

Introduction of Financial Accounting

What is Financial Accounting?

Financial accounting is a particular type of accounting that includes a method of documenting, summarising, and reporting the transactions arising from business operations for a period of time. Such transactions are outlined in the preparation of accounts, including the balance sheet, income statement, and cash flow statement, which document the financial results of the company over a particular period of time.

In India, companies must report the transactions that occur during the fiscal period or a financial year between 1 April to 31 March.

Financial accounting reflects the accounting on "accrual basis" over the accounting on "cash basis". Non-profit firms, companies, and small businesses use accountants in financial matters.

What are the Objectives of Financial Accounting?

The primary objective of Financial Accounting is to reveal the profits and losses of the business and provide a true and fair view of the business which is aimed at safeguarding the interest of various stakeholders internal as well as external which are connected to the business.

Objectives of Financial Accounting

#1 – Compliance with Statutory Requirements

One of the objectives is to ensure compliance with local laws related to taxation, companies Act and other statutory requirements relevant to the country where the business undertakes. It ensures that the business affairs adhere to such laws and relevant provisions comply while business is conducted.

#2 – Safeguarding of Interest of Various Stakeholders

It provides suitable and relevant information related to **business operations** to various stakeholders such as Shareholders, Prospective Investors, Financers, customers, creditors. They are not just appropriate for those who are having existing business relationships but also for those who are interested in having future collaboration with the business by providing them with meaningful information about the business. Further financial accounting standards ensure control over **accounting policies** of business to protect the interest of investors.

#3 – Helps in the Measurement of Profit and Loss of Business

It measures the profitability of the business for a particular period and discloses the net profit or loss of the business as a whole. It also exhibits the Assets and Liabilities of the business.

#4 – Presentation of Historical Records

It focuses on the presentation of historical records and not on forecasting future, unlike other accounting. The primary rationale in preparation of **Financial Accounts** is the ascertainment of profit earned or loss incurred by the business in the period concerned.

#5 – Focus on External Transaction of Business

It focuses on a transaction which the business enters into with external parties, which can be customers, suppliers, etc. and based on these transactions, the accounts are prepared to quantify the business, costs incurred as expenses, and resultant profit or loss earned.

#6 – Periodic Reporting and Wide Availability

Financial Accounting is undertaken with a pre-specified periodic reporting period, which is usually quarterly, half-yearly, and annually. It enables easy comparison and also keeps the information relevant and informative for various stakeholders. Further Financial Accounts are available publicly and are accessible to everyone who wants to know about the business and its performance.

#7 – Basis for Other Accounting

The other types of accounting, namely **cost accounting** or management accounting, provides its base data from financial accounting. As such, it acts as a source for different types of accounting undertaken by the business. It deals with business transactions broadly, which acts as a base for Cost Accounting to break further to identify costs with products and services.

#8 – Meeting the Objective of Various Stakeholders

- Another essential objective is meeting the needs of various stakeholders, which are associated with the business. Different stakeholders have different purposes, such as lenders to the business intends to assess the capability of the business to pay interest and principal, which is lent to the business or prospective lenders, so they are more interested in the **solvency of the business** and focus on that aspect.

- Similarly, customers are interested in knowing the growth and stability of the business and focus more on **cash flow statements** and **financial statements** to determine the ability of the business to provide better business terms and a consistent supply of goods and services.

#9 – Only Financial Transactions

Financial Accounting records only those transactions which can be denominated in monetary terms or those which include financial aspects as such non-financial transactions are outside its purview, and it serves the objective of only Financial Transactions

#10 – Reliability and Relevance

An important objective is to prepare such financial statements that are reliable, and decisions can be based on it. For this purpose, such Accounting should represent a faithful representation of transactions and events undertaken by the business, should be represented in their actual substance and economic reality perspective.

#11 – Easy to Understand

- Among all the objectives discussed above, it is the primary objective that Financial Accounts are prepared in such a way that they are easily understandable by intended users.
- However, while meeting this objective in mind, it must be equally essential to ensure that no material information is omitted because it will be complex and cumbersome to understand for various users. In short, efforts must be made to prepare Financial Accounts in an easy way to know wherever possible.

