Chapter 1

RESEARCHING GAAP

BACKGROUND AND INTRODUCTION

Overview of GAAP

This chapter provides an overview of generally accepted accounting principles (GAAP), including the processes involved in its development.

GAAP Defined

> *The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.*
>
> —U.S. Auditing Standards Board, AU §411

OBJECTIVE OF GAAP REPORTING

Generally accepted accounting principles (GAAP) are concerned with the measurement of economic activity, the timing when such measurements are to be made and recorded, the disclosures surrounding this activity, and the preparation and presentation of summarized economic information in the form of financial statements.

There are two broad categories of accounting principles: those dealing with *recognition and measurement*, and those dealing with *presentation and disclosure*.

Recognition and measurement principles determine when and how transactions and events items enter the accounting cycle and impact the financial statements. These quantitative standards require economic information to be reflected numerically.

Presentation and disclosure principles involve qualitative considerations regarding information that is deemed an essential ingredient of a full set of financial statements, the absence or inappropriate presentation of which would make the financial statements materially misleading.

Disclosure principles complement recognition principles by explaining assumptions underlying the numerical information and by providing additional information about accounting policies, contingencies, uncertainties, and other matters that are essential to fully understand the performance and financial condition of the reporting entity.

WHO CREATED GAAP?

Over time, different professional and statutory bodies have been given responsibility for the promulgation of GAAP, with multiple organizations often sharing this responsibility. All GAAP established by earlier standard-setting bodies, to the extent not withdrawn or superseded, continues in effect. GAAP in effect as of July 1, 2009, have been incorporated in the Accounting Standards Codification (ASC) of the Financial Accounting Standards Board (FASB), and that promulgated hereinafter will be set forth as changes to ASC and not as freestanding pronouncements, such as FASB statements.

Committee on Accounting Procedure

The 1929 market crash led to the first serious attempt to create formalized generally accepted accounting principles in 1930, in the hope that a set of uniform and stringent financial reporting requirements would prevent a recurrence. The American Institute of Accountants (which in 1957 was renamed the American Institute of Certified Public Accountants [AICPA]) created a special committee to work with the New York Stock Exchange toward the goal of establishing standards for accounting procedures. The special committee recommended five rules to the Exchange, published in 1938 as Accounting Research Bulletin (ARB) 1 of the Committee on Accounting Procedure. The Committee subsequently published 51 such Bulletins, including ARB 43, which consolidated and superseded all prior bulletins and also attempted to achieve uniformity in accounting terminology. However, its limited resources and lack of serious research efforts in support of its pronouncements were questioned in the late 1950s as a number of very complex controversial topics loomed on the horizon.

Accounting Principles Board

In response, the Accounting Principles Board (APB) was created to facilitate the development of principles that were to be based primarily on the research of a separate Accounting Research Division of the AICPA. The Division was to undertake extensive research, publish its findings, and then permit the APB to take the lead in the discussions that would ensue concerning accounting principles and practices. The Board's authority was enforced primarily through its prestige and Rule 203 of the AICPA Code of Professional Conduct. Furthermore, formal approval of Board issuances by the Securities and Exchange Commission (SEC) gave additional support to its activities.

During the Board's 14 years of existence, it issued 31 authoritative Opinions plus 4 nonauthoritative Statements. The Board made only scant use of the efforts of the Accounting Research Division, which published 15 research studies during its lifetime, and the respective agendas of the two bodies were independently arrived at. The general opinion was that the APB did not, ultimately, operate differently or more effectively than had the Committee on Accounting Procedure, resulting in calls for its replacement.

Financial Accounting Standards Board

Based on findings by the Wheat Study Group, the independent Financial Accounting Standards Board (FASB) was created in 1972. The Board currently consists of five members (until 2008, there were seven full-time members) having diverse backgrounds in public accounting, private industry, and academia. The Board is assisted by a staff of professionals that conducts research and works directly with the Board. FASB is recognized as authoritative through Financial Reporting Release (FRR) 1 of the SEC and through Rule 203 of the AICPA Code of Professional Conduct.

FASB is an independent body, relying on the Financial Accounting Foundation for selection of its members and approval of its budgets. FASB is supported by the sale of its publications and by fees assessed on all public companies (imposed under the Sarbanes-Oxley Act of 2002) based on their market capitalizations. The Board of Trustees of the Foundation is composed of members of the

- American Accounting Association
- American Institute of Certified Public Accountants
- CFA Institute

- Financial Executives International
- Government Finance Officers Association
- Institute of Management Accountants
- National Association of State Auditors, Comptrollers, and Treasurers
- Securities Industry Association

From its inception through the mid-2009 implementation of the Accounting Standards Codification (discussed below), the Board issued several types of pronouncements.[1] The most important of these were Statements of Financial Accounting Standards and the FASB Interpretations, the latter of which were used to clarify or elaborate on existing Statements or pronouncements of predecessor bodies. Under the GAAP hierarchy that existed prior to mid-2009, FASB Standards and Interpretations constituted category A GAAP, which also included FASB Staff Positions—a more recent form of official guidance—and the Board's FAS 133 implementation issues. Technical Bulletins, which were formerly category B GAAP, usually addressed issues not covered directly by existing standards and were primarily used to provide guidance where it was not expected to be costly or require a major change in practice. Bulletins were discussed at Board meetings and subject to Board veto. Both Technical Bulletins and Interpretations were designed to be responsive to implementation and practice problems on relatively narrow subjects.

The FASB staff was empowered to issue Implementation Guides and Staff Positions, which were included in category D of the former GAAP hierarchy. In a question-and-answer format, these implementation guides addressed specific questions that arose when a Standard was initially issued. FASB Staff Positions (FSP), of which many were produced over several years through mid-2009, were responses to questions on appropriate application of FASB literature that were expected to have widespread relevance. Implementation guides and Staff Positions were drafted by the staff and then issued, provided that a majority of the FASB Board members did not object.

Effective July 1, 2009, all codified GAAP was placed in a single level of the hierarchy (a second, lower level contains what formerly was defined as category E, consisting of scholarly writings, texts and guides by private-sector authors, guidance by other relevant bodies, etc.). The formerly important distinctions among categories A to D have completely evaporated.

American Institute of Certified Public Accountants (AICPA)

The Accounting Standards Executive Committee (AcSEC) has been the senior technical committee at the AICPA. It was authorized to set accounting standards and to speak for the AICPA on accounting matters. These were prepared largely through the work of various AICPA committees and task forces. AcSEC issued Statements of Position (SOPs) and industry audit and accounting guides (AAG), which were reviewed and cleared by the FASB and thus constituted category B GAAP under the former hierarchy. SOPs provided guidance on financial accounting and reporting issues. AAGs were intended to provide guidance to auditors in examining and reporting on financial statements of entities in specific industries and provided standards on accounting problems unique to a particular industry. AcSEC Practice Bulletins (formerly category C GAAP) usually provided guidance on very narrowly defined accounting issues. Effective November 2002, however, FASB reclaimed the sole authority to promulgate general-purpose GAAP, relegating AcSEC to the issuance of industry-specific accounting and auditing standards. Its role in the future has not yet been made clear.

Emerging Issues Task Force (EITF)

The Emerging Issues Task Force (EITF), formed by FASB in 1984 to assist in identifying current or emerging issues and implementation problems before divergent practices become entrenched, has most often restricted its attention to narrow issues. Task Force members have been drawn primarily from public accounting firms but also included individuals who would be aware of

[1] *Through July 1, 2009, the FASB issued 168 Statements on Financial Accounting Standards, 48 Interpretations, 51 Technical Bulletins as well as over 88 Staff Positions and over 30 implementation compilations. Most, but not all, of this literature remained in effect as of mid-2009. The preponderance of currently effective GAAP is the product of the FASB, and not of its predecessors, although a small number of such older standards remain in effect.*

issues and practices that should be considered by the group. Nonvoting representatives of the SEC and the FASB attend EITF for discussion purposes.

In terms of operations, an issues paper is prepared for each EITF agenda item; after discussion, if a consensus is reached, the consensus is referred to the FASB for ratification. Absent a consensus, the matter may end up on FASB's agenda or be resolved by the SEC, or may simply remain unresolved, with no standard-setting body currently considering it.

FASB has historically published a volume of EITF Abstracts, which are summaries of each Issue Paper and the results of Task Force discussion. Under the Accounting Standards Codification process, there will be no freestanding EITF consensuses (nor FASB Statements, etc.) but rather only amendments to or replacements of specific provisions in the Codification, issued as Accounting Standards Updates (ASU).

Effective status of consensuses. Although EITF pronouncements were technically category C GAAP, they were so specialized that generally there had been no salient category A or B GAAP on the respective topics, making the consensuses the highest-ranking guidance. The SEC was of the view that Task Force consensuses constituted GAAP for public companies, and it would question any accounting that differed from them. The SEC believed that the EITF supplied a public forum to discuss accounting concerns and assist in providing advice, and it had always been supportive of the Task Force's work.

