Accounting concepts, conventions and solutions

Business, Accounting

Table of Contents QUESTION ONE: Accounting Concepts and Conventions a) Accounting Concepts Accounting Concepts are broad basic assumptions that underlie the periodic financial accounts of business enterprises. They outline the rules of accounting that should be followed in preparation of all financial statements. These concepts are outlined in the International Accounting Standard 1(IAS 1)-presentation of financial statements. The word ‘ concept’ in this context means an idea or thought that has a universal application.

This includes; i) The going concern concept: implies that the business will continue in operational existence for the foreseeable future, and that there is no intention to put the company into liquidation or to make drastic cutbacks to the scale of operations. Financial statements should be prepared under the going concern basis unless the entity is being (or is going to be) liquidated or if it has ceased (or is about to cease) trading. The directors of a company must also disclose any significant doubts about the company’s future if and when they arise. (Agatha, 2010) The main significance f the going concern concept is that the assets of the business should not be valued at their ‘ break-up’ value, which is the amount that they would sell for it they were sold off piecemeal and the business were thus broken up. ii) The accruals concept (or matching concept): states that revenue and costs must be recognized as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate. Example

Assume that a firm makes a profit of ? 100 by matching the revenue (? 200) earned from the sale of 20 units against the cost (? 100) of acquiring them. (Williamson, 2001) If, however, the firm had only sold eighteen units, it would have been incorrect to charge profit and loss account with the cost of twenty units; there is still two units in stock. If the firm intends to sell them later, it is likely to make a profit on the sale. Therefore, only the purchase cost of eighteen units (? 90) should be matched with the sales revenue, leaving a profit of ? 90. The balance sheet would therefore look like this: ? | Assets| | Stock (at cost, i. e. 2 x ? 5)| 10| Debtors (18 x ? 10)| 180| | 190| Liabilities| | Creditors| 100| | 90| Capital (profit for the period)| 90| If, however the firm had decided to give up selling units, then the going concern concept would no longer apply and the value of the two units in the balance sheet would be a break-up valuation rather than cost. Similarly, if the two unsold units were now unlikely to be sold at more than their cost of ? 5 each (say, because of damage or a fall in demand) then they should be recorded on the balance sheet at their net realizable value (i. . the likely eventual sales price less any expenses incurred to make them saleable, e. g. paint) rather than cost. This shows the application of the prudence concept. In this example, the concepts of going concern and matching are linked. Because the business is assumed to be a going concern it is possible to carry forward the cost of the unsold units as a charge against profits of the next period. Essentially, the accruals concept states that, in computing profit, revenue earned must be matched against the expenditure incurred in earning it. ii) The entity concept: The concept is that accountants regard a business as a separate entity, distinct from its owners or managers. The concept applies whether the business is a limited company (and so recognized in law as a separate entity) or a sole proprietorship or partnership (in which case the business is not separately recognized by the law. iv) The money measurement concept: The money measurement concept states that accounts will only deal with those items to which a monetary value can be attributed.

For example, in the balance sheet of a business, monetary values can be attributed to such assets as machinery (e. g. the original cost of the machinery; or the amount it would cost to replace the machinery) and stocks of goods (e. g. the original cost of goods, or, theoretically, the price at which the goods are likely to be sold). The monetary measurement concept introduces limitations to the subject matter of accounts. A business may have intangible assets such as the flair of a good manager or theloyaltyof its workforce.

These may be important enough to give it a clear superiority over an otherwise identical business, but because they cannot be evaluated in monetary terms they do not appear anywhere in the accounts. v) The historical cost concept: A basic concept of accounting is that resources are normally stated in accounts at historical cost, i. e. at the amount that the business paid to acquire them. An important advantage of this procedure is that the objectivity of accounts is maximized: there is usually objective, documentary evidence to prove the amount paid to purchase an asset or pay an expense.

Historical cost means transactions are recorded at the cost when they occurred. In general, accountants prefer to deal with costs, rather than with ' values'. This is because valuations tend to be subjective and to vary according to what the valuation is for. For example, suppose that a company acquires a machine to manufacture its products. The machine has an expected useful life of four years. At the end of two years the company is preparing a balance sheet and has decided what monetary amount to attribute to the asset. vi) The realization concept: Realization: Revenue and profits are recognized when realized.

The concept states that revenue and profits are not anticipated but are recognized by inclusion in the income statement only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty. vii) Duality concept: This concept ensures that transactions are recorded in books at least in two accounts, if one account is debited it's also credited with the same amount in a different account. The recording system is also known as double entry system. Assets = Liabilities + Capital.

Every transaction has a two-fold effect in the accounts and is the basis of double entry bookkeeping. b) Accounting conventions Conventions, unlike concepts, are guidelines derived by usage and practice. They are guidelines that arise from the practical application of accounting principles. An accounting convention is not a legally-binding practice; rather, it is a generally-accepted convention based on customs, and is designed to help accountants overcome practical problems that arise out of the preparation of financial statements. As customs change, so to will accounting conventions.

Basically, conventions fill in the gaps between guidelines and practical usage. If an accounting regulatory body sets forth a guideline that addresses the same topic as the accounting convention, the accounting convention will no longer be applicable. Concepts supersede conventions. i) The consistency concept states that in preparing accounts consistency should be observed in two respects. a)Similar items within a single set of accounts should be given similar accounting treatment. b)The same treatment should be applied from one period to another in accounting for similar items.

This enables valid comparisons to be made from one period to the next. (Crovit, 2008) An accounting method used in one accounting period should be the same as the method used for events or transactions which are materially similar in other period (i. e. accounting practices should remain unchanged from period to period). This also involves treatment of transaction and valuation method. Consistency is also advisable so that the comparison of accounting figures over time is meaningful. Consistency also states that if a change becomes necessary, the change and its effect should be clearly stated. i) The materiality concept: An item is considered material if it's omission or misstatement will affect the decision making process of the users. Materiality depends on the nature and size of the item. Only items material in amount or in their nature will affect the true and fair view given by a set of accounts. An error that is too trivial to affect anyone's understanding of the accounts is referred to as immaterial. In preparing accounts it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.

Determining whether or not an item is material is a very subjective exercise. There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example to define material items as those with a value greater than 5% of the net profit disclosed by the accounts). But some items disclosed in accounts are regarded as particularly sensitive and even a very small misstatement of such an item would be regarded as a material error. An example in the accounts of a limited company might be the amount of remuneration paid to directors of the company.

The assessment of an item as material or immaterial may affect its treatment in the accounts. For example, the profit and loss account of a business will show the expenses incurred by he business grouped under suitable captions (heating and lighting expenses, rent and rates expenses etc); but in the case of very small expenses it may be appropriate to lump them together under a caption such as ' sundry expenses', because a more detailed breakdown would be inappropriate for such immaterial amounts. a)If a balance sheet shows fixed assets of ? million and stocks of ? 30, 000 an error of ? 20, 000 in the depreciation calculations might not be regarded as material, whereas an error of ? 20, 000 in the stock valuation probably would be. In other words, the total of which the erroneous item forms part must be considered. b)If a business has a bank loan of ? 50, 000 balance and a ? 55, 000 balance on bank deposit account, it might well be regarded as a material misstatement if these two amounts were displayed on the balance sheet as ‘ cash at bank ? , 000’. In other words, incorrect presentation may amount to material misstatement even if there is no monetary error. iii) The Prudence convention (conservatism): The prudence convention (classified as a concept by some others) states that where alternative procedures, or alternative valuations, are possible, the one selected should be the one that gives the most cautious presentation of the business’s financial position or results.

This policy tends to understate rather than overstate net assets and net income, and therefore lead entities to " play safe". In accounting, it states that when choosing between two solutions, the one that will be least likely to overstate assets and income should be selected. According to this concept " expected losses are losses but expected gains are not gains". On the basis of this concept closing stock is valued at cost price or market price, whichever is lower. Provisions for bad and doubtful debts are maintained.

