Accounting Concepts and Principles

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Introduction

- Actually there are a number of accounting concepts and principles based on which we prepare our accounts
- These generally accepted accounting principles lay down accepted assumptions and guidelines and are commonly referred to as accounting concepts

Users of Financial Statements

- Investors
  - Need information about the profitability, dividend yield and price earnings ratio in order to assess the quality and the price of shares of a company
- Lenders
  - Need information about the profitability and solvency of the business in order to determine the risk and interest rate of loans
- Management
  - Need information for planning, policy making and evaluation
- Suppliers and trade creditors
  - Need information about the liquidity of business in order to access the ability to repay the amounts owed to them

- Government
  - Need information about various businesses for statistics and formulation of economic plan
- Customers
  - Interested in long-tem stability of the business and continuance of the supply of particular products
- Employees
  - Interested in the stability of the business to provide employment, fringe benefits and promotion opportunities
- Public
  - Need information about the trends and recent development

Limitations of conventional financial statements

- Companies may use different methods of valuation, cost calculation and recognizing profit
- The balance sheet does not reflect the true worth of the company
- Financial statements can only show partial information about the financial position of an enterprise, instead of the whole picture

Accounting Concepts

Accounting Concepts

- Business entity
- Money Measurement/stable monetary unit
- Going Concern
- Historical Cost
- Prudence/conservatism
- Materiality

- Objectivity
- Consistency
- Accruals/matching
- Realization
- Uniformity
- Disclosure
- Relevance

Business Entity

- Meaning
  - The business and its owner(s) are two separate existence entity
  - Any private and personal incomes and expenses of the owner(s) should not be treated as the incomes and expenses of the business
  - therefore say that the <u>accounting is done in the enterprises.</u>

Business Entity

- Examples
  - Insurance premiums for the owner’s house should be excluded from the expense of the business
  - The owner’s property should not be included in the premises account of the business
  - Any payments for the owner’s personal expenses by the business will be treated as drawings and reduced the owner’s capital contribution in the business

Money Measurement

Money Measurement

- Meaning
  - All transactions of the business are recorded in terms of money
  - It provides a common unit of measurement
- Examples
  - Market conditions, technological changes and the efficiency of management would not be disclosed in the accounts

Going Concern

Going Concern

- Meaning
  - The business will continue in operational existence for the foreseeable future
  - Financial statements should be prepared on a going concern basis unless management either intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so

- Example
  - Possible losses form the closure of business will not be anticipated in the accounts
  - Prepayments, depreciation provisions may be carried forward in the expectation of proper matching against the revenues of future periods
  - Fixed assets are recorded at historical cost

Historical Cost

Historical Cost

- Meaning
  - Assets should be shown on the balance sheet at the cost of purchase instead of current value
- Example
  - The cost of fixed assets is recorded at the date of acquisition cost. The acquisition cost includes all expenditure made to prepare the asset for its intended use. It included the invoice price of the assets, freight charges, insurance or installation costs

Prudence/Conservatism

Prudence/Conservatism

- Meaning
  - Revenues and profits are not anticipated. Only realized profits with reasonable certainty are recognized in the profit and loss account
  - However, provision is made for all known expenses and losses whether the amount is known for certain or just an estimation
  - This treatment minimizes the reported profits and the valuation of assets

- Example
  - Stock valuation sticks to rule of the lower of cost and net realizable value
  - The provision for doubtful debts should be made
  - Fixed assets must be depreciated over their useful economic lives

Materiality

Materiality

- Meaning
  - Immaterial amounts may be aggregated with the amounts of a similar nature or function and need not be presented separately
  - Materiality depends on the size and nature of the item

- Example
  - Small payments such as postage, stationery and cleaning expenses should not be disclosed separately. They should be grouped together as sundry expenses
  - The cost of small-valued assets such as pencil sharpeners and paper clips should be written off to the profit and loss account as revenue expenditures, although they can last for more than one accounting period

Objectivity

Objectivity

- Meaning
  - The accounting information should be free from bias and capable of independent verification
  - The information should be based upon verifiable evidence such as invoices or contracts

- Example
  - The recognition of revenue should be based on verifiable evidence such as the delivery of goods or the issue of invoices

Consistency

Consistency

- Meaning
  - Companies should choose the most suitable accounting methods and treatments, and consistently apply them in every period
  - Changes are permitted only when the new method is considered better and can reflect the true and fair view of the financial position of the company
  - The change and its effect on profits should be disclosed in the financial statements

