Chapter

2 Generally Accepted Accounting Principles

CHAPTER CONTENTS

INTRODUCTION

Generally Accepted Accounting Principles (GAAPs) are the basic foundation of accounting structure. These broad guidelines are the accounting standards in the form of rules, procedures, doctrines, tenets, assumptions, postulates, concepts and conventions which bring about uniformity in recording, classifying, summarizing, interpreting, reporting and the presentation of the accounting information. To make the accounting information convey the same meaning to all parties, accountants from all over the world have developed certain rules, procedures and conventions, which represent a consensus view of the profession of good accounting practices and procedures and are generally referred to as Generally Accepted Accounting Principles. These principles have been developing over the years from experience, necessity, reason, custom, usage and individual and corporate practices, desirability of different accounting associations and government regulations by keeping in view the interest of the users of accounting information.

MEANING OF ACCOUNTING PRINCIPLES

The term 'Principle' refers to the fundamental belief or a general truth which once established does not change. It also means the rule of action or conduct and can be applied to the rules of accounting.

Definitions of Accounting Principles

According to the Canadian Institute of Chartered Accountants, "Accounting principles are the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions and procedures where alternatives exist. Rules governing the formation of accounting axioms and principles have arisen from the common experience, historical precedent, statements by individuals and professional bodies and regulation of government agencies."

The American Institute of Certified Public Accountants (AICPA) defines accounting principles as "a general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice."

In short, accounting principles are usually the concepts and conventions which have been adopted as a general guide by the accountants all over the world. However, these principles are not the result of any laboratory tests or experiments unlike the test of natural sciences but mere conventions and practices. Therefore, it can be concluded that accounting principles are not eternal truths, because they are not based on observations and experiments on conventions, reasons and experience and serve as guidelines to ensure uniformity and understandability and enhance the usefulness of accounting statements in a fast changing business environment.

CHARACTERISTICS OR FEATURES OF ACCOUNTING PRINCIPLES

The following are the main features of accounting principles:

1. **Relevance or usefulness:** Relevance refers to usefulness. Application of such principles makes the accounting information more meaningful and useful to the users. Any accounting guidelines which does not enhance the utility of the accounting records to its users cannot be accepted as an accounting principle.
2. **Objectivity:** Objectivity denotes freedom from personal bias. A principle must be objective in the sense that the accounting information is not affected or influenced by personal bias and whims but solidly supported by facts and figures. This in turn increases the reliability of accounting statements.
3. **Feasibility:** Feasibility relates to the operational aspect. Accounting principles must be applied easily and economically without any complexity or problem. The cost in terms of time, money, efforts should not outweigh its benefits to the users of accounting data.

Therefore, it may be concluded that accounting principles should be recognized in the light of their usefulness to the users of accounting information and their relevance to the decision-making processes. Secondly, these principles ensure fairness, justice, impartiality in the processing and reporting of the accounting information, which itself is free from undue influence.

Lastly, accounting principles should reflect economic reality, and the choice should depend upon the economic consequences.

CLASSIFICATION OF ACCOUNTING PRINCIPLES

The accounting principles can be classified into two categories:

(a) Accounting concepts
(b) Accounting conventions

The term *accounting concept* is used to connote the basic accounting postulates, i.e. the necessary assumptions and conditions upon which accounting is based. It refers to the accounting propositions upon which accounting is based. Actually, the concepts are self-evident statements or truths and are fundamental to the accounting practice. Accounting concepts are so basic that people accept them as valid without questioning. Accounting concepts provide guidelines in processing the accounting information, i.e. recording, classifying, summarizing, interpreting and reporting.

The *conventions* connote customs, traditions or practices as a guide to the preparation of accounting statements. These are the rules which are referred to for the solution of certain given problems in accounting.

The terms concepts and conventions can be explained in a better manner with the help of Figure 2.1.

- **Accounting principles**
  - **Accounting concepts**
    - Business entity concept
    - Going concern concept
    - Accounting period concept
    - Money measurement concept
    - Dual aspect concept
    - Cost concept
    - Matching concept
    - Realization concept
    - Accrual concept
  - **Accounting conventions**
    - Consistency
    - Materiality
    - Conservatism
    - Full disclosure

Fig. 2.1 Accounting principles.

