Financial Accounting
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Lecture – 13
1.12 Generally Accepted Accounting Principles II

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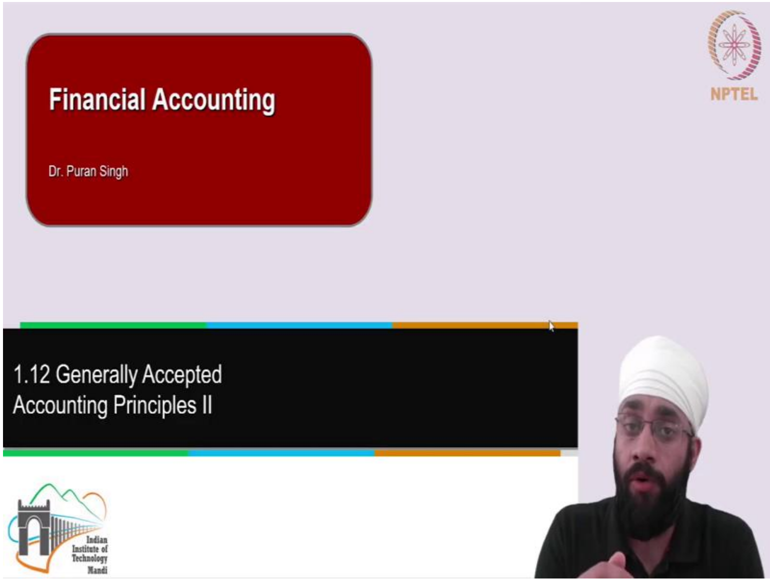

In this video, I am going to talk about the remaining 5 accounting principles which are as follows.

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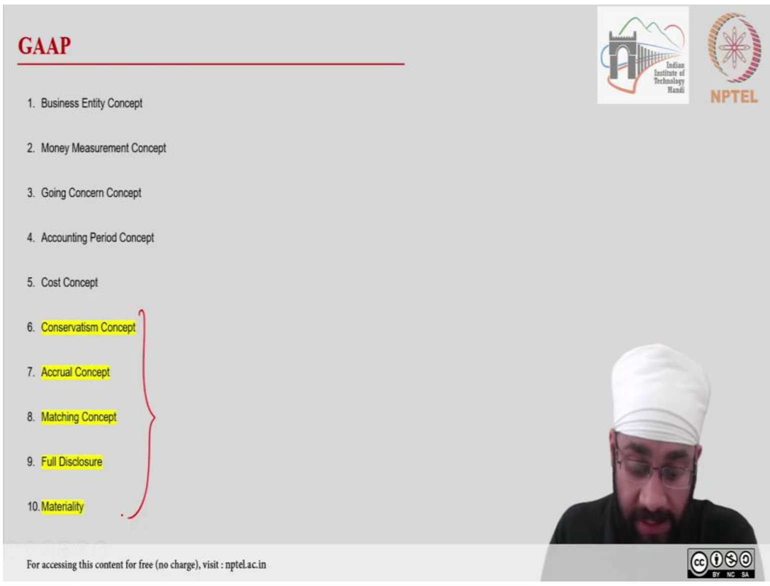

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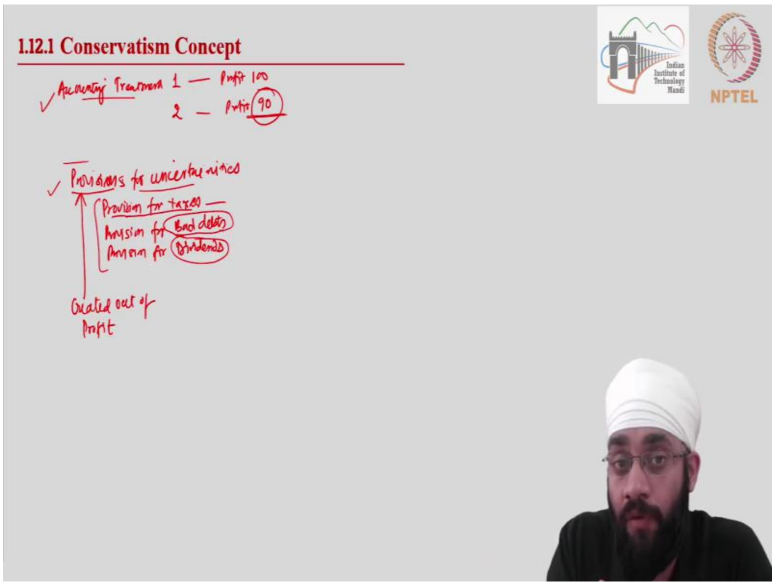

