Chapter 2

# Generally Accepted Accounting Principles

- **Who Are the SEC, AICPA, FASB, and IASB? (or What Is This, Alphabet Soup?)**
- **Generally Accepted Accounting Principles (GAAP)**
- **What Are the Differences Between U.S. Accounting Standards and International Standards?**

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# Generally Accepted Accounting Principles (GAAP)

## Who Is the IASB?

The International Accounting Standards Board (IASB) is the independent, accounting standard setting body.

The IASB was founded on April 1, 2001, as the successor to the International Accounting Standards Committee (IASC). It is responsible for developing International Financial Reporting Standards (the new name for International Accounting Standards issued after 2001), and promoting the use and application of these standards. The Board has 15 members, each with one vote. They are selected as a group of experts with a mix of experience in standard- setting, preparing and using accounts, and academic work.

## What Are Generally Accepted Accounting Principles (GAAP)?

Generally Accepted Accounting Principles begin with the three basic assumptions made about each business. First, it is assumed that the business is separate from its owners or other businesses. Revenue and expenses should be kept separate from personal expenses. Second, it is assumed that the business will be in operation indefinitely. This validates the methods of putting Assets on the Balance Sheet, depreciation and amortization. Only when liquidation of a business is certain does this assumption no longer apply. Third, it is assumed a business's accounting records include only quantifiable transactions. Certain economic events that affect a company, such as hiring a new employee or introducing a new product, cannot be quantified in monetary units and, therefore, do not appear in a company's accounting records.

Financial statements must present relevant, reliable, understand-able, sufficient, and practicably obtainable information in order to be useful. This brings up an interesting question: what should a country do when their currency is not stable?

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Accounting records must always be recorded using a stable currency. In the United States this is the dollar, in Europe it is the Euro, etc. This brings up an interesting question: What should a country do when its currency is not stable?

## Relevant Information

Relevant information is information that helps financial statement users estimate the value of a firm and/or evaluate how well the firm is being managed. The financial statements must be stated in terms of a monetary unit, since money is our standard means of determining the value of a company.

In the United States, accountants use the stable monetary unit concept, which means that even though the value of the dollar changes over time (due to inflation), the values that appear on the financial statements normally are presented at historical cost. Historical cost presents the information on the financial statements at amounts the individual or company paid for them or agreed to pay back for them at the time of purchase. This method of accounting ignores the effect of inflation. In many other countries throughout the world, the accounting profession does account for inflation. Not all information about a firm is relevant for estimating its value or evaluating its management. For example, you don't need the information of how many individuals over forty years of age work for the company, or what color the machinery is painted in order to make financial decisions about a company. Even some financial information is not relevant, like how much money the owner of a corporation has in the bank, because as we reviewed in chapter 1, the business's accounting records are kept separate from its owner's, and the owner's financial information is irrelevant to the business.

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Changes in the Works: In August 2008 the Securities and Exchange Commission announced that within the next decade the United States will abandon GAAP, used by accountants for almost 75 years, and join the more than 100 countries worldwide in using IFRS (discussed in detail on page 22.) A timetable was set for all U.S. companies to drop GAAP by 2016, with some larger companies in the Unites States possibly switching in 2009. Yet things can still change, and many questions are unanswered.

## Reliable Information

Reliable information is key in accounting. Sufficient and objective evidence should be available to indicate that the information presented is valid. In addition, the information must not be biased in favor of one statement user or one group of users to the detriment of other statement users. The need for reliable information has caused the federal government to pass laws requiring public companies to have their records and financial statements examined (audited) by independent auditors who will make sure that what companies report is accurate. This will be the topic of chapter 11.

## Verifiable Information

The need for verifiable information does not preclude the use of estimates and approximation. If you were to eliminate all estimates from accounting, the resulting statements would not be useful primarily because the statements would not provide sufficient information. The approximations that are used, however, cannot be "wild guesses." They must be based on sufficient evidence to make the resulting statements a reliable basis for evaluating the firm and its management.

One example of a place in the financial statements where we estimate the value is with depreciation. Once we purchase a Long-Term Asset (anything that the company owns that will last longer than one year; for example, a building), we then need to spread the cost of this building over the life of the Asset. This is called depreciation. In order to do this we must estimate the life of that particular Asset. We can't know exactly how long that will be, but since we do have experience with these types of Assets, we can estimate the Asset's life. We assume that the building will be useable for, say, twenty years and depreciate (or spread) the cost of the building (the Asset) over twenty years (the estimated life).

For example, if we buy this building for $100,000 and assume that it is going to last twenty years, the annual depreciation would be $5,000 per year ($100,000/20). This $5,000 becomes one of the Expenses for the company and is shown on the Income Statement along with the other Expenses. We will look at this topic in depth in chapter 4.

