

Visual Learning Maps

Introductory Financial Accounting



Click to Go to the Website

VIRTUAL TEXT BOOK

Generally Accepted Accounting Principles GAAP – 1 of 4

All of Accountancy is built upon the Foundation Equation and GAAP.

GAAP is about common sense.

Although Albert Einstein said: “The rarest commodity in the universe is common sense;” these notes explain GAAP as a logical and reasonable set of rules used to guide preparers of financial statements that measure, communicate and present financial information.

As in other disciplines, Accounting issues arise that are not absolutely clear. Grey areas get discussed and resolved according to what adheres to GAAP and what violates GAAP. Just as Engineers may discuss and resolve problems based on calculus, and Physicians approach clinical diagnoses discussions based on anatomical and symptomatological terms; accounting measurement and presentation issues are discussed in terms of the common ground of GAAP.

The term” Generally Accepted” is much stronger than it appears to be. For example - In the United States of America the Financial Accounting Standards Board (FASB) issues written Standards for Accounting that, by law, must be followed by all companies filing with the Securities Exchange Commission (SEC). Similar standards boards exist worldwide that provide standards codified into statute law.

Because GAAP is codified in statute law, the rules are authoritative. Breaking GAAP law has very serious consequences. Not many years ago, one of the largest Accounting firms in the world disappeared because one of its clients broke GAAP law, and the external audit did not identify the infraction.

The GAAP for this course is about two groups:

- 1) Assumptions or Concepts; and
- 2) Principles

GAAP – 2 of 4

Entity Assumption or Concept

This means that the economic events (money moving and credit transactions), must be measured specifically to a particular business activity **and** that these monetary measurements are separate from any other monetary activities such as the personal expenditures of the owner(s). The business is regarded as a separate "person." An entity can be a small corner store or a huge multi-national business enterprise. An entity can be a proprietorship, one owner; a partnership, more than one owner; or a corporation that has numerous shareholders.

Monetary Unit Assumption

This means simply that financial statements must be expressed in terms of money. Financial statements are about hard core money matters – what was earned, what was spent and what the financial position is; they are not about management attitude, product quality, employee value or customer perception.

It is also desirable that the financial statements be prepared in a familiar and stable currency. The problem with this is – there is no single currency that remains stable over time. What cost \$1 or 1 Franc or 1£ twenty years ago costs a multiple of that today. Still, some currencies are more stable than others. Euro Dollars, US dollars and British Ponds are preferable as monetary presentation units to Shillings from the Republic of Gowanzee, or Jovian Dollars.

Time Period Concept

Financial statements must be prepared based on a time period that is both familiar and relevant to the reporting entity **and** to those interested in reviewing the financial statements. Oddly enough, the calendar has evolved as the Time Period Concept basis for financial reporting. Filings for income tax purposes are generally required on an annual basis; whereas filings required by securities commissions are generally required quarterly. Owners and management need monthly financial statements for decision making and planning.

Going Concern Assumption

Financial statements are prepared based on the assumption that the business will keep on going and going - doing business to meet its business goals. Accounting measurements can then be applied to measure assets at cost and the recording of depreciation of those assets can be logically and appropriately recorded.

There are instance when an entity is not a Going Concern. A business proceeding through bankruptcy is not a Going Concern, and therefore the assets are stated at liquidation values.

GAAP – 3 of 4

Cost Principle

This means that assets must be recorded at their cost. Whatever price the business entity paid - that is what must be recorded on the balance sheet.

There are reasonable “what if” questions around this Principle. What if a business bought a building and land twenty years ago for \$200,000 and today it is worth \$500,000; shouldn't the *real* value be shown in the financial statements?

Answer: No.

Here's why: The *real* value is a valuation estimate, and is therefore subjective. It may well be a very good estimate, but nevertheless only transactions that reflect the real movement of money or economic activity are allowed to be recorded in the financial statements.

There was a time when asset increases based on estimate valuations were permitted to be recorded in the financial statements. The subjectivity and abuse of estimates to write up assets was a key cause of the 1929 Stock market Crash.

Revenue Principle

Revenue should be recognized in the financial statements in the accounting period in which it is earned.

There are three criteria that must be met to record revenue. If a business is unsure of any one of these, **revenue should not be recorded**. They are:

- The business has done the work – meaning the revenue has been earned.
- The business can quantify the amount of revenue earned
- The business has a reasonable expectation that the revenue will be collected from the customer

GAAP – 4 of 4

Matching Principle

This Principle requires financial statements to “MATCH” expenses to revenue. Expenses are incurred to generate revenue, so the expenses should follow and be mated to the revenue generated in the same accounting period. Assets such as a factory building or a delivery truck contribute to generating revenue over a period of years; therefore a portion of their cost becomes expense as depreciation over the lifetime of the asset.

If the cost of the truck were expensed immediately on the purchase date, the revenue generated by the truck over the period of years would not be matched to the expense - so income would be understated in the first accounting period and income would be overstated in the others.

On the other hand - the gas for the truck last month is used up during the month, so **it is correctly** expensed immediately because it was used in the generation of revenue this month. The same is true for rent, salaries, advertising, repairs and any other operating expenses.

Disclosure Principle

This means **Full Disclosure**.

Financial statements communicate information to readers that includes numeric exhibits titled balance sheet, income statement and cash flow statement. Financial statements also include a section immediately following the exhibits titled “**Notes to the Financial Statements.**” The Notes provide important information to readers. This is where the Disclosure Principle resides and is entrenched.

In most annual reports the first Note is titled "Accounting Policies." Preparers of financial statements must decide "what" is important to readers. This is not an easy task; however, number one is that readers want to be first assured that the financial exhibits have been prepared according to GAAP. If statements are not prepared according to GAAP, there must be a justifiable explanation; if not, the statements will be perceived as worthless communication.

Preparers of financial statements are constantly faced with the question "what do we know that informed readers don't - and what part of that do readers want to know?"