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READING

Basic Accounting Concepts and Assumptions

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1 INTRODUCTION

To understand any complex field that involves a diversity of practices and approaches, it's important first to understand the field's fundamental ideas, its basic premises. In financial accounting, some basic concepts and assumptions constitute a framework that informs the work of everyone involved. These concepts and assumptions guide the organizations that set accounting standards, such as the **Financial Accounting Standards Board (FASB)** in the United States and the **International Accounting Standards Board (IASB)**; they give preparers of financial statements a shared foundation for the reporting of data; and they help users fully appreciate the information that financial statements convey.

These basic accounting concepts and assumptions are not the same as accounting standards or principles. For example, a manager of a US company who wants to know how to account for inventory cannot turn to the basic concepts to create or justify some version of inventory accounting. Instead, he or she must refer to Accounting Standards Codification Topic 330, "Inventory," in the FASB's generally accepted accounting principles, known as US GAAP. Accounting principles provide guidance on accounting policy decisions for a specific transaction or event; the basic concepts are the broader framework that defines both the value and the limitations of financial statements.

Where did these concepts and assumptions originate? Some have developed over years of practice. Some have been identified by the FASB in its Statements of Financial Accounting Concepts (SFAC). The IASB has issued an almost identical set of publications called Conceptual Framework for Financial Reporting (CFFR). This reading covers the key concepts and assumptions observed in practice, regardless of their source.

Although accounting's basic concepts and assumptions have remained largely unchanged for decades, if not centuries, they can change over time. For example, recently the use of the fair value measurement concept has replaced the historical cost concept in many accounting applications.

The basic accounting concepts and assumptions described in this reading apply to general purpose financial statements. According to the FASB, "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt investments and making or settling loans and other forms of credit. General purpose financial reports are not designed to show the value of a

reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity.”¹

General purpose financial statements prepared using either US GAAP or International Financial Reporting Standards (IFRS) are for the most part based on a similar set of concepts and assumptions.

Students wishing to gain a deeper or more formal understanding of the FASB and IASB Concepts Statements should consult the sources listed toward the end of this reading.

2 ESSENTIAL READING

2.1 Basic Accounting Concepts

In this reading, we cover 12 basic accounting concepts and assumptions that anyone in a field in which financial statements play a role—general management as well as finance and accounting—needs to understand.

- | | |
|---------------------|---------------------------|
| 1 Business Entity | 7 Matching |
| 2 Going Concern | 8 Dual Aspect |
| 3 Monetary Unit | 9 Reliability of Evidence |
| 4 Historical Cost | 10 Disclosure |
| 5 Accounting Period | 11 Materiality |
| 6 Consistency | 12 Conservatism |

2.1.1 Business Entity

This concept defines the accountant’s area of interest: a business entity that is separate and distinct from its owners. The concept thus sets limits on the possible objectives and contents of financial reports. The accountant’s role is to prepare financial statements for the business entity—the affairs of the owners are irrelevant to those statements.

The business entity concept applies equally to incorporated, unincorporated, small, and big businesses. In the case of incorporated, widely held, and publicly owned companies, such as General Motors, it is not difficult to separate the affairs of the business from those of its owners.

In the case of small businesses, in which the owners exert day-to-day control and personal and business assets are often intermingled, the boundaries of the business entity may be more difficult to define, for financial—as well as managerial—accounting purposes. In those cases, the accountant must try to tease apart the owners' and the entity's assets and liabilities.

2.1.2 Going Concern

Unless evidence suggests otherwise, those preparing and auditing general purpose financial statements for a business entity assume that the entity will continue operations into the foreseeable future. The going concern assumption reflects management's and investors' normal expectation about the life of a business. To avoid misleading readers of financial statements, the financial statements of business entities with limited lives must clearly indicate the terminal date and type of liquidation involved. Otherwise, the reader will assume that the accounts are based on the presumption that the enterprise has an indefinitely long life.

