

The Term



The term **Accounting Principles** means:

the “**Ground Rules**” for preparing the financial statements.

They provide the general framework to determine:

- What information is to be included in financial statements and
- How this information is to be presented.



Accounting principles are not like physical laws: they do not exist in nature awaiting discovery.

Rather, they are developed by Accountants as and when need arises.

True & Fair View



The accounting policies and methods adopted should present the “True & Fair” View of the real circumstances prevailing. It requires the financial statements not to be prepared in the most favourable light. It is achieved when the financial information presented in the financial statements bears the following characteristics:

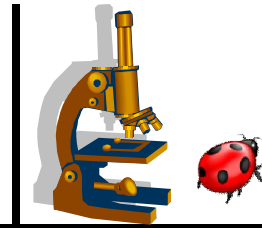
- Relevance
- Reliability
- Comparable
- Understandable



True & Fair view is an overall objective which is achieved by applying a range of accounting concepts mentioned below.

Hence, it is an **END** not a **MEANS**.

Materiality



“All immaterial items should be recognized as an expense (hence charged to P & L a/c) in the period they are incurred. They should not be presented on the face of balance sheet.”



An item is regarded as **MATERIAL** if:

“The inclusion or exclusion of it can significantly affect the decision making of users of financial statements”.



In fact, there is no formal definition of the term materiality.

The decision as to - what is material and what is not, is a matter of judgment and discretion. It will vary with respect to size and type of business entity.

Every organization establishes its own threshold level of materiality.

A business purchases a ruler. The ruler costs \$0.45.

It is estimated to last for three years.



Required: How should the above transaction be treated?

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The Entity Concept



The business is regarded as a separate unit from the owner.

It implies that assets/liabilities of the business are distinct from those of the owner.

All the transactions are recorded from only and only the business point of view.

The Dual Aspect Concept



Every financial transaction has dual impact on the financial statement of the entity

i.e. a **DEBIT** and a corresponding **CREDIT**.

Both the debit and credit are equal in amount and involve at least two different accounts.

The idea is based on the theme of “Accounting Equation”:

$$\underline{\text{Assets = Capital + Liabilities}}$$

The Money Measurement Concept



Only the transaction bearing the financial character can be recorded in the accounts.



This principle help provides a uniform criterion for quantifying all items of assets, liabilities, revenues and expenses by translating them into monetary values.



However, at the same time, this concept imposes a great limitation on accounting system by precluding the impact of the **Vital but Non-Financial** information. For example,

- Working environment ,health and safety conditions etc of entity
- Expertise, skills, motivation, satisfaction and commitment of the staff
- Arrival of new competitor or a rival product
- Changes in legal regulations serious effecting the survival of entity

The owner of a business is planning to include his financial manager as an asset in the end of year balance sheet at a value to the business of \$200,000. However, the HR manager feels that this is too high a valuation and says that the financial manager should be included at \$50,000 since this is his annual salary.



Required: Comment on the above situation and suggest an advice with reference to accounting principles.

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The Historic Cost Concept



All the assets are normally valued and presented in the balance sheet at their cost price rather than current market price.



The objective of the Historic Cost concept is to provide an authentic and objective basis for asset valuation.



However, the greatest criticism of historic cost approach is that it presents an outdated view of financial position.

The business has just purchased a specialized piece of computerized manufacturing machinery for \$24000. It will be used for three years. It would certainly have no resale value because of its specialized nature.



Required: How should the machinery be valued?

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The Objectivity Concept



All financial transactions should be recorded in a dispassionate, neutral and bias-free way.

This is achieved when the figures are properly evidenced and supported by verifiable source documents e.g. invoice, property deeds etc.

For example, if land was shown in the balance sheet at cost, any ACCA who performed an audit of the business would be able to find “objective evidence” that the land was actually valued at cost of acquiring it.



Since the market values are constantly changing, the estimate of future market value would be purely a personal opinion (subjective). Hence, pricing the transactions on market values is not factual and objective

George owns a 1970 vintage delivery van that cost \$11,000 a number of years ago. He could sell it for \$29,000 today but he said recently “I love my van and I would not sell it if you offered me \$100,000”.



Required: Comment on the above situation and suggest an advice with reference to accounting principles?

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The Going-Concern Concept



It is assumed that the business entity will continue in operational existence for the foreseeable future.

The IMPACT of going concern on final accounts is that:

- IF going concern **holds**, all the assets are valued at their historic cost
(Because, they are primarily acquired for **USE** in business and not for **RESALE**)
- IF going concern **ceases**, all the assets are valued at their nearest market values
(to reflect the **True & Fair view** of circumstances)

Land and Building cost \$100,000	It could be sold for \$220,000	
Equipment cost \$58,000	It has a current scrap value of \$5,000	
Fixtures cost \$77,000	They could be sold for \$48,000	
Warehouse cost \$89,000	It has a replacement cost of 305,000	

Required: Identify the value of each asset to be shown on the balance sheet when

- (i) Going concern holds
- (ii) Going concern ceases

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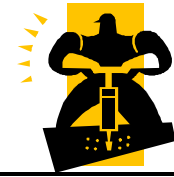
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The Consistency Concept



The essence of consistency concept is that **a method once adopted should be applied continuously in the subsequent years to ensure comparability.**

It implies that the same accounting treatment should be observed with the transactions of the similar nature in the present and future periods.



The only exception to consistency is when a change in circumstances necessitates adoption of alternative method which is likely to present Better true & fair view.

