Financial Accounting
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Lecture – 12
1.11 Generally Accepted Accounting Principles I

In this video, I am going to talk about Generally Accepted Accounting Principles. By now you must be familiar with the 4 key accounting terms, which are assets, liabilities, incomes and expenses. The next step is to learn how the records are going to be prepared for various transactions that fall into these 4 categories. But before we learn the process of recording, classifying and summarizing we need to agree upon certain ground rules. Generally Accepted Accounting Principles or in short called GAAP are the ground rules for preparing the financial statements.

Let us look at these Generally Accepted Accounting Principles.

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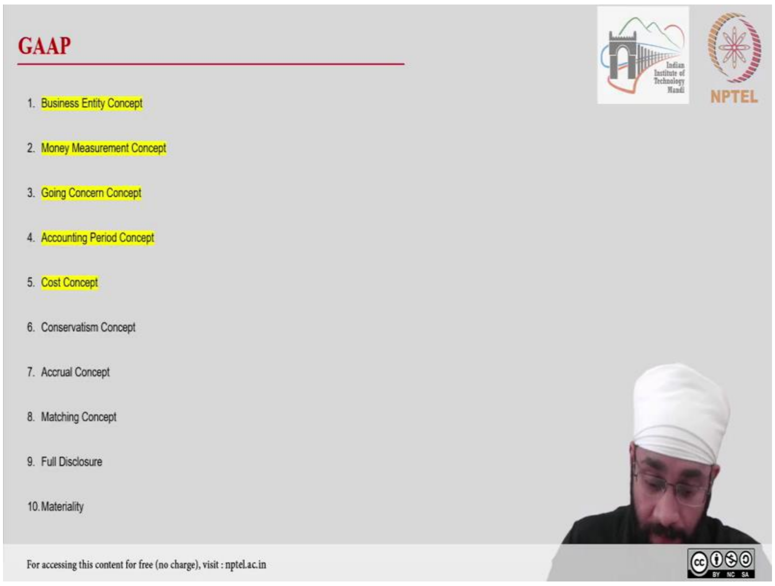

I am going to discuss about 10 of these. There are a few more, if you look at different textbooks, you have different lists, but everybody would agree on these ten accounting principles. And in this video, I am going to address 5 of these and then the remaining 5 will be addressed in the following video.

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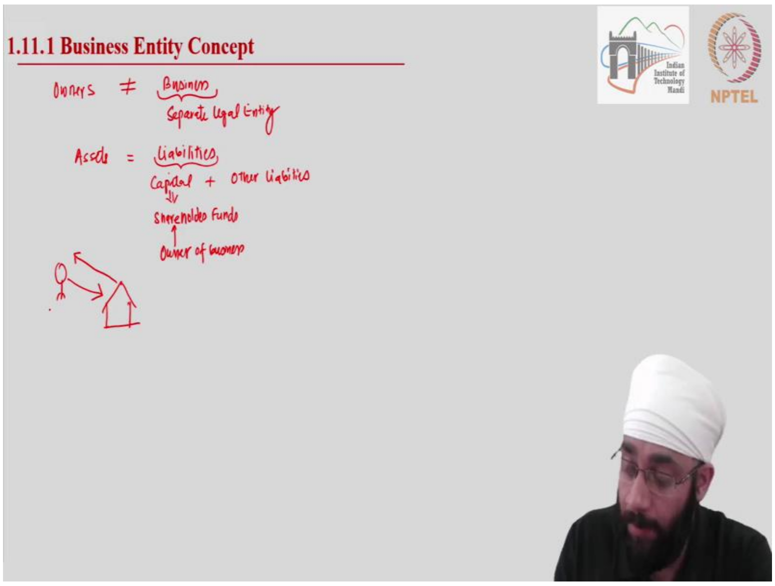

The first generally accepted accounting principle is called the principle of business entity or also referred to as business entity concept. This principle means that the owners of the business and the business itself, are not the same. We have to create a clear distinction between owner's transactions and business's transactions. You cannot mix the two.

The business is a separate legal entity. The business is a separate legal entity and hence the name business entity principle. The business has its own entity, so you should not mix it up with the transaction, the personal transactions of the owner. And we saw a proof of this in the accounting equation. The accounting equation is assets equals to liabilities and if you look into more details on the liability side you have capital and you have the rest of liabilities. I am just writing this to illustrate to you how owners are kept separate from the business. Now, what is capital? The capital is the contribution that is made by shareholders, the shareholders' funds. Who is a shareholder? Shareholder is the part owner of the business. Therefore, what is happening is that in the business we are creating a new liability, the company has to return this money to the owner. A business unit has to return this capital to the owner at some point in time. So, we create owner's money and we treat owner's money as a liability for the business: that is what entity concept of the business means.

