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Use of Accounting Postulate Concepts and Principles as a Basis for Improving the Quality of Financial Reporting: A Conceptual Approach

Aliu Momodu Muhammed
e-mail:aliuauchi389@gmail.com
and
Unuigbokhai, Olufemi Anthony
Department of Accountancy, Auchi Polytechnic, Auchi, Edo State, Nigeria.

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ABSTRACT

Since accounting has evolved over many years through trial and error, it should be continually improved to give a better final product to satisfy the requirements of end-users who utilize financial statements. Despite changes in the purchasing power of money, accounting has been unwilling to introduce into the accounts modifications of values in order to reflect changes in the value of the monetary standard. Therefore, "values in accounting are expressed in terms of money as a fixed and constant standard. This paper reviewed and scrutinized accounting postulates, concepts and principles as basis for improving the quality of financial reporting, although the continuity postulate assumes that the entity will exist for an infinite period of time, users require a variety of information about the financial situation and performance of an enterprise to make short-term decision. In response to this constraint, the accounting period assumption holds that financial reports showing changes in the wealth of an enterprise should be published periodically.

Introduction

Contemporary concepts of accounting evolved with the growth of accounting theory in the western world, in relation to developments in economic life and the changing needs of different groups for accounting information. This was clearly explained by Catlett (1962), who indicates that accounting was created and developed to accomplish various desired objectives and, therefore, it is not based on fundamental laws or absolute precept. Since accounting has evolved over many years through trial and error, it should be continually improved to give a better final product to satisfy the requirements of end-users who utilize financial statements.

Even more critically, there is no unanimity among accounting authors in defining postulates. Some authors refer to assumptions, while other uses the term "concepts" or "conventions". Paton (1975) uses many terms which include postulates, assumptions and concepts. This paper reviews and scrutinizes accounting postulates, concepts and principles as basis for improving the quality of financial reporting.

1. Accounting Postulates

According to Hendriksen (1984), "postulates are basic assumptions or fundamental propositions concerning the economic, political and sociological environments in which accounting must operate. The basic criteria are that (1) they must be relevant to the development of accounting logic, (2) they must be accepted as valid by the participants in the discussion as either being true or providing a useful starting point as an assumption in the development of accounting logic.

Often, what is referred to as 'postulates' by some writers, are called 'concepts' or 'principles' by other writers and vice versa. However, Belkaoui (2002) enumerated accounting postulates and principles to include:

Accounting Postulates

1) Entity postulate
2) Going concern postulate
3) Unit of measurement postulate
4) Accounting period postulate

Accounting principles

1. Cost principle
2. Revenue principle
3. Matching principle
4. Objectivity principle
5. Consistency principle
6. Full disclosure principle
7. Conservatism principle
8. Materiality principle
9. Uniformity and comparability principle.

Accounting Entity

The entity postulate assumes that the financial statements and other accounting information are for the specific business enterprise which is distinct from its owners. Newman and Mellman (1967) are of the view that an accounting entity is "Any economic unit which has been selected as the subject to be accounted for (that is, as the accounting entity) is to be viewed, in the accounting process, as a real entity, existing in its own right, separate and distinct from other entities which have dealings with it.

This postulate enables the accountant to distinguish between the person or persons who own the enterprise and the enterprise itself. It also enables the accountant to segment the enterprise into smaller accounting entities for measuring performance or control it. It also states that financial accounting information relates to the activities of a business entity only, and not to the activities of its owners, given that the enterprise is something separate and distinct from those who provide its capital. The business entity or unit owns the resources of the company and is liable to the claims of the providers of capital and to those of the creditors. Accordingly, the accounting equation is:

Assets = Liabilities + Stockholders' Equity (Glautier and Underdown, 1988).

The Going Concern Postulate

The going concern, or continuity postulate, holds that the business entity will continue its operations long enough to realize its projects, commitments and going activities.

The postulate assumes that the entity is not expected to be liquidated in the foreseeable future or that the entity will continue for an indefinite period of time (Belkaoui, 2002). Although, most economic units are organized for operation over an indefinite period of time, it is frequently argued that the entity should logically be viewed as remaining in operation indefinitely under normal circumstances. Such a hypothesis of stability reflects the expectations of all parties interested in the entity. Thus, the financial statements provide a tentative view of the financial situation of the firm and are only part of a series of continuous reports (Belkaoui, 1985).

