# Generally Accepted Accounting Principles

**Generally Accepted Accounting Principles (GAAP)** is the standard framework of guidelines for [financial accounting](http://en.wikipedia.org/wiki/Financial_accounting). It includes the standards, conventions, and rules accountants follow in recording and summarizing transactions, and in the preparation of [financial statements](http://en.wikipedia.org/wiki/Financial_statements).

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## Overview

Financial accounting information must be assembled and reported objectively. Third-parties who must rely on such information have a right to be assured that the data are free from bias and inconsistency, whether deliberate or not. For this reason, financial accounting relies on certain standards or guides that are called "General Accepted Accounting Principles" (GAAP).

Principles also derive from tradition, such as the concept of matching. In any report of financial statements (audit, compilation, review, etc.), the preparer/auditor/[CPA](http://en.wikipedia.org/wiki/CPA) must indicate to the reader whether or not the information contained within the statements complies with GAAP.

### Principle of regularity

Regularity can be defined as conformity to enforced rules and laws.

### 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, a revenue with an expense, etc.

### 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, a 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 is mitigating the previous one about 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](http://en.wikipedia.org/wiki/Depreciation)).

### 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.

## United States' GAAP Hierarchy

In the [United States](http://en.wikipedia.org/wiki/United_States), GAAP derives, in order of importance, from:

1. issuances from an authoritative body designated by the [American Institute of Certified Public Accountants](http://en.wikipedia.org/wiki/American_Institute_of_Certified_Public_Accountants)(AICPA) Council (for example, the [Financial Accounting Standards Board](http://en.wikipedia.org/wiki/Financial_Accounting_Standards_Board) Statements, AICPA [Accounting Principles Board](http://en.wikipedia.org/wiki/Accounting_Principles_Board) Options, and AICPA Accounting Research Bulletins);
2. other AICPA issuances such as AICPA Industry Guides;
3. industry practice; and
4. into para-accounting literature in the form of books and articles.

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|  | **House of GAAP** |
| Category (A)(Most authoritative) | FASB Standards and Interpretations | Accounting Principles Board (APB) Opinions | AICPA Accounting Research Bulletins (ARBs) |
| Category (B) | FASB Technical Bulletins | AICPA Industry Audit and Accounting Guides | AICPA Statements of Position (SOPs) |
| Category (C) | FASB Emerging Issues Task Force (EITF) | AICPA AcSEC Practice Bulletins |
| Category (D)(Least authoritative) | AICPA Accounting Interpretations | FASB Implementation Guides (Q and A) | Widely recognized and prevalent industry practices |

Category A and B are considered authoritative. Category C and D are considered marginally authoritative, thoughts on interesting and unique issues, but could be invalid given a large level of materialism. Category C and D are considered a talking and reasoning phase of bringing issues to an authorize level of GAAP.

## National GAAP

Every country has their own [version](http://en.wikipedia.org/wiki/Standard_accounting_practice) of GAAP with standards set by a national governing body.

## Required Departures from GAAP

Under the AICPA's Code of Professional Ethics under Rule 203 - Accounting Principles, a member must depart from GAAP if following it would lead to a material misstatement on the financial statements, or otherwise be misleading. In the departure the member must disclose, if practicable, the reasons why compliance with the accounting principle would result in a misleading financial statement. Under Rule 203-1-Departures from Established Accounting Principles, the departures are rare, and usually take place when there is new legislation, the evolution of new forms of business transactions, an unusual degree of materiality, or the existence of conflicting industry practices. This is taken from the Page 56 in the auditing textbook "Auditing, an integrated approach" by Alvin Arens and James Loebbecke, published in 1980 by Prentise Hall, [ISBN 0-13-051656-2](http://en.wikipedia.org/w/index.php?title=Special:Booksources&isbn=0130516562).

## International GAAP

Due to [globalisation](http://en.wikipedia.org/wiki/Globalisation), [International Financial Reporting Standards](http://en.wikipedia.org/wiki/International_Financial_Reporting_Standards) are required and established by [International Accounting Standards Committee](http://en.wikipedia.org/wiki/International_Accounting_Standards_Committee).

