ACCOUNTING CONVENTIONS

Distinction between Accounting Concepts and Accounting Assumptions

Basis	*Accounting Concepts*	*Accounting Conventions*
1. Nature	Accounting concepts are basic assumptions or rules on the basis of which transactions are recorded and financial statements are prepared.	Accounting conventions are statements of practice which are followed as accepted methods or procedures.
2. Personal Judgment	They are not affected by personal judgment or bias of the persons concerned.	They are affected by the personal judgment or bias of the persons concerned.
3. Relative Importance	Accounting concepts are relatively more important than the accounting conventions.	Accounting conventions are relatively less important than accounting concepts.
4. When used	Accounting concepts are used while recording the transactions as well as while preparing financial statements.	Accounting conventions are used while preparing financial statements.
5. Uniformity	There is uniformity in their use in different forms of business organisations.	There is no uniformity in their use in different firms/types of business organisations.
6. Number	Number of accounting concepts are more as compared to accounting assumptions.	Number of accounting assumptions are less as compared to accounting concepts.

1. Full Disclosure : Accounting aims to communicate financial information to internal and external users. **According to the principle of full disclosure all significant financial information must be disclosed. There should be full, fair and adequate disclosure. Full disclosure** means presentation of all relevant information *i.e.,* nothing is omitted. **Fair disclosure** means that the information given is unbiased, *i.e.,* it gives a true and fair view of the results of operations and that of the financial position of the business. **Adequate disclosure** means that sufficient information has been provided which influences the decisions of the user. In other words, financial statements should contain information sufficient to make them useful and not misleading.

The principle of full disclosure gains more significance in case of joint stock company because of separation of management and ownership. To ensure full disclosure the Companies Act, 2013 has prescribed the format of the Balance Sheet and contents of the Profit and Loss Account. Similarly separate formats have been prescribed for banking companies and insurance companies by the relevant statutes.

Accounting Standard-1 (AS-1) provides that (*i*) all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed; and (*ii*) any change in an accounting policy which has a material effect should be disclosed. For example, if an enterprise has been depreciating its specific fixed asset on straight line basis for the last three years and changes its method of charging depreciation to written down value method then it should disclose this fact and the effect of change should also be disclosed in the financial statements.

The implication of this convention is that the users of accounting information will be able to take informed decisions.

2. Materiality : *The principle of materiality requires that focus should be on material information and resources of the enterprises should not be spent on recording and reporting of immaterial information.* An information is considered to be material if the knowledge of this information is significant to the users of accounting reports. In other words, an information is material if it is significant enough to influence the decision of an informed investor. Immaterial items may be left out or merged with other items.

Insignificant details which are difficult to handle may be avoided because it may detract from good prediction and decision making.

According to AICPA, "A statement, fact or item is material, if giving full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to 'make a difference' in the conduct and judgment of a reasonable person." Thus, whether an item is material or not depends on its nature and/or the amount.

Therefore, those events are not recorded in accounting which are so insignificant that the work of recording them is not justified by its usefulness. For example, purchase of a pencil or issue of a pencil from store is treated as an expense and not an asset although the pencil may be used in the next financial year also.

Thus materiality places a restriction on what should be disclosed. It is a modifying principle as it modifies the principle of full disclosure.

3. Consistency : *The consistency principle refers to the use of same accounting policies by a firm or accounting entity from period to period.* Such consistency is necessary for comparing the data reported in financial statements for one period with that of another period. For example, there are several methods of charging depreciation and that of inventory valuation. Any one of the several methods of depreciation or of inventory valuation may be adopted as is considered fit. If a particular asset is depreciated by straight line method, this method should be followed year after year. Similarly, if inventory is valued by FIFO method, this method should be followed consistently in future also. The application of this principle makes financial statements more comparable and thus more useful.

However, the consistency principle does not say that accounting policies cannot be changed at all. They can be changed in certain circumstances. For example, method of charging depreciation can be changed for better presentation of financial statements or if it is required by the statute or by the accounting standard. But when a change in accounting policy is made, the fact of the change should be disclosed and its effect on the financial results of the enterprise should also be disclosed.

4. Conservatism or Prudence : *According to this principle when more than one measurement alternative is permissible for a transaction, that alternative should be selected which has the least favourable immediate effect on net profit or capital. In simple words the principle is often stated, "Anticipate no profit, but provide for all possible losses."* This is a policy of following cautions approach in the uncertain environment. It is an important modifier of the cost concept. It affects mainly the current assets. According to the cost concept the stock-in-trade should be valued at cost but according to the conservation principle it is valued at the lower of cost or market value. Some of the other applications of the conservatism principle are as follows :

(*i*) Making provision for bad and doubtful debts and for discount on debtors.

(*ii*) Creation of investment fluctuation fund.

(*iii*) Amortisation of intangible assets like goodwill, patents, trade marks as early as possible.

(*iv*) Reporting the joint life policy at surrender value.

(*v*) Not making provision for discount on creditors.

The principle has been applied vigorously in the past as a way of dealing with uncertainty. It was also applied to protect creditors against an unwarranted distribution of dividends. It is also assumed that overstatement of profit is more dangerous for the business and its owners than understatement. The conservatism principle is applied less strongly now than was the case earlier. Some are of the view that 'conservatism' should be replaced by 'prudence' according to which conservatism principle should be applied only when great uncertainty and doubt exists.

According to E.S. Hendriksen, "Conservatism is, at best, a very poor method of treating existence of uncertainty in valuation and income. At its worst, it results in a complete distortion of accounting data." Conservatism conflicts with the full disclosure principle. It also conflicts with consistency because there can be no uniform standards for its implementation.