2. Accounting Assumptions and Concepts

2.1 Accounting Assumptions, Principles and Concepts

Students' Notes:

- ***Every Field is based on certain Principles, Concepts and Ideas. (Either scientifically proved or traditionally followed). Accounting Field is also based on Certain (a) Assumptions, (b) Concepts, (c) Principles and (d) Conventions. This segment discusses them in detail.***
- ***The Understanding of the following segment assumes the greatest importance for understanding the logic of accounting entries.***

	Item	Description
1	**Accounting Assumptions**	(a) "Assumption" refers to the fundamental **Premise / Condition** based on which the entire accounting process is carried out. (b) In Accounting, there are 3 Fundamental Accounting Assumptions. (c) **Example:** When a person started a particular business, we assume that the person started the business for continuing it to earn profits and not for closing it.
2	**Accounting Concepts**	(a) "Concept" means any idea or notion, which has a universal application. (b) **Accounting Concepts** are the basic conditions which lay down the foundation for formulating the accounting principles. (c) They are clearly defined and supported by reasoning.
3	**Accounting Principles**	(a) **Accounting Principles** refer to the set of doctrines associated with the theory and procedures of accounting. (b) They serve as an explanation of current practices and as a **guide** for **selection of conventions** or **procedures where alternatives exist.** (c) Accounting Policies should be – (i) based on real assumptions, (ii) simple and easily understandable, (iii) consistently followed, (iv) informational to the Users, and (v) able to reflect future predictions.
4	**Accounting Conventions**	(a) **Accounting Conventions** are the general procedures emerging out of **usage and practice** of accounting principles. (b) Conventions may **not** have universal application. (c) They may contradict the basic accounting principles. (d) Further, certain conventions may be **changed** over a period of time, by Accounting Bodies like ICAI, for improving the quality of Financial Statements. (e) **Example:** In India, pedestrians walk on the left side and the vehicles go on the right side of the road. This is traditionally accepted practice and everybody follows it

Concepts vs Conventions:

(a) Concepts are clearly defined and supported by reasoning while conventions may not be clearly defined.
(b) Concepts support the principles whereas Conventions may contradict the principles.

Note: The above terms Concepts, Principles and Conventions, are sometimes used interchangeably. In the Exam questions, the students have to give a liberal meaning to the above words.

Note: Gist of Accounting Assumptions / Concepts / Conventions

1. **Fundamental Accounting Assumptions: Only 3** – (a) Going Concern, (b) Consistency and (c) Accrual. *(They are also considered as part of Accounting Concepts)*

2. **Accounting Concepts:**

(a) Business Entity	(g) Consistency
(b) Money Measurement	(h) Cost
(c) Accounting Period / Periodicity	(i) Realisation
(d) Accrual	(j) Dual Aspect
(e) Matching	(k) Full Disclosure
(f) Going Concern	(l) Substance Over Legal Form

Note: Verifiable Objective Evidence Concept stipulates that all accounting transactions must be recorded based on invoices, correspondence, vouchers and business documents.

3. **Accounting Conventions:** (a) Conservatism (b) Materiality.

2.2 Fundamental Accounting Assumptions

1. **Going Concern:**
   (a) The enterprise is normally viewed as Going Concern, i.e. **continuing** in operation for the foreseeable future (endlessly).
   (b) It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of reducing substantially its level of operations.

(c) **Example:** When we invest in shares of Reliance Company, we normally assume that the Company's operations will be continued. We do not expect the Company to be closed.

(d) **Exception to Going Concern Assumption –** Joint Venture (Which is created for specific purpose / period)

(e) *Going Concern is also considered as one of the accounting concepts.*

(f) **Significance:**

- The Going Concern Convention is important for valuation of assets and liabilities.
- It indicates the need to value the assets based on the future returns that can be earned from such assets.
- ***Based on Going Concern Assumption, Historical Cost is used for measuring / valuing Fixed Assets. If the Going Concern assumption becomes inappropriate (i.e. if the Enterprise cannot be taken as a going concern) then assets should be valued at their Net Realisable Value, i.e. if the business is to be closed, then the assets must be valued at Market Values and not at cost.***

2. **Consistency:**

(a) **Meaning:** The accounting principles followed by the entity shall be consistent i.e. the same, over a period of time. Frequent changes in accounting policies will distort comparison.

