Generally Accepted Accounting Principles (GAAP)

GAAP is the standard framework of guidelines for financial accounting. It includes concepts, conventions, assumptions, standards, etc. which the accountants follow in recording transactions and in preparing financial statements. These principles have been developed to ensure uniformity and easy understanding of the accounting information. When everyone follows GAAP, it results in accounting information which is consistent, reliable and comparable to earlier years and among business firms.

Accounting is a social science and not a natural science like physics or chemistry. Therefore, accounting principles are manmade and not as exact and rigid as that of natural sciences. Accounting principles are constantly evolving and are influenced by changes in economic, social and legal environment so as to keep the reporting of accounting information relevant to the current practices.

GAAP are the pillars on which the structure of accounting is resting. It is very essential that the accountants and the users of accounting information understand GAAP.

Discussion of various accounting principles in this chapter is divided into (i) Accounting concepts; (ii) Accounting conventions and (iii) Accounting standards.

ACCOUNTING CONC

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ACCOUNTING CONCEPTS

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Certain concepts are perceived, assumed and accepted in accounting to provide a unifying structure and internal logic to accounting process. The word concept means idea or notion, which has universal application. Financial transactions are interpreted in the light of the concepts, which govern accounting methods. Concepts are those basic assumptions and conditions, which form the basis upon which the accountancy has been laid. Unlike physical science, accounting concepts are only result of broad consensus. These accounting concepts lay the foundation on the basis of which the accounting principles are formulated.

Accounting Concepts

- Accounting entity
- Money measurement
- Going concern
- Cost concept
- Dual aspect
- Accounting period
- Matching concept

1. Accounting Entity Concept

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For accounting purpose, it is assumed that business has a separate existence and its entity is different from the person or persons who own it. The affairs of the individual behind a business must be kept separate from the affairs of the business. Accounting is done for the business entity as distinguished from the persons who own the entity. The best example can be taken of a sole trader or a one man business. A sole trader takes money from his business by way of drawings for his personal use. Despite it being his own business and apparently his own money, there are still two aspects of this transaction of drawings — the business is giving money and the individual is receiving money. This concept of accounting does not permit a businessman to intermingle his personal transactions with those of his business. In other words, entity concept requires that for accounting purposes, a distinction has to be made between personal transactions and business transactions.

This concept of a separate entity is applicable to all forms of business organisations — sole proprietorship, partnership, joint stock company, etc. Although for legal and many other purposes, sole traders and partners may not be distinguished from their respective business, yet for accounting purposes they are regarded as different entities.

2. Money Measurement Concept

Accounting records only those transactions or events which can be measured in terms of money and money means currency of the country, e.g. in India it is Rupee, in USA it is Dollar, etc. In other words, any event or transaction which cannot be expressed in terms of money is not recorded in the account books. For example, purchase of furniture, sale of goods, payment of wages and salaries, loss of goods by fire accident, etc. are all recorded in the account books because these can be expressed in terms of money. But there may be some events which are very important for the business enterprises but cannot be measured or expressed in money terms, and therefore, are not recorded in the books of account. For example, if the general health of the executive chairman of the company has suddenly deteriorated, if the company has improved the quality of its products, if the company has devised a new sales promotion policy, these cannot be expressed in terms of money and thus are not recorded in the books even though there events have financial implications.

The money measurement concept puts a serious handicap on the utility of accounting records and the users of accounting information should be aware that they do not get a complete picture of the business events.

3. Going Concern Concept

As per this concept, it is assumed that the business will continue to operate for an indefinite period of time in the future unless there is good evidence to the contrary. In other words, going concern concept means that business has continuity of life and there is no intention or necessity of liquidating the business in the near foreseeable future. When a business will continue in the foreseeable future, it implies that it will be able to meet its contractual obligations and use its resources according to its plans.

The significance of this concept can be better understood by comparing it with a possible alternative *i.e.*, the business is likely to be liquidated very shortly. If business is assumed to have a very short life, then its fixed assets like machinery, land and buildings etc. will be valued at their market value which may be much less or much more than their cost price. As against this, under the concept of going concern, the fixed assets are valued at cost less depreciation, because the market values are relevant only in the event of liquidation of business. This implies that it is due to going concern assumption that business assets are classified between fixed assets and current assets, whereby fixed assets are valued at cost minus depreciation and current assets (which have a short life) are valued at cost or market value, whichever is less.

