

GAAP:

Generally Accepted Accounting Principles (GAAP) are the body of concepts, principles and procedures developed primarily by the Financial Accounting Standards Board (FASB) as well as by convention (how it has always been done). The three main sources for GAAP are:

1. FASB pronouncements (statements);
2. Security and Exchange Commission (SEC) regulations for listed companies; and
3. Accounting practices developed by respected industries and by public and private bodies over time.

GAAP can be followed by all entities, including not-for-profit, publicly traded, closely held, corporations, partnerships, sole proprietorships, etc. The most common entities that must follow GAAP are those that are regulated by the SEC. In effect, publicly traded companies and others required by law. Many companies voluntarily follow GAAP because they issue (show) their financial statements to outsiders for such purposes as borrowing money or securing business contracts.

The FASB:

The FASB comprises of seven full-time members who must give up their association with employers and serve a five-year term with one five-year renewal permitted. Members represent segments of the business world, such as financial statement preparers, users and analyzers. Only a couple members may be CPAs. The basic procedure when developing a new FASB statement or changing a previous one is to:

1. Appoint a task force to coordinate the topic.
2. Prepare a discussion memorandum to identify problems and possible solutions by citing various issues involved.
3. Hold a public hearing to get a wide range of feedback.
4. Analyze oral and written responses to the discussion memorandum.
5. Issue an exposure draft proposing a statement of financial accounting standards.
6. Hold a public hearing on the proposed statement.
7. Analyze oral and written responses to the exposure draft.
8. Issue a final statement of financial accounting standards.

The process forces FASB members to carefully consider different viewpoints and to justify their conclusions, not merely to reach a quick decision. Five positive votes are needed to pass a Statement of Financial Accounting Standard (SFAS). The SFAS is issued after deliberation and input from any interested parties and includes an appendix with background material on that topic and the reasons behind the FASB's conclusions.

As of June 2009 the FASB has issued 165 standards, 48 interpretations as well as other pronouncements. Some amend or modify existing standards and some are highly specialized, such as for specific industries. Most standards apply universally and have an important effect on financial statements. The FASB is currently working with the International Accounting Standards Board in order to develop a comprehensive common "international GAAP" that would eventually replace the current U. S. GAAP.

GAAP is also established for state and local governments by the Governmental Accounting Standards Board (GASB) and for the federal government by the Federal Accounting Standards Advisory Board (FASAB).

Basic GAAP Concepts:

GAAP begins with four basic assumptions and also includes four principles and four constraints. GAAP is greatly enhanced if Consistently applied. There are also rules covering many topics including but not limited to bad debts, inventory, depreciation, leases, pensions, deferred taxes, intangible assets, bonds, equity, etc.

The four basic assumptions of accounting are the Economic or Separate Entity, Monetary Unit, Time Period and Going concern. The four principles of accounting are Historical Cost, Full Disclosure, Revenue Recognition and Matching. The four constraints of accounting are Materiality, Conservatism, Cost-Benefit and Industry Practice. Other important aspects of accounting are Consistency and Stable Dollar.

Assumptions of Accounting:

The **Economic or Separate Entity** assumption is concerned with the reporting unit or unit of accountability. The company's financial transactions are the only transactions recorded and reported upon even if the company is not a separate legal entity. The company is always assumed to be a distinct and separate reporting unit. For example, a sole proprietorship business is legally inseparable from the owner but for accounting purposes the owner's personal transactions and the business transaction are never commingled.

Following the **Monetary Unit** assumption means that only those business transactions that can be expressed in financial terms (dollars and cents in the U.S.) are recorded. In effect, the transaction resulted in or will result in money changing hands at some point in time. For example, the hiring of an employee is not a financial transaction but the paying of an employee's wages is a financial transaction.

Interested parties, such as owners, creditors, governmental agencies, etc., want to see reports (balance sheet, income statement, etc.) about the company. The basic reporting **Time Period** is one year. It is assumed that these annual reports can be prepared without material distortion of the events even though some of the financial transactions have not been completed as of the end of the time period under consideration. Interim or less than one year (for example, monthly or quarterly) financial statements are also often prepared.