Newman and Mellman (1967) define the continuity concept as follows: "Unless and until the entity has entered into a state of liquidation, it is to be viewed as having an indefinite life".

Glautier and Underdown (1988) are of the view that the going concern postulate is considered very important: many assets derive their value from their employment in the firm, and should the firm cease to operate, the value which could be obtained for these assets on a closing-down sale would probably be much less than their book-value. That is the reason why the valuation of assets used in a business is based on the assumption that the business is continuing, and not on the verge o cessation.

However, the going concern postulate justifies the valuation of assets on a non-liquidation basis and forms the basis for depreciation accounting. Firstly, because neither current nor liquidation values are appropriate for asset valuation, the going concern postulate calls for the use of historical cost for many valuation. Secondly, the fixed assets and intangibles are amortized over their useful life rather than over a shorter period in expectation of early liquidation.

This postulate, however, has come under attacks from many accountants. Sterling (1973) describes it as an unreasonable and absurd assumption. He argues that the high rates of business failures make it difficult to build an evidential case for a projection of continuity. Fremgen (1968) also attacks the going concern assumption, arguing that it "is not a scientific fact or even a completely rational assumption".

Money Measurement Postulate

Money measurement postulate holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms. Obviously, financial statements should indicate the money used.

This assumption implies that the purchasing power of the monetary unit is stable over time. Belkaoui (2002) is of the opinion that to express accounting information in terms of money alone may exclude factors such as quality of the product. Another disadvantage of this assumption is that it ignores changes in the purchasing power.

Newman and Mellman (1967) believe that using monetary terms to measure financial position at a given moment in time is the most objective and least biased method. Despite changes in the purchasing power of money, accounting has been unwilling to introduce into the accounts modifications of values in order to reflect changes in the value of the monetary standard. Therefore, "values in accounting are expressed in terms of money as a fixed and constant standard".

Paton and Littleton (1967) do not agree that accounting qualitative measurements should be designed to interpret and influence business conduct. To do so, in their opinion, overstates the purpose and subject-matter of accounting. They argue that the term "measured consideration" is more appropriate than the word "value" to indicate the type of information which makes up the subject-matter of accounting. If the value which expresses the mutual valuation of the buyer and seller as of the moment of exchange, changes, the recorded price-aggregate is still the best means available for representing varied transactions in homogenous terms.

Recently, accounting information resulting from the application of the historical cost concept has been questioned (Schroeder, 1987) by various financial - statement user groups. It is argued that the use of historical cost information frequently results in income not being recognized during the period in which it occurs, and also results in overstating income in period of inflation. Changes in prices create two accounting problems: (i) Valuation: the value of individual assets changes in relation to all other assets in the economy, irrespective of any change in the general level of price; (ii) Measurement Unit: the value of the measurement unit changes because prices in general change.

Two different viewpoints as to how to present financial information to account for the effect of changing prices and values on an enterprise, to overcome the disadvantages of historical cost information. One school of thought advocates statements prepared on the basis of current value to address the valuation problem. The other purposes "price-level-adjusted financial statements", that is adjustment of historical cost information to account for the effect of the overall change in prices. This viewpoint addresses the measurement unit problem.

Accounting Period Postulate

The life of an entity is currently regarded as consisting of a chain of periodical segments (Eltegani, 1994). The final statements which report on the activities for a year and the condition of the entity as at the close of that year, are based on what is referred to by many writers as the 'accounting period convention' (Newman and Mellman, 1967). Belkaoui (2002) claims that, although the continuity postulate assumes that the entity will exist for an infinite period of time, users require a variety of information about the financial situation and performance of an enterprises to make short-term decision. In response to this constraint, the accounting period assumption holds that financial reports showing changes in the wealth of an enterprise should be published periodically.

Paton and Littleton (1967), considers this postulate as one of the important conventions of accounting. For the purpose of comparisons between revenues and applicable costs related to a fiscal year, the accounting period postulate enables accountants to analyze and rearrange original accounting data to reflect immediate administrative decision and provides administratively useful data for future use (Littleton, 1970).

