

ACCOUNTING CONCEPTS AND PRINCIPLES

Learning Objective

- To identify and explain the varied accounting concepts and principles

Key Understanding

- Understanding of the different accounting concepts and principles to solve exercises on accounting as applied in various case

Key Question

- What are the various accounting concepts and principles?

Accounting Concepts and Principles

1. Accrual accounting
2. Matching principle
3. Use of judgment and estimates
4. Prudence
5. Substance over form
6. Going concern assumption
7. Accounting entity assumption
8. Time period assumption
9. Generally Accepted Accounting Principles (GAAP)
10. International Financial Reporting Standards (IFRS) and Philippine Financial Reporting Standards (PFRS)

Accrual Accounting

The fundamental idea of *accrual accounting* can be stated as follows:

“The effects of business transactions should be recognized in the period in which they occurred. Income should be recognized in the period when it is earned regardless of when the payment is received. Expenses should be recognized in the period when it is incurred regardless of when the expenses are paid.”

Accrual Accounting

- Suppose Andrew, a budding entrepreneur, established a merchandising business that sells ready-to-wear clothes to different *ukay-ukay* stores in the country. The income from Andrew's business primarily comes from selling goods to customers. Sales to customers can be for cash or on credit. If the business was able to sell goods for cash, this will be recorded in the accounting records of the company. On the other hand, if the goods were sold on credit, the transaction should still be recorded in the accounting records as *accounts receivable*.
- This is the essence of accrual accounting. An accountant does not have to wait for cash to be received or for cash to be paid before he or she records a business transaction. Because of accrual accounting, use of accounts such as accounts receivable, accounts payable, prepaid expenses, accrued expenses, deferred income, and accrued income are possible.

Accrual Accounting

- Accrual accounting also results in financial statements that are more accurate and more reliable in terms of assessing the past performance of the company. Since income is recognized when earned and expenses are recognized when incurred, financial statements for a particular period properly reflect the financial transactions pertaining to that period.
- The opposite of accrual accounting is the *cash basis of accounting*. Under the cash basis of accounting, income is recognized when cash is received and expenses are recognized when cash is paid. As its name implies, under the cash basis of accounting the receipt and/or payment of cash is a requisite before transactions are recorded in the accounting records of a company.

Matching Principle

- The *matching principle* is closely related to accrual accounting. Under the matching principle, expenses are recognized in the same period as the related revenue. Revenues of a business always come with expenses. No business can generate revenues without incurring expenses. The matching principle states that related revenues and expenses should always go together. In other words, if the revenues are recorded in period 1, the related expenses should also be recorded in period 1.

Matching Principle

- For example, Rudy, a car salesman who works for Honda, has a monthly salary of ₱30 000. Aside from that, he receives a commission of 5% for all the sales he made for the month. During the month of December, he was able to sell 10 cars for a total amount of ₱12M. The ₱12M is recorded as sales of the company. By selling 10 cars for the month, Rudy is entitled to receive ₱630 000 (i.e., ₱30 000 monthly salary plus ₱600 000 commission). The monthly salary of Rudy plus his commissions are expenses of the company. By the end of the month, the salary of Rudy and his commissions are still not yet paid. Under the matching principle, the ₱630 000 will be recorded as an expense in December even though it is not yet paid since it is related to the ₱12M in revenues. Without the matching principle, the ₱630 000 may be recorded as an expense in January when the payment to Rudy is made.
- Remember that under the matching principle, expenses follow the related revenues. Like accrual accounting, the matching principle also provides more accurate and more reliable information in the financial statements. It prevents understatement of expenses in one period while overstating expenses in the next period.

Use of Judgment and Estimates

- *Accounting estimates* are approximations made by accountants or the management in the preparation of financial statements. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Some items in a company's accounting records such as cash; property, plant, and equipment (PPE); and accounts payable can be measured precisely. For these items that can be measured with precision, the use of estimates is not required. As you study higher levels of accounting, you will encounter items in a company's accounting records that cannot be exactly measured. Thus, these items require the use of accounting estimates.

