EduTap

SEBI GRADE A

Accounting

Basic Principles of Accounting

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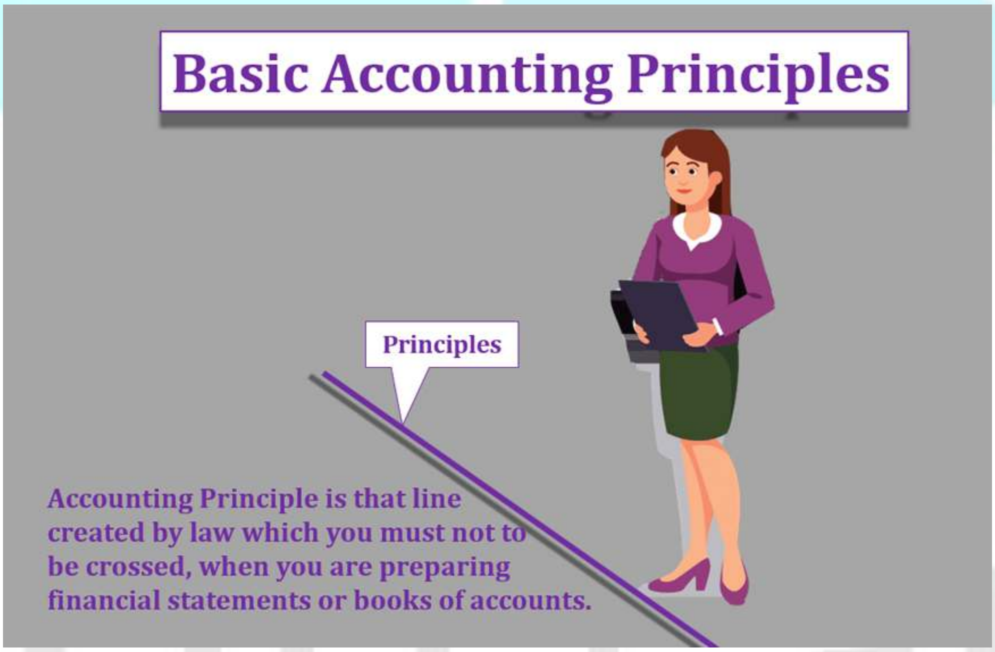
Basic Principles of Accounting

1 What are the Basic Accounting Principles?

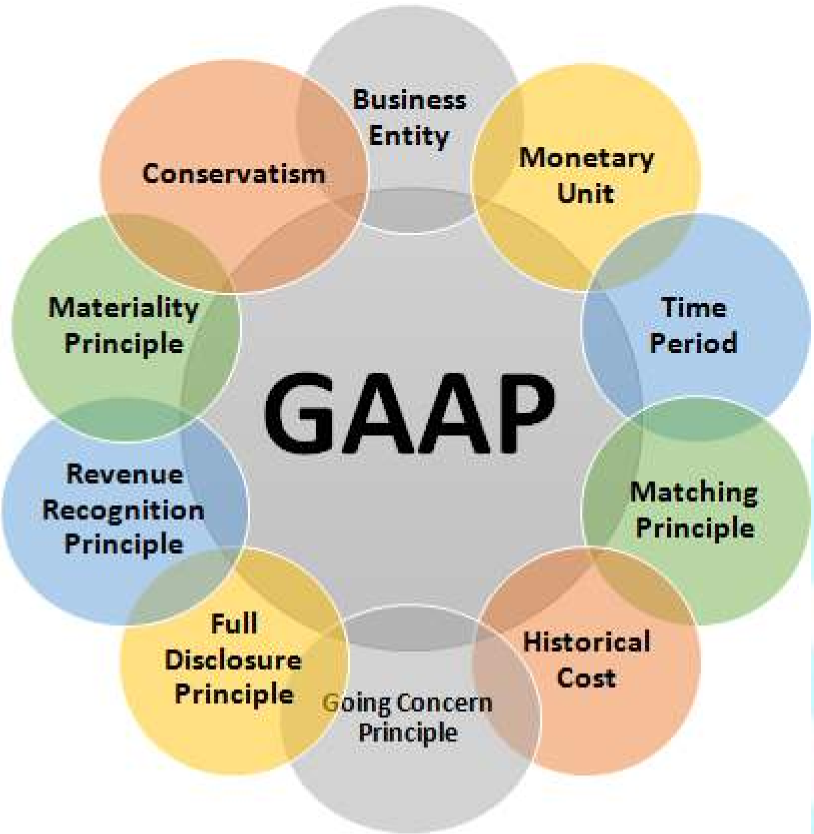
Accounting principles are the rules that an organization follows when reporting financial information. A number of basic accounting principles have been developed through common usage.

