

# Generally Accepted Accounting Principles (GAAP) and Basic Accounting Concepts

## MEANING OF KEY TERMS USED IN THE CHAPTER

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| <p><b>1. Generally Accepted Accounting Principles (GAAP)</b></p> | Generally Accepted Accounting Principles are basic or fundamental propositions based on which transactions and events are recorded in the books of account and financial statements are prepared. |
| <p><b>2. Fundamental Accounting Assumptions</b></p>              |   |
| <p><b>(i) Going Concern Assumption</b></p>                       | Under this assumption, it is presumed that the business will continue for a foreseeable future and there is no intention to close down the business or scale down its operations significantly.   |
| <p><b>(ii) Accrual Assumption</b></p>                            | Under this assumption, a transaction is accounted at the time when it is entered into and not when settlement takes place.  |
| <p><b>(iii) Consistency Assumption</b></p>                       | Under this assumption, accounting practices once adopted should be applied consistently year after year. They may be changed under following three conditions:                                    |
|  | (a) If law requires the change,   |
|  | (b) If Accounting Standard requires the change, or  |
|  | (c) If it results in more fair presentation of financial affairs of the business.   |

## CHAPTER SUMMARY

- **Accounting Principles.** Accounting is the language of business and every language has certain rules of grammar. Similarly, in order to understand accounting information and for maintaining uniformity and consistency, certain principles are needed in accounting.  
Accounting Principles are the norms or rules which are to be followed in treating various items of assets, liabilities, expenses, incomes, etc.
- **Generally Accepted Accounting Principles (GAAP)** refers to the rules or guidelines adopted for recording and reporting business transactions, in order to bring uniformity and consistency in the preparation and presentation of financial statements.
- **Accounting Concepts**
  - (i) Going Concern Concept.** The business will continue for an indefinite period and there is no intention to close the business or reduce its size of operations significantly.
  - (ii) Accounting (Business) Entity Concept.** Business is treated as a separate entity distinct from its owners.
  - (iii) Money Measurement Concept.** Transactions and events that can be expressed in money or in money terms are recorded in the books of account.

- (iv) **Accounting Period (or Periodicity) Concept.** Life of an enterprise is divided into time intervals which are known as **accounting periods**, at the end of which Income Statement and Position Statement are prepared to show the performance and financial position.
- (v) **Complete or Full Disclosure Concept.** According to this concept, the financial statements and accompanying notes should contain a complete disclosure of all significant financial information. Disclosure should be full, fair and adequate.
- (vi) **Revenue Recognition or Realisation Concept.** According to Revenue Recognition Concept, revenue is considered as earned on the date when it is realised. Revenue is generally recognised in case of sales of goods when an exchange between buyer and seller has taken place and the earning process of revenue is complete or virtually complete. Generally, revenue is recognised at the point of sales or rendering services.
- (vii) **Verifiable Objective (Evidence) Concept.** There must be objective evidence of transactions which are capable of verification.
- (viii) **Matching Concept.** Costs incurred during a particular period should be set out against the revenue of that period to ascertain profits.
- (ix) **Historical Cost Concept.** The underlying idea of Cost Concept is that the asset must be shown at its cost price, which is the cost of acquisition *less* depreciation.
- (x) **Accrual Concept.** This concept recognises revenues and expenses as they are earned or incurred respectively ignoring the date of receipt or payment.
- (xi) **Dual Aspect Concept.** Every transaction has two aspects: one aspect of a transaction is debited while the other is credited.
- (xii) **Materiality Concept.** Items or events having a significant effect need to be disclosed.
- (xiii) **Consistency Concept.** Accounting practices once selected and adopted should be applied consistently year after year.
- (xiv) **Prudence or Conservatism Concept.** Do not anticipate profits but provide for all possible losses.
- (xv) **Timeliness.** Provide the financial statements or information to users within a reasonable time.

The chapter introduces the students to:

- **Generally Accepted Accounting Principles (GAAP).** These principles are the basic or fundamental propositions based on which transactions are recorded in the books of account and financial statements are prepared.
- **Accounting Concepts**
  - > **Going Concern Concept.**

Under this concept, it is assumed that the enterprise will continue to operate indefinitely in future and there is no intention to close or scale down its operations significantly. It is because of this concept that assets are recorded at their historical value and depreciated every year.

Going Concern Concept along with Accrual Concept and Consistency Concept, is a fundamental accounting concept. It is recognised to be the fundamental accounting concept by the Accounting Standard-1, Disclosure of Accounting Policies.

It is presumed to have been followed. It means that while preparing the financial statements it is presumed to have been followed unless it is stated otherwise in the financial statements, *i.e.*, the enterprise is not a going concern. If the enterprise is not a going concern, the financial statements will be prepared differently than the regular financial statements.