The going concern concept provides a sound basis for proper measurement of profit. In the absence of this assumption, an accountant will be compelled to determine the current value of assets and liabilities every time he prepares financial statements.

4. Cost Concept

According to this concept, an asset is recorded in the books of account at the cost paid to acquire it. This cost is the basis for all subsequent accounting for this asset. For example, if a business buys a building at a cost of ₹ 20 lakhs, it will be recorded in the books at ₹ 20 lakhs. If the market value of this building at the time of purchase is ₹ 25 lakhs or say ₹ 15 lakhs, i.e. more or less than the price paid, it will be recorded at the actual cost of ₹ 20 lakhs and not at the market value. The rationale of cost concept is that cost price is objectively verifiable. As this cost relates to past, it is more correctly referred to as historical cost.

The cost concept does not mean that assets remain on the accounting record at their original cost. This actual cost figure is systematically reduced over its life by the process of depreciation. In future if the asset is sold, the profit or loss on sale would be calculated on the basis of cost price less depreciation.

5. Dual Aspect Concept (Accounting Equation Concept)

This is the very foundation of the universally applicable double entry book keeping system. It stems from the fact that every transaction has a twofold effect and this is called dual (or double) aspect or duality of a transaction.

In a business, the resources owned are called assets and the claims of various parties against these assets are called equities. According to this dual aspect concept, total assets must be equal to the claims of various parties against these assets. This has been earlier explained in the forms of an accounting equation as follows:

Assets = Equities

or   Assets = Capital + Liabilities

When a transaction takes place, it may change the total of assets and equities but their relative position remains unchanged.

In other words, every financial transaction behaves in a dual way. For example, when an asset (e.g. machine) is purchased, another asset (cash or bank) is simultaneously decreased. Similarly, when goods are sold, an asset (i.e. stock of goods) is decreased, but the asset of cash is increased.

6. Accounting Period Concept

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As per the going concern concept, a business is assumed to have an indefinitely long period of life. But the owner of the business cannot wait for such a long time for the determination of profit or loss from the operations of the business. Thus, there is felt a need to determine the profit or loss at regular intervals of time. This means accounting period concept is related to going concern concept.

The accountants generally choose some convenient segment of time, generally one year, for determining the amount of profit or loss. This segment of time is known as accounting period. The accounting period is defined as the interval of time at the end of which Profit and Loss Account and Balance Sheet are prepared. This accounting period may be also be of shorter or longer duration than one year. It may begin on any day of the year. For example, it may be from 1st Jan. to 31st Dec. or from 1st April to 31st March. In India, accounting period is of 12 months starting from 1st April each year. This is also required for tax purposes.

7. Matching Concept (Accruals)

In the ascertainment of profit/loss of a business during an accounting period, it is necessary that the revenues realised in the period should be 'matched' with the expenses of the same period on a comparable basis. In other words, when revenue is realised on goods sold during a period, all costs attributes to those goods should also be charged as expenses to that very period.

Thus revenues and the relevant expenses should be correlated and matched so that a clear picture is available. For example, 1,000 pens are purchased at a cost of ₹ 5 each and out of these 800 pens are sold at ₹ 6 each. What is the amount of profit? Since 200 pens are still unsold and in stock, the sale proceeds of only 800 pens (₹ 4,800) should be matched with the cost of 800 pens (₹ 4,000). The profit is thus ₹ 800 *i.e.* revenue of ₹ 4,800 – cost ₹ 4,000. But if sale proceeds are compared with the total purchases (₹ 5,000), it would show a loss of ₹ 200 which is not correct since 200 pens are still in stock and these will be sold later. This is the basic idea of matching principle.

