# unit 7. Concepts and principles

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**7.0 aims and objectives**

This unit aims at discussing the basic accounting concepts and procedures used in the preparation of finical reports. It also discusses in detail the Generally Accepted Accounting Principles.

After studying this unit, you will be able to:

* describe the development of accounting concepts and principles
* dentify and illustrate the application of basic accounting concepts and principle
* sol e exercises and problems.

**7.1 INTRODUCTION**

The historical development of accounting practice has been closely related to economic developments. In the earlier periods, a business enterprise was very often managed by its owner, and the accounting records and reports were used mainly by the owner – manager in conducting the business. Bankers and other lenders often relied on their personal relationship with the owner rather than on financial statements as the basis for making loans for business purposes. If a large amount was owed to a bank or supplier, the creditor often participated in management decisions.

As business organizations grew in size and complexity, “management” and “outsiders” became more clearly differentiated. From the later group, which includes owners (stock holders), creditors, government, labor unions, customers and the general public, came the demand for accurate financial information for use in judging the performance of management.

In addition, as the size and complexity of the business unit increased, the accounting problems involved in the preparation of financial statements became more and more complex. With these developments came an awareness of the need for a framework of concepts and generally accepted accounting principles to serve as guidelines for the preparation of the basic financial statements.

Accounting concepts and principles include conventions, axioms, standards, rules, guidelines and procedures that are necessary to have accounting practice at a particular period of time. The word “principles” as used in the context of generally accepted accounting principles does not have the same authoritativeness as universal principles or natural laws relating to the study of astronomy, physical or other physical sciences.

Accounting principles have been developed by individuals to help make accounting data more useful in an ever-changing society. They represent the best possible guides, based on reason observation, and experimentation, to the achievement of the desired results. These principles are continually re examined and revised to keep pace with the increasing complexity of business operations. General acceptance among the members of the accounting profession is the criterion for determining an accounting principle.

Responsibility for the development of accounting principles has rested primarily on practicing accountants and accounting educators, working both independently and under the sponsorship of various accounting organization. These principles are also influenced by business practice and customs, ideas and beliefs of the users of the financial statements, governmental agencies, stock exchanges and other business groups.

**Check Your Progress Exercise -1**

1. Accounting principles and concepts are needed due to different reasons. What are they?

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**7.2 Generally Accepted Accounting Principles (GAAP)**

**1. Business Entity Concept**

The business entity concept assumes that a business enterprise is separate and distinct from the persons who supply its partial or all assets and from every other business. Businesses are perceived and treated as a distinct separate entities regardless of the legal concept because in so far as a specific business is concerned, the purpose of accounting is to record its transactions and periodically report its financial positions and profitability. Consequently, the records and reports of the business should not include either the transactions of another business or the personal assets or transactions of its owner or owners. To include either would distort the financial position and profitability of the business.

The accounting equation, Assets = Equities, or Assets = Liabilities + Owners equity, is an expression of the entity concept: i.e. the business owns the assets and owes the various claimants. Thus, the accounting process is primarily concerned with the enterprise as a productive economic unit and only secondarily concerned with the investor as a claimant to the assets of the business.

***Note:*** the legal entity concept may not go in accordance with the business entity concept depending on the type of the business enterprise, i.e., whether the business is a sole proprietorship, partnership or corporate entity. The two concepts match for corporate entity but not for the other two business enterprises.

**2. Going Concern Concept**

Only in rare cases is a business organized with the expectation of operating for only a certain period of time. In most cases, it is not possible to determine in advance the length of life of an enterprise, and so an assumption must be made.

The nature of the assumption will affect the manner of recording some of the business transactions, which in turn will affect the data reported in the financial statements.

The going concern concept assumes that the business enterprise continues its operations (at profit) for indefinite period of time. A business enterprise purchases and holds assets for use in its operations. The market value of those assets may change over time. However, the accounting records for those assets are not adjusted to reflect the market value changes. This is because of the going concern concept. As a going concern, the assets used in carrying on the operation of the business are not for sale. Obviously, they cannot be sold without disturbing the business operation. Therefore, their market values are not particularly relevant and need not be shown. That is, the going concern concept provides much of the justification for recording plant assets at acquisition cost and depreciating them in an orderly manner without reference to their current realizable values. If there is no immediate expectation of selling them, plants assets should not be reported on the balance sheet at their estimated realizable values regardless of whether their current market value is less than or greater than their book value.