Use of Judgment and Estimates

- *Warranty expense* is an item in the accounting records that requires the use of estimates. A *warranty* is a guarantee made by the seller to the buyer promising to repair or replace the thing sold if necessary within a specified period of time. When a seller sells goods, there are revenues generated that are recorded in the company's accounting records.
- According to the matching principle, all related expenses should also be recorded in the same period the revenues are recognized. Warranty expense is related to the revenues generated from the sale of goods. The problem is what amount of warranty the company should recognize in the accounting records.

Use of Judgment and Estimates

- A company is not entirely sure when warranties will be performed by the company. It can be in the same period as the related revenues, one year after the date of sale, or even further into the future. Because of this, the warranty expense in a company's accounting records is usually estimated based on historical data.
- However, the use of accounting estimates cannot be abused by an entity by purposely overestimating expenses. Some companies overestimate expenses to decrease net income and decrease the taxes payable. Judgment used in making accounting estimates should be backed up by a reasonable basis. It is more desirable to use less judgment in the accounting process because the use of judgment leads to more subjective financial statements.

Prudence

- *Prudence* in the accounting sense is also called *conservatism*. Some financial transactions are sometimes uncertain (like the warranty expense in the above example) when they will occur. Nevertheless, we still need to report these transactions if they pertain to a specific period.
- In reporting these transactions, an accountant needs to apply the concept of prudence. When applying the concept of prudence, an accountant makes sure that income and assets are not overstated and liabilities and expenses are not overstated.

Prudence

- According to Valix et al. (2013), "In the simplest words, conservatism means in case of doubt, record any loss and do not record any gain." For example, when an accountant is unsure whether or not to recognize an expense, the concept of prudence states that he or she should recognize it in the accounting records. On the other hand, if an accountant is unsure whether or not to recognize income, prudence states that he or she should not recognize it.
- Albeit *prudence* is the preferred course of action when making judgments; deliberately being too conservative is not an allowed practice. Like what is stated in the foregoing, companies might claim that they are just exercising prudence when recognizing expenses even though the main purpose is to bloat expenses for lower tax payments.

Substance over Form

- Information presented in the financial statements of a company should truthfully and faithfully represent the financial condition and financial performance of the company. For this to be possible, an accountant should look at the substance of every financial transaction rather than its legal form.
- Most of the time, the substance of a transaction does not differ from its legal form. An example is the sale of goods. In this transaction, there can be no doubt that the substance and legal form of the transaction is a sale.

Substance over Form

- A transaction where the substance differs from the legal form is a *lease*. In a *lease*, the lessor allows the lessee to use the former's property in exchange for a periodic fee. However, when ownership of the property transfers to the lessee at the end of the lease, the substance differs from the legal form. In this case, the transaction is really a sale of property with installment payments instead of a lease. The lessee will record an asset and a liability in his or her accounting records instead of recognizing an expense.
- When the substance differs from the legal form, follow the substance of the transaction. In the example given, the substance is a sale of property in installment payments while the legal form is a lease. The transaction should be treated as a sale of property in installments since substance prevails over legal form.

Going Concern Assumption

- The *going concern assumption* states that the operations of a business will continue indefinitely into the future. This means that the operations of a business will not stop in the near future and it will not be forced to liquidate its assets to pay off its liabilities. The going concern assumption allows accountants to defer recognition of expenses in the future.
- For example, Company A rents a building for ₱100 000 per month. On January 1, 2016, the company paid the rent for two years in the amount of ₱2 400 000. Under the going concern assumption, the ll company can recognize the part of the ₱2 400 000 that is not yet incurred. On January 1, 2016, the company has not yet used the building but they already paid the rent. In this case, the accountant can record an asset (i.e., prepaid expense) instead of recognizing an expense immediately. If the entity is not a going concern, there is no point recognizing the payment as an asset since the company will not derive all benefits from it. A company that is not a going concern will halt operations in the near future, so the payment of ₱2 400 000 will be recognized wholly as an expense instead of recording an asset.

