Financial Accounting Principles, Concepts and Conventions

1. **Accounting Principles**

   Every science consists of principles. Since accounting is a science, it also consists of principles. A principle may be defined as a rule of action or conduct or a guide to action. Hence accounting principles are the rules of action or conduct which are adopted by the accountants universally.

2. **Characteristics of Accounting Principles**

   (a) **Objectivity:** It is based on facts and impartial attitude ought to have been adopted for it.

   (b) **Application:** If the application of the principle is possible, it is regarded as a good principle. In case theoretically principle is sound but its application is difficult, then the principle has no value.

   (c) **Use:** The principle should be such by whose use utility of accounting record is increased.

   (d) **Simplicity:** The principle should have simplicity. If it is simple it will commend popularity.

3. **Generally Accepted Accounting Principles**

   Accounting principles when accepted by accountants all over the world, are known as "Generally Accepted Accounting Principles" (GAAP). In this way GAAP are the set of rules and guidelines used in accounting. Accounting principles become GAAP when they satisfy following three criteria:–

   (a) **Usefulness:** The accounting principle should increase the usefulness of accounting records by making accounting information more meaningful.

   (b) **Objectivity:** An accounting principle should be reliable and trustworthy in the sense that accounting information should be supported by facts and should not be influenced by personal bias.

   (c) **Feasibility:** An accounting principle should be practical in sense that it can be implemented without any difficulty.

4. **Accounting Concepts**

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

   (a) **Accounting Period Concept:** Every businessman wants to know the result of his investment and efforts after a certain period. Usually one year period is regarded as an ideal for this purpose. It may be of 2 years 6 months or 3 months also. This period is called accounting period. It depends on the nature of business and object of the proprietor of business.

   (b) **Duel Aspect concepts:** Is the core of accounting. Accounting to this concept, all business transactions involve two fold aspects and both the aspects have to be recorded in the books of account. In order to understand this concept, it is necessary for us to understand simultaneously the meaning of three terms:–

      (i) Assets
      (ii) Capital
      (iii) Creditors i.e. Liabilities

(c) **Money measurement concept:** Means that only those transactions, which can be expressed in terms of money, are recorded in the books of account. It implies that transactions or fact, which cannot be expressed in terms of money, are not recorded in the books of account, though they may be very useful for the business.

(d) **Realization concept** is related to recognition of revenues. According to this concept, revenue should be recorded only when it is realized. When the property in goods or services are passed to the buyer and he becomes legally liable to pay.

(e) **Separate Entity Concept:** Business is treated separate from its owners. All the transactions are recorded in the books of the business and not in the books of the business and not in the books of the proprietor. On the basis of this concept the proprietor is treated as a creditor for the business. When he contributes capital, he is treated as a person who has invested his amount in the business and therefore, capital appears in the liability side of balance sheet of the proprietor's business. Thus, this concept thus requires to make a distinction between (i) personal transactions and (ii) business transactions of the entity in order to ascertain financial position and operating results of business entity.

(f) Cost concept closely related to going concern concept. According to cost concept, assets are recorded in the accounting records at the price paid of acquire them and he cost will be the basis for all subsequent accounting for the asset. 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 asset is recorded at cost at the time of it's purchase abut it may systematically be reduced in it's value by charging depreciation.

(g) **Going Concern Concept:** This concept relates with the indefinite long economical life of the business. The assumption is that business will continue to exist for unlimited period unless of course it is dissolved due to some reason or the other. This is why in balance sheet, market price of fixed assets is not considered. When final accounts are prepared, record is made for outstanding expenses and prepaid expenses because of the assumption that business will continue. If the condition of business is depreciated to such an extent that it is to be closed down, even then accountant's concept is that business is to continue and he records all big and small transactions, he never stops making record on the possibility of closing down of business.

(h) **Accounting Equivalence Concept:** The proprietor provides the funds for acquisition of assets, hence the assets owned by the business must be equal to the funds provided by the proprietor which is technically called 'Equity'. Whatever properties or things are owned by the proprietor, they are termed as assets of the proprietor. Hence, accounting equivalence concept is:–

Assets = Equities

These days in addition to own funds, money is borrowed which is known as liability. Hence, assets are acquired through equity and liability. Therefore, accounting equation is A = E

Assets = Owner's Equity + Liabilities or Outsiders' equities

(i) **Verifiable Objective Evidence Concept:** This concept relates with the verification of accounting record with the outside evidence. Outside evidence means study of those documents and vouchers etc. on the basis of which accounting records has been made. This sort of verification has become very important these days, because of indirect management which is increasing by leaps and bounds due to large-scale production. When all purchases and sales were made by the sole trader himself, verification of accounting record was not of much importance.

