

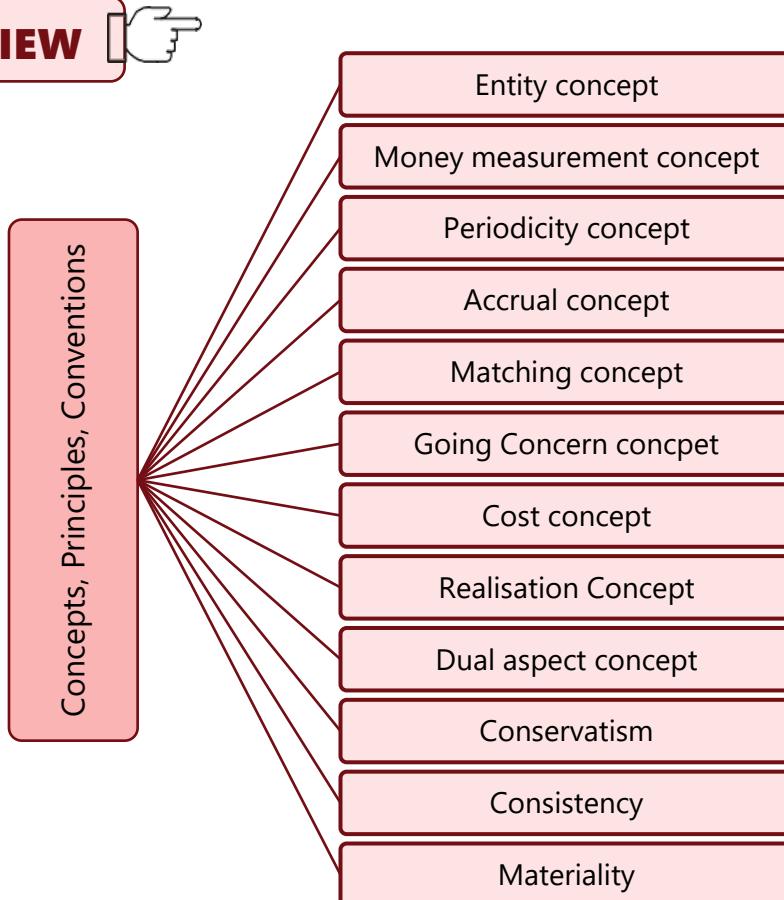
UNIT – 2 ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Grasp the basic accounting concepts, principles and conventions and observe their implications while recording transactions and events.
- ◆ Identify the three fundamental accounting assumptions:
 - Going Concern
 - Consistency
 - Accrual
- ◆ Understand the qualitative characteristics that will help to develop the skill in course of time to prepare financial statements.

UNIT OVERVIEW



2.1 INTRODUCTION

Let us imagine a situation where you are a proprietor and you take copies of your books of account to five different accountants. You ask them to prepare the financial statements on the basis of the above records and to calculate the profits of the business for the year. After few days, they are ready with the financial statements and all the five accountants have calculated five different amounts of profits and that too with very wide variations among them. Guess in such a situation what impact would it leave on you about accounting profession. To avoid this, a generally accepted set of rules have been developed. This generally accepted set of rules provides unity of understanding and unity of approach in the practice of accounting and also in better preparation and presentation of the financial statements.

Accounting is a language of the business. Financial statements prepared by the accountant communicate financial information to the various stakeholders for decision-making purpose. Therefore, it is important that financial statements prepared by different organizations should

be prepared on uniform basis. Also, there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own norms and notions for accounting of different items, then there will be an utter confusion.

To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of 'Generally Accepted Accounting Principles' (GAAPs). The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called concepts, conventions, postulates, principles etc. These GAAPs are the backbone of the accounting information system, without which the whole system cannot even stand erectly. These principles are the ground rules, which define the parameters and constraints within which accounting reports are generated. Accounting principles are basic norms and assumptions on which the whole accounting system has been developed and established. Accountant also adheres to various accounting standards issued by the regulatory authority for the standardization of accounting policies to be followed under specific circumstances. These conceptual frameworks, GAAPs and accounting standards are considered as the theory base of accounting. Globally, for achieving the standardization, countries use the framework under International Financial Reporting Standards (IFRS). However, countries may apply their respective GAAPs and related conceptual frameworks. For example, in India, companies are required to use AS or Ind-AS frameworks as applicable.



2.2 ACCOUNTING CONCEPTS

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Certain concepts are perceived, assumed and accepted in accounting to provide a unifying structure and internal logic to accounting process. The word concept means idea or notion, which has universal application. Financial transactions are interpreted in the light of the concepts, which govern accounting methods. Concepts are those basic assumptions and conditions, which form the basis upon which the accountancy has been laid. Unlike physical science, accounting concepts are only result of broad consensus. These accounting concepts lay the foundation on the basis of which the accounting principles are formulated.



