



**SATIC SOLUTIONS**

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# **UNDERSTANDING GAAP**

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*A Complete Guide for Business Owners*

*Everything you need to know about Generally Accepted Accounting  
Principles*

saticolutions.com | Fractional CFO & Advisory  
2026 Edition

## Foreword

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If you have ever looked at a set of financial statements and felt like you were reading a foreign language, this book is for you.

GAAP, Generally Accepted Accounting Principles, is the framework that governs how businesses in the United States record, report, and present their financial information. It is the language that accountants, auditors, investors, and lenders all speak. And yet, most business owners have never been properly introduced to it.

That gap is costly. Not understanding GAAP means not fully understanding your own financial statements. It means being unable to spot errors in your books, unable to have an informed conversation with your accountant, and unable to present credible financials when a lender or investor asks for them.

This book changes that. Written specifically for business owners, not accountants, it explains GAAP in plain English, with real-world examples drawn from the kinds of businesses that need this knowledge most: small and mid-sized companies navigating growth, fundraising, and financial complexity for the first time.

By the end of this book, you will understand how financial statements are constructed, why the rules exist, and how GAAP affects decisions you are probably already making without realising it.

*, The Team at Satic Solutions*

# Chapter 1: What Is GAAP and Why Does It Matter?

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## 1.1 The Problem GAAP Solves

Imagine you are considering investing in two businesses. Both tell you they made a profit last year. But the first business records revenue when a contract is signed. The second records revenue only when cash is received. The first includes depreciation on equipment. The second writes off the full cost the year it is purchased.

Both businesses might be telling the truth. But their numbers are not comparable. Without a common set of rules, financial statements would mean different things depending on who prepared them and what choices they made.

That is the problem GAAP solves. It is a standardised set of rules, principles, and procedures that governs how financial information is recorded and reported. When a business follows GAAP, anyone reading its financial statements, an investor, a lender, a potential buyer, can trust that the numbers mean what they appear to mean.

## 1.2 Who Creates and Enforces GAAP?

GAAP in the United States is primarily set by the Financial Accounting Standards Board, known as the FASB. The FASB is an independent, private-sector organisation established in 1973. It issues detailed standards, called Accounting Standards Updates or ASUs, that govern how specific transactions should be accounted for.

The Securities and Exchange Commission, or SEC, has the legal authority to set accounting standards for publicly traded companies, but it has historically deferred to the FASB. For private companies, GAAP is not legally mandatory in the same way, but lenders, investors, and sophisticated buyers almost always require it.

### Key Institutions in US Accounting

FASB (Financial Accounting Standards Board): Sets US GAAP standards. SEC (Securities and Exchange Commission): Oversees public company reporting. AICPA (American Institute of CPAs): Supports the accounting profession. PCAOB (Public Company Accounting Oversight Board): Oversees public company auditors.

## 1.3 GAAP vs. Non-GAAP

You will sometimes hear companies refer to non-GAAP metrics, particularly in earnings announcements. Non-GAAP measures are financial figures that have been adjusted in ways that deviate from official standards. Common adjustments include removing stock-based compensation, restructuring charges, or amortisation of acquired intangibles.

Companies use non-GAAP measures because they believe they give a clearer picture of ongoing business performance. But non-GAAP metrics are not standardised. Two companies can define the same non-GAAP measure differently, making comparison unreliable.

For most small and mid-sized business owners, the practical takeaway is this: when your bank, your investors, or a potential acquirer ask for your financials, they want GAAP-compliant statements. Non-GAAP adjustments are a large-company conversation.

## 1.4 GAAP vs. IFRS

Outside the United States, most countries use IFRS, International Financial Reporting Standards, issued by the International Accounting Standards Board. IFRS and GAAP are similar in many respects but differ on specific treatments.

Topic	GAAP vs IFRS Difference
Revenue recognition timing	Similar framework under ASC 606
Inventory valuation methods	GAAP allows LIFO; IFRS prohibits it
Intangible asset treatment	Some differences in impairment

	testing
Development costs	GAAP expenses most; IFRS can capitalise some
Revaluation of assets	GAAP uses historical cost; IFRS allows revaluation

If your business operates in both the US and UK markets, as many Satic Solutions clients do, understanding both frameworks matters. US subsidiaries or reporting entities will need GAAP compliance. UK entities will typically report under IFRS or UK GAAP.

## Chapter 2: The Core Principles of GAAP

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GAAP is not simply a list of rules. Underlying those rules are a set of foundational principles. Understanding these principles helps you understand why the rules exist, and what the rules are trying to achieve.

### 2.1 The Principle of Regularity

An accountant must follow GAAP regulations as a standard. This means financial statements must be prepared in accordance with established rules, not personal judgement or convenience. The principle of regularity is the foundation that makes all other principles meaningful.

#### What This Means For You

You cannot choose which accounting rules to follow based on which makes your business look better. The rules apply consistently, and your accountant is professionally obligated to follow them.

### 2.2 The Principle of Consistency

A business must apply the same accounting methods and procedures from one period to the next. If you change an accounting method, you must disclose the change, explain why it was made, and show the financial impact of the change.

This principle exists because comparability matters. If you could switch methods freely, your year-over-year comparisons would be meaningless. An investor looking at three years of financials needs to know that the numbers were prepared the same way each year.

### 2.3 The Principle of Sincerity

The accountant must provide an accurate and impartial picture of the business's financial position. Financial statements are meant to be honest.

They are not marketing materials. They should reflect the reality of the business, not the most optimistic possible interpretation of it.

## 2.4 The Principle of Permanence of Methods

Similar to consistency, this principle requires that the procedures used in financial reporting must be consistent across all reporting periods. This applies not just to major accounting policies but to all methods and estimates used throughout the financial statements.

