UNIT-3 Accounting Concepts & Standards

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Understand basic accounting principles.
- ✓ Describe the bases of accounting.
- ✓ Describe the accounting terminology and equation.

Unit 3

Accounting Concepts & Standards

Introduction

Rules and guidelines are meant for the sheer purpose of facilitating and guiding an activity. These rules become universally applicable and they are more valuable if they are standardised. While driving, you are expected to stay to the left because it is a standard traffic rule. All drivers are supposed to follow this rule because in the absence of standard traffic rules, there would be chaos on the roads. Accounting has evolved over hundreds of years and during this period certain rules and conventions have been adopted to make accounting practices more uniform universally. One must be familiar with accounting rules and conventions to understand accounting reports.

Accounting principles comprise of rules, procedures, and conventions that have been adopted and agreed on by those, who have indulged in good accounting practices over years. According to the Canadian Institute of Chartered Accountants, accounting principle is defined as "the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices as a guide for the selection of conventions or procedures where alternatives exist. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experiences, historical precedent, statements by individuals and professional bodies and regulations of Governmental agencies."

Therefore, to avoid chaos, financial statements and reports follow accounting principles. Every business adopts its own method of accounting, but a few basic accounting principles are adhered to which are: relevance, objectivity, and feasibility.

The accounting principle adopted by a business should be relevant enough to be useful to its users. It should be objective and free of any personal biases. Lastly, it must be considered feasible and free of any unnecessary costs and implications. Numerous words are used for accounting principles such as tenets, conventions, concepts, doctrines etc. however, it can be broadly categorized into two groups: Accounting Concepts and Accounting Conventions.

Accounting Framework

Accounting Framework basically comprises accounting principles and conventions. According to Hendriksen (1977), the Accounting Theory is defined as "the logical reasoning in the form of a set of broad principles that

(i) provide a reference by which accounting practice is evaluated and

(ii) guide the emergence of new conventions. Therefore, like any other discipline, accounting procedures also rely on an underlying theory upon which knowledge is expanded and new practices are brought forward.

Although Accounting Theory is used to understand existing practices and to lay the groundwork for new practices, its most essential objective is to provide a logical set of principles to evaluate and develop accounting practices.

The American Institute of Certified Public Accountants (AICPA) says the following about accounting theory and principles:

An organization's financial statements are a result of processing a large amount of data regarding the financial and economic activities of the business for analysis and reporting. The process of making financial statements must be in accordance with accounting rules and principles. Generally, accepted accounting principles are a result of a consensus reached at a particular time about which resources and obligations are to be treated as assets and liabilities, how and when to record changes in assets and liabilities, how to measure these changes, and which information has to be disclosed.

Generally, accepted accounting principles not only include the broad guidelines for accounting practices, they also outline specific and detailed rules and procedures. Basically, they comprise all conventions and rules of accounting practice that have been agreed upon at a particular time.

(Source: AICPA. Statements of the Accounting Principles Board No.4 "Basic Concept and Accounting Principles Underlying Financial Statement of Business Enterprises," October, 1970, pp. 54-55)

The term `principle' means a "general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice." According to this definition, the key phrases for a 'principle' are **general law** and **guide to action.**

There is no one specific way of recording events according to accounting principles. Accounting principles are just laws and guide to action. Hence, there are various existing methods in accounting world that serve the purpose.

The principles of accounting have been made keeping in mind their usefulness. It is usually considered that for any accounting principle to be generally accepted, it should be **relevant, objective,** and **feasible.** **Relevance** of a principle which is based on the notion that it reveals useful information that a person seeks about a business. **Objectivity** of a principle means that it is reliable to a degree and is free from the influence of all sorts of personal biases of persons who came up with the principle or apply it. It also implies that information generated from the principle can be verified. **Feasibility** of a principle means that its implementation or application is cost-friendly and without any hindering complications.

Accounting Concepts

Accounting is the language of businesses and it has various terminologies. The differences in accounting terminology which gives rise to many problems as writers use different words and terms for the same idea. Therefore, the accounting theory can get confusing.

There are various words that can be used to describe basic accounting ideas, such as: concepts, conventions, postulates, assumptions, fundamentals, principles, propositions, etc. The general usage of these terms in accounting has assigned loose, overlapping meanings to them. For example, an idea that is described as a concept by one author is also termed as a convention by another. In another instance, the

idea, which is implied in Conservatism, is described as a convention, a principle, and a doctrine by three different authors.