2.3 ACCOUNTING PRINCIPLES

"Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist."

Accounting principles must satisfy the following conditions:

1. They should be based on real assumptions;

2. They must be simple, understandable and explanatory;
3. They must be followed consistently;
4. They should be able to reflect future predictions;
5. They should be informational for the users.



2.4 ACCOUNTING CONVENTIONS

Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

In the study material, the terms 'accounting concepts', 'accounting principles' and 'accounting conventions' have been used interchangeably to mean those basic points of agreement on which financial accounting theory and practice are founded.



2.5 CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

Now we shall study in detail the various accounting concepts on which accounting is based. The following are the widely accepted accounting concepts:

(a) **Entity concept:** Entity concept states that business enterprise is a separate identity apart from its owner. Accountants should treat a business as distinct from its owner. Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of accounts. The practice of distinguishing the affairs of the business from the personal affairs of the owners originated only in the early days of the double-entry book-keeping. This concept helps in keeping business affairs free from the influence of the personal affairs of the owner. This basic concept is applied to all the organizations whether sole proprietorship or partnership or corporate entities.

Entity concept keeps the business separate from its owner. In a way, the entity concept helps to ascertain how much amount of money is due to the owner in form of his capital and share of profits earned. It also helps to perform accounting from the point of view of the business and not that of the owner. For example, if a person runs a business and pays money from his own pocket for his son's school fee, it will not constitute a transaction in the books of the business. However, if the person withdraws

money from the business to pay for his son's school fee it will constitute a transaction to be recorded in the books of the business as amount withdrawn by the owner.

Entity concept means that the enterprise is liable to the owner for capital investment made by the owner. Since the owner invested capital, which is also called risk capital, he has claim on the profit of the enterprise. A portion of profit which is apportioned to the owner and is immediately payable becomes current liability in the case of corporate entities.

Example 1: Mr. X started business investing ₹ 7,00,000 with which he purchased machinery for ₹ 5,00,000 and maintained the balance in hand. The financial position of the will be as follows:

	₹
Capital	7,00,000
Machinery	5,00,000
Cash	2,00,000

This means that the enterprise owes to Mr. X ₹ 7,00,000. Now if Mr. X spends ₹ 5,000 to meet his family expenses from the business fund, then it should not be taken as business expenses and would be charged to his capital account (i.e., his investment would be reduced by ₹ 5,000). Following the entity concept the revised financial position would be

Liability	₹	₹
Capital	7,00,000	
<i>Less : Drawings</i>	(5,000)	6,95,000
Machinery		5,00,000
Cash		1,95,000

- (b) **Money measurement concept:** As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms.

For example, a business owning a factory on a piece of 1 acre of land, with an office building with 2 floors, having 20 computers, and 10 units of machine cannot show these items under different measurement units. These items need to be expressed in monetary terms. The factory price might be 50 Cr, cost of land might be 30 Cr, building

with a cost of 15 Cr, computers at a cost of 10 lac and machines with a cost of 10 Cr need to be recorded.

However, the concept has its own limitations. Transactions and events that cannot be expressed in terms of money are not recorded in the business books. For example; employees of the organization are, no doubt, the assets of the organizations but their measurement in monetary terms is not possible therefore, not included in the books of account of the organization. Measuring unit for money is taken as the currency of the ruling country i.e., the ruling currency of a country provides a common denomination for the value of material objects.

It may be mentioned that when transactions occur across the boundary of a country, one may see many currencies. Suppose a businessman sells goods worth ₹ 50 lakhs at home and he also sells goods worth of 1 lakh Euro in the United States. What is his total sales? ₹ 50 lakhs plus 1 lakh Euro.

These are not amenable to even arithmetic treatment. So, transactions are to be recorded at uniform monetary unit i.e. in one currency. Suppose EURO 1 = ₹ 71.

Total Sales = ₹ 50 lakhs plus 71 lakhs = ₹ 121 lakhs. Money Measurement Concept imparts the essential flexibility for measurement and interpretation of accounting data.

This concept ignores that money is an inelastic yardstick for measurement as it is based on the implicit assumption that purchasing power of the money is not of sufficient importance as to require adjustment. For example, a unit of land purchased 10 years ago for 40 Cr and a similar unit of land purchased now for 90 Cr will still be shown at the respective values, i.e., total of 130 Cr. Though in real world, the true value of the units together might be 180 Cr (90 + 90). Accordingly, accounting does not give a true and fair view of the affairs of the business.

As mentioned earlier, many material transactions and events are not recorded in the books of accounts just because they cannot be measured in monetary terms. Yet it is used for accounting purposes because it is not possible to adopt a better measurement scale.

Entity and money measurement are viewed as the basic concepts on which other procedural concepts hinge.

- (c) **Periodicity concept:** This is also called the concept of definite accounting period. As per 'going concern' concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business.

If a textile mill lasts for 100 years, it is not desirable to measure its performance as well as financial position only at the end of its life.

