GAAP

General Accepted Accounting Principles

Generally accepted accounting principles, or GAAP as they are more commonly known, are rules for the preparation of financial statements. Every publicly traded company must release their financial statements each year. These statements are used by investors, banks and creditors to determine the financial health of the company and its suitability for investment or extension of credit. In order to properly compare and evaluate companies and their results, the financial statement must provide similar information in a similar format. Every country has its own generally accepted accounting principles, and all publicly released financial statements must comply with these rules.

Ads by Google
 Financial Statements
matically create customised IFRS-compliant statements
.cqs.co.za
ı ACCA from Home
Hours Online ACCA Video Course LSBF Tutors, 24/7 Support, Apply!
.StudyInterActive.org/ACCA
unting Courses + MBA
MBA or MSc Fully Sponsored with ACCA/CIMA Course, Apply Now!
.LSBF.org.uk/ACCA
l Accounting
ı Africa's leading accounting and ERP software developer.
.pastel.co.za
Accounting Course
le-Entry Accounting Made Easy YouTube Videos, Texts, Figures
.lapasserelle.com

Although there is no comprehensive list of generally accepted accounting principles, the structure is based around four key assumptions, four basic principles and four basic constraints.

Four Key Assumptions

The key assumptions in generally accepted accounting principles are: business entity, going concern, monetary unit and time period principle. The business entity assumption is the idea that the business functions as a legal and financial entity separate from its owners or any other business. This assumption means that all the amounts shown as revenue or expense in the financial statements are for the business alone and do not include any personal expenses. "Going concern" is the assumption that the business will operate for the foreseeable future. This is important when calculating the values for assets, depreciation and amortization. The monetary unit assumption is that all the amounts listed use one stable currency, and that any amounts in another currency are clearly listed. "Time period" assumes that all the transactions reported did in fact occur within the time period as listed.

Gaap Accounting
Generally Accepted Accounting
Generally Accepted Accounting Principles

Governmental Accounting
Accounting Resources
Gaap Book
Accounting Reference

Four Basic Principles

The four basic principles in generally accepted accounting principles are: cost, revenue, matching and disclosure. The cost principle refers to the notion that all values listed and reported are the costs to obtain or acquire the asset, and not the fair market value. The revenue principle states that all revenue must be reported when is it realized and earned, not necessarily when the actual cash is received. This is also known as accrual accounting. The matching principle holds that the expenses in the financial statement must be matched with the revenue. The value of the expense is included in the financial statements when the work product is sold, not necessarily when the work or invoice is issued. Finally, the disclosure principle holds that information pertinent to make a reasonable judgment on the company's finances must be included, so long as the costs to obtain that information is reasonable.

Ads by Google
IAS GAAP
German GAAP
Lease Accounting Fasb
CRM Accounting Reporting

Four Basic Constraints

The four basic constraints in generally accepted accounting principles are: objectivity, materiality, consistency and prudence. The objective constraint states that all the information included in the financial statements must be supported by independent, verifiable evidence. When deciding what to include or exclude from the financial statements, the significance of the item must be considered under the materiality constraint. If this information would be significant to a reasonable third party, it must be included. The company is required to use the same accounting methods and principles each year under the consistency constraint and any variation must be reported in the financial statement notes. Under the constraint of prudence, accountants are required to choose a solution that reduces the likelihood of overstating assets and income.

Ads by Google

GAAP is an international convention of good accounting practices. It is based on the following core principles. In certain instances particular types of accountants that deviate from these principles can be held liable.

The Business Entity Concept

The business entity concept provides that the accounting for a business or organization be kept separate from the personal affairs of its owner, or from any other business or organization. This means that the owner of a business should not place any personal assets on the business balance sheet. The balance sheet of the business must reflect the financial position of the business alone. Also, when transactions of the business are recorded, any personal expenditures of the owner are charged to the owner and are not allowed to affect the operating results of the business.

The Continuing Concern Concept

The continuing concern concept assumes that a business will continue to operate, unless it is known that such is not the case. The values of the assets belonging to a business that is alive and well are straightforward. For example, a supply of envelopes with the company's name printed on them would be valued at their cost. This would not be the case if the company were going out of business. In that case, the envelopes would be difficult to sell because the company's name is on them. When a company is going out of business, the values of the assets usually suffer because they have to be sold under unfavourable circumstances. The values of such assets often cannot be determined until they are actually sold.