The Prudence Concept



“All anticipated losses should be accounted for immediately; however, all anticipated gains should be awaited for.”

The emphasis of prudence concept is that:

- Asset should not be overstated and
- Liabilities should not be understated.



However, prudence should not be:

- Invoked to justify setting up hidden reserves, excessive provisions ,or understating the assets
- Seen as a tool for smoothing profits in financial statements.

The Accruals Concept



“**Expenses** should be recognized when they are incurred (fall due) and **NOT** necessarily when they are paid in cash.”

Similarly,

” **Incomes** should be recognized when they are earned and **NOT** when they are received in cash”

It emphasizes to account for the non-cash impact of certain transactions.

George has accounting year end on 31 Dec each year.

The following amounts have been paid during the year ended 31 Dec 2007:



	\$
Wages	35,000
Rent	6,600
Rates	1,400
Insurance	2,200
Motor expenses	14,300

- i. Wages due to workers for the work completed during the last week of the year but unpaid amount to \$900.
- ii. Rent for Dec 2007 \$500 was paid on 11 Jan 2008.
- iii. Rates have been paid \$400 relating to the period 01 Jan – 31 March 2008.
- iv. Insurance includes a premium \$250 for the period 01 Jan – 28 Feb 2008.
- v. Motor expenses do not include \$325 paid on 17 Jan 2008 for a vehicle service completed on 15 Dec 2007

Required: Calculate the amounts to be included in P&L a/c for the year ended 2007 for the above items.

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- » True & Fair view
- » Materiality
- » Entity
- » Matching/accrual
- » Prudence
- » Going concern
- » Historic cost
- » Objectivity
- » Consistency

For each of the following statements:

- a) state the relevant accounting concept and
- b) suggest an appropriate treatment, if necessary:

i. The accountant of a large metropolitan auto dealership depreciates metal wastebaskets over a period of 5 years.

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ii. Upon the finishing of cabinets, a furniture manufacturer has decided to increase the balance sheet valuation of cabinets at their sale value and recognize the expected profit.

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iii. A business has purchased new machinery to be installed in the production department. The estimated scrap value of machinery is nil. Hence, it is decided to charge the cost to expenses.

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iv. An airline has decided not to depreciate its aircrafts because an excellent maintenance program keeps the planes in "as good as new" condition.

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v. Land costing \$100,000 was sold for cash \$105,000. However, no gain was recorded in the accounts because of inflation.

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- » True & Fair view
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vi. When equipment is purchased, an estimate of its useful life is made, and then it is depreciated over this period.

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vii. The personal assets of the owner of a sole trader are not disclosed in the balance sheet of the business, even when these personal; assets are sufficient to assure payment of all the business' liabilities.

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viii. The accountant of accompany has decided to make an estimate of doubtful debts. But the Director is not willing to understate the debtors in the balance sheet.

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ix. Over past 5 years, equipment has been depreciated by using reducing balance method. However, this year Directors have announced to adopt straight line method as it is in common fashion now.

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x. Hand tools with a small unit cost have been charged to expenses when purchased. Even though they are expected to have a useful life of several years.

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- » True & Fair view
- » Materiality
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- » Consistency

xi. A construction company has decided to value all its projects at cost rather than at expected selling price.

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xii. On the closing date of accounts 31 Dec, 2007: The accountant of a company has discovered \$5000 electricity bill not yet paid. The Directors have insisted not to include this unpaid bill in P & L a/c as no cash has been paid.

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xiii. The British Airways, a large multinational, has sold its tickets and received cash \$ 10m in advance for next two years. The management has decided to include this amount in the current year incomes as cash has been received.

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xiv. Tekken plc is in financial crisis. In order to present amore impressive balance sheet, the directors have decided to include in the company's balance sheet personal assets viz; saving accounts, automobiles, real estate properties etc.

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xv. Dorian plc is in serious difficulties and likely to shut down in near future. However, the management of the company is hopeful that Dorian will make recovery. Hence, all the assets are valued in the balance sheet at their historic cost.

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Activity

- » True & Fair view
- » Materiality
- » Entity
- » Matching/accrual
- » Prudence
- » Going concern
- » Historic cost
- » Objectivity
- » Consistency

- i) wages outstanding at the end of financial year: \$450
- Accruals
 - materiality
 - going concern
 - consistency
- ii) A regular customer who owes \$2250 has just gone into liquidation.
- accruals
 - business entity
 - prudence
 - materiality
- iii) Steve puts some of his house telephone bills on the business profit & loss a/c as he regularly uses his telephone to ring the clients.
- accruals
 - materiality
 - business entity
 - money measurement
- iv) A fixed asset costs \$10,000. It is expected to have a life of 10 years with no residual value. Annual depreciation charge is \$1000.
- materiality
 - business entity
 - Historic Cost
 - prudence
- v) It is expected that business will suffer losses in the future, because a new competitor has just arrived. It has been decided to create a provision for future losses
- consistency
 - going concern
 - money measurement
 - prudence
- vi) Jim feels that the old fixtures valued at a cost \$1000 on the balance sheet could fetch \$350 on auction.
- Historic cost
 - prudence
 - consistency
 - money measurement
- vii) A new 'sellotape' dispenser has been purchased. It will be used for at least 5 years. The purchase price of \$7.50 has been included in stationery.
- accruals
 - going concern
 - materiality
 - business entity
- viii) Frank believes that about 2 % of his debts outstanding at the end of year are doubtful. He intends to create a provision for doubtful debts.
- Money measurement
 - going concern
 - consistency
 - prudence