

Conventions, Assumption, Concepts and Principles of Accounting

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1. Introduction

Accounting is known as the language of business though it is equally important for non business entities. Like every language has certain rules of grammar, for better understanding of accounting, certain principles are used in the accounting. To ensure uniformity in accounting, certain accounting principles or concepts or conventions or postulates or assumptions are used while writing accounts and in preparing financial statements. The terms, principle, concept, convention, doctrine, postulate and assumption are sometimes used interchangeably. These accounting principles provide a theoretical and logical base to accounting. They are based on logic and hence to avoid divergent practices in writing accounts and in preparing financial statements, Accountants accept these principles or concepts which are framed after deliberations amongst the experts in this subject. As these principles are widely accepted and applied in practice by accountants, they are also known as **Generally Accepted Accounting Principles or GAAPs**. According to the American Institute of Certified Public Accountants (AICPA), “Principles of Accounting are the general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice.”

Accounting principles are developed with a view to make users of financial statements understand them uniformly. There is no rigidity in these principles. They can become generally acceptable to all only if they are understood by those who write the accounts and users of accounting information in the same way and are also practical and objective. If these principles are not uniformly understood, accepted and adopted by all, each accountant may use them according to his own perception and understanding. This can result into lack of uniformity and can distort the accounting information instead of such information becoming useful. Therefore, it is essential that these basic accounting principles or concepts or conventions should be understood well by all as Accounting gets its theoretical and logical base only on the strength of these principles.

2. Accounting Principles, Concepts and Conventions

Different authors classify these accounting principles differently. However, without classifying them separately as principles, concepts, conventions, doctrines, postulates and assumptions, some such concepts are given below :

- (1) Going Concern
- (2) Consistency
- (3) Accrual
- (4) Accounting Entity
- (5) Money Measurement
- (6) Periodicity
- (7) Full Disclosure
- (8) Materiality
- (9) Prudence
- (10) Cost
- (11) Dual Aspect
- (12) Matching Cost with Revenue
- (13) Realisation or Revenue Recognition
- (14) Verifiability and Objectivity of Evidence

Syllabus of Standard 11 covers only first eleven concepts out of those listed above. However, for information of students, brief discussion is included on other concepts also.

(1) Going Concern Concept: This is an important concept of accounting. When business is started, it is assumed that the same will continue for very long period in future. Therefore, it is called going concern concept. The following are some of the practices or illustrations based on this concept.

(i) Fixed assets are shown in the balance sheet at their depreciated values. In other words, realisable or market value of fixed assets are not shown in the balance sheet. As the fixed assets are for use in business for long period and not meant for sale, their market values are not shown in the balance sheet based on going concern assumption.

(ii) Prepaid revenue expenses are shown on the asset side of balance sheet because of going concern assumption that business will continue for a long time and it is expected that the entity shall get the benefit of such prepaid expenses in future.

(iii) Deferred revenue expenses are sometimes shown on the asset side of balance sheet because of going concern assumption that business will continue for a long time and it is expected that the entity shall get the benefit of such expenses in future.

(iv) Semi finished goods or work-in-progress is valued at cost incurred thereon and not at their realisable value. This is because of the going concern assumption. At any given moment, business enterprise may have some semi finished goods in process. If the business is to be liquidated today, such semi finished goods may fetch very low value if it is sold as such and it has to be valued at such realisable value. However, because of going concern assumption, we assume that the manufacturing process will be carried out till completion of finished goods and therefore the final product will emerge. Hence, such semi finished goods are valued on the basis of cost incurred thereon and not at their realisable value in semi-finished condition.

(v) Financial statements are prepared at the end of accounting period. When the life of business entity is of very long period, on the basis of assumption of going concern, stakeholders or persons who have stake in this entity cannot wait to know what is the performance or position when it is closed down or liquidated. Hence, to get information about the profit or loss or about assets or liabilities at reasonable interval, accounts are written regularly and periodical financial statements are prepared at the

end of accounting period. This statement can also be associated with Accounting Period Concept.

(vi) Distinction is made between 'capital expenditure' and 'revenue expenditure' because of going concern assumption.

It should be noted that in the following circumstances, going concern assumption should not be followed :

- (a) When the object for which a business was established is achieved or is likely to be accomplished in very short period;
- (b) When an industrial unit is declared sick;
- (c) When a business is passing through severe financial crises and is likely to be liquidated very shortly;
- (d) When a liquidator is appointed for liquidation of a company/entity/unit/firm;

(2) Consistency Concept: The principle of consistency suggests that while writing accounts or for preparing financial statements, the same policies, procedures and methods should be followed every year. In other words, policies, procedures and methods followed while writing accounts or for preparing financial statements should be followed consistently year after year. It can also be stated that the consistency concept requires that once an entity had decided on one accounting method, it should use the same method for all subsequent events of the same type or periods unless there is a sound reason to change the same. Accounts remain comparable only if consistency is maintained. If consistency is not maintained in accounting, the accounts may not remain comparable and can also mislead at times. For example, if stock is valued by FIFO method, the entity should follow the same method year after year as far as possible. If the method used for stock valuation is changed every year, the accounts do not remain comparable and the profit or loss position of different years may also indicate different positions. Consistency also requires that such methods should not be changed frequently, unless there is a compelling reason to do so. It should be remembered that an accounting practice that is followed based on some accounting principle or concept consistently does not violate the principle of consistency. For example, valuation of stock at 'cost or market price whichever is less' this will not violate the principle of consistency. Consistency concept refers to consistency over a time and it does not mean that the treatment of different categories of transactions must be consistent with one another. It only means that transactions in a given category must be treated consistently from one accounting period to the next one. For example, fixed assets are valued at cost whereas inventory or stock-in-trade is valued at cost or market price whichever is less. Here, there is no violation of principle of consistency.

In the consistency principle, personal bias can be avoided, the accountant has to follow consistently the same set of principles, practices, procedures or methods every year.