The Principle of Conservatism

The principle of conservatism provides that accounting for a business should be fair and reasonable. Accountants are required in their work to make evaluations and estimates, to deliver opinions, and to select procedures. They should do so in a way that neither overstates nor understates the affairs of the business or the results of operation.

The Objectivity Principle

The objectivity principle states that accounting will be recorded on the basis of objective evidence. Objective evidence means that different people looking at the evidence will arrive at the same values for the transaction. Simply put, this means that accounting entries will be based on fact and not on personal opinion or feelings.

The source document for a transaction is almost always the best objective evidence available. The source document shows the amount agreed to by the buyer and the seller, who are usually independent and unrelated to each other.

The Time Period Concept

The time period concept provides that accounting take place over specific time periods known as fiscal periods. These fiscal periods are of equal length, and are used when measuring the financial progress of a business.

The Revenue Recognition Convention

The revenue recognition convention provides that revenue be taken into the accounts (recognized) at the time the transaction is completed. Usually, this just means recording revenue when the bill for it is sent to the customer. If it is a cash transaction, the revenue is recorded when the sale is completed and the cash received.

It is not always quite so simple. Think of the building of a large project such as a dam. It takes a construction company a number of years to complete such a project. The company does not wait until the project is entirely completed before it sends its bill. Periodically, it bills for the amount of work

completed and receives payments as the work progresses. Revenue is taken into the accounts on this periodic basis.

It is important to take revenue into the accounts properly. If this is not done, the earnings statements of the company will be incorrect and the readers of the financial statement misinformed.

The Matching Principle

The matching principle is an extension of the revenue recognition convention. The matching principle states that each expense item related to revenue earned must be recorded in the same accounting period as the revenue it helped to earn. If this is not done, the financial statements will not measure the results of operations fairly.

The Cost Principle

The cost principle states that the accounting for purchases must be at their cost price. This is the figure that appears on the source document for the transaction in almost all cases. There is no place for guesswork or wishful thinking when accounting for purchases.

The value recorded in the accounts for an asset is not changed until later if the market value of the asset changes. It would take an entirely new transaction based on new objective evidence to change the original value of an asset.

There are times when the above type of objective evidence is not available. For example, a building could be received as a gift. In such a case, the transaction would be recorded at fair market value which must be determined by some independent means.

The Consistency Principle

The consistency principle requires accountants to apply the same methods and procedures from period to period. When they change a method from one period to another they must explain the change clearly on the financial statements. The readers of financial statements have the right to assume that consistency has been applied if there is no statement to the contrary.

The consistency principle prevents people from changing methods for the sole purpose of manipulating figures on the financial statements.

The Materiality Principle

The materiality principle requires accountants to use generally accepted accounting principles except when to do so would be expensive or difficult, and where it makes no real difference if the rules are ignored. If a rule is temporarily ignored, the net income of the company must not be significantly affected, nor should the reader's ability to judge the financial statements be impaired.

The Full Disclosure Principle

The full disclosure principle states that any and all information that affects the full understanding of a company's financial statements must be include with the financial statements. Some items may not affect the ledger accounts directly. These would be included in the form of accompanying notes. Examples of such items are outstanding lawsuits, tax disputes, and company takeovers.

GAAP is a collection of methods used to process, prepare, and present public accounting information. GAAP is overall very general in its methods, as it needs to be somewhat applicable to many different types of industries. GAAP can be principle-based or specific technical requirements. Due to the fact that in many instances it is flexible and general, most industries in the United States are expected to follow GAAP principles.

Although different organizations contribute to GAAP, the Financial Accounting Standards Board (FASB) is the main contributor to GAAP. This is done through one of four categories of methods which differ on method and level of importance.

FASB is an organization that has been granted the authority to establish generally accepted accounting principles (GAAP) by the Securities and Exchange Commission (SEC).

Generally Accepted Accounting Principles (GAAP)

Generally accepted accounting principles (GAAP) are varied but based on a few basic principles that must be upheld by all GAAP rules. These principles include consistency, relevance, reliability, and comparability.

