

The Philosophy of Accounting

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Maybe the phrase *philosophy of accounting* is too strong, but accounting does rest on a rather small set of fundamental assumptions and principles. People often refer to these fundamentals as *generally accepted accounting principles*.

I want to quickly summarize what these principles are. I find — and I bet you'll find the same thing — that understanding the principles gives context and makes accounting practices more understandable. With this in mind, let me go through the half dozen or so key accounting principles and assumptions.

Revenue principle

The *revenue principle*, also known as the realization principle, states that revenue is earned when the sale is made. The sale is made, typically, when goods or services are provided. A key component of the revenue principle, when it comes to the sale of goods, is that revenue is earned when legal ownership of the goods passes from seller to buyer.

Note that revenue isn't earned when you collect cash for something. It turns out, perhaps counterintuitively, that counting revenue when cash is collected doesn't give the business owner a good idea of what sales really are. Some customers may pay deposits early, before actually receiving the goods or services. Often customers want to use trade credit, paying a firm at some point in the future for goods or services. Because cash flows can fluctuate wildly — even something like a delay in the mail can affect cash flow — you don't want to use cash collection from customers as a measure of sales. Besides that, you can easily track cash collections from customers. So why not have the extra information about when sales actually occur?

Expense principle

The *expense principle* states that an expense occurs when the business uses goods or receives services. In other words, the expense principle is the flip side of the revenue principle. As is the case with the revenue principle, if you receive some goods, simply receiving the goods means that you have incurred the expense of the goods. Similarly, if you received some service — services from your lawyer, for example — you have incurred the expense. It doesn't matter that your lawyer takes a few days or a few weeks to send you the bill. You incur an expense when goods or services are received.

Matching principle

The *matching principle* is related to the revenue and the expense principles. The matching principle states that when you recognize revenue, you should match related expenses with the revenue. The best example of the matching principle concerns the case of businesses that resell inventory. In the hot dog stand example, you should count the expense of a hot dog and the expense of a bun on the day when you sell that hot dog and that bun. Don't count the expense when you buy the buns and the dogs. Count the expense when you sell them. In other words, match the expense of the item with the revenue of the item.

Accrual-based accounting, which is a term you have probably heard, is what you get when you apply the revenue principle, the expense principle, and the matching principle. In a nutshell, accrual-based accounting means that you record revenue when a sale is made and record expenses when goods are used or services are received.

Cost principle

The *cost principle* states that amounts in your accounting system should be quantified, or measured, by using historical cost. For example, if you have a business and the business owns a building, that building, according to the cost principle, shows up on your balance sheet at its historical cost. You don't adjust the values in an accounting system for changes in a fair market value. You use the original historical costs.

I should admit that the cost principle is occasionally violated in a couple of ways. The cost principle is adjusted through the application of depreciation, which I discuss in the next chapter. Also, sometimes fair market values are used to value assets, but only when assets are worth less than they cost.

Objectivity principle

The *objectivity principle* states that accounting measurements and accounting reports should use objective, factual, and verifiable data. In other words, accountants, accounting systems, and accounting reports should rely on subjectivity as little as possible.

An accountant always wants to use objective data (even if it's bad) rather than subjective data (even if the subjective data is arguably better). The idea is that objectivity becomes a protection against the corrupting influence that subjectivity can introduce into a firm's accounting records.

Continuity assumption

The *continuity assumption* — accountants call it an *assumption* rather than a *principle* for reasons unbeknownst to me — states that accounting systems assume that a business will continue to operate. The importance of the continuity assumption becomes most clear if you consider the ramifications of assuming that a business won't continue. If a business won't continue, it becomes very unclear how one should value assets if the assets have no resale value. This sounds like gobbledygook, but think about the implicit continuity assumption built into the balance sheet for a hot dog stand at the beginning of the day.

Implicit in that balance sheet is the assumption that hot dogs and hot dog buns have some value because they can be sold. If a business won't continue operations, no assurance exists that any of the inventory can be sold. If the inventory can't be sold, what does that say about the owner's equity value shown in the balance sheet?

You can see, I hope, the sorts of accounting problems that you get into without the assumption that the business will continue to operate.

Unit-of-measure assumption

The *unit-of-measure assumption* assumes that a business's domestic currency is the appropriate unit of measure for the business to use in its accounting. In other words, the unit-of-measure assumption states that it's okay for U.S. businesses to use U.S. dollars in their accounting. And it's okay for U.K. businesses to use pounds sterling as the unit of measure in their accounting system. The unit-of-measure assumption also states, implicitly, that even though inflation and occasionally deflation changes the purchasing power of the unit of measure used in the accounting system, that's still okay. Sure, inflation and deflation foul up some of the numbers in a firm's financial statements. But the unit-of-measure assumption says that's usually okay — especially in light of the fact that no better alternatives exist.

Separate entity assumption

The *separate entity assumption* states that a business entity, like a sole proprietorship, is a separate entity, a separate thing from its business owner. And the separate entity assumption says that a partnership is a separate thing from the partners who own part of the business. The separate entity assumption, therefore, enables one to prepare financial statements just for the sole proprietorship or just for the partnership. As a result, the separate entity assumption also relies on a business being separate and distinct and definable as compared to its business owners.

These are the basic accounting principles that underlie business accounting. These principles and assumptions are implicit in all the discussions in this book as well as those in all the other books of this all-in-one desk reference. It is no exaggeration to say that they permeate almost everything related to business accounting.