They form the basis upon which the complete suite of accounting standards have been built.



1.1 Basic Principles of Accounting

GAAP (Generally Accepted Accounting Principles) is the framework, rules and guidelines of the financial accounting profession with a purpose of standardizing the accounting concepts, principles and procedures. Here is the list of top basic accounting principles that company follow quite often.



1. Business Entity
A business is considered a separate entity from the owner(s) and should be treated separately. Any personal transactions of its owner should not be recorded in the business accounting book, vice versa. Unless the owner's personal transaction involves adding and/or withdrawing resources from the business.

2. Going Concern
It assumes that an entity will continue to operate indefinitely. In this basis, assets are recorded based on their original cost and not on market value. Assets are assumed to be used for an indefinite period of time and not intended to be sold immediately

3. Monetary Unit
The business financial transactions recorded and reported should be in monetary unit, such as INR,US Dollar, Canadian Dollar, Euro, etc. Thus, any non-financial or non-monetary information that cannot be measured in a monetary unit are not recorded in the accounting books, but instead, a memorandum will be used.

4. Historical Cost
All business resources acquired should be valued and recorded based on the actual cash equivalent or original cost of acquisition, not the prevailing market value or future value. Exception to the rule is when the business is in the process of closure and liquidation.

5. Matching Concept
This principle requires that revenue recorded, in a given accounting period, should have an equivalent expense recorded, in order to show the true profit of the business.

6. Accounting Period

This principle entails a business to complete the whole accounting process of a business over a specific operating time period. It may be monthly, quarterly or annually. For annual accounting period, it may follow a Calendar or Fiscal Year.

7. Conservatism

This principle states that given two options in the valuation of business transactions, the amount recorded should be the lower rather than the higher value.

8. Consistency

This principle ensures consistency in the accounting procedures used by the business entity from one accounting period to the next. It allows fair comparison of financial information between two accounting periods.

9. Materiality

Ideally, business transactions that may affect the decision of a user of financial information are considered important or material, thus, must be reported properly. This principle allows errors or violations of accounting valuation involving immaterial and small amount of recorded business transaction.

10. Objectivity

This principle requires recorded business transactions should have some form of impartial supporting evidence or documentation. Also, it entails that bookkeeping and financial recording should be performed with independence, that's free of bias and prejudice.

2 Benefits of accounting principles given in Accounting Standards or Indian Accounting Standards (Ind AS)

Accounting principles are given in Accounting Standards (AS) and Indian Accounting Standards (Ind AS) are of great importance as it provides the basis for:

1. Recognition of an item as income, expense, asset, or liability

2. At what amount it shall be recognized in the books of accounts and

3. How to present these items in the statement of P&L or Balance sheet

4. It also provides all disclosures are required to be made with respect to the items recognized.

Accounting principles guide entities on preparation and presentation of financial statements. It reduces the inconsistencies, presents true and fair view of state of affairs and makes comparison easier.

3 Concept Check

Q.1) Going concern can be defined best as:

A. The concept provides the basis for the formation of the accounting equation.
B. This concept refuses allocation of cost on different accounting periods.
C. This concept discusses the issue of the realization of profit.
D. This concept assumes that the business will operate for a long period of time and will not be dissolved in the near future.

Answer is D.

Q.2) According to consistency convention, accounting principles should be:

A. Consistent
B. Variable
C. Flexible
D. Factual

Answer is A.

Q.3) One of the following is not an example of the materiality concept:

A. Purchase of pencil recorded as an expense instead of including in stock
B. Purchase of car for private use
C. Purchase of plant for business
D. Purchase of building to extend the business

Answer is A.

Q.4) GAAP stands for:

A. Generally Accepted Accounting Provisions
B. Generally Accepted Accounting Policies
C. Generally Accepted Accounting Principles
D. None of these

Answer is C.

Q.5) Due to which concept, accounting does not record non-financial transactions?

A. Going concern concept
B. Money measurement concept
C. Accrual concept
D. Cost concept

Answer: B