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ACCOUNTING CONVENTIONS AND STANDARDS

In the previous lesson, you have studied the accounting concepts like business entity, money measurement, going concern, accounting period, cost, duality, realisation, accrual and matching. These concepts or assumptions or principles are working rules for all accounting activities.

You may visit some business units doing a particular kind of business. Enquire them and find out how unsold goods are being valued. You will find that they follow the same method of valuation of unsold stock of goods. If you ask them, why do they value the unsold goods at cost or market price, whichever is lower, even though the market price is higher than the cost price, the businessman may answer that it is the convention, tradition or practice or custom of the business, that business is following year after year. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts. Apart from these, the Institute of Chartered Accountants of India (ICAI), which is the main regulatory body for standardisation of accounting policies in the country has issued a number of accounting standards from time to time to bring consistency in the accounting practices. We shall study about accounting conventions and standards in detail in this lesson.

OBJECTIVES

After studying this lesson, you will be able to :

- explain the meaning of accounting convention;
- explain the meaning and significance of accounting consventions like consistency, full disclosure, materiality and conservatism;
- state the meaning of the term Generally Accepted Accounting Principles (GAAP);

- explain the concept of accounting standards and enumerate the various accounting standards issued by the Institute of Chartered Accountants of India.

3.1 MEANING OF ACCOUNTING CONVENTIONS

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. They are followed like customs, traditions, etc. in a society. Accounting conventions are evolved through the regular and consistent practice over the years to facilitate uniform recording in the books of accounts. Accounting Conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years. The most important conventions which have been used for a long period are :

- Convention of consistency.
- Convention of full disclosure.
- Convention of materiality.
- Convention of conservatism.

3.2 CONVENTION OF CONSISTENCY

The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is a comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable.

Generally a businessman follows the undermentioned general practices or methods year after year.

While charging depreciation on fixed assets or valuing unsold stock, once a particular method is used it should be followed year after year so that the financial statements can be analysed and compared provided that the depreciation on fixed assets is charged or unsold stock is valued by using particular method year after year. This can be further clarified as : in case of charging depreciation on fixed assets accountant can decide to adopt any one of the methods of depreciation such as diminishing value method or straight line method.

Similarly, in case of valuation of closing stock it can be valued at actual cost price or market price or whichever is less. However precious metals like gold, diamond, minerals are generally valued at market price only.

Notes

Notes

Types of consistency

There are three types of consistency namely :

i. **Vertical consistency (Same organisation) :** It is to be found within the group of inter-related financial statements of an organisation on the same date. It occurs when fixed assets have been shown at cost price and in the interrelated income statement depreciation has also been charged on the historical cost of the assets.

ii. **Horizontal consistency (Time basis) :** This consistency is to be found between financial statements of one entity from period to period. Thus, it helps in comparing performance of the business between two years i.e. current year with past year.

iii. **Dimensional consistency (Two organisations in the same trade) :** This consistency is to be found in the statements of two different business entities of the same period. This type of consistency assists in making comparison of the performance of one business entity with the other business entity in the same trade and on the same date.

Therefore, as per this convention the same accounting methods should be adopted every year in preparing financial statements. But it does not mean that a particular method of accounting once adopted can never be changed. Whenever a change in method is necessary, it should be disclosed by way of footnotes in the financial statements of that year.

Significance

- It facilitates comparative analysis of the financial statements.
- It ensures uniformity in charging depreciation on fixed assets and valuation of closing stock.

INTEXT QUESTIONS 3.1

Fill in the blanks with suitable word/words

i. Convention of consistency means that same accounting principles should be used for preparing financial statements ....

ii. Unsold goods are valued at cost price or .... whichever is ....

iii. Precious metals, like gold, mineral and others are generally valued at...........

iv. As per the convention of .... year after year same methods are followed.

3.3 CONVENTION OF FULL DISCLOSURE

Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. **Adequate** means sufficient set of information to be disclosed. **Fair** indicates an equitable treatment of users. **Full** refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information. Let us relate it to the business. The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholders would like to know profitability of the firm while the creditors would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statements disclose all relevant information in full, fair and adequate manner.