(b) **Example:** If one year, a particular payment is treated as expense, then the assumption is that the subsequent years also it shall be treated only as an expense.

(c) Consistency is also considered as one of the Accounting Concepts.

(d) **Exception:** As per Consistency Concept, a change in an accounting policy should be made only -

- If the adoption of a different accounting policy is required by Statute, or
- For compliance with an Accounting Standard, or
- If it is considered that the change would result in a more appropriate presentation of the Financial Statements of the Enterprise.

3. **Accrual:**

(a) Revenue and Costs are **"accrued"**, i.e. recognized as they are earned or incurred and recorded in the Financial Statements of the period to which they **relate**, and not when money is received or paid.

(b) **Example:** If a sale for ₹ 10,000 is made on credit to a person in 2018, but the settlement is received in 2019. In this case, ₹ 10,000 shall be treated as income in 2018 (in the year of accrual) and not in 2019. (year of receipt)

(c) *Accrual is also treated as* ***one of the Accounting Concepts.***

Disclosure Requirements

If the above assumptions are **followed in preparing accounts**	If the above assumptions are **not followed**
Separate disclosure is **not required**, since their acceptance and use **are assumed.**	Disclosure is **necessary**, *specifying that the general accounting assumptions are not followed.*

Students' Note: Accrual Vs Receipt

(a) "Accrual" means "right to **receive/obligation to pay** money". "Receipt" means "**Actual Receipt/Payment** of money"

(b) "Accrual Basis" is otherwise called as "Mercantile Basis"

(c) **Example:** B sold to A for ₹ 10,000 on 1st January on credit for 60 days. In this case, B has a right to receive money from A but he can actually receive money only on 2nd March (after 60 days). Hence, ₹ 10,000 has accrued on 1st January, but it is received on 2nd March. Sales will be recorded on 1st January and not on 2nd March.

2.3 Accounting Concepts

A. Business Entity Concept

1. **Meaning:** The Business Enterprise is a **separate identity and distinct** from that of its Owners or Managers. The Owner of the business and the business as such is treated as two different persons.

2. **Impact of above concept:** All transactions are classified into – (a) Business Transactions, and (b) Personal Transactions. Business Transactions are recorded in the books of accounts of the business. Owner's Personal transactions are recorded in his personal book of account and not in the books of the business.

3. **Example:**
   (a) Mr.A is a owner of a CA firm "M/s A & Co." The profits arising from M/s A & Co. belong to Mr.A only. However, for accounting purposes, Mr.A is a different person and M/s A & Co. is a different person.
   (b) Accounting will be done only for the transactions in which M/s A & Co is involved and not for A's personal transactions.

4. **Accounting Entity:** The Entity for which the accounting is to be made may be

Business Undertakings	(a) Business Unit itself (i.e. Sole Proprietorship Firm, Partnership Firm, Company or Government Undertaking), or (b) a defined part of a business (i.e. a department), or (c) a combination of related businesses (i.e. Holding and Subsidiary Company) depending on the User's needs.
Non–Business Undertakings	Trusts, Club, Religious Bodies or Government

5. **Impact on Accounting:** The entity concept has the following impact for accounting –
   (a) **Business Viewpoint:** All transactions are recorded from the viewpoint of the entity itself and not from the viewpoint of other parties such as Owners, Managers or Customers.
   (b) **Owner–Business transactions:** This concept leads to Lender – Borrower relationship between the business and the owner of the business.