## 2.5 The Principle of Non-Compensation

All aspects of an organisation's financial performance must be reported, both positive and negative, without any attempt to offset one against the other. You cannot bury a loss inside a revenue line. You cannot net a bad debt against gross revenue. Every significant item must be reported separately.

## 2.6 The Principle of Prudence

Financial data must be reported based on hard evidence, not speculation. When there is uncertainty, accounting leans toward caution. You recognise potential losses as soon as they become probable. You do not recognise potential gains until they are realised.

This is sometimes called conservatism, and it has real implications. A business following GAAP will tend to report lower income in good times than a business that aggressively recognises revenue, because GAAP applies caution to uncertain situations.

## 2.7 The Principle of Continuity

Also known as the going concern assumption, this principle assumes that a business will continue operating indefinitely. This assumption justifies the

way assets are valued, at cost minus accumulated depreciation, rather than at liquidation value.

If a business is in financial difficulty and its ability to continue as a going concern is in doubt, the auditor must disclose this. A going concern warning in an audit opinion is a serious red flag for lenders and investors.

## 2.8 The Principle of Periodicity

Financial activity must be reported during the relevant accounting period. Businesses report their financial performance in defined time periods, typically monthly, quarterly, and annually. Revenue and expenses must be assigned to the correct period, not shifted to make a particular period look better or worse.

## 2.9 The Principle of Materiality

Financial statements must disclose all information that would be significant enough to influence a reader's decisions. Small or trivial amounts do not need to be separately disclosed. But anything material, anything that a reasonable person would consider important, must be disclosed fully and clearly.

### Real-World Example

If your business has a potential lawsuit pending, and the financial exposure is material relative to your balance sheet, GAAP requires you to disclose it, even if the outcome is uncertain. You cannot simply omit it because it is uncomfortable.

## 2.10 The Principle of Utmost Good Faith

All parties involved in financial reporting, management, accountants, auditors, must act in good faith. Financial statements must be prepared honestly, with full transparency, and without intent to mislead. This principle underpins the entire framework.



## Chapter 3: The Three Core Financial Statements

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GAAP-compliant financial reporting requires three primary financial statements. Together, they tell the complete story of a business's financial health. Understanding each one individually, and how they connect to each other, is essential for any business owner.

### 3.1 The Balance Sheet (Statement of Financial Position)

The balance sheet is a snapshot of your business's financial position at a single point in time. It answers one question: what does the business own, what does it owe, and what is left over for the owners?

The balance sheet is built around the fundamental accounting equation:

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$$\text{ASSETS} = \text{LIABILITIES} + \text{OWNERS' EQUITY}$$

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#### Assets

Assets are everything the business owns or controls that has economic value. Under GAAP, assets are divided into current assets and non-current assets.

- Current assets: Cash, accounts receivable, inventory, and other items expected to be converted to cash within 12 months.
- Non-current assets: Property, plant and equipment, intangible assets, and long-term investments.

#### Liabilities

Liabilities are everything the business owes to others. Like assets, they are divided into current and non-current.

- Current liabilities: Accounts payable, accrued expenses, deferred revenue, and debt due within 12 months.

- Non-current liabilities: Long-term debt, lease obligations, and deferred tax liabilities.

## Owners' Equity

Owners' equity, sometimes called shareholders' equity or net worth, is the residual interest in the assets after deducting liabilities. It represents the book value of the business to its owners.

- Contributed capital: Money invested by owners.
- Retained earnings: Cumulative profits that have not been distributed to owners.

### Why the Balance Sheet Always Balances

Every transaction a business records affects at least two accounts, and the effect is always equal on both sides. When you borrow \$100,000 from a bank, assets increase by \$100,000 (cash) and liabilities increase by \$100,000 (loan payable). The equation stays balanced. This is the foundation of double-entry bookkeeping, the system GAAP is built on.

## 3.2 The Income Statement (Profit and Loss Statement)

If the balance sheet is a photograph, the income statement is a video. It covers a period of time, a month, a quarter, a year, and shows how the business performed financially during that period.

The income statement answers: did the business make money, and how?

### Revenue

Revenue is the income generated from the business's primary operations. Under GAAP, revenue is recognised when it is earned, not necessarily when cash is received. This is one of the most important and sometimes counterintuitive aspects of GAAP accounting.

## Cost of Goods Sold (COGS)

COGS represents the direct costs of producing the goods or services that generated revenue. For a manufacturer, this includes raw materials and direct labour. For a service business, it includes the direct cost of delivering the service.

## Gross Profit

Gross profit is revenue minus COGS. It represents the profit generated before overhead expenses. Gross margin, gross profit as a percentage of revenue, is one of the most important metrics for assessing business efficiency.

## Operating Expenses

Operating expenses include all costs incurred in running the business that are not directly tied to production. This includes sales and marketing, general and administrative costs, and research and development.

## EBITDA and Operating Income

Operating income, also called EBIT (Earnings Before Interest and Taxes), is gross profit minus operating expenses. EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortisation) adds back non-cash charges and is widely used as a proxy for operating cash flow, particularly in business valuations.

## Net Income

Net income is the bottom line: revenue minus all expenses, including interest and taxes. It is the profit available to the owners after all obligations are met.

### Profit Is Not Cash

One of the most important things to understand about the income statement is that net income is not the same as cash generated. A business can be profitable and simultaneously run out of cash. This is why the cash flow statement exists, and why understanding all three statements together is

essential.

### 3.3 The Cash Flow Statement

The cash flow statement shows exactly how cash moved in and out of the business during a period. It reconciles net income to actual cash flow by adjusting for non-cash items and changes in working capital.