Let us get started with the conservatism concept or principle of conservatism. So, the principle states that, we have to be conservative in reporting the profits or the gains in the business. What this really means is that if there were, let us say, two types of accounting treatments - accounting treatment 1 and 2- such that the first one results in a profit of 100, and the other one results in a profit of 90, which one should you choose? The principle dictates that you should be conservative in reporting profits, hence, choose the one which shows lesser profit. In other words, the principle dictates that we should not try to overstate the profits which are not certain.

Now, there are likelihoods or possibilities that you may or may not recover this money. Thus, you should adjust for that uncertainty and just show only that amount which is certain. Another variation of this principle is to create the provisions for uncertainties. What this means is to create provision for possible losses. When we were going through the balance sheet of Reliance Industries Limited, we looked at an item called provisions and I told to postpone it for the future. Now, let me explain that provision. Provision is made for uncertainties and can be for various purposes such as provision for taxes, provision for bad debts, provision for any dividends that you might have to give in the future, etc. What does this mean? This means that a provision has to be created, out of profits. During the year that you make some profit, you keep part of it as a reserve, as a provision, because in future there may be a liability, which you might have to pay and at that point in time you may not have immediate money, funds available.

So, right now, keep saving for the rainy day, is what this principle says. Provision for taxes - taxes are a certain regular expense. However, how much tax to be paid is something which is very variable; tax might vary due to changes in business related rules and regulations, geographies, type of taxes, etc. So, due to all of that, you create a provision and you try to have that amount in this specific reserve, in this provision; so that even if the amount of taxes is higher than what we anticipated we have money with us to take care of it.

Similarly, you have provision for bad debts which means, it is possible that some of the customers may not pay back for the goods that they have bought from the company. So, in that case, what do you do? You have to create a reserve. Whenever such a loss happens, you can recuperate the loss from this reserve, from this provision that you have created on an ongoing basis. Similarly, dividends are paid by the companies which are mature in their lifecycle or have many years of existence. These companies pay regular dividends and they have to create provisions for dividends, because dividends may increase or decrease. Above are some examples of provisions. So, I discussed two different things in the conservatism concept; the first one was you should always prefer an accounting treatment which understates the profits, understates the gains of the business and you should always prepare to state the possible losses that you may face and also prepare for those losses.

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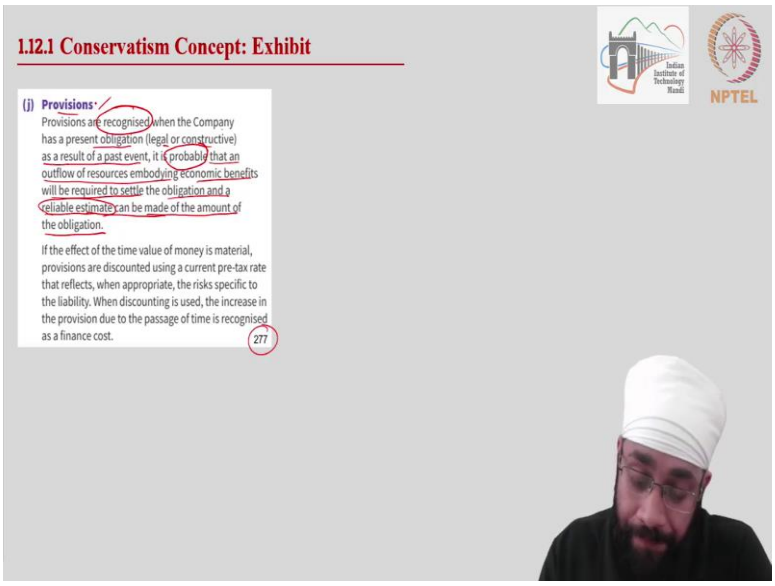

Now, let me quickly show you an exhibit; this is from page 277 of the annual report of Reliance Industries Limited and there is an item called provisions, what does it say? Provisions are recognized when a company has a present obligation; it can be a legal obligation or it can be some other kind of obligation. As a result of a past event, it is probable that an outflow of resources embodying an economic benefit will be required to settle the obligation and reliable estimates can be made of the amount of the obligation. So, you see there is some certainty-reliable estimates can be made; there is an uncertainty also that a liability may arise in future. So, you have to recognize, you have to create such provisions in the books of accounts. So, this is a proof of this principle of conservatism.