Event	From Business' View	Treatment
Owner invests money in business	It is money borrowed by business from the owner and hence is a liability	Capital (Note)
Owner withdraws money from business	It is repayment of loan by the business to the owner	Drawings (Note)
Profits of the Business	Whatever profits earned by the business belong to the owner. Hence, profits are also considered as liability of the business to the owner.	Added to Capital
Losses of the Business	Similar to profits, losses also belong to the owner. But, losses will reduce the amount due to the owner	Reduced from Capital

***Note:** The above terms are used to distinguish the Owner's loans/repayments from other persons' loans / repayments.*

   (c) **Owner vs Business Transactions:**
   - The Owner's Personal transactions are not recorded in the Books of Accounts of the Business.
   - For eg. If the owner purchases Television for his home, it shall not be recorded in the books of the business. ***(Reason:** This is to find out the true profits and true financial position of the business. If the Owner's personal transactions are combined with business transactions, then the very purpose of accounts will be lost.)*

   (d) **Payments to Owners vs Payments to Others:**
   - Payments to Outsiders represent the expenses for operating the business, e.g. Rent, Interest on Loans, etc.
   - Payments of Profits to the Owners like Dividend, etc. are not treated as Expenses.

   (e) The Entity Concept gives meaning to the basic accounting equation viz. Equity + Liabilities = Assets.

B. Money Measurement Concept

1. **Meaning:** Accounting Data must be quantified so that data can be aggregated and hence summarized. Hence, all transactions and events should be measured in terms of money. Transactions are recorded in books of account, in the **ruling currency of the country where the books of accounts are prepared.**

2. **Common Unit:** A common measuring unit in terms of money helps to – (a) quantify data, and (b) enable determination of profit / loss and financial position. For example, the **Rupee** is the common unit of measurement for economic events and transactions in India. It is the legal tender used as the medium of exchange in market transactions.

3. **Justification of Money Measurement:**
   (a) All transactions should be measured in terms of money.
   (b) Managerial planning and control must take shape in monetary terms. The profit objective should be stated in monetary denominations in order to make performance evaluation meaningful.
   (c) It is used for providing financial information to Shareholders, employees and a variety of other users who need such information for decision–making.

4. **Criticism of Money Measurement:**
   (a) **Value of Money erodes** over a period of time. Future Cash Flows have a lower value than the Present Cash Flows. Hence, Money by itself is not a meaningful measurement base.

   Example: One kg of Onion in a year was sold at ₹ 40; and next year it increased to ₹ 80. This implies that the **real value of money has gone down.** However, this is not reflected in Money Measurement Concept.

   (b) **Exchange value of a currency** (e.g. Rupee) in relation to other currency **is not constant** over a time period. Hence, money does not provide a stable measurement yardstick.

   (c) **Many material transactions and events are not recorded** in the books of accounts just because they **cannot be measured** in terms of **money**. **Example:** Appointment of new Chairman for the Company.

5. **Impact on Accounting:**
   (a) As per Money Measurement Concept, only those transaction, which are capable of being measured in terms of money are recorded in the books of accounts, that too in the ruling currency of the country, e.g. in Rupees in India, in Dollars in USA, in Pounds in UK.

   (b) Transactions which are not in monetary terms, even if they affect the results of the business materially, are not recorded in the book of accounts.

Note: *Entity and Money Measurement Concepts are the **basic concepts** on which the other procedural concepts depend.*

C. Periodicity or Accounting Period Concept

1. **Need:** As per the Going Concern Assumption, the enterprise has an indefinite life. However, it is necessary to sub–**divide such indefinite period** into a **smaller time units** for (a) measurement of performance; (b) understanding the financial position of the enterprise and (c) control over operations. Such smaller and usable time–frame for reporting purposes is called **Accounting Period**.

2. **Meaning:**
   (a) Hence, during the life–time of an entity, Financial Statements can be prepared in periodic intervals of time. The economic life of an enterprise is split into the periodic interval (being a financial year).

   (b) As per Periodicity Concept, the Financial Statements should be prepared after **every accounting / financial period, and not at the end of the life of the entity**.

