8 Accounting assumptions and principles

A Assumptions

When writing accounts and financial statements, accountants have to follow a number of assumptions, principles and conventions. An **assumption** is something that is generally accepted as being true. The following are the main assumptions used by accountants:

- The **separate entity** or **business entity** assumption is that a business is an accounting unit separate from its owners, creditors and managers, and their assets. These people can all change, but the business continues as before.
- The **time-period** assumption states that the economic life of the business can be divided into (artificial) time periods such as the **financial year**, or a quarter of it.
- The **continuity** or **going concern** assumption says that a business will continue into the future, so the current market value of its assets is not important. (See Unit 7)
- The **unit-of-measure** assumption is that all financial transactions are in a single monetary unit or currency. Companies with **subsidiaries** – that is, other companies that they own – in different countries have to convert their results into one currency in **consolidated financial statements** for the whole group of companies.

BrE: financial year; AmE: fiscal year

B Principles

The following are the most important accounting principles (as well as the **consistency** principle and the **historical cost** principle, mentioned in Unit 7):

- The **full-disclosure** principle states that financial reporting must include *all* significant information: anything that makes a difference to the users of financial statements.
- The principle of **materiality**, however, says that very small and unimportant amounts do not need to be shown.
- The principle of **conservatism** is that where different accounting methods are possible, you choose the one that is least likely to overstate or over-estimate assets or income.
- The **objectivity** principle says that accounts should be based on facts and not on personal opinions or feelings. Accounts, therefore, should be **verifiable**: it should be possible for internal and external auditors to show that they are true. This isn't always possible, however: depreciation or amortization, and provisions for bad debts, for example, are necessarily **subjective** – based on opinions.
- The **revenue recognition** principle is that revenue is recognized in the accounting period in which it is earned. This means the revenue is recorded when a service is provided or goods delivered, not when they are paid for.
- The **matching** principle, which is related to revenue recognition, states that each cost or expense related to revenue earned must be recorded in the same accounting period as the revenue it helped to earn.

"New from accounting, sir. Two and two is four again"

8.1 Match the accounting assumptions and principles (1–6) to the activities they prevent (a–f). Look at A and B opposite to help you.

1 conservatism principle
2 matching principle
3 separate entity assumption
4 revenue recognition principle
5 time-period assumption
6 unit-of-measure assumption

a showing a profit divided into US dollars, euros, Swiss francs, etc.
b publishing financial statements for a 15-month period, because this will show better profits
c waiting until customers pay before recording revenue
d waiting until customers pay before recording expenses
e listing the owners' personal assets in a company's financial statements
f valuing assets and estimating future revenue at the highest possible figures

8.2 Complete the sentences. Look at A and B opposite to help you.

1 A company's .... does not have to begin on 1 January, like the calendar year.
2 If an American company owns a company in Britain, this is a ....
3 Multinationals, with companies in lots of different countries, combine all their results in one set of ....
4 Every entry in a company's accounts must be ....: there must be a document available showing that it is true.

8.3 Complete the table with words from A, B and C opposite and related forms. Put a stress mark in front of the stressed syllable in each word. The first one has been done for you. Then complete the sentences below with words from the table.

Verb	Noun	Adjective
as'sume		–
	disclosure	–
–	objectivity	
recognize		–
–	subjectivity	
	verification	

1 Both the internal and the external auditors have to .... the accounts.
2 Companies have to .... all relevant financial information in their annual reports.
3 Despite the .... principle, accountants have to make some subjective judgements.
4 Even if a company is going through a bad period, for accounting purposes we .... it's a going concern.

Over to you

Look at the Annual Reports of one or two companies. How many of the assumptions and principles described here are mentioned in the notes to the financial statements?