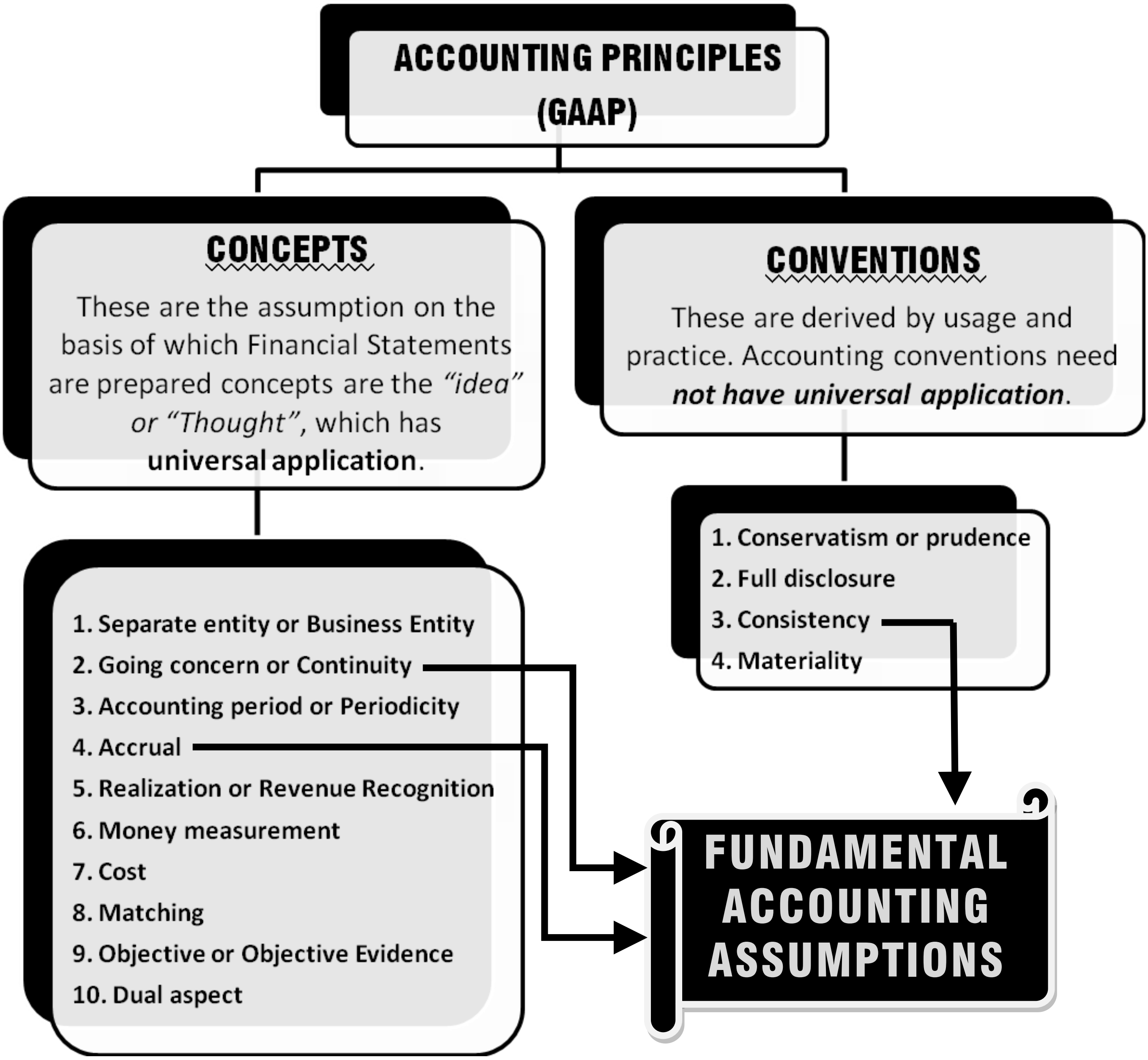
Chapter 01

ACCOUNTING PRINCIPLES, ACCOUNTING POLICIES AND ACCOUNTING STANDARDS

As we know that **accounting is the language of business**, which communicates the position of a business houses to the outside world. In order to make this language easy and commonly understandable by all, it is necessary that it should be based on certain uniform doctrine and standards are known as accounting principles.

Thus, accounting principles may be defined as those rules doctrine and standard which are followed by all the accountants universally at the time of recording business transactions and events.

These principles can be classified into the categories:



1. Separate Entity Concept or Business Entity Concept:

According to this concept, business and businessman, both should be treated as separate entities at the time of recording transactions in the books of business. This concept makes it possible-

- Account Books in Name of Business Entity
- Records only Transactions of Business Entity
- Not to record the private transactions of business in the books of business,
- Recorded from View-Point of Business
- To record the transactions between businessman and business
- To present the true fair view of the business affairs.

Why this concept?

Thus, if this concept is not followed, then the private transactions of the proprietor will be mixed up with the transactions of business and then, the true and fair position of the business could not be known. That is why, when one person invests Rs. 1,00,000 into business, it is deemed that the proprietor has given that amount to the business and therefore, this amount is shown as a liability in the books of the business. In case, the proprietor withdraws Rs. 20,000 from the business, it will be charged to him and therefore, the net amount payable by the businessman will be shown as Rs. 80,000.

