

Concepts in accounting and developing financial statements



**ASSIGN
BUSTER**

There are likely to be various user groups with an interest in a particular organisation, in the sense of needing to make decisions about that organization.

User group

- Competitors – they use for: to assess the threat to sales and profits posed by those businesses. To provide a benchmark against which the competitors' performance can be measured
- Employees (non-management) – to assess the ability of the business to continue to provide employment and to reward employees for their labour
- Government – to assess how much tax the business should pay, whether it complies with agreed pricing policies and whether financial support is needed.
- Community representatives – to assess the ability of the business to continue to provide employment for the community and purchase community resources. To assess whether the business could help fund environmental improvements.
- Investment analysts – to assess the likely risks and returns associated with the business in order to determine its investment potential and to advise clients accordingly.
- Suppliers – to assess ability of the business to pay for the goods and services supplied.
- Lenders – to assess the ability of the business to meet its obligations and to pay interest and to repay the amount borrowed.

- Managers – to help make decisions and plans for the business and to exercise control so that the plans come to fruition.
- Owners – to assess how effectively the managers are running the business and to make judgements about likely levels of risk and return in the future.

There may be conflicts of interest arising between the various user groups over the ways in which the wealth of the business is generated and/or distributed. For example, a conflict of interest may arise between the managers and the owners of the business. Although managers are appointed to act on behalf of the owners, there is always a risk that they will put their own interests first. They may use the wealth of the business to furnish large offices, buy expensive cars or whatever. Accounting information has an important role to play in reporting, the extent to which various groups have benefited from the business. Thus, owners may rely on accounting information to check whether the pay and benefits of managers are in line with agreed policy. A further example of potential conflict is between owners and lenders. There is a risk that the funds loaned to a business will be used for purposes that have not been agreed.

Concepts used in financial statement are:

a) Money measurement concept – accounting normally deals with only those items that are capable of being expressed in monetary terms. Money has the advantage that it is a useful common denominator with which to express the wide variety of resources held by a business. However, not all such resources are capable of being measured in monetary terms and so will be excluded

from a balance sheet. The money measurement concept, thus, limits the scope of accounting reports.

b) Historic cost concept – Assets are shown on the balance at a value that is based on their historic cost (that is, acquisition cost). This method of measuring asset value has been adopted by accountants in preference to methods based on some form of current value. Many commentators find this particular convention difficult to support as outdated historic cost are unlikely to help in the assessment of current financial position. It is often argued that recording assets at their current value would provide a more realistic view of financial position and would be relevant for a wide range of decisions. However, a system of measurement based on current values can present a number of problems.

c) Going concern concept – The going concern concept holds that a business will continue operations for the foreseeable future. In other words, there is no intention or need to sell off the assets of the business. Such a sale may arise when the business is in financial difficulties and it needs cash to the creditors. This convention is important because the value of fixed assets on sale is often low in relation to the recorded values, and an expectation of having to sell off the assets would mean that anticipated losses on sale should be fully recorded. However, where there is no expectation of the need to sell off the assets, the value of fixed assets can continue to be shown at their recorded values (that is, based on historic cost). This concept, therefore, provides support for the historic cost concept under normal circumstances.

d) Business entity concept – For accounting purposes, the business and its owner(s) are treated as quite separate and distinct. This is why owners are treated as being claimants against their own business in respect of their investment in the business. In the business entity concept must be distinguished from the legal position that may exist between businesses and their owners. For sole proprietorships and partnerships, the law does not make any distinction between the business and its owner(s). For limited companies, on the other hand, there is a clear legal distinction the business and its owners. For accounting purposes, these legal distinctions are irrelevant and the business entity convention applies to all businesses.

e) Dual aspect concept – each transaction has two aspects, both of which will affect the balance sheet. Thus, the purchase of a motor car for cash results in an increase in one asset (motor car) and a decrease in another (cash). The repayment of a loan results in the decrease in liability (loan) and the decrease in asset (cash/bank)

f) Prudence – The prudence concept holds that financial statements should err on the side of caution. The concept evolved to counteract the excessive optimism of some managers and owners, which resulted, in the past, in an overstatement of financial position. Operation of the prudence concept results in the recording of both actual and anticipated losses in full, whereas profits are not recognised until they are realized (that is, there is reasonable certainty that the profit will be received). When the prudence concept conflicts with another concept, it is prudence concept that will normally prevail.

g) Stable monetary unit concept - the stable monetary unit concept holds that money, which is the unit of measurement in accounting, will not change in value over time. However, in the UK and throughout much of the world, inflation has been a persistent problem over the years and this has meant that the value of the money has declined in relation to other assets. In past years, high rates of inflation have resulted in balance sheets, which are drawn up on a cost basis, reflecting figures for assets, that were much lower than if current values were employed. The value of freehold land and buildings, in particular, increased rapidly during much of the 1970s, 1980s and 1990s, at least partly as a result of a reduction in the value of each £1. Where land and buildings were held for some time by a business, there was often a significant difference between their original cost and their current market value. This led to the criticism that balance sheet values were seriously understated and, as a result, some businesses broke away from the use of historic cost as the basis for valuing this particular asset. Instead, freehold land is periodically revalued in order to provide a more realistic statement of financial position. Although this represents a departure from accounting concept, it is a practice that has become increasingly common.

h) Objectivity concept - the objectivity concept seeks to reduce personal bias in financial statements. As far as possible, financial statements should be based on objective, verifiable evidence rather than matters of opinion.

i) Separate determination concept - the separate determination concept refers to determining the aggregate amount of each asset or liability, the amount of each individual asset or a liability should be determined separately from all other assets and liabilities.

<https://assignbuster.com/concepts-in-accounting-and-developing-financial-statements/>

j) Substance concept – the substance over form holds if legal form of the transaction differs from its real substance, accounting should show the transaction in accordance with its real substance, i. e., how the transaction affects the economic situation of the business.