The logic behind the principle of consistency is that the users of financial statements lose confidence in the accounts if frequent changes are made in the policies or practices based on personal whims and fancy of those preparing the same.

The following are some of the practices or illustrations based on this concept :

(i) If depreciation is provided by 'written down value' method in a year, the same method should be followed consistently every year. The consistency, in method of depreciation allows reader of financial statements ease in comparing the profitability of different periods without any need for adjustment in figures. For example, if method is changed from 'straight line' to 'written down value' method in the next year, the comparison of profit or loss of two years would require analyst to take into account the

impact of change in method of depreciation. However, if there is no change in method, the comparison of results of two years would be easier.

(ii) The method of stock valuation should be followed consistently and it should not be changed frequently. This statement is based on principle of consistency as it suggests that the accounting practice should remain the same from one year to another. It is not proper to value stock-in-trade according to one method in one year and according to another method next year.

(3) Accrual Concept: This concept is relevant in the area of revenue and costs. Revenue or costs are accrued i.e. recognised, as they are earned or incurred and not only when cash is received or paid. Also the revenue and costs will be recorded in the period to which they relate. This concept implies that the revenue should be recognised and recorded in accounting as and when it is earned or it accrues irrespective of the time or period of receipt. Similarly, expenses should be recognised and recorded in accounting as and when it is incurred irrespective of the period of payment thereof.

There are two systems of accounting. (i) Cash basis and (ii) Accrual basis. In cash basis, the revenue is recognised only when cash is received and expenses or costs are recognised only when cash is actually paid. Only some professional like doctors, lawyers and chartered accountants follow cash system of accounting. For companies, it is mandatory to follow accrual system of accounting. Most of the enterprises follow accrual system in which revenue or costs are recognised as they are earned or incurred irrespective of whether cash is received or not. The cash system is discussed here only for academic interest and for better understanding of the concept of accrual. In absence of any contrary information, it may be assumed that the accounts are maintained by accrual system.

The concept of Accrual of revenue is similar to concept of realisation of revenue or revenue recognition. It guides about the point in time when revenue should be recognised or when revenue should be treated as realised. However, Accrual Concept deals with accrual of not only revenue but also that of costs.

The following illustrations and discussion will help in understanding this concept :

(i) When goods are sold on credit to a customer, the revenue should be recognised in accounting when such goods are sold even though cash is not yet received for such sale. The logic in recognising revenue in this case is that the person to whom the goods are sold has legally become liable to pay the value of goods as agreed and hence this money will come at a future date. The amount that will be recognised as revenue is reasonably certain to be realised. Therefore, the revenue from this sale of goods will be recognised as and when the event of sale of goods has occurred. Thus, accrual concept requires treating revenue as accrued when goods are sold irrespective of the period when cash is received.

(ii) Salary payable for March, 2016 will be treated as expense for the month of March, 2016 even if it is paid in April, 2016 because the benefit of service of employee is taken in the month of March. Based on accrual concept, since the salary expense is incurred for March, 2016, it will be recorded in the period to which it relates.

(iii) Even though cash is received, advance received against sale of goods is not recorded as sales until the goods are supplied against the advance. This is because of accrual concept according to which revenue should be recognised and recorded in accounting as and when it is earned or it accrues irrespective of fact whether cash is received or not. Even if advance is received, as the goods are not supplied against

this advance, revenue cannot be said to accrue. Hence, based on accrual concept, revenue will not be recognised when advance is received because the goods are yet to be supplied.

The International Accounting Standards Committee (IASC) and the Institute of Chartered Accountants of India (ICAI) treats following three concepts as the fundamental accounting assumptions :

- (i) Going Concern
- (ii) Consistency
- (iii) Accrual

(4) Accounting Entity Concept: This concept is also referred to as Business Entity concept or Entity concept or Separate Entity concept by some authors. According to this concept, it is assumed that for the purpose of accounting, the entity is treated as having separate existence and is different from that of its owner(s). Only when the transactions between owner(s) and business entity are recorded treating them as two separate entities, the true picture of the firm or entity will be available. For example, Renuka Rajdev is proprietor of M/s. Ahmedabad Corporation. In this case, though Renuka Rajdev is sole owner of M/s. Ahmedabad Corporation, she will be treated as an entity separate from that of M/s. Ahmedabad Corporation for the purpose of accounting. Accordingly, if she withdraws any money or goods from business entity M/s. Ahmedabad Corporation, the business entity will debit the amount thereof to her drawings account. In the same manner, if she brings some capital in the business entity, the business entity will credit her Capital Account. This concept can also be extended to accounting separately for various divisions or branches of a firm or a company in order to ascertain the results of each division separately. Due to this concept only, some branches are preparing its own accounts independently.

Based on this concept, accounting is done for only those transactions and events which affect the business. Personal transactions of owner(s) which are not affecting business at all are not recorded in the books of accounts of business.

Each entity is considered as a separate entity from its owners even if such entities have common owners. Treating each entity as separate, accounts are maintained for each entity separately. For example, Navin Khandelwal is proprietor of M/s. Khandelwal Associates and is also a proprietor of another firm M/s. Navin Associates. In this case, all these entities viz. Navin Khandelwal, Khandelwal Associates and Navin Associates will be treated as separate entities for the purpose of accounting. Due to separate entity concept or Accounting Entity Concept, owner's capital is shown on the liability side of balance sheet of business entity.

Forms of business organisation may comprise of proprietorship firm, partnership firm, company, society or any other legal entity. In case of proprietorship firm, the Accounting Entity concept differs from legal concept. According to Accounting Entity concept, owner and business are treated as two separate entities. However, law does not distinguish between a proprietary firm and its proprietor. Legally, since the liability of proprietorship firm or proprietary concern is unlimited, personal assets of proprietor can be attached for payment of business liabilities and business assets could be used for discharging personal liabilities.

