

# ACCOUNTING - CONVENTIONS

We will discuss the accounting conventions in this section.

## Convention of Consistency

To compare the results of different years, it is necessary that accounting rules, principles, conventions and accounting concepts for similar transactions are followed consistently and continuously. Reliability of financial statements may be lost, if frequent changes are observed in accounting treatment. For example, if a firm chooses cost or *market price whichever is lower* method for stock valuation and *written down value method* for depreciation to fixed assets, it should be followed consistently and continuously.

Consistency also states that if a change becomes necessary, the change and its effects on profit or loss and on the financial position of the company should be clearly mentioned.

## Convention of Disclosure

The Companies Act, 1956, prescribed a format in which financial statements must be prepared. Every company that fall under this category has to follow this practice. Various provisions are made by the Companies Act to prepare these financial statements. The purpose of these provisions is to disclose all essential information so that the view of financial statements should be true and fair. However, the term 'disclosure' does not mean all information. It means disclosure of information that is significance to the users of these financial statements, such as investors, owner, and creditors.

## Convention of Materiality

If the disclosure or non-disclosure of an information might influence the decision of the users of financial statements, then that information should be disclosed.

For better understanding, please refer to General Instruction for preparation of Statement of Profit and Loss in revised scheduled VI to the Companies Act, 1956:

- A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or Rs 1,00,000 whichever is higher.
- A Company shall disclose in Notes to Accounts, share in the company held by each shareholder holding more than 5% share specifying the number of share held.

## Conservation or Prudence

It is a policy of playing safe. For future events, profits are not anticipated, but provisions for losses are provided as a policy of conservatism. Under this policy, provisions are made for doubtful debts as well as contingent liability; but we do not consider any anticipatory gain.

For example, If A purchases 1000 items @ Rs 80 per item and sells 900 items out of them @ Rs 100 per item when the market value of stock is *i* Rs 90 and in condition *ii* Rs 70 per item, then the profit from the above transactions can be calculated as follows:

Particulars	Condition <i>i</i>	Condition <i>ii</i>
Sale Value A 900x100	90,000.00	90,000.00
Less - Cost of Goods Sold		
Purchases	80,000.00	80,000.00
Less - Closing Stock	8,000.00	7,000.00

Cost of Goods Sold $B$	72,000.00	73,000.00
Profit $A - B$	18,000.00	17,000.00

In the above example, the method for valuation of stock is '*Cost or market price whichever is lower*'.

The prudence however does not permit creation of hidden reserve by understating the profits or by overstating the losses

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