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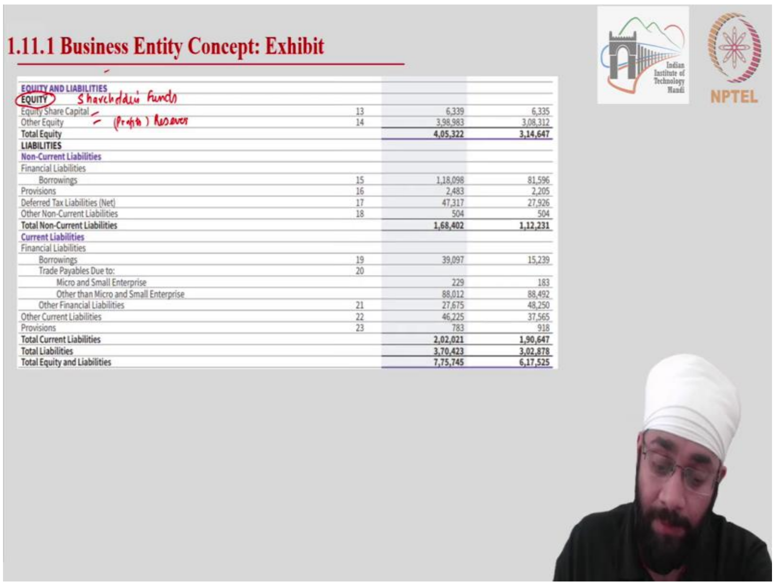

Let me give you a quick exhibit of this as well. We looked at Reliance Industry Limited's balance sheet. This is the equity side of the balance sheet. And I told you that this equity is what represents shareholder's funds, shareholder's funds, the money brought in by shareholders. And there is a head called other equity which is essentially the profits which are accumulated over a period of time; this section has the reserves of profit that you accumulate over a period of time. Both of these are owed by the business to the owner of the business.So, there you go that is the business entity concept. This is the most important concept of all. Most of the time, in the process of recording, classifying and summarizing the transactions, you might get confused and mix up the transactions of individuals and businesses.

While writing in the books of accounts, you always have to think that you are the business. You are not writing in your personal books, you are writing in business books. So, if business was a real person what would it write in its books of accounts? More on that when we go to the process of recording.

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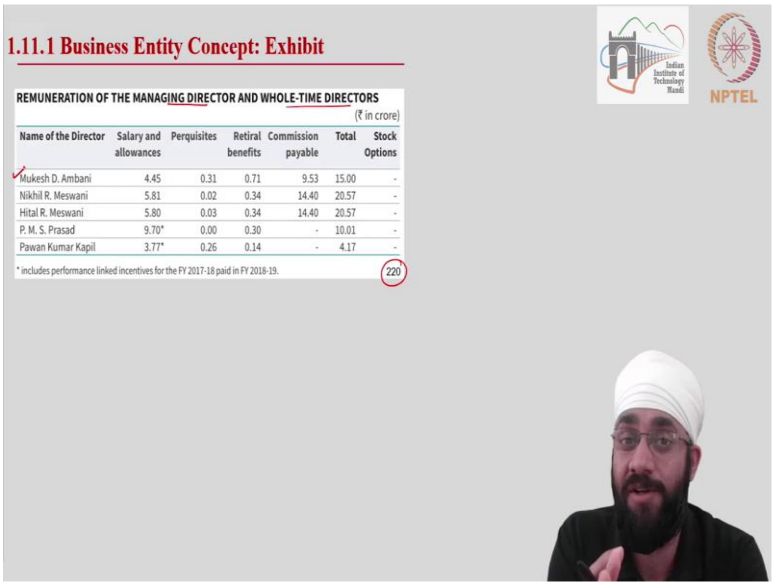

Another example of the business entity concept can be seen in an excerpt from the annual report of Reliance Industries. On page number 220, you can see the remuneration of the managing director and the whole time directors. You know that Mr. Mukesh Ambani is the owner, the promoter and the owner or promoter is getting paid by the business as well. So, not only the owner supplies capital to the business and earns profits on that capital, the owner also works for the business, is employed by the business and the owner can demand or the company can pay remuneration for the day-to-day regular services of the owner.

That is another proof or an exhibit to tell you how companies treat owners separately, although the company will not have an existence if the owners do not exist. But in the eyes of law, the company is an artificial legal person. So, you have to treat it like that. You have to keep the records of the company separate.

