Business Analysis for Engineers
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Lecture-6
Accounting Principles-2

Good morning class, before I get into the other 5 accounting concepts that we still have the covered just a quick clarification in last classes exercise that we did was 1 and 3 in which I was talking about their partners capital, how that gets the recorded as the owner's equity and in which the partner could get some portion of the retains earning or also can draw from the partners contribution.

We made an example entry in that the there was a specific reference on earnings amount of 30000 while I had mentioned is 30000 but actually the example is 35000 that makes the total 91000 tally. Otherwise if it is 30000 the total is 86000. So that is the minor correction that you will have to ensure. Now the remaining portion of this class I will be covering the remaining 5 accounting principles.

Now you would have understood that with those 6 accounting principles that we had already covered you had a fair understanding of how a balance sheet is created and what a balance sheet is and how these accounting principles are more or less balance sheet centric which explains the remaining 5 accounting principles or more or less income statement centric or you need to have an understanding of what an income statement is.

So that you appreciate these accounting principles. Now I have already explain to the class the income statement is the flow statement, it indicates the financial performance of an entity throughout a given period of time. So the 5 accounting principles that we saw before was relevant to a balance sheet which had already mentioned that it is a status report. Now the income statements of flow statement which means it is over a period of time.

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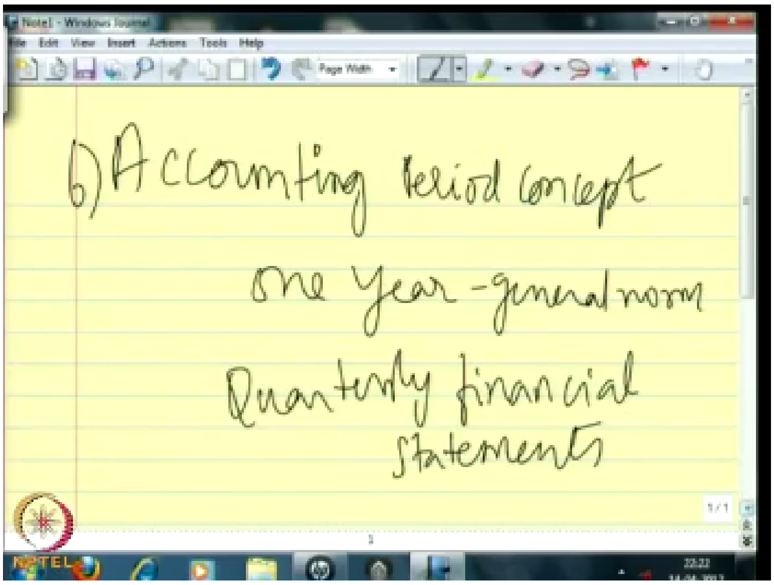

Then the 6 accounting principle to begin with has to do something with the period that we are interested in understanding. So the 6 accounting principle is the accounting or the 6 accounting concept on which accounting principles are being frame is the accounting period concept. Now what do you mean by accounting period concept which means that every entity we need to measure the activity of a entity for a specific interval of time or specific period of time.

No doubt that every entity is assumed to be a going concern as per one of the concept that we have already discussed. We need to observe the financial performance intervals of time, how small are how big should this interval of time we depends on the type of entity that we are handling. I give two examples the first example let say the entity the character of the entity is in such a way that it does business only for short periods of time.

Let us say IIT here, we are having a summer camp in swimming and there is an entity that conduct swimming camps, coaching classes during summer for one month period and this is the entity which means the entity time interval that is of concern to us which is one month period, so one month period students come join, pay fees, that is expenses, you incur those expenses at the end of 1 month period the summer camp concludes.

And then the entity disappear. This is one example where the interval that we are concerned is just is one month period, but invariably business entities operate beyond this one month time interval, business entities are assume to exist for an infinite period of time. So typically the interval that we are interested in standing is more than this one month period. So we have this terminology called the physical period.

And for business entities which operate for an indefinite period of time as per the going concern going concern going entity concept, the longer time period is what we are interested. Now as the entity is going concern we need some reasonable time intervals at which point of time we need to understand what has been the financial performance. So the accounting period concept says that define this time interval.

