Accounting Principles and Convention

➢ Differences between IFRS and Indian GAAP : The basic difference between IFRS and Indian GAAP is that IFRS is Principle based, while Indian GAAP is Rule based. Some of the other differences are :

Basic of Difference	Indian GAAP	IFRS
(i) Financial Statements	Specific formats to be followed, based on the type of industry i.e., as per the Companies Act or Banking Act or Insurance Acts, etc.	No prescribed format.
(ii) Prior Period adjustment	Ib be separately disclosed in the current Statement of Profit and Loss.	Generally corrected in the Current Financial Statement.
(iii) Revenue recognition	Revenue is recognized when all significant risks and rewards of owner-ship are transferred or on a percentage of completion basis.	Revenue is recognized when all significant risks and rewards of ownership are transferred.
(iv) Cash flow statement	Mandatory only for listed companies and companies meeting certain turnover conditions.	Mandatory for all entities.
(v) Extraordinary items	Defined as events or transactions clearly distinct from ordinary activities and not ex-pected to recur frequently and regularly.	Prohibited.
(vi) Valuation	Based on Historical cost.	May be based on Fair Value Concept.

Besides the above, some differences exist in other areas of inventory valuation, treatment of dividends, accounting for foreign

currency transactions, accounting for fixed assets, accounting for taxes on income, useful life of intangible assets, etc.

2 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

In order to maintain uniformity and consistency in the process of accounting, certain rules or principles have been developed, which are generally accepted by the accounting profession. These rules are called by different names, such as principles, assumptions, concepts, conventions, postulates and modifying principles.

Rules + Procedure(Standard)

3.3 MEANING AND NATURE OF ACCOUNTING PRINCIPLES

The term 'principle' has been defined by American Institute of Certified Public Accountants (AICPA) as 'A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice'.

Thus, *Accounting Principles refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements.*

The Accounting Principles have evolved over a long period of time on the basis of past experiences, usages or customs by individuals and professional bodies and regulations by government agencies and have general acceptability among most accounting professionals.

These principles are classified into two categories:

1. Accounting Concepts: Accounting Concepts refer to the necessary assumptions and ideas,

which are fundamental to the accounting practice. These accounting assumptions or concepts must be followed as they provide basic foundation for the accounting process.

Accounting Concepts are the necessary assumptions, conditions or postulates upon which the accounting is based.

2. Accounting Conventions: Accounting conventions are the customs or traditions guiding the preparation of accounts. They are adopted to make financial statements clear and meaningful.

Nature of Accounting Principles

Accounting concepts are the basic assumptions that guide how transactions are recorded and measured, while accounting conventions are the guidelines that determine how transactions are presented and disclosed.

BASIS FOR COMPARISON	ACCOUNTING CONCEPT	ACCOUNTING CONVENTION
Meaning	Accounting concepts refers to the rules of accounting which are to be followed, while recording business transactions and preparing final accounts.	Accounting conventions implies the customs or practices that are widely accepted by the accounting bodies and are adopted by the firm to work as a guide in the preparation of final accounts.
What is it?	A theoretical notion	A method or procedure
Set by	Accounting bodies	Common accounting practices
Concerned with	Maintenance of accounts	Preparation of financial statement
Biasness	Not possible	Possible

The main features of accounting principles are:

1. **Accounting Principles are man-made**, i.e. they have been developed by accountants and academicians on the basis of periodic observations and experience. So, they are not as exact as principles of natural science.

2. **Accounting Principles are not rigid or static in nature**, i.e. they are flexible. They are constantly influenced by changes in the legal, social and economic environment as well as the needs of the users.

3. **Accounting Principles act as guide for accounting and are generally accepted**. The general acceptance of an accounting principle usually depends on how well it satisfies the following three criteria.

(i) Relevance: A principle is relevant only if it results in information that is useful to the users of accounting information.