ACCOUNTING CONVENTIONS

The term accounting conventions is used to signify customs or traditions as a guide to the preparation of accounting statements. These have emerged out of accounting practices over a period of time. Some of the important accounting conventions are discussed below:

1. Convention of Consistency

In accounting, varied procedures and methods prevail for recording the same transaction or event. This convention of consistency ensures that the same accounting method or procedure will be followed for similar items year after year. This helps to achieve comparability of the financial statements of an enterprise over the time. For example, depreciation on fixed assets may be provided by straight line method or written down value method or any other method. Each method has its own merits and demerits. The consistency convention requires that once a company has decided on one of these methods, it should treat the same event in all subsequent transactions in the same fashion. For example, if a company has adopted written down value method of depreciation, the same method must be used in all subsequent years and the method of depreciation should not be changed from year to year. If frequent changes are made in the manner of handling a given class of transactions in the accounting records, comparison of accounting figures of one period with that of the other period becomes difficult.

Accounting Conventions
- Consistency
- Conservation
- Materiality
- Full disclosure

This convention does not imply that once a particular method of accounting has been adopted then it cannot be changed. As stated earlier that accounting is a social science and therefore, desirable changes can be made in it once in a while whenever the circumstances so demand but not every now and then. Changes in accounting policy can also be made to comply with the provisions of law and also to make accounts in accordance with the Accounting Standards.

2. Convention of Conservatism (Prudence Convention)

Prudence means policy of playing safe and avoiding risks. Convention of conservatism implies financial prudence. This convention requires that while preparing accounts and computing profit/loss, the accountant should take into account the prospective or likely future losses but should ignore prospective profits. Convention of conservatism is often stated as, *"Anticipate no profits but provide for all probable losses"*. This convention makes provision for anticipated future loses but no provision is made for unrealized future profits. This means that this convention makes early recognition of unfavourable events so as to play safe. For example, valuation of inventory is at 'cost or market price, whichever is less'. This means that when value of inventory goes down in market, the inventory value would be written off to the extent of reduction in value. But if market value of inventory increases, the increase would not be recorded unless the profit is actually realised by selling the stocks. Examples of the use of this convention are:

(i) Making provision for bad and doubtful debts

(ii) Not providing for discount on creditors

(iii) Showing the joint life policy at surrender value

(iv) Valuing inventory at cost or market price, whichever is less.

(v) Create investment fluctuations reserve.

This conservatism convention is sometimes criticised on the ground that it may lead to window dressing, encourage accountants to create secret reserves (*e.g.* by creating excess provision for bad and doubtful debts). Thus, there is need to apply this convention with greater caution and care so that there is no understatement of income and wealth.

3. Convention of Materiality

This convention states that accounting should focus on only important and material information and should not waste resources in recording insignificant and irrelevant information. According to AAA (American Accounting Association), *"an item should be regarded as material if there is a reason to believe that knowledge of it would influence the decision of an informed investor."* The term materiality is in fact a subjective term and whether an item is material or not should be left to the discretion of the accountant. For example small items like pen, pencil, calculator, etc. are, no doubt, assets of the business in the technical sense. Every time pen or pencil is used, a part of the asset is used up. Theoretically, it may be possible to ascertain the depreciated value of the pen or pencil, but the cost of such computation and recording is so disproportionate to the utility of such computation that this exercise is not worthwhile. Therefore, such small items are shown as consumed on the date of their purchase and treat their cost as revenue expenses because this is not a material event. But this treatment is not extended to plant and machinery on which depreciation is provided year after year because time is a material item.

There is no exact line of separating material events from immaterial events. The decision depends upon judgment and the common sense.

4. Convention of Full and Fair Disclosure

The financial statements must disclose all the relevant and material information about the financial activities of a business enterprise in conformity with the generally accepted accounting principles. The information disclosed should be full, fair and adequate. Full disclosure implies that no information of substance should be omitted while fair disclosure means that accounting principles have been applied in a fair manner so that financial statements report true and fair view of the results of the business. Adequate disclosure means minimum set of information to ensure that anything which influences the decision of the user must be reported.

This convention is vigorously applied in the company form of business organisation because of separation of management and ownership. In pursuant of full disclosure, the companies Act has prescribed a format of Balance Sheet and Profit and Loss Account. All major accounting policies and other information are to be provided in the footnotes and annexes, etc. For example, in the Balance Sheet, the basis of valuation of assets such as inventory, investments, etc should be clearly stated. Similarly, change in the method of providing depreciation during the year, if any, must also be disclosed.