   (c) Generally, a period of 12 months (i.e. one year) is considered as the accounting period, by most enterprises. In the Corporate Sector, Interim Financial Reporting is also prevalent. The length of the accounting period is also determined by the statute in certain cases.

   Note: *Normally the term "Financial Year" refers to the period for which the accounts are prepared. It is usually taken as the period from 1st April to 31st March of the next year.*

3. Periodicity Concept **facilitates** in –
   (a) Comparison of Financial Statements of different periods,
   (b) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business,
   (c) Matching periodic revenues with expenses for getting correct result of the business operations.

4. **Expense Classification:** Based on the Periodicity Concept, expenses are classified into –

Nature	Meaning	Treatment for determining profits
(a) Capital	They create an enduring benefit, (say, for 7 to 10 years) **Example:** Factory Building, Machinery, Motor Car, Land etc. ***They are otherwise called as "Fixed Assets"***	They are **deducted** from Income **over their useful** in **a specified proportion. This deduction is otherwise called as "Depreciation".**
(b) Revenue	They result in benefit which is fully used within **one** financial period **Example:** Rent, Repairs, Insurance, Salary etc. They are otherwise called as **"Expenses"**	They are **deducted** from Income **in FULL** in the **period in which they are incurred.**
(c) Deferred Revenue	They take the nature of both revenue and capital expenditure. They are **revenue expenditure which provide benefits for 3 to 5 years.**	They are **deducted** from Income over the periods in which the benefits arise.

Nature	Meaning	Treatment for determining profits
	Example: Advertisement. It is strictly a revenue expenditure, but as the benefits from advertisement may arise for 3 to 5 years, it is *deferred and treated as revenue in 3 to 5 years*	

Exception: In Joint Venture Accounting, the above classification of Capital and Revenue Expenditure is not applicable, **as the Venture is only for a specific duration, and not on long–term basis.**

D. Accrual Concept

1. **Meaning:** "Accrual" means recognition of revenue as they are earned and the cost as they are incurred and not when money is received or paid. This Concept relates to measurement of income, identifying Assets and Liabilities. *[This concept is also one of the Fundamental Accounting Assumptions.]*
2. **Method:** Under Accrual Concept, all transactions and events are recognized on **mercantile basis,** i.e. as they are earned or incurred, and recorded in the Financial Statements of the period to which they **relate**, and not when cash is actually received or paid.
3. As per Accrual Concept, **Profits = Revenue** Less **Expenses**
   (a) **Revenue** = Gross Inflow of Cash, Receivables and other consideration arising in the course of ordinary activities of an enterprise from sale of goods, from rendering services, and from the use by others of enterprise's resources yielding interest, royalties and dividends.
   (b) **Expenses** = Cost relating to the operations of an accounting period, or to the revenue earned during the period, or the benefits of which do not extend beyond that period.

E. Matching Concept

1. **Meaning:**
   (a) Performance of a business entity is measured with reference to a specific accounting period.
   (b) Hence, to determine the profits for a particular period, Revenue **earned** in that period **should be matched** with the expenses **incurred** for earning such revenue.
2. **Impact of Matching Concept:** As per Matching Concept.

Profit for any period = Periodic Revenue **Less** Matched Expenses

Periodic Revenue: Income **earned** during the period
↓
Sales, Interest, Commission, Dividend on shares for the accounting period
Actual Receipt of income is not criteria
(Refer Point No.3)

Matched Expenses = Expense attributable to earning income in that period + Expense relatable to that period as such
↓
- Revenue → Direct Costs; Fixed Period Costs **(Refer below)**
- Share of Deferred Revenue **(Refer below)**
- Share of Cost of Fixed Assets (Refer below) For Eg. Depreciation

Notes:
(a) **Direct Costs –** Expenses directly related to output / sales of an enterprise, e.g. Materials Consumed, Labour etc.
(b) **Fixed Period Costs –** Expenses incurred over the period and not directly related to the goods / services sold / rendered by the enterprise. It may be difficult to relate such expenditure with the revenue earned. e.g. Salaries, Office Rent, Insurance Premium etc.
(c) **Deferred Revenue Expenditure – Refer Periodicity Concept:** e.g. Advertisement, Research & Development etc.
(d) **Fixed Assets** – Expenses spent on fixed assets for the production of goods and services, for a longer timeframe. The cost of assets to be charged as depreciation against the revenue of a particular period is a matter of judgment.

