

Chapter - 2

Theory base of Accounting

Generally Accepted Accounting Principles (GAAP)

Generally Accepted Accounting Principles(GAAP) refers to *the rules or guidelines adopted for recording and reporting of business transactions*, in order to bring uniformity in the preparation and the presentation of financial statements .

Basic accounting concepts

1. Business Entity Concept : The concept of business entity assumes that *business has a distinct and separate entity from its owners*. It means that for purposes of accounting the business and its owners are to be treated as *two separate entities*. e.g. capital is treated as liability of the business to the owner.

2. Money measurement concept : The concept of money measurement states that only those transactions and happenings in an organisation *which can be expressed in terms of money* are to be recorded in the books of accounts. Eg. Sale of goods ₹10,000.

3. Going concern concept : The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely i.e. *for a fairly long period of time*. It provides *the very basis for showing the value of assets in the balance sheet*.

4. Accounting period concept :Accounting period refers to *the span of time* at the end of which the financial statements of an enterprise are prepared.

5. Cost concept :The cost concept requires that all assets are recorded in the book of accounts *at their purchase price*. The purchase price includes cost of acquisition, transportation, installation and making the asset ready to use.

6. Dual aspect concept :Dual aspect is the *foundation or basic principle* of accounting. This concept states that *every transaction has a dual or two-fold effect* and should therefore be recorded at two places. In other words, at least two accounts will be involved in recording a transaction. For example, Vysakh started business with ₹2,00,000. This will result in an increase in the assets(cash) by ₹200000. At the same time owner's equity (capital) will also increase by an equal amount. The duality principle is commonly expressed in terms of fundamental accounting equation:

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

7. Revenue recognition principle : The concept of revenue recognition requires that the revenue for a business transaction should be included in the accounting records *only when it is realised*. Revenue is assumed to be *realised at the point of time when goods have been sold or service has been rendered*.

8. Matching concept : It states that expenses incurred in an accounting period should be matched with revenues during that period. In other words, *the revenue and expenses incurred to earn these revenue must belong to the same accounting period*.

9. Full disclosure concept : The principle of full disclosure requires that *all material information must be fully disclosed in the financial statements*. This is to enable the users to make correct assessment about the profitability and financial soundness of the enterprise and to take important decisions.

10. Consistency concept : This concept states that *accounting policies and practices followed by enterprises should be uniform and consistent over the period of time*. This makes inter-firm and inter-period comparisons possible. For example, if closing stock is valued at 'cost or market price, whichever is lower' the same practice should be followed year after year.

11. Conservatism concept/Prudence : This principle states that *anticipated profits are not to be considered but only possible losses, while recording business transactions*. Valuing closing stock at cost or market value whichever is lower, creating provision for doubtful debts, discount on debtors etc. from the books of accounts are some of the examples of the application of the principle of conservatism.

12. Materiality Concept : This concept states that *accounting should focus on material facts*. If the item is likely to influence the decision of an investor or a creditor, it should be regarded as material, and shown in the financial statements.

13. Objectivity concept : The concept of objectivity requires that *accounting transaction should be recorded in an objective manner, free from bias of accountants and others*. This can be possible when each of the transaction is supported by verifiable documents or vouchers. For example, purchase of materials may be supported by cash receipt.

Systems of Accounting

Systems of recording transactions in books of accounts are classified into two:

1. Double entry system
2. Single entry system

Double entry system is a complete system as *both the aspects of a transaction are recorded in the books of accounts.*

Single entry system is not a complete system of maintaining records of financial transactions. *It does not record two-fold effect of each and every transaction.*

Basis of accounting

Considering the timing of recognition of revenue and costs, there can be two approaches to accounting:

1. Cash basis and
2. Accrual basis

Under the **cash basis**, *entries in the book of accounts are made when cash is received or paid.*

Under the **accrual basis**, *revenues and costs are recognised in the period in which they occur.*

Accounting standards

Accounting standards are *written statements of uniform accounting rules and guidelines in practice for preparing the uniform and consistent financial statements.* Accounting standard is an authoritative statement issued by ICAI, a professional body of accounting in our country.

Need for accounting standards

Accounting standards help to bring uniformity and full disclosure of accounting information.

Benefits of Accounting Standards

1. Accounting standard helps in eliminating variations in accounting treatment to prepare financial statements.
2. Accounting standards may call for disclosures of certain information which is not required by law, but useful to various users.
3. Accounting standard facilitate inter-company and intra company comparison.

Limitations of Accounting Standards

1. Accounting standard makes choice between different alternate accounting treatments difficult to apply.
2. It is not flexible in applying accounting standards.
3. Accounting standard cannot override the statute.

Applicability of Accounting Standards

Accounting standard is applicable to :

1. Sole Proprietorship
2. Partnership.
3. Societies
4. Trusts
5. Hindu Undivided Family
6. Association of persons
7. Cooperative societies
8. Companies
9. International Financial Reporting System

International Financial Reporting Standards(IFRSs)

International Financial Reporting Standards(IFRSs) are *globally accepted accounting standards developed by International Accounting Standard Board(IASB)*. IFRS is a set of accounting standards for reporting different types of business transactions and events in the financial statements.

Need for IFRS

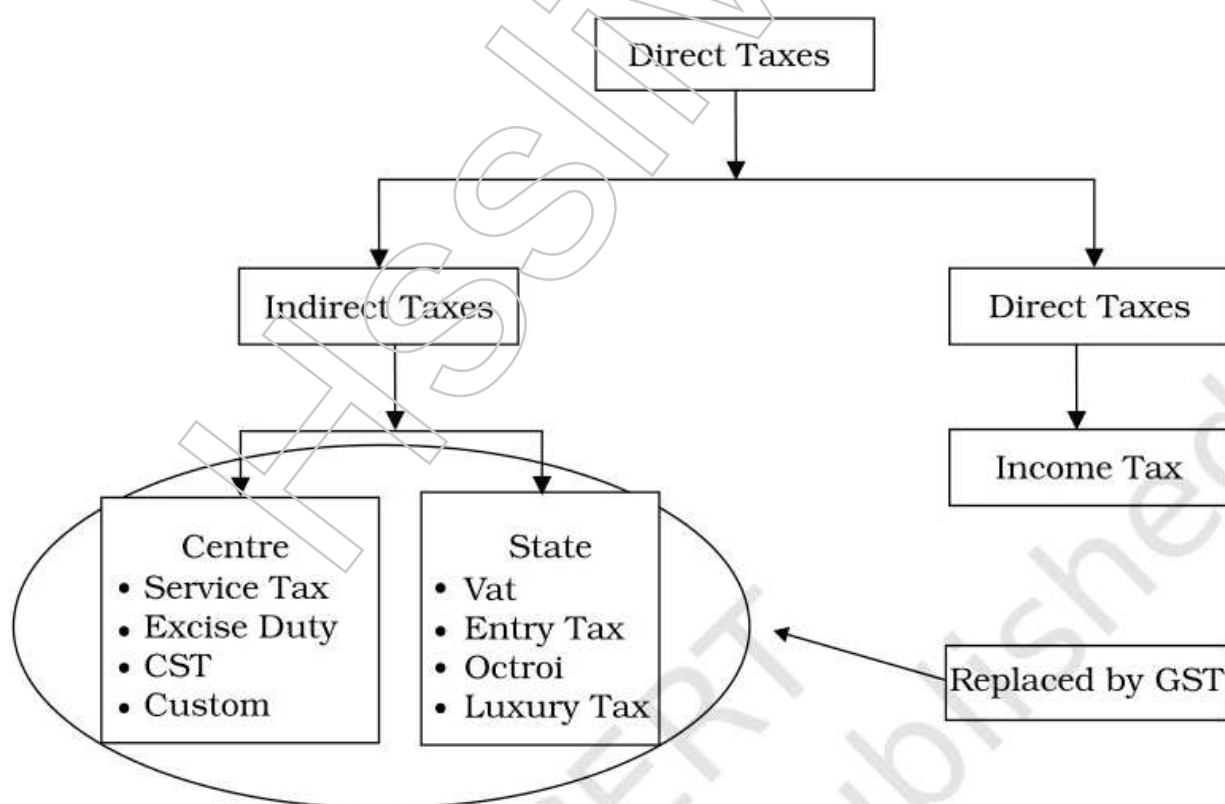
1. IFRS *helps to prevent material manipulation or errors in financial statements.*
2. IFRS helps in *global harmonisation.*
3. It facilitates *global investment.*

Goods and Services Tax (One Country One Tax)

GST is *a destination based tax on consumption of goods and services*. It is proposed to be levied at all stages right from manufacture up to final consumption. Under this system, the taxes paid at previous stages is credited and available as set off.

There are **three** main components of GST. They are :

1. **CGST** : CGST means Central Goods and Services Tax. *Taxes collected under CGST will constitute the revenues of the Central Government.* Central excise duty, additional excise duty, central sales tax etc. are examples for this.
2. **SGST** : SGST means State Good and Services Tax. *A collection of SGST is the revenue of the State Government.* With GST all state taxes like VAT, entertainment tax, luxury tax, entry tax etc. Will be merged with GST. For example, Anil, a dealer in Kerala, sell goods to Kalam in Kerala worth ₹10,000. If the GST rate is 18%, i.e., 9% CGST and 9% SGST, ₹900 ($₹10,000 \times 9/100$) will go to central government and ₹900 ($₹10,000 \times 9/100$) will go to Kerala Government.
3. **IGST** : IGST means Integrated Goods and Services Tax. *Revenue collected under IGST is divided between Central and State Government as per the rates specified by the Government. IGST is charged on transfer of goods and services from one state to another.* Import of goods and services are also covered under IGST.



Characteristics of Goods and Services Tax

1. GST is a common law and procedure throughout the country under single administration.
2. GST is a destination based tax and levied at a single point at the time of consumption of goods and services by the end consumer.
3. GST is a comprehensive levy and collection on both goods and services at the same rate with benefit of input tax credit or subtraction of value.
4. Minimum number of rates of tax does not exceed two.
5. There is no scope for levy of cess, resale tax, additional tax, turnover tax etc.
6. There is no multiple levy of tax on goods and services, such as sales tax, entry tax, octroi, entertainment tax or luxury tax etc.

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