Confliction with law:

The concept of separate entity is applicable to all forms of business organizations. The relationship, created by law between business and businessman, should not be taken into consideration at the time of recording transaction. For example, in case of a partnership business or in case of a sole proprietorship business, the partners or sole proprietor are not considered as separate entities in the eyes of law, but for accounting purposes they will considered as separate entities.

REMEMBER

- Accountants treat a business as distinct from the persons who own it. But according to law business and the proprietor are one and the same.
- According to this concept, all the business transactions are recorded in the books of accounts from the view point of the business only. Business transactions are recorded in the business books of accounts and owner’s transactions in his personal books of accounts.
- Since distinction is made between business and owner, it becomes possible to record transactions of the business with the proprietor also. Without such a distinction, the affairs of the firm will be all mixed up with the private affairs of the proprietor and the true picture of the firm will not be available.

2. Going Concern or Continuity Assumption:

The Going Concern Concept is the basic idea the business will continue for a long time, followed by all accountants, while recording and reporting the business transactions. As per this concept, unless otherwise known it is assumed that the firm is a going concern and its business will continue for an indefinite time. A firm is said to be a going concern, if there is neither intention nor necessary to wind up the affairs of business or substantially curtail the scale of its operation. It is due to this concept that:

- Proper distinction is made between capital and revenue expenditure
- Assets are classified into current assets and fixed assets,
- Liabilities are classified into short-term liabilities and long term liabilities,
- Use its fixed Assets till the end of their useful life,

- Carry forward (Defer) expenses or income to future years. (Expenses useful for 2 or 3 years are taken as deferred revenue expenditure),
- Repay its long-term loans,
- Expenses useful for many years are treated as fixed assets, to be written off, not in the year of purchase, by way of depreciation over its useful life.

REMEMBER Going Concern Concept is one of the Fundamental Accounting Assumptions.

- The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.
- It is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations.
- If such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

3. Accounting Period Concept or Periodicity Concept:

This concept is the based on Going Concern, concept. As per the going concern concept, the life of the business is considered to be indefinite. However, the measurement of income and study of the financial position of a business house after a very long period would not be helpful in taking the corrective action within the right time.

In order to tackle the above problem, accounting period concept is developed. As per this concept, the life of the business is divided into appropriate segments or into time interval and after every time interval, the businessman must 'stop' and 'see back', how things are going. A segment or time interval is called 'Accounting Period', which is usually one year. The relationship between Going Concern and Periodicity can be depicted by the following diagram:

$Year_1$	$Year_2$	$Year_3$	$Year_4$	$Year_5$	$Year_6$	$Year_7$

Life of Organization

Thus, 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 position of the business at the end of Accounting Period.

Further, it is to be noted that this concept is also necessary for the allocation of expenses between capital and revenue. That portion of capital expenditure, which is consumed during the current period, is charged as expenses to income statement and unconsumed portion is shown in the balance sheet as an asset for the future consumption.

REMEMBER

- However the businessman/users of financial information desire to know the results of the operation and financial position at appropriate time intervals.
- Therefore, the life of the business is divided into appropriate segments/time interval. Each segment/time interval is called as Accounting period.
- Normally the Accounting period is "one year" [12 months].
- Any period can be selected as Accounting Period depending upon the convenience of the business or as per the business practices in country.
- Accounting attempts to present the gains or losses earned or suffered by the business during the period under review.

4. Accrual Concept:

According to this principle –

- All the revenues should be recognized when they are earned, not when they are received in cash, and
- Similarly, the expense should be recognized when they are incurred, not when they are paid this concept is **based on the matching concept** of accounting.

For example, suppose a building is taken on rent for the purpose of business on 1st February. The financial year ends on 31st December. In such a situation, as per accrual, the total rent for eleven months should be shown in the profit and loss account, irrespective of the actual amount paid for rent during the year.

REMEMBER Accrual Concept is one of the Fundamental Accounting Assumptions.

- All income and charges relating to the financial period to which the financial statements relate should be taken into account, regardless of the date of receipt or payment.
- Income should be accounted on earned basis and not on receipt basis.
- Expenses should be accounted on incurred basis and not on paid basis.

5. Realization Concept or Revenue Recognition Concept:

This concept deals with the problem, when the revenue should be recognized?" According to this concept, the sale should be recognised at the point, when the property in goods passes to the buyer and he becomes legally liable to pay and other income is recognised, when they accrue.

Mr. A place an order with Mr. B for supply of certain goods, which are yet to be manufactured. On receipt of order, Mr. B purchases raw materials employs workers, produces the goods and delivers finished goods to A Mr. A makes payment on receipt of goods. In this case, the sale will be presumed to have been made not at the time of receipt of the order for the goods, but at the time, when goods are delivered to Mr. A.

- When cash is received **(Cash Sale).**
- When the customer has become legally liable to pay the price **(Credit Sale).**
- When specific service is performed **(Service contract).**

REMEMBER

- This concept emphasizes that profit should be considered only when realized.
- When profit should be deemed to have accrued? Whether at the time of receiving the order or at the time of execution of the order or at the time of receiving the cash?
- **Answer:** As per law (Sales of Goods Act), the revenue is earned only when the goods are transferred. It means that profit is deemed to have accrued when 'property (ownership) in goods passes to the buyer' viz. when sales are affected.

