Tutorial 5: **Accounting concepts and conventions**

Part A:

1. For each of the following statements, state the accounting concept that is most closely related to it:

a) Once a particular financial period is adopted by a business, it is not changed from one period to the next.
Consistency - similar accounting policies (ie financial period) must be used in preparation of financial performance and financial position.

b) The financial statements of a business report the economic activities of the business only and do not include the economic activities of the owners of the business.
Business entity - the business enterprise and its owners are two separate independent entities.

c) Generally a business is assumed to have an indefinite life (continuing), unless there is evidence to indicate otherwise (dissolving).
Going concern - a business firm will continue to carry on its activities for an indefinite period of time. Hence, it will not be dissolved in the near future.

d) The cost of a calculator in an office is treated as a period expense rather than depreciating its cost over its useful life.
E.g., *calculator* - materiality depends on the size and nature. Calculator can be used for more than 1 years, however, because of its small value/immaterial nature, it will be written off as an expense instead of a non-current asset.

Materiality : asset → expense (because of its small value - size and nature)

e) The record of credit sales is done by referring to sales invoices issued to customers.
Objectivity - the information that is included in accounting records must be verifiable. In this case, the sales invoices issued to the customer can be a source document.

f) An accountant generally recognised losses when there is evidence to indicate a high probability of the losses occurring, but gains are not recognised until they are actually realised.
Conservatism/Prudence - It's better for cash flow to overestimate the expenses instead of income. All foreseeable losses should be recognised in the accounts and reported immediately while any possible profits should only be recognised when it has actually happened.

g) Business premises are shown on the statement of financial position as RM100,000, its original cost 15 years ago, although its current value is RM1.5 million.
Historical cost - This concept requires assets, in this case, business premises to be shown at the price it has been acquired (cost price) instead of market price, so that it can be verified easily from the supporting documents.

h) Expenses are recognised in the same accounting period as the revenues which result from the incurrence of these expenses.
Accrual/matching concepts - It helps in determination of profit by knowing the actual expenses and actual income during a particular time period.

2. For each of the following independent situations, one or more accounting concepts have been violated. State the concept(s) that has been violated and explain the correct procedure that should be used.

a) Depreciation expense was not recorded for the current year because the management wanted to show a higher net profit.
Consistency - Record every year
Matching - Usage with expense, the revenue and the expenses incurred to earn the revenues must belong to the same accounting period.
Prudence - Choosing the worst-case scenario by not overstating profit/income and not understating the expenses/loss.

Matching concept - Depreciation represents the value of non-current assets that has decreased as a result of use in helping the business to generate revenue for the year. It should be deducted as expenses for the period. Depreciation should be charged on these assets to ensure accurate records have been presented.

b) Mr.Tan, the owner of a sundry shop, included his family's personal use of some of the goods as business expenses.
Business entity concept - This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. The business and personal transactions of its owner (i.e. for personal or family use) are separate. Hence, Mr. Tan should not include his family's personal use of some goods as business expenses, but record it as drawings in the account.

c) The Classic Shop reported its stock of antique paintings at RM700,000, the selling price, instead of RM300,000, the cost of the painting. The difference was recorded in the Statement of Profit or loss as an extraordinary gain.
Prudence/conservatism concept - The price of the paintings which are inventories (trading stock) should not be overstated. It should be stated at the price it has been acquired, which is the historical cost. Moreover, these paintings haven't been sold and the gain has not been made yet. According to the prudence concept, gains should not be recognised in the accounts until it has been released or sold. In conclusion, the Classic Shop should restate the cost of painting to its historical cost which is RM 300,000.

d) A motorcycle shop reports all its assets at current market value (market price) instead of its original cost (price when it has been acquired) less accumulated depreciation.
Prudence: Assets should not be stated at above the cost.
Original cost: Historical cost
Going concern: What is the relation?

Historical cost concept- All assets should be recorded in the books of accounts at their purchase price / original cost less accumulated depreciation. Hence, the motorcycle shop should report all its assets at original cost less accumulated depreciation.

e) Extreme Trading changes its stock valuation method every year. Management would choose the method that will report the kind of net profit that it wants to portray to its shareholders.

Consistency concept - This concept shows that similar accounting policies must be used in preparing and reporting the similar items in the financial statement from period to period. If the method adopted for the valuation of stock is changing every year, the profit figures will not be comparable and will always result in a higher profit, thus violating the prudence concept. Hence, once a stock valuation method has been adopted, it should be used consistently from period to period to enable meaningful comparisons. Changes are permitted and if there is any change in the accounting policy, the amount of difference that arises due to the change in policy should be determined and reported, to enable meaningful comparison to be made. In conclusion, Extreme Trading should stick to one stock valuation method in preparing the financial statements from period to period. Necessary required changes are fully disclosed by presenting them in the financial statements indicating their probable effects on the financial results of business.

f) Arts Deco, records revenue on receiving a customer's purchase order instead of when it delivers the goods to the customer.
Realisation - This concept states that the revenue from any business transaction should be included in accounting records only when it is realised, which is the revenue is realised at the time when goods or services are actually delivered. Hence, Arts Deco should only record revenue when the goods have been delivered to the customer.

g) F&M has been sued by a local authority for polluting the river behind its premises. There is a 60% chance that the company will have to pay out a very heavy fine which will drastically reduce its net profit. This was not mentioned in its recent financial statements.
Prudence concept - Prudence concept states that all foreseeable losses should be recognised in the accounts and reported immediately. Hence, F&M should mention the possible fine on river pollution in its recent financial statement.

Part B: ***(Questions for students own practice)***

Question 1

Kathy argues that since her business deals mostly with cash, it is not necessary to record the utilities incurred for the month of December although the utilities bills have been received but not yet paid. She plans to pay them in January next year and feels that these expenses should be recorded only in January next year. What would you advise her?

According to the **matching concept**, it states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period, whether received/not received during that year and all costs incurred, whether paid/not paid during the year should be taken into account. The utilities bills have been received in December even though it will only be paid in January next year. The utilities bills should be recorded as expense to be deducted from the revenue.

Question 2

You are the accountant of Big Boss Trading. From your experience, you noted that there were always some customers that have failed to settle their debts in the past. Therefore, you have proposed to provide an allowance of doubtful debts of 3% on the total trade receivables amount of RM1.5 mil. Your boss has strongly objected to this proposal. How would you advise him?

According to the **prudence/conservatism concept**, the assets (trade receivables) should ot be overstated. Since there are always customers that failed to settle their debt, Big Boss Trading should make allowance for doubtful debts, in this case, 3% (RM 45,000) is not collectible. Hence, the net traded receivables should be RM 1,455,000.

Question 3

John, an eager junior bookkeeper, is concerned that the firm he is working for does not record depreciation expenses for the firm's pencil sharpeners. The cost of these sharpeners amounts to RM100 and can be used for 2 years. He feels that these sharpeners should be depreciated using the straight-line method of depreciation. What is your opinion?

Materiality concept - A firm's pencil sharpeners can be used for more than one year. By nature, it should be accounted for as a non-current asset and then depreciated over its useful life. However, because of its immaterial/small value, the firm's pencil sharpeners are written off as an expense in the SPL in the year it is bought.

refer C5 page 4 2.10 Materiality