In partnership firm other than limited liability partnership (LLP), because of unlimited liability of partners, net personal assets after discharging personal debts can be applied for paying off liabilities of the partnership firm. Similarly, assets remaining in partnership firm after paying of firm's liabilities can be applied for discharging personal liabilities of partners to the extent of their share.

Legally, a company has a status of an artificial person distinct from its owners or shareholders. Once shareholders pay full amount of capital subscribed by them, they are not liable to contribute any additional amount for company's liabilities. Thus, separate entity of owners from business entity can be easily understood in case of company form of organisation.

When owner is considered as an entity separate from the business entity, it helps in preparation of accounts and knowing the result of the business. Based on this concept only, one can know whether business resources are used efficiently or not.

When owner is treated as an entity separate from that of the business enterprise, the owners shall have their claim on the assets of the business entity. Balance sheet also suggests this. For example, if Renuka Rajdev has introduced capital of ₹ 1,00,000 in her proprietary firm M/s. Ahmedabad Corporation, she has claim to that extent on the assets of M/s. Ahmedabad Corporation. Let us understand this with the help of an illustration of Balance Sheet based on imaginary numbers.

Balance Sheet of M/s Ahmedabad Corporation

Capital and Liabilities	Amount (₹)	Assets	Amount (₹)
Renuka Rajdev's capital	1,00,000	Fixed assets	75,000
Creditors	2,00,000	Current assets	2,25,000
Total	3,00,000	Total	3,00,000

It can be seen from the above balance sheet that the owner's capital is also shown on Liabilities side like any other creditors. The above information can also be presented in the form of an accounting equation.

$$\text{Capital (1,00,000) + Outside liabilities (2,00,000) = Total assets (3,00,000)}$$

$$\text{Capital + Liabilities = Total assets}$$

$$\text{In short, } C + L = A$$

This fundamental accounting equation also suggests that the owner is an entity different from the business.

The following are some of the practices or illustrations based on this concept :

(i) When college fee of son of proprietor is paid from business entity, the drawings account of proprietor is debited with such amount. This statement is based on Accounting Entity concept as though proprietor is sole owner of the business enterprise, for the purpose of accounting, owner and business are treated as two separate entities. Hence, if proprietor withdraws some money from business for personal use, the business will debit such amount to proprietor's drawings account.

(ii) When partner of a partnership firm introduces his capital into the firm, the partnership firm will credit this amount to partner's capital. This is because the partner and partnership firm are two separate entities for the purpose of accounting based on Accounting Entity concept.

(iii) Partnership firm gives interest on partners' capital and charges interest on partners' drawings depending upon the agreement. This is based on Accounting Entity concept that treats partners and partnership firm as two separate entities for the purpose of accounting.

(iv) Independent branch prepares its own trial balance separately because of Accounting Entity Concept as it is a separate entity for the purpose of accounting.

(5) Money Measurement Concept: In business, all transactions are represented in monetary unit. For accounting, money is accepted as common measurement unit. Economic worth of assets and liabilities as also revenue and expenses are stated in monetary terms for the purpose of accounting. Money measurement concept has two implications. Transactions which can be measured in terms of money will be recorded in monetary terms in accounting and the transactions which cannot be measured in terms of money will not be recorded in the books of accounts. Though physical units are involved in many financial transactions, accounting thereof is made in terms of common measurement unit of money only based on Money Measurement Concept. For example, if we purchase 5 chairs and 10 tables, the total amount paid or payable for these furniture items will be debited to Furniture Account and though the quantity of chairs and tables may be recorded in narration of transaction, the accounting entry will be based on monetary value of such items purchased. Similarly, when wages are paid based on number of hours or days worked to different workers, the transaction will be recorded in books of accounts based on the monetary amount involved. Thus, for any revenue expense or revenue income or assets or liabilities, money is the only measurement unit and hence for accounting, the concept of money measurement is well accepted.

This concept has two important limitations. (1) The transactions and events affecting business, though important, are not recorded in the books of accounts of business if they cannot be measured in terms of money. (2) The money value changes from time to time but transactions are recorded in the books of account at their monetary value on the date of transaction and hence the effect of change in value of money is totally ignored. For example, land purchased in the year 2005 is recorded at its historical cost of say ₹ 2 crores and even if the value of such land is ₹ 50 crores in 2016 as the accounts are prepared on the basis of historical cost (the cost at the time when the transaction has taken place) and thereby the effect of change in value of money is ignored. Despite these limitations, Money Measurement concept is generally accepted accounting principle as not following this concept may result into more grave issues or problems than these limitations.

The following are some of the practices or illustrations that can help understand this concept better :

(i) No accounting entry is recorded for strike by factory workers even if it is an important event affecting business. As this event cannot be measured in terms of money, no accounting entry is made according to Money Measurement concept.

(ii) No accounting entry is recorded in books of account for resignation of a competent and efficient production manager that may adversely affect the production. As this event cannot be measured in terms of money, no accounting entry is made according to Money Measurement concept.

(iii) Instead of recording physical quantity of goods sold, the sales will be recorded at monetary value of such goods. This is based on Money Measurement concept as for the purpose of accounting, money is accepted as common measurement unit.

(6) Periodicity Concept: This concept is also referred to as Accounting Period concept by some authors. This concept is related to going concern concept. The going concern concept implies that the business activities will continue indefinitely or for a very long time in absence of any contrary indication. If one waits till closure of business, complete picture of profit or loss can be known only at the time of liquidation or closure of business. But, it is not usually possible for a businessman to wait till the closure of business. Moreover, other stakeholders of the business like investors, creditors, tax authorities etc. are generally interested in information of business operations every year. Therefore, the life of the business is divided into specific accounting periods. This is known as Accounting Period. At the end of each accounting period, financial statements are prepared. Such accounting period is also known as accounting year. Usually, the accounting period is of 12 months. Accounting results are also prepared at the end of

every year because the period of 12 months covers the effect of various seasons on the business. Therefore, the accounts are also known as annual accounts. Such an accounting year could be a calendar year, a samvat year, a financial year, co-operative year or any other period. In India, according to Income Tax law, businessmen (assesses) are required to furnish the details of income for income tax purpose for every financial year i.e. For a period of 12 months starting from 1st April and ending on 31st March next year.