By requiring an enterprise to provide periodic, short-term financial reports, the period convention thus implies the accrual basis of accounting. "This entails the assignment of revenue to the period in which it was earned (rather than when received). Backer (1959) was of the view that "sales of assets will be considered as revenue during the year in which sales took place regardless of when payment is received.

However, the accounting period postulate, besides helping in investment decisions, assist in the prediction of bankruptcies and risk and, hence, is useful in making loans (Watts and Zimmerman, 1986).

Concepts

Accounting concepts are self-evident statements or truths. Accounting concepts provide the conceptual guidelines for application in the financial accounting process, i.e., for recording, measurement, analysis and communication of information about an organization. These concepts provide help in resolving future accounting issues on a permanent or a longer basis, rather than trying to deal with each issue on an ad-hoc basis. The concepts are important because they (a) help explain the "why" of the accounting (b) provide guidance when new accounting situations are encountered and (c) significantly reduce the need to memorize accounting procedures when learning about accounting.

Accounting Principles

Accounting principles are general decision rules derived from the accounting concepts. According to American Institute of certified Public Accountant (AICPA), principles means "a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice:' principles are general approaches used in the recognition and measurement of accounting events.

Anthony and Reece (1991), comment:

> *"Accounting principles are man-made. Unlike the principles of physics, chemistry and other sciences, accounting principles were not deducted from basic axioms, nor can they be verified by observation and experiment. Instead, they have evolved. This evolutionary process is going on constantly; accounting principles are not eternal truths".*

Accounting Principles are listed as follows:

1. Cost Principle: This principle holds that the acquisition cost, or historical cost, is the appropriate valuation basis for recognition of the acquisition of all goods and services, expenses costs and equities. It implies that an item is valued at the exchange price at the date of acquisition and is recorded in the financial statements at that value or an amortized position of that value. According to Accounting Principles Board (APB), Statement No. 4 defines cost as follows: cost is the amount, measured in money, of cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services performed, or a liability incurred, in consideration of goods or services received or to be received. Cost can be classified as unexpired or expired. Unexpired costs (assets) are those which are applicable to the production of future revenues….. Expired costs are not applicable to the production of future revenues, and for that reason, are treated as deductions from current revenues or are changed against retained earnings.

However, the cost principle can be justified in terms of both its objectivity and the going concern postulate. First, acquisition cost is objective, verifiable information. Second, the going-concern postulate assumes that the entity will continue its activities indefinitely, thereby eliminating the necessity of using current values or liquidation values for asset evaluation (Belkaoui, 2002).

Furthermore, because of changes in price levels and purchasing power, some accountants argue that accounting would be more useful if estimates of current and future values were substituted for historical costs under certain conditions. The extent to which cost and values should be reflected in the accounts is central to much of current accounting controversy.

Therefore, the historical cost concepts implies that since the business is not going to sell its assets as such, there is little point in revaluing assets to reflect current values. In addition, for practical reasons, the accountant prefers the reporting of actual costs to market values which are difficult to verify. By using historical cost accountant's already difficult task is not further complicated by the need to keep additional records of changing market value. Thus, the cost concepts provide greater objectivity and greater feasibility to the financial statements.

Dual-Aspect Principle: This concept holds that any transaction or event affecting the wealth of entity must have two aspects recorded in order to maintain the equality of both sides of the accounting equation. There are four categories of events affecting the accounting equation such that:

a. Both sources and forms of wealth increase by the same amount.
b. Both sources and forms of wealth decrease by the same amount.
c. Some forms of wealth increase while others decrease without any change in the source of wealth.
d. Some sources of wealth increase while others decrease without any change in the form in which wealth is held.

Accrual Principle: According to Financial Accounting Standards Board (FASB), "accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for the enterprises in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash in received or paid by the enterprise. Accrual accounting is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the enterprise, not just with the beginning and end of that process. It recognizes that the buying, producing, selling and other operations of an enterprise during a period, as well as other events that affect enterprise performance, often do not coincide with the cash receipts and payments of the period".

