Basic Accounting Principles

A number of basic accounting principles have been developed through common usage. They form the basis upon which modern accounting is based. The best-known of these principles are as follows:

- *Accrual principle*. This is the concept that accounting transactions should be recorded in the accounting periods when they actually occur, rather than in the periods when there are cash flows associated with them. This is the foundation of the accrual basis of accounting. It is important for the construction of financial statements that show what actually happened in an accounting period, rather than being artificially delayed or accelerated by the associated cash flows. For example, if you ignored the accrual principle, you would record an expense only when you paid for it, which might incorporate a lengthy delay caused by the payment terms for the associated supplier invoice.
- *Conservatism principle*. This is the concept that you should record expenses and liabilities as soon as possible, but to record revenues and assets only when you are sure that they will occur. This introduces a conservative slant to the financial statements that may yield lower reported profits, since revenue and asset recognition may be delayed for some time. Conversely, this principle tends to encourage the recordation of losses earlier, rather than later. This concept can be taken too far, where a business persistently misstates its results to be worse than is realistically the case.
- *Consistency principle*. This is the concept that, once you adopt an accounting principle or method, you should continue to use it until a demonstrably better principle or method comes along. Not following the consistency principle means that a business could continually jump between different accounting treatments of its

transactions that makes its long-term financial results extremely difficult to discern.

- *Cost principle*. This is the concept that a business should only record its assets, liabilities, and equity investments at their original purchase costs. This principle is becoming less valid, as a host of accounting standards are heading in the direction of adjusting assets and liabilities to their fair values.
- *Economic entity principle*. This is the concept that the transactions of a business should be kept separate from those of its owners and other businesses. This prevents intermingling of assets and liabilities among multiple entities, which can cause considerable difficulties when the financial statements of a fledgling business are first audited.
- *Full disclosure principle*. This is the concept that you should include in or alongside the financial statements of a business all of the information that may impact a reader's understanding of those financial statements. The accounting standards have greatly amplified upon this concept in specifying an enormous number of informational disclosures.
- *Going concern principle*. This is the concept that a business will remain in operation for the foreseeable future. This means that you would be justified in deferring the recognition of some expenses, such as depreciation, until later periods. Otherwise, you would have to recognize all expenses at once and not defer any of them.
- *Matching principle*. This is the concept that, when you record revenue, you should record all related expenses at the same time. Thus, you charge inventory to the cost of goods sold at the same time that you record revenue from the sale of those inventory items. This is a cornerstone of the accrual basis of accounting. The cash basis of accounting does not use the matching the principle.
- *Materiality principle*. This is the concept that you should record a transaction in the accounting records if not doing so might have altered the decision making process of someone reading the company's financial statements. This is quite a vague concept that

is difficult to quantify, which has led some of the more picayune controllers to record even the smallest transactions.

- *Monetary unit principle*. This is the concept that a business should only record transactions that can be stated in terms of a unit of currency. Thus, it is easy enough to record the purchase of a fixed asset, since it was bought for a specific price, whereas the value of the quality control system of a business is not recorded. This concept keeps a business from engaging in an excessive level of estimation in deriving the value of its assets and liabilities.
- *Reliability principle*. This is the concept that only those transactions that can be proven should be recorded. For example, a supplier invoice is solid evidence that an expense has been recorded. This concept is of prime interest to auditors, who are constantly in search of the evidence supporting transactions.
- *Revenue recognition principle*. This is the concept that you should only recognize revenue when the business has substantially completed the earnings process. So many people have skirted around the fringes of this concept to commit reporting fraud that a variety of standard-setting bodies have developed a massive amount of information about what constitutes proper revenue recognition.
- *Time period principle*. This is the concept that a business should report the results of its operations over a standard period of time. This may qualify as the most glaringly obvious of all accounting principles, but is intended to create a standard set of comparable periods, which is useful for trend analysis.

These principles are incorporated into a number of accounting frameworks, from which accounting standards govern the treatment and reporting of business transactions.