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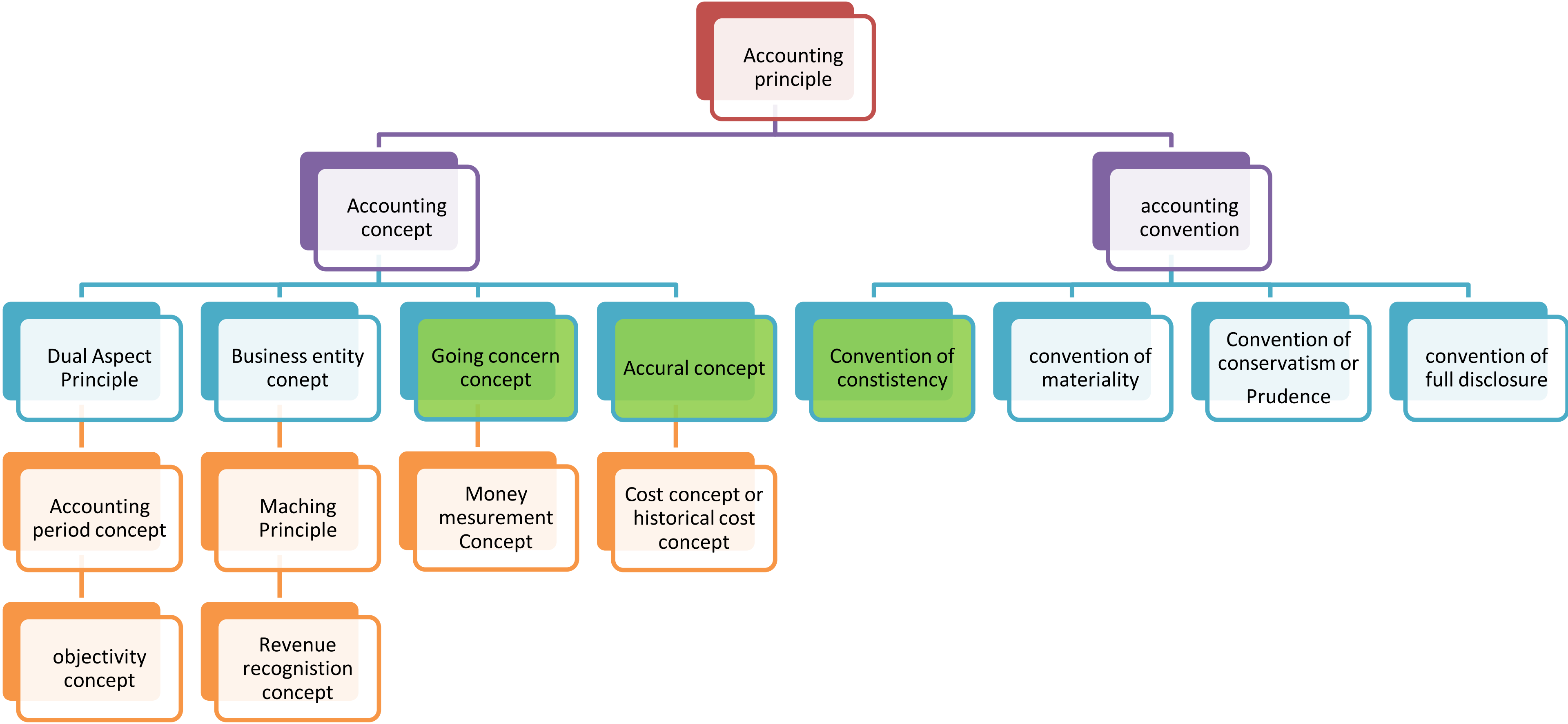
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Accounting principle

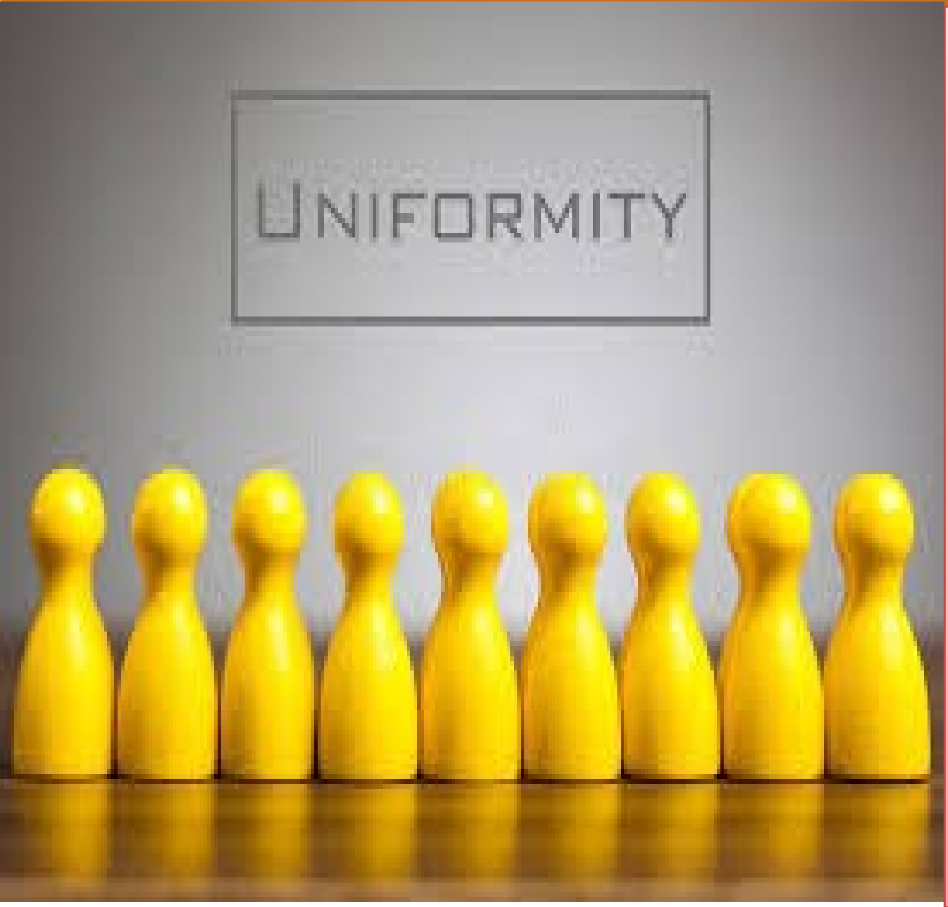
- *Accounting principles have been defined as "the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exist".*
- *In other words, accounting principles are guidelines to establish standards for sound accounting practices and procedures in reporting the financial status and periodic performance of a business.*

Characteristics of Accounting Principle

- Accounting principles are made and developed by man (accountant) and ,as such they do not have the authoritativeness of universal principle , like other natural sciences, viz ., physics, chemistry, mathematics etc., since they cannot be validated / proved by reference to natural laws as in the case of physical sciences. They are the best possible suggestions based on practical experience , reasons and observation which have been developed by the accountants.
- Accounting principle is developed for common usage to ensure uniformity and understand- ability. They also enhanced the usefulness of facts and figures relating to economic activities of the firm.
- The principle are not so specifically made or enhanced by any authority.
- The principle are in the process of evolution, i.e., are not in their finished form. On the other hand, they are fast developing.
- They are not rigid.
- The principle should generally be accepted and for the purpose the three criteria (referred to above) –viz., usefulness, objectivity and feasibility- must be fulfilled.

Need/ importance of accounting principle

(1)Uniformity of accounting



Accounting is considered as the language of business. Accounting as language to e understandable to all m must follow certain principle uniformly all over the world. Therefore, accounting principles bring about the uniformity in accounting practices.

(2) Comparability of accounting information

Accounting principle, if consistently followed, will make the accounting information comparable over a number of periods. Therefore, accounting information must satisfy the criteria of comparability so that if can be useful to the users.

(3) Reliability of accounting information

Financial statement show operational result and financial position for the users. Therefore, this information must be uniform and reliable for any decision making purposes. Accounting principle makes the financial statements more reliable and non -biased.

