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DEVELOPMENT OF GAAP

What Is GAAP?

> *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. Auditing Standards Board (ASB), AU Section 411*

Generally accepted accounting principles (GAAP) are concerned with the measurement of economic activity, the time 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. GAAP develops when questions

arise about how to best accomplish those objectives—measurement, timing of recognition, disclosure, or presentation. In response to those questions, GAAP is either prescribed in official pronouncements of authoritative bodies empowered to create it, or it originates over time through the development of customary practices that evolve when authoritative bodies fail to respond. Thus, GAAP is a reaction to and a product of the economic environment in which it develops. As such, the development of accounting and financial reporting standards has lagged the development and creation of increasingly intricate economic structures and transactions.

There are two broad categories of accounting principles—recognition and disclosure. Recognition principles determine the timing and measurement of items that enter the accounting cycle and impact the financial statements. These are quantitative standards that require economic information to be reflected numerically.

Disclosure principles deal with factors that are not always numeric. Disclosures involve qualitative information that is an essential ingredient of a full set of financial statements. Their absence would make the financial statements misleading by omitting information relevant to the decision-making needs of the reader. Disclosure principles complement recognition principles by explaining assumptions underlying the numerical information and providing additional information on accounting policies, contingencies, uncertainties, etc., which are essential to fully understand the performance and financial condition of the reporting enterprise.

Who Created GAAP?

From time to time, the bodies given responsibility for the promulgation of GAAP have changed, and indeed more than a single such body has often shared this responsibility. GAAP established by all earlier standard-setting bodies, to the extent not withdrawn or superseded, remains in effect at the present time. These bodies are described in the following paragraphs.

Committee on Accounting Procedure. The first serious attempt to create formalized generally accepted accounting principles began in 1930, primarily as a consequence of the stock market crash of 1929 and the widespread perception that an absence of uniform and stringent financial reporting requirements had contributed to the rampant stock market speculation of the preceding decade that culminated with that crash. (Previously, GAAP had largely been defined by academic writings and general industry practices.) 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 that were published in 1938 as Accounting Research Bulletin (ARB) 1 of the Committee on Accounting Procedure. The Committee subsequently published 51 such bulletins, including Accounting Research Bulletin 43, which consolidated and superseded Bulletins 1– 42. The Committee also attempted to achieve uniformity in accounting terminology. However, the Committee's limited resources and lack of serious research efforts in support of its pronouncements were questioned in the late 1950s, particularly as a number of very complex controversial topics loomed on the horizon.

Accounting Principles Board. The profession's response was to substitute, under its auspices, the Accounting Principles Board (APB) for the Committee on Accounting Procedure. This was done to facilitate the development of principles, which were to be based primarily on the research of a separate division of the AICPA, the Accounting Research Division. Under this strategy, the Division was to undertake extensive research, publish its

findings, and then permit the Accounting Principles Board to take the lead in the discussions that would ensue concerning accounting principles and practices.

During the Board's fourteen years of existence, it issued 31 authoritative opinions and 4 nonauthoritative statements. They dealt with amendments of Accounting Research Bulletins, opinions on the form and content of financial statements, and issuances requiring changes in both the recognition and disclosure principles of the profession. However, the Board did not make use of the efforts of the Accounting Research Division, which published fifteen research studies during its lifetime. Both the Board and the Division acted independently in selecting topics for their respective agendas. The Board issued pronouncements in areas where little research had been done, and the Division performed research studies without seeking to be all-inclusive or exhaustive in analysis. The Accounting Principles Board did not, ultimately, operate differently or more effectively than had the Committee on Accounting Procedure.

Financial Accounting Standards Board. As a result of these operational problems, in 1971 the AICPA appointed the "Wheat Study Group," chaired by former SEC commissioner Francis M. Wheat. The Wheat Study Group was charged with examining the standard-setting process and making recommendations regarding the form and structure of the standard-setting process as well as whether standard setting should reside in the government or in the private sector. Based on the recommendations of this group, the Financial Accounting Standards Board (FASB) was formed in 1972.

FASB is recognized as authoritative through Financial Reporting Release 1 of the Securities and Exchange Commission 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 based on their market capitalizations.

From its inception through the mid-2009 implementation of the Accounting Standards Codification (discussed below), the Board issued several types of pronouncements. The most important of these are Statements of Financial Accounting Standards and the FASB Interpretations, the latter of which are used to clarify or elaborate on existing Statements or pronouncements of predecessor bodies. Prior to mid-2009, Standards and Interpretations constituted category A GAAP, which also included FASB staff positions—a relatively recent form of 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 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. Staff positions, of which many were produced in the past several years, 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. In addition, staff positions were required to be exposed on the FASB Web site for a 30-day comment period before issuance.

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Beginning July 1, 2009, all codified GAAP was placed in a single level of the hierarchy (the second, lower level will contain what formerly was defined as category E, consisting of scholarly writings, texts and guides by private-sector authors, guidance by other relevant bodies, and so forth), so the formerly important distinctions among categories A-D were eliminated.

