2

ACCOUNTING CONCEPTS AND CONVENTIONS

In the previous lesson, you studied the meaning and objectives of Financial Accounting. There are some concepts and conventions which are followed in accounting for a long time. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus, are universally accepted rules and are termed as 'Generally Accepted Accounting Principle' or GAAP. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts. In this lesson you will learn accounting concepts and conventions.

OBJECTIVES

After studying this lesson, you will be able to :

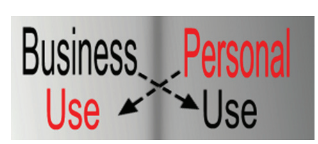
- understand the meaning of the term accounting concepts;
- explain the meaning and significance of accounting concepts : Business Entity, Money Measurement, Going Concern and Dual Aspect;
- understand the meaning of the term accounting conventions and
- explain the meaning and significance of accounting conventions of Materiality, Conservatism and Consistency.

2.1 ACCOUNTING CONCEPTS

Accounting Concepts refer to the basic assumptions, rules and principles which work as the basis of recording of business transactions and preparing accounts. Main Accounting Concepts are:

- Business Entity Concept
- Money Measurement Concept
- Going Concern Concept
- Dual Aspect Concept

2.2 BUSINESS ENTITY CONCEPT



This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate 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 cash/goods from the business 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 from the point of view of the owner.

Let us take an example, Ms. Sakshi started business by investing ₹ 2,00,000. She purchased goods for ₹ 20,000, Furniture for ₹ 10,000, Plant and Machinery of ₹ 50,000 and ₹ 10,000 remained in hand. These are the assets of the business and not of the owner. According to the business entity concept ₹ 2,00,000 will be treated by business as capital i.e. a liability of business towards the owner of the business.

Now suppose she takes away from business ₹ 5,000 in cash and goods worth ₹5,000 for her domestic purposes. This withdrawal of cash & goods by the owner from the business are her private expenses and not the expenses of the business. These are termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct entities. Accordingly, any expense incurred by owner for himself/herself or for his/her family from business will not be considered as an expense but it will be treated as drawings. Since business and its owners according to this concept are treated as separate entities therefore, the transactions between these two are recorded in the books of accounts.

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.

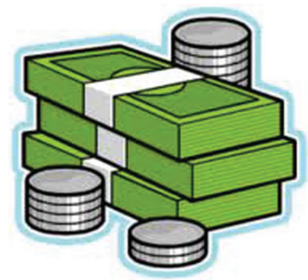
ii. ___________ concept assumes that business enterprise and its owners are two separate independent entities.

iii. The goods withdrawn from business for owner's personal use are called ___________ .

2.3 MONEY MEASUREMENT CONCEPT

This concept assumes that all business transactions must be in terms of money that is in the currency of the concerned 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 ₹ 1,00,000, purchase of raw materials ₹ 50,000, rent paid ₹ 20,000 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, loyalty and 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 2011, an organisation may have a factory on a piece of land measuring 5 acres, office building containing 10 rooms, 20 personal computers, 30 office chairs and tables, 50 kg of raw materials etc. These are expressed in different units, but for accounting purposes these are to be recorded in money terms i.e. in rupees (₹). In this case, the cost of factory land may be say ₹ 6 crore, office building ₹ 5 crore, computers ₹ 5 lakhs, office chairs and tables ₹ 1 lakh, raw material ₹ 15 lakhs. Thus, the total assets of the organisation are valued at ₹ 11 crore and ₹ 21 lakhs. Therefore, the transactions which can be expressed in terms of money are recorded in the books of accounts 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.

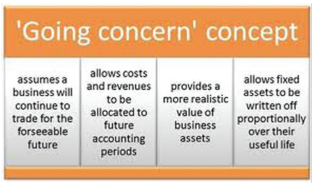
INTEXT QUESTIONS 2.2

From the following identify the transactions that can be recorded in books of accounts and that cannot to be recorded?

i. Health of a Managing Director.

ii. Purchase of factory building ₹ 5 crore.

Notes



iii. Rent paid ₹ 20,000.

iv. Goods worth ₹ 40,000 given as charity.

v. Delay in supply of raw materials.

2.4 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 purchased plant and machinery of ₹ 1,00,000 and its life span is 10 years. According to this concept every year some amount will be shown as expense 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 is not correct 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 assets.
- 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.
- Because of this concept business can be 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:

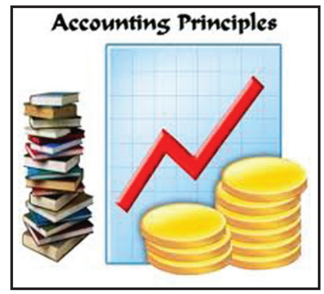
i. Going concern concept states that every business firm will continue to carry on its activities ____________ (for a definite time period, for an indefinite time period)

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)

Notes



v. ____________ concept states that business is a distinct entity from its owner. (Going concern, Business entity)

2.5 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:

Assets = Liabilities + Capital

The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. Owner's claim is also termed as capital or owner's 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 help 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:

i) **Capital brought in by the owner of the business :** First aspect Receipt of cash, Second aspect Increase in Capital (owner's equity).

ii) **Purchase of machinery by cheque :** First aspect Owning of Machinery, Second aspect Reduction in Bank Balance.

iii) **Goods sold for cash :** First aspect Receipt of cash, Second aspect, delivery of goods to the customer.

iv) **Rent paid in cash to the landlord :** First aspect Rent (Expenses incurred), Second aspect payment of cash.