Let us take an example. As per accounts, net sales are ₹1,50,000, it is important for the interested parties to know the amount of gross sales which may be ₹2,00,000 and the sales return ₹50,000. The disclosure of 25% sales returns may help them to find out the actual sales position. Therefore, whatever details are available, that must be honestly provided. Additional information should also be given in the financial statements. For example, in a balance sheet the basis of valuation of assets, such as investments, inventories, land and building etc. should be clearly stated. Similarly, any change in the method of depreciation or in making provision for bad debts or creating any reserve must also be shown clearly in the Balance Sheet. Therefore, in order to achieve the purpose of accounting, all the transactions of a business and any change in accounting policies, methods and procedures are fully recorded and presented in accounting.

To ensure proper disclosure of material accounting information, the Companies Act 1956, under schedule VI has provided a format for the preparation of Profit and Loss account and Balance Sheet of a company. It is necessary for every company to follow this format. The regulatory bodies like Securities and Exchange Board of India (SEBI) has also made compulsory for complete disclosures by registered companies.

Significance

- It helps in meaningful comparison of financial statements of the different business units.
- This can also help in the comparison of financial statements of different years of the same business unit.
- This convention is of great help to investor and shareholder for making investment decisions.
- The convention of full disclosure presents reliable information.

Notes

INTEXT QUESTIONS 3.2

Fill in the blanks with appropriate word/words :

i. The shareholders would like to know about the __________ of the business.

ii. The convention of full disclosure requires that there should be full, __________ and __________ disclosure of accounting information.

iii. The creditors are interested to know the __________ of the business.

iv. All relevant material facts should be __________ in the financial statements.

v. The full disclosure convention presents __________ information.

3.4 CONVENTION OF MATERIALITY

The convention of materiality states that, to make financial statements meaningful, only material facts i.e. important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Material fact means the information of which will influence the decision of its user.

For example, a businessman is dealing in electronic goods. He purchases T.V., Refrigerator, Washing Machine, Computer etc. for his business. In buying these items he uses larger part of his capital. These items are significant items; thus, these should be recorded in the books of accounts in detail. At the same time to maintain day to day office work he purchases pen, pencil, match box, scented stick, etc. For this he will use very small amount of his capital. But to maintain the details of every pen, pencil, match box or other small items is not considered of much significance. These items are insignificant items and hence they should be recorded separately. Thus, the items that are significantly important in recording the details are termed as material facts or significant items. The items that are of less significance are immaterial facts or insignificant items.

Thus according to this convention, important and significant items should be recorded in their respective heads and all immaterial or insignificant transactions should be clubbed under a different accounting head.

Significance

- It helps in minimising the errors of calculation.
- It helps in making financial statements more meaningful.
- It saves time and resources.

INTEXT QUESTIONS 3.3

Fill in the blanks with suitable word/words :

i. ____________ convention states that to make financial statements more meaningful, only significant and important items should be supplied to the users.

ii. Convention of materiality states that significant items should be disclosed under ____________.

iii. ____________ convention keeps accounts manager to focus on important /significant items.

iv. ____________ means the information which will influence the decision of its users.

3.5 CONVENTION OF CONSERVATISM

This convention is based on the principle that **"Anticipate no profit, but provide for all possible losses"**. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.

Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future, provision should be made in the books of accounts for the same. For example, valuing closing stock at cost or market price whichever is lower, creating provision for doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent, etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

Significance

- It helps in ascertaining actual profit.
- It is useful in the situation of uncertainties and doubts.
- It helps in maintaining the capital of the enterprise.

INTEXT QUESTIONS 3.4

Give your decision in the following situations :

i. A business has unsold stock at the end of year. The cost price is ₹2,00,000 and the market price is ₹2,50,000. At which price the unsold stock be recorded ?

ii. What will be your decision if the cost price in the above case is ₹2,10,000 ?

iii. A businessman anticipates that it may not be possible to collect ₹50,000 from one of his debtors. will he record this transaction in the books of accounts and at what value?