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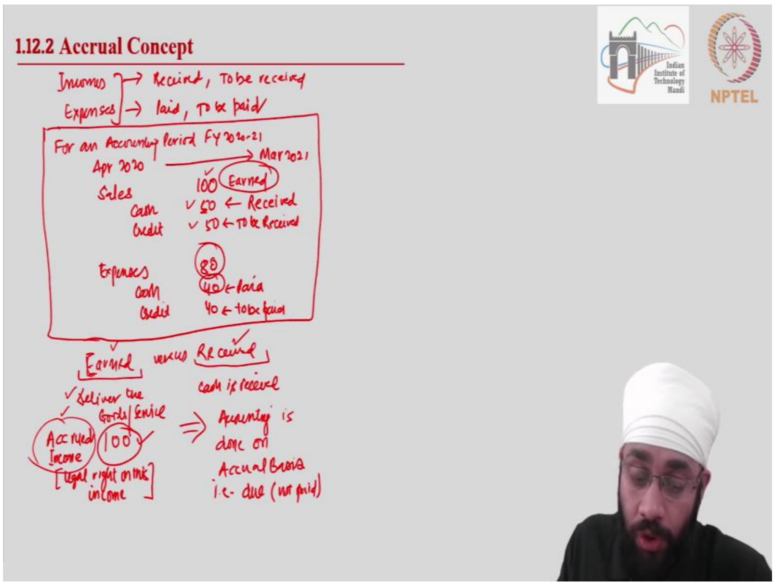

Next, is the principle of accrual or also called accrual concept. Now, there are incomes and expenses of different stages, there could be incomes which have been received and there could be incomes that are yet to be received and the same applies for expenses as well. What does this mean? You create financial records for an accounting period or a financial year. So, let us say financial year 2020-21, it starts in April 2020, it ends in March 2021. You sold goods worth 100 as total sales. However, you received cash for only you know 50 percent of it and the other 50 percent of the sale is on credit. What does this mean? This means that you have received 50 and 50 is yet to be received.

So, we are talking about having cash received for sales or not. Same for expenses. Let us say in order to sell these goods, you had expenses of 80 and you paid for say half of the expenses and the rest of the expenses are yet to be paid. So, this is paid and this is to be paid. Again, I want to clarify that the expenses and incomes can be in two different stages, paid and yet to be paid (or not paid). Now, let me club this understanding with the concept of when you earn i.e., revenues. Now, in the sales, the revenue that you have made during the year you have transferred the ownership of the goods, you have shipped the goods to the customer, they have received the goods that you sold to them. And, they are supposed to pay you; half of them have already paid but half of them have not paid you or yet to pay you. The other concept that I want to club this with is the concept of earnings, when have you earned? When have you earned versus, when have you received the income; you have earned 100 rupees, you have earned 100 rupees during the year, because you have transferred the ownership the possession of the goods to the customer. So, earned versus received. Earned means when you deliver; deliver the goods or services and receive means when cash or cash in the bank that is received by you. Now, which one should you consider in the books of the accounts? Which one you know you are supposed to report in the financial results for the accounting period or for quarters as well? What amount should you report? Should you report the received amount or should you report the earned amount?

This is where this principle comes in. This principle- the accrual principle says, that you have earned 100 means the 100 rupees have accrued to you, it is an accrued income; accrued means it has become due to be paid to you, you have the legal right on this income. If the customer does not pay you, then you can go to the court of law and sue the customer and then he will have to pay it or the legal processes will ensure that you get your money- that is, what is the concept of accrued income. I am repeating it; accrued income means you have earned the right to receive and you earn the right when you deliver the goods or services to your customer.

