 5 years, then, only 1/5 of the cost of machine should be treated as an expense to generate sales for the accounting period and remaining 4/5 of the machine be shown as an asset in the balance sheet.
iv. If insurance premium paid is partly related to next accounting year, the part related to current year is an expense of the current year and rest is an expense of the next year.
v. The costs of goods are also matched with their sales revenue while preparing profit and loss account, cost of goods sold need to be considered (Cost of all the goods produced less cost of unsold goods (Stock).

(14) Verifiable Objective Concept: This concept requires that accounting transactions should be recorded in an objective manner and they should be free from the personal bias of the accountant. This is feasible only when each transaction is supported by documentary evidence or vouchers. For example, in case of purchase of goods for cash, there should be cash memo. In case of credit purchase of goods, invoice and copy of Delivery Chalan be examined.

VERY SHORT ANSWER QUESTION

1. **Give two characteristics of accounting principle :**
   Ans (i)Accounting principle are man made
   (ii) accounting principle are flexible
2. **What is business is entity concept?**
   Ans : business is treated as an entity separate and distinct for it owners

3. **What is money measurement Concept ?**
   Ans: Only those transaction and events are recorded in accounting which can be expressed in terms of money.
4. **What os going concern concept?**
   Ans Business will continue to exit for long time in the future and there is no intention to close it or reduce its size significantly
5. **What is accounting period concept?**
   Ans Entire life of an enterprise is divided into time intervals which are known as accounting period at the end of which a profit and loss account is prepared to ascertain the profit and a balance sheet is prepared to ascertain the financial postion.
6. **What is cost concept?**

Ans : Assets are shown in the books at cost of acquisition less depreciation

7. **What is dual aspect concept ?**

Ans : Every business transaction is recorded having a dual aspect. One aspect is debited while other is credited .

8. **What is matching concept?**
   Ans : All cost incurred during a particular period should be charged to revenue of that period fo determining the net profits.
9. **How does the matching concept apply to depreciation ?**
   AnsAccording to matching concept , all cost which are incurred in an accounting period should be charged be against the revenue of that period . Hence depreciation of current year is charged against the current year's revenue . In other works , full cost of the asset is not treated as an expense as and expense in the years of its purchase itself rather it is spread over its useful life .
10. **What is accrual concept ?**
    AnsRevenue is recorded when sales are made or services are rendered and its is immaterial whether cash is received or not .

11. **What is convention of full disclosure ?**
    Ans: There should be sufficient disclosure of information which is of significant interest to the user of financial statements
12. **What is concept of consistency ?**
    Ans: Accounting principles and methods once selected and adopted should be applied consistently from one year to another .

13. **What is convention of prudence or conservatism?**

Ans: All anticipated loss should be recorded in the books of accounts , but all anticipated or unrealized gains should be ignored .

14. **What is convention of materiality ?**

Ans : items having an insignificant effect or being irrelevant to the user of financial statements need not be disclosed .

15. **Which principle states that the financial statements should disclose all significant information ?**

Ans : Convention of full disclosure .

16. **'Closing stock is valued at lower cost or realisable value '. Which principle of accounting is applied here?**

Ans: Convention of Full Disclosure

17. **Why should a business follow the consistency Concept ?**

AnsOne of the qualitative characteristic of accounting information is comparability i.e the financial statement must be comparable from year to year . It is possible only when accounting principles are not changed and followed consistently year after year .

18. **State one limitation of historical cost.**

Ans: during periods of inflation the figure of net profit will be distorted because depreciation based on historical cost will be charged against revenues at current prices.

19. **Why the entire life of business is divided into time intervals?**

Ans : To ascertain the amount of profit earned or loss suffered by the business .

20. **Under which principle , resignation by a Marketing Manager is not recorded in books of accounts?**

Ans: Money Measurement Concept.

<u>OBJECTIVE TYPE QUESTION</u>

1. **Fill in the blanks:-**
   i. Concept of ....requires that the same accounting methods should be used from one accounting period to the next .
   ii. Recognition of cost in the same period as associated revenues is called ....
   iii. Personal transaction are distinguished from business transactions in accordance with the concept of ....
   iv. If a firm belives that some of its debtors may 'default' . It should act on this by making sure that all possible losses are recoreded in the books .this is an example of the .... convention .
   v. The fact that a business is separate and distinguishable from its owner is best exemplified by the .... concept .
   vi. Everything a firm owns ,it also owes ou to somebody. This co-incidence is explain by the .... concept.

vii. The ....concept states that if straight line method of depreciation is very used in one year , then it should also be used in the next year .

viii. A firm may hold stock which is heavily in demand. Consequently , the market value of this stock may be increasing . Normal accounting procedure is to ignore this because of the.............

i. Consistency	ii .Matching	iii . Business Entity
iv . Prudence	v . Business entity	vi .Dual Aspect
vii Consistency	Viii .Convention of prudence	Ix . Dual aspect

ix. The management of a firm is remarkably incompetent , but the firm's accountant cannot take this into account while preparing books of accounts because of .... concept.