So, a small but workable fraction of time is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Generally, one year period is taken up for performance measurement and appraisal of financial position. However, it may also be 6 months or 9 months or 15 months.

According to this concept accounts should be prepared after every period & not at the end of the life of the entity. Usually, this period is one calendar year. We generally follow from 1st April of a year to 31st March of the immediately following year.

Thus, for performance appraisal it is not necessary to look into the revenue and expenses of an unduly long time-frame. This concept makes the accounting system workable and the term 'accrual' meaningful. If one thinks of indefinite time-frame, nothing will accrue. There cannot be unpaid expenses and non-receipt of revenue. Accrued expenses or accrued revenue is only with reference to a finite time-frame which is called accounting period.

Thus, the periodicity concept facilitates in:

- (i) Comparing of financial statements of different periods
- (ii) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business
- (iii) Matching periodic revenues with expenses for getting correct results of the business operations

(d) Accrual concept: Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.

To understand accrual assumption knowledge of revenues and expenses is required. Revenue is the gross inflow of cash, receivables and other consideration arising in the course of the ordinary activities of an enterprise from sale of goods, from rendering services and from the use by others of enterprise's resources yielding interest, royalties and dividends. For example, (1) Mr. X started a cloth merchandising. He invested ₹ 50,000, bought merchandise worth ₹ 50,000. He sold such merchandise for ₹ 60,000. Customers paid him ₹ 50,000 cash and assure him to pay ₹ 10,000 shortly. His revenue

is ₹ 60,000. It arose in the ordinary course of cloth business; Mr. X received ₹ 50,000 in cash and ₹ 10,000 by way of receivables.

Take another example; (2) an electricity supply undertaking supplies electricity spending ₹ 16,00,000 for fuel and wages and collects electricity bill in one month ₹ 20,00,000 by way of electricity charges. This is also revenue which arose from rendering services.

Lastly, (3) Mr. A invested ₹ 1,00,000 in a business. He purchased a machine paying ₹ 1,00,000. He rented it for ₹ 20,000 annually to Mr. B. ₹ 20,000 is the revenue of Mr. A; it arose from the use of the enterprise's resources.

Expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period.

In the first example, Mr. X spent ₹ 50,000 to buy the merchandise; it is the expense of generating revenue of ₹ 60,000. In the second instance ₹ 16,00,000 are the expenses. Also whenever any asset is used it has a finite life to generate benefit. Suppose, the machine purchased by Mr. A in the third example will last for 10 years only. Then ₹ 10,000 is the expense every year relating to the cost of machinery.

Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. The accrual concept relates to measurement of income, identifying assets and liabilities.

Example: Mr. J D buys clothing of ₹ 50,000 paying cash ₹ 20,000 and sells at ₹ 60,000 of which customers paid only ₹ 50,000.

His revenue is ₹ 60,000, not ₹ 50,000 cash received. Expense (i.e., cost incurred for the revenue) is ₹ 50,000, not ₹ 20,000 cash paid. So the accrual concept based profit is ₹ 10,000 (Revenue – Expenses).

As per Accrual Concept: Revenue – Expenses = Profit

Accrual Concept provides the foundation on which the structure of present-day accounting has been developed.

Alternative as per Cash basis

Cash received in ordinary course of business – Cash paid in ordinary course of business = profit.

Timing of revenue and expense booking could be different from cash receipt or paid.

- (i) when cash received before revenue - a liability is created when cash is received in advance

- (ii) when cash received after revenue is - an asset called Trade receivables is booked created
- (iii) when cash paid before expense is - creates an asset called Trade Advance booked when cash is paid in advance
- (iv) when cash paid after expense is - creates a liability called payables or booked Trade payables or outstanding liabilities

(e) **Matching concept:** In this concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash. This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes.

It is not necessary that every expense identify every income. Some expenses are directly related to the revenue and some are time bound. For example:- selling expenses are directly related to sales but rent, salaries etc are recorded on accrual basis for a particular accounting period. In other words periodicity concept has also been followed while applying matching concept.

Mr. P K started cloth business. He purchased 10,000 pcs. garments @ ₹ 100 per piece and sold 8,000 pcs. @ ₹ 150 per piece during the accounting period of 12 months 1st January to 31st December, 2022. He paid shop rent @ ₹ 3,000 per month for 11 months and paid ₹ 8,00,000 to the suppliers of garments and received ₹ 10,00,000 from the customers.

Let us see how the accrual and periodicity concepts operate.

Periodicity Concept fixes up the time-frame for which the performance is to be measured and financial position is to be appraised. Here, it is January 2022 - December, 2022. Therefore, revenues and expenses are to be measured for the year 2022 and assets and liabilities are to be ascertained as on 31st December, 2022.

