2

ACCOUNTING CONCEPTS

In the previous lesson, you have studied the meaning and nature of business transactions and objectives of financial accounting. In order to maintain uniformity and consistency in preparing and maintaining books of accounts, certain rules or principles have been evolved. These rules/principles are classified as concepts and conventions. These are foundations of preparing and maintaining accounting records. In this lesson we shall learn about various accounting concepts, their meaning and significance.

OBJECTIVES

After studying this lesson, you will be able to :

- explain the term accounting concept;
- explain the meaning and significance of various accounting concepts : Business Entity, Money Measurement, Going Concern, Accounting Period, Cost Concept, Duality Aspect concept, Realisation Concept, Accrual Concept and Matching Concept.

2.1 MEANING AND BUSINESS ENTITY CONCEPT

Let us take an example. In India there is a basic rule to be followed by everyone that one should walk or drive on his/her left hand side of the road. It helps in the smooth flow of traffic. Similarly, there are certain rules that an accountant should follow while recording business transactions and preparing accounts. These may be termed as accounting concept. Thus, this can be said that :

> Accounting concept refers to the basic assumptions and rules and principles which work as the basis of recording of business transactions and preparing accounts.

The main objective is to maintain uniformity and consistency in accounting records. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus they are universally accepted rules. Following are the various accounting concepts that have been discussed in the following sections :

- Business entity concept
- Money measurement concept
- Going concern concept
- Accounting period concept
- Accounting cost concept
- Duality aspect concept
- Realisation concept
- Accrual concept
- Matching concept

Business entity concept

This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense. Thus, the accounting records are made in the books of accounts from the point of view of the business unit and not the person owning the business. This concept is the very basis of accounting.

Let us take an example. Suppose Mr. Sahoo started business investing Rs100000. He purchased goods for Rs40000, Furniture for Rs20000 and plant and machinery of Rs30000. Rs10000 remains in hand. These are the assets of the business and not of the owner. According to the business entity concept Rs100000 will be treated by business as capital i.e. a liability of business towards the owner of the business.

Now suppose, he takes away Rs5000 cash or goods worth Rs5000 for his domestic purposes. This withdrawal of cash/goods by the owner from the

business is his private expense and not an expense of the business. It is termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct persons. Accordingly, any expenses incurred by owner for himself or his family from business will be considered as expenses and it will be shown as drawings.

Significance

The following points highlight the significance of business entity concept :

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- This concept restraints accountants from recording of owner's private/ personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view
- It is the very basis of accounting concepts, conventions and principles.

INTEXT QUESTIONS 2.1

Fill in the blanks with suitable word/words

(i) The accounting concepts are basic ..... of accounting.

(ii) The main objective of accounting concepts is to maintain ..... and ..... in the accounting record.

(iii) ..... concept assumes that business enterprise and its owners are two separate independent entities.

(iv) The goods drawn from business for owner's personal use are called .....

2.2 MONEY MEASUREMENT CONCEPT

This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees.

Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts. For example, sale of goods worth Rs.200000, purchase of raw materials

Rs.100000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts. For example, sincerity, loyality, honesty of employees are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Another aspect of this concept is that the records of the transactions are to be kept not in the physical units but in the monetary unit. For example, at the end of the year 2006, an organisation may have a factory on a piece of land measuring 10 acres, office building containing 50 rooms, 50 personal computers, 50 office chairs and tables, 100 kg of raw materials etc. These are expressed in different units. But for accounting purposes they are to be recorded in money terms i.e. in rupees. In this case, the cost of factory land may be say Rs.12 crore, office building of Rs.10 crore, computers Rs.10 lakhs, office chairs and tables Rs.2 lakhs, raw material Rs.30 lakhs. Thus, the total assets of the organisation are valued at Rs.22 crore and Rs.42 lakhs. Therefore, the transactions which can be expressed in terms of money is recorded in the accounts books, that too in terms of money and not in terms of the quantity.

Significance

The following points highlight the significance of money measurement concept :

- This concept guides accountants what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

INTEXT QUESTIONS 2.2

Put a tick mark (√) against the information that should be recorded in the books of accounts and cross mark (×) against the information that should not be recorded

(i) Health of a managing director

(ii) Purchase of factory building Rs.10 crore

(iii) Rent paid Rs.100000

(iv) Goods worth Rs.10000 given as charity

(v) Delay in supply of raw materials

2.3 GOING CONCERN CONCEPT

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet; For example, a company purchases a plant and machinery of Rs.100000 and its life span is 10 years. According to this concept every year some amount will be shown as expenses and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it will not be proper to charge the amount from the revenues of the year in which the item is acquired. Only a part of the value is shown as expense in the year of purchase and the remaining balance is shown as an asset.

