Chapter - IV

GENERALLY ACCEPTED

ACCOUNTING PRINCIPLES
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4.1. Introduction:

In order to bring uniformity in terminology, approach and presentation of accounting result, the institute of chartered accountants of India established on 22nd April 1977, an accounting standards board (ASB). The main function of the ASB is to formulate accounting standards so that such standards will be established by the council of institute of chartered accountants, while formulating the accounting standards, the ASB will give due consideration to the international accounting standards and try to integrate them to the extent possible. It will also take in to account the applicable laws, customs, usage and the business environments prevailing in India.

4.2. The Accounting standards:

AS-1: Disclosure of accounting policies- effect from 1-4-1991,

AS-2: Valuation of inventory effect from 1-4-1999.


AS-4: Contingencies and events occurring after balance sheet date, effect from 1-4-1995.

AS-5: Net profit or loss, prior period items and changes in accounting policies, effect from 1-4-1996.

AS-6: Depreciation accounting, effect from 1-4-1995.

AS-7: Accounting for construction contracts, effect from 1-4-1991.

AS-8: Accounting for research and development, effect from 1-4-1991.


AS-10: Accounting for fixed assets, effect from 1-4-1991.
AS-11: Accounting for effect of changes in foreign exchange rate, effect from 1-4-1995.

AS-12: Accounting for Government grants, effect from 1-4-1994.

AS-13: Accounting for investments, effect from 1-4-1995.

AS-14: Accounting for amalgamation, effect from 1-4-1994.

AS-15: Accounting for retirement benefits in the financial statement of employers, effect from 1-4-1995.

AS-16: Borrowing costs, effect from 1-4-2000

AS-17: Segment reporting, effect from 1-4-2001.


AS-20: Consolidated financial statements, effect from 1-4-2001.

AS-21: Earning per share, effect from 1-4-2001.


AS-24: Discontinuing operations, effect from 1-4-2002.

AS-25: Interim financial reporting, effect from 1-4-2002.

AS-26: Intangible assets, effect from 1-4-2003.


Besides the above twenty-seven accounting statements, the ASB had issued the accounting terminology. The tasks of formulating statements on accounting for financing costs, accounting for current assets and current
liabilities, financial instruments accounting for disclosure by banks and financial institutions etc. has been taken up. In addition to that task of preparation of a framework for the preparation and presentation of financial statements has also been undertaken. ASB is thus on the move. Its efforts are directed at establishing accounting standards which will be adopted by management's of different enterprises and will definitely result in the improvement of quality of presentation of financial statements in India.

4.3. Disclosure of accounting policies:
The main feature of the standard AS.1 announced by the ASB, regarding disclosure of accounting policies are as follows:-

A) Fundamental accounting assumptions:

1) Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed.

2) Fundamental accounting assumptions are:

   a) **Going concern**: The enterprise is normally viewed as a going concern, as continuing in operation for foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity for liquidation or of curtailing materially the scale of its operations.

   b) **Consistency**: It is assumed that accounting policies are consistent from one period to another.

   c) **Accrual**: Revenue and costs are accrual i.e., recognized
as they are earned or incurred (and not as money is received or
paid) and recorded in the financial statements of the periods to
which they relate (the considerations affecting the process of
matching costs with revenues under the accrual are not
dealt with in the statement.

In case any of the above fundamental accounting assumptions is not followed,
the fact should be disclosed in the financial statements together with reasons.

**B) Accounting policies:**

1) Accounting policies refer to the specific accounting principle and
standards of applying those principles adopted by enterprises in the
preparation and presenting of financial statements. There is no single
list of accounting policies which are applicable to all circumstances.
The different circumstances in which the enterprise operate in a
situation of diverse and complex economic activity make alternative
accounting principles and methods of applying those principles
acceptable. The choice of appropriate accounting principle in the
specific circumstances of each enterprise calls for considerable
judgement by the management of the enterprise.