What are the Types of Accounting?

There are several types of accounting that range from auditing to the preparation of tax returns. Accountants tend to specialize in one of these fields, which leads to the different career tracks noted below:

- *Financial accounting.* This field is concerned with the aggregation of financial information into external reports. Financial accounting requires detailed knowledge of the accounting framework used by the reader of a company's financial statements, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). Or, if a company is publicly-held, it requires a knowledge of the standards issued by the government entity responsible for public company reporting in a specific country (such

as the Securities and Exchange Commission in the United States). There are several career tracks involved in financial accounting. There is a specialty in external reporting, which usually involves a detailed knowledge of accounting standards. There is also the controller track, which requires a combined knowledge of financial and management accounting.

- *Public accounting.* This field investigates the financial statements and supporting accounting systems of client companies, to provide assurance that the financial statements assembled by clients fairly present their financial results and financial position. This field requires excellent knowledge of the relevant accounting framework, as well as an inquiring personality that can delve into client systems as needed. The career track here is to progress through various audit staff positions to become an audit partner.
- *Government accounting.* This field uses a unique accounting framework to create and manage funds, from which cash is disbursed to pay for a number of expenditures related to the provision of services by a government entity. Government accounting requires such a different skill set that accountants tend to specialize within this area for their entire careers.
- *Forensic accounting.* This field involves the reconstruction of financial information when a complete set of financial records is not available. This skill set can be used to reconstruct the records of a destroyed business, to reconstruct fraudulent records, to convert cash-basis accounting records to the accrual basis, and so forth. This career tends to attract auditors. It is usually a consulting position, since few businesses require the services of a full-time forensic accountant. Those in this field are more likely to be involved in the insurance industry, legal support, or within a specialty practice of an audit firm.
- *Management accounting.* This field is concerned with the process of accumulating accounting information for internal operational reporting. It includes such areas as cost accounting and target costing. A career track in this area can eventually lead to the controller position, or can diverge into a number of specialty positions, such as cost accountant, billing clerk, payables clerk, and payroll clerk.
- *Tax accounting.* This field is concerned with the proper compliance with tax regulations, tax filings, and tax planning to reduce a company's tax burden in the future. There are multiple tax specialties, tracking toward the tax manager position.

- *Internal auditing.* This field is concerned with the examination of a company's systems and transactions to spot control weaknesses, fraud, waste, and mismanagement, and the reporting of these findings to management. The career track progresses from various internal auditor positions to the manager of internal audit. There are specialties available, such as the information systems auditor and the environmental auditor.
- Cost Accounting

Cost accounting is considered a type of managerial accounting. Cost accounting is most commonly used in the manufacturing industry, an industry that has a lot of resources and costs to manage. It is a type of accounting used internally to assess a company's operations.

Cost accounting concerns itself with recording and analyzing manufacturing costs. It looks at a company's fixed (unchanging and constant costs, like rent) and variable costs (changing costs, like shipping charges) and how they affect a business and how these costs can be better managed, according to Accounting Tools.

Users of Accounting information and their information needs:

There are many different users of accounting information and the users may be inside or outside the organization. Accounting information is economic information, as it relates to financial or economic activities of a business organization. There are so many people using the accounting information for so many diverse purposes, thus, the purpose of financial statements is to cater for the needs of the users that could lead them to make better financial decisions. The users may be classified into Internal and external users.

Internal users or Primary users of accounting information include:

Management- Accounting information is of great assistance to management for planning, controlling and decision making process. Also, management needs the accounting information to evaluate the performance of the organization and position, so that the necessary measures may be

taken to bring improvements in terms of business results. Besides, accounting information is useful to help managers to do their jobs better.

Employees - Employees use the accounting information to find out the financial health, amount of sales and profitability of business to determine their job security, the possibility of future remuneration, retirement benefits and employment opportunities.

