CHAPTER TWO

ACCOUNTING STANDARDS, CONCEPTS AND CONVENTIONS

CHAPTER OUTLINE

- Accounting Concepts
- Accounting Equation
- Assets
- Liabilities
- Capital
- Expenses

Learning Objectives

At the end of this chapter, the student should be able to:

- Explain the meaning and purpose of accounting standards, concepts and conventions.
- Trace the evolution and purpose of accounting standards.
- Explain different accounting concepts and conventions.
- State the accounting equation.
- Differentiate major constituents of accounting equation (assets, capital and liability).

2.1 ACCOUNTING CONCEPTS: These are particular statements of accounting theory. They are rules adopted as guides to action which rest on general acceptance. It is the generally accepted accounting principles that ought to be followed in preparation of financial statements.

The following are some of the common concepts:

Business entity concept: This concept implies that there should be a distinction between a business and its owner. This means that all transactions should be recorded as they affect the business distinct from the owner. Simply put, this concept sees the business and its owner as two separate entities. Hence, every transaction relating to the business is entirely different from the owner. All transactions and other events are recorded from the point of view of the entity itself, and not from the perspective of other stakeholders such as the owners.

Accrual concept: This concept states that income should be recognized when they are earned not when they are received; and expenses should be recognized or recorded when they are incurred not when they are paid. The recognition of this concept gives rise to prepayments and accrued expenses. Prepayments occur when payment has been made for services or goods yet to be consumed while accrued expenses occur when a liability has been incurred but not yet paid for.

Matching concept: This is closely related to accrual concept. It can be seen as an advancement of accrual concept. It simply states that for any accounting period, the earned revenue should be matched with the cost that earned it. This simply means that while preparing a financial report for a particular period, all income for the period must be matched with the expenses associated with the period under reference. Whenever the matching concept is not strictly adhered to, it gives rise to either overstatement or understatement of accounting profit.

Money measurement concept: This concept states that every item in the account must be measurable in monetary terms e.g. in naira, dollars, etc. This is based on the fact that money serves as the common denominator used to measure assets and liabilities. Hence, accounting transactions are
expressed in monetary terms. The value of goods and services must be stated in monetary terms. The concept totally abolishes the barter system where goods are exchanged for goods.

**Duality concept:** This is a basic concept in accounting which states that for every debit entry, there must be a corresponding credit entry and vice versa. This will be clearly illustrated while treating the accounting equation at the end of this chapter.

**Periodicity concept:** This is concerned with the breaking of the life span of a business entity into intervals for periodic review of the operations and performance of the business entity. Even though we talk about going concern assumption (that is believing that the business has no intention to liquidate completely or significantly scale down its operations), there is still need to break the business life into periods for proper appraisal and for determination of periodic profit or loss.

**Historical cost concept:** This concept states that once an asset is acquired at a particular date, the acquisition cost values are retained throughout the accounting process and referred to whenever one is reporting on the assets irrespective of the prevailing price of the asset in the market. (That is, the historical cost is to be maintained).

**CONVENTIONS:** These are general policy statements to guide the profession especially when there is contradiction between some fundamental concepts. Such conventions include Objectivity, Conservatism or Prudence, Consistency, Materiality and Full Disclosure.

**Objectivity:** This is a term which states that data can be independently verified without bias or personal influence. It therefore, holds that records that are kept should be truthful, accurate and fair. It should be devoid of ambiguity and subjectivity.

**Conservatism or Prudence:** This is the convention that tends to see accountants as misers. It states that in any situation where there is no guide to indicate which procedure to use, one is expected to select the one that will give a conservative result i.e. understate rather than overstate income. This implies that an accountant should be prudent in any decision he makes. For accountants, it is safer to understate than to overstate revenue and to recognize all foreseeable losses.

The operating rule of conservatism is as follows: An entity should not anticipate income and should provide for all estimated losses.

If an entity is faced with the choice between two methods of valuing an asset, the accountant should select a method that leads to the lesser value. The convention does not allow intentional overstatement of liabilities or understatement of assets.

**Consistency:** This states that once a method or a standard is adopted in treating an item in the financial statements, that method should be maintained in subsequent periods unless there are conditions that necessitate a change. When such occurs, the departure as well as its effects on the financial statement must be disclosed. A typical example is the treatment of stock valuation using First-in-first-out (FIFO), Last-in-first-out (LIFO), weighted average or any other acceptable method. Any method adopted should be consistently used.

**Materiality:** The central point in materiality is to assess the significance of an item in relation to the whole and accord such item strict accounting treatment based on its size. For instance, a broom that costs N50 is treated as a revenue expenditure regardless of the fact that it may be useful to the organization beyond one year.

**Full disclosure:** This is a convention that seems sacrosanct in the current wave of International Financial Reporting Standard (IFRS) introduction in the country. It implies that all material facts relating to the account should be fully disclosed. This type of reporting facilitates transparency and comprehension.

**Substance over form:** This convention states that accounting reality in a transaction takes precedence over its legal form. This convention is usually applied in hire purchase accounting. Even though the law provides that the
sells should retain ownership until the payment of the final installment, the asset is recorded and recognized in the accounting books of the buyer.

ASSUMPTIONS: Considering the concepts earlier discussed, certain underlying assumptions are made so as to limit divergence in their interpretations. The two basic assumptions include:

Going concern: This states that in the absence of any contrary information, the business will continue to operate indefinitely or forever. It is assumed that the business is not intending to liquidate or discontinue with significant part of its operations. Its assets and liabilities are valued at historical cost. Once the business is going into liquidation, it will be valued using realizable method.

Stability: This assumption ignores the changes in monetary value associated with either inflation or deflation. In accounting, the monetary unit is assumed to be stable; hence N1 today is assumed to be the same many years ago and many years to come irrespective of time value of money. This assumption gives rise to historical and other related concepts.

2.2 ACCOUNTING EQUATION
This is the base upon which every book-keeping and accounting lies. It aims at highlighting foundations of accounting. Accounting principles of recording transactions and other events are based on the relationship presented in the accounting equation.

Wherever a business is to start, there must be introduction of money or money's worth otherwise referred to as resources. In accounting terms, these resources are referred to as capital, which incidentally becomes the initial asset of the business. The capital is therefore, the initial resource used to start the business. At this beginning, the asset of the business is equal to the capital, hence the accounting equation ASSET = CAPITAL (liability to owner) at the commencement of the business.

Assets refer to the things that the business is using to operate such as Cash, Fixtures and Fittings, Land, Buildings, e.t.c. while capital is the money or money's worth used to start the business.

As the business progresses, the owner may obtain goods on credit from the supplier or borrow additional loan from the bank or any other source to finance the business. This definitely will increase the available assets in the form of stock or cash while liabilities in form of loan from third parties may be introduced with resultant changes in the variables in the accounting equation. Hence, the equation now becomes Asset = Capital + Liabilities.

Accounting equation therefore, tries to show that in every situation the two sides must be equal. It means that the totals of the two sides must always be equal, no matter the number of entries on each side. The value of each classification of the actual assets, capital and liabilities may change but the equality of assets with that of the total of capital and liabilities will always hold true. The accounting equation forms the bedrock of establishing the statement of financial position of the business.

Illustration 2.1
Onyemaechi, a sole proprietor of Mache Enterprises started business with cash of N300,000. To state the equation, it is as follows:

Assets = Capital + Liabilities.
N300,000 (Cash) = N300,000 (Capital) + 0 (Liabilities)

Commencing the business with the above cash, Mache rented an office space for N50,000, bought Furniture and fitting worth N100,000 and purchased goods for cash worth N85,000 for resale (i.e Stock). The Accounting equation remains the same but its composition will change as follows:

\[
\text{ASSETS} = \text{CAPITAL} + \text{LIABILITY} \\
\text{Stock (N85,000), } + \text{F & F (N100,000)} \\
\text{Rent (N50,000)} \\
\text{+ Cash (N65,000)} \\
= N300,000 \text{ which is the same as Capital (N300,000)} + 0 \text{ (Liab).}
\]

If in addition to the cash invested, Mache introduced another N200,000 borrowed from the bank so as to boost the business, the accounting equation remains as stated above except that cash will increase to N265,000.
while liabilities now becomes N200,000 stated thus:

<table>
<thead>
<tr>
<th>ASSET AND EXPENSES</th>
<th>CAPITAL AND LIABILITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock N85,000</td>
<td>Capital N300,000</td>
</tr>
<tr>
<td>F &amp; F N100,000</td>
<td>Creditors N200,000</td>
</tr>
<tr>
<td>Cash N265,000</td>
<td></td>
</tr>
<tr>
<td>Rent N50,000</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL N500,000</strong></td>
<td><strong>N500,000</strong></td>
</tr>
</tbody>
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From the foregoing, we can now understand that the two sides are always equal. Though capital is described as a liability, the two are not used interchangeably because in the event of liquidation (that is, if the business ceases to exist), the liabilities to third parties are settled first from the business assets while the liability of capital, that is for the owner, is settled from the residue, if any.

The variables used in discussing the accounting equation include:
- Assets
- Liabilities
- Capital
- Expenses

2.3 ASSETS
Assets are resources controlled by an entity as a result of past events, from which future economic benefits are expected to flow to the entity. In other words, assets are resources owned or controlled by the company for the purpose of generating revenue. Assets can be classified into two; non-current assets and current assets.

Non-current assets. These were formerly strictly referred to as fixed assets before the introduction of International Financial Reporting Standard (IFRS). They are those assets that are used for production. They provide benefit to the entity for more than one accounting period. Examples of non-current assets are Property, Plant and Equipment (PPE), Fixtures and Fittings, Machinery, e.t.c. Note that entities that trade in these assets cannot classify them as non-current or fixed assets because they do not hold the assets for use in production or renting to others or in administration.

Current assets: These are assets used to support the current operation. They are part of the working capital. Current assets are predominantly used to run the day to day activities of the business. Assets that cannot be classified as current assets are classified as non-current assets. Examples of current assets are stock, receivables, cash, bank, e.t.c.

2.4 LIABILITIES
Liabilities are the present obligations of the entity arising from past events; their settlement is expected to result in cash outflow from the entity. Liabilities are further sub-divided into non-current and current liabilities. Liabilities that are expected to be settled within the normal operating cycle or accounting period are classified as current liabilities while liabilities which cannot be settled within one accounting period are referred to as non-current liabilities. Examples of current liabilities are payables, bank overdrafts, e.t.c while examples of non-current liabilities are long term loans.

Current assets can be seen as short term assets while current liabilities are short term liabilities. The difference between current assets and current liabilities gives the working capital of an entity. The working capital is very vital to the continued existence of the entity.

2.5 CAPITAL
Capital is the resource introduced by the owner(s) of the business for the commencement of the business. It can be money or money's worth introduced as a capacity to enable the business to commence.

2.6 EXPENSES
Expenses are measures of decrease in economic benefits during the accounting period. It may be in the form of outflow or depletion of assets or incurrence of liabilities that result in decrease in equity or capital other than normal distribution such as dividends to shareholders. Expenses in this sense include losses.