Bookkeeping!
Financial Reporting
& GAAP Rules

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What are Generally Accepted Accounting Principles ?

In The United States your Financial Statements and the Methods used in preparing them must abide by several rules, standards, assumptions, principles, guidelines, and modifying conventions. Other countries also have similar rules and standards. Collectively, these are referred to as **Generally Accepted Accounting Principles (GAAP**). In other words GAAP consists of the basic principles, assumptions and guidelines , the detailed rules and standards issued by the Financial Accounting Board (FASB), and the generally accepted industry practices.

Generally Accepted Accounting Principles (GAAP) are the accounting rules used by companies (public and private) to prepare financial statements. Special rules apply to local and state governments and are determined by the Governmental Accounting Standards Board (GASB).

Generally Accepted Accounting Principles are not laws per se, but the Securities and Exchange Commission (SEC) requires publicly traded companies to adhere to these rules.

GAAP attempts to standardize the methods and rules used by businesses so that we **don't** have each business "**doing their own thing**". This allows the users of financial statements to compare one company with another or compare a company's financial statement with their related industry statistics derived from the financial statements of companies common to that industry.

GAAP provides the foundation for accounting by providing basic rules and concepts that aid in handling the various accounting issues a business encounters.

Shoot even games have Rules. Look at all the rules for our game of football. Think of GAAP as the rules for the "Game" of Accounting.

These rules of accounting (GAAP) have evolved from a basic framework and basic objectives of Financial Reporting.

What are the **Basic Objectives OF Financial Reporting ?**

Financial Reporting Should:

Provide the users of financial information such as managers, owners, potential investors, creditors, and other users with useful information that may affect the decisions they are confronted with.

To be useful and helpful to users, financial statements and information must have the following **Qualitative Characteristics**: In other words, the information possesses these qualities or characteristics.

Relevant:
The definition of relevant as it applies to financial information evolves from the general definition of the term relevant.

Relevant

Bearing upon, or properly applying to, the case in hand; pertinent; applicable.

As the term applies to financial information, information is relevant if it makes a difference in a decision maker's ability to predict the future (predictive value) or to confirm or correct prior expectations (feedback value). The information must also be available on a timely basis.

In summary, information should be timely and bear on the decision-making process by possessing feedback and/or predictive value. Feedback information provides us with information about what has happened while predictive information provides us with data to help guide us in predicting what will occur in the future.

Knowing that the president of a company is married and has four children is information that would probably not be relevant to many financial decisions.

- **Reliable:**
  The definition of reliable as it applies to financial information evolves from the general definition of the term reliable.

  Reliable

  - Giving the same result on successive
  - trials. High degree of certainty
  - Worthy of reliance or trust
  - Suitable or fit to be relied on; worthy of dependence or reliance; trustworthy.

  Information is reliable if it is:
  - Verifiable means that accountants using the same method would come up with similar results or numbers.
  - Neutral and unbiased.
    Neutral means the information should not favor certain interest groups. Bias is when information is consistently presented as to high or low. Bias can be caused by using an improper measurement method.
  - Representational Faithfulness means the information presents what really happened or existed.

  In order to be reliable, information must be faithful in representation, free from bias, neutral, and verifiable.

- **Comparable:**
  Information must be measured and reported in a similar manner by all types of businesses. This allows comparison of the financial statements of different entities (businesses) or comparisons for the same entity (business) over different periods.
- **Consistent:**
  The same accounting methods should be applied from period to period and all changes to more acceptable methods should be well explained and justified. Deviations in measured outcomes from period to period should be the result of deviations in performance not changes in methods.

Constraints and Modifying Conventions:

Constraints:
Unfortunately, information is not free. The qualitative characteristics of useful accounting information are constrained by two factors.

- Materiality- Information is material if it provides information that would effect a decision (decision maker). The materiality of an item requires judgment and depends on the relative size of the item, how accurately the information can be estimated, and the nature of the item.
- Relative Cost Benefit- Information should only be provided if its benefits exceed its costs. GAAP attempts to provide guidance in this area.

Modifying Conventions:

- Conservatism
  Accountants have a tendency to stray away from painting too rosy a picture. In other words, if in doubt, err to the side of caution. While accountants don't want to misinform users of financial information, they also don't want to be sued.
- Industry Practices
  Are the specific methods or practices that specific industries have developed and use to present information related to their unique needs.

Lets use a simple table to summarize, organize, and present the useful qualities of financial information that we just discussed. This table is based on a diagram from Statements Of Financial Accounting Concepts (SFAC) Number 2 issued by the Financial Accounting Standards Board.

Useful Information For Decision Makers					
Benefits > Costs					
Understandability					
Decision Usefulness					
Relevance			Reliability		
Predictive Value	Feedback Value	Timeliness	Verifiability	Neutral	Representational Faithfulness
Comparability / Consistency					
Materiality					

The two constraints on financial information Cost Benefit and Materiality are highlighted in yellow. Normally information that doesn't fall within these constraints (boundaries) is not provided to users of financial information. Exceptions would be if certain information was required by a governmental agency regardless of the materiality or the cost of obtaining the information.