Owners – Owners use the accounting information for analyzing the viability and profitability of their investments. Accounting information enables the owners to assess the ability of the business organization to pay dividends. It also leads them to determine any future course of action.

External users or Secondary users of accounting information include:

Creditors – Creditors are interested in accounting information, because it enables them to determine the credit worthiness of the business. The credit terms and standards are set on the basis of the financial health of a business, so, it helps them to analyze by using the accurate information accordingly. Creditors include suppliers and lenders of finance, such as banks. Trade creditor are generally interested in the accounting information for a short period of time than lenders.

Investors – They need the information, because they are concerned with the risk inherent in investing and the returns. Since it is important to assess the feasibility of making investments in the company, they need to analyze before they provide any financial resources to the company.

Customers – Customers have interest in the accounting information for assessing the financial position of a business, especially, when they have a long term involvement with, as it enables to maintain a steady source of business.

Regulatory Authorities – The accounting information is needed for them to ensure that it is in accordance with the rules and regulations and that it protects the interests of the stake holders who rely on such information.

Government agencies - Government agencies use financial information of businesses for the purpose of imposing taxes and regulations.

General public - General public also uses accounting information of business organizations. For example, accounting information is:

- a source of education for students of accounting and finance.
- a source of valuable data for those researching on organizational impacts on individuals and economy as a whole.
- a source of information for the people looking for job opportunities.
- a source of information about the future of a particular enterprise.

Accounting concepts and conventions:

Accounting Concepts:

Concepts represent abstract ideas which serve to systematize function. It is an opinion formulated over the years based on experience. Following are the accounting concepts :

ENTITY CONCEPT :

For accounting purposes the "business" is treated as a separate entity from the proprietor (s). This concept helps in keeping private affairs of the proprietor away from the business affairs. Thus a proprietor invests Rs. 1,00,000 in the business, it is deemed that the proprietor has given ` Rs. 1,00,000 to the "business" and it is shown as a "liability" in the books of the business. (because business has to ultimately repay to the proprietor). Similarly, if the proprietor withdraws ` Rs. 10,000 from the business it is charged to him. Accounting entity concept enables to record transactions between business and the proprietor. It ensures that accounting records reflect only the activities of the business. It separates business transactions from personal transactions of the proprietor.

This concept is applicable to all forms of business organisations. Although in the eyes of law a sole trader & his business or the partners & their business are one & the same, for accounting purposes they are regarded as separate entities. It is the "business" with which we are concerned.

DUAL ASPECT CONCEPT :

As per this concept, every business transaction has a dual effect. According to Dual Aspect Concept, every transaction has two aspects :

- 1) It increases one asset and decreases another asset.
- 2) It increases an asset and simultaneously increases liability.
- 3) It decreases an asset and increases another asset.
- 4) It decreases an asset and decreases a liability.
- 5) It increases one liability and decreases another liability.
- 6) It increases a liability and increases an asset.
- 7) It decreases liability and increases other liability.
- 8) It decreases a liability and decreases an asset.

Example: If goods are purchased on cash basis for Rs. 1,00,000 stock of goods is increased and balance of cash is decreased.

GOING CONCERN CONCEPT (CONTINUITY OF ACTIVITY) :

Enterprise is normally viewed as a going concern that is continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation of curtailing materially the scale of the operation. It is assumed that the business concern will continue for a fairly long time, unless & until it has entered into a state of liquidation. It does not imply permanent existence but simply stability & continuity for a period sufficient to carry business plans. It implies that assets are acquired for utilisation & not for sale. Similarly, depreciation on assets is provided on the basis of expected lives of the assets rather than on their market values. e.g. :If book value of a machine is Rs. 1,00,000 and net realisable value is Rs. 80,000 businessman will ignore realisable value and provide depreciation on book value.

MONEY MEASUREMENT CONCEPT:

In accounting, everything is recorded in terms of money. Events or transactions which cannot be expressed in terms of money are not recorded in the books of accounts, even if they are very important or useful for the business. Purchase and sale of goods, payment for expenses and receipt of income are monetary transactions which find place in accounting. Death of an executive, resignation of a manager, integrity of persons are the events which cannot be expressed in money. These are not included in accounting systems.

