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Accounting principles in Marketing Industry

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Generally Accepted Accounting Principles (GAAP) refers to a set of guidelines, rules and standards used throughout the accounting industry in preparing and standardizing financial statements.

If your company hopes one day to issue stock or participate in mergers and acquisitions, knowledge of generally accepted accounting principles (GAAP) is critically important. GAAP is a term that refers to a set of rules, standards and practices used throughout the accounting industry to prepare and standardize financial statements that are issued outside the company. These standards help investors and creditors better compare companies. Companies are expected to follow generally accepted accounting principles when they report their financial information.

Although there are numerous principles and guidelines that make up GAAP as defined by the FASB, you can condense them into this list of 10 basic accounting principles that are some of the most commonly used in the industry—and therefore, some of the most important to understand.

1. Economic Entity Assumption

In essence, the economic entity assumption principle is the accounting concept that states that a business is an entity unto itself and should be treated as such. This principle is also sometimes called the “separate entity assumption.”

It is because of the economic entity assumption principle, therefore, that your accountant would advise you to separate your business transactions from your personal transactions—and the reason it’s so important to open a separate business bank account. Even in the case of a sole proprietorship, where your business activity appears on your personal tax return, the economic entity assumption still applies— because, legally, your business can exist independently of you.

2. Revenue Recognition Principle

Like the matching principle, the revenue recognition principle relates to the accrual basis of accounting. The revenue recognition principle dictates that revenue is reported when it’s earned, regardless of when payment for the product or service is actually received. With this basic accounting principle, therefore, your business could earn monthly revenue even if you haven’t received any actual cash that month.

The purpose of the revenue recognition principle, then, is to accurately report income, or revenue, when the sale is made, even if you bill your customer or receive payment at a later time.

3. Matching Principle

For tax purposes, many small businesses, especially sole proprietorships, choose to operate on a cash basis—meaning revenue is reported when cash is received and expenses are reported when cash is spent (or when your business’s credit card is charged).

However, the matching principle specifies that businesses should use the accrual method of accounting and report all financial information using that method.

Under this basic accounting principle, expenses should be matched with revenues and therefore, sales and the expenses used to produce those sales are reported in the same accounting period. These expenses can include wages, sales commissions, certain overhead costs, etc.

4. Cost Principle

The cost principle dictates that the cost of an item doesn’t change in financial reporting. Therefore, even if you’ve bought an item within a year that’s grown substantially in value—a building, for example—your accountant will always report that asset at the amount for which it was obtained. In other words, you’re always reporting the historical cost of the asset or item.

This basic accounting principle is important because it reminds business owners not to confuse cost with value. Although the value of items and assets changes over time, the gain or loss of your assets is only reflected in their sale or in depreciation entries. If you need a true valuation of your business without selling your assets, then you’ll need to work with an appraiser, as opposed to relying on your financial statements.

5. Principle of Conservatism

The principle of conservatism is the second principle that allows an accountant to use their best judgment in particular situations. In this case, when there’s more than one acceptable way to record a transaction, the principle of conservatism instructs the accountant to record expenses and liabilities as soon as possible, but to only record revenues and gains when they occur.

It’s important to understand, however, that this basic accounting principle is only invoked when there are multiple acceptable ways for the accountant to record the transaction. The principle of conservatism does not allow a business accountant to completely disregard other accounting principles.