CHAPTER 4

Basic Accounting Concepts

This chapter describes the 11 basic concepts from which principles of accounting are derived.

The material presented here should be regarded as an overview. Each of the topics introduced would be discussed in more depth.

BASIC CONCEPTS

Accounting principles are built on a foundation of a few basic concepts.

These concepts are so basic that most accountants do not consciously think of them; they are regarded as self-evident. Non-accountants will not find these concepts to be self-evident, however. Accounting could be constructed on a foundation of quite different concepts; indeed, some accounting theorists argue that certain of the present concepts are wrong and should be changed. Nevertheless. in order to understand accounting as it now exists, one must understand the underlying concepts currently used.

The Financial Accounting Standard Board (FASB) completed its project "Conceptual Framework" in 1985 with the publication of the sixth *Statement of Fínancial Accountíng Concepts.*[1]

[1]*No.* 1, "Objectives of Financial Reporting by Business Enterprises" (November 1976); *No. 2,* "Qualitative Characteristics of Accounting Information" (May 1960); *No.* 3, "Elements of Financial Statements of Business Enterprises" (December 1960); *No.* 4, "Objectives of Financial Reporting by Non-business Organizations" (December 1960); *No.* 5, "Recognition and Measurement in Financial Statements of Business Enterprises" (December 1964); and *No.* 6, "Elements of Financial Statements" (December 1965), replacing *No. 3*.

These statements are intended to provide the FASB with explicit conceptual criteria to help resolve future accounting issues, rather than trying to deal with each issue on an ad hoc basis. The concept statements themselves do not establish generally accepted accounting principles (GAAP). Prior to the FASB's effort, other groups had addressed the task of identifying basic accounting concepts. These earlier efforts resulted in specific lists of basic concepts.[2]

The concepts we shall use in this book, while not identical to those listed by other authors or groups, reflect concepts that are widely accepted and applied in practice by accountants in North America and over all accounting world. These 11 concepts are as fo11ows:

1. Money measurement.
2. Entity.
3. Going concern.
4. Cost.
5. Dual aspect.
6. Accounting period.
7. Conservatism.
8. Realization.
9. Matching.
10. Consistency.
11. Materiality.

THE MONEY MEASUREMENT CONCEPT

In financial accounting, a record is made only of information that can be expressed in monetary terms. The advantage of such a record is that money provides a common denominator by means of which heterogeneous facts about an entity can be expressed as numbers that can be added and subtracted.

Example. Although it may be a fact that a business owns $30,000 of cash; 6,000 pounds of raw material; six trucks; 50,000 square feet of building space; and so on, these amounts cannot be added together to produce a meaningful total of what the business owns. Expressing these items in monetary terms$30,000 of cash; $9,000 of raw material; $150,000 of trucks; and $4,000,000 of buildings-makes such an addition possible. Thus, despite the old cliché about not adding apples and oranges, it *is* easy to add them if both the apples and the oranges are expressed in terms of their respective monetary values.

Despite its advantage, the money measurement concept imposes a severe limitation on the scope of an accounting report. Accounting does not report the state of the president´s health, that the sales manager is not on speaking terms with the production manager, that a strike is beginning, or that a competitor has placed a better product on the market. Accounting therefore does not give a complete account of the happenings in an organization or a full picture of its condition. It follows, then, that the reader of an accounting report should not expect to find therein all of the, or perhaps even the most important, facts about an organization.

Money is expressed in terms of its value at the time an event is recorded in the accounts. Subsequent changes in the purchasing power of money do not affect this amount. Thus, a machine purchased in 2007 for $200,000 and land purchased in 1992 for $200,000 are each listed in the 2007 accounting records at $200,000, although the purchasing power of the dollar in 2007 was much less than it was in 1992. It is sometimes said that accounting assumes that money is an unvarying yardstick of value, but this statement is inaccurate. Accountants know full well that the purchasing power of the dollar changes. They do not, however, attempt to reflect such changes in the accounts.

[2]AAA, *A Statement of Basic Accounting Theory* (Sarasota, Fla.: 1966), lists four "basic standard," and five "guidelines." AICPA, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," *MB Statement No.* 4 (New York: October 1970). lists 13 "basic features."