Going Concern means that, absent information to the contrary, it is assumed a business will continue operating indefinitely into the future. This assumption permits recording accrued revenues and expenses and deferred revenues and expenses, which means recognizing revenues and expenses before or after the actual cash flow. In other words, revenues and expenses can occur and are recorded in the books regardless of when the cash is received or paid. Without the Going Concern assumption this practice would not be justified, as well as many other practices.

Principles of Accounting:

When recording financial transactions initially, they must be recorded at their original cash equivalent cost, in effect, recording transactions at their **Historical Cost**. The historical cost of a cash transaction is easily determined but the historical cost of a non-cash transaction is not. Non-cash transactions should be recorded at the fair market value of the assets given up.

Full Disclosure requires that sufficient information be provided in financial statements to ensure that they are not misleading. The information may be included on the face of statements or in the footnotes. The notes to financial statements are considered an integral part of the financial statements.

Revenue Recognition (recording in the books and reporting in the financial statements) occurs during the same accounting period that the company completed the services promised or delivered the goods to the customer. This concept is followed even if the customer paid before or paid after the period in which the company provided the service or delivered the product. Receiving cash from a customer before earning the revenue results in an unearned revenue account, which is a liability situation. Earning revenue before the cash is received (accrued revenue) creates an account receivable.

Expenses should be recorded (**Expense Recognition** should occur) in the same accounting period in which they helped create revenue regardless of when they are paid for. For example, the cost of an inventory item, whether paid for or not, is to be removed from the asset account (inventory) and put into an expense account (cost of goods sold) during the same period in which the inventory item is delivered to the customer. Remember, upon delivery of inventory to the customer the business would also recognize revenue. In effect, *Matching of expenses to revenue* must occur during the same time period the expenses helped create the revenue. Another example would be the cost of employees (wages expense) should be recorded (**Matched**) during the same accounting period in which they worked, even if they get paid in a later time period. Another example is payments for rent. If rent is paid for in advance (prepaid rent) it should not be reclassified to rent expense until the time period it relates to ends.

Constraints of Accounting:

Materiality is concerned with whether an item's magnitude makes a difference to a decision maker. For example, if an acquired asset is expected to last for three years, theoretically it should be capitalized (recorded as an asset) and depreciated over three years. In effect, the cost would be spread over a three year period. But if the asset cost is **immaterial**, for example \$25, most companies would simply expense the \$25 in the current year, and it would not require any further attention or accounting treatment. Materiality is "relative" to each company. Meaning that what is material for one company may not be for another. One needs to be cognizant (keep in mind) of the impact of several immaterial items in the same period being material.

Conservatism requires that if more than one accounting method is equally defensible, the one resulting in the least immediately favorable impact on the financial statements be used. This will mean that losses that are probable but have not yet occurred are recognized, but gains that are probable are not recognized until they have occurred. Make sure the method chosen does not overstate assets or revenues, nor does it understate liabilities or expenses. In effect, in situations where there is doubt use the most conservative approach.

Cost-Benefit analysis is comparing the outflows of resources (efforts) necessary to create additional inflows of resources (rewards). In business as well as in life you should only do those things

that will benefit you more than they will cost you. This concept can also be applied to financial statement disclosures.

Some businesses are so different from most others that they require their own way of accounting for certain aspects of their business transactions. These special **Industry Practices** apply only to certain atypical businesses such as those in the oil and gas, utilities and mining industries. When preparing or reading financial statements of these types of businesses you need to be aware of the particular accounting Industry Practice.

Other Aspects of Accounting:

Consistency means that accounting methods should not be changed from period to period. This permits financial statements to be compared over time. For example, the company should use the same depreciation, inventory costing and other methods from one year to the next so that depreciation and inventory costs can be compared among different years. An entity can change accounting methods if it follows established procedures and discloses the changes, and their impact, in the financial statements.

Stable dollar means ignoring inflation in traditional accounting. Some country economies have rampant inflation and as such current value accounting is more appropriate but in the U.S. the traditional model is based upon Historical Cost.