

Accounting Conventions

4.1 Introduction

Before studying this lesson, visit any five business houses and enquire about the valuation of unsold goods, whether they value at cost price or market price or at lower of the two. You will find that they value their unsold goods at cost or market price, whichever is lower. Why do they value the unsold goods at cost or market price whichever is lower?

It is the universal practice (custom or tradition) that the businessmen adopt. This is an example of convention. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts. These conventions indicate to the accountants that only probable losses are recorded and not future profits, etc. Like this convention, there are other Accounting Conventions. We shall study about them in detail in this lesson.

4.2 Objectives

After studying this lesson, you will be able to :

- define the term 'Accounting Convention';
 - list the four Accounting Conventions, viz. Convention of Consistency, Full Disclosure, Materiality and Conservatism;
 - recognise the need for comparing the current results with those of the past years;
 - infer the meaning and significance of Convention of consistency;
 - explain the meaning and significance of Convention of full Disclosure;
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- state the meaning of material facts;
- distinguish between material and immaterial transactions of business;
- recognise the importance of Materiality Convention;
- explain the meaning and significance of Convention of Conservatism with examples.

4.3 Meaning and need for accounting convention

Let us study the following example. Amitabh has a big business. He is dealing in lakhs of rupees. One of his transactions is for Rs.6750.87. He can record this transaction as Rs.6751, rounding off the paise to the nearest rupee.

Like Amitabh, other big businessmen may be using this practice in recording the transactions because amount in paise is not so significant for their business. But when one is in small business recording details about paise may be important and so one may record every paise in all transactions. In the above example, the businessmen record only those aspects of their transactions which are very important for the business.

Let us now define an 'Accounting Convention'. An accounting convention is a common practice which is universally followed in recording and presenting accounting information of business. They are followed like customs in a society. As a society develops its own customs for its day-to-day activities, so conventions are developed by business to facilitate its recording in the books of accounts. Conventions help in comparing accounting data of different business units or of the same unit for different periods. These too, have been developed over years out of observations and the necessity of making accounting data more useful.

- (i) Convention of Consistency
- (ii) Convention of Full Disclosure
- (iii) Convention of Materiality
- (iv) Convention of Conservatism

We shall study the details of these conventions in this lesson.

i) Convention of Consistency

The meaning of the word 'Consistency' is continuity in methods or practices. In accounting context, consistency means followers using the same accounting methods or practice year after year. You can also say that the methods followed for making accounting information is not altered generally during its life. A businessman for example, follows the following practices or methods generally year after year:

- (i) Method of charging depreciation
- (ii) Method of valuation of unsold goods

Let us explain the above methods:

(i) Method of charging depreciation .

Machines and other fixed assets used in a business slowly decline in value over time. In accounting, we provide for depreciation (i.e. decline in value for using an assets) on machines and other assets. There are different methods to calculate depreciation like, straight line method, written down value method etc. All these methods are acceptable in accounting. The businessmen can adopt anyone of these methods, they prefer. The method, once adopted should be followed every year so that financial results become comparable.

(ii) Method of valuation of unsold goods

There are various methods for valuation of unsold goods at the end of the year. These may be valued at cost price or market price or at the lower of two. Generally, unsold goods are valued at cost price or market price whichever is lower by business concerns. However, in some cases like precious metals, mineral oils, the unsold goods may be valued at *market price*.

As per the convention of consistency, the same accounting methods should be adopted every year in preparing financial statements. This should not be taken to mean that this convention does not allow a business to change accounting methods and procedures under any circumstances. Whenever a change in methods is necessary, it must be disclosed by way of footnotes in the financial statements of that year.

Intext Questions 4.1

Fill in the blanks with suitable words

- (i) By following the convention of consistency, financial statements of various years becomes _____
 - (ii) Unsold goods are valued at cost price or market prices whichever is _____
 - (iii) Gold is generally valued at _____
 - (iv) Each business record only those aspects of transactions which are _____
 - (v) As per the convention of consistency every year _____ methods are followed.
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4.4 Convention of Full Disclosure

Suppose, you want to go to your doctor for your treatment, you are advised to tell all the symptoms so that you can get the best possible treatment. Similarly in accounting, financial disclosure means that all financial information regarding business transactions must be given in full. Let us take the example of business. The business provides financial information to various parties like owners, creditors, lenders etc. The owners like to know about the financial position of the business 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 objectives. If the financial information is complete, then only it is possible for different parties to use that information in the best manner. Similarly, another example could be claim of a very big amount pending in a court of law against a business, any loan taken by mortgage of any asset, writing of preliminary expenses, commission, etc. should be properly brought to the notice of users of accounting information.

If there is a change in accounting methods of providing depreciation on fixed assets, or in the methods of valuation of stock or in making provision for doubtful debts, these should be clearly shown in the Balance Sheet by way of notes. Similarly, we can say that all important facts are to be fully disclosed, otherwise financial statements would be incomplete, unreliable and misleading. 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. The convention of such presentation is called full Disclosure Convention.

This enables the meaningful comparison of financial statements of the different business units. This also enables the comparison of financial statements of different years of the unit.