THE ENTITY CONCEPT

Accounts are kept for entities, as distinguished from the persons who are associated with these entities. In recording events in accounting. the important question is, How do these events affect the entity? How they affect the persons who own, operate, or otherwise are associated with the entity is irrelevant. For example, suppose that the owner of a clothing store removes $100 from the store's cash register for his or her personal use. The real effect of this event on the owner as a person may be negligible; although the cash has been taken out of the business's "pocket" and put into the owner's pocket, in either pocket the cash belongs to the owner. Nevertheless, because of the entity concept, the accounting records show that the business has less cash than it had previously.

It is sometimes difficult to define with precision the entity for which a set of accounts is kept. Consider the case of a married couple who own and operate an unincorporated retail store. In *law* there is no distinction between the financial affairs of the store and those of its owners. A creditor of the store can sue and, if successful, collect from the owners' personal resources as well as from the resources of the business. In *accounting,* by contrast, a set of accounts is kept for the store as a separate business entity, and the events reflected in these accounts must be those of the entity. The non-business events that affect the couple must not be included in these accounts. In accounting the *business* owns the resources of the store, even though the resources are legally owned by the couple. In accounting debts owed by the business are kept separate from personal debts owed by the couple. The expenses of operating the store are kept separate from the couple's personal expenses for food, clothing, housing, and the like.

The necessity for making such a distinction between the entity and its owners can create problems. Suppose, for example, that the couple lives on the same premises as the business. How much of the rent, electric bill, and property taxes associated with these premises is properly an expense of the business, and how

much is personal expense of the family? Answers to questions like these are often difficult to ascertain, and are indeed somewhat arbitrary.

For a *corporation* the distinction is often quite easily made. A corporation is a legal entity, separate from the persons who own it, and the accounts of many corporations correspond exactly to the scope of the legal entity. There may be complications, however. In the case of a group of legally separate corporations that are related to one another by shareholdings, the whole group may be treated as a single entity for financial reporting purposes, giving rise to what are called *consolidated* accounting statements. Conversely, within a single corporation, a separate set of accounts may be maintained for each of its principal operating units. For example, General Electric Company maintains separate accounts for each of its several business units (appliances, motors, plastics, lighting, aircraft engines, and others).

An **entity** is any organization or activity for which accounting reports are prepared. Although our examples tend to be drawn from business companies, accounting entities include governments, churches, universities, and other non-business organizations.

One entity may be part of a larger entity. Thus, a set of accounts may be maintained for an individual elementary school, another set for the whole school district, and still another set for all the schools in a particular state. There even exists a set of accounts, called the national income accounts, for the entire economic activity of the United States. In general, detailed accounting records are maintained for entities at the lowest level in the hierarchy, and reports for higher levels are prepared by summarizing the detailed data of these low-level entities.

THE GOING-GONCERN CONCEPT

Unless there is good evidence to the contrary, accounting assumes that an entity is a **going concern** - that it will continue to operate for an indefinitely long period in the future. The significance of this assumption can be indicated by contrasting it with a possible alternative, namely, that the entity is about to be liquidated. Under the latter assumption, accounting would attempt to measure at all times what the entity's resources are currently worth to potential buyers. Under the going-concern concept, by contrast, there is no need to constantly measure an entity's worth to potential buyers, and it is not done. Instead, it is assumed that the resources currently available to the entity will be used in its future operations. In a manufacturing company, for example, resources will be used to create goods that will eventually be sold to customers. At the time such a sale takes place, accounting recognizes the value of the goods as evidenced by their selling price. The current resale values of the individual machines, supplies, and other resources used in the manufacturing process are irrelevant because there is no intention of selling them individually. Rather, they will be used as part of the manufacturing process, and it is the resulting goods that will be sold.

> **Example.** At any given moment, a blue jeans manufacturer has jeans in various stages of the production process. If the business were liquidated today, these partially completed jeans would have little if any value. Accounting does not attempt to value these jeans at what they are currently worth. Instead, accounting assumes that the manufacturing process will be carried through to completion, and therefore that the amount for which the partially completed jeans could be sold if the company were liquidated today is irrelevant.

If, however, the accountant has good reason to believe that an entity is going to be liquidated, then its resources would be reported at their liquidation value. Such circumstances are uncommon.