The going concern assumption similarly supports the treatment of prepaid expenses as assets, even though they may not be salable.

Doubt as to the continued existence of a firm may be disclosed in a note to the financial statements.

If a business enterprise is to be sold or liquidated, financial statements should be prepared from the “quitting concern” or liquidating point of view rather than from a “going concern” point of view. That is, in such cases, the cost principle and the going concern would not be applied in preparing the financial statements. Instead the estimated market values become more useful and informative.

**3. (Historical) Cost Principle**

Under this principle, which is a fundamental principle in accounting, all goods and services purchased are recorded at cost, where costs are measured on a cash or equivalent basis. If the consideration given for an asset or service is cash, cost is measured at the entire cash outlay made to secure the asset or the service. Otherwise, cost is measured at the cash equivalent value of the consideration given or the cash equivalent value of the thing received whichever is more clearly evident.

For example, if a business paid Birr 15,000 for a lot of land to be used in business operation, the land should be recorded at a cost of Birr 15,000. It does not make any difference if the buyer or any other competent outside appraiser think that the land worth more or less than Birr 15,000. Therefore, the journal entry would be recorded in the buyer’s book as follows:

Land-------------------------------------15,000

Cash--------------------------------------15,000

**4. Objectivity Principle**

This principle requires that entries in the accounting records and data reported on financial statements be based on objectively determined evidence. This principle answers the question why assets and services are recorded at cost rather than some other amount such as estimated market value. As a rule, costs are objective since normally are established by buyers and sellers, each striking the best possible bargain for themselves. If this principle is not followed, the confidence of the many users of the financial statements could not be maintained. For example, objective evidence such as invoices and vouchers for purchass, bank statements for the amount of cash in bank, and physical counts for merchandise on hand supports much of the accounting. Such evidence is completely objective and can be verified.

Evidence is not always conclusively objective, for there are many cases in accounting in which judgments, estimates, and other subjective factors must be taken into account. In such situations, the most objective evidence available should be used. For example, the provision for doubtful accounts is an estimate of the losses expected from failure to collect sales made on account. The estimation of this amount should be based on such objective factors as past experience in collecting accounts receivable and reliable forecasts of future business activities. To provide accounting reports that can be accepted with confidence, evidence should be developed that will minimize the possibility of error, intentional bias, or fraud.

**Check Your Progress Exercise – 2**

1. What does the objectivity principle require for information presented in financial statement?

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2. A business shows office stationery on the balance sheet at its cost Birr 430 cost, although it cannot be sold for more than Birr 10 as scrap paper. Which accounts principle require this treatment?

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5. Stable Monetary Unit Concept /Unit of measurement

Accounting transactions are measured, recorded and reported in terms of monetary unit. In the process of measuring, recording and reporting the monetary unit is treated as a stable unit of measure like a gallon, a kilometer etc. However, the monetary unit is not a stable unit of measure nevertheless; accountants use a monetary unit as a standard unit of measurement in their reports. Money is both the common factor of all business transactions and the only feasible unit of measurement that can be used to achieve uniform financial data.

The generally accepted use of the monetary unit for accounting for and reporting the activities of an enterprise has got two major limitations: First, it limits the scope of accounting reports. The scope of the report will be on information which can be quantifiable and measurable interims of monetary unit. What so ever the information is useful to the user, unless it is measurable interims of monetary unit, it cannot be reported on the financial statements. Secondly, as it is stated above, any monetary unit in the world is not stable due to economic changes. Therefore, the accountants report could be highly criticized for not being fully informative.

To consider the above two limitations, accountants usually prepare reports which accompany the financial statements. These reports try to inform relevant unquantifiable information and reflect the effects of change in purchasing power of the monetary unit.

1. **The Periodicity Concept /Accounting period Concept/**

According to this concept, the life of a business entity should be broken into segment periods for accounting purposes. A complete and accurate, picture of an enterprise’s success or failure cannot be obtained until it discontinues operations, converts its assets into cash, and pays off its debts. Then, and only then is it possible to determine its true net income. But many decisions regarding the business must be made by management and interested outsiders during its existence. Therefore, it is essential to stop the operation of the business artificially at frequent intervals so as to produce periodic reports on operations, financial position, and cash flows. These reports reduced will help the user how well or bad the business was operating during those periods. These periods are timely and provide a consistent frame of reference to measure the business activities and compare those measurements with previous periods and other companies.

Reports may be prepared when a certain job or project is completed, but more often they are prepared at specific time intervals. For a number of reasons, including custom and various legal requirements, the longest interval between reports is one year.

This element of periodicity creates many of the problems of accountancy. The basic problem is the determination of periodic net income. For example, the need for adjusting entries, problems of inventory costing, problems of recognizing the uncollectibilty of the receivables, and problem of selecting depreciation methods are directly related to the periodic measurement process.

### Check Your Progress Exercise - 3

What are the two major limitations of stable monetary unit concept on the accounting reports?

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**7. The Matching Principle**

How well or bad the company is doing is reflected to users on the income statement prepared for a period of time. The income statement tries to measure the business’s earnings by comparing the revenue with expenses of that period which is covered by the income statement.

The matching principle means that after the revenues for an accounting period have been determined, the costs associated with those revenues must be deducted in order to determine net income. The term matching refers to the close relationship that exists between certain costs and the revenue realized as a result of incurring those costs.

Thus, the use of matching as a pervasive principle in the income measurement offers another practical reason for the widespread use of cost principle. For example, the expenditure for advertising is a cost to be matched against the sales that is promoted. The recognition of uncollectible accounts is also supported by the matching principle. Uncollectibles arise from credit sales to customers who fails to pay their bills. To match this expense (uncollectible amount) , it becomes important to estimate what part of the credit sales is to be uncollectible in the future. The use of estimate is necessary in order to carry the matching principle.

**8. Revenue Realization Principle**

States that revenue from business transactions is recorded when goods or services are sold. Some business sell goods or services on one date but receive payment on a later date. In such cases, the revenue is recorded on the date of sale, not necessarily when the cash is received.

**9. Adequate Disclosure Principle**

All financial statements and accompanying statements should include the necessary data that helps to facilitate the user’s understanding. Thus, all relevant information to the users must be disclosed. However, full disclosure does not mean that everything must be disclosed. That would be too costly. A balance must be maintained between the cost of disclosing information and its relevance to users. Basically, if the information will make a difference in investors’ or creditors’ decisions it should be disclosed. Therefore, the criterion for disclosure is based on value judgment rather than objective facts.

Financial statements are made more useful by the use of headings and subheading, and by merging items in significant categories. Although all essential data should be disclosed with in these categories, judgments must be exercised by excluding non-essential information to avoid clutter. For example, detailed information as to the amount of cash in various special and general funds, the amount on deposit in each of several banks, and the amount invested in various marketable government securities is not needed by the reader of financial statements. Such information displayed on the balance sheet would hinder rather than aid understanding.

In most cases, all of the pertinent data needed by the reader cannot be presented in the financial statements themselves. The statements therefore normally include essential or explanatory information in accompanying notes. Adequate disclosures are necessary for both historical facts and subsequent events to the issuance of financial statements. The following are some examples:

* Summary of significant accounting policies.
* Change in accounting methods used by the business
* Contingent liabilities and commitments.
* Events subsequent to the date of statements
* Replacement cost of inventiories and plant assets etc.

**10. The Consistency Principle**

The amount and direction of change in net income and financial position from period to period is very important to readers and may greatly influence their decisions. Therefore, interested person should be able to assume that successive financial statements of an enterprise are based on consistently on the same generally accepted accounting principles. If the principles are not applied consistently, the trends indicated could be the result of changes in the principles used rather than the result of changes in business conditions or managerial effectiveness.

