- Explain the meaning of accounting principles
- Differentiate between accounting concepts and conventions
- Appreciate the importance of different accounting concepts and conventions
- Name the accounting standards issued by the Institute of Chartered Accountants of India
- Describe the different systems of accounting

## 2.2 MEANING OF ACCOUNTING PRINCIPLES

Accounting principles[1] may be defined as those rules of action adopted by accountants universally while recording accounting transactions. "They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist." These principles can be classified into two categories:

(*i*) Accounting Concepts[2]
(*ii*) Accounting Conventions

### Accounting Concepts

The term 'concepts' includes those basic assumptions or conditions upon which the science of accounting is based. The following are the important accounting concepts:

(*i*) Separate Entity Concept
(*ii*) Going Concern Concept
(*iii*) Money Measurement Concept
(*iv*) Cost Concept
(*v*) Dual Aspect Concept

[1] Also termed as 'Accounting Standards'.
[2] Also termed as 'Accounting Postulates'.

(*vi*) Accounting Period Concept
(*vii*) Periodic Matching of Cost and Revenue Concept
(*viii*) Realisation Concept

### Accounting Conventions

The term 'conventions' includes those customs or traditions which guide the accountant while preparing the accounting statements. The following are the important accounting conventions.

(*i*) Convention of Conservatism
(*ii*) Convention of Full Disclosure
(*iii*) Convention of Consistency
(*iv*) Convention of Materiality

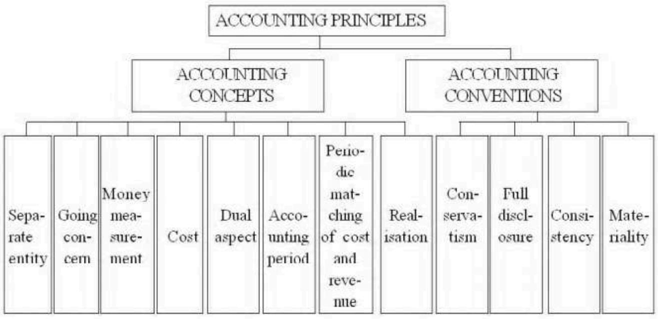

***Fig. 2.1*** *Accounting Conventions*

Each of the above concepts and conventions are being explained below.

## 2.3 ACCOUNTING CONCEPTS

1. **Separate entity concept.** In accounting business is considered to be a separate entity from the proprietor(s). It may appear to be ludicrous that one person can sell goods to himself but this concept is extremely helpful in keeping business affairs strictly free from the effect of private affairs of the proprietor(s). Thus, when one person invests Rs 10,000 in business, it will be deemed that the proprietor has given that much money to the business which will be shown as a 'liability' in the books of the business. In case the proprietor withdraws Rs 2,000 from the business, it will be charged to him and the net amount payable by the business will be shown only as Rs 8,000.

The concept of separate entity is applicable to all forms of business organizations. For example, in case of a partnership business or sole proprietorship business, though the partners or sole proprietor are not considered as separate entities in the eyes of law, but for accounting purposes they will be considered as separate entities.

2. **Going concern concept**. According to this concept it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant, while valuing the assets, does not take into account the forced sale value of assets. Moreover, he charges depreciation on fixed assets on the basis of their expected lives rather than on their market value.

It should be noted that the 'going concern concept' does not imply permanent continuance of the enterprise. It rather presumes that the enterprise will continue in operation long enough to charge against income, the cost of fixed assets over their useful lives, to amortize over an appropriate period other costs which have been deferred under the actual or matching concept, to pay liabilities when they become due, and to meet contractual commitments. Moreover, the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is normally not impaired.

The enterprise will not be considered as a going concern when it has gone into liquidation or it has become insolvent. Of course, the receiver or the liquidator may endeavour to carry on business operations for some period pending arrangement with the creditors or final buyer for the sale of the business as a going concern. The going concern status of the concern will stand terminated from the date of his appointment or will be at least regarded as suspended, pending the results of his efforts.

3. **Money measurement concept**. Accounting records only monetary transactions. Events or transactions which cannot be expressed in money do not find place in the books of accounts though they may be very useful for the business. For example, if a business has got a team of dedicated and trusted employees, it is definitely an asset to the business but since their monetary measurement is not possible, they are not shown in the books of the business.