(ii) Objective: A principle is objective if it is free from personal bias of the persons preparing the accounting information.

(iii) Feasible: A principle is feasible if it can be applied without undue complexity or cost.

3.4 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

Fundamental Accounting Assumptions are the assumptions which are presumed to have been followed while preparing the book of accounts. ***If a firm does not follow any of the fundamental accounting assumptions, then the firm is required to disclose this fact together with the reason for not following them.***

The three basic Accounting Assumptions are:

1. Going Concern Assumption;

2. Consistency Assumption; and

3. Accrual Assumption.

1. Going Concern Assumption

According to this assumption, it is assumed that business shall continue for an indefinite period of time and there is neither any intention nor any necessity to close down the business or scale down its operations significantly.

• Business transactions are recorded from this point of view.

• On the basis of this assumption, fixed assets are recorded at their cost and depreciation is charged on the basis of their expected lives rather than their market values.

• Going Concern concept facilitates the distinction between Current and Non-Current Assets, Long-term and Short-term liabilities and Capital and Revenue Expenditure.

• It is also because of this assumption that outside parties enter into long-term contracts with the enterprise, give loans and purchase debentures and shares of the enterprise.

• This assumption is also known as *'Continuity Assumption'*.

2. Consistency Assumption

According to this assumption, accounting practices once selected and adopted, should be applied consistently year after year.

• This concept provides comparability to accounting data of the same enterprise over different time periods (known as intra-firm comparison) and with other firms (known as inter-firm comparison).

• Consistency eliminates personal bias and helps in achieving results that are comparable.

• This concept become particularly more important when two or more methods or alternative accounting practices are available and each one is equally acceptable.

For example, out of the two methods of charging depreciation (Written Down Value Method and Straight Line Method), a firm can choose any one method. But, according to this assumption, it is expected that the method once chosen and applied should be applied consistently year after year.

• But, this concept does not mean that method or a practice once adopted cannot be changed.

° The method or practice may be changed if the Law or Accounting Standard requires it or if the change will result in more meaningful presentation.

° However, the nature and effect of the change of method and justification for the change,

must be clearly disclosed.

3. Accrual Assumption

According to the Accrual Assumption, revenue and expenses are recorded in the period in which they become due, rather when they are received or paid.

• According to this assumption, a transaction is recorded in the books when it is entered into and not when the settlement takes place. It means:

◦ Revenue is recorded when sales are made or services are rendered, irrespective of the fact whether cash is received or not. For example, if a firm has sold goods on 27th June, 2015 on 2 months credit, then the sale must be recorded on 27th June, 2015, although the amount will be received in August.

◦ Similarly, expenses are recorded in the period in which they have become due rather than in the period in which they are paid.

• This concept recognises the assets, liabilities, incomes and expenses as and when transactions relating to it are entered into

• To arrive at the correct profit or loss during an accounting period, all expenses and incomes be recorded on accrual basis and not on cash basis.

3.5 ACCOUNTING PRINCIPLES

1. Accounting Entity or Business Entity Principle

According to this principle, business is considered to be a separate and distinct entity from its owners.

• Accounting is always done from the point of view of the business and not its owners. So, all the business transactions are recorded from the point of view of the business and not from that of the owners.

• The personal transactions of the owner are kept separate from the business. For example, house, car, personal income and expenditure of the proprietor must be kept separate from the business accounts.

• The proprietor or owner is treated as a creditor of the business to the extent of capital invested by him in the business.

When the owner brings in some money as capital, it is treated as liability of the business to the owner. Similarly, when he withdraws money from the business for his personal expenses (drawings), it is treated as reduction of the owner's capital and consequently a reduction in the liabilities of the business.

• This principle applies to all forms of business organisations, i.e., sole proprietorship, partnership or a company.

