

WEEK 2 Notes & Activity

Sub-strands 12.1.1.2: Principles of Accounting (concepts, assumptions and conventions)

1. Accounting entity – when the business is regarded as an entity or body separate from the owners. The transactions are recorded from the view point of the business and treat the owners as outsiders. That is we are keeping the books of the business and not the owner(s).

2. Revenue Recognition Principle – Under this principle revenue is to be recorded when it is realized (or realizable), and when it is earned and not when it is received. Revenue is realized when goods or services are exchanged, is realizable when assets received can be converted to cash, and is earned when all necessary requirements are met entitling the company to the benefits represented by the revenue (e.g. services performed).

For example, suppose a neighborhood coffee house orders 100 coffee mugs from a coffee wholesaler in June. The coffee house takes delivery of the new mugs in July and pays for the order in August. The wholesaler does not recognize the revenue from this sale in June, when the order was placed, or in August, when the cash was received. For recording purposes, the revenue is recognized by the wholesaler in July, when the coffee mugs were delivered to the coffeehouse.

This principle is used for the recognition of revenue for both goods and services. For example, if an attorney is hired with an agreed upon retainer fee of \$2,500 in May, and the services are not performed until July, the attorney does not recognize the revenue until July. The attorney must earn the income before it can be recorded as such, even though he/she received cash for the service at an earlier date.

3. Historical Cost Principle – The historical cost principle deals with the valuation of both assets and liabilities. The value at the time of acquisition is used to value most assets and liabilities. For example, say the coffee wholesaler purchased an office building in 2000 for \$1.2 million. Over time this asset has most likely appreciated in value. However, in accordance with the cost principle, the original (historical) price of the building is what is recorded as the cost of the building in the books of the business.

4. Matching Principle – This principle mandates that the expenses of a business need to line up with its revenue. The expense or cost of doing business is recorded in the same period as the revenue that has been generated as the result of incurring that cost.

In the case of the coffee wholesaler, when the 100 coffee mugs were delivered in July they changed from being a part of inventory (asset) to a cost of goods sold entry (expense) in the month that the revenue from the sale was recognized. At this point, the difference between the revenue and expense is determined as the gross profit from the sale.

5. Full Disclosure Principle – This principle states that all past, present and future information that may have had an impact on the financial performance of the company needs to be fully disclosed. The historical performance of a company is readily available, but examining the numbers does not always provide the entire financial picture of a company. Sometimes there are alternative situations that need to be reported. Pending or current lawsuits are one example of a transaction that could severely impact a company's bottom line. In addition, incomplete financial transactions or any other conditions that could impact the company's performance must also be disclosed. Most of these transactions are disclosed in the footnotes to the financial statements.

6. Going Concern concept – For accounting purposes, the going concern principle states that the financial activities of a business are assumed to be in operation for an indefinite period of time and not likely to be liquidated (wound up) in the foreseeable future hence historical costs rather than the liquidated values are generally used. This allows a business to operate with a view towards a long term.

7. Monetary measurement – This principle states that information in the financial statements must be expressed in monetary units. The reason is that economic activity is expressed in monetary unit, and thus, it makes sense to apply the same basis for accounting purposes.

The monetary unit assumption also states that a stable unit of currency is to be used as the unit of record. Here in Tonga, the Tongan Pa'anga is typically the currency of choice.

8. Accounting Period – This assumption allows for the division of businesses operational activities into artificial time periods for reporting purposes as determined by the business owners. The coffeehouse can record information on a daily, weekly, monthly, quarterly and yearly basis during a time frame they deem relevant.

9. Accrual basis – accrual basis is the recording and recognizing of revenues when they are earned and recognize expenses when they are incurred rather than received (revenue) or paid (expenses).

Transaction details are therefore recorded in the period in which they relate to even though money received or paid from these transactions is in another accounting period.

10. Materiality – the treatment of an item depends on its importance and significance as its impact on the decision making. How important an item is in relation to the business will to some extent dictates how it will be treated in the accounting records and reports.

For example, cents or even a dollar does not really affect the decision about the business and therefore some accountants rounded them off in the financial report so the size of the business is also another factor that determines the materiality of an item.

11. Prudence (conservatism) – prudence is the adoption of cautious (careful, be on the safe side) accounting practices.

This is mainly when there is uncertainty in the results to be reported. Accountants traditionally want to protect their own interest in times of uncertainty and therefore prefer to understate the profit and assets rather than overstating them.

12. Consistency – this means that the accounting practices being used are consistent both within one accounting period and from one accounting period to another. This requires the general treatment, such as valuation and measurement, of items does not differ from one accounting period to another.

One of the reason is to avoid misleading interpretation and wrong comparisons of results of one period with those of another period. If for some reason it is desirable to change the basis of measurement from one period to another, then this must be disclosed by way of footnote to enable the users to make any adjustments they consider necessary.

Activity 1: Accounting concepts

1. List the adopted concepts in accounting.

- i. _____
- ii. _____
- iii. _____
- iv. _____
- v. _____
- vi. _____
- vii. _____
- viii. _____
- ix. _____
- x. _____
- xi. _____
- xii. _____

2. Identify the concepts applied in the preparation of Revenue Statement.

3. Identify the concepts applied in the preparation of Balance Sheet Statement.

4. Describe the ideas of generally accepted accounting concepts.

5. Explain how these concepts are applied in report preparation.

6. Distinguish between the accrual basis and cash basis.

7. Explain the application of the concept consistency in the need to change accounting methods or report formats.

Sub-strands 12.1.1.3: Relationships between the accounting concepts

Financial measurement and measurement bases, restricted to historical cost, current cost and realizable value:

- **Historical cost**
 - Assets are recorded at the amount of cash paid (or payable) at the time of their acquisition.

- **Current cost**
 - Assets are carried at the amount of cash that would have to be paid if the same, or an equivalent asset, was acquired currently.

- **Realisable value**
 - Assets are carried at the amount of cash that would currently be obtained by selling the asset in an ordinary disposal.

Activity:

1. Explain the relationship between these concepts when preparing accounting reports.

2. Explain the difference between objectivity and subjectivity.

3. Explain the limitations of historical costs basis.
