Accounting Concepts

Solution to Problem 46
Concept matching

A. Economic entity assumption
B. Going concern assumption
C. Monetary unit assumption
D. Periodicity assumption
E. Historical cost principle
F. Revenue recognition principle
G. Matching principle
H. Full disclosure principle
I. Relevance characteristic
J. Reliability characteristic
K. Consistency characteristic

Match the letter of each with the appropriate phrase that states its application. Items A-K may be used more than once or not at all.

C Stable-dollar assumption (do not use E to answer this item)
F Earning process completed and realized or realizable
J Presentation of error-free information with representational faithfulness
D Yearly financial reports
G Accruals and deferrals in adjusting and closing process (do not use B to answer this item)
C Useful standard measuring unit for business transactions
H Notes as necessary information to a fair presentation
A Affairs of the business distinguished from those of its owners
B Business enterprise assumed to have a long life
E Valuing assets at amounts originally paid for them
K Application of the same accounting principles as in the preceding year
H Summarizing significant accounting policies
I Presentation of timely information with predictive and feedback value
What is the difference between accrual accounting and cash basis accounting? It is often said that accrual accounting better indicates a company’s continuing ability to generate favorable cash flows than information related just to cash receipts and cash payments. How is this so?

An accounting method that measures the performance and position of a company by recognizing economic events regardless of when cash transactions occur. The general idea is that economic events are recognized by matching revenues to expenses (the matching principle) at the time in which the transaction occurs rather than when payment is made (or received). This method allows the current cash inflows/outflows to be combined with future expected cash inflows/outflows to give a more accurate picture of a company's current financial condition.

Accrual accounting is considered to be the standard accounting practice for most companies, with the exception of very small operations. This method provides a more accurate picture of the company's current condition, but its relative complexity makes it more expensive to implement. This is the opposite of cash accounting, which recognizes transactions only when there is an exchange of cash.

The need for this method arose out of the increasing complexity of business transactions and a desire for more accurate financial information. Selling on credit and projects that provide revenue streams over a long period of time affect the company's financial condition at the point of the transaction. Therefore, it makes sense that such events should also be reflected on the financial statements during the same reporting period that these transactions occur.

For example, when a company sells a TV to a customer who uses a credit card, cash and accrual methods will view the event differently. The revenue generated by the sale of the TV will only be recognized by the cash method when the money is received by the company. If the TV is purchased on credit, this revenue might not be recognized until next month or next year.

Advantages and disadvantages of the accrual method. While the accrual method shows the ebb and flow of business income and debts more accurately, it may leave you in the dark as to what cash reserves are available, which could result in a serious cash flow problem. For instance, your income ledger may show thousands of dollars in sales, while in reality your bank account is empty because your customers haven't paid you yet.

Advantages and disadvantages of the cash method And though the cash method provides a more accurate picture of how much actual cash your business has, it may offer a misleading picture of longer-term profitability. Under the cash method, for instance, your books may show one month to be spectacularly profitable, when actually sales have been slow and, by coincidence, a lot of credit customers paid their bills in that month. Accrual accounting, however, says that the cash method isn't accurate because it is likely, if not certain, that the company will receive the cash at some point in the future because the sale has been made. Therefore, the accrual accounting method instead recognizes the TV sale at the point at which the customer takes ownership of the TV. Even though cash isn't yet in the bank, the sale is booked to an account known in accounting lingo as "accounts receivable," increasing the seller's revenue.
Solution to Problem 48
Relevance.

In the chapter on accounting concepts and theory, relevance was put forth as one of the basic concepts of accounting. As best you can, define and describe relevance. Why is the term relevance important in accounting?

Relevance is fundamental characteristics of accounting information. Others include representational faithfulness, reliability, comparability and understandability.

Relevance requires that users need financial accounting information and it is expected to affect their decisions. In other words, accounting information is expected to pertain to decisions being made by financial statement users. If it pertains to a user decision, relevant information has at least one of three qualities: (1) it provides new information useful in making predictions about some future business operation, (2) it provides meaningful confirmation for something known before, and (3) it is material, or large enough to make a difference in the decision.

All financial accounting disclosures should be relevant to decisions being made by financial statement users. If so, then the benefit from providing the information exceeds the cost of providing it. If accounting information is not relevant, then it should not be included in financial reports.

Solution to Problem 49
Reliability.

Reliability is a fundamental characteristic of accounting information. As best you can, define and describe it. Why is it important in accounting?

Reliability requires that the information should be accurate and trustworthy. In other words, if users make use of accounting information it should not lead them astray into making bad decisions. If a user cannot trust accounting information, it should neither be provided nor used.

Solution to Problem 50
Faithful representation

In the chapter on accounting concepts and theory, faithful representation is put forth as a fundamental characteristic of accounting information. As best you can, define and describe it. Why is this term important in accounting?