3. **Nature of Income / Expenses:**

Particulars	Income	Expenses
Inclusions	Sale/Service rendered but money not received. ***(Outstanding Income / Accrued Income)***	Services received / purchases made but money **not paid *(Outstanding Expenses / Sundry Creditors)***
Exclusions	Advances received before sale / service is not income ***(Income received in advance)***	Advances paid before purchases made / services received ***(Prepaid Expenses/Expenses paid in advance)***

4. **Impact:** The Accrual Concept, together with Periodicity and Matching concepts, give rise to the recognition of – (a) Prepaid Expenses (b) Outstanding Expenses (c) Income Receivable and (d) Income Received in Advance.

F. Cost Concept

1. **Meaning:** As per Cost Concept, Value of an asset as shown in the Balance Sheet must be its Historical Cost, i.e. Acquisition Cost. This is the conventionally adopted measurement base for valuation of assets.
2. **Significance / Merits:**
   (a) Historical Cost is **objective** and free from bias.
   (b) Historical Cost is **easier to ascertain** than Current Cost, Present Value, etc.
   (c) Historical Cost represents an **actual figure** / outflow of resources for acquiring the asset, and does not reflect a hypothetical or notional figure.
3. **Criticism:** Historical Cost is criticized on the following grounds –
   (a) Historical Cost **does not reflect the true value** of the asset, particularly in an inflationary situation.
   (b) Financial Statements prepared on the basis of Cost Concept loses comparability.
   (c) Many assets (like Human Resources) do not have acquisition costs. Cost Concept fails to recognize such assets.

Note: Due to the above criticism, other measurement bases like Current Costs, Net Realisable Value, Present Value, etc. are suggested.

G. Realisation Concept

1. **Meaning:** As per Realisation Concept, An asset is recorded at its Historical Cost and any change in its value should only be recognised when it is realized, i.e. at the time of its actual sale / disposal.
2. **Concept:** It emphasises that there is no certainty of income until a sale has been made and hence increases in value of the asset should not be taken into account unless it is actually realised.
3. **Criticism:** However, Realisation Concept is criticised by arguing that if the value of an asset has been permanently changed, Profit or Loss arising out of such change should be considered to reflect true and fair financial position of the enterprise. Otherwise, accounting will become distorted and meaningless.
4. **Revaluation:** So, Fixed Assets may be revalued periodically. However, selective revaluation of an asset may lead to unrepresentative or misleading amounts being reported in Financial Statements. Hence, revaluation of assets should be done on a systematic basis. For Example, all machineries shall be revalued rather than a single machinery.

Fair Value: *Thus the Realisation Concept is slowly being replaced by the recognition of assets at their Fair Market Value (Fair Value Accounting Concept). However Accountants follow a more conservative path. They try to cover all probable losses but do not count probable gains.*

H. Dual Aspect Concept

1. **Meaning:** The Dual Aspect Concept is the **core of double entry book–keeping.**
2. **Basis:** As per this concept, **every transaction or event has two aspects**, which have to be recorded in the books. The amounts of both the aspects are equal.