2. Money Measurement Principle

According to this principle, only those transactions and events are recorded in *the books of accounts which are capable of being expressed in terms of money.*

• Suppose a business enterprise has ` 70,000 cash, 2 buildings, and 4 machines. These assets cannot be added and shown in the Financial Statements unless they are valued in terms of money and then added up together to know the worth of the business. So, money is the common denominator in which all transactions are recorded.

• This concept suffers from two major limitations:

(i) *Qualitative transactions are not recorded,* irrespective of their importance. For example, sincerity and quality of the employees or quality of the product are not recorded in the Financial Statements even though they are so crucial for the enterprise, (ii) Money is considered to have static value as transactions are recorded at value on transaction date. However, *value of money does not remain same* over a period of time due to change in the price level.

3. Accounting Period Principle

According to this principle, the economic life of an enterprise is split into periodic intervals (known as accounting period) so that its performance is measured at regular period.

• The accounts of an enterprise are maintained following the Going Concern Concept, which says that the business is intended to continue for an indefinite period of time. It means that the true results of the business operations can be ascertained only when the business is completely wound up.

• However, ascertainment of profit after a very long period will be of little use to the users of financial statements as they need accounting information at regular intervals for decision making.

• So, life of a business is split into periodic interval, which is known as *'Accounting Period'.*

• Accounting period of one year is usually adopted for this purpose. In India, it generally starts on 1st day of April and ends on 31st of March next year.

• At the end of an accounting period:

° Profit and Loss Account is prepared to know the profit earned during the accounting year; and

° Balance Sheet is prepared to know the financial position of the business at the end of the year.

4. Full Disclosure Principle

According to the this principle, the financial statements should completely

disclose all the significant information relating to the economic affairs of the enterprise.

• The disclosure can be done cither in the financial statements or in the footnotes/ like in case of contingent liabilities (or Notes to Accounts in case of companies).

• Full Disclosure is not only a legal requirement, but it also makes the accounting system fair and transparent.

• As per the Companies Act, every company is required to disclose essential information in the financial statements.

• Incomplete information ham pers the basic purpose of financial statements. So, all the material and relevant facts should be disclosed in the financial statements.

• Full Disclosure ensures that financial statements present a true and fair view of the profitability and financial position of the business to its various end users.

5. Materiality Principle

According to this principle, all relatively relevant items, the knowledge of which might influence the decision of the users of the financial statements, should be disclosed in the financial statements.

• As per this Materiality, only those items should be disclosed that have significant effect or are relevant to the user. So, this principle is contradictory to the Full Disclosure principle.

• An item which is significant for one enterprise, may be insignificant for another enterprise. For example, tools costing ` 5,000 is material for a small car workshop, but for a large enterprise, like Tata Motors, it may be insignificant.

• So, whether an item is material or not will depend on its nature and/or amount.

6. Prudence or Conservatism Principle

According to this principle, all prospective losses should be recorded in the books of accounts, but all anticipated profits should be ignored.

• Due to this principle, provision is made for all known liabilities and losses, even though their amount cannot be determined with certainty.

• For example, provision for doubtful debts is made in anticipation of actual bad debts. Similarly, closing stock is valued at lower of cost or net realisable value.

• This principle aims to ensure that the Financial Statements present a true and fair view of the state of affairs of the business and does not exhibit a better picture than what actually is.

Drawbacks of Conservatism Principle

(i) It may lead to creation of Secret Reserves: **Creation of too much provisions, like creating excess provision for doubtful debts or charging excessive depreciation, may lead to creation of secret reserves.**

(ii) It may lead to overstatement of liabilities: **Conservatism provides for all the anticipated expenses and losses, but does not record anticipated revenues. So, it may result in overstatement of liabilitie.**

So, this principle should be carefully applied so that the results depicted by the Financial Statements are not distorted.

7. Cost Concept or Historical Cost Principle

According to this principle, an asset is recorded in the books at the price paid to acquire it and cost becomes the basis for its accounting in the subsequent accounting periods.

