Conceptual Framework and Principles

by Sophia

WHAT'S COVERED

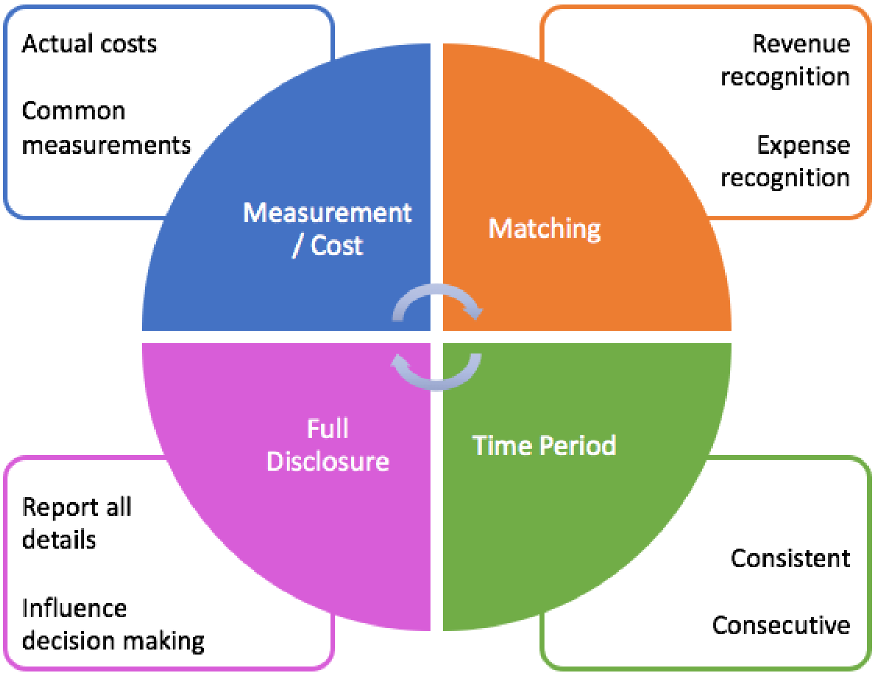
This tutorial will cover some key principles underlying the practice of accounting.

Our discussion breaks down as follows:

1. Principles of Accounting

Let's begin by discussing four key accounting principles:

- *Measurement/Cost Principle*. The measurement/cost principle is that accounting is based on actual costs. The common measurements used for the measurement/cost principle in accounting are historical cost and fair value.
- *Matching Principle*. This principle deals with revenue recognition, which is that revenues are recognized when they are earned-- the keyword being "earned." The other matching principle is the expense recognition principle, which is that expenses are recorded when incurred to generate revenue. This is where we get the match: we are matching our expenses with our revenue.
- *Full Disclosure Principle*. The keyword here is "disclosure." A company must report all the details behind the financial statements that may impact user decisions. If it influences decisions, information must be provided in the financial statements or the notes to the financial statements.
- *Time Period Principle*. A company must have consistent and consecutive periods of reporting, whether monthly, quarterly, or annually.



2. Additional Principles of Accounting

The chart below details some additional principles in accounting:

Principle	Meaning
Verifiability	The accounting information can be independently verified.
Economic Entity	A company is separate from owners and other businesses.
Monetary Unit Principle	Transactions are denominated in currency, depending on a country's native currency (e.g., for U.S.-based businesses, transactions are denominated in dollars, whereas in Europe, transactions are denominated in euros.)
Materiality	If error or omission would influence decisions, then that information is considered material.
Going Concern	A company will be able to continue to operate to fulfill its commitments.
Objectivity	Information provided cannot be biased towards one user group; the information must be objective.
Understandability	The quality of information that can be understood by reasonably informed users, meaning reasonably informed users need to be able to understand the information in the financial statements.
Reliability	The information provided is complete and free from material error, and therefore reliable.
Comparability	Information reported for different companies is reported similarly (i.e., Company A and Company B must report in such a way that they can be easily compared).

3. Accrual Basis vs. Cash Basis

Now, let's talk about accrual basis versus cash basis. Under accrual basis, everything hinges on the revenue and expense recognition:

- Revenues are recognized when earned.
- Expenses are recognized when they are incurred.

Our principles--our revenue, our expense, and our matching principles--are guiding us in accrual basis. Also, accrual basis is the type of accounting that we must use for GAAP.
In contrast, under the cash basis:

- Revenues are recognized when cash is received.
- Expenses are recognized when cash is paid.

Under cash basis, cash drives recognition. We're not concerned with matching our revenues with our expenses when they're incurred. It is purely based on when cash is paid and cash is received. Also, the cash basis of accounting is not GAAP.

SUMMARY

Today we learned about the four key **principles of accounting**: the measurement/cost principle, full disclosure principle, time period principle, and matching principle, involving revenue recognition and expense recognition. We also covered several **additional principles** which are useful in the practice of accounting. Lastly, we learned about **accrual basis versus cash basis**. Remember, accrual basis is the GAAP basis of accounting.

Source: Adapted from Sophia instructor Evan McLaughlin.