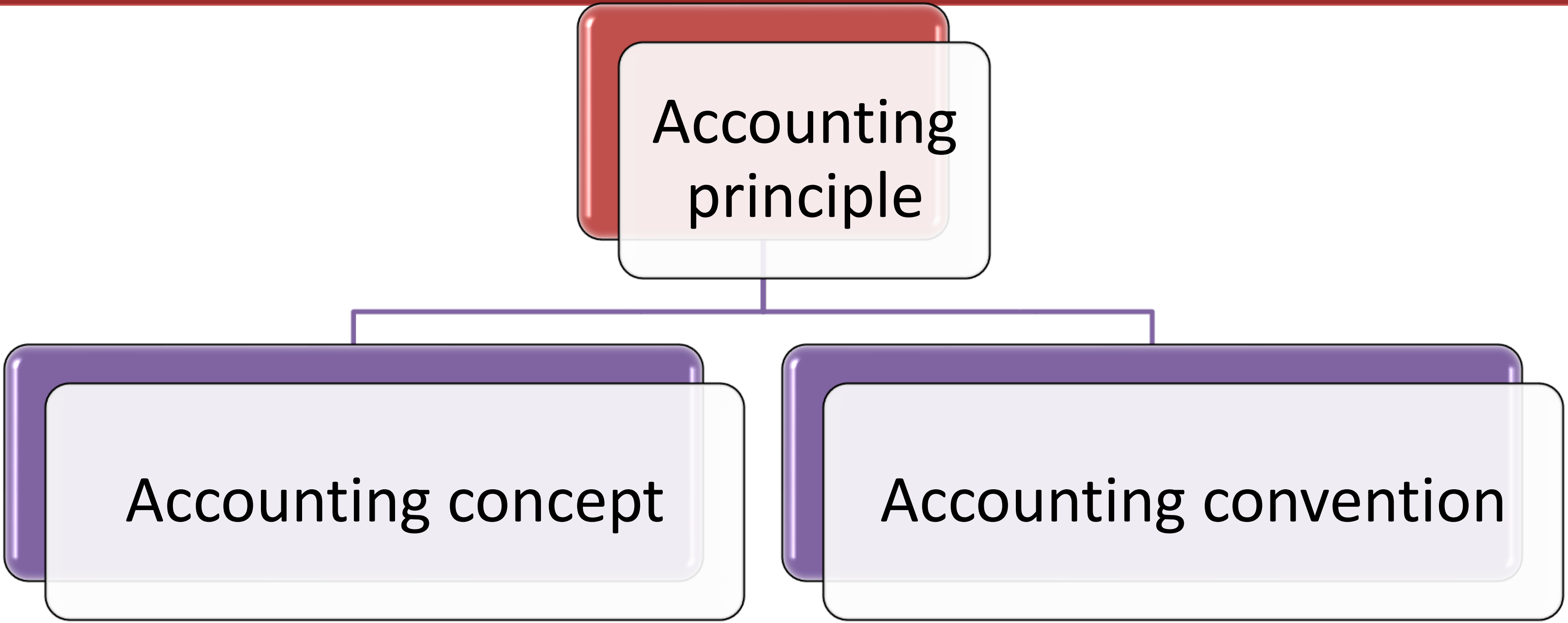
(4) Neutrality in accounts

Financial information is required by different classes of users having conflicting interest. Accounting principles help to maintain neutrality in presenting the financial information and leave little scope for statements becoming biased to a particular class of users.

(5) Guidelines to accountants

Accounting principle provides guidelines to the accountants in preparing and presenting financial statements in different situations. Thus, the scope of personal choice is reduced to the minimum.

Accounting principle can broadly classified into two categories



Note- The international accounting standard (IAS 1) has distinguished the above into:

1. Fundamental accounting assumption (concept) and
2. Accounting policies (convention)

ACCOUNTING CONCEPT

Accounting concept

Accounting concepts are defined as basic assumptions on the basis of which financial statements of a business entity are prepared. They are used as a foundation for formulating various methods and procedures for recording and presenting the business transactions.

Accounting concepts have gradually developed over a period over a period of time because of following factors

1. New invention, improvement in technology globalization of business activities and introduction of new types of business transaction.

Hence new concepts have to be developed to meet the requirement of the accounting profession. Accounting concepts do not remain static or fixed but are always changing.

2.Changes in legal, economic and social environments.

Existing laws are modified or amended and new laws are introduced and this requires the new accounting concepts in the field of income tax, sales tax, value added tax, Goods and services tax and so on. Economic data especially for planning purpose are created out of accounting or financial data. Similarly, social environment which deals with poverty, social security, pollution etc has to take into consideration the accounting information and measurement.

Dual aspect concept or Balance sheet equation concept

This concept is based on double entry book-keeping which means that accounting System is set up in such a way that a record is made of the two aspects of each transaction that affects the records. The recognition of the two aspects to every transaction is known as dual aspect concept. Modern financial accounting is based on dual aspect concept. One entry consists of debit to one or more accounts and another entry consists of credit to some other one or more accounts. However, the total amount debited is always equal to the total amount credited. Therefore, at any point of time total assets of a business are equal to its total liabilities. Liabilities to outsiders are known as liabilities, but a liability to owners is referred to as capital.

Dual aspect concept or Balance sheet equation concept

Thus, this concept expresses the relationship that exists among assets, liabilities and the capital in the form of an accounting equation which is as follows:

Asset =Equity

Or

Assets = Liabilities + Capital,

Or

Capital = Assets – Liabilities

BENEFITS of dual aspect concept

- Every transaction in the business firm is recorded on the basis of Dual aspects
- The principle of double entry system that is every debit has corresponding credit is in line with dual aspect concept.
- The dual aspect concept facilitates the preparation of the trial balance which enables accountant to detect the errors committed in the recording process. In this way the accountant can maintain strict control on the clerical or junior staff.
- The dual aspect concept helps the business enterprise to determine profit or loss from time to time. Capital of the business can be calculated at the beginning of the accounting period and also at the end of the accounting period. If capital at the end after making adjustment for drawing and introduction of the capital is more than the capital at the beginning, the difference is taken as profit. On the other hand, if the capital at the ends after adjustment is less than the capital at the beginning the difference is taken as the loss for the year.

Balance sheet

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 75,000 75,000	Machinery cash	2,00,000 1,00,000
	3,00,000		3,00,000

Transaction

a) A new machine purchased paying Rs 50,000 in cash

b) A new machine purchased for Rs 50,000 on credit, paying cash later on

c) Cash paid to repay bank loan to the extent Rs 50,000

d) Raised bank loan Rs 50,000 to pay off other loan

Effect: - A new machine purchased paying Rs 50,000 in cash

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 75,000 75,000	Machinery cash	2,00,000 1,00,000
	3,00,000		3,00,000

Balance sheet

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 75,000 75,000	Machinery cash	2,50,000 50,000
	3,00,000		3,00,000

Effect: - A new machine purchased for Rs 50,000 on credit, paying cash later on

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 75,000 75,000	Machinery cash	2,00,000 1,00,000
	3,00,000		3,00,000

Balance sheet

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan Creditor of machinery	1,50,000 75,000 75,000 50,000	Machinery cash	2,50,000 1,00,000
	3,50,000		3,50,000

Effect: Cash paid to repay bank loan to the extent Rs 50,000

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 75,000 75,000	Machinery cash	2,00,000 1,00,000
	3,00,000		3,00,000

Balance sheet

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 25,000 75,000	Machinery cash	2,00,000 50,000
	2,50,000		2,50,000

Effect: - Raised bank loan Rs 50,000 to pay off other loan

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 75,000 75,000	Machinery cash	2,00,000 1,00,000
	3,00,000		3,00,000

Balance sheet

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Bank loan Other loan	1,50,000 1,25,000 25,000	Machinery cash	2,00,000 1,00,000
	3,00,000		3,00,000

Business entity concept

According to this concept, business is treated as an entity separate from its owners. It is treated to have a distinct accounting entity which controls the resources of the concern and is accountable thereof. Accounts are kept for a business entity as distinguished from the person(s) owning it. All transactions of the business are recorded in the books of the business from the point of view of the business. Transactions are also recorded between the owner and the business, for instance, when capital is provided by the owner, the accounting record will show the business as having received so much money and as owing to the proprietor. This concept is based on the sense that proprietors entrust resources to the management and the management is expected to use these resources to the best advantage of the firm and to account for the resources placed at its disposal. Hence, in accounting for every type of business organization, be it sole trader ship or partnership or joint stock Company, business is treated as a separate accounting entity.