American Institute of Certified Public Accountants (AICPA). The Accounting Standards Executive Committee (AcSEC) has been the senior technical committee at the AICPA. It is composed of fifteen volunteer members, representative of industry, academia, analysts, and both national and regional public accounting firms. All AcSEC members are CPAs and members of the AICPA.

AcSEC has been authorized to set accounting standards and to speak for the AICPA on accounting matters. The accounting standards that AcSEC issued 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, 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. Industry audit and accounting guides 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. Until relatively recently, the standards issued by AcSEC addressed topics broadly applicable to all industries in addition to industry-specific topics.

Emerging Issues Task Force (EITF). The Emerging Issues Task Force (EITF) was formed in 1984 by the FASB in order to assist the Board in identifying current or emerging issues and implementation problems before divergent practices become entrenched. The guidance provided has often been restricted to narrow issues that were of immediate interest and importance. Task Force members have been drawn primarily from public accounting firms but also included individuals who would be aware of issues and practices that should be considered by the group.

For each EITF agenda item, an issues paper is developed by members, their firms, or the FASB staff. After discussion by the Task Force, a consensus may be reached on the issue, in which case the consensus is referred to the FASB for ratification at its next scheduled meeting. If no consensus is reached, the matter may end up on the Board agenda or be resolved by the SEC, or the issue will remain unresolved with no standard-setting organization currently considering it. These issues may be in especially narrow areas having little broad-based interest. Occasionally, FASB may include a narrow issue in the scope of a broader project and reaffirm or supersede the work of the Task Force.

Although EITF pronouncements were technically category C GAAP, they were so specialized that generally there had been no category A or B GAAP covering the respective topics, making the consensuses the highest ranking guidance on the issue. The SEC was of the view that a Task Force consensus constituted GAAP for public companies, and it would question any accounting that differed from it.

The EITF also previously published Discussion Issues, which are FASB staff announcements and SEC staff announcements regarding technical matters that are deemed important by the FASB or SEC staff, but that do not relate specifically to a numbered EITF issue. These announcements were designed to help provide guidance on the application of relevant accounting pronouncements. Production of discussion issues declined over recent years and it was not anticipated that further discussion issues would be produced.

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Other sources. Not all GAAP has resulted from a deliberative process and the issuance of pronouncements by authoritative bodies. Certain principles and practices evolved into current acceptability without formally adopted standards. For example, depreciation methods such as straight-line and declining balance have both long been acceptable, as are alternative inventory costing methods such as LIFO and FIFO. There are, however, no definitive pronouncements that can be found to state this. Furthermore, there are many disclosure principles that evolved into general accounting practice because they were originally required by the SEC in documents submitted to them. Among these are reconciling the actual rate with the statutory rate used in determining income tax expense, when not otherwise obvious from the financial statements themselves. 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 are found in the second level (of the two levels) of the new hierarchy.

Accounting Standards Codification. FASB completed its project to codify GAAP in 2009 and released it in mid-2009; at that time, all existing GAAP literature was officially withdrawn.

The accounting standards codification eliminates the multilevel hierarchy in favor of a bifurcation between authoritative and nonauthoritative guidance. The Codification does not change GAAP, per se, but instead introduces a new structure—one that is organized into a more readily accessible, user-friendly online research system. It thus 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. According to FASB, this new system should reduce the amount of time and effort required to solve an accounting research issue; mitigate the risk of noncompliance with standards through improved usability of the literature; provide accurate information with real-time updates as new standards are released; and assist the FASB with the research and convergence efforts required during the standard-setting process.

How Is GAAP Created?

For many decades, until the changes being wrought by the new Codification begin to be felt, GAAP has been created by the promulgation of standards and interpretations by the bodies granted statutory and professional authority to make such rules. 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, and will continue to be, to involve constituents who would be affected by the newly issued guidance so that the standards created will result in information that reports economic activity as objectively as possible without attempting to influence behavior in any particular direction. Ultimately, however, the guidance is the judgment of the FASB or the AICPA, based on research, public input, and deliberation. The FASB's due process procedures are described below. The AICPA follows similar procedures in its projects, but may have a reduced role in the future. "Due process," however, will remain as a guiding principle in the overall development of GAAP.

The FASB receives requests for new standards from all parts of its diverse constituency, including auditors, industry groups, the EITF, and the SEC. Requests for action include both suggestions for new topics and suggestions for reconsideration of existing pronouncements. For each major project it adds to its technical agenda, the FASB begins by appointing an advisory task force of approximately fifteen outside experts. Care is taken to ensure that various points of view are represented on the task force. The task force meets with and advises the Board and staff on the definition and scope of the project and the nature and extent

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of any additional research that may be needed. The FASB and its staff then debate the significant issues in the project and arrive at tentative conclusions. As it does so, the FASB and its staff study existing literature on the subject and conduct or commission any additional research as needed. The task force meetings and the Board meetings are open to public observation and a public record is maintained. Many of these proceedings are also available by live or archived audio Webcast as well as via telephone.

