TSSM™
Creating VCE Success

Accounting
Teach Yourself Series
Topic 1: Accounting Principles

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Accounting Principles

Accounting Principles guide the way the financial records of a small business are kept. If these principles are followed reports can be prepared in a manner that conforms with the Qualitative Characteristics discussed in Teach Yourself Series 2.

On some occasions these principles and characteristics will conflict but it is important to understand these principles and recognise when they don't have to be followed.

Initial terminology

As it appears in Units 1 - 4

Before starting to record financial transactions it is important to understand the rules that guide the recording of these transactions. These rules are referred to as Accounting Principles and there are 7 Accounting Principles that apply to recording transactions through Units 1, 2, 3 and 4.

These Accounting Principles are:

- Entity
- Historical Cost
- Going Concern
- Reporting Period
- Conservatism
- Consistency
- Monetary Unit

Entity

As it appears in Units 1 - 4

Small businesses analysed in VCE Accounting are owned and operated by one person – a sole trader. It is important that the financial records of the business are kept separate from the personal financial records of the owner. They are separate legal entities. This is necessary so that decisions made by the business are not influenced or affected by the financial position of the owner.

The Entity Principle requires that the financial records of the business and the owner are kept separate.

Review Questions

1. Read the following scenarios and explain why the Accounting Principle of Entity is being breached.
   a. The owner of a business does not record the cash he takes out out the cash register to buy petrol for the family car.

   b. Marie is a doctor who runs her own practice. Her husband Rob is a plumber who runs his own business. The transactions of both businesses and the family are combined into one set of accounting records.

2. On 7 January 2010 the accountant noticed that the owner was using his personal vehicle for business activities. The accounting suggested he transfer ownership of the vehicle to the business. The details were:

Vehicle (at cost)	$30 000
Registration (paid on 1 April 2009)	$600
Loan – Nateast	$12 000

   Explain, with reference to an accounting principle, why an entry in the records of the business was required.

Historical Cost

As it appears in Units 1 - 4

During its life, a business will purchase a variety of Assets. Some will be for resale purposes (eg; Stock), while others will be used in the business for an extended period of time to assist the business in earning Revenue (eg; Motor Vehicle, Equipment). During the time that a business holds an Asset there are a number of values the business may use when recording these Assets.

An Asset such as a Motor Vehicle could be valued at the price paid for the Asset or at its market value – what it could be sold for at that point in time. Assets such as a Motor Vehicle lose value once they have been used – once a new car is driven it becomes 'second hand'.

On the other hand, Stock is purchased at one price and it is intended that it will be resold at a higher price. If the business is confident of selling the stock at the higher price then shouldn't the business use that value to record the Stock?

The Historical Cost Principle requires that the financial transactions of the business should be recorded at their original cost or value. This cost is verifiable as there is a document that will support that valuation. Many other valuations do not have a verifiable document – the 'price tag' on an item of stock is not verifiable until the stock is sold at that price.

Review Questions

3. Read the following scenarios and explain why the Accounting Principle of Historical Cost has been breached.

- **a.** The owner of a business wishes to borrow $40,000 from the bank. She provides the bank with financial reports of the business to support her Loan application. These records show the Building with a value of $750,000 – a value provided by an independent valuer earlier this year.

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- **b.** Paula purchased a computer for the business for $2,500. She believes it is now worth $500 because a newer model has been made available. She has decided to use this new value in her records.

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Solutions to Review Questions

1. The Accounting Principle of Entity is being breached:
    - **a.** When business funds are used to pay personal expenses they must be recorded. It becomes difficult to gauge performance of the business if we are unable to determine what transactions relate to the business and what transaction don't.
    - **b.** Combining the financial records of two businesses will make it difficult to determine how each individual business is performing. Each business should be assessed on it's own so separate records should be kept.

2. As the Asset now officially belongs to the business the business now needs to recognise this in the records and reports so an entry is required to transfer ownership.

3. The Accounting Principle of Historical Cost has been breached:
    - **a.** The value provided for the Buildings is not verifiable. Whilst the value has come from an independent third party it can be argued that the figure is not based on reliable evidence, just an opinion.
    - **b.** The amount paid is the only verifiable amount. Paul's valuation is biased and therefore should not be used.

4. Stock Control is reported at its Historical Cost rather than at its selling price which is not verified until the stock is sold.

5. *Answer:* C

    Explanation:

    $36,000 is the Historical Cost and the only one able to be verified by a source document