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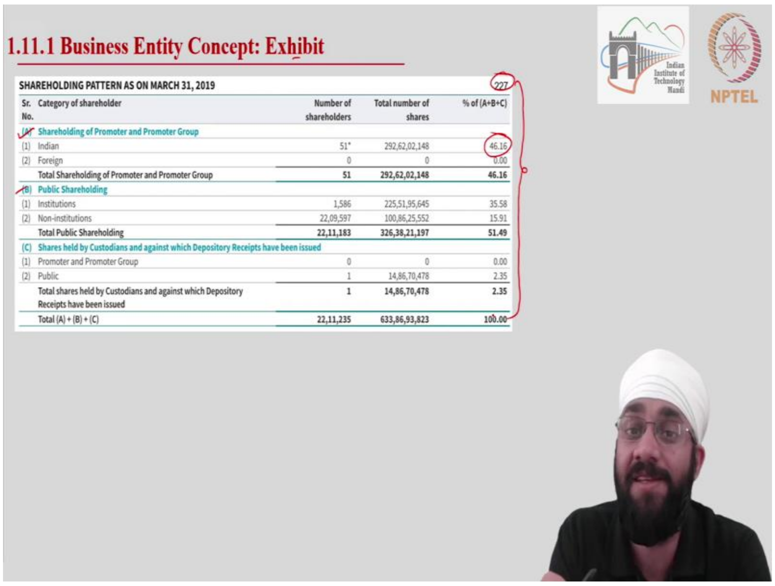

SHAREHOLDING PATTERN AS ON MARCH 31, 2019 — 227

Sr. No.	Category of shareholder	Number of shareholders	Total number of shares	% of (A+B+C)
(A)	Shareholding of Promoter and Promoter Group			
(1)	Indian	51*	292,62,02,148	46.16
(2)	Foreign	0	0	0.00
	Total Shareholding of Promoter and Promoter Group	51	292,62,02,148	46.16
(B)	Public Shareholding			
(1)	Institutions	1,586	225,51,95,645	35.58
(2)	Non-institutions	22,09,597	100,86,25,552	15.91
	Total Public Shareholding	22,11,183	326,38,21,197	51.49
(C)	Shares held by Custodians and against which Depository Receipts have been issued			
(1)	Promoter and Promoter Group	0	0	0.00
(2)	Public	1	14,86,70,478	2.35
	Total shares held by Custodians and against which Depository Receipts have been issued	1	14,86,70,478	2.35
	Total (A) + (B) + (C)	22,11,235	633,86,93,823	100.00

For another detailed exhibit, go to page number 227 in the annual report and you can see that the promoters shareholding is 46 percent in the company and then there is public shareholding. All these people are the owners of the business and the business reports as to who is it owned by. Just to create that distinction that we are owned by these different investors, all these people are owners, but they are separate from the business. The business owes to all these different categories of people, ok.

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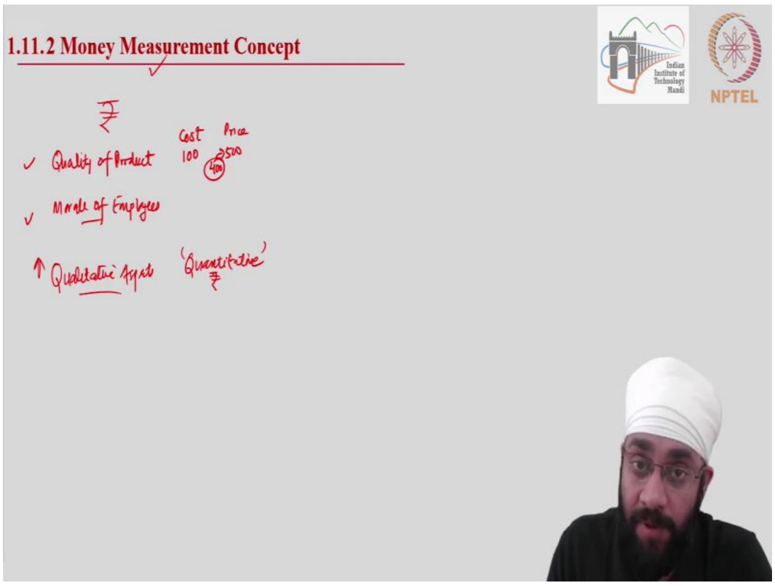

That was the first principle. Let us move on to another principle which is called money measurement concept or principle of money measurement. This is very simple. What it means is you can only record the transactions which can be expressed in terms of money. In the books of accounting, if you cannot express something in terms of money, something does not have monetary value, it is not possible to record that in the books of accounts, right. So, it is all about money. There are things which can be important for the business. For example, the quality of the product. Is it important for business? Yes, it is important. Does the sale depend upon the quality of the product? It does. But can you express the quality of a product in money? Is there a transaction that happens in terms of the quality of the product? No, it does not happen. You cannot express it in terms of money. The best thing that you can do is charge a higher price, and when you charge a higher price you know that is taken care of in a sale transaction. For example, if your cost is 100 and you are charging, let us say, 500 for it because the quality of the product is very high because you put in a lot of resources material or there are lots of overheads - despite the competitor selling at 400- you selling at 500 reflects the quality perception; your perception of the quality of the product.