However, the elements of financial statements are accounted for and include in financial statements through the use of accrual accounting procedures. Accrual accounting rests on the concepts of accrual, deferral, allocation amortization, realization and recognition. The FASB opted for the following definitions of these concepts:

- Accrual is the accounting process of recognizing non-cash events and circumstances as they occur, specifically, accrual entails recognizing revenues and related increases in assets and expenses and related increases in liabilities for amounts expected to be received or paid, usually in cash, in the future…
- Deferral is the accounting process of recognizing a liability for a current cash receipts or an asset for a current cash payment (or current incurrence of a liability) with an expected future impact on revenues and expenses…
- Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. It is a broader term than "amortization", that is, amortization is an allocation process…
- Amortization is the accounting process of systematically reducing an amount by periodic payments, or write-downs…
- Realization is the process of converting noncash resources and rights into money; it is most precisely

used in accounting and financial reporting to refer to sales of assets for cash or claims of cash. The related terms, "realized" and "unrealized", therefore identify revenues or gains and losses on assets sold and unsold, respectively…

- Recognition is the process of formally recording or incorporating an item in the accounts and financial statements of an enterprise. Thus, an element may be recognized (recorded) or unrecognized (unrecorded). "Realization" and "recognition" are not used synonymously, as they sometimes are in the accounting and financial literature (Vatter, 1947).

Therefore, the researcher is of the view that accrual basis of accounting refers to a form of keeping those records not only transactions that result from the receipt and disbursement of cash but also the amounts that the entity owes others and that others owe the entity.

Conservatism: This principle holds that when choosing among two or more acceptance accounting techniques, some preference is shown for the option that has the least favourable impact on the stockholder's equity (Belkaoui, 2002). The concept suggests that when and where uncertainty and risk exposure so warrant, accounting takes wary and watchful stance until the appearance of evidence to the contrary.

Newman and Mellman (1967) argued that conservatism may be expressed as a necessary condition for the fair presentation of accounting data. They argue that this concept comes into place because events or activities which must be reflected in the accounting process are characterized by uncertainty. The conservatism concept is used to avoid risk in terms of accounting results and is equivalent to taking a cautions or prudent approach to valuation.

Hindmarch (1977) justifies this concept on grounds that uncertainty prevails in the economic environment. He argues that "if it is possible to measure with accuracy then conservatism has little impact, but there are many situations where accuracy cannot be achieved and in such situations this concept should prevent optimism.

Many authors criticize the principle of conservatism. Sterling (1973) points out that "the Finney and Miller test, which mirror the mainstream of accounting thought, referred to conservatism as a 'principle of accounting' through fourth editions. In the fifth edition, however, they complain about the 'fetish of conservatism'. Finney and Miller (1960), argue that, in the early days of the development of accounting, public accountants' records were required mainly for the preparation of reports for bankers and guarantors of short-term credit, who were primarily interested in the margin of security, when the interest of bankers and other short-term creditors changed, accountants, who were influenced by their attitudes, changed their emphasis. Thus conservatism was a more highly esteemed virtue in the past than it is today. As stated by Belkaoui (2002): "The present view of conservatism as an accounting principle is bound to disappear. Sterling (1973) argues that "conservatism yields, not only zero information, but also, misinformation" because historical costs, when they are used, are themselves conservative. Hence, he concluded, historical costs are justified if and only if conservatism is justified. Thus historical costs also yield misinformation.

As a result of the conservatism principle, profits may be shifted from one year to another.

The Matching Principle

The matching principle (or convention) holds that expenses should be recognized in the same period as associated revenue. Hence, the matching principle links revenue with their relevant expenses. This means identifying the gains resulting from transactions and setting them off against those expenses which are related to those transactions (Belkaoui, 2002). One of the consequences of the conventional matching principle is that it relegates the balance sheet to a secondary position.

Three matching principles are employed by accountants; associating cause and effect, systematic and rational allocations, and immediate recognition. Applying these principles involves a great deal of Judgment. The accountant should determine whether a cost pertains to future revenues and hence should be deferred; whether a cost is related to past revenues and therefore should be written against prior income; or whether a cost, although not yet paid is related to current revenues and, therefore, should be incurred.

