A1 - Accounting Concepts and Conventions

There are some important concepts which are taken for granted in preparing accounts. A statement of accounting practice (SSAP 2 Disclosure of accounting Policies) describes 5 concepts as fundamental accounting concepts: they are;

- Prudence
- Accruals
- Going Concern
- Consistency
- Materiality

The Prudence Concept

Very often an accountant has to make a choice as to which figure he will take for a given item. The Prudence concept means that normally he will take the figure which will understate rather than overstate the profit. Alternatively, this could be expressed as choosing the figure which will cause the capital of the firm to be shown at a lower amount rather than at a higher one. This could be said to be to make sure that all losses are recorded in the books, but that profits should not be anticipated by recording prematurely.

For example, cookers of Hotpoint are stated in their balance sheet at their actual cost £150 rather than their selling price of £200. This is simply the aspect of the prudence concept; to value the machines at £200 would be to anticipate making a profit before the profit has been realised.

The other aspect of the prudence concept is that where loss is foreseen, it should be anticipated and taken into account immediately. If a purchases stock for £1250 but because of a sudden slump in the market only £950 is likely to be realised when the stock is sold. The prudence concept dictates that the stock should have been valued at £950. It is not enough to wait until the stock is sold, and then recognise the £300 loss; it must be recognised as soon as it is foreseen. For example, if Bosch bring out a state of the art washing machine Hotpoint may lower its asking prices so they can compete with a new model.

A profit can be realised to be a **realised profit** when it is in the form of:

- Cash

- Another asset which has a reasonably certain cash value, this includes debtors from what they owe.

The SSAP 2 quotes:

"Revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form of either cash or of other assets, the ultimate cash realisation of which can be assessed with reasonable certainty; provision is made for all known…..expenses and losses whether the amount of these is known with certainty or is best estimate in the light of information."

This concept led accountants into being portrayed as being rather miserable by nature; they were used to favouring looking on the dark side of things and ignoring the bright side. However, the concept has seen considerable changes in the last few decades, and there has been a shift along the scale away from the gloomy view and more towards the desire to paint a brighter picture when it is warranted. An example of the 'Prudence Concept' is the provision for bad debts:

Example:

Where an expense such as a bad debt is matched in the same period with revenue from the sale, then all is in order for the purposes of net calculation. However, it is very often the case that it is not until a period later than that in which the sale took place is it realised that the debt is a bad debt. Therefore, to try to bring into the period in which the sale was made a charge for bad debts resulting from such sales, the accountant brings in the concept of an estimated expense. Such an item of expense for an expense that had taken place, but which cannot be calculated with substantial accuracy is known a provision. The item of estimated expense for bad debts is therefore known as a **provision for bad debts**. In addition writing of debts are irrecoverable. It is necessary as a matter of business prudence, to change the Profit and Loss Account with the amount of the provision for any debt, the recovery of which is in doubt:

Company begins trading and sells goods worth £100,000. There are outstanding debts of £15,000. Of these debts the company is doubtful £6,000 will ever be paid.

The company make a provision for bad debts of £6,000. Sales will be shown in the Profit and Loss account with the value of £100,000 and the provision for bad debts will be charged at £6,000. Due to the uncertainty of sales not being realised, the prudence concept suggests that the £6,000 should not be included to the profit of the year.

The Accruals Concept:

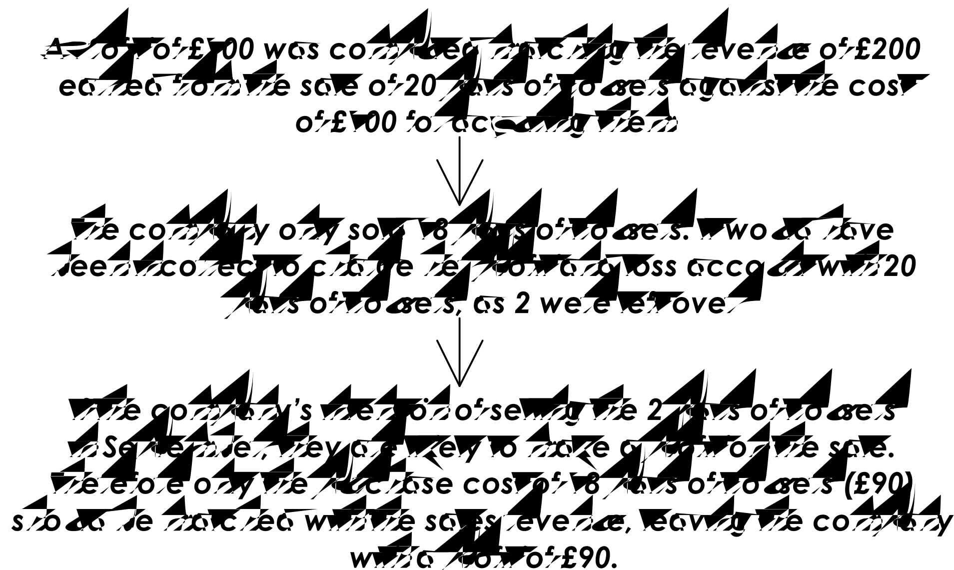
The definition which is given by the SSAP 2 for accruals is:

“The Accruals concept states that revenue and costs must be recognised 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.”

The fact that net profit is said to be the difference between revenues and expenses rather than between cash receipts and expenditures is known as the ‘Accruals Concept’. A great deal of attention is therefore paid to this which, when the mechanics needed to bring about the Accruals Concept are being performed, is known as ‘matching’ expenses against revenues.