Intext Questions 4.2

Fill in the blanks with suitable words:

- (i) The owners would like to know about the _____ of the business.
 - (ii) The creditors are interested in knowing the _____ of the business.
 - (iii) All the material facts would be _____ in the financial statements.
 - (iv) The Full Disclosure convention provides _____ information.
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4.5 Convention of Materiality

Before studying this convention, let us examine the following example:

A businessman is dealing in electrical items. He purchases bulbs, tube-lights, electric wires etc. for his business. In buying these articles a larger part of his capital is used. On the other hand, he also has to purchase pen, pencil, paper etc. in which a smaller part of his capital is involved. He will maintain record of all the items. But to maintain the details of every pen, pencil or other stationery items is not considered of much significance. So, the items that are significantly important in recording the details are termed as material facts. The items that are of less significance are immaterial facts. In accounting, we distinguish between material and immaterial facts otherwise accounting information will be burdened with unimportant details. Let us study another example. A businessman starts a textile mill. Take only two items weaving machine and bulbs for light in the office. He will purchase these items for his business. From the accounting point of view, weaving machine is more important than bulbs. Therefore, distributing the cost of machine over various years is important. But, it is not so important to distribute the cost of bulbs. If an accountant starts keeping the details of each bulb, then his work would be unduly burdened with every small details. It is also not useful for the businessman to know every small details since it does not affect the financial position in any significant manner.

According to the Convention of Materiality only those transactions, important facts and items are shown which are useful and material for the business.

However, the convention of materiality does not state that immaterial transactions are not to be recorded. On the contrary, it states that immaterial transactions should be clubbed under important heads. For example, pen, pencil, paper etc. can be shown under the head **stationery**. If a business is dealing in stationery item, then it will treat these items as important items.

Intext Questions 4.3

Classify the following under material items and immaterial items.

A businessman is manufacturing cotton garments. He purchased business premises, weaving machines and raw cotton. He also purchased furniture, bulbs, tubelight etc. for his office. He paid salary to an accountant and purchased paper, pen and other books for accounting purposes.

Material items

Immaterial items

4.6 Convention of Conservatism

Let us consider the following example:

A businessman sells goods not only for cash but also on credit. When goods are sold on credit, the businessman has to collect money at a later date. Sometimes the businessman is unable to collect the amount for goods sold on credit. This is a loss to the business out of the goods sold on credit in a year. This loss is recorded in the books of accounts at the end of the year. On the basis of experience, we earmark some amount for such purposes and show such amounts as loss. Similarly, there may be some creditors who may not claim money from us. But we do not earmark such likely gains. Let us take one more example. A businessman is expecting a profit of Rs.10,000 on the sale of a fixed asset. This possible profit will not be recorded until the actual sale of the fixed asset takes place. In the above situations, businessman takes decision that he will be recording only probable losses.

According to this convention all anticipated or probable losses are recorded as and when they occur and anticipated profits are not recorded. Profit are recorded only when the same have been earned. In the same way stock at the end of the year is valued at the cost price or market price whichever is lower. A businessman values the stock at the price which is lower of the two on the basis of the convention of conservatism. He is recording probable loss before it actually occurs.

The convention of conservatism is a useful tool in situations of uncertainty and doubt.

Intext Questions 4,4

Give your decision in the following situations:

- (i) A business has an unsold stock at the end of year. The cost price is Rs.1,20,000 and the market price is Rs.1,35,000. At which price the unsold stock be recorded?
- (ii) What will be your decision if the cost price in the case (i) is Rs. 1,50,000?
- (iii) A businessman anticipates that it may not be possible to collect Rs.1,50,000 from one of his debtors. Will he record this transaction?
- (iv) A creditor has not claimed a debt of Rs.10,000 since long. The businessman does not know his whereabouts. He feels that this amount will not be claimed. Should we record this anticipated profit?

4.7 What You have Learnt

- 1. Accounting conventions are common practices which are followed in recording and presenting accounting information of a business.
 - 2. According to the convention of consistency, the same accounting method should be adopted every year in preparing books of accounts.
 - 3. The financial results become comparable if the convention of consistency is followed.
 - 4. The accounting information must fully disclose all the relevant, important and material facts.
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5. According to the convention of materiality only those transactions, important facts and items are shown which are useful and material for the business.
6. The objective of convention of materiality is to avoid burdening accounting information with every small details.
7. According to the convention of conservatism, probable losses are recorded whereas probable profits are not recorded.

4.8 Terminal Questions

1. Answer the following questions in one sentence (1-10 words)
 - (i) Name the convention that states closing stock is valued at cost price or market price or lower of the two.
 - (ii) Name the convention that states the same accounting methods should be adopted every year in preparing financial statements.
 - (iii) Give the name of the convention that says only probable losses should be recorded but not probable profits.
 2. Define the term 'accounting convention'. (30-50 words).
 3. Explain the meaning and significance of convention of consistency in about 30-50 words.
 4. Define the convention of full disclosure and explain its significance in about 50 words.
 5. Distinguish between material and immaterial transactions of business (30 words).
 6. Explain the meaning and significance of convention of conservatism with examples (about 100 words).
 7. Explain the meaning and significance of materiality convention with examples.
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4.9 Answers to Intext Questions

4.1 (i) Comparable (ii) lower (iii) Market price

(vi) important(v) same

4.2 (i) Financial position(ii) solvency

(iii) fully disclosed (iv) reliable

4.3 Material items-business premises, weaving machines, raw cotton, furniture, salary.

Immaterial items-bulbs, tubelights, paper, pen, books for accounting purposes.

4.4 (i) Rs. 1,20,000

(ii) Rs. 1,35,000

(iii) Yes (as Bad debt)

(iv) No
