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## Chapter -3

# Accounting Principles

## **Theory Base of Accounting**

Theory base of accounting consists of principles, concepts, conventions, rules and guidelines developed over a period of time to bring uniformity and consistency to the process of accounting.

## **Meaning of Accounting Principles**

Accounting principles are the principles have been generally accepted by accountants all over the world as general guidelines for preparing the accounting statements. These principles have developed over a course of period from usage, reason, common experiences, historical precedents, statements of individuals. Professional bodies and regulation or Government agencies.

## **Nature or Characteristics of Accounting Principles:**

1. Accounting principles are uniform set of rules or guidelines developed to ensure uniformity and easy understanding of the accounting information.
2. Accounting principles are manmade and are derived from experience and reason.
3. Accounting principles are not static and are bound to change with the passage of time in response to the changes in business practices, government policies and needs of the users of accounting information.
4. The general acceptance of an accounting principle depends upon how well it satisfies the following three criteria:
  - (a) **Relevance:** A principle is relevant if it results in information that is useful to the user of the accounting information.

**(b) Objectivity: A principle is objective if it is free from personal bias or judgements of those who furnish the information.**

**(c) Feasibility: A principle is feasible if it can be applied without undue cost.**

## **Need of Accounting Principles**

**In order to make the accounting information meaningful it is significant that such information is reliable as well as comparable. The comparability of information is required to see how a firm has performed as compared to the other firms and how it has performed as compared to the previous years.**

**The Accounting principle bring uniformity and consistency to the process of accounting.**

## **GENERALLY ACCEPTED ACCOUNTING PRINCIPLES**

**In order to maintain uniformity and consistency in accounting records, 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, concepts, conventions, postulates, assumptions and modifying principles.**

**Generally Accepted Accounting Principles (GAAP) 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 Generally Accepted Accounting Principles have evolved over a long period of time on the basis of past experiences, usages or customs, statements by individuals and professional bodies and regulations by government agencies and have general acceptability among most accounting professionals. However, the principles of accounting are not static in nature. These are constantly influenced**

by changes in the legal, social and economic environment as well as the needs of the users.

These principles are also referred as concepts and conventions. The term concept refers to the necessary assumptions and ideas which are fundamental to accounting practice, and the term convention connotes customs or traditions as a guide to the preparation of accounting statements.

## **Kinds of Accounting Principles**

Accounting principles are described by various terms such as assumptions, conventions, concepts, doctrines, postulates etc.

These principles can be classified mainly into two categories:

(I) Accounting Concepts or Assumptions (II) Accounting Principles

**(I) ACCOUNTING CONCEPTS OR ASSUMPTIONS:** - In order to make the accounting language convey the same meaning to all people and to make it more meaningful, most of the accountants have agreed on a number of concepts which are usually followed for preparing the financial statements.

**1. Going Concern Concept:** - As per this concept it is assumed that the business will exist for a long period in the future. The transactions are recorded in the books of the business on the assumption that it is a continuing enterprise. It is on this as that we record fixed assets at their original cost and depreciation is charged on these assets.

**2. Consistency Concept:** - This concept states that accounting principles and methods should remain consistent from one year to another. These should not be changed from year to year, in order to enable the management to compare the Profit Loss Account and Balance Sheet of the different periods and draw important

conclusions about the working of the enterprise.

**3. Accrual Concept:** - In accrual concept revenue is recorded when sales are made or services are rendered and it is immaterial whether cash is received or not. Similar according to this concept, expenses are recorded in the accounting period in which they assist in earning the revenue whether the cash is paid for them or not.

**4. Revenue Recognition (Realisation) Concept:** - The concept of revenue recognition requires that the revenue for a business transaction should be included in the accounting records only when it is realised.

**5. Objectivity Concept:** - The concept of objectivity requires that accounting transaction should be recorded in an objective manner, free from the bias of accountants and others. This can be possible when each of the transaction is supported by verifiable documents or vouchers.

## **(II) ACCOUNTING PRINCIPLES:**

**1. Business Entity Principle:** - According to this principle, business is treated as a unit separate and distinct from its owners, creditors, managers and others.

**2. Money Measurement Principle:** - Only those transactions and events are recorded in accounting which are capable of being expressed in terms of money.

**3. Accounting Period Principle:** - As the business is intended to continue indefinitely for a long period, the true results of the business operations can be ascertained only when the business is completely wound up. Thus, the entire life of the firm is divided into time - intervals for the measurement of the profits of the business.

Twelve month period is usually adopted for this purpose. According to the amended income tax law, a business has compulsorily to adopt financial year beginning on 1st April and ending on 31st March in the next calendar year, as its accounting period.

**4. Principle of full disclosure:** - There should be a sufficient disclosure of information which is of material interest to the users of the financial statements such as proprietors, present and potential creditors, investors and others. Various items or facts which do not find place in accounting statements are shown in the Balance Sheet by way of footnotes.

**5. Principle of Materiality:** - This principle is an exception to the principle of full disclosure. According to this principle, items having an insignificant effect or being irrelevant to the user need not be disclosed. These unimportant items are either left out or merged with other items, otherwise accounting statements will be unnecessarily overburdened.

**6. Principle of Conservatism or Prudence:** - According to this principle, all anticipated losses should be recorded in the books of accounts, but all anticipated unrealized gains should be ignored. In other words, conservatism is the policy of playing safe. Provision is made for all known liabilities and losses.

**7. Cost Principle or Historical Cost Principle:** - According to this principle, an asset is ordinarily recorded in the books of accounts at the price at which it was acquired. Since the acquisition cost relates to the past, it is referred to as historical cost.

**8. Matching Principle:** - For matching costs with revenue, first revenues should be recognised and then costs incurred for generating that revenue should be recognised.

**9. Dual Aspect Principle: - Every transaction affects at least two accounts. If one account is debited, any other account must be credited. The system of recording transactions based on this principle is called as 'Double Entry System'. It is because of this principle that the two sides of the Balance Sheet are always equal and the following accounting equations will always hold good at any point of time:**

**Assets = Liabilities + Capital**

**OR**

**Capital = Assets - Liabilities**

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