Discussion topics. The EITF also previously published Discussion Issues, which were FASB and SEC staff announcements regarding technical matters that were deemed important but that did not relate specifically to a numbered EITF issue. These announcements were designed to help provide guidance on the application of relevant accounting pronouncements. These were increasingly infrequent over recent years, and it is anticipated that further discussion issues will not be produced.

Other Sources

Not all GAAP resulted from a deliberative process and the issuance of pronouncements by authoritative bodies. Historically, certain principles and practices evolved into acceptability without formal adoption of standards. Examples include straight-line and declining balance depreciation methods and last-in, first-out (LIFO) and first-in, first-out (FIFO) inventory costing methods. There are also many disclosure principles that evolved into general accounting practice after first being required by the SEC in submissions made to it—for example, reconciliations of the effective and statutory tax rates. Even much of the content of statements of financial position and income statements has evolved over the years in the absence of adopted standards. These other sources of GAAP remain relevant and will be found in the second (i.e., nonauthoritative) level of the new hierarchy.

ACCOUNTING STANDARDS CODIFICATION

Following a costly five-year effort, FASB in 2008 largely completed its project to codify GAAP. After a one-year test period, FASB determined that the codification would become effective July 1, 2009, superseding all existing GAAP literature.

The accounting standards Codification eliminated the multilevel hierarchy that previously existed in favor of a simple bifurcation between authoritative and nonauthoritative guidance. The Codification does not change GAAP, per se, but instead introduces a new, more readily accessible, user-friendly online research system. It reorganizes the multitude of GAAP pronouncements into about 90 accounting topics and displays all topics using a consistent structure. The Codification also includes relevant SEC guidance, which follows the same topical structure used in the Codification. This structure permits real-time updating as new standards are released and offers many other advantages, although users first will have to incur the substantial fixed cost of learning the new system.

HOW IS GAAP CREATED?

For many decades, GAAP has been created by the promulgation of standards and interpretations by the bodies granted statutory and professional authority to make such rules. Prior to the ASC, the FASB and AICPA both long adhered to rigorous "due process" when creating new guidance in category A and category B GAAP. The goal was to involve constituents who would be affected by the newly issued guidance, so that any new standards would result in information that would more meaningfully report economic activity without attempting to influence behavior in any particular direction. The FASB's due process procedures are described next. (The AICPA followed similar procedures but in the future it will have a reduced role.) Due process will remain as a guiding principle in the overall development of GAAP under the ASC structure.

Due Process prior to ASC. The FASB received requests for new standards from its diverse constituency, which includes reporting entities, auditors, industry groups, users, the EITF, and the SEC. Requests for action may have included suggestions for new topics as well as for reconsideration of existing pronouncements. For each major project added to its technical agenda, the FASB appointed an advisory task force of approximately 15 outside experts, taking care that various points of view were represented. The Task Force would meet with and advise the Board and staff on the definition and scope of the project and the nature and extent of any additional research that appeared to be needed. The FASB and its staff then debated the significant issues in the project and arrived at tentative conclusions, after studying existing literature and conducting or commissioning additional research, as needed. Task Force and Board meetings were open to public observation, and a public record was maintained. Many of these proceedings were also available by live or archived audio Webcast as well as via telephone.

If the accounting problem being considered by the Board was especially complex, the FASB began by publishing a discussion memorandum or another discussion document, generally setting forth the definition of the problem, the scope of the project, and the financial accounting and reporting issues; discussing research findings and relevant literature; and presenting alternative solutions to the issues under consideration and the arguments and implications relative to each. This was distributed to interested parties by request and was available on the FASB Web site, with a deadline for written comments specified and often with an invitation to present viewpoints at a public hearing.

Any individual or organization could request to speak at the public hearing, which was conducted by the FASB and the staff assigned to the project, with public observers welcome. After individual presentations, the FASB and staff asked questions that were based on written material submitted by the speakers prior to the hearing as well as on the speaker's oral comments. In addition, all written comments submitted were analyzed. The FASB members studied this analysis and read the comment letters to help them reach conclusions. The hearing transcript and written comments became part of the public record.

After the comment letters and oral presentations responding to the discussion document had been considered, formal deliberations began. (For less complex accounting issues, if no discussion document was prepared, the due process began at this point.) The FASB deliberated at meetings that are open to public observation, although observers could not participate in the discussions. Prior to each Board meeting, the staff presented a written analysis and recommendations of the issues to be discussed. During the meeting, the staff would present a summary of the written materials and the Board would discuss each issue. The Board would meet as many times as necessary to resolve the issues.

When the Board reached tentative conclusions on all the issues in the project, the staff prepared an Exposure Draft, which would set forth the Board's conclusions about the proposed standard (or interpretation) of financial accounting and reporting, the proposed effective date and method of transition, background information, and an explanation of the basis for the Board's conclusions. The Board would review and, if necessary, revise, the Exposure Draft. Then a vote would be taken about whether the Exposure Draft could be published for public comment. A majority of the Board members had to vote to approve an Exposure Draft for issuance for comment. If three votes were not obtained (after the Board was reduced to five members; when the Board consisted of seven members, four votes were required), the FASB would hold additional meetings and redraft the Exposure Draft until the necessary support could be obtained.

Any individual or organization could provide comments about the conclusions in the Exposure Draft during the exposure period, which was generally sixty days or more. The Board sometimes would decide to have a public hearing to hear constituents' views. At the conclusion of the comment period, all comment letters and oral presentations were analyzed by the staff, and the Board members read the letters and the staff analysis. At that point, the Board was ready to redeliberate the issues, with the goal of issuing final accounting standards.

If substantial modifications had been made, the Board would issue a revised Exposure Draft for additional public comment. If so, the Board also might have decided that another public hearing was warranted. When the Board was finally satisfied that all reasonable alternatives had been adequately considered, the staff would draft a final pronouncement for the Board's vote. Three votes were required for adoption of a pronouncement (now that the Board has been reduced to five members). Once issued, the standards become GAAP after the effective date stated in the pronouncement.

Due Process under ASC

The process to be followed under the new ASC structure largely follows that that previously existed. Public involvement and due process continue to be key elements in the standard-setting process; the major difference is that revisions, deletions, or additions to the ASC, rather than full-fledged freestanding pronouncements, will normally be the end product of the process.

For major projects, FASB has established the next procedures for developing accounting standards, some of which may be omitted for those projects that are focused on narrower application and implementation issues. Additional steps may be inserted during the course of any given project, even if not specifically required by FASB's Rules of Procedures.

First, FASB will receive from various sources requests or recommendations for possible projects and reconsideration of existing standards. The FASB chair will then decide whether to add a project to the technical agenda. This decision will be subject to oversight by the Financial Accounting Foundation's Board of Trustees, after appropriate consultation with FASB members and others.

Next, the Board will deliberate at one or more public meetings the various issues identified and analyzed by its staff. FASB will then issue an Exposure Draft. (Optionally, as may be deemed needed, a discussion paper may be issued to obtain input that is used to develop an Exposure Draft.)

Subsequently, FASB may hold a public roundtable meeting on the Exposure Draft, if that is seen as being useful or necessary. The staff will analyze comment letters, any public roundtable discussion, and any other information. FASB then will redeliberate the proposed provisions at public meetings.

Finally, the Board will issue an Accounting Standards Update (ASU) describing amendments to the Accounting Standards Codification (ASC). The ASU will delete, add, or revise specific paragraphs in the ASC, and a given ASU may alter a variety of existing topics and subtopics on an as-needed basis. Thus, a given ASU is not necessarily a coherent whole setting forth the entirety of a new standard, as was past practice, when FASB standards, interpretations, technical bulletins, or staff positions were promulgated.

HIERARCHY OF GAAP UNDER THE CODIFICATION

Hierarchy

On July 1, 2009, the FASB Accounting Standards Codification™ became the single official source of authoritative, nongovernmental U.S. generally accepted accounting principles (GAAP). It thus supersedes all extant FASB, AICPA, EITF, and related literature. After that date, only one level of authoritative GAAP exists, excluding the guidance issued by the Securities and Exchange Commission. All other literature will be nonauthoritative. In effect, therefore, the former five-level U.S. GAAP hierarchy has been compressed to two levels.

Only "As Amended" Guidance Included in ASC

The Codification includes all the former category A to D GAAP issued by accounting standard-setters, including pronouncements issued by the FASB, EITF, the Accounting Standards Executive Committee (AcSEC), the Accounting Principles Board, and so on, to the extent still binding on financial reporting practice. The materials used to create the Codification are the "as-amended" versions of those original accounting standards. Therefore, the Codification does **not** identify as sources any documents that solely amend other standards.

