

1.5: Describe Principles, Assumptions, and Concepts of Accounting and Their Relationship to Financial Statements

Accounting Principles, Assumptions, and Concepts

The Financial Accounting Standards Board (FASB) is an independent, nonprofit organization that sets the standards for financial accounting and reporting, including generally accepted accounting principles (GAAP), for both public- and private-sector businesses in the United States.

GAAP are the concepts, standards, and rules that guide the preparation and presentation of financial statements. If US accounting rules are followed, the accounting rules are called US GAAP. International accounting rules are called International Financial Reporting Standards (IFRS). Publicly traded companies (those that offer their shares for sale on exchanges in the United States) have the reporting of their financial operations regulated by the Securities and Exchange Commission (SEC).

The SEC is an independent federal agency that is charged with protecting the interests of investors, regulating stock markets, and ensuring companies adhere to GAAP requirements. By having proper accounting standards such as US GAAP or IFRS, information presented publicly is considered comparable and reliable. As a result, financial statement users are more informed when making decisions. The SEC not only enforces the accounting rules but also delegates the process of setting standards for US GAAP to the FASB.

Some companies that operate on a global scale may be able to report their financial statements using IFRS. The SEC regulates the financial reporting of companies selling their shares in the United States, whether US GAAP or IFRS are used. The basics of accounting discussed in this chapter are the same under either set of guidelines.

Ethical Considerations: Auditing of Publicly Traded Companies

When a publicly-traded company in the United States issues its financial statements, the financial statements have been audited by a Public Company Accounting Oversight Board (PCAOB) approved auditor. The PCAOB is the organization that sets the auditing standards, after approval by the SEC. It is important to remember that auditing is not the same as accounting. The role of the Auditor is to examine and provide assurance that financial statements are reasonably stated under the rules of appropriate accounting principles. The auditor conducts the audit under a set of standards known as Generally Accepted Auditing Standards. The accounting department of a company and its auditors are employees of two different companies. The auditors of a company are required to be employed by a different company so that there is independence.

The nonprofit Center for Audit Quality explains auditor independence: “Auditors’ independence from company management is essential for a successful audit because it enables them to approach the audit with the necessary professional skepticism.”¹ The center goes on to identify a key practice to protect independence by which an external auditor reports not to a company’s management, which could make it more difficult to maintain independence, but to a company’s audit committee. The audit committee oversees the auditors’ work and monitors disagreements between management and the auditor about financial reporting. Internal auditors of a company are not the auditors that provide an opinion on the financial statements of a company. According to the Center for Audit Quality, “By law, public companies’ annual financial statements are audited each year by independent auditors—accountants who examine the data for conformity with U.S. Generally Accepted Accounting Principles (GAAP).”² The opinion from the independent auditors regarding a publicly-traded company is filed for public inspection, along with the financial statements of the publicly-traded company.

The Conceptual Framework

The FASB uses a **conceptual framework**, which is a set of concepts that guide financial reporting. These concepts can help ensure information is comparable and reliable to stakeholders. Guidance may be given on how to report transactions, measurement requirements, and application on financial statements, among other things.³

The conceptual framework sets the basis for accounting standards set by rule-making bodies that govern how the financial statements are prepared. Here are a few of the principles, assumptions, and concepts that provide guidance in developing GAAP.

Revenue Recognition Principle

The **revenue recognition principle** directs a company to recognize revenue in the period in which it is earned; revenue is not considered earned until a product or service has been provided. This means the period of time in which you performed the service

or gave the customer the product is the period in which revenue is recognized.

There also does not have to be a correlation between when cash is collected and when revenue is recognized. A customer may not pay for the service on the day it was provided. Even though the customer has not yet paid cash, there is a reasonable expectation that the customer will pay in the future. Since the company has provided the service, it would recognize the revenue as earned, even though cash has yet to be collected.

For example, Lynn Sanders owns a small printing company, Printing Plus. She completed a print job for a customer on August 10. The customer did not pay cash for the service at that time and was billed for the service, paying at a later date. When should Lynn recognize the revenue, on August 10 or at the later payment date? Lynn should record revenue as earned on August 10. She provided the service to the customer, and there is a reasonable expectation that the customer will pay at the later date.

Expense Recognition (Matching) Principle

The **expense recognition principle** (also referred to as the matching principle) states that we must match expenses with associated revenues in the period in which the revenues were earned. A mismatch in expenses and revenues could be an understated net income in one period with an overstated net income in another period. There would be no reliability in statements if expenses were recorded separately from the revenues generated.

For example, if Lynn earned printing revenue in April, then any associated expenses to the revenue generation (such as paying an employee) should be recorded on the same income statement. The employee worked for Lynn in April, helping her earn revenue in April, so Lynn must match the expense with the revenue by showing both on the April income statement.

Cost Principle

The **cost principle**, also known as the historical cost principle, states that virtually everything the company owns or controls (*assets*) must be recorded at its value at the date of acquisition. For most assets, this value is easy to determine as it is the price agreed to when buying the asset from the vendor. There are some exceptions to this rule but always apply the cost principle unless FASB has specifically stated that a different valuation method should be used in a given circumstance.

The primary exceptions to this historical cost treatment, at this time, are financial instruments, such as stocks and bonds, which might be recorded at their fair market value. This is called mark-to-market accounting or fair value accounting and is more advanced than the general basic concepts underlying the introduction to basic accounting concepts; therefore, it is addressed in more advanced accounting courses.

Once an asset is recorded on the books, the value of that asset must remain at its historical cost, even if its value in the market changes. For example, Lynn Sanders purchases a piece of equipment for \$40,000. She believes this is a bargain and perceives the value to be more at \$60,000 in the current market. Even though Lynn feels the equipment is worth \$60,000, she may only record the cost she paid for the equipment of \$40,000.

Full Disclosure Principle

The **full disclosure principle** states that a business must report any business activities that could affect what is reported on the financial statements. These activities could be nonfinancial in nature or be supplemental details not readily available on the main financial statement. Some examples of this include any pending litigation, acquisition information, methods used to calculate certain figures, or stock options. These disclosures are usually recorded in footnotes on the statements, or in addenda to the statements.

Separate Entity Concept

The **separate entity concept** prescribes that a business may only report activities on financial statements that are specifically related to company operations, not those activities that affect the owner personally. This concept is called the separate entity concept because the business is considered an entity separate and apart from its owner(s).

For example, Lynn Sanders purchases two cars; one is used for personal use only, and the other is used for business use only. According to the separate entity concept, Lynn may record the purchase of the car used by the company in the company's accounting records, but not the car for personal use.

Conservatism

This concept is important when valuing a transaction for which the dollar value cannot be as clearly determined, as when using the cost principle. **Conservatism** states that if there is uncertainty in a potential financial estimate, a company should err on the side of

caution and report the most conservative amount. This would mean that any uncertain or estimated expenses/losses should be recorded, but uncertain or estimated revenues/gains should not. This understates net income, therefore reducing profit. This gives stakeholders a more reliable view of the company's financial position and does not overstate income.

Monetary Measurement Concept

In order to record a transaction, we need a system of **monetary measurement** or a *monetary unit* by which to value the transaction. In the United States, this monetary unit is the US dollar. Without a dollar amount, it would be impossible to record information in the financial records. It also would leave stakeholders unable to make financial decisions, because there is no comparability measurement between companies. This concept ignores any change in the purchasing power of the dollar due to inflation.

Going Concern Assumption

The **going concern assumption** assumes a business will continue to operate in the foreseeable future. A common time frame might be twelve months. However, one should presume the business is doing well enough to continue operations unless there is evidence to the contrary. For example, a business might have certain expenses that are paid off (or reduced) over several time periods. If the business will stay operational in the foreseeable future, the company can continue to recognize these long-term expenses over several time periods. Some red flags that a business may no longer be a going concern are defaults on loans or a sequence of losses.

Time Period Assumption

The **time period assumption** states that a company can present useful information in shorter time periods, such as years, quarters, or months. The information is broken into time frames to make comparisons and evaluations easier. The information will be timely and current and will give a meaningful picture of how the company is operating.

For example, a school year is broken down into semesters or quarters. After each semester or quarter, your grade point average (GPA) is updated with new information on your performance in the classes you completed. This gives you timely grading information with which to make decisions about your schooling.

A potential or existing investor wants timely information by which to measure the performance of the company and to help decide whether to invest. Because of the time period assumption, we need to be sure to recognize revenues and expenses in the proper period. This might mean allocating costs over more than one accounting or reporting period.

The use of the principles, assumptions, and concepts in relation to the preparation of financial statements is better understood when looking at the full accounting cycle and its relation to the detailed process required to record business activities (Figure 1.5.1).

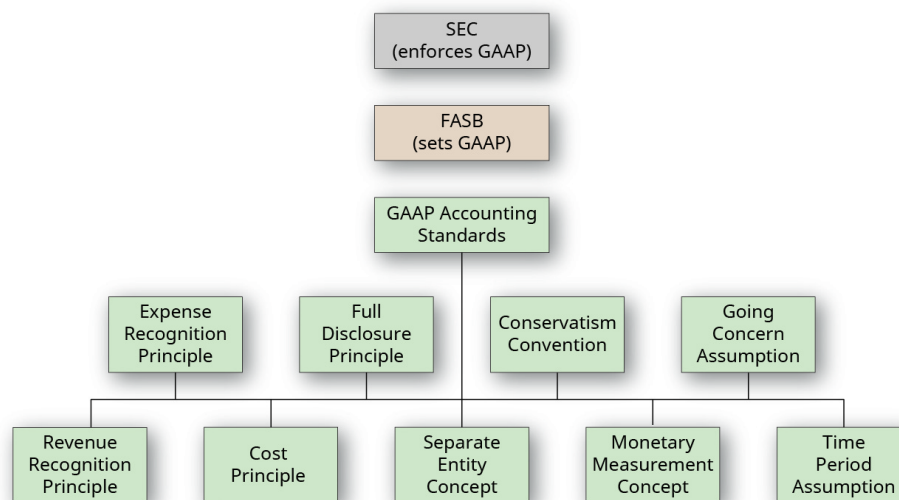


Figure 1.5.1: GAAP Accounting Standards Connection Tree. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The Accounting Equation

The accounting equation is important to the study of accounting because it shows what the organization owns and the sources of (or claims against) those resources. The accounting equation is expressed as follows:

Assets = Liabilities + Owner's Equity

The accounting equation can be thought of from a “sources and claims” perspective; that is, the assets (items owned by the organization) were obtained by incurring liabilities or were provided by owners. Stated differently, everything a company owns must equal everything the company owes to creditors (lenders) and owners (individuals for sole proprietors or stockholders for companies or corporations).

You may recall from mathematics courses that an equation must always be in balance. Therefore, we must ensure that the two sides of the accounting equation are always equal. We explore the components of the accounting equation in more detail shortly. First, we need to examine several underlying concepts that form the foundation for the accounting equation: the double-entry accounting system, debits and credits, and the “normal” balance for each account that is part of a formal accounting system.

Footnotes

- [1](https://www.iasplus.com/en/binary/us...auditguide.pdf) Center for Audit Quality. *Guide to Public Company Auditing*. <https://www.iasplus.com/en/binary/us...auditguide.pdf>
- [2](https://www.iasplus.com/en/binary/us...auditguide.pdf) Center for Audit Quality. *Guide to Public Company Auditing*. <https://www.iasplus.com/en/binary/us...auditguide.pdf>
- [3](http://www.fasb.org/jsp/FASB/Page/Br...=1176168367774) Financial Accounting Standards Board. “The Conceptual Framework.” <http://www.fasb.org/jsp/FASB/Page/Br...=1176168367774>

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