Fundamental accounting concepts are the broad assumptions, which underlie financial accounts and statements of a business. Some of the more recognised accounting ideas are explained below as 'concepts' in order to avoid the confusion arising from differences in accounting terminology. The terms explained below are called 'concepts,' while others can be called 'conventions.' The ideas that are treated as basic assumptions and have a direct impact on the quality of accounting information are called concepts. A change in any of these accounts would result in altering the nature of financial accounting.

Business Entity Concept

A business entity is an organisation, which has been established to accomplish shared goals and objectives. This concept implies that the business is separate from the people who own it and provide capital to it.

The business entity concept can be expressed in the form of an accounting equation as given below:

Assets = Liabilities + Capital

According to this equation, the business owns assets and owes its earnings to various claimants. The accounting concept of the business entity for sole traders is different from the legal concept. In accounting, the income, expense, assets, and liabilities, which are not related to the sole proprietorship business, are excluded from business accounts. Legally, the sole proprietor is required to settle business loans even if he/she has to utilise personal assets.

In the case of partnerships, business liabilities are settled by using business assets and any surplus asset or income in used to pay off personal liabilities of partners. Similarly, private assets are used to settle private liabilities first and then, any surplus is used to settle business liabilities. In the case of companies, the existence of the business is treated independently of the shareholders' existence.

Money Measurement Concept

Money is the common denominator, which is used to express different facts, events, and business transactions in numerical terms. Anything that cannot be expressed in monetary terms is not recorded in accounting. Therefore, it is one of the loopholes of the concept of money management, which states that all business transactions cannot be taken into account. Another drawback is that the effect of inflation is ignored because stable values are used for measurement.

Continuity Concept

According to this concept, the business entity is considered to be a **going concern**, or in other words, it is assumed that the business will be in operation for a long time, with no foreseeable end in sight. This concept considers that business owners have no intention of wrapping up the business and liquidating its assets, unless there is evidence to suggest otherwise.

The continuity assumption is importance because it considers a business to add value to its resources for the duration that it is functioning. A business organization's success is measured by the subtracting the

input values (expenses) from output values (revenue). All unused resources are reported at their cost and not at their market value.

The concept that the business will not be liquidated any time in the foreseeable future is the basis for many accounting practices and procedures. Depreciation is calculated based on the continuity concept in accounting. Investors invest their capital in a company with assumption that the company would not go bankrupt. The process of correctly and accurately recording accounting transactions, reporting capital investments, and maintaining efficient management practices is based upon the assumption that an enterprise will always be in business as a going concern. Higher current market values and liquidation values are irrelevant to accounting under this concept. The continuity concept provides are foundation for cost application in accounting for assets.

If an accountant has evidence to suggest that the business organization will be bankrupt in the near future, then the resources are reported at their current values (liquidation values).

Cost Concept

Any land, machinery, equipment buildings, or property rights that a business owns are called its assets. Monetary values that are assigned to these assets have their basis in the cost concept. According to this concept, an asset is worth the cost that was paid at the time that it was acquired. In other words, assets are recorded at their purchase price and any variation in the value of the asset afterwards is ignored for accounting practices. Therefore, the monetary value (as known as as the 'book value') assigned to assets in financial statements does not necessarily reflect their current market value at that particular time.

Certain assets such as cash have the same accounting value and market value. Generally it is believed that the longer a company holds an asset, the more its accounting value is likely to correspond with its market value.

However, the cost concept does not mean that the recorded monetary value of an asset stays the same during the time that the business possesses it. This is where the concept of depreciation comes in. Depreciation is the slow reduction in the value of an asset over its long but limited life. The concept of depreciation will be discussed in detail in subsequent units, but for now, it is important to know that depreciation is recorded as an expense in financial statements and has the effect of reducing the business's profit in each accounting period. There is no direct relationship between depreciation and the market value of the asset; therefore, the purpose of depreciation is not to alter the value of the asset so that it matches the change in the market value of that asset. The real purpose of depreciation is to allocate or distribute the cost of the asset over its useful life without trying to bring it closer to its market value.

The primary reason why assets are recorded at their purchase cost and not their market values is that the cost concept fulfils all three criteria of accounting: relevance, objectivity and feasibility.

Accrual Concept

In business operations, the obligation to pay and the actual movement of cash may not coincide. Similarly, there is a difference between the right to receive cash and the actual receipt. The accrual concept in accounting acknowledges this distinction.

When we talk about the sale of goods, revenue from the sale can be received

- **(i)** Before the right to receive is created
- **(ii)** After the right to receive is created.

An accountant can get guidance on cash receipts from the accrual concept. In the first case, the right to receive has not been created; hence, the revenue of the period will not include the receipt. In the second case, although, the amount has been received in the subsequent period, the revenue will be included and recognised.

Expenditure made by a firm would be treated similarly. Firms can choose to make cash payments either before or after the point when payments are due. It may be noted here that expenses include - and recognise - only those payments which have been due and are payable. All advance payments not belonging to the subject accounting period are never treated as expenses. Hence, the persons receiving such advance payments are debtors until maturation of their rights of receiving the cash. Similarly, if the payments have not been made when they are due, they are still treated as expenses incurred and are recorded. The persons who are due to receive the payments are creditors in this case.

Concept of Conservatism

Conservatism is prudence. It is an approach best described as “anticipate no profit, provide for all possible losses". It is a conservative and a cautious approach, which accountants can adopt. While practicing this approach accountants record minimum possible revenues and values of assets and generous and high estimates for expenses and liabilities.

Following this approach would mean that revenues and gains are only recorded when actual cash payments are received or assets are realised with greater extent of certainty. On the other hand, all losses and expenses are recognised and accounted for, even when the actual amount is not certain and we only have an estimate. It would mean all probable losses in the light of contingencies are accounted for.

A contingency refers to a situation or a condition where the ultimate outcome-loss or the gain cannot be accurately determined. The outcome is known only after the event has occurred. For example, a customer has sued a company and the outcome of this lawsuit is not known until the judgment has been passed in court. In this case, the company will practice prudence and the financial statements will reflect a possibility of loss.

Due to the contingency concept, net assets of a business are understated rather than overstated in the financial statements and the income is more likely to be overstated rather than understated. It is because

of this concept that stock of goods that remains unsold, this is also called inventory, is valued at cost or market value; whichever of the two values is lower. Contingency is a modification of the cost concept.

However, the logic and application of this concept has been challenged lately. It has been argued that the contingency concept does not allow fair determination of profit and misrepresents the financial position of the business. If this concept is not applied rationally, then, financial figures can end up being too misrepresentative of the actual situation. It is because of these concerns that contingency is not applied today as strongly as it was applied in the past.

Materiality Concept

The Materiality Concept says that small, insignificant transactions need not be given the same attention and strict treatment as other significant transactions. The cost of giving these events the correct accounting treatment exceeds the usefulness of the information that is derived from recording them. For example, a business acquires a pair of scissors costing £1 and lasting two years. The cost and effort that is required to give this acquisition the correct accounting treatment over a period of two years is not worth the benefit that the business derives from it. In other words, it will be a regarded as immaterial transaction.

The cost incurred to purchase this pair of scissors will only be recorded as an expense for the period in which it was acquired. If the business has any unused stock of stationery, the entire cost incurred to acquire stationery will be treated as an expense in that period without taking into account the unused stock. Like other inventory, specifically significant assets and resources, the unused stock of stationery will not be carried forward as opening stock in the next accounting period.

There are no hard and fast rules to define which events are to be treated as material or immaterial, it really depends upon the accountant's judgment and common sense. The materiality of an event or transaction depends on the significance of surrounding events and transactions. In this case, it helps to have a uniform policy for judging materiality.

Consistency Concept

According to the Consistency Concept, the business must choose one out of several possible ways to treat accounting events of the same nature and apply that particular procedure in all its financial statements. In other words, the business must be consistent in its accounting practices and procedures. For example, there are two ways to treat a trade discount on the raw materials that a business purchases.

The discount can either be deducted from the cost of goods and the net amount be entered or it can be treated as income with the entire cost of goods purchased recorded in the financial statement. Similarly, there are different ways to record the decrease in value of assets over time due to usage (which is known as depreciation) and different methods to value inventory. The business must choose one way to record these transactions and events in their financial statements. If, however, for some justified reason the company has to change the accounting practice it has been in the past, the accounting records must specifically mention this change.

Inconsistency in financial statements and accounting record means that users of financial information will not be able to compare financial statements from two accounting periods and therefore, they will not be

able to draw valid conclusions from them. That would defeat the whole purpose of making financial statements, which are supposed to provide valuable information. Inconsistency can also result in manipulation and misrepresentations of important accounting figures such as assets and income. It is safe to say that the comparability of financial statements depends on the consistency of accounting practices.

