FINANCIAL MANAGEMENT

Accounting and Auditing

Lecture No. 3


بسم الله الرحمن الرحيم

FACUALTY PROFILE

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BASICS OF ACCOUNTING


GAAP

WHY

NEEDED

HISTORY OF THE EVOLUTION OF GAAP:

- The scrutiny of the Great Depression in the USA disclosed that different accounting policies were being pursued by different companies.
- **The Securities and Exchange Commission (SEC)** and the **Committee on Accounting Procedures (CAP)** pointed out the effects of these anomalies.
- Then **USA set up in 1973 the Financial Accounting Statement Broad (FASB).**
- **FASB** develop some generally accepted rules and procedures.
- Those known as **GAAP** (Generally Accepted Accounting Principles)

THAT'S WHY NEEDED

1. Harmonisation of Accounting Practices.
2. Reduction of Fuaud and Mis-representation.
3. Standard of Accounting.
4. Defence against windo-dressing.
5. Development of International Capital Market.
6. Listing of Securities.
7. Decision for Investment.

MEANING OF ACCOUNTING PRINCIPLES AND CONCEPTS

Accounting information is used by various stakeholders. Since all the stakeholders should understand the accounting language in the same sense. Therefore, some **Rules & Regulations** and **concepts** of accounting **generally accepted** all over the word while preparation of financial statements.