Accrual Concept operates to measure revenue of ₹ 12,00,000 (arising out of sale of garments 8,000 Pcs × ₹ 150) which accrued during 2022, not the cash received ₹ 10,00,000 and also the expenses correctly. Shop rent for 12 months is an expense item amounting to ₹ 36,000, not ₹ 33,000 the cash paid.

Should the accountant treat ₹ 10,00,000 as expenses for purchase of merchandise? And should he treat ₹ 1,64,000 as profit? (Revenue ₹ 12,00,000-Merchandise ₹ 10,00,000. Shop Rent ₹ 36,000). Obviously, the answer is No. Matching links revenue with expenses.

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

But this unqualified equation may create misconception.

It should be defined as: Periodic Profit = Periodic Revenue – Matched Expenses

From the revenue of an accounting period such expenses are deducted which are expended to generate the revenue to determine profit of that period.

In the given example revenue relates to only sale of 8,000 pcs. of garments. Therefore, the cost of 8,000 pcs of garments should be treated as expenses.

	₹	₹
Thus, Profit = Revenue		12,00,000
Less Expenses:		
Merchandise	8,00,000	
Shop Rent	36,000	(8,36,000)
		3,64,000
Assets:		
Inventory (2,000 pcs x ₹100)		2,00,000
Trade receivables		2,00,000
Cash (Cash Receipts ₹10,00,000 – cash payments ₹ 8,33,000)		1,67,000
		5,67,000
Liabilities:		
Trade Payables		2,00,000
Expenses Payables		3,000
Capital (Profit)		3,64,000
		5,67,000

Thus, accrual, matching and periodicity concepts work together for income measurement and recognition of assets and liabilities.

- (f) **Going Concern concept:** The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an

intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used needs to be disclosed.

The valuation of assets of a business entity is dependent on this assumption. Traditionally, accountants follow historical cost in majority of the cases.

Suppose Mr. X purchased a machine for his business paying ₹ 5,00,000 out of ₹ 7,00,000 invested by him. He also paid transportation expenses and installation charges amounting to ₹ 70,000. If he is still willing to continue the business, his financial position will be as follows:

BALANCE SHEET

Liability	₹	Assets	₹
Capital	7,00,000	Machinery	5,70,000
		Cash	1,30,000
	7,00,000		7,00,000

Now if he decides to back out and desires to sell the machine, it may fetch more than or less than ₹ 5,70,000. So his financial position should be different. If going concern concept is taken, increase/ decrease in the value of assets in the short-run is ignored. The concept indicates that assets are kept for generating benefit in future, not for immediate sale; current change in the asset value is not realisable and so it should not be counted.

This can be understood differently with some examples we may have come across in real life. Recently during pandemic, many businesses were shutting down due to heavy losses. If the financial statement of these entities does not reveal the fact of winding up due to losses, it will mislead the stakeholders. And, a sudden news of the business shutting down would be a setback to those stakeholders.

Therefore, entities need to assess at the time of preparation of financial statements, whether they are likely to continue to operate their business. If the Going Concern assumption is under question, the same information should be communicated to the stakeholders.

- (g) **Cost concept:** By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity. When a machine is acquired by paying ₹ 5,00,000, following cost concept the value of the machine is taken as ₹ 5,00,000. It is highly objective and free from all bias. Other measurement bases are not so objective. Current cost of an asset is not easily determinable. If the asset is purchased on 1.1.1995 and such model is not available in

the market, it becomes difficult to determine which model is the appropriate equivalent to the existing one. Similarly, unless the machine is actually sold, realisable value will give only a hypothetical figure. Lastly, present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

However, the cost concept creates a lot of distortion too as outlined below:

- (a) In an inflationary situation when prices of all commodities go up on an average, acquisition cost loses its relevance. For example, a piece of land purchased on 1.1.1995 for ₹ 2,000 may cost ₹ 1,00,000 as on 1.1.2022. So if the accountant makes valuation of asset at historical cost, the accounts will not reflect the true position.
- (b) Historical cost-based accounts may lose comparability. Mr. X invested ₹ 1,00,000 in a machine on 1.1.1995 which produces ₹ 50,000 cash inflow during the year 2022, while Mr. Y invested ₹ 5,00,000 in a machine on 1.1.2005 which produced ₹ 50,000 cash inflows during the year. Mr. X earned at the rate 50% while Mr. Y earned at the rate 10%. Who is more efficient? Since the assets are recorded at the historical cost, the results are not comparable. Obviously, it is a corollary to (a).
- (c) Many assets do not have acquisition costs. Human assets of an enterprise are an example. The cost concept fails to recognise such asset although it is a very important asset of any organization.

Many other controversial issues have arisen in financial accounting that revolves around the cost concept which will be discussed at the advanced stage. However, later on we shall see that in many circumstances, the cost convention is not followed. See conservatism concept for an example, which will be discussed later on in this unit.