The cash flow statement is divided into three sections:

#### Operating Activities

This section shows the cash generated or consumed by the business's core operations. It starts with net income and adjusts for non-cash items (like depreciation) and changes in working capital (like increases in accounts receivable or inventory).

Positive operating cash flow is the most important sign of a healthy business. A business that consistently generates negative operating cash flow, even while reporting profit, is a business with a fundamental problem.

#### Investing Activities

This section shows cash spent on acquiring or disposing of long-term assets, equipment, property, acquisitions. Negative investing cash flow is often a sign of growth investment, which can be healthy. Persistent negative investing cash flow without a corresponding return is a warning sign.

#### Financing Activities

This section shows cash flows related to debt and equity, borrowing money, repaying loans, issuing shares, paying dividends. It explains how the business is funding itself.

### The Three Statements Together

Net income flows from the income statement into retained earnings on the balance sheet. The cash flow statement reconciles net income to the change in cash shown on the balance sheet. The three statements are interlocked. A change in one always ripples through the others.

## Chapter 4: Revenue Recognition Under GAAP

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Revenue recognition is one of the most consequential, and most complex, areas of GAAP. How and when you recognise revenue affects your income statement, your tax position, your financial ratios, and how investors perceive your business.

### 4.1 The Old Rules and Why They Changed

Prior to 2018, revenue recognition was governed by a patchwork of industry-specific rules that had accumulated over decades. The rules were inconsistent across industries, creating situations where economically similar transactions were accounted for very differently.

In 2014, the FASB issued ASC 606, a new, comprehensive standard for revenue recognition that applies across industries. Public companies adopted it in 2018. Private companies had an additional year. ASC 606 is now the governing standard.

### 4.2 The Five-Step Model

ASC 606 requires businesses to follow a five-step process to determine when and how much revenue to recognise.

#### Step 1: Identify the Contract

A contract is an agreement between two parties that creates enforceable rights and obligations. Under GAAP, a contract does not need to be written, it can be oral or implied by business practice. But for revenue to be recognised, a contract must exist and the parties must be committed to perform their obligations.

## Step 2: Identify the Performance Obligations

A performance obligation is a promise to transfer a distinct good or service to a customer. A single contract can contain multiple performance obligations. A software company, for example, might have a contract that includes both the software licence and ongoing maintenance support, these are separate performance obligations that must be accounted for separately.

## Step 3: Determine the Transaction Price

The transaction price is the amount of consideration you expect to receive in exchange for fulfilling your performance obligations. This sounds simple, but it gets complex when contracts include variable consideration, discounts, refunds, performance bonuses, or price concessions.

## Step 4: Allocate the Transaction Price

When a contract has multiple performance obligations, the transaction price must be allocated to each one based on its standalone selling price. If you sell software and support together for \$12,000, and you would normally charge \$9,000 for the software and \$6,000 for the support separately, you allocate the \$12,000 proportionally.

## Step 5: Recognise Revenue When Performance Obligations Are Satisfied

Revenue is recognised when, or as, control of a good or service transfers to the customer. This can happen at a point in time (when you deliver a product) or over time (as you provide a service over a contract period).

### A Common Misconception

Many business owners believe revenue is recognised when they invoice a customer. This is not correct under GAAP. Revenue is recognised when the performance obligation is satisfied, when the customer receives the benefit of what you have provided. Invoicing is a billing event, not a revenue recognition event.

### 4.3 Point-in-Time vs. Over-Time Recognition

Whether revenue is recognised at a point in time or over time has significant practical implications for your financial statements.

Point-in-Time Recognition	Over-Time Recognition
Delivering a physical product	Providing ongoing services
Completing a one-time project	Long-term construction contracts
Transferring a software licence	SaaS subscriptions
Selling a piece of equipment	Maintenance agreements

### 4.4 Deferred Revenue

Deferred revenue is cash you have received from a customer for which you have not yet fulfilled your performance obligation. Under GAAP, this is a liability, not revenue, because you still owe the customer something.

For subscription businesses, annual prepayments create deferred revenue that must be recognised ratably over the subscription period. A business that receives \$1.2 million in annual subscription payments on January 1 cannot recognise all of it as revenue in January. It recognises \$100,000 per month as the service is delivered.

## Chapter 5: Expenses and the Matching Principle

The matching principle is one of GAAP's most important foundations. It states that expenses must be recognised in the same period as the revenue they helped generate. You cannot expense the cost of producing a product in the year you manufacture it if you sell it in the following year.

### 5.1 How the Matching Principle Works

Consider a simple example. A business manufactures 1,000 units of a product in December at a cost of \$50,000. It sells 600 units in December and 400 units in January.

- Under the matching principle, the cost of the 600 units sold in December (\$30,000) is expensed in December, matched to the revenue from those sales.
- The cost of the 400 units sold in January (\$20,000) sits in inventory on the December balance sheet and is expensed in January when the revenue is recognised.

This is why inventory is an asset, not an expense, until the goods are sold.

### 5.2 Accrual Accounting vs. Cash Accounting

The matching principle is the heart of accrual accounting, the method GAAP requires. Under accrual accounting, revenue and expenses are recognised when they are earned or incurred, not when cash changes hands.

Cash accounting, by contrast, records revenue when cash is received and expenses when cash is paid. It is simpler, but it does not comply with GAAP and it can give a misleading picture of business performance.

Accrual Accounting	Cash Accounting
Matches revenue to related costs	Simple to maintain
Required by GAAP	Common for very small businesses
Better reflects economic reality	Does not comply with GAAP

Requires more complex bookkeeping	Can mislead on profitability
Can show profit while cash is tight	Easier to understand day-to-day

### Why This Matters For Your Business

If you are using cash-basis accounting and your bank or investor asks for GAAP-compliant financials, you will need to convert. This is a significant undertaking that becomes more complex the longer it is deferred. Building accrual-based bookkeeping from the start is almost always the right decision for any business expecting to grow.