Mr abhinav started business with investing Rs 7, 00,000 with which he purchased machinery for Rs 5, 00,000 and maintained balance in hand. The financial position of the business (which is shown by balance sheet) will be as follows:

Balance sheet of M/s Abhinav pvt Ltd

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital	7,00,000	Machinery cash	5,00,000 2,00,000
	7,00,000		7,00,000

This means that enterprise owes to Mr abhinav Rs 7, 00,000. Now if Mr abhinav spend Rs 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 (i.e. his investment would be reduced by Rs 5,000).Following the entity concept the revised financial position would be

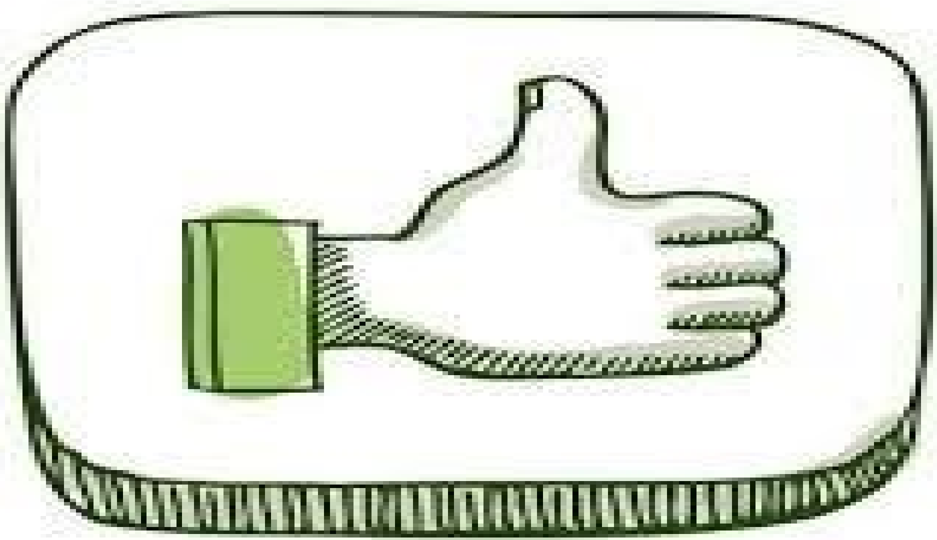
Balance sheet of M/s Abhinav pvt Ltd

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital 7 ,00,000 Less: Drawing 5,000	 6,95,000	Machinery cash	5,00,000 1,95,000
	6,95,000		6,95,000

Reason of applied in all form of the business organisation

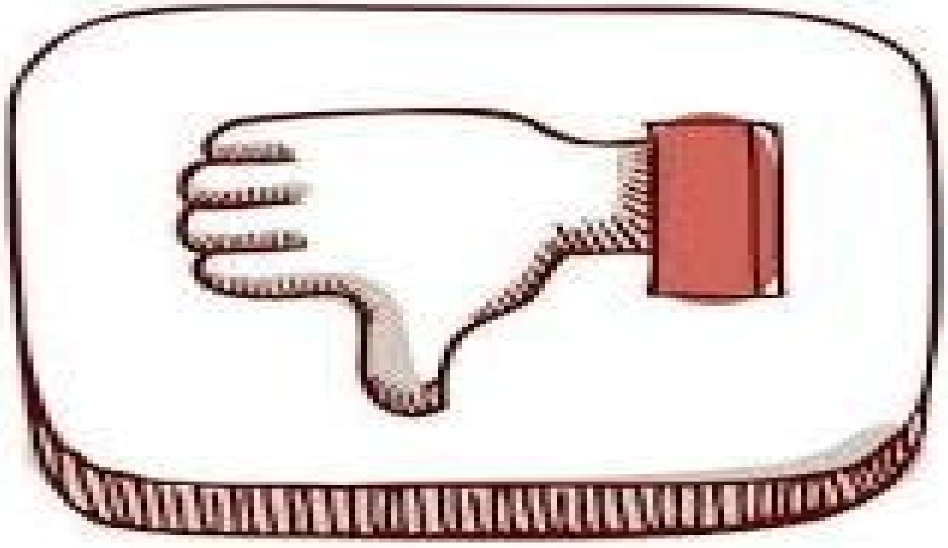
- It gives a solution to the problem of separating our business transaction from personal transaction.
- To ascertain the return on capital employed
- To ensure the proper used of the fund provided by the owners.
- To hold little to property in the name of the firm.
- To enter into transaction with outsiders in the name of the firm.

Advantages of Business entity concept



- This concept stresses the importance of the business unit.
- This concept can be applied to any form of business organisation.
- It helps in separating out the business transaction form the personal transaction of the owners.
- It is the basis of the double entry system of book-keeping.
- This concept can be applied along with proprietary and fund concepts.
- It is possible to measure how successful or otherwise the business has been in terms of profit or loss.

Disadvantages of Business entity concept



- Accounting is done form the view point of the business unit, which is an artificial person.
- This concept sometimes coincides with the legal fact.
- To some extent, present accounting practices is not based on this concept.
- The owner cannot be identified with the existence of the business unit.
- This concept does not stress the importance of the proprietors.
- It is not concerned with increase of wealth of the owners.

Going concern concept or concept of continuity

Business transactions are recorded on the assumption that the business will continue for a long-time. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. Therefore, it would be able to meet its contractual obligations and use its resources according to the plans and pre-determined goals. It is on this concept that a clear distinction is made between assets and expenses. Transactions are recorded in such a manner that the benefits likely to accrue in future from money spent now or the future consequences of the events occurring now are also taken into consideration. It is because of this concept that fixed assets are valued on the basis of cost less proper depreciation keeping in mind their expected useful life ignoring fluctuations in the prices of these assets.

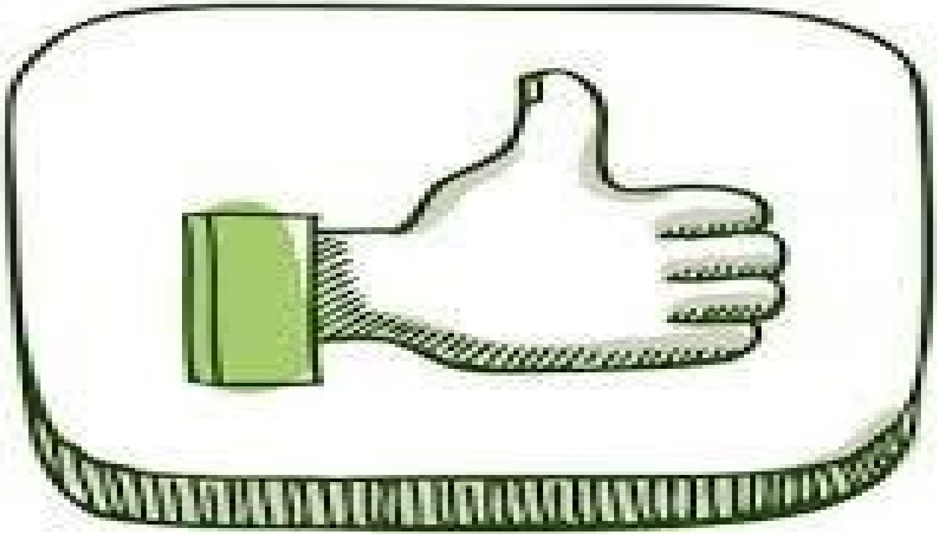
Mr abhinav purchased a machine for his business paying Rs 5, 00,000 out of Rs 7, 00,000 invested by him. He also paid transportation expenses and installation charges amounting to Rs 70,000. If he is still willing to continue the business, his financial position is as follows:

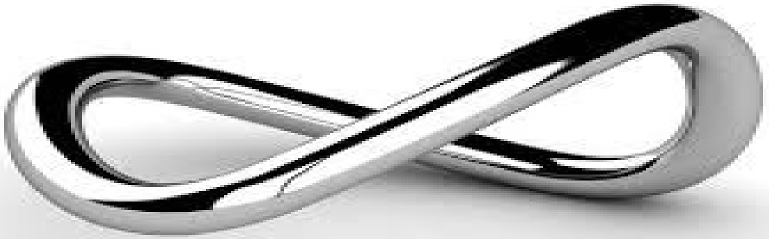
Balance sheet of M/s Abhinav pvt Ltd

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital	7 ,00,000	Machinery cash	5,70,000 1,30,000
	7 ,00,000		7 ,00,000

Now if decided to back out and desire to sell the machine, it may fetch more than and less than Rs 5, 70,000. So his financial position will be different. If going concern concept is taken increased / decrease in the value of the asset in short run is ignored. The concept indicates that asset are kept generating for benefit in the future, not for immediate sale; current change in the asset value is not realised and so it should not be counted.

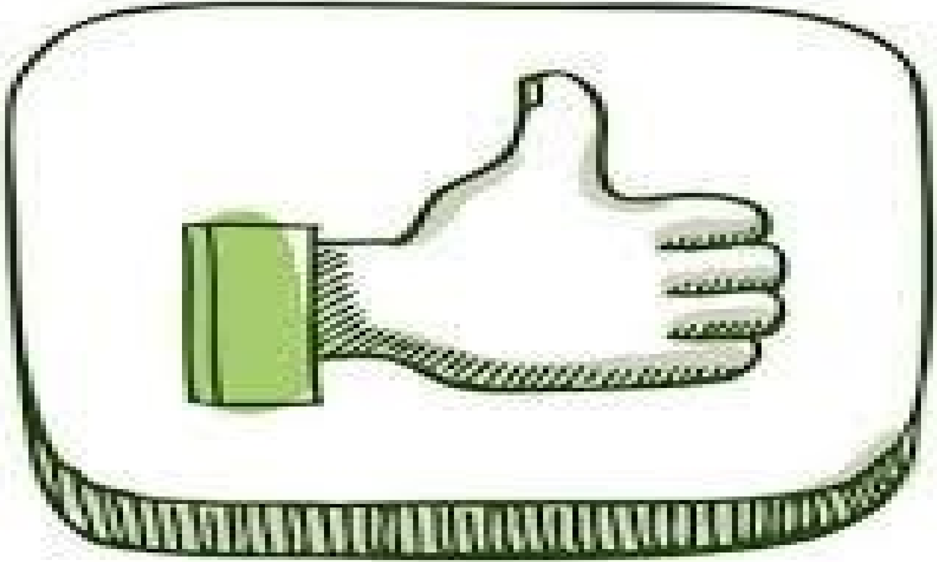
Advantages of Going concern concept





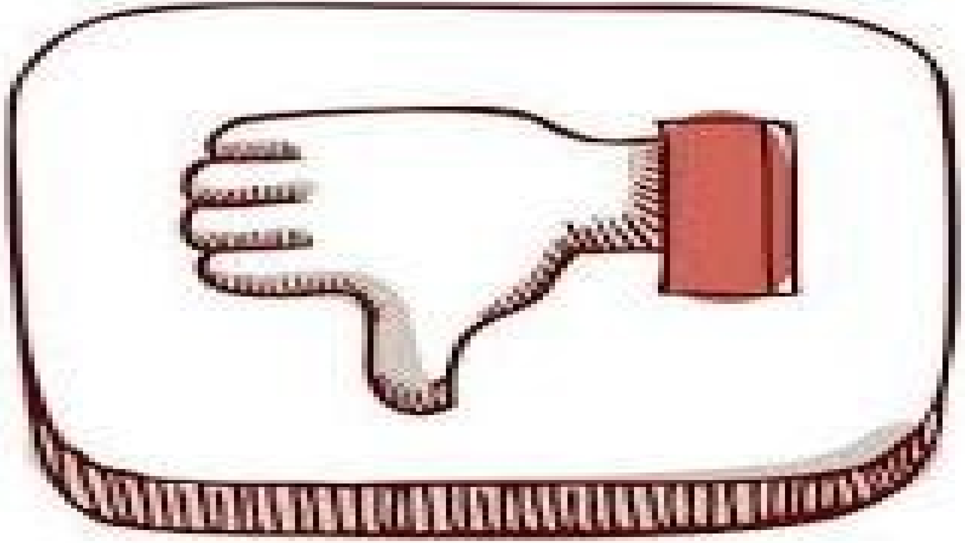
- *This concept enables the preparation of financial statement, namely: profit and loss account and balance sheet on yearly basis because the firm is presumed to have longer life than one year.*
- *The going concern concept makes possible a clear distinction between revenue expenditures and capital expenditures. Since the business enterprise is assumed to have long life, those expenditures whose use or benefit will expire or end within year (e.g. stationary , rent, electricity ,salaries etc.) are treated as revenue expenditures and those expenditure whose benefit will available form many years (e.g. building, machinery furniture and the like) are treated as capital expenditure . The yearly benefit of capital expenditure is treated as deprecation. In the absence of this assumption, that is, the business will continue only for short period, all expenditure will have to be treated as revenue expenditure. There is no question of any distinction between capital expenditure and revenue expenditure.*
- *It is because of this assumption that assets are classified as fixed assets to be used for more than one year and current assets to be used only for one year. Similarly liabilities are also classified as long term liabilities and short term liabilities.*

Advantages of Going concern concept



- *The fixed asset is valued for the balance sheet purpose at their cost price that is cost* ***minus*** *depreciation and not at their market or realised values. If we value the assets at market price, it would be difficult to compare the financial position of two or more years.*
- *Investors are assured that they will continue to get income, if any, on their investment in the near future.*
- *It is under this concept that useful life of the asset is estimated for the purpose of calculating the depreciation so that there is proper matching of the revenue of the current year with the cost of the assets (i.e. depreciation).*
- *It is because of this concept that outstanding expenses and accrued income and prepaid income and income received in advance are adjusted while preparing the final accounts of the business enterprises.*
- *The outsiders enter into long- term contract with the firm to give long term loan to the firm and invest money in the debentures of the company because the investors feel that the business is a going concern.*
- *The going concern concept is responsible for the accounting period concept since the life of the business is divided into accounting periods of one year.*

Disadvantages of Going concern concept



- **Sick unit:** this concept does not hold good in case of business firms which are sick because there is no possibility of the continuation of the business activities in the future.
- **Unit of liquidation**: this concept does not apply in case of business units which are on liquidation i.e. in the process of closure where the realizable value and not the cost price or book value is relevant.

Accrual concept

Every transaction and event affects, one or more or all the three aspects viz., assets, liabilities and capital. Normally all transactions are settled in cash but even if cash settlement has not taken place, it is proper to record the transaction or the event concerned into the books. ***This concept implies that the income should be measured as a difference between revenues and expenses rather than the difference between cash received and disbursements.*** *Business transactions are recorded when they occur and not when the related payments are received or made. This concept is called accrual basis of accounting and it is fundamental to the usefulness of financial accounting information.*

Accrual concept

It is not necessary that there is an immediate settlement in cash for any transaction or event therefore accrued revenues and costs are recognized as they are earned and incurred and recorded in the financial statements of the period. On the basis of this concept, adjustment entries relating to outstanding and prepaid expenses and income received in advance etc. are made. They have their impact on the profit and loss account and the balance sheet.

Mr J.D. buys clothing of Rs 50,000 paying cash Rs 20,000 and sells at Rs 60,000 of which customer paid only Rs 50,000.

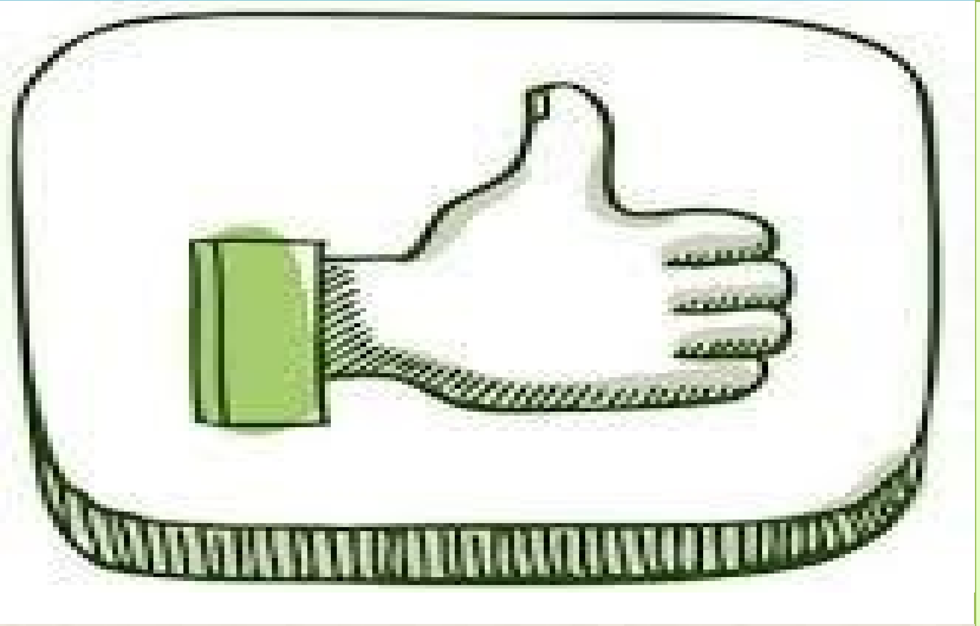
SOLUTION:

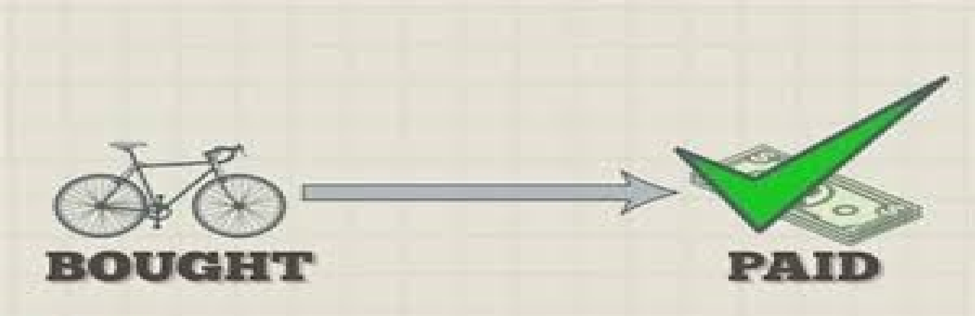
His Revenue is Rs 60,000 , Not Rs 50,000 Cash Received. Expenses (i.e. Cost Incurred for the Revenue) is Rs 50,000, Not Rs 20,000 Paid in Cash. So Accrual Concept Based Profit is Rs 10,000 (Revenue – Expenses)

AS PER THE REVENUE CONCEPT

REVENUE- EXPENSE = PROFIT

Advantages of Accrual concept





- This concept has been responsible for the application of accrual basis of accounting as against cash basis of accounting.
- This concept is of great help in the preparation of financial statements since all transaction are recorded whether they are settled in cash or not.
- This concept has given solid accounting principle regarding recognition of both revenue and expenses. Accordingly revenues accrue in that year in which they are earned and not necessarily in the year in which cash is actually received for them and expenses accrue in the year in which they are incurred and not in the year they are actually paid.
- It is because of accrual concept (which has introduced into accounts accrual basis of accounting) that interest on capital, interest on drawings , provision for depreciation , provision for doubtful debts etc. are recorded though no cash is received or paid for them , for preparing the financial statement of the business firm.

Accounting period concept

It is customary that the life of the business is divided into appropriate parts or segments for analyzing the results shown by the business. Each part or segment so divided is known as an accounting period. It is an interval of time at the end of which the income or revenue statement and balance sheet are prepared in order to show the results of operations and changes in the resources which have occurred since the previous statements have been prepared. Normally, the accounting period consists of twelve months.

In India, the 12 month started from 1 April and ended with 31st March.

Matching concept or periodic matching concept

This concept is based on accounting period concept. In order to determine the profit earned or loss suffered by the business in a particular defined accounting period, it is necessary that expenses of the period should be matched with the revenues of that period. The term 'matching' means appropriate association of related revenues and expenses. Therefore, income made by the business during a period can be ascertained only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. According to this concept, adjustments should be made for all outstanding expenses, accrued incomes, unexpired expenses and unearned incomes etc. while preparing the final accounts at the end of the accounting period.

Mr M. saikia stated cloth business. He purchased 10,000 pieces garments @Rs 100 per pieces and sold 8,000 pieces @150 per pieces during the accounting period of 12 Months 1st January 2018 to 31st December 2018. He paid shop rent @ Rs 3,000 per month for 11 Month and paid Rs 8, 00,000 to the suppliers of garments and received Rs 10, 00,000 from the customer.

Let us see how the accrual, accounting period and matching concept operate

accounting period 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 2018 to December 2018. so, revenue and expenses to be measured for the year 2011 and asset and liabilities are to be ascertained as on 31st December 2018.
accrual concept operate to measure revenue of Rs 12,00,000 (arising out of sale of garment 8,000 pieces × Rs 150) which accrue 2018, not the cash received Rs 10,00,000 and also the expenses correctly.
shop rent is an expenses item amounting to Rs 36,000, not Rs 33,000 the cash paid.
should accountant treat Rs 10, 00,000 as expenses for purchase of merchandise?
should he treat Rs 1, 64,000 as profit?

Revenue	Merchandise	Shop Rent	Profit
12, 00,000	10, 00,000	36,000	1, 64,000

Obviously, the answer is no. matching links revenue with expenses.

Revenue – Expense = Profit
But this unqualified equation may crate misconception. It should be defined as:
Period profit = period revenue – matched expense
From the revenue of an accounting period such expense are deducted which are expended to generate the revenue to determine the profit of that period.
In the given example, revenue related to only sale of 8,000 pieces of garments. So the cost of 8,000 pieces of garments should be treated as expense.

Thus Profit

Liabilities	Details (Rs)	Amount (Rs)
Revenue		12,00,000
Less : expense		
Merchandise	8,00,000	
Shop rent	36,000	8,36,000
Profit	7 ,00,000	3,64,000

Balance sheet
As on 31st December 2018

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital (profit) Trade payables Expenses payable	3,64,000 2,00,000 3,000	Inventory (2000×100) Trade receivable Cash in hand (Cash receipt Rs 10,00,000- Cash payment Rs 8,33,000)	2,00,000 2,00,000 1,67,000
	5,67,000		5,67,000

Advantages of Matching concept

- This concept ensures the appropriate or proper determination of revenue and related expenses for matching purpose.
- The matching concept makes certain the correct determination of income because the accountant would use the appropriate accrual basis of accounting.
- According to this concept , all costs incurred during the period are not considered but only the costs relating to the accounting period are taken into account though they are not directly related to revenues.

Money Measurement Concept Or Monetary concept

Money measurement concept holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms. Thus, only such transactions and events which can be interpreted in terms of money are recorded. Events which cannot be expressed in money terms do not find place in the books of account though they may be very important for the business. Non-monetary events like, death, dispute, sentiments, efficiency etc. are not recorded in the books, even though these may have a great effect. Accounting therefore, does not give a complete account of the happenings in a business or an accurate picture of the conditions of the business. Thus, accounting information is essentially in monetary terms and quantified. The system of accounting treats all units of money as the same irrespective of their time dimension. This has created doubts about the utility of the accounting data, leading to the introduction of inflation accounting.

suppose , an indian businessman sell good worth Rs 50 lakhs at home and he also sells good worth of 1 lakh euro in the france.

what is his total sale?

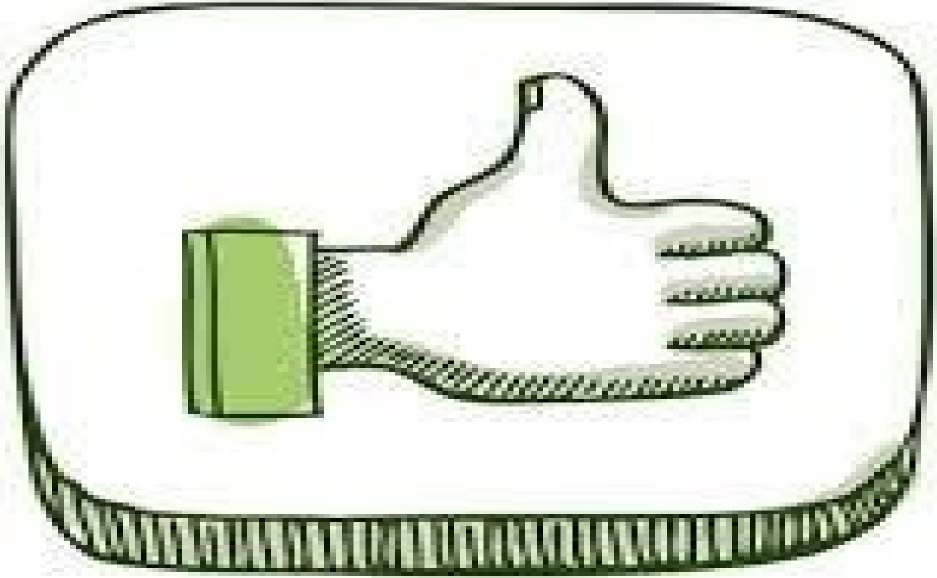
Rs 50 lakhs + 1 lakh euro

These are not amenable to even arithmetic treatment. so transaction is to be recorded at uniform monetary unit i.e. in one currency. suppose euro 1 = Rs 55

total sales = Rs 50 lakh + Rs 55 lakh = 105lakh

money measurement concept imparts the essential flexibility of measurement and interpretation of accounting data.

Advantages of *Money Measurement Concept*



- **Evolution of divergent items into common denominator:** Money is the common measuring unit; it makes the recording the comparison possible. Thus it gives a complete picture of assets, liabilities, incomes and expenses of an enterprise.
- **Medium of communication:** Money measurement is the communicating process of the activities of a firm.
- **Valuation of assets and liabilities:** As the value of assets and liabilities of a business concern can be converted into monetary units, the total assets and total liabilities cab be computed.
- **Objectivity:** the expression of various elements of financial statements make the accounting objectives and verifiable.