Periodicity Concept

It is important to know the outcome of business operations of a company from time – to - time, although full knowledge of this can only be acquired after the business ceases to function, all of its assets are sold and its liabilities paid off. The interested parties and stakeholders require a periodic update on the financial position of an enterprise. In order to provide information, the accountant reports any change in the company's wealth over a period of time. The period after which a company's financial position is reported varies, however, as per the established business practices and government requirements, this period is usually a year. Some companies report that after a calendar year while others adopt the financial year. The accounting practice of adopting a twelve-month reporting pattern is only applicable for external reporting. Companies usually adopt a much shorter interval (usually about three months) for the purpose of internal reporting.

There are some difficulties associated with applying the periodicity concept. Matching the earnings and costs of an accounting period takes into account all the revenues and costs related to that period regardless of whether they have been paid for or received in cash. Although, there are obvious difficulties arising from short term reporting, as well as the allocation of costs over the longer term, however, the benefits of this practice exceed the costs.

Knowledge of all accounting concepts gives rise to some valid concerns. The contradiction in these concepts can be illustrated by considering an example. Let's say that a firm bought some land in 2011 for price of £ 100,000, constructed a manufacturing plant on that land in 2012 and started operations in 2013. The plant has been a profitable venture for the firm. In the firm's balance sheet, which lists all its assets and liabilities for the year 2013, a monetary value has to be assigned to the land that was bought in 2011. The current estimated market value of that land is £ 1,000,000.

Should the land be valued at its current market value, i.e. £ 1,000,000, in the balance sheet? The answer is *no*.

Land would be assigned its original cost of £100,000 in the balance sheet to abide by the accounting concepts discussed earlier. The **Money Measurement Concept** of prevents us from taking into account any changes in price levels over the two-year period in order to keep the purchasing power of money stable. According to the **Realisation Concept**, all unrealised profits will be ignored as long as the land is in possession of the firm and does not get sold off.

The current market value of the land stays irrelevant to the firm's balance sheet because of the **Continuity** Concept, the firm is considered to be a going concern and is expected to stay in business. If the firm was to end its business and sell all assets, including the land, then, it would place the value of the land at its current market value in the balance sheet.

The **Objectivity Concept** comes into play, as the land is valued at its original purchase price in 2011. There is evidence that the value of land acquired by the firm in 2011 was actually £ 100,000 because there is proof of that transaction having taken place. However, there is no evidence to support the market value of the land in 2013. It raises questions of objectivity such as: is there a quotation for an identical piece of land? Or, was there a

similar land plot that was sold for £ 1,000,000 at the same time in 2013?

In other words, there is no verifiable evidence to say that it is an objective fact that the value of land in 2013 was £ 1,000,000. Matters become more complicated if the manufacturing plant, which constructed the land in 2012, is taken into consideration. The **Conservatism Concept** prevents us from estimating the value of land without taking into account the construction that has taken place on it as it would not be an accurate estimate and may result in a misrepresentation of financial figures.

Accounting Standards

Various accounting concepts discussed before are the fundamentals of accounting theory. However, these concepts are only conventions and postulates, alternatives to which can be adopted. It is because of the practice of accounting concepts differently by every business organization that their financial reports cannot be compared or evaluated against each other. Full information about the accounting methods used by each business will be required to undertake the task of comparing their financial results.Sometimes, the difference in accounting methods used by one business makes it hard to compare the financial results of the same company from two different periods.

Need for Standards

One of the most pivotal objectives of financial statements is to provide information about the financial position of the business to interested parties such as investors and shareholders. The accountant's job is to make sure that accurate information is properly presented andthat it reaches these stakeholders at the right time. However, there should be some universally accepted standards, which are set in place to ensure that financial information is not manipulated to present the financial position of the company to outsiders the way the owners like it. The public and other external parties must have trust in the information that they are provided with and they must believe that the financial statements were prepared in accordance with strict principles of logic, fairness and consistency. It is only then that they will be able to make important financial decisions based on the information they are provided. For example, if the profitability and financial well-being of a company is misrepresented, in the financial statements in an attempt to lure investors, it could lead to bad investing decisions and have a very negative effect on the company in the long run.

A true understanding of the need for accounting standards comes about when you consider how the basic function of accounting i.e. information and communication, affects the society as a whole. Accounting information enables investors to allocate limited resources and capital in a way that they think would be most efficient, profitable, and beneficial to them. They make this decision by comparing and evaluating

financial information of different businesses. In theory, and in a broader perspective, this should lead to efficient allocation of scarce resources in the economy to maximise the benefit to the society as a whole.

If there were no appropriate accounting standards to abide by, the larger objective of maximising the welfare of the nation would remain unfulfilled. The investor would not be able to make informed investing decisions as no comparison or evaluation of accounting information would be possible.

