THEME: ACCOUNTING PRINCIPLES & STANDARDS

By John W. Day MBA

ACCOUNTING TERM: Accounting Principles

Accounting principles are the basic assumptions, rules of operation, and essential characteristics that make up the framework for the construction of accounting financial statements.

FEATURE ARTICLE: Accounting Principles And Accounting Standards: Avoid Them At Your Own Peril.

Long ago, I was perplexed to discover that there was no “set” of accounting principles that was presented in one form such as you might find in the Bill of Rights. This is not to say that the principles are incomplete or vague, it only means that the definitions of accounting principles can be presented in various formats, which may lead to confusion for some people, especially beginners.

Be that as it may, accounting principles are absolutely necessary when preparing financial statements, just as the rules of a particular card game make the card game possible in the first place. Accounting principles are like the glue that holds the accounting process together. For example, financial statements have an overall objective, which is to provide the user of the statements a useful tool for making business decisions.

In order to be useful, the accounting information must have certain characteristics, such as being dependable and practical. To be dependable, the accounting information must be unbiased, accurate, and verifiable. To be practical, accounting information must be predictable, prepared in a timely fashion, and be able to provide meaningful feedback. Additional characteristics are that the accounting information must be consistent, comparable, serve a utilitarian need (such as cost/benefit), and make a material difference.

Besides characteristics, certain operational rules are established as to when revenue and expenses are reported; how expenses are matched to revenue; what to do when a choice can be made that might overstate or understate figures; and, what information should be disclosed so that the reader will fully understand the circumstances under which the information is being presented.

There are also basic assumptions that the reader can count on, such as: the information is related to the business entity only and doesn’t have any unrelated information mixed in; the business is a going concern and won’t cease operations soon; the financial information presented is measured in specific time intervals such as a month, quarter or year; the financial information is using a certain unit of measure such as dollars, not board feet, etc.; the information is presented at historical cost, i.e., when received, paid, or incurred; and, the method of accounting being used is double-entry and not some other method.

These are accounting *principles* as opposed to accounting *standards*. An accounting standard is an agreement as to how an accounting issue will be treated. For instance, a standard might state what type of inventory system is appropriate to use for a certain type of business; how capital leases should be recorded; how many years intangible assets should be amortized; what methods of depreciation should be used, and so on. There are literally thousands of accounting standards that have been issued over the years. These standards are constantly being revised or discarded as they become outdated.

Accounting principles are discussed in detail in Phase II of my Accounting for Non-Accountants online course at http://www.reallifeaccounting.com

If you want to play the accounting "game of cards", you must become familiar with the "rules of the game", which are accounting principles and standards. If you choose to not play by the rules, you do so at your own peril, as we have seen recently in the corporate accounting scandals.

QUESTION: Is There An Accounting Police Force?

Who created accounting principles? Who sets and revises accounting standards? What if you don't follow all the rules, do you go to jail? Is there an accounting police force that investigates and arrests violators? It would seem that there must be some regulatory force to make sure that providers of financial statements conform to the rules. There is, up to a point, and here is how it works:

Mainly, it's all voluntary and it works pretty well. First, double-entry accounting originated in Italy in the 1400's, so its been around awhile. Accounting principles have evolved over the years just as have accounting standards. The reason why the system works is that the business community could not function if there was not commonality and consistency in financial statement reporting. It would be chaos, much like if there were no driving rules of the road.

Therefore, in the United States, a body of experts known as the Financial Accounting Standards Board (FASB pronounced Fasbee) was established in 1973, which superseded another board called the Accounting Principles Board (APB). The FASB members go through a lengthy process of analyzing and reviewing problems in the accounting field that are brought to them. After much thought, they will make a pronouncement as to what they think the new or revised way of approaching the treatment of an accounting issue should be.

They are a non-governmental organization that has private financing. A big supporter of FASB is the American Institute of Certified Public Accountants (AICPA). Many Certified Public Accountants (CPAs) belong to this prestigious organization and are obligated to abide by its guidelines and principles of behavior. Other countries no doubt have similar organizations that require high levels of accounting professional conduct.

FASB established an accounting code called "Generally Accepted Accounting Principles" or (GAAP). The assumption is that if a business financial statement is prepared according to GAAP, then the user of that financial statement could rely on or trust the information more readily than if not prepared according to GAAP. Those businesses that deviate from GAAP, and many smaller businesses do, cannot say that their statements are prepared under GAAP; in fact, they should inform the reader that they are not. However, let the buyer beware.

One governmental body that has a policing function is the Securities Exchange Commission (SEC). It is primarily concerned with public companies because their job is to protect investors from unscrupulous acts. Recently, the SEC has gotten into the act of establishing accounting standards. It has its hands full today.

Since most businesses use their financial statements to prepare their required income tax returns, the Internal Revenue Service (IRS) may audit those tax returns and review the financial statements upon which the tax returns are based. Not following the rules can get you in trouble with this governmental body.

You can see that in many ways compliance to the principles and standards is a mixture of voluntary and regulatory behavior. Currently, there is an effort underway to set international accounting standards due to the inexorable globalization process. This is a massive undertaking that will take years, but it is obviously necessary and inevitable.

TIP: Eight Good Reasons To Prepare Financial Statements

The following is a list of reasons why small businesses should have financial statements prepared:

1) Financial statements help keep information organized so the user will have efficient access to it when needed.

2) When summarized, the information has predictive value that is vital for making key business decisions.

3) Financial statements can provide 3rd party users the confidence they need to enter into business transactions with you.

4) Financial statement information enables you to comply readily with government agency mandatory reports.

5) Financial statements provide a historical record of business activity that can be used to settle disputes.

6) Financial statement information can be used to detect fraud, theft, or other illegal activities that may occur within a business.

7) Financial statements provide valuable information on the overall health of a business.

8) Financial statements can provide information about the quality and performance of those responsible for managing the business.

A more detailed explanation of each reason can be found in Phase I of my Accounting for Non-Accountants course.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at http://www.reallifeaccounting.com to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog .

