

# What the Generally Accepted Accounting Principles (GAAP) Mean to Your Business

7 min read



## Key Takeaways

- By establishing a set accounting method, GAAP ensures all businesses record and report their financials in the same way.
- Even if your company is not publicly traded, you will still likely need to generate financial documents based on GAAP rules in order to operate.
- After considering both the pros and cons of GAAP analysis, you might find that a dual-method accounting system designed for GAAP-compliance and management insights offers the most benefit to your business.

You know the drill- as a small business owner, you find yourself constantly juggling responsibilities (with what seems like no end in sight). It's not uncommon to find yourself knee-deep in your back office, tackling different financial issues that have been thrown onto your plate.

**Oftentimes business owners don't realize there are actually different methods of accounting and they serve your business in different ways.**

As a business owner, you've made a decision about the type of accounting you use in your company. But you may not have completely understood the differences and weighed the pros and the cons, especially whether dual methods are important if you want your business to grow.

Here's a quick review and why you should know this...

Some of the most common or frequently used types of accounting include:

- **Tax Accounting** - Governed by the Internal Revenue Code [1], tax accounting focuses on keeping records and preparing financial documents for the purpose of savvy tax filing [2].
- **Audit Accounting** - External audit standards follow the Generally Accepted Auditing Standards (GAAS) [3], and audit accounting practices prepare a business for an audit by establishing sound internal financial controls and maintaining compliance.
- **Management Accounting** - Management or managerial accounting principles are designed to track a company's finances for the purpose of developing and implementing strategies, measuring and improving performance, and illuminating a business's key revenue or growth drivers [4]. [Management reporting and accounting](#) exist solely for internal use by the leaders in a business. This type of accounting and reports generated by it are not intended for public distribution, financial compliance, or tax filing.
- **Pro Forma Accounting** - Pro forma accounting allows a company to exclude items that it feels obscure the true nature of their financial health or projections. This might include one-time, extraneous expenses or unusual inflows of cash. Pro forma accounting does not create an accurate financial record but rather aims to generate an accurate projection of a company's financial future [5].

- **Financial Accounting** - Financial accounting follows the Generally Accepted Accounting Principles (GAAP) as defined by the Financial Accounting Standards Board (FASB) [6]. Financial accounting and GAAP primarily exist to create a standard that allows a company's financial reports to be compared objectively to that of other businesses and previous financial records. While financial accounting does have a few internal uses, it exists essentially for external purposes.

As you can see, each type of accounting follows a different set of standards and rules, and each serves different purposes in running a business.

Let's take a closer look at financial accounting and GAAP analysis...

## **GAAP Analysis in Financial Accounting**

GAAP provides general rules and guidelines that help to govern the world of finance and accounting. **By establishing a set accounting method, GAAP ensures all businesses record and report their financials in the same way.** As a result, it improves the consistency, clarity, and comparability of financial information across all businesses and industries [7].

Essentially, GAAP establishes a common financial language, so that an investor or lender can be sure that the information reported in a company's financial statements is based on the same set of rules and guidelines that any other business following GAAP would use.

For example, GAAP creates transparency in financial information and makes it possible to compare the reported revenue and growth of one company to another.

## **What Businesses Need to Use GAAP?**

The Security and Exchange Commission requires all publicly traded companies in the United States to submit GAAP-compliant financial statements. This enables potential investors to consistently assess and compare financial health when making investment decisions.

But, don't stop reading just yet. **Even if your company is not publicly traded, you will still likely need to generate financial documents based on GAAP rules in order to operate.**

Most banks, private investors, and other financial institutions will require the submission of financial statements that follow GAAP as either a condition of granting loan approval or when deciding whether to invest.

## **The Impact of GAAP Analysis and Financial Accounting Methods on Your Business**

When you're aware of all the different methods of accounting, it becomes clear that, as a business leader, the decision on the basis of accounting you will use in your company is important for compliance.

Choosing to base your accounting method on the FASB's Generally Accepted Accounting Principles has both positive and negative impacts [8].

Let's weigh the options...

### **Pro: Comparable Financial Statements**

Comparability of financial statements is one of the top reasons why business leaders decide to use GAAP-compliant financial statements.

Firstly, GAAP-compliant financial statements allow you to reliably assess and compare your business's performance over time since you'll be generating financial statements and keeping records within a well-established, written framework of bookkeeping and accounting rules and guidelines.

**When your financial statements are kept consistently month by month or year by year, you can accurately evaluate your business's growth and performance.**

Additionally, comparable financial statements are also attractive to investors and creditors who, at a glance, can read and understand your company's financial statements and glean an immediate, transparent understanding of your business's financial health.

