

Generally Accepted Accounting Principles (GAAP)



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After the U.S. stock market crash in 1929, government agencies scrambled to find a way to better regulate the financial practices of publicly held companies, with

GAAP the result.

Since 1973, the Financial Accounting Standards Board (FASB), with input from other organizations such as the American Institute of Certified Public Accountants (AICPA), the U.S. Securities and Exchange Commission (SEC), and the Governmental Accounting Standards Board (GASB), have overseen GAAP rules and regulations.

What Is GAAP?

Generally accepted accounting principles or GAAP is a set of accounting rules and procedures governed by the FASB.

Any publicly held company in the U.S. must follow GAAP rules when creating financial statements to ensure that the company's financial statements are complete, consistent, and comparable.

Using this standard creates transparency and allows potential and current investors to better analyze and compare information from multiple publicly held companies.

What Are the Main Principles of GAAP?

GAAP's set of standards uses 4 primary principles and 10 guiding principles.

The four primary principles are:

■ The Main Principles of GAAP



The Cost Principle



The Revenues Principle



The Matching Principle



The Disclosure Principle

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- **The Cost Principle** - The cost principle states that all listed values are

accurate and reflect actual costs rather than perceived or market costs.

In other words, your assets must reflect historic cost, not current market cost.

- **The Revenues Principle** - The revenues principle states that when revenue is recognized, it should be reported.

This is essential in accrual accounting, as the sale of a product or service should be reported when that sale is completed, not when money is received from the customer.

- **The Matching Principle** - The matching principle refers to the matching of revenue with related expenses, indicating that any expenses incurred from revenue production should be reported in the same period as the revenue that was generated.

In other words, if you pay salespeople a commission on sales, the commission must be reported in the same period that the revenue is generated.

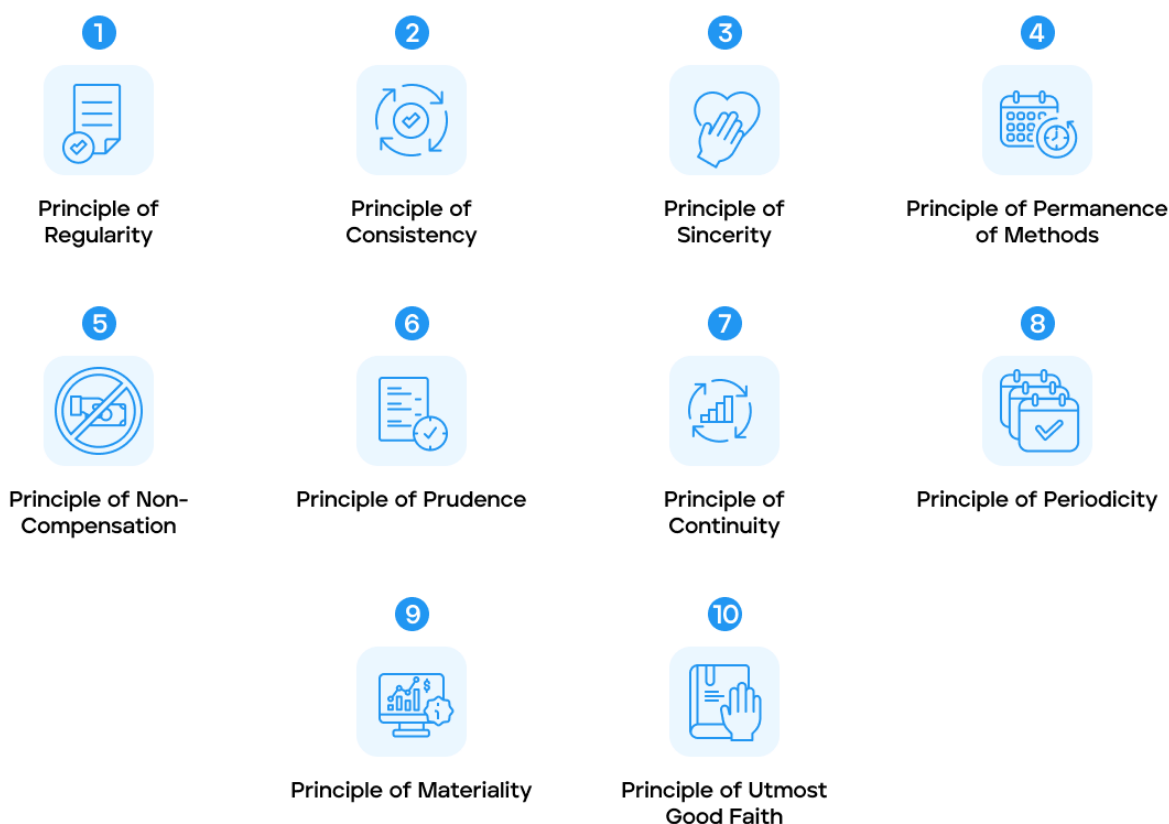
- **The Disclosure Principle** - Companies must declare all required information when reporting on the financial status of the company.

