

ACCOUNTING ASSUMPTIONS, CONCEPTS AND CONVENTIONS**Fundamental Accounting Assumptions**

- a. Going concern
- b. Consistency
- c. Accrual

Accounting Concepts, Principles and Conventions

Accounting Concepts are assumptions on the basis of which Financial Statements are prepared. Concept means "Idea" or "Thought" which has universal application

Accounting Conventions are derived by usage and practice. They need not have universal application.

a. Entity Concept:

- ✓ Accountants treat a business as distinct from the persons who own it. But according to law business and the proprietor are one and the same.
- ✓ According to this concept, all the business transactions are recorded in the books of accounts from the view point of the business only. Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of accounts.
- ✓ Since distinction is made between business and owner, it becomes possible to record transactions of the business with the proprietor also. Without such a distinction, the affairs of the firm will be all mixed up with the private affairs of the proprietor and the true picture of the firm will not be available.

b. Money Measurement concept:

- ✓ In accounting, only those business transactions and events which are of financial nature are recorded.
- ✓ To be precise, the transactions should be measurable in terms of money. Otherwise it should not be recorded.

Example:

Car – 2 No.s
Stock – 5 kgs
Furniture – 5 Chairs and two tables
Computer – 3
Land – 10 acres
Building Rs.10,000

From the above information, a person cannot prepare a statement informing that the total of assets is 10,025 [i.e.10000+10+3+5+5+2]

- ✓ This concept has the following limitation.

- a. It does not give a complete account of the happenings in business unit.

Example:

→ Strike in the factory

→ Sales manager is not speaking with production manager

- b. It is not capable of recording transactions which cannot be expressed in terms of money.

→ Employees are the assets of the organization

Note: Though this concept has its own limitations, still it is used for accounting purposes, because there is not better measurement scale other than this concept.

c. Accrual concept:

- ✓ All income and charges relating to the financial period to which the financial statements relate should be taken into account, regardless of the date of receipt or payment.
- ✓ Income should be accounted on earned basis and not on receipt basis
- ✓ Expenses should be accounted on incurred basis and not on paid basis

d. Going concern concept

- ✓ The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.
- ✓ It is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations
- ✓ If such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

e. Cost concept

- ✓ According to this concept, an asset is ordinarily recorded in the books at the price at which it was acquired i.e. at its cost price.
- ✓ It must be remembered that the real worth of the assets changes from time to time. So, it does not mean that the value of such assets is wrongly recorded in the books.
- ✓ The book value of the assets as recorded does not reflect their real value. They do not signify that the values noted therein are the values for which they can be sold.
- ✓ Though the assets are recorded in the books at cost, in course of time, they become reduced in value on account of depreciation charges.
- ✓ The idea that the transactions should be recorded at cost rather than at a subjective or arbitrary value is known as Cost Concept.

f. Realisation concept

- ✓ This concept emphasizes that profit should be considered only when realized.
- ✓ When profit should be deemed to have accrued? Whether at the time of receiving the order or at the time of execution of the order or at the time of receiving the cash?
- ✓ Answer: As per law (Sales of Goods Act), the revenue is earned only when the goods are transferred. It means that profit is deemed to have accrued when 'property (ownership) in goods passes to the buyer' viz. when sales are affected.

g. Dual aspect concept

- ✓ Dual aspect principle is the basis for Double Entry System of book-Keeping.
- ✓ All business transactions recorded in accounts have two aspects.
- ✓ One is debit aspect and another one is credit aspect
- ✓ For every debit, there must be an equal and corresponding credit
- ✓ Now look at the following for Dual Aspect Concept

1 st Aspect		2 nd Aspect	
	Example		Example
Asset increases	Purchase of Machinery	Asset decreases	Payment of Cash
Asset increases	Purchase of Machinery	Liability increases	Payment at future date [on credit basis]
Asset decreases	Payment of Cash	Liability decreases	Settlement of Liability
Liability	Bank loan	Liability	Payment to creditors [using the

increases	obtained	decreases	loan amount]
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Alternatively,

1 st Aspect	2 nd Aspect
Asset decreases	Asset increases
Liability increases	Asset increases
Liability decreases	Asset decreases
Liability decreases	Liability increases

h. Periodicity concept

- ✓ Going Concern Concept is one of the Fundamental Accounting Assumption.
- ✓ However the businessman/users of financial information desire to know the results of the operation and financial position at appropriate time intervals.
- ✓ Therefore, the life of the business is divided into appropriate segments/time interval. Each segment/time interval is called as Accounting period.
- ✓ Normally the Accounting period is "one year" [12 months].
- ✓ Any period can be selected as Accounting Period depending upon the convenience of the business or as per the business practices in country
- ✓ Accounting attempts to present the gains or losses earned or suffered by the business during the period under review.

i. Matching Concept

- ✓ As per this concept, all expenses matched with the revenue of that period should only be taken into consideration.
- ✓ If any revenue is recognized, then expenses related to earn that revenue should also be recognized
- ✓ This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash.
- ✓ This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes
- ✓ It is not necessary that every expense identify every income. Some expenses are directly related to the revenue and some are time bound.

j. Materiality Concept:

- ✓ The term materiality is highly subjective and it cannot be exactly defined
- ✓ What is material and What is immaterial will depend upon the facts and circumstances of the case
- ✓ Information is material if its misstatement (i.e. omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information.
- ✓ Materiality principle permits other concepts to be ignored, if the effect is not considered material.
- ✓ This principle is an exception of "full disclosure concept".
- ✓ Example: Stationary purchased by the organization though not used fully in the accounting year purchased still shown as an expense of that year because of the materiality concept. Similarly depreciation on small items like books, calculators etc. is taken as 100% in the year of purchase though used by the company for more than a year. This is because the amount of books or calculator is very small to be shown in the balance sheet though it is the asset of the company.
- ✓ The essence of the materiality concept is that the omission or misstatement of an item is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying on the report would have been changed or influenced by the inclusion or correction of the item.

Accounting Conventions**a. Consistency**

- ✓ As per this principle, accounting policies should remain unchanged from one period to another
- ✓ The rules, practices, concepts and principles used in accounting should be continuously observed and applied year after year
- ✓ Comparisons of financial results of the business among different accounting period can be significant and meaningful only when consistent practices were followed in ascertaining them.
- ✓ **Example:** Depreciation can be provided in different methods. Inventory can be valued in different method. The method followed should be regular and consistent.

b. Full Disclosure

- ✓ As per this principle, the financial statement should act as a means of conveying information and not as a means of concealing information
- ✓ The doctrine suggests that all accounting statements should disclose all significant information to the users financial information
- ✓ This doctrine however does not express that the trade secrets or other necessary information should also be disclosed.
- ✓ Materiality concept is an exception to Full Disclosure Concept

c. Conservatism [Prudence Concept]

- ✓ This concept emphasizes that profit should never be overstated or anticipated.
- ✓ Traditionally, accounting follows the rule "anticipate no profit and provide for all possible losses.
- ✓ Example: Closing stock is valued at cost price or market price, whichever is lower. The effect of the above is that in case market price has come down then provide for the 'anticipated loss' but if the market price has gone up then ignore the 'anticipated profits'.
- ✓ To be precise, anticipated profit should not be accounted and anticipated loss should be accounted.