Generally Accepted Accounting Principles (GAAP) & Basic Accounting Concepts

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- ✶ Introduction to GAAP
- ✶ Need for Accounting Principles
- ✶ Characteristics of Accounting Principles
- ✶ Accounting Concepts & Conventions

Introduction to GAAP

Generally Accepted Accounting Principles (GAAPs) are a set of basic rules and procedures prescribed by the Institute of Chartered Accountants of India (ICAI) which have to be followed while preparing financial statements. These are the accounting principles, concepts and conventions which ensure that financial reporting is transparent and consistent from one organisation to another. The management and the auditors are bound by the Companies Act of 2013 to follow GAAPs.

According to The American Institute of Certified Public Accountants "*Principles of Accounting are the general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice*"

Need For Accounting Principles

The basic objective of accounting is to communicate information about the financial well-being of an enterprise to the users of the financial statements. As the accounting principles and assumptions followed across various enterprises are different due to biases and difference of opinion between the accountants.

This gives rise to the need for a set of universally accepted guidelines and rules which help in making financial results of various enterprises comparable across industries and time period. In today's dynamic environment the needs and expectations of businesses from accounting keep on changing, hence the accounting principles have to be developed and changed according to the needs of business.

Characteristics of Accounting Principles

1. ***Flexible in Nature*:** As we know businesses operate in a dynamic environment and in order to keep up with the ever changing needs of the business world and economy, the principles of accounting must be flexible in nature.

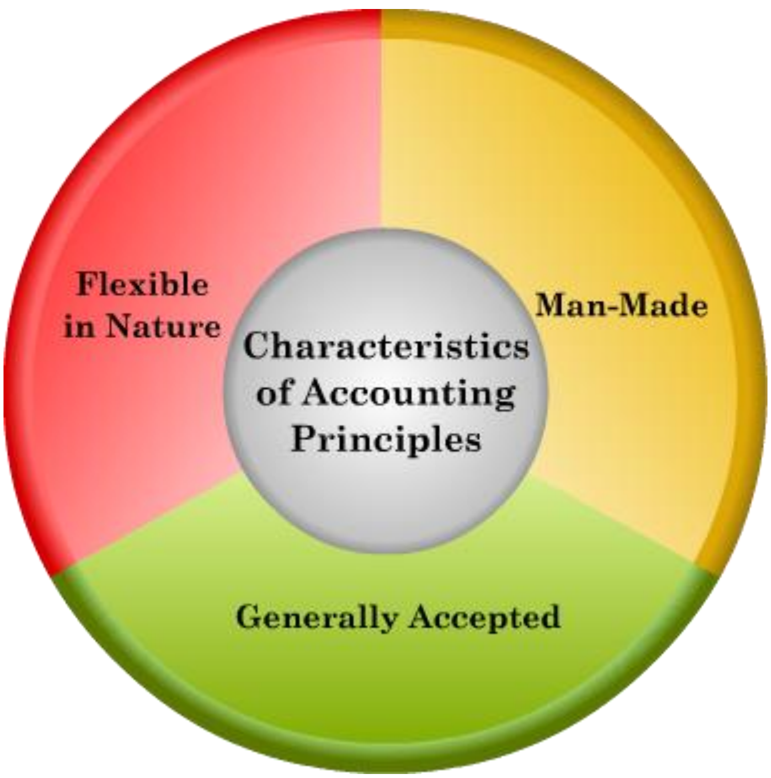
2. ***Man-made*:** These principles have been developed by accountants and academicians over a long period of time through continuous application, while adapting to the ever changing needs of the businesses.

3. ***Generally Accepted*:** These principles are universally accepted, free from personal bias. In order to be universal in character three basic criteria should be fulfilled which are as follows :

   a. Usefulness

   b. Objectivity and

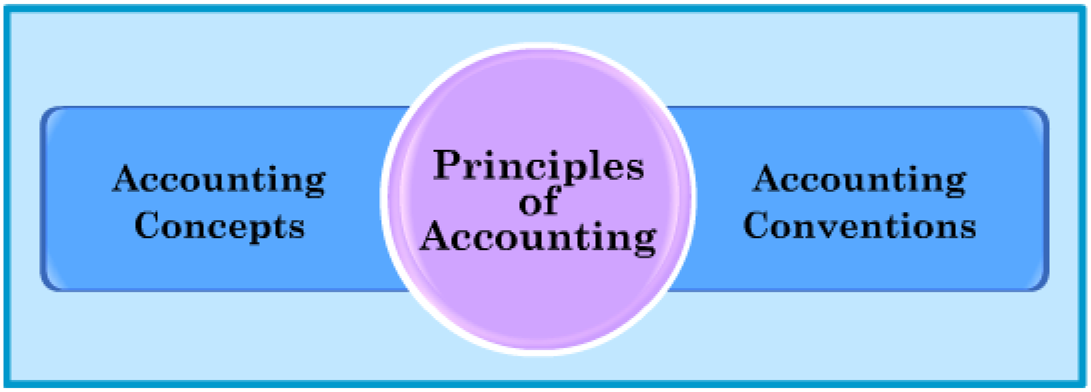
   c. Feasibility



Accounting Concepts and Conventions

1. ***Accounting Concepts*:** These are the basic propositions and fundamental assumptions on which accounting operate. Financial statements are prepared and transactions are recorded on the basis of these generally accepted rules of accountancy. By following accounting concepts we can ensure that the users of such financial statements are better able to understand and compare the financial statements.

2. **Accounting Conventions:** Accounting conventions are the customs and traditions that guide an accountant while preparing the financial statements. These are those guidelines that have been arrived at after years of practice and will change in case of change in environment. These are not legally binding on an accountant but are just generally accepted practices.



Fundamental Accounting Assumptions

Objectives

After going through this lesson, you shall be able to understand the following Fundamental Accounting Assumptions.

- Going Concern
- Consistency
- Accrual

Let us first understand the meaning and importance of these fundamental accounting assumptions with the below video.

Going Concern

Going concern is the basic underlying assumption of accounting. Financial statements are prepared assuming that the business is a going concern i.e. the company intends to continue the business and will be able to do so. In short, it means business will continue indefinitely.

The business will continue operating and will not close but will realise assets and discharge liabilities in the normal course of operations.