Consistency means that all information should be gathered and presented the same across all periods. For example, a company cannot change the way they account for inventory from one period to another without noting it in the financial statements and having a valid reason for the change.

Relevance means that the information presented in financial statements (and other public statements) should be appropriate and assist a person evaluating the statements to make educated guesses regarding the future financial state of a company.

Reliability means simply that the information presented in financial statements is reliable and verifiable by an independent party. Basically a company must confirm that if an independent auditor were to base their reports off of the same information that they would come up with the same results. Following this generally accepted accounting principle (GAAP) also means that the company is representing a clear picture of what really happened (and is happening) with their company.

Read on

- Financial Statements-Balance Sheet
- Quick Reference GAAP Guide
- Mark-to-Market Takes Precedence in Global Crisis

Comparability is one of the most important GAAP categories and one of the main reasons having something similar to GAAP is necessary. By ensuring comparability, a company's financial statements and other documentation can be compared to similar businesses within its industry. The importance of this principle cannot be overstated, as without comparability

investors would be unable to discern differences between companies within an industry to benchmark how a company is doing compared to its peers.

Generally accepted accounting principles (GAAP) ensures that all companies are on a level playing field and that the information they present is consistent, relevant, reliable, and comparable. Although U.S. GAAP is only applicable in the U.S., other countries have their own versions that are similar in purpose, although not always in design.

What Does *Generally Accepted Accounting Principles - GAAP* Mean?
The common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

Investopedia explains *Generally Accepted Accounting Principles - GAAP*
GAAP are imposed on companies so that investors have a minimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such things as revenue recognition, balance sheet item classification and outstanding share measurements. Companies are expected to follow GAAP rules when reporting their financial data via financial statements. If a financial statement is not prepared using GAAP principles, be very wary!

That said, keep in mind that GAAP is only a set of standards. There is plenty of room within GAAP for unscrupulous accountants to distort figures. So, even when a company uses GAAP, you still need to scrutinize its financial statements.

Tabulated below the major differences between Periodic Inventory System and Perpetual Inventory System:

Periodic Inventory System	Perpetual Inventory System
Inventory account and cost of goods sold are non-existent until the physical count at the end of the year.	Account and the balance of costs of goods sold and inventory account exist all the time.

Purchases account is used to record purchases.	No individual purchases account but the purchases are recorded in the Inventory Account.
Purchase Return account is used to record Purchases Returns account.	No individual Purchase Returns account but the purchases return are recorded in the Inventory Account.
Cost of goods sold or cost of sale is computed from the ending inventory figure	Record cost of goods sold/cost of sale – inventory is reduced when there is a sale.
For goods returned by customers there are no inventory entries.	Returns from customers are recorded by reducing the cost of goods sold and adding back into inventory.

What is Perpetual Inventory System?

Difference needs to be made here between the periodic inventory system and the perpetual inventory system. In the periodic inventory system, the inventory would be calculated once in a month, or 6 months or a year. Periodic means that the inventory would not be continually on watch, but instead, would be assessed periodically, the period being pre-decided by the company.

Perpetual inventory system is continuously (perpetually) being assessed. This is basically because the treatment of the various transactions of purchase and sale directly affects the inventory in bookkeeping. Let us try and understand perpetual inventory system with the help of perpetual inventory system example.

Let us take the example of a mall. The business model of the mall works on a resale basis i.e. whatever inventory comes in from the dealer is sold to the final customer without any processing. Perpetual inventory system, you will find works best in such a case. Now in the periodic inventory system, you would have a book of purchases from the individual dealer and a book for recording cash sales to customers. You would also have a book monitoring the inventory value periodically depending on the inventory valuation method which your

company follows.

Let us now contrast this with the perpetual inventory system. In this system, the individual books for sales and purchases are done away with and there is only one book, recording the inflow and outflow of the goods, known as the merchandise inventory account. All the purchases for each day are recorded on one side of the book and all the sales on the other side of the book. The account is balanced at the end of each day which yields the inventory position for the day. Read more on balance sheets.