The going concern assumption reflects the emphasis in accounting on the continuing nature of business activity. For example, the accountant expects that in the normal course of business the company will receive the full value of most of its accounts receivable. Accordingly, these items are recorded at their face value, less some deduction for anticipated bad debts, rather than at current liquidation value. Similarly, expenditures for finished goods inventories are recorded as assets, since the accountant assumes the inventories will be disposed of in the normal course of operations. The going concern assumption does not imply, however, that the future will be the same as the past.

2.1.3 Monetary Unit

Accounting is a measurement process dealing only with events that can be measured in monetary terms. The monetary unit concept reflects the fact that money is the common denominator used in business to measure the exchange value of goods, services, and capital. Obviously, financial statements should indicate the currency on which they are based. For example, Exhibit 1 shows the 2015 consolidated statement of financial position (balance sheet) for The Daimler Group, the manufacturer of Mercedes-Benz cars and trucks. The report notes that the amounts are in euros.

EXHIBIT 1 Consolidated Balance Sheet for The Daimler Group

B.34 Consolidated statement of financial position			
	Dec. 31, 20X5	Dec. 31, 20X4	X5/X4 % change
In millions of euros			
Assets			
Intangible assets	10,069	9,367	+7
Property, plant and equipment	24,322	23,182	+5
Equipment on operating leases and receivables from financial services	112,456	94,729	+19
Equity-method investments	3,633	2,294	+58
Inventories	23,760	20,864	+14
Trade receivables	9,054	8,634	+5
Cash and cash equivalents	9,936	9,667	+3
Marketable debt securities	8,273	6,634	+25
Other financial assets	7,454	5,987	+25
Other assets	8,209	8,277	−1
Total assets	217,166	189,635	+15
Equity and liabilities			
Equity	54,624	22,584	+23
Provisions	26,145	28,393	−8
Financing liabilities	101,142	86,689	+17
Trade payables	10,548	10,178	+4
Other financial liabilities	12,360	10,706	+15
Other liabilities	12,347	9,085	+36
Total equity and liabilities	217,166	189,635	+15

Source: Daimler Annual Report 2015.

The monetary unit concept highlights one of the limitations of accounting—its inability to record or communicate factors such as the state of the company president's health, the attitude of the labor force, or the relative advantage of competitive products. Consequently, the most important aspects of a business may not be reflected in the financial statements.

Another limitation of the monetary unit concept as applied in US GAAP is that it fails to distinguish between the purchasing power of monetary units in different periods. This can become a significant problem in trying to interpret financial statements during periods of high inflation. For example, expenses may include dollars spent recently to acquire goods and services as well as dollars

spent in earlier periods when the dollar purchased more goods and services. IFRS allows the monetary unit to be stated in inflation-adjusted units of purchasing power.

2.1.4 Historical Cost

For accounting purposes, business transactions are measured initially in terms of their actual (historical) cost, a value that is usually easily documented by reliable sources such as contracts, invoices, and other readily available sources. This basic accounting concept applies not only to the initial recording but also in many cases to the subsequent reporting of transactions. While agreeing with the need to record historical cost initially, the FASB and IASB have concluded that financial statements would be “more useful” if, under certain conditions, such as in the case of readily marketable securities, actual or estimates of current value were substituted for historical costs.

As a result, financial statements are said to conform to the “mixed attributes” accounting model. That is, some balances, such as property, plant, and equipment, are reported under US GAAP on a historical cost basis while others, such as marketable securities held for trading purposes, are reported on some measure of current value. It is important that financial statement users learn when and which accounts are stated at their historical cost or at current value.

In the case of monetary assets, accounting is more likely to report them periodically at some measure of their current value. For example, under certain conditions, marketable securities can be reported at their market value on the balance sheet date.

The market value of many assets may change over time. Typically, in the case of nonmonetary assets, US GAAP does not recognize such changes. As a result, the value of nonmonetary assets shown on financial statements seldom reflects the assets’ current market value.

In practice, there have been a number of modifications to the historical cost concept. For example, under special conditions, inventory may be reported at market values if those are lower than historical costs. Assets acquired for stock are recorded at the estimated market value of the stock exchanged. Mutual funds and pension funds whose assets consist almost entirely of securities report the market value of their investments, taking the unrealized gain or loss into income at the end of each reporting period. Similarly, donated assets may be carried at their appraised value at the time of acquisition, and IFRS allows depreciable assets to be reported at their fair value using what is called the revaluation model as long as fair value can be measured reliably.