Limitation of *Money Measurement Concept*

- It does not consider the changes in the purchasing power of money.
- It excludes qualitative aspect of an event.
- It does not consider the development of human resource accounting.

Cost concept or Historical cost concept

- *According to cost concept, the various assets acquired by a concern or firm should be recorded on the basis of the actual amounts involved or spent. This amount or cost will be the basis for all subsequent accounting for the assets. The cost concept does not mean that the assets will always be shown at cost. The fixed asset will be recorded at cost at the time of its purchase but it may systematically be reduced in its value by charging depreciation. These assets ultimately disappear from the balance sheet when their economic life is over and they have been fully depreciated and sold as scrap. It may be noted that if nothing has been paid for acquiring something, it would not be shown in the accounting books as an asset.*
- *Cost concept is not much relevant for investors and other users because they are more interested in knowing what the business is actually worth today rather than the original cost.*

Advantages of Cost concept

- *Market value change every year when the financial statement are prepared. It would make the preparation of financial statement difficult and time consuming because no easy record of market value can be made.*
- *The cost is objectively verifiable because the cost recorded in the books of account is based on actual contract between the buyer and the seller.*
- *The estimation of the amount of depreciation of fixed assets is very easy and simple because for the calculation of depreciation, only the cost price and an estimate of useful life of the fixed asset are required.*
- *The cost concept recognizes the fact that depreciation is the process of allocation of the cost of an asset over its useful life and not a process of valuation (i.e. based on market value of the fixed asset.)*

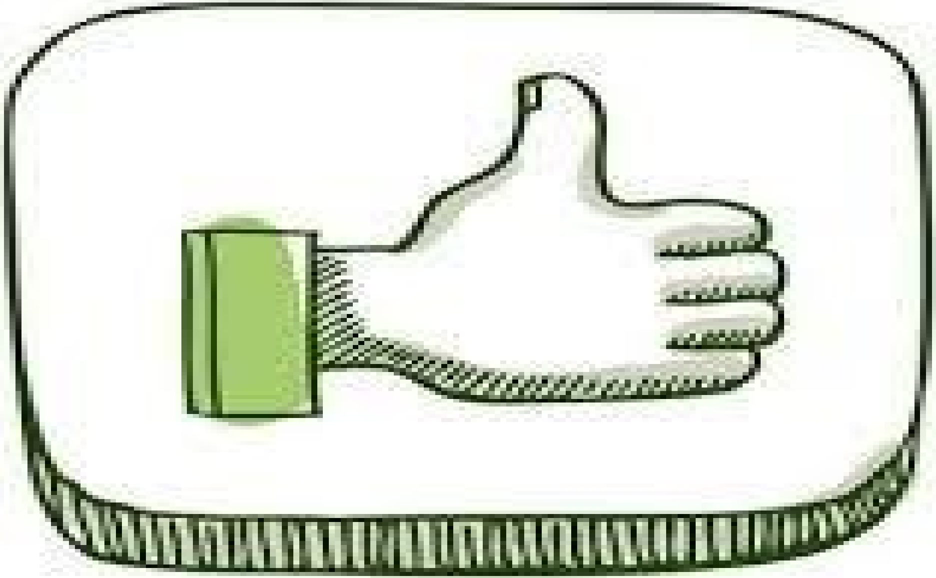
Disadvantages of Cost concept

- ***Fixed asset for which nothing has been paid (or no cost incurred)*** *are not recorded in the books of accounts. For example the knowledge and technological skill built inside the enterprise, a favourable location, brand name and reputation of the business,* ***(etc., goodwill)*** *find no mention in accounting record , though they are all valuable assets.*
- ***The cost concept ignores the effect of inflation*** *with that depreciation based on historical costs will be charged (or* ***matched)*** *with revenue earned at current price. In this way the profit or income figure would be distorted and cannot be relied on.*
- *the actual information needed by management , investors, creditors , financial analyst, government etc., may be the current values of the assets and therefore values based on historical cost may not be useful for their purposes.*
- *Both fixed asset and current assets are required at cost agreed upon by the buyer and seller. But under the cost concept, only fixed assets are shown at cost or book value (cost* ***minus depreciation)*** *as the case may be. Current assets are shown at cost or market price whichever is lower.*
- ***Under the cost concept, the market values are ignored****, with the result that the balance sheet does not disclose the real worth of the business.*
- *Many assets do not have acquisition cost. Human asset of an enterprise are an example. The cost concept failed to recognize such assets although it is very important asset of any organisation.*

Objectivity concept or objective evidence concept

Objective concept states that recording of the business or accounting transaction should not be influenced by personal bias of ether the management or the accountant who prepares the accounts. As such all accounting entries should be supported by source documents or business documents such as purchase a sales invoice, pay- in –slips. Counterfoils of cheque book, vouchers for different payments, cash memos, agreements in regard to purchase or sale of properties and so on.

Advantages of Objectivity concept



- *This concept has ensured the availability of true accounting records and financial statements.*
- *Accounting records and financial statements are readily accepted by various groups or individual users of accounting information.*
- *There is little scope for manipulation in the accounting records.*
- *The concept minimizes or reduces the scope for personal bias or judgment of the accountant.*

Revenue recognizes concept or realization concept

- *According to this concept revenue is recognised only when a sale is made. Unless money has been realised i.e., cash has been received or a legal obligation to pay has been assumed by the customer, no sale can be said to have taken place and no profit can be said to have arisen. It prevents business firms from inflating their profits by recording incomes that are likely to accrue i.e. expected incomes or gains are not recorded.*
- *When an asset is recorded in its historical cost of Rs 5 lakhs and even if its current cost is Rs.15 lakh, the change is not counted unless there is certainty that such changes will be materialized*

Mr. Amal bought a piece of land on January 1, 1995 paying Rs 2,000; its current market value is Rs 1, 02,000 on 31 December 2018. Should the accountant show the land at Rs 2,000 following the cost concept and ignoring Rs 1, 00,000 value increases since it is not realised? If he does so the financial position would be:

Balance sheet of Mr Amal

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital	2,000	Land	2,000
	2,000		2,000

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

Balance sheet Mr Amal

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Capital Unrealized gain	2,000 1,00,000	Machinery cash	2,000
	1,02,000		1,02,000

Now days the real revaluation of assets has become a widely accepted practice when the change in the value is of permanent nature accountant adjust value change to creation of revaluation (capital) reserve.

Accounting convention

Accounting convention is a rule or an accepted method or procedure or a statement of practice which is adopted either by general agreement or common consent which may be in writing or implied.

Benefit of accounting convention

- *Accounting convention ensures the **truthfulness or authenticity** of the financial statements.*
- *Accounting convention makes the **preparation and presentation** of the financial statements easy.*
- *Accounting convention **enables inter-firm and intra-firm comparison** of the financial statements because of the element of uniformity.*
- *Accounting convention makes the financial statement **clear and meaningful**.*

Difference between Accounting concept and Accounting convention

Points of difference	Accounting concept	Accounting convention
1. Assumption or custom	Accounting concept are basic assumptions, accepted true ,on the basis of which business transactions are recorded in the books of accounts	Accounting convention are customs or guidelines accepted by general agreements or usage which are followed in the preparation of the profit and loss account and balance sheet.
2.Personal judgment	There is no personal judgment or bias in the adoption of accounting concept	Individual bias may play an important role in the adoption of accounting convention.
3. importance	Accounting concepts are foundation of systematic and proper recording.	Accounting convention are not so important as accounting concepts
4.Maintenance of accounts vs. financial statements	Accounting concepts are concerned with the maintenance of accounts.	Accounting convention are used for preparing the profit and loss account and the balance sheet.