THE COST CONCEPT

The economic resources of an entity are called its assets. They consist of money, land, buildings, machinery, and other property and property rights. A fundamental concept of accounting, closely related to the going-concern concept, is that an asset is ordinarily entered in the accounting records at the price paid to acquire it-at its cost.[3] This cost is the basis for all subsequent accounting for the asset.

Since, for a variety of reasons, the real worth of an asset may change with the passage of time, the accounting measurement of assets does not necessarily-indeed, does not ordinarily-reflect what assets are worth, except at the moment they are acquired. There is therefore a considerable difference between the way in which assets are measured in accounting and the everyday, non-accounting notion that assets are measured at what they are worth. In accounting, assets are initially recorded at their cost. (For emphasis, this is also referred to as an asset's ***historical* cost**.) This amount is ordinarily unaffected by subsequent changes in the value of the asset. By contrast. in ordinary usage the "value" of an asset usually means the amount for which it currently could be sold.

> **Example.** If a business buys a plot of land, paying $250,000 for it, this asset would be recorded in the accounts of the business at the amount of $250,000. If a year later the land could be sold for $275,000, or if it could be sold for only $220,000, no change would ordinarily be made in the accounting records to ref1ect this fact.

Thus, the amounts at which assets are shown in an entity's accounts do *not* indicate sales values of the assets. Probably the most common mistake made by uninformed persons reading accounting reports is that of believing

[3] *APB Opinion No.* 29 (May 1973) requires that donated assets be entered at their fair value at the dale of receipt.

there is a close correspondence between the amount at which an asset appears in these reports and the actual value of the asset. The amount reported as cash is, of course, the value of the cash the entity owns. However, the amounts reported for land, buildings, equipment, and similar assets have no necessary relationship to what these items are currently worth. In general, it is safe to say that the longer an asset has been owned by an entity, the less likely it is that the amount at which the asset appears on the accounting records corresponds to its current market value.

The cost concept does not mean that all assets remain on the accounting records at their original purchase price for as long as the entity owns them. The cost of an asset that has a long but nevertheless limited life is systematically reduced over that life by the process called depreciation, as discussed in Chapters 2 and 8. The purpose of the depreciation process is to remove systematically the cost of the asset from the asset accounts and to show it as a cost of operations. Depreciation has no necessary relationship to changes in market value or in the real worth of the asset.

Goodwill. It follows from the cost concept that if an entity pays *nothing* for an item it acquires (other than as a donation), this item will usually *not* appear on the accounting records as an asset. Thus, such factors as the knowledge and skills that are built up as a business operates, the teamwork that grows up within the organization, the increasing importance of a favorable location as time goes on, the good reputation a company builds with its customers, the trade names developed by the company-none of *these* appears as an asset in the accounts of the company.

On some accounting reports the term *goodwill* appears. Reasoning from the everyday definition of this word, one might conclude that it represents the accountant's appraisal of what the company's name and reputation are worth. This is not so. Goodwill appears in the accounts of a company only when the company has *purchased* some intangible and valuable economic resource. A common case is when one company buys another company and pays more than the fair value of its individual assets. The amount by which the purchase price exceeds the value of these assets is called goodwill, representing the value of the name, reputation, clientele, or similar intangible resources of the purchased company. Unless a business has actually purchased such intangibles, however, no item for goodwill is shown in its accounts. If the item does appear, the amount shown initially is the purchase price, even though the management may believe that the real value is considerably higher.

> **Example.** When Philip Morris Incorporated paid $5.8 billion to acquire the General Foods Corporation, $2.8 billion was for the value of the General Foods organization and its various brand names (e.g., Jell-O, Good Seasons. Kool-Aid. Maxwell House). This $2.8 billion was recorded in the Philip Morris accounts as goodwill.

To emphasize the distinction between the accounting concept and the ordinary meaning of value, the term **book value** is used for the historical cost amounts as shown in the accounting records and the term **market value** for the actual value of the asset as reflected in the marketplace.

Rationale for the Cost Concept. The cost concept provides an excellent illustration of the problem of applying the three basic criteria: relevance. objectivity, and feasibility. If the only criterion were relevance, then the cost concept would not be defensible. Clearly, investors and other financial statement users are more interested in what the business is actually worth today than in what the assets cost originally.