- (h) **Realisation concept:** It closely follows the cost concept. Any change in value of an asset is to be recorded only when the business realises it. When an asset is recorded at its historical cost of ₹ 5,00,000 and even if its current cost is ₹ 15,00,000 such change is not counted unless there is certainty that such change will materialize.

However, accountants follow a more conservative path. They try to cover all probable losses but do not count any probable gain. That is to say, if accountants anticipate decrease in value they count it, but if there is increase in value they ignore it until it is realised. Economists are highly critical about the realisation concept. According to them, this concept creates value distortion and makes accounting meaningless.

Example: Mr. X purchased a piece of land on 1.1.1995 paying ₹ 2,000. Its current market value is ₹ 1,02,000 on 31.12.2022. Should the accountant show the land at ₹ 2,000 following cost concept and ignoring ₹1,00,000 value increase since it is not realised? If he does so, the financial position would be:

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	2,000	Land	2,000
	2,000		2,000

Is it not proper to show it in the following manner?

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	2,000	Land	1,02,000
Unrealised Gain	1,00,000		
	1,02,000		1,02,000

Now-a-days the revaluation of assets has become a widely accepted practice when the change in value is of permanent nature. Accountants adjust such value change through creation of revaluation (capital) reserve.

Thus, the going concern, cost concept and realization concept gives the valuation criteria.

(i) **Dual aspect concept:** This concept is the core of double entry book-keeping. Every transaction or event has two aspects:

- (1) It increases one Asset and decreases other Asset;
- (2) It increases an Asset and simultaneously increases Liability;
- (3) It decreases one Asset, increases another Asset;
- (4) It decreases one Asset, decreases a Liability.

Alternatively:

- (5) It increases one Liability, decreases other Liability;
- (6) It increases a Liability, increases an Asset;
- (7) It decreases Liability, increases other Liability;
- (8) It decreases Liability, decreases an Asset.

Example :**BALANCE SHEET**

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	75,000	Cash	1,00,000
Other Loan	75,000		
	3,00,000		3,00,000

Transactions:

- (a) A new machine is purchased paying ₹ 50,000 in cash.
- (b) A new machine is purchased for ₹ 50,000 on credit, cash is to be paid later on.
- (c) Cash paid to repay bank loan to the extent of ₹ 50,000.
- (d) Raised bank loan of ₹ 50,000 to pay off other loan.

Effect of the Transactions:

- (a) Increase in machine value and decrease in cash balance by ₹ 50,000.

BALANCE SHEET (1 & 3)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

- (b) Increase in machine value and increase in Creditors by ₹ 50,000.

BALANCE SHEET (2 & 6)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Creditors for machinery	50,000	Cash	1,00,000
Bank Loan	75,000		
Other Loan	75,000		
	3,50,000		3,50,000

- (c) Decrease in bank loan and decrease in cash by ₹ 50,000.

BALANCE SHEET (4 & 8)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	25,000	Cash	50,000
Other Loan	75,000		
	2,50,000		2,50,000

- (d) Increase in bank loan and decrease in other loan by ₹ 50,000.

BALANCE SHEET (5 & 7)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	1,25,000	Cash	1,00,000
Other Loan	25,000		
	3,00,000		3,00,000

We may conclude that every transaction and event has two aspects.

This gives basic accounting equation :

$$\text{Equity (E)} + \text{Liabilities (L)} = \text{Assets (A)}$$

or

$$\text{Equity (E)} = \text{Assets (A)} - \text{Liabilities (L)}$$

Or, Equity + Long Term Liabilities + Current Liabilities = Fixed Assets + Current Assets

Or, Equity + Long Term Liabilities = Fixed Assets + (Current Assets – Current Liabilities)

Or, Equity = Fixed Assets + Working Capital – Long Term Liabilities

ILLUSTRATION 1

Develop the accounting equation from the following information: -

Particulars	March 31, 2021 ₹)	March 31, 2022 ₹)
Capital	1,00,000	?
12% Bank Loan	1,00,000	1,00,000

<i>Trade Payables</i>	75,000	70,000
<i>Fixed Assets</i>	1,25,000	1,10,000
<i>Trade Receivables</i>	75,000	80,000
<i>Inventory</i>	70,000	80,000
<i>Cash & Bank</i>	5,000	6,000

Required

Find the profit for the year & the Balance sheet as on 31/3/2022.