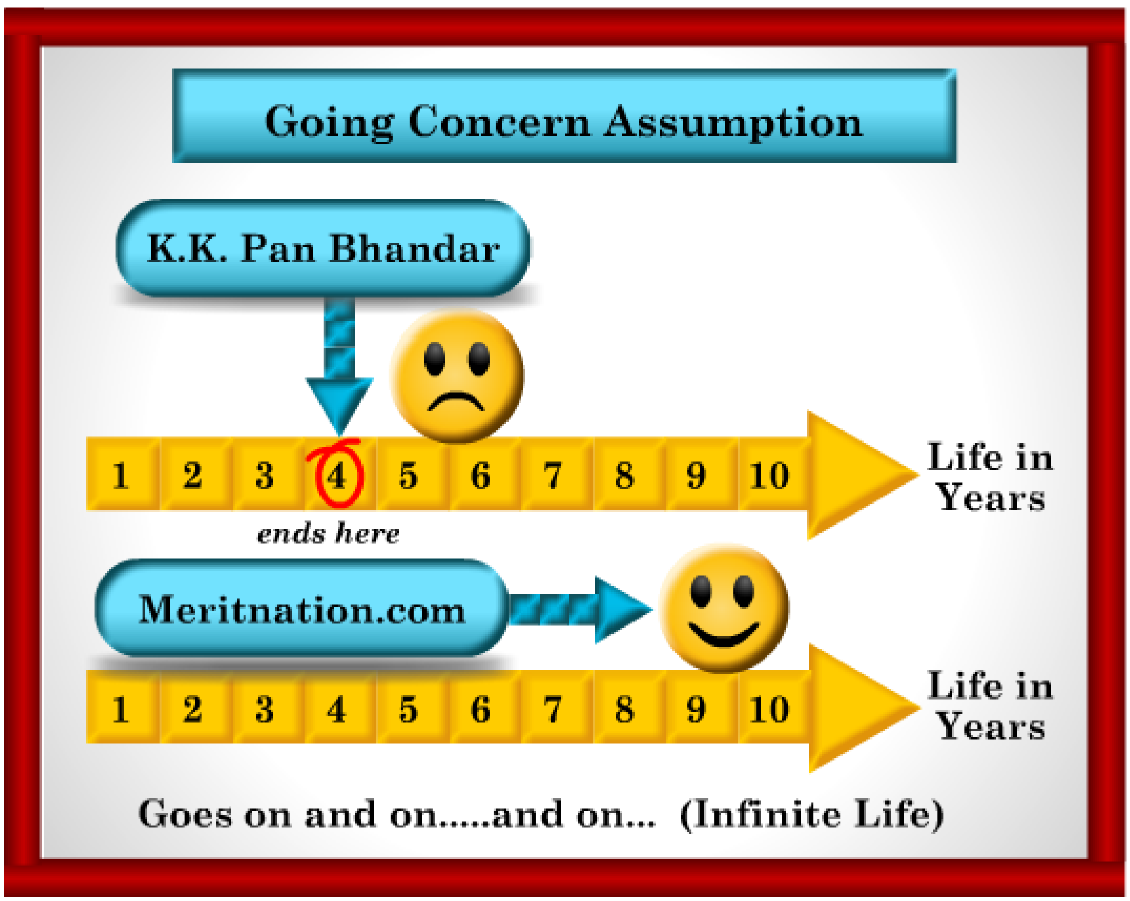
<u>Examples</u>

1. A nationalized company is in cash flow problems but the government of the country provided a guarantee to the company to help it out with all payments, the company is a going concern despite poor financial position.

2. An insurance company is in serious financial troubles and the government is not willing to bail it out. The Board of Directors have passed a resolution to liquidate the business. The insurance company is not a going concern.

3. An oil and gas firm operating in Sudan is stopped by a Sudanese court from carrying out operations in Sudan. The firm is not a going concern in Sudan, because it has to shut down.

4. A manufacturing company has a current ratio below 0.5. A creditor $1,000,000 demanded payment which the company could not make. The creditor requested the court to liquidate the business and recover his debts and the court grants the order. The company is no longer a going concern.



Consistency

The convention of consistency means accounting practices once adopted must be applied consistently in future. An accurate presentation and comparison of financial position of an enterprise over a period of time can only be made if the accounting policies so followed are consistent over the years.

But the concept of consistency does not mean the business cannot change to a better method or presentation, the methods can be changed according to the requirements of business but the fact of such changes must be disclosed with reason in the financial statements.