Significance

The following points highlight the significance of going concern concept;

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the fixed asset.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- A business is judged for its capacity to earn profits in future.

INTEXT QUESTIONS 2.3

Fill in the blanks by selecting correct words given in the bracket/brackets:

(i) Going concern concept states that every business firm will continue to carry on its activities …….. (for a definite time period, for an indefinite time period)

(ii) Fixed assets are shown in the books at their …….. (cost price, market price)

(iii) The concept that a business enterprise will not be closed down in the near future is known as …….. (going concern concept, money measurement concept)

(iv) On the basis of going concern concept, a business prepares its ..... (financial statements, bank statement, cash statement)

(v) ..... concept states that business will not be dissolved in near future. (Going concern, Business entity)

2.4 ACCOUNTING PERIOD CONCEPT

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financical position, tax computation etc.

Further, this concept assumes that, indefinite life of business is divided into parts. These parts are known as Accounting Period. It may be of one year, six months, three months, one month, etc. But usually one year is taken as one accounting period which may be a calender year or a financial year.

> Year that begins from 1st of January and ends on 31st of December, is known as Calendar Year. The year that begins from 1st of April and ends on 31st of March of the following year, is known as financial year.

As per accounting period concept, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent, salaries etc. paid for the period are accounted for and against that period only.

Significance

- It helps in predicting the future prospects of the business.
- It helps in calculating tax on business income calculated for a particular time period.
- It also helps banks, financial institutions, creditors, etc to assess and analyse the performance of business for a particular period.
- It also helps the business firms to distribute their income at regular intervals as dividends.

INTEXT QUESTIONS 2.4

Fill in the blanks with suitable word/words.

(i) Recording of transactions in the books of accounts with a definite period is called ……. concept.

(ii) The commonly accepted accounting period in India is …….

(iii) According to accounting period concept, revenue and expenses are related to a ……. period.

(iv) If accounting year begins from 1st of January, and ends on 31st of December, it is known as …….

(v) If accounting year begins from 1st of April and ends on 31st of March, then accounting year is known as …….

2.5 ACCOUNTING COST CONCEPT

Accounting cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them. For example, a machine was purchased by XYZ Limited for Rs.500000, for manufacturing shoes. An amount of Rs.1,000 were spent on transporting the machine to the factory site. In addition, Rs.2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e. Rs.503000. This cost is also known as historical cost. Suppose the market price of the same is now Rs 90000 it will not be shown at this value. Further, it may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The cost concept is also known as historical cost concept. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price.

Significance

- This concept requires asset to be shown at the price it has been acquired, which can be verified from the supporting documents.
- It helps in calculating depreciation on fixed assets.
- The effect of cost concept is that if the business entity does not pay anything for an asset, this item will not be shown in the books of accounts.

INTEXT QUESTIONS 2.5

Fill in the blanks with suitable word/words

(i) The cost concept states that all fixed assets are recorded in the books of accounts at their ..... price.

(ii) The main objective to adopt historical cost in recording the fixed assets is that the cost of the assets will be easily verifiable from the ..... documents.

(iii) The cost concept does not show the ..... of the business.

(iv) The cost concept is otherwise known as ..... concept.

2.6 DUAL ASPECT CONCEPT

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded.

Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :

$$\boxed{\text{Assets} = \text{Liabilities} + \text{Capital}}$$

The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. This claim is also termed as capital or owners equity and that of outsiders, as liabilities or creditors' equity.

The knowledge of dual aspect helps in identifying the two aspects of a transaction which helps in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

Let us analyse some more business transactions in terms of their dual aspect :

1. Capital brought in by the owner of the business

   The two aspects in this transaction are :

   (i) Receipt of cash

   (ii) Increase in Capital (owners equity)

2. Purchase of machinery by cheque

   The two aspects in the transaction are

   (i) Reduction in Bank Balance

   (ii) Owning of Machinery

3. Goods sold for cash

   The two aspects are

   (i) Receipt of cash

   (ii) Delivery of goods to the customer

4. Rent paid in cash to the landlord

   The two aspects are

   (i) Payment of cash

   (ii) Rent (Expenses incurred).

