

# Theory Base of Accounting

**Meaning of GAAP:** Accounting principles, concepts and conventions are commonly known as Generally Accepted Accounting Principles (GAAP). These principles are the base of Accounting. Generally Accepted Accounting Principles (GAAP) refer to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity and consistency in the preparation and the presentation of financial statements.

## Fundamental Accounting Assumptions

**1. Going Concern Assumption:** This concept assumes that an enterprise has an indefinite life or existence. It is assumed that the business does not have an intention to liquidate or to scale down its operations significantly.

### Relevance:

1. Distinction is made between capital expenditure and revenue expenditure.
2. Classification of assets and liabilities into current and non-current.
3. Depreciation is charged on fixed assets and fixed assets appear in the balance sheet at book value, without having reference to their market value.

**2. Consistency Assumption:** According to this assumption, accounting practices once selected and adopted, should be applied consistently year after year. This will ensure a meaningful study of the performance of the business for a number of years. Consistency assumption does not mean that particular practices, once adopted, cannot be changed. The only requirement is that when a change is desirable, it should be fully disclosed in the financial statements.

**Relevance:** It helps the management in decision-making as they can compare the financial information of current year with that of previous years.

**3. Accrual Assumption:** As per Accrual assumption, all revenues and costs are recognized when they are earned or incurred. It is immaterial, whether the cash is received or paid at the time of a transaction or on a later date. e.g., if a credit sale (Credit for two months) for ₹ 15,000 is made on 15th Feb. 2019, then the revenue earned is to be recorded on 15th Feb. 2019, not on the date when cash is realized, i.e., after two months. In case of expenses, if at the end of the year, salary for two months is due but not paid, then the expenses of salary will be recorded in the current year in which the salary is due, not in the next year when it will be paid.

**Relevance:** Earning of revenue and consumption of a resource (expenses) can be accurately matched to a particular accounting period.

## Accounting Principles

**1. Accounting Entity:** An entity has a separate existence from its owner. According to this principle, business is treated as an entity, which is separate and distinct from its owner. Therefore, transactions are recorded and analysed, and the financial statements are prepared from the point of view of business and not the owner. The owner is treated as a creditor (Internal liability) for his investment in the business, i.e. to the extent of capital invested by him. Interest on capital is treated as an expense like any other business expense. His private expenses are treated as drawings leading to reduction in capital.

**2. Money Measurement Principle:** According to this principle, only those transactions that are measured in money or can be expressed in terms of money are recorded in the books of accounts of the enterprise. Non-monetary events like death of any employee/manager, strikes, disputes etc., are not recorded at all, even though these also affect the business operations significantly.

### Limitations:

1. It ignores the qualitative aspect e.g., efficient human resources (Assets), satisfied customers (Assets) and dishonest employees (liabilities).

2. Value of money (currency) is not stable.

To make accounting records simple, relevant, understandable and homogeneous, facts are expressed in a common unit of measurement i.e., money, which is not stable.

**3. Accounting Period Principle:** According to this principle, the life of an enterprise is divided into smaller periods so that its performance can be measured at regular intervals. These smaller periods are called accounting periods. Accounting period is defined as the interval of time, at the end of which the profit and loss account and the balance sheet are prepared, so that the performance is measured at regular intervals and decisions can be taken at the appropriate time. Accounting period is usually a period of one year.

**Relevance:**

1. This Assumption requires the allocation of expenses between capital and revenue.
2. Portion of capital expenditure that is consumed during the current year is charged to the Income Statement and the remaining portion i.e., the unconsumed portion is shown as an asset in the Balance Sheet.
3. As per the income tax law, tax on income is calculated on annual basis from 1st April to 31st March (Financial Year).
4. Timely decision for corrective measures can be taken by the management by using these financial statements.

**4. Full Disclosure Principle:** According to this principle, apart from legal requirements, all significant and material information related to the economic affairs of the entity should be completely disclosed in its financial statements and the accompanying notes to accounts. The financial statements should act as a means of conveying and not concealing the information. Disclosure of information will result in better understanding and the parties may be able to take sound decisions on the basis of the information provided. e.g., footnotes such as:

1. Contingent liabilities in respect to a claim of a very big amount against the business are pending in a Court of Law.
2. Change in the method of providing depreciation.
3. Market value of investment.

**5. Materiality Principle:** Disclosure of all material facts is compulsory but it does not imply that even those figures which are irrelevant are to be included in the financial statements. According to this principle, only those items or information should be disclosed that have a material effect and are relevant to the users. So, an item having an insignificant effect or being irrelevant to user need not be disclosed separately, it may be merged with another item. If the knowledge about any information is likely to affect the user's decision, it is termed as material information.