6. Money Measurement Concept:

As per this concept, only monetary transactions are recorded in the books of accounts. The transactions, which cannot be expressed in monetary terms, do not find place in the books of accounts, although they may be very useful for the business.

Measurement of business transactions in money helps in understanding the state of affairs of the business in a better way. For example, if a business owns cash of Rs. 10,000, 600 kg. of raw materials, two truck, 1000 square feet of building space etc. these items cannot be added together to produce a meaningful total, what the business owns. However, if these items are expressed in monetary items such as Rs. 10,000 of cash, Rs. 12,000 of raw materials (600 kg.), Rs. 2,00,000 of two trucks and Rs. 5,00,000 of 1000 square feet of building, all such items can be added and a better estimate about the assets of the business will be available.

Some people think that the Accounting gives a full picture of business. It is never true, because in Accounting, only monetary items are recorded; no record is made for non-monetary items. Thus accounting does not give the picture of non- monetary items.

It is due to this concept that:

- Recording in Terms of Money,
- Recording only Monetary Items.

REMEMBER

- In accounting, only those business transactions and events which are of financial nature are recorded.
- To be precise, the transactions should be measurable in terms of money. Otherwise it should not be recorded.

  Example:

Car	–	2 No.s
Stock	–	5 kgs
Furniture	–	5 Chairs and two tables
Computer	–	3
Land	–	10 acres
Building	–	Rs.10,000

  From the above information, a person cannot prepare a statement informing that the total of assets is 10,025 [i.e.10000+10+3+5+5+2]
- This concept has the following limitation.

  a) It does not give a complete account of the happenings in business unit.

  Example:
  - Strike in the factory
  - Sales manager is not speaking with production manager

  b) It is not capable of recording transactions which cannot be expressed in terms of money.
  - Employees are the assets of the organization

Note: Though this concept has its own limitations, still it is used for accounting purposes, because there is not better measurement scale other than this concept.

7. Cost Concept:

Accounting to this concept:

- As asset is recorded in the books at the price, which is paid to acquire it, and
- This cost is the basis for all subsequent accounting for that asset.

For example, if a plot of land is purchased for Rs. 1,50,000 then as per this concept, the asset will be recorded in the books at Rs. 1,50,000, even if its market value at that time is Rs. 2,00,000. In case a year later, the market value of this asset comes down to Rs. 1,00,000 it will continue to be shown at Rs. 1,50,000 and not at Rs. 1,00,000.

The cost concept does not mean that the asset will always be shown at cost. It has also been started 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 its purchase, but it may systematically be reduced in its value by charging depreciation.

Advantage: Cost concept has the advantage of bringing objectivity in 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.

Drawbacks: However if cost concept is followed in the following situations, then the financial statements will not depict the true and fair position of the business:-

- In case of inflationary trend in the price of the assets (such as land), the historical cost does not have relevance. For example, suppose during the financial year, an asset is purchased for Rs. 50,000 and at the end of financial year, its market value is Rs. 2,00,000. In the financial statements, the assets will be shown at Rs. 50,000, which will not depict the true and fair view of the land.
- In case, asset does not have any acquisition value, (for example, assets acquired by the firm by way of gift), such asset will not be shown in the financial statement, if cost concept is followed, because nothing is paid for it. This will adversely affect the concept of true and fair view.

REMEMBER

- According to this concept, an asset is ordinarily recorded in the books at the price at which it was acquired i.e. at its cost price.
- It must be remembered that the real worth of the assets changes from time to time. So, it does not mean that the value of such assets is wrongly recorded in the books.
- The book value of the assets as recorded does not reflect their real value. They do not signify that the values noted therein are the values for which they can be sold.
- Though the assets are recorded in the books at cost, in course of time, they become reduced in value on account of depreciation charges.
- The idea that the transactions should be recorded at cost rather than at a subjective or arbitrary value is known as Cost Concept.

8. Matching Concept:

This is based on the Accounting Period Concept. The main object of running a business is to each profit. In order to ascertain the profits, made by the business during a period, it is necessary that' 'Revenues' of the period should be matched with the 'Cost or Expenses' of that period. The effect of this principle can be summarized as follows:

(a) When an item of revenue is entered in the profit and loss account, then all the expenses, incurred to earn that income (whether paid or not) should be entered on the expenses side.
(b) When some amount is spent in the current year, and the income against it will be earned in the subsequent years, then the expenditure should be shown in the subsequent years, when the income is earned.

It is due to the concept that necessary entries are made for outstanding expense, prepaid expenses, accrued income and unaccrued income in the books of accounts.

REMEMBER

- As per this concept, all expenses matched with the revenue of that period should only be taken into consideration.
- If any revenue is recognized, then expenses related to earn that revenue should also be recognized.
- This concept is based on accrual concept as it considers the occurrence of expenses and

income and do not concentrate on actual inflow or outflow of cash.

- This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes.
- It is not necessary that every expense identify every income. Some expenses are directly related to the revenue and some are time bound.