Once the two aspects of a transaction are known, it becomes easy to apply the rules of accounting and maintain the records in the books of accounts properly.

The interpretation of the Dual aspect concept is that every transaction has an equal effect on assets and liabilities in such a way that total assets are always equal to total liabilities of the business.

Significance

- This concept helps accountant in detecting error.
- It encourages the accountant to post each entry in opposite sides of two affected accounts.

INTEXT QUESTIONS 2.6

Write the two aspects (effects) of the following transactions.

S.No.	Transaction	Ist aspect	IInd aspect
(i)	Owner brings cash in business		
(ii)	Goods purchased for cash		
(iii)	Goods sold for cash		
(iv)	Furniture purchased for cash		
(v)	Received cash from Sharma		
(vi)	Purchased machine from Rama on credit		
(vii)	Paid to Ram		
(viii)	Salaries Paid		
(ix)	Rent Paid		
(x)	Rent Received		

2.7 REALISATION CONCEPT

This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not.

In other words, it can be said that :

> Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.

Let us study the following examples :

(i) N.P. Jeweller received an order to supply gold ornaments worth Rs.500000. They supplied ornaments worth Rs.200000 up to the year ending 31st December 2005 and rest of the ornaments were supplied in January 2006.

(ii) Bansal sold goods for Rs.1,00,000 for cash in 2006 and the goods have been delivered during the same year.

(iii) Akshay sold goods on credit for Rs.50,000 during the year ending 31st December 2005. The goods have been delivered in 2005 but the payment was received in March 2006.

Now, let us analyse the above examples to ascertain the correct amount of revenue realised for the year ending 31st December 2005.

(i) The revenue for the year 2005 for N.P. Jeweller is Rs.200000. Mere getting an order is not considered as revenue until the goods have been delivered.

(ii) The revenue for Bansal for year 2005 is Rs.1,00,000 as the goods have been delivered in the year 2005. Cash has also been received in the same year.

(iii) Akshay's revenue for the year 2005 is Rs.50,000, because the goods have been delivered to the customer in the year 2005. Revenue became due in the year 2005 itself. In the above examples, revenue is realised when the goods are delivered to the customers.

> The concept of realisation states that revenue is realized at the time when goods or services are actually delivered.

In short, the realisation occurs when the goods and services have been sold either for cash or on credit. It also refers to inflow of assets in the form of receivables.

Significance

- It helps in making the accounting information more objective.
- It provides that the transactions should be recorded only when goods are delivered to the buyer.

INTEXT QUESTIONS 2.7

Ascertain the amount of current revenue realized for the year ending 31st December 2006

(i) An order, to supply goods for Rs.20,00,000 is received in the year 2006. The goods have been supplied only for Rs.10,00,000 in 2006.

(ii) What will be the revenue (i) if the payment of Rs.6,00,000 is received in cash in 2006 and the balance payment of Rs.4,00,000 received in 2007.

(iii) What will be the revenue if the goods have been sold on credit and the payment of Rs.1500000 is received in the year 2007, while all the goods of Rs.20,00,000 are supplied in the year 2006.

(iv) What will be the revenue if an advance payment of Rs.100,000 is received in the year 2006 and the balance received in the year 2007.

2.8 ACCRUAL CONCEPT

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses.

The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of the fact when the cash is received. For example, a firm sells goods for Rs 55000 on 25th March 2005 and the payment is not received until 10th April 2005, the amount is due and payable to the firm on the date of sale i.e. 25th March 2005. It must be included in the revenue for the year ending 31st March 2005. Similarly, expenses are recognised at the time services provided, irrespective

of the fact when actual payment for these services are made. For example, if the firm received goods costing Rs.20000 on 29th March 2005 but the payment is made on 2nd April 2005 the accrual concept requires that expenses must be recorded for the year ending 31st March 2005 although no payment has been made until 31st March 2005 though the service has been received and the person to whom the payment should have been made is shown as creditor.

In brief, accrual concept requires that revenue is recognised when realised and expenses are recognised when they become due and payable without regard to the time of cash receipt or cash payment.

Significance

- It helps in knowing actual expenses and actual income during a particular time period.
- It helps in calculating the net profit of the business.

INTEXT QUESTIONS 2.8

Fill in the blanks with suitable word/words :

(i) Accrual concept relates to the determination of .....