The accounting concepts and conventions are explained in details here.

Accounting Concepts

Business entity concept

According to this concept, a business concern is separate and distinct from its owners, irrespective of the nature or type of the organization, i.e. sole trade, partnership or joint stock company. This clearly draws the line of demarcation between business transactions and personal transactions, between business assets and personal assets, between business liabilities and personal liabilities, and between operating incomes and non-operating incomes. The accounting equation 'Capital + Liabilities = Assets' clearly reflects the application of the concept of entity. Like other claimants (creditors, lenders, investors), the owner also owes money from the business in the form of money invested as capital along with profit or loss made. That is why, when a person starts business with some initial amount of capital, the cash a/c is debited and the capital a/c is credited. This will be his investment in the business. So we can say that 'Business' and 'Businessman' (owner) are two separate entities. The transactions in a business are always recorded from the point of view of the business, but not from that of the businessman. A businessman's transactions with the business are recorded separately. For example, goods and amount withdrawn for personal use by a businessman, income tax or life insurance premium paid from the business funds on the life of the businessman, etc.

The business entity concept employed in accounting for a sole proprietorship is distinct from the legal concept of a sole proprietorship. Legally, a sole proprietor is personally liable for his business debts and even his private assets can be used to make payment to business creditors, because the liability of a sole trader is unlimited in case of sole proprietorship. Similarly in case of a partnership firm, the business assets of the firm are used at first for paying the business liabilities of the firm, and if any surplus remains after paying the liabilities of the firm, the share of partner's surplus can be used for the payment of his private liabilities. In the same manner, private assets of individual partners are used firstly for the payment of their individual private liabilities and any surplus can be utilized for the payment of the firm's liabilities.

In case of a joint stock company, there is some legal distinction between the owners, (shareholders) and the business. Shareholders are only liable to the amount of share capital they have agreed to subscribe to. They are not personally liable for the debts of the company. The main effect of this concept in case of a joint stock company is to recognize its separate entity from its shareholders.

Going concern concept

According to International Accounting Standards (IAS), "The enterprise is normally viewed as a going concern that is coninuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidating or of curtailing the scale of its operations." This implies that a business as an entity has a continuity of life and is going to last indefinitely in future. It is a going concern and not a gone concern. It will not be wounded up in near future, except for those which are intended to last for a short period of time (such as joint ventures). Continuity is applicable for all forms of accounting entities. Even a joint stock company is deemed to have perpetual succession. This does not mean that business entities will exist forever, but surely for a sufficiently longer period of time. The application of this concept justifies the accounting treatment of the following transactions:

3. Charging of depreciation over the useful life of asset on written down value/cost basis and not on current market price
4. Amortization of intangible assets over their effective life
5. Showing prepaid expenses, deferred revenue expenditure and unexpired cost as assets

Accounting period concept

Besides owners and management there are others who have interest in the business enterprise and its day-to-day performance such as creditors, investors, lenders, employees and the government. The continuity of such concern makes the measurement of performance a complicated process as the actual results (profits and losses) can be ascertained only at the time of winding up. Obviously, the net income of the concern can be measured by comparing the net assets in the beginning and the net assets at the time of winding up or dissolution. Since these groups cannot wait for a very long period of time, so there is a need to split the life of the business into annual intervals which is known as *accounting period.*

Normally, an accounting period is for a period of one year. It may be a calendar year or a financial year. Calendar year ranges from 1st January to the 31st December and the financial year ranges from 1st April to the 31st March of every year. This is taken as an ideal period, because it also satisfies the legal requirements of the Companies Act, 1956 and makes compliance of the legal provisions of the Income Tax Act, 1961, relating to the filing of annual return. This concept helps to estimate profits or losses or exhibit true and fair view of the state of affairs of a business but also presents the proper valuation of assets and liabilities at regular intervals. This concept clearly makes difference between expired and unexpired cost, outstanding and prepaid expenses, accrued and advanced income, and revenue and deferred revenue expenditure. Even the allocation of capital expenditure over the effective life of asset has been made possible because of this concept. Charging of annual depreciation to profit and loss account is a clear example of this.