And invariably this definition this duration of the specific time interval is an alignment with what an accounting period is, generally it is a 1 year period and that is why you find annual reports on an every year bases for various business entities year ending 2008, 9, 10, 11 and so on. So the accounting period in general for a going concern whose existence is for an infinite period of time is assumed to be 1 year.

That is a standard unit of accounting period which means for the majority of statutory purposes we submit income statement and balance sheet for one year period of time, sales revenue at the end of 1 year during the period of 1 year and then we record expenses during this one year period based on which we find the financial performance. So this 1 year is a unit accounting period.

But have not set that as somebody internal to the organisation that is a management, I would like to know at different times slots, what has happen to the entity, let me for example say I took a decision today and that I would like to know the impact of this decision on the income statement 2 months later 3 months later, and I have already told you that the accounting system records every activity in a concern almost on a day-to-day basis which means 2 months later.

If I need to know what the balance sheet is and what the income statement is yes I can know about it. So for the purpose of analysing the impact of certain decisions let us say within the next 3 months period I can say I will put a holt the time halt and the end of the third month I can prepare an income statement and balance sheet and this you would see normally when companies release quarterly results.

On one hand that is also a stat we requirement especially for listed companies probably beside the guideline say that you have to find a quarterly return, that is why you see companies announcing there quarterly results quarter 1, quarter 2, quarter 3, quarter 4 results, now these are also income statements and balance sheet at the end of every quarter and when you look at the income statement and balance sheet at the end of every year this quarterly financial statements will be unit for those annual return.

They will be integrated and they will form a part of the annual returns when you see, it would not be different for the purpose of knowing in advance as somebody inside the organisation as a management person I do not have to wait for 1 year to know the impact of certain decisions on the income statement I can know immediately on a quarterly basis. If I want to do in a fortnightly basis yes I can do, if I do it on if I need to do it on a monthly basis yes I can do.

That is the purpose of convenience and practicality quarterly statements are also fine, so in general and accounting period means a specific interval a time interval which will provide some rule for entities to understand record communicate and create this financial statements. So this is the accounting period concept which means the specific time intervals and there should be some reasonability in fixing those time intervals as I said before it could be quarterly.

And invariably one year time duration is the general norm the accepted norm where every and every one year an entity has 2 file is balance sheet and income statement. So on accounting period provides this specific time interval by which entities have to record and communicate all the activities that happen in that particular corresponding time interval. In this case the general cases one year.

So that is the accounting period concept where you have 1 year as the general norm and of course there is room for all your quarterly financial statements. This is a very generic accounting concept.

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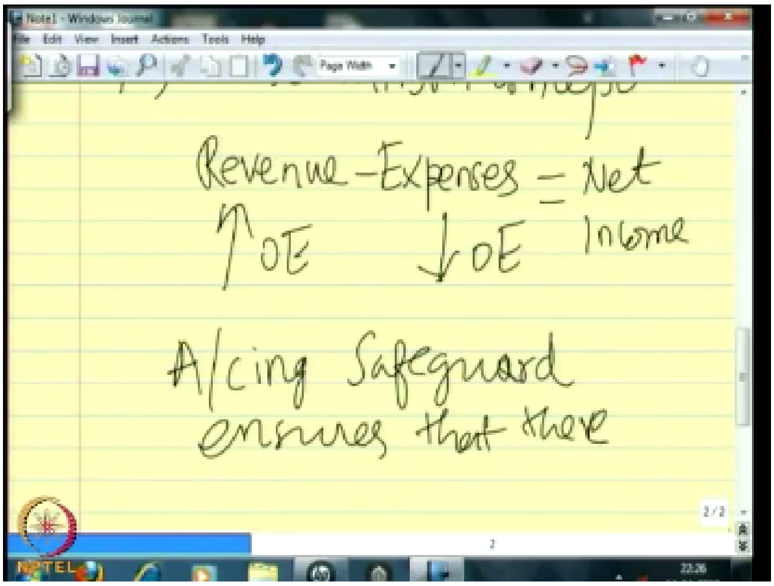

So the next accounting concept is call the conservatism concept. Now conservatism concept is a very important when it comes to the issue of recognising revenues of an entity, see before I explain this conservatism concept you must understand 2 things that the revenue of an entity increases the owners equity, this we saw in last class, and the expenses of the same entity owners equity and it is this revenue-expenses is your net income and I will explain this for that when I actually talk about the income statement. Now this I am telling you now, so that you do not get confused between revenue cash receipts.