Measurement of a business event in money helps in understanding the state of affairs of the business in a much better way. For example, if a business owns Rs 10,000 of cash, 600 kg of raw materials, two trucks, 1,000 square feet of building space etc., these amounts cannot be added together to produce a meaningful total of what the business owns. However, if these items are expressed in monetary terms such as Rs 10,000 of cash, Rs 12,000 of raw materials, Rs 2,00,000 of trucks and Rs 50,000 of building, all such items can be added and a much more intelligible and precise estimate about the assets of the business will be available.

4. **Cost concept**. The concept is closely related to going concern concept. According to this concept:

(*a*) an asset is ordinarily entered in the accounting records at the price paid to acquire it, and

(*b*) this cost is the basis for all subsequent accounting for the assets.

If a business buys a plot of land for Rs 50,000, the asset would be recorded in the books at Rs 50,000 even if its market value at that time happens to be Rs 60,000. In case, a year later, the market value of this asset comes down to Rs 40,000, it will ordinarily continue to be shown at Rs 50,000 and not at Rs 40,000.

The cost concept does not mean that the asset will always be shown at cost. It has also been stated above that cost becomes the basis for all future accounting for the asset. It means that the asset is recorded at cost at the time of its purchase, but it may systematically be reduced in its value by charging depreciation.

The cost concept has the advantage of bringing objectivity into the preparation and presentation of financial statements. In the absence of this concept the figures shown in the accounting records would have depended on the subjective views of a person. However, on account of continued inflationary tendencies, the preparation of financial statements on the basis of historical costs, has become largely irrelevant for judging the financial position of the business. This is the reason for the growing importance of inflation accounting.

5. **Dual aspect concept.** This is the basic concept of accounting. According to this concept every business transaction has a dual effect. For example, if *A* starts a business with a capital of Rs 10,000, there are two aspects of the transaction. On the one hand the business has an asset of Rs 10,000, while on the other hand the business has to pay to the proprietor a sum of Rs 10,000 which is taken as proprietor's capital. This expression can be shown in the form of following equation:

Capital (Equities) = Cash (Assets)
10,000 = 10,000

The term 'assets' denotes the resources owned by a business while the term 'Equities' denotes the claims of various parties against the assets, Equities are of two types. They are: owners' equity and outsiders' equity. Owners' equity (or capital) is the claim of owners against the assets of the business while outsiders' equity (for liabilities) is the claim of outside parties, such as creditors, debenture-holders etc., against the assets of the business. Since all assets of the business are claimed by someone (either owners or outsiders), the total assets will be equal to the total liabilities, Thus:

Equities = Assets
*or* Liabilities + Capital = Assets

In the example given above, if the business purchases furniture worth Rs 5,000 out of the money provided by *A*, the situation will be as follows:

Equities = Assets
Capital Rs 10,000 = Cash Rs 5,000 + Furniture Rs 5,000

Subsequently, if the business borrows Rs 30,000 from a bank, the new position would be as follows:

Equities = Assets
Capital Rs 10,000 + Bank Loan Rs 30,000 = Cash 35,000 + Furniture Rs 5,000.

The term 'accounting equation' is also used to denote the relationship of equities to assets. The equation can be technically stated as "for very debit, there is an equivalent credit". As a matter of fact the entire system of double entry book-keeping is based on this concept. This has been explained in detail later in the chapter.

6. **Accounting period concept**. According to this concept, the life of the business is divided into appropriate segments for studying the results shown by the business after each segment. This is because though the life of the business is considered to be indefinite (according to going concern concept), the measurement of income and studying the financial position of the business after a very long period would not be helpful in taking proper corrective steps at the appropriate time. It is, therefore, absolutely necessary that after each segment or time interval the businessman must 'stop' and 'see back', how things are going. In accounting, such a segment or time interval is called 'accounting period'. It is usually of a year.

At the end of each accounting period an Income Statement and a Balance Sheet are prepared. The Income Statement discloses the profit or loss made by the business during the accounting period while the Balance Sheet depicts the financial