Money measurement concept

Accounting is the language of business which can be interpreted by a monetary unit. It is the only unit of measurement that measures the transactions of a business enterprise. It means that accounting records, reports and interprets those business transactions and events which can be expressed in terms of money. It measures material, labour, expenses, investment, sales, purchases, assets and liabilities in monetary units, which provides a common denominator. The events or transactions, howsoever important may be, if cannot be expressed in terms of money, do not find any place in the books of accounts, for example, the quality of products, dedicated staff, efficient and far-sighted management, better working conditions, competitors' strategy and price policy which are crucial for the smooth running, expansion and growth of an enterprise, but cannot be recorded in the books of accounts. Only those transactions which can be expressed in terms of money can be recorded. For example, a business owns Rs. 1,00,000 of cash, 60 tonnes of raw material, two motor vans, 1,000 square feet of land, etc. These amounts cannot be added together to produce a meaningful total of what the business owns. However, these amounts can be expressed in monetary

sh	Rs. 100,000
w Material	Rs. 50,000
o Motor Vans	Rs. 2,00,000
00 Square Feet Land	Rs. 1,50,000
tal	**Rs. 5,00,000**

ssets when added together will amount to Rs. 5,00,000. This gives a more intelligible
imate about the assets of the business.

oncept

ic concept of accounting. According to this concept, every business transaction has
may be either:

ving the benefit, or
g the benefit.

involve acquisition of assets, purchase of goods for cash or on credit, sale of goods
credit, payment of salaries or other business expenses or raising a loan, etc. In each
actions, two aspects are involved, say purchase of goods for cash Rs. 1,00,000
eceipt of goods worth Rs. 1,00,000 (b) payment of cash. If it is on credit basis, it
pt of goods and acknowledgement of debt to the supplier. This recognition of the
lating to debit and credit is known as the dual aspect concept, which is based on the
System. Accordingly, this system requires debit for what comes in and credit for
, debit for the receiver and credit for the giver and debit for all expenses and losses
all incomes and gains. This can be explained in the form of accounting equations

rts business with initial capital of Rs. 6,00,000
al = Cash
,00,000 = Rs. 6,00,000
osited in a bank Rs. 4,00,000
tal = Cash + Bank
,00,000 = Rs. 2,00,000 + Rs. 4,00,000
hased goods and paid by cheque Rs. 80,000
tal = Cash + Bank + Stock
,00,000 = Rs. 2,00,000 + Rs. 3,20,000 + Rs. 80,000
aspect concept can be explained as follows:

Capital + Liabilities = Assets

or

Capital = Assets – Liabilities

ve equation states that for every debit, there is a credit and vice versa.

paid to acquire them. In case of fixed assets, only Written Down Value (i.e. cost – depreciation) is shown in the balance sheet in the subsequent years. For example, if a firm buys a piece of land for Rs. 1,00,000, it will be recorded in the books at Rs. 1,00,000 even if the market price at that time happens to be Rs. 1,50,000. After 5 years, if the market value of the land increases to Rs. 2,50,000, it will continue to be shown as Rs. 1,00,000 in the books of accounts, but not as Rs. 2,50,000.

According to this concept, the events which do not cost anything to the organization are not recorded, although it may affect the valuation of the business. For example, if some of the top executives, who have taken the business to new heights of success, leave the organization, the real value of the business will change immediately, which will be reflected in the market price of the company's shares. This event, though of great importance, will not be recorded in the books of accounts as an asset.

Since the valuation of fixed assets does not depend on the market value, this concept follows the objective approach, as the figures are not influenced by personal bias. Had there been the market value concept, it would have been a difficult job for an accountant in deciding which value to follow – wholesale or retail or so on.

Matching concept

Matching concept is based on the accounting period concept. The main objective of running a business is to earn profit. In order to calculate the profit made by the business during a period, it is necessary that revenues of the period should be matched with the costs (expenses) of the period. The concept 'matching' implies appropriate association of related revenues and expenses. The matching concept is different under each system of accounting. In cash system, only actual receipt and payments are recognized as 'revenue and expenses' for any accounting year. In other words, revenues are recognized when realized in cash and expenses are recognized when actually paid in cash. This is irrespective of the goods supplied or services rendered or benefits received. The cheque received or issued is treated at par with cash realized and cash paid. But in accrual basis of accounting, revenues are recognized when sale is made or service is rendered in any accounting period whether realized in cash or not. Revenues are recognized on due basis whether paid or not, i.e. expenses related to the accounting period are accounted for. This process of recognizing and relating expenses with revenues is called matching concept.