# Generally Accepted Accounting Principles (USA)

This article or section is in need of attention from an expert on the subject.
[WikiProject Economics](http://en.wikipedia.org/wiki/Wikipedia%3AWikiProject_Economics) or the [Economics Portal](http://en.wikipedia.org/wiki/Portal%3AEconomics) may be able to help recruit one.
If a more appropriate [WikiProject](http://en.wikipedia.org/wiki/Wikipedia%3AWikiProject) or [portal](http://en.wikipedia.org/wiki/Portal%3AList_of_portals) exists, please adjust this template accordingly.

Generally accepted accounting principles or US GAAP are the [accounting rules](http://en.wikipedia.org/wiki/Generally_Accepted_Accounting_Principles) used to prepare [financial statements](http://en.wikipedia.org/wiki/Financial_statements) for publicly traded [companies](http://en.wikipedia.org/wiki/Companies) and many private companies in the [United States](http://en.wikipedia.org/wiki/United_States). Generally accepted accounting principles for local and state governments operates under a different set of assumptions, principles, and constraints, as determined by the [Governmental Accounting Standards Board](http://en.wikipedia.org/wiki/Governmental_Accounting_Standards_Board) (GASB).

In the United States, as well as in other countries practicing under the English [common law](http://en.wikipedia.org/wiki/Common_law) system, the [government](http://en.wikipedia.org/wiki/Government) does not set accounting standards, in the belief that the private sector has better knowledge and resources. The GAAP is not written in [law](http://en.wikipedia.org/wiki/Law), although the [U.S. Securities and Exchange Commission](http://en.wikipedia.org/wiki/U.S._Securities_and_Exchange_Commission) (SEC) requires that it be followed in financial reporting by publicly traded companies. Currently, the Financial Accounting Standards Board (FASB) sets accounting principles for the profession. The US GAAP provisions differ somewhat from [International Financial Reporting Standards](http://en.wikipedia.org/wiki/International_Financial_Reporting_Standards) though efforts are underway to reconcile the differences so that reports created under international standards will be acceptable to the SEC for companies listed on US markets.

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## Basic Objectives

Financial reporting should provide information that is:

* useful to present to potential investors and creditors and other users in making rational investment, credit, and other financial decisions.
* helpful to present to potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts.
* about economic resources, the claims to those resources, and the changes in them.

## Fundamental Qualities

To be useful and helpful to users, financial statements must be:

* Relevant: relevant information makes a difference in a decision. It also helps users make predictions about past, present and future events (it has predictive value). Relevant information helps users confirm or correct prior expectations (it has feedback value). It must also be available on time, that is before decisions are made.
* Reliable: reliable information is verifiable (when independent auditors using the same methods get similar results), neutral (free from bias), and demonstrate representational faithfulness (what really happened or existed).
* Comparable: information must be measured and reported in a similar manner for different enterprises (allows financial statements to be compared between different companies).
* Consistent: the same accounting methods should be applied from period to period and all changes in methods should be well explained and justified.

## Basic Concepts

To achieve basic objectives and implement fundamental qualities GAAP has four basic assumptions, four basic principles, and four basic constraints.

### Assumptions

* Economic Entity Assumption assumes that the business is separate from its owners or other businesses. Revenues and expenses should be kept separate from personal expenses. This applies even for [partnerships](http://en.wikipedia.org/wiki/Partnership) and [sole proprietorships](http://en.wikipedia.org/wiki/Sole_proprietorship) as corporates they are considered separate legal entities
* Going Concern Assumption assumes that the business will be in operation for a long time. This validates the methods of asset capitalization, depreciation, and amortization. Only when liquidation is certain is this assumption not applicable.
* Monetary Unit Assumption assumes a stable [currency](http://en.wikipedia.org/wiki/Currency) is going to be the unit of record. The [FASB](http://en.wikipedia.org/wiki/FASB) accepts the nominal value of the [US Dollar](http://en.wikipedia.org/wiki/US_Dollar) as the monetary unit of record unadjusted for inflation (The IAI accepts the nominal value of IDR as the monetary unit of record unadjusted for inflation)
* Periodic Reporting Assumption assumes that the business operations can be recorded and separated into different periods (most common periods are months, quarters and years). This is required for comparison between present and past performance.

