**Principles of Accounting**

Principles refer to the rules that are adopted by accountants in recording and preparing reports of financial transactions. Accounting principles can be discussed in terms of Accounting concepts and conventions. Highlight and briefly explain any five (5).

**Accounting concepts:**

* Entity concept: this simply states that the business is separate from its owners. Financial statements or reports are prepared for the business.
* Going concern concept: a business is expected to have an infinite life. It should continue to operate into the foreseeable future without a need for winding up or reducing the scale of its operations.
* Periodicity concept: the business life is divided into specific or definite time periods for assessing its financial performance and financial position. This is known as accounting period and usually consists of 12 months.
* Measurement concept: accounting is concerned only with those transactions that can be measured in monetary terms. Qualitative characteristics like management competence and labour skills are difficult to measure on monetary basis and as such, are mostly unaccounted for.
* Historical cost concept: the basis for recording the values of income, expenses, assets acquired and liabilities are at their actual or original values. Historical cost concept does not recognise changes in the value of money e.g. price changes due to inflation.
* Dual aspect concept: there are two sides to a transaction. This is the double entry principle that for every giver of value, there is a receiver of that value. As will be seen later under accounting equation, the dual aspect also relates to the assumption that all assets (resources) of an organisation are financed by liabilities.
* Accrual concept: Revenue and expenses are recognised as they are earned and incurred respectively not when they are actually received or paid.
* Matching concept: Revenue earned for a period is matched against all expenses incurred to generate that revenue.
* Realisation concept: this is specific to recognition of revenue. Revenue is recognised when the said transaction is completed whether payment has been received or not. If goods have been sold, the transaction is deemed to be completed when the title to those goods, is transferred from the seller to the buyer. Even though payment is not received, income is assumed to have been earned and is recognised.

**Accounting conventions:**

* Prudence/Conservatism: Caution should be exercised in the recognition of income whereas all expenses, known and foreseeable losses should be adequately provided for in the accounts. Prudence as a convention posits that it is better to understate than overstate.
* Materiality: items of material values should be strictly accounted for. An item is said to be material if its inclusion or omission from the accounts can affect the judgement or decision of a user of that account.
* Consistency: the way items in the account are treated should persist i.e. the accounts should be prepared on a consistent basis and in a consistent manner. This will enable the comparison of accounts over a period of time.
* Objectivity: accounts should be prepared without any bias towards any party or group with an interest in the activities of an organisation. It should be a true presentation of performance and state of affairs of the business.
* Substance over form: Transactions should be accounted for in accordance with their economic reality and not legal form. Where the two are in conflict, the economic reality supersedes the legal reality e.g. assets acquired on hire purchase.

**Accounting Equation**

This is also known as the Statement of Financial Position/Balance Sheet Equation. It is an expression that the assets of an organisation (resources controlled by it) should equal Liabilities (the claims of owners and/or outsiders on these resources). In other words, assets are financed by liabilities.

From the above; Assets = Liabilities. Funds sourced from internal and external parties are used to finance the acquisition of assets for business expansion and increase in value.

Liabilities can be categorised into Capital, Long term (Non Current) and Current Liabilities. These are the claims of owners (Capital) and outsiders (Non Current and Current Liabilities) on the assets of an organisation. Therefore; Assets = Capital + Liabilities.

From the above equation, we can have; Assets – Liabilities = Capital.

Assets – Liabilities = Net Assets = Capital. Net Assets represent the residual interest in the wealth of an organisation (Assets) after settling its Non Current and Current liabilities. The residual interest belongs to the Owners (represented by Capital).

**Definition of Components of the Statement of Financial Position**

**Liabilities**: classified into Capital, Non Current and Current Liabilities.

**Capital** is amount invested in a business by owners. In addition to Capital, depending on the business, you could have Profit or Reserves (as in companies), which are amounts of current profit not appropriated but reserved for business use. It increases the value of Owner’s Capital. Likewise, in an account of a sole trader for example, you could have Drawings which are withdrawals from a business/ amounts invested and therefore deducted from Capital.

**Non Current Liabilities (Long-term)** are those owed to outsiders and which fall due in a time period beyond a year. They could be in form of long term bank loans or debentures (loans raised through the capital market in case of companies).

**Current liabilities** are short term liabilities maturing within a period of one year e.g. trade payables (creditors), accrued expenses, bank overdraft e.t.c.

**Assets**: classified into Non Current (Fixed assets) and Current Assets.

**Non Current Assets (Fixed assets)** are tangible assets whose useful economic life exceeds one year and are used in generation of economic benefit e.g. plant and machinery, land and building, motor vehicles, furniture e.t.c.

**Current Assets** are those whose economic lives do not last beyond a year and are usually transformed into other forms of assets. Cash can be converted to Stock when goods are purchased for resale, on to debtors when sold on credit and cash when the amounts due are recovered or when goods are sold directly for cash. The cash can again be used to acquire inventory resulting in a constant cycle. Thus, current assets are otherwise referred to as **circulating assets**.

There could be **intangible assets** (lacking physical substance but which generate value to a business) such as goodwill and long term investments made by entities. These are commonly shown below the Fixed Assets as in the traditional format of presentation.

**Illustration**

With the following information, demonstrate knowledge of the Accounting Equation N

Plant and Machinery 2,530,000

Income received in advance 148,570

Motor Vehicles 1,480,300

Inventory 359,200

Creditors 760,420

Prepaid Expenses 230,800

Debtors 454,530

Accrued Expenses 95,390

Cash at Bank 890,700

Bills payable 46,850

Long- term Loan 1,500,000

Bills receivable 63,900

**Ledgers and Classification of Accounts**

Ledgers are books of accounts for record of business transactions. A page in a ledger is an account titled and divided into two parts – the Debit and Credit side.

The Debit Side (Dr) connotes receipt of value and the Credit Side (Cr) connotes otherwise that is, giving of value.

The ledger operates on the **Double Entry Principle; for every debit entry, there must be a corresponding credit entry. For every receiver, there is a giver.**

**Read: History of the Double Entry System.**

**Division of Ledgers**

These are into three categories:

1. Sales Ledger- for accounts of trade debtors.
2. Purchases Ledger- for accounts of trade creditors.
3. General/Nominal Ledger- for all other accounts except the two stated above that is, trade debtors and trade creditors.

**Types/Classification of Accounts**

Accounts are classified into two: **Personal** and **Impersonal** Accounts.

1. **Personal Accounts** are those of persons- natural or corporate (business) entities. Examples are Debtors, Creditors, Capital (proprietor or owners’ investment) and Bank account (of the individual or entity). Debtors’ and Creditors’ accounts make up the Sales and Purchases ledger respectively.
2. **Impersonal Accounts** are those of non persons and are divided into two main categories which make up the general or nominal ledger:
3. **Real Accounts**- these are accounts of **tangible assets** like motor vehicles, buildings, plant and machinery, cash, stock.
4. **Nominal Accounts-** these are accounts sub divided into three more categories of **Income/revenue** (e.g. sales, rent received, dividends, commission received etc.) **Expenditure** (wages, rent paid, purchases, interest paid on loans, etc.) **and Intangible assets (**Goodwill, Patents, Trademarks, Copyrights etc).

Think of the ledger as a whole, and accounts as the parts that make up the whole.