## Understandable Information

To be understandable the financial information must be comparable. Any item on the Balance Sheet that an accountant labels as an Asset or Liability, users of the financial statements should also call Assets and Liabilities. Statement users must compare financial statements of various firms with one another, and they must compare statements of an individual firm with prior years' statements of that same firm in order to make valid decisions. Thus the accounting practices that a firm uses for a particular transaction should be the same as other firms use for the identical transaction. This practice should also be the same practice the firm used in previous periods. This concept is called Consistency. Information that is both comparable and consistent becomes understandable to the users of the financial information.

## Quantifiable Information

Information is easier to understand and use if it is quantified. Most information that accountants and users of financial information use is represented by numbers. The information that is presented in the financial statements is presented in a numerical form; however, where that is impossible, the information (if it is relevant, reliable, understand-able, and practicably obtainable) will be presented in narrative form, usually in a footnote to the statements. Accountants include narrative information along with quantifiable information because of the need for adequate or full disclosure; statement users must have sufficient information about a firm.

An example of non- quantifiable information that might be included in the footnotes to the financial statements would be details of an outstanding patent infringement lawsuit against the company, which would be considered a contingent Liability.

## Obtainable Information

Furthermore, to be useful, information must be reasonably easy to obtain. This fits into the concept of cost vs. benefit. The information must be worth more than what it will cost to obtain it and must be secured on a timely basis. Financial statements must be prepared at least once a year (in many cases, quarterly or monthly), and attempting to incorporate unobtainable information could seriously delay these schedule

An example of obtainable information is the number of shares sold by the corporation during the year. Another example would be the amount of sales by the business during the year. An example of information that might not be considered obtainable would be the nitty-gritty details of the pension plan systems used in each of the subsidiaries of a multinational corporation. A more reasonable and easily obtainable piece of data might be the total amount of money that is being spent on the company's pensions around the world.

## The Entity Concept

Financial statements must also present information representing each separate entity. This idea is called the Entity Concept. In other words, the transactions of each business or person are kept separate from those of other organizations or individuals. Therefore, the transactions of the subsidiaries of a multinational corporation must all be kept separate from each other. Even though at the end of the year the records of all of the subsidiaries might be consolidated into one set of financial statements, the records and transactions of each subsidiary are kept separate during the year.

## The Going Concern

It is normally assumed that a company will continue in business into the future. This concept is called the Going Concern Principle. We make several estimates in order to complete the financial statement presentations (for example, depreciation of an Asset over its life), and if we did not assume that the company was going to remain in business in the indefinite future, we could not use this sort of information.

The alternative to the Going Concern Principle is to assume that management plans to liquidate the business. When this is known for sure about a business, a different set of accounting principles and rules are used. In general, when a company liquidates, the Assets of the company will be listed at the price at which they can be sold rapidly. This amount will usually be below the values stated on the Balance Sheet, since they will be sold at "fire sale" prices.

## Realizable Value

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> Accounting Outside the United States: In the United States, for the purpose of preparing financial statements, accountants are not al-lowed to write up Assets to value higher than the historical cost (defined on page 25). This is not true in all countries of the world, where accountants may argue that if you can write down an Asset to reflect "reality," why not do the same when an Asset increases in value? Thus in many countries outside of the United States, the accountants are allowed to write up Assets when they increase in value to reflect "market value" as well as write them down when the market value is lower than the historical cost. This is an important point to keep in mind when reviewing financial statements prepared in companies domiciled outside of the United States.

Assets normally are not shown on the Balance Sheet at more than either their historical cost or an amount for which they can be sold below historical cost. For example, if a company has Inventory that is listed at a historical cost of $100,000, but due to the economy, the competition, or new technology, is today only worth $8,000, this Asset should be written down and shown on the Balance Sheet at $8,000. The section on conservatism (page 21) sheds more light on this topic. An example of an exception to this rule is with marketable securities (stocks). These Assets are shown on the Balance Sheet at their cur-rent market price.

## Materiality

Financial statements' data must be as simple and concise as possible. An item is considered material when its inclusion or exclusion in the financial statements would change the decision of a statement user. A rule of thumb in accounting might be that any item worth 10 percent of the business's Net Income is considered material and should be reported in financial statements; there is no firm dollar amount to be followed here. The important factor to remember is whether the amount in question will change the user's decision. This concept is called the Materiality Principle.

Items that are not material should not be included on the statements separately. If these items were included in the financial statements, they would obscure the important items of interest to the reader. Thus, in some cases, many immaterial items should be grouped together and called "miscellaneous" or the items could be added to other items, so that the total becomes material. That is, the items can be lumped in together with other items that are material and the entire bundle can be considered material.

