REGIONAL TRAINING INSTITUTE, JAIPUR
INDIAN AUDIT AND ACCOUNTS DEPARTMENT

Basic Principles of Accounting

Annual Accounts

Annual accounts are usually described as "**financial accounts**", "company **accounts**" or "statutory **accounts**". **Annual accounts** provide a comprehensive report of a company's **financial** activity over the last **financial** year.

Balance Sheet:

Balance Sheet is the financial statement of a company, which includes assets, liabilities, equity capital, total debt, etc. at a point in time. Balance sheet includes assets on one side, and liabilities on the other. For the balance sheet to reflect the true picture, both heads (liabilities & assets) should tally (Assets = Liabilities + Equity).

Profit & Loss Account:

The profit and loss (P&L) statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a fiscal quarter or year. The P&L statement is synonymous with the income statement. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. Some refer to the P&L statement as a statement of profit and loss, income statement, statement of

operations, statement of financial results or income, earnings statement or expense statement.

Basic Accounting Principles:

Definition:

Accounting principles are the principle, concept, basic, guidance, as well as the rule that use by the accountant to prepare the financial statements of an entity.

A number of basic accounting principles have been developed through common usage. They form the basis upon which the complete suite of accounting standards have been built. The best known of these principles are as follows:

Contents

1. **Business Entity Concept**
2. **Money Measurement Concept**
3. **Going Concern Concept**
4. **Cost Concept**
5. **Dual Aspect Concept**
   - Quiz 1 on above 5 Principles
6. **Accounting Period Concept**
7. **Matching Concept**
8. **Accrual Concept**
9. **Objective Evidence Concept**
10. **Convention of Consistency**
    - Quiz on above 5 Principles
11. **Convention of Disclosure**
12. **Convention of Materiality**
13. **Conservation or Prudence**
    - Quiz on all Basic Accounting Principles

1. Business Entity Concept

According to this concept, the business and the owner of the business are two different entities. In other words, I and my business are separate.

In other words, while recording transactions in a business, we take into account only those events that affect that particular business; the events that affect anyone else other than the business entity are not relevant and are therefore not included in the accounting records of the business.

The concept is very important because if transactions are mixed up with that of its owners or other businesses, the accounting information would lose its usability.

Example-

Mr A starts a new business in the name and style of M/s Independent Trading Company and introduced a capital of Rs 2,000,000 in cash. It means the cash balance of M/s Independent Trading Company will increase by a sum of Rs 2,000,000/-. At the same time, the liability of M/s Independent Trading Company in the form of capital will also increase. It means M/s Independent Trading Company is liable to pay Rs 2,000,000 to Mr A.

Next Page **Index**

2. Money Measurement Concept

According to this concept, “we can book only those transactions in our accounting record which can be measured in monetary terms.”

Example

Determine and book the value of stock of the following items:

Shirts Rs 5,000/-
Pants Rs 7,500/-

Coats 500 pieces
Jackets 1000 pieces

Value of Stock = ?

Here, if we want to book the value of stock in our accounting record, we need the value of coats and jackets in terms of money. Now if we conclude that the values of coats and jackets are Rs 2,000 and Rs 15,000 respectively, then we can easily book the value of stock as Rs 29,500 (as a result of 5000+7500+2000+15000) in our books. We need to keep quantitative records separately.

Next Page Index

3. Going Concern Concept

Our accounting is based on the assumption that a business unit is a going concern. We record all the financial transaction of a business in keeping this point of view in our mind that a business unit is a going concern; not a gone concern. Otherwise, the banker will not provide loans, the supplier will not supply goods or services, the employees will not work properly, and the method of recording the transaction will change altogether.

