

## Chapter 6

### GENERALLY ACCEPTED ACCOUNTING PRINCIPLES – PERVASIVE PRINCIPLES

#### GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

137. Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analyzed, and reported. This process should be carried out in accordance with generally accepted accounting principles. Generally accepted accounting principles incorporate the consensus<sup>38</sup> at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.

138. *Generally accepted accounting principles* therefore is a technical term in financial accounting. Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The

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<sup>38</sup> Inasmuch as generally accepted accounting principles embody a consensus, they depend on notions such as *general acceptance* and *substantial authoritative support*, which are not precisely defined. The Securities and Exchange Commission indicated in Accounting Series Release No. 4 that when financial statements are “prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate . . . .”: The AICPA Special Committee on Opinions of the Accounting Principles Board defines *generally accepted accounting principles* as those “having substantial authoritative support.” Problems in defining substantial authoritative support are discussed in Marshall Armstrong, “Some Thoughts on Substantial Authoritative Support,” *The Journal of Accountancy*, April 1969, pp. 44-50.

standard<sup>39</sup> of “generally accepted accounting principles” includes not only broad guidelines of general application, but also detailed practices and procedures.<sup>40</sup>

139. Generally accepted accounting principles are conventional—that is, they become generally accepted by agreement (often tacit agreement) rather than by formal derivation from a set of postulates or basic concepts. The principles have developed on the basis of experience, reason, custom, usage, and, to a significant extent, practical necessity.

140. In recent years Opinions of the Accounting Principles Board have received considerable emphasis as a major determinant of the composition of generally accepted accounting principles. All of the Accounting Research Bulletins and the early Opinions of the Accounting Principles Board include the statement that “. . . the authority of the bulletins [or Opinions] rests upon their general acceptability . . . .” Beginning with Opinion No. 6 (October 1965), however, Opinions of the Accounting Principles Board include a statement to reflect the adoption in October 1964 by Council of the American Institute of Certified Public Accountants of a resolution that provides in essence that accounting principles accepted in Opinions of the Accounting Principles Board constitute, per se, generally accepted accounting principles for Institute members. The Council also recognizes that accounting principles that differ from those accepted in Opinions of the Accounting Principles Board can have substantial authoritative support and, therefore, can also be considered to be generally accepted accounting principles.

141. In this Statement the discussion of present generally accepted accounting principles is divided into three sections: (1) pervasive principles, which relate to financial accounting as a whole and provide a basis for the other principles, (2) broad operating principles, which

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<sup>39</sup> The independent auditor’s report gives the auditor’s opinion as to whether the financial statements “present fairly the financial position . . . and the results of . . . operations, in conformity with generally accepted accounting principles . . . .”

<sup>40</sup> “The term ‘principles of accounting’ as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them.” Statements on Auditing Procedure No. 33, *Auditing Standards and Procedures*, p. 40.

guide the recording, measuring, and communicating processes of financial accounting, and (3) detailed principles, which indicate the practical application of the pervasive and broad operating principles. This classification provides a useful framework for analysis, although the distinctions between the types of principles, especially between the broad operating and detailed principles, are somewhat arbitrary. This chapter discusses the pervasive principles. The broad operating and detailed principles are discussed in Chapters 7 and 8, respectively.

142. The three types of principles form a hierarchy. The pervasive principles are few in number and fundamental in nature. The broad operating principles derived from the pervasive principles are more numerous and more specific, and guide the application of a series of detailed principles. The detailed principles are numerous and specific. Detailed principles are generally based on one or more broad operating principles and the broad operating principles are generally based on the pervasive principles. No attempt is made in this Statement to indicate specific relationships between the principles.

#### **PERVASIVE PRINCIPLES**

143. The pervasive principles specify the general approach accountants take to recognition and measurement of events that affect the financial position and results of operations of enterprises. The pervasive principles are divided into (1) pervasive measurement principles and (2) modifying conventions.

#### **Pervasive Measurement Principles**

144. The pervasive measurement principles (P-1 to P-6) establish the basis for implementing accrual accounting. They include the initial recording principle, the realization principle, three pervasive expense recognition principles, and the unit of measurement principle. These principles broadly determine (1) the types of events to be recognized by financial accounting, (2) the bases on which to measure the events, (3) the time periods with which to identify the events, and (4) the common denominator of measurement.

145. *Initial Recording.* The principle for initial recording of assets and liabilities is important in financial accounting because it determines (1) the data that enter the accounting process, (2) the time of entry, and (3)

generally the amounts at which assets, liabilities, revenue, and expenses are recorded.

#### *P-1. Initial recording of assets and liabilities.*

Assets and liabilities generally are initially recorded on the basis of events in which the enterprise acquired resources from other entities or incurs obligations to other entities.<sup>41</sup> The assets and liabilities are measured by the exchange prices<sup>42</sup> at which the transfers take place.

146. The initial recording of assets and liabilities may also reflect the elimination of other assets or liabilities, for example, the payment of cash in acquiring equipment. The amounts at which assets and liabilities are initially recorded may be carried without change, may be changed, for example, by amortization or write off, or may be shifted to other categories. The effects of transactions or other events to which the entity is not a party are usually not recognized in the accounting records until transactions of the enterprise occur, although there are significant exceptions to this general principle (see paragraph 183). The effects of executory contracts also are generally not recognized until one of the parties at least partially fulfills his commitment.

147. *Income Determination.*<sup>43</sup> Income determination in accounting is the process of identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period. Revenue for a period is generally determined independently by applying the realization

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<sup>41</sup> This principle does not cover the first recording of assets produced or constructed by the enterprise from other assets that previously have been initially recorded. Accounting for produced or self-constructed assets is discussed in paragraph 159.

<sup>42</sup> In transfers that do not involve money prices, such as barter transactions or investments by owners, assets are usually measured at "fair value," that is, at the amount of money that would be involved if the assets were received in exchanges that involved money prices. For exceptions to this general rule see paragraph 182, M-2B and M-2C.

<sup>43</sup> The term *matching* is often used in the accounting literature to describe the entire process of income determination. The term is also often applied in accounting, however, in a more limited sense to the process of expense recognition or in an even more limited sense to the recognition of expenses by associating costs with revenue on a cause and effect basis (see paragraph 157). Because of the variety of its meanings, the term *matching* is not used in this Statement.

principle. Expenses are determined by applying the expense recognition principles on the basis of relationships between acquisition costs<sup>44</sup> and either the independently determined revenue or accounting periods. Since the point in time at which revenue and expenses are recognized is also the time at which changes in amounts of net assets are recognized, income determination is interrelated with asset valuation. From the perspective of income determination, costs are divided into (1) those that have “expired” and become expenses and (2) those that are related to later periods and are carried forward as assets in the balance sheet. From the perspective of asset valuation, those costs that no longer meet the criteria of assets become expenses and are deducted from revenue in determining net income.

148. *Revenue and Realization.* Revenue is gross increase in assets or a gross decrease in liabilities recognized and measured in conformity with generally accepted accounting principles that results from those types of profit-directed activities of an enterprise that can change owners’ equity (see paragraph 134). Revenue under present generally accepted accounting principles is derived from three general activities: (a) selling products, (b) rendering services and permitting others to use enterprise resources, and (c) disposing of resources other than products – for example, plant and equipment or investments in other entities. Revenue does not include receipt of assets purchased, proceeds of borrowing, investments by owners, or adjustments of revenue of prior periods.

149. Most types of revenue are the joint result of many profit-directed activities of an enterprise and revenue is often described as being “earned” gradually and continuously by the whole of enterprise activities. *Earning* in this sense is a technical term that refers to the activities that give rise to the revenue – purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth. All of the profit-directed activities of an enterprise that comprise the process by which revenue is earned may be called the *earning process*.

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<sup>44</sup> See paragraph 65 for a general discussion of the term *cost* and paragraph 164 for a discussion of the meaning of the term *cost* under present generally accepted accounting principles.

150. Revenue is conventionally recognized at a specific point in the earning process of a business enterprise, usually when assets are sold or services are rendered. This conventional recognition is the basis of the pervasive measurement principle known as realization.

P-2. *Realization.* Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place.

151. The exchange required by the realization principle determines both the time at which to recognize revenue and the amount at which to record it. Revenue from sales of products is recognized under this principle at the date of sale, usually interpreted to mean the date of delivery to customers. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used. Revenue from sales of assets other than products is recognized at the date of sale. Revenue recognized under the realization principle is recorded at the amount received or expected to be received.

152. Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices.<sup>45</sup> The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristic of unit interchangeability are reasons given to support this exception.

153. The realization principle requires that revenue be earned before it is recorded. This requirement usually causes no problems because the earning process is usually complete or nearly complete by the time of the required exchange. The requirement that revenue be earned becomes important, however, if money is received or amounts are billed in advance of the delivery of goods

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<sup>45</sup> This increase in assets is often reported in the income statement as a reduction of cost of goods sold rather than as sales revenue.

or rendering of services. For example, amounts for rent or magazine subscriptions received in advance are not treated as revenue of the period in which they are received but as revenue of the future period or periods in which they are “earned.” These amounts are carried as “unearned revenue” – that is, liabilities to transfer goods or render services in the future – until the earning process is complete. The recognition of this revenue in the future period results in recording a decrease in a liability rather than an increase in an asset.