3. The possible combinations of the effects of each transaction is as under –

1st Aspect	2nd Aspect	Example	Effect of Transaction
Increase in one Asset	Decrease in another Asset	Purchase of Machine for ₹ 40,000 by paying cash.	• Machinery A/c increased by ₹ 40,000 • Cash A/c decreased, by ₹ 40,000.
Increases an Asset	Increases a Liability	Purchase of goods for ₹ 90,000 on credit.	• Stock A/c increased, by ₹ 90,000, & • Creditors A/c increased by ₹ 90,000.
Decreases an Asset	Decreases a Liability	Payment of Cash ₹ 20,000 to Creditors	• Cash A/c decreased, by ₹ 20,000 & • Creditors A/c decreased by ₹ 20,000.
Increases one Liability	Decreases another Liability	Creditors paid from Bank Overdraft ₹ 10,000	• Bank O/D increased by ₹ 10,000 • Creditors Decrease by ₹ 10,000

4. **Significance:** This concept gives rise to the accounting equation: **"CAPITAL + LIABILITIES = ASSETS".** This equation can take many forms, and some forms are given below –

Capital + Liabilities	=	Assets
Equity (i.e. Capital) + External Liabilities	=	Fixed Assets + Current Assets
Equity + Long Term Liabilities + Current Liabilities	=	Fixed Assets + Current Assets
Equity + Long Term Liabilities	=	Fixed Assets + (Current Assets – Current Liabilities)
Equity + Long Term Liabilities	=	Fixed Assets + Net Working Capital
Equity	=	Fixed Assets + Net Working Capital – Long Term Liabilities
Capital + Income / Profits + Liabilities	=	Assets + Net Loss + Expenses
Note: Closing Capital = Opening Capital (±) Profits / (Losses) during the year (+) Additional Capital (–) Drawings (+) Interest on Capital (–) Interest on Drawings		

Note: Capital is otherwise called as Equity. *Both the sides of the equations shall always tally.*

5. **Example:** *Refer the end of this Chapter for the effect of each transaction on the above equation.*

I. Full Disclosure Concept

1. **Meaning:** As per this concept, all the events and transactions which are relevant shall be **disclosed** in the Books of Accounts and the Financial Statements. The events may relate to the current or the subsequent Accounting Periods.

2. **Purpose:** The users of the Financial Statements must be aware of all relevant events and transactions to understand the real position of the business.

3. **Disclosure:** The term "Disclosure" means that **a statement describing the event / transaction** (including the amount involved) should be added to the financial statements **as a note therein.** *(Disclosure is not same as accounting. Accounting means Accounting Entries will be passed, whereas in disclosure, a mere statement is given; Journal Entry not passed.)*

4. **Example:** The legal suit filed against a Company for violation of Copyrights shall be disclosed as part of the financial statements, though it cannot be measured accurately.

5. **Exception:** The **Conventions of Materiality and Conservatism are exceptions to the Concept of Full Disclosure**, due to following reasons:
   (a) **Materiality Vs Full Disclosure: (Refer Materiality Convention below)**
   - As per Full Disclosure, **all relevant events and transactions** must be disclosed.
   - As per Materiality, Accounting Principles to be applied **only for MATERIAL** events & transactions and not for all.

   (b) **Conservatism Vs Full Disclosure: (Refer Conservatism Convention below)**
   - As per Full Disclosure, **all relevant events and transactions** must be disclosed
   - As per Conservatism, only those events and transactions which lead to **Possible Losses** must be accounted and disclosed. **Unrealised profits shall not be accounted / disclosed.**

J. Substance over Legal Form Concept

1. **Meaning:** The accounting treatment and presentation in Financial Statements, of transactions and events, should be governed by their substance and not merely by the legal form.

2. **Examples:**
   (a) **Sale of Land & Building without Registration:** If the Firm has sold its Land and Building, received the consideration and handed over the possession to the Buyer, it **should be recorded as Sale** of Land and Building. This recognition **cannot be postponed for mere procedural formality** pending, e.g. registration of Sale Deed.
   (b) **Hire Purchase – Considered as Sale:** In case of an Asset acquired on Hire Purchase, ownership is not transferred till last instalment is paid. However, the Asset is shown in the books of the Hire Purchaser.
   (c) **Financing Agreement:** A Ltd enters into an agreement with B Ltd for sale of goods at ₹ 2,50,000. However, the same goods are to be repurchased in the next year for ₹ 2,75,000. This is **not** a **trading** transaction, and effectively **reflects a financing transaction**. It should be recorded only as a **financing transaction.**

2.3 Accounting Conventions

A. Conservatism Convention

1. **Meaning:**
   (a) Conservatism or Prudence demands that **unrealised profits and gains should not be recognised** in the accounts. However, **provision** should be **made for all actual and possible losses**.
   (b) The Accountants should not anticipate income, but should provide all possible losses.