3.6 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) AND ACCOUNTING STANDARDS

In order to maintain uniformity and consistency in accounting records throughout the world, certain rules and principles have been developed which are generally accepted by the accounting profession. These rules/principles are called by different names such as principles, concepts, conventions, postulates, assumptions. These rules/principles are judged on their general acceptability rather than universal acceptability. Hence, they are popularly called Generally Accepted Accounting Principles (GAAP). The term "generally accepted" means that these principles must have support, that generally comes from the professional accounting bodies. Thus, Generally Accepted Accounting Principles (GAAP) refer to the rules or guidelines adopted for recording and reporting of business transactions of financial statements. These principles have evolved over a long period of time on the basis of past experiences, usages or customs, etc. These principles are also referred as concepts and conventions, which have already been discussed.

Accounting standards : Concept and Objectives

The term standard denotes a discipline, which provides both guidelines and yardsticks for evaluation. As guidelines, accounting standards provide uniform practices and common techniques of accounting. As a general rule, accounting standards are applicable to all corporate enterprises. They are made operative from a date specified in the standards. The Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) in April, 1977 for developing accounting standards. However, the International Accounting Standards Committee (IASC) was set up in 1973, with its headquarter in London (U.K.).

The Accounting Standards Board is entrusted with the responsibility of formulating standards on significant accounting matters keeping in view the international developments, and legal requirements in India.

The main function of the ASB is to identify areas in which uniformity in standards is required and to develop draft standards after discussions with representatives of the Government, public sector undertakings, industries and other agencies.

In the initial years, the standards are of recommendatory in nature. Once an awareness is created about the benefits and relevance of accounting standards, steps are taken to make the accounting standards mandatory for all companies. In case of non compliance, the companies are required to disclose the reasons for deviations and its financial effects:

Till date, the IASC has brought out 40 accounting standards. However, the ICAI has so far issued 29 accounting standards. These are :

AS-1 Disclosure of accounting policies (January 1979). This standard deals with the disclosure of significant accounting policies in the financial statements.

AS-2 Valuation of Inventories (June 1981). This standard deals with the principles of valuing inventories for the financial statements.

AS-3 **(Revised)** Cash flow statement (June 1981, Revised in March 1997). This standard deals with the financial statement which summarises for a given period the sources and applications of an enterprise.

AS-4 Contingencies and events occurring after the Balance Sheet date (November 1982, Revised in April, 1995) This standard deals with the treatment of contingencies and events occurring after the balance sheet date.

AS-5 Net profit or loss for the period, prior period (period before the date of balance sheet) items and changes in accounting policies (November 1982, Revised in February 1997). This standard deals with the treatment in financial statement of prior period and extraordinary items and changes in accounting policies.

AS-6 Depreciation Accounting (November 1982). This standard applies to all depreciable assets. But this standard does not apply to assets in the category of forests, plantations and similar natural resources and wasting assets.

AS-7 Accounting for construction contracts (December 1983, revised in April 2003). This standard deals with accounting for construction contracts in the financial statements of contractors.

AS-8 Accounting for Research and Development (January 1985). This standard deals with the treatment of costs of research and development in financial statements.

AS-9 Revenue Recognition (November 1985). This standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise.

AS-10 Accounting for fixed assets (November 1991). This standard deals with recognition of fixed assets grouped into various categories, such as land, building, plant and machinery, vehicles, furniture and gifts, goodwill, patents, trading and designs.

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AS-11 Accounting for the effects of change in foreign exchange Rates. (August 1991 and Revised in 1993). This standard deals with the issues relating to accounting for effect of change in foreign exchange rates.

AS-12 Accounting for Government grants (April 1994). This standard deals with the accounting for government grants.

AS-13 Accounting for investments (September 1994). This standard deals with accounting aspect concerning investments in the financial statements. These include classification, determination of cost for initial recognition, disposal and re-classification of investment.

AS-14 Accounting for amalgamation (October 1994). This standard deals with accounting treatment of any resultant goodwill or reserves in amalgamation of companies.

AS-15 Accounting for retirement Benefits in the financial statements of employers (January 1995). This standard deals with accounting for retirement benefits in the financial statements of employers.

AS-16 Borrowing Costs (April 2000). This standard deals with the uses involved relating to capitalization of interest on borrowings for purchase of fixed assets.

AS-17 Segment reporting (October 2000). This standard applies to companies which have an annual turnover of ₹50 crores or more. These companies have to present segment wise financial statements and consolidated financial statements.

AS-18 Related party disclosures (October 2000 revised 1st July 2003). This standard requires certain disclosure which must be made for transactions between the enterprise and related parties.

AS-19 Leases (January 2001). This standard deals with the accounting treatment of transactions related to lease agreements.

AS-20 Earning per share (April 2001). This standard deals with the presentation and computation of earning per share (EPS).

AS-21 Consolidated financial statements (April 2001). This standard deals with the preparation of consolidated financial statements with an intention to provide information about the activities of a group.

AS-22 Accounting for taxes on Income (April 2001). This standard deals with determination of the account of tax expenses for the related revenue.

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AS-23 Accounting for investments in Associates in consolidated financial statements (July 2001). This standard deals with the principles and procedures to be followed for recognising, in the consolidated financial statement.

AS-24 Discontinued operations (February 2002). This standard deals with the principles of discontinuing operations of an enterprise with the activities which are continuing.

AS-25 Interim financial reporting (February 2002). This standard deals with the minimum content of interim financial report.

AS-26 Intangible Assets (February 2002). This standard prescribed the accounting treatment for intangible assets which are not covered by any other specific accounting standard.

AS-27 Financial reporting of interest for joint venture (February 2002). This standard sets principles and procedures for accounting for interest in joint venture.

AS-28 Impairment of Assets (2004). This standard prescribed procedures to ensure that an asset is carried at no more than its carrying amount and procedures as to when to recognise an asset as impaired.

AS-29 Provision for contingent labilities and contingent assets (2004). This standard deals with measurement and recognition criteria in three areas, namely provisions, contingent liabilities and contingent assets.

All the above standards issued by the Accounting Standards Board are recommended for use by companies listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

INTEXT QUESTIONS 3.5

Fill in the blank with appropriate words

i. AS1 deals with ....

ii. AS29 deals with ....

iii. AS26 deals with ....

iv. AS20 deals with ....

v. AS21 deals with ....

vi. AS22 deals with ....

vii. GAAP stands for ....

viii. Accounting standard Board (ASB) was established ....

ix. International Accounting Standard Committee was established ....

x. AS2 deals with ....

Notes

WHAT YOU HAVE LEARNT

- Accounting conventions are common practices which are followed in recording and presenting accounting information of business.
- Convention of consistency states that the same accounting methods should be adopted every year in preparing financial statements.
- Convention of disclosure states that all material and relevant facts relating to financial statements should be fully disclosed.
- Convention of materiality states that, to make financial statements more meaningful only significant information should be shown in the financial statements.
- Convention of conservatism states that, profit should not be recorded until it is realised. But if business anticipates any loss in near future provision should be made in the books of account.
- Generally accepted accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financial statements.

TERMINAL EXERCISE

1. Explain the convention of consistency with example.
2. Explain the accounting convention of conservatism with example.
3. What do you mean by accounting standards? Enumerate the accounting standard issued by the ASB from time to time.
4. Explains the convention of materiality.
5. Explain the accounting convention of full disclosure with example.

ANSWERS TO INTEXT QUESTIONS

3.1 (i) year after year (ii) market price, lower
(iii) market price (iv) consistency

3.2 (i) profitability (ii) fair, adequate (iii) solvency
(iv) disclosed (v) reliable

3.3 (i) Materiality (ii) separate head
(iii) Materiality (iv) Material fact

3.4 (i) cost price i.e. ₹2,00,000 (ii) Cost price i.e.₹21,00,000
(iii) Yes, as a bad debt ₹50,000

3.5 (i) Disclosure of accounting policies

(ii) Provisions, contingent liabilities and contingent assets

(iii) Intangible assets (iv) Earning per share

(v) Consolidated financial statements

(vi) Accounting for taxes on income

(vii) Generally Accepted Accounting principle

(viii) April, 1977 (ix) 1973 (x) Inventory valuation

ACTIVITY

Visit a number of business units and enquire from the accountants how do they deal with the following while preparing the accounts :

1. Valuation of the stock at the end of the accounting period.
2. At what intervals do they close their account books?
3. What method of depreciation did they use in the last three or four years?
4. Have they ever suffered losses or earned profits because of the lethargic attitude or loyality towards the organisation?

Complete the answer and draw the conclusion whether they are following some accounting concepts or not. If yes, name the accounting conventions/accounting concepts.