Generally Accepted Accounting Principles (G.A.A.P)

GAAP is an international convention of good accounting practices. It is based on the following core principles. In certain instances particular types of accountants that deviate from these principles can be held liable. Discussed below are 10 major GAAP Principles/Assumption:

1. The Economic Entity Assumption

The business as a single entity concept states that all financial records of the business should be separate from the owners or other businesses. A company must report the assets and liabilities of different subsidiaries separately and not mix with the books of another company. In the absence of this principle, the records of multiple entities would get mixed, making it unfeasible from the point of view of financial audit or tax purpose.

2. Monetary Unit Assumption

There should be a specific unit of currency in which the company should record transactions. All the transactions in the financial statements should be in the same currency unit, be it the US dollar, Euro, Indian Rupee or any other currency. It would be wrong to record some transactions in one currency and some in another currency.

3. Time Period Assumption

Financial statements are always related to a specific time, usually towards the end of the financial accounting period. All three financial statements – Income, Balance Sheet and Cash Flow Statement have a start, as well as, the end date. It is done to ensure that stakeholders are aware of the time period for which the company is reporting numbers.

4. Revenue Recognition Principle

This principle, as the name suggests, states that a company should record both revenue and expenses when earned and not when it gets the cash. Therefore, the income statement of the company includes accrued income and expense. In case there is any doubt on the suppliers regarding the payment, the accountant should put the item under the allowance for doubtful accounts.

5. Going Concern Principle

As clear from the name, everyone expects a business to run eternally with no end date. It also means that the business must not to cease operations and liquidate the assets in the near future at very low fire-sale prices. Because of this principle, a company can defer certain expenses to a future date.

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If an accountant believes that the company might no longer be a going concern, the accountant must detail the same in his or her assessment. In case of liquidation, the accountant must write-down the value of the assets to their liquidation value. A point to note is that the value of a going concern firm is perceived to be higher than the liquidation value. This is because, in the former, there are chances that the company would turn profitable.

6. Full Disclosure Principle

Every company must make full disclosure and ensure that all the details and financial numbers are open to the public. This principle ensures that companies do not hide any material information, which can impact the investment decision of the stakeholders. Also, this principle ensures that the companies do not indulge into any unethical operations and businesses. And, no financial information that should be in the public domain is hidden intentionally.

7. Matching Principle

It is one of the most basic principles. And, requires a company to report an expense in the period in which it earns the corresponding revenue. The matching principle depends on the accrual basis of accounting and adjusting entries. In case, an expense is not directly related to the revenue, then it should be reported on the income statement when it expires or is used up. And, if the future benefit of a cost cannot be determined, it should be charged to expense immediately.

8. Principle of Materiality

As per this GAAP principle, it is important for the bookkeeper to think materialistically. An accountant should be able to differentiate between the important and not so important issues. Errors are inevitable in accounting. However, it is up to the bookkeeper to decide on whether the error is important enough to give more time to it, or can be ignored. For example, it is upto the accountant to decide if a $10 error can be ignored or not.

9. Principle of Conservatism

The principle suggests that an accountant must record expenses as and when they occur. On the other hand, the accountant should only record income when there is actual cash flow. This principle helps while recording transactions that are uncertain.

10. Historical Cost Principle

As per this principle, a company should record the purchase the goods, services, or capital assets at the price they actually paid for it. On the balance sheet, companies keep showing the asset at the historical without adjusting for any fluctuation in the market value.

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Accrual Accounting vs. Cash Basis Accounting: An Overview

The main difference between accrual and cash basis accounting lies in the timing of when revenue and expenses are recognized. The cash method is a more immediate recognition of revenue and expenses, while the accrual method focuses on anticipated revenue and expenses.

Accrual Basis Accounting

Revenue is accounted for when it is earned. Typically, revenue is recorded *before* any money changes hands. Unlike the cash method, the accrual method records revenue when a product or service is delivered to a customer with the expectation that money will be paid in the future. Expenses of goods and services are recorded despite no cash being paid out yet for those expenses.

Cash Basis Accounting

Revenue is reported on the income statement only when cash is received. Expenses are only recorded when cash is paid out. The cash method is mostly used by small businesses and for personal finances.

Difference Between Single Entry System and Double Entry Accounitng System

A business entity can record its monetary transactions either on Single Entry System or Double Entry System of Bookkeeping. The former is less laborious as well as less time consuming while the latter completely records the transactions which need substantial effort and time.

Single entry system of bookkeeping is economical but at the same time it is unscientific because it does not records all the transactions rather only a few ones are tracked and some are recorded partially. On the other hand, **double entry system** of bookkeeping is based on fundamental prinicples of accounting and so it records each and every aspect of the transaction.

Key Differences between Single Entry System and Double Entry System

The following are the major differences between single entry system and double entry system of bookkeeping:

1. The bookkeeping system in which only one aspect of a transaction is recorded, i.e. either debit or credit, is known as Single Entry System. Double Entry System is a system of keeping records, whereby both the aspects of a transaction are captured.
2. Single Entry Transaction is simple and easy whereas Double Entry System is complex as well as it requires expertise in accounting for maintaining records.
3. In single entry system, incomplete records are maintained while in double entry system complete recording of transactions is there.
4. In single entry system comparison between two accounting periods is very difficult. Conversely, we can easily compare two accounting periods in the double entry system.

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5. Single Entry System maintains personal and cash accounts. On the other hand, personal, real and nominal accounts are kept in Double Entry System.
6. The Single Entry system is best suited for small enterprises, but big organizations prefer Double Entry System.
7. Frauds and embezzlement are easy to identify in double entry system which cannot be located in single entry system.