154. *Expense Recognition.* Expenses are gross decreases in assets or gross increases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners’ equity (see paragraph 134). Important classes of expenses are (1) cost of assets used to produce revenue (for example, cost goods sold, selling and administrative expenses, and interest expense), (2) expenses from nonreciprocal transfers and casualties (for example, taxes, fires, and theft), (3) cost of assets other than products (for example, plant and equipment or investments in other companies) disposed of, (4) cost incurred in unsuccessful efforts, and (5) declines in market prices of inventories held for sale. Expenses do not include repayments of borrowing, expenditures to acquire assets, distributions to owners (including acquisition of treasury stock), or adjustments of expenses of prior periods.

155. Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods.<sup>46</sup> The expenses of a period are (a) costs directly associated with the revenue of the period, (b) costs associated with the period on some basis other than a direct relationship with revenue, and (c) costs that cannot, as a practical matter, be associated with any other period.

156. Three pervasive expense recognition principles specify the bases for recognizing the expenses that are deducted from revenue to determine the net income or loss

of a period. They are “associating cause and effect,” “systematic and rational allocation,” and “immediate recognition.”

157. P-3. *Associating cause and effect.*<sup>47</sup> Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue.

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

158. Several assumptions regarding relationships must be made to accumulate the costs of products sold or services provided. For example, manufacturing costs are considered to “attach” to products on bases of association such as labor hours, area or volume of facilities used, machine hours, or other bases presumed to indicate the relationship involved. “Attaching” costs to products often requires several allocations and reallocations of costs. Also, assumptions regarding the “flow” of costs or of physical goods (LIFO, FIFO, average) are often made to determine which costs relate to products sold and which remain in inventory as assets.

159. P-4 *Systematic and rational allocation.* In the absence of a direct means of associating cause and effect, some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided.

If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumptions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively

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<sup>46</sup> See paragraph 174.

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<sup>47</sup> The term *matching* is often applied to this process (see paragraph 147, footnote 43).

demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

160. *P-5 Immediate recognition.* Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

Application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

161. *Application of Expense Recognition Principles.* To apply expense recognition principles, costs are analyzed to see whether they can be associated with revenue on the basis of cause and effect. If not, systematic and rational allocation is attempted. If neither cause and effect associations nor systematic and rational allocations can be made, costs are recognized as expenses in the period incurred or in which a loss is discerned. Practical measurement difficulties and consistency of treatment over time are important factors in determining the appropriate expense recognition principle.

162. *Effect of the Initial Recording, Realization, and Expense Recognition Principles.* The essential effect of these principles as they now exist is that measurement of the assets, liabilities, revenue, and expenses of a business enterprise is based primarily on its own exchanges.

Resources and obligations that result from executory contracts are generally not recorded as assets and liabilities until one of the parties at least partially fulfills his commitment. Furthermore, not all changes in the utility or price of assets are recognized. Increases in assets and the related revenue are usually not recorded if they result from events wholly internal to the enterprise. For example, revenue that is earned during the production process is generally not recorded until the goods and services produced are exchanged. Also, increases or decreases in assets and related revenue and expenses that result from events in which the enterprise does not participate directly are usually not recorded.<sup>48</sup> For example, most changes in prices of productive resources are not recognized until enterprise transactions take place.

163. Under the initial recording, realization, and expense recognition principles assets are generally carried in the accounting records and presented in financial statements at acquisition cost or some unexpired or unamortized portion of it. When assets are sold, the difference between the proceeds realized and the unamortized portion of acquisition cost is recognized as an increase (or decrease) in the enterprise's net assets.

164. The initial recording and realization conventions are the basis for the "cost principle" (which is more accurately described as the acquisition-price or historical-cost rule). Cost can be defined in several ways – for example, as the amount of money that would be required to acquire assets currently (replacement cost) or as the return from alternative uses of assets, such as selling them (opportunity cost). However, "cost" at which assets are carried and expenses are measured in financial accounting today usually means historical or acquisition cost because of the conventions of initially recording assets at acquisition cost and of ignoring increases in assets until they are exchanged (the realization convention).<sup>49</sup> The term *cost* is also commonly used in financial accounting to refer to the amount at which assets are initially recorded, regardless of how the amount is determined.

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<sup>48</sup> Exceptions include the cost or market rule for inventories (see paragraph 183).

<sup>49</sup> See paragraph 65 for general discussion of the term *cost*. The discussions of cost in paragraphs 65 and 164 are broader than that in Accounting Terminology Bulletin No. 4, paragraph 2, which defines only historical or acquisition cost.