Going Concern Assumption

- However, if there is substantial doubt about the ability of a company to continue as a going concern, the company can abandon this assumption. The following items are evidences that a company is not a going concern:
 1. The results of operations consistently show losses
 2. Inability to pay the obligations of the company in time
 3. Loan defaults
 4. Suppliers do not sell on credit to the company
 5. Legal proceedings against the company

Accounting Entity Assumption

- According to the accounting entity assumption, the business (which can be a sole proprietorship, partnership, or corporation) is separate from the owners, managers, and employees operating the business. Likewise, if a person owns multiple businesses, each business is distinct from all the others. This means that if a person has three businesses, then each business will keep its own accounting records. The assets and liabilities of the three businesses should not be mixed with one another.
- The main purpose of the accounting entity assumption is for the fair presentation of the financial statements of the company. If the personal transactions of owners, managers, and employees are recognized in the accounting records of the business, the financial statements will not accurately represent the results of operations of the business.



Time Period Assumption

- Users of the accounting information of a company need periodic reports to enable them to make economic decisions. An owner or stockholder needs reports consistently to decide if he or she will still keep his or her ownership interest in the company. A supplier needs reports consistently to decide if it is still beneficial to transact with the company. This is where the time period assumption comes into play.
- The *time period assumption* states that the indefinite life of a company can be divided into periods of equal length for the preparation of financial reports. Normally, the periods span for one year. Every year, most businesses produce financial reports for the benefit of the users of accounting information. Still, there are businesses that produce financial reports on periods less than or in excess of one year. The frequency of financial reporting also depends on the normal operating cycle of a business.



Generally Accepted Accounting Principles (GAAP)

- The Generally Accepted Accounting Principles (GAAP) consists of accounting principles, standards, rules, and guidelines that companies follow to achieve consistency and comparability in their financial statements. Companies that apply the GAAP help not only external users of accounting information, but also the management as well. Since the GAAP enhances the consistency and comparability of a company's financial statements, it will be easier for external users to examine if the company is doing well currently or in relation to its past performance. Simultaneously, GAAP also helps management in understanding trends persistent in the company. Management can also compare past and current performance to check the strong and weak points of company operations.
- Another feature of the GAAP is that it is agreed upon by practitioners. Individuals in the accountancy profession are the ones who create accounting standards such as the GAAP. The formulation, development, and modification of the GAAP go through a rigorous process involving professional judgement and research.



International Financial Reporting Standards (IFRS)

- The International Financial Reporting Standards (IFRS) are pronouncements issued by the International Accounting Standards Board (IASB) that intend to enhance the comparability of the financial statements of all companies around the world. In light of globalization, the IFRS will provide a way for users of accounting information to easily understand the results of operations of companies all around the globe.



International Financial Reporting Standards (IFRS)

- In the past, the function of the IASB is performed by the International Accounting Standards Committee (IASC). The pronouncements of the IASC are called International Accounting Standards (IAS). Up to this day, the IASB still adheres to the IAS in addition to their own pronouncements—the IFRS.
- In the Philippines, the development of accounting standards that will be used in the country consider the pronouncements issued by the USA Financial Accounting Standards Board (FASB) and the IASB (Valix et al. 2013). The Philippines follows the standards of both the IAS and the IFRS. In contrast, USA follows guidelines provided by the GAAP. The Philippines are fully compliant with the IFRS effective January 2005.



International Financial Reporting Standards (IFRS)

- The following factors are considered in the decision to adapt the IFRS (Valix et al. 2013):
 1. Philippine organizations' support of international accounting standards
 2. Increasing internalization of businesses which greatly calls for a common language for financial reporting
 3. Improvement of international accounting standards or removal of free choices of accounting treatments
 4. International accounting standards being recognized by the World Bank, Asian Development Bank, and World Trade Organization



Philippine Financial Reporting Standards (PFRS)

- The Philippine Financial Reporting Standards Council (PFRSC) issues standards to be used in the Philippines in the form of Philippine Financial Reporting Standards (PFRS).
- The PFRS include all of the following:
 1. Philippine Financial Reporting Standards (PFRS) which corresponds to International Financial Reporting Standards (IFRS)
 2. Philippine Accounting Standards (PAS) which corresponds to International Accounting Standards (IAS)
 3. Interpretations of accounting standards issued by the Philippine Interpretations Committee in accordance with interpretations of the IFRIC and the Standing Interpretations Committee