All listed companies in India publish interim quarterly financial reports by preparing interim accounts which become useful to investors in their investment decisions. In this case, the accounting period is of 3 months. Some enterprises prepare monthly accounts for their internal use and in that case accounting period could be a month. Thus, whenever accounts are prepared at interval of a particular period such period is known as accounting period and this concept of preparing accounts at regular interval is also known as Periodicity Concept.

The following are some of the illustrations based on this concept :

(i) Based on Periodicity concept or Accounting Period concept, Profit and Loss Account and Balance Sheet are prepared at the end of every accounting period.

(ii) Since the life of the business is assumed to be indefinite or for a very long period, such life is divided into convenient accounting periods to ascertain performance and position of entity at the end of each such accounting period. This practice is based on Periodicity concept.

(7) Full Disclosure Concept: This concept is also referred to as Disclosure concept by some authors. According to this concept, all material information should be disclosed in the financial statements. To enable the users of the financial statements to take informed economic decisions, it is necessary to disclose all the relevant information in the financial statements. No material information affecting the interest of general investors should remain undisclosed or concealed. Financial statements should be prepared honestly. According to Section 129(1) of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.

According to general instruction No. 2 of Schedule III to the Companies Act, 2013, the disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

The practice of appending notes or schedules to the financial statements has developed as a result of this principle of full disclosure. For example, information about contingent liabilities, market value of certain investments, method of providing depreciation, method of valuation of stock and other accounting policies are disclosed in financial statements with a view to disclose significant or material information. Good accounting practice demands that all significant information should be disclosed irrespective of legal requirements to do so. Even when there is no legal requirement to disclose a particular information, material or significant information is to be disclosed.

The following are some of the illustrations based on this concept :

(i) Change in method of depreciation is material information as it affects the profit or loss of the enterprise and also affects the book value of fixed assets shown in the balance sheet. It also indicates change in policy. Hence, based on Full Disclosure concept, this should be disclosed in financial statements along with the impact of such change.

(ii) Information about the change in method of stock or inventory valuation and its impact should be disclosed in financial statements.

(8) Materiality Concept: This concept is associated with the principle of full disclosure. According to full disclosure principle, all material information should be disclosed in the financial statements. Materiality depends on the relevance and reliability of information. Information will be considered material only when the same is relevant and significant.

According to this concept, any information would be shown in detail in financial statements only when the same is useful to the users of such information. While Materiality principle implies that material information should be disclosed, it may also imply that immaterial information may not be disclosed. For example, when small tools like small hammers, nails, screws, screwdrivers, etc. are used, there is no need to maintain separate accounts for each of such items. Only one account of Loose Tools would serve the purpose. Similarly, instead of keeping separate accounts for pencil, erasers, pen, etc., only one account styled as 'Stationery Expense Account' shall be maintained because it is not necessary to maintain separate accounts for small and immaterial items. Therefore, there is no need of separate disclosure or note for such immaterial items in accounts or in financial statements. Materiality also depends on the amount involved in a transaction. For example, purchase of dustbin for ₹ 20 should be considered as an expense instead of considering the same to be a fixed asset. In Schedule III to the Companies Act, 2013, General Instructions for Preparation of Statement of Profit and Loss states that a Company shall disclose by way of notes additional information regarding aggregate expenditure and income on any item of income or expenditure which exceeds one percent of the revenue from operations or ₹ 1,00,000 whichever is higher.

It is not possible to give a definite rule for determining materiality in each case. It depends upon the quantum of amount, relevance or importance of a transaction or information in the business. In terms of materiality concept, an accountant need not attempt to record events so insignificant that the work of recording them is not justified by the usefulness of the results. Whether an event or information or transaction is material or not also depends upon the judgment and common sense of the accountant.

The following are some of the illustrations based on this concept :

(i) Instead of charging expenses of only partly used note pad, full cost of notepad is charged as expense to Profit and Loss Account even if the part thereof is still unused. Conceptually, a writing pad is an asset of the entity. Every time the page from such pad is used, part of the pad is used up and to the extent the same remains unused, it is an asset. Theoretically, it may be possible to ascertain the number of pages used and the remaining pages at the end of an accounting period. But the cost of such effort would be unwarranted and no accountant would usually attempt to do this. Instead, usually, cost of such writing pads are written off as expense either when the same is purchased or when the same is issued for use.

(ii) Any item of income or expenditure which does not exceed one percent. of the revenue from operations or ₹ 1,00,000, whichever is higher is not required to be separately shown in Statement of Profit and Loss of a company, unless specifically mandated otherwise.

(iii) If accounting year ends of 31st March, 2016 and a Telephone bill is received for the period of 2-3-2016 to 01-04-2016, entire value of this bill may be charged as expense to profit and loss account for the period ended 31st March, 2016 instead of charging expense for one day in the year 2016-17.

(9) Prudence Concept: This concept is also referred to as Conservatism concept by some authors. Financial statements are usually prepared on conservative basis. Window dressing of accounting i.e. showing the performance or position different than the actual one is not permitted. In other words, showing a position better than what it is, is not good. At the same time, it is also not proper to show performance or position substantially worse than what it is and thus create secret reserve. Prudent reporting based on conservatism builds confidence in the results and, in the long run, best serves the interest of all stakeholders and users of financial statements. This policy of prudent reporting leads to the concept of prudence or conservatism. According to this concept of prudence, an accountant does not take into account anticipated

gain or profit but provides for all anticipated losses. Based on this concept there is preference for understatement of revenue or asset rather than overstatement when dealing with measurement of uncertainties. At the same time there is preference for estimating higher number for liabilities or expenses when dealing with measurement of uncertainties. This concept is also stated as **anticipate no profits but anticipate all losses and provide for them**. The two aspect of prudence can be stated as under.