For example, when presenting financial statements, the recipients of those statements must be provided with the details they need to better understand the statement.

This should include details such as the inventory valuation method used, how depreciation is calculated, if there have been any significant write-offs, what those write-offs were, and why they were written off.

In addition to these main principles, GAAP compliance requires that the following guiding principles be followed:

GAAP Compliance Requires the Following Guiding Principles Be Followed



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1. **Principle of Regularity:** GAAP compliance requires that accountants adhere to GAAP accounting standards.
2. **Principle of Consistency:** Financial statements must be consistent and comparable every accounting period.
3. **Principle of Sincerity:** A business must show an accurate depiction of its financials at all times.
4. **Principle of Permanence of Methods:** Accounting practices are consistent across multiple accounting periods.
5. **Principle of Non-Compensation:** An organization's performance must be fully reported without expectation of debt compensation.

6. **Principle of Prudence:** An organization's accounting entries are timely and realistic.
7. **Principle of Continuity:** Short-term and long-term classifications are based on the idea that the business will remain in operation.
8. **Principle of Periodicity:** The organization's accounting periods are regular, routine, and consistent.
9. **Principle of Materiality:** Organizational assets are valued at cost and all financial reports are based on truthful information.
10. **Principle of Utmost Good Faith:** Every person involved in the accounting process is acting honestly.

Why Is GAAP Important?

Compliance with GAAP standards provides transparency both internally and for those considering investing in a business.

Internally, GAAP provides consistency for managers to make more informed decisions while providing investors and potential investors with accurate financial data.

Without GAAP compliance, companies could easily create financial information that distorts the company's true financial position.

In addition, when all companies are required to follow the same guidelines, it becomes easier for investors, creditors, and lenders to easily review and understand a company's actual financial health.

How does GAAP differ from IFRS?

While GAAP standards are used exclusively in the U.S., other countries typically use the International Financial Reporting Standards (IFRS).

Developed by the International Accounting Standards Board (IASB), the IFRS is used in more than 100 countries, with the IFRS Foundation responsible for

maintaining and updating the standards in the countries that use it.

Though both are used to maintain transparency in accounting, there are some significant differences between the two:

■ How GAAP differs from IFRS

	GAAP	IFRS
GEOGRAPHIC REACH	GAAP is used in the U.S.	IFRS is used globally by more than 100 countries worldwide
STANDARDS BASIS	GAAP is a rules-based system	IFRS is principles-based, giving it some room for flexibility
INVENTORY REPORTING	GAAP standards prefer the LIFO method for reporting inventory	IFRS currently prohibits the LIFO method from being used in reporting
INVENTORY WRITE-DOWN	GAAP prohibits the reversal of the write-down	IFRS allows the write-down to be reversed should the value increase in the future
ASSET VALUATION	GAAP supports only the cost model which values fixed assets at historic cost	IFRS allows the use of the revaluation model which allows companies to revalue fixed assets up or down to market value
IMPAIRMENT LOSSES	GAAP rules prohibit the reversal of impairment losses on any type of company asset	IFRS rules allow companies to reverse impairment losses aside from goodwill
LIABILITIES REPORTING	GAAP rules require businesses to separate liabilities into current and non-current liabilities	IFRS does not require a company to do so

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• Geographic Reach

GAAP is used in the U.S. while IFRS is used globally by more than 100 countries worldwide.