Consistency principle requires that the same generally accepted accounting principles are used from period to period for the same accounting events. Therefore, once an accounting method or principle is adapted, it should be used for reasonable period of time. This is because accounting information is more useful if it can be compared with similar information for the same company from time to time. However, consistency principle does not prohibit switching from one accounting method to another. Changes are permissible when it is believed that the uses of a different principle will more fairly state net income and financial position. Examples of change in accounting principles include a change in the method of inventory pricing, a change in depreciation method for previously recorded assets and a change in the method of accounting for long- term construction contracts. Consideration of changes in accounting principles must be accompanied by consideration of the general rule for disclosure of such changes, which is as follows:

The nature of and justification for a change in accounting principle and its effects on income should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.

There are various methods of reporting the effect of a change in accounting principle on net income. The cumulative effect of the change on net income may be reported on the income statement of the period in which the change is adopted. In some cases the effect of the change could be applied retroactively to past periods by presenting revised income statements for the earlier years affected.

The application of the consistency principle does not require that a specific method be used uniformly throughout an enterprise. For example, it is not unusual for large enterprises to use different costing methods and pricing methods for different segments of their inventories.

**11. The Materiality Concept**

In following generally accepted accounting principles, the accountant must consider the relative importance of any event, accounting procedure or change in procedure that affects items on the financial statements. The concept of materiality is relative. What is material for one firm may be immaterial for another firm. The determination of what is important and what is not requires the exercise of judgments. Precise criteria cannot be formulated. Some factors do help to identify events as being material or immaterial. This is done by comparing the size and nature of an item or event with the size and nature of other events or items. For example, the erroneous classification of a Birr 10,000 asset on a balance sheet exhibiting total assets of Birr 10,000,000, would probably be immaterial. If the assets total only Birr 100,000, however, it would certainly be material. If the Birr 10,000 represented a note receivable from an officer of the enterprise, it might well be material even in the first assumption.

The concept of materiality may be applied to procedures used in recording transactions. For example, small expenditures for plant assets may be treated as an expense of the period rather than as an asset. The saving in clerical costs is justified if the practice does not materially affects the financial statements.

Customs and practicality also influence the criteria of materiality. For example, corporate financial statements seldom report the cents amount or even the hundreds of dollars. A common practice is to round to the nearest thousands. For large corporations, there is an increasing tendency to report the financial data in terms of millions, carrying figures to one decimal.

**12. The conservatisms (prudence) concept**

Accountants follow methods and procedures that yield the lesser amount of net income or net asset value. Of an accountant faced two methods of handling a particular event, he /she tends to use the method which understate the net income or net asset. This is done to protect the firm from uncertain risk of loss. Thus, conservatism is usually expressed by the statement “anticipate no profit but provide for all losses”. Such an attitude of pessimism has been due in part to the need for an offset to the optimism of business management.

Current accounting thought has shifted somewhat from this philosophy of conservatism. Conservatism is no longer considered to be a dominant factor in selecting among alternatives.

***N.B:*** *the concepts and principles of objectivity disclosure, consistency and materiality are more important than conservatism and the latter should be a factor only when the others don’t play a significant role in the decisions to be made by users of financial statements.*

**7.3 Summary**

The accounting profession is guided by basic accounting concepts and principles. In recording business transactions and in preparing financial statements, accountants apply these principles and concepts.

Accounting principles differ from the principles related to the physical sciences. Accounting principles are developed by individuals to help make accounting data more useful in an ever – changing society. These principles are continually reexamined and revised to keep pace with the increasing complexity of business operations.

**7.4 Answers to check your progress**

1. Accounting principles and concepts are needed because of the following facts:

1. The development of business firm in size and form.
2. The complexity of business transactions.
3. The need for separation of management and owners
4. The demand for accurate, timely and relevant information by users.

2. i) the objectivity principle requires that accounting records be based on verifiable events

such as business transactions between independent parties.

ii) the historical cost principle.