Like in revenue, all costs incurred during the period are not taken in accounting. Only the costs related to the accounting period are taken. Let us make this concept clear with the help of the following example:

A businessman buys 10 fans at a cost of Rs. 10,000. He paid Rs. 500 as freight and insurance, Rs. 200 as octroi and carriage and rent outstanding was Rs. 1,000. He sells all fans at a price of Rs. 20,000 against which is matched the cost of fans Rs. 10,000, freight and insurance Rs. 500, octroi and carriage Rs. 200 and rent outstanding Rs. 1,000. The net profit of the period is Rs. 8,300 (Rs. 20,000 – Rs. 11,700). The nature of profit and cash is not synonymous. For example, if a business makes a profit of Rs. 10,000, it does not mean that it has the same amount of cash or cash is increased by the same amount, because there are outstanding expenses and creditors and outstanding debtors. An increase in cash does not mean increase in profit. Cash can increase because of issue of shares or sale of fixed assets

the revenue of a particular period. Similarly, it is difficult to ascertain how much capital
iture should be written off by way of depreciation during a particular period.

ation concept

also known as *Revenue Recognition Concept*. According to International Accounting rds Committee, "Revenue is gross inflow of cash, receivables or other consideration arising course of an enterprise from the sale of goods, from the rendering of services and from g the assets. Revenue is measured by the charges made to customers or clients for goods ed and services rendered to them and by the charges and rewards arising from the provision ts. It excludes amounts collected on behalf of third parties such as certain taxes".

other words, this principle recognizes revenue when a transaction rendering services or effected, be it a cash sale, a credit sale or an instalment sale. This implies that revenue tion does not necessarily mean that revenue must realize in cash. According to this concept, e is considered as being earned on the date at which it is realized, i.e. on the date when the ty in goods passes to the buyers and he becomes legally liable to pay. We can make this with the following example:

places an order with Y for the supply of certain goods yet to be manufactured. On receipt of Y purchases raw materials, employs workers, produces the goods and delivers them to X. kes payment on receipt of goods. In this case, revenue was not realized at the time of the t of order, but was considered to have been realized at the time when goods were delivered However, there are certain exceptions to this concept such as:

1. In case of hire-purchase the ownership of the goods passes to the buyers only when the last instalment is paid, but sales are assumed to have been made to the extent of instalments received and instalments outstanding.
2. In case of contract accounts, though the contractee is liable to pay only when the whole contract is completed as per the terms of contract, the profit is calculated on the basis of the work, certified year after year as per certain accepted accounting norms.

ual concept

rding to this concept, revenue is recognized when it is realized, i.e. when sale is complete is not important whether cash is received or not. Expenses are recognized in the accounting d in which they help in earning revenue whether the cash is paid or not. Therefore, to ascertain orrect profit or loss for an accounting period and to show the true and fair financial position e business at the end of the accounting period, a record of all expenses and incomes relating e accounting period is kept, whether the actual cash has been paid or received or not. Thus, utstanding expenses and the outstanding incomes are taken into consideration while preparing inal accounts of a business.

ounting Conventions

vention of consistency

vention of consistency assumes that accounting policies should be consistent from one period e other. It implies that rules, policies, principles and methods adopted by a firm for the ose of preparation and presentation of accounts should not be subject to frequent changes.

If it is done so, the comparison of its financial statements over a few years and with other firms would be difficult. According to International Accounting Standards (IAS-1), consistency is a fundamental assumption, and it is assumed that accounting policies should be consistent from one period to the other. In order to bring uniformity of preparation, presentation, understanding and to enhance usefulness of financial statements, it is essential that precise rules or conventions are continuously adhered to from year to year. It does not mean that it is rigid in its approach. It suggests the adoption of new improved accounting policies to bring about a qualitative change in the reporting of accounting data. Consistency aims to eliminate personal bias through uniformity of recording and reporting of accounting information. Following examples are also considered while applying the convention of consistency:

1. Valuation of stock at the cost or the market price whichever is less.
2. Valuation of investment at the market price or the cost whichever is less.
3. Change of methods of charging depreciation due to the change in expected life of an asset.