Following are the example of the areas in which different accounting
policies maybe adopted by different enterprises.

   a) Methods of depreciation, depletion and amortization.

   b) Treatment of expenditure during the construction.

   c) Conversion or translation of foreign currency items.
d) Valuation of inventories.

e) Treatment of goodwill.

f) Valuation of investments.

g) Treatment of retirement benefits.

h) Recognition of profit on long term contracts.

i) Valuation of fixed assets.

j) Treatment of contingent liabilities.

2) The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies, should represent a true and fair view of the state of affairs of the enterprise, as at the balance sheet date and of the period ended on that date. For this purpose, the major considerations governing the selection of and application of accounting policies are:-

a) Prudence: Uncertainties inevitable surround many transactions. This should be recognized by exercising prudence in preparing financial statements; prudence does not however justify the creation of secret or hidden resources.

b) Substance over form: Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

c) Materiality: Financial statements should disclose all items, which are material enough to affect evaluation or decisions.
3) To ensure proper understanding of financial statements, all significant accounting policies adopted in the preparation should be disclosed.

4) The disclosure of significant accounting policies as such should form a part of financial statements and the significant accounting policies should normally be disclosed at one place.

5) Any changes in accounting policy which has a material effect in the current period or which is reasonably expected to have a material in the later periods should be disclosed, in the case of a change in the accounting policy, which has a material effect in the current period, the amount by which an item, in the financial statement is by such a change should be disclosed to all ascertainable. Where such an amount is not ascertainable wholly or in part, the fact should be indicated.

4.4. System of Book Keeping:

Booking is an art of recording pecuniary or business transactions in a regular and systematic manner. This recording of transactions may be done according to any of the following two systems.

A) Single entry system

An incomplete double entry system can be termed as a single entry system. According to Kohler"it is a system of book keeping in which as a rule only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances. This system has been developed by some business, who for their convenience keep only some essential records.
Since all records are not kept, the system is not reliable and can be used only by small firms."

**B) Double entry system:**

The system of double entry book keeping which is believed to have originated with the Venetian merchants of the fifteenth century, is the only system of recording the two fold aspect of the transaction. This has been to some extent related with the dual aspect concept. The system recognizes that every transaction have a two fold effect. If some one receives something that either some other person must have given it, or the first mentioned person must have lost something, or some service etc. must have been rendered by him.

**C) Accounting equation:**

The system of double entry system of book keeping can very well be explained by the accounting equation:-

\[ \text{Assets} = \text{equities}. \]

The properties owned by business are called assets. The rights to the properties are called equities, may be sub divided in to two principles types, the rights of the creditors and the rights of the owners. The equity of creditors representing debts of the business are called liabilities. The equity of owners is called capital or proprietor ship or owner equity. Thus:

\[ \text{Assets} = \text{liabilities} + \text{capital}. \]

\[ \text{Assets} - \text{liabilities} = \text{capital}. \]
4.5. System of accounting:

There are basically two systems of accounting:

A) Cash system of accounting:

It is a system in which accounting entries are made only when cash is received or paid. No entry is made when a payment or receipts is merely due. Government system of accounting is mostly on the cash system. Certain professional people record their income on cash basis, but while recording expenses they take into account the outstanding expenses also. In such a case, the financial statement prepared by them for determination of their income is termed as receipts and expenditure account.

B) Mercantile or accrual system of accounting:

It is a system in which accounting entries are made on the basis of amounts having become due for payment or receipt. This system recognizes the fact that if a transaction or event has occurred, its consequences cannot be avoided and therefore should enter in to books in order to present a meaningful picture of profit earned or loss suffered and also of the financial position of the firm concerned. The difference between cash system and mercantile system of accounting will be clear with the help of following example. A firm close its books on 31st Dec each year. A sum of Rs 500 has become due for payment on account of rent for the year 2000. The amount has however been paid in Jan 2001. In this case, if the firm is following cash system of accounting, no entry will be made for the rent having become due in the books of accounts of the firm in 2000. The entry will be made only in Jan 2000 when the rent is
actually paid. However if the firm is following mercantile system of accounting, two entry will be made; 1) On 31st Dec 2000 rent account will be debited while the landlords account will be credited by the amount of outstanding rent. 2) In Jan 2000, landlords account will be debited while the cash account will be credited with the amount of the rent actually paid. The mercantile system is considered to be better since it take in to account the effects of all transactions already entered into. This system is followed by most of the industrial and commercial firms.