So, in the books of accounts when you are showing financial results for a period of time you should show a total 100 rupees as your income and not only 50; which means, that accounting this leads us to the conclusion that accounting records are prepared. So, accounting is done on an accrual basis means that it has become due; does not matter whether it has been paid or not.

So, accounting is done on an accrual basis. Similarly, if you look at expenses you are yet to pay 40, only 40 has been paid by you. However, for the given financial year you will say my total expenses in the financial year are 80, I have not paid it, but accounting is done on accrual basis, credit basis, due basis. So, if I have received the services of my employees for this year, then I will have to pay them; even if I pay next year I will be paying them for this year. That is the principle of accrual on which the accounting is so heavily based. As we move along in the process and learn the process of recording, classifying and summarizing the business transactions you will see that we make use of this concept a lot, this principle is going to be used very heavily.

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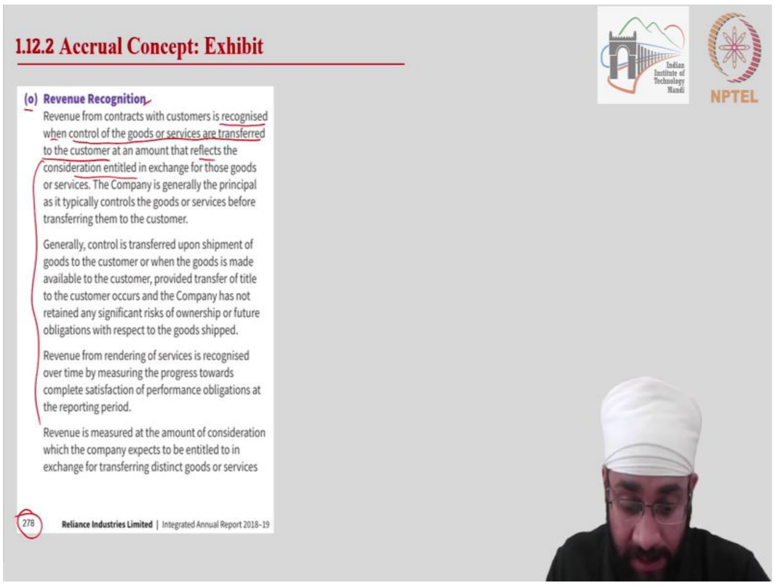

Let me show you an exhibit. This is page number 278 in the annual report of Reliance Industries Limited and there is an item called revenue recognition. Revenue from contracts with customers is recognized or recorded when the control of goods or services are transferred to the customer (they say control that means it has been delivered and if after that they lose the goods then we are not responsible) at an amount that reflects the consideration. Then there are the rest of the details, but all I am trying to say is look at the annual reports- they tell you that we are using these principles. All the companies have to disclose in their annual reports the accounting principles that they are following and give the detail of how they are doing it.

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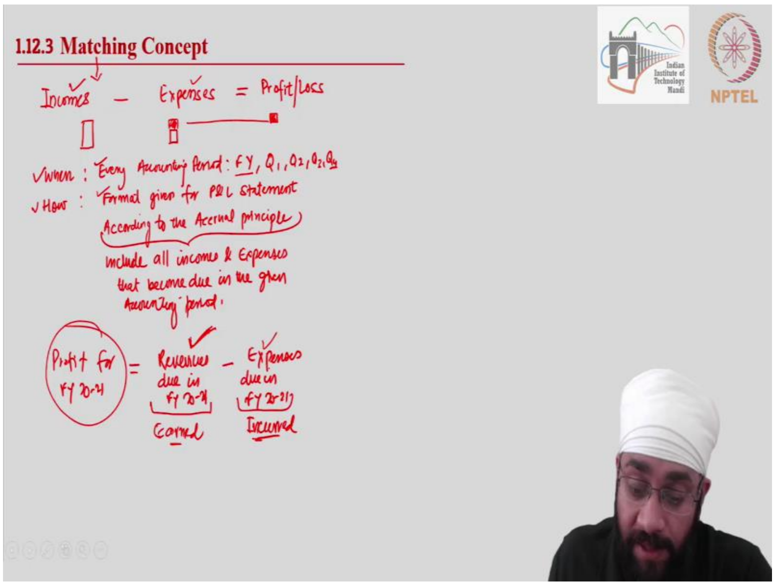