However, can we directly write in the balance sheet of the company that the quality of the product is an asset for us? In general discussion, in common parlance, people talk like that. The biggest asset for our company is the quality of the product, but you have to create a distinction between the English language and the accounting language. In accounting language, assets have a very specific meaning. The quality of the product is not the asset. The asset is something on which you spend the money for a longer duration of time and that specific asset helps you build capacity to generate more income over a period of time. And now, we have learnt a ground rule to add to it that we should be able to express this asset's value in terms of money. If you cannot, you cannot record it in the books of accounts.

Similarly, you can talk about the morale of employees. If the employees are not motivated, they will not be productive, they will not be efficient, they will not contribute positively to the business that is going to affect the internal functioning of the organization and also the output which organization delivers. However, can you express the morale of the employees in terms of money? Well, there is no transaction again that happens. You could pay them more. If you pay them more, maybe they will be more motivated, but when you pay them more their salaries go up and you record that as an increased salary, that is it, but you do not write it down in the books of accounts as the morale of employees. So, do understand, you have to create a distinction between the qualitative aspects and the quantitative aspects. You have to be very clear that although the qualitative aspects of business may have high importance, they do affect the output of an organization. Only things that you can record in the books of account are quantitative numbers and also in terms of money. That is the money measurement principle for you.

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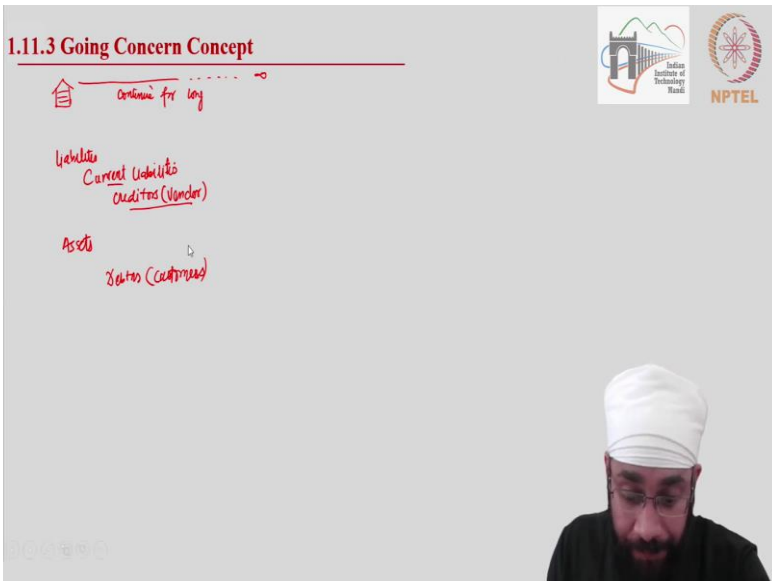

Let us talk about another principle which is going concern, the principle of going concern. What does it mean? This means when a company is formed- an artificial legal person-what is the age of the artificial legal person? For a real person the average age in India is about 65. So, for an artificial legal person what is the average age? There is no limitation to the age of an artificial legal person. It is expected to continue till infinity. That is the purpose of creating a separate legal entity.

If an individual owns the business and you mix the two identities you do not follow the entity principle business entity principle. Thus, if the individual dies or if the individual is sick the business is sick or business dies, right. This individual has everything inside him, he knows what the business is about and he maintains all the relationships in the business.

So, everything is dependent upon him. But when you create a separate legal entity then people may come and go. The promoters may sell off their shares to somebody else and somebody else can come in and start running the company, but the company will continue to exist. So, that is the basic idea behind all these principles- to think differently about the company form of business.

