

2.3: The Need for Generally Accepted Accounting Principles

Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Describe the purpose of U.S. generally accepted accounting principles (U.S. GAAP) and the benefits that these rules provide.
2. Explain the importance of U.S. GAAP to the development of a capitalistic economy.
3. Understand the role played by the Financial Accounting Standards Board (FASB) in the ongoing evolution of U.S. GAAP.
4. Discuss the advantages and the possibility of switching from U.S. GAAP to International Financial Reporting Standards (IFRS).

Question: Rules and principles exist within financial accounting that must be followed. They provide the standard guidance necessary for achieving effective communication. For example, assume that a reporting organization encounters an uncertainty (such as a lawsuit) and is now preparing financial information to portray the reality of that event. When faced with complexity, how does the financial accountant know what reporting guidelines to follow? How does a decision maker looking at reported information know what reporting guidelines have been followed?

Answer: A significant body of **generally accepted accounting principles** (frequently referred to as **U.S. GAAP**) has been created in the United States over many decades to provide authoritative guidance and standardization for financial accounting. When faced with a reporting issue, such as a lawsuit, the accountant consults U.S. GAAP to arrive at an appropriate resolution, one that results in fair presentation. If both the accountant and the decision maker understand U.S. GAAP, even the most complex financial information can be conveyed successfully. A proper likeness can be portrayed and communicated.

Thus, the financial information to be distributed by an organization in the form of financial statements is structured according to U.S. GAAP. This textbook is an exploration of those accounting principles that serve as the foundation for financial accounting in this country¹.

Based on coverage here, students who seek to become accountants can learn to report financial information that is fairly presented. That means that it is reported according to U.S. GAAP so that it contains no material misstatements. Students who want to evaluate specific organizations in order to make decisions about them should learn U.S. GAAP in order to understand the data being reported.

Although some elements of U.S. GAAP have been in use almost throughout history, many of these rules and principles are relatively new—often developed within the last 30 to 40 years. Accounting principles evolve quite quickly as the nature of business changes and new issues, problems, and resolutions arise. Fairly important changes in U.S. GAAP occur virtually every year.

The existence of U.S. GAAP means that a business in Seattle, Washington, and a business in Atlanta, Georgia, will account for information in much the same manner². Because of this standardization, any decision maker with an adequate knowledge of financial accounting—whether located in Phoenix, Arizona, or in Portland, Maine—should be able to understand the fairly presented financial information conveyed by a wide variety of companies. They all speak the same language. Put simply, U.S. GAAP enables organizations and other parties to communicate successfully.

Test Yourself

The acronym GAAP stands for which of the following?

- A. General Automatic Accounting Procedures.
- B. Generally Accepted Accounting Principles.
- C. General American Accounting Processes
- D. Generally Agreed Accountant Practices

The correct answer is B and as the name implies these are rules that have received broad acceptance in the accounting world and are used to guide how financial information is communicated to users.

Question: An article in the Wall Street Journal contained the following comment about U.S. GAAP: “When the intellectual achievements of the 20th century are tallied, GAAP should be on everyone’s Top 10 list. The idea of GAAP—so simple yet so radical—is that there should be a standard way of accounting for profit and loss in public businesses, allowing investors to see how

a public company manages its money. This transparency is what allows investors to compare businesses as different as McDonald's, IBM and Tupperware, and it makes U.S. markets the envy of the world" (Shirky, 2001).

Could U.S. GAAP be so very important? Can the development of U.S. GAAP possibly be one of the ten most important intellectual achievements of the entire twentieth century? A list of other accomplishments during this period would include air travel, creation of computers, landing on the moon, and the development of penicillin. With that level of competition, U.S. GAAP does not seem an obvious choice to be in the top ten. How can it be so important?

Answer: The United States has a capitalistic economy, which means that businesses are (for the most part) owned by private citizens and groups rather than by the government. To operate and grow, these companies must convince investors and creditors to contribute huge amounts of their own money voluntarily. Not surprisingly, such financing is only forthcoming if the possible risks and rewards can be assessed and then evaluated with sufficient reliability. Before handing over thousands or even millions of dollars, investors and creditors must believe that they have the reliable data required to make reasonable estimations of future stock prices, cash dividends, and cash flows. Otherwise, buying stocks and granting credit is no more than gambling. As this quote asserts, U.S. GAAP enables these outside parties to obtain the information they need to manage their perceived risk to acceptable levels.

Without U.S. GAAP, investors and creditors would encounter significant difficulties in evaluating the financial health and future prospects of an organization. They would face even greater uncertainty and be likely to hold on to their money or invest only in other, safer options. Consequently, if U.S. GAAP did not exist, the development and expansion of thousands of the businesses that have become a central part of today's society would be limited or impossible simply because of the lack of available resources.