Revenue is not cash, but you should understand that an activity that brings in revenue to an entity increases the owners equity and activity that consumes or creates an expense to the entity reduces the owners equity, and the more revenue less is the expense the more is your net income, increase in income means the owner's equity or the owner is better off, here again we should not confused between income and cash.

Because increase in income means your owner is better off and he say that increase in cash also means that the owner is better off now assume that an entity borrows money and it is from that borrow well the cash balance has increased, so it does not mean that the owner is better of, so there is a different between income and cash. Now have this at the background I will give you some specific to understand this in a better line.

But for the purpose of conservatism concept have this is the background, now the conservatism concept is essential because it is all about report financial statement is about reporting activities in an entity and specifically when we are talking about income statement we are reporting the revenue of an organisation, the revenue of an entity the sales revenue and the expenses which means the natural tendency as human being is to report higher revenue.

So that you present the income statement in a form where the net profit or the net income is high the profitability is high, this is the natural tendency favourable reporting if I can call it so which means there is a chance that will also end up reporting revenues which actually is not earned or cannot be earned by the entity, as a result of which we need some accounting safeguards.

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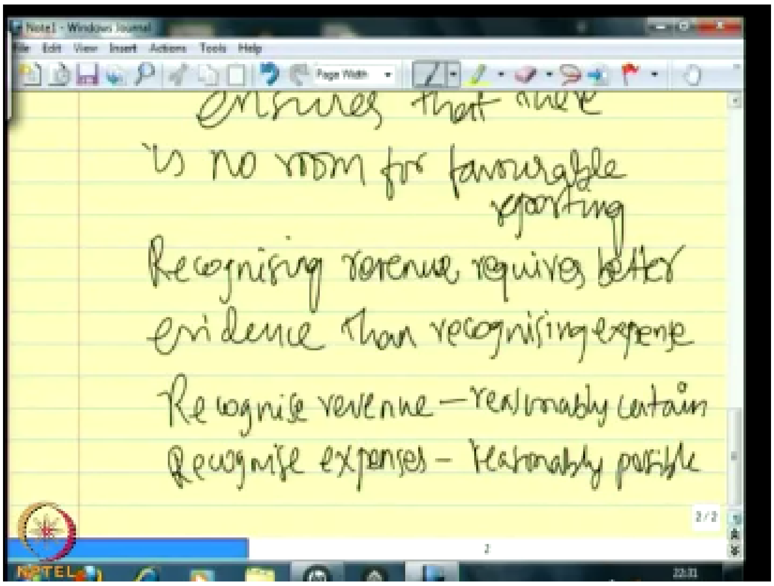

Against the such favourable reporting because reporting stand by human beings, so we need some accounting safeguards again such favourable reporting and this concept of conservatism is the tack accounting safeguard, so the safeguard ensure that there is trial no room for favourable reporting. Now how does this ensure, the concept is that to recognise revenue you need better evidence than to recognise expenses.

So that is the fundamental remains of this conservatism concept which clearly says that recognizing revenue requires better evidence then recognising expense. And this is the accounting safeguard very reasonable because if you say that you have the entity as earn revenue conservatism says please provide me enough evidence that supports this claim that that is revenue activity.

If you say that the entity has incur and expense then in terms of the evidence requirement it is not as strong requirement as the case of revenue is, I give you a very small example suppose you are running a dealer net, you are running an automobile dealership, you are selling cars, somebody walks into your store let us say Mercedes Benz, so somebody says I want to buy a Mercedes Benz car.

As a sales person you provide him all product literature, provide all product features everything, then he says well I like this car, so I have decided that I will buy this car next month and then come this month end you are filing the quarterly results let us say, now the question is based on the interaction that you had with prospective customer would due at the end of this month record the conversation that just gave you little signal that somebody is going to buy a Mercedes Benz from you.

And because he told you that he is going to buy it next month will you record this as a sales revenue that is the question that you left the answer, but the principle of conservatism says no do not record this as a revenue for this month because the sales transaction has not happened at all, it is just the customer said I will come next month and by the car, so let the customer come and buy the car.