## 5.3 Prepaid Expenses

A prepaid expense is a cost that has been paid in cash but not yet incurred in an economic sense. The most common examples are insurance premiums paid annually and rent paid in advance.

Under GAAP, prepaid expenses are assets, not expenses, until the period they cover arrives. If you pay \$24,000 for annual insurance on January 1, you record a \$24,000 prepaid expense on the balance sheet and recognise \$2,000 per month as an expense over the year.

## 5.4 Accrued Expenses

An accrued expense is a cost that has been incurred but not yet paid. Common examples include wages earned by employees but not yet paid, interest owed on a loan, and services received but not yet invoiced.

Under GAAP, accrued expenses are liabilities. They must be recorded in the period they are incurred, not the period they are paid. Failing to accrue expenses properly means your income statement overstates profit in the current period.

## Chapter 6: Assets, Depreciation, and Amortisation

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How GAAP requires you to account for assets, particularly long-lived assets, has a significant impact on your financial statements. Understanding depreciation and amortisation is essential for any business owner who owns equipment, property, or intangible assets.

### 6.1 Capitalising vs. Expensing

When a business acquires an asset, GAAP requires a judgement: should this cost be capitalised (recorded as an asset) or expensed immediately?

The general principle is that costs that provide economic benefit beyond the current accounting period should be capitalised. Costs that are consumed in the current period should be expensed.

- A laptop computer costing \$2,000 that will be used for three years: capitalised.
- Office supplies purchased this month that will be used this month: expensed.
- A building renovation that extends the useful life of the property: capitalised.
- Routine maintenance that keeps an asset in its current condition: expensed.

### 6.2 Depreciation of Tangible Assets

When a long-lived tangible asset is capitalised, its cost is not expensed all at once. Instead, the cost is spread over the asset's useful life through depreciation. This aligns with the matching principle, the cost of the asset is recognised in the periods during which it generates economic benefit.

## Straight-Line Depreciation

The most common method. The cost minus residual value is divided equally across the useful life.

### Example

A piece of equipment costs \$100,000 and has a residual value of \$10,000 and a useful life of 10 years. Annual depreciation =  $(\$100,000 - \$10,000) / 10 = \$9,000$  per year.

## Accelerated Depreciation

Methods like double-declining balance recognise more depreciation expense in the early years of an asset's life. This can be appropriate for assets that lose value quickly. Note that depreciation for tax purposes (under MACRS) often differs from GAAP depreciation.

## 6.3 Amortisation of Intangible Assets

Amortisation is the equivalent of depreciation for intangible assets, assets without physical form. Common intangible assets subject to amortisation include patents, trademarks, customer lists, and non-compete agreements acquired in a business purchase.

Intangible assets with a finite useful life are amortised over that life. Intangible assets with an indefinite useful life, most commonly goodwill, are not amortised but are tested annually for impairment.

## 6.4 Goodwill and Impairment

Goodwill arises when a business is acquired for more than the fair value of its net identifiable assets. It represents the premium paid for brand, customer relationships, workforce, and strategic value.

Under GAAP, goodwill is not amortised. Instead, it sits on the balance sheet at its recorded value until, and unless, it is impaired. Impairment occurs when the carrying value of goodwill exceeds its fair value. When impairment

is recognised, it is a non-cash expense that reduces the balance sheet value and hits the income statement.

## Chapter 7: Inventory Accounting

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For businesses that hold inventory, products manufactured or purchased for sale, how inventory is valued under GAAP affects both the balance sheet and the income statement. The method chosen can significantly impact reported profit, taxes, and financial ratios.

### 7.1 Why Inventory Valuation Matters

When you sell a product, you must expense its cost. But if you purchased the same product at different prices over time, which cost do you use? The answer depends on your inventory valuation method. The method chosen affects COGS on the income statement and inventory value on the balance sheet.

### 7.2 FIFO, First In, First Out

Under FIFO, the cost of the oldest inventory is expensed first. The inventory remaining on the balance sheet is valued at the most recent costs.

In a rising-price environment, FIFO results in lower COGS and higher reported profit compared to other methods. This can make the business look more profitable but also means higher taxable income.

### 7.3 LIFO, Last In, First Out

Under LIFO, the cost of the most recently purchased inventory is expensed first. LIFO is only permitted under US GAAP, it is prohibited under IFRS.

In a rising-price environment, LIFO results in higher COGS and lower reported profit, which reduces taxable income. Many companies use LIFO specifically for this tax benefit. However, inventory on the balance sheet is valued at older, often lower costs, which can significantly understate the actual current value of inventory.

## 7.4 Weighted Average Cost

This method calculates an average cost per unit based on the total cost of inventory available and the total number of units. COGS and ending inventory are both valued at this average cost. It smooths out price fluctuations and is simpler to administer than FIFO or LIFO.

### **Important: Consistency Required**

Once you choose an inventory method, GAAP's consistency principle requires you to use it every period. You cannot switch methods to manage your reported profit. If you do change methods, the change must be disclosed, justified, and the financial impact quantified.

## 7.5 Lower of Cost or Net Realisable Value

Under GAAP, inventory must be reported at the lower of its cost or its net realisable value, the estimated selling price in the ordinary course of business, minus the costs to complete and sell.

If inventory has been damaged, become obsolete, or if market prices have fallen below cost, you must write the inventory down. This is an application of the principle of prudence, you do not overstate assets on the balance sheet.