Features of the Perpetual Inventory System

Now the perpetual inventory system is best suited for the sort of enterprises that usually keep a high inventory and have a high turnover. It is also well suited for the type of industries where there isn't much processing to do, so the inventory exists at only one level (for sale) rather than at three levels (raw materials, work in progress and for sale). It is well suited for the fact that inventory checking is an important part of the operations of this industry.

Furthermore, the perpetual inventory system is further aided by the presence of RFID checkers. These RFID checkers make the inventory calculation and recording purchases and sales easier and eliminate the need for manual checking at regular intervals. Of course, one cannot avoid situations where there may be a theft or unaccounted spoilage or a system failure which may send the thing into a disarray and manual backup may be called for. Read on for a glossary of accounting terms and definitions.

So this was all about the perpetual inventory system. As you can see, the basic difference between the periodic and the perpetual inventory systems is that in the latter, the inventory is always kept a close watch on, due to the accounting system and company policies.

INVENTORIES AND FINANCIAL STATEMENTS

Inventories are usually the largest current asset of a business, and proper measurement of them is necessary to assure accurate financial statements. If inventory is not properly measured, expenses and revenues cannot be properly matched. When ending inventory is incorrect, the following balances of the balance sheet will also be incorrect as a result: merchandise inventory, total assets, and owner's equity. When ending inventory is incorrect, the cost of merchandise sold and net income will also be incorrect on the income statement.

INVENTORY ACCOUNTING SYSTEMS

The two most widely used inventory accounting systems are the periodic and the perpetual. The perpetual inventory system requires accounting records to show the amount of inventory on hand at all times. It maintains a separate account in the subsidiary ledger for each good in stock, and the account is updated each time a quantity is added or taken out. In the periodic inventory system, sales are recorded as they occur but the inventory is not updated. A

physical inventory must be taken at the end of the year to determine the cost of goods sold. Regardless of what inventory accounting system is used, it is good practice to perform a physical inventory at least once a year.

DETERMINING INVENTORY QUANTITIES & COSTS

All goods owned by a business (whether or not physically present on the business premises), are included in inventory when an inventory is taken. This requires that all shipping documents be examined, and all merchandise out on consignment be identified. Determining the quantity of goods on hand should be performed by at least two individuals, and a third should verify accuracy of the count (especially if the goods have a high monetary value). When determining the cost of goods, all expenses incurred to acquire them are included in the purchase price.

INVENTORY COSTING METHODS - PERIODIC

The periodic system records only revenue each time a sale is made. In order to determine the cost of goods sold, a physical inventory must be taken. The most commonly used inventory costing methods under a periodic system are
1)- first-in first-out (FIFO),
2)- last-in first-out (LIFO), and
3)- average cost or weighted average cost.
These methods produce different results because their flow of costs are based upon different assumptions. The FIFO method bases its cost flow on the chronological order purchases are made, while the LIFO method bases it cost flow in a reverse chronological order. The average cost method produces a cost flow based on a weighted average of unit costs.

COMPARING INVENTORY COSTING METHODS

The choice of inventory costing method affects the balances of
1)- ending inventory,
2)- cost of goods sold, and
3)- gross and net profit.
During periods of rising prices, the FIFO method generally produces a larger ending inventory, a smaller cost of goods sold and a higher profit. During periods of rising prices, the LIFO method produces a smaller ending inventory, a larger cost of goods sold and a smaller profit. During periods of declining prices the effects of the two methods are reversed. The average cost method produces results that are in between the LIFO and FIFO methods.

USING NON-COST METHODS TO VALUE INVENTORY

Under certain circumstances, valuation of inventory based on cost is impractical. If the market price of a good drops below the purchase price, the lower of cost or market method of valuation is

recommended. This method allows declines in inventory value to be offset against income of the period. When goods are damaged or obsolete, and can only be sold for below purchase prices, they should be recorded at net realizable value. The net realizable value is the estimated selling price less any expense incurred to dispose of the good.

PERIODIC VS. PERPETUAL INVENTORY SYSTEMS

There are fundamental differences for accounting and reporting merchandise inventory transactions under the periodic and perpetual inventory systems. To record purchases, the periodic system debits the Purchases account while the perpetual system debits the Merchandise Inventory account. To record sales, the perpetual system requires an extra entry to debit the Cost of goods sold and credit Merchandise Inventory. By recording the cost of goods sold for each sale, the perpetual inventory system alleviated the need for adjusting entries and calculation of the goods sold at the end of a financial period, both of which the periodic inventory system requires.