For example, FAS 149 was an amendment of FAS 133, so the content of FAS 149 is included through the as-amended version of FAS 133. Similarly, a great deal of literature (FASB Statements, Technical Bulletins, and Interpretations, as well as scores of EITF Issues, etc.) amended the venerable lease accounting standard, FAS 13, and those amending materials also are no longer referenced.

As with former practice, when certain standards and other guidance were issued with delayed effective dates, the Codification will include materials that may not yet be mandatorily effective. The content from new standards that are not yet fully effective for all reporting entities appears in the Codification as boxed text and is labeled as *pending content*. The pending content text box includes the earliest transition date and a link to the related transition guidance, also found in the Codification.

For reference purposes, the Codification permits backward tracing to the actual literature from which the Codification was derived. Of course, in the future, new pronouncements will add to or amend the Codification only, and no stand-alone FASB Statements or other guidance will be promulgated; thus, there will be no original source to be referenced as a stand-alone pronouncement.

For this reason, researching GAAP in official sources will now demand familiarity with, and access to, the Accounting Standards Codification™ issued by FASB. Understanding the structure of the Codification will thus be of great importance to all who have a need to understand GAAP and to research and apply GAAP to specific facts and circumstances.

SEC Guidance Included in ASC

Included in the Codification is relevant SEC guidance, which follows the same topical structure used throughout the Codification. This represents a departure from past practice, since SEC materials were not previously included in official GAAP guidance (although it obviously still had been binding on publicly held reporting entities and also was to be given some consideration as "category E" hierarchy literature even by nonissuers, since it represented the best thinking on a given topic). To increase the utility of the Codification for public companies, relevant portions of authoritative content issued by the SEC and selected SEC staff interpretations and administrative guidance have been included for reference in the Codification. The sources include Regulation S-X, Financial Reporting Releases (FRR)/Accounting Series Releases (ASR), Interpretive Releases (IR), and SEC staff guidance in Staff Accounting Bulletins (SAB), EITF Topic D, and SEC Staff Observer comments. The Codification does not, however, incorporate the entire population of SEC rules, regulations, interpretive releases, and staff guidance, such as content related to matters outside of the basic financial statements, including Management's Discussion and Analysis (MD&A), or to auditing or independence matters.

Using the ASC

The Codification content is arranged within *Topics, Subtopics, Sections,* and *Subsections*. All accountants should quickly develop a facility to navigate through this material. Use of obsolete references (e.g., in audit file memoranda) will imply a lack of technical competence and may pose litigation or other risks for both preparers and auditors.

Topics represent a collection of related guidance. The topics correlate closely to standards issued by the International Accounting Standards Board (IASB), consistent with the agreed-upon plan to converge U.S. GAAP and IFRS. (The widely discussed potential supersession of U.S. GAAP by IFRS would likely render the ASC useless.) Topics reside in four main areas as follows:

1. *Presentation.* Topics relating only to presentation matters; they do not address recognition, measurement, and derecognition matters. Examples of these topics are income statement, balance sheet, and earnings per share.
2. *Financial statement accounts.* The Codification organizes topics into a financial statement order, including assets, liabilities, equity, revenue, and expenses. Topics include, for example, receivables, revenue recognition, and inventory.
3. *Broad transactions.* These topics relate to multiple financial statement accounts and are generally transaction oriented. Topics include, for example, business combinations, derivatives, and nonmonetary transactions.
4. *Industries.* These topics relate to accounting that is unique to an industry or type of activity. Topics include, for example, airlines, software, and real estate.

Subtopics represent subsets of a topic and typically are identified by type or by scope. For example, operating leases and capital leases are two separate subtopics of the leases topic, distinguished by type of lease. Each topic contains an *overall subtopic* that generally represents the pervasive guidance for the topic, which includes guidance that applies to all other subtopics. Each additional subtopic represents incremental or unique guidance not contained in the overall subtopic.

Sections represent the nature of the content in a subtopic—for example, recognition, measurement, and disclosure. The sectional organization for all subtopics is the same. In a manner similar to that used for topics, sections correlate closely with sections of individual International Accounting Standards.

Sections are further broken down into *subsections, paragraphs,* and *subparagraphs*, depending on the specific content of each section.

Hybrid Classification Scheme Used in ASC

FASB has developed a hybrid classification system specifically for the Codification. The structure of the classifications system is: XXX-YY-ZZ-PP, where XXX = Topic, YY = Subtopic, ZZ = Section, PP = Paragraph. An "S" preceding the section number denotes SEC guidance.

New standards will be composed of two items: the standard (similar to existing standards with a *Basis for Conclusions*) and an appendix of *Codification Update* instructions. The title of the combined set of standard and instructions will be *Codification Update YYXX,* where YY is the last two digits of the year and XX is the sequential number for each update. For example, the combined numbers would be 09-01, 09-02, and so on. All authoritative GAAP issued by the FASB will be issued in this format, regardless of the form in which such guidance may have been issued previously (e.g., EITF Abstracts, FASB Staff Positions, FASB Statements, and FASB Interpretations).

The FASB will organize the content of new standards using the same Section headings as those used in the Codification. The Codification Update Instructions are similar to the Amendments sections of current FASB standards. They will display marked changes to the pertinent sections of the Codification. New standards will not be deemed authoritative in their own right; instead, the new standards will serve only to update the Codification and provide the historical basis for conclusions of a new standard.

IMPORTANT CONCEPT OF MATERIALITY IN APPLYING GAAP

Materiality as a concept has great significance in researching, understanding, and implementing GAAP. Each standard or other document that has been issued by the FASB concludes by stating that its provisions need not be applied to immaterial items. Disputes over financial statement presentations often turn on the materiality of items that were, or were not, recognized, measured, and presented in certain ways.

Materiality Defined

Materiality is defined by the FASB as the magnitude of an omission or misstatement in the financial statements that makes it probable that a reasonable person relying on those financial statements would have been influenced by the omitted information or made a different judgment if the correct information had been known. However, due to its inherent subjectivity, the definition does not provide definitive guidance in distinguishing material information from immaterial information. The individual accountant must exercise professional judgment in evaluating information and concluding on its materiality. Materiality as a criterion has both quantitative and qualitative aspects, and items should not be deemed *immaterial* unless all potentially applicable quantitative and qualitative aspects are given full consideration and found not relevant.

Quantitative Component to Materiality

Quantitatively, materiality has been defined in relatively few pronouncements, which is a testament to the great difficulty of setting precise measures for materiality. For example, in ASC 280-10, addressing segment disclosures, a material segment or customer is defined as representing 10% or more of the reporting entity's revenues (although, even given this rule, qualitative considerations may cause smaller segments to be deemed reportable). The SEC has in various of its pronouncements defined materiality as 1% of total assets for receivables from officers and stockholders, 5% of total assets for separate balance sheet disclosure of items, and 10% of total revenue for disclosure of oil and gas producing activities.

Although materiality judgments traditionally have been primarily based on quantitative assessments, the nature of a transaction or event can affect a determination of whether that transaction or event is material. For example, a transaction that, if recorded, changes a profit to a loss or changes compliance with ratios in a debt covenant to noncompliance would be material even if it involved an otherwise immaterial amount. Also, a transaction that might be judged immaterial if it occurred as part of routine operations may be material if its occurrence helps meet certain objectives. For example, a transaction that allows management to achieve a target or obtain a bonus that otherwise would not become due would be considered material, regardless of the actual amount involved.

Another factor in judging materiality is the degree of precision that may be attained when making an estimate. For example, accounts payable usually can be estimated more accurately than a possible loss from the incurrence of an asset retirement obligation. An error that would be material in estimating accounts payable might be acceptable in estimating the retirement obligation.

Certain events or transactions may be deemed material because of their nature, regardless of the dollar amounts involved, and thus require disclosure under any circumstances. Offers to buy or sell assets for more or less than book value, litigation proceedings against the company pursuant to price-fixing or antitrust allegations, and active negotiations regarding their settlement can have a material impact on the enterprise's future profitability and, thus, are all examples of items that would not be capable of being evaluated for materiality based solely on numerical calculations.

It is clear that materiality, as traditionally defined by the accounting and auditing establishment, may no longer align with the definition implicitly applied by financial statement users, including the SEC and other regulatory authorities. It has become clear that a more nuanced and complex definition of materiality may now be required. In general, a decision regarding the application of GAAP (e.g., the choice of a nonstandard costing or revenue recognition method for a particular transaction) should be viewed as being immaterial only if all conceivable effects, such as the impact on common financial statement ratios or trends, are expected to be truly immaterial. A strict application of a quantitative threshold—say, 5% of net income—should be avoided, and once a materiality level is established, it should be strictly maintained in the face of identified errors or warranted adjustments in amounts greater than what had been defined.