Let us move on to the next principle; the next principle is called matching concept or the principle of matching. So, the clear question is what are we matching and why are we matching that? We match the incomes to expenses. Why do we do that? We do that to figure out if we made a profit or a loss. How do we match it? We compare these two- income minus expenses is equal to profits: that is what is meant by matching. These are my expenses and this is my income- I am matching it. This is my graph of income,this is my graph for expenses. The remaining is my profit, here right, that is what matching indicates in this principle. It is very generic, but there must be some more essence to it which is as follows. Now, when do we do it? We do it every accounting period which means, you have a financial year or you can have a quarter 1, quarter 2, quarter 3, quarter 4; quarter 4 is actually the end of year. So, you directly go to the end of the financial year.

So, every period which is significant for the company on when they are required to do, you match your incomes to your expenses to figure out the outcome of the business- that is number one. Second is how? How do we match it? You match it according to a format, format given for profit and loss statement and I showed to you and I will show you now as well.

For Reliance Industries Limited you have a format, you have incomes at the top and within incomes you show your operating incomes, you show your non-operating incomes, you show if you have collected any taxes and so on.

So, a format has been prescribed for the companies to follow. And, then within the financial year, the incomes and expenses are going to be matched according to the accrual principle. Now, what does it mean? According to accrual principle we have to recognize the revenue or we have to record the expenses when they become due on accrual basis. Therefore, for a given financial year, matching the incomes and expenses we include all incomes and expenses that become due in the given accounting period.

So, the accounting period can be a quarter or financial year. So, the point is, if during the period for which you are preparing the financial statements, if an expense or a revenue has become due then you should show that in the income statement to figure out the profit or loss. Again, this principle is building upon the accrual principle, but it really also brings the principle of accounting period. It clarifies to us that the profit for a period profit for financial year 20-21 is equal to revenues- revenues due in financial year 20-21 minus the expenses due in financial year 20-21 . You may have received the revenue or it may have become due and you may have paid the expenses or they may have become due: you should include them. Even if you have not received the revenues, you record them and that is how you figure out profit for a given period; that is the matching principle, you match revenues earned in a given period.

Thus, revenue earned and expenses incurred means they have become due in a given period. So, instead of a cash basis, you go on an accrual basis and you match your expenses and incomes to find out the profit - that is what matching principle is.

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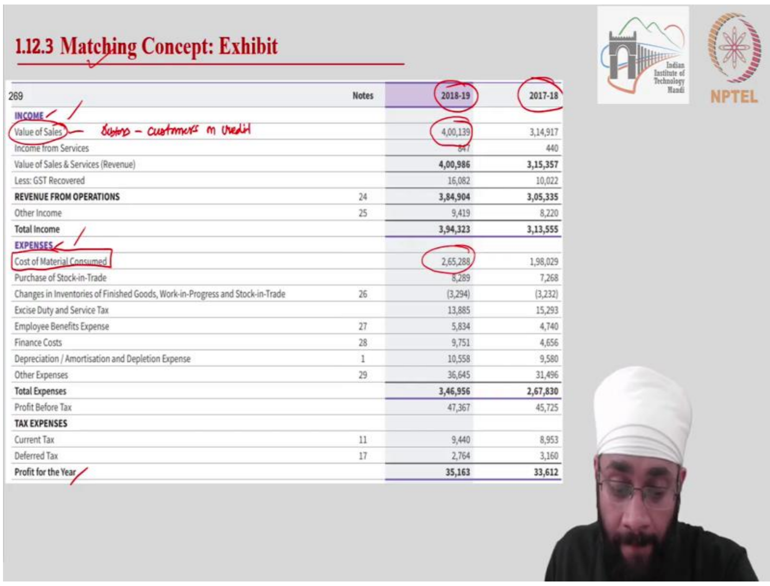

Let us now look at an exhibit to prove this point; you have income and you have expenses; you are matching them to find your profit. Although they are not required to report how much was on credit, you could easily go to the balance sheet and look at what is the debtors amount because that is a kind of credit sale. So, this sale would include the debtors as well. So, customers to whom goods have been sold on credit; the money which is to be received from those people is included in this amount.