Transactions which affect business materially but not convertible in money cannot be recorded in the books of accounts. To assess financial health of business it is necessary to decide total value of assets & liabilities. e.g. A business concern has a big building constructed on a plot of 1000 sq. ft., furniture consisting of 20 chairs, 10 tables and 10 Godrej cupboards, amount to be received from the customers for 5000 units sold on credit, amount payable to supplier for 300 units purchased. From the above details it is very difficult to assess financial health unless the above items are expressed in terms of money. It is clear that non monetary events cannot be recorded in the books of accounts. The transactions, events or assets which are expressed in terms of equivalent monetary value are recorded in the books of accounts.

COST CONCEPT (OBJECTIVITY CONCEPT):

This concept does not recognise the realisable value, the replacement value of the real worth of an asset. Thus as per cost concept :

- 1) An asset is ordinarily recorded at the price paid to acquire it i.e. at its cost, and
- 2) This cost is the basis for all subsequent accounting for the assets.

The cost concept does not mean that the asset will always be shown at cost. It only means that the cost becomes the basis for all subsequent accounting for the asset. Thus the asset recorded at cost at the time of purchase may systematically be reduced by the process of depreciation. The cost concept also implies that if nothing has been paid to acquire an asset, it cannot be shown as an asset in the books of accounts.

COST ATTACH CONCEPT:

This concept is also known as “costmerge” concept. When a finished good is produced from the raw material there are certain process and costs which are involved like labor cost, power and other overhead expenses. These costs have a capacity to “merge” or “attach” when they are brought together.

ACCOUNTING PERIOD CONCEPT:

An accounting period is the interval of time at the end of which the income statement and financial position statement (balance sheet) are prepared to know the results and resources of the business.

ACCRUAL CONCEPT:

It implies recording of revenues & expenses of a particular accounting period, whether they are received/ paid in cash or not. Under cash system of accounting, the revenues & expenses are recorded only if they are actually received/ paid in cash irrespective of the accounting period to which they belong. But under accrual method, the revenues & expenses relating to that particular accounting period only are considered. The Accountant records revenues as they are earned and expenses as they are incurred.

Illustration 1 : Mr. Memo pays to Mr. Nemo Rs. 5,000 on 15th March, 2015 for service to be rendered from 1st April to 30th June, 2015. Has Mr. Memo earned revenue on March, 15 ?

Solution : Mr. Nemo has not earned any revenue. He has received cash but not rendered service. On 15th March, under accrual method, Mr. Nemo will record unearned Service Revenue. It is liability because he has an obligation to perform a service in future.

Illustration 2 : Ms. Isha purchases a goods of Rs. 80,000 from Ms. Lara by paying a cash of Rs. 30,000 & sells at Rs. 1,00,000 of which the customers paid only Rs. 75,000. Illustrate the concept of accrual.

Solution : Revenue of Ms. Isha is Rs. 1,00,000 & not Rs. 75,000 received from the customer. Expenses are Rs. 80,000 (cost incurred for the revenue) & not Rs. 30,000 paid by her to supplier. Hence profit as per accrual concept is Rs. 20,000 (Revenue - Expenses).

PERIODIC MATCHING OF COST AND REVENUE CONCEPT:

This concept is based on the period concept. Making profit is the most important objective that keeps the proprietor engaged in business activities. That is why most of the accountant's time is spent in evolving techniques for measuring the profit/profitability of the concern. To ascertain the profit made during a period, it is necessary to match "revenues" of the period with the "expenses" of that period. Income (profit) earned by the business during a period is compared with the expenditure incurred to earn the revenue.

