

Online Study Materials

Topic: -5, Accounting Concepts and Conventions

(Dr. Vinod Kr. Mishra, HoD, Commerce, MLSM)

In dealing with the framework of accounting theory, we are confronted with a serious problem arising from differences in terminology. A number of words and terms have been used by different authors to express and explain the same idea or notion. The various terms used for describing the basic ideas are: concepts, postulates, propositions, assumptions, underlying principles, fundamentals, conventions, doctrines, rules, axioms, etc. Each of these terms is capable of precise definition. But, the accounting profession has served to give them loose and overlapping meanings. One author may describe the same idea or notion as a concept and another as a convention and still another as postulate. For example, the separate business entity idea has been described by one author as a concept and by another as conventions. It is better for us not to waste our time to discuss the precise meaning of generic terms as the wide diversity in these terms can only serve to confuse the learner. We do feel, however, that some of these terms/ideas have a better claim to be called 'concepts' while the rest should be called 'conventions'. The term 'Concept' is used to connote the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. In other words, fundamental accounting concepts are broad general assumptions which underline the periodic financial statements of business enterprises. The reason why some of these terms should be called concepts is that they are basic assumptions and have a direct bearing on the quality of financial accounting information. The term 'convention' is used to signify customs or tradition as a guide to the preparation of accounting statements.

Accounting Concepts

The important accounting concepts are briefly described as follows:

1. Separate Business Entity Concept: - In accounting we make a distinction between business and the owner. All the books of accounts records day to day financial transactions from the view point of the business rather than from that of the owner. The proprietor is considered as a creditor to the extent of the capital brought in business by him. For instance, when a person invests Rs. 10 lakh into a business, it will be treated that the business has borrowed that much money from the owner and it will be shown as a 'liability' in the books of accounts of business. Similarly, if the owner of a shop were to take cash from the cash box for meeting certain personal

expenditure, the accounts would show that cash had been reduced even though it does not make any difference to the owner himself. Thus, in recording a transaction the important question is how does it affect the business? For example, if the owner puts cash into the business, he has a claim against the business for capital brought in.

2. Money Measurement Concept: - In accounting, only those business transactions are recorded which can be expressed in terms of money. In other words, a fact or transaction or happening which cannot be expressed in terms of money is not recorded in the accounting books. As money is accepted not only as a medium of exchange but also as a store of value, it has a very important advantage since a number of assets and equities, which are otherwise different, can be measured and expressed in terms of a common denominator.

We must realise that this concept imposes two limitations. Firstly, there are several facts which though very important to the business, cannot be recorded in the books of accounts because they cannot be expressed in money terms. For example, general health condition of the Managing Director of the company, working conditions in which a worker has to work, sales policy pursued by the enterprise, quality of product introduced by the enterprise, though exert a great influence on the productivity and profitability of the enterprise, are not recorded in the books. Similarly, the fact that a strike is about to begin because employees are dissatisfied with the poor working conditions in the factory will not be recorded even though this event is of great concern to the business. You will agree that all these have a bearing on the future profitability of the company.

3. Dual Aspect Concept: - Financial accounting records all the transactions and events involving financial element. Each of such transactions requires two aspects to be recorded. The recognition of these two aspects of every transaction is known as a dual aspect analysis. According to this concept every business transaction has dual effect. For example, if a firm sells goods of Rs. 10,000 this transaction involves two aspects. One aspect is the delivery of goods and the other aspect is immediate receipt of cash (in the case of cash sales). In fact, the term 'double entry' book keeping has come into vogue because for every transaction two entries are made. According to this system the total amount debited always equals the total amount credited. It follows from 'dual aspect concept' that at any point in time owners' equity and liabilities for any accounting entity will be equal to assets owned by that entity.

The total of assets will be equal to total of liabilities plus owners capital because all assets of the business are claimed by either owners or outsiders.

4. Going Concern Concept: - Accounting assumes that the business entity will continue to operate for a long time in the future unless there is good evidence to the contrary. The enterprise is viewed as a going concern, that is, as continuing in operations, at least in the foreseeable future. In other words, there is neither the intention nor the necessity to liquidate the particular business venture in the predictable future. Because of this assumption, the accountant while valuing the assets do not take into account forced sale value of them. In fact, the assumption that the business is not expected to be liquidated in the foreseeable future establishes the basis for many of the valuations and allocations in accounting. For example, the accountant charges depreciation of fixed assets values. It is this assumption which underlies the decision of investors to commit capital to enterprise.