(ii) Goods of Rs.50000 are sold on 25th March 2006 but payment is received on 10th April 2006. It will be a revenue for the year ending .....

(iii) Accrual concept requires revenue is recognised when ..... and expenses are recognised when they become .....

2.9 MATCHING CONCEPT

The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept.

Let us study the following transactions of a business during the month of December, 2006

(i) Sale : cash Rs.2000 and credit Rs.1000

(ii) Salaries Paid Rs.350

(iii) Commission Paid Rs.150

(iv) Interest Received Rs.50

(v) Rent received Rs.140, out of which Rs.40 received for the year 2007

(vi) Carriage paid Rs.20

(vii) Postage Rs.30

(viii) Rent paid Rs.200, out of which Rs.50 belong to the year 2005

(ix) Goods purchased in the year for cash Rs.1500 and on credit Rs.500

(x) Depreciation on machine Rs.200

Let us record the above transactions under the heading of Expenses and Revenue.

	Expenses		Amount Rs		Revenue		Amount Rs
1.	Salaries		350	1.	Sales		
2.	Commission		150		Cash	2000	
3.	Carriage		20		Credit	1000	3000
4.	Postage		30	2.	Interest received		50
5.	Rent paid	200		3.	Rent received	140	
	Less for 2005	(50)	150		Less for 2007	(40)	100
6.	Goods purchased						
	Cash	1500					
	Credit	500	2000				
7.	Depreciation on machine		200				
	Total		2900		Total		3150

In the above example expenses have been matched with revenue i.e (Revenue Rs.3150-Expenses Rs.2900) This comparison has resulted in profit of Rs.250. If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept.

Therefore, the matching concept implies that all revenues earned during an accounting year, whether received/not received during that year and all cost incurred, whether paid/not paid during the year should be taken into account while ascertaining profit or loss for that year.

Significance

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.
- It is very helpful for the investors/shareholders to know the exact amount of profit or loss of the business.

INTEXT QUESTIONS 2.9

Fill in the blanks with suitable word/words :

(i) Expenses are matched with ……...……. generated during a period.

(ii) Goods sold for cash is an example of ……...…….

(iii) Salaries paid is an example of ……...…….

(iv) Income is the excess of ……...……. over ……...…….

(v) ……...……. concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period

(vi) ……...……. concept states how the expenses should be compared with revenues for ascertaining exact profit or loss for a particular period

WHAT YOU HAVE LEARNT

- Accounting concept refers to the basic assumptions which serve the basis of recording actual business transactions.
- The important accounting concepts are business entity, money measurement, going concern, accounting period, cost concept, duality aspect concept, realisation concept, accrual concept, and matching concept.
- Business entity concept assumes that for accounting purposes, the business enterprise and its owner(s) are two separate entities.
- Money measurement concept assumes that all business transactions must be recorded in the books of accounts in terms of money.
- Going concern concept states that a business firm will continue to carry on activities for an indefinite period of time.
- Accounting period concept states that all the business transactions are recorded in the books of accounts on the assumption that profits of transactions is to be ascertained for a specified time period.
- Accounting cost concept states that all assets are recorded in the books of accounts at their cost price.
- Dual aspect concept states that every transaction has a dual effect.

- Realisation concept states that revenue from any business transaction should be included in the accounting records only when it is realised
- Matching concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period

TERMINAL QUESTIONS

1. Explain meaning and significance of going concern concept.
2. What do you mean by business entity concept?
3. State meaning and significance of money measurement concept.
4. Write short notes on the following
   (a) Cost concept
   (b) Accrual concept
   (c) Matching concept
   (d) Accounting period concept
5. What do you mean by accounting concept? Explain any four accounting concepts.

ANSWERS TO INTEXT QUESTIONS

Intext Questions 2.1

(i) rules (ii) uniformity and consistency
(iii) Business entity concept (iv) drawings

Intext Question 2.2

(i) × (ii) √ (iii) √ (iv) √ (v) ×

Intext Question 2.3

(i) for an indefinite time period (ii) cost price
(iii) going concern concept (iv) financial statements
(v) Going concern

Intext Question 2.4

(i) accounting period (ii) one year
(iii) particular (iv) calender year
(v) financial year

Intext Question 2.5

(i) purchase (ii) supporting
(iii) true net worth (iv) historical cost

Intext Question 2.6

(i) Owner's capital, cash (ii) Goods received, cash
(iii) Cash received, goods sold (iv) Furniture, cash
(v) Cash, Sharma (vi) Machine, Rama
(vii) Ram, cash (viii) Salaries, cash
(ix) Rent, cash (x) Cash, rent