Measuring “cost” can pose some problems. For example, issues can arise as to which cost elements should be included in the cost of assets created by the company rather than bought from outsiders. If an asset is acquired through a swap, then the value to be placed on the asset given up or received may be unclear.

2.1.5 Accounting Period

For decision-making purposes, managers and investors need periodic “test readings” of the progress of the business. Accounting recognizes this, breaking the flow of business activity into a series of reporting periods or fiscal years that are usually 12 months in length. Most companies also issue quarterly financial statements to stockholders. For management use, financial statements covering a month or week may be prepared. Regardless of the length of the period, the financial statements must indicate the period covered. Exhibit 2 shows the consolidated statements of income from an annual report (10-K) for The Gap, Inc., a US clothing retailer. The amounts are expressed in millions and report the net income of the company in accounting periods of 12 months (the fiscal years). The Gap, Inc.’s fiscal year is a 52-week or 53-week period ending on the Saturday closest to January 31. The fiscal years ended January 31, 2015 (fiscal 2014), and February 1, 2014 (fiscal 2013), consisted of 52 weeks. The fiscal year ended February 2, 2013 (fiscal 2012), consisted of 53 weeks.

EXHIBIT 2 Consolidated Statements of Income for The Gap, Inc.

(\$ and shares in millions, except per share amounts)	Fiscal Year		
	2014	2013	2012
Net sales	\$16,435	\$16,148	\$15,651
Cost of goods sold and occupancy expenses	\$10,146	\$9,855	\$9,480
Gross profit	\$6,289	\$6,293	\$6,171
Operating expenses	\$4,206	\$4,144	\$4,229
Operating income	\$2,083	\$2,149	\$1,942
Interest expense	75	61	87
Interest income	(5)	(5)	(6)
Income before income taxes	\$2,013	\$2,093	\$1,861
Income taxes	751	813	726
Net income	\$1,262	\$1,280	\$1,135

Source: The Gap, Inc., Annual Report 2014.

Although it is the practice to report earnings in 12-month segments, breaking business activity into a series of discrete segments creates a number of accounting problems. For example, given the uncertainties surrounding the life of an asset and its scrap value, how should the cost of a long-lived asset be allocated across periods? How should the income and costs associated with long-term contracts covering several accounting periods be treated? Such questions must be resolved in light of the particular circumstances and relevant GAAP (or IFRS). There is no easy, general solution. The accountant and business manager must rely on their experience, knowledge, and judgment to arrive at the appropriate answer.

The definition of the accounting period will depend on the nature of the business. For most US companies, the annual accounting period runs from January 1 to December 31. Some companies use a different annual period, usually because their yearly business cycle does not conform to the calendar year. For example, the annual statements of US department stores are more revealing if their fiscal period begins on February 1 and ends January 31. By January 31, inventories are low, and most product returns have been made. Exhibit 3 shows several large public corporations and their fiscal year ends.

EXHIBIT 3 Fiscal Year Ends of Selected Public Companies

Company	Fiscal Year End
Best Buy Co., Inc.	January 31
Bed Bath & Beyond, Inc.	March 1
Sony Corp.	March 31
Wiley	April 30
Darden Restaurants, Inc.	May 25
General Mills, Inc.	May 31
Sysco Corp.	June 27
Winn-Dixie Stores, Inc.	June 29
Estée Lauder Companies, Inc.	June 30
Costco Wholesale Corp.	August 31
Apple, Inc.	September 24
Walt Disney Co.	September 27
Hewlett-Packard Co.	October 31
Deere & Co.	October 31
Levi Strauss & Co.	November 30
Archer Daniels Midland Co.	December 31

2.1.6 Consistency

The consistency concept states that once an entity has decided on one accounting method, it should use the same method for all subsequent events of

the same character unless it has a sound reason to change methods. Clearly, comparing inter-period results would be difficult if a company changed its depreciation policy each year, for example. Consistency must not trump flexibility, however. Changes in accounting policies are appropriate when justified by changing circumstances.

