Financial statements accruals prudence and going concern concepts

ASSIGN BUSTER

Discuss the problems for companies in applying the accruals, prudence and going concern concepts when preparing financial statements, and explain why at least two other concepts might also be important.

Accounting concepts and conventions as used in accountancy are the rules and principles applied when recording economic events and in the preparation of financial statements, that all accountants abide by. Some of the fundamental accounting concepts that will be discussed are the accruals, matching, prudence, going concern and consistency concepts.

In drawing up accounting statements, you have to make sure that they fairly reflect the true value of the business and the results of its operation. Whether they are external “ financial accounts” or internally-focused “ management accounts”, a clear objective has to be that the accounts fairly reflect the true value of the business and the results of its operation.

Therefore we use the ‘ true and fair view’. The true and fair view is applied in ensuring whether accounts do indeed portray the business’ activities. To support this view, accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently. Accounting concept and conventions [online], Available from: http://tutor2u. net/business/accounts/accounting_conventions_concepts. htm, Date accessed 12/11/12.

Under the accruals concept revenue and costs are accrued (that is, recognized as they are earned or incurred, not as money is received or paid), matched with one another so far as their relationship can be established and

recorded in the accounting records and reported in the financial statements of the periods to which they relate.. Thomas, A 1996, An Introduction to Financial Accounting, 2nd edition, McGraw-Hill

Having decided on the point at which revenue and expenses are recognised we turn to the matching convention. The matching convention in accounting is designed to provide guidance concerning the recognition of expenses. This convention states that expenses should be matched to the revenue that they helped to generate. Applying this convention may mean that a particular expense reported in the profit and loss account for a period may not be the same figure as the cash paid for that item during the period. McLaney E, Atrill P 1999, Accounting an Introduction, 3rd edition, Prentice Hall Europe

All expenses should be matched to the period for which the sales revenue to which they relate is reported. In practice, this may be difficult to do for certain expenses such as gas charges incurred, as this is unlikely to be linked directly to particular sales. As a result, the gas charges incurred would be matched to the period to which they relate. Let’s say that the gas company has yet to send out bills for the quarter that ends on the same financial year end. In this situation, an estimate will have to be made of gas expense outstanding. If the expense is predicted reasonably accurately it will have the desired effect of showing that, at the end of the accounting year. Businesses may face a difficulty in making an accurate prediction especially if it’s their first year in business or the usage of gas varies constantly.

Continuity (going concern) this states that in the absence of evidence to the contrary it is assumed that the business will continue into the indefinite

future. This convention has a major influence on the assumptions made when evaluation particular items in the balance sheet. This allows us to assume that stock will eventually be sold in the normal course of business (at normal selling prices). It also allows for the principal of depreciation. If we assume a car will have a useful life to the business of five years, we depreciate this fixed asset over five years. Alexander D, Britton A 1999, Accounting An Introduction, 5th edition, Gray Publishing, Kent.

Problems may arise for companies applying the concepts of accruals and going concern. Under the accruals concept, revenue and costs are charged to the profit and loss account for the accounting period in which they were earned or incurred, not when cash is received or paid. Hence on the profit and loss account income or expenses shown is not what the business received/spent and then the concept of continuity attempts to spread the cost. Thus the concept displays a false picture as to what cash reserves are available within the business, which could result in serious cash flow problems. For example, the sales ledger may show many sales, while in reality the bank account may be empty because debtors haven't paid yet, therefore the problems will arise when the debtors find it hard to pay off their debt, or delay in payment which will then affect the company's working capital. Thus, the profit indicated in the annual accounts is unrealistic – as this shows a false picture on the actual business performance at the end of the financial year. The Isab Argues That The Accruals And Going Concern Concepts Are Key Underlying Assumption In The Preparation Of Financial Statements. [online], Available from: http://www. oppapers. com/essays/Isab-Argues-Accruals-Going-Concern-Concepts/148529 [Accessed: 12. 11. 2009].

Prudence is the exercise of a degree of caution when conditions are uncertain. The aim is to ensure that income and assets are not over-stated and expense and liabilities are not under-stated. Financial Accounting an Introduction 2008, Accounting An Introduction, Ashford Colour Press, Hampshire. The prudence concept dictates that if the resulting future revenue (advertising, research) cannot be assessed with reasonable certainty, the expenditure should be treated as an expense in the profit and loss account of the year in which it is incurred. Managers should also not be over-optimistic in financial reporting, i. e. overstate profits, overstating profits is potentially dangerous because it can lead to a reduction of capital and dividends being paid out of profits that have not been earned.

The prudence concept may be inconsistent with the matching principle and problems may arise for the business. Certain costs such as development expenditure should be carried forward to future years as a fixed asset and matched with the sales revenue generated by this expenditure. However, the prudence concept dictates that if future revenues are difficult to predict accurately, costs such as development expenditure should be written off to the profit and loss account in the year in which they are incurred. The business may overstate its expenses for the year when the benefit from the expense may be beneficial for many future years, like depreciation. Thomas, A 1996, An Introduction to Financial Accounting, 2nd edition, McGraw-Hill

The consistency is concept is also of vital importance for businesses. The consistency concept dictates that there should be ‘ consistency of accounting treatment of like items within each accounting period and from one period to the next’. For example deprecation should be calculated the

same way for every financial year and the purchase of certain tools and equipment should also be treated as fixed assets in subsequent years. This is to ensure meaningful comparisons can be made between different accounting periods and limit the possibility of misrepresentation.
Thomas, A 1996, An Introduction to Financial Accounting, 2nd edition, McGraw-Hill