The SEC, in its Staff Accounting Bulletin 99 (SAB 99), provides a useful discussion of this issue. Although not strictly applicable to nonpublic preparers of financial statements, this guidance is worthy of consideration by all accountants and auditors. Among other things, SAB 99 notes that deliberate application of nonacceptable accounting methods cannot be justified merely because the impact on the financial statements is deemed to be immaterial. SAB 99 also usefully reminds preparers and others that materiality has both quantitative and qualitative dimensions, which must both be given full consideration. Staff Accounting Bulletin 108 (SAB 108) later added to the literature of materiality with its discussion of considerations applicable to prior period restatements.

Qualitative Component to Materiality

In addition to the more obvious quantitative aspect to materiality, there is an equally important, but more elusive, qualitative aspect to be considered. Examples of qualitative factors that could possibly cause a quantitatively immaterial misstatement or omission to be deemed material, as cited by SAB 99, are

- Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
- Whether the misstatement masks a change in earnings or other trends
- Whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- Whether the misstatement changes a loss into income or vice versa
- Whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- Whether the misstatement affects the registrant's compliance with regulatory requirements
- Whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- Whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- Whether the misstatement involves concealment of an unlawful transaction

THE SARBANES-OXLEY ACT OF 2002

One result of a spate of business failures and accounting scandals occurring in the late 1990s/early 2000s was the enactment of the Sarbanes-Oxley Act, which included among its provisions these five sweeping changes:

1. Establishment of the Public Company Accounting Oversight Board (PCAOB), to oversee the audits of public companies that are subject to the securities laws of the United States (referred to as "issuers") and to establish auditing, quality control, ethics, independence, and other standards relating to the auditing of the financial statements of issuers. Three of the five PCAOB members cannot be and must not have been certified public accountants.
2. Placing of severe limits on an audit firm's ability to provide nonaudit services to its issuer audit clients.
3. Establishment of a requirement that the chief executive officer (CEO) and the chief financial officer (CFO) of each issuer certify in each periodic report to the SEC

   a. The appropriateness of the financial statements and disclosures.
   b. That those financial statements and disclosures fairly present, in all material respects, the operational and financial condition of the issuer.

4. Requirement for the SEC to conduct a study of off-balance-sheet transactions and the use of special-purpose entities, and to report its recommendations to Congress.
5. Requirement for the U.S. Government Accountability Office (GAO) to conduct a study regarding the consolidation of public accounting firms since 1989, including the present and future impact of the consolidation, and the solutions to any problems it discovers.

Internal Control Assessments

Another important provision of the Sarbanes-Oxley Act, set forth in Section 404, increases corporate management's responsibility for assessing the effectiveness of internal control over financial reporting. Operational management, as well as financial management, must now be more cognizant of their joint responsibility for quality financial reporting. Management's methods for assessing internal control will, and should, vary from company to company.

Corporate management must assess the risk of material financial statement misstatement along two dimensions: (1) inherent risk—the susceptibility of one or more financial statement assertions to a material misstatement, and (2) fraud risk—the risk of material misstatement due to fraudulent financial reporting or theft of assets.

Sarbanes-Oxley and the Development of GAAP

The principal regulatory focus of the Sarbanes-Oxley Act is on auditors and corporate management, which is appropriate because major financial reporting debacles such as Enron and WorldCom were primarily the result of management fraud and audit failures rather than of inherently faulty accounting standards. However, several requirements of the Act have the possibility of affecting future GAAP and its standards setters.

The Act defined the required characteristics of an accounting standards-setting body. For the time being, standards will continue to be set by FASB. The SEC reaffirmed in 2003 that it will continue to acknowledge FASB's pronouncements as being generally accepted. However, FASB is expected to announce some changes to demonstrate that it "has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices" and "considers, in adopting accounting principles . . . the extent to which international convergence on high quality accounting standards is necessary or appropriate."

Debate over Principles- and Rules-Based Standards

Sarbanes-Oxley required that the SEC conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system. The study was to

> *include an examination of—(i) the extent to which principles-based accounting and financial reporting exists in the United States; (ii) the length of time required for change from a rules-based to a principles-based financial reporting system; (iii) the feasibility of and proposed methods by which a principles-based system may be implemented; and (iv) a thorough economic analysis of the implementation of a principles-based system.*

That study was conducted as mandated, and the report thereon was released in 2003. (It can be found on the Special Studies section of the SEC's Web site, at www.sec.gov/news/studies/principlesbasedstand.htm.) Briefly, it found that the oft-cited distinction between rules-based and principles-based standards was largely illusory, inasmuch as high-quality financial reporting standards must be (and have generally been) based on sound principles, but that a pure, principles-only set of standards, without practical guidance, would not serve the public interest.

Principles-based standards. Some have suggested that rules-based accounting standards contributed to the Enron, WorldCom, and other collapses. It is true that certain detailed rules found under U.S. GAAP (e.g., capital lease requirements such as the "90% test") have encouraged carefully constructed evasions (e.g., so-called 89% leases), which often provoke even more detailed rules, followed by yet more "engineered" transactions and reporting stratagems. Some observers suggested that the answer to the problems of "gaming the rules" and the ever-increasing complexity of resulting standards might have been found in embracing a principles-based, as opposed to a rules-based, approach to standards setting. To some (limited) extent, the standards published by the International Accounting Standards Board exhibited that characteristic, and some therefore argued that a movement toward principles-based standards might be facilitated by the convergence of U.S. GAAP and international standards.

The idea of a principles-based approach to U.S. standard setting is not new. FASB's conceptual framework, summarized later in this chapter, contains the body of principles that underlies U.S. accounting and reporting. The FASB has used the conceptual framework in developing its accounting standards for almost 30 years. However, FASB sometimes has bowed to pressure to provide exceptions to its principles in order to achieve other "desired" accounting results (e.g., to limit the volatility of reported earnings, as with current pension accounting requirements under FAS 87). Indeed, it is probably the existence of multiple exceptions to the promulgated standards, more than any failure to ground these in general principles, that opened the door to various reporting practices that, in certain circumstances, permitted the conduct of financial reporting frauds.

If a principles-based approach were implemented by FASB, accounting standards would continue to be developed from the conceptual framework (which is, as of early 2010, currently under revision), but the principles would apply more broadly than under existing standards. That is, there would be fewer exceptions to the principles in the standards. In addition, standard-setters would provide less interpretive and implementation guidance for applying the standards because the overall principle would ostensibly provide the necessary foundation for the answer with such guidance being considered superfluous. Exceptions would be extremely limited, or nonexistent, under a principles-based approach.

In addition, a principles-based approach requires accountants to more diligently exercise good professional judgment and to resist the urge to seek specific answers and rulings on every implementation issue. It also would require that the SEC and users of financial information accept the consequences of applying professional judgment, which means there would undoubtedly be some divergence in practice, possibly resulting in some loss of comparability of the financial statements of reporting enterprises.

As of early 2010, it appears that the debate over rules- or principles-based standards may be implicitly resolved by either the full convergence of U.S. GAAP with International Financial Reporting Standards (IFRS) or, in what was formerly thought to be unlikely but which is now deemed to be a very real possibility, having IFRS supersede U.S. GAAP. The fact that well over 100 other nations have opted to endorse IFRS (at least for publicly held companies' financial reporting), with as many as another 50 now taking steps to have IFRS supersede their respective national GAAP regimes, coupled with the possible granting of permission for IFRS-based reporting by U.S. companies registered with the SEC, makes this further development increasingly probable, in the authors' view.

Standards Overload

The recent criticisms of rules-based standards join earlier criticisms about the complexity of accounting standards. Some accountants complain about "standards overload," saying that there are too many accounting standards, which are individually too complex to be understood and implemented, and that too many organizations (SEC, FASB, EITF, AICPA, etc.) have historically been empowered to issue these pronouncements. Complaints regarding standards overload are not new, and with about 168 FASB Statements (some no longer effective) and myriad other standards (including hundreds of EITF Issues), these complaints must be given credence. (The process of Codification has eliminated the original standards and other authoritative literature but has not reduced the amount of guidance contained therein.) However, the solution, if there is one, is not obvious. Nor is it clear that financial reporting frauds, audit failures, or other such phenomena have been the result of this overload. Overwhelmingly, frauds result from the deliberate misapplication of GAAP and not from an inability on the part of preparers and auditors to comprehend the requirements of the standards.

Some have said that a solution would be to reduce and simplify GAAP, especially for entities having characteristics suggesting that the risk of misleading the users of the financial statements might be low. For example, some recommend a size test, with smaller entities following a subset of the standards that are mandated for larger entities (a system now used in the United Kingdom and soon being proposed by IASB as well). Even this simple suggestion has complications, however; size could arguably be determined by the amount of assets, revenues, or net worth, or the number of owners. Others recommend that public entities, regardless of size, follow a more comprehensive set of standards than privately owned businesses. The recently promulgated IFRS for Small and Medium-Sized Entities (IFRS for SMEs), which currently can be utilized by U.S.-based reporting entities that do not have public ownership or accountability, is the most prominent example of such a solution to this perceived problem.

Those who disagree say that differing standards would reduce the quality of financial reporting. For example, if decisions about which entities should follow which standards were made using a single criterion for all standards (such as size or ownership), some entities that engage heavily in a certain type of transaction (e.g., derivative financial instruments) might not be subject to the standards for that transaction—even though the recognition, measurement, and disclosure of those transactions were critical to understanding the financial condition and results of operations of the entity. To solve that problem, criteria would need to be based in some way on the underlying subject matter of the standard, which would result in an accountant having to examine each standard to determine if it would apply to a particular entity. That could compound the standards overload problem rather than solve it.

To respond to the demand for simpler standards for smaller or nonpublic reporting entities, FASB has endeavored over recent decades to offer somewhat differentiated standards for disclosures. ASC 825-10-50 exempts nonpublic companies from certain financial instrument disclosures if the entity's total assets are less than $100 million and the entity has not held or issued any derivative financial instruments. Nonpublic companies also are not required to disclose earnings per share (ASC 260-10), segment information (ASC 220-10), or certain pension and postretirement information (ASC 715-20). These exemptions have not, however, been widely hailed as representing significant progress against the perceived problem of standards overload.

To obtain better insight into these issues, in early 2004, the AICPA formed a Private Company Financial Reporting Task Force and charged it with conducting empirical research on the needs of preparers and users of private company financial statements and how well GAAP was meeting those needs, and developing recommendations based upon the results of the study. The findings were mixed, at best, showing a lack of clear consensus on this issue. Further efforts will doubtless be made in the near term to research and perhaps resolve what has been a many-decades-long debate.

Other FASB Initiatives to Reduce Complexity

In addition to the codification project, FASB has attempted to reduce the complexity of accounting standards by reducing the number of standard-setting bodies that issue authoritative accounting pronouncements. FASB changed the process of the EITF to give FASB more direct involvement with its agenda, deliberations, and conclusions. Two FASB board members were added to the EITF Agenda Committee, and FASB was required to ratify each EITF consensus at a public board meeting before the consensus officially becomes GAAP. Also, FASB and the AICPA agreed that AcSEC would cease issuing Statements of Position that create broadly applicable GAAP, instead limiting its work to specialized industry accounting standards. FASB announced its intention to collaborate with representatives from the EITF, AICPA, and SEC to develop a model for deciding if additional authoritative standards are necessary on a given topic and then how to most effectively segregate duties among those bodies with respect to issuing those standards.

FASB also expressed its intent to more thoroughly assess the cost-benefit relationships of proposed standards. Presumably, complex standards are more costly to implement, and thus the costs are more likely to outweigh the expected benefits to users. If so, enactment would be less probable. To understand the costs of a proposed standard, FASB intends to actively engage its constituents in a discussion of the costs as a formal step in the Board's due process. To understand more fully the benefits of a proposed standard, FASB has created a User Advisory Council, a group of 40 professionals representing a variety of investment and analytical disciplines, which will be consulted on specific projects as well as helping the Board formulate its overall agenda. FASB also established a Small Business Advisory Committee (SBAC) in order to obtain additional needed input from its small business constituents.

In 2005, the FASB and AICPA separately issued Exposure Drafts proposing to move the nongovernmental GAAP Hierarchy, discussed earlier in this chapter, from the auditing literature to the accounting literature. In connection with this change, the Exposure Drafts also designated FASB Staff Positions (FSP) and Derivatives Implementation Group Issues (DIG) as "category A" GAAP. This resulted in FAS 162, issued in May 2008. FAS 162 was only transitional in nature and is not included in the Codification, which streamlined the hierarchy to only two categories or levels: guidance within the Codification and all other guidance.

Although these FASB initiatives are viewed by many as a step in the right direction, it remains to be seen whether they successfully answer criticisms of standards overload. The financial environment is increasingly complex and litigious, which makes a lessening of the burden of GAAP unlikely in the near term.

AICPA and Its Diminished Influence

In the aftermath of the various financial reporting scandals previously discussed, many in the business and accounting communities criticized the AICPA for not proactively and forthrightly acknowledging systematic shortcomings in both the financial reporting and auditing realms and for not taking a visible leadership role in developing proposed solutions regarding their remediation. This perception that the AICPA was sitting on the sidelines as these scandals unfolded undoubtedly contributed to the creation, by the Sarbanes-Oxley Act, of the Public Company Accounting Oversight Board and its charge to oversee the auditing profession with respect to the audits of issuers (i.e., public companies). The PCAOB assumed the AICPA's previous responsibilities for ethics, independence, quality control, continuing professional education, peer review, and auditing standards as they relate to auditors of public company issuers.

Under these circumstances, the AICPA was (and still is) in danger of being rendered irrelevant as a standard setter and, no less, as a standard bearer for the profession. Its Auditing Standards Board (ASB) has continued to issue pronouncements that are binding on auditors of nonissuers (i.e., nonpublic companies) while the PCAOB has diverged from the AICPA's auditing standards by issuing its own standards. This action has fueled the debate regarding the advisability of "big GAAS, little GAAS." To the detriment of the auditing profession, the ultimate resolution of this conflict might be left to the judiciary if, as is quite conceivable, a nonissuer audit failure is alleged to have occurred that the plaintiff alleges might have been prevented had the auditor followed the PCAOB Standards instead of the Auditing Standards Board Standards.

Alleged Harmful Effects Caused by Financial Reporting Standards

In general, reporting entities have not welcomed proposals for new standards, since these inevitably involve change, costs of implementation, and, perhaps, a period of confusion while the marketplace assimilates the new information. In addition, the business community often claims that FASB does not understand the economic impact of new standards on their businesses. It complains that the implementation of certain accounting standards will harm businesses' ability to compete in the global marketplace and will impede their ability to raise debt or equity capital on favorable terms.

Two early examples of such resistance accompanied the issuance of FAS 43 (compensated absences) and FAS 106 (postretirement benefits). In both cases, the business community said that the new standard would cause it to reduce benefits to employees—and in some cases it did just that. The counterargument was perhaps more impressive, however: As a consequence of formerly failing to fully account for the actual economics of promises made or benefits granted, companies were misled regarding their true financial condition, which, once exposed, resulted in changes in behavior that were arguably long overdue. Managers were harmed by their former ignorance and by the delay; they were not hurt by the truth. (Proposed changes to accounting for pensions and other postemployment benefits, discussed in Chapter 16, will inevitably also trigger much anguish and again, quite possibly, reductions in promised benefits).

In two recent cases, dissatisfaction with proposed standards escalated to the point where the business community asked the federal government to intervene. When, in the mid-1990s, FASB proposed that the value of stock options granted to employees be reflected as an expense in the financial statements, the business community, and particularly technology firms, loudly claimed that the proposed recognition would have a dramatic and negative economic effect. First, the argument went, it would force them to discontinue issuing stock options, which would prevent the companies from compensating valuable employees, leading to increased turnover, loss of key talent, and dire macrolevel economic consequences. Second, to the extent options were granted and reflected in expense, it would cause the firms' costs of capital to increase significantly because of lower levels of reported profitability. Finally, it arguably would put U.S. firms at a competitive disadvantage to foreign companies that did not have to expense the value of stock options (or were not offering this benefit to employees), although IFRS does demand accounting for the economic cost of stock-based compensation in a manner quite similar to that under current U.S. GAAP (based on FAS 123[R]).

Before that battle ended, "sense of the House" and "sense of the Senate" resolutions had been introduced, objecting to FASB's tentative conclusions, and a bill had been introduced that would have, if enacted, precluded the recognition of the value of stock options as an expense as a matter of law. This debate threatened not only the stock-based compensation standard but also the future of accounting standard setting in the private sector itself. That concern contributed to FASB's decision to issue FAS 123 with only a requirement for disclosure of the value of stock options, with recognition and measurement optionally continuing under prior (APB 25) rules. Not surprisingly, virtually all publicly held companies continued to utilize the "implicit value" approach of APB 25, even though FAS 123 clearly stated that the "fair value" approach was preferable GAAP.

Another such situation arose later, when FASB was pursuing its derivative financial instruments project, when the business community again approached the Congress with a request for it to intercede in the debate. Although the federal government was not as quick to intervene in this instance, FASB was again criticized by several members of Congress and by their staff. To have been thus criticized and, in part, thwarted by influential government officials twice in a span of five years might have proved to be detrimental as the Congress considered legislation in response to the collapse of Enron Corp. However, standard setting in the private sector, and the supremacy of FASB in the standard-setting role, appear to have survived those challenges, at least for the immediate future. It remains to be seen how, if at all, convergence with—or possible supersession by—IFRS might be responded to by those who wish to see a more prominent role by government in the financial reporting standard-setting sphere.

