GAAP – Generally Accepted Accounting Principles

U.S. GAAP (Generally Accepted Accounting Principles) are basic accounting principles and guidelines that are the standard for accounting in the United States. Following is a list of the ten accounting principles along with a highly condensed explanation of each principle and how they are applied by accountants, as GAAP is required by all Govt contractors regardless of company size and GAAP is prerequisite to CPFF.

1. Economic Entity Assumption

This accounting principle assumes the accountant keeps all of the *business* transactions of company separate from the owner's *personal* transactions. For *legal* purposes, a sole proprietorship and its owner are considered to be one entity, but for accounting purposes they are considered to be two separate entities.

2. Monetary Unit Assumption

Economic activity is measured in U.S. dollars so it is assumed that the dollar's purchasing power has not changed over time. Therefore, accountants ignore the effect of inflation on recorded amounts. Dollars from a 1960 transaction are combined with dollars from a 2015 transaction.

3. Time Period Assumption

Assumes it is possible to report the activities of a business in relatively short, time intervals such as five months ended May 31, 2015, or the 5 weeks ended May 31, 2015. It is *imperative* that a (period of time) be shown in the heading of each income statement. Labeling these financial statements with "December 31" is not good enough–the reader needs to know if the statement covers the *one week* ended December 31, 2015 the *month* ended December 31, 2015 the *three months* ended December 31, 2015 or the *year ended* December 31, 2015.

4. Cost Principle

The term “cost" refers to the amount that was spent (cash or cash equivalent) when an item as *originally* obtained, whether purchased last year or thirty years ago. For this reason, the amounts shown on financial statements are referred to as *historical* cost amounts. Because of this accounting principle asset amounts are *not* adjusted upward for inflation. In fact, as a general rule, asset amounts are not adjusted to reflect *any* type of increase in value. Hence, an asset amount does not reflect the amount of money a company would receive if it were to sell the asset at today's market value. (An exception is certain investments in stocks and bonds that are actively traded on a stock exchange.) If you want to know the current value of a company's long-term assets, you will not get this information from a company's financial statements–you need to look elsewhere, perhaps to a third-party appraiser.

5. Full Disclosure Principle

If certain information is important to an investor or lender using the financial statements, that information should be disclosed within the statement or in the notes to the statement. There are often numerous pages of "footnotes" attached to financials. For example, if a company is named in a lawsuit that demands a significant amount of money. When the financial statements are prepared if not clear whether the company might win or lose the lawsuit, lawsuit will be described in the footnotes. A company usually lists its significant accounting policies as the first note to its financial statements. Therefore, the footnotes are considered an integral part of financial statements, particularly for public companies since they have an obligation to their shareholders.

6. Going Concern Principle

This accounting principle assumes that a company will continue to exist long enough to carry out its objectives and commitments and will not liquidate in the foreseeable future. If the company's future financial situation is such that the accountant believes the company will not be able to continue on, the accountant is required to disclose this assessment. The going concern principle allows the company to defer some of its prepaid expenses until future accounting periods.

7. Matching Principle

This accounting principle requires companies to use the accrual basis of accounting. The matching principle requires that expenses be matched with revenues. For example, wages to employees are reported as an expense in the month employees worked, and not in the month they are paid. (The expense is occurring as the sales are occurring.) Because we cannot measure the future economic benefit of things such as advertisements (and thereby we cannot match the ad expense with related future revenues), the accountant charges the ad amount to expense in the period that the ad is run.

8. Revenue Recognition Principle

Under accrual basis of accounting (as opposed to cash basis of accounting), revenues are recognized as soon as a product has been sold or a service has been performed, regardless of when the money is actually received. Under this basic accounting principle, a company could earn and report $20,000 of revenue in its first month of operation but receive $0 in actual cash in that month.

9. Materiality

This basic accounting principle allows accountant to violate another principle if an amount is insignificant. Professional judgement is needed to decide whether an amount is insignificant or immaterial. An example of an obviously immaterial item is the purchase of a $150 printer by a multi-million dollar company. Since the printer will be used for five years, the *matching* principle directs the accountant to expense the cost over the five-year period. The **materiality** guideline allows this company to violate the matching principle and to expense the entire cost of $150 in the year it is purchased. The justification is that no one would consider it misleading if $150 is expensed in the first year instead of $30 being expensed in each of the five years that it is used. Because of materiality, financial statements usually show amounts rounded to the nearest dollar, to the nearest thousand, or to the nearest million dollars depending on the size of the company.

10. Conservatism

If a situation arises where there are two acceptable alternatives for reporting an item, conservatism directs the accountant to choose the alternative that will result in less net income and/or less asset amount. Conservatism helps the accountant to "break a tie." It does not direct accountants to be conservative. Accountants are expected to be unbiased and objective. For example, *potential* losses from lawsuits will be reported on the financial statements or in the notes, but *potential* gains will not reported. Also, an accountant may write inventory *down* to an amount that is lower than the original cost, but will not write inventory *up* to an amount higher than the original cost.