To many people the actual payment of an item in a period is taken being matched against the revenue of the period when the net profit is calculated. The fact that expenses consists of the assets used up in a particular period in obtaining the revenues of that period, and that cash paid in a period and expenses of a period are usually different.

Example:



This is what the balance sheet would look like:

Assets	**£**
Stock (at cost, i.e 2x5)	*10*
Debtors (18x10)	*180*
	190
Liabilities	
Creditors	*100*
	90
Capital (profit from the period)	*90*

The company decided to give up selling boxes of chocolates therefore the Going Concern concept would no longer apply and the value of the boxes of chocolates in the balance sheet would be adjusted to valuation rather than cost

↓

The boxes of chocolates are to be sold as a reduced price due to damage or a downturn in trade then they should be recorded on the balance sheet as they're net realisable value rather then cost. This shows the application of the Prudence Concept.

The Companies Act 1985 gives legal recognition to the accruals concept, stating that: **"All income and charges relating to the financial year to which the accounts relate shall be taken into account, without regard to the date of receipt or payment".** This has the affect as we have seen, of requiring businesses to take credit for sales and purchases when made rather then when paid for, and also to carry unsold stock forward in the balance sheet rather than to deduct its cost from profit for the period.

The Going Concern Concept

Unless the opposite is known accounting always assumes that the business will continue to operate for an indefinitely long period of time. Only if the business was going to be sold would it be necessary to show how much the assets would fetch. In accounting records this is normally assumed to be of no interest to the firm. This is obviously connected with the cost concept, as if firms were not assumed to be going concerns the cost concept could not really be used, e.g. if businesses were always to be treated as though they were going to be sold immediately after the accounting records were drafted, then the saleable value of the assets would be more relevant than the cost. The SSAP 2 defines:

"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 operation".

The main significance of the Going Concern Concept is that the assets of the business should not be valued at their 'break-up' value, which is the amount it would sell for if they were sold of piecemeal and the business were thus broken up. Some organisations strip their businesses of assets, which means they sell different assets in eventual closure. An example of this is depreciation.

In accountancy companies write off fixed assets each year. This appears as a charge on the profit and loss account before tax is paid. The charge is called depreciation; it is not a cost, it is a provision. In effect, depreciation reduces the book value of an asset; it doesn't reflect the value of monetary transactions. There is no single approved way for calculating depreciation. The method chosen for depreciating assets should be used constantly. However, the method used to depreciate fixed assets may be changes, but only if the new method gives a fairer presentation of profit (losses) and of the financial position:

Straight-Line Method: This is the simplest and easiest approach. This reduces the book value of the asset by the same amount each year over the assets useful life. This straight line method is useful when the business is expecting constant returns over the life of an asset.

Reducing Balance Method: This recognises the fact that few assets decline in value by the same amount each year. This method reduces the value by the same amount each year. The method reduces the value of an asset by a fixed percentage (%) each year. This means that depreciation is highest in the early years and lower in the later years. The method takes into account the fact that as a machine gets older it requires more maintenance, and costs are liable to increase as its earning power decreases. An example for the Going Concern Concept is as follows:

A company purchases a clothes making machine at £60,000, which has an estimated life of 10 years. It is normal to write off the cost of the asset to the profit and loss account over this time. In this case a depreciation cost of £6,000 per annum will be charged.

↓

Using the Going Concern Concept, it is presumed that the business will continue operating and so the asset will [illegible] 10 years. A depreciation charge of £6,000 will be made each year, and the value

of the asset in the balance sheet will be its cost less the accumulated amount of depreciation charged to date.

↓

After 1 year, the net book value of the asset will be £60,000 - £6,000 = £54,000, after 2 years, £48,000 and so on.

We have to take into consideration that this asset may have no operational use outside the business and in a forced sale, the value would only be at maximum a quarter of what it is worth. Applying the Going Concern Concept, it might be argued that the asset is over valued at say £55,000 and that it should be written down to its break up value so it is treated as an expense in the balance sheet. Provided the Going Concern Concept is valid, so that the asset will continue to be used and will not be sold, it is appropriate accounting practice to value the asset its net book value, which is very unfair to many organisations.

The Consistency Concept

There are many areas in which judgement must be exercised in attributing money values to items appearing in accounts. Over the years certain procedures and principles have come to be recognised as good accounting practice, but within these limits there are often various acceptable methods of accounting for similar items. The Consistency Concept states:

"That similar items should be accorded similar accounting treatments".

The Consistency Concept states that in preparing accounting consistency should be observed in two respects:

- Similar items within a single set of accounts should be given similar accounting treatment.
- 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.

Each business should, within these limits, select methods which give the most equitable picture of activities of the business. However, this cannot be done if one method is used in one year and another method in the next year and so on. Constantly changing profits would lead to a distortion of the profits calculated from the accounting records. Therefore the concept of consistency comes into play. This is so the firm has one fixed method.

Sometimes inconsistency arises between the different accounting concepts, as shown:

- **Accruals and Prudence;** The accruals concept requires future income in relation to credit sales to be accrued. The prudence concept dictates that caution should be exercised, so that if there is doubt about the subsequent receipt, no accrual should be made.
- **Consistency and Prudence;** If circumstances change, prudence may conflict with the consistency concept, which requires the same treatment year after year.

In all situations where prudence conflicts with another accounting concept, prudence must prevail and the other concept must be iver-ridden.

The Materiality Concept.

This is when only items in amount or in their nature will the true and fair view given by a set of accounts.

An error is too trivial to affect anyone's understanding of the accounts is referred to 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 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 accounts of a limited company might be the amount of remuneration paid to the 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 the business grouped under suitable captions; under very small cases 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.

Example:

If a balance sheet shows fixed assets of £3 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 error forms part must be considered.