REVENUE RECOGNITION (REALISATION CONCEPT) :

According to this concept profit should be accounted for only when it is actually realised. Revenue is recognised only when sale is affected or the services are rendered. Sale is considered to be made when the property in goods passes to the buyer and he is legally liable to pay. However, in order to recognise revenue, receipt of cash is not essential. Even credit sales result in realisation, as it creates a definite asset called debtor. Similarly income like commission,

interest, rent etc. are shown in Profit & Loss Account on accrual basis though they may not be realised in cash on the date of preparing accounts.

VERIFIABLE OBJECTIVE EVIDENCE CONCEPT:

According to this concept all accounting transactions should be evidenced and supported by objective documents. These documents include invoices, contract, correspondence, vouchers, bills, passbooks, cheque etc.

PERIODICITY CONCEPT:

The periodicity concept, can be also called the time interval concept, is a period during which business enterprises are required to prepare financial statement at specified intervals. Under this concept periodicity concept are generated over relatively short periods of time for example, a year or a quarter, so that performances can be measured and compared to each other's [1].

This statement requires the company to have a profit and loss account and a balance sheet prepared at regular intervals to identify information about the business unit for all shortcomings in performance evaluation, tax calculations, budget control and the like. Determining the income of a period leads to a comparison of the results of subsequent periods[2]. The periodicity concept are specific to a business' type and there are some types of business which are called „continuing profit seeking enterprises”. In this type of enterprise, enterprises last indefinitely. In such cases, accounting and reporting must be carried out periodically

ACCOUNTING CONVENTIONS

Conventions are the customs or traditions guiding the preparation of accounting statements. They are adapted to make financial statements clear and meaningful. They represent usage or methods generally accepted and customarily used. These exist in cases where there are different alternatives, which are equally logical and some of these are generally accepted having consideration of cost, time, habit or convenience. Following are the accounting conventions:

CONVENTION OF DISCLOSURE :

This means that the accounts must be honestly prepared and they must disclose all material information. The accounting reports should disclose full and fair information to the proprietors, creditors, investors and others. The term disclosure only implies that there must be a sufficient disclosure of information which is of material interest to proprietors, and potential creditors and investors

CONVENTION OF MATERIALITY :

The accountant should attach importance to material details and ignore insignificant details. If this is not done, accounts will be overburdened with minute details. Therefore, keeping the convention of materiality in view, unimportant items are either left out or merged with other items. Whether the information is material or not depends upon the circumstances of the case & common sense. The rule to be kept in mind is that if omission of the information impairs the decision or conduct of its user, it should be regarded as material.

However, an item may be material for one purpose but immaterial for another, material for one concern but immaterial for another or material for one year but immaterial for the next year.

CONVENTION OF CONSISTENCY :

The comparison of one accounting period with the other is possible only when the convention of consistency is followed. It means accounting from one accounting period to another should on the same basis. If stock is valued at cost or market price whichever is less this principle should be followed every year. Any change from one method to another would lead to inconsistency. However consistency does not mean non-flexibility. It should permit introduction of improved techniques of accounting.

CONVENTION OF CONSERVATISM :

As per this convention all prospective losses are taken into consideration but not all prospective profits. In other words anticipate no profit but provide for all possible losses. This convention is being criticised on the ground that it goes not only against convention of full disclosure but also against the concept of matching cost & revenues. It encourages creation of secret reserves by making excess provision for depreciation, bad and doubtful debts etc. The income statement shows a lower net income & the balance sheet overstates the liabilities & understates the assets.

Following are the examples of application of conservatism :

- 1) Making provision for doubtful debts and discount on debtor
- 2) Not providing for discount on creditor
- 3) Valuing stock in trade at cost or market price whichever is less.
- 4) Creating provisions against fluctuations in the price of investments.
- 5) Showing joint life policy at surrender value and not at the paid up amount.
- 6) Amortisation of intangible assets like goodwill which has indefinite life.

Meaning of Accounting Theory:

The term, 'Accounting Theory' refers to the generally accepted logical explanation in the field of accounting which indicates a few principles, concepts, and methodology for them in applying to solve various accounting problems.

