

Accounting Concept and Conventions

In drawing up accounting statements, whether they are external "financial accounts" or internally-focused "management accounts", a clear objective has to be that the accounts fairly reflect the true "substance" of the business and the results of its operation.

The theory of accounting has, therefore, developed the concept of a "*true and fair view*". The true and fair view is applied in ensuring and assessing whether accounts do indeed portray accurately the business' activities.

To support the application of the "true and fair view", accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently.

Accounting Period Concept

Also known as Time Period where business operation can be divided into specific period of time such as a month, a quarter or a year (accounting period)

Final accounts are prepared at the end of the accounting period ie one year. Internal accounts can be prepared monthly, quarterly or half yearly.

Accounting Conventions

The most commonly encountered convention is the "**historical cost convention**". This requires transactions to be recorded at the price ruling at the time, and for assets to be valued at their original cost. Under the "historical cost convention", therefore, no account is taken of changing prices in the economy. Business should report its activities or economic events at their actual cost. For example, fixed assets are recorded at their cost in accounts except for land which can be revalued due to application.

The other conventions you will encounter in a set of accounts can be summarised as follows:

Money measurement concept Also known as Monetary unit. Transactions related to the business, and having money value are recorded in the books of accounts. Events or transactions which cannot be expressed in term of money do not find a place in the books of accounts. Items that are not accounted for (unless someone is prepared to pay something for them) include things like workforce skill, morale, market leadership, brand recognition, quality of management etc.

Separate Entity This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that relate to the business. Also known as Accounting Entity convention .Thus, business records should be separated and distinct from personal records of business owner.

Realisation With this convention, accounts recognise transactions (and any profits arising from them) at the point of sale or transfer of legal ownership - rather than just when cash actually changes hands. For example, a company that makes a sale to a customer can recognise that sale when the transaction is legal - at the point of contract. The actual payment due from the customer may not arise until several weeks (or months) later - if the customer has been granted some credit terms.

Materiality An important convention. As we can see from the application of accounting standards and accounting policies, the preparation of accounts involves a high degree of judgement. Where decisions are required about the appropriateness of a particular accounting judgement, the "materiality" convention suggests that this should only be an issue if the judgement is "significant" or "material" to a user of the accounts. The concept of "materiality" is an important issue for auditors of financial accounts.

Dual Aspect Concept: Double entry system. For every debit, there is a credit entry of an equal amount.

Substance Over Form: Real substance takes over legal form namely we consider the economic or accounting point of view rather than the legal point of view in recording transactions.

Objectivity and Subjectivity: Objectivity is following rules of the industry and based on objective evidence and subjectivity is to follow ones own rules and methods

Accounting Concepts

Four important accounting concepts underpin the preparation of any set of accounts:

Going Concern

Accountants assume, unless there is evidence to the contrary, that a company is not going broke. This has important implications for the valuation of assets and liabilities. The business will follow accounting concepts and methods on the assumption that business will continue its operation to the foreseeable future or for an indefinite period of time.

Consistency

Transactions and valuation methods are treated the same way from year to year, or period to period. Users of accounts can, therefore, make more meaningful comparisons of financial performance from year to year. According to this convention, accounting practices should remain unchanged from one period to another. For example, if depreciation is charged on fixed assets according to a particular method, it should be done year after year. Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change.

Prudence/Conservatism Concept Profits are not recognised until a sale has been completed. In addition, a cautious view is taken for future problems and costs of the business

They are "provided for" in the accounts" as soon as there is a reasonable chance that such costs will be incurred in the future. Take into account unrealized losses, not unrealized profit/gains. Assets should not be over-valued, liabilities under-valued. Provisions are example of prudence or conservatism concept. Also under this prudence/conservatism concept, stock/inventory is value at lower cost or market value. This concept guides accountants to choose option that minimize the possibility of overstating an asset or income.

Matching or Accuals Requires all revenues and expenses to be taken into account for the period in which they are earned and incurred when determining the profit/(loss) of the business. The net profit/(loss) is the difference between the revenue EARNED and the expenses INCURRED and not the difference between the revenue RECEIVED and expenses PAID.

Key Characteristics of Accounting Information

There is general agreement that, before it can be regarded as useful in satisfying the needs of various user groups, accounting information should satisfy the following criteria:

Criteria **What it means for the preparation of accounting information**

Understandability This implies the expression, with clarity, of accounting information in such a way that it will be understandable to users - who are generally assumed to have a reasonable knowledge of business and economic activities

Relevance This implies that, to be useful, accounting information must assist a user to form, confirm or maybe revise a view - usually in the context of making a decision (e.g. should I invest, should I lend money to this business? Should I work for this business?)

Consistency This implies consistent treatment of similar items and application of accounting policies

Comparability This implies the ability for users to be able to compare similar companies in the same industry group and to make comparisons of performance over time. Much of the work that goes into setting accounting standards is based around the need for comparability.

Reliability This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant missed out) and capable of being verified (e.g. by a potential investor).

Objectivity This implies that accounting information is prepared and reported in a "neutral" way. In other words, it is not biased towards a particular user group or vested interest