6. Key Assumptions

Accounting is perceived as concrete. Most casual observers associate the accounting discipline with science and math in terms of absolute precision. However, accounting is actually more like art and social science. This distinction is difficult to make in an abbreviated discussion, but an illustration may help. As you consider the following illustration, forget everything you know about accounting "rules" and simply try to answer the question based on economic truth.

Suppose you purchased a home for $200,000, and sold it 10 years later for $300,000. How much profit did you make? It seems simple enough, until you consider the following additional facts:

- You are moving to a new city, and the $300,000 will buy you an identical home to the one you sold, or
  You are moving to a new city, and the $300,000 will buy you only a smaller home, or
  You are moving to a new city, and the $300,000 will buy you a nicer home, or
  You are retiring and moving to a condo that will cost less than $300,000, or
  You are having children and needing a bigger home that will cost more than $300,000, and

- The general inflation during the past ten years has been low, and $300,000 today will buy more than $200,000 did ten years ago, or
  The general inflation during the past ten years has been high, and $300,000 today will buy less than $200,000 did ten years ago, or
  The general inflation during the past ten years has been modest, and $300,000 today will buy what $200,000 did ten years ago, and

- You paid $100,000 in interest and taxes on the home during the past ten years, or
  You paid less than $100,000 in interest and taxes on the home during the past ten years, or
  You paid more than $100,000 in interest and taxes on the home during the past ten years.

You can see that there is not a single correct answer to the question. Rather, the answer depends on what methods and assumptions you employ in your measurement system. For example, suppose you were told to determine the profit by (1) comparing sales price to historical cost, (2) ignoring any subsequent reinvestment of the proceeds of the sale, (3) disregarding inflation, and (4) not factoring in the interest and taxes incurred during the holding period. Now you can assert that the profit is $100,000. You may not agree with this answer, but at least you know how it is derived. Accounting is not based on absolute truths.

Throughout this text, you have been exposed to many measurement methods and principles (e.g., entity concept, historical cost principle, revenue and expense recognition rules, objectivity principles, etc.). Underpinning this system are some fundamental assumptions. From your individual perspective, these assumptions may or may not be valid. However, agreement with these assumptions is secondary to knowing that they are a part of the measurement model in use.

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6.1 Entity Assumption

Accounting information should be presented for specific and distinct reporting units. In other words, the entity assumption requires that separate transactions of owners and others not be commingled with the reporting of economic activity for a particular business. On one hand, an individual may prepare separate financial statements for a business they own even if it is not a separate legal entity. On the other hand, consolidated financial statements may be prepared for a group of entities that are economically commingled but are technically separate legal units.

6.2 Going-Concern Assumption

In the absence of evidence to the contrary, accountants base their measurement and reporting on the going-concern assumption. This means that accountants are not constantly assessing the liquidation value of a company in determining what to report, unless of course liquidation looks as though it is a possibility. This allows for orderly allocation of long-term costs and revenues based on a presumption that the business will continue to operate into the future. Accountants are notoriously conservative (when in doubt, select the lower asset/revenue measurement choice, and the higher liability/expense measurement choice), but not to the point of introducing bias based on an unfounded fear for the future.

6.3 Periodicity Assumption

Accountants assume they can divide time into specific measurement intervals (i.e., months, quarters, years). This periodicity assumption is necessitated by the regular and continuing information needs of financial statement users. More precision could be achieved if accountants had the luxury of waiting many years to report final results, but users need timely information. For instance, a health club may sell lifetime memberships for a flat fee, not really knowing how long their customers will utilize the club. But, the club cannot wait years and years for their customers to die before reporting any financial results. Instead, methods are employed to attribute portions of revenue to each reporting period. This is justified by the periodicity assumption.

6.4 Monetary Unit Assumption

The significance of this assumption is easily taken for granted. It means that accounting measures transactions and events in units of money. To understand the impact of the monetary unit assumption, think about your personal car for a moment. In your mind, how did you visualize it -- as a dollar amount, or by model, age, mileage, functionality, etc.? Stated differently, if someone asked me what I drive, I would not say $10,000; I would simply report the make and model of my vehicle. However, accounting purports to measure all things in units of money. This solution overcomes the problems that would arise by mixing measures in the financial statements (e.g., imagine the confusion of combining acres of land, cash in bank, square feet of buildings, etc.). The monetary unit assumption is core and essential to the double-entry, self-balancing accounting model.

6.5 Stable Currency Assumption

Inflation wrecks havoc on the usefulness of financial data. For example, suppose a power plant that was constructed in 1970 is still in operation. Its accounting reports may show a profit by including currently generated revenues with depreciation of old ("cheap") construction costs. A different picture might appear if one reconsidered the "value" of the power plant that is being "used up" by generating the current revenue stream. Suffice it to say that the steady beat of inflation can distort performance measurement. Accountants have struggled with this issue for many years, and the FASB even experimented with supplemental reporting requirements for several years. At the present time, inflation is relatively tame, and this is not a hot topic. However, it certainly has the potential to reemerge as a significant issue if inflation reappears its ugly head again. In the meantime, accountants operate under the stable currency assumption, going along as though costs and revenues incurred in different time periods can be safely used without adjusting for changes in the value of the monetary unit over time.

6.6 What do you Think?

After reflecting on the above, how do you now regard accounting? Hard science or social science? Math or art? Will you think of accounting measures as absolute truth or abstract representation? And, are you starting to discern why accounting thought and knowledge entails far more than mere bookkeeping? Most importantly, when you use accounting reports, will you expand your horizon to consider more than just a company's reported bottom line?