9. Objective Concept OR Objective Evidence Concept:

According to this concept, the accounting data and accounting information should be verifiable and free from personal bias. For example, in the case of Fixed Assets, the amount can be verified by purchase bill etc. They should be objective (out of one's mind), not subjective (of one's mind).

However, there are some areas in Accounting, where evidence cannot be available to verify information and where estimations are made. For example, the estimation of depreciation, estimation of Bad and Doubtful debts, etc. These estimates should be free any bias and should be based on reasonable analysis.

10. Dual Aspects Concept:

This is a basic concept of accounting. Accounting to this concept, every business transactions has dual effect-

1st Aspects		2nd Aspects
(i) It increases on Asset *[Purchase of Machinery]*	and	decreases other Asset, *[Payment of Cash]*
(ii) It increases an Asset *[Purchase of Machinery]*	and	simultaneously increase liability, ***[Payment at future date** (on credit basis)]*
(iii) It decreases one Asset, *[Payment of Cash]*	and	decreases one Liability *[Settlement of Liability]*
(iv) It increase liability, *[Bank Loan Obtained]*	and	decreases simultaneously liability ***[Payment to Creditors** (Using Loan Amount)]*

Alternatively-

1st Aspects		2nd Aspects
(i) It decreases on Asset	and	increases other Asset,
(ii) It increase liability	and	simultaneously, increases an Asset
(iii) It decreases Liability,	and	decreases one Asset
(iv) It decreases liability,	and	simultaneously increase liability

For example, suppose Mr. A purchases some goods worth Rs. 1000 in cash. In this business transaction, Mr. A gets the goods of worth Rs. 1000, but on the other hand, he lost the cash of Rs. 1000. So, Goods Account and Cash Account shall be affected by this transaction.

Thus in every business transaction, one aspect represents the assets or expenses other represents the claim or income and these two expects are always equal. This approach generates the concept of accounting equation, which can be summarized as below:

Liabilities	=	Assets
External Liabilities + Capital	=	Assets

For example, if A starts a business with a capital of Rs. 1,00,000. There are no aspects of this transaction. On the one hand, the business has asset (in the form of cash) of Rs. 1,00,000, while on the other hand the business has to pay to the proprietor a sum of Rs. 1,00,000, which is known as proprietor's capital. This expression can be shown in the form of accounting equation as follows:

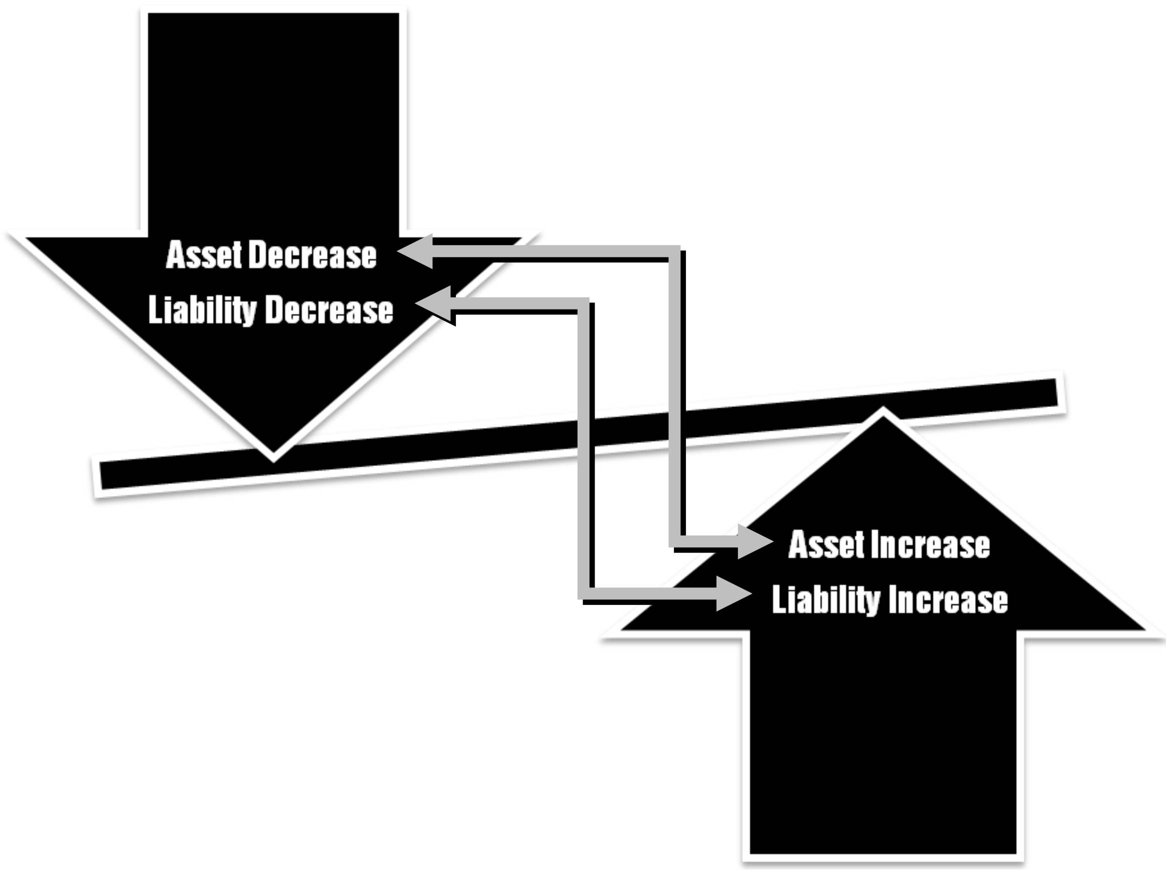
Capital (Liability)	=	Cash (Assets)
1,00,000	=	1,00,000