Financial statements generated using GAAP guidelines can be easily compared to GAAP-compliance financials from other companies. This simplifies the process of comparing your business's performance to that of your competitors and that of your industry as a whole. GAAP-compliant financial statements enable your business to be benchmarked against others in the industry.

### **Pro: Growth-Ready**

Perhaps you're seeking private investors or bank loans. Or maybe your company is not yet publicly traded, but you're heading in that direction.

However, **if your business is set to expand in the future, having a history of GAAP-compliant financial statements ready to deliver will ensure that you're always ready for growth** – whether it comes as a result of going public, seeking private investors, or taking out bank loans.

If you plan to go public in the future, you'll be legally required to produce GAAP-compliant financial statements. If you want to position your business competitively among private investors and lenders, then you'll give yourself the best shot if you can provide them with GAAP-compliant financial statements that are easily understandable and comparable.

### **Con: Cost of GAAP-Compliant Statements**

Implementing GAAP-compliant record-keeping and financial statements can present a fairly substantial cost – **especially to small businesses.**

If you choose to use GAAP standards in your business from the start, the costs will be minimal (or at least comparable) to what you would spend to start out using another accounting method.

If you decide to adopt financial accounting practices that use GAAP standards later on, then you'll incur the additional cost of changing your existing bookkeeping and accounting systems, implementing new systems, and updating your financial reports as you go forward.

Additionally, there will be a cost for reassessing past financial records to ensure your current balance sheet is accurate and GAAP-compliant.

### **Con: Making Business Decisions with GAAP Financial Statements**

GAAP-compliant financial statements are preferable for people outside of your company (potential investors and bank lenders) who need to make decisions by assessing your business's financials.

However, **they're not always that transparent for people inside a business who are trying to set internal goals, develop business strategies, and make data-driven decisions to steer the business in the right direction [9].**

For example, GAAP-based financial statements use broad brush strokes and tend to produce a financial picture of an entire business without allowing for business leaders to look at their businesses on a more granular level. So, while GAAP statements might allow you to see your business's overall profitability, they won't necessarily help you compare gross profit margins by unit to determine which jobs, clients, or employees were most responsible for your profitability.

## What's the Difference?

FINANCIAL VS. MANAGEMENT	
<b>EXTERNAL</b> Banks Regulators Investors	<b>INTERNAL</b> CEOs Owners Management
<b>MANDATORY</b> Must adhere to all set standards and guidelines. Required by IRS, Banks, etc.	<b>OPTIONAL</b> Not needed but it will help your business identify areas to improve upon
<b>OVERALL</b> Shows your company's overall performance at a given time	<b>SEGMENTED</b> Choose exactly what you want to segment. P&L by class, job, team, department, etc.
<b>GAAP</b> Must follow the guidelines and rules	<b>NOT GAAP</b> You can produce reports how you'd like
<b>PAST</b> Looks backwards at how your company performed	<b>FUTURE</b> Helps make predictions about the future growth and profitability of your company

### [Financial Vs. Management Reports: What's The Difference?](#)

After considering both the pros and cons of GAAP analysis, **you might find that a dual-method accounting system designed for GAAP-compliance and management insights offers the most benefit to your business.**

In order for a business to be successful, business leaders need both Financial and Management Reporting. If you don't [receive management reporting](#) each month you could be missing out on information that can help your company grow or prevent you from implementing costly programs that don't provide an ROI.

## Financial Accounting vs. Management Accounting: Can Your Business Afford to Use Both?

Small businesses managing their back-office entirely with in-house employees and processes likely cannot afford to maintain both a system of financial accounting and a

system of management accounting. This essentially requires a business to maintain two sets of books.

However, with the right tools and back-office strategy, small businesses can accomplish both – especially when small business owners decide to leverage the power of outsourced accounting services. With outsourced accounting services, small businesses can afford access to a team of business accounting experts who can help establish an efficient in-house system of record-keeping and accounting that [automates](#) the processes of [expense categorization](#), financial reporting, and financial statement generation.

With a smart, well-designed back office, even small businesses can take advantage of the business insights available with management accounting while readying themselves for investors and public trading with GAAP-compliant financial statements.

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[1] <https://www.investopedia.com/terms/i/internal-revenue-code.asp>

[2] <https://www.investopedia.com/terms/t/tax-accounting.asp>

[3] <https://www.investopedia.com/terms/a/audit.asp>

[4] <https://www.investopedia.com/terms/m/managerialaccounting.asp>

[5] <https://www.investopedia.com/terms/p/proforma.asp>

[6] <https://www.investopedia.com/terms/f/financialaccounting.asp>