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This report will identify a problem in accounting field and then show with the help of data, how to solve it. More specifically, we will take some of the basic concepts of accounting, define them, analyze the consequences of ignoring the concepts and then show with the help of data how these concepts will help the business. Although these principles form the basis of accounting but sometimes, businesses ignore their importance knowingly or unknowingly. In the following lines, we will take a look on the accounting principles and concepts, the problems created if they are ignored and how to solve these relevant problems.

An accrual is a journal entry which is made for a revenue or expense for a transaction for which cash amount has not been received or paid. Using accrual system is the only option for some businesses which are involved in selling and purchasing of merchandise. The major requirement for an accounting entity is that it should recognize revenues and expenses in the correct accounting period. A business can over state or understate a business profit or loss if it does not adhere to this concept properly. People who prepare financial statements for government organizations will face problems like inertia and sectorial egos while making their financial statements (Hendrawan Santosa Putra, 2018). The failure to apply the accruals concept will affect all the financial statements of an enterprise because this concept is related to the ongoing operations of a business. A credit sale has been made on 15th December of a year amounting to $ 2000 and it closes its accounts on 31st December each year. The accounting people erroneously omit to record the sale in the same year in which it took place. This action reduces the revenues of the firm by the same amount which affects the net profit of the business. This net profit will be ultimately added to owner’s equity so it will reduce the net worth of the company. The solution to this problem is that the accounting people must be trained to apply the correct concept so that there is no discrepancy in the accounting records. Overstating the profits and overall value of business will present a wrong picture of business operations to all external parties. There can be severe consequences for the business if some stakeholder sues it for misrepresenting its picture.

The second principle of accounting is conservatism which states that revenues and assets should be recorded when business is assured about them to receive. On the other hand, expenses and liabilities should be recorded as quickly as possible. Conservatism is used to present a realistic picture of the business to all stakeholders. Although this picture is not very bright, it shows a true and fair view of the business which is a basic requirement of accounting. Similarly, the lower cost or market value principle will be applied by the business when an asset is to be valued. If there is uncertainty regarding a loss, the business should go towards recording a loss whereas if the same scenario occurs with profit, it should not be recorded in books of accounts. A problem will arise if any business does not adhere to the conservatism principle, it will present an untrue picture of the business to various stakeholders. As an example, we can assume that a business has recorded a revenue of $ 10000 that is not assured or that is doubtful to be received. Now the revenues of business will increase as well as profits for the time being but what will happen if these revenues are not actually received by the business? The stakeholders will be badly affected because revenues and profits will be lowered. Some researchers argue that conservatism may not be considered a desirable quality of financial reporting information (Hellman, 2008). These researchers state that conservatism is not an appropriate way to deal with uncertainty. The changes in business conditions should be shown by changes in future estimates and probabilities assigned to the events. Whatever is the case, a business will present its true and fair picture only if it follows conservatism principle. The external stakeholders will be most affected because they will take certain decisions on the basis of faulty or overestimated financial statements. A business may also have to face lawsuits if it shows a rosy picture of its operations to stakeholders and it does not turn out the same way in real (Postner, 1986).

Consistency is referred to the usage of same accounting principles from one accounting period to another. In terms of figures, we can suppose that a business calculates depreciation on assets using straight line method in one accounting year but changes to the written down value method in the very next year. This practice will not allow the stakeholders to compare one set of financial statements with those prepared in the other time period. Another important change may be related to calculation of bad debts. We suppose that the company had equal value of receivables in both years. The change was made in provisions for doubtful debts from 5% to 7.5%. This will reduce the amounts of receivables to be shown in balance sheet depicting that the business has not been able to receive from defaulters properly in the last year. Some researchers argue that it is more important for firms to adhere to accounting principles than the accounting standards because accounting standards need clarifications and in some cases, judgment to be correctly understood (Wustemann & Wustemann, 2010). Businesses are answerable to a variety of stakeholders in the modern world including shareholders of the company. If businesses are not consistently following accounting practices, they will not be able to present comparable information to them over a period of time. This will mean that it will not get any investment either by shareholders or in the name of loans from creditors. All these things require that consistent accounting policies must be followed by businesses. A very common example is the change in depreciation methods followed by businesses, which means that a straight line method is changed to a diminishing balance method. This will result in faster depreciation of assets and relatively lower net worth of business as well as lower profits. Sometimes, these changes are also made to save on taxes. If there is any change made to accounting procedures, the same should be shown in the notes to financial statements which form an important part of these statements.

Economic entity concept shows that there is a difference between transactions completed by the business and transactions completed by the owners in their personal capacity. In other words, owners have limited liability with respect to the losses incurred by business. These owners will be liable to pay the loss to the extent that they had invested in the business. If the business mixes its transactions with those undertaken by the owner, it will not be able to present the true and fair view of their business to the stakeholders. This is especially true for the sole proprietors who have unlimited liability that means the losses will be recovered by selling the private property of owners. In case of a company, the owners and business are separate entities and business is treated as an artificial person. If a car bought by an owner is considered a business expense and included in the financial statement of business, it will affect all the financial statements of business. The depreciation charged by business in income statement will decrease the profit and car shown as a part of business assets will overstate the total value of assets owned by business. This aspect will be highlighted by an independent auditor who will separate the expenses which are legally allowed to be included in financial statements. The solution of this problem will be that the personnel who prepares financial statements should be properly trained so that there is a clear separation of business accounts and private accounts. The businesses can also hire more people who can help in verifying the authenticity of books of accounts. For the sole proprietors, they can keep a separate account for business transactions (Husband, 1954).

The matching principle requires that revenues and related expenses must be recognized within the same accounting period or in other words, an income statement must contain revenues which are matched by corresponding expenses on the other side. The Matching principle states that the revenues generated in any given period of time should be matched against the expenditures made to generate those revenues. This is an important aspect of accounting because this lets the stakeholders know the actual profits made in any given transaction. The failure to apply matching principle will result in over or underestimation of profits and worth of the business. An example can be given where a business has made a payment of $ 1000 in terms of insurance premium but this amount of money pertains to four months and the business prepares the financial statements at the end of every month. If the business applies the matching principle, it will apportion the amount among 4 months and record $ 250 for each month. Failure to apply this principle will affect almost all the stakeholders. If profits are understated, it will affect the owners because they will not get proper return on their investments. Overstating the profits will mean that the business picture will be shown better than what it is and creditors will think that it is worth forwarding loan to this business. Failing to implement this concept will affect the income statement as well as balance sheet of a business. Balance sheet will show the net worth of a business and if its figures are not presented in a proper manner, prospective buyers may be fooled. In order to make sure that matching principle has been properly applied by the business, adjusting entries have to be used at the ending date of financial period. These entries apportion revenues and expenses according to the time frame within which they have been incurred. Some expenses have been paid in advance and are called prepaid expenses, these should be deducted from the respective expense account in income statements and shown as an asset in the balance sheet. There are some expenses which are yet to be paid which may also include income taxes, these are added to the respective heads of expenses and are shown as a liability in the balance sheet (Drinkwater & Edwards, 1965). The revenues received in advance are called unearned revenues and are deducted from the respective amounts in income statement. These are shown as a liability in the balance sheet. Accrued revenues are the ones which are not yet received. Adhering to all types of expenses and revenues in a correct manner will make sure that there is no serious issues in the financial statements. A practical example of matching principle is a scenario including commission on sales that is paid in the following month. A business paying commission will record it in the month of sale although it will be actually paid in the next month (Lee & Kyu-jin, 2019).

The materiality principle shows that an accounting standard can be ignored if doing this does not have significant impact on the financial statements. In other words, the financial statements will contain only those items which have a significant impact on the financial performance of the company. There must be care exercised in omitting certain information from the financial statements because omitting a certain piece of information may mean that a stakeholder will not be able to assess the financial performance of the company. Shareholders may not be able to assess their true value if some aspect is omitted from the statement of owner’s equity. This also pertains to skipping any accounting principle on the basis that it will have minimal effect on the usability of these statements. An example can be given for matching concept which will definitely affect the usability of financial statements if it is ignored. It is important that the personnel preparing the financial statements are adequately trained to know what aspects can be skipped from entering in the financial statements.

All the above principles are equally important and not adhering to them will create severe problems but in my opinion, businesses should pay special attention to matching principles and accruals basis of accounting.

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