SOLUTION

For the year ended March 31, 2021:

$$\text{Equity} = \text{Capital} \quad ₹ 1,00,000$$

$$\begin{aligned}\text{Liabilities} &= \text{Bank Loan} + \text{Trade Payables} \\ &₹ 1,00,000 + ₹ 75,000 = ₹ 1,75,000\end{aligned}$$

$$\begin{aligned}\text{Assets} &= \text{Fixed Assets} + \text{Trade Receivables} + \text{Inventory} + \text{Cash & Bank} \\ &₹ 1,25,000 + ₹ 75,000 + ₹ 70,000 + ₹ 5,000 = ₹ 2,75,000 \\ \text{Equity} + \text{Liabilities} &= \text{Assets} \\ ₹ 1,00,000 + ₹ 1,75,000 &= 2,75,000\end{aligned}$$

For the year ended March 31, 2022:

$$\text{Assets} = ₹ 1,10,000 + ₹ 80,000 + ₹ 80,000 + ₹ 6,000 = ₹ 2,76,000$$

$$\text{Liabilities} = ₹ 1,00,000 + ₹ 70,000 = ₹ 1,70,000$$

$$\begin{aligned}\text{Equity} &= \text{Assets} - \text{Liabilities} = ₹ 2,76,000 - ₹ 1,70,000 = ₹ 1,06,000 \\ \text{Profits} &= \text{New Equity} - \text{Old Equity} = ₹ 1,06,000 - ₹ 1,00,000 = ₹ 6,000\end{aligned}$$

- (j) **Conservatism:** Conservatism states that the accountant should not anticipate any future income however they should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. Later on, we shall see that the golden rule of current assets valuation - 'cost or market price whichever is lower' originated from this concept.

The Realisation Concept also states that no change should be counted unless it has materialised. The Conservatism Concept puts a further brake on it. It is not prudent to count unrealised gain but it is desirable to guard against all possible losses.

For this concept there should be at least three qualitative characteristics of financial statements, namely,

- (i) *Prudence*, i.e., judgement about the possible future losses which are to be guarded, as well as gains which are uncertain.
- (ii) *Neutrality*, i.e., unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,
- (iii) *Faithful representation of alternative values.*

This concept is of wider importance to investors since they would need to take a decision about their money being invested in the business. Recording future profits when these have not been earned would suggest that the business is booming, and the investors would be tempted to put more money into the same. However, eventually if the profit is not earned, the investors are likely to lose their investments. At the same time, if the entity expects to make a loss in future, it is prudent to show that loss in the books in present itself. This acts as a safeguard for the investors as they would be prudent to make the investment decisions. For example: Mr. X runs a business of computers. He purchased 10 computers at a cost of ₹ 20,000 each and is expecting to be able to sell these computers at the current market price of ₹ 25,000 each. Note that the conservatism principle does not allow to recognise the profit on the computers unless the sale has been made. Since, this is a future profit, Mr. X needs to follow a prudent approach while recording the transactions in his books and ignore the profit until it is earned

However, before sale, the market price of the computers declines to ₹ 17,000 each. Under the conservatism approach, Mr. X needs to recognise that loss of ₹ 3,000 per computer, even though the sale has not been made.

Many accounting authors, however, are of the view that conservatism essentially leads to understatement of income and wealth and it should not be the basis for the preparation of financial statements.

- (k) **Consistency:** In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

The concept of consistency is applied particularly when alternative methods of accounting are equally acceptable. For example, a company may adopt any of several methods of depreciation such as written-down-value method, straight-line method, etc. Likewise, there are many methods for valuation of inventories. But following the principle of consistency it is advisable that the company should follow consistently

over years the same method of depreciation or the same method of valuation of Inventories which is chosen. However, in some cases though there is no inconsistency, they may seem to be inconsistent apparently. In case of valuation of Inventories if the company applies the principle 'at cost or market price whichever is lower' and if this principle accordingly results in the valuation of Inventories in one year at cost price and the market price in the other year, there is no inconsistency here. It is only an application of the principle.

But the concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.

An enterprise should change its accounting policy in any of the following circumstances only:

- a. To bring the books of accounts in accordance with the issued Accounting Standards.
- b. To comply with the provision of law.
- c. When under changed circumstances, it is felt that new method will reflect a true and fair picture in the financial statement.

(I)

Materiality: Materiality principle permits other concepts to be ignored, if the effect is not considered material. This principle is an exception to full disclosure principle. According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of the accountant but will not be relevant to the users' need should not be disclosed in the financial statements.

The term materiality is the subjective term. It is on the judgement, common sense and discretion of the accountant that which item is material and which is not. For example, stationary purchased by the organization though not used fully in the accounting year purchased still shown as an expense of that year because of the materiality concept. Similarly, depreciation on small items like books, calculators etc. is taken as 100% in the year of purchase though used by the entity for more than a year. This is because the amount for books or calculator is very small to be shown in the balance sheet though it is the asset of the company.

The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making the decision etc. Moreover, an item material to one person may be immaterial to another person. What is important is that omission of any information should not impair the decision-making of various users.



2.6 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions:

- (i) Going Concern
- (ii) Consistency
- (iii) Accrual

All the above three fundamental accounting assumptions have already been explained in para 2.5.

If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements. However, if any of the above-mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.