In the example given above, if the furniture worth Rs. 50,000 is purchased, the situation will be as follows:
Capital (Rs. 1,00,000) = Cash (Rs. 50,000) + Furniture (Rs. 50,000)

Thus, this concept develops a relationship between liabilities and assets. The Accounting Equation can be technically started as "for every debit, there is an equivalent credit". As a matter of fact, the entire Double Entry System of Book-Keeping is based on this concept.

REMEMBER

- Dual aspect principle is the basis for Double Entry System of book-Keeping.
- All business transactions recorded in accounts have two aspects.
- One is debit aspect and another one is credit aspect.
- For every debit, there must be an equal and corresponding credit.
- Now look at the following for Dual Aspect Concept.



Accounting Conventions

The term 'CONVENTIONS' refers to those rules, which common consent, express or implied, are employed in the solution of given class of problem or guides the behavior in certain situation. For Example, keeping to the left while driving is an example of convention. Using the sign '+' for addition and '-' for subtraction are another examples of convention.

Similarly in Accounting, there are some rules, which by common, express or implied, are employed to tackle the various Accounting Problems. These rules are known as Accounting Conventions. Different conventions have emerged in the world of accounting to improve the financial in the public interest.

The following are the important accounting conventions:

1. Conservatism or Prudence:

This principle suggests that "the future profits should not be recognized in present, but all the possible future losses should be provided at present."

On account of this convention, the inventory is valued at cost of market price whichever is lower, a provision is made for possible bad and doubtful debts against, but a provision for discount on creditors is not made.

Its effect: However, it is to be noted that this principle mainly affects the current assets. The fixed assets are not affected by this principle. Inventory valuation, estimation of doubtful debts etc. are some area, where this principle plays important role.

Drawbacks: This doctrine of accounting has been seriously criticized by experts on the following grounds:

- Confliction with the convention of consistency: If this principle is followed, then it is possible that the stock of one accounting period is valued on the cost and of other year at market value. Thus this principle conflicts with the principle of consistency.
- Creation of Secret Reserves: When excessive provision is made for doubtful debts or depreciation, then it leads to the creation of secret reserves. Thus this principle conflicts with the principle of full disclosure.
- Based on subjective judgments: The estimation of future losses is a subjective judgment and thus this principle conflicts with the principles of disclosure.

Whatever the criticism may be, ultimately we see that the main intention of this principle is to prohibit the ***"Window Dressing"*** of Financial Statements, i.e. showing a position better than what it is.

- Recording only Actual Income
- Recording only Actual cost
- Recording even Expected Losses.

REMEMBER

- This concept emphasizes that profit should never be overstated or anticipated.
- Traditionally, accounting follows the rule "anticipate no profit and provide for all possible losses.
- **Example:** Closing stock is valued at cost price or market price, whichever is lower. The effect of the above is that in case market price has come down then provide for the 'anticipated loss' but if the market price has gone up then ignore the 'anticipated profits'.
- To be precise, anticipated profit should not be accounted and anticipated loss should be accounted.

2. Full disclosure:

According to this principle, the financial statement should act as means of conveying information and not as means of concealing information. Therefore, financial statement must disclose, truly and fairly, all the information,

- Which they purport to represent, and
- Which are material interests to the users of accounts?

However, Full Disclosure does not mean that all the information, that one might expect, should be given in the financial statement. If the information is of material interest to the users of accounts, such information must be disclosed in Financial Statements:

It is due to this principle, the Companies Act, 1956, requires that Income Statement and Balance Sheet of a company must given in a prescribed the form, Generally, different notes, such as notes about contingent liabilities or market value of investments etc., are annexed with the financial statement, which do not find place in the accounting. This is done in pursuant to convention of full disclosure.

REMEMBER

- As per this principle, the financial statement should act as a means of conveying information and not as a means of concealing information.
- The doctrine suggests that all accounting statements should disclose all significant information to the users financial information.
- This doctrine however does not express that the trade secrets or other necessary information should also be disclosed.
- Materiality concept is an exception to Full Disclosure Concept.

3. Consistency:

According to this convention, accounting policies should remain unchanged from one period to another. For example, if the stock is valued if FIFO method is one accounting year, then this policy should be followed in the subsequent years also. Similarly, if depreciation is charged in accordance with WDV Method, then this method should be followed in the year after year.

REMEMBER Consistency is one of the Fundamental Accounting Assumptions.

- As per this principle, accounting policies should remain unchanged from one period to another.
- The rules, practices, concepts and principles used in accounting should be continuously observed and applied year after year.
- Comparisons of financial results of the business among different accounting period can be significant and meaningful only when consistent practices were followed in ascertaining them.
- **Example:** Depreciation can be provided in different methods. Inventory can be valued in different method. The method followed should be regular and consistent.

4. Materiality:

This principle is basically a modified form of the Principle of Full Disclosure. The full disclosure principle requires that all facts, necessary to ensure that the financial statements are not misleading must be disclosed. However, according to the Materiality principle, only material items are required to disclose in the financial statements and the items, which immaterial to the users of accounts may not be disclosed.

Now the question arises. "What is the meaning of Material Information?" This is because what information is material from the view-point of one person, may be immaterial from the view –point of other person. This is a question of facts and circumstances. However, as per AS-1, issued by ICAI, any information, misstatement of which may change the decision of users of financial statements, shall be deemed to be material information and should be properly disclosed in the financial statements.

REMEMBER

- The term materiality is highly subjective and it cannot be exactly defined.
- What is material and what is immaterial will depend upon the facts and circumstances of the case.
- Information is material if its misstatement (i.e. omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information.
- Materiality principle permits other concepts to be ignored, if the effect is not considered material.
- This principle is an exception of "full disclosure concept".
- **Example:** Stationary purchased by the organization though not used fully in the accounting year purchased still shown as an expense of that year because of the materiality concept. Similarly depreciation on small items like books, calculators etc. is taken as 100% in the year of purchase though used by the company for more than a year. This is because the amount of books or calculator is very small to be shown in the balance sheet though it is the asset of the company.
- The essence of the materiality concept is that the omission or misstatement of an item is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying on the report would have been changed or influenced by the inclusion or correction of the item.

USERS OF ACCOUNTING

The several of accounting and their varied needs are as follows:

USERS	INFORMATION REQUIRED
INTERVAL USERS	
1. Management	In order to decide future course of action, Management needs information about- ➩ Short solvency of the firm, ➩ Long-term solvency of the firm, ➩ Activity position of the firm (viz., effective utilization of its resources), ➩ Profitability in relation to turnover, ➩ Profitability in relation to investments
EXTERNAL USERS	
2. Short Term Creditors	They need formation to determine- ➩ Whether the amount owing to them will be paid when due, ➩ Whether they should extend, maintain or restrict credit to an individual enterprise
3. Long Term Creditors	Long-term creditors need information to determine- ➩ whether their principle and the interest thereon will be paid when due, and ➩ Whether they should extend, maintain or restrict the credit to an enterprise.
4. Present Investors	Present investors need information- ➩ To judge prospects for their investment, and ➩ To determine whether they should, buy, hold or sell the shares
5. Potential Investors	Potential investors need information- ➩ To judge prospects enterprise, and ➩ To determine whether they should buy the shares
6. Employee Groups	Employee groups need information to form judgment about ➩ Stability, continuity and growth of the enterprise, ➩ The ability of a firm to pay wages and other benefit and enhancement
7. General Public	The general public needs information to evaluate the effectiveness of the economic entity from which is buys goods services.
8. Tax Authorities	Tax Authorities need information to assess the tax liabilities of an enterprise.

ACCOUNTING AND OTHER DISCPLINE

Relation Ship of Accounting with Economics:

Prof. Robbins has defined term 'economics' as follows-

"Economics is the science, which studies human behavior as a relationship between ends and scarce means which have alternatives uses."

However when a person is to take any economical decision, he has to depend mainly on the accounting information. Generally an accountant is concerned with the economic problems of an only one enterprise only, but an economist is concerned with the problems of an industry as a whole.

Micro levels data, arranged by the accounting system, is summed up to get macro level data base. Thus at the macro level, accounting provides the basic data, upon which the economic models are developed.

However, there exists a wide gulf between economists' and accountants' concept of income and capital For example, the profit according to an economist is not same thing as the profit according to an accountant. No doubt, accountants have derived the ideas of value, income and capital maintenance from economists, but suitably modified to make them usable in practical circumstances. Thus, Economics and Accounting are close related subjects.

Relationship of Accounting with Mathematics

Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity etc. are some examples of fundamental uses of mathematics in accounting.

Presently graphs and charts are being widely used for communicating accounting information to the users. Thus the knowledge in geometry and trigonometry has become essential to have a better understanding about the accounting communication system.

Relationship of Accounting with Statistics

Collection, Tabulation, Analysis and presentation of data are some primary functions, which are performed by both Accountants and statisticians.

The accountant is mainly concerned with the monetary data, although to some extent, he is also concerned with the quantitative data. But a statistician is concerned equally with the monetary and quantitative data.

The use of statistics is accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. But for decision-making purposes, such precision is not necessary and hence the statistical approximations are sought.

Accounting records generally confined to one year, while statistical analysis is more useful if a longer period is taken. For example, a longer period will be required to fit the trend line.

Statistical methods are helpful in developing accounting data and in their interrelation. Therefore the study and application of statistical methods will add extra edge to the accounting data.

Relationship of Accounting with Law

Every business house has to work within legal environment. All the transactions with suppliers and customers are governed by the Contract Act, Sale of Goods Act, Negotiable Instruments Act, etc. The entity, itself, created and controlled by laws. For example a partnership business is controlled by Partnership Act, a company is created and controlled by the Companies Act. Very often the accounting system to be followed has been prescribed by the law. For example the Companies Act has prescribed the format of financial statements.