But who knows what a business is worth today? Any estimate of current value is just that-an estimate-and informed people will disagree on what the estimate should be. For example. on the same day, some people believe that the shares of stock of a given company are overpriced and they should therefore sell the stock; others believe that the shares are underpriced and they buy. Furthermore, accounting reports are prepared by an organization's management. If these reports contained estimates of what the entity is actually worth, these would be management's estimates. It is quite possible that such estimates would be biased.

The cost concept, by contrast, provides a relatively objective foundation for accounting. It is not *purely* objective, as we shall see, for judgments are necessary in applying it. It is much more objective, however, than the alternative of attempting to estimate current values. Essentially, readers of an accounting report must recognize that it is based on the cost concept, and they must arrive at their own estimate of current value partly by analyzing the information in the report and partly by using non-accounting information.

Furthermore, a "market value" or "current worth" concept would be difficult to apply because it would require that the accountant attempt to keep track of the ups and downs of the market price of each asset. The cost concept leads to a much more feasible system.

In summary, adherence to the cost concept indicates a willingness on the part of the accounting profession to sacrifice some degree of relevance in exchange for greater objectivity and greater feasibility.

THE DUAL-ASPECT CONCEPT

The economic resources of an entity are called assets. The claims of various parties against these assets are called equities. There are two types of equities: (1) liabilities, which are the claims of creditors (that is, everyone other than the owners of the business) and (2) owners' equity, which is the claims of the owners of the business. (Owners' equity for an incorporated business is commonly called shareholders' equity.) Since all of the assets of a business are claimed by someone (either by its owners or by its creditors) and since the total of these claims cannot exceed the amount of assets to be claimed. it follows that

ASSETS = LIABILITIES

This is the fundamental accounting equation, which is the formal expression of the dual-aspect concept. As we shall see, all accounting procedures are derived from this equation. To reflect the two types of liabilities, the equation is.

ASSETS = OWNERS' EQUITY + OTHER LIABILITIES

Events that affect the numbers in an entity's accounting records are called transactions. Although it is certainly not self-evident to someone just beginning to study accounting, every transaction has a *dual impact* on the accounting records. Accounting systems are set up so as to record both of these aspects of a transaction; this is why accounting is called a double-entry system.

To illustrate the dual-aspect concept, suppose that Ms.]ones starts a business and that her first act is to open a bank account in which she deposits $40,000 of her own money. The dual aspect of this transaction is that the business now has an asset, cash, of $40,000, and Ms.]ones, the owner, has a claim, also of $40,000, against this asset. In other words,

Assets (cash), $40,000 = Equities (owner's), $40,000

If as its next transaction, the business borrowed $15,000 from a bank, the business's accounting records would change in two ways: (1) they would show a $15,000 increase in cash, making the amount $55,000, and (2) they would show a new claim against the assets, the bank's claim, in the amount of $15,000. At this point. the accounting records of the business would show the following:

Assets (cash), $55,000 = Equities (owner's), $40,000 + bank's claim (other liabilities), $15,000

To repeat, every transaction recorded in the accounts affects at least two items. There is no conceivable way that a transaction can result in only a single change in the accounts.

THE CONSERVATISM CONCEPT

Managers are human beings. Like most humans, they would like to give a favorable report on how well the entity for which they are responsible has performed. Yet, as the FASB says, "prudent reporting based on a healthy skepticism builds confidence in the results and, in the long run, best serves all of the divergent interests (of financial statement users)."[4] This longstanding philosophy of prudent reporting leads to the conservatism concept.

This concept is often articulated as a preference for understatement rather than overstatement of net income and net assets (i.e., owners' equity) when dealing with measurement uncertainties. Thus, if two estimates of some future amount are about equally likely, there is a preference for using the smaller number when measuring assets or revenues, and the larger for liabilities or expenses. For decades the concept was stated informally as "anticipate no profits but anticipate all losses."

We state the conservatism concept's two aspects somewhat more formally:

1. Recognize *revenues* (increases in retained earnings) only when they are ***reasonably certain***.

[4] "Qualitative Characteristics of Accounting Information." *FASB Statement of Accounting Concepts No.* 2 (May 1960), par. 97.