Ans

(B). Mention whether the following are true or false:

i. Convention of Prudence results in understatement of profit and asset and overstatement of liabilities.
ii. Business entity concept is not applicable to sole trading concerns and partnership concerns is not applicable to sole trading concerns and partnership concerns .
iii. Only those fact and events are recorded in accounting which are capable of being expressed in terms of money .
iv. All items or facts whether material or immaterial are recorded in accounting .
v. Assets will be equal to capital if there are no liabilities.
vi. Revenues are matched with expenses in accordance with going concern assumption .
vii. Entire life of the firm is divided into time intervals for the measurement of profit in accordance with ' Going Concern Assumption'.
viii. Materiality principle is an exception to the 'full Disclosure Convention' .
ix. If a firm adopts different accounting principles in two accounting periods it conflicts with the concept of consistency.
x. The essence of convention of prudence is to anticipate no profit and provide for all possible losses.

Ans True : i, iii , v, viii , ix , x
False : ii , iv , vi , vii

(C). Choose the best Alternate

1. As per Income Tax Act , accounting period is :
   a. From 1st January to 31st December
   b. From 1st April to 31st March
   c. From 1st July to 30 June
   d. From Diwali to Diwali
2. As dual Aspect Concept :
   a. Assets= Liabilities –Capital
   b. Assets=Capital – Liabilities
   c. Assets=Liabilities+ Capital
   d. Capital = Assets +Liabilities
3. Concept of Consistency means:
   a. All the firms in the same industry should use identical accounting principle and procedures
   b. All principles and procedures of accounting are utilised
   c. Accounting principle and method should remain consistent from one year to another.
   d. All of the above
4. Convention of conservatism takes into account:
   a. All future profits and losses
   b. All future profit and not losses
   c. All future losses and not profits
   d. Neither profit nor losses of the future
5. According to Convention of Conservatism closing stock is valued at
   a. At cost price
   b. At realisable value
   c. Cost price or realisable
   d. At real value
6. According to Convention of Conservatism
   a. Provision is made of bad and doubtful debts
   b. Depreciation is charged an assets
   c. Recording is made of outstanding expenses
   d. All of the above
7. According to which concept even the proprietor of the business is treated as a creditor of the business
   a. Going concern concept
   b. Cost concept
   c. Business Entity concept
   d. Accounting period concept
8. Due to which concept qualitative transactions are not recorded in the books :
   a. Business Entity Concept

b. Money Measurement Concept
c. Historical cost Concept
d. Dual aspect Concept

9. Accrual to which concept is based on :
   a. Matching Concept
   b. Dual aspect concept
   c. Cost concept
   d. Going concern concept
10. According to which concept the same accounting method should be used each year :
    a. Prudence
    b. Full disclosure
    c. Materiality
    d. Consistency
11. Due to which of the following , contingent liabilities are shown in the balance sheet:
    a. Dual aspect Concept
    b. Convention of full disclosure
    c. Convention of Materiality
    d. Going concern concept
12. The cost of small calculator is accounted as an expense and not shown as an asset a financial statements of a business entity due to ....
    a. Materiality Convention
    b. Matching concept
    c. Periodicity concept
    d. Convention of full disclosure
13. According to the cost concept
    a. Assets are recorded at lower of cost and market value .
    b. Assets are recorded by estimating the market value at the time of purchase
    c. Assets are recorded at the value paid for acquiring it.
    d. Assets are not recorded
14. Providing depreciation on fixed asset is in accordance with which of the following principle /concept .
    (i) Going concern (ii) Matching Concept (iii) materiality
    a. (i) & (ii)
    b. (ii) & (iii)
    c. (i) & (iii)
    d. All the three
15. The owner of the firm records his medical expenses in the firms income statement . indicate the principle that is violated
    a. Cost concept
    b. Prudence

c. Full discloser
d. Entity concept

16. M/s future Ltd has invested Rs 10,000 in the shares of Relicam Industries Ltd current market value of these shares is Rs 10,500. Accountant of Future ltd want to show Rs 10,500 as value of investment in the books of accounts which accounting convention restricts him from doing so ?
    a. Full disclosure
    b. Consistency
    c. Conservatism
    d. materiality
17. Which of these is not a fundamental accounting assumption ?
    a. Going concern
    b. Consistency
    c. Accrual
    d. Materiality
18. Omission of paise and showing the round figures on financial statements is based on
    a. Conservatism convention
    b. Consistency concept
    c. Materiality convention
    d. Money measurement concept
19. Income is measured on the basis of
    a. Matching concept
    b. Consistency concept
    c. Cost concept
    d. None of the above

Ans							
	1(b)	2 (c)	3(c)	4(c)	5 (c)	6(a)	7(c)
	8 (b)	9(a)	10(d)	11(b)	12(a)	13(c)	14(a)
	15(d)	16(c)	17(d)	18(c)	19(a)		