Similarly, the cost of material consumed, it does not say that you have paid for these materials; it is possible that you have to pay for this and you will pay for maybe 50 percent of this in the next year, it does not matter. You have received the material they are with you now, it is your responsibility to maintain it and your supplier will recover the money from you- if you do not pay legally he has the right. So, this amount will include the price of all the material which you have received.

So, you compare these two you know in a given financial year - here 18-19 and 17-18. Now, you can match your income and expenses and find out your profit.

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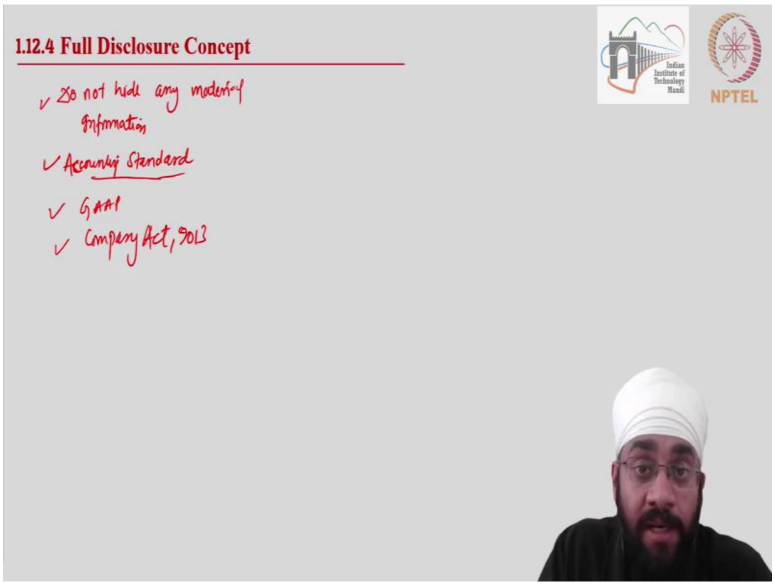

Let us go to another principle and this is going to be a quick- full disclosure principle; this simply means do not hide information, do not hide any material information. Now, a public company is owned by the public - there are a lot of disclosures, there are actually accounting standards which are further minute versions of accounting principles. For example, these are like the boxing match I mentioned earlier.

In a boxing match you decide, what is going to be the venue 3 months in advance, who are the opponents and what will be the rules of engagement and so on. That is decided way in advance and then when the boxing match actually happens, then what are the technicalities involved? How do you count the score? And how will a winner be decided? When the opponents have to stop the match, there will be a referee, there are minute details which you have to follow.

Similarly, generally accepted accounting principles are broad understandings and common knowledge and guidelines which you have to follow. The accounting standards further give you the specific details of treatments of some of the items. So, in this principle of full disclosure what we are really talking about is that the company has to disclose all the important significant information. Second, they have to follow the accounting standards; which have been given and they have to disclose information also as per the generally accepted accounting principle and any other act like Companies Act 2013; you have to follow that and disclose that as well.

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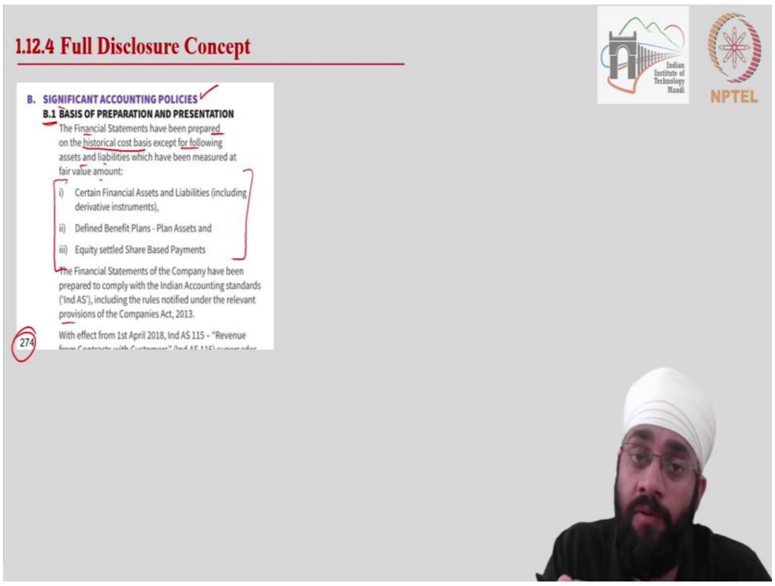

I will quickly show you exhibits to further prove how full disclosure is adopted by these companies. So, this is page 274 in the annual report of RIL. It says significant accounting policies. I am only showing one accounting policy, but in any annual report you would see that the company has given the details of accounting policies that they have used in preparing their financial statements.