The association between revenues and expenses depends on one of four criteria:

1. Direct matching of expired costs with a revenue (for example, cost of goods sold matched with related sale).
2. Direct matching of expired cost with the period (for example, president's salary for the period).
3. Allocation of costs over periods benefited (for example depreciation).
4. Expensing all other costs in the period incurred, unless it can be shown that they have future benefit (for example, advertising expenses).

Unexpired costs (that is, assets) not meeting one of these four criteria for expensing the current period are chargeable to future periods and may be classified under different categories in the application of the matching principle. Basically, certain costs or period costs are allocated to or matched with revenues and the other costs are reported and carried forward as assets. Costs allocated and matched with period revenues are assumed to have an expired service potential (Belkaousi, 2002).

Objectivity Principle: This principle holds that accounting must be carried out on an objective and factual basis. Entries in the books of accounts and the data reported in the financial statements must be based upon objectively determine evidence. Strict adherence to the objectivity concept is necessary to maintain the confidence of the users of the financial statements. This is also necessary to minimize the possibility of error and intentional fraud or bias.

However, financial reporting is considered useful if it provides useful information to present potential investors, creditors and other users on which to base rational investments, credit and similar decisions.

The development of new ways and means for realizing objectivity is particularly needed in the present situation of inflation. Although historical cost, for example, realizes objectivity for recording values of different items at their acquisition, it does not maintain the same if used as the basis of valuation.

Consistency Principle: This principle holds that in accounting processes, all concepts, principles and measurement approaches should be applied in a similar or consistent way from one period to another period in order to ensure that the data reported in financial statements are reasonably comparable over time.

Therefore, consistency is a user constraint intended to facilitate the user's decision by ensuring the comparable presentation of the financial statements of a given firm over time, thereby enhancing the utility of the statements. In the standard opinion, the certified public accountant recognizes the consistency principle by nothing whether or not the financial statements have been prepared in conformity with generally accepted accounting principles applied on a basis "consistent with that of the proceeding year". (Belkaoui, 2002).

The objective of consistency is to eliminate the personal bias of the accountant in reporting information. The rationale behind this convention is that frequent changes in accounting treatment would make the financial statements unreliable to their users, such as management, bank and investors.

Full Disclosure Principle: This convention requires that financial statements be designed and prepared to portray accurately the economic events that have affected the firm for the period and to contain sufficient information to make them useful and not misleading to the average investor (Belkaoui, 2002). However, all information which is of material interest to the owner, managers, investors etc, should be disclosed in accounting statements. There is a consensus in accounting that the disclosure should be full, fair and adequate. Full refers to a complete and comprehensive presentation of information; fair implies an ethical constraint dictating an equitable treatment of users; and 'adequate' connotes a minimum set of information to be disclosed.

In general, it is expected that any matter of significance, such as major commitments, will be disclosed if knowledge of it would affect the decision of an average investor. The term "Disclosure", does not mean that any and all information is to be included in the accounting statements. It implies is of material interest to different users.

Adequate disclosure, however, leaves several questions open to interpretation;

what is meant by fair and adequate disclosure? Adequate connotes a minimum set of information to be disclosed; fair implies an ethical constraint dictating an equitable treatment of users; and complete and comprehensive presentation of information.

Materiality principle: The principle holds that transactions and events having significant economic effects may be handled in the most expeditions manner, whether or not they conform to generally accepted principles and need not be disclosed. Materiality serves as an implicit guide for the accountant in terms of what should be disclosed in the financial reports, enabling the accountant to decide what is not important or what does not matter on the basis of record-keeping costs, accuracy of financial statements, and relevance to the user (Belkaoui, 2002).

According to APB statement No. 4, materiality implies that "financial reporting is only concerned with information that is significant enough to affect evaluations or decisions". Similarly, APB opinion No. 22 also recommends the disclosure of all policies or principles that materially affect the financial position, results of operations and changes in the financial position of the entity.

The importance of the materiality principle relates to the simple fact that accounting and audit depend to a large extent on sampling. Since it is impractical and sometimes impossible to show all and every detail of the firm's transactions, the accountant is given the right to decide what is relevant and what is not.

To sum up, accounting principles are generally accepted for fairness accounting in financial reporting. Accounting principles are also largely acceptable. However, all principles which help achieve the objective of justice are acceptable and desirable.

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