### Principles

* The historical cost principle requires companies to account and report based on acquisition costs rather than [fair market value](http://en.wikipedia.org/wiki/Fair_market_value) for most assets and liabilities. This principle provides information that is reliable (removing opportunity to provide subjective and potentially biased market values), but not very relevant. Thus there is a trend to use fair values. Most debts and securities are now reported at market values.
* The revenue recognition principle requires companies to record when revenue is (1) [realized](http://en.wikipedia.org/wiki/Realize) or realizable and (2) [earned](http://en.wikipedia.org/wiki/Earn), not when cash is received. This way of accounting is called [accrual basis accounting](http://en.wikipedia.org/wiki/Accrual_basis_accounting).
* The [matching principle](http://en.wikipedia.org/wiki/Matching_principle). [Expenses](http://en.wikipedia.org/wiki/Expense) have to be matched with [revenues](http://en.wikipedia.org/wiki/Revenue) as long as it is reasonable to do so. Expenses are recognized not when the work is performed, or when a product is produced, but when the work or the product actually makes its contribution to revenue. Only if no connection with revenue can be established, cost can be charged as expenses to the current period (e.g. office salaries and other administrative expenses). This principle allows greater evaluation of actual profitability and performance (shows how much was spent to earn revenue). Depreciation and Cost of Goods Sold are good examples of application of this principle.
* The full disclosure principle. Amount and kinds of information disclosed should be decided based on trade-off analysis as a larger amount of information costs more to prepare and use. Information disclosed should be enough to make a judgment while keeping costs reasonable. Information is presented in the main body of financial statements, in the notes or as supplementary information.

### Constraints

* Cost-benefit relationship states that the benefit of providing the financial information should also be weighed against the cost of providing it.
* [Materiality](http://en.wikipedia.org/wiki/Materiality) states that the significance of an item should be considered when it is reported. An item is considered significant when it would affect the decision of a reasonable individual.
* Industry practices states that accounting procedures should follow industry practices.
* Conservatism states that when choosing between two solutions, the one that will be least likely to overstate assets and income should be picked.

## Setting GAAP

These organizations influence the development of GAAP in the United States.

* [United States Securities and Exchange Commission](http://en.wikipedia.org/wiki/United_States_Securities_and_Exchange_Commission) (SEC)

The SEC was created as a result of the [Great Depression](http://en.wikipedia.org/wiki/Great_Depression). At that time there was no structure setting accounting standards. The SEC encouraged the establishment of private standard-setting bodies through the [AICPA](http://en.wikipedia.org/wiki/AICPA) and later the [FASB](http://en.wikipedia.org/wiki/FASB), believing that the private sector had the proper knowledge, resources, and talents. The SEC works closely with various private organizations setting GAAP, but does not set GAAP itself.

* [American Institute of Certified Public Accountants](http://en.wikipedia.org/wiki/American_Institute_of_Certified_Public_Accountants) (AICPA)

In 1939, urged by the SEC, the AICPA appointed the Committee on Accounting Procedure (CAP). During the years 1939 to 1959 CAP issued 51 Accounting Research Bulletins that dealt with a variety of timely accounting problems. However, this problem-by-problem approach failed to develop the much needed structured body of accounting principles. Thus, in 1959, the AICPA created the Accounting Principles Board (APB), whose mission it was to develop an overall conceptual framework. It [issued 31 opinions](http://en.wikipedia.org/wiki/List_of_APB_Opinions) and was dissolved in 1973 for lack of productivity and failure to act promptly. After the creation of the [FASB](http://en.wikipedia.org/wiki/FASB), the AICPA established the Accounting Standards Executive Committee (AcSEC). It publishes:

1. Audit and Accounting Guidelines, which summarizes the accounting practices of specific industries (e.g. casinos, colleges, airlines, etc.) and provides specific guidance on matters not addressed by FASB or GASB.
2. Statements of Position, which provides guidance on financial reporting topics until the FASB or GASB sets standards on the issue.
3. Practice Bulletins, which indicate the AcSEC's views on narrow financial reporting issues not considered by the FASB or the GASB.
* [Financial Accounting Standards Board](http://en.wikipedia.org/wiki/Financial_Accounting_Standards_Board) (FASB)