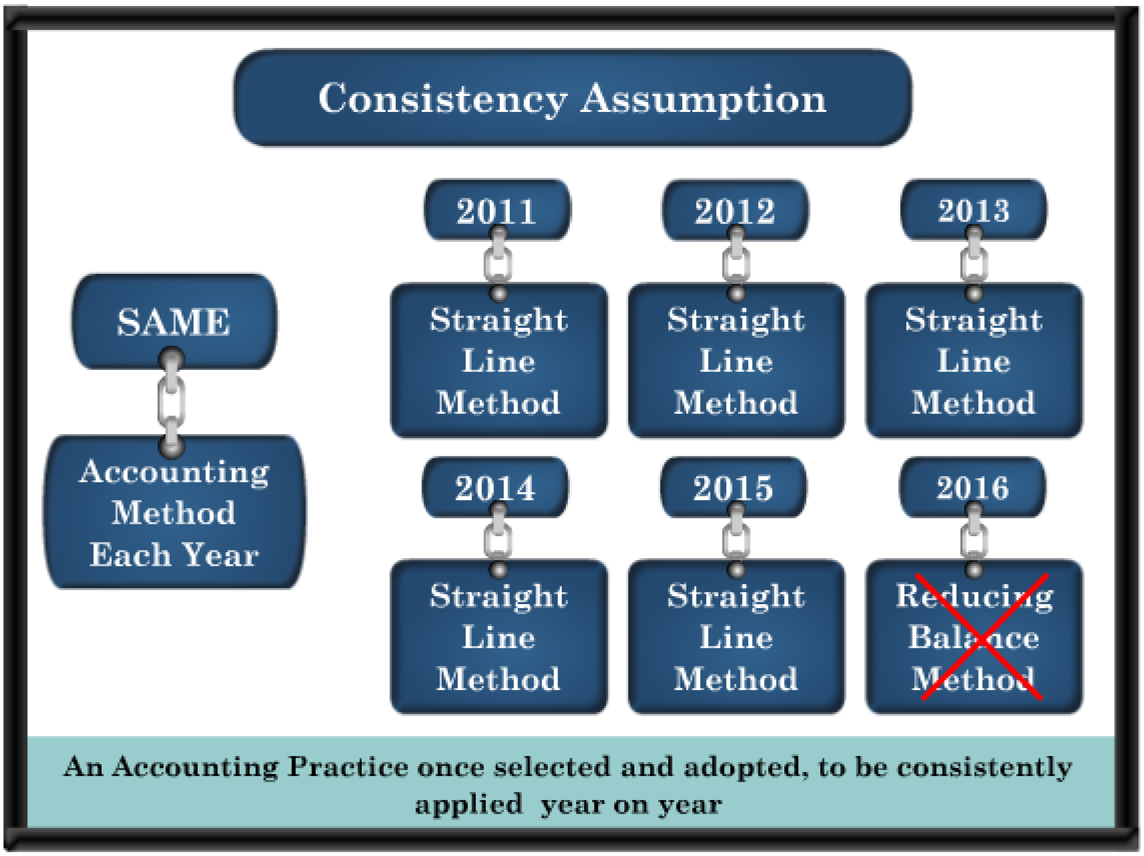
<u>Examples</u>

1. Mr. Y is a garment retail trader. He uses Last-in-first-out method of inventory valuation in respect of stock at Retail outlet A and First-in-first-out inventory valuation method in respect of stock at Retail outlet B.

   In such a situation, if there is no valid reason for the different treatment of same stock located at different retail outlets, Mr. Y has to use any one of the valuation methods consistently for all stock.

2. Company X has been using Written down method for charging depreciation on Furniture. By applying consistency concept the company shall continue to use Written down method of depreciation in respect of Furniture in the following periods.

   In case company X wants to switch to some other method of charging depreciation, say straight line method, it must mention in its financial report, the reason for such change, the nature of the change and the effect of such change and other similar items.



Accrual

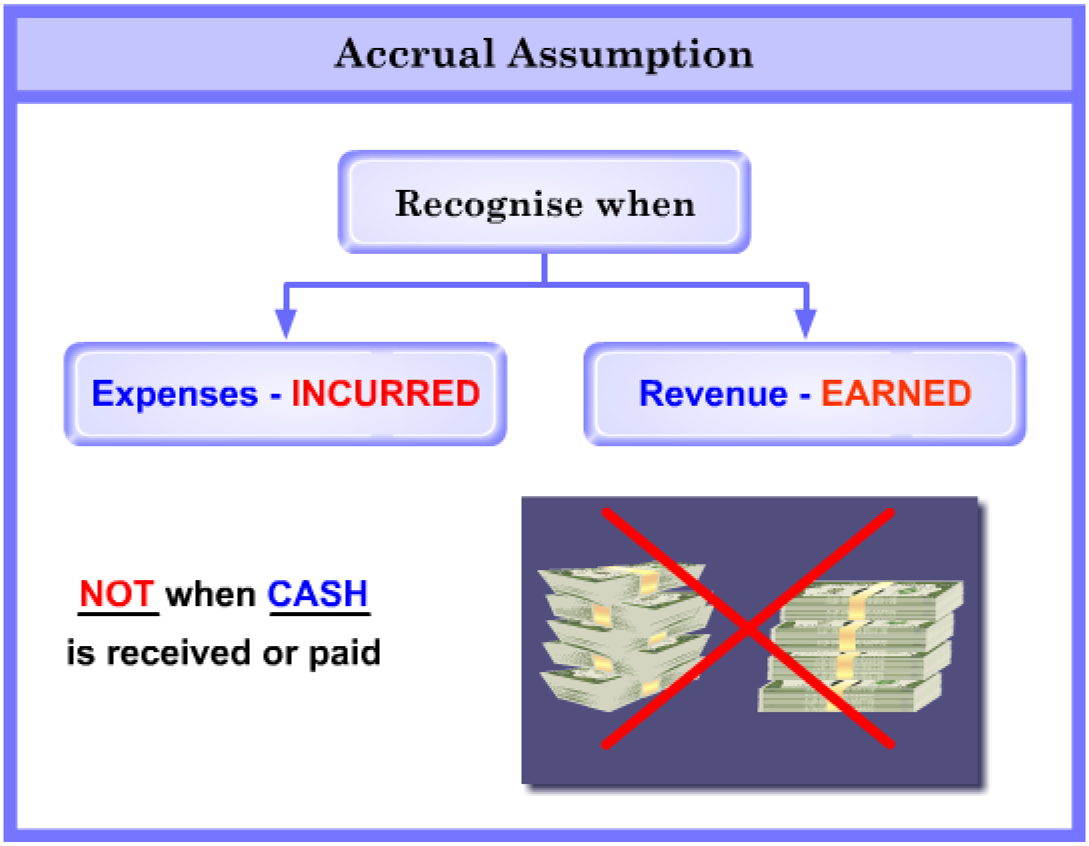
According to the accrual concept, a business transaction is recorded as and when it occurs and not when payment for the same is received/made. The sale from any transaction is recorded under this concept i.e. when the sale actually occurs and not when the payment for the same is received; similarly in case of an expense the transaction is recorded when the expense is incurred and not when payment for the same is made.

Examples

1. A Company records its electricity bills when it receives the bills, not when the payment for the same is made, as electricity service has already been provided to the company. In such a case, the company has to ignore the date on which the payment is being made.

2. A Mumbai based Law firm has obtained its premises on rent and has paid Rs 1,20,000 on 1st October. The premises has not been put to use yet so it hasn't recorded this payment. A half yearly report is prepared on 31st March, the firm expensed out six months' rent i.e. 60,000 [Rs 1,20,000/12*6] because time equivalent to 6 months has expired.

3. Air Asia sells its tickets days or even weeks before the actual flight date, but it does not record the receipts as revenue as the flight being the event on which revenue is based has not occurred till date.



Principles and Concepts of Accounting

Objectives

After going through this lesson, you shall be able to understand the following Principles & Concepts of Accounting.