➤ **Accounting (Business) Entity Concept.**

Under this concept, business is considered to be a separate entity from its owners. Transactions are recorded in the books of account from the point of view of the business and not from that of owners.

➤ **Money Measurement Concept.**

Under this concept, only those transactions and events are recorded in the books of account that can be measured in terms of money. Transactions and events that cannot be measured in terms of money such as quality of the staff, industrial relations, etc. are not recorded.

➤ **Accounting Period or Periodicity Concept.**

Under this concept, life of the business is broken into smaller parts (usually a year). Financial statements are prepared for the accounting period and communicated to the users.

➤ **Concept of Complete or Full Disclosure.**

Under this concept, there should be complete reporting of the financial statements of all significant information relating to the affairs of the enterprise that is understandable to the users.

➤ **Revenue Recognition or Realisation Concept.**

Under this concept, revenue is recognised when the transaction has been entered into and the obligation to receive the amount has been established. It is to be noted that recognition of revenue and receipt of amount are two separate aspects. For example, in a transaction for sale of goods, revenue is recognised when the title of the goods is transferred to the buyer and not before. Similarly, in a transaction for rendering service, revenue is recognised when the service has been rendered.

➤ **Verifiable Objective (Evidence) Concept.**

Objectivity means reliability, trust worthiness and verifiability means that the transactions and events are recorded in the books of account on the basis of evidence ascertaining the correctness thereof. In other words, it holds that recording of transactions and events should be free from personal bias. For example, sales is evidenced by sale invoices, purchases is evidenced by purchase bills and so on.

But, accounting is never free from personal bias because estimates have to be made. For example, useful life of an asset is estimated and depreciated over the estimated useful life. When an estimate is made personal bias always gets involved.

➤ **Matching Concept or Matching Principle.**

Under this concept, revenue earned and cost incurred to earn the revenue should be matched. It means when revenue is recognised all expenses incurred (whether paid or not) to earn the revenue should also be recognised. It also means that if recognition of revenue is not recognised, all expenses incurred in relation to that income are also not recognised as expense and is carried forward in the balance sheet as an asset. These expenses are recognised as expenses, *i.e.*, transferred to Profit and Loss Account in the year in which revenue is recognised.

There are expenses which are not directly associated with the revenue (for example, salary paid to staff). These expenses are recognised as expense in the year they are incurred because the benefit of such expenses expires with the expiry of the accounting year.

➤ **Historical Concept.**

Under this concept, assets are recorded in the books of account at the price that is paid to acquire (purchase) the asset. It includes all expenses incurred to make it ready for use. For example, cost of machinery will include purchase price, freight cost, octroi, installation expenses of machinery, etc.

➤ **Accrual Concept.**

Under this concept, transactions are recorded at the time when they take place and not when the settlement of the transaction takes place. Assuming the liability or recognising the asset and payment made or received are separate from each other.

Accrual Concept, along with Going Concern Concept and Consistency Concept, is a fundamental accounting concept. It is recognised to be the fundamental accounting concept by the Accounting Standard-1, Disclosure of Accounting Policies.

Accrual Concept is presumed to have been followed. It means that while preparing the financial statements it is presumed to have been followed unless it is stated otherwise in the financial statements, *i.e.*, the enterprise is not a going concern. If the enterprise is not a going concern, the financial statements will be prepared differently than the regular financial statements.

➤ **Dual Aspect Concept.**

According to this concept, every transaction has two aspects, a debit and credit aspect and the amounts under the two aspects are equal.

➤ **Materiality Concept.**

Under this concept, transactions are recorded in the books of account on the basis of materiality. An item is regarded as material if there is reason to believe that knowledge of it would influence the decision of an informed user.

➤ **Consistency Concept.**

Under this concept, accounting policies and practices once adopted and applied should be followed consistently year after year. However, it does not mean that accounting policies and practices once adopted and applied cannot be changed by the enterprise. Accounting policy may be changed under the following three situations:

- (i) If there is a change in law because of which accounting policy needs to be changed, or
- (ii) there is a change in the accounting standard, or
- (iii) the change will lead to better presentation and reporting.

Consistency Concept along with Going Concern Concept and Accrual Concept is a fundamental accounting concept. It is recognised to be the fundamental accounting concept by the Accounting Standard-1, Disclosure of Accounting Policies.

Consistency Concept is presumed to have been followed. It means that while preparing the financial statements it is presumed to have been followed unless it is stated otherwise in the financial statements, *i.e.*, the enterprise is not a going concern. If the enterprise is not a going concern, the financial statements will be prepared differently than the regular financial statements.

➤ **Conservatism or Prudence Concept.**

Under this concept, prospective losses are recognised (accounted) but prospective incomes are not. This concept is often described as *“Do not anticipate profits, but provide for all losses”*.

➤ **Timeliness.**

This concept requires that financial statements or information should be made available to the user within a reasonable time as the information not provided within reasonable time loses its importance and relevance.

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