However legal prescription about the accounting system is the product of development in accounting knowledge. That is to say legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In what way, accounting influences law and is also influenced by law.

Relationship of Accounting with Management

Management is a broad occupational field, which comprises many functions and application of many disciplines including statistics, mathematics, economics, etc. Accountants are well placed in the management and play a key role in the management them. A large portion of accounting information is prepared for management decision-making. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management, he understands the data requirement. So, accounting system can be molded to serve the management purpose.

ACCOUNTING POLICIES

The Accounting Policies refer to those specific Accounting. Principles and Methods, which are adopted by the entity in the preparation of the financial Statements. For example, if an organization uses the FIFO method for Stock Valuation, then it would be an Accounting Policy of that organization.

It is to be noted that there can't be a standard set of Accounting Policies, which are applicable to all organizations under all circumstances. What Accounting policy should be adopted by the organization? It is decided by the Management.
To ensure the better understanding of the Financial Statements, Accounting Policies have to be followed consistently.
If the accounting policies are not consistently followed, then the following useful comparisons cannot be made:

- Intra-Firm Comparison, i.e. the comparison of the figures of one accounting year with those of the other accounting year of the same firm.
- Inter-Firm Comparison, i.e. the comparison of the figures of one firm with those of another firm of the same industry, and
- Pattern Comparison, i.e. comparison of the figures of one firm with those of the industry to which the firm belongs.

However the changes in the accounting policies are recommended by AS-1 only in the following circumstances:

(a) If it is required by the law,
(b) If it is required by the governing body of accounting, i.e. ICAI,
(c) If the change is considered more appropriate for the true and fair presentation of the financial statements.

Further, in case of any change in accounting policies, the following disclosure requirements are determined by Accounting Standard (AS)-1:

(a) If the change has a material effect on the current period and the effect of change is ascertainable, then such amount due to change should be disclosed.
(b) If the change has a material effect on the current period, but the effect of change is not ascertainable, then the fact should be properly disclosed.
(c) If the change has no material effect on the current period, but is expected to have a material effect in the later periods, then the fact should be properly disclosed.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

According to the AS-1 on "Disclosure of Accounting Policies" (issued b ICAI), there are only three fundamental accounting assumptions, which are as follows:

- Going concern
- Consistency
- Accrual

[Remark: For Detail, please see the previous topic, i.e. Accounting Principles]

If the above fundamental accounting assumptions are followed at the time of preparation of Financial Statement, then the specific disclosure is not necessary. However, if any of the above assumptions are not followed, the fact should be properly disclosed in the financial statement.

ACCOUNTING EQUATION

The idea of accounting equation is derived from the Dual Aspect Concept of Accounting. As per this concept, every business transaction has a double effect. If someone receives something, than either some other person must have given it, or the first motioned person must have lost something, or some service, etc. must have been rendered by first motioned person.

For example, suppose Mr. A purchase some goods worth Rs. 1000 in cash. In this business transaction, Mr. A gets the goods of worth Rs. 1000, but lost the cash of Rs. 1000, Goods Account and Cash Account shall be affected by this transaction.

Thus in every business transaction, one aspect represents the assets or expenses and other represents the claim or income and these two aspects are always equal. This approach generates the concepts of Accounting equation, which can be summarized as below:

Liabilities = Assets (External Liabilities + Capital = Assets)

For example, if A starts a business with a capital of Rs. 1,00,000 there are two aspects of this transaction. On the one hand the business has asset (in the form of cash) of Rs. 1,00,000 while on the other hand the business has to pay to the proprietor a sum of Rs. 1,00,000 which is known as proprietor's capital. This expression can be shown in the form of following equation:

Capital (Liabilities) = Cash (Assets) [1,00,000 = 1,00,000]

In the example given above, if the furniture worth Rs. 50,000 is purchased, the situation will be as follows:

Capital (Rs. 1,00,000) = Cash (Rs. 50,000) + Furniture (Rs. 50,000)

Thus this concept develops a relationship between liabilities and assets. The Accounting Equation can be technically started as "for every debit, there is an equivalent credit". As a matter of fact, the entire double entry system of book-keeping is based on this concept.

SYSTEMS OR METHODS OF BOOK KEEPING

Book-keeping is the art of recording business transactions in a systematic manner. This recording of transactions is a systematic manner may be done according to any of the following two systems:

1. Single entry system:

An incomplete Double Entry System can be termed as a single entry system. Under this system, the preliminary books of accounting, such as a cash-book, purchase book, sales book etc. are maintained in the proper way. The ledger is also maintained, but in the ledger, only the personal accounts are opened and the posting is made from the original books only in the personal account. In this system the nominal accounts and real accounts are not opened in the ledger.

In nutshell, the businessman keeps the record of only essential information, i.e. record of cash, bank and personal accounts. Thus under this system, some transactions are recorded in the both sides, some are recorded only on single side and others are completely omitted.