3. The two major limitations of stable monetary unit concept are:

1. The scope of the report will be on information, which can be quantifiable and measurable in terms of money.
2. Any monetary unit in the world is not stable due to economic changes.
   1. **MODEL EXAMINATION QUESTIONS.**

**A) Discussion Questions**

1. For accounting purposes, what is the nature of the assumption as to the length of life of an enterprise?
2. Why should the most objective evidence available be used as the basis for data reported on financial statements?
3. If a complete and accurate picture of an enterprise’s success or failure is desired, what accounting period must be used to report on operations?
4. Is revenue from sales of merchandise on account more commonly recognized at the time of sale or at the time of cash receipt?
5. When there are several acceptable alternative accounting methods that could be used, the method used by an enterprise should be disclosed in the financial statements. Give examples of accounting methods that fall in this category.
6. If significant changes are made in the accounting principle applied from one period to the next, why the effect of these changes should be disclosed in the financial statements?
7. You have just been employed by a relatively small merchandising business that records its revenues only when cash is received and its expense only when cash is paid you are aware of the fault that the enterprise should record its revenues and expenses on the accrual basis. Would changing to the accrual basis violate the principle of consistency? Discuss.
8. The accountant for a large department store charged the acquisition of a pencil sharpener to an expense account, even though the asset had an estimated useful life of 10 years. Which accounting concept supports this treatment of the expenditure?
9. Why do the financial statements of a business present its activities separate from its owner’s activities?
10. The monetary principle assumes that money is a useful standard measuring unit for reporting the effects of business transactions. State and explain two major criticism or limitations of this accounting principle.

**B) Exercises**

1. Each of the following statements represents a decision made by an accountant. State whether or not you agree with the decision. Support your answer with reference to generally accepted accounting principles that are applicable in the circumstance.
2. In preparing the balance sheet, detailed information as to the amount due from hundreds of customers was omitted. The total amount was presented under the captain “Accounts Receivable”
3. Used computer equipment, with an estimated useful life of 5 years and no salvage value, was purchased early in the current fiscal year for Birr 150,000. Since the company planned to purchase new equipment, costing Birr 250.000, to replace this equipment at the end of five years, depreciation expense of Birr 50,000 was recorded for the current year. The depreciation expense thus provided for one fifth of the cost of the replacement.
4. All minor expenditures for office equipment are charged to an expense account.
5. Merchandise transferred to other parties on a consignment basis and not sold was included in merchandise inventory.
6. Land, used as a parking lot, was purchased 10 years ago for Birr 50,000. Since its market value is now Birr 90,000, the land account is debited for Birr 40,000 and a gain account is credited for a like amount. The gain is presented as an “other income” item in the income statement.
7. Thirty days before the end of the current year, sales catalogs were acquired for birr 45,000. Although the catalogs are not salable the unused portion is included as an asset in the balance sheet at the end of the year.
8. Merchandise inventory at the end of the current year was estimated by the general manager, who “eye balled”, the inventory on hand and then determined its cost, based on the estimate of current costs. The accountant used the general manager’s estimate for recording the cost of the inventory in the accounts.
9. Financial statements adjusted to eliminate the effects of inflation (using the current cost method) were presented as supplementary financial data.
10. Net income for the current year is expected to be larger than normal. Therefore the accountant used the declining – balance method for determining depreciation for the current year to reduce the net income to a more normal amount. The accountant plans to return its future years to the use of the straight-line method that has been used in all past years for determining income.

**7.6 reference books**

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**7.7 GLOSSARY**

* 1. **Adequate disclosure** – the concept that financial statements and their accompanying footnotes should contain all of the pertinent data believed essential to the reader understands of an enterprises financial status.
  2. **Business Entity concept** – the concept that assumes that accounting applies to individual economic units and each unit is separate and district from the persons who supply its assets.
  3. **Conservatism** – the concept that dictates that in selecting among alternatives, the method or procedure that yields the lesser amount of net income or asset values should be selected.
  4. **Consistency** – the concept that assumes that the same generally accepted accounting principles have applied in the preparation of successive financial statements.
  5. **Cost Principle** – the principle that assumes that the monetary records for properties and services purchased by a business should be maintained in terms of its cost.
  6. **Going Concern Concept** – the concept that assumes that a business entity has a reasonable expectation of continuing in business at a profit for an indefinite period of time.
  7. **Matching** – the principle of accounting that all revenues should be matched with the expenses incurred in earning those revenues during a period of time.
  8. **Materiality** – the concept that recognizes the practicality of ignoring small or insignificant deviations from generally accepted accounting principles.
  9. **Periodicity concept** – the concept that states that the life of a business entity should be broken into segment periods for accounting purposes.