Takin' Care of Business

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# Accounting Principles


### Recognition: Cash-Basis vs Accrual Accounting

In **cash-basis accounting**, companies record expenses when the cash is actually laid out. They book revenue when they receive payment. For example, if a painter completed a project on December 30, 2016, but doesn't get paid for it until the owner inspects it on January 10, 2017, the painter reports those cash earnings on her 2017 tax report. In cash-basis accounting, cash earnings include checks, credit-card receipts, or any other form of payment. Because it is easy, smal companies that haven't incorporated and most sole proprietors use cash-basis accounting.

If a company uses **accrual accounting**, it records revenue when the actual transaction is completed, such as the completion of work specified in a contract, not when it receives the cash. The company records revenue when it earns it, even if the customer hasn't paid yet. For example, a carpentry contractor who uses accrual accounting records the revenue earned when he completes the job, even if the customer hasn't paid the bill yet.

Expenses are handled the same. Expenses are recorded when they're incurred, even if it hasn't paid yet. For example, when a carpenter buys lumber for a job, he may do so on account and not actually lay out the cash for the lumber until later when he gets the bill.

Generally accepted accounting principles (GAAP) are a common set of accounting rules and standards that dictate how financial statements are prepared. Public companies, nonprofit organizations, and government entities are required to prepare financial statements in accordance with GAAP. These guidelines were developed over time by the Financial Accounting Standards Board (FASB), and the American Institute of Certified Public Accountants (AICPA).

GAAP encompasses a wide range of accounting practices and philosophies. Some key areas covered by GAAP include:

- **Recognition:** How assets, liabilities, revenues, and expenses are recognized on financial statements
- **Measurement:** How profits and losses are measured and reported on financial statements
- **Presentation:** How information needs to be presented on financial statements
- **Disclosure:** What information needs to be shared on financial statements

## Goals of GAAP

The purpose of GAAP is to create a uniform standard for financial reporting. When financial information is made available to the public, it should serve the purpose of helping investors make informed decisions as to where to put their money. Similarly, it should enable lenders to properly assess the financial condition of companies looking to borrow money.

When applied to non-profits and government organizations, the goal of GAAP is to ensure complete transparency on the part of the reporting entities. Information provided under GAAP needs to be not only clear, comprehensive, and easily understood, but verifiable by auditors and other outside parties.

## Importance of GAAP

Without GAAP, companies wouldn't be held to a strict set of standards, which means they'd have a lot more leeway in deciding what information they choose to share or keep hidden. GAAP, therefore, serves the very-important function of making sure companies and organizations can't "cheat" on their financial reporting.

GAAP allows investors to easily evaluate companies simply by reviewing their financial statements. If an investor is torn between two companies in the same industry, that investor can compare their respective statements to determine which is doing a better job at generating revenue and managing cash flow.

However, this wouldn't be possible if companies were allowed to pick and choose what financial information to present. When applied to government entities, GAAP helps taxpayers understand how their tax dollars are being spent.

GAAP also helps companies gain key insights into their own practices and performance. Furthermore, GAAP minimizes the risk of erroneous financial reporting by having numerous checks and safeguards in place. The information provided in GAAP-compliant financial statements can therefore generally be regarded as reliable and accurate.

Source: www.fool.com