

## **CHAPTER 3**

### **GAAP and BASIC ACCOUNTING CONCEPTS**

#### **❖ Generally Accepted Accounting Principles (GAAP)**

A set of rules and guidelines which were formed, developed and gradually changed from time to time in order to:

- bring uniformity and consistency in the process of accounting.
- enhance utility of accounting information to users of accounting information.
- set a universal guidelines to record the transactions and events.

#### **❖ Basic Accounting Concepts and Conventions**

These concepts are used for recording business transactions, preparing financial statements and presenting accounting information in the best possible manner. These concepts comprise of basic accounting assumptions.

**Various Accounting Concepts and Conventions are as follows:**

- **Business Entity Concept**

This concept treats business as a separate identity from its owner. All business transactions are recorded in the books of business from the business's point of view not from the owner's point of view.

**For example:** Started business with cash Rs 1,00,000. According to the Business Entity Concept, business being a separate entity needs to pay back this amount at the time of closure. Thus Rs 1,00,000 is a liability for the business.

- **Money Measurement Concept**

According to this concept, only those events are recorded in the books of account, to which money value is attached or which can be expressed in monetary terms.

- **Going Concern Concept**

This concept holds that the business will continue its operation for indefinite period, irrespective of its owners. The purpose of this concept is to differentiate between capital expenditure and revenue expenditure.

- **Accounting Period Concept**

According to this concept, the life of an enterprise is divided into different accounting period (say years, half-yearly, quarterly, days), so that the performance of the business in each period and at regular intervals can be measured and assessed.

- **Cost Concept**

According to this concept, all assets of a business are recorded at their acquisition price (i.e. the price paid to acquire them) and not at their current market price. The acquisition price forms the basis for charging depreciation and maintaining other accounting records of the asset in the subsequent periods.

- **Dual Aspect Concept**

According to this concept, all the transactions that are recorded in the books of account have dual aspects. In other words, every transaction effects two accounts simultaneously, i.e. debit and credit.

- **Revenue Recognition Concept**

According to this concept, revenue is recognised when the right of receiving of the revenue is established and not when the revenue is actually received.

**For Example:** Goods sold on credit Rs 5,000 on January 01 and the payment is received on February 11. In this case, revenue is recognised in the month of January and not in February, as the right of receiving the amount is established in January.

- **Matching Concept**

This concept suggests that in order to ascertain actual profit or loss made during a period, expenses incurred (during the period) for earning revenues should be matched with their related revenues earned during that particular period. In other words, both the expenses and revenues should belong to the same accounting period.

- **Consistency Concept**

This concept suggests that the accounting policies and practices once adopted should be followed from year to year. In other words, accounting practices should not be frequently changed. Adherence to Consistency Concept infuses higher degree of consistency and thereby enabling meaningful comparison and better assessment of the performance of the business over the years.

- **Full Disclosure Concept**

According to Full Disclosure Concept, besides disclosing statutory required information, vital information that is significant and relevant to the different users of accounting information must also be disclosed.

- **Conservatism Concept**

This concept holds that in order to ascertain profit or loss made during an accounting period, all anticipated losses should be deducted from the revenues but all anticipated profits should not be taken into consideration until and unless they are realised.

- **Materiality Concept**

This concept implies that only those items which may affect the decisions of the informed investors are considered as material. Materiality of an item depends on the nature and the amount of the item.

- **Objectivity Concept**

According to this concept, transactions recorded in the books of accounts should be free from personal bias. In other words, transactions recorded should be objective, i.e. should be supported by verifiable evidences.