Getting back to it, going concern concept says that the business is expected to continue for a very long period of time-years and years- you do not expect companies to come to an end. Unless, of course, they are inefficiently managed and have to be shut down; but companies do not just die because people move out of these companies. To prove the point further I will show you an exhibit where you would notice that under liabilities there were items called current liabilities. Current liabilities mean these are the expenses that you have to pay and they have become overdue, you did not pay them in time. One example of this is creditors. Creditors are your vendors, they ship you the raw materials for example, and then they say within 3 months you have to pay us that is a credit policy. So, the policies of business are also based upon the going concern concept. The vendor believes or expects that the company is going to continue, the company is not coming to an end. Contrast this with a customer who comes to your shop, you sell goods to him and you say please pay me immediately. You do not let the customer walk out without paying. You go to a supermarket will they let you take the stuff and move out of the store without paying? No, they will not. But if you know that person personally, you have some relationship with him then you can say, can I pay you tomorrow and he might agree because he knows where you live, he knows where you studied, maybe you are friends for many years, because you have personal equity, personal reputation with the person he will allow you to pay you later. So, there is a continuity. He can catch you after that.

In this case, the creditors are building a relationship with the company. The company is expected to pay back in the future because the company is expected to exist in the future. An unknown customer coming to your shop, you do not know whether this person is going to come back to me. Maybe if you let this person go you have no idea about who he is, but if he walks out of the store with the promise to pay you tomorrow, maybe he will never come back, maybe he will get hit by a truck unfortunately and he never comes back, who are you going to recover the money from. So, you know for all these reasons the legal entities continue to exist. You get into a transaction with a company not an individual because the company is expected to continue.

So, creditors extend you credit period and under assets you have current assets and you have debtors. Who are debtors? These are your customers. Again, these customers can also be companies. You can have different policies for individuals, you will say only cash sales, there is no credit. But if there is another business which is purchasing from you then you can say, for businesses we have a credit policy of 3 months.

Even if the owner of the business sells the business to somebody else in the books of accounts of the company it will be written that this much amount is due to this company and that regardless of who the owner or the manager is at that point in time, whether he changes or not, the books stay there. So, your recovery is assured; your recovery is secured by this process.

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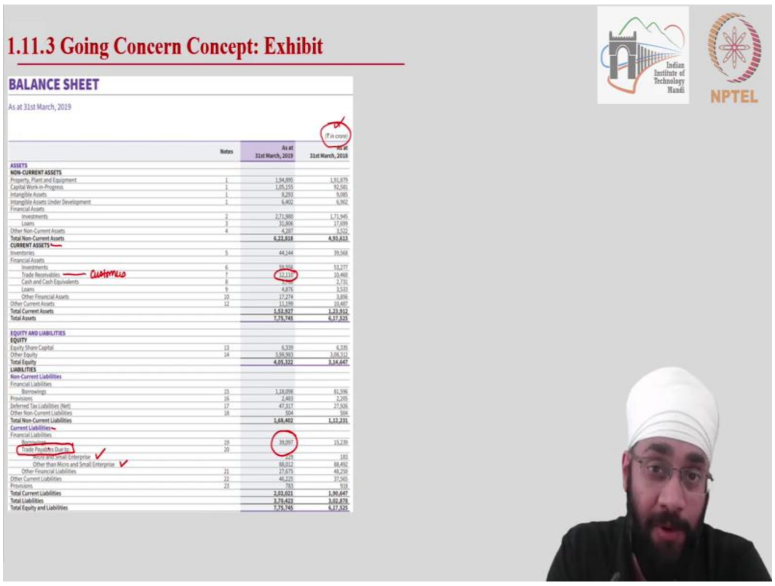

Let us move on to an exhibit. So, I just showed you that under the current assets you have trade receivables. These are your customers. These are your customers and the total amount which Reliance Industries has to recover is 12,000 crores. Now, if these customers were going to run off then you would never do the business, the Reliance Industry will go out of the business. Because, and possibly, RIL does a lot of business with other businesses, so you expect those businesses to continue as well and you have a credit policy.

On the other side, you have under current liabilities the trade payables and you have to pay to micro and small enterprises and some other micro and small enterprises. So, there is a total of about 40000, 39000 crores which Reliance Industries has to pay to other companies and typically these are micro and small enterprises. Thus, if the business was not expected to continue for long, all of this would not be possible. And business is expected to continue for long because of the previous principle which was the business entity principle. Owner’s entity is separate from the business and the business has an eternal legal entity and this business can be sued, this business can be transacted independently of its owners.

Let us go to another principle which is called the accounting period concept.

