

Topic: **Basic Principle of Accounting**

|  |
| --- |
|   |

**Question:** Rahulreceives a Rs 2000 electricity bill for his four rented rooms. He pays the Rs 2000 from his business, claiming it as an electrical expense.

Under the business entity concept is this correct?

1. MONEY MEASUREMENT CONCEPT:

The **money measurement concept** is one of the fundamental accounting principles. It states that accounting will only recognize and record business transactions that can be expressed in monetary terms. In other words, only transactions that have a measurable value in monetary units are included in the financial statements.

**1.**

**BUSINESS ENTITY CONCEPT**

A

ccounting principle that states the

**business**

**entity**

**concept**

,

also known as the

**economic**

**entity**

**assumption**

, is a

fundamental that a business is treated as a separate entity from

its owners, managers, and other businesses. This concept is

essential because it helps in distinguishing the financial

transactions and records of the business from the personal

transa

ctions of its owners

**Example**: when a company purchases inventory for $5,000, this transaction is recorded because it involves a measurable monetary value. However, non-monetary factors like employee satisfaction or the company's reputation, even though important, are not recorded due to the limitations of the money measurement concept.

1. **GOING CONCERN CONCEPT:**

The **going concern concept**, also known as the **continuity assumption**, is a fundamental accounting principle that assumes a business will continue to operate indefinitely and will not be liquidated in the foreseeable future. This concept implies that the business is expected to remain in operation for the foreseeable future, allowing it to meet its obligations, realize assets, and continue its operations without the need for substantial changes in its financial structure.

**Example**: if a bakery is thriving and expected to keep making profits, it is viewed as a going concern, allowing investors to have confidence in its long-term sustainability.

# 3. ACCOUNTING PERIOD CONCEPT

The accounting period concept, also known as the periodicity concept, is the principle in accounting that suggests a business should divide its financial activities into specific time periods, such as months, quarters, or years, to report and analysis its financial performance and position. This concept helps in regular financial reporting and ensures that financial statements are prepared at regular intervals, making it easier for stakeholders to assess the company's progress and make informed decisions.

**Example**: A company might prepare its financial statements for a one-year accounting period from January 1st to December 31st. This concept allows for consistent and comparable financial information, aiding stakeholders in assessing the company's performance over specific, standardized time intervals.

# 4. COST CONCEPT

The cost concept in accounting states that assets should be recorded and reported in financial statements at their historical cost, which is the amount of money paid or the fair value of other assets given up to acquire the asset at the time of its acquisition.

**Example**: If a company purchases a piece of machinery for

$10,000, the cost concept dictates that the machinery should be recorded on the balance sheet at its original purchase price of $10,000, even if its market value has changed since the purchase. This concept ensures reliability and consistency in financial reporting.

# 5. DUAL ASPECT CONCEPT

The dual aspect concept forms the basis of the doubleentry accounting method. This requires that each business transaction be recorded in two separate accounts. According to the dual aspect concept, every transaction impacts the business in two ways which must be equal and opposite.

# 6. REVENUE RECOGNITION [REALISATION] CONCEPT

The revenue recognition concept in accounting refers to the principle that revenue should be recognized (recorded) in the financial statements when it is earned and realizable, regardless of when the payment is

received. In simpler terms, a company should recognize revenue when it delivers goods, provides services, or when there is an agreement for payment, and it is reasonably certain that the payment will be received.

**Example**: If a software company sells a software license to a customer, the revenue from that sale should be recognized in the financial statements when the license is delivered to the customer, and the customer can use the software. It doesn't matter if the customer pays upfront, in installments or after a certain period. The revenue is recognized when the company fulfil its obligation to deliver the software license.

This concept is crucial for ensuring that financial statements accurately represent a company's performance and financial position, providing useful information to investors and stakeholders.

# 7. MATCHING CONCEPT

The matching concept, also known as the matching principle, is an accounting principle that states that expenses should be recognized in the same period as the revenues they help to generate. In other words, all expenses incurred in generating revenue should be recorded in the same accounting period as the revenue that they helped to produce.