• Asset is recorded at cost at the time of its acquisition and is reduced year after year by charging depreciation based on the useful life of that asset rather than its market value. So, an asset is shown in the Balance Sheet at its book value, i.e. cost less depreciation.

• If nothing is paid to acquire an asset, then the same will not be recorded as an asset.

• Since the acquisition cost of an asset relates to the past, it is referred to as *'Historical Cost'.*

• This principle brings *Objectivity* in the preparation of financial statements as cost price paid for the purchase of asset is verifiable from the cost records. So, the information stated in the financial statements is not influenced by personal bias or judgments.

Drawbacks of Cost Principle

1. It ignores recording of assets for which nothing in monetary terms is paid. For example, good brand name, favourable location, technological knowledge, etc. will remain unrecorded even though these are valuable assets.

2. It results in inflated or understated profit during inflation as depreciation is charged on the basis of historical cost and not on the basis of market value.

8. Matching Principle

According to this principle, expenses incurred in an accounting period should be matched with the revenues recognised in that period.

• Profit earned by a business during a period can be correctly measured only when the revenue earned during the period is matched with the expenditure incurred to earn that revenue. Such matching of revenue with expenses is based on accrual system of accounting.

• Following are the points that should be kept in mind for matching cost with revenue:

° **When an item of revenue is included in the Profit and Loss Account, then all the expenses incurred, whether paid or not, should be shown as expenses in the Profit and Loss Account. It means, if there is any outstanding expense, then will be shown in the Profit and Loss Account.**

° If an expense is paid during an accounting period, but revenue related to it will be earned in the following period, then such expense will be shown as an expense only next year and not this year. For example, Prepaid Insurance. Such prepaid expense is shown as an asset in the Balance Sheet.

° In the same manner, if a revenue is received, but against it services will be rendered next year, then revenue will be also recognised in the next year and will be shown as a liability in the Balance Sheet. For example, unearned salary.

9. Dual Aspect or Duality Principle

According to this principle, every business transaction has two aspects, a debit and a credit of equal amount.

• In other words, for every debit, there is a credit of equal amount in one or more accounts and vice-versa. The system of recording transactions based on this principle is termed as 'Double Entry System'.

• Because of this principle, Balance Sheet has two sides: Assets side and Liabilities side and both are always equal to each other under all circumstances.

• For example, suppose Ankit starts a business by investing ` 5,00,000 in cash and takes a loan of ` 1,00,000 from the bank.

° Now, the assets (cash) in the business will increase by ` 6,00,000 (=` 5,00,000 + ` 1,00,000).

° At the same time, it will increase owner's equity or capital by ` 5,00,000; and

° Claims of outsiders, i.e. liabilities will increase by ` 1,00,000.

° Now, this transaction can be expressed as:

Assets (Cash) = Claim of Outsiders (Bank Loan) + Owner's Equity (Capital)

6,00,000 = 1,00,000 + 5,00,000

• This fundamental equation will always remain good in all situations.

10. Revenue Recognition Principle

According to this principle, revenue must be recognised when a transaction has *been entered into and the obligation to receive its payment has been established.*

• It is very important to decide the point of time when revenue can be assumed to have been recognised as revenue recognised is only considered for computation of profit.

• *Example:* Suppose a firm sells goods in January 2015, but receives the amount in March 2015. As per the principle of revenue recognition, revenue from this sale should be recognized in January 2015 itself as the legal obligation to pay the amount has been established on this date. However, if the firm had received only an advance in January 2015 for sale of goods in April, 2015, then revenue from this sale shall be recognized in April, 2015.

11. Verifiable Objective Concept

According to this concept, all transactions should be recorded in an objective manner and they should be free from personal bias.

• It implies that all accounting transactions should be supported by documentary evidence or vouchers.

• These supporting documents include cash memo, invoices, bills, etc.

• For example, cash purchase of goods should be supported by a Cash Memo and credit purchase by an invoice.