If the accounting problem being considered by the Board is especially complex, the FASB will begin by publishing a Discussion Memorandum or another discussion document. The discussion document generally sets forth the definition of the problem, the scope of the project, and the financial accounting and reporting issues; discusses research findings and relevant literature; and presents alternative solutions to the issues under consideration and the arguments and implications relative to each. It is distributed to interested parties by request and is available on the FASB Web site. The document is prepared by the FASB staff with the advice and assistance of the task force. It specifies a deadline for written comments and often contains an invitation to present viewpoints at a public hearing.

Any individual or organization may request to speak at the public hearing, which is conducted by the FASB and the staff assigned to the project. Public observers are welcome. After each individual speaks, the FASB and staff ask questions. Questions are based on written material submitted by the speakers prior to the hearing as well as on the speaker's oral comments. In addition to the hearing, the staff analyzes all the written comments submitted. The FASB members study this analysis and read the comment letters to help them reach conclusions. The hearing transcript and written comments become part of the public record.

After the comment letters and oral presentations responding to the discussion document are considered, formal deliberations begin. (If the accounting problem is not as complex and no discussion document was issued, the due process begins at this point.) The FASB deliberates at meetings that are open to public observation, although observers do not participate in the discussions. The agenda for each meeting is announced in advance. Prior to each Board meeting, the staff presents a written analysis and recommendations of the issues to be discussed. During the meeting, the staff presents orally a summary of the written materials and the Board discusses each issue presented. The Board meets as many times as is necessary to resolve the issues.

When the Board has reached tentative conclusions on all the issues in the project, the staff prepares an Exposure Draft. The Exposure Draft sets forth the Board's conclusions about the proposed standards 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 reviews, and if necessary, revises, the Exposure Draft. Then, a vote is taken about whether the Exposure Draft can be published for public comment. A majority of the Board members must vote to approve an Exposure Draft for issuance for comment. If four votes are not obtained, the FASB holds additional meetings and redrafts the Exposure Draft.

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

As in the earlier process, all Board meetings are open to the public. During these meetings, the Board considers the comments received and may revise their earlier conclusions. If substantial modifications are made, the Board will issue a revised Exposure Draft for addi-

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tional public comment. If so, the Board also may decide that another public hearing is necessary. When the Board is satisfied that all reasonable alternatives have been adequately considered, the staff drafts a final pronouncement for the Board's vote. Once issued, the standards become GAAP after the effective date stated in the pronouncement.

The Hierarchy of GAAP after Codification

On July 1, 2009, the FASB Accounting Standards Codification™ became the single official source of authoritative, nongovernmental US generally accepted accounting principles (GAAP). It superseded all extant FASB, AICPA, EITF, and related literature. After that date, only one level of authoritative GAAP existed, excluding the guidance issued by the Securities and Exchange Commission (SEC). All other literature is nonauthoritative. In effect, therefore, the formerly five-level US GAAP hierarchy was compressed to two levels.

The Codification did not change GAAP, but rather introduced a new structure—one that is organized into an easily accessible, user-friendly online research system. The Codification reorganizes the large number of discrete US GAAP pronouncements into roughly 90 accounting Topics, and displays all Topics using a consistent structure.

Also 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 it was not previously included in official GAAP guidance (although it obviously was binding on publicly held reporting entities, and was to be given some consideration as "category E" hierarchy literature even by nonissuers). 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 are being 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.

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The Codification includes all category A–D GAAP issued by accounting standard setters, including pronouncements issued by the FASB, EITF, the Accounting Standards Executive Committee (AcSEC), the Accounting Principles Board, etc., to the extent still binding on financial reporting practice. The source of materials used to create the Codification is 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 Statement 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 also are no longer referenced.

As with former practice, when certain standards and other guidance were issued with delayed effective dates, the Codification includes materials that may not yet be mandatorily effective. The content from new standards that is 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. There will thus be no original source to be identified as a stand-alone pronouncement.

Thus, researching GAAP in official sources in the future will 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.

The Codification content is arranged within *Topics, Subtopics, Sections,* and *Subsections*. All accountants should quickly develop a facility to navigate through this material.

Topics represent a collection of related guidance. Topics reside in four main areas as follows:

- *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.
- *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.
- *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.
- *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 are typically 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.

FASB has developed a hybrid classification system specifically for the Codification. The following is the structure of the classifications system: 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, etc. 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 (for example, EITF Abstracts, FASB Staff Positions, FASB Statements, and FASB Interpretations).

The FASB organizes the content of new standards using the same Section headings as those used in the Codification. The Codification Update Instructions are similar to the

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Amendments sections of current FASB standards. They display marked changes to the pertinent sections of the Codification. New standards are not deemed authoritative in their own right; instead, the new standards serve only to update the Codification and provide the historical basis for conclusions of a new standard.

The Concept of Materