

**Visual Learning Maps**

*Introductory Financial Accounting*



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## **VIRTUAL TEXT BOOK**

### **CONSTRAINTS – 1 of 2**

The goal of financial statements is to provide readers with the most relevant, reliable, comparable, consistent information possible in order that those readers can make informed decisions. Constraints provide flexibility within GAAP to achieve the goal of quality.

Constraints in Accounting are about two specific thinking filters that allow preparers of financial statements to slightly alter GAAP in order to present information in the most qualitative way. The two constraints are Materiality and Conservatism.

#### **MATERIALITY**

When accounting information is material, it means that the information is significant for decisions to be made by readers. The opposite is true when an item is immaterial – the information will have no affect on decisions, and may even get in the way of decision making because it is clutter on the financial exhibits.

When an amount, transaction or transactions are immaterial, normal GAAP need not be followed; however, justification must be absolutely clear.

#### **Here is an example:**

A computer keyboard adheres to the definition of an asset – the business owns it and it has future value. Strict compliance with GAAP requires the keyboard to be accounted for as an asset; however, Materiality allows the keyboard to be accounted for as an expense because the amount, compared to the cost of the computer, is insignificant – immaterial. Knowing the cost of keyboards in the business is not useful to decision makers.

If keyboards were accounted for as assets and depreciated over their useful lives, costly detailed records would have to be designed and maintained. Serial numbers would have to be put on every keyboard in order to segregate and identify each keyboard. People would have to go around counting keyboards and checking serial numbers periodically to verify that the asset record, reflected on the balance sheet, were correct. This is a waste of time and money – the cost of maintaining and proving the record would be greater than the asset!

# **CONSTRAINTS – 2 of 2**

## **CONSERVATISM**

The reputation Accountants have as being conservative is not unfounded, but it has a specific meaning as a thinking process applied to measuring and communicating financial information.

Conservatism is vigilance that guards the balance sheet from having assets overstated and protects the income statement from having income overstated.

Situations arise in Accounting where different equally objective methods are available to account for transactions – Conservatism requires that the method to be used is the one that decreases the asset most or increases expense most.

### **Here is an example:**

Until recent years, telecommunication companies used a lot of large bundled copper cable in downtown cities to provide telephone lines for large businesses. These huge cables had an estimated useful life of 40 years, and were depreciated on that basis. But change happened - changes in technology; and demand changes by businesses, such as the need for broadband services. Because of this, telecommunication companies foresaw that much of the copper cable would be replaced by fibre optic cable long before the end of the useful life of the copper cable. Therefore the useful life of the cable was significantly reduced in the depreciation calculations. This had the affect of considerably reducing the value of the asset “cable” and increased expense; thereby reducing net income.

The fact is that the cable does have a 40 year useful life, but Conservatism requires entries to be made to reduce the asset value and increase expense.