So, it says financial statements have been prepared on a historic cost basis and you know this is the cost principle that we learned earlier. Now, you know there are some exceptions you are making, there are certain things you are actually following as you have to disclose as a company; you put all that information in the annual reports. This is the concept of full disclosure.

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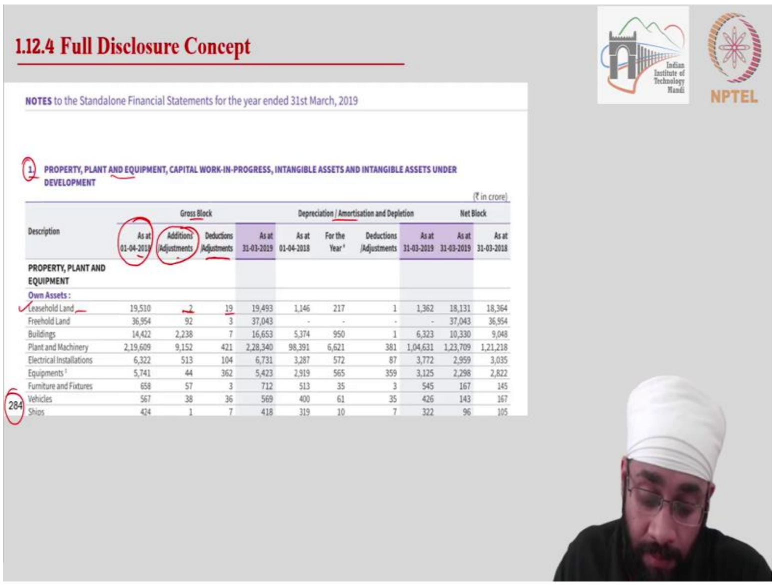

Description	Gross Block				Depreciation / Amortisation and Depletion				Net Block	
	As at 01-04-2018	Additions /Adjustments	Deductions /Adjustments	As at 31-03-2019	As at 01-04-2018	For the Year *	Deductions /Adjustments	As at 31-03-2019	As at 31-03-2019	As at 31-03-2018
PROPERTY, PLANT AND EQUIPMENT										
Own Assets :										
Leasehold Land	19,510	2	19	19,493	1,146	217	1	1,362	18,131	18,364
Freehold Land	36,954	92	3	37,043	-	-	-	-	37,043	36,954
Buildings	14,422	2,238	7	16,653	5,374	950	1	6,323	10,330	9,048
Plant and Machinery	2,19,609	9,152	421	2,28,340	98,391	6,621	381	1,04,631	1,23,709	1,21,218
Electrical Installations	6,322	513	104	6,731	3,287	572	87	3,772	2,959	3,035
Equipments [1]	5,741	44	362	5,423	2,919	565	359	3,125	2,298	2,822
Furniture and Fixtures	658	57	3	712	513	35	3	545	167	145
Vehicles	567	38	36	569	400	61	35	426	143	167
Ships	424	1	7	418	319	10	7	322	96	105

Another example of this is in the property plant and equipment, this is balance sheet note number 1- breakdown of assets fixed assets. So, you have gross block depreciation and you will see you know within these tables- and I have not spoken about these earlier-there is a balance at the beginning of the year then there were some adjustments during the year which could be the purchase of some more land or selling some land. So, all of those details have to be provided by this company.