- Examples
  - If a company adopts straight line method and should not be changed to adopt reducing balance method in other period
  - If a company adopts weight-average method as stock valuation and should not be changed to other method e.g. first-in-first-out method

Accruals/Matching

Accruals/Matching

- Meaning
  - Revenues are recognized when they are earned, but not when cash is received
  - Expenses are recognized as they are incurred, but not when cash is paid
  - The net income for the period is determined by subtracting expenses incurred from revenues earned

- Example
  - Expenses incurred but not yet paid in current period should be treated as accrual/accrued expenses under current liabilities
  - Expenses incurred in the following period but paid for in advance should be treated as prepayment expenses under current asset
  - Depreciation should be charged as part of the cost of a fixed asset consumed during the period of use

Problems in the recognition of expenses

- Normally, expenses represents resources consumed during the current period. Some costs may benefit several accounting periods, for example, development expenditures, depreciation on fixed assets.

Recognition criteria for expenses

- Association between cause and effect
  - Expenses are recognized on the basis of a direct association between the expenses incurred on the basis of a direct association between the expenses incurred and revenues earned
  - For example, the sales commissions should be accounted for in the period when the products are sold, not when they are paid

- Systematic allocation of costs
  - When the cost benefit several accounting periods, they should be recognized on the basis of a systematic and rational allocation method
  - For example, a provision for depreciation should be made over the estimated useful life of a fixed asset
- Immediate recognition
  - If the expenses are expected to have no certain future benefit or are even without future benefit, they should be written off in the current accounting period, for example, stock losses, advertising expenses and research costs

Realization

Realization

- Meaning
- Revenues should be recognized when the major economic activities have been completed
- Sales are recognized when the goods are sold and delivered to customers or services are rendered

Recognition of revenue

- The realization concept develops rules for the recognition of revenue
- The concept provides that revenues are recognized when it is earned, and not when money is received
- A receipt in advance for the supply of goods should be treated as prepaid income under current liabilities
- Since revenue is a principal component in the measurement of profit, the timing of its recognition has a direct effect on the profit

Recognition criteria for revenues

- The uncertain profits should not be estimated, whereas reported profits must be verifiable
- Revenue is recognized when

1. The major earning process has substantially been completed
2. Further cost for the completion of the earning process are very slight or can be accurately ascertained, and
3. The buyer has admitted his liability to pay for the goods or services provided and the ultimate collection is relatively certain

- Example
  - Goods sent to our customers on sale or return basis
  - This means the customer do not pay for the goods until they confirm to buy. If they do not buy, those goods will return to us
  - Goods on the ‘sale or return’ basis will not be treated as normal sales and should be included in the closing stock unless the sales have been confirmed by customers

Problems in the recognition of revenue

- Normally, revenue is recognized when there is a sale
- The point of sales in the earning process is selected as the most appropriated time to record revenues
- However, if revenue is earned in a long and continuous process, it is difficult to determine the portion of revenue which is earned at each stage
- Therefore, revenue is permitted to be recorded other than at the point of sales

Exceptions to rule of sales recognition

1. Long-term contracts
   - Owning to the long duration of long-term contracts, part of the total profit estimated to have been arisen from the accounting period should be included in the profit and loss account
2. Hire Purchase Sale
   - Hire purchase sales have long collection period. Revenue should be recognized when cash received rather than when the sale (transfer of ownership) is made
   - The interest charged on a hire purchase sale constitutes the profit of transaction

3. Receipts from subscriptions

- A publisher receives subscriptions before it sends newspapers or magazines to its customers
- It is proper to defer revenue recognition until the service is rendered.
- However, part of subscription income can be recognized as it is received in order to match against the advertising expenses incurred

Disclosure

Disclosure

- Meaning
  - Financial statements should be prepared to reflect a true and fair view of the financial position and performance of the enterprise
  - All material and relevant information must be disclosed in the financial statements

Uniformity

Uniformity

- Meaning
  - Different companies within the same industry should adopt the same accounting methods and treatments for like transactions
  - The practice enables inter-company comparisons of their financial positions

Relevance

Relevance

- Meaning
  - Financial statements should be prepared to meet the objectives of the users
  - Relevant information which can satisfy the needs of most users is selected and recorded in the financial statement

Questions ???