Let the customer come and buy the car, let there be some evidence that endorses your claim that the revenue transaction is happened, So there again there will be two specific cases 1 the customer will say here is my written communication to that effect that I am going to buy the car do the payment later case also how to interpret this that I will come to that a little later, but even without that written communication it is not advisable to record a revenue based on just an assurance somebody says that I will buy this car next month.

Now comes to another different example the same dealership store the gudon's manager comes in report that one Mercedes Benz car is missing. Now as somebody was running the entity I have a very confidence that the moment that a lot to complain that I will get that Mercedes Benz car probably 3 months, 4 months later, but again end of this month I will have to file my financial statement.

The question is whether you will report is missing Mercedes Benz as a bad expense, despite the fact that you are very confident that you will get the car 2 months 3 months later I think unable to understand the difference. So conservatism concept says that I need strong evidence to support revenue claims and this slightest evidence possible is enough to record expenses.

So put it in proper understanding perspective conservatism says recognize revenue only if you are reasonably certain about.

So there should be an element of certainty and it comes to recognising revenue, but when it comes to recognising expenses conservatism says you recognise expenses, it is reasonably possible in the slightest the possibility that it could be an expense.

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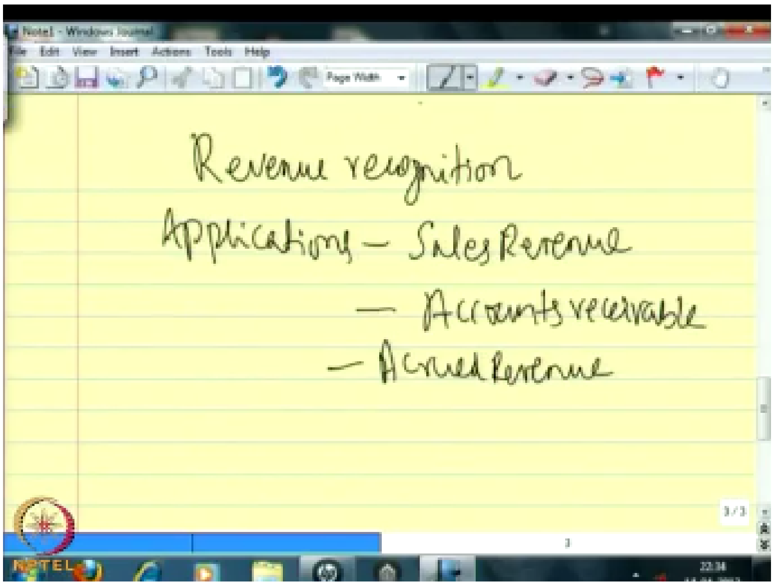

Please record it as an expert that is the principle of conservatism. So why it is essential because if you look at revenue recognition some applications, one is a direct sales revenue where you sell something you get cash. So there is no doubt in that, it is recorded as sales revenue, that is also something called accounts receivable. It means that you sell something on credit somebody promises to pay something the money after a brief period of time.

I have already gave you the example for even in this case based on historical customer relationship entities record this as sales revenue and they receive the amount for that it just get adjusted with cash and accounts receivable. In different form of accounts receivable is also accrued revenue, this is nothing but similar to accounts let us say for a bank it has given money, it is suppose to earn interest.

And at the end of the period it does not get the interest of the loan amount, but it record that as a revenue because it will get the interest revenue after a period of time. This is form of accounts receivable, but then you also find some entities using this word a accrued revenue.

So when it comes to revenue recognition you have a revenue activity that generate cash immediately after it happens or the revenues recognize the cash comes into the entity later.

So that is why initially I said you have appreciate the different between revenue and cash receipts, I will give you a small example for you to understand that, because you need to really appreciate the distinction between revenue cash receipts.