The most recent example of claims being made that financial reporting requirements were causing harm to specific reporting entities, entire industry segments, or the domestic and international economies as a whole arose during the recent (and continuing) financial crisis affecting many nations. Arguably, this has been a natural bubble-bursting process that has its roots in the vast expansion of credit granting, particularly for domestic residences, and the rapidly escalating asset prices that resulted therefrom. The diminished valuations of financial instruments precipitated by the subprime mortgage crisis, followed by declining home prices, followed by economic contraction overall, coupled with the widespread required use of fair value ("mark to market") for such instruments, led to a demand that the *accounting rules* be relaxed or permanently changed, in order to ameliorate the *economic* and *financial* effects that were seen as being a consequence of financial reporting requirements. (For example, financial firms reported about $175 billion of value write-downs in 2008, in the aggregate, with further losses taken in 2009.)

In this instance (as with the reaction against fair value accounting for stock-based compensation proposals in the mid-1990s), powerful business and political interest lined up to pressure the accounting standardsetters, arguing that perceived or potential bad consequences should serve to derail rational financial reporting objectives. The large declines in fair (i.e., market) values of financial instruments held by banks, dutifully reported in accordance with GAAP, were said to somehow *not* be representative of actual fair values (due to reportedly unprecedented illiquidity and other market anomalies) and thus in need of modification, thereby understating actual losses and overstating bank and thrift capital.

FASB responded, under duress, by issuing some clarification (which should have been unnecessary, since GAAP—found at ASC 820-10—already provides guidance for valuing instruments when nominal market quotes are unreliable) and addresses circumstances when markets may be inactive and/or when market prices reflect only distressed sales. The effects on reported earnings and capital of banks and thrifts have been significant, according to reports that were circulated beginning in early 2009. Concerns about the impact of, and the virtue of using, fair values have continued to be raised, although, in the authors' opinion, the trend toward the incorporation of fair values into GAAP-basis financial reporting is unstoppable, and warranted.

RESEARCHING GAAP PROBLEMS

The research procedures presented here are intended to serve as a general model for approaching research on accounting issues or questions you may have. These procedures are only intended as an illustration of the process, not as a "cookbook" approach. These procedures should be refined and adapted to each individual fact situation.

Research Procedures

Step 1: Identify the problem. It has been observed that the mere act of defining a problem contributes mightily to solving the problem. This certainly applies to the domain of researching financial reporting issues. Most often it is found that incorrect answers (e.g., regarding the proper way to report revenue-producing activities) flow from improper definition of the actual question to be resolved. Provisional definitions of problems should be vigorously challenged *before* attempting to search for solutions. The process to be employed is to

- Gain an understanding of the problem or question.
- Challenge the tentative definition of the problem and revise, as necessary.
- Problems and research questions can arise from new authoritative pronouncements, changes in a firm's economic operating environment, or new transactions, as well as from the realization that the problem had not been properly defined in the past.
- It is important to remember that research can be performed before or after the critical event has occurred. However, if proposed transactions and potential economic circumstances are anticipated, more deliberate attention can be directed at finding the correct solution, and certain proposed transactions having deleterious reporting consequences might be avoided altogether or structured more favorably.
- If little is known about the subject area, it may be useful to consult general reference sources (e.g., *Journal of Accountancy, CPA Journal, BusinessWeek*) to become more familiar with the topic and build up some economic horse sense in the area (i.e., the basic what, why, how, when, who, where). Web-based research vastly expands the ability to gather useful information.
- If you are a preparer/auditor, ensure that you have sufficiently determined whether the issue you are researching is a GAAP issue or an auditing issue so that your search is directed to the appropriate literature.
- With the ongoing process of convergence with IFRS (and possible IFRS adoption) a reality, it will be wise to consider not merely short-term implications under U.S. GAAP but longer-term potential ramifications if changes are made to existing GAAP.

Step 2: Analyze the problem

- Identify critical factors, issues, and questions that relate to the research problem.
- What are the options? Brainstorm possible alternative accounting treatments. Note that alternatives continue to narrow both under U.S. GAAP and also due to ongoing efforts to converge to IFRS.
- What are the goals of the transaction? Are these goals compatible with full and transparent disclosure and recognition? Evolving GAAP and IFRS will both place greater emphasis on "transparency" in financial reporting.
- What is the economic substance of the transaction, irrespective of the manner in which it appears to be structured?
- What limitations or factors can impact the accounting treatment?

Step 3: Refine the problem statement

- Clearly articulate the critical issues in a way that will facilitate research and analysis.

Step 4: Identify plausible alternatives

- Plausible alternative solutions are based upon prior knowledge or theory.
- Additional alternatives may be identified as steps 5 to 7 are completed.
- The purpose of identifying and discussing different alternatives is to be able to respond to key accounting issues that arise out of a specific situation.
- The alternatives are the potential methods of accounting for the situation from which only one will ultimately be chosen.
- Exploring alternatives is important because many times there is no single cut-and-dried financial reporting solution to the situation.

- Ambiguity often surrounds many transactions and related accounting issues. Accordingly, the accountant and business advisor must explore the alternatives and use professional judgment in deciding on the proper course of action.
- Remember that other accountants may reasonably disagree with the judgment used or conclusions made, but this does not necessarily mean they are right.

Step 5: Develop a research strategy

- Determine which authorities or literature needs to be searched. Often it will be necessary to search all authoritative literature, which is now combined in the Accounting Standards Codification™ promulgated by FASB. The topic-based organization of this material should facilitate conducting such research, allowing the user to zero in on a detailed-level issue by beginning with a broad topic definition.
- Generate keywords or phrases that will form the basis of an electronic search.
- Consider trying a broad search to
  - Assist in developing an understanding of the area.
  - Identify appropriate search terms.
  - Identify related issues and terminology.
- Consider trying very precise searches to identify if there is authoritative literature directly on point.

Step 6: Search authoritative literature. This step involves implementation of the research strategy through searching, identifying, and locating applicable information.

- Research published GAAP, now codified in the ASC.
- Research using *Wiley GAAP*.
- Research other literature.
- Research practice.
- Use theory.
- Find analogous events and/or concepts that are reasonably similar.

Step 7: Evaluation

- Analyze and evaluate all of the information obtained.
- This evaluation should lead to the development of a solution or recommendation. Again it is important to remember that steps 3 to 7 describe activities that will interact with each other and lead to a more refined process in total, and a more complete solution. These steps may involve several iterations.

Researching Nonpromulgated GAAP

Researching nonpromulgated GAAP consists of reviewing pronouncements in areas similar to those being researched, reading accounting literature mentioned in the GAAP hierarchy as "other sources," and careful reading of the relevant portions of the FASB Conceptual Framework summarized later in this chapter. Understanding concepts and intentions espoused by accounting experts can give the essential clues to a logical formulation of alternatives and conclusions regarding problems that have not yet been addressed by the standard-setting bodies.

Both the AICPA and FASB publish a myriad of nonauthoritative literature. FASB publishes the documents it uses in its due process: Discussion Memorandums, Invitations to Comment, Exposure Drafts, and Preliminary Views as well as minutes from its meetings. It also publishes research reports, newsletters, and implementation guidance. The AICPA publishes its Exposure Drafts, as well as Technical Practice Aids, Issues Papers, comment letters on proposals of other standard-setting bodies, and the monthly periodical, *Journal of Accountancy.* Technical Practice Aids are answers published by the AICPA Technical Information Service to questions about accounting and auditing standards. AICPA Issues Papers are research documents about accounting and reporting problems that the AICPA believes should be resolved by FASB. They provide information about alternative accounting treatments used in practice. These two AICPA publications, which are not approved by FASB, have no authoritative status, but those who depart from their guidance should be prepared to justify that departure based on the facts and circumstances of the particular situation. Listings of FASB and AICPA publications are available at their Web sites. (A list of Web site addresses is located at the end of this chapter.)

The Securities and Exchange Commission issues Staff Accounting Bulletins and makes rulings on individual cases that come before it, which create and impose accounting standards on those whose financial statements are to be submitted to the Commission. The SEC, through acts passed by Congress, has been given broad powers to prescribe accounting practices and methods for all statements filed with it.

The International Accounting Standards Board publishes its standards, interpretations, the *Framework for the Preparation and Presentation of Financial Statements*, and project archives. Summaries of the standards and interpretations and the project archives are available at the Board's Web site, along with instructions for purchasing the complete standards, interpretations, and other materials.

The American Accounting Association (AAA) is an organization consisting primarily of accounting educators. It is devoted to encouraging research into accounting theory and practice. The issuances of the AAA tend to be normative, that is, prescribing what GAAP ought to be like, rather than explaining current standards. However, the monographs, committee reports, and *The Accounting Review* published by the AAA may be useful sources for research into applicable accounting standards.