It should be noted that an item material for one enterprise may not be material for another enterprise, e.g., an expense of ₹ 50,000 is immaterial for an enterprise having sales of ₹ 100 crores but it is material for an enterprise with sales of ₹ 10,00,000.

**6. Prudence Principle:** According to this principle, prospective profit should not be recorded but all prospective losses should immediately be recorded. The objective of this principle is not to overstate the profit of the enterprise in any case i.e., do not anticipate any profits but anticipate for all possible losses. This concept ensures that a realistic picture of the company is portrayed. When different equally acceptable alternative methods are available, the method having the least favourable immediate effect on profit should be adopted. e.g.,

1. Valuation of stock at cost or realizable value, whichever is lower.
2. Provision for doubtful debts and provision for discount on debtors is made.

**7. Cost Principle:** According to this Principle, an asset is recorded in the books of accounts at its original cost comprising of the cost of acquisition and all the expenditure incurred for making the assets ready to use. This cost becomes the basis of all subsequent accounting transactions for the asset, since the acquisition cost relates to the past, it is referred to as the historical cost.

e.g., Machinery was purchased for ₹ 1,50,000 in cash and ₹ 20,000 was spent on the installation of machine, then ₹ 1,70,000 will be recorded as the cost of machine in the books and depreciation will be charged on this cost. If the market value of the machine goes up to ₹ 2,00,000 due to inflation, then the increased value

will not be recorded. This cost is systematically reduced year after year by charging depreciation and the assets are shown in the Balance Sheet at book value (cost - depreciation).

**8. Matching Principle:** According to this principle, all expenses incurred by an enterprise during an accounting period are matched with the revenues recognized during the same period.

The matching principle facilitates the ascertainment of the amount of profit earned or loss incurred in a particular period by deducting the related expenses from the revenue recognized in that period.

The following treatment of expenses and revenues are done due to matching principle.:

1. Ascertainment of Prepaid Expenses.
2. Ascertainment of Income received in advance.
3. Accounting of closing stock.
4. Depreciation charged on fixed assets.

**9. Dual Aspect Principle:** According to this principle, every business transaction has two aspects - a debit and a credit of equal amount. In other words, for every debit there is a credit of equal amount in one or more accounts and vice-versa. The system of recording transactions on the basis of this principle is known as "Double Entry System". Due to this principle, the two sides of the Balance Sheet are always equal and the following accounting equation will always hold good at any point of time.

$\text{Assets} = \text{Liabilities} + \text{Capital}$

e.g., Ram started business with cash ₹ 1,00,000. It increases cash in assets side and capital in liabilities-side by ₹ 1,00,000.

$\text{Assets (₹ 1,00,000)} = \text{Liabilities} + \text{Capital (₹ 1,00,000)}$

### **Bases of Accounting**

There are two bases of ascertaining profit or loss, namely: (1) Cash Basis, and (2) Accrual Basis.

**1. Cash Basis of Accounting:** Under this system of accounting, transactions are recorded in the books of accounts only on the receipt/ payment of cash. The income is calculated as the excess of actual cash receipts (in respect of sale of goods, services, properties etc.) over actual cash payments (regarding purchase of goods, expenses, rent, electricity, salaries etc.). Entry is not recorded when a payment or receipt is merely due i.e., outstanding expenses, accrued incomes are not treated. This method is contradictory to the matching principle.

**2. Accrual Basis of Accounting:** Under this system of accounting, revenue and expenses are recorded when they are recognized i.e., income is recorded as income when it is accrued (when transaction takes place) irrespective of the fact whether cash is received or not. Similarly, expenses are recorded when they are incurred or become due and not when the cash is paid for them. Under this system, expenses such as outstanding expenses, prepaid expenses, accrued income and income received in advance are identified and taken into account. Under the Companies (amendments) Act 2013, all companies are required to maintain their accounts according to accrual basis of accounting.

### **Difference between accrual basis of accounting and cash basis of accounting**

<b>Basis</b>	<b>Accrual Basis of Accounting</b>	<b>Cash Basis of Accounting</b>
<b>Recording of transactions</b>	Both cash and credit transactions are recorded.	Only cash transactions are recorded.
<b>Profit or Loss</b>	Profit or Loss is ascertained correctly due to complete record of transactions.	Correct profit/loss is not ascertained because it records only cash transactions.
<b>Distinction between Capital and Revenue items</b>	This method makes a distinction between capital and revenue items.	This method does not make a distinction between capital and revenue items.
<b>Legal position</b>	This basis is recognized under the companies Act, 2013.	This basis is not recognized under the companies Act, 2013.