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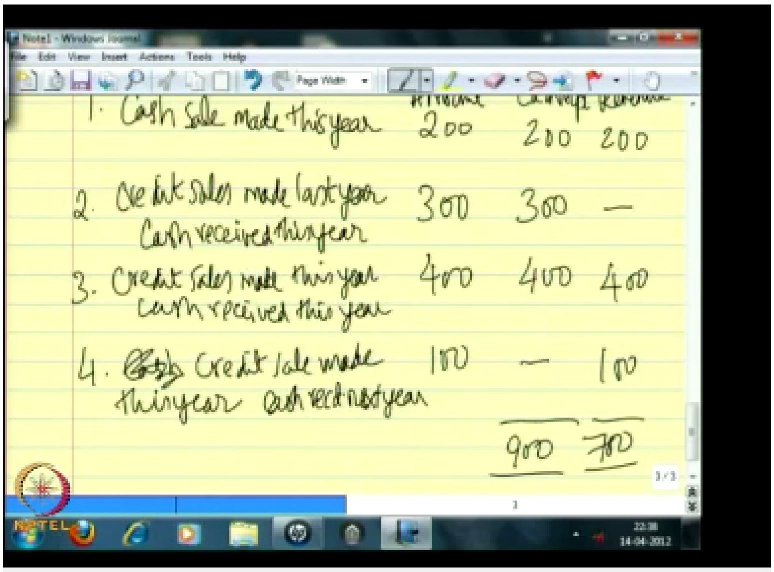

Now for example let us say case 1 the cash sale made this year ok, so we talking about this year, this is the amount, let us say 200 rupees worth cash sales was made this year. Let us see how this affects cash receipts and sales revenue or just revenue, cash receipts and revenue. Now it is cash sale made this year, which means I got cash this year itself and principle of conservatism says because you just got cash for the sale you do not require a better evidence.

Because there is cash for the same, because nice that as a revenue, credit sales made last year**,** cash received this year. Let us say the amount of credit sale that was made last year was 300, it is the entire amount that was received as cash receipt, so what would be the cash receipts this year 300 and assume that this customer was a credit where the customer which means the principle of conservatism says though you did not receive cash.

That it is very strong evidence because of the credit worthiness of the customer you recognise that as a sales revenue and since this is a credit sale that was made last year this is already been recognised as a sales revenue in last year remember you are talking about this year, so there is no sales revenue for this transaction this year. Next example is credit sales made this year cash received this year.

Let us say the amount is 400, this replicate the receive cash this year itself for a credit sale which was made some time earlier already recognised as a revenue and hence you also recognise this is a revenue from this year itself. The fourth cases cash sorry credit sale made this year, and cash received next year, let us say the amount is 100, now what happens in a cash receipt as a credit sale and I have not received any cash payment.

And are you going to recognize this revenue yes because this customer is already in a credit worthy customer. So for this year sales I recognise this is a revenue, but not as cash yes because I am not received cash for this year, so if you look at the total say 900 here and 700 here, so this is the point that I want to make that your revenue is not equal to the cash receipts for this particular year.

Because you have already recognise revenues for which you are collecting cash this year, or you have recognise revenues this year and collected cash this year. So the third cases you have recognise revenue this year for which you are going to collect cash next year. All these 3 combinations exist, but that does not prevent you from recording sales revenue for a particular year because you are reasonably certain that for a credit for the customer of this time I can recognise this as revenues for this particular year.

Because there is strong evidence to support that the last 10 years that I have been servicing this customer I have been able to collect all the cash for which I have made credit sales. So this is the principle of conservatism which says you recognise revenue if you reasonably certain and recognise expenses if there is a reasonable possibility, you need strong evidence support revenue claims.

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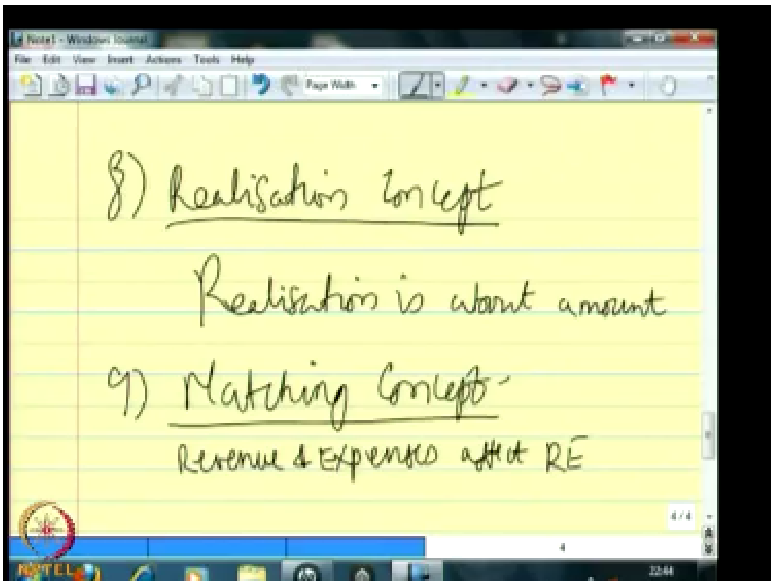

And this life for an expense is recognise it as an expense, this is the principle of conservatism. The next principle is realisation concept. The next concept about 8 accounting principle is this concept of realisation, so the previous one the recognition of revenue recognition concept or conservatism concept is about timing, when should I recognizing revenues and expenses.