- Business Entity Concept
- Money Measurement Concept
- Prudence or Conservatism
- Dual Aspect or Duality
- Matching Concept
- Historical Cost Concept
- Accounting Period Concept
- Full Disclosure Principle
- Materiality Concept
- Objectivity Concept
- Revenue Recognition or Realisation Concept

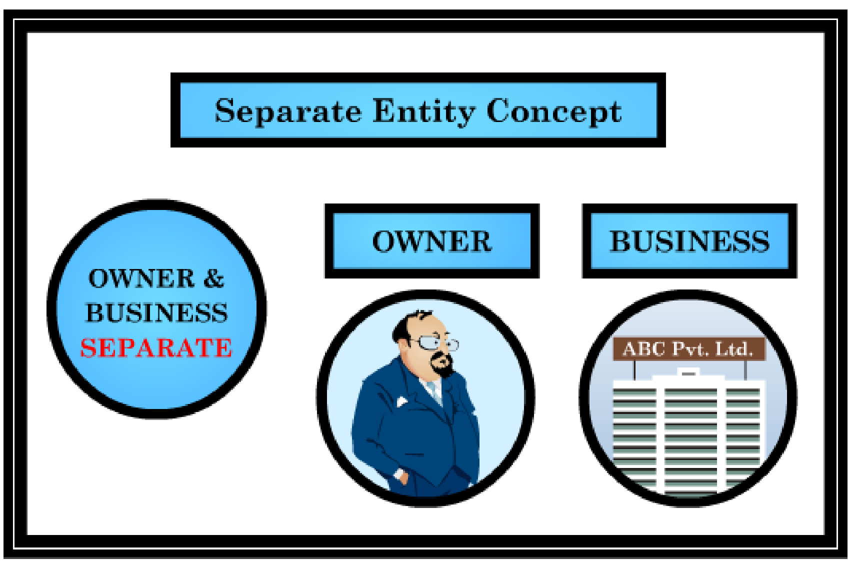
Business Entity Concept
According to the business entity concept, a business is a separate entity from its owners. This basically means that personal transactions of the owners of the business are to be treated separately from the business transactions. While preparing accounts of any form of organisation be it Sole Proprietorship, Partnership, Company etc. we have to always treat the personal transactions of the owner as separate from the business transactions.

<u>Examples</u>

1. Mr. A, a lawyer has 5 rooms in his house, which he has rented for Rs 50,000 per month. He decided to start his own practice for which he decided to use one of the rooms. According to the business entity concept, only 1/5th of the rent i.e. Rs 10, 000 should be charged to business, as the other 4 rooms are used for personal purposes.

2. Mr. A has to pay membership fees of Rs 1,000 per month to Bar Council of India; he paid the same through his personal account. In such a situation the same has to be considered as his additional capital.

3. Mr. A received a telephone bill of Rs 2,500. The full amount was paid through his business account. Rs 2,000 are considered as drawings as only Rs 500 (1/5th) is related to his business and the remaining Rs 2,000 is for his personal reasons.

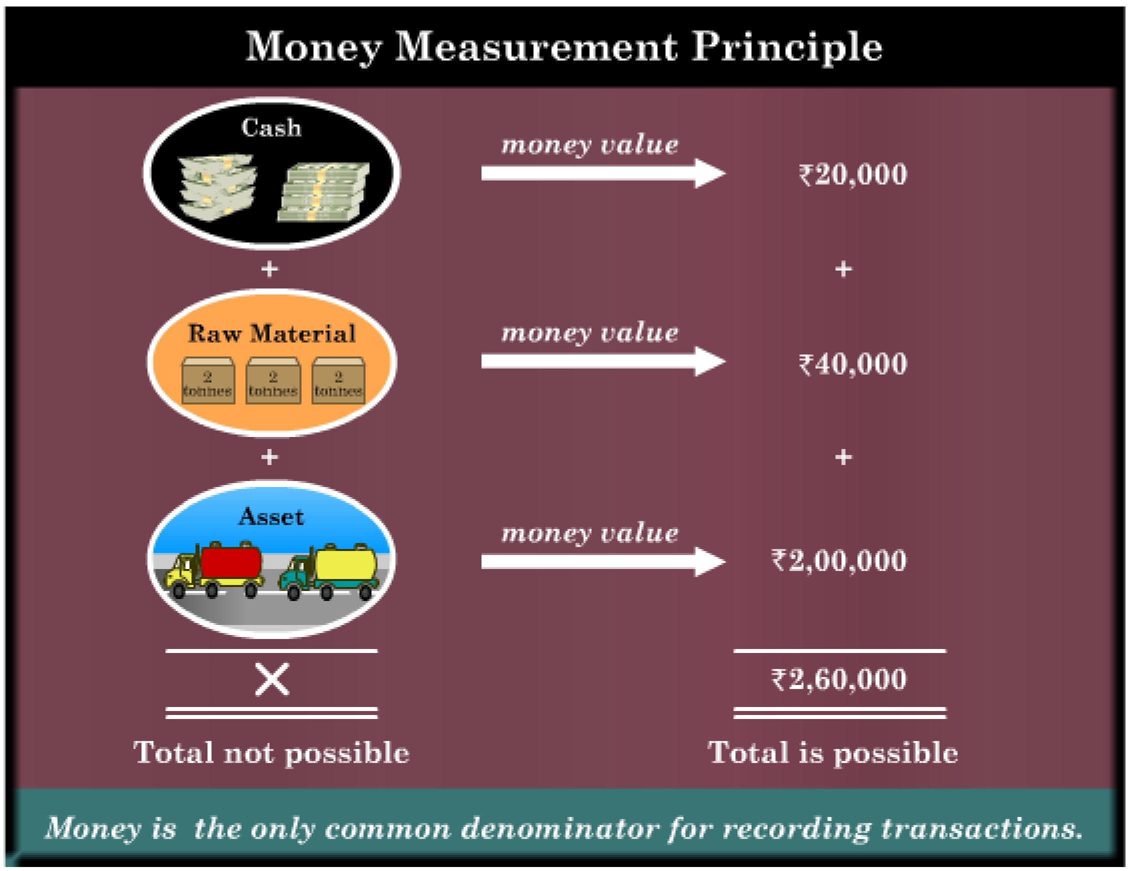


Money Measurement Concept
According to the money measurement concept, only the transactions that are measurable in money terms are to be recorded in the books of accounts of the business. On the other hand, those transactions that are not measurable in monetary

terms are to be left out of record. There are two inherent limitations in this concept which are:

1. Items that cannot be expressed in terms of money cannot be recorded as accounting transactions. For example, employee skill level, working conditions, loyalty of customers, employee morale etc.

2. Money is assumed to have static value across the years but this doesn't hold good as the value of money keeps on changing day-by-day.



