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United States Accounting Standards – An overview of GAAP

What is GAAP?

GAAP (pronounced “gap”) is an acronym for generally accepted accounting principles. These are the guiding rules and pronouncements used to determine United States financial accounting treatment. In an attempt to define GAAP the primary professional association for Certified Public Accountants-- the American Institute of Certified Public Accountants (AICPA)-- provided guidance in Statement on Auditing Standards (SAS) No. 69. According to SAS 69, "The phrase 'generally accepted accounting principles' is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time." [1](#) In plain English, GAAP represents the current, accepted accounting rules.

SAS 69 also describes the GAAP hierarchy. It ranks the various sources of GAAP, so that when there is a conflict between two potential sources, a level of priority exists. Higher categories carry more weight and must be followed when conflicts occur. SAS 69 presents the GAAP hierarchy by identifying four categories, or levels, of established accounting principles. In addition, SAS 69 recognizes an additional, lowest level of GAAP consisting of other types of accounting literature that may be useful in resolving financial reporting problems. This lowest level is used when an accounting issue has not been addressed by another GAAP source. The GAAP hierarchy is not static. New rule-making bodies and modifications can be added, for instance both SAS 91 and SAS 93 provide modifications to the GAAP hierarchy.

Rules-based v. principles based accounting

United States GAAP follows rules-based accounting standards. This means that specific accounting rules are set forth and must be followed in order to comply with GAAP. For example, if an airline company leases a jet, the company must follow specific GAAP rules to determine if the transaction is an operating lease or a capital lease. The main difference being that a capital lease would have to appear on the balance sheet of the airline (it should be noted, for reasons beyond the scope of this article, that the airline will almost certainly want to avoid having the lease appear as an asset on its balance sheet). Therefore, two virtually identical lease

transactions could be classified entirely differently based upon how they follow the GAAP leasing rules.

Critics contend that while this system sets forth voluminous rules, it allows a dishonest company to follow the rules technically while simultaneously betraying their intent. Enron Corporation appears to have technically followed GAAP accounting rules while creating its numerous complex capital structures and transactions. However, it seems that the sole purpose for entering into many of these Byzantine transactions was to keep billions of dollars of debt and other obligations off its financial statements, thus hiding many liabilities from the view of the company's creditors and investors. [2](#)

The alternative system is a principles-based system. This system provides few exact rules and little implementation guidance. Instead, general principles are put forward and companies must ensure that their financial statements fairly and accurately represent these principles. Proponents argue that this type of system does not allow for Enron-type financial engineering, where complex transactions are undertaken in order to get around following specific rules-based accounting standards. Critics believe a principles-based system allows too much leeway for companies, because they generally do not have to follow specific rules, only wide-arching principles. Canada's accounting rules are much more principles based than U.S. GAAP. A recent study has concluded that Canada's principles-based system has allowed its companies to smooth their earnings over time and therefore mute the impact of negative events on their earnings. [3](#)

Highest level of GAAP authority (Level A)

The highest-level issuer of accounting standards has not remained constant over time, which tends to lead to some confusion. Since 1973 the Financial Accounting Standards Board (FASB) has had this role. Two FASB releases are placed within the highest level of GAAP authority:

- Statements of Financial Accounting Standards (SFAS)
- Financial Accounting Standards Board Interpretations (FINs)

As their title indicates, the Statements of Financial Accounting Standards represent the primary FASB-issued accounting pronouncement. The FIN serves to clarify, explain, or elaborate on existing accounting standards.

Prior to the establishment of FASB in 1973, there were several predecessor bodies whose pronouncements, if not superseded by a more recent accounting pronouncement, also belong to the most authoritative level of GAAP authority:

- Accounting Principles Board Opinions (APBs)
- Accounting Research Bulletins (ARBs)

For example, most of the rules set forth in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, have not been superseded. Even though APB 18

was issued in 1971, several years before the establishment of the FASB, it still provides many of the rules for GAAP treatment of this issue.

The Other Levels

The first step of financial accounting research is usually to see if the issue is addressed by one or more of Level A authorities. If not then lower level material should be consulted to determine GAAP.

Lower Levels of GAAP (Levels B-E)

Level B

- FASB Technical Bulletins (FTB)
- AICPA Industry Audit and Accounting Guide
- AICPA Statement of Position (SOP)

Level C

- Consensus Positions of the Emerging Issues Task Force (EITF)
- AICPA AcSEC Practice Bulletins (PB)

Level D

- AICPA Accounting Interpretations (AIN)
- FASB Implementation Guides (FIG)
- Industry practices widely recognized and prevalent

Level E (Other GAAP Accounting Literature)

- FASB Statements of Financial Accounting Standards (SFAC)
- APB Statements
- AICPA Issues Papers
- International Accounting Standards Committee Statements
- Government Accounting Standards Board (GASB) Statements, Interpretations, and Technical Bulletins
- Federal Accounting Standards Advisory Board (FASAB) Statements, Interpretations, and Technical Bulletins
- Pronouncements of other professional associations and regulatory bodies
- AICPA Technical Practice Aids
- Accounting textbooks, handbooks, and articles

The Role of the SEC

Congress has given the Securities and Exchange Commission (SEC) the power to establish accounting standards for publicly traded companies by Congress. The SEC has historically deferred this power to the accounting standards bodies in the private sector, such as the Financial Accounting Standards Board (FASB). The SEC releases three primary sources of accounting guidance:

- SEC Financial Reporting Releases (FRR)

- Accounting and Auditing Enforcement Release (AAER)
- SEC Staff Accounting Bulletin (SAB)

Even though, according to SAS 69, these materials would fall under the lowest level of GAAP – as regulatory agency pronouncements – for a publicly traded company, any guidance from the SEC actually carries much greater weight than a normal Category/Level E authority.

The next article in this series will discuss sources for obtaining GAAP literature.

Endnotes

1. AICPA Professional Standards. New York: American Institute of Certified Public Accountants. 2002.
2. Liesman, Steve. "SEC Accounting Cop's Warning: Playing by the Rules May Not Head Off Fraud Issues," *Wall Street Journal*. February 12, 2002, p. C7.
3. Karleff, Ian. "Accounting Rules Favour Canada v. U.S.: 'A Fox Guarding Chickens'". *Financial Post*. February 7, 2003, p. IN 1.