2. **Example:** Assume that Mr.Z is dealing in two commodities – Pen and Pencil. The following details are given –

Particulars	Pen	Pencil
Quantity in Stock on 31st March	10,000 Nos.	15,000 Nos.
Cost of purchase of above stocks	₹ 10 / Pen	₹ 5 / Pencil
Market Value of Stock on 31st March	₹ 8 / Pen	₹ 8 / Pencil
Relevant amount for valuation	₹ 8 / Pen	₹ 5 / Pencil
Stock Value on 31st March	₹ 80,000	₹ 75,000
Treatment	**Expected Loss to be recognised**	**Unrealized loss not to be recognised**
Reasoning	There is a possible loss of ₹ 2/Pen, totaling upto ₹ 20,000	There is an expected gain of ₹ 3/pen, but that will not be considered as it is not sold

3. **Applications of Conservatism Convention:**
   (a) **Choice among different methods of Valuation:** If there is a choice between two methods of valuing an asset, the Accountant should choose a method which leads to the lesser value, e.g. Current Assets are valued at Cost or NRV, whichever is lower.
   (b) **Market Value vs Book Value:** If the market value of the fixed assets is greater than the Book Value of fixed assets, then the difference between Market Value and Book Value shall not be recorded in the books of accounts as it is not realized profits.
   (c) This concept prohibits Window Dressing. *(Window Dressing means* ***manipulating*** *the Financial Statements to make them attractive viz. inflating the profits, suppressing expenses, treating revenue expenditure as capital expenditure etc.)*
   (d) **Exceptions:** It is considered as an exception to – (a) Full Disclosure Concept (b) Consistency Concept.

4. **Advantages:** This Concept has led to the following qualitative characteristics of Financial Statements – (a) Prudence, (b) Neutrality, and (c) Faithful representation of alternative values.

5. **Disadvantages:**
   (a) Conservatism is **subjective** as the amount of possible losses may be quantified by different persons in a different manner and hence the loss amount determined by different persons **may not be the same.**
   (b) If the principle of Conservatism is **stretched without reservation**, it may result in – (a) Creation of Secret Reserves, (b) Violation of the Doctrine of Full Disclosure, and (c) Reported Profits being less than Actual Profits.
   (c) Conservatism is an exception to the doctrine of full disclosure **(Refer Exception under Full Disclosure)**

B. Materiality Convention

1. **Meaning:** As per Materiality Concept, all items having **significant** economic effect on the business should be disclosed in the Financial Statements.

2. **Material items** refer to the items in the financial statements the knowledge of which might influence the decisions of the users of Financial Statements.

3. **Examples:**

   (a) **Stationery** (like Notebooks, Calculator) purchased by the Firm, though not used fully in the accounting year purchased, is still shown as an expense of that year because of the Materiality concept. This is because the amount of such Stationery is very small to be shown as asset though it constitutes Assets of the Firm.

   (b) **Payment of Penalties/Fines for violation of law** should be disclosed separately, even if the amount is negligible. It should not be clubbed together with "Office Expenses" or "Miscellaneous Expenses".

4. **Factors:** Materiality depends on the size and nature of the items or errors, judged in the particular circumstances of its misstatement.
5. **Advantage:** Materiality provides a threshold or cut–off point for classifying the amounts into Assets or Expenses.
6. **Exception:** This principle is an exception to the Full Disclosure principle.
7. **Disadvantage:** Materiality is more a subjective and a judgmental principle.

   For Example, ₹ 10,000 spent on advertisement may be material for a small Firm with Sales of ₹ 1 Lakh; However, the same amount is not material for a Company like Reliance Industries.