

K.P. COLLEGE, MURLIGANJ, MADHEPURA

SUBJECT: Financial Accounting MJC-1

SEM- 1

STUDY MATERIAL

BY: DR.HARISH KHANDELWAL (ASSISTANT PROFESSOR)

Department of Commerce

Accounting Principles

Accounting Principles are the principle, concept, basic, guidance, as well as the rule that use by the accountant to prepare the financial statements of an entity. They are also used by the standard-setting body to develop accounting standards and frameworks.

You may find out some of the accounting principles have been set out in the qualitative and quantitative characterization of information in IFRS.

Most of the accounting principles are also set in the accounting standard and well as frameworks. Even those the accounting standards (local GAAP) vary from one country to another, but the principles that set out in the standards are at the same fashion.

For example, [GAAP](#) or [IFRS](#) is different in many areas but the principles that use in those standards are very much the same.

Even the accounting principles in one financial reporting standard to another is not much different, most investors still not get comfort when the investments are moved to the country where different accounting standards are required.

Yet, in the near future, IFRS will replace the local GAAP and be the world accepted accounting standard.

List of accounting principles:

Accrual Principle:

Accrual accounting concept has required the revenues and expenses to be recorded and recognized in the entity's financial statements when they are incurred rather than when cash is paid or received.

This principle helps the users of financial statements to get the financial information that really reflected with the current financial status or the economic situation of the entity.

The recognition is not only related to the cash flow like cash basis where the revenues are recorded and recognized in the financial statements only when the cash is collected from the customers for the services or products that entity sales to them. And the expenses are recordings and recognized in the financial statements when the cash is an outflow from the entity.

For example, based on accrual accounting principle, sales revenues from selling of cloths are recognized where the right and obligation are transferred from seller to buyer even the seller does not receive the payments from buyer.

Records and recognize the sales based on the accrual basis, the users could see all of the sales that entity make during the period for both credit sales and cash sales. It provides a complete picture of sales during the period.

Another example related to accrued expenses is that the maintenance expenses are recognizing at the time that services consume by entity rather than at the time that the entity paid to suppliers.

This recognition will bring the complete picture to the users of financial statements about how much the maintenance expenses incurred during the period rather than just showing how much the payments are made for maintenance expenses during the period as per cash basis.

Conservatism principle:

Conservatism principle concern about the reliability of Financial Statements of an entity for the benefit of users especially in the areas of overstating the revenue and assets as well as understating the liabilities and expenses.

This accounting principle requires the entity to record and recognize the liabilities and expenses in the financial statements as soon as possible when there is uncertainty about the outcome.

And the entity should not recognize assets or revenue in the financial statements if the outcome is not certain. If it does, the revenues might be overstated and lead users to make the wrong economic decision.

For example, the entity should recognize the expenses immediately in the financial statements if there is the probability that an entity might lose the lawsuit to its customers.

This is to ensure that the liabilities are recognized in the financial statements and it is actually reflecting the current financial situation of the entity that it probably makes a loses.

If these expenses are material to financial statement and they are not recording, then the potential investors who make their decision make their decision based on the financial statements that off these expenses could potentially make loses.

The entity might come to the situation where it is probably of winning the lawsuit. In this case, and base on this principle, the entity should not recognize the possible revenue from this lawsuit.

In addition, the entity might also come to the situation where inventories or fixed assets that entity just purchased last month could be purchase now by spending less money. In this case, the entity should consider writing off the portion that different into expenses so that assets could be present at the realizable value.

Consistency principle:

This is the accounting principle that requires the entity to apply the same accounting method, policies, and standard for reporting its financial statements. There are many benefits for the stakeholders of financial statements when the consistency principle is correctly and strictly applied.

For example, if different accounting policies or methods are used to measure and recognize the revenues then there will the significant different revenues amount present in the income statement while there could be slightly differenced if the same accounting policies or methods of measurement and recognition are used.

For example, depreciation rate and methods should be applying consistently from one accounting period to period to the same fixed assets. If there is any change in accounting policies, the appropriate standard should be applying.

Another example is that your entity is current using FIFO to value your inventories and this method should be used to value your inventories not only in this period but also in the next period. This is also assumed your entity should FIFO was used to value previous inventories.

Cost Principle or Historical Cost Principle:

The concept of historical cost principle is that the assets should be recorded base on the price at the time they are purchased. And the liabilities should be recorded based on the values that expected to pay at the original value rather than market value or inflation-adjusted value.

The historical cost principle is also called the cost principle. To avoid incorrect recognition and measurement, it is recommended that the accountant should follow the accounting standards that they are using to prepare the financial statements.

Business Entity Principle:

Business Entity Concept or Business Entity Principle considers the owner of an entity has different legal liabilities. Under this concept, the entity must record all transactions separately from its owner or owners and other business.