▪ **Standards Basis**

One of the more significant differences between GAAP and IFRS is that GAAP is a rules-based system while IFRS is principles-based, giving it some room for flexibility.

▪ **Inventory Reporting**

GAAP standards prefer the LIFO method for reporting inventory, while IFRS currently prohibits the LIFO method from being used in reporting.

▪ **Inventory Write-Down**

Both GAAP and IFRS allow companies to write down inventory to market value. IFRS allows the write-down to be reversed should the value increase in the future.

GAAP prohibits the reversal of the write-down.

▪ **Asset Valuation**

GAAP supports only the cost model which values fixed assets at historic cost while IFRS allows the use of the revaluation model which allows companies to revalue fixed assets up or down to market value.

In addition, GAAP rules state that intangible assets should be valued at fair value while in IFRS, intangible assets are valued based on future economic benefits.

▪ **Impairment Losses**

Both GAAP and IFRS standards allow businesses to recognize impairment losses on assets should the market value of the asset decline.

However, should the market change, IFRS rules allow companies to reverse impairment losses aside from goodwill, while GAAP rules prohibit the reversal of impairment losses on any type of company asset.

• **Liabilities Reporting**

GAAP rules require businesses to separate liabilities into current and non-current liabilities, while IFRS does not require a company to do so.

Businesses that operate or trade internationally may opt to use both methods when preparing financial statements.

How Do Generally Accepted Accounting Principles (GAAP) Impact Financial Reporting?

GAAP impacts every item on the financial statement, increasing transparency, while also having a significant impact on investors and other financial institutions.

GAAP standards require that companies use specific guidelines when creating financial statements, and that reporting practices remain the same across all publicly held companies.

GAAP rules also require that specific financial reports are produced by these companies and that all financial transactions are recognized, measured, and displayed across all publicly held companies.

In many cases, companies will run both GAAP and non-GAAP financial statements, which are often used internally.

Companies also have the option to release both GAAP-compliant and non-GAAP-compliant financial statements as long as they properly disclose the non-GAAP reporting totals.

Other ways that GAAP impacts financial statements is that non-GAAP reporting typically excludes acquisition expenses, litigation expenses, relocation expenses, fines and penalties, and unusual tax expenses.

Excluding these items from reporting typically results in a higher net profit, which is why non-GAAP reporting is often more favorable to a company than reporting that follows GAAP.

GAAP reporting also excludes EBITDA (earnings before income taxes, depreciation, and amortization), which also reduces the amount of profit reported by a company.

How Do Companies Implement GAAP in Their Financial Reporting?

Companies following GAAP rules need to use the following guidelines when producing financial statements:

■ How Companies Implement GAAP in Their Financial Reporting



Recognition



Measurement



Presentation



Disclosure

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- **Recognition** - Any company financial statement needs to recognize and include all assets, revenue, liabilities, and expenses.
- **Measurement** - Financial statements produced by a company must follow all GAAP standards.
- **Presentation** - To be GAAP compliant, a company must produce the financial statements required by GAAP.
- **Disclosure** - A company's financial reporting must include any relevant notes or disclosures needed to explain the data included in the financial report.

What Is an Example of GAAP?