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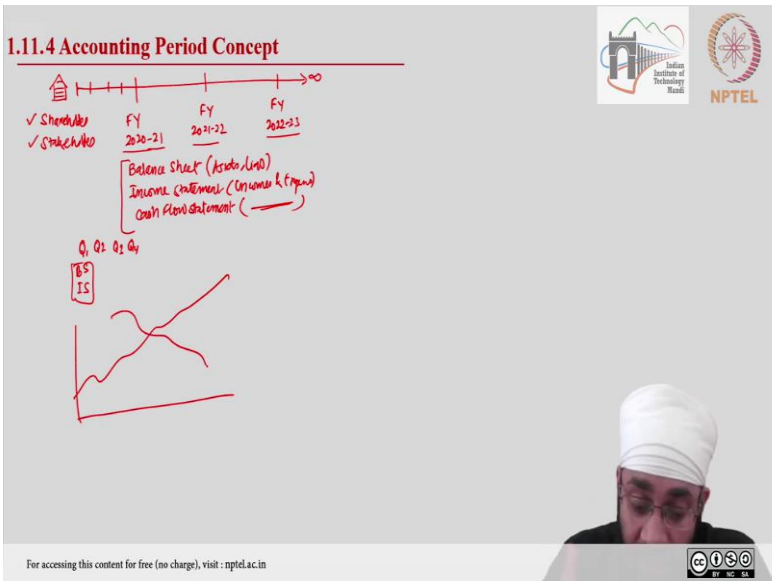

Now, what is the accounting period? In the previous principle that we discussed we said the business is expected to continue for a long period of time, it may not come to an end if everything financially goes well. Now, in order for various shareholders or let us say stakeholders (shareholders are only the investors but stakeholders also include employees, government, customers, all the rest of parties involved) to understand if the business is going to exist in the future or not, these people need to know how well the business is doing well financially.

In the previous principle, we said business can continue for a long period of time regardless of the owners of the business, the management of the business; these people can change. However, if the business runs into financial difficulty, it will shut down and there will be loss around that. And if there are frauds and so on, there can be legal cases against the company and people will be penalized, the company will have to come to an end. You do not want that to happen.

So, all the stakeholders of the business need to have a clear picture of what is going on in the company. So, they are not going to wait for the company to come to an end and then look at it oh what happened, what were the reasons, right. So, there needs to be regular checkpoints, there need to be regular milestones when you are going to look at the company's financials to see what is the revenue, what is the profit, where is the money coming from, how much are you spending, is there something wrong and what is going on in the various departments in the company. You want to know that periodically.

So, what you need to do is to divide the infinite life of a company into smaller pieces and these pieces are called financial years. So, we are going to divide the life of the company into financial years. So, right now we are into the financial year 2020-21 then you will have 21-22, financial year 22-23 and so on, it will continue. Now, for each financial year the companies have to prepare and submit their financial reports. An annual report has to be published by the public companies. Private companies do not have to disclose their financials publicly, but they still have to submit their financials with the registrar of companies which is a regional body where companies are registered and companies supply their regular periodical information and updates.

So, all the companies have to follow financial years, and in most countries the calendar year is the financial year, but in India we follow the financial year differently from the calendar year. For each financial year you have a balance sheet, an income statement, and another statement called the cash flow statement. We have not looked at the cash flow statement, but after we are done with the first two we will go to the third one that basically is a build-up upon the first two. So, these 3 statements are going to talk about assets and liabilities of the business, incomes and expenses for the business, and hence the profit, and let me leave this blank for now. So, at the end of every year you can figure out what is going on in the company.

However, 1 year may be a long period of time during which frauds can happen, things can go wrong. So, the public companies are further expected to divide their financial year into quarters, so you have quarters 1, 2, 3 and 4. So, every 3 months the companies are supposed to publish their balance sheet and income statement. They are supposed to report their financials quarterly even, and this is for public companies, companies that are listed and in which the general public has invested their money.

So, that is the accounting period concept. You need to review the performance of the business and you do that periodically. Those periods are financial years and we call them you know accounting periods. So, we follow a financial year as an accounting period during which we take care of recording, classifying and summarizing the transactions. For every such accounting period, you could compare year-on-year over a period of time- whether the profits are going up or are we losing money- what is happening in the company. Let us move on.

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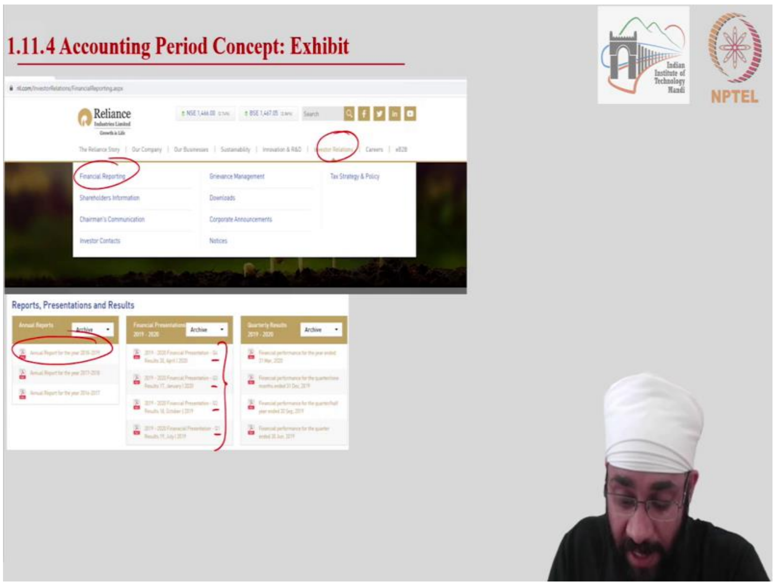