- (i) Recognise revenue or gain only when they are reasonably certain.
- (ii) Recognise expenses or losses as soon as they are reasonably possible.

The following are some of the illustrations based on this concept :

(1) Closing stock is valued at cost or market price, whichever is less. For example, if cost of closing stock of inventory is ₹ 20,000 at the end of the year and its market value is ₹ 30,000, the closing stock will be valued at ₹ 20,000. At the same time, if cost of closing stock of inventory is ₹ 20,000 at the end of the year and its market value is ₹ 17,000, the closing stock will be valued at ₹ 17,000. Here, anticipated profit of ₹ 10,000 (₹ 30,000 less ₹ 20,000) is not taken into account as the same is not actually realised. However, the anticipated loss of ₹ 3000 (₹ 20,000 less ₹ 17,000) is taken into account when we value closing stock at ₹ 17,000 against its cost of ₹ 20,000.

(2) Provision for doubtful debts is made in the accounts.

(3) Provision for discount reserve on debtors is made in the accounts.

(4) Provision for discount reserve on creditors is not made in the accounts.

(5) Contingent liabilities are shown in the balance sheet whereas contingent assets are not shown therein.

(6) Provision for reduction or erosion in value of investments is usually made in the books of account.

(7) When goods are supplied on 'sale or return' basis, the revenue is not recognised till the confirmation is received from the buyer for having agreed to purchase the same.

(8) In case of long term contracts, when the work completed is very less or negligible, say less than 25%, the entire profit is reserved for future contingencies and is transferred to work in progress account. In other words, no profit is taken into account or profit is ignored for such long term contracts where very less or negligible work has been completed. However, if there is any loss, the same will be taken into account.

(9) All research and development expenses are usually debited to profit and loss account of the year in which they are incurred even if the benefit of such expenses is derived in future.

(10) Provision for loss of theft of uninsured stock will be made in the books of accounts soon after the theft even if there is possibility of recovery of this stock if police catches the thief.

(11) Banks credit interest on doubtful advances to Interest Suspense Account and not to Interest Account. Recovery of interest on doubtful advances is uncertain and hence based on prudence or conservatism concept, instead of crediting the same to Interest income, it is credited to Interest Suspense Account.

(10) Cost Concept: According to the cost concept, transactions will be recorded in the books of account at their monetary cost of acquisition. In other words, if there is cost, the transaction will be recorded at cost at which the transaction has taken place and not any more or less value than that. It also implies that if there is no cost, the transaction will not be recorded in the books of account. Thus, transactions are recorded based on the amounts actually involved. This is a fundamental

concept in accounting in the sense that it prevents recording the transactions at any arbitrary values. This concept is mainly applied in the transactions of acquisition of assets wherein the amount to be recorded is objectively arrived at based on the mutually agreed value between two parties. However, sometimes, accounting has necessarily to be based on estimates. For example, depreciation to be calculated on assets is usually based on estimates as precise life of any asset cannot be known.

The following are some of the illustrations based on this concept :

(1) If a piece of land is purchased by Aditi from Anil for ₹ 5 lakhs, this transaction will be recorded in the books of account at ₹ 5 lakhs only being the monetary cost thereof. Even if Aditi feels that this land is worth ₹ 10 lakhs, she cannot record this transaction at ₹ 10 lakhs in her books as her cost for land is ₹ 5 lakhs. At the same time, even if Anil feels that this piece of land is worth ₹ 3 lakhs, he cannot record this transaction at ₹ 3 lakhs in his books when he has actually sold it for ₹ 5 lakhs.

(2) No accounting entry is made for free samples received as there is no cost.

(11) Dual Aspect Concept: Duality principle is a fundamental accounting convention and is the underlying basis for double entry book keeping system or accounting system.

According to Dual Aspect concept, every transaction has two-fold effect or has a dual impact on the accounting records. (i) from the angle of benefit received and (ii) from the angle of benefit given. For example, purchased Furniture of ₹ 10,000 for cash. In this transaction, Furniture of ₹ 10,000 is received and Cash ₹ 10,000 is given or it goes out of business. If Furniture is purchased on credit, Furniture comes in and the equal amount of liability is credited to be discharged in future. Thus, 'every receiver is a giver and every giver is a receiver'. In the above example, purchaser of Furniture gets Furniture and gives cash. On the other hand, seller of furniture gives Furniture and gets cash. Thus, for proper recording of transactions, dual effects are necessary. For recording this two-fold effect in the books of accounts, accounting terminology of 'debit' and 'credit' are used. The structure of Accounting is based on this concept of duality. Accounting Equation or Balance Sheet equation is also based on Dual Aspect concept. Thus, total debit effects and total credit effects of various transactions recorded in books of accounts and posted in ledger accounts are always equal. Accounting system is designed so as to record both these effects of a transaction and hence it is called as double-entry system. It should be remembered that every transaction recorded in the accounts affects at least two items.

The economic resources of an entity are known as assets. The claims of various parties against these assets are called capital and liabilities. Capital is the owners' claim against the assets of the business. In case of proprietary firm, it is known as proprietor's capital. In case of partnership firm, it is known as partners' capital. In case of incorporated entities, capital or owner's equity is also known as shareholders' equity or shareholders' fund. In short, terms like "capital", "owners' fund", "owners' equity", "net worth", "shareholders Fund", "equity", "proprietor's capital" or "partners' capital" denote the claim of owners against the assets of enterprise. Liabilities are the claims of creditors (i.e. every one other than the owners) against the assets of the business. Since all the assets of the business are claimed by its creditors and owners and these claims cannot exceed the amount of assets, the fundamental accounting equation or the balance sheet equation will be as under.