## Chapter 8: Liabilities, Debt, and Contingencies

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How liabilities are recorded under GAAP affects your balance sheet, your key financial ratios, and how lenders and investors perceive your business. Understanding what GAAP requires you to recognise, and when, is essential for managing your financial presentation.

### 8.1 Current vs. Non-Current Liabilities

GAAP requires liabilities to be classified based on when they are due. Current liabilities are due within 12 months of the balance sheet date. Non-current liabilities are due after 12 months.

This classification matters because lenders and investors use it to assess liquidity. The current ratio, current assets divided by current liabilities, is one of the most commonly used measures of short-term financial health. Misclassifying liabilities between current and non-current distorts this analysis.

### 8.2 Accounts Payable and Accrued Liabilities

Accounts payable represents amounts owed to suppliers for goods and services received but not yet paid. Accrued liabilities represent obligations incurred but not yet invoiced, wages payable, interest accrued, taxes owed.

Both must be recorded in the period the obligation is incurred, not the period the cash is paid. Failing to accrue liabilities properly overstates profit and understates the balance sheet.

### 8.3 Debt and Notes Payable

Borrowings from banks or other lenders are recorded at the amount borrowed. Debt is then separated between the current portion, principal due

within 12 months, and the long-term portion. Interest expense is recorded separately as it accrues, even if it is not paid monthly.

Debt issuance costs, fees paid to arrange a loan, are treated as a reduction of the carrying value of the debt and recognised over the life of the loan under GAAP.

## 8.4 Contingent Liabilities

A contingent liability is a potential obligation that depends on the outcome of a future event, most commonly litigation. GAAP requires specific treatment depending on the probability of the obligation materialising:

- Probable and estimable: The liability must be accrued on the balance sheet and disclosed in the notes.
- Probable but not estimable: Must be disclosed in the notes but does not need to be accrued.
- Reasonably possible: Must be disclosed in the notes.
- Remote: No disclosure required.

### Why This Matters

If your business has outstanding litigation, contract disputes, or warranty obligations, GAAP may require you to record a liability before the outcome is known. Many business owners are surprised to learn that you cannot simply ignore a potential obligation until it is resolved, if it is probable and estimable, it belongs on your balance sheet now.

## Chapter 9: Equity and Retained Earnings

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The equity section of the balance sheet tells the story of how the business has been funded and how it has performed since inception. Understanding how GAAP treats equity is important for founders, investors, and anyone considering buying or selling a business.

### 9.1 Components of Equity

For most small and mid-sized businesses, equity consists of a small number of components:

- Common stock and additional paid-in capital: The amount invested by the owners, recorded at par value plus any premium paid above par.
- Retained earnings: The cumulative net income of the business since inception, less any dividends or distributions paid to owners.
- Treasury stock: Shares repurchased by the company from investors, recorded as a reduction of equity.
- Accumulated other comprehensive income: Certain gains and losses that bypass the income statement, such as unrealised gains on certain investments or foreign currency translation adjustments.

### 9.2 Retained Earnings

Retained earnings is one of the most important numbers on the balance sheet. It shows how much of the business's cumulative profits have been reinvested in the business rather than distributed to owners.

When a business is profitable, net income increases retained earnings. When a business pays dividends or makes distributions to owners, retained earnings decreases. A business with consistently growing retained earnings is one that is profitable and reinvesting in itself.

A business with a retained earnings deficit, sometimes shown as an accumulated deficit, has lost more money than it has earned since inception. This is common in early-stage businesses that are investing heavily in growth, but it is a figure that deserves careful attention.

## 9.3 Dividends and Distributions

Under GAAP, dividends are recorded when they are declared, not when they are paid. Once a dividend is declared, it becomes a liability, dividends payable, until the cash is distributed.

For S-corporations and partnerships, distributions to owners are not expenses, they do not flow through the income statement. They reduce equity directly. Many business owners confuse owner distributions with business expenses, which distorts both the income statement and the equity section.

## Chapter 10: Financial Statement Notes and Disclosures

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The financial statements themselves are only part of a GAAP-compliant financial report. The notes to the financial statements are equally important. For many users of financial statements, the notes contain the most important information.

### 10.1 Why Notes Matter

Financial statements present numbers. Notes explain those numbers. They provide the context, assumptions, and detail that make the numbers meaningful. A balance sheet might show \$2 million in long-term debt. The note tells you the interest rate, the maturity date, the covenants, and whether the business is in compliance with those covenants.

### 10.2 Required Disclosures

GAAP requires certain disclosures in the notes regardless of the size or type of business. These typically include:

- Summary of significant accounting policies: A description of the accounting methods used, including revenue recognition, inventory valuation, depreciation methods, and any significant judgements or estimates.
- Details of long-term debt: Terms, interest rates, maturities, and covenant compliance.
- Related party transactions: Any transactions between the business and its owners, management, or their affiliates.
- Commitments and contingencies: Future obligations, including lease commitments, purchase commitments, and pending litigation.
- Subsequent events: Material events that occurred after the balance sheet date but before the financial statements were issued.

## 10.3 Accounting Estimates and Judgements

GAAP requires management to make numerous estimates in preparing financial statements. The useful lives used for depreciation, the allowance for doubtful accounts, the fair value of stock-based compensation, the probability of a contingent liability, all of these require judgement.

The notes must disclose the nature of significant estimates and the assumptions used. Changes in estimates must be disclosed and their financial impact quantified. This is an area where the quality of your accountant and CFO matters significantly, poorly constructed estimates can materially distort your financial statements.

