Accounting Principles: Concepts and Conventions

Mr. Manoj Kumar

Assistant Professor, School of Business Management

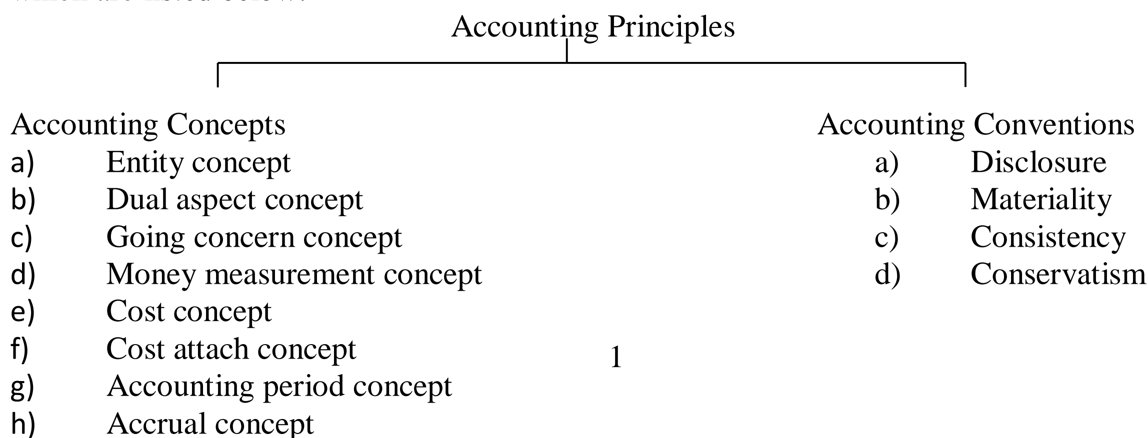
Chhatrapati Sahu Ji Maharaj University, Kanpur

Generally Accepted Accounting Principles

In order to maintain uniformity and consistency in accounting records, certain rules or principles have been developed which are generally accepted by the accounting profession. These rules are called by different names such as principles, concepts, conventions, postulates, assumptions and modifying principles. The term 'principle' has been defined by AICPA as 'A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice'. The word 'generally' means 'in a general manner', i.e., pertaining to many persons or cases or occasions. Thus, Generally Accepted Accounting Principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements. For example, one of the important rule is to record all transactions on the basis of historical cost, which is verifiable from the documents such as cash receipt for the money paid. This brings in objectivity in the process of recording and makes the accounting statements more acceptable to various users. The Generally Accepted Accounting Principles have evolved over a long period of time on the basis of past experiences, usages or customs, statements by individuals and professional bodies and regulations by government agencies and have general acceptability among most accounting professionals. However, the principles of accounting are not static in nature. These are constantly influenced by changes in the legal, social and economic environment as well as the needs of the users. These principles are also referred as concepts and conventions. The term concept refers to the necessary assumptions and ideas which are fundamental to accounting practice, and the term convention connotes customs or traditions as a guide to the preparation of accounting statements. In practice, the same rules or guidelines have been described by one author as a concept, by another as a postulate and still by another as convention.

CONCEPTS & CONVENTIONS IN ACCOUNTING

Accounting provides financial information about a business organisation. For this information to be prepared on uniform basis entire accounting is based on certain principles which are listed below:-



i) Periodic matching of cost and Revenue concept
j) Realisation concept
k) Varifiable objective evidence concept

ACCOUNTING CONCEPTS

Concepts represent abstract ideas which serve to systematize function. It is an opinion formulated over the years based on experience. Following are the accounting concepts :-

1] ENTITY CONCEPT :-

For accounting purposes the "business" is treated as a separate entity from the proprietor (s). This concept helps in keeping private affairs of the proprietor away from the business affairs Thus a proprietor invests 1,00,000/- in the business, it is deemed that the proprietor has given 1,00,000/- to the "business" and it is shown as a "liability" in the books of the business. (because business has to ultimately repay to the proprietor). Similarly, if the proprietor withdraws 10,000/- from the business it is charged to him.