Assets = Liabilities + Capital

Alternatively, Accounting equation can be stated as,

$A = L + C$ where, A = Assets

L = Liabilities

C = Capital

Understanding fundamental accounting equation will be of utmost use in understanding the entire process of accounting.

This equation is not only helpful in understanding the dual aspect of any transaction but it also helps in understanding the account to be debited or credited. For example, when proprietor brings capital of ₹ 10,000 by cash in business name as Radhika Corporation, the business gets cash ₹ 10,000 which is debited to Cash Account and Capital account is credited by ₹ 10,000. The balance sheet of firm will appear as under.

Balance Sheet of Radhika Corporation

Capital and Liabilities	Amt. (₹)	Assets	Amt. (₹)
Capital	10,000	Fixed assets	0
Liabilities	0	Current assets – Cash	10,000
Total	10,000	Total	10,000

The effect of above stated transaction is that asset viz. Cash increases and capital increases. Alternatively, we can say that Cash Account is debited and Capital Account is credited.

We should remember that **Debit** is that portion of transaction that accounts for increase in asset or expense and decrease in liabilities, capital or income. In above stated transaction, debit is on account of increase in cash.

Similarly, we should remember that **Credit** is that portion of transaction that accounts for decrease in asset or expense and increase in liabilities, capital and income. In above stated transaction, credit is on account of increase in capital.

The Dual Aspect concept is of utmost importance in mastering the art of accounting. To understand the rules of debit and credit or journal entries easily with this Dual Aspect concept, one may remember only one thing and the rest would follow as corollary. Remember that increase in Asset means Debit or A+. Now as a corollary to this, decrease in Asset means credit; increase in liability means credit; increase in capital means credit; decrease in liability means debit; and decrease in capital means debit. In the above stated transaction, from the view point of business entity, cash which is an asset increases and hence cash account is debited; and Capital increases and hence Capital Account is credited.

Each transaction has two aspect or effect or dual aspect. This can also be understood by the following example. If business acquires asset, it must result in one of the following.

(i) Decrease in some other asset. For example, purchased machinery for cash. In this case asset viz. Machinery increases and another asset viz. Cash decreases.

(ii) Increase in liability. For example, if asset is acquired on credit, the obligation to pay the amount thereof will result into increase in liability.

(iii) Increase in capital. For example, if owner has brought personal asset into business, capital increases.

The following are some of the illustrations based on this concept :

(i) When goods costing ₹ 5000 is sold for ₹ 7000 for cash, the effect of this transaction will be reduction in asset or inventory by ₹ 5000; increase in cash balance by ₹ 7000 and increase in capital by ₹ 2000 being profit on sale of such goods. Thus, overall net effect or two-fold effect is that capital increases by ₹ 2000; and assets increase by ₹ 2000 (7000 - 5000).

(ii) When goods costing ₹ 4000 is purchased on credit, the effect of this transaction will be increase in stock or inventory or asset by ₹ 4000 and increase in creditors or liability by ₹ 4000. Thus, overall effect or two-fold effect is that asset increases by ₹ 4000; and liability increases by ₹ 4000.

(iii) When loan of ₹ 10,000 is received from a friend by Cheque, overall effect or two-fold effect is that asset i.e. Bank balance increases by ₹ 10,000; and liability i.e. Loan from Friend increases by ₹ 10,000.

(iv) When salary of ₹ 8000 is paid by cash, it being an expense, increases the loss or reduces the profit and thus reducing the capital by ₹ 8000. The second effect is it reduces cash by ₹ 8000. Thus the two fold effect is decrease in capital by ₹ 8000 and decrease in asset by ₹ 8000.

Other Concepts :

(1) **Matching Cost with Revenue :** According to this concept, cost incurred during a particular period should be matched against the revenue of that period to ascertain profit or loss.

(2) **Realisation or Revenue Recognition :** According to this concept, revenue should be recognised in the period in which it is earned irrespective of the fact whether cash is received or not during that period.

(3) **Verifiability and Objectivity of Evidence :** According to this concept, there should be objective evidence, for transactions recorded in accounts, which are capable of verification.

3. Illustrations

(a) **State the name of the accounting principle, concept or convention which is followed in the practices or statements given below :**

- (1) Market value of fixed assets as on 31-03-2016 is ₹ 5 lakhs and depreciated value is ₹ 4 lakhs on this date. In this case, fixed assets will be shown in the balance sheet at ₹ 4 lakhs on 31-03-2016 and not at ₹ 5 lakhs.
- (2) Usually, provision for discount reserve on creditors is not made.
- (3) Provision is made for doubtful debtors.
- (4) Closing stock is valued at the cost price or market price whichever is less.
- (5) Revenue from sales is recorded in book of accounts even if goods are sold on credit and the amount is not yet received in cash.
- (6) Fixed assets of business are shown in balance sheet at their depreciated value and not at their realisable values.
- (7) Partnership firm gives interest on partners' capital and charges interest on partners' drawings if it is so agreed.
- (8) Accounts of business are prepared for a specific period.
- (9) No accounting entry is passed in books of accounts for resignation of an efficient Plant Manager of a firm even if this event will adversely affect production of the firm.
- (10) In addition to book value of investment in listed shares, the market value thereof is also shown as additional information in financial statements.
- (11) Entire expense of a ball pen refill purchased for ₹ 5 on 25-03-2016 is debited to Stationery Expenses on date of purchase itself even if only about a half of this refill is used by 31st March, 2016.
- (12) As far as possible same method of providing depreciation should be followed year after year.
- (13) Mangal Corporation purchased a car for ₹ 5 lakhs and this was the last piece available with seller and now there are buyers ready to pay even ₹ 7 lakhs for this car. Hence, owner of

Mangal Corporation wants to record this transaction of purchase of car at ₹ 7 lakhs even though the car is actually purchased for ₹ 5 lakhs. However, the Accountant of the firm has argued that based on generally accepted accounting principle, this transaction has to be recorded only at ₹ 5 lakhs and it cannot be recorded at ₹ 7 lakhs.