So realization concept is about amount how much should be realized as revenues or expenses. So realization is about amount, for example you got a grocery store, you buy something you pay cash, the grocery store recognize that as a revenue and also realizes the entire amount as against going to a grocery store and you say I will pay the entire amount 1 month later, and in recognition concept you find this customer doing this very often.

And that he has paid the entire amount the subsequent month, so you recognise that is a revenue and if your experience has been that every time he pays he pays the entire amount then your concept says you record the entire amount as revenue during that time or if your experience has been that divarication and more often in the recent past that this customer has ended up paying only 90% but what he suppose to take.

But nevertheless I am going to recognize that as a revenue, in that case you realise that revenue to the extent of 90% and then remaining 10% you can treated as a bad expense. So remember the principle of recognition is about timing whether I have to recognise that as a sales revenue this period itself. These are we revitalization concept having recognise that as a revenue, how much should realise whether it is entire 100%, the 200% credit worthy or otherwise.

If it is otherwise to what extent is this revenue realizable to what amount can I realise this revenue is decided by the realisation concept. The next concept is the matching concept, in matching concept I have already told you that revenue and expenses affect the retained earnings. So I keep an event will affect revenues and expenses show the match matching concept says defect event that news and expenses must be recorded within the same accounting period.

So both the effects for let us say sales generating item I mean sales generating event, the effect of that and the revenues and the corresponding expenses of this event has to be recorded within the same accounting period, that is the matching concept. You match revenues and related revenue to that particular revenue within the same accounting period. So that you do not overestimate your net income and hence your retained earnings or do not end up underestimating your net income or your net retained earnings.

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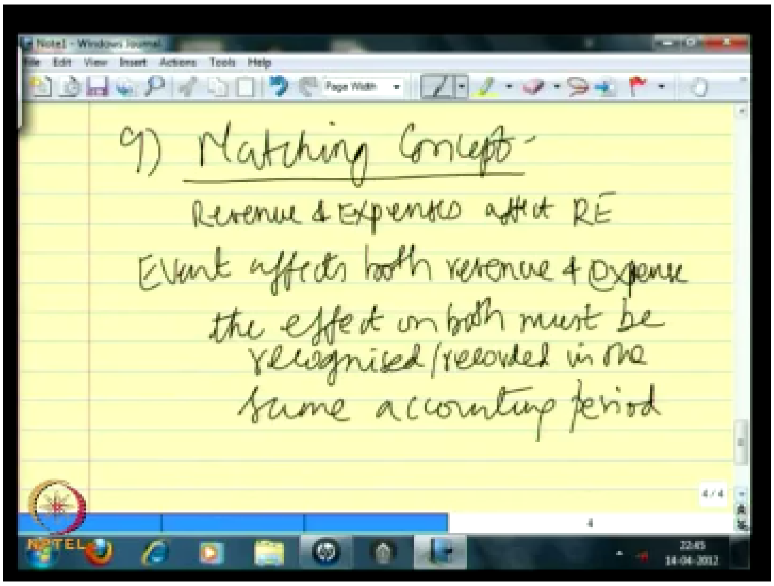

So it says if a event affects both revenue and expense, the effect on both must be recognised or recorded in the same accounting period. So this avoids any mismatch, overestimation or underestimation of revenue or expenses whatever the case may be. So the next concept is consistency concept. Now different activities happen in the business entity. There will be some activities which have a particular character.

And that you have decided that for activities of this particular type I am using this method to record these transactions and when you have chosen to use a particular method for entries belonging to the same character as much as possible try to retain the same method unless you have compelling reasons to differ in the methodology. I will give you a small example and I will explain about this in detail when we talk more about depreciation.