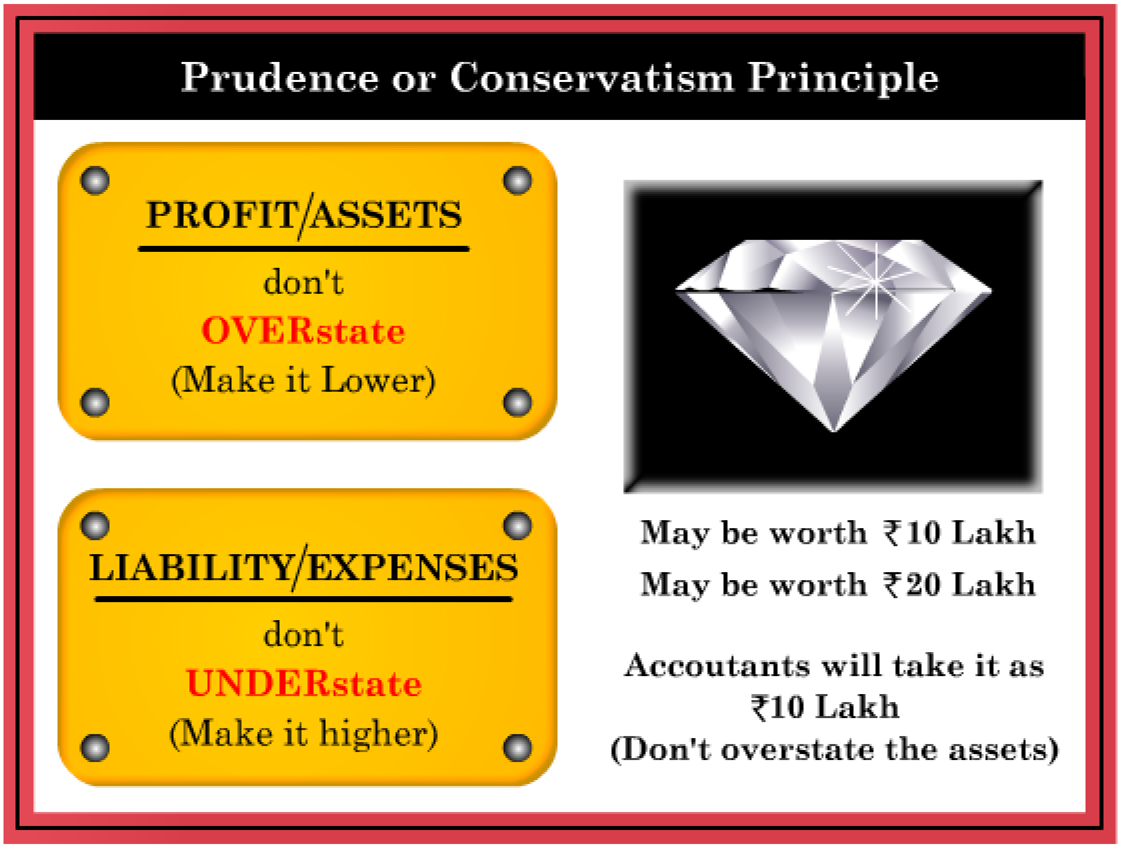
Prudence or Conservatism

While preparing accounting statements we make use of estimates as certain accounting data might be uncertain but it is important to disclose the same in order to present a true and fair view of actual position of the business. While making such estimates an accountant has to be prudent or must have a conservative outlook regarding the same. The concept of Prudence states that "One shall not anticipate profit but shall always provide for all prospective losses". This makes sure that the assets and incomes are not overstated, while liabilities and losses are not understated.

<u>Examples</u>

1. Bad debts are bound to occur in any form of business. Due to the principle of prudence we make provision for bad debts which helps a business show its current position.

2. The value of assets is checked from time to time to make sure that their book value is not much different than their actual market value. In case of fixed assets, if the actual market value is very low then the assets have to be impaired.

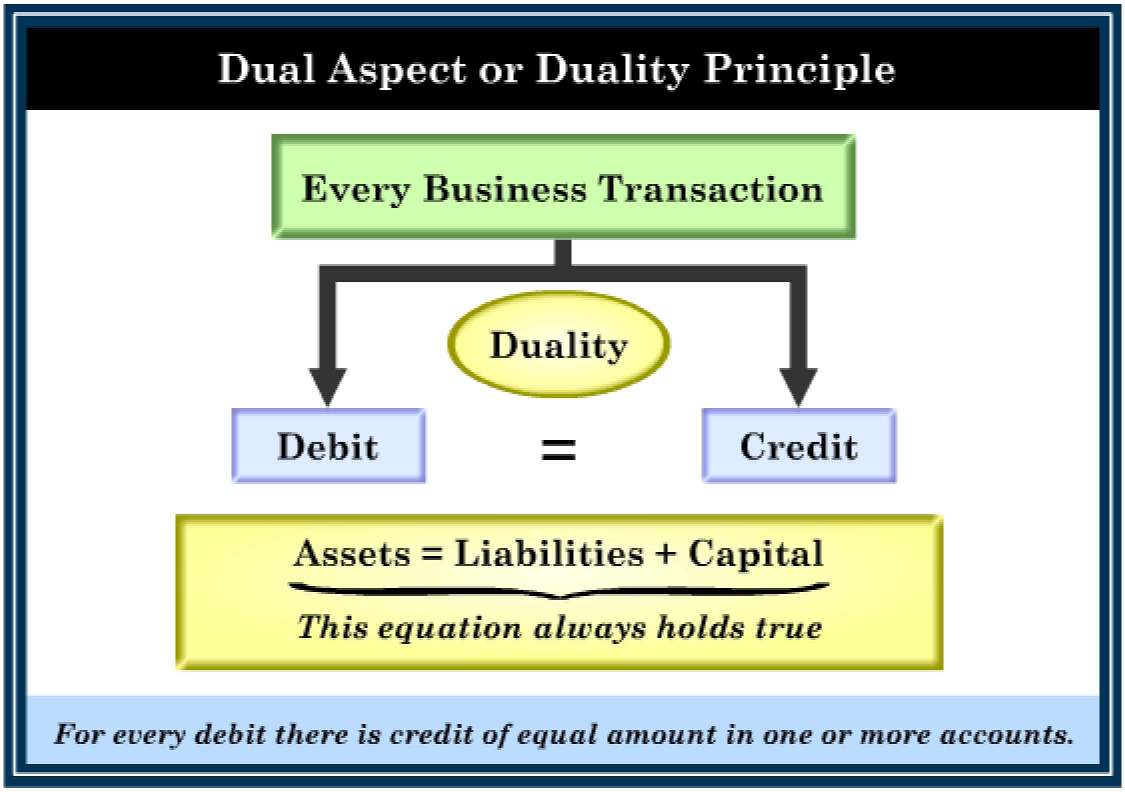


Dual Aspect or Duality
This concept states that every financial transaction has two fold effects. These two aspects always have equal effect. In simple terms we can state that for every debit there exists a credit.