Accounting entity concept enables to record transactions between business and the proprietor. It ensures that accounting records reflect only the activities of the business. It separates business transactions from personal transactions of the proprietor.

This concept is applicable to all forms of business organisations. Although in the eyes of law a sole trader & his business or the partners & their business are one & the same, for accounting purposes they are regarded as separate entities. It is the "business" with which we are concerned.

2] DUAL ASPECT CONCEPT: -

As per this concept, every business transaction has a dual effect. According to Dual Aspect Concept, every transaction has two aspects: -

1) It increases one asset and decreases another asset.
2) It increases an asset and simultaneously increases liability.
3) It decreases an asset and increases another asset.
4) It decreases an asset and decreases a liability.
5) It increases one liability and decreases another liability.
6) It increases a liability and increases an asset.
7) It decreases liability and increases other liability.
8) It decreases a liability and decreases an asset.

Example: -If goods are purchased on cash basis for 1,00,000 stock of goods is increased and balance of cash is decreased.

3] GOING CONCERN CONCEPT (CONTINUITY OF ACTIVITY) :-

Enterprise is normally viewed as a going concern that is continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation of curtailing materially the scale of the operation. It is assumed that the business concern will continue for a fairly long time, unless & until it has entered into a state of liquidation. It does not imply permanent existence but simply stability & continuity for a period sufficient to carry business plans. It implies that assets are acquired for utilisation & not for sale. Similarly, depreciation on assets is provided on the basis ofexpected lives of the assets rather than on their market values.

e.g.:- If book value of a machine is 1,00,000/- and net realisable value is 80,000/- businessman will ignore realisable value and provide depreciation on book value.

4] MONEY MEASUREMENT CONCEPT: -

In accounting, everything is recorded in terms of money. Events or transactions which cannot be expressed in terms of money are not recorded in the books of accounts, even if they are very important or useful for the business. Purchase and sale of goods, payment

for expenses and receipt of income are monetary transactions which find place in accounting. Death of an executive, resignation of a manager, integrity of persons are the events which cannot be expressed in money. These are not included in accounting systems.

Transactions which affect business materially but not convertible in money cannot be recorded in the books of accounts. To assess financial health of business it is necessary to decide total value of assets & liabilities. e.g. A business concern has a big building constructed on a plot of 1000 sq. ft., furniture consisting of 20 chairs, 10 tables and 10 Godrej cupboards, amount to be received from the customers for 5000 units sold on credit, amount payable to supplier for 300 units purchased. From the above details it is very difficult to assess financial health unless the above items are expressed in terms of money. It is clear that non-monetary events cannot be recorded in the books of accounts. The transactions, events or assets which are expressed in terms of equivalent monetary value are recorded in the books of accounts.

5] COST CONCEPT (OBJECTIVITY CONCEPT): -

This concept does not recognise the realisable value, the replacement value of the real worth of an asset. Thus as per cost concept :-

1) An asset is ordinarily recorded at the price paid to acquire it i.e. at its cost, and
2) This cost is the basis for all subsequent accounting for the assets.

The cost concept does not mean that the asset will always be shown at cost. It only means that the cost becomes the basis for all subsequent accounting for the asset. Thus the asset recorded at cost at the time of purchase may systematically be reduced by the process of depreciation. The cost concept also implies that if nothing has been paid to acquire an asset, it cannot be shown as an asset in the books of accounts.

6] COST-ATTACH CONCEPT:-

This concept is also known as “cost-merge” concept. When a finished good is produced from the raw material there are certain process and costs which are involved like labor cost, power and other overhead expenses. These costs have a capacity to “merge” or “attach” when they are broughtr together.

7] ACCOUNTING PERIOD CONCEPT:-

An accounting period is the interval of time at the end of which the income statement and financial position statement (balance sheet) are prepared to know the results and resources of the business.