4.6. Journalizing transactions:

The journal records all daily transactions of a business in to the order in which they occur. A journal may therefore be defined as a book containing a chronological record of transactions. It is the book in which the transactions are recorded first of all under the double entry system. Thus journal is the books of original record. A journal does not replace but precedes the ledger. The process of recording transactions in a journal is termed as journalizing.

A Performa of journal is given below.

<table>
<thead>
<tr>
<th>Journal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
</tr>
<tr>
<td>(1)</td>
</tr>
</tbody>
</table>

1) **Date**: The date on which the transaction was entered is recorded.

2) **Particulars**: The two aspects of transactions are recorded in this
column, i.e. The details regarding accounts which have to be debited and credited.

3) L.F: It means ledger folio. The transactions entered in the journal are later on posted to the ledger. The relevant ledger folio is entered here. Procedure regarding posting the transactions in the ledger is indicated.

A) Rules of debit and credit:
The transactions in the journal are recorded on the basis of the rules of debit and credit. For this purpose business transactions have been classified into three categories:

1) Transactions relating to persons.
2) Transactions relating to properties and assets.
3) Transactions relating to incomes and expenses.

On the basis of, it becomes necessary for the business to keep an account of:

   a) Each person with whom it deals.
   b) Each property or asset which the business owns.
   c) Each item of income or expense.

The account falling under the first heading called personal accounts. The accounts falling under second heading are termed as real accounts. The accounts falling under the third heading are termed as nominal accounts. The classification of the accounts as explained above can be put in the form of the following chart.
Each of the above categories of accounts and the relevant rule for debit and credit has been explained as follows:

B) Personal accounts:

The personal accounts include the accounts of persons with whom the business deals. These accounts can be classified into three categories.

1) Natural personal accounts: The term natural personal means persons who are creation of God. For example, Mohans account, Sohans account etc.

2) Artificial personal accounts: These accounts include accounts of corporate bodies or institutions, which are recognized as persons in business dealings. For example, the account of a limited company, the
account of a cooperate society, the account of a club, the account of Government etc.

3) **Representative personal account:** There are accounts represent a certain person or group of persons. For example, if the rent is due to the landlord, an outstanding rent account will be opened in the books. Similarly for salaries due to the employees (not paid) an outstanding salaries account will be opened. The outstanding rent account represents the account of the landlord to whom the rent is to be paid while the outstanding salaries account represents the account of the persons to whom the salaries have to be paid. All such accounts are therefore termed as representative personal accounts. The rule is "Debit the receiver and Credit the giver."

C) **Real accounts:** The real accounts may be of the following types:

1) **Tangible real accounts:**

Tangible real accounts are those relate to such things which can be touched, felt, measured etc. Example of such accounts are cash account, building account, furniture account, stock account etc. It should be noted that bank account is a personal account, since it represents the account of the banking company an artificial person.

2) **Intangible real accounts:**

These accounts represent such things which can not be touched, of course they can be measured in terms of money. For example, patents accounts,
good will account etc. the rule is "Debit what comes in and Credit what goes out."

For example if a building has been purchased for cash, building account should be debited, since it is coming in the business, while cash account should be credited, since cash is going out the business similarly when furniture is purchased for cash, furniture account should be debited, while the cash account should be credited.