Rule of Debit and Credit for Journalizing Business Transactions:

A ledger account (also known as T-account) consists of two sides – a left hand side and a right hand side. The left hand side is commonly referred to as debit side and the right hand side is commonly referred to as credit side. In practice, the term debit is denoted by "Dr" and the term credit is denoted by "Cr".

In the rest of the discussion we shall use the terms debit and credit rather than left and right.

When a financial transaction occurs, it affects at least two accounts. For example, purchase of machinery for cash is a financial transaction that increases machinery and decreases cash because machinery comes in and cash goes out of business. The increase in machinery and decrease in cash must be recorded in the machinery account and the cash account respectively. As stated earlier, every ledger account has a debit and a credit side. Now the question is that on which side the increase or decrease in an account is to be recorded. The answer lies in the learning of **normal balances of accounts** and the **rules of debit and credit**.

Normal balance of accounts

The understanding of **normal balance of accounts** helps understand the rules of debit and credit easily. If the normal balance of an account is debit, we shall record any increase in that account on the debit side and any decrease on the credit side. If, on the other hand, the normal balance of an account is credit, we shall record any increase in that account on the credit side and any decrease on the debit side.

The normal balance of all asset and expense accounts is debit whereas the normal balance of all liabilities and equity (or capital) accounts is credit. The normal balance of a contra account (discussed later in this article) is always opposite to the main account to which the particular contra account relates.

Rules of debit and credit

(1). Asset accounts:

Normal balance: Debit

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Rule: An increase is recorded on the debit side and a decrease is recorded on the credit side of all asset accounts.

(2). Expense accounts:

Normal balance: Debit

Rule: An increase is recorded on the debit side and a decrease is recorded on the credit side of all expense accounts.

(3). Liability accounts:

Normal balance: Credit

Rule: An increase is recorded on the credit side and a decrease is recorded on the debit side of all liability accounts.

(4). Revenue/Income accounts:

Normal balance: Credit

Rule: An increase is recorded on the credit side and a decrease is recorded on the debit side of all revenue accounts.

(5). Capital/Equity accounts:

Normal balance: Credit

Rule: An increase is recorded on the credit side and a decrease is recorded on the debit side of all equity accounts.

(6) Contra accounts:

Normal balance: Always opposite to the relevant normal account. The normal balance of a contra account can be a debit balance or a credit balance

An example: Accounts receivable is an asset account that normally has a debit balance. The allowance for doubtful accounts is a contra account to the accounts receivable and normally has a credit (opposite) balance.

Other examples of contra accounts include:

- accumulated depreciation account – a contra asset account
- sales returns and allowances account – a contra revenue account
- sales discount account – a contra revenue account

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- drawings account – a contra equity account
- treasury stock account – a contra equity account
- bonds discount account – a contra liability account

As the normal balance of a contra account is always opposite to the normal balance of the relevant main account, it causes a reduction in the reporting amount of the main account. For example, if the balance in ***building account*** is $500,000 and the balance in ***accumulated depreciation – building*** account is $150,000, the building would be reported at $350,000 (= $500,000 – $150,000) in the balance sheet.

Rule: If the normal balance of the contra account is debit, the increase will be recorded on the debit side and the decrease will be recorded on the credit side. If, on the other hand, the normal balance of the contra account is credit, the increase is recorded on the credit side and the decrease is recorded on the debit side.

A summary of the whole discussion about rules of debit and credit is given below:

Account type	Normal Balance	Increase	Decrease
Asset	Debit	Debit	Credit
Expense	Debit	Debit	Credit
Liability	Credit	Credit	Debit
Revenue/Income	Credit	Credit	Debit
Equity/Capital	Credit	Credit	Debit
Contra	Opposite to normal account	Credit, if normal balance of contra account is credit Debit, if normal balance of contra account is debit	Debit, if normal balance of contra account is credit Credit, if normal balance of contra account is debit

The following example may be helpful to understand the practical application of rules of debit and credit explained in above discussion:

Example:

The following transactions are related to Small Traders:

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1. Started business with cash $95,000.
2. Furniture purchased for cash to be used in business $8,000.
3. Purchased goods for cash $40,000.
4. Purchased goods on credit from Big Traders $57,000.
5. Sold goods for cash $5,000.
6. Purchased equipment for business $4,000.
7. Sold goods on credit to John Retailers $1,500.
8. Paid salary to employees $1,200

Required: Identify the accounts involved in above transactions and state the nature of each account. Also mention how increases or decreases in accounts resulting from above transactions should be recorded.

Solution:

	Account Involved	Nature of Account	Increase/ Decrease	Debit	Credit
1.	Cash	Asset	Increase	95,000	
	Capital	Equity	Increase		95,000
2.	Furniture	Asset	Increase	8,000	
	Cash	Asset	Decrease		8,000
3.	Purchases	Expense	Increase	40,000	
	Cash	Asset	Decrease		40,000
4.	Purchases	Expense	Increase	57,000	
	Accounts payable	Liability	Increase		57,000
5.	Cash	Asset	Increase	5,000	
	Sales	Revenue	Increase		5,000
6.	Equipment	Asset	Increase	4,000	
	Cash	Asset	Decrease		4,000
7.	Accounts receivable	Asset	Increase	1,500	
	Sales	Revenue	Increase		1,500
8.	Salary	Expense	Increase	1,200	
	Cash	Asset	Decrease		1,200

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Five Basic Questions for Transaction Analysis:

1. What's going on?
2. What accounts are affected?
3. How are they affected?
4. Does the balance sheet balance?
5. Does the analysis make sense?

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