Accounting Principles

(Cheat Sheet)

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Accounting Principles

The financial statements distributed to people outside of a U.S. corporation must be in compliance with generally accepted accounting principles (GAAP or US GAAP). US GAAP includes basic accounting concepts and underlying principles to very complex and detailed accounting standards issued by the Financial Accounting Standards Board (FASB). The following are some of the underlying concepts, principles and assumptions of accounting.

Cost Principle

The cost principle (or historical cost principle) requires that transactions be recorded at their cost. *Cost* is defined as the cash amount or the cash equivalent amount at the time of the transaction. Except for certain marketable investment securities and impairments, the recorded amounts are not increased for inflation or market values. However, there are cases when the cost amounts are reduced to amounts that are less than the original cost amount.

Example 1. A company purchased land in the year 1983 for $50,000. The company continues to own the land without making any improvements. A recent appraisal indicates the land's current market value is $475,000. The company's current balance sheet will report the land at $50,000.

Accrual Method of Accounting

The accrual method of accounting (or accrual basis of accounting) is to be used instead of the cash method of accounting due to various accounting principles (matching, revenue recognition). The accrual method results in a better picture of a corporation's net income during a specified period of time and it results in a better picture of a corporation's assets and liabilities at any moment in time. Generally speaking, the accrual method of accounting means that revenues and assets are reported when they are earned (not when cash is received) and expenses, losses, and liabilities are reported when the transactions occur (not when cash is paid out).

Example 2. A contractor provided emergency service to a client on December 30. The work required the contractor to rent some special equipment for $2,000. The contractor will bill the client $19,000 on January 10 and will pay the equipment rental company on January 10. Under the accrual method of accounting the contractor had revenue of $19,000 in December and equipment rent expense of $2,000 in December. (Under the cash method, the company would report the revenue and expense in January.)

Matching Principle

The matching principle, which is associated with the accrual method of accounting, requires a company to match expenses with revenues. For example, a retailer's income statement should match the cost of the goods that were sold with the sales of the goods. It also requires the matching of sales commission expense with the related sales. If these cause and effect relationships are not present, an expense is to appear on the income statement when a cost is used up or has expired. If there is uncertainty, a cost should be expensed immediately. For instance, the cost of a retailer's ads that were run in December is to be expensed in December, since there is uncertainty as to any future benefit from the ads.

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Full Disclosure Principle

The full disclosure principle requires a company to report information that will make a difference to an investor, lender, or other decision maker. As a result of the full disclosure principle a company's financial statements must include notes to the *financial statements*.

Economic Entity Assumption

The economic entity assumption allows accountants to prepare financial statements for a sole proprietorship's business transactions (even though legally there may not be any separation between the owner and the business). The economic entity assumption also results in accountants preparing consolidated financial statements for a group of corporations that have common ownership.

Periodicity (or Time Period) Assumption

The periodicity (or time period) assumption allows accountants to report financial information for distinct time periods even though a business is an ongoing operation. In other words, the periodicity assumption allows the accountant to report 1) revenue and expense amounts for a distinct time period such as a month, quarter, etc., and 2) asset and liability amounts for the final moment of an accounting period.

Monetary Unit Assumption

The monetary unit assumption allows accountants in the U.S. to express the results of past business transactions in U.S. dollars. The monetary unit assumption also means that the previously recorded amounts will *not* be adjusted for inflation since it also assumes that the U.S. dollar does not lose purchasing power over time.

Example 3. A company purchased land several years ago for $200,000. The company continues to hold the land without making any improvements. During the time after the land was purchased the general price index for inflation has increased by 5% and the value of land has increased by 15%. The company's current balance sheet will report the land at $200,000

Going Concern Assumption

The going concern assumption means that the accountant believes that the business will be able to continue on (rather than having to be liquidated). This justifies deferring some costs to the balance sheet and then later matching them to the related revenues or to the accounting period when they will be used up.

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Materiality

The concept of materiality allows a minor violation of an accounting principle if the amount is insignificant. The amount must be very minor in relation to a corporation's assets and net income. In other words, a lender or investor must not be misled.

Example 4. Companies often expense immediately the purchase of assets that have a cost of $500 or less. The justification is that a lender or investor will not be misled with a $500 expense occurring in the first year instead of $100 per year for 5 years.

Industry Practices

Often industries that are regulated by government agencies will have unique financial reporting requirements. As a result, the external financial statements issued by the company will often be in the format required by the government. This concept is sometimes referred to as *industry practices or industry peculiarities*. For example, the balance sheet of an electric utility will have a format that lists its property, plant and equipment before its current assets.

Conservatism

The concept of conservatism provides guidance to an accountant who is faced with two acceptable alternative ways for reporting an amount. Conservatism tells the accountant to "break the tie" by using the alternative that will result in less net income and less assets or greater liabilities. The concept does NOT instruct accountants to report the lowest amounts possible.

Example 5. Due to advances in technology, most of the items in a company's inventory have had their value dropped dramatically. Should the company report the loss in value now, or should the company wait until the items in inventory are sold. Conservatism directs the accountant to report the loss now (as opposed to waiting until the items are sold).

Consistency

Consistency means that the same method of accounting should be followed from period to period. For example, if a company has adopted the LIFO cost flow assumption for valuing its inventory, it is required to use LIFO in all of the subsequent years. (In the year that a company switched from FIFO to LIFO, the financial statements must communicate clearly that the FIFO consistency had ended.)

Reliability

Another qualitative characteristic of accounting is reliability. This means that accountants should be reporting amounts that are dependable and free from bias.

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