### **A Note on Audits vs. Reviews vs. Compilations**

There are three levels of assurance a CPA can provide on financial statements:

**Audit:** The highest level. The CPA obtains sufficient evidence to express an opinion on whether the statements are fairly presented in accordance with GAAP. Required by most lenders for significant facilities and by investors in formal fundraising. **Review:** A more limited engagement. The CPA performs analytical procedures and inquiry but does not obtain the evidence required for an audit. Provides limited assurance. **Compilation:** The lowest level. The CPA assembles the financial statements from management-provided information but provides no assurance on their accuracy.

## Chapter 11: GAAP for Growing Businesses

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Many of the GAAP topics in earlier chapters become especially relevant at specific stages of business growth. This chapter addresses the GAAP considerations that matter most as your business scales.

### 11.1 When You Need GAAP-Compliant Financials

Not every business needs fully GAAP-compliant financial statements on day one. But there are specific trigger events that make GAAP compliance not just desirable but necessary:

- Seeking a bank loan above a certain threshold: Most lenders require audited or reviewed GAAP financials for credit facilities above \$1 to \$2 million.
- Raising equity capital: Professional investors, angel investors, venture capital, private equity, will require GAAP-compliant financials before closing an investment.
- Preparing for acquisition: Any serious buyer will conduct financial due diligence that requires GAAP-compliant records. Gaps discovered during due diligence reduce your valuation or kill the deal.
- Adding a co-founder or partner: New equity holders need reliable financials to assess what they are receiving.
- Government contracting: Many government contracts require GAAP-compliant financial reporting.

### 11.2 Common GAAP Errors in Growing Businesses

The following errors appear repeatedly in the financials of growing businesses. Each one creates problems when a business attempts to raise capital, secure debt, or prepare for an exit.

#### Revenue Recognised Too Early

Recording revenue when a contract is signed or cash is received, rather than when the performance obligation is satisfied, overstates revenue in early

periods and creates a reconciliation problem when the obligation is eventually fulfilled.

### **Expenses Capitalised That Should Be Expensed**

Capitalising costs that do not meet the criteria, routine maintenance, software maintenance fees, marketing costs, inflates assets and understates expenses. This makes the business look more profitable in the short term but creates problems when auditors review the balance sheet.

### **Owner Compensation Not at Market Rate**

In private businesses, owners sometimes pay themselves below-market salaries to make the business look more profitable, or above-market compensation that benefits them personally but distorts the business's true operating economics. Both approaches create problems in due diligence.

### **Intermingled Personal and Business Expenses**

Personal expenses run through the business, vehicles, travel, meals, home offices, must be carefully documented and, where not legitimately business expenses, excluded. Commingled expenses are one of the most common sources of financial statement problems in private company due diligence.

### **Undisclosed Related Party Transactions**

Transactions between the business and its owners, family members, or affiliated businesses must be disclosed. Failure to disclose related party transactions is not simply a GAAP violation, it is the kind of omission that destroys trust in due diligence.

#### **The Cost of Getting It Wrong**

Financial statement restatements, discovered errors, and undisclosed issues found during due diligence are among the most common reasons acquisitions fail or valuations are reduced. The cost of building proper financial

infrastructure early is a fraction of the cost of fixing problems discovered later.

### 11.3 Building GAAP-Ready Infrastructure

Becoming GAAP-compliant is not a one-time exercise. It requires ongoing discipline in how financial information is recorded, reviewed, and presented. The foundations of GAAP-ready financial infrastructure are:

1. Proper accounting software: QuickBooks, Xero, NetSuite, or similar platforms configured correctly for accrual-basis accounting.
2. A qualified accountant or bookkeeper: Someone who understands GAAP requirements, not just basic data entry.
3. A monthly close process: Revenue recognised correctly, expenses accrued, reconciliations completed, and management accounts produced within 15 days of month end.
4. A chart of accounts structured for GAAP reporting: Revenue, COGS, and operating expenses separated correctly; assets and liabilities classified appropriately.
5. A fractional CFO or financial advisor: Someone who reviews the financials, catches errors, and ensures the statements tell a complete and accurate story.

## Chapter 12: Reading and Using Your Financial Statements

Understanding GAAP is not just about compliance. It is about being able to read and use your financial statements as management tools. This chapter gives you the practical framework for doing that.

### 12.1 The Five Questions Your Financials Should Answer

Every time you review your financial statements, you should be able to answer five questions:

6. Is the business profitable? Look at net income and gross margin on the income statement.
7. Is the business generating cash? Look at operating cash flow on the cash flow statement.
8. Is the business solvent? Look at total liabilities versus total equity on the balance sheet.
9. Is the business liquid? Look at the current ratio, current assets divided by current liabilities.
10. Is the business growing sustainably? Look at revenue growth alongside operating cash flow growth. Revenue growth funded by increasing debt or deteriorating working capital is not sustainable.

### 12.2 Key Financial Ratios Every Business Owner Should Know

<b>Gross Margin</b>	Gross Profit / Revenue. Measures the profitability of your core product or service before overhead.
<b>Operating Margin</b>	Operating Income / Revenue. Measures how efficiently you run the business overall.
<b>Net Margin</b>	Net Income / Revenue. The bottom-line profitability as a percentage of revenue.
<b>Current Ratio</b>	Current Assets / Current Liabilities. A ratio above 1.5 is

	generally considered healthy.
<b>Quick Ratio</b>	$(\text{Current Assets} - \text{Inventory}) / \text{Current Liabilities}$ . A more conservative liquidity test.
<b>Debt-to-Equity</b>	$\text{Total Liabilities} / \text{Total Equity}$ . Measures how leveraged the business is.
<b>Days Sales Outstanding</b>	$\text{Accounts Receivable} / (\text{Revenue} / 365)$ . How many days on average to collect payment.
<b>Days Payable Outstanding</b>	$\text{Accounts Payable} / (\text{COGS} / 365)$ . How many days on average before you pay suppliers.
<b>Inventory Turnover</b>	$\text{COGS} / \text{Average Inventory}$ . How many times inventory is sold and replaced in a period.