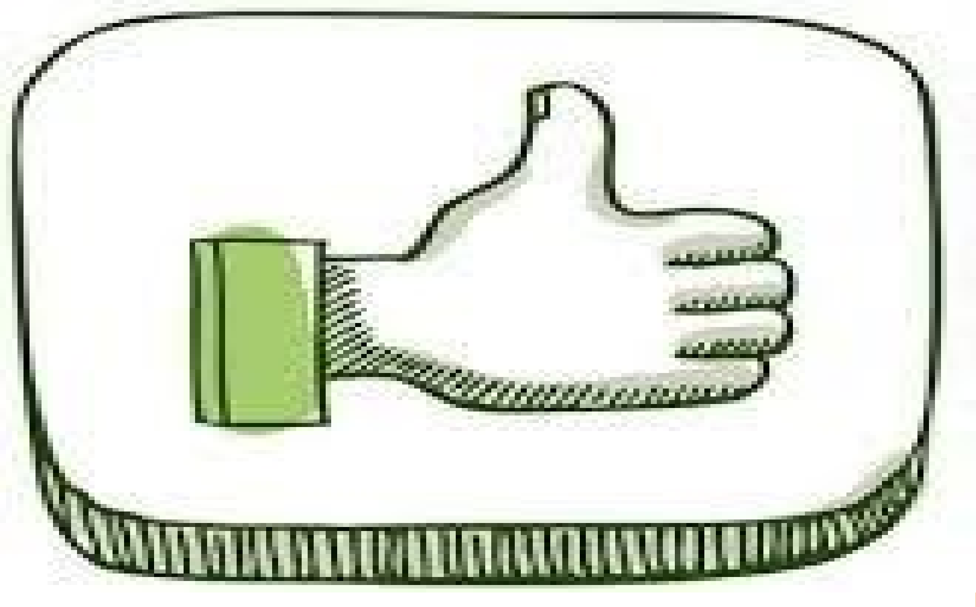
Difference between Accounting concept and Accounting convention

Points of difference	Accounting concept	Accounting convention
5. uniformity in use	There is a uniform use of accounting concepts in different types of business organisation.	There is no uniformity in the application of accounting convention in different enterprises.
6. legal position	Accounting concepts are established by law.	Accounting convention are established by common accounting practices
7. number	There are many accounting concepts	The number of accounting convention is limited to few.
8. consistency	Accounting concepts are internally consistency in the same organisation.	There is no internal consistency in the application of accounting conventions even in the same organization.

Convention of consistency

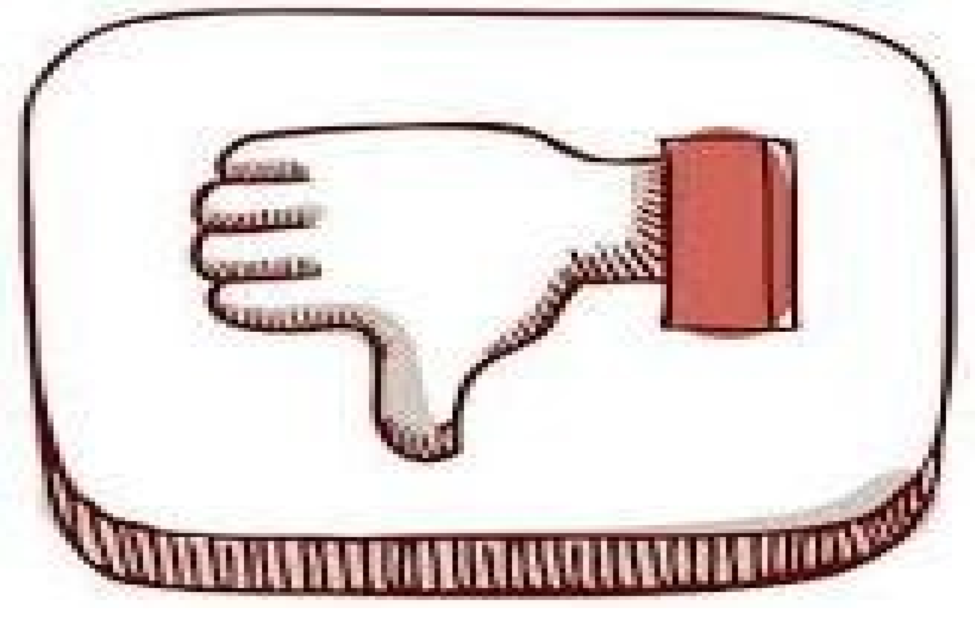
- *The consistency convention implies that the accounting practices should remain the same from one year to another. The results of different years will be comparable only when accounting rules are continuously adhered to from year to year.* ***For example****, the principle of valuing stock at cost or market price whichever is lower or fist in first out (FIFO) basis or weighted Average basis etc. should be followed year after year to get comparable results.* ***Similarly,*** *if depreciation is charged on fixed assets according to* ***diminishing balance method or straight line method*** *it should be done year after year. The rationale behind this principle is that frequent changes in accounting treatment would make the financial statements unreliable to the persons who use them.*
- *The consistency convention does not mean that a particular method of accounting once adopted can never be changed. When an accounting change is desirable, it should be fully disclosed in the financial statements along with its effect in terms of rupee amounts on the reported income and financial position of the year in which the change is made.*

Advantages of Convention of consistency



- *The concept of consistency makes the financial statements* ***free form personal bias and distortion.***
- *Since the financial statements for different year have been prepared following the same accounting policies, it* ***makes the financial statements reliable and comparable*** *over a number of years and helps the users to arrive at correct conclusions.*
- *The concept has* ***contributed to*** *a great extent to the* ***development of accounting standards*** *for uniform application both in the national and international.*

Disadvantages of Convention of consistency



- *The consistency convention may deliberately* ***understate revenue and disclose pessimistic or gloomy picture of financial position.***
- *Financial statement may* ***not show a true and fair view*** *of the states of affaires of the business entity.*
- *The convention of consistency may* ***encourage the creation of secret reserves*** *by making consistently excess provision for future contingencies.*
- *Convention of consistency goes* ***against the convention of full disclosure.***

The principle of full disclosure

The principle requires that all significant information relating to the economic affairs of enterprise should fully disclose. In other words, there should be sufficient disclosure of information which is material in interest to the users of financial statements such as proprietors, present and potential creditors, investors and others. The principle is so important that Companies Act makes ample provisions for disclosure of essential information in the financial statement of a company. The Performa and contents of Balance sheet and profit & loss account are prescribed by companies Act. Various items or facts which do not find place in accounting statements are shown in the balance sheet by way

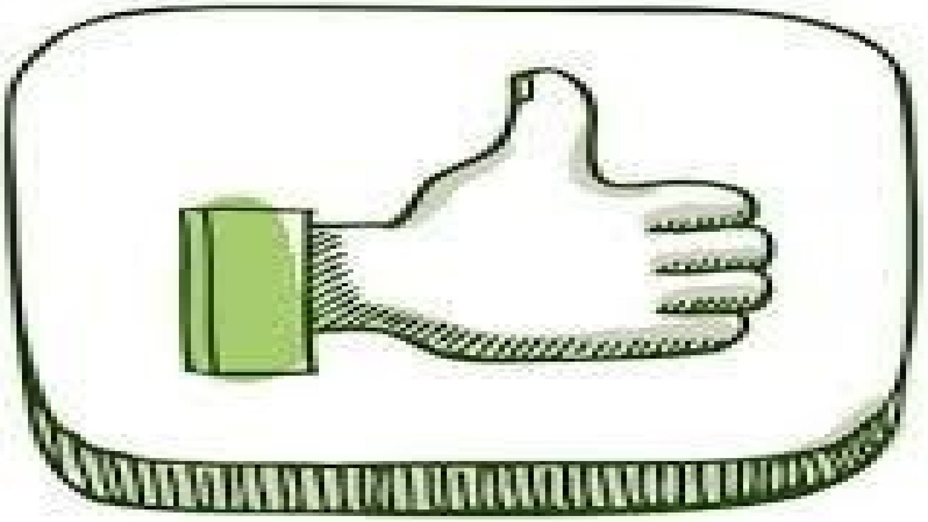
o f footnotes. Such as:

i) Contingent liabilities: - for instance, a claim of a very big sum pending in a court of law against the enterprise should be brought to the notice of the users of the financial statements; otherwise the statements would be misleading.

ii) If there is a change in the method of valuation of stock, or for providing deprecation or in making provision of doubtful debts, it should be disclosed in the balance sheet by way of a footnote.

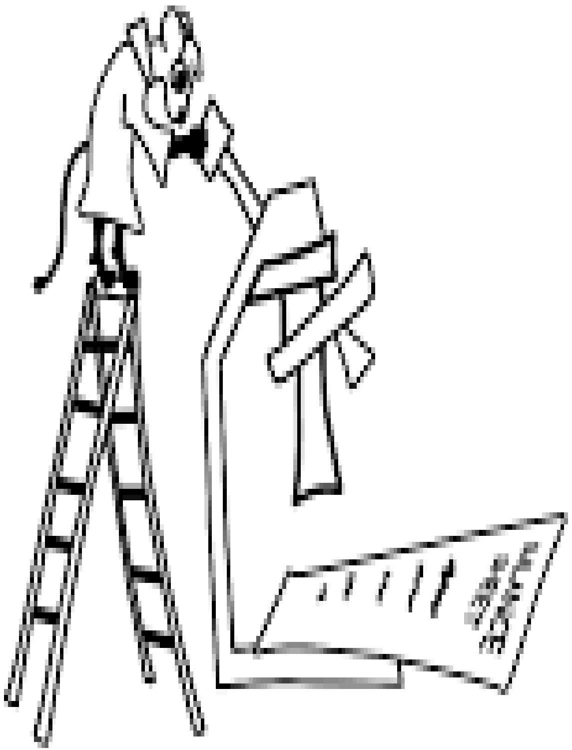
iii) Market value of investments should be given by way of a footnote.