Realizing the need to reform the APB, leaders in the accounting profession appointed a Study Group on the Establishment of Accounting Principles (commonly known as the Wheat Committee for its chair Francis Wheat). This group determined that the APB must be dissolved and a new standard-setting structure be created. This structure is composed of three organizations: the Financial Accounting Foundation (FAF, it selects members of the FASB, funds and oversees their activities), the Financial Accounting Standards Advisory Council (FASAC), and the major operating organization in this structure the Financial Accounting Standards Board (FASB). FASB has 4 major types of publications:

1. Statements of Financial Accounting Standards - the most authoritative GAAP setting publications. More than 150 have been issued to date.
2. Statements of Financial Accounting Concepts - first issued in 1978. They are part of the FASB's conceptual framework project and set forth fundamental objectives and concepts that the FASB use in developing future standards. However, they are not a part of GAAP. There have been [7 concepts published to date](http://en.wikipedia.org/wiki/List_of_FASB_Statements_of_Financial_Accounting_Concepts).
3. Interpretations - modify or extend existing standards. There have been around [50 interpretations published to date](http://en.wikipedia.org/wiki/List_of_FASB_Interpretations).
4. Technical Bulletins - guidelines on applying standards, interpretations, and opinions. Usually solves some very specific accounting issue that will not have a significant, lasting effect.

In 1984 the FASB created the Emerging Issues Task Force (EITF) which deals with new and unusual financial transactions that have the potential to become common (e.g. accounting for Internet based companies). It acts more like a problem filter for the FASB - the EITF deals with short-term, quickly resolvable issues, leaving long-term, more pervasive problems for the FASB.

* [Governmental Accounting Standards Board](http://en.wikipedia.org/wiki/Governmental_Accounting_Standards_Board) (GASB)

Created in 1984, the GASB addresses state and local government reporting issues. Its structure is similar to that of the FASB's.

* Other influential organizations (e.g. American Accounting Association, Institute of Management Accountants, Financial Executives Institute)

## House of GAAP

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|  | House of GAAP |
| Category (a)(Most authoritative) | FASB Standards and Interpretations | Accounting Principles Board (APB) Opinions | AICPA Accounting Research Bulletins (ARBs) |
| Category (b) | FASB Technical Bulletins | AICPA Industry Audit and Accounting Guides | AICPA Statements of Position (SOPs) |
| Category (c) | FASB Emerging Issues Task Force (EITF) | AICPA AcSEC Practice Bulletins |
| Category (d)(Least authoritative) | AICPA Accounting Interpretations | FASB Implementation Guides (Q and A) | Widely recognized and prevalent industry practices |
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|   | Introduction to Basic Accounting Principles  |
|  | There are general rules and concepts that govern the field of accounting. These general rules—referred to as basic accounting **principles and guidelines**—form the groundwork on which more detailed, complicated, and legalistic accounting rules are based. For example, the [**Financial Accounting Standards Board (FASB)**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-F.html#financial accounting standards board) uses the basic accounting principles and guidelines as a basis for their own detailed and comprehensive set of accounting rules and standards. The phrase "[**generally accepted accounting principles**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-G.html#generally accepted accounting principles (GAAP))" (or "GAAP") consists of three important sets of rules: (1) the basic accounting principles and guidelines, (2) the detailed rules and standards issued by FASB and its predecessor the Accounting Principles Board (APB), and (3) the generally accepted industry practices. If a company distributes its financial statements to the public, it is required to follow generally accepted accounting principles in the preparation of those statements. Further, if a company's stock is publicly traded, federal law requires the company's financial statements be audited by independent public accountants. Both the company's management and the independent accountants must certify that the financial statements and the related notes to the financial statements have been prepared in accordance with GAAP. GAAP is exceedingly useful because it attempts to standardize and regulate accounting definitions, assumptions, and methods. Because of generally accepted accounting principles we are able to assume that there is consistency from year to year in the methods used to prepare a company's financial statements. And although variations may exist, we can make reasonably confident conclusions when comparing one company to another, or comparing one company's financial statistics to the statistics for its industry. Over the years the generally accepted accounting principles have become more complex because financial transactions have become more complex.  |  |
|  | Basic Accounting Principles and Guidelines  |
|  | Since GAAP is founded on the basic accounting principles and guidelines, we can better understand GAAP if we understand those accounting principles. The table below lists the ten main accounting principles and guidelines together with a highly condensed explanation of each.