Accountants place considerable emphasis on consistency because it improves the reliability of the information reported to external parties. When expressing an audit opinion, the auditor notes whether the statements were prepared “on a basis consistent with that of the preceding year.” If accounting policy changes were made, the auditor notes these in the audit opinion and insists that the nature and impact of these changes are fully disclosed.

Consistency does not necessarily require uniformity of accounting practices among affiliated business units or even within a unit or company. One unit may value inventory on the LIFO (Last In, First Out) basis, whereas another may use the FIFO (First In, First Out) basis. Similarly, a single unit might use both methods to value different parts of its inventory. In either case, the inventory accounting policy should be disclosed and consistently followed.

Consistency also does not imply uniformity in the treatment of particular items among independent companies. Indeed, one characteristic of US accounting practice is the diversity of accounting methods in use, all of which meet the criterion of generally accepted accounting principles.

2.1.7 Matching

The income or profit reported on a financial statement is the net result of the matching of related costs and revenues of a period. This process can be described as matching “effort and accomplishments”—costs measure effort, and revenues measure the related accomplishments. But the process can become complicated, because costs often cannot be easily matched with specific current or anticipated revenues.

Not all expenses exhibit a cause-and-effect relationship, and in those cases, the matching principle is a bit more difficult to execute. Matching costs and revenues may require deferring recognition of expenses and revenues to future periods. For example, cash may be spent today to obtain subscriptions to a magazine that will provide subscribers with copies for the next five years. In this case, the accountant will not recognize the cash outlay as an expense until the magazines are due and the expected revenues are earned. At that time, the costs and revenues would be matched. In the meantime, however, the unexpired cost would be reported as an asset (i.e., capitalized), since it will produce future benefits in the form of subscription revenue as the magazines are delivered.

Whether or not costs should be deferred and, if deferred, over what time period, are difficult questions to resolve in practice.

The matching process is usually achieved through application of the accrual method of accounting rather than the cash method. The cash method of accounting records cash receipts and disbursements and focuses on changes in the cash account. The accrual method seeks to measure changes in the owners' equity during the accounting period. Revenues are realized from noncapital transactions that result in an increase in the owners' equity. In contrast, expenses are expired costs that are associated with the period, or with revenues during the period that decrease owners' equity. The difference between revenues and expenses is the net income for the period. These changes in the owners' equity may not result in changes in the cash account. For example, a \$100 sale on credit will increase accounts receivable and the owners' equity. The accrual method recognizes the fact that the service has been performed and a valuable asset created. Under the cash method, no record of revenue would be made until the customer's \$100 cash was received. Similarly, no record of the related cost would be made until it was paid in cash.

2.1.8 Dual Aspect

Every transaction affects at least two items in the basic accounting equation and preserves the equation's equality. This is the dual aspect concept.^a The fundamental accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' equity}$$

Assets represent probable future, measurable economic benefits that the reporting entity has acquired through a transaction. Assets include such items as cash, inventories, and buildings.

An asset can represent an expected future economic benefit in several ways:

- 1 The asset may be used to acquire other assets. Cash is the principal example of an asset that derives its value from its purchasing power.
- 2 The asset represents a claim on another entity for money—for example, accounts receivable, which are amounts owed to the reporting company for credit sales.
- 3 The asset can be converted to cash or a money claim. Finished goods inventories that will be sold in the normal course of business are an example.

^a The dual aspect concept is the basis for double-entry bookkeeping.

