<u>Accounting concepts and conventions</u>

Accounting is the language of business and it is used to communicate financial information. In order for that information to make sense, accounting is based on 12 fundamental concepts. These fundamental concepts then form the basis for all of the Generally Accepted Accounting Principles (GAAP). By using these concepts as the foundation, readers of financial statements and other accounting information do not need to make assumptions about what the numbers mean.

For instance, the difference between reading that a truck has a value of $9000 on the balance sheet and understanding what that $9000 represents is huge. Can you turn around and sell the truck for $9000? If you had to buy the truck today, would you pay $9000? Or, perhaps the original purchase price of the truck was $9000. All of these assumptions lead to very different evaluations of the worth of that asset and how it contributes to the company's financial situation.

For this reason it is imperative to know and understand the eleven key concepts.

ELEVEN KEY ACCOUNTING CONCEPTS

Entity

Accounts are kept for entities and not the people who own or run the company. Even in proprietorships and partnerships, the accounts for the business must be kept separate from those of the owner(s). This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that relate to the business

Money-Measurement

For an accounting record to be made it must be able to be expressed in monetary terms. For this reason, financial statements show only a limited picture of the business. Consider a situation where there is a labor strike pending or the business owner's health is failing; these situations have a huge impact on the operations and financial security of the company but this information is not reflected in the financial statements.

Going Concern

Accounting assumes that an entity will continue to operate indefinitely. This concept implies that financial statements do not represent a company's worth if its assets were to be liquidated, but rather that the assets will be used in future operations. This concept also allows businesses to spread (amortize) the cost of an asset over its expected useful life.

Cost
An asset (something that is owned by the company) is entered into the accounting records at the price paid to acquire it. Because the "worth" of an asset changes over time it would be impossible to accurately record the market value for the assets of a company. The cost concept does recognize that assets generally depreciate in value and so accounting practice removes the depreciation amount from the original cost, shows the value as a net amount, and records the difference as a cost of operations (depreciation expense.) Look at the following example:

Truck	$10,000	purchase price of the truck
Less depreciation	$ <u>1,000</u>	amount deducted as a depreciation expense
Net Truck:	$ 9,000	net book-value of the truck

The $9000 simply represents the book value of the truck after depreciation has been accounted for. This figure says nothing about other aspects that affect the value of an item and is not considered a market price.

Dual Aspect
This concept is the basis of the fundamental accounting equation:

Assets = Liabilities + Equity

1. Assets are what the company owns.
2. Liabilities are what the company owes to creditors against those assets
3. Equity is the difference between the two and represents what the company owes to its investors/owners.

All accounting transactions must keep this equation balanced so when there is an increase on one side there must be an equal increase on the other side or an equal decrease on the same side.

Objectivity
The objectivity concept states that accounting will be recorded on the basis of objective evidence (invoices, receipts, bank statement, etc…). This means that accounting records will initiate from a source document and that the information recorded is based on fact and not personal opinion.

Time Period
This concept defines a specific interval of time for which an entity's reports are prepared. This can be a fiscal year (Mar 1 – Feb 28), natural year (Jan 1 – Dec 31), or any other meaningful period such as a quarter or a month.

Conservatism
This requires understating rather than overstating revenue (income) and expense amounts that have a degree of uncertainty. The rule is to recognize revenue when it is reasonably certain and recognize expenses as soon as they are reasonably possible. The reasons for accounting in this manner are so that financial statements do not overstate the company's financial position. Accounting chooses to err on the side of caution and protect investors from inflated or overly positive results.

Realization
Revenues are recognized when they are earned or realized. Realization is assumed to occur when the seller receives cash or a claim to cash (receivable) in exchange for goods or services. This concept is related to conservatism in that revenue (income) is only recorded when it actually occurs and not at the point in time when a contract is awarded. For instance, if a company is awarded a contract to build an office building the revenue from that project would not be recorded in one lump sum but rather it would be divided over time according to the work that is actually being done.

Matching
To avoid overstatement of income in any one period, the matching principle requires that revenues and related expenses be recorded in the same accounting period. If you bill $20,000 of services in a month, in order to accurately represent the income for the month you must report the expenses you incurred while generating that income in the same month.

Consistency
Once an entity decides on one method of reporting (i.e. method of

accounting for inventory) it must use that same method for all subsequent events. This ensures that differences in financial position between reporting periods are a result of changes in the operations and not to changes in the way items are accounted for.

Materiality

Accounting practice only records events that are significant enough to justify the usefulness of the information. Technically, each time a sheet of paper is used, the asset “Office supplies” is decreased by an infinitesimal amount but that transaction is not worth accounting for.

By understanding and applying these principles you will be able to read, prepare, and compare financial statements with clarity and accuracy. The bottom-line is that the ethical practice of accounting mandates reporting income as accurately as possible and when there is uncertainty, choosing to err on the side of caution.