

Accounting Principles and Concepts

The Accounting Principles

They are several assumptions concerned with the recording of transactions in the books. The most important is that the financial statements known as the final accounts must be drafted in the same way. This is so that there is a common format that all accounting users of information can understand. The following will use the financial statements:

1. A banker - to decide on whether to provide the company with loan.
2. Investor - someone wishing to buy the business.
3. The owner to know his profit.
4. Tax department for tax purposes.

This means that the banker, the prospective buyer; of the business, the owner and the other people all see the same income statement (trading and profit and loss account) and balance sheet.

The following accounting **principles** are followed to provide consistent usable financial statements:

- 1) **Relevance:** Financial information is considered relevant if it affects the business decisions.
- 2) **Reliability:** Information should be free from significant errors, bias & independently verified.
- 3) **Comparability:** Could be compared with other periods and similar business.
- 4) **Understandability:** The financial report "Income statement (trading & profit & loss account) & balance sheet" must be capable of being understood by the users of the report.

The Accounting Concepts

The **accounting concepts** are the rules that are applied in recording transactions and preparing the Trading and Profit and Loss account and the Balance sheet.

1. Business Entity Concept

This rule states that only the transactions of the business should be recorded and NOT the owner's private transactions.

Example: the owner buys himself groceries will Not be recorded

2. Money Measurement Concept

Only transactions that can be expressed in monetary terms are to be recorded.

Example: the motivational level and skills of the employees will NOT be recorded

3. Historic Cost Concept

All transactions are recorded at their cost to the business.

Example: a machine bought for a bargain at 50% less than what it is worth, will still be recorded at the cost paid and not at the higher value it may be worth.

4. Realisation Concept

Profits are realized (actually earned) when cash or a debtor replaces the goods or services. A transaction is NOT realized when an order is received or when a debtor pays his debt.

Example: A sale is considered to be realized when a customer takes ownership of the good or service regardless of whether money is received straight away.

5. Dual Aspect Concept (duality)

Every transaction will affect two items in the business – this is represented by both a debit AND a credit entry in the ledger. *Example: A transaction is considered to have a giving and taking effect so the purchase of stock for cash will reduce the cash amount in the balance sheet and increase the stock of goods.*

6. Consistency Concept

Transactions of a similar nature should always be recorded in the same (or consistent) way. This is to ensure that the Profit and Loss Accounts and Balance Sheets can be meaningfully compared each year.

Example: keeping the percentage rate of depreciation the same every year

7. Materiality Concept

This concept implies that you should not waste time recording transactions that are trivial (involving very small amounts of money).

*Example: Depreciation on a cheap waste paper bin
Paper clips left over at the end of the year to be used the following year*

BE CAREFUL: what is trivial to a large business could be material to a small business.

8. Accruals (Matching) Concept

The Trading and Profit and Loss Account should only include the income earned and expenses incurred for the current financial year.

Example: rent still owing at the end of the year should be included in this year's expenses.

9. Prudence Concept

This concept states that profits must not be overstated and the value of Assets must not be shown to be too high. The accountants' duty is to ensure that the readers of the final accounts get a true and proper picture of the financial state of the business.

Example: writing off a bad debt even though there is a small chance that the debtor may still pay.

10. Going Concern Concept

It is assumed that a business will continue to exist for a long period of time.

Example: on the last day of the financial year, the government passes a law which prevents us from selling our product. We should still continue to draw up the final accounts.

11. Substance over form

The practical view (the substance) is preferred to the legal view (the form) in Accounting.

Example: a machine bought on hire purchase remains the possession of the seller until the last payment is made (legal or form view). From an accounting view, the machine is used in the business and so will be shown on the Balance Sheet as a fixed asset of the business (substance).