- (14) ABC Corporation received free samples of goods worth ₹ 5000 from a supplier but ABC Corporation did not record this transaction in its books of account even though it received the goods.

Answer :

- (1) Going Concern concept. The fact that the fixed assets are shown at their depreciated value and not at their realisable values in the balance sheet is based on going concern concept. If the business is not to continue for long period, we would show the fixed assets at realisable value of ₹ 5 lakhs. However, in absence of any contrary information, according to going concern concept, it is always assumed that the entity will continue for a very long time.
- (2) Prudence or conservatism Concept. According to prudence or conservatism, revenue or gain should be recognised only when they are reasonably certain. Discount to be earned from creditors is probable and not sure and hence anticipated gain, unless, reasonably certain, is ignored. Hence, no provision is made for discount reserve on creditors.
- (3) Prudence or conservatism Concept. Provision is made for doubtful debtors as it is an anticipated loss and according to this principle, all anticipated losses are provided for.
- (4) Prudence or conservatism Concept. It is based on the prudence or conservatism concept that takes into account anticipated loss but ignores anticipated gain.
- (5) Accrual or conservatism Concept. Based on accrual concept, when sales is made on credit, the third party legally becomes liable to pay the amount of goods and hence revenue should be recognised soon after the sale is made or when ownership in goods are passed to the buyer thereof.
- (6) Going Concern Concept. Fixed assets of business are shown in balance sheet at their depreciated value and not at their realisable values as the fixed assets are meant for use in the business and business is to continue for a very long time or for indefinite period.
- (7) Accounting Entity Concept. As partnership firm and partners are treated as two separate entities, partnership firm can allow interest on partners' capital and can charge interest on partners' drawings if it is so agreed.
- (8) Periodicity Concept. Since life of business is indefinite, Accounts of business are prepared for a specific period to ascertain performance or position of business at regular intervals.
- (9) Money Measurement Concept. As the event of resignation of an efficient Plant Manager cannot be measured in terms of money, it cannot be recorded in books of accounts. Only those events or transactions which can be measured in terms of money are recorded in books of accounts.
- (10) Full Disclosure Concept. Since all material information should be disclosed in the financial statements, in addition to book value of investment in listed shares, the market value thereof is also shown as additional information in financial statements.
- (11) Materiality Concept. Based on materiality concept, all immaterial items will be dealt with in accounts in the most expedient manner. The cost of pen refill being immaterial, its cost can be charged as expense either when the same is purchased or when issued for use.

- (12) **Consistency Concept.** Consistency principle expects that whatever accounting method or policy is followed, should be consistently followed. Hence, based on this principle, as far as possible same method of providing depreciation should be followed year after year.
- (13) **Cost Concept.** According to this concept, the transactions have to be recorded based on the underlying cost thereof. Hence, even though the owner considers an asset purchased as worth more or less than the actual purchase price, the transaction will be recorded at cost thereof and at no other value.
- (14) **Cost Concept.** As there is no cost, the transaction will not be recorded in absence of any cost.
- (b) **Fill in the blanks choosing the most appropriate option from the given options :**
- (1) Concept suggests that method of valuation of stock should not be changed year after year.
- (a) Materiality (b) Cost
(c) Consistency (d) Dual Aspect
- (2) Fixed assets are depreciated based on the Principle of
- (a) Materiality (b) Money Measurement
(c) Accounting Entity (d) Going Concern
- (3) Based on Concept, provision for outstanding salary for the month of March is made in the month of March while finalising the accounts even though the salary for that month is actually paid in April next.
- (a) Accrual (b) Cost
(c) Money Measurement (d) Dual Aspect
- (4) Based on Concept, amount paid for personal travelling expenses of proprietor from the firm is debited by firm to the drawings account of proprietor.
- (a) Materiality (b) Accounting Entity
(c) Periodicity (d) Dual Aspect
- (5) Based on Concept, no accounting entry is made in the books of accounts for advantage of having a team of sincere, honest, hardworking and efficient employees with the firm.
- (a) Materiality (b) Full Disclosure
(c) Money Measurement (d) Dual Aspect
- (6) Based on Concept, Profit and Loss Account and Balance Sheet are prepared at the end of each accounting period.
- (a) Materiality (b) Cost
(c) Money Measurement (d) Periodicity
- (7) Whenever there is change in method of providing depreciation, the impact of such change on the profit or loss and in the value of asset should be disclosed in financial statements based on Concept.
- (a) Full Disclosure (b) Cost
(c) Going Concern (d) Dual Aspect

- (8) Instead of preparing separate accounts for items like pen, erasers, rough writing pads, pencil and other stationery items, they are all grouped under one Stationery Expense Account based on Concept.
- (a) Dual Aspect (b) Materiality
(c) Consistency (d) Accounting Entity
- (9) Based on Concept, provision may be made for contingent liabilities in books of account but not for contingent assets.
- (a) Materiality (b) Cost
(c) Dual Aspect (d) Prudence or Conservatism
- (10) Krupa Corporation entered into agreement on 01-06-2016 for purchase of a Factory Building for ₹ 5 crores from Anil Enterprise. Actual payment of ₹ 5 crores was made and deed for this transaction was executed on 15-06-2016 when the market value of this factory building had gone up to ₹ 6 crores. Even though the value has increased to ₹ 6 crores, this transaction will have to be recorded only at ₹ 5 crores in the books of accounts based on Concept.
- (a) Materiality (b) Dual Aspect
(c) Consistency (d) Cost
- (11) Fundamental Accounting equation or Balance Sheet equation i.e. Assets = Liabilities + Capital is based on _____ Concept.
- (a) Materiality (b) Cost
(c) Dual Aspect (d) Consistency
- (12) The reason for valuing work in process on the basis of the cost incurred thereon is Concept.
- (a) Materiality (b) Going Concern
(c) Full disclosure (d) Accounting Entity