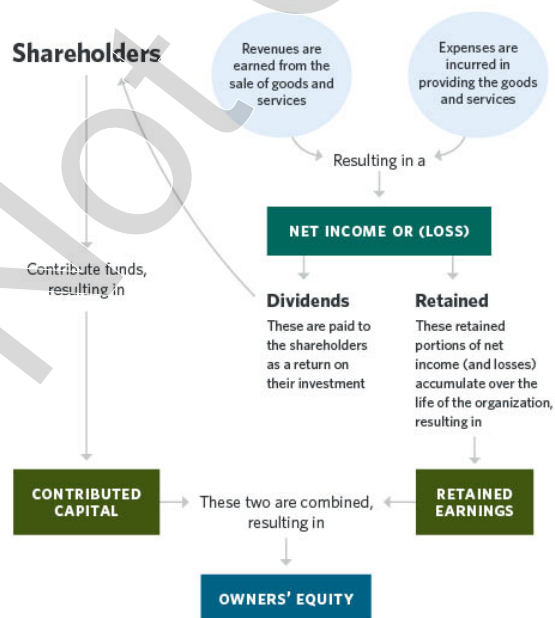
- 4 The asset has potential benefits, rights, or services, allowing the entity to earn something from its use. Such assets include items like raw materials.

Liabilities are probable future sacrifices of measurable economic benefits arising from the entity's obligations to convey assets to or perform services for a person, firm, or another organization. These obligations require future settlement and represent claims of a nonownership nature on the entity's assets. Accounts payable to trade creditors, bonds payable, and taxes payable are examples of liabilities.

Liabilities also include deferred credits. These do not represent clear-cut claims on the entity. They result from the need to recognize some expenses currently in order to get a "proper" matching of costs and revenues. To offset the expense item, a reserve balance is reported as a liability. Examples of deferred credits are reserves set up for tax payments that may or may not be paid in the future but that accounting standards require to be recognized as an expense currently.

Stockholders' or owners' equity represents the ownership interest in the entity. It is the excess of the entity's total assets over its total liabilities. As Exhibit 4 shows, equity comes about from capital contribution from the stockholders (owners) and from the net income that is retained after dividends are paid to the stockholders (retained earnings).

EXHIBIT 4 Sources of Equity



Accounting systems are designed to record events in terms of their influence on at least two of the following categories: assets, liabilities, and owners' equity. Thus, every accounting event has a dual aspect. For example, assume Jane Smith invested \$5,000 in a new business; the accounting entry would recognize the \$5,000 asset of the business and Jane Smith's claim on this asset:

$$\text{Asset, \$5,000} = \text{Stockholders' equity, \$5,000}$$

Now, if the company borrowed \$1,000 from the bank, assets (cash) would increase by \$1,000 and liabilities (bank loan payable) would also increase. Here are how things would stand after the bank loan. Notice how the assets are still equal to the liabilities and the stockholders' equity:

Assets	=	Liabilities	+	Equity
Cash +\$6,000		Bank loan payable +\$1,000		Stockholders' equity +\$5,000
<hr/>		<hr/>		<hr/>
Total +\$6,000		Total +\$6,000		

Next, assume the business used \$2,000 of its cash to acquire some inventory. The asset "cash" is reduced by \$2,000, and the asset "inventory" is increased by a similar sum. Thus, the double-entry system requires two entries for each event. Other systems are possible, but the double-entry system is the most widely used.

Assets	=	Liabilities	+	Equity
Cash +\$4,000		Bank loan payable +\$1,000		Stockholders' equity +\$5,000
Inventory +\$2,000				
<hr/>		<hr/>		<hr/>
Total +\$6,000		Total +\$6,000		

2.1.9 Reliability of Evidence

Accountants recording events rely as much as possible on objective, verifiable documentary evidence instead of on the subjective and potentially biased judgments of a person. Acceptable evidence includes source documentation (both paper and digital) of such items as:

- Sales invoices
- Purchase (supplier) invoices

- Checks written and received
- Payment vouchers
- Bank statements
- Receiving reports
- Time cards and payroll journals
- Credit memos

The audit is the mechanism that allows users of financial statements to place trust in those reports. Auditors look for distinct audit trails and supporting documentation and test internal controls, which help ensure that business transactions are reliably recorded and supported by evidence.

The desire to base decisions on objective evidence is one of the principal arguments in support of the historical cost concept, although, as noted earlier, some proponents of alternative approaches believe these approaches can be objective.

In practice, accountants cannot always rely on objective, verifiable evidence. Many major decisions, such as the allocation of costs between periods, must be based on reasonable estimates after considering all relevant facts. In addition, in many instances, because of the volume of transaction processing it is not feasible for an auditor to verify the recording of every event. As a result, auditors base their opinions in large part on a sampling of transactions and on assessments of the company's internal controls—the procedures management adopts to safeguard assets, ensure the reliability and accuracy of data, and encourage adherence to company policies.

As a result of the Sarbanes-Oxley Act, the management of US-based public companies must provide an assessment of internal control over financial reporting (ICFR) within their annual report. The independent auditors are required to “attest” to and report on that assessment. To do that, the auditor must gather evidence to test that management's assertion that its ICFR is effective and correct.

2.1.10 Disclosure

Accounting reports should disclose enough information that they will not mislead careful readers who are reasonably well informed in financial matters. This is the disclosure concept. Special disclosure is made of unusual items, changes in expectations, significant contractual relations, and new activities. The disclosure can be included in the body of a financial statement, in the auditor's

opinion, or in the notes to the statement. Exhibit 5 shows the equity section of Ford Motor Company's balance sheet as of December 31, 2014 (amounts in millions). Notice that the common stock and the class B stock have parenthetical data showing the number of shares issued and authorized as of the balance sheet date. In addition, there are references to notes for such components as capital stock, accumulated other comprehensive income/(loss), and treasury stock.

EXHIBIT 5 Equity Section of Ford Motor Company's Balance Sheet as of December 31, 2014

Equity	(amounts in millions)
Capital stock (note 23)	
Common stock, par value \$.01 per share (3,938 million shares issued of 6 billion authorized)	39
Class B stock, par value \$.01 per share (71 million shares issued of 530 million authorized)	1
Capital in excess of par value of stock	21,089
Retained earnings	24,556
Accumulated other comprehensive income/(loss) (note 17)	(20,032)
Treasury stock (note 23)	(848)
Total equity attributed to Ford Motor Company	24,805
Equity attributable to noncontrolling interests	27
Total equity	24,832
Total liabilities and equity	\$208,527

Source: Ford Motor Company 10-K for the fiscal year ended December 31, 2014.

2.1.11 Materiality

Accounting standards apply only to material items. Inconsequential items can be dealt with expediently. This is the materiality concept. In applying this concept, care must be taken to ensure that the cumulative effect of a series of immaterial items does not materially alter the total statements.

Whether or not an item is immaterial is a matter of judgment. One common test of materiality is whether the decision of a reasonably well informed reader of financial statements would be altered if the item were treated differently. If the decision would change, then the item is material.

2.1.12 Materiality

Accounting standards apply only to material items. Inconsequential items can be dealt with expediently. This is the materiality concept. In applying this concept, care must be taken to ensure that the cumulative effect of a series of immaterial items does not materially alter the total statements.

Whether or not an item is immaterial is a matter of judgment. One common test of materiality is whether the decision of a reasonably well informed reader of financial statements would be altered if the item were treated differently. If the decision would change, then the item is material.

SFAC 8 states the following:

Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral, and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible.

On the topic of **neutrality**, it states:

A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

2.2 Financial Analysis

Those who use financial statements might be tempted to dismiss the subject matter covered in this reading as being primarily of interest to accountants and accounting standard setters. That would be a mistake. Not only should those

who set the standards and those who apply them be aware of basic accounting concepts, but also any financial statement user should understand the assumptions that underlie the financials.

Financial statements, as noted earlier, are presented on the assumption that the reader understands the basics of accounting and finance. Therefore, knowledge of basic accounting concepts is required to be a literate reader of financial statements.

The basic accounting concepts determine the character and scope of data used for financial statement analysis. Because no one set of measurement concepts governs accounting, financial statements include amounts that are arrived at by a variety of valuation procedures, based on cash, economic, financial, and accrual concepts of measurement. A statement user who does not appreciate an account's valuation basis can easily misinterpret financial statements.

One of the purposes of financial analysis is to determine whether the basic accounting concepts reflected in a particular company's financial statements are reasonable representations of the company's circumstances. Knowledge of the basic concepts is necessary to make an appropriate determination. For example, the "going concern" assumption suggests that even if a company issues audited financial statements with no indication that the auditors or management question the company's continued existence, analysts should not assume that the issuer will in fact be in existence in the near future. An important use of financial analysis is to identify approaching financial difficulties and possible bankruptcy on the basis of data contained in a company's most recent financial statements, which may have been based on the assumption that the entity was a going concern.