Only on the basis of this assumption can the accounting process remain stable and achieve the objective of correctly reporting and recording on the capital invested, the efficiency of management, and the position of the enterprise as a going concern.

5. Accounting Period Concept: -This concept requires that the life of the business should be divided into appropriate segments for studying the financial results shown by the enterprise after each segment. A year is the most common interval on account of prevailing practice, tradition and government requirements. Some firms adopt financial year of the government, some other calendar year. Although a twelve-month period is adopted for external reporting, a shorter span of interval, say one month or three months is applied for internal reporting purposes.

6. Cost Concept: - The term 'assets' denotes the resources land building, machinery etc. owned by a business. The money values that are assigned to assets are derived from the cost concept. According to this concept an asset is ordinarily entered on the accounting records at the price paid to acquire it. For example, if a business buys a plant for Rs. 5 lakh the asset would be recorded in the books at Rs. 5 lakhs, even if its market value at that time happens to be Rs. 6 lakhs. Thus, assets are recorded at their original purchase price and this cost is the basis for all subsequent accounting for the business. The assets shown in the financial statements do not necessarily indicate their present market values. The term 'book value' is used for amount shown in the accounting records.

7. The Matching concept: - This concept is based on the accounting period concept. In reality we match revenues and expenses during the accounting periods. Matching is the entire process of periodic earnings measurement, often described as a process of matching expenses with revenues. In other words, income made by the enterprise during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue.

8. Accrual Concept: - It is generally accepted in accounting that the basis of reporting income is accrual. Accrual concept makes a distinction between the receipt of cash and the right to receive it, and the payment of cash and the legal obligation to pay it. This concept provides a guideline to the accountant as to how he should treat the cash receipts and the right related thereto.

9. Realisation Concept: - Realisation is technically understood as the process of converting non-cash resources and rights into money. As accounting principle, it is used to identify precisely the amount of revenue to be recognised and the amount of expense to be matched to such revenue for the purpose of income measurement. According to realisation concept revenue is recognised when sale is made.

Accounting Conventions

1. Convention of Materiality: - **Materiality** concept states that items of small significance need not be given strict theoretically correct treatment. In fact, there are many events in business which are insignificant in nature. The cost of recording and showing in financial statement such events may not be well justified by the utility derived from that information. For example, an ordinary calculator costing Rs. 100 may last for ten years.

However, the effort involved in allocating its cost over the ten years period is not worth the benefit that can be derived from this operation. The cost incurred on calculator may be treated as the expense of the period in which it is purchased. Similarly, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred.

2. Convention of Conservatism: - This concept requires that the accountants must follow the policy of “playing safe” while recording business transactions and events. That is why, the accountant follows the rule anticipate no profit but provide for all possible losses, while recording the business events. This rule means that an accountant should record lowest possible value for assets and revenues, and the highest possible value for liabilities and expenses.

According to this concept, revenues or gains should be recognised only when they are realised in the form of cash or assets (i.e. debts) the ultimate cash realisation of which can be assessed with reasonable certainty. Further, provision must be made for all known liabilities, expenses and losses, Probable losses regarding all contingencies should also be provided for. 'Valuing the stock in trade at market price or cost price whichever is less', 'making the provision for doubtful debts on debtors in anticipation of actual bad debts', 'adopting written down value method of depreciation as against straight line method', not providing for discount on creditors but providing for discount on debtors', are some of the examples of the application of the convention of conservatism.

4. Convention of Consistency:- The convention of consistency requires that once a firm decided on certain accounting policies and methods and has used these for some time, it should continue to follow the same methods or procedures for all subsequent similar events and transactions unless it has a sound reason to do otherwise. In other words, accounting practices should remain unchanged from one period to another. For example, if depreciation is charged on fixed assets according to straight line method, this method should be followed year after year. Analogously, if stock is valued at 'cost or market price whichever is less', this principle should be applied in each subsequent year.

The various terms used for describing the basic ideas are: concepts, postulates, propositions, assumptions, underlying principles, fundamentals, conventions, doctrines, rules, axioms, etc. Some of these terms/ideas have a better claim to be called 'concepts' while the rest should be called 'conventions'.

The term 'Concept' is used to connote the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. In other words, fundamental accounting concepts are broad general assumptions which underline the periodic financial statements of business enterprises. The term 'convention' is used to signify customs or tradition as a guide to the preparation of accounting statements.