On the Reliance Industries’ website, under investors' financials we looked at this annual report in the previous videos. But if you notice you have q 1, q 2, q 3, q 4 financial results as well. Just wanted to show you a proof; I am not just talking out of thin air but it is actually true.

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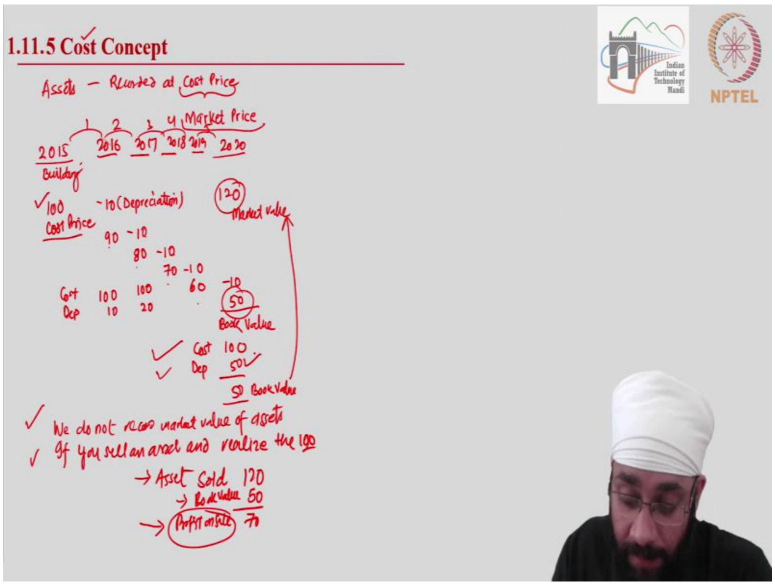

Let us talk about the last principle for this video. It is called cost concept. What does it mean? Now, cost concept means that all the assets which are purchased by the business are going to be recorded at their cost price. Now, the question is if not cost price what else? Is there another price which can be there? Well, yes. There can be another price that is market price. Now, what is the market price? Let us compare these two. Let us say in 2015, you purchased a building for which you paid 100 units of money. In 2020, if you want to sell off this building you could make let us say 120 units of money. Now, this is the market value and this is the cost price. Now, what happens during 2016, 17, 18 and 19? There are a number of accounting periods in between. I am referring to the previous principle of accounting periods. So, there are 1, 2, 3, 4 and 5 accounting periods which have lapsed during this time.

So, what happens? Now, this 100 was used for one accounting period, its value has to come down because there is regular wear and tear, all of that, so there has to be a reduction. Let us agree on a 10 unit reduction in the value of the building. So, you would have a reduction of 10, therefore, the value is going to be 90. In the following year, again another deduction, let us assume equal deduction happens, so you have let us say 10 and let me write 80 here, another reduction. Again in 2018, you have a deduction of 10 and the value is 70. And finally, with a deduction of 10 you have 60, another one actually. So, another deduction here and the value of the building in 2020 is equal to 50.

These 10s that I am deducting in 5 time periods reduce the value of building. Therefore, the current book value, this is the book value, (book value means value in the books of accounts- the value of the building was 100 to begin with that was the cost price) is 50. Every year we charged 10 as depreciation. When I say charged, I mean deducted; charged is a typical word which we use while recording the transaction in the books of accounts- you will get familiar with it. So, 10 rupees as depreciation is being charged and then every year you have a new book value for the building. Say in 2016, 100 was the cost price and depreciation was 10. In the following year, again 100 is the cost price and 20 is the depreciation and so on. So, in the final year how we are going to; what we are going to say here is 100 is the cost price and 50 is the total depreciation which has been charged.

Therefore, the current book value is 50. Just another way of representing it. So, the cost concept, the principle of cost says that you should always show the cost of the asset at which it was purchased and you show the total accumulated depreciation along with it.