Depreciation as I told you is the cost of using an asset, now there are different methods of depreciation, I can either use a simple straightforward linear straight line method or accelerated depreciation is also possible for sums of digit method is also possible, so different ways of depreciating an asset. But if I have decided or assets of a particular type I am going to follow straight line method.

Then the principle of consistency says that we adopt the same method when we comes to depreciating assets of this particular type every accounting period. Do not keep changing the depreciation method rather it is like you say straight line for this year, next year I am going to follow accelerated the next year sums of digits and again back to straight line, no do not do that. As long as you continue to adopt the same methodology to record entries of similar character activities.

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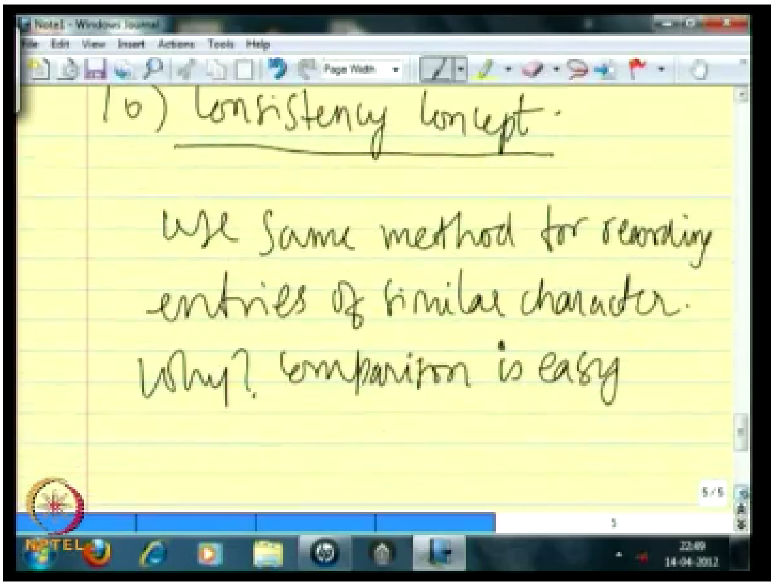

Then you follow the principle of consistent, now why is it essential, it is essential because let us say we are comparing financial performance and to compare the performance of the entity we use an income statement and the balance sheet and if you are comparing it over 5 year period how the entity has performed in the last 5 years, immediately I look at the income statement and balance sheet to make the comparison.

Now only if I am able to follow the same method to record entries of identical types would then be possible for me to make a good comparison. Now if the way in which I have recorded these transactions have followed different methods in each of these 5 years then I would not be doing a fare comparison or I would not be doing a fair performance analysis of the firm. So for that purpose it is always advice because of this principle of consistency we use the same method for recording entries of similar character.

Why because comparison is easy does not mean that I should not change methodologies yes you can change methodology, as long as you have enough reasons compelling reasons, that usually you will find in an annual report on income statement balance sheet there is something call an auditors loan, where the auditor would have explained that till last year I was following the firm was following these right hand method for depreciation.

And it is from this year that it is switching over to an accelerated mode and you will have reasons explain for that. So it is possible for you to change the methodology, but as long as you are not changing the methodology, so this is easy to make a comparison and hence at consistency is required to ensure that you follow a common identical methodologies when it comes to recording entries of identical character.

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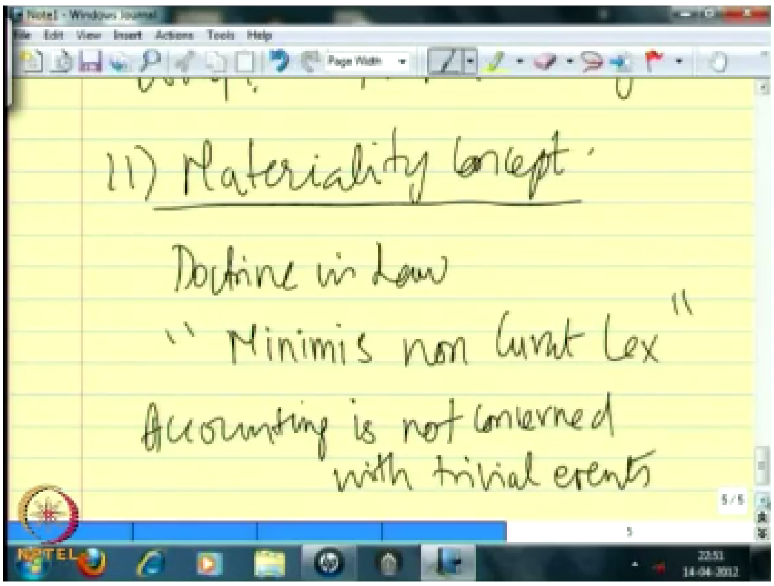