165. *Unit of Measure.* In the United States, the U.S. dollar fulfills the functions of medium of exchange, unit of account, and store of value. It provides the unit of measure for financial accounting. Stating assets and liabilities and changes in them in terms of a common financial denominator is prerequisite to performing the operations – for example, addition and subtraction – necessary to measure financial position and periodic net income.

166. Defining the unit of measure in terms of money presents problems because of decreases (inflation) or increases (deflation) in the general purchasing power of money over time. The effects of inflation in the United States are not considered sufficiently important at this time to require recognition in financial accounting measurements.

P-6. *Unit of measure.* The U.S. dollar is the unit of measure in financial accounting in the United States. Changes in its general purchasing power are not recognized in the basic financial statements.

167. *Effect of the Unit of Measure Principle.* The basic effect of this principle is that financial accounting measures are in terms of numbers of dollars, without regard to changes in the general purchasing power of those dollars.

168. The unit of measure principle is applied together with the other pervasive measurement principles. Costs are therefore measured in terms of the number of dollars initially invested in assets. If moderate inflation or deflation persists for several years or if substantial inflation or deflation occurs over short periods, the general purchasing power of the dollars in which expenses are measured may differ significantly from the general purchasing power of the dollars in which revenue is measured. Methods of accounting which tend to minimize this effect in the determination of periodic income – most notably the last-in, first-out method of inventory pricing and accelerated depreciation of plant and equipment – have become generally accepted and widely used in the United States. Methods of restating financial statements for general price-level changes have been used in some countries that have experienced extreme inflation but are not now used in the basic financial statements in the United States.<sup>50</sup>

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<sup>50</sup> Accounting Principles Board Statement No. 3, *Financial Statements Restated for General Price-Level Changes*, issued in June 1969, recommends supplementary disclosure of general price-level information.

## Modifying Conventions

169. The pervasive measurement principles are largely practical responses to problems of measurement in financial accounting and do not provide results that are considered satisfactory in all circumstances. Certain widely adopted conventions modify the application of the pervasive measurement principles. These modifying conventions, discussed in the following paragraphs, have evolved to deal with some of the most difficult and controversial problem areas in financial accounting. They are applied because rigid adherence to the pervasive measurement principles (1) sometimes produces results that are not considered to be desirable, (2) may exclude from financial statements some events that are considered to be important, or (3) may be impractical in certain circumstances.

170. The modifying conventions are applied through generally accepted rules that are expressed either in the broad operating principles or in the detailed principles. The modifying conventions are a means of substituting the collective judgment of the profession for that of the individual accountant.

171. *Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost and market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles.

172. *Emphasis on Income.* Over the past century businessmen, financial statement users, and accountants have increasingly tended to emphasize the importance of net income and that trend has affected the emphasis in financial accounting. Although balance sheets formerly were presented without income statements, the income statement has in recent years come to be regarded as the most important of the financial statements. Accounting principles that are deemed to increase the usefulness of the income statement are therefore sometimes adopted by the profession as a whole regardless of their effect on the

balance sheet or other financial statements. For example, the last-in, first-out (LIFO) method of inventory pricing may result in balance sheet amounts for inventories that become further removed from current prices with the passage of time. LIFO, however, is often supported on the grounds that it usually produces an amount for cost of goods sold in determining net income that more closely reflects current prices. This result is believed to compensate for the effect under the LIFO method of presenting inventories in the balance sheet at prices substantially different from current prices.

173. *Application of Judgment by the Accounting Profession as a Whole.* Sometimes strict adherence to the pervasive measurement principles produces results that are considered by the accounting profession as a whole to be unreasonable in the circumstances or possibly misleading. Accountants approach their task with a background of knowledge and experience. The perspective provided by this background is used as the basis for modifying accounting treatments when strict application of the pervasive measurement principles yields results that do not appear reasonable to the profession as a whole.

174. The exception to the usual revenue realization rule for long-term construction-type contracts, for example, is justified in part because strict adherence to realization at the time of sale would produce results that are considered to be unreasonable. The judgment of the profession is that revenue should be recognized in this situation as construction progresses. Similarly, the most meaningful concept of net income in the judgment of the profession is one that includes all items of revenue and expense recorded during the period except for certain items that can be clearly identified with prior periods under carefully specified conditions. Extraordinary items are segregated in the current income statement so that their effects can be distinguished. Also, avoiding undue effects on the net income of a single period is judged by the profession to be important in certain circumstances. For example, actuarial gains and losses recognized in accounting for pension cost may be spread over the current year and future years.