## Quiz

The owners of a business decide to write up the value of their land, which ten years ago cost $10,000 to purchase and today sits in a prime location of the city and has been appraised at $40,000. Should they value their land on the Balance Sheet at $10,000 or $40,000? See page 23 for the answer.

### Conservatism

Another traditional practice that accountants use to guide them in pre-paring financial statements is called Conservatism. Whenever two or more accounting practices appear to be equally suitable to record the transaction under consideration, the accountant should choose the one that results in the lower or lowest Asset figure on the Balance Sheet and the higher or highest Expense on the Income Statement, so as not to be overly optimistic about financial events. This principle of accounting is highly controversial since while we are conservative, we may be violating other Generally Accepted Accounting Principles like consistency. In addition it is often asked, “Why is the lower value better, if the higher value better represents the true value of the Asset?”

An example of the Conservatism Principle in action might be in the presentation of Inventory on the Balance Sheet. There are several different generally accepted accounting methods that are allowed to assign a value to Inventory. The accountant should choose the one that presents Inventory at the lowest value so as not to overstate this particular Asset.

The conservatism idea is misused, however, when the accountant chooses a practice that is not as suitable to the situation as an alternative practice merely to report lower Assets and higher Expenses.

### GAAP and Small Business

Small business owners have been asking for alternatives to GAAP for a long time. The feeling is that the GAAP used for public companies are irrelevant to small businesses and are very difficult and expensive to implement. To some people the solution is a separate set of standards for private companies—one that takes their needs specifically into account.

The FASB listened and appointed a committee in September 2006 to investigate the differences in reporting and accounting between private and public companies. It was determined that the final goal was to give small businesses a greater voice in standard setting and not to establish two sets of standards.

The Committee decided that it was not in the best interest of the public to have two classes of GAAP. It determined that two sets of standards would not only be confusing to the public, but also create the possibility of one set being considered more authoritative than the other.

## What Are the Differences Between U.S. Accounting Standards and International Standards?

International Financial Reporting Standards are issued by the International Accounting Standards Board (IASB), headquartered in London. The Board has the goal of creating global accounting standards that are transparent, enforceable, understandable, and of high quality. More than one hundred countries currently use or coordinate with IFRS.

This Board and the standards that it issues are very important for the future of accounting. As globalization continues to connect businesses across the world, it is increasingly important for investors to be able to compare companies under similar standards. It is also much more cost efficient for a company doing business in several different countries to issue one set of financial statements that is understood in all of those countries, rather than having to use the accounting standards of each country.

IFRS puts all companies in all countries on a level playing field since they all have to present their financial information in a consistent, reliable manner. This certainly makes their financial results more comparable.

The biggest difference between U.S. GAAP and the International Accounting Standards is that the U.S. standards are based on rules and the International Standards are based upon principles. So what does this mean? It means that the U.S. standards have created a complex system of rules attempting to cover every situation that does or might occur, often masking economic reality.

The principles-based system of accounting encourages company boards and accountants to do the right thing in allowing them to report what is correct for the user, rather than reporting based upon a set of rules. U.S. GAAP rules allowed trillions of dollars in securitized financial assets and liabilities to stay off the books of U.S. financial firms, while the international standards, more focused on the true underlying economics, kept these items on the books of firms based outside the United States.

The upcoming change to IFRS is going to be enormous for U.S. companies in dollars and methodology. While there will be some ambiguity in the reporting, the accountant will need to explain why certain reporting standards have been used for more accuracy.

Some of the specific areas of differences between the U.S. and International Standards include:

- Business combinations
- Financial statement presentation
- Post-retirement benefits
- Revenue recognition
- Liabilities and equity
- Intangible assets
- Leases
- Asset valuation

In this chapter you have learned about GAAP in the United States as well as some of the differences between these and international reporting standards. In chapter 3 you will learn about the balance sheet and how it is used.

## *Answer*

In the United States a company cannot write the value of its Assets above the historical cost of that Asset. The argument is that if it does write the value, it leaves too much room for manipulating the financial statements, which could mislead the users of the financial statements. The practice of writing up Assets, though accepted in other foreign countries, would violate such GAAP as:

1) conservatism, 2) reliability, and 3) verifiability.

## GLOSSARY

**American Institute of Certified Public Accountants (AICPA):** The professional organization of the Accounting profession. This group has the responsibility for setting the ethics regulations for the profession as well as writing and grading the Certification Public Accountants' Examination (CPA Examination).

**Conservatism Principle:** Whenever two or more accounting practices appear to be equally suitable to the transaction under consideration, the accountant should always choose the one that results in the lower or lowest Asset figure on the Balance Sheet and the higher or highest Expense on the Income Statement.