For example, Mr. A started his business with an amount of Rs 1,00,000; this will result in- an increase in the cash balance on the asset side by Rs 1, 00,000. Due to operation of duality, the owner’s equity or capital will also increase by an equal amount. We can observe here that the two items that got affected are cash and capital account.
In a similar way, let’s suppose Tom bought goods worth Rs 50,000 on credit then on one hand his assets will increase by Rs 50,000 while on the other hand his liabilities will also increase by Rs 50,000.

Hence the duality principle can be expressed in terms of fundamental

Accounting Equation which can be written as follows: **Assets = Liabilities + Capital**



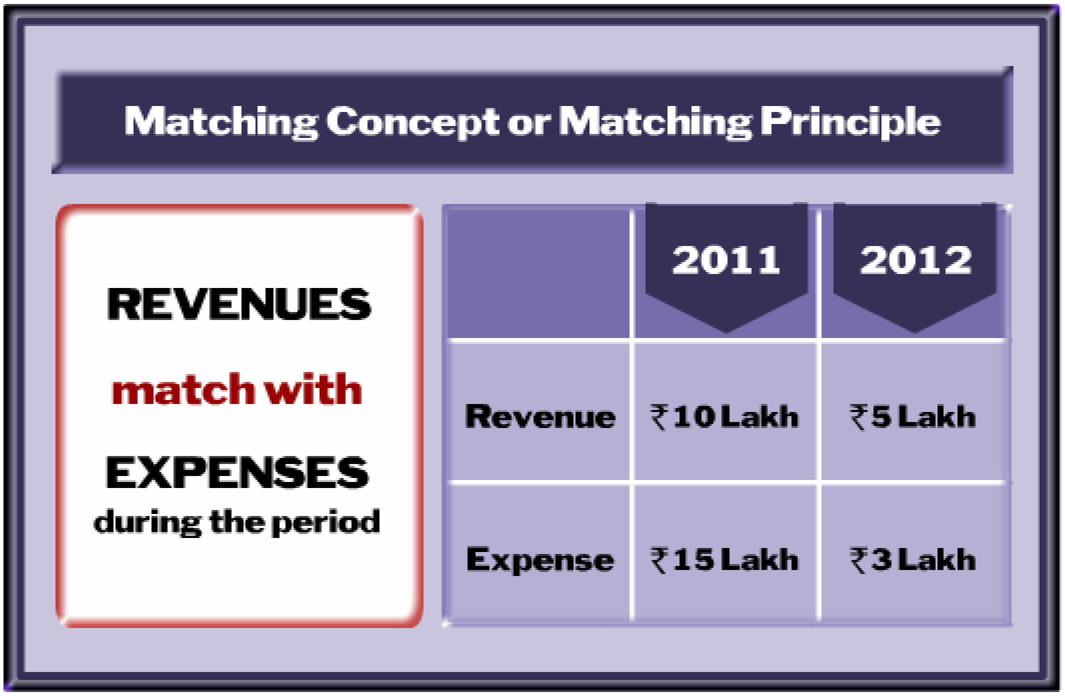
Matching Concept
According to the matching principle, the expenses which have been incurred to earn revenue shall be recorded in the same accounting period during which such revenue is recognised and not in the next or previous accounting period.

<u>Examples</u>

1. Sales worth Rs 5,00,000 is made in 2012. Total Inventory worth Rs 2,50,000 were purchased, of which Rs 50,000 remained in hand at the end of 2012.

   Rs 2,00,000 [i.e. Rs 2,50,000 minus Rs 50,000] is the cost of earning revenue worth Rs 5,00,000 and this 2,00,000 shall be recorded in 2012 resulting in gross profit of Rs 3,00,000.

2. A Law Firm pays Rs 50,000 per month as salary to each of the 4 lawyers employed by it. Rs 2,00,000 worth of monthly salaries must be matched with the revenue generated say Rs 4,00,000.



Historical Cost Concept
As discussed till now, accountancy relates to past events and the basic objective of preparation of financial statements is to enable comparability of financial data and consistency in adoption of financial policies. In order to achieve the above objectives the transactions shall be recorded on historical cost. In case in the subsequent period there is an increase in the value of the assets then the same shall not be recorded in the books of accounts.

<u>Examples</u>

1. In May 2013, 1000 units of inventory were purchased by Mr. X for Rs 10 per unit, in June 2013 the value of Inventory rose to Rs 12 per unit. According to the historical cost concept, the inventory shall appear at Rs 10,000 not at Rs 12,000.

2. XYZ Ltd. developed ERP software at a cost of Rs 25,00,000, while the benefit that can be derived out of the same is Rs 75,00,000. In such a situation, we will recognise Rs 25,00,000 in the Balance sheet as the cost of ERP and not Rs 75,00,000.