## 12.3 Red Flags in Financial Statements

When reviewing your own financial statements, or evaluating another business, these are the patterns that warrant immediate scrutiny:

- Revenue growing faster than cash: If revenue is rising but operating cash flow is flat or negative, receivables may be growing uncollected or revenue may be recognised prematurely.
- Gross margin declining: Either prices are falling or costs are rising faster than revenue. Both require investigation.
- Inventory growing faster than revenue: May indicate slow-moving or obsolete inventory that needs to be written down.
- Accounts payable growing faster than revenue: May indicate cash flow pressure, the business is stretching its suppliers.
- Related party transactions increasing: Requires careful scrutiny to ensure they are on arm's-length terms.
- Goodwill representing a large portion of total assets: Creates impairment risk if business performance deteriorates.

## Chapter 13: GAAP and Tax, Understanding the Difference

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One of the most common sources of confusion for business owners is the difference between GAAP accounting and tax accounting. The two systems exist for different purposes and operate under different rules. Your financial statements and your tax return will not, and should not, look the same.

### 13.1 Why GAAP and Tax Rules Differ

GAAP is designed to give a fair and accurate picture of a business's economic performance. Tax rules are designed to raise revenue for the government in a way that is administratively practical and reflects specific policy choices.

These objectives sometimes align, but often they do not. Tax rules often allow accelerated deductions that GAAP would spread over a longer period. Tax rules may disallow certain expenses that GAAP recognises. The result is that the same business transaction can be treated very differently under the two systems.

### 13.2 Deferred Tax Assets and Liabilities

Because GAAP and tax accounting diverge on timing, a business's taxable income in any given year often differs from its GAAP income. When GAAP income exceeds taxable income, for example, because GAAP requires income to be recognised earlier, a deferred tax liability arises. The business has a future tax obligation that has not yet been paid.

When taxable income exceeds GAAP income, for example, because a deduction is taken for tax purposes before the related expense is recognised under GAAP, a deferred tax asset arises. The business has a future tax benefit.

### 13.3 Common Timing Differences

Creates Deferred Tax Liability	Creates Deferred Tax Asset
Accelerated depreciation (MACRS vs straight-line)	Revenue deferred for tax but recognised under GAAP
Revenue recognised earlier for GAAP than tax	Expense deductible for tax before GAAP recognition
Prepaid income taxable when received	Bad debt deduction differs between systems
Instalment sales differ between GAAP and tax	Stock compensation timing differences

#### Practical Advice

Many small business owners use their tax return as a proxy for their financial performance. This is a mistake. Your tax return is optimised to minimise your tax burden. Your GAAP financials are designed to accurately represent your economic performance. The two serve different masters, and you need both.

## Chapter 14: Preparing for an Audit

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For growing businesses, the first formal audit is a significant milestone. It signals to the market that the business is serious, transparent, and ready for institutional relationships. But audits are also demanding, in time, cost, and the scrutiny they bring. Understanding what auditors look for helps you prepare effectively.

### 14.1 What Auditors Actually Do

Auditors do not simply review your financial statements and sign off. They obtain evidence, through document inspection, confirmation with third parties, physical observation, and analytical procedures, to support an opinion on whether the financial statements are fairly presented in accordance with GAAP.

Auditors assess risk. They identify areas where the financial statements are most susceptible to material misstatement, whether due to error or fraud, and focus their procedures there. High-risk areas typically include revenue recognition, accounts receivable, inventory, and management estimates.

### 14.2 What Auditors Look For

In the audit of a small or mid-sized business, the following areas receive the most scrutiny:

- Revenue recognition: Are the correct amounts being recognised in the correct periods? Are there unusual transactions near period end that might represent premature revenue recognition?
- Related party transactions: Are transactions with owners, family members, or affiliated businesses properly identified and disclosed?
- Management estimates: Are the assumptions underlying key estimates, the allowance for doubtful accounts, the useful lives used for depreciation, the fair value of stock compensation, reasonable and consistent?

- Completeness of liabilities: Are all obligations, including contingent liabilities, properly identified and recorded?
- Equity transactions: Are all equity issuances, repurchases, and distributions properly recorded and documented?

### 14.3 How to Prepare

The businesses that move through an audit most efficiently are those that have maintained clean, organised records throughout the year. Last-minute preparation is expensive and stressful. Ongoing preparation is straightforward.

11. Reconcile all accounts monthly: Bank accounts, accounts receivable, accounts payable, and all balance sheet accounts should be reconciled to supporting documentation every month.
12. Maintain a complete audit trail: Every transaction should have supporting documentation, invoices, contracts, receipts, bank statements.
13. Document significant transactions and estimates: Write down the assumptions and reasoning behind significant judgements. Do not rely on memory.
14. Resolve open items promptly: Do not let unexplained differences accumulate. Investigate and resolve them when they arise.
15. Prepare a PBC list in advance: Auditors provide a Prepared By Client list of documents they need. Anticipate this list and gather documentation before the audit begins.

## Chapter 15: GAAP and Business Valuation

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One of the most important applications of GAAP for business owners is in the context of business valuation. Whether you are raising capital, selling the business, bringing in a partner, or simply understanding what you have built, GAAP-compliant financial statements are the foundation of any credible valuation.

### 15.1 Why GAAP Matters in Valuation

Valuation is ultimately about the economic reality of a business. GAAP financial statements, prepared correctly, provide the most reliable picture of that reality. They are the starting point for any serious valuation exercise.