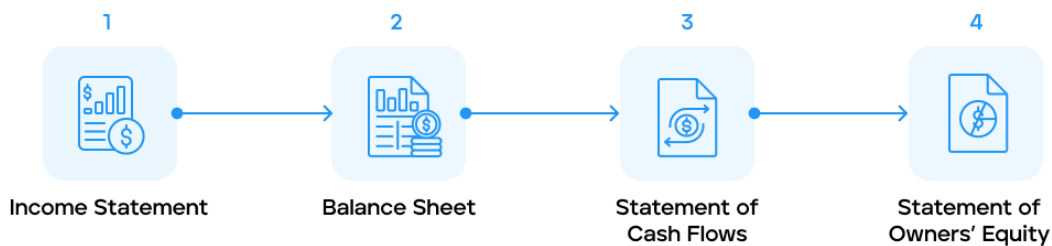
Linda owns a small business and is currently the only investor in the company.

When she produces financial statements, Linda typically runs a cash flow

statement monthly and a balance sheet and income statement quarterly, though the interval can vary.

If Linda owned a publicly held business or had investors, she would be required to produce her financial statements according to GAAP guidelines, which require the following statements at regular intervals:

■ An Example of GAAP



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1. Income Statement
2. Balance Sheet
3. Statement of Cash Flows
4. Statement of Owners' Equity

In addition, if Linda's company was publicly held, she would be required to produce all of her financial statements at the same intervals.

Another example of GAAP in use is consistency.

For instance, if Linda were to change the way she produced financial statements in the future, she would need to disclose the change and explain why those changes were made.

What Are the Key Differences Between GAAP and Non-GAAP Financial Reporting?

The major difference between GAAP and non-GAAP reporting is the level of consistency across multiple companies.

GAAP requires a consistent format to be used, with financial statements prepared in an exact fashion, regardless of company size or industry.

GAAP standards also allow for easy comparison of financial statements from previous years.

Non-GAAP financial reporting isn't necessarily inaccurate or false, but because there are no specific requirements in place, companies are free to use the format of their choice when creating financial statements.

This creates a level of inconsistency, since Company A may format and create their financial statements differently than Company B, making it impossible to compare the financial data for the two companies.

Another major difference is the way one-time items are reported.

Because non-GAAP reporting does not take one-time items such as a one-time gain, loss, or expense that is not recurring into consideration when preparing financial statements, the results of the statements will vary from those that were prepared using GAAP standards.

How Are the Generally Accepted Accounting Principles (GAAP) Enforced in the United States?

GAAP rules are enforced by the FASB and the SEC, with the FASB charged with setting GAAP rules, while the SEC currently has the authority to both set and enforce GAAP rules and principles.

GAAP standards are not a law, but a violation of these standards by a publicly traded company can have serious ramifications starting with a significant loss of public credibility, which can directly impact stock prices and company valuations.

In addition, the SEC can choose to penalize a business for GAAP violations.

Are There Any Downsides to Using GAAP?

GAAP presents many advantages, increasing honesty and transparency in reporting while making it easy to compare one company's financial performance to another's.

In addition, it levels the playing field for a diverse selection of companies, since all publicly held companies are required to follow GAAP standards, regardless of the industry they're in.

But GAAP also has some downsides. Because it uses a one-size-fits-all approach, following GAAP guidelines can be difficult for some businesses.

In addition, smaller businesses may find it difficult to follow all GAAP principles in their business.

Another downside to GAAP is that it's used exclusively in the U.S., which can make it difficult for businesses trading globally to adhere to GAAP standards along with IFRS standards as well.

Following GAAP rules may not be the best way to manage your business internally.

While following GAAP rules may be necessary, many businesses also use non-GAAP-compliant financial statements when making internal business decisions.

GAAP Is a Necessity for Any Publicly Traded Company

If you're a publicly traded company, you must adhere to GAAP standards. While not a requirement for private companies, many choose to follow GAAP standards for increased transparency.

If you're planning on taking your company public in the foreseeable future, it's also a good idea to familiarize yourself with GAAP requirements.

The best way to ensure that you're GAAP compliant is to hire experienced accountants or a CPA who can help ensure that your business remains GAAP

compliant.

Another way to stay GAAP compliant is to use a solid accounting software application that can produce all of the necessary financial statements you need to remain in compliance.

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