Example

A business unit makes investments in the form of fixed assets and we book only depreciation of the assets in our profit & loss account; not the difference of acquisition cost of assets less net realizable value of the assets. The reason is simple; we assume that we will use these assets and earn profit in the future while using them. Similarly, we treat deferred revenue expenditure and prepaid expenditure. The concept of going concern does not work in the following cases:

- If a unit is declared sick (unused or unusable unit).
- When a company is going to liquidate and a liquidator is appointed for the same.
- When a business unit is passing through severe financial crisis and going to wind up

Next Page Index

4. Cost Concept

It is a very important concept based on the Going Concern Concept. We book the value of assets on the cost basis, not on the net realizable value or market value of the assets based on the assumption that a business unit is a going concern. No doubt, we reduce the value of assets providing depreciation to assets, but we ignore the market value of the assets.

The cost concept stops any kind of manipulation while taking into account the net realizable value or the market value. On the downside, this concept ignores the effect of inflation in the market, which can sometimes be very steep. Still, the cost concept is widely and universally accepted on the basis of which we do the accounting of a business unit.

Example:-

if an asset is acquired at an original cost of Rs. 50,000, and that asset's market value increases over five years to Rs. 75,000, the cost principle will remain recorded at the initial value of Rs. 50,000.

Next Page Index

5. Dual Aspect Concept

There must be a double entry to complete any financial transaction, means debit should be always equal to credit. Hence, every financial transaction has its dual aspect:

- we get some benefit, and
- we pay some benefit.

For example, if we buy some stock, then it will have two effects:

- the value of stock will increase (get benefit for the same amount), and
- it will increase our liability in the form of creditors.

Transaction	Effect
Purchase of Stock for Rs 25,000	Stock will increase by Rs 25,000 (Increase in debit balance) Cash will decrease by Rs 25,000 (Decrease in debit balance) or Creditor will increase by Rs 25,000 (Increase in credit balance)

➢ Quiz 1 on above 5 Principles

Next Page Index

6. Accounting Period Concept

The life of a business unit is indefinite as per the going concern concept. To determine the profit or loss of a firm, and to ascertain its financial position, profit & loss accounts and balance sheets are prepared at regular intervals of time, usually at the end of each year. This one-year cycle is known as the accounting period. The purpose of having an accounting period is to take corrective measures keeping in view the past performances, to nullify the effect of seasonal changes, to pay taxes, etc.

Based on this concept, revenue expenditure and capital expenditure are segregated. Revenues expenditure are debited to the profit & loss account to ascertain correct profit or loss during a particular accounting period. Capital expenditure comes in the category of those expenses, the benefit of which will be utilized in the next coming accounting periods as well.

Accounting period helps us ascertain correct position of the firm at regular intervals of time, i.e., at the end of each accounting period.

Next Page **Index**

7. Matching Concept

Matching concept is based on the accounting period concept. The expenditures of a firm for a particular accounting period are to be matched with the revenue of the same accounting period to ascertain accurate profit or loss of the firm for the same period. This practice of matching is widely accepted all over the world. Let us take an example to understand the Matching Concept clearly.

The following data is received from M/s Globe Enterprises during the period 01-04-2012 to 31-03-2013:

S.No.	Particulars	Amount
1	Sale of 1,000 Electric Bulbs @ Rs 10 per bulb on cash basis.	10,000.00
2	Sale of 200 Electric Bulb @ Rs. 10 per bulb on credit to M/s Atul Traders.	2,000.00
3	Sale of 450 Tube light @ Rs.100 per piece on Cash basis.	45,000.00
4	Purchases made from XZY Ltd.	40,000.00
5	Cash paid to M/s XYZ Ltd.	38,000.00
6	Freight Charges paid on purchases	1,500.00
7	Electricity Expenses of shop paid	5,000.00
8	Bill for March-13 for Electricity still outstanding to be paid next year.	1,000.00

Based on the above data, the profit or loss of the firm is calculated as follows:

Particulars	Amount	Total
Sale		
Bulb	12,000.00	
Tube	45,000.00	57,000.00
Less -		
Purchases	40,000.00	
Freight Charges	5,000.00	
Electricity Expenses	1,500.00	
Outstanding Expenses	1,000.00	47,500.00
Net Profit		**9,500.00**

In the above example, to match expenditures and revenues during the same accounting period, we added the credit purchase as well as the outstanding expenses of this accounting year to ascertain the correct profit for the accounting period 01-04-2012 to 31-03-2013.