Statement users must be able to distinguish between the financial consequences that are included in financial statements and those that are not. A knowledge of basic accounting concepts is helpful in this regard. For example, financial statement analysis is usually undertaken for a specific decision, such as buying a security, determining a bond rating, or valuing a company. The basic accounting concepts reflected in the accounting data may result in financial statement data that are irrelevant for those decisions. For example, the market value of the properties of a company being considered for acquisition is important economic data for determining the acquisition price. Market price data related to properties will not be found in US GAAP-based financial statements. Yet there is something in the statements that could be misinterpreted as data relevant to property valuation—namely, the net book value (original cost less accumulated depreciation) of the company's properties. A statement user who is ignorant of the historical cost concept may unwittingly use those accounting values instead of the more relevant economic values. One

who is aware of accounting concepts is less likely to fall into the trap of thinking the accounting data is something other than what it is intended to represent.

2.3 Summary

The basic accounting concepts and assumptions covered in this chapter may be summarized as follows:

- 1 **Business Entity:** Financial statements are prepared for a business entity that is separate and distinct from its owners.
- 2 **Going Concern:** Unless evidence suggests otherwise, it is assumed that the entity will continue operations into the foreseeable future.
- 3 **Monetary Unit:** Accounting is a measurement process that deals only with events that can be measured in monetary terms.
- 4 **Historical Cost:** Nonmonetary and monetary assets are ordinarily initially recorded at their acquisition price. This price, rather than current fair value, is the basis for subsequent accounting for nonmonetary assets. Most monetary assets are accounted for at fair value following their acquisition. IFRS permits some nonmonetary assets to be accounted for at fair value following acquisition.
- 5 **Accounting Period:** Accounting measures activities for a specific interval of time, called the accounting period.
- 6 **Consistency:** Similar transactions are reported in a consistent fashion.
- 7 **Matching:** Accounting profit is the net result of matching related costs and revenues.
- 8 **Dual Aspect:** Every transaction affects at least two items in the basic accounting equation.
- 9 **Reliability of Evidence:** Accountants recording events rely as much as possible on objective, verifiable documentary evidence.
- 10 **Disclosure:** Accounting reports should disclose enough information that they will not mislead careful readers reasonably well informed in financial matters.
- 11 **Materiality:** Accounting standards apply only to significant items.
- 12 **Conservatism:** A degree of professional skepticism should be adopted when assessing the prospects that incomplete transactions will be concluded successfully. Although conservatism has been rejected by the FASB and IASB as an “official” accounting concept, it is often observed by managers and others who believe that conservative accounting is both prudent and responsible.

Except in rare instances, these basic accounting concepts and assumptions are not tools for determining the accounting for specific financial transactions and events. That is the role of US GAAP and IFRS. The basic accounting concepts and assumptions are the framework upon which financial reporting in general is based.

3 SUPPLEMENTAL READING

3.1 Qualitative Characteristics of Useful Financial Information^b

The FASB and IASB have jointly issued Statement of Financial Accounting Concepts No. 8 (SFAC No. 8). It sets forth their views on the qualitative characteristics of financial information that is most useful to existing and potential investors, lenders, and other creditors for making decisions about the reporting entity.

While SFAC No. 8 confirms a number of the basic accounting concepts and assumptions discussed in this reading, it was not the boards' intention to present SFAC No. 8 as a statement of basic accounting concepts and assumptions. Rather, the purpose is to provide general guidance to the two boards on the nature of useful financial information as they carry out their standard-setting roles.

Financial information that falls short of SFAC No. 8's useful information characteristics should be regarded with caution by financial statement users. Knowing SFAC No. 8's content helps financial report users make this assessment.

The boards concluded in SFAC No. 8 that financial information is useful when it is both relevant to the users' need for the information and it faithfully represents what it purports to represent. In the boards' opinion, the usefulness of financial information is enhanced if it is material, comparable, verifiable, timely, and understandable. SFAC No. 8 defines these requirements as follows:

- **Relevance:** Financial information is relevant if it would make a difference in the decisions of users because of its predictive or confirmatory value, or both.

^b The IASB refers to its version of SFAC No. 8 as The Conceptual Framework for Financial Reporting, Chapter 3, "The qualitative characteristics of useful financial information."

- **Faithful representation:** To be useful, financial information must faithfully represent the phenomena it purports to represent. A perfectly faithful representation would be complete, neutral, and free from error. While this may be difficult to adopt in practice, the objective is to optimize those qualities to the extent possible.
- **Materiality:** Information that is immaterial is not useful. Immaterial information is information that would not influence the decisions of financial statement users.
- **Comparability:** Current or past financial information about a reporting entity is more useful if it can be compared with similar information about other entities or the same entity in a different period.
- **Verifiability:** Verifiability means that knowledgeable and independent individuals would reach a consensus that a particular representation is measurably faithful.
- **Timeliness:** The financial statement information should be available to financial statement users in time to influence their decisions.
- **Understandability:** According to SFAC No. 8, the boards believe classifying, characterizing, and presenting information clearly and concisely makes it understandable.

In SFAC No. 8 the boards recognize that preparing financial reports is costly. Preparer costs are a constraint that the boards are fully aware of as they deliberate new standards. In the end, the boards hope their decisions on new standards will strike the right balance between costs and benefits.

4 KEY TERMS

audit trail Paper or digital trail that gives a step-by-step documented history of a transaction. It enables an auditor to trace the financial data from the financial statements to the general ledger to the source document (invoice, receipt, voucher, check, etc.). The presence of a reliable audit trail is an indicator of good internal controls.

Conceptual Framework for Financial Reporting (CFFR) A framework that describes the objective of, and the concepts for, general purpose financial reporting; assists in the development of future IFRS standards; and assists management and accountants in developing consistent accounting policies when no IFRS standard applies to a particular transaction.

Financial Accounting Standards Board (FASB) The private-sector organization in the United States that establishes financial accounting and reporting standards.

fiscal year The 12-month period over which a company reports its financial results. Many companies align their fiscal year with the calendar year, but they may choose to report over any 12-month period.

internal control over financial reporting (ICFR) Policies, procedures, and activities that help ensure that financial statements are presented in accordance with generally accepted accounting principles and faithfully represent the financial condition and results of operations of a reporting entity.

International Accounting Standards Board (IASB) The accounting standard-setting body outside the United States.

International Financial Reporting Standards (IFRS) The rules and standards developed by the IASB.

monetary assets Cash, accounts receivable, or a note receivable in which the amount is a fixed, stated quantity. Holding these assets during periods of inflation will result in a loss of purchasing power.

neutrality A requirement that information contained in the financial statements be free from bias.

nonmonetary assets Assets that appear on the balance sheet but are not cash or cannot be readily converted into cash. Generally, nonmonetary assets include fixed assets, such as property, plant, and equipment, as well as intangible items, such as goodwill.

purchasing power The value of money expressed in terms of the amount of goods or services that can be purchased with it. All else being equal, inflation decreases purchasing power.

retained earnings An owners' equity account that reflects the amount of resources a business generates by running its operations and keeps for internal purposes.

revaluation model Under IFRS, an entity can report its property, plant, and equipment at fair value (less subsequent accumulated depreciation) as long as fair value can be reasonably measured.

Sarbanes-Oxley Act A US law that was passed by Congress as a reaction to a number of high-profile corporate and accounting scandals in the early 2000s. It set new or enhanced oversight standards for US public company boards, management, and accounting firms.

Statements of Financial Accounting Concepts (SFAC) A document issued by the FASB covering broad financial reporting concepts, providing a general overview of accounting concepts, definitions, and ideas.

US GAAP The set of accounting standards issued by the FASB and followed by most US companies.

5 ENDNOTES

- 1 Financial Accounting Standards Board. "Statement of Financial Accounting Concepts No. 8." http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176157498129&acceptedDisclaimer=true, accessed July 20, 2016.