Governmental agencies, such as the Government Accountability Office, the Federal Accounting Standards Advisory Board, and the Cost Accounting Standards Board, have certain publications that may assist in researching written standards. Also, industry organizations and associations may be other helpful sources.

Certain publications are helpful in identifying practices used by entities that may not be promulgated as standards. The AICPA publishes an annual survey of the accounting and disclosure policies of many public companies in *Accounting Trends and Techniques* and maintains a library of financial statements that can be accessed through a computerized search process (NAARS). EDGAR (Electronic Data Gathering, Analysis, and Retrieval) publishes the SEC filings of public companies, which includes the companies' financial statements. Through selection of keywords and/or topics, these services can provide information on how other entities resolved similar problems.

Internet-Based Research Sources

There has been and continues to be an information revolution affecting the exponential growth in the volume of materials, authoritative and nonauthoritative, that are available on the Internet. A listing of just a small cross-section of these sources is presented next.

Accounting Web Sites

AICPA Online	www.aicpa.org	Includes accounting news section; CPE information; section on professional ethics; information on relevant congressional/ executive actions; online publications, such as the *Journal of Accountancy*; Accounting Standards Executive Committee; also has links to other organizations; includes links to authoritative standards for nonissuers including auditing standards, attestation standards, and quality control standards.
American Accounting Association	www.aaahq.org	Accounting news; publications; faculty information; searchable; links to other sites.
FASB	www.fasb.org	Information on FASB; includes list of new Pronouncements/Statements; summaries of selected projects; summaries/status of all FASB Statements. Due to funding provided by PCAOB, FASB now posts its Statements, Interpretations, Staff Positions, and newly issued EITF Issues on its Web site.

FASB Codification	asc.fasb.org/home	Searchable database using the new accounting codification; includes cross-referencing and tutorials
GASB	www.gasb.org	Information on GASB; new GASB documents; summaries/status of all GASB statements; proposed Statements; Technical Bulletins; Interpretations
IASB	www.iasb.org.uk	Information on the IASB; lists of Pronouncements, Exposure Drafts, project summaries, and conceptual framework
NASBA	www.nasba.org	National State Boards of Accountancy (NASBA); includes listings of registered CPE sponsors and links to state boards of accountancy, as well as standards governing continuing professional education that it jointly issues with the AICPA
PCAOB	www.pcaobus.org	Sections on rulemaking, standards (including the interim auditing, attestation, quality control, ethics, and independence standards), enforcement, inspections and oversight activities
Rutgers Accounting Web	www.accounting.rutgers.edu	Includes links to journals and publications, software, publishers, educational institutions, government agencies, and information regarding continuous auditing initiatives
SEC	www.sec.gov	SEC digest and statements; EDGAR searchable database; information on current SEC rulemaking; links to other sites
WebCPA	www.webcpa.com	Breaking news regarding the profession, links to regulators, taxing agencies, associations, and agencies

Example of How to Solve a GAAP Problem

As an example of how to solve a GAAP problem, let us examine how the FASB and its staff approached a question raised by the Edison Electric Institute (EEI) in the project that eventually led to FAS 143, *Asset Retirement Obligations* (now ASC 410-20).

The EEI requested that the FASB add a project to its agenda to determine the appropriate accounting for removal costs, such as the costs of nuclear decommissioning and similar costs affecting other industries. At the time this was raised, the existing accounting practices for removal costs were inconsistent as to the criteria used for recognition, measurement, and the presentation of the obligation in the financial statements. Some entities did not recognize any obligations for removal costs until actually incurred. Other entities estimated the cost of retiring the asset and accrued a portion of that amount each period as an expense, with an offsetting liability, so that when the asset was retired, a liability for the full amount of the removal costs would already be on the ledger. Still others recognized the expense but displayed the credit side of the entry as a contra asset rather than a liability.

FASB looked for an analogous situation and found one in FAS 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* (ASC 932-235-10). Paragraph 37 of that standard states that "estimated dismantlement, restoration, and abandonment cost shall be taken into account in determining amortization and depreciation rates." The effect of that paragraph was that the credit side of the entry was to accumulated depreciation, which could result in an accumulated depreciation amount that exceeded the cost of the asset. There was no recognition of an obligation to dismantle and restore the property (a liability). Instead the focus was on achieving a particular pattern of expense recognition. Because the amount of the obligation that the entity had incurred was not a central concern under ASC 932, the FASB (which embraced a balance sheet orientation in its conceptual framework, which was issued after ASC 932 was promulgated) rejected it and sought another solution.

FASB next considered the definition of a liability in paragraphs 36-40 of Statement of Financial Accounting Concepts (CON) 6 to determine whether nuclear decommissioning and similar asset retirements could be considered liabilities of the entities owning the assets. Since the first characteristic of a liability—that an entity has "a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand"—would be met when an entity is required by current laws, regulations, or contracts to settle an asset retirement obligation upon retirement of the asset, FASB concluded that accounting for this liability would be the central goal of the new standard.

In some situations, the duty or responsibility to remove the asset is created by an entity's own promise. In other situations, the duty or responsibility is created by circumstances in which an entity finds itself bound to perform, and others are justified in relying on the entity to perform. Thus, in its initial deliberations, the FASB decided that entities should report both legal and constructive obligations in their financial statements. Paragraph 36 of CON 6, which defines the essential characteristics of a liability, recognizes both types of obligations. It states:

> *[A]lthough most liabilities rest generally on a foundation of legal rights and duties, existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if for other reasons the entity has the duty or responsibility to pay cash, to transfer other assets, or to provide services to another entity.*

Paragraph 40 of CON 6 provides further insight. It states:

> *Liabilities stemming from equitable or constructive obligations are commonly paid in the same way as legally binding contracts, but they lack the legal sanction that characterizes most liabilities and may be binding primarily because of social or moral sanctions or custom. An equitable obligation stems from ethical or moral constraints rather than from rules of common or statute law.*

During its due process, FASB heard from constituents that without improved guidance for determining whether a constructive obligation exists, inconsistent application of the final standard would result. After further consideration of the qualitative characteristics of reliability and comparability found in CON 2, and the recognition characteristic of reliability in CON 5, the FASB decided to confine recognition only to legal obligations, including legal obligations created under the doctrine of promissory estoppel.

FASB also considered the second characteristic of a liability, that "the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice." It concluded that an asset retirement obligation had that characteristic.

FASB considered the third and final characteristic of a liability, namely that "the transaction or other event obligating the entity has already happened." It concluded that an entity must look to the nature of the duty or responsibility to assess whether the obligating event has occurred. FASB provides the example of a nuclear power facility: Although the operator assumes responsibility for decontamination upon receipt of a license, it is not until the facility is operated and contamination occurs that there is an obligating event.

When contemplating the manner in which the asset retirement obligation could be measured, FASB was guided by CON 7. In that concepts statement, FASB concluded that "the only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value." Based on this, FASB determined that an asset retirement obligation should be measured at fair value, but in the (typical) absence of quoted market prices or prices for similar liabilities, entities should use present value techniques to measure the liability.

In deciding on the appropriate designation of the debit offsetting the entry recording the obligation, FASB first made reference to the definition of an asset under CON 6. FASB concluded that capitalized asset retirement costs would not qualify for presentation as a separate asset because no separate future economic benefit flows from these costs. Thus, asset retirement costs do not meet the definition of an asset in paragraph 25 of CON 6. However, FASB observed that current accounting practice includes in the historical cost basis of an asset all the costs that are necessary to prepare the asset for its intended use. FASB concluded that the requirement for capitalization of the asset retirement cost as part of the historical cost of the asset and then depreciating that asset both (1) obtains a measure of cost that more closely reflects the entity's total investment in the asset, and (2) permits the allocation of that cost to expense in the periods over which the related asset would be expected to provide benefits.

Thus, in this actual situation, by reasoning from analogous situations and applying established accounting concepts, FASB was able to develop an important new standard. In a like manner, solutions to GAAP practice problems can be reached. Those solutions will serve the reporting entity in achieving GAAP-compliant financial reporting until a standards-setting body resolves the problem by issuing authoritative guidance.

FASB CONCEPTUAL FRAMEWORK

FASB has issued seven pronouncements (six of which remain extant) called Statements of Financial Accounting Concepts (CON) in a series designed to constitute a foundation of financial accounting standards. This conceptual framework is designed to prescribe the nature, function, and limits of financial accounting and to be used as a guideline that will lead to consistent standards. These conceptual statements do not establish accounting standards or disclosure practices for particular items. They are not enforceable under the AICPA Code of Professional Conduct.