**Consistency:** Practices and methods used for presentation on the financial statements should be the same year to year and process to process. If for any reason the company and its accountants decide to change the method of presentation for any item on the financial statements, it must present a footnote to the financial statements explaining why the methods were changed.

**Entity Concept:** The principle that requires separation of the transactions of each business or person from those of other organizations or individuals. For example, when a company is owned by one per-son, the personal finances of the individual who owns the company are not included on the company's financial statements. The opposite is also true the financial information of the company is not included in the financial statements of the individual owner.

**Financial Accounting Standards Board (FASB):** The board that sets the accounting standards to be followed for the preparation of financial statements. All rulings from the FASB are considered to be GAAP.

**Generally Accepted Accounting Principles (GAAP):** A standardized set of accounting rules used in the United States and prescribed by various organizations, like the FASB and the SEC. These rules guide the uniform preparation of financial statements.

**Going Concern Principle:** This principle assumes that a company will continue in business into the future. Without this assumption most of the accounting information could not be presented in the financial statements since we are always making assumptions (e.g., what the life of a Long-Term Asset is). The only way to make this assumption is to further assume that the business will be in existence in the indefinite future.

**Historical Cost Principle:** According to this rule, most Assets and Liabilities should be represented on the Balance Sheet at the amount that was paid to acquire the Asset, or for the Liabilities, at the amount that was contracted to be paid in the future. No account is taken for either inflation or changing value of Assets over time.

**International Accounting Standards Board (IASB):** The board responsible for setting the International Accounting Standards used by more than one hundred countries throughout the world. It is made up of fourteen international members and is based in London.

**International Financial Reporting Standards (IFRS):** The standards issued by IASB, meant to level the playing field for better comparisons of financial data as companies become more global in their scope.

**Materiality Principle:** This principle states that an item should only be included on the Balance Sheet if it would change any decisions of a statement user. If, for example, a multimillion-dollar corporation were to donate $100 to a charity, this information would not change any decision that management or an owner would make. However, since corporate money was spent, this distribution of the $100 must be combined with other small expenditures and reported as a " miscellaneous Expense."

**Monetary Unit:** U.S. Dollars, Euros, Yen, etc. Since a business's accounting records can only include quantifiable transactions, these transactions need to be reported in one of these stable currencies.

**Obtainable Information:** Information reported in financial statements must be accessible in a timely manner without an unreasonable expenditure of resources—for example, time, effort, and money—to be included in the financial statements.

**Quantifiable Information:** Information is easier to understand and use if it is quantified. However, when the information cannot be quantified but is still relevant to the users of the financial statements, it must be shown in the financial statements in narrative form in the footnotes.

**Realizable Value Principle:** This indicates that Assets should normally not be shown on the Balance Sheet at a value greater than they can bring to the company if sold. If the original historical cost, for example, is $5,000, and the maximum that the company can sell that Asset for today is $4,000, this Asset should be shown on the Balance Sheet at the lower amount because of this principle.

**Recognition Principle:** This is the process of recording Revenue into the financial statements. Revenue is recorded at the point of the transfer of the merchandise or service, and not at the point of receiving the cash. That means, for example, that once a service is provided for which a charge has been incurred, that service should be shown on the financial statements regardless of whether money has actually changed hands. Similarly Expenses are recognized when incurred, not when the money is exchanged for that particular Expense.

**Relevant Information:** Information reported on financial statements must be relevant in that it helps statement users to estimate the value of a firm and/or evaluate the firm's management. Not all information about a company is relevant to this decision-making process. For example, the number of women versus men currently employed at the company would not be considered relevant, even though it might be important data in other contexts. Thus, this type of information is not included in the financial statements.

**Reliable Information:** There should be sufficient and objective evidence available to indicate that the information presented is valid.

**Securities and Exchange Commission (SEC):** The body created by Congress in 1934. One of its duties is to prescribe the accounting principles and practices that must be followed by the companies that come within its jurisdiction.

**Separate Entities:** See Entity Concept.

**Stable-Monetary-Unit Concept:** Even though the value of the dollar changes over time (due to inflation), the values that appear on the financial statements in the United States are normally presented at historical cost and do not take inflation into account.

**Understandable Information:** Financial information must be comparable and consistent. If one accountant calls a particular item an Asset, the accountant must follow the set of rules known as Generally Accepted Accounting Principles to arrive at the definition of that Asset. Thus, when any user of the financial statements reads these statements, he understands the meaning and classification of the Asset.

**Verifiable Information:** Information on the financial statements must be based on sufficient evidence that can be substantiated and provides a reliable basis for evaluating the firm and its management.