This means that the transactions that record in the entity accounts are only those transactions that belong to the entity. Any financial transactions, assets, liabilities, and equities that belong to owner, owners or other entity should not include in entity accounts.

This principle could help to minimize conflict between owners in case there are many owners of the entity. And it also prevents the owner to avoid tax obligation to the government. It also benefits to owners or shareholders to assess the performance of each entity separately and well as to assess the financial position of the entity.

Full Disclosure Principle:

Full Disclosure Principle requires the entity to disclose all necessary information in its financial statements. The main idea behind this principle is that the users of financial statements of entity might depend on the financial information disclosed in the financial statements to make their decision.

Therefore, it is important to make sure that all the information that they should know are available to them. This is why this principle is introduced to ensure that information that should be disclosed in the entity's financial statements as per the requirement of accounting standards or frameworks had been disclosed. In practice, you might follow each accounting standard whether the situation that happens in your entity should be disclosed or not as per standard.

The information to be disclosed is only the financial information but also non-financial information such as new law and regulation that come into effect soon and the entity's business might get hurt from that law and regulation. The subsequent adversely affect the revenues or the going concern of entity.

For example, the government of the country where the entity run its business just amount that numbers of the tax rate will increase and it will come to effect next year. Entity's business and specifically profits will get hurt.

Going Concern Principle:

Going concern is the concept that assumes entity will remain the business in the foreseeable period which is normally twelve months from the operating date. If the financial statements are prepared based on the going concern basis.

In others words, the entity does not face going concern problem, then the users of financial statements could their reliance on entity's financial information that they are valued by considering the entity could survive in the period of twelve months.

There are many factors that indicate entity might face going concern problem. Or entity might stop it business in the period of twelve months from the reporting date of financial statements.

For examples, the entity's main services or products are no longer need in the markets and sales dramatically drop also most to zero. This situation indicates that an entity probably liquidates its assets to support its operation in the period of less than twelve months.

The entity should conduct going concern assessment annually to see if it is in the going concern problems. The assessment should not only focus on financial factors but also non-financial factors that might affect the entity to shut down its business.

Matching principle:

Matching Principle is the accounting principle that uses to records and recognizes expenses and revenues in the financial statements. This principle wants to make sure that the incomes and expenses in the income statement really reflected in the period that they actually incurred.

When this principle is correctly applied, net income is truly and fairly present in the income statement. It is not the result of overstatement or understatement of revenues or expenses.

For example, when the entity sells goods to its customers, the entity will generate revenues and at the same time, the entity also has to spend its finish goods to its customers.

In this case, sales revenues are recognized in the income statement and the cost of goods sold is also recognized in the same period. Revenues are matched with cost of goods sold in the income statement.

If either revenue or costs of goods sold are deferred to the next period because of whatever reason, then net income will not arrive as it should be. Then the users' decision could when wrong if it is depending on this information.

The entity might come into the situation where customers pay for the goods they have not received. In this case, the entity could not recognize the payments that they received from customers as revenue. This is because goods are not delivered to customers yet.

Materiality principle:

Materiality Principle or materiality concept is the accounting principle that concern about the relevance of information, and the size and nature of transactions that report in the financial statements.

Based on this concept, financial information is material if its omission and addition could be misleading the users' decision. The same size and nature of financial information might material to one entity's financial statements but might not material to another.

This principle is not only used by the accountant to prepare the financial statements as the basis to decide the financial transaction and event that is material to financial statements, but it is also used by the auditor as to calculate the tolerable error, performance materiality as well as planning materiality.

These materiality use as the matrix or tools for auditors to decide if unadjusted transactions or amounts are material to financial statements. This unadjusted transactions or amounts is part of auditors' evident to support their opinions.

Monetary unit principle:

Monetary Unit Assumption is the accounting principle that concern about the valuation of transactions and event that entity records in its financial statements. In monetary unit assumption, transactions or even could records in the Financial Statements only if they could measure in the monetary.

There are many transactions that occur in and by entity every day. Not all of those transactions are recording in the financial statements. For example, sales staff got accident and the entity pay for the costs of accident and hospital.

The entity could record these costs in the income statement but the entity could not record the costs that sales staff's performance becomes low as the result of an accident.

Reliability principle:

Reliability Principle is the accounting principle that concern about the reliability of financial information that presents in the financial statements of an entity. This accounting concept is quite an importance for the users of financial information. If the information is not reliable, then the decision making will be unlikely correct.

Revenue Recognition Principle:

There are many principles that use to recognize revenue in the Financial Statements. For example, Accrual Basis or Cash Basis. In accrual accounting Principle, Revenue should be recognized when risks and rewards are transferred.

Time period principle:

Time Period Principle or Periodicity Principle, Financial Statements of an entity could be prepared in an artificial period of time. They are no need to be prepared based on the regulatory requirement.