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| **Basic Accounting Principle** | **What It Means in Relationship to a Financial Statement** |
| **1. Economic Entity Assumption /****(Economic) Substance Over (Legal) Form** | The accountant keeps all of the *business* transactions of a sole proprietorship separate from the business 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, and only transactions that can be expressed in U.S. dollars are recorded (Economic activity is measured in Indonesia Rupiah / IDR, and only transactions that can be expressed in Indonesia Rupiah / IDR are recorded)Because of this basic accounting principle, it is assumed that the dollar's purchasing power has not changed over time. As a result accountants ignore the effect of inflation on recorded amounts. For example, dollars from a 1960 transaction are combined (or shown with) dollars from a 2006 transaction. |
| **3. Time Period Assumption** | This accounting principle assumes that it is possible to report the complex and ongoing activities of a business in relatively short, distinct time intervals such as the five months ended May 31, 2006, or the 5 weeks ended May 1, 2006. The shorter the time interval, the more likely the need for the accountant to estimate amounts relevant to that period. For example, the property tax bill is received on December 15 of each year. On the income statement for the year ended December 31, 2006, the amount is known; but for the income statement for the three months ended March 31, 2006, the amount was not known and an estimate had to be used. It is *imperative* that the time interval (or period of time) be shown in the heading of each income statement, statement of stockholders' equity, and statement of cash flows. Labeling one of these [**financial statements**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-F.html#financial statements) with "December 31" is not good enough--the reader needs to know if the statement covers the *one week* ending December 31, 2006 the *month* ending December 31, 2006 the *three months* ending December 31, 2006 or the *year ended* December 31, 2006.  |
| **4. Cost Principle** | From an accountant's point of view, the term "cost" refers to the amount spent (cash or the cash equivalent) when an item was *originally* obtained, whether that purchase happened 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. It is because of this basic accounting principle that numerous pages of "footnotes" are often attached to financial statements. As an example, let's say a company is named in a lawsuit that demands a significant amount of money. When the financial statements are prepared it is not clear whether the company will be able to defend itself or whether it might lose the lawsuit. As a result of these conditions and because of the full disclosure principle the lawsuit will be described in the notes to the financial statements. A company usually lists its significant accounting policies as the first note to its financial statements. |
| **6. Going Concern Principle / Continuity of Activity** | 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 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 / Effort and Accomplish-ment** | This accounting principle requires companies to use the [**accrual basis of accounting**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accrual basis of accounting). The matching principle requires that expenses be matched with revenues. For example, sales commissions expense should be reported in the period when the sales were made (and not reported in the period when the commissions were paid). Wages to employees are reported as an expense in the week when the employees worked and not in the week when the employees are paid. If a company agrees to give its employees 1% of its 2005 revenues as a bonus on January 15, 2006, the company should report the bonus as an expense in 2005 and the amount unpaid at December 31, 2005 as a liability. (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 the [**accrual basis of accounting**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accrual basis of accounting) (as opposed to the [**cash basis of accounting**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#cash basis of accounting)), [**revenues**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-R.html#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. For example, if ABC Consulting completes its service at an agreed price of $1,000, ABC should recognize $1,000 of revenue as soon as its work is done--it does not matter whether the client pays the $1,000 immediately or in 30 days. Do not confuse *revenue* with a [***cash receipt***](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#cash receipt). |
| **9. Materiality** | Because of this basic accounting principle or guideline, an accountant might be allowed to violate another accounting principle if an amount is insignificant. Professional judgment 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 highly profitable multi-million dollar company. Because 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. The basic accounting principle of conservatism leads accountants to anticipate or disclose losses, but it does not allow a similar action for gains. For example, *potential* losses from lawsuits will be reported on the financial statements or in the notes, but *potential* gains will not be 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. |

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