Now, let me come to the market value. In 2020, if you are going to sell the building at 120 now, what should be written in the books of accounts? Till the time, you have not sold the building at 120 rupees, this 120 does not exist in the books of accounts. It is a notional value. It is a future value, when you sell it then you will get that money. So, the market value actually has no place in the books of accounts as far as recording for assets is concerned. Thus, I am going to write, we do not record the market value of assets. We only record the cost price, the book value of the assets.

Now, if you sell, however, realize (by realize I mean you receive the money120 which is the market value then what happens? You write in the books of account that you have sold the asset. You have sold the asset for 120, the book value was 50 and you have made a profit on sale of asset. And now, we are going to show it. It is no longer a book value- it is an actual value, it is no longer a market value. It is now an actual value which we have received. So, you show a profit on sale, asset has been sold compared to the book value you make a profit.

And if you remember from the previous videos, profit on sale is again an income for the business, but it is a non-operating income. We did not set up the business to sell our assets, but it is done once in a while.

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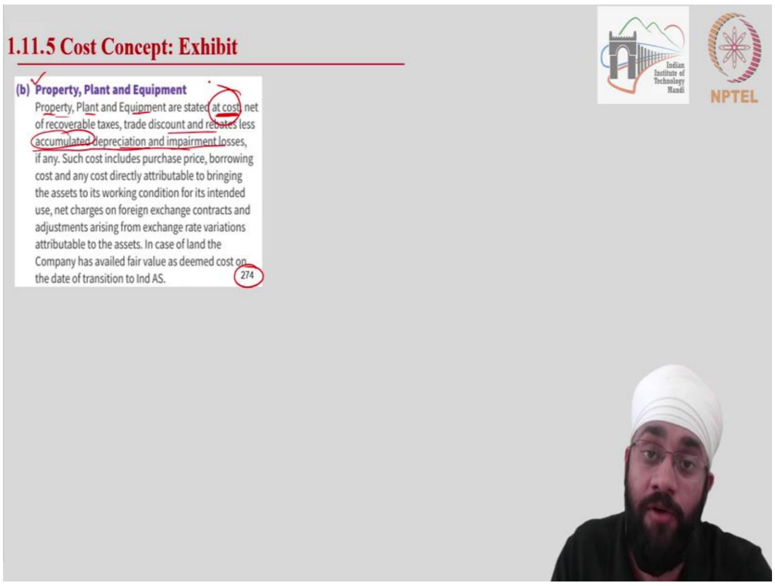

So, that is the cost concept for you. Quickly another exhibit for you from page number 274 of Reliance Industry Limited's annual report. It says property, plant and equipment are stated at cost. If you look at any annual report, they will show you what are the policies, what are the principles that they have followed and this is that section, where they say the assets have been stated at cost, and then you know the accumulated depreciation. Accumulated depreciation refers to this 50, this is the accumulated you know cumulative depreciation over a period of time and any other losses.

So, there are some other advanced items as well. But I wanted to show you only this point that the companies have to report in their annual statement that they are following the cost principle and actually other principles as well.

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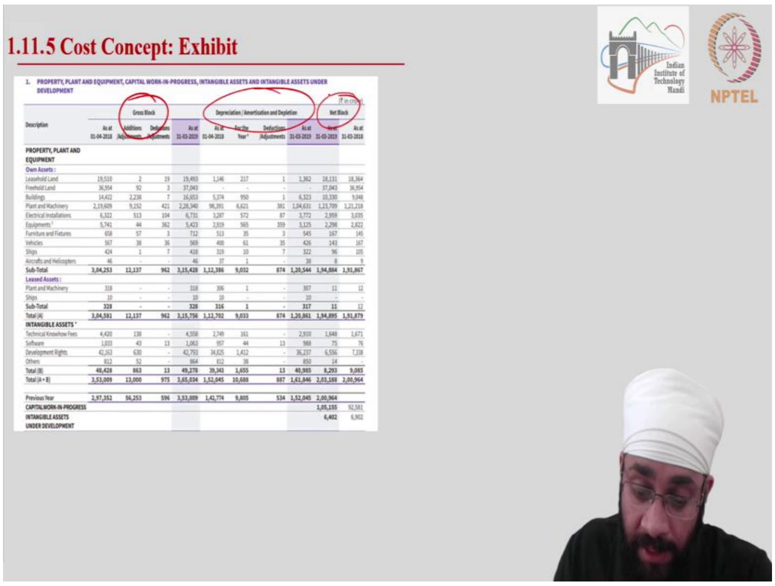

I showed you this earlier as well. You have the cost price or the gross block here, then there is total accumulated depreciation till date and this is the net block. This is how the details are shown.

So, there we go. In this video, we discuss the 5 accounting principles; the ground rules using which the financial statements are prepared, transactions are recorded. I will see you in the next video.