It means the collection of cash and payment in cash is ignored while calculating the profit or loss of the year.

Next Page Index

8. Accrual Concept

In the matching concept, the revenue generated in the accounting period is considered and the expenditure related to the accounting period is also considered. Based on the accrual concept of accounting, if we sell some items or we rendered some service, then that becomes our point of revenue generation irrespective of whether we received cash or not. The same concept is applicable in case of expenses. All the expenses paid in cash or payable are considered and the advance payment of expenses, if any, is deducted.

Most of the professionals use cash basis of accounting. It means, the cash received in a particular accounting period and the expenses paid cash in the same accounting period is the basis of their accounting. For them, the income of their firm depends upon the collection of revenue in cash. Similar practice is followed for expenditures. It is convenient for them and on the same basis, they pay their Taxes.

Next Page **Index**

9. Objective Evidence Concept

According to the Objective Evidence concept, every financial entry should be supported by some objective evidence. Purchase should be supported by purchase bills, sale with sale bills, cash payment of expenditure with cash memos, and payment to creditors with cash receipts and bank statements. Similarly, stock should be checked by physical verification and the value of it should be verified with purchase bills. In the absence of these, the accounting result will not be trustworthy, chances of manipulation in accounting records will be high, and no one will be able to rely on such financial statements.

Next Page Index

10. Convention of Consistency

To compare the results of different years, it is necessary that accounting rules, principles, conventions and accounting concepts for similar transactions are followed consistently and continuously. Reliability of financial statements may be lost, if frequent changes are observed in accounting treatment. For example, if a firm chooses cost or *market price whichever is lower* method for stock valuation and *written down value method* for depreciation to fixed assets, it should be followed consistently and continuously.

Consistency also states that if a change becomes necessary, the change and its effects on profit or loss and on the financial position of the company should be clearly mentioned.

- Quiz on above 5 Principles

Next Page **Index**

11. Convention of Disclosure

The Companies Act, 2013, prescribed a format in which financial statements must be prepared. Every company that fall under this category has to follow this practice. Various provisions are made by the Companies Act to prepare these financial statements. The purpose of these provisions is to disclose all essential information so that the view of financial statements should be true and fair. However, the term 'disclosure' does not mean all information. It means disclosure of information that is significance to the users of these financial statements, such as investors, owner, and creditors.

Next Page **Index**

12. Convention of Materiality

If the disclosure or non-disclosure of an information might influence the decision of the users of financial statements, then that information should be disclosed.

For better understanding, please refer to General Instruction for preparation of Statement of Profit and Loss in revised scheduled VI to the Companies Act, 1956:

- A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or Rs 1,00,000 whichever is higher.
- A Company shall disclose in Notes to Accounts, share in the company held by each shareholder holding more than 5% share specifying the number of share held.

Next Page Index

13. Conservation or Prudence

It is a policy of playing safe. For future events, profits are not anticipated, but provisions for losses are provided as a policy of conservatism. Under this policy, provisions are made for doubtful debts as well as contingent liability; but we do not consider any anticipatory gain.

For example, If A purchases 1000 items @ Rs 80 per item and sells 900 items out of them @ Rs 100 per item when the market value of stock is (i) Rs 90 and in condition (ii) Rs 70 per item, then the profit from the above transactions can be calculated as follows:

Particulars	Condition(i)	Condition(ii)
Sale Value (A) (900x100)	90,000.00	90,000.00
Less - Cost of Goods Sold		
Purchases	80,000.00	80,000.00
Less - Closing Stock	8,000.00	7,000.00
Cost of Goods Sold (B)	72,000.00	73,000.00
Profit(A-B)	**18,000.00**	**17,000.00**

In the above example, the method for valuation of stock is *'Cost or market price whichever is lower'*.

The prudence however does not permit creation of hidden reserve by understating the profits or by overstating the losses.

➢ Quiz on above all Principles

Index