Reasonable accounting standards should prevent an organization from reporting an increase in profits made possible only through changing accounting methods rather than by means of becoming more efficient or profitable. The freedom of businesses to adopt any accounting practice or method would give business owners the discretion to distort crucial information. It would lead to misinformed investing decisions and unfair allocation of capital. This kind of freedom would serve the purpose of less profitable businesses, cause capital to be allocated to inefficient companies that distort their financial information and away from profitable businesses that adopt strict and consistent accounting methods.

Changing Nature of Generally Accepted Accounting Principles (GAAP)

Professional accounting associations such as the Institute of Chartered Accountants in England and Wales (ICAEW) and the Association of Chartered Accountants (ACCA) have developed the Generally Accepted Accounting Principles (GAAP), in an attempt to highlight the socio-economic, legal, and political factors that affect the accounting profession. The formulation of these accounting principles in not only based years of academic research but also on the regulatory laws enforced by the government such as Companies Act (1956), and Income Tax Act (1961), etc. Moreover, stock exchanges and agencies, such as, the Controller of Capital issues (CCI) also guides the extent to which the information is required to be disclosed.

The business environment remains in constant flux due to changes in government policies and laws, the changing economic situation and changes in the business structure. Generally Accepted Accounting Principles need to be evaluated from time to time in order to keep them relevant to an ever-changing business environment. It is necessary for accounting principles to keep up with changing times so that businesses are able to make financial statements that are valuable, acceptable and meet the needs for the users of financial information.

The following is an explanation of accounting standards that are in practice across the globe.

Attempts towards Standardisation

Standardisation in UK and USA:

The Institute of Chartered Accountants in England and Wales started making recommendations to come up accounting standards that could be applicable across the board in 1942. However, in 1969 when there was widespread criticism of different accounting practices being adopted by companies and the lack of uniform accounting principles leading, ICAEW established an Accounting Statements Committee (ASC). Well-known companies had reported huge losses as a result of diverse accounting methods and the job of ASC was to bridge the gap between different accounting practices that were in use.

There is a procedure through which accounting standards are established. It begins with an **'exposure draft'** on a subject that is put forth for discussion by accounting professionals. Comments and observations made during these discussions are noted and incorporated in coming up with a standard accounting method for dealing with that specific subject. A formal statement regarding accounting methods is called a **Statement of Standard Accounting Practice (SSAP).**

When the Institute announces a formal statement regarding any accounting method it signifies an acceptance of that statement by the accounting profession. Any deviation from an accounting standard by a business organization is required to be fully disclosed and reported. The ASC has issued nineteen formal statements of accounting standards so far and some exposure drafts are still under consideration.

In the United States, Securities Exchange Commission (SEC) was established in 1933 in order to evolve accounting methods and practices. The SEC is a government owned regulatory body to monitor, regulate and control companies that issue and deal with securities. Another organization, known as the Accounting Principles Board (APB) was established in 1957 and it was based on carrying out research to set forth basic accounting concepts or postulates. In 1973, the Financial Accounting Standards Board (FASB) was established for the purpose of announcing statements that have been included in generally accepted accounting principles from time to time.

The SEC's consistent support of FASB has lent credibility to the Board's announcementsand their accounting policies. By 1985, the FASB had successfully issued five statements of accounting concepts and eighty-eight statements of accounting standards.

Standards at International Level:

There was an international inclination towards standardising accounting procedures as the size of business organizations increased, international trade grew, and multi-national firms began getting established. In 1972, an international congress of accountants was organized in Sydney, Australia with the objective of bringing uniformity to accounting principles and for coming up with standard accounting practices. As a result of this congress, the International Accounting Standards Committee (IASC) was established in 1973 to formulate International Accounting Standards.

All members of the IASC were required to abide by these standards and disclose any variation or deviation from the standards in financial reports. From the time of its establishment to the present time, the IASC has issued forty international accounting standard statements. In 1978, a professional body, by the name of International Federation of Accountants (IFAC), was formed.

There have been attempts in Canada and countries in the European Union, as well, to move towards more standardised accounting practices and uniform accounting principles in order to bring consistency and transparency in financial reporting.

Further Reading:

- ✓ ***Hennie van Greuning, Marius Koen, (2001), International Accounting Standards: A Practical Guide (Second Edition).***
- ✓ ***John Blake, Henry Lunt, (2001), Accounting Standards.***
- ✓ ***Georgette T. Bailey, Ken Wild, (1998), International Accounting Standards.***