By any standard, the explosive development of the U.S. economy during the twentieth and twenty-first century (especially following World War II) has been spectacular, close to unbelievable. This growth has been fueled by massive amounts of money flowing from inside and outside the United States into the country's businesses. Much of the vitality of the U.S. economy results from the willingness of people to risk their money by buying capital stock or making loans to such companies as McDonald's, IBM, and Nintendo. Without those resources, most businesses would be small or nonexistent and the United States would surely be a radically different country.

Question: If U.S. GAAP is so very important, who creates it? If U.S. GAAP is constantly evolving, how does that occur?

Answer: Since 1973, the primary authoritative body in charge of producing U.S. GAAP has been the Financial Accounting Standards Board (frequently referred to as FASB) ³. FASB is an independent group supported by the U.S. government, various accounting organizations, and private businesses. It is charged with establishing and improving the standards by which businesses and not-for-profit organizations (such as charities) produce the financial information that they distribute to decision makers.

Typically, accounting problems arise over time within various areas of financial reporting. New types of financial events can be created, for example, that are not covered by U.S. GAAP or, perhaps, weaknesses in earlier rules start to become evident. If such concerns grow to be serious, FASB will step in and study the issues and alternatives and possibly pass new rules or make amendments to previous ones. FASB is methodical in its deliberations and the entire process can take years. Changes, additions, and deletions to U.S. GAAP are not made without proper consideration.

Several other bodies also play important roles in the creation of U.S. GAAP. They are normally discussed in detail in upper-level accounting textbooks. However, the major authority for the ongoing evolution of U.S. GAAP lies with FASB and its seven-member board. It released approximately 170 official statements during its first thirty-six years of existence. The impact that those rulings—and other types of FASB pronouncements—has had on U.S. GAAP and the financial reporting process is almost impossible to overemphasize. In 2009, FASB combined all authoritative accounting literature into a single source for U.S. GAAP, which is known as the *Accounting Standards Codification*. By bringing together hundreds of official documents, FASB has made U.S. GAAP both more understandable and easier to access. Multiple sources have been woven together in a logical fashion so that all rules on each topic are in one location. Now that all the rules are in one place (electronic database) all changes to the rules are referred to as updates rather than official statements. In 2021, FASB released 10 accounting standards updates (ASU) that affected rules on a variety of topics from leases to intangible assets. These updates are then incorporated into the codification for reference purposes.

As just one example, FASB recently made a number of critical changes in the accounting for leases of real estate and equipment. Previous rules had been the subject of much criticism by the investing community for failing to properly portray the financial impact of leasing arrangements. After years of deliberation and input from accountants and investors, the members of the board

came to believe that new rules were needed to improve the reporting of lease obligations to decision makers trying to predict stock prices, cash dividends, and cash flows.

Key Takeaway

No language can enable communication without some standardization and rules. In the United States, this structure is created by U.S. generally accepted accounting principles (U.S. GAAP). The availability of these authoritative guidelines has played a central role in the growth of the U.S. economy since the end of the Great Depression. U.S. GAAP is constantly evolving as accountants seek better methods of providing financial information in an ever-changing business world. The main authority for the development of U.S. GAAP lies with the Financial Accounting Standards Board (FASB).

¹Many countries other than the United States have developed their own individual systems of generally accepted accounting principles. These alternatives are utilized in specific areas of the world. In addition, international accounting standards (created by the London-based International Accounting Standards Board) known formally as International Financial Reporting Standards, or IFRS, also exist and are now used in numerous countries. U.S. GAAP is by far the most sophisticated system in the world because a significant portion of the capital markets exist here. Unless noted otherwise, U.S. GAAP is being described in this textbook. However, in recent years, a strong push toward universal acceptance of IFRS has taken place. Therefore, their potential impact will be analyzed throughout this book in special discussions of relevant topics.

²As will be discussed later in this textbook, key points exist within financial accounting where more than one approach can be used for reporting purposes. Rigid standardization is found in many areas of financial reporting but not in all.

³Considerable information can be found about the Financial Accounting Standards Board by touring <http://www.fasb.org>. The tab “About FASB” is especially informative.

⁴The role played in the U.S. economy by public accounting firms will be described in [Chapter 4 “Why Should Decision Makers Trust Financial Statements?”](#). Some of these organizations have grown to enormous size. According to its Web site as of June 30, 2020 (<http://www.pwc.com>), PricewaterhouseCoopers employs 284,258 individuals working in over 157 countries. During 2020, the firm received in excess of \$43 billion from customers for the services it rendered to them.

References

Shirky, C., “How Priceline Became a Real Business,” *Wall Street Journal*, August 13, 2001, A-12.

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