Therefore, revenue and profits are not anticipated but are recognized by inclusion in the profit and loss account only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty: provision is made for all liabilities (expenses and losses) whether the amount of these is known with certainty or is best estimate in the light of the information available. (Pixley, 2002)

Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities or losses.

The other aspect of the prudence concept is that where a loss is foreseen, it should be anticipated and taken into account immediately. If a business purchases stock for ? 1, 200 but because of a sudden slump in the market only ? 900 is likely to be realized when the stock is sold the prudence concept dictates that the stock should be valued at ? 900. It is not enough to wait until the stock is sold, and then recognize the ? 300 loss; it must be recognized as soon as it is foreseen. (Pixley, 2002) A profit can be considered to be a realized profit when it is in the form of: •Cash Another asset that has a reasonably certain cash value. This includes amounts owing from debtors, provided that there is a reasonable certainty that the debtors will eventually pay up what they owe. Example A company begins trading on 1 January 20X2 and sells goods worth ? 100, 000 during the year to 31 December. At 31 December there are debts outstanding of ? 15, 000. Of these, the company is now doubtful whether ? 6, 000 will ever be paid. The company should make a provision for doubtful debts of ? 6, 000. Sales for 20x5 will be shown in the profit and loss account at their full value of ? 00, 000, but the provision for doubtful debts would be a charge of ? 6, 000. Because there is some uncertainty that the sales will be realized in the form of cash, the prudence concept dictates that the ? 6, 000 should not be included in the profit for the year. iv) Objectivity (neutrality): An accountant must show objectivity in his work. This means he should try to strip his answers of any personal opinion or prejudice and should be as precise and as detailed as the situation warrants. The result of this should be that any number of accountants will give the same answer independently of each other.

Objectivity means that accountants must be free from bias. They must adopt a neutral stance when analyzing accounting data. In practice objectivity is difficult. Two accountants faced with the same accounting data may come to different conclusions as to the correct treatment. It was to combat subjectivity that accounting standards were developed. v) Full disclosure It states that information that might affect the judgments of the users of financial information should be presented in the main body of financial statements or in the notes or as supplementary information.

Amounts and kinds of information disclosed should be decided based on a tradeoff analysis as a larger amount of information costs more to prepare than to use. Information disclosed should be enough to make a judgment while keeping costs reasonable. QUESTION TWO: Clashing accounting concepts and conventions that might bring about inconsistency in the accounting process Accounting concepts or conventions could clash or there could be inconsistency between them in such a way that users may have more than one definite method of treating items in the financial statements hence causing uncertainty.

Examples include: 1. Clash between the accruals/matching concept and the prudence convention The accruals concept requires future income (e. g. in relation to credit sales) to be accrued. On the other hand the prudence concept dictates that caution should be exercised, so that if there is doubt about the subsequent receipt, no accrual should be made. There is a clash in that credit sales should be recognised immediately the sale is made (regardless of payment) under accrual concept while prudence states that incomes be recognized only when receipt is certain.

A good example would be the treatment of deferred revenue expenditures that are usually spread over a number of years, during which the organisation is expected to earn additional revenue out of the expenditure. While this treatment is an accepted principle, there may be a counter-treatment, argued by another group, to charge the item as an expense, the entire amount in the year it was spent, on the grounds of conservatism/prudence. In other words, there may be a direct clash between the accruals and conservatism principles. 2.

Clash between the historical cost concept and Prudence convention The prudence convention states that where alternative procedures, or alternative valuations, are possible, the one selected should be the one that gives the most cautious presentation of the business’s financial position or results. Therefore it requires that stocks should always be valued at the lowest of cost or net realisable value. Net realisable value is the selling price of the stock minus any costs involved in getting this stock into saleable condition (e. g. repair costs).

