The accruals and going concern concepts essay sample

Finance

The accruals and going concern concepts are regarded as fundamental in the preparation of financial statements. Discuss the advantages and disadvantages of these concepts, explaining the reasons why these concepts may be difficult to apply or may be inconsistent with other concepts.

Accounting statement and records are a periodic summary of account activity within a period and the documentations involved in the preparation of it (Thomas and Ward, 2012: 4). They are done based on a set of rules developed from the basic accounting concepts. First, the concept of a " true and fair view" is to ensure that an accurate financial statement is required. It suggests that accounts should meet both the legal requirement and social expectation in communication with shareholders and other stakeholders (Flint, 1982: 29). The accruals and going concern concepts are the fundamental principles for the preparation of a financial statement with " true and fair view". However, a coin has two sides. In this essay, the advantages and disadvantages of the accruals and going concern concepts will be discussed. The reasons why these concepts are difficult to apply will be given. The conflicts between these two fundamental concepts with other concepts will then be further investigated

To start with, the accrual concept refers to the matching of costs and revenues. It means the expenses must match against income when transactions occur rather than when cash payment is received or paid (Marriott, Edwards and Mellett, 2008: 218). For instance, a business' cash sales are ₤10, 000 and credit sales are ₤3, 000 of which ₤1, 000 are received after the accounting period. According to the accruals concept, the sales income of ₤13, 000 should be accounted for as income earned for the period despite the fact that the cash payment is received after the accounting period

It is worth to mention that, in United Kingdom, tax computation is based on the profit which calculated by accrual accounting. According to HM Revenue & Customs, “ a taxpayer includes all incomings earned in the tax year regardless of when they are due or when they are received”. The followings are the main advantages, disadvantages as well as the hardships while applying of the concept.

Firstly, it records the historical trend of business operations (Vitez). The business transactions are more accurate which facilitates decision-making (Hong Kong Finance Bureau, 1999: 10). For the business owners, it gives the provision of the sales trends in certain economic conditions. For example, it can be told by viewing the accrual basis accounts that which product can be produced more in the season to reach a higher profit.

Secondly, it provides a better picture of financial performance as it matches the revenues with the costs of the activities (Agarwal, 2012). It is because the business can still face a financial crisis when the account shows positive cash picture, because there may be some debts to be paid. Matching the revenues and the costs of the business activities easily allows owners to see the more accurate income and debts flow of the firm which also helps decision-making. Moreover, the banks and lender could have a general estimation to the repayment ability by reviewing the financial statement prepared under the accrual concepts.

Nevertheless, accrual accounting is time consuming and therefore incurs the business additional labour costs (Vitez). It usually requires business owners to spend more time reviewing transactions and making journal entries for expenses not yet paid and revenues not yet received (Shanker). It may create hardship to small business.

Another disadvantage and difficulty is that it “ may leave you in the dark as to what cash reserves are available, which could result in a serious cash flow problem” (Fishman) Accrual accounting may create a false impression. Because of that, assumptions or decisions could be made. For example, even there is a profit in the profit and loss account, there may also be liquidity problems if the profits do not turn into cash.

The going concern concept is defined as “ the assumption that an entity will continue in operational existence for the foreseeable future” by Thomas and Ward (2012: 66). There should be no intention or necessity to reduce the scale of the business significantly or to shut it down (Benidict and Elliott, 2011: 558). Under this concept, assets are valued at their historical costs which are based on their nominal or original amounts, adjusted for depreciation where applicable (Harvey and Keer, 1978: 17). The followings are the benefit and drawback of the concept.

One benefit of this concept is that it allows a business to draw a distinction between current and non-current asset. Current asset is the one that can turn into cash within a one-year period. Non-current assets will only be shown in accounts using going concern concept since the business is support to run long enough to have all the assets to be fully utilised. Therefore, business can be measured and compared over different periods and this aids decision making for management and other related parties.

However, since the going concern concept suggests that assets should record at their historical cost, it ignores the inflation. Some of these assets are likely to be recorded less than the amount what they are actually worth. That is why firms need to seek professional revaluation to adjust the value of the assets.

Besides, there is a doubt over the truth and fairness of the financial statements as they appears the business performance under going concern basis when it is not actually so. It is unlikely that a business will continue in operational existence forever in reality, yet it is difficult to predict when an enterprise suspends operation.

While the accrual and going concern concepts are fundamental assumption for financial accounts, they may still conflict with others. Prudence concept is one of them.

There may be a direct inconsistent between the accrual and prudence concept. Prudence is also known as concept of conservatism which suggests that the accounts should be prepared on a prudent basis (Thomas and Ward, 2012: 72). That means a treatment which minimises the profit and value of assets, or maximises the loss and value of liability should be used. For example, bookkeepers estimate provision for bad debts to reduce the potential cost of the business. Therefore, if a business which uses accrual basis to record revenue-to-be-received into the sales, it can be seen as an overstatement under the prudence concept.

This principle also has inconsistent with the going concern concept. As mentioned earlier in this essay, assets are valued at their historical costs. On one hand, it could understate the value of assets because of the inflation. And yet on the other hand, it could exaggerate it. Under the prudence basis, the valuation should be based on the lowest possible estimate (Thomas and Ward, 2012: 72). For example, when a company is insolvent or under liquidation, the company will be forced to dispose its assets at bargain prices, that may be well below the fair market value, within a short period. In this case, the valuation of the assets should be based on the lowest net realizable value instead of historical cost or fair market value.

To sum up, the accrual and going concern concepts are important fundamental assumption for financial accounts which bring benefits to the business especially to decision-making. However, there are still some drawbacks and difficulties when use of these two concepts. In addition, these two concepts may conflict with other concept such as “ prudence principle”. In case of inconsistent, accountants must consider which concept is most important and create a balance between them in order to give a true and fair view which “ requires the exercise of skilled judgement in the unique circumferences of each individual case” (Flint, 1982: 4).

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