Intext Question 2.7

(i) Rs.10,00,000 (ii) Rs.10,00000
(iii) Rs.20,00000 (iv) Rs.1,00,000

Intext Question 2.8

(i) income (ii) 31st March, 2006 (iii) realised, due

Intext Question 2.9

(i) revenue (ii) revenue
(iii) expense (iv) revenue, expenses
(v) matching (vi) matching

Activity

In our country business concerns are not following the same accounting period every year. Enquire from various sources and list various such periods prevailing in our country. One for example is given

1. Year ending 31st March (financial year)
2. .....
3. .....
4. .....
5. .....

3

ACCOUNTING CONVENTIONS AND STANDARDS

In the previous lesson, you have studied the accounting concepts like business entity, money measurement, going concern, accounting period, cost, duality, realisation, accrual and matching. These concepts or assumptions or principles are working rules for all accounting activities.

You may visit some business units. Enquire them and find out how unsold goods are being valued. You will find that they follow the same method of valuation of unsold stock of goods. If you ask them, why do they value the unsold goods at cost or market price, whichever is lower, even though the market price is higher than the cost price, the businessman may answer that it is the convention, tradition or practice or custom of the business, that business is following year after year. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts. Apart from these, the Institute of Chartered Accountants of India (ICAI), which is the main regulatory body for standardisation of accounting policies in the country has issued a number of accounting standards from time to time to bring consistency in the accounting practices. We shall study about accounting conventions and standards in detail in this lesson.

OBJECTIVES

After studying this lesson, you will be able to :

- explain the meaning of accounting convention;
- explain the meaning and significance of accounting conventions like consistency of full disclosure, materiality and convservatism;
- state the meaning of the term Generally Accepted Accounting Principles (GAAP);
- explain the concept of accounting standard and enumerate the various accounting standards issued by the Institute of Chartered Accountants of India.

3.1 MEANING AND CONVENTION OF CONSISTENCY

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. They are followed like customs, tradition, etc. in a society. Accounting conventions are evolved through the regular and consistent practice over the years to facilitate uniform recording in the books of accounts. Accounting Conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years. The most important conventions which have been used for a long period are :

- Convention of consistency.
- Convention of full disclosure.
- Convention of materiality.
- Convention of conservatism.

Convention of consistency

The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable.

Generally a businessman follows the undermentioned general practices or methods year after year.

(i) While charging depreciation on fixed assets or valuing unsold stock, once a particular method is used it should be followed year after year so that the financial statements can be analysed and compared provided the depreciation on fixed assets is charged or unsold stock is valued by using particular method year after year. This can be further clarified as : in case of charging depreciation on fixed assets accountant can decide to adopt any one of the methods of depreciation such as diminishing value method or straight line method.

Similarly, in case of valuation of closing stock it can be valued at actual cost price or market price or whichever is less. However precious metals like gold, diamond, minerals are generally valued at market price only.

Types of consistency : There are three types of consistency namely :

(i) **Vertical consistency** (Same organisation) : It is to be found within the group of inter-related financial statements of an organisation on the same date. It occurs when fixed assets have been shown at cost price and in the interrelated income statement depreciation has also been charged on the historical cost of the assets.

(ii) **Horizontal consistency** (Time basis) : This consistency is to be found between financial statements of one entity from period to period. Thus, it helps in comparing performance of the business between two years i.e. current year with past year.

(iii) **Dimensional consistency** (Two organisations in the same trade) : This consistency is to be found in the statements of two different business entities of the same period. This type of consistency assists in making comparison of the performance of one business entity with the other business entity in the same trade and on the same date.

Therefore, as per this convention the same accounting methods should be adopted every year in preparing financial statements. But it does not mean that a particular method of accounting once adopted can never be changed. Whenever a change in method is necessary, it should be disclosed by way of footnotes in the financial statements of that year.

Significance

- It facilitates comparative analysis of the financial statements.
- It ensures uniformity in charging depreciation on fixed assets and valuation of closing stock.

INTEXT QUESTIONS 3.1

Fill in the blanks with suitable word/words

(i) Convention of consistency means that same accounting principles should be used for preparing financial statements .....

(ii) Unsold goods are valued at cost price or ..... whichever is .....

(iii) Precious metals, like gold, mineral and others are generally valued at..... .