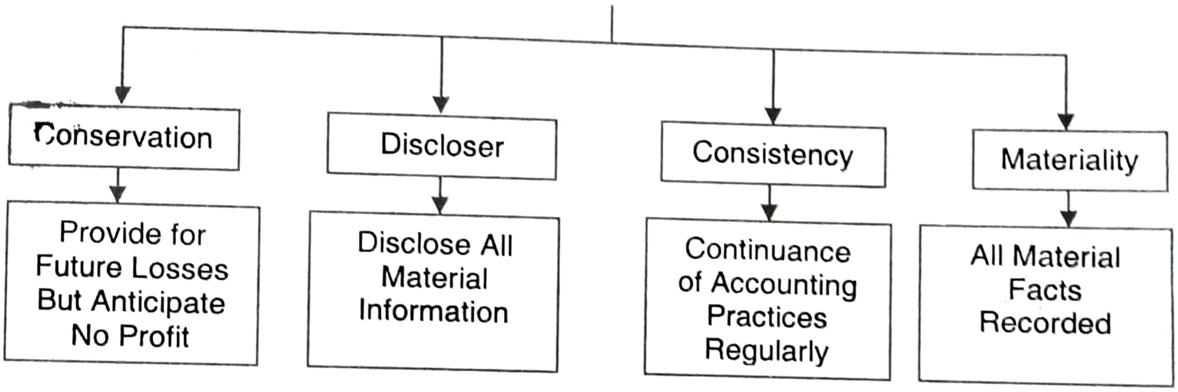
(j) **Matching of Cost and Revenue Concept:** Every businessman is eager to make maximum profit at minimum cost. Hence, in an accounting period namely one year, he tries to find out revenue and cost of this year and compares it with that of another year and thus he can make an idea about progress or downfall of business. Efforts made to make revenue are termed as cost and the positive results of these efforts are termed as revenue. This concept is also known as concept of efforts and accomplishment.

(k) Accrual Concept: If the accounting period is one year for a business, whatever net profit is made during the year, it increases the owner's equity i.e., capital. The net loss made during the year decreases owner's equity, i.e., capital. Excess of revenue income over revenue expenses is net profit, while excess of revenue expenses over revenue income is loss.

5. Accounting Convention

Accounting is based usages and custom. Custom or usage is a practice, which is use since long. Naturally accountants have to adopt that usage or custom. These are termed as convention in accounting "The term convention denotes customs or traditions which the accountant persue, while preparing the accounting statement".

Types of Accounting Conventions



(a) Convention of conservatism: Conservatism means taking the gloomy side of the situation. Future is uncertain. Though an estimate is made about future events and circumstances, but no one can guess the future with perfect certainty in business. Hence some arrangements or provision is made to meet the future uncertainties. Every sincere business makes an estimate of future loss and then some provision for it is made such as provision for bad debt. Businessman mostly ignores the items of future profit. This tendency is termed as conservatism and it is very natural tendency and is in existence since long.

(b) Convention of full disclosure: According to this convention, all account principles should be honestly prepared and to the end full disclosure of all significant information's should be made. All information which of material interest to proprietors, creditors and investors should be disclosed in the accounting statement. Full disclosure of all relevant facts in accounts is the necessity in order to make accounting records useful. It is not a new thing but it is based on convention.

(c) Convention of Consistency: Accounting rules, practices and conventions should be continuously observed and applied i.e. these should not change from one year to another. Continuation of one practice for a number of years indicate consistency e.g. if an asset is deprecated on diminishing balance method in one year the same method of depreciation be adopted in other year also. This is consistency.

(d) Convention of materiality: Accounting records should be made of all material facts and immaterial items may be mixed out with material items and then recorded or they may be ignored. This a convention. Materiality is a very important convention, which occupied not only a key position in an accounting but forms a base for accounting.