FASB's conceptual framework is intended to serve as the foundation upon which the Board can construct standards that are both sound and internally consistent. The fact that the framework was intended to guide FASB in establishing standards is embodied in the preface to each of the Concepts Statements. The preface to CON 6 states:

> *The Board itself is likely to be the most direct beneficiary of the guidance provided by the Statements in this series. They will guide the Board in developing accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives.*

The conceptual framework is also intended for use by the business community to help understand and apply standards and to assist in their development. This goal is also mentioned in the preface to each of the Concepts Statements, as this excerpt from CON 6 shows:

> *However, knowledge of the objectives and concepts the Board will use in developing standards also should enable those who are affected by or interested in financial accounting standards to understand better the purposes, content, and characteristics of information provided by financial accounting and reporting. That knowledge is expected to enhance the usefulness of, and confidence in, financial accounting and reporting. The concepts also may provide some guidance in analyzing new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.*

The FASB Special Report, *The Framework of Financial Accounting Concepts and Standards* (1998), states that the conceptual framework should help solve complex financial accounting or reporting problems by

- *Providing a set of common premises as a basis for discussion;*
- *Providing precise terminology;*
- *Helping to ask the right questions;*
- *Limiting areas of judgment and discretion and excluding from consideration potential solutions that are in conflict with it; and*
- *Imposing intellectual discipline on what traditionally has been a subjective and ad hoc reasoning process.*

Of the seven Concepts Statements, the fourth, *Objectives of Financial Reporting by Nonbusiness Organizations*, is not covered here due to its specialized nature.

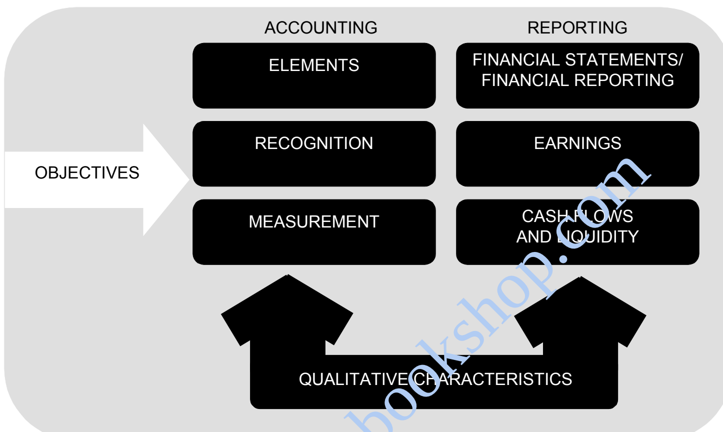
Components of the conceptual framework. The components of the conceptual framework for financial accounting and reporting include objectives, qualitative characteristics, elements, recognition, measurement, financial statements, earnings, funds flow, and liquidity. The relationship between these components is illustrated in the following diagram reproduced from a FASB Invitation to Comment, *Financial Statements and Other Means of Financial Reporting.*

In the diagram, components to the left are more basic and those to the right depend on components to their left. Components are closely related to those above or below them.

The most basic component of the conceptual framework is the objectives. The objectives underlie the other phases and are derived from the needs of those for whom financial information is intended. The qualitative characteristics are the criteria to be used in choosing and evaluating accounting and reporting policies.

Elements of financial statements are the components from which financial statements are created. They include assets, liabilities, equity, investments by owners, distributions to owners, comprehensive income, revenues, expenses, gains, and losses. In order to be included in financial statements, an element must meet criteria for recognition and possess a characteristic that can be reliably measured.

Conceptual Framework for Financial Accounting and Reporting



Reporting or display considerations is concerned with what information should be provided, who should provide it, and where it should be displayed. How the financial statements (financial position, earnings, and cash flow) are presented is the focal point of this part of the conceptual framework project.

A CON does not establish GAAP. Since GAAP may be inconsistent with the principles set forth in the conceptual framework, the FASB expects to reexamine existing accounting standards. Until that time, a CON does not require a change in existing GAAP. CON do not amend, modify, or interpret existing GAAP, nor do they justify departing from GAAP based upon interpretations derived from them.

Complete coverage of the FASB Concepts Statements is offered in *Wiley GAAP 2010.*

CONDUCTING RESEARCH THROUGH THE FASB CODIFICATION WEB SITE

As noted previously in this chapter, the FASB has completed its project to codify GAAP, thereby eliminating the multilevel hierarchy in favor of a single, centralized database of authorized documentation. The FASB has compiled this Codification into a Web site, which is located at http://asc.fasb.org/home. The site is intended to be easily searchable for research purposes. This section provides an overview of the site's contents and search functionality.

On all pages of the site, all categories of the Codification are listed down the vertical menu bar on the left side of the page, revealing these primary topics, and the numbering series for each one:

- *Presentation (200).* Covers the reporting aspects of GAAP, such as the balance sheet, income statement, and segment reporting.
- *Assets (300).* Contains GAAP for all types of assets, such as receivables, investments, and intangibles.
- *Liabilities (400).* Contains GAAP for all types of liabilities, such as commitments, contingencies, and guarantees.
- *Equity (500).* Covers GAAP for such topics as stock, stock dividends, and treasury stock.

- *Revenue (600).* Includes all revenue topics, including product revenue, services revenue, and a great deal of industry-specific topics.
- *Expenses (700).* Clusters all types of expense-related GAAP into five broad categories, which are cost of goods sold, research and development, compensation, income taxes, and other expenses.
- *Broad Transactions (800).* Contains the major transactional topics, such as business combinations, derivatives, and foreign currency matters.
- *Industry (900).* Itemizes GAAP for specific industries, such as entertainment, real estate, and software.
- *Master Glossary.* Includes a compilation of terminology assembled from the multitude of original GAAP source documents.

The numbering series indicated next to each bullet point shows the three-digit number assigned to each topic. For example, the Presentation topic contains a number of subtopics, all indexed with numbers in the 200 range; the Balance Sheet subtopic is numbered 210, while the Interim Reporting subtopic is numbered 270. These index numbers become more apparent while perusing the submenus attached to each primary topic. For example, the submenu for the Presentation topic reveals 14 subcategories, numbered from 205 (for Presentation of Financial Statements) to 280 (for Segment Reporting).

At the most granular level of detail, the Codification has a two-digit numerical code for a standard set of categories, which follow:

- *Overview and Background (05).* Provides overview and background material.
- *Scope and Scope Exceptions (15).* Outlines the transactions, events, and other occurrences to which the subtopic guidance does or does not apply.
- *Glossary (20).* Contains definitions for terms found within the subtopic guidance.
- *Recognition (25).* Defines the criteria and timing for recording an item in the financial statements.
- *Initial Measurement (30).* Provides guidance on the criteria and amounts used to measure a transaction at the initial date of recognition.
- *Subsequent Measurement (35).* Provides guidance on the subsequent measurement and recognition of an item.
- *Other Presentation Matters (45).* A catchall category providing guidance not included in the preceding sections.
- *Disclosure (50).* Provides guidance regarding disclosure in the notes to or on the face of the financial statements.
- *Implementation Guidance and Illustrations (55).* Contains illustrations of the guidance provided in the preceding sections.
- *Relationships (60).* Contains links to guidance that may be helpful to the reader of the subtopic.
- *SEC Materials (S99).* Contains selected SEC content for use by public companies.

By drilling down through the various topics and subtopics in the sidebar, a researcher can eventually locate the relevant GAAP information. However, there are three other ways to access GAAP information through the Codification site that may prove to be easier.

- *Cross-referencing.* If the researcher knows the reference number of an original GAAP source document, such as an EITF consensus or a FASB Staff Position, then s/he can enter this information through the Cross-Reference tab, which is located at the top center of the Codification home page. A By Standard search box will appear, where the researcher can select from a drop-down menu containing three-digit abbreviations for all of the various GAAP source documents. For example, FTP represents the FASB Staff Positions, while APB represents the Accounting Principles Board Opinions. After making a selection from this menu, the available list of all corresponding documents will appear next to it, in the Standard Number drop-down menu. Selecting a document from this list will bring up the corresponding topic, subtopic, section, and paragraph number in the Codification, as well as a hyperlink to the underlying text.

- *Codification search.* If the researcher is searching for specific words or phrases, then the best search tool is the Codification search bar, which is located in the upper right corner of any page on the site. To use it for a precision search, enter quotes around the search text; for a less precise search that returns individual words within the search text, do not use quotes. If the resulting set of links is too voluminous, then use the Narrow by Topic option on the right side of the page. This option allows the researcher to reduce the number of selections to only certain topic areas. For example, to determine the appropriate presentation of cash on the balance sheet, search on the word Cash, and then narrow the selection to just the Presentation topic, and then narrow further to just the Balance Sheet subtopic.
- *Advanced search.* The most detailed researching method is the Advanced Search option, which is located below the search bar in the upper right corner of any site page. The resulting search page reveals a combination of options; the researcher can use text, Codification numbers, document titles, and topics to prepare a more refined search.

The simplified structure of the Codification makes it a much simpler database than the old GAAP hierarchy for researching purposes, which is also enhanced by the Codification Web site's excellent search tools.