

## Principles of Canadian Accounting<sup>1</sup>

1. **The Entity Principle**
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### 1. The Entity Principle

The entity principle provides that the accounting for an enterprise or organization be kept separate from the personal affairs of its owner, or from any other business or organization. This means that the owner of a business should not place any personal assets on the business balance sheet. The balance sheet of the business must reflect the financial position of the business alone. Also, when transactions of the business are recorded, any personal expenditures of the owner are charged to the owner and are not allowed to affect the operating results of the business.

### 2. The Consistency Principle

This principle states that when a business has once fixed a method for the accounting treatment of an item, it will enter in exactly the same way all similar items that follow. The consistency principle requires accountants to apply the same methods and procedures from period to period. When they change a method from one period to another they must explain the change clearly on the financial statements. The readers of financial statements have the right to assume that consistency has been applied if there is no statement to the contrary. The consistency principle prevents people from changing methods for the sole purpose of manipulating figures on the financial statements.

### 3. The Time Period Principle

The time period principle provides that accounting take place over specific time periods known as fiscal periods, and transactions are allocated to these fiscal periods. These fiscal periods are of equal length, and are used when measuring the financial progress of

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<sup>1</sup> Adapted by Brown Governance Inc. from: Wiley GAAP 2003: Interpretation and Application of Generally Accepted Accounting Principles, updated for IFRS and revisions to Canadian accounting principles.

a business. Each accounting entry should be allocated to a given period, and split accordingly if it covers several periods. If a client pre-pays a subscription (or lease, etc.), the given revenue should be split to the entire time-span and not counted for entirely on the date of the transaction.

#### **4. The Measurement Principle**

The measurement principle states that the accounting for transactions must be on a reasonable basis. The most “reasonable” basis depends on the type of asset, liability, revenue or expense. In many cases the most reasonable measurement is the original price (cost). This is the simplest measurement, the figure that appears on the source document for the transaction in almost all cases. In other cases, where the main concern is impairment in value below cost (e.g. inventory, goodwill), a more reasonable basis would be the lower of an asset’s cost and its fair value (LCM). In other cases, where the enterprise’s earnings are reliant on the fair value (e.g. financial instruments, investments held for trading), the measurement basis ought to be fair value.

#### **5. The Objectivity Principle**

The objectivity principle states that accounting will be recorded on the basis of objective evidence. Objective evidence means that different people looking at the evidence will arrive at the same values for the transaction. Simply put, this means that accounting entries will be based on fact and not on personal opinion or feelings.

#### **6. The Reasonableness (Prudence) Principle**

This principle aims at showing the reality "as is": one should not try to make things look prettier than they are. Further, one should show the full details of the financial information and not seek to compensate (offset) a debt with an asset, revenue with an expense, etc.

Revenues should be taken into the accounts (recognized), and expenses accrued, at the time the transaction is completed. Usually, this just means recording revenue when the bill for it is sent to the customer. If it is a cash transaction, the revenue is recorded when the sale is completed and the cash received.

It is not always quite so simple. Think of the building of a large project such as a dam. It takes a construction company a number of years to complete such a project. The company does not wait until the project is entirely completed before it sends its bill. Periodically, it bills for the amount of work completed and receives payments as the work progresses. Revenue is taken into the accounts on this periodic basis. It is important to take revenue into the accounts properly. If this is not done, the earnings statements of the company will be incorrect and the readers of the financial statement misinformed.

## **7. The Continuing Concern Principle**

The continuing concern principle assumes that a business will continue to operate, unless it is known that such is not the case. The values of the assets belonging to a business that is alive and well are straightforward. For example, a supply of envelopes with the company's name printed on them would be valued at their cost. This would not be the case if the company were going out of business. In that case, the envelopes would be difficult to sell because the company's name is on them. When a company is going out of business, the values of the assets usually suffer because they have to be sold under unfavorable circumstances. The values of such assets often cannot be determined until they are actually sold.

## **8. The Full Disclosure Principle**

The full disclosure principle states that any and all information that affects the full understanding of a company's financial statements must be included with the financial statements. Some items may not affect the ledger accounts directly. These would be included in the form of accompanying notes. Examples of such items are outstanding lawsuits, tax disputes, and company takeovers.

## **9. The Materiality Principle**

An item is considered material if its omission or misstatement will affect the decision making process of the users. Materiality depends on the nature and size of the item. Only items material in amount or in their nature will affect the true and fair view given by a set of accounts. The materiality principle requires accountants to use generally accepted accounting principles except when to do so would be expensive or difficult, and where it makes no real difference if the rules are ignored. If a rule is temporarily ignored, the net income of the company must not be significantly affected, nor should the reader's ability to judge the financial statements be impaired.