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

The following points highlight the significance of Dual Aspect Concept

- This concept helps the accountant in detecting errors.
- It encourages the accountant to post each entry in opposite sides of two affected accounts.
- It helps in preparing the Financial Position Statement/ Balance Sheet on a particular date.

INTEXT QUESTIONS 2.4

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.	Commission received		

2.6 MEANING OF ACCOUNTING CONVENTIONS

Accounting conventions refer to common practices which are universally followed in recording and presenting accounting information of the business entity. These are followed like customs, traditions 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 time are:

- Convention of Consistency.
- Convention of Materiality.
- Convention of Conservatism.

2.7 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 a 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 same general practices or methods year after year, for preparing the books of accounts.

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 that, the depreciation on fixed assets is charged or unsold stock is valued by using same method year after year. This can be further clarified in case of charging depreciation on fixed assets, accountant can decide to adopt any one method 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, whichever is less. However, precious metals like gold, diamond, minerals are generally valued at market price only.

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

The following points highlight the significance of Convention of Consistency

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

INTEXT QUESTIONS 2.5

Fill in the blanks with suitable word/words:

i. Convention of consistency means that same accounting principles should be followed for preparing financial statements __________ .

ii. Unsold goods are valued at cost price or __________ whichever is________.

iii. Precious metals, like gold, silver etc. are generally valued at __________ .

iv. As per the convention of __________ year after year same methods of valuation of assets is followed.

2.8 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 refers to the information that 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

The following points highlight the significance of Convention of Materality

- It helps in minimising errors in calculation.
- It helps in making Financial Statements more meaningful.
- It saves time and resources.

INTEXT QUESTIONS 2.6

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 accountants and manager to focus on important /significant items.

iv. ___________ means the information which will influence the decision.

2.9 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 more profit is shown than the 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 earned. 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

The following point highlight the significance of convention of conservatism

- It helps in ascertaining actual profit.
- It is useful in the situation of uncertainties and doubts.
- It helps in maintaining the capital at its real value.

INTEXT QUESTIONS 2.7

I. Give your decision in the following situations :

(i) A business has unsold stock at the end of year. The cost price is ₹20,000 and its market price is ₹25,000. At which price the unsold stock should be recorded?

(ii) What is your decision if the cost price in the above case is ₹21,000 ?

(iii) A businessman anticipates that it may not be possible to collect ₹5,000 from one of his debtors. Will he record this transaction in books of account?

II. Multiple Choice Questions

i. According to going concern concept, a business is viewed as having:
   a) a limited life
   b) a very long life
   c) an indefinite life
   d) a long life

ii. Valuation of stock at lower of cost or net realizable value is an example of
   a) Consistency convention
   b) Conservation convention
   c) Materiality convention
   d) None of the above

iii. According to which of the following concepts the two aspects of a transaction are recorded.
   a) Matching concept
   b) Money Measurement concept
   c) Dual aspect concept
   d) Realisation concept

iv. According to which of the following accounting concepts, even the owner of a business is considered as creditor to the extent of his capital.
   a) Money measurement concept
   b) Dual aspect concept
   c) Business entity concept
   d) Realisation concept

v. The convention of conservatism takes into account
   a) All prospective losses but leaves prospective profits
   b) All prospective profits & leaves prospective losses
   c) All prospective profits and prospective losses
   d) Leaves all prospective profits and prospective losses

WHAT YOU HAVE LEARNT

- An 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, dual aspect 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 its activities for an indefinite period of time.
- Dual aspect concept states that every transaction has a dual effect.
- 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 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 earned. But if business anticipates any loss in near future, provision for it should be made in the books of accounts.

TERMINAL EXERCISE

1. Explain the meaning and significance of going concern concept.
2. What is meant by business entity concept?
3. State the meaning and significance of money measurement concept.
4. What do you mean by accounting concept? Explain any four accounting concepts.
5. Explain the convention of consistency with the help of an example.
6. Explain the accounting convention of conservatism with example.
7. Explain the convention of materiality.
8. State the meaning and significance of dual aspect concept.

ANSWER TO INTEXT QUESTIONS

2.1 i) Rules ii) Business Entity iii) Drawings

2.2 i) not recorded ii) recorded iii) recorded iv) recorded v) not recorded

2.3 i) for an indefinite time period ii) cost price iii) going concern concept iv) financial statements v) Business Entity

2.4 i) Cash, Owner's capital 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, Commission

2.5 i) Year after year ii) Market Price, Less
iii) Market Price iv) Consistency

2.6 i) Materiality ii) Different Accounting Heads
iii) Materiality iv) Materiality

2.7 **I.** i) ₹ 20,000 ii) ₹ 21,000 iii) yes
II. i) c ii) b iii) c iv) c v) a

ACTIVITY FOR YOU

- Enquire from various Business Entities and list various accounting periods in which these entities are not following same accounting practices.