Chapter-1 Theory Base of Accounting

Accounting principles, concepts and conventions are known as Generally Accepted Accounting Principles (GAAP). These principles are the base of Accounting. Generally Accepted Accounting Principles (GAAP) refers 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.

These principles have evolved over a long period of time on the basis of experiences of the accountants, customs, legal decisions etc., and which are generally accepted by the accounting professionals.

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 has neither intention to liquidate nor to scale down its operations significantly.

Relevance:

(a) Distinction is made between capital expenditure and revenue expenditure.

(b) Classification of assets and liabilities into current and non-current.

(c)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 along with its effect on income statement and Balance Sheet.

Any accounting practice may be changed if the law or Accounting standard requires so, to make the financial information more meaningful and transparent.

Relevance: It helps the management in decision-making by utilizing the comparable financial information.

3. Accrual Assumption: Accrual concept applies equally to revenue and expenses. As per this assumption, all revenue and costs are recognized when they are earned or incurred.

It is immaterial, whether the cash is received or paid at the time of transaction or later date e.g., if a credit sale (Credit for two months) for Rs. 15,000 is made on 15th Feb. 2015, then the revenue earned is to be recorded on 15th Feb. 2015, not on the date of cash realized, i.e., after two months. In case of Expenses, if at the end of the year the two months' salary is due but not paid, then the expenses of salary will be recorded in the current year in which salary is due, not in the next year in which it will be paid.

Relevance: Earning of a 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; analyzed and financial statements are prepared from the business point of view and not of the owner.

The owner is treated as a creditor (Internal liability) for his investment in the business, as if the firm has borrowed from its owner instead of the outside parties. Interest on capital is treated as expense like any other business expense. His private expenses are treated as drawings leadings 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 term of money are recorded in the books of accounts of the enterprises. 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 qualitative aspect e.g., efficient human resources (Assets), satisfied customers (Assets) and dishonest employee (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- money. ,

3.Accounting Period Principle: According to this principle, the whole indefinite life of an enterprise is divided into parts, known as accounting period.

Accounting period is defined as interval of time, at the end of which the profit and loss account and balance sheet are prepared, so that the performance is measured at regular intervals and decision can be taken at the appropriate time. Accounting period is usually a period of one year and that year may be financial year or calendar year.

Relevance:

1. This Assumption requires showing the allocation of expenses between Capital and Revenue.

2.Portion of Capital Expenditure that is consumed during the current year is charged to Income statement and rest of the portion i.e., Unconsumed portion is shown as an asset in the Balance Sheet.

3. As per income tax law, tax on income is calculated on annual basis from 1st April to 31st March (Financial Year)

4. Timely action for corrective measures can be taken by the Management.

4. Full Disclosure Principle: According to this principle, apart from legal requirements all significant and material information relating to the economic affairs of the entity should be completely disclosed in its financial statements and accompanying notes to accounts.

The financial statements should act as 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 financial statements. According to this principle, only those items or information should be disclosed that have material effect and relevant to the users. So, item having an insignificant effect or being irrelevant to user need not be disclosed separately, these may be merged with other item.
If the knowledge of any information may 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 item of expenses Rs. 50,000 is immaterial for an enterprise having turnover of Rs. 100 crore.