For example, if the Rs. 1,000 is paid for Telephone expenses, then under the single entry system, its entry shall be made in the payment side of Cash-Book, but irrespondingly no account shall be opened for Telephone expenses, which is of a nominal nature. However if Rs. 1000 is paid to Mr. Ram, who is a creditor, then its entry shall be made in the payment side of Cash-Book and the corresponding entry will be made in the Ram's Account, which is of personal nature.

Since all records are not kept in this system, so it is not reliable and is suitable only by small business houses.

2. Double entry system:

According to this system, every business transaction has a two-fold effect. If someone receives something, than-

- Either some other person must have given it, or
- The first motioned person must have lost something, or
- Some service, etc. must have been rendered by him.

For example, suppose Mr. A purchases some goods worth Rs. 1,000 in cash. In this business transaction, Mr. A gets the goods of worth Rs. 1,000, but lost the cash of Rs. 1,000, Goods Account and Cash Account shall be affected by this transaction.

Thus in this system, the both aspects of every transaction are recorded in the books of accounts. In fact, this system of accounting is based on the Dual Aspect Concept of Accounting.

METHODS OF ACCOUNTING

As is pointed out earlier, the main object of accounting is to know the result of a business house. There are three accounting methods or systems to find out the business results, which are summarized below:

1. Accrual or Mercantile System
2. Cash System
3. Hybrid System or Mixed System

1. Accrual or Mercantile System of Accounting:

This system of accounting is based on the Accrual concept. In this system,

- All the revenues are recognised when they are earned, not when are received in cash, and
- Expenses are matched against such revenue or the expenses should be recognised when they are incurred, not when they are paid

For example, suppose a building is taken on rent for the purpose of business of 1st February. The rent is paid only for 10 months. The financial year ends on 31st December. In such a situation, if mercantile system of accounting is followed, then the total rent for rent for eleven months should be shown in the profit and loss account, irrespective of the actual amount paid for rent during the year.

2. Cash System of Accounting:

Under this system of Accounting,

- All the revenues are recognized, when they are received in cash, not when they are earned, and
- Similarly, the expenses are recognized, when they are paid in cash, not when they are incurred.

In the case of above example, if the cash system of accounting is followed, then the rent for only 10 months shall be shown in the profit and loss account.

Thus under this system, only cash receipt and payments are recorded. No treatment is done for outstanding and prepaid items.

3. Hybrid System of Accounting:

This system is mixture of cash system and mercantile system. Under this system of accounting,

- Some items of Incomes are accounted on cash system and other on mercantile system, and
- Some items of Expenses are accounted on Cash system and other on mercantile system.

However, it is to be noted that practically this system is not adopted by any business house, because section 145 of Income tax Act, 1961 does not allow any person to maintain accounts on hybrid system. This section permits only mercantile system or cash system.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

1. Understandability:

Financial Statement must be readily understandable by the users. But this does not mean that complex and not easily understandable information should not be included in financial statement, even if it relevant for decision making by the users.

2. Relevance:

Financial statement must contain all the information, which are relevant, i.e. material, to the users of financial statement. As per AS-1 (issued by ICAI). Information becomes material, if its omission or misstatements could influence the economic decisions of users of the financial statement. Thus, materiality provides a threshold or a base to decide what information to be included in financial statements and what not.

3. Reliability & Faithful Representation:

Reliability is another qualitative characteristic, which the financial statements must possess to be useful to the users. If the information, contained in the financial statements is not reliable, it could not serve purpose of users.

Fraud and errors make the financial statements unreliable. Therefore there should be faithful representation of transaction and events in the financial statement.

4. Comparability:

The financial statement should also have the characteristics of comparability. Usually the users want to make the following comparison:

- **Intra-Firm Comparison,** i.e. the comparison of the figures of one accounting year with those of the other accounting year of the same firm,
- **Inter-firm Comparison,** i.e. the comparison of the figures of one firm with those of the another firm of the same industry, and
- **Pattern Comparison,** i.e. comparison of the figures of one firm with those of the industry to which the firm belongs. By this way the users want to develop some judgments.

5. Substance over Form:

The financial information must be presented in accordance with their substance, not by their legal form.

For Example, in the case of Hire purchase sale, legally, the ownership in goods is transferred by seller to the buyer only at the payment of last installment. But in reality, the buyer uses the assets as owner from the date of entering into transaction, not on the date of payment of last installment. Similarly, all the significant risks and returns, inherent in the ownership of goods, are also transferred on the same date. Such transaction therefore, should be treated as purchase of assets on the date of entering into the transaction, not on the date of payment of last installment.

6. Prudence:

Financial statement should have the characteristics of prudence, i.e. accounting uncertainties should be dealt in such a way that assets and incomes are not overstated and similarly, liabilities and losses are not understated.

7. Completeness:

The information contained in the financial statements should be complete in all respect. All the transactions and events of financial nature should be reflected in the financial statements. Not only the financial information, but the non-financial information, which may be useful to the users of accounts, should also disclose in the financial statements. For example, if the organization has followed any rule and regulation, and due to non-compliance of these rules and regulation, the government may give order for closing up of the business, then non-financial information must be disclosed in the financial statement as per SAP-21.

8. True & Fair Picture:

True & Fair presentation information is the fundamental rule that should be strictly followed at the time of preparation and presentation of financial statements.