GLOBAL GYAN

Lesson - Accounting Principles

We began our journey of Making Sense of numbers by reviewing these key concepts:

- Accounting Principles are nothing but the "Grammar" for Financial statements. A set of principles accepted & understood by everyone uniformly as the language of Finance. This Grammar is called Generally Accepted Accounting Principles (GAAP)

- There are 10 overall principles of accounting of which we focused on two major ones in the lesson. A detailed note on all 10 is available as an annexure.

    - **Revenue Recognition Principle**- We recognize revenue when a product is sold or a service delivered, irrespective of when Money is received. Thus, Money could be received in advance or in arrears, but revenue shall be recognized upon delivery. *Remember the example of the Mobile phone operator*

    - **Matching Principle**- In line with revenue recognition, Matching Principle states that Costs/expenses that are related to the generation of revenues should be booked at the same time when we booked revenue, irrespective of whether Money was paid to the vendor during that period. *Remember the example of salaries & incentives.*

In the next section we would delve deeper into the application of these principles by looking at the Profit & Loss Statement.

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Srinivasa Addepalli wrote this Note solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation.

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Annex 1
Details of 10 Principles of Accounting

1. Economic Entity Assumption

Accounts are maintained for each "entity" separately – typically, an entity could be a company or a firm or an individual. Therefore, even in the case of two companies that are owned by the same shareholders, or a company and its wholly-owned subsidiary, since the entities are different, accounts would be maintained separately for them. Consider a company with two subsidiaries and a joint venture; four separate, stand-alone accounts would be drawn up for these entities. In addition, the parent company would also "consolidate" all these accounts and publish a consolidated set of financial statements.

2. Monetary Unit Assumption

Accounts are maintained only for those activities or events that can be measured in financial terms, in the relevant currency of that country. If a company's activity does not have a financial implication, then it does not get captured in the accounts.

3. Time Period Assumption

Accounts are prepared for distinct time periods, which can range from a day to a year. Of course, shorter the time period, tougher (and more expensive and sometimes, irrelevant) it is to prepare the accounts, but it is possible. All financial statements have the appropriate time period clearly labelled, and it is usual practice to provide information about one or more past periods for comparison purposes.

4. Cost Principle

Cost data is captured in the accounts at the original value that was spent on the item, irrespective of how long ago that was. Therefore, an asset that is shown on the books would make reference to the amount paid at the time of its purchase and not factor any inflation that has occurred since then. Therefore, it is possible to sometimes see land and buildings recorded at very low values, even though the current market price of such assets might be manifold.

5. Full Disclosure Principle

The primary audience for the financial statements are the owners / shareholders of a company, and therefore, it is expected that the accounts provide as detailed, accurate and complete picture of the company as possible. While we might focus our attention on the three summary financial statements, the statements include several notes that provide a high level of details and disclosures. Even items that may not be easily or clearly quantified can be disclosed in the notes, if they are significant enough for the investors.

6. Going Concern Principle

The accounts are prepared assuming that the business or company is operating as usual, and will continue to do so, in the foreseeable future ("going concern"). That allows certain long-term items to be presented with a degree of certainty. For instance, if a company has a lot of inventory stored in its warehouses, the financial statements reflect their actual cost because it is believed that they would be used up in due course. However, if the company were on the

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verge of being shut down, the inventory might have to be sold at a distress sale and would probably not fetch the same amount as its recorded value.

7. Revenue Recognition Principle

Financial statements are prepared on the basis of accrual of revenues, i.e. revenues are recognized (booked in the accounts) in the period when a product is sold or a service is delivered. It does not matter when the actual cash against that product or service is received (could be earlier or later or at the time of sale); what matters is the activity that leads to the revenue. In fact, it is not even required that an invoice have been generated; as long as there is reasonable evidence of the sale or service, and its value can be quantified, revenues would be booked in that period.

8. Matching Principle

This principle follows from revenue recognition and requires that expenses be matched with revenues. Therefore, expenses that are related to the generation of revenues are booked in the period when the revenue was generated, rather than when the expense was actually paid. Therefore, an employee commission or bonus which might be paid quarterly or at the end of the year, would be booked in the accounts at the time of the sale (in case of a commission) or through the year (in case of a performance bonus). Similarly, the cost of a machine that is used to generate revenues has to be accrued through the periods when it is used, giving rise to the concept of assets and depreciation.

9. Materiality Principle

This is essentially to make life easy for company management and its accountants – when faced with a dilemma, they can check if either of the options makes any 'material' difference to the overall results. For instance, while costs are recognized as assets if they have useful life beyond the current, it is possible for a relatively small cost to be treated as an expense, so that the additional hassle of recording, tracking and depreciating it over its life can be avoided.

10. Conservatism

This is also a principle that is used to break dilemmas – accountants are advised to choose the option that is conservative (or less risky for the shareholders). Therefore, an option that results in lower revenue or higher cost being recognized is better than the other way round. Essentially, we'd rather have a positive surprise (upside) in future than a downside.

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