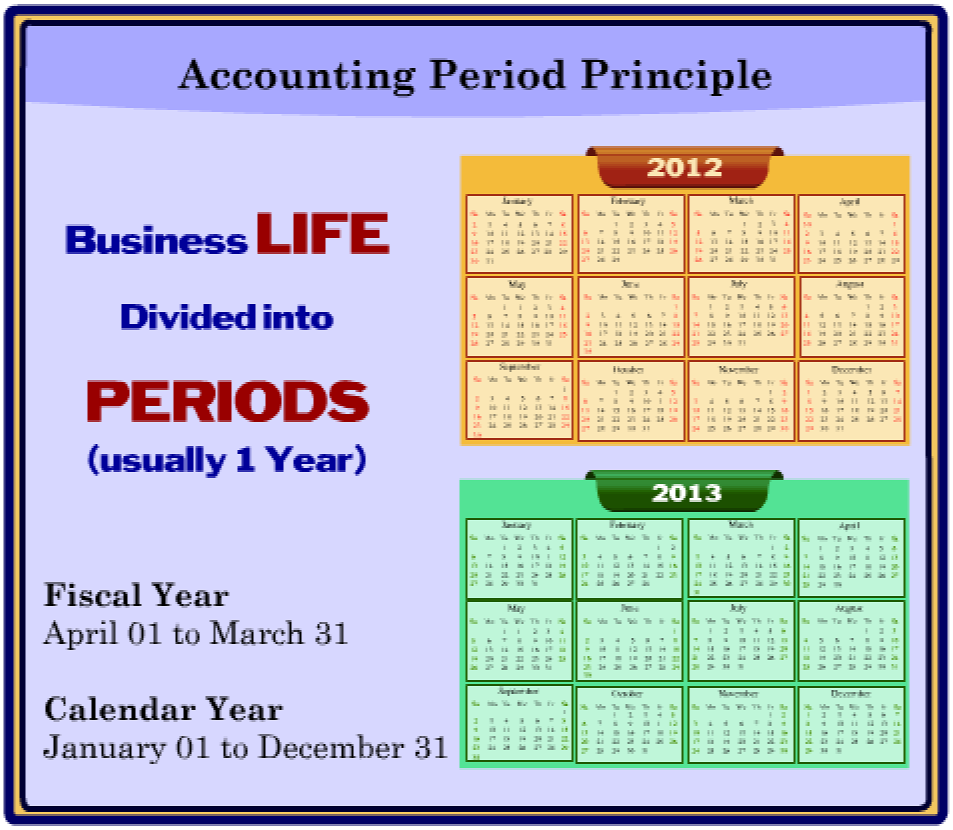
Accounting Period Concept

Even though a business is assumed to continue forever (going concern assumption) but it is necessary to keep accounts in such a way that the results are known at frequent intervals. This time interval is known as “Accounting Period”. While accounting periods might vary in terms of reporting dates but they must be consistent.

The various users of accounting information require financial information at regular intervals, so we cannot wait for the liquidation of the company for the preparation of financial statements. Hence, as per the accounting period concept the financial statements are prepared at regular interval of time.

<u>Examples</u>

1. XYZ Ltd. refused to prepare books of accounts for the year ended 31 March 2013 saying that according to the concept of going concern its business is never ending entity and it shall go on forever so it shall not prepare the accounts. But, Mr. B clarified this doubt of XYZ Ltd. by quoting the Accounting Period Concept, thus XYZ Ltd. has to prepare its books of accounts for the year ending 31 March 2013.



Full Disclosure Principle
According to the principle of full disclosure, the financial statements shall disclose all material facts either on the face of it or in the notes to accounts. Full disclosure principle is of great relevance to materiality concept. Even though the provisions of Companies Act, 1956 has made many disclosures mandatory for the companies but still there are several ways in which the businesses can make better disclosure.

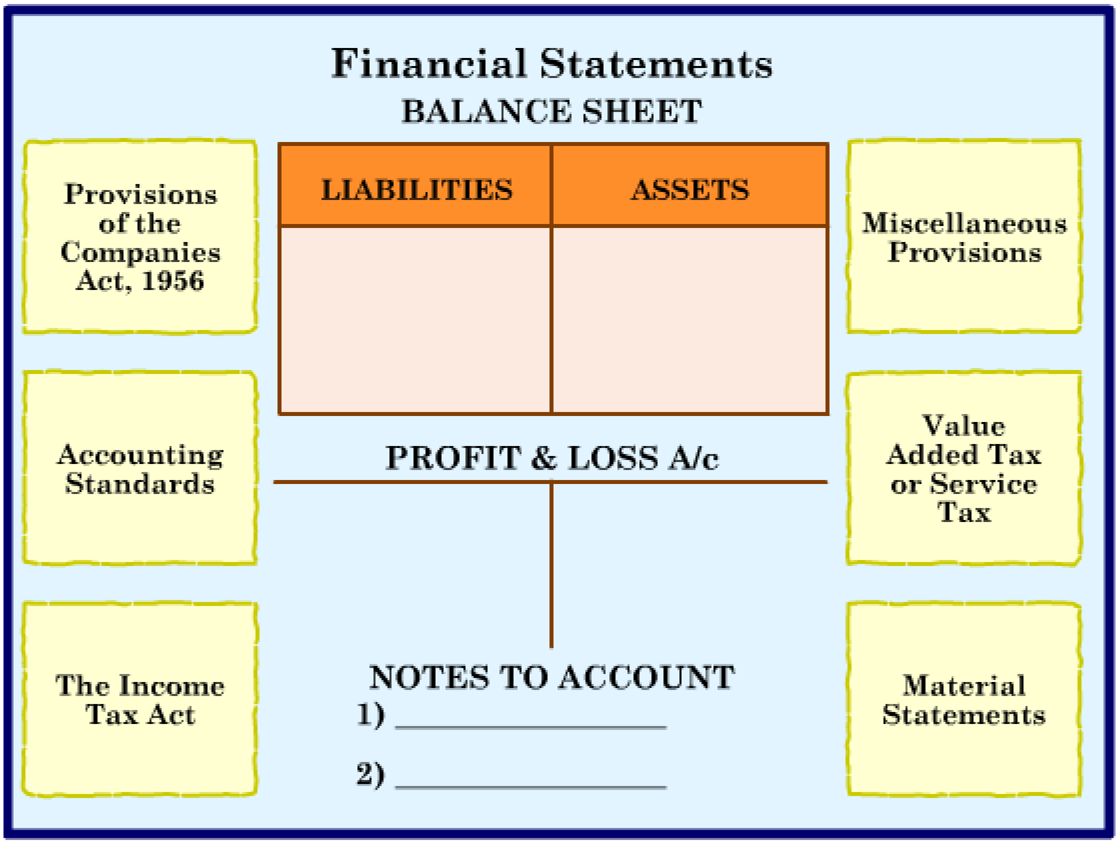
Examples

1. A business shall disclose all its accounting policies in order to help the users of financial statements to better understand the financial reports.

2. Contingent liabilities, contingent assets and other legal obligations etc. must be disclosed in the financial statements so that it helps the users to make an informed choice.

3. Events that have occurred after the preparation of financial statements but before the issue of financial statements are to be disclosed in the financial statements.

4. ABC Ltd sold one of its subsidiaries G Ltd to Mrs. A (director Mr. A’s wife), then such information should be disclosed in the financial statements.



Materiality Concept

The main aim of preparation of financial statements is to enable the end users of the financial statements in making informed decisions. Thus, all such information which has the ability to affect the end users decisions is material in nature and must be disclosed in the financial statements.