INVENTORY COSTING METHODS - PERPETUAL

The perpetual inventory system requires that a separate inventory ledger be maintained for each good. Inventory ledgers provide detailed information on purchases, cost of goods sold, and inventory on hand. Each column gives information on quantity, unit cost, and total cost. When the average cost method is used, an average unit cost of each good is calculated each time a purchase is made. The advantages of the perpetual inventory system is a high degree of control, it aids in the management of proper inventory levels, and physical inventories can be easily compared. Whenever a shortage (i.e. a missing or stolen good) is discovered, the Inventory Shortages account should be debited.

METHODS USED TO ESTIMATE INVENTORY COST

In certain business operations, taking a physical inventory is impossible or impractical. In such a situation, it is necessary to estimate the inventory cost. Two very popular methods are
1)- retail inventory method, and
2)- gross profit (or gross margin) method.

The retail inventory method uses a cost to retail price ratio. The physical inventory is valued at retail, and it is multiplied by the cost ratio (or percentage) to determine the estimated cost of the ending inventory.

The gross profit method uses the previous years average gross profit margin (i.e. sales minus cost of goods sold divided by sales). Current year gross profit is estimated by multiplying current year sales by that gross profit margin, the current year cost of goods sold is estimated by subtracting the gross profit from sales, and the ending inventory is estimated by adding cost of goods sold to goods available for sale.

- **Principle of regularity**: Regularity can be defined as conformity to enforced rules and laws.
- **Principle of consistency**: This principle states that when a business has once fixed a method for the accounting treatment of an item, it will enter all similar items that follow in exactly the same way.
- **Principle of sincerity**: According to this principle, the accounting unit should reflect in good faith the reality of the company's financial status.
- **Principle of the permanence of methods**: This principle aims at allowing the coherence and comparison of the financial information published by the company.
- **Principle of non-compensation**: One should show the full details of the financial information and not seek to compensate a debt with an asset, revenue with an expense, etc. (see convention of conservatism)
- **Principle of prudence**: This principle aims at showing the reality "as is": one should not try to make things look prettier than they are. Typically, revenue should be recorded only when it is *certain* and a provision should be entered for an expense which is *probable*.
- **Principle of continuity**: When stating financial information, one should assume that the business will not be interrupted. This principle mitigates the principle of prudence: assets do not have to be accounted at their disposable value, but it is accepted that they are at their historical value (see depreciation and going concern).
- **Principle of periodicity**: Each accounting entry should be allocated to a given period, and split accordingly if it covers several periods. If a client pre-pays a subscription (or lease, etc.), the given revenue should be split to the entire time-span and not counted for entirely on the date of the transaction.
- **Principle of Full Disclosure/Materiality**: All information and values pertaining to the financial position of a business must be disclosed in the records.
- **Principle of Utmost Good Faith**: All the information regarding to the firm should be disclosed to the insurer before the insurance policy is taken.

Every day, accountants make judgments about how to record business transactions. They often base their decisions on the financial objectives of the companies for which they work. Other times they turn to generally accepted accounting principles (GAAP) to steer their decisions.

GAAP are not a fixed set of rules. They are guidelines or, more precisely, a group of objectives and conventions that have evolved over time to govern how financial statements are prepared and presented. The Financial Accounting Standards Board, the American Institute of Certified Public Accountants, and the Securities and Exchange Commission provide guidance about acceptable accounting practices.

Good Reasons to Use GAAP
Every business that expects anyone outside the company to look at its financial data should use GAAP. Compliance with GAAP helps maintain creditability with creditors and stockholders because it reassures outsiders that a company's financial reports accurately portray its financial position. Plus, anyone who reads your financial statements — stockholders, creditors, security analysts or outside companies — will assume that the reports comply with GAAP.

Certified public accountants routinely audit companies to determine if their financial statements are prepared according to GAAP. These audit findings are typically included with companies' financial statements.