Convention of materiality

According to American Accounting Association (AAA), an item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investors. As per IAS-5, all material information should be disclosed, which is necessary to make the financial statements clear and understandable. Any information which is insignificant and immaterial from the point of view of users of financial statements should not be reported. But what is material and what is immaterial depends on the size and nature of the organization.

The term 'materiality' is a subjective term. An accountant should record an item as material even though it is of very small amount, and its knowledge seems to influence the decision of the proprietor or the investors. For example, a minor expenditure of Rs. 10 for the purchase of a Ball Point pen may be treated as an expense of the period rather than an asset. Only round figures (to the nearest rupee) may be shown in the financial statements to make accounting data more accurate. Similarly, for income tax purposes, the income has to be rounded to the nearest ten rupees. So, materiality is purely a matter of personal judgement and should be left to the discretion of the accountant.

Convention of conservatism

This is also known as *Doctrine of Prudence*. It refers to the policy of playing safe by providing for all possible losses but not for the anticipated gains. Due to business uncertainties and risk, it is wiser to account for possible losses. It compels a businessman to wear a 'risk-proof' jacket, as the working rule is: 'anticipate no-profit, but provide for all possible losses." For example, closing stock is valued at the cost or the market price whichever is less. If the market price is higher than the cost, the higher amount is ignored in the accounts and the closing stock is valued at the cost which is less than the market price. But if market price is less than the cost, the higher amount of cost will be ignored and the stock will be valued at the market price which is less than the cost.

IAS-1 states: "Uncertainties inevitably surround many transactions. This should be recognized by exercising prudence in financial statements. Prudence does not, however, justify the creation of secret or hidden reserves." According to the APB (USA) statement: "Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors and accountant have generally preferred that possible efforts in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to convention of conservatism".

Thus, conservatism does not mean a deliberate and consistent understatement of income or under-valuation of assets but it refers to an approach which safeguards the interest of all those concerned. It is applied when uncertainty is inherent in the activities such as uncertainty regarding realization of income, estimated liability or occurrence of loss, etc. However, a more cautious approach is required with regard to the application of the doctrine of conservatism so that it does not distort the actual earnings of the firm, and balance sheet exhibits true and fair view of the state of affairs of the business enterprise.

Convention of full disclosure

One of the primary objectives of published corporate accounts is to provide information in such a form as to minimize uncertainty about the validity of the information and to enable the users (creditors, shareholders, investors, bankers, etc.) to make their own assessment of the risk associated with the enterprise. In other words, this convention specifies that there should be complete and full disclosure of all significant information relating to the financial affairs of a business enterprise. Infact, the extent of disclosure should be determined in the light of the needs of the users of financial statements. The basis of valuation of certain assets such as market value of land and building, inventories, investment, etc. changes in the method of charging depreciation, and even contingent liabilities are shown by way of foot-notes or as additional information. The Companies Act, 1956 also provides forms and schedules of accounts in which financial statements are to be prepared. In this way, the Companies Act also makes proper provisions for the disclosure of significant information relating to the published account.

ACCOUNTING STANDARDS

The Britishers introduced the term 'standards' in place of 'principles' in 1969, when they set up the Accounting Standards Steering Committee. The Americans adopted the same term during the formation of the Financial Accounting Standard Board (FASB) in 1973. In India, the term 'standard' has been vigorously used since the formation of the Accounting Standards Boards (ASB) in 1977.

To maintain an uniformity in accounting standards all over the world for the purpose of preparation, presentation and reporting of accounting information, the International Accounting Standards Committee (IASC) comprising sixteen accounting bodies of nine countries, viz. UK, USA, Canada, Australia, France, Germany, Japan, Holland and Mexico was formed in 1973. The agreement and constitution was signed by the member Nations in June 1973, followed by a revised agreement and constitution in October 1977. According to the agreement, the IASC was to formulate and publish in the public interest, the standards to be observed in the presentation of audited accounts and to promote their world wide acceptance and observance.

Thus, the objective of IASC was to develop certain accounting standards to be observed in the presentation of financial statements to bring about uniformity and enhance reliability of accounting information and reporting. The Institute of Chartered Accountants of India and ICWAI are both the members of the International Accounting Standards Committee. The committee issues standards which do not have any legal imposition but are of great persuasive value.