

Generally Accepted Accounting Principles

Accountants use **generally accepted accounting principles (GAAP)** to guide them in recording and reporting financial information. GAAP comprises a broad set of principles that have been developed by the accounting profession and the Securities and Exchange Commission (SEC). Two laws, the Securities Act of 1933 and the Securities Exchange Act of 1934, give the SEC authority to establish reporting and disclosure requirements. However, the SEC usually operates in an oversight capacity, allowing the FASB and the Governmental Accounting Standards Board (GASB) to establish these requirements. The GASB develops accounting standards for state and local governments.

The current set of principles that accountants use rests upon some underlying assumptions. The basic assumptions and principles presented on the next several pages are considered GAAP and apply to most financial statements. In addition to these concepts, there are other, more technical standards accountants must follow when preparing financial statements. Some of these are discussed later in this book, but other are left for more advanced study.

Economic entity assumption. Financial records must be separately maintained for each economic entity. Economic entities include businesses, governments, school districts, churches, and other social organizations. Although accounting information from many different entities may be combined for financial reporting purposes, every economic event must be associated with and recorded by a specific entity. In addition, business records must not include the personal assets or liabilities of the owners.

Monetary unit assumption. An economic entity's accounting records include only quantifiable transactions. Certain economic events that affect a company, such as hiring a new chief executive officer or introducing a new product, cannot be easily quantified in monetary units and, therefore, do not appear in the company's accounting records. Furthermore, accounting records must be recorded using a stable currency. Businesses in the United States usually use U.S. dollars for this purpose.

Full disclosure principle. Financial statements normally provide information about a company's past performance. However, pending lawsuits, incomplete transactions, or other conditions may have imminent and significant effects on the company's financial status. The full disclosure principle requires that financial statements include disclosure of such information. Footnotes supplement financial statements to convey this information and to describe the policies the company uses to record and report business transactions.

Time period assumption. Most businesses exist for long periods of time, so artificial time periods must be used to report the results of business activity. Depending on the type of report, the time period may be a day, a month, a year, or another arbitrary period. Using artificial time periods leads to questions about when certain transactions should be recorded. For example, how should an accountant report the cost of equipment expected to last five years? Reporting the entire expense during the year of purchase might make the company seem unprofitable that year and unreasonably profitable in subsequent years. Once the time period has been established, accountants use GAAP to record and report that accounting period's transactions.

Accrual basis accounting. In most cases, GAAP requires the use of accrual basis accounting rather than cash basis accounting. **Accrual basis accounting**, which adheres to the revenue recognition, matching, and cost principles discussed below, captures the financial aspects of each economic event in the accounting period in which it occurs, regardless of when the cash changes hands. Under cash basis accounting, revenues are recognized only when the company receives cash

or its equivalent, and expenses are recognized only when the company pays with cash or its equivalent.

Revenue recognition principle. Revenue is earned and recognized upon product delivery or service completion, without regard to the timing of cash flow. Suppose a store orders five hundred compact discs from a wholesaler in March, receives them in April, and pays for them in May. The wholesaler recognizes the sales revenue in April when delivery occurs, not in March when the deal is struck or in May when the cash is received. Similarly, if an attorney receives a \$100 retainer from a client, the attorney doesn't recognize the money as revenue until he or she actually performs \$100 in services for the client.

Matching principle. The costs of doing business are recorded in the same period as the revenue they help to generate. Examples of such costs include the cost of goods sold, salaries and commissions earned, insurance premiums, supplies used, and estimates for potential warranty work on the merchandise sold. Consider the wholesaler who delivered five hundred CDs to a store in April. These CDs change from an asset (inventory) to an expense (cost of goods sold) when the revenue is recognized so that the profit from the sale can be determined.

Cost principle. Assets are recorded at cost, which equals the value exchanged at the time of their acquisition. In the United States, even if assets such as land or buildings appreciate in value over time, they are not revalued for financial reporting purposes.

Going concern principle. Unless otherwise noted, financial statements are prepared under the assumption that the company will remain in business indefinitely. Therefore, assets do not need to be sold at fire-sale values, and debt does not need to be paid off before maturity. This principle results in the classification of assets and liabilities as short-term (current) and long-term. **Long-term assets** are expected to be held for more than one year. **Long-term liabilities** are not due for more than one year.

Relevance, reliability, and consistency. To be useful, financial information must be relevant, reliable, and prepared in a consistent manner. **Relevant information helps** a decision maker understand a company's past performance, present condition, and future outlook so that informed decisions can be made in a timely manner. Of course, the information needs of individual users may differ, requiring that the information be presented in different formats. Internal users often need more detailed information than external users, who may need to know only the company's value or its ability to repay loans. **Reliable information** is verifiable and objective. **Consistent information** is prepared using the same methods each accounting period, which allows meaningful comparisons to be made between different accounting periods and between the financial statements of different companies that use the same methods.

Principle of conservatism. Accountants must use their judgment to record transactions that require estimation. The number of years that equipment will remain productive and the portion of accounts receivable that will never be paid are examples of items that require estimation. In reporting financial data, accountants follow the **principle of conservatism**, which requires that the less optimistic estimate be chosen when two estimates are judged to be equally likely. For example, suppose a manufacturing company's Warranty Repair Department has documented a three-percent return rate for product X during the past two years, but the company's Engineering Department insists this return rate is just a statistical anomaly and less than one percent of product X will require service during the coming year. Unless the Engineering Department provides compelling evidence to support its estimate, the company's accountant must follow the principle of

conservatism and plan for a three-percent return rate. Losses and costs—such as warranty repairs—are recorded when they are probable and reasonably estimated. Gains are recorded when realized.

Materiality principle. Accountants follow the **materiality principle**, which states that the requirements of any accounting principle may be ignored when there is no effect on the users of financial information. Certainly, tracking individual paper clips or pieces of paper is immaterial and excessively burdensome to any company's accounting department. Although there is no definitive measure of materiality, the accountant's judgment on such matters must be sound. Several thousand dollars may not be material to an entity such as General Motors, but that same figure is quite material to a small, family-owned business.