



Accounting Concept Underlying Assumptions, Principles, and Conventions

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Financial accounting relies on several underlying concepts that have a significant impact on the practice of accounting.

Assumptions

The following are basic financial accounting assumptions:

- Separate entity assumption - the business is an entity that is separate and distinct from its owners, so that the finances of the firm are not co-mingled with the finances of the owners.
- Going concern assumption - the business is going to be operating for the foreseeable future.
- Stable monetary unit assumption - e.g. the U.S. dollar, Euro
- Fixed time period assumption - info prepared and reported periodically (quarterly, annually, etc.)

Principles

The basic assumptions of accounting result in the following accounting principles:

- Historical cost principle - assets are reported and presented at their original cost and no adjustment is made for changes in market value. One never writes up the cost of an asset. Accountants are very conservative in this sense. Sometimes costs are written down, for example, for some short-term investments and marketable securities, but costs never are written up.
- Matching principle - matching of revenues and expenses in the period earned and incurred.
- Revenue recognition principle - revenue is realized (reported on the books as earned) when everything that is necessary to earn the revenue has been completed.

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- Full disclosure principle - all of the information about the business entity that is needed by users is disclosed in understandable form.

Modifying Conventions

Due to practical constraints and industry practice, GAAP (General Accepted Accounting Principle) principles are not always applied strictly but are modified as necessary. The following are some commonly observed modifying conventions:

- Materiality convention - a modifying convention that relaxes certain GAAP requirements if the impact is not large enough to influence decisions. Users of the information should not be overburdened with information overload.
- Cost-benefit convention - a modifying convention that relaxes GAAP requirements if the expected cost of reporting something exceeds the benefits of reporting it.
- Conservatism convention - when there is a choice of equally acceptable accounting methods, the firm should use the one that is least likely to overstate income or assets.
- Industry practices convention - accepted industry practices should be followed even if they differ from GAAP.

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