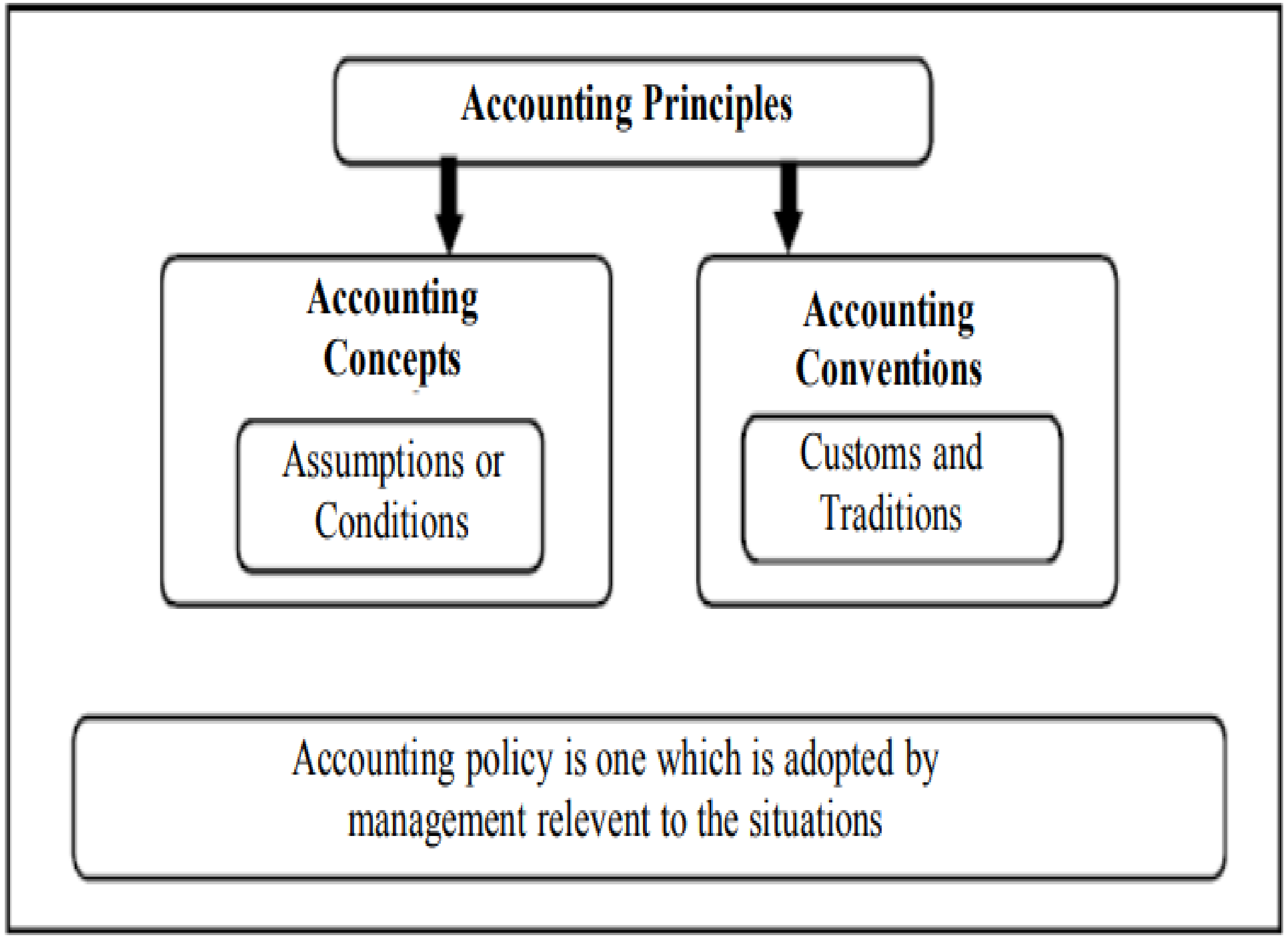
Define

Generally accepted accounting principles (GAAP) refer to a common set of accepted accounting principles, standards, and procedures that companies and their accountants must follow when they compile their financial statements.

Meaning of Accounting Principles

- Accounting principles refer to the rules and actions adopted by the accountants globally for recording accounting transactions.
- These are classified into two categories:
  - Accounting concepts
  - Accounting conventions

The principles are doctrines associated with theory and procedures and current practices of accounting. These principles may be classified as concepts and conventions



1. Accounting Concepts

- Accounting concepts include the assumptions and conditions on which the science of accounting is based.
- These are also known as accounting standards.

Concepts take the form of assumptions or conditions, which guide the accountants while preparing accounting statements.

2. Accounting Conventions

Accounting conventions include the customs and traditions that assists the accountants in preparing accounting statements.

Difference between Concepts and Conventions

Following is the difference between concepts and conventions:

1. Concepts are established by law whereas conventions are guidelines based upon customs or usage.
2. In adoption of concepts, there is no role of personal judgment where as conventions adoption is affected by personal Judgment.
3. Accounting concepts are adopted in different enterprises to bring uniformity. There cannot be uniformity in adoption of accounting conventions by different enterprises.

Accounting Principles

Accounting Concepts

1. Entity concept
2. Money measurement concept
3. Cost concept
4. Going concern concept
5. Realisation concept
6. Accrual concept
7. Dual aspect concept
8. Revenue recognition concept
9. Matching concept
10. Accounting period concept
11. Objective evidence concept

Accounting Convention

1. Convention of Disclosure
2. Convention of Materiality
3. Convention of consistency
4. Convention of Conservatism

Business Entity

Business Entity

- Meaning
  - The business and its owner(s) are two separate existence entity
  - Any private and personal incomes and expenses of the owner(s) should not be treated as the incomes and expenses of the business

- Examples
  - Insurance premiums for the owner's house should be excluded from the expense of the business
  - The owner's property should not be included in the premises account of the business
  - Any payments for the owner's personal expenses by the business will be treated as drawings and reduced the owner's capital contribution in the business

Money Measurement

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Money Measurement

- Meaning
  - All transactions of the business are recorded in terms of money
  - It provides a common unit of measurement
- Examples
  - Market conditions, technological changes and the efficiency of management would not be disclosed in the accounts

Going Concern Concept

Going Concern

- Meaning
  - The business will continue in operational existence for the foreseeable future
  - Financial statements should be prepared on a going concern basis unless management either intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so

- Example
  - Possible losses form the closure of business will not be anticipated in the accounts
  - Prepayments, depreciation provisions may be carried forward in the expectation of proper matching against the revenues of future periods
  - Fixed assets are recorded at historical cost

Historical Cost

Historical Cost

- Meaning
  - Assets should be shown on the balance sheet at the cost of purchase instead of current value
- Example
  - The cost of fixed assets is recorded at the date of acquisition cost. The acquisition cost includes all expenditure made to prepare the asset for its intended use. It included the invoice price of the assets, freight charges, insurance or installation costs

Prudence/Conservatism

PRUDENCE/CONSERVATISM

- Meaning
  - Revenues and profits are not anticipated. Only realized profits with reasonable certainty are recognized in the profit and loss account
  - However, provision is made for all known expenses and losses whether the amount is known for certain or just an estimation
  - This treatment minimizes the reported profits and the valuation of assets

- Example
  - Stock valuation sticks to rule of the lower of cost and net realizable value
  - The provision for doubtful debts should be made
  - Fixed assets must be depreciated over their useful economic lives

MATERIALITY

Materiality

- Meaning
  - Immaterial amounts may be aggregated with the amounts of a similar nature or function and need not be presented separately
  - Materiality depends on the size and nature of the item

- Example
  - Small payments such as postage, stationery and cleaning expenses should not be disclosed separately. They should be grouped together as sundry expenses
  - The cost of small-valued assets such as pencil sharpeners and paper clips should be written off to the profit and loss account as revenue expenditures, although they can last for more than one accounting period

Objectivity

Objectivity

- Meaning
  - The accounting information should be free from bias and capable of independent verification
  - The information should be based upon verifiable evidence such as invoices or contracts

Objectivity concept in accounting is referred to as the principle which states that financial statements should be **objective in nature**.

In other words, the financial information **should be unbiased and free from any kind of internal and external influence**.

- Example
  - The recognition of revenue should be based on verifiable evidence such as the delivery of goods or the issue of invoices

Consistency

Consistency

- Meaning
  - Companies should choose the most suitable accounting methods and treatments, and consistently apply them in every period
  - Changes are permitted only when the new method is considered better and can reflect the true and fair view of the financial position of the company
  - The change and its effect on profits should be disclosed in the financial statements

- Examples
  - If a company adopts straight line method and should not be changed to adopt reducing balance method in other period
  - If a company adopts weight-average method as stock valuation and should not be changed to other method e.g. first-in-first-out method

Matching

MATCHING

- Meaning

The **matching principle** requires that revenues and any related expenses be recognized together in the same reporting period.

According to which a business needs to record its expenses in the same period of time as the revenues that they are related with.

- Example

Depreciation of any fixed assets i.e Building depreciation should be deducted year to year basis in which earning from building incurred.

Realization

Realization

Meaning

- Revenues should be recognized when the major economic activities have been completed
- The realization principle is the concept that **revenue can only be recognized once the underlying goods or services associated with the revenue have been delivered or rendered**, respectively. Thus, revenue can only be recognized after it has been earned.

  i.e Only contract for sale is not considered as sale done.

- Example
  - **The customer pays when the item ships, but you can only record the transaction as revenue when the customer receives the shoes and the process is complete**. Then, you can recognize the revenue and record the amount in your client's ledger.

Disclosure

Disclosure

- Meaning
  - Financial statements should be prepared to reflect a true and fair view of the financial position and performance of the enterprise
  - All material and relevant information must be disclosed in the financial statements

Uniformity

Uniformity

- Meaning
  - Different companies within the same industry should adopt the same accounting methods and treatments for like transactions
  - The practice enables inter-company comparisons of their financial positions

Relevance

Relevance

- Meaning
  - Financial statements should be prepared to meet the objectives of the users
  - Relevant information which can satisfy the needs of most users is selected and recorded in the financial statement

QUESTION OF THE DAY

EXPLORE UR NERVES….

DISCUSS WHY GAAP PRINCIPLES ARE IMPORTANT IN FINANCIAL ACCOUNTING. GIVE EXAMPLES OF VARIOUS TRANSACTIONS FOUND IN MOST OF ORGANIZATIONS AND WHICH GAAP PRINCIPLES WOULD APPLY???
(specify your arguments with transactions)


Thank
You


Q&A
You have
Questions
We have
Answers