8] ACCRUAL CONCEPT: -

It implies recording of revenues & expenses of a particular accounting period, whether they are received/ paid in cash or not. Under cash system of accounting, the revenues & expenses are recorded only if they are actually received/ paid in cash irrespective of the accounting period to which they belong. But under accrual method, the revenues & expenses relating to that particular accounting period only are considered. The Accountant records revenues as they are earned and expenses as they are incurred.

9] PERIODIC MATCHING OF COST AND REVENUE CONCEPT:-

This concept is based on the period concept. Making profit is the most important objective that keeps the proprietor engaged in business activities. That is why most of the accountant’s time is spent in evolving techniques for measuring the profit/profitability of the concern. To ascertain the profit made during a period, it is necessary to match “revenues” of the period with the “expenses” of that period. Income (profit) earned by the business during a period is compared with the expenditure incurred to earn the revenue.

10] REVENUE RECOGNITION (REALISATION CONCEPT) :-

According to this concept profit should be accounted for only when it is actually realised. Revenue is recognised only when sale is affected or the services are rendered. Sale is considered to be made when the property in goods passes to the buyer and he is legally liable to pay. However, in order to recognise revenue, receipt of cash is not essential. Even credit sales result in realisation, as it creates a definite asset called debtor. Similarly income like commission, interest, rent etc. are shown in Profit & Loss Account on accrual basis though they may not be realised in cash on the date of preparing accounts.

11] VERIFIABLE OBJECTIVE EVIDENCE CONCEPT:-

According to this concept all accounting transactions should be evidenced and supported by objective documents. These documents include invoices, contract, correspondence, vouchers, bills, passbooks, cheque etc.

ACCOUNTING CONVENTIONS

Conventions are the customs or traditions guiding the preparation of accounting statements. They are adapted to make financial statements clear and meaningful. They represent usage or methods generally accepted and customarily used. These exist in cases where there are different alternatives, which are equally logical and some of these are generally accepted having consideration of cost, time, habit or convenience. Following are the accounting conventions: -

1] CONVENTION OF DISCLOSURE :-

This means that the accounts must be honestly prepared and they must disclose all material information. The accounting reports should disclose full and fair information to the proprietors, creditors, investors and others. The term disclosure only implies that there must be a sufficient disclosure of information which is of material interest to proprietors, and potential creditors and investors

2] CONVENTION OF MATERIALITY :-

The accountant should attach importance to material details and ignore insignificant details. If this is not done, accounts will be overburdened with minute details. Therefore, keeping the convention of materiality in view, unimportant items are either left out or merged with other items. Whether the information is material or not depends upon the circumstances of the case & common sense. The rule to be kept in mind is that if omission of the information impairs the decision or conduct of its user, it should be regarded as material.

However, an item may be material for one purpose but immaterial for another, material for one concern but immaterial for another or material for one year but immaterial for the next year.

3] CONVENTION OF CONSISTENCY :-

The comparison of one accounting period with the other is possible only when the convention of consistency is followed. It means accounting from one accounting period to another should on the same basis. If stock is valued at cost or market price whichever is less this principle should be followed every year. Any change from one method to another would lead to inconsistency. However consistency does not mean non-flexibility. It should permit introduction of improved techniques of accounting.

4] CONVENTION OF CONSERVATISM :-

As per this convention all prospective losses are taken into consideration but not all prospective profits. In other words anticipate no profit but provide for all possible losses. This convention is being criticised on the ground that it goes not only against convention

of full disclosure but also against the concept of matching cost & revenues. It encourages creation of secrete reserves by making excess provision for depreciation, bad and doubtful debts etc. The income statement shows a lower net income & the balance sheet overstates the liabilities & understate the assets.

Following are the examples of application of conservatism :-

1) Making provision for doubtful debts and discount on debtor
2) Not providing for discount on creditor
3) Valuing stock in trade at cost or market price whichever is less.
4) Creating provisions against fluctuations in the price of investments.
5) Showing joint life policy at surrender value and not at the paid up amount.
6) Amortisation of intangible assets like goodwill which has indefinite life.