This means that we can value stock at current market rates, but only if the selling price is lower than the cost. However, if the replacement cost of these stocks is lower than cost or net realisable value then it may seem prudent to use the replacement cost to value these stocks. On the other hand, the historical cost concept implies that all assets acquired, service rendered or received, expenses incurred etc. should be recorded in the books at the price at which it was acquired (its cost price). The cost is distinct from its value and the record does not signify the value.

It also holds that cost is the most reliable and verifiable value at which a good is or services should be initially recognized. Therefore in determining inventory prices, the two principles may clash in application. QUESTION THREE: Solutions to the clashing accounting concepts and conventions William (2001) outlines basic rules that should be observed in applying particular accounting concepts in case of conflict. He states that despite the fact that most of the concepts have been universally accepted, accountants quite often come across situations where two concepts are in onflict and one overrides the application of the other. These are situations where an accountant will find it necessary to apply his professional skill and judgment to come up with the best possible solution. To quote from IAS 1, " There are many different accounting policies in use even in relation to the same subject: judgment is required in selecting and applying those which, in the circumstances of the enterprise, are best suited to present properly its financial position and the results of its operation. " 1. Solution to the clash between accruals and prudence When there is a clash between the two, prudence prevails.

Although the accruals concept is universally accepted in trading and manufacturing organizations, there are occasions when the concept of conservatism overrides the application of the accruals concept. A typical example would be the accounts prepared for professional firms of accountants, lawyers and medical practitioners. In these accounts, recognition is generally given to the accruals concept insofar as it relates to expenses. In computing the incomes, however, a rather conservative approach is followed and only those items that are actually realized are accounted for in the accounts.

This treatment has been accepted by the accountancy profession on the grounds of conservatism, although it generally defeats the concept of the accruals concept. When the accountant has a choice between two alternative treatments, remember, he should select the one that shows a less encouraging position of the financial situation. To follow the principle of conservatism is not easy; and good judgment is necessary to decide the right course of action. There is however, a great deal of difference between being conservative and being over conservative.

The rule of conservatism should not be stretched to the point where it might eventually result in distorting the financial results. For example, capital items such as buildings, vehicles, machinery etc, which are capitalized in accordance with Generally Accepted Accounting Principles (GAAPs), must always be capitalized and no deviation should be recommended on the grounds of conservatism. 2. Solution to the clash between historical cost concept and Prudence convention Williamson (2001) states that prudence should prevail over the historical cost concept.

This is important in order for financial statements to avoid overstating profits or disguising losses which may lead users to make wrong decisions. An example is that of fixed assets which should be valued at their historical cost (because it is objective). However, it is prudent to reduce their values to reflect wear and tear so as not to overstate profits. Also, according to the accruals concept, we should match an expense to when it was incurred.

Therefore, fixed assets should appear as their historical cost less any depreciation.

Also, the cost of these assets should be 'spread' over their lifetime in the accounts. REFERENCES 1. Agatha J. , Mengyu and W. , Askew S. ,(2010). " The Switch from US GAAP to IFRS". Proceedings of the Northeast Business & Economics Association 48–54 2. Arens A. , and Loebbecke, J. , " Auditing, an integrated approach", 1980 Prentice Hall 3. Carruthers, Bruce G. , & Espeland, Wendy Nelson, Accounting for Rationality: Double-Entry Bookkeeping and the Rhetoric of Economic Rationality, American Journal ofSociology, Vol. 7, No. 1, July 1991, pp. 40-41, 44 46 4. Crovitz, L. (2008). " Closing the Information GAAP". The Wall Street Journal vol III 5. Oldroyd, David & Dobie, Alisdair: Themes in the history of bookkeeping, The Routledge Companion to Accounting History, London, July 2008 6. Pixley, Francis William: Accountancy—constructive and recording accountancy (Sir Isaac Pitman & Sons, Ltd, London, 2002) 7. Williamson, D. (2001), Accounting Business Spreadsheeting, Prentice Hall, London