(iv) As per the convention of ..... year after year same methods are followed.

3.2 CONVENTION OF FULL DISCLOSURE

Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. **Adequate** means sufficient set of information to be disclosed. **Fair** indicates an equitable treatment of users. **Full** refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information. Let us relate it to the business. The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholder would like to know profitability of the firm while the creditor would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statement discloses all relevant information in full, fair and adequate manner.

Let us take an example. As per accounts, net sales are Rs.150,000, it is important for the interested parties to know the amount of gross sales which may be Rs.200,000 and the sales return Rs.50,000. The disclosure of 25% sales returns may help them to find out the actual sales position. Therefore, whatever details are available, that must be honestly provided. Additional information should also be given in the financial statement. For example, in a balance sheet the basis of valuation of assets, such as investments, inventories, land and building etc. should be clearly stated. Similarly, any change in the method of depreciation or in making provision for bad debts or creating any reserve must also be shown clearly in the Balance Sheet. Therefore, in order to achieve the purpose of accounting, all the transactions of a business and any change in accounting policies, methods and procedures are fully recorded and presented in accounting.

To ensure proper disclosure of material accounting information, the Companies Act 1956, under schedule VI has provided a format for the preparation of Profit and Loss account and Balance Sheet of a company. It is necessary for every company to follow this format. The regulatory bodies like Securities and Exchange Board of India (SEBI) has also made compulsory for complete disclosures by registered companies.

Significance

- It helps in meaningful comparison of financial statements of the different business units.

- This can also help in the comparison of financial statements of different years of the same business unit.
- This convention is of great help to investor and shareholder for making investment decisions.
- The convention of full disclosure presents reliable information.

INTEXT QUESTIONS 3.2

Fill in the blanks with appropriate word/words.

(i) The shareholder would like to know about the ..... of the business.

(ii) The convention of full disclosure requires that there should be full, ... and ..... disclosure of accounting information.

(iii) The creditors are interested to know the ..... of the business.

(iv) All relevant material facts should be ..... in the financial statement.

(v) The full disclosure convention presents ..... information.

3.3 CONVENTION OF MATERIALITY

The convention of materiality states that, to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Material fact means the information of which will influence the decision of its user.

For example, a businessman is dealing in electronic goods. He purchases T.V., Refrigerator, Washing Machine, Computer etc. for his business. In buying these items he uses larger part of his capital. These items are significant items; thus should be recorded in books of accounts in detail. At the same time to maintain day to day office work he purchases pen, pencil, match box, scented stick, etc. For this he will use very small amount of his capital. But to maintain the details of every pen, pencil, match box or other small items is not considered of much significance. These items are insignificant items and hence they should be recorded separately. Thus, the items that are significantly important in recording the details are termed

as material facts or significant items. The items that are of less significance are immaterial facts or insignificant items.

Thus according to this convention important and significant items should be recorded in their respective heads and all immaterial or insignificant transactions should be clubbed under a different accounting head.

Significance

- It helps in minimising errors in calculation.
- It helps in making financial statements more meaningful.
- It saves time and resources.

INTEXT QUESTIONS 3.3

Fill in the blanks with suitable word/words

(i) …… convention states that to make financial statements more meaningful, only significant and important items should be supplied to the users.

(ii) Convention of materiality states that insignificant items should be disclosed under ……

(iii) …… convention keeps accounts and manager to focus on important /significant items.

(iv) …… means the information which will influence the decision of its user.

3.4 CONVENTION OF CONSERVATISM

This convention is based on the principle that **"Anticipate no profit, but provide for all possible losses"**. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.

Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future,

provision should be made in the books of accounts for the same. For example, valuing closing stock at cost or market price whichever is lower, creating provision for doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent, etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

Significance

- It helps in ascertaining actual profit.
- It is useful in the situation of uncertainties and doubts.
- It helps in maintaining the capital of the enterprise.

INTEXT QUESTIONS 3.4

Give your decision in the following situations :

(i) A business has unsold stock at the end of year. The cost price is Rs.200000 and the market price is Rs 250000. At which price the unsold stock be recorded ?

(ii) What will be your decision if the cost price in the above case is Rs.210000 ?

(iii) A businessman anticipates that it may not be possible to collect Rs.50000 from one of his debtors. will he record this transaction in books of account and at what value?