Financial Reporting Should Also ....

1. Provide understandable information that can be used to help predict future cash flows for the business or firm. What's an example of financial information or statement used to present this type of information ? Statement Of Cash Flows.
2. Provide information about the firm's property (economic resources) and the claims to those resources and the effects of transactions that change the resources and claims. What's an example of financial information or statements that present this type of information ? The Balance Sheet and Income Statement.

You should now at least have a pretty good idea of what the accounting profession considers as useful financial information.

Let's take a look at an accounting joke to illustrate what we mean by useful and timely information.

A fellow has been learning to be a balloonist and takes his first solo flight. Unfortunately the wind gets up, he is blown off course and is forced to land. He is in a paddock close to a road but has no idea where he is. He sees a car coming along the road and hails it. The driver gets out and the balloonist says, "G'day sir, can you tell me where I am?"

"Yes, of course", says the motorist. "You have just landed in your balloon and with this wind you have obviously been blown off course. You are in the back field on John Dawson's farm, 13.5 miles from Knoxville. John will be plowing and sowing corn in the back field next week. There is a bull in the field. It is behind you and about to attack you."

At the moment the bull reaches the balloonist and tosses him over the fence. Luckily he is unhurt. He gets up, dusts himself off and says to the motorist, **"I see you're an accountant".**

"Good Grief", says the driver, "you're right. How did you know that?"

"I employ accountants", says the balloonist. **"The information you gave me was detailed, precise and accurate. Most of it was useless and it arrived far too late to be of any help."**

Now that we have a basic understanding of the type of information needed and used for reporting financial results, lets take a look at the foundation upon which the detailed Generally Accepted Accounting Principles are built.

GAAP Basic Foundation

GAAP has four basic assumptions, four basic principles, and four basic constraints and modifying conventions.

Assumptions:

1. **The Business or Economic Entity Assumption**

This assumption requires every business to be accounted for separately from the owner. Personal and business-related transactions are kept apart from each other. In other words, the separate personal transactions of owners and others is not commingled with the reporting of the economic activity of the business. One of the first recommendations almost all accountants tell a client is to at least establish a business checking account and to use it to only record their business transactions.

2. **The Going-Concern Assumption**

This assumption assumes that a business will continue operating and will not close or be sold. It assumes that a business will be in operation for a long time. Based on this assumption, actual costs instead of liquidation values are used for presenting financial information. This assumption is abandoned in the event that a business is actually going out of business.

3. **Monetary Assumption**

- a. Monetary Unit Assumption

  This assumption assumes accounting measures transactions and events in money and only transactions that can be monetized (stated in a monetary unit such as the dollar) are recorded and presented in financial statements.

  Simply stated, money is the common denominator (measurement unit) used for reporting financial information.

  Look at the confusion of combining and presenting information using different measurement units such as:

  - Land - Number of Acres
  - Building - Square Footage
  - Cash -Dollars
  - Truck- Miles
  - Employees- Number
  - Employees- Work Hours
  - Employees-College Educated
  - Secret Manufacturing Method - Number Of Patents

  Although these statistics or facts might be useful, how can we summarize and add them together in order to provide any meaningful information ? If we use one unit of measurement - money -dollars or your currency (yen, pound, etc.) all our financial information can be easily summarized and provide users with understandable and meaningful financial information about the business instead of a bunch of unrelated facts.

- b. Stable Currency Assumption

  This assumption assumes that costs and revenues incurred in different time periods can be safely used without adjusting for changes in the value of the monetary unit over time.

  The fact that inflation may destroy some of the usefulness of financial information is ignored. Even though a business may have purchased land for $10,000 fifty years ago and the land is currently worth $200,000 stated in "today's dollars", the value of the land is shown at it's original cost of $10,000 on the Balance Sheet.

4. **Time Period (Periodicity) Assumption**

This assumption assumes that business operations can be recorded and separated into different time periods such as months, quarters, and years. This is required in order to provide timely information that is used to compare present and past performance.

Principles

1. **The Historical Cost Principle**

This principle requires that most assets are recorded at their original acquisition cost and no adjustment is made for increases in market value. In other words, the value of an asset is never "written up" even though the asset may actually be worth more than its cost. On the other hand, cost is sometimes "written down" for example marketable securities and inventory. See conservatism convention.

The purpose of this principle is to provide reliable and unbiased financial information but some of the values whose values are materially greater than cost are not very relevant information. This deficiency is often addressed by supplying additional supplementary information that also includes market values.

Wouldn't we have a mess if we let every business state their assets at what **they think** they're worth ?

2. **Realization Principle - Revenue Recognition**

The revenue recognition principle requires companies to record revenue when it is realized or realizable and actually earned. In other words, at the time the goods are actually sold or the services are rendered.