That is why 'Accounting Theory' is that part of accounting which develops and inculcates all the logical and confirmed hypothesis in the form of rules and principles for supporting and evaluating the conventional accounting practices as well as for developing a new methodology to overcome the deficiency of the present system of accounting.

According to Hendrikson, "Accounting Theory may be defined as logical reasoning in the form of a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures." Therefore, accounting theory evaluates the present accounting practices as well as provides a signal for bringing changes in the traditional accounting practices for keeping pace with the ever-changing scenario.

Objects and Benefits or Advantages of Accounting Theory:

No discipline can be built up in a scientific manner unless it is backed by a sound theoretical base. As such, the prime object of accounting theory is to promulgate few well-defined and logical principles, by the application of which all aspects of accounting practice can be evaluated and updated. In addition to that, the required methodologies can also be chalked out for the proper performance of such activities. Nowadays, the importance of accounting theory in the field of accounting cannot be denied. Consequently, accounting practitioners should have a sound knowledge of accounting theories.

The main objects and importance are enumerated below:

(i) Fair knowledge of Accounting:

Sound knowledge of accounting theories assist the accounts practitioners in real application of accounting principles, postulates concepts, conventions, hypothesis, techniques, and assumptions in the field of accounting.

(ii) Justification of On Going Practices:

Knowledge of accounting theories assists accounting practitioners to justify existing accounting

practices. If any confusion arises regarding accounting practice, then this can be resolved on the basis of logic and reasoning behind it.

(iii) Increase in Efficiency:

Accounting theories boosts the efficiency of an accountant. He can accomplish the accounting Job with more ease and confidence on the basis of rules, **principles, postulates, concepts, and conventions of accounting theory.**

(iv) Fair preparation of Financial Statement and their Proper Analysis:

Sound knowledge of accounting theories assists an accountant to ensure, true and fair presentation of operating results and financial position of the concern and their true analysis.

(v) Selection of Best Alternative:

The fair knowledge of accounting theories assists the accounting practitioners in selecting the best alternative among the different alternative courses of-actions in the various accounting field. Consequently, accounting decision making can be highly effective.

(vi) Rational Accounting:

Fair application of accounting theories in the field of accounting assists the accountants in making proper execution of all the functions of accounting both in the case of trading and non-trading concern.

(vii) Detection of Deficiency:

The knowledge of accounting theories assists the accounting practitioners in detecting the loopholes, deficiency, or inconsistency if any, in the existing practices and taking necessary corrective action to remove them.

(viii) Socio-Economic Change:

The fair concept of accounting theories assists the accounting practitioners in making proper decisions regarding changes to be adopted in accounting practices incommensurate with the

changes taken place in socio-economic and industrial policies, government rules and regulations, and related acts.

(ix) Alternation of Method of Accounting:

The sound **knowledge of accounting theories** enables the accountants to determine the alternation to be made in the existing accounting practices under revised or changed circumstances.

(x) Invention of new technique:

The study of accounting theories broadens the knowledge, perception, and concept of accounting theory. Thorough knowledge of accounting theories prevents them from happening mechanical and stereotyped and makes them the founder of new techniques and procedures of accounting for the total solution of any problem relating to every aspect of accounting.

(xi) Solution of Accounting Problems:

Accounting theories intensify the presence of the mind of accountants. As a result, they can easily find out the solution to any problem on accounting created in any respect.

(xii) Scientific outlook in Accounting:

Accounting theory provides a scientific background and outlook to the accounting practices on the basis of accounting concepts, assumptions, postulates, hypotheses, and axioms. Consequently, the subjective choice and personal Judgements of individual accountants and particular concerns can be correctly replaced by the logical principles in the field of accounting practices.

The relation between Accounting Theory and Accounting Practices:

Accounting Theory is the set of systematic and definite directive principles and methodology as different from practice. Truly speaking, no theory can be different from its practice which it explains, analyses, and attempts to predict.