2.7 FINANCIAL STATEMENTS

The aim of accounting is to keep systematic records to ascertain financial performance and financial position of an entity and to communicate the relevant financial information to the interested user groups. The financial statements are basic means through which the management of an entity makes public communication of the financial information along with selected quantitative details. They are structured financial representations of the financial position and the performance of an enterprise. To have a record of all business transactions and also to determine whether all these transactions resulted in either 'profit or loss' for the period, all the entities will prepare financial statements viz., balance sheet, profit and loss account, cash flow statement etc. by following various accounting concepts, principles, and conventions which have been already discussed in detail.

2.7.1 Qualitative Characteristics of financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The following are the important qualitative characteristics of the financial statements:

1. **Understandability:** An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business, economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

- 2. Relevance:** To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

- 3. Reliability:** To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

- 4. Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

5. Materiality: The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

6. Faithful Representation: To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain

cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

7. **Substance over Form:** If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentations and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.
8. **Neutrality:** To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.
9. **Prudence:** The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.
10. **Full, fair and adequate disclosure:** The financial statement must disclose all the reliable and relevant information about the business enterprise to the management and also to their external users for which they are meant, which in turn will help them to take a reasonable and rational decision. For it, it is necessary that financial statements are prepared in conformity with generally accepted accounting principles i.e the information is accounted for and presented in accordance with its substance and

economic reality and not merely with its legal form. The disclosure should be full and final so that users can correctly assess the financial position of the enterprise.

The principle of full disclosure implies that nothing should be omitted while principle of fair disclosure implies that all the transactions recorded should be accounted in a manner that financial statement purports true and fair view of the results of the business of the enterprise and adequate disclosure implies that the information influencing the decision of the users should be disclosed in detail and should make sense.

This principle is widely used in corporate organizations because of separation in management and ownership. The Companies Act in pursuant of this principle came out with the format of balance sheet and profit and loss account. The disclosures of all the major accounting policies and other information are to be provided in the form of footnotes, annexures etc. The practice of appending notes to the financial statements is the outcome of this principle.

- 11. Completeness:** To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Thus, if accounting information is to present faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality, not by their legal form. For example, if a business enterprise sells its assets to others but still uses the assets as usual for the purpose of the business by making some arrangement with the seller, it simply becomes a legal transaction. The economic reality is that the business is using the assets as usual for deriving the benefit. Financial statement information should contain the substance of this transaction and should not only record going by legality. In order to be reliable, the financial statements information should be neutral i.e., free from bias. The prepares of financial statements however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of judgement needed in making the estimates required under condition of uncertainty such that assets and income are not overstated and loss and liability are not understated.

SUMMARY

- ◆ Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared.
- The following are the widely accepted accounting concepts:
- | | |
|-------------------------|-------------------------------|
| (a) Entity concept | (b) Money measurement concept |
| (c) Periodicity concept | (d) Accrual concept |
| (e) Matching concept | (f) Going Concern concept |
| (g) Cost concept | (h) Realisation concept |
| (i) Dual aspect concept | (j) Conservatism |
| (k) Materiality | |
- ◆ Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist."
 - ◆ Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time.
 - ◆ There are three fundamental accounting assumptions:

(i) Going Concern	(ii) Consistency	(iii) Accrual
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 - ◆ Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. Understandability, Relevance, Reliability, Comparability, Materiality, Faithful Representation, Substance over Form, Neutrality, Prudence, Full, fair and adequate disclosure and Completeness are the important qualitative characteristics of the financial statements.

TEST YOUR KNOWLEDGE

True and False

1. *The concept helps in keeping business affairs free from the influence of the personal affairs of the owner is known as the matching concept.*
2. *Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.*
3. *Accrual means recognition as money is received or paid and not of revenue and costs as they are earned or incurred.*

4. *The Conservatism Concept states that no change should be counted unless it has materialized.*
5. *The concept of consistency implies non-flexibility as not to allow the introduction of improved method of accounting.*
6. *The materiality depends only upon the amount of the item and not upon the size of the business, nature and level of information, level of the person making the decision etc.*
7. *Accrual basis of accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.*

Multiple Choice Questions

1. (i) *All the following items are classified as fundamental accounting assumptions except*
 - (a) *Consistency.*
 - (b) *Business entity.*
 - (c) *Going concern.*
(ii) *Two primary qualitative characteristics of financial statements are*
 - (a) *Understandability and materiality.*
 - (b) *Relevance and reliability.*
 - (c) *Neutrality and understandability.*
(iii) *Kanika Enterprises follows the written down value method of depreciating machinery year after year due to*
 - (a) *Comparability.*
 - (b) *Convenience.*
 - (c) *Consistency.*
(iv) *A purchased a car for ₹5,00,000, making a down payment of ₹1,00,000 and signing a ₹4,00,000 bill payable due in 60 days. As a result of this transaction*
 - (a) *Total assets increased by ₹5,00,000.*
 - (b) *Total liabilities increased by ₹4,00,000.*
 - (c) *Total assets increased by ₹ 4,00,000 with corresponding increase in liabilities by ₹4,00,000.*