When revenue is earned normally has no relationship to when the cash resulting from the earnings is actually received. This principle is the basis for accrual accounting.

3. **Matching Principle**

The Matching Principle goes hand in hand with the Revenue Realization Principle. The matching principle is recording the revenues earned during a period using the revenue realization principle and matching (offsetting) the revenues with the expenses incurred in generating this revenue.

Expenses are recorded in the period and matched with the revenues recorded using the following methods:

- Associate Cause and Effect

Many costs can be directly linked to the revenue they help to produce. Cost of Goods Sold and Sales Commissions for example are directly related to the sale of the product.

- Systematic and Rational Allocation

Some costs such as the cost of Equipment Purchased provide benefit for many years and to many periods. Instead of recording the entire cost as an expense in the period the equipment was purchased which would greatly distort earnings, the cost is allocated to revenue recognized in the periods that receive benefit from the use of the equipment. Allocating or spreading the cost of the equipment over many periods (expensed) is called depreciation.

- Immediate recognition If no connection or relationship with revenue can be established, cost is immediately offset against revenue and charged to an expense in the current period (office salaries, professional fees, and other administrative expenses).

4. **Adequate Disclosure (Full Disclosure Principle)**

The Adequate Disclosure Principle states that all pertinent and material financial information concerning the business and its activities is fully disclosed in an understandable form. Information is presented in the main body of the financial statements, in the notes to the financial statements, or as supplementary information. What actually constitutes adequate disclosure often involves professional judgment.

Constraints and Modifying Conventions

1. **Materiality Convention**
The Materiality Convention states that the significance of an item should be considered in order to determine what is reported.

2. **Cost-Benefit Convention**
The Cost-Benefit Convention states that the benefit of providing the financial information should also be weighed against the cost of providing it.

3. **Conservatism Convention**
The Conservatism Convention states that when choosing between two alternatives, the one that will be least likely to overstate assets and income should be picked.

4. **Industry Practices Convention**
The Industry Practice Convention states that when customary industry practices exists they should be followed and used for financial reporting.

These constraints and conventions should already look familiar to you. They were discussed earlier in our section about the Objectives Of Financial Reporting.

Summary

In order to "Play" the "Game Of Accounting" a business has to learn and play by the Rules. The Rules (GAAP) have been established so that everyone plays the "Accounting Game" in a similar manner. In order to properly play the "Game of Accounting" a key requirement is to provide useful and understandable information that provides feedback or predictive value that can aid in decisions and analysis.

Shoot that wasn't too bad ! **Don't fool yourself** - what we discussed is just the tip of the iceberg. The rules we discussed just lay the general ground work for the more detailed rules. There have been more than 150 detail Statements of Financial Accounting Standards (most authoritative GAAP setting publications) issued by the Financial Accounting Standards Board.

Who's Responsible for Making The Rules and Providing Guidance Regarding GAAP (Accounting Rules) ?

If you were paying attention, the previous paragraph provides a big hint. Originally, the American Institute Of Certified Public Accountants (AICPA), the membership association for CPAs, was the organization in charge of defining accounting standards. This duty was assumed by the **Financial Accounting Standards Board (FASB)** in 1973.

These organizations influence developing General Accepted Accounting Principle (GAAP) in the United States.

- ### Official Rule Makers

- **Financial Accounting Standards Board (FASB)**
  Since 1973 the FASB has been the organization designated as responsible for establishing authoritative financial accounting and reporting standards for business and other private-sector entities.

  Types Of Publications
- **Statements of Financial Accounting Standards** are the published standards and rules that comprise the main authoritative standards and rules of GAAP.
- Interpretations are publications that modify or extend existing standards.
- Technical Bulletins are guidelines used for applying standards, interpretations, and opinions normally to very specific accounting issues or problems.

The Interpretations and Technical Bulletins provide additional clarification and guidelines to help in utilizing and applying the Statements Of Financial Accounting Standards.

- Statements of Financial Accounting Concepts are a part of the FASB conceptual framework project and set forth fundamental objectives and concepts that the FASB will use in developing future standards. These are just guides and are not officially considered as Generally Accepted Accounting Principles (GAAP).

- **Government Accounting Standards Board (GASB)**
  Created in 1984, the GASB addresses state and local government reporting issues.

- Other Influential Organizations

- Securities and Exchange Commission (SEC)
  The SEC has statutory authority to establish financial accounting and reporting standards for publicly-held companies. The Sarbanes-Oxley Act established the SEC's Public Company Accounting Oversight Board (PCAOB) as a watchdog to "police" CPA's and crack down on corporate accounting scandals. Prior to this act CPA's policed themselves.
- American Institute Of Certified Public Accountants
  (AICPA) The professional membership association of
- CPA's. American Accounting Association (AAA)
  Academic Organization that promotes accounting education, research, and practice by publishing journals and research papers.