According to the opinion of Kenneth S Most, “A theory is an explanation, but not every explanation is a theory in the scientific meaning of the word.” Thus only those explanation may

be considered as the theory which makes analysis of the facts and predicts accounting practices. The following relation can be established between Accounting theory and Accounting practices:

i) Cause and Effect Relation:

A cause and effect relationship can be built up between accounting theory and accounting practice. Accounting theory is considered to be a cause while accounting practice is the effect.

ii) Target and Path Relation :

Accounting is accomplished in a systematic manner by following the accounting theory. As such, accounting theory may be considered as a target, while the path of Accounting practice is followed to reach such an established target.

iii) Science and Art Relation:

Like other branches of science, accounting theory is based on certain specific accounting concepts, **principles, hypotheses, conventions, and so on**. As such, accounting theory is called a science. On the other hand, accounting practice is an art, because practical accounting is done on the basis of it.

iv) Creator and Creation Relation:

Accounting theory is the creator of different accounting practices which in turn creates the necessary methodologies for the accomplishment of the different functions of accounting. Without the existence of accounting theory, accounting practices cannot be done in a systematic manner. On contrary, if there is no necessity for accounting practice, then the drawing of accounting theory is a useless job.

v) Changeability Relation:

Sometimes accounting practices are revised on the basis of prior change of accounting theory and vice versa.

vi) Genus and Species Relation:

Accounting theory is the Genus by following which different Species i.e. Accounting practices are generated according to the convenience of different concerns. Therefore, Accounting theory is almost generally accepted, while accounting practices differ according to the inter-personal anomaly of the accountant or the difference in the practical application.

Generally Accepted Accounting Principles (GAAP)

What Are Generally Accepted Accounting Principles?

Generally accepted accounting principles (GAAP) refer to a common set of accounting principles, standards, and procedures issued by the Financial Accounting Standards Board (FASB). Public companies in the United States must follow GAAP when their accountants compile their financial statements. GAAP is a combination of authoritative standards (set by policy boards) and the commonly accepted ways of recording and reporting accounting information. GAAP aims to improve the clarity, consistency, and comparability of the communication of financial information.

GAAP may be contrasted with pro forma accounting, which is a non-GAAP financial reporting method. Internationally, the equivalent to GAAP in the United States is referred to as International Financial Reporting Standards (IFRS). IFRS is followed in over 120 countries, including those in the European Union (EU).

Understanding GAAP

GAAP helps govern the world of accounting according to general rules and guidelines. It attempts to standardize and regulate the definitions, assumptions, and methods used in accounting across all industries. GAAP covers such topics as revenue recognition, balance sheet classification, and materiality.

The ultimate goal of GAAP is to ensure a company's financial statements are complete, consistent, and comparable. This makes it easier for investors to analyze and extract useful information from the company's financial statements, including trend data over a period of time. It also facilitates the comparison of financial information across different companies.

These 10 general concepts can help you remember the main mission of GAAP:

1. Principle of Regularity

The accountant has adhered to GAAP rules and regulations as a standard.

2. Principle of Consistency

Accountants commit to applying the same standards throughout the reporting process, from one period to the next, to ensure financial comparability between periods. Accountants are expected to fully disclose and explain the reasons behind any changed or updated standards in the footnotes to the financial statements.

3. Principle of Sincerity

The accountant strives to provide an accurate and impartial depiction of a company's financial situation.

4. Principle of Permanence of Methods

The procedures used in financial reporting should be consistent, allowing comparison of the company's financial information.

5. Principle of Non-Compensation

Both negatives and positives should be reported with full transparency and without the expectation of debt compensation.

6. Principle of Prudence

This refers to emphasizing fact-based financial data representation that is not clouded by speculation.

7. Principle of Continuity

While valuing assets, it should be assumed the business will continue to operate.

8. Principle of Periodicity

Entries should be distributed across the appropriate periods of time. For example, revenue should be reported in its relevant accounting period.

9. Principle of Materiality

Accountants must strive to fully disclose all financial data and accounting information in financial reports.

10. Principle of Utmost Good Faith

Derived from the Latin phrase "*uberrimae fidei*" used within the insurance industry. It presupposes that parties remain honest in all transactions.