ACCOUNTING CONCEPTS

Accountants follow concepts commonly accepted by the profession as guides for reporting and interpreting accounting information. The accounting procedures described in this textbook are based on the application of accepted concepts. Eleven commonly accepted concepts are described in this appendix and referenced throughout the textbook.

ACCOUNTING CONCEPTS

Accounting Period Cycle

Changes in financial information are reported for a specific period of time in the form of financial statements.

Financial statements summarize the financial information that a business records. The time period for which financial statements are prepared depends on the needs of the business. An accounting period may be one month, three months, six months, or one year. For tax purposes, every business prepares financial statements at the end of each year.

Adequate Disclosure

Financial statements contain all information necessary to understand a business' financial condition.

Owners, managers, lenders, and investors rely on financial statements to make informed decisions. All relevant financial information must be adequately and completely disclosed on financial statements.

A business reports only the total liabilities of $200,000.00 on its balance sheet. However, the total liabilities include $75,000.00 in current liabilities and $125,000.00 in long-term liabilities. Therefore, the balance sheet does not adequately disclose the nature of the liabilities. The critical information not disclosed is that $75,000.00 is current and due within a few months.

Business Entity

Financial information is recorded and reported separately from the owner's personal financial information.

A business's records must not be mixed with an owner's personal records and reports. For example, a business owner may buy insurance to protect the business and insurance to protect the owner's home. Only the insurance obtained for the business is recorded in the business' financial records. The insurance purchased for the owner's personal home is recorded in the owner's personal financial records. One bank account is used for the business and another for the owner. A business exists separately from its owners.

Consistent Reporting

The same accounting procedures must be followed in the same way in each accounting period.

Business decisions are based on the financial information reported on financial statements. Some decisions require a comparison of current financial statements with previous financial statements. If accounting information is recorded and reported differently each accounting period, comparisons from one accounting period to another may not be possible. For example, in one period a business reports $170,000.00 for total operating expenses and in the next period it reports $120,000 as cost of merchandise sold and $50,000 as operating expenses. A user of this information cannot adequately compare the two accounting periods. Therefore, unless a change is necessary to make information more easily understood, accounting information is reported in a consistent way for each accounting period.

Going Concern

Financial statements are prepared with the expectation that a business will remain in operation indefinitely.

New businesses are started with the expectation that they will be successful. Accounting records and financial statements are designed as though businesses will continue indefinitely. A business bought store equipment for $30,000.00. The store equipment is expected to last 10 years. Yearly depreciation, therefore, is recorded and reported based on the expected life of the equipment. After six years of the expected 10-year life, the equipment's book value (cost less accumulated depreciation) is $13,200.00. If the business ended operations and the equipment had to be sold, the amount received may be less than the $13,200.00. However, accounting records are maintained with the expectation that the business will remain in operation indefinitely and that the cost will be allocated over the useful life of the equipment. The equipment value, therefore, remains $13,200.00 on the records regardless of what the equipment may be worth when sold.

Historical Cost

The actual amount paid for merchandise or other items bought is recorded.

The actual amount paid for an item in a business transaction may be different from the value. For example, OfficeMart purchased a delivery truck valued at $20,000.00 and advertised at a sale price of $18,000.00. OfficeMart negotiated to purchase the delivery truck for $17,000.00 The amount recorded in accounting records for the delivery truck is the historical cost, $17,000.00—the actual amount paid.

Six months later, OfficeMart sells the delivery truck to Flowers by Giverney for $15,000.00. For Flowers by Giverney, the historical cost of the delivery truck is $15,000.00.

Matching Expenses with Revenue

The revenue from business activities and the expenses associated with earning that revenue are recorded in the same accounting period.

Business activities for an accounting period are summarized in financial statements. To adequately report how a business performed during an accounting period, all revenue earned as a result of business operations must be reported. Likewise, all expenses incurred in producing the revenue during the same accounting period must be reported. Matching expenses with revenue gives a true picture of business operations for an accounting period.

For example, a business had sales of $100,000.00 in December. Expenses before adjustment were $80,000.00. Adjustments for items such as uncollectible accounts expense, supplies expense, and depreciation expense totaled $5,000.00. Therefore, total expenses for December should be reported as $85,000.00. The matching of expenses with revenues results in an accurate report of net income of $15,000.00. By including all expenses, readers of the financial statements have a more complete picture of the financial condition of the business.

Materiality

Business activities creating dollar amounts large enough to affect business decisions should be recorded and reported as separate items in accounting items in accounting records and financial statements.

Business transactions are recorded in accounting records and reported in financial statements in dollar amounts. How the amounts are recorded and reported depends on the amount involved and the relative importance of the item in making business decisions. Dollar amounts that are large will generally be considered in making decisions about future operations. A separate accounting record is kept for items with dollar amounts large enough to be considered in making decisions about future operations. Dollar amounts that are small and not considered important in decision making may be combined with other amounts in the accounting records and financial statements.

For example, modems and print motors used to manufacture fax machines are considered direct materials and accounted for separately. Connectors and gears used in the manufacture of fax machines are parts with a small enough dollar value that they are grouped together and their total value is recorded in the accounting records as indirect material.

Objective Evidence

A source document is prepared for each transaction.

The source document is the original business paper indicating that the transaction did occur and that the amounts recorded in the accounting records are accurate and true. For example, a check is the original business paper for cash payments. The original business paper for purchases on account is the purchase invoice. When accounting information reported on the financial statements needs to be verified, an accountant will first check the accounting record. If the details of an entry need further checking, an accountant will then check the business papers as objective evidence that the transaction did occur.

Realization of Revenue

Revenue is recorded at the time goods or services are sold.

A business may sell either goods or services. Cash may be received at the time of sale or an agreement may be made to receive payment at a later date. Regardless of when cash is actually received, the sale amount is recorded in the accounting records at the time of sale. For example, a business sells office furniture for $2,000.00. The business agrees to an initial payment of $400.00 with the remaining balance to be divided in four monthly payments of $400.00 each. The full $2,000.00 of revenue is recorded at the time of sale even though $1,600.00 will be paid later.

Unit of Measurement

Business transactions are reported in numbers that have common values—that is, using a common unit of measurement.

All transactions are recorded in accounting records in terms of money. Useful nonfinancial information may also be recorded to describe the nature of a business transaction. If part of the information in the accounting records is financial and part is nonfinancial, the financial statements will not be clear. For example, if Zytech states its sales in number of units sold (nonfinancial) and its expenses in dollars (financial), net profit cannot be calculated. Instead, total expenses (financial) subtracted from money taken in through sales (financial) equals profit.