**Example**: Let's consider a company that sells products. If the company sells $10,000 worth of products in a particular month, the cost of goods sold (COGS), which includes expenses like raw materials, labor, and manufacturing overhead, directly related to producing those products, should be matched with the $10,000 in revenue from the sales. This means that the expenses associated with producing the $10,000 worth of products should be recognized in the same month as the revenue from selling those products.

By following the matching concept, a company can accurately determine its profitability for a specific period, providing a clearer picture of its financial performance. This principle ensures that financial statements reflect the economic reality of the transactions and help stakeholders make informed decisions.

**8. ACCRUAL CONCEPT**

|  |  |
| --- | --- |
|  |  |
| The accrual concept is a fundamental accounting principle that states that transactions should be recorded in the accounting period in which they occur, regardless of when the cash is received or paid. In other words, revenues and expenses are recognized when they are earned or incurred, not necessarily when the cash is exchanged.  **Exampl**if a company rec |

e: If a company provides services to a client in December but does not

receive payment until January, the revenue from the services should be recognized in

December when the services were provided, following the accrual concept. Similarly, eives an invoice for services or goods in December but does not pay

until January, the expense should be recognized in December when the services or goods were received.

The accrual concept ensures that financial statements provide a more accurate representation of a company's financial position and performance during a specific period, as it reflects all relevant transactions, whether or not cash has been exchanged. This principle is essential for matching revenues and expenses accurately, enabling stakeholders to assess a company's profitability and financial health.

## 9. CONVENTION OF FULL DISCLOSURE

|  |
| --- |
|  |

The **Convention of Full Disclosure** is an important accounting principle that emphasizes the need for a company to provide all necessary information in its financial statements and accompanying footnotes, allowing external users to understand the financial condition and performance of the business completely.

In simpler terms, the principle of full disclosure requires companies to disclose all relevant information about their financial position, operating results, and other aspects of their business operations. This includes not only the data presented on the face of financial statements but also additional information provided in the footnotes to the financial statements. Such disclosures might include details about contingent liabilities, related party transactions, accounting policies, and any other information that could impact the decision-making of users of the financial statements.

**10. CONSISTENCY CONCEPTY**

The consistency concept is an important accounting principle that states that once a company has chosen an accounting method or treatment for a particular type of transaction or event, it should continue to use the same method for similar events in the future. In other words, accounting methods and practices should be consistent over time within the same company.

 **Example**: if a company chooses to depreciate its machinery using the straight-line method in one accounting period, it should continue to use the straight-line method for depreciation in subsequent periods. Changing the depreciation method without a valid reason would violate the consistency principle.

# 11. CONSERVATISM CONCEPT

The conservatism concept in accounting, also known as the prudence concept, suggests that when accountants face uncertainty about two equally acceptable accounting methods or valuations, they should choose the method that is least likely to overstate assets or income. In other words, it advises accountants to be cautious and not to overstate a company's financial position or profitability.

**Example**: If a company is uncertain about the collectability of a specific receivable, the accountant might choose to write

down the receivable to a more conservative estimate of its realizable value, rather than keeping it at the higher, potentially optimistic value. By erring on the side of caution, the company avoids presenting a financial picture that is overly optimistic and might mislead stakeholders.

The conservation concept ensures that financial statements are not overly optimistic, providing a more realistic and cautious view of a company's financial health. This principle is essential for the reliability and credibility of financial reporting, as it helps prevent the manipulation of financial statements to present a rosier picture than the actual financial reality.

# 12. MATERIALITY CONCEPT

The materiality concept in accounting refers to the principle that financial information should be presented in a way that is material (significant) to the users of the financial statements. In other words, information is material if omitting it or misstating it could influence the economic decisions of users of the financial statements.

Accountants assess the materiality of information based on its nature and amount. If a transaction or piece of information,

whether it's a financial figure or a narrative detail, is large enough to impact the decisions of investors, creditors, or other stakeholders, it is considered material. Materiality is a relative concept; what might be material for one company could be immaterial for another, based on their size, nature of operations, and other factors.

When preparing financial statements, accountants focus on including material information to ensure that financial statements are relevant and reliable. Including immaterial details could clutter the financial statements, making it harder for users to discern the key information needed for decision-making. On the other hand, omitting material information can be misleading. Thus, the materiality concept helps accountants strike a balance between providing relevant information and avoiding unnecessary complexity in financial reporting.