Advantages of principle of full disclosure



- ***Disclosure of complete information for all users:*** *full disclosure concept ensures that financial statements contain full and fair information of the enterprise of decision making purpose of the different classes of users.*
- ***Elimination of personal choice of accountants:*** *According to this concept, it obligatory for the accountant to report full facts in the financial statements. So it eliminates the personal choice in the matter of reporting.*
- ***Facilitate easy understanding of financial statements:*** *As all assets and liabilities and incomes and expenditure are shown under proper heads with explanatory notes, it becomes easier for the users to understand the significance of the financial statements.*
- ***Elimination of the chance of deliberate omission of items:*** *as assets and liabilities are to be shown under proper heads, any deliberate omission of an item is not possible.*

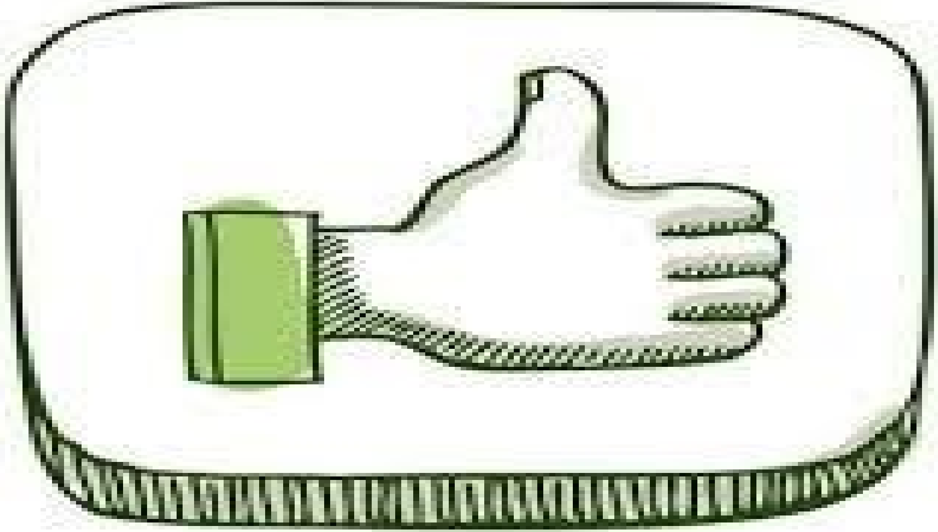
Principle of materiality

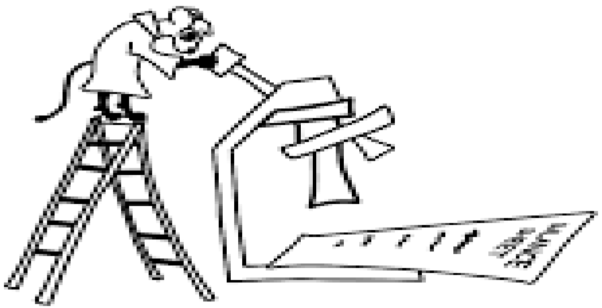


Significance to the overall financial picture

- *This principle is an exception to the principle of full disclosure. According to this principle, items having an insignificant effect or being irrelevant to the user need not be disclosed. These unimportant items are either left out or merged with other items, otherwise accounting statements will be unnecessarily overburdened.*
- *According to American accounting association – "an item should be regarded as material if there is reason to believe that knowledge of it would influence decision of informed investors."*
- *According to KOHLER – "material is the characteristics attaching to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgment of a reasonable person."*
- *For instance:*
- *The cost of small tools may be material for a small repairs workshop, but the same figure may be immaterial for Escorts Limited. Similarly the nature of the transaction should also be taken into consideration. A difference of Rs 500 in the valuation of stock may be regarded as immaterial, but the difference of Rs 500 in cash could be termed material*

Advantages of Principle of materiality





Significance to the overall financial picture

- ***makes the financial statement precise and useful*** *: this concept makes the financial statements precise and from unnecessary insignificant detail. Under this concept, financial statements contain only significant information useful to users.*
- ***makes the maintenance of accounts and preparation of final statements cost effective****: as every minute details of transaction are not required to be recorded and presented , it reduces the expenses to be incurred for the maintenance of accounts and preparation of final statements by ignoring insignificant details.*

Principle of Conservatism or Prudence

According to this principle, all anticipated losses should be recorded in the books of accounts, but all anticipated or unrealized gains should be ignored. In other words, conservatism is the policy of playing safe. Provision is made for all known liabilities and losses even the though amount cannot be determined with certainty. Likewise, when there are different alternatives for recording a transaction, the one having least favourable immediate effect on profits or capital should be adopted.

Following are the example of the application of the principle of conservatism:-

i) Closing stock is valued at cost price or realisable value whichever is less

ii) Provision for doubtful debts is created in anticipation of actual bad-debts.

iii) Provision for a pending law suit against the firm, which may either, be decided in its favour.

Effect of Principle of Conservatism

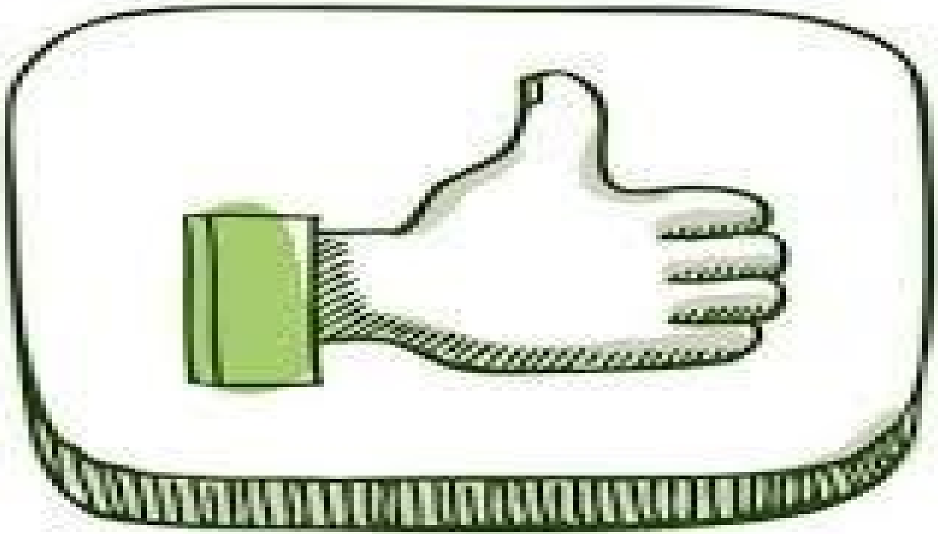
The principle of conservatism should be used very cautiously; otherwise it will have two effects:

(i) Profit & Loss Account will disclose lower profits in comparison to the actual profits

(ii) Balance Sheet will disclose understatement of assets and overstatement of liabilities in comparison to the actual values.

The above mentioned effects will result in creation of secret reserves which is in direct conflict with the principle of full disclosure.

Advantages of Conservatism or Prudence



- ***Make financial statements prudent:*** *this concept makes the financial statements prudent because the real worth of the business is greater than what actually it is shown after providing for all possible future losses.*
- ***Makes the users decision sound:*** *the accounting statements prepared following this concept make the decision of the users sound and free from risk.*
- ***Providing for all possible future losses****: according to this concept all possible future losses are provided for; hence the financial position of and enterprise becomes stronger.*

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

Financial statements are prepared keeping in mind certain fundamental assumption states that the following have been accepted as fundamental accounting assumption. Accounting standard (AS-1): Institute of Chartered Accountants of India states the following have been accepted as fundamental accounting assumption:

(a) Going concern

(b) Accrual concept

(c) Consistency concept

The rationale or significance of fundamental assumptions is that they need not be specifically stated since it is assumed that the accountant has followed them while preparing the financial statements. Disclosure is necessary as a note to the financial statements if fundamentals assumptions have not been followed.