

Fundamental Concepts of Accounting

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.

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).

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.)

Name _____



Date _____

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:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

- Assets are what the company owns.
- Liabilities are what the company owes to creditors against those assets
- 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.

Name _____



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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.

Name _____



Date _____

Student Worksheet –Fundamental Concepts of Accounting

1. If a firm believes that some of its debtors may "default" on their payments, it should act on this by making sure that all possible losses are recorded in the books. This is an example of the _____ concept in operation.
2. The fact that a business is separate and distinguishable from its owner is best exemplified by the _____ concept.
3. The fact that everything a firm owns, it also owes out to somebody in the form of liability or equity. This relationship is explained by the _____ concept.
4. Because of the _____ concept, when an office manager purchases office supplies, he or she does not account for the use of each paperclip or staple.
5. The _____ concept states that if one method of accounting for depreciation is used one year, then the same method should also be used the following year.
6. If a firm holds land that has recently doubled in value, the _____ concept states that this increase is not normally recorded in the firm's financial records.
7. If a company receives an order for goods that amount of the order is not recorded as revenue because of the _____ concept.
8. If a business experiences a loss for three years straight, the _____ concept tells us to assume the business will continue operations regardless.
9. The calculation of profits is based on expenses incurred during the period rather than simply those actually paid for. This statement describes the _____ concept.
10. If the management of "Dunces, Corp" are less than competent, the accountants [can or cannot] record this information in the financial statements. The concept that supports this practice is the _____ concept.
11. Using a sales invoice as the basis for recording a sale of merchandise is an example of using which concept as the basis for recording the transaction?
 - a. Recognition principle
 - b. Objectivity principle
 - c. Realization principle
 - d. Going-concern concept

Name _____



Date _____

12. The Income Statement for CHG, Inc reports a profit of \$80,000 for the year. This includes an amount of \$5,000 for an order that was just received.

The real profit is _____ because we need to apply the _____ concept

13. During the year Regina Facion has taken clothes from her boutique for personal use. She included the \$1500 cost of those items as a business expense and her yearly profit ended up being \$25,000.

The _____ concept applies here and the profit figure should be _____

