Generally Accepted Accounting Principles (GAAP)

Accounting principles help hold a company's financial reporting to clear and regulated standards. In the United States, these standards are known as the Generally Accepted Accounting Principles (GAAP or U.S. GAAP). Companies required to meet GAAP standards must do so in all financial reporting or risk facing significant consequences.

What Is GAAP?

GAAP is a set of detailed accounting guidelines and standards meant to ensure publicly traded U.S. companies are compiling and reporting clear and consistent financial information. Any company following GAAP procedures will produce a financial report comparable to other companies in the same industry. This provides investors, creditors and other interested parties an efficient way to investigate and evaluate a company or organization on a financial level. Under GAAP, even specific details such as tax preparation and asset or liability declarations are reported in a standardized manner.

GAAP is managed and published by the Financial Accounting Standards Board (FASB), which regularly updates the list of principles and standards. It is the U.S. equivalent of the International Financial Reporting Standards (IFRS). Though only regulated and publicly traded businesses are legally obligated to follow GAAP, some private companies also choose to meet the same standards in financial statements.

GAAP Compliance

Publicly traded companies in the U.S. must be GAAP compliant. This means these companies' financial statements must follow all the GAAP principles and meet GAAP standards. Any external party looking at a company's financial records will be able to see that the company is GAAP compliant, making it both easier to attract investors and to successfully pass external audits. Hiring a professional accounting team trained in GAAP and having internal auditors track and check finances are two ways to ensure your company is meeting GAAP standards.

If a company is found violating GAAP principles, there are many possible consequences. From large monetary fines to significant negative impacts on credibility to internal financial issues as a result of incorrect bookkeeping, it is always more advantageous to comply with GAAP guidelines from the start rather than lose out on possible investors and opportunities by failing to maintain high-quality work.

GAAP vs. IFRS

GAAP is a U.S.-based set of standards. Outside the U.S., the most commonly used accounting regulations are known as the International Financial Reporting Standards (IFRS). The IFRS is used in over 100 countries, including countries in the European Union, Japan, Australia and Canada. The IFRS Foundation is responsible for overseeing, maintaining and updating the accounting standards in each of these countries.

Publicly traded domestic companies are required to follow GAAP guidelines, but private companies can choose which financial standard to follow. Some companies in the U.S.—particularly those that are traded internationally or see a lot of international business—may use dual reporting (i.e., both methods) when preparing financial statements. It is also possible, though time-consuming, to convert GAAP documents and processes to meet IFRS standards. Whether or not the two systems will ever truly integrate or converge remains to be seen, though efforts were made by the U.S. Securities and Exchange Commission from 2010 to 2012 to come up with an official plan for convergence.

Key Principles of GAAP

The core of GAAP revolves around a list of ten principles. Together, these principles are meant to clearly define, standardize and regulate the reporting of a company's financial information and to prevent tampering of data or unethical practices.

1. Principle of Regularity

GAAP must always be followed by accountants and businesses when handling financial information. At no point can a company or financial team choose to ignore or modify any of the regulations.

2. Principle of Consistency

Accountants are responsible for using the same standards and practices for all accounting periods. If a method or practice is changed, or if you hire a new accountant with a different system, the change must be fully documented and justified in the footnotes of the financial statements. This principle ensures that any company's internal financial documentation is consistent over time.

3. Principle of Sincerity

This principle states that any accountant or accounting team hired by a company is obligated to provide the most unbiased, accurate financial report possible. Although a business may be in a bad financial situation, one that may even compromise its future, the accountant may only report on the situation as it is.

4. Principle of Permanence of Methods

This principle requires accountants to use the same reporting method procedures across all the financial statements prepared. Though it is similar to the second principle, it narrows in specifically on financial reports—ensuring any report prepared by one company can be easily compared to one another.

5. Principle of Non-Compensation

All negative and positive values on a financial statement, regardless of how they reflect upon the company, must be clearly reported by the accounting team. Accountants cannot try to make things look better by compensating a debt with an asset or an expense with revenue.

6. Principle of Prudence

Formally reported data must be fact-based and dependent on clear, concrete numbers. It's easy to start wandering into speculation when you talk about finance—especially when thinking about the future of the company—and this principle makes sure to keep accountants firmly grounded in reality. Businesses can still engage in speculation and forecasting, of course, but they cannot add this information to formal financial statements.

7. Principle of Continuity

When compiling reports, accountants must assume a business will continue to operate. The principle applies regardless of the status of the company.

8. Principle of Periodicity

Essentially, this principle requires accountants to report financial information only in the relevant accounting period. For example, if an accounting team is compiling a report on the revenue earned within a quarter, the report must focus only on that exact period. This is intended to prevent any possibility of fudging numbers or data across time—e.g., if a company earns more one quarter than the next, the accountant must truthfully represent this fact instead of changing the period dates or altering the data to hide or reduce the difference.

9. Principle of Materiality

Accountants must, to the best of their abilities, fully and clearly disclose all the available financial data of the company. They are obligated to acquire this information from the business, which is why an accounting team's requests may seem intensely thorough when requesting financial information.

10. Principle of Utmost Good Faith

Any person or party involved in, or responsible for, the financial side of a business must be honest in all reports and transactions. Along with several other principles, this serves to maintain an ethical standard and responsibility in all financial dealings.

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