C) Nominal accounts:

These accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business, salary is paid to the manager, rent is paid to the landlord. Commission is paid to the salesman, cash goes out of the business and it is some thing real, while salary, rent or commission as such do not exist, the accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information it may be difficult for the person concerned to explain how the cash at his disposal was utilized. Nominal accounts include accounts of all expenditures, losses, incomes and gains. The examples of such accounts are rent, rates, lighting, insurance, dividends, and loss by fire etc. the rule is "Debit all expenses and losses, Credit all gains and incomes." Both real account and nominal accounts come in the category of impersonal accounts. It should be noted that when some prefix or suffix is added to a nominal account, it becomes a personal account.
The following table explain the above rule:

<table>
<thead>
<tr>
<th>No.</th>
<th>Nominal account</th>
<th>Personal account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Rent account.</td>
<td>Nominal account Personal account Rent prepaid account, outstanding rent account.</td>
</tr>
<tr>
<td>2</td>
<td>Interest account</td>
<td>Outstanding interest account, interest received in advance account, paid interest account</td>
</tr>
<tr>
<td>3</td>
<td>Salary account</td>
<td>Outstanding salaries account, prepaid salaries account.</td>
</tr>
<tr>
<td>4</td>
<td>Insurance account</td>
<td>Outstanding insurance account prepaid Insurance account.</td>
</tr>
<tr>
<td>5</td>
<td>Commission account.</td>
<td>Outstanding commission account, prepaid commissions</td>
</tr>
</tbody>
</table>

4.7. Compound journal entry:

Sometimes these are a number of transactions on the same relating to one particular account or to one particular nature. Such transactions may be recorded by means of a single journal entry instead of passing several journal entries. Such entry regarding recording a number of transactions is termed as a compound journal entry. It may be recorded in any of the following ways.

1. One particular account may be debited while several other accounts may be credited.

2. One particular account may be credited and several other accounts may be debited.

3. Several account my be debited and several accounts may be credited.

In this regard it is worth while to indicate the classification of goods account.
A) Classification of goods account:

The term goods include articles purchased by the business for resale. Goods purchased by the business may be returned back to the supplier. Similarly goods sold by the business to its customers can also be returned by the customers back to the business due to certain reasons. In business it is desired that a separate record be kept of all sale, purchase and return of goods. Hence goods account can be classified into the following categories:

1) Purchases Account:

The account is meant for recording all purchases of goods come in on purchasing goods and therefore the purchase account is debited on purchase of goods.

2) Sales account:

The account is meant for recording of selling of goods. The goods go out on selling of goods and therefore on sale of goods, the sales account is credited.

3) Purchases return account:

The account is meant for recording return of goods purchased. The goods go out on returning of goods to the suppliers and therefore, the account should be credited on returning goods purchased.

4) Sales returns account:

The account is meant for recording return of goods sold, by the customers. The goods come in and therefore, the sales returns account should be debited on return of goods. When goods are withdrawn by the proprietor
of the business for his personal use, he is to be charged for them since business and the proprietor are two different persons as per separate entry concept. The problem is at what price should he be charged? He cannot be charged at the selling price for the goods. It will not be fair. He has to be charged with only the cost price of the goods withdrawn by him. It will be therefore, appropriate to reduce the purchase of the business by the amount of goods withdrawn by the proprietor for his personal use if the goods were purchased partly for the business and partly for him.

4.8. Rules for ledger posting:

A) Ledger:

Ledger is a book which contains various accounts. In other words, ledger is the set of accounts. It contains all account of the business enterprise whether real, nominal or personal. It may be kept in any of following two forms:

1) Bound ledger.

2) Loose leaf ledger.

It is common to keep the ledger in the form of loose cards these days. This helps in posting transactions particularly when mechanized system of accounting is used.

B) Posting:

The term posting means transferring the debit and credit items from the journal to their respective accounts on the ledger. It should be noted that the exact names of accounts used in the journal should be carried to the
ledger for example, expenses account has been debited, it would not be correct to debit the office expenses account in the ledger. Though in the journal, it might have been indicated clearly in the narration that it is an item of office expenses. The correct course would have to be to record the amount to the office expenses account in the journal as well as in the ledger. Posting may be done at any time. However it should be completed before the financial statements are prepared, it is advisable to keep the more active accounts posted to date. The example of such accounts are the cash account, personal account of various parties.

C) Method of posting:
The posting may be done by the book keeper from the journal to the ledger by any of the following methods.