- (v) Mohan purchased goods for ₹15,00,000 and sold 4/5th of the goods amounting ₹18,00,000 and met expenses amounting ₹2,50,000 during the year, 2022. He counted net profit as ₹3,50,000. Which of the accounting concept was followed by him?
- (a) Entity.
 - (b) Periodicity.
 - (c) Matching.
- (vi) A businessman purchased goods for ₹25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2022. The market value of the remaining goods was ₹4,00,000. He valued the closing Inventory at cost. He violated the concept of
- (a) Money measurement.
 - (b) Conservatism.
 - (c) Cost.
- (vii) Capital brought in by the proprietor is
- (a) Increase in asset and increase in liability
 - (b) Increase in liability and decrease in asset
 - (c) Increase in asset and decrease in liability
- (viii) During the life-time of an entity, accounting provides financial statements in accordance with which basic accounting concept:
- (a) Conservatism
 - (b) Matching
 - (c) Accounting period
- (ix) A concept that a business enterprise will not be liquidated in the near future is known as :
- (a) Going concern
 - (b) Economic entity
 - (c) Monetary unit

2. (i) *Assets are held in the business for the*
- (a) *Resale.*
 - (b) *Conversion into cash*
 - (c) *Earning revenue.*
- (ii) *Revenue from sale of products, is generally, realised in the period in which*
- (a) *Cash is collected.*
 - (b) *Sale is made*
 - (c) *Products are manufactured.*
- (iii) *The concept of conservatism when applied to the balance sheet results in*
- (a) *Understatement of assets.*
 - (b) *Overstatement of assets.*
 - (c) *Overstatement of capital.*
- (iv) *Decrease in the amount of trade payables results in*
- (a) *Increase in cash.*
 - (b) *Decrease in bank over draft account.*
 - (c) *Decrease in assets.*
- (v) *The determination of expenses for an accounting period is based on the principle of*
- (a) *Objectivity.*
 - (b) *Materiality.*
 - (c) *Matching.*
- (vi) *Economic life of an enterprise is split into the periodic interval to measure its performance is as per*
- (a) *Entity.*
 - (b) *Matching.*
 - (c) *Periodicity.*
3. (i) *If an individual asset is increased, there will be a corresponding*
- (a) *Increase of another asset or increase of capital.*
 - (b) *Decrease of another asset or increase of liability.*
 - (c) *Decrease of specific liability or decrease of capital.*

- (ii) Purchase of machinery for cash
- (a) Decreases total assets.
- (b) Increases total assets.
- (c) Retains total assets unchanged.
- (iii) Consider the following data pertaining to Alpha Ltd.:

Particulars	₹
Cost of machinery purchased on 1st April, 2021	10,00,000
Installation charges	1,00,000
Market value as on 31st March, 2022	12,00,000

While finalizing the annual accounts, if the company values the machinery at ₹ 12,00,000. Which of the following concepts is violated by the Alpha Ltd.?

- (a) Cost.
- (b) Matching.
- (c) Accrual.

Theoretical Questions

1. Write short notes on:
 - (i) Fundamental accounting assumptions.
 - (ii) Periodicity concept.
 - (iii) Accounting conventions.
2. Distinguish between:
 - (i) Money measurement concept and matching concept
 - (ii) Going concern and cost concept
3. Briefly explain the qualitative characteristics of the financial statements.

ANSWERS/HINTS

True and False

1. False: Under matching concept all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.
2. True: Since the owner invested capital, he has claim on the profits of the enterprise.
3. False: Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
4. False: The Realisation Concept states that no change should be counted unless it has materialised.
5. False: The concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.
6. False: As per materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements.
7. False: Cash Basis of Accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.

Multiple Choice Questions

1.(i)	(b)	(ii)	(b)	(iii)	(c)	(iv)	(c)	(v)	(c)	(vi)	(b)
(vii)	(a)	(viii)	(c)	(ix)	(a)	2.(i)	(c)	(ii)	(b)	(iii)	(a)
(iv)	(c)	(v)	(c)	(vi)	(c)	3.(i)	(b)	(ii)	(c)	(iii)	(a)

Theoretical Questions

1. (i) **Fundamental accounting assumptions:** There are three fundamental accounting assumptions: Going Concern; Consistency and Accrual. If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements.
- (ii) **Periodicity concept:** According to this concept accounts should be prepared after every period & not at the end of the life of the entity. For details, refer para 2.5.

(iii) **Accounting conventions:** Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. For details, refer para 2.4.

2. (i) Distinction between Money measurement concepts and matching concept

As per **Money Measurement concept**, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions and events that cannot be expressed in terms of money are not recorded in the business books.

In **Matching concept** all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

(ii) Distinction between Going concern and cost concept

Going Concern Concept

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.

Cost concept

By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. For details refer para 2.5.

3. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. For details, refer para 2.7.1.