3.5 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) AND ACCOUNTING STANDARDS

In order to maintain uniformity and consistency in accounting records throughout the world, certain rules and principles have been developed which are generally accepted by the accounting profession. These rules/ principles are called by different names such as principles, concepts, conventions, postulates, assumptions. These rules/principles are judged on their general acceptability rather than universal acceptability. Hence, they are popularly called Generally Accepted Accounting Principles (GAAP). The term "generally accepted" means that these principles must have support, that generally comes from the professional accounting bodies. Thus, Generally Accepted Accounting Principles (GAAP) refer to the rules or guidelines adopted for recording and reporting of business transactions of financial statements. These principles have evolved over a long period

of time on the basis of past experiences, usages or customs, etc. These principles are also referred as concepts and conventions, which have already been discussed.

Accounting standards

The term standard denotes a discipline, which provides both guidelines and yardsticks for evaluation. As guidelines, accounting standard provides uniform practices and common techniques of accounting. As a general rule, accounting standards are applicable to all corporate enterprises. They are made operative from a date specified in the standard. The Institute of Chartered Accountant of India (ICAI) constituted the Accounting Standards Board (ASB) in April, 1977 for developing accounting standards. However, the International Accounting Standards Committee (IASC) was set up in 1973, with its headquarter in London (U.K.).

The Accounting Standards Board is entrusted with the responsibility of formulating standards on significant accounting matters keeping in view the international developments, and legal requirements in India.

The main function of the ASB is to identify areas in which uniformity in standards is required and to develop draft standards after discussions with representatives of the Government, public sector undertaking, industries and other agencies.

In the initial years the standards are of recommendatory in nature. Once an awareness is created about the benefits and relevance of accounting standards, steps are taken to make the accounting standards mandatory for all companies. In case of non compliance, the companies are required to disclose the reasons for deviations and its financial effect :

Till date, the IASC has brought out 40 accounting standards. However, the ICAI has so far issued 29 accounting standards. These are :

AS-1 Disclosure of accounting policies (January 1979). This standard deals with the disclosure of significant accounting policies in the financial statements.

AS-2 Valuation of Inventories (June 1981). This standard deals with the principles of valuing inventories for the financial statements.

AS-3 (Revised) Cash flow statement (June 1981, Revised in March 1997). This standard deals with the financial statement which summaries for a given period the sources and applications of an enterprise.

AS-4 Contingencies and events occurring after the Balance Sheet date (November 1982, Revised in April, 1995) This standard deals with the treatment of contingencies and events occurring after the balance sheet date.

AS-5 Net profit or loss for the period, prior period (period before the date of balance sheet) items and changes in accounting policies (November 1982, Revised in February 1997). This standard deals with the treatment in financial statement of prior period and extraordinary items and changes in accounting policies.

AS-6 Depreciation Accounting (November 1982). This standard applies to all depreciable assets. But this standard does not apply to assets in the category of forests, plantations and similar natural resources and wasting assets.

AS-7 Accounting for construction contracts (December 1983, revised in April 2003). This standard deals with accounting for construction contracts in the financial statements of contractors.

AS-8 Accounting for Research and Development (January 1985). This standard deals with the treatment of costs of research and development in financial statements.

AS-9 Revenue Recognition (November 1985). This standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise.

AS-10 Accounting for fixed assets (November 1991). This standard deals with recognition of fixed assets grouped into various categories, such as land, building, plant and machinery, vehicles, furniture and gifts, goodwill, patents, trading and designs.

AS-11 Accounting for the effects of change in foreign exchange Rates. (August 1991 and Revised in 1993). This standard deals with the issues relating to accounting for effect of change in foreign exchange rates.

AS-12 Accounting for Government grants (April 1994). This standard deals with the accounting for government grants.

AS-13 Accounting for investments (September 1994). This standard deals with accounting aspect concerning investments in the financial statements. These include classification, determination of cost for initial recognition, disposal and re-classification of investment.

AS-14 Accounting for amalgamation (October 1994). This standard deals with accounting treatment of any resultant goodwill or reserves in amalgamation of companies.

AS-15 Accounting for retirement Benefits in the financial statements of employers (January 1995). This standard deals with accounting for retirement benefits in the financial statements of employers.

AS-16 Borrowing Costs (April 2000). This standard deals with the uses involved relating to capitalization of interest on borrowing for purchase of fixed assets.

AS-17 Segment reporting (October 2000). This standard applies to companies which have an annual turnover of Rs 50 crores or more. These companies have to present financial statements and consolidated financial statements.

AS-18 Related party disclosures (October 2000 revised 1st July 2003). This standard requires certain disclosure which must be made for transactions between the enterprise and related parties.

AS-19 Leases (January 2001). This standard deals with the accounting treatment of transactions related to lease agreements.

AS-20 Earning per share (April 2001). This standard deals with the presentation and computation of earning per share (EPS).

AS-21 Consolidated financial statements (April 2001). This standard deals with the preparation of consolidated financial statements with an intention to provide information about the activities of a group.

AS-22 Accounting for taxes on Income (April 2001). This standard deals with determination of the account of tax expenses for the related revenue.

AS-23 Accounting for investments in Associates in consolidated financial statements (July 2001). This standard deals with the principles and procedures to be followed for recognising, in the consolidated financial statement.

AS-24 Discontinued operations (February 2002). This standard deals with the principles of discontinuing operations of an enterprise with the activities which are continuing.

AS-25 Interim financial reporting (February 2002). This standard deals with the minimum content of interim financial report.

AS-26 Intangible Assets (February 2002). This standard prescribed the accounting treatment for intangible assets which are not covered by any other specific accounting standard.

AS-27 Financial reporting of interest for joint venture (February 2002). This standard sets principles and procedure for accounting for interest in joint venture.

AS-28 Impairment of Assets (2004). This standard prescribed procedure to ensure that an asset is carried at no more than its carrying amount and procedures as to when to recognise an asset as impaired.

AS-29 Provision for contingent labilities and contingent assets (2004). This standard deals with measurement and recognition criteria in three areas, namely provisions, contingent liabilities and contingent assets.

All the above standards issued by the Accounting Standards Board are recommended for use by companies listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

INTEXT QUESTIONS 3.5

Fill in the blank with appropriate words

(i) AS1 deals with .....

(ii) AS29 deals with .....

(iii) AS26 deals with .....

(iv) AS20 deals with .....

(v) AS21 deals with .....

(vi) AS22 deals with .....

(vii) GAAP stands for .....

(viii) Accounting standard Board (ASB) was established .....

(ix) International Accounting Standard .....

(x) AS2 deals with .....

WHAT YOU HAVE LEARNT

- Accounting conventions are common practices which are followed in recording and presenting accounting information of business.
- Convention of consistency states that the same accounting methods should be adopted every year in preparing financial statements.
- Convention of disclosure states that all material and relevant facts relating to financial statements should be fully disclosed.

- Convention of materiality states that, to make financial statements more meaningful only significant information should be shown in the financial statements.
- Convention of conservatism states that, profit should not be recorded until it is realised. But if business anticipates any loss in near future provision should be made in the books of account.
- Generally accepted accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financial statements.

TERMINAL QUESTIONS

1. Explain the convention of consistency with example.
2. Explain the accounting convention of conservatism with example.
3. What do you mean by accounting standards? Enumeratre the accounting standard issued by the ASB from time to time.
4. Explains the convention of materiality.
5. Explain the accounting convention of full disclosure with example.

ANSWERS TO INTEXT QUESTIONS

Intext Questions 3.1

(i) year after year (ii) market price, lower

(iii) market price (v) consistency

Intext Questions 3.2

(i) profitability (ii) fair, adequate (iii) solvency

(iv) disclosed (v) reliable

Intext Questions 3.3

(i) Materiality (ii) separate head

(iii) Materiality (iv) Material fact

Intext Questions 3.4

(i) cost price i.e. Rs.200000 (ii) Cost price i.e. Rs.2100000

(iii) Yes, as a bad debt Rs.50000

Intext Questions 3.5

(i) Disclosure of accounting policies

(ii) Provisions, contingent liabilities and contingent assets

(iii) Intangible assets

(iv) Earning per share

(v) Consolidated financial statements

(vi) Accounting for an income

(vii) General Accepted Accounting principle

(viii) April, 1977

(ix) 1973

(x) Inventory valuation

Activity

Visit a number of business units you can and enquire from the accountants how do they deal with the following while preparing the accounts :

1. Valuation of the stock at the end of the accounting period.

2. At what intervals do they close their account books?

3. What method of depreciation did they use in the last three or four years?

4. Have they ever suffered losses or earned profits because of the lethargic attitude or loyality towards the organisation?

Complete the answer and draw the conclusion whether they are following some accounting concepts or not. If yes name the accounting conventions/ accounting concepts.