Now the last concept is materiality concept. Now what is this materiality concept. Now the materiality concept is very simple. There is a doctrine in law which says minimis, non curat lex which means this law this doctrine in law says that the court will not considered trivial matters, this is what this means. The court is least bothered about trivial issue, now extending this doctrine to the materiality concept.

Accounting is not concerned with trivial events, that should be an exact line that separates material events and immaterial events, see you will understand that the principle of conservatism or the realisation concept. There is always a room for subjectivity because you think somebody is credit worthy, there will always be another person who will think the same person is not credit worthy.

You think you can realise 100% of the sales revenue recognise there is somebody will always think that I can realize only 75%. There is always room for subjectivity as a result of with there will be judgemental errors, but as long as it falls within an accepted frame work which has some reasonability we accept the financial statements are prepared. In similar lines the material and materiality concept.

There will be some events which I think it is immaterial for me record that. I give an example so let us say the business entity, the office administrative office purchases stationery, pens, pencils, erasers, markers and all that. No doubt that the pen, pencil, marker that you purchase as an asset with the administrative office, but does that mean that you are going to record every pens that you purchase and suppose you are going to use that pain for 3 years.

You will be depreciating the pen at the end of every year, pens you be depreciating every month, no then what is the alternative I would say I recorded as an expense for that particular year, which means I just say I purchased pen, pencil, erasers for 10000 rupees and it got consumed during that particular year, whether it is consumed or not that is different issue it is a different issue or probably it is not even material enough for me to see weather check whether this has been consumed in the year or not.

And if it is not consumed then the extent to which it is consumed is only treated as an expense and whatever remaining half pencils or the pen that you have has to be recorded as an asset no, that entire 10000 rupees is treated as an expense for that particular year. For a sense materiality concept says you ignore such a material events what you should be looking at with those significant material evens and it is only those events be exercising enough cautions, proper judgement in measuring the worth of that event.

And communicating it properly. There is not a big error in a financial statement because you failed to record some of those immaterial events properly, not that you have failed to record it but record it properly, it is ok because it is immaterial, but the same will not protect you when it comes to recording events of great material value. So these 11 concepts the 5 that we saw before and the 6 that we saw now.

Quick recap is to what they are, first we started off with money measurement, then going concern, fast concept, the principle of duality, then was the entity concept that says individual is different from the concern and the other 6 concept the accounting period concept, the conservatism concept, the realisation concept, the matching concept, consistency concept and materiality concept.

These 11 concepts from the fundamentals for the accounting principles, now why these are important as I told you before is because it removes to a certain extent some levels of subjectivity, I am not saying that all of those who will be following these concepts will have the same level of objectivity but at least it would remove some reasonable levels of subjectivity when it comes to recording these transactions.

Now if you know this 11 concepts what are we going to do with this 11 concepts, just as the 5 concepts there enough for us to understand this balance sheet, in the 6 concept that we saw today, importantly the principle of conservatism and the realization concept, these 2 will have an impact on an income statement because an income statement records your revenue and you will record a revenue when only when you think you have recognised it.

And to what extent your record as a revenue depends on what happened you have realize that revenue. So it is very important from an income statement point of view. So matching concept says the moment you have recognised revenues make sure that those expenses related to that particular revenue gets recorded within the same accounting period. So you are also interested in knowing what these expenses are.

So you have revenue, you have expenses and revenue-expenses is your income. And with revenues expenses and income you will be able to estimate the financial performance of an entity and this statement that captures the revenue expense and income is your income statement. So when we sit for next class a very brief overview of what an income statement is, what constitutes an income statement.

And then we will start the basics on double entry bookkeeping. The income statements I told you before is essential because it provides some inputs to understand the financial performance of an entity. So when we meet next class we will talk about income statement and also double entry bookkeeping. Thank you.