Faithful representation exists when there is agreement between a specific piece of accounting information and the phenomenon it purports to represent. For example, assume that the term cash in the balance sheet is understood by external users to represent currency only. If cash includes equity securities then it lacks faithful representation.

To break it down further, faithful representation requires that information be (1) complete, (2) neutral, and (3) free from material error.
Solution to Problem 51
Comparability.

In the chapter on accounting concepts and theory, *comparability* was put forth as one of the basic concepts of accounting. As best you can, define and describe *comparability*. Why is the term comparability important in accounting?

Comparability is a quality of accounting information pertaining to complete sets of financial statements. When evaluating financial statements from one company over time, it should be possible to analyze them and draw reliable conclusions about similarities and differences in reported results for different years.

Also, financial statements for different companies in the same industry and using the same accounting standards should be comparable. That is, it should be possible to analyze the financials (for different companies) and draw conclusions about similarities and differences in reported performance.

Solution to Problem 52
Conservatism.

In the chapter on accounting concepts and theory, *conservatism* was put forth as one of the basic concepts of accounting. As best you can, define and describe *conservatism*. Why is the term conservatism important in accounting?

Conservatism is succinctly described as being slow to recognize revenues/gains and quick to recognize expenses/losses. With respect to revenue, the revenue recognition principle is strictly adhered to: that the revenue is completely earned (all work done) and either cash has been received or it is likely/probable that cash will be received. With respect to expense or loss, the third part of the expense matching principle (that there is no future value for the asset or expenditure) is rigorously applied.

The value of this principle is that optimistically overstating earnings is defined as inappropriate in the world of accounting.

Solution to Problem 53
Historical cost

In the chapter on accounting concepts and theory, the *historical cost principle* was put forth as one of the basic concepts of accounting. As best you can, define and describe the *historical cost principle*. Why is the term important in accounting?

In an economy that benefits from a stable currency unit, it is agreed that amounts reported in financial statements should be valued at their original historical costs. For depreciable assets, amortized historical costs are appropriate. Historical costs are desirable because (1) they reflect what the company actually paid to acquire the resource, (2) the amounts are verifiable, (3) subjective valuation of subsequent value is avoided. The underlying assumption is that historical costs best permit investors to predict future cash inflows resulting from use of the resource.
Solution to Problem 54
Materiality.

In the chapter on accounting concepts and theory, *materiality* was put forth as one of the basic concepts of accounting. As best you can, define and describe *materiality*. Why is the term materiality important in accounting?

U.S. Federal law requires publicly listed companies to disclose material information, defined by the U.S. Supreme Court as information presenting “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.” (TSC Indus. V. Northway, Inc., 426 U.S. 438 (1976)). An example of materiality is when a company must decide whether something is treated as a separate line item or aggregated with and merged into a different line item.

Solution to Problem 55
Going concern.

In the chapter on accounting concepts and theory, *going concern* was put forth as one of the basic concepts of accounting. As best you can, define and describe *going concern*. Why is the term going concern important in accounting?

Going concern – that assumption that a company will continue to operate in the foreseeable future. Bankruptcy or liquidation is not expected. The significance of this principle becomes apparent when the value of a running business is compared with the value of one being liquidated. Historical cost accounting, with use of the recognition and matching principles is appropriate for going concerns, but not companies that are not going concerns. Only liquidation values are relevant for these companies.

Solution to Problem 56
Asset.

In the chapter on accounting concepts and theory, *asset* was put forth as one of the basic elements of accounting. As best you can, define and describe *asset*. Be sure to include the three essential characteristics. Why is the term *asset* important in accounting? Using a purchase of three months of insurance coverage as an example, explain how this prepaid insurance is justified as a recorded asset on the balance sheet.

An asset is a resource that is going to be used in business operations in order to generate revenues. If resources don’t in any way help in generating revenues, funds should not be spent to acquire the resources.

For an asset to be recorded in the accounts and reported in the financial statements, it should possess all of the following three characteristics. First, it should have expected future benefit. In other words, it should help in generating a future revenue. Second, it should be controllable by the company. The company is able to specify who is to use the asset, and can prevent unauthorized parties from using it. Third, the asset should be present as a result of an exchange.
transaction. In other words, the company either has received the asset, or it has paid for the asset and is awaiting its arrival.

Asset is important in accounting because it is one of the building block elements, and is essential for the balance sheet and generating new revenue.

Prepaid insurance results has been paid for (exchange), is expensed over time (estimable value), the company receives checks from insurance company if damages result (future value), and the company is the identifiable recipient of the checks and can legally force the insurance company to pay.

Solution to Problem 53
Other concept definitions.

Please define the following terms, and provide a good example.

Verifiability
Neutrality
Timeliness
Consistency
Decision usefulness
Confirmatory value
Predictive value
Benefit-cost constraint
Understandability
Economic entity
Monetary unit
Periodicity
Full disclosure principle

Please refer to chapter 2 in the Kieso textbook.