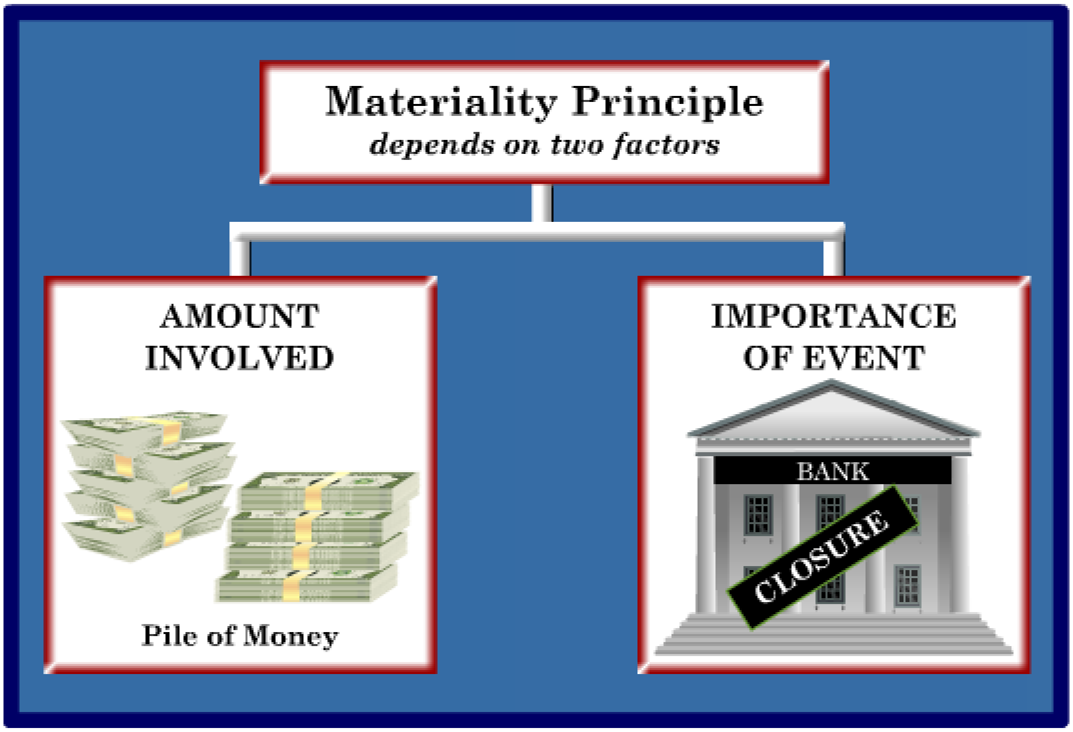
The decision whether information is relevant or not involves an element of judgement. This depends on two factors i.e. the amount involved or importance of the event.

<u>Examples</u>

1. XYZ Ltd Company is involved in exploration of gold mines in Zambia, the government of Zambia has passed a new legislation that will place a ban on export of gold from the country that will seriously jeopardise the future prospects of the company. In such a case, this being material information shall be disclosed in the financial statements of XYZ Ltd.

2. The remuneration paid to the directors and key employees shall be disclosed in the financial statements as this is a material figure for various stakeholders.

3. The various accounting policies employed by organisations must be disclosed in the financial statements in order to enable a better understanding of financial position of the company.



Objectivity Concept
According to the objectivity principle, the accounting should be free from personal bias. That is, the accounting transaction should be supported with written documents such as cash memo, invoices etc. It basically means that the accounting entries shall be based on facts rather than being open to interpretation, as interpretations are nothing but opinions.

<u>Examples</u>

1. Mr. X bought a plot of land 5 years ago for Rs 20,00,000. Today, he gets the valuation of plot done from 5 different valuators who all are experts in their field. But, at the end of the day they are giving an opinion only on the value of land which is subjective. The only thing objective here is the value of land 5 Years ago i.e. Rs 20, 00,000 and the same should be taken into consideration.

2. Miss A is an accountant responsible for auditing the accounts of XYZ Ltd. She asks for invoices and other documents to support the purchases and sales. XYZ Ltd requests her to take the numbers as given as it will involve too much work for them to search for related documents. Subsequently, she took the totals as given violating the objectivity principle because financial statements must be based on verifiable and reliable documents and not on someone’s opinion or interpretation.

Revenue Recognition or Realisation Concept
According to the concept of revenue recognition, revenue is to be recognised only when rewards and benefits associated with the items sold and services provided are transferred i.e. when the right to receive money is established. In other words, at the point where the seller has completed his part of the transaction.

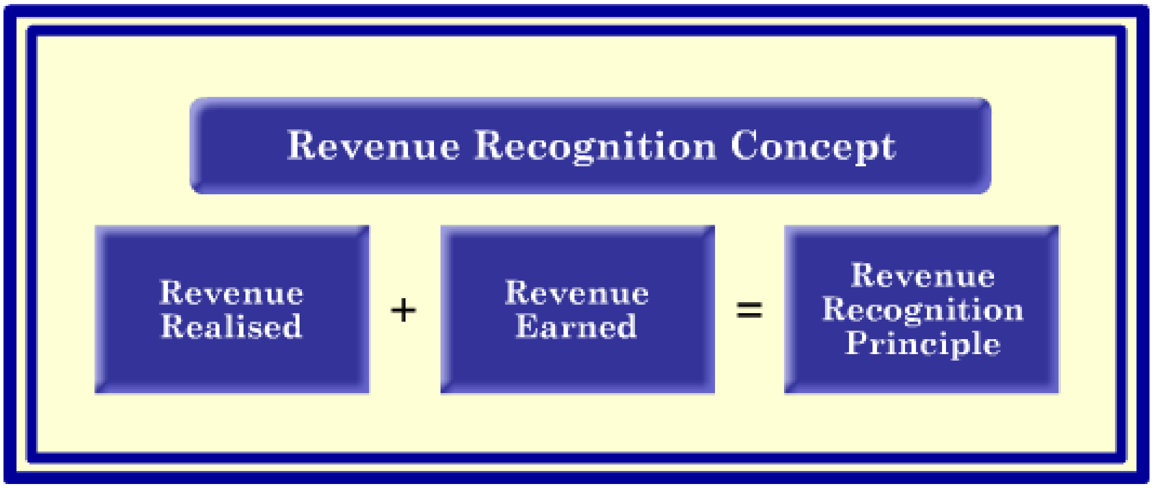
It is to be noted that receipt of revenue and receipt of an amount are two distinct aspects.

<u>Examples</u>

1. When Vodafone sells you the talk time through scratch cards, it does not recognise the revenue when the scratch card is sold, but it is recognised when the subscriber makes a call and consumes talk time.

2. India Today Receives an annual subscription of Rs 240 from Mr. X during the beginning of the year but it recognises revenue worth Rs 20 (i.e. Rs 240/12) each month.

3. Star Sports recognises the revenue when the advertisement is actually aired. That is, it does not matter whether the payment is received in advance or after the broadcast of advertisement.


Revenue Recognition Concept
Revenue Realised
+
Revenue Earned
=
Revenue Recognition Principle