1) He may take a particular side first. For example, he may take the debit first and make the complete postings of all debits from the journal to ledger.

2) He may take a particular account and post all debits and credit relating to that account appearing on one particular page of the journal. He may then take some other accounts and follow the same procedure.

3) He may complete posting of each journal entry before proceeding to the next journal entry.

It is advisable to follow the last method. One should post each debit and credit item as it appears in the journal. The ledger folio (LF) column in the journal is
used at the time when debit and credit are posted to the ledger. The page number of the ledger on which the posting has done is mentioned in the L.F column of the journal. Similarly a folio column in the ledger can also be kept where the page from which posting has been done from the journal may be mentioned. Thus there are cross-references in the journal and the ledger. A proper index should be maintained in the ledger giving the names of the accounts and the page numbers.

D) Rules regarding posting:
The following rules should be observed while posting transactions in the ledger from the journal.

1) Separate Accounts should be observed while posting transactions in the ledger relating to different accounts recorded in the journal. For example, separate accounts may be opened for sales, purchases, sales returns, purchases returns, salaries, rent, cash, etc.

2) The concerned account, which has been debited in the journal, should also be debited in the ledger. However, a reference should be made of the other account which has been credited in the journal. For example, salaries paid, the salaries account should be debited to the ledger, but reference should be given of the cash account, which has been credited in the journal.

3) The concerned account, which has been credited in the journal should also be credited in the ledger, but reference should be given of the account in the journal. For example, for salaries paid, cash account has
been credited in the journal. It will be credited in the ledger also, but reference will be given of the salaries account in the ledger. Thus it may be concluded that while making posting in the concerned account which has been debited or credited in the journal should be debited or credited in the ledger, but reference has to be given of the other account which has been credited in the journal, as the case may be.

E) The use of words "To" and "By":

It is customary to use words "To" and "By" while making posting in the ledger. The word "To" is used with the accounts, which appear on the debit side of a ledger account. For example in the salaries account, instead of writing only cash, the words “To cash” will appear on the debit side of the account. Similarly the word “By” is used with accounts which appear on the credit side of a ledger account. For example the words "By salaries A/C" will appear on the credit side of the cash account instead of only salaries A/C. the words "To and By," do not have specific meaning. Modern accountants are therefore ignoring the use of these words.

F) Balancing of an account:

In the business, there may be several transactions relating to one particular account. In journal these transactions appear on different pages in a chronological order while they appear in a classified from under that particular account in the ledger. At the end of a period, the businessman will be interested in knowing the position of particular account. This means he should total the debits and credits of the account separately and find out the net
balance. This technique of finding out the net balance of an account, after considering the total of both debit and credit appearing in the account is known as balancing the account. The balance is put on the side of the account which is smaller and a reference is given that it has been carried forward or carried down to the next period. On the other hand, in next period a reference is given that the opening has been brought the forward or brought down from the previous period. It is to be noted that the balance of an account is always known by the side, which is greater. For example, the debit side of the cash account is greater than the credit side. It will be therefore said that the cash account is showing a debit balance; similarly, the credit side of capital account is greater then debit side. It will be therefore said that the capital account is showing a credit balance.

4.9) Rules for preparing trial balance:

When the various debit balances and the credit balances of the different accounts are taken down in a statement, such a statement so prepared is termed as a trail balance. In the other words, trial balance is a statement containing the various ledger balances on a particular date. For example, with the balances of the ledger accounts prepared in the illustration the trial balance can be prepared as:-

132
**Trial Balance**

<table>
<thead>
<tr>
<th></th>
<th>Debit Rs.</th>
<th>Credit Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Account</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td>Capital Account</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Purchase Account</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Mohan Account</td>
<td></td>
<td>2,000</td>
</tr>
<tr>
<td>Sales Account</td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>16,000</strong></td>
<td><strong>16,000</strong></td>
</tr>
</tbody>
</table>

**a) Methods of preparing trial balance:**

A trial balance may be prepared according to any of the two methods.

1) **Total method:** In case of this method, the totals of debit and credit of the accounts are shown in the trial balance. Trial balance is prepared before ledger accounts are balanced. The totals of the debit and credit column of the trial balance must be equal. This method is not popular.

2) **Balance method:** In case of this method, the balance of the ledger accounts are shown in the respective debit and credit columns of the debit column must be equal to the total balance of credit column. This is the most column method of preparing a trial balance.
It has been already indicated that a journal is a book of prime entry. It means all business transactions are to be first recorded in the journal. However in a big business recording of all transactions in one journal will not be inconvenient, but also cause delay in collecting information recorded. The journal is therefore sub divided in to many subsidiary books.

A) **Special journal**: The term special journal means a journal, which is meant for a special purpose. The following are the various types of special journals.

1) **Cash journal**: The cash journal is meant for recording all cash transactions. It may be further classified in to cash receipts journal and cash payments journal. Cash receipts journal records all cash receipts, which cash payments journal records all cash payments.

2) **Goods journal**: The journal is meant for recording all transactions relating to goods. It may further be classified in to following categories:

   a) **Purchase journal**: The journal is meant for recording all credit purchase of goods. Cash purchases are to be recorded in the cash journal. Moreover only purchases of goods is to be recorded in this journal. The term goods means articles purchased for resale.

   b) **Sales journal**: The journal is meant for recording all credit sales of goods. Cash sales of the goods are to be recorded in the cash journal.
c) **Purchase return journal**: The journal is meant for recording all returns of goods purchased on credit. It is also known as returns outward journal.

d) **Sales returns journal**: It is meant for recording all returns of goods sold on credit, it is also known as returns inward journal.

3) **Bill Journal**:  
The journal is meant for recording all bills of exchange, or promissory notes received or issued by the business. They are two types:

a) **Bills receivable journal**: It is meant for recording all bills of exchange or promissory notes received by the business from its debtors.

b) **Bills payable journal**: It is meant for recording all bills of exchange or promissory notes issued by the business in favour of its creditors.

B) **General journal**:  
It is also known as a journal proper. It is meant for recording all such transactions for which no special journal has been kept by the business, a matter of fact it is meant for recording such transactions which do not occur frequently hi the business and therefore do not warrant setting up special journals. Examples of such transactions are as follows:

1) **Opening Entries**: When a new set of books is started, the old accounts have to be brought forward in the beginning of the year from last
books. The opening entries are meant for recording these transactions. The entries are made from the balance sheet of the last year.

2) **Closing Entries:** At the end of accounting year, the nominal accounts are closed by transferring them to trading account or profit or loss account. The entries made are termed as closing entries.

3) **Adjustment Entries:** At the end of the accounting year adjustment entries are to be passed for outstanding and prepaid expenses, accrued / outstanding income etc, entries for all these adjustment are passed in the general journal.

4) **Transfer Entries:** Transfer entries are required for transferring one account to the other. Entries for such transfer are passed in the general journal.

5) **Rectification Entries:** The rectification entries are passed for rectifying the errors, which might have been committed in the books of account. For example, the account of Rama might have been debited in place of the account of Krishna, the necessary rectifying entry will be passed in the general journal.

6) **Purchases Of Fixed Assets:** The entries for purchases of fixed assets such as plant, machinery etc. on credit is passed in this journal.
The practice and procedure of accounting is determined by the generally accepted accounting standards and rules. This rules and standard are developed by accounting bodies, which are established by government from time to time. It is mandatory that each and every firm should follow these accounting standards rules pertaining to the preparation of accounts. Due to this reason, in this chapter efforts are made to describe various standards and rules formulated by accounting bodies for the preparation of accounts.

4.11 Conclusion:

The practice and procedure of accounting is determined by the generally accepted accounting standards and rules. This rules and standard are developed by accounting bodies, which are established by government from time to time. It is mandatory that each and every firm should follow these accounting standards rules pertaining to the preparation of accounts. Due to this reason, in this chapter efforts are made to describe various standards and rules formulated by accounting bodies for the preparation of accounts.