Answer :

- (1) (c) Consistency (2) (d) Going Concern (3) (a) Accrual
(4) (b) Accounting Entity (5) (c) Money Measurement (6) (d) Periodicity
(7) (a) Full Disclosure (8) (b) Materiality (9) (d) Prudence or Conservatism
(10) (d) Cost (11) (c) Dual Aspect (12) (b) Going Concern

Exercise

1. Explain the need for accounting principles or concepts or conventions or postulates or assumptions that are used while writing accounts and in preparing financial statements.
2. **Write a short-note on :**
 - (i) Going Concern Concept; (ii) Consistency Concept; (iii) Accrual Concept; (iv) Accounting Entity Concept or Business Entity Concept or Entity Concept or Separate Entity Concept; (v) Money Measurement Concept; (vi) Periodicity or Accounting Period Concept; (vii) Full Disclosure or Disclosure Concept; (viii) Materiality Concept; (ix) Prudence or Conservatism Concept; (x) Cost Concept; (xi) Dual Aspect or Duality Concept.
3. Explain the concept of going concern giving example.
4. Explain the concept of consistency giving example.

5. Explain the concept of accrual with example.
6. Explain the concept of accounting entity with example.
7. Explain the concept of consistency with example.
8. Explain the concept of money measurement with example.
9. Explain the concept of periodicity with example.
10. Explain the concept of full disclosure with example.
11. Explain the concept of materiality with example.
12. Explain the concept of prudence with example.
13. Explain the concept of dual aspect with example.
14. Which three accounting principles or concepts or conventions are treated as fundamental accounting assumptions by ICAI?
15. **State the name of the accounting principle, concept or convention with which the following statements or situations are associated :**
 - (1) Revenue expenses paid in advance are shown on the asset side of balance sheet.
 - (2) Semi finished goods or work-in-progress is valued at cost incurred thereon and not at their realisable value.
 - (3) Financial statements are prepared at the end of accounting period.
 - (4) If depreciation is provided by straight line method in a year, the same method should be followed consistently every year.
 - (5) Frequent changes in the methods of depreciation or stock valuation should be avoided.
 - (6) When goods are purchased on credit from a supplier, the Purchase should be recorded in accounts immediately, even though cash is not yet paid for such purchase as the amount becomes payable once the goods are purchased.
 - (7) When partner of a partnership firm withdraws any amount from the firm, the partnership firm will debit this amount to partner's drawings account.
 - (8) No accounting entry is recorded for death of a key employee of the firm even if it is an important event affecting business.
 - (9) In absence of any contrary information, life of the business is assumed to be indefinite or for a very long period and hence such life is divided into convenient accounting periods to ascertain performance and position of entity at the end of each such accounting period.
 - (10) Any item of income or expenditure which does not exceed one percent. of the revenue from operations or ₹ 1,00,000, whichever is higher is not required to be shown separately in Statement of Profit and Loss of a company, unless specifically required otherwise.
 - (11) Information about the change in method of stock or inventory valuation and its impact should be disclosed in financial statements.
 - (12) Information about the change in method of providing depreciation and its impact should be disclosed in financial statements.
 - (13) Provision for discount reserve on debtors is made in the accounts but Provision for discount reserve on creditors is not usually made in the accounts.
 - (14) Provision for loss of theft of uninsured machinery will be made in the books of accounts soon after the theft even if there is possibility of recovery of this machinery if police catches the thief.
 - (15) Anil purchased a shop from Bimal for ₹ 10 lakhs. Anil feels that he has got a very good bargain and he would have paid even ₹ 20 lakhs for this shop as he felt that this shop is at

prime location. On the other hand, Bimal feels that this shop was very unlucky for him and he would have sold it even for ₹ 5 lakhs. Because of these perceptions, though actual transaction has taken place at ₹ 10 lakhs, Anil wants to record this transaction in his books at ₹ 20 lakhs and Bimal wants to record this transaction in his books at ₹ 5 lakhs but their accountants have told them that the transaction should be recorded at ₹ 10 lakhs only based on some accounting principle, concept or convention which they do not remember.

- (16) It should be remembered that every transaction recorded in the accounts affects at least two items and accounting system is designed so as to record dual effects of a transaction. Hence, Accounting is called as '**double-entry system**' or '**double-entry book keeping system**'.
- (17) Excellent quality management system of an entity is not reflected in its books of accounts even if such system enhances goodwill of the entity.
- (18) Advance received from a customer cannot be credited to sales account.
- (19) Capital is shown on the liability side of Balance Sheet of a business entity.
- (20) Independent branch prepares its own trial balance separately.
- (21) Trial Balance tallies if arithmetical accuracy is ensured.

16. Answer the following questions :

- (1) The owner of a business takes away goods of ₹ 3000 from business for personal use. Where will you debit this? According to which Concept?
- (2) Fixed assets are shown in the balance sheet at their cost or market price whichever is less. Is this statement true or false? If the same is false, rewrite the correct statement and state the principle associated with it.
- (3) According to which accounting principle or concept does Bank credit interest on doubtful advances to Interest Suspense Account?
- (4) A trader has taken a loan of ₹ 1,00,000 from a friend on 01-06-2016 at an interest rate of 12 % per annum and interest is payable annually on 1st June every year. The first interest on this loan will be payable by trader on 1st June, 2017. Accounting year of this trader ends on 31st March every year. Will there be any accounting entry for interest in the books of this trader for the year ending on 31st March, 2017? If yes, for which amount? According to which Concept?
- (5) An employee has filed a suit against a company claiming compensation of ₹ 1,00,000 for dismissing him from his job. According to the estimate of Advocate of the Company, sum of ₹ 40,000 is likely to become payable. Will there be any entry in the books of the company for this event? If yes, for which amount? According to which Principle? If the matter is pending in the court of law, is there any requirement to disclose the details of claim for compensation in financial statement? If yes, according to which concept?