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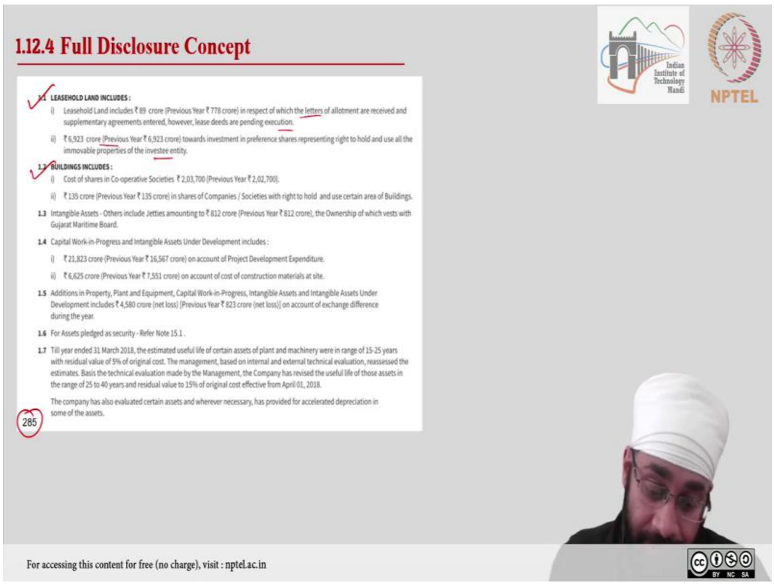

Further, you look at this leasehold land- that is not all the information we have about leasehold land; you can look through the annual report and find out more. So, if you go to page 285, the next page, you will see for leasehold land for building, they are giving more information; some more details have been provided about these assets as well.

And, if you look through other sections of the report you will find what new assets they purchased, what were their locations, and so on. So, another exhibit to show you that companies have to go in great depth to disclose the details of the assets, liabilities, incomes, and expenses.

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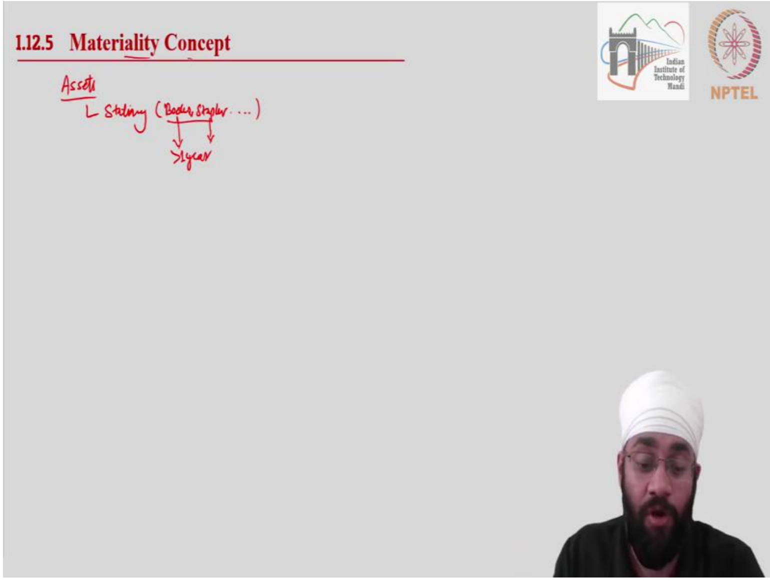

We come to the last accounting principle for this video which is the materiality concept; what does this mean? Let us say assets of smaller value like stationery- books, stapler and so on- should you regard these things as assets or expenses? Going by the definition- books, stapler, these things stay with you for more than 1 year- the life is more than that. However, the value is very small and the importance that these things will have in the running of the business, functioning of a business or on the outcomes of business is very low; it is not a very material item. Therefore, the concept says please do not create a record for every small thing; every pencil, every pen, every eraser that you purchase for the business, do not create separate records for that. Create generic headings, create stationery and then club hundreds of small items under that. So, it is easy for the stakeholders to look at the financial reports and understand that and also pay more attention to the material facts, more significant numbers, rather than getting into very small details which may not be of great consequence.

That is the materiality concept of the principle of materiality for you. So, there you go we discussed about 10 accounting principles and there are, as I said a few more here and there, but you know I largely covered those in these 10 accounting principles. These are the ground rules which we are going to be following and I have already shown you the statements of Reliance Industries Limited, also shown you proofs of how these principles are being followed.

So, I will see you in the next video.