2. Recognize *expenses* (decreases in retained earnings) as soon as they are ***reasonably possible***.

Examples. In December 1993 Lynn Jones agrees to buy an automobile from Varsity Motors, Inc., for delivery in January 1994. Although this is good news to Varsity Motors, it is possible that something will go wrong and the sale will not be consummated. Therefore, the conservatism concept requires that the revenue not be recorded, that is, *recognized,* until the automobile is actually delivered. Thus, Varsity Motors does not recognize revenue from this transaction in 1993 because the revenue is not *reasonably certain* in 1993, even though it is *reasonably possible.* Rather, if the automobile is actually delivered in 1994, revenue *is* recognized in 1994.

As another example, an uninsured automobile disappears from Varsity Motors' Premises in December 1993. Possibly, it will be recovered; possibly, it has been stolen and is gone forever. In the latter case Varsity Motors' retained earnings has decreased; the company has incurred an expense. Suppose that Varsity Motors is not reasonably certain that the auto is gone forever until early 1994. Nevertheless, the conservatism concept requires that the expense be recognized in 1993, the year in which it became *reasonably possible* that there was an expense, rather than in 1994, the year in which the expense became *reasonably certain.*

As a final example, consider the amount reported as inventory. If late in 1993 an entity learns that the selling price of certain goods in its inventory has declined to less than the cost of these goods, a loss (i.e., an expense) is recognized in 1993, even though in actual fact prices may rise again and the goods may be sold in 1994 at a profit. This is because it is *reasonably possible* that owners' equity has been reduced in 1993. (This is "lower of cost or market" rule, probably the most well-known application of the conservatism concept).

Obviously, in various situations there are problems in deciding what is meant by such imprecise phrases as *about equally likely, reasonably certain,* and *reasonably possible.* For some specific problems accounting principles give guidance-for example, the inventory principle just described. However, as with many accounting matters, judgment is often involved, and there is only a fine line between "prudently" reporting net income and owners' equity on the one hand and misleadingly understating them on the other.

THE REALIZATION CONCEPT

The conservatism concept suggests the period *when* revenue should be recognized. Another concept, the realization concept, indicates the *amount* of revenue that should be recognized from a given sale.

Realization refers to inflows of cash or claims to cash (e.g., accounts receivable) arising from the sale of goods or services. Thus, if a customer buys $50 worth of items at a grocery store, paying cash, the store realizes $50 from the sale. If a clothing store sells a suit for $300, the purchaser agreeing to pay within 30 days, the store realizes $300 (in receivables) from the sale, *provided* that the purchaser has a good credit record so that payment is reasonably certain (conservatism concept).

The realization concept states that the amount recognized as revenue is the amount that is reasonably certain to be realized-that is, that customers are reasonably certain to pay. Of course, there is room for differences in judgment as to how certain "reasonably certain" is. However, the concept does clearly allow for the amount of revenue recognized to be less than the selling price of the goods and services sold. One obvious situation is the sale of merchandise at a discount-at an amount less than its normal selling price. In such cases, revenue is recorded at the lower amount, not the normal price.

> **Example**. In many instances, the sale of a new car is made at a negotiated price that is lower than the manufacturer's list ("sticker") price for the automobile. In these circumstances, revenue is the amount at which the sale is made, rather than the list price. If the list price is $25,000 and the car is actually sold for $23,500, then the revenue is $23,500.

A less obvious situation arises with the sale of merchandise on credit.

When a company makes a credit sale, it expects that the customer will pay the bill. Experience may indicate, however, that not all customers do pay their bills. In measuring the revenue for a period, the amount of sales made on credit should be reduced by the estimated amount of credit sales that will never be realized-that is, by the estimated amount of bad debts.

> **Example**. If a store makes credit sales of $100,000 during a period and if experience indicates that 3 percent of credit sales will eventually become bad debts, the amount of revenue for the period is $97,000, not $100,000.

Although conceptually the estimated amount of bad debts is part of the calculation of revenue, in practice this amount is often treated as an expense. Thus, revenue is often reported as $100,000, and there is an expense-bad debt expense-of $3,000. The effect on net income is the same as if the revenue were reported as $97,000.