There has been some discussion in recent years about changing or doing away with GAAP. Some of the criticism stems from the challenge that GAAP poses to small businesses.

Still, even banks and finance companies often require their clients to use GAAP or have audited financial statements. And investors who are accustomed to using financial information prepared according to GAAP might balk if your statements don't meet their expectations.

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.

Read more: http://www.cliffsnotes.com/study_guide/Generally-Accepted-Accounting-Principles.topicArticleId-21081,articleId-21005.html#ixzz1EWY2Tf93

GAAP is an international convention of good accounting practices. It is based on the following core principles: The Business Entity Concept, The Continuing Concern Concept, The Principle of Conservatism, The Objectivity Principle, The Time Period Concept, The Revenue Recognition Convention, The Matching Principle, The Cost Principle, The Consistency Principle, The Materiality Principle and The Full Disclosure Principle.

Business entity concept: It is one of the main accounting
principle of accounting this concept says that Business should be treated seperately from the proprietor or investor
In simple words owner of the business should be treated separately from the business whatever profits come in to
the business should be taken in company account.

The business entity concept provides that the accounting for a business or organization be kept separate from the personal affairs of its owner, or from any other business or organization. This means that the owner of a business should not place any personal assets on the business balance sheet. The balance sheet of the business must reflect the financial position of the business alone. Also, when transactions of the business are recorded, any personal expenditures of the owner are charged to the owner and are not allowed to affect the operating results of the business.

The historical cost of the asset is the purchase price of the asset minus the accumulated depreciation over time. This is recorded in your books for financial purposes.

When you sell the asset, you sell it at market value. The difference between the market value and the historical is recognized in your financials as either a gain or loss on sale of an asset.

Historical cost is a term used instead of the term *cost*. Cost and historical cost usually mean the original cost at the time of a transaction. The term *historical cost* helps to distinguish an asset's original cost from its replacement cost, current cost, or inflation-adjusted cost. For example, land purchased in 1992 at cost of $80,000 and still owned by the buyer will be

reported on the buyer's balance sheet at its cost or historical cost of $80,000 even though its current cost, replacement cost, and inflation-adjusted cost is much higher today.

The cost principle or historical cost principle states that an asset should be reported at its cost (cash or cash equivalent amount) at the time of the exchange transaction and should include all costs necessary to get the asset in place and ready for use.

The prudence concept in accounting states that a company should never overstate it's income, and it should never understate it's expenses. This means that the highest level for the expenses should be used and the lowest level of profits in making financial statements.

A company is being prudent if they acknowledge that a portion of their receivables are likely uncollectable. Prudence requires you to be realistic about profits, assets and liabilities. It is unrealistic to assume that all debts will be paid with no issues or problems.

Recognize revenue only when they are reasonably certain

- **Recognize expenses as soon as they are reasonably possible**

NOTES:

This concept basically does not encourage the anticipation of recognizing income when it is not certain. It prefers that any expenses that can be reasonably ascertain should be taken up.

Prudence
Otherwise known as conservatism. It is this concept more than any other that has given rise to the idea that accountants are pessimistic boring people!! Basically the concept says that whenever there are alternative procedures or values, the accountant will choose the one that results in a lower profit, a lower asset value and a higher liability value. The concept is summarised by the well known phrase 'anticipate no profit and provide for all possible losses'. Thus, undue optimism can never be part of the make up of an accountant! The danger is that if an optimistic view of profits is given then dividends may be paid out of profits that have not been earned.

In accounting, the concept of materiality allows you to violate another accounting principle if the amount is so small that the reader of the financial statements will not be misled.

A classic example of the materiality concept or the materiality principle is the immediate expensing of a $10 wastebasket that has a useful life of 10 years. The *matching* principle directs you to record the wastebasket as an asset and then depreciate its cost over its useful life of 10 years. The *materiality* principle allows you to expense the entire $10 in the year it is acquired instead of recording depreciation expense of $1 per year for 10 years. The reason is that no investor, creditor, or other interested party would be misled by not depreciating the wastebasket over a 10-year period.

Determining what is a material or significant amount can require professional judgment. For example, $5,000 might be immaterial for a large, profitable corporation, but it will be material or significant for a small company that has very little profit.