Businesses without GAAP-compliant financials are valued at a discount, or not at all, because the acquirer or investor cannot verify the numbers. The time and cost of cleaning up the financials comes out of your valuation, not theirs.

### 15.2 EBITDA and Its GAAP Foundation

EBITDA, Earnings Before Interest, Taxes, Depreciation, and Amortisation, is the most widely used valuation metric for private businesses. It starts with GAAP operating income and adds back non-cash charges.

The reliability of EBITDA depends entirely on the reliability of the underlying GAAP financials. An EBITDA figure prepared from cash-basis or inconsistently maintained books is not a meaningful valuation input.

### 15.3 Normalisation Adjustments

In private company valuations, buyers and investors typically make normalisation adjustments to GAAP financials to arrive at a figure that reflects the true, sustainable earnings of the business. Common adjustments include:

- Owner compensation above or below market rate.
- One-time or non-recurring revenue or expenses.
- Personal expenses run through the business.
- Related party transactions not at arm's length.
- Rent paid to owner-controlled entities above or below market rates.

Each adjustment must be supportable. Buyers will scrutinise every normalisation claim. The more clearly documented and justifiable your adjustments, the stronger your negotiating position.

### **The Valuation Multiple**

Private businesses are typically valued at a multiple of EBITDA. That multiple varies by industry, growth rate, and risk profile. But a business with clean, audited GAAP financials commands a higher multiple than one with unaudited, inconsistently prepared books, even if the underlying business is identical. Financial quality is a valuation input.

## Glossary of Key GAAP Terms

The following terms appear throughout this book and throughout GAAP-compliant financial reporting. Every business owner working with financial statements should be familiar with them.

<b>Accounts Payable</b>	Amounts owed to suppliers for goods and services received but not yet paid.
<b>Accounts Receivable</b>	Amounts owed to the business by customers for goods or services delivered.
<b>Accrual Accounting</b>	An accounting method where revenue and expenses are recognised when earned or incurred, not when cash is received or paid.
<b>Accrued Expense</b>	An expense that has been incurred but not yet paid or invoiced.
<b>Amortisation</b>	The systematic expensing of an intangible asset over its useful life.
<b>ASC 606</b>	The FASB standard governing revenue recognition across all industries.
<b>Balance Sheet</b>	A financial statement showing assets, liabilities, and equity at a point in time.
<b>Capital Expenditure</b>	Spending on long-lived assets that is capitalised and depreciated over time.
<b>Cash Flow Statement</b>	A financial statement showing how cash moved in and out of the business.
<b>COGS</b>	Cost of Goods Sold. The direct cost of producing the goods or services sold.
<b>Contingent Liability</b>	A potential obligation whose existence depends on the outcome of a future event.
<b>Deferred Revenue</b>	Cash received for a performance obligation not yet fulfilled. Recorded as a liability.
<b>Depreciation</b>	The systematic expensing of a tangible long-lived asset over its useful life.
<b>EBITDA</b>	Earnings Before Interest, Taxes, Depreciation, and Amortisation.

<b>FASB</b>	Financial Accounting Standards Board. The body that sets US GAAP.
<b>GAAP</b>	Generally Accepted Accounting Principles. The standard framework for US financial reporting.
<b>Going Concern</b>	The assumption that a business will continue operating indefinitely.
<b>Goodwill</b>	The premium paid in an acquisition above the fair value of net identifiable assets.
<b>Gross Margin</b>	Gross Profit divided by Revenue. A measure of core profitability.
<b>IFRS</b>	International Financial Reporting Standards. Used in most countries outside the US.
<b>Impairment</b>	A reduction in the carrying value of an asset when its fair value falls below its book value.
<b>Income Statement</b>	A financial statement showing revenue, expenses, and profit over a period.
<b>Matching Principle</b>	The requirement to recognise expenses in the same period as the revenue they generated.
<b>Materiality</b>	The threshold above which information is significant enough to require disclosure.
<b>Net Income</b>	Revenue minus all expenses, including interest and taxes. The bottom line.
<b>Performance Obligation</b>	A promise to transfer a distinct good or service to a customer under a contract.
<b>Prepaid Expense</b>	A cost paid in cash before the related benefit is received. Recorded as an asset.
<b>Retained Earnings</b>	Cumulative net income since inception, less dividends and distributions paid.
<b>Revenue Recognition</b>	The process of determining when and how much revenue to record.
<b>Working Capital</b>	Current Assets minus Current Liabilities. A measure of short-term liquidity.

## Closing Thoughts: Making GAAP Work For Your Business

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GAAP is not simply a compliance requirement. Understood properly, it is one of the most powerful tools available to a business owner.

The principles of GAAP, matching, consistency, prudence, full disclosure, are not arbitrary bureaucratic rules. They are the accumulated wisdom of the accounting profession about how to present financial information in a way that is reliable, comparable, and meaningful.

A business that embraces GAAP, that builds accrual-based bookkeeping, monthly closes, and properly prepared financial statements into its operating rhythm, is a business that understands its own economics clearly. It can make better decisions. It can move faster when opportunities arise. It can enter investor conversations, lender meetings, and acquisition negotiations from a position of confidence rather than vulnerability.

The businesses that struggle most with their finances are almost always the ones that deferred this investment. The cleanup cost is always higher than the prevention cost. And the missed opportunities, the loan not secured, the investor not landed, the acquisition not completed, are costs that never appear on any financial statement but are felt nonetheless.

If this book has given you a clearer understanding of what GAAP is, why it exists, and how to apply it, then it has done its job. The next step is to apply that understanding in your business, and to make sure you have the financial partnership to help you do it well.

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