THE MATCHING CONCEPT

As noted earlier, the sale of merchandise has two aspects: (1) a revenue aspect, reflecting an increase in retained earnings equal to the amount of revenue realized, and (2) an expense aspect, reflecting the decrease in retained earnings because the merchandise (an asset) has left the business. In order to measure correctly this sale's *net* effect on retained earnings in a period, both of these aspects must be recognized in the same accounting period. This leads to the matching concept: when a given event affects both revenues and expenses, the effect on each should be recognized in the *same* accounting period.

Usually, the matching concept is applied by first determining the items of revenue to recognize for the period and their amounts (in accordance with the conservatism and realization concepts), and then matching items of cost to these revenues. For example, if goods costing $1,000 are sold for $1,500, it is first determined when the $1,500 is reasonably certain to be realized; then the $1,000 cost of sales is matched with those revenues as an expense, resulting in $500 income (profit) from the sale. However, in some situations the applicable expenses are identified first, and then revenues are matched to them. Here we shall assume that applicable revenues of a period have been identified; the problem is to determine the costs that match with these revenues. These matched costs are expenses of the period.

THE CONSISTENCY CONCEPT

These concepts that have been described in preceding text are so broad that in practice there are several different methods in which a given event may be recorded. As mentioned above, for example, bad debts may be recognized either as a reduction in revenue or as an expense. The consistency concept states that once an entity has decided on one method it should use the *same* method for all subsequent events of the same character unless it has a sound reason to change methods. If an entity frequently changed the manner of handling a given class of events in the accounting records-for example frequently changing between the straight-line method and an accelerated method for depreciating its building - comparison of its financial statements for one period with those of another period would be difficult.

Because of this concept, changes in the method of keeping accounts are not made lightly. If a company changes an accounting method from the method used in the preceding year, the company's outside auditors must report this in their opinion letter-the auditors' report that accompanies the annual financial statements distributed to shareholders.

Consistency, as used here, has a narrow meaning. It refers only to consistency *over time,* not to *logical* consistency at a given moment of time. For example, long-lived assets are recorded at cost, but inventories are recorded at the lower of their cost or market value. Some people argue that this is inconsistent. Whatever the merits of this argument may be, it does not involve the accounting concept of consistency. This concept does not mean that the treatment of different categories of transactions must be consistent with one another, but only that transactions in a given category must be treated consistently from one accounting period to the next.

THE MATERLALITY CONCEPT

In law there is a doctrine called *de minimis non curat lex,* which means that the court will not consider trivial matters. Similarly, the accountant does not attempt to record events so insignificant that the work of recording them is not justified by the usefulness of the results.

Example. Conceptually, a. brand-new pad of paper is an asset of the entity. Every time someone writes on a page of the pad, part of this asset is used up, and retained earnings decreases correspondingly. Theoretically, it would be possible to ascertain the number of partly used pads that are owned by the .entity at the end of the accounting period and to show this amount as an asset. But the cost of such an effort would obviously be unwarranted, and no accountant would attempt to do this. Accountants take the simpler, even though less exact course of action and treat the asset as being used up either at the time the pads were purchased or at the time they were issued from supplies inventory to the user.

Unfortunately, there is no agreement as to the exact line separating material events from immaterial events. The decision depends on judgment and common sense. It is natural for the beginning student, who does not have an appreciation of the cost of collecting accounting information, to expect an accountant to be more meticulous in recording events in the accounts than the practicing accountant actually would be.

The materiality concept is important in the process of determining the expenses and revenue for a given accounting period. Many of the expense items are necessarily estimates, and in some cases they are not very close estimates. Beyond a certain point it is not worthwhile to attempt to refine these estimates.

Example. Telephone bills, although rendered monthly, often do not coincide with a calendar month. It would be possible to analyze each bill and classify all the toll calls according to the month in which they were made. This would be following the matching concept precisely. Few companies bother to do this, however. On the grounds that a procedure to determine the actual expense would not be justified by the accuracy gained, they simply consider the telephone bill as an expense of the month in which the bill is received. Since the amount of the bill is likely to be relatively stable from one month to another, no significant error is introduced.

Materiality is also used in another sense in accounting. The principle of full disclosure requires that all important information about the financial condition and activities of an entity must be disclosed in reports prepared for outside parties. In this sense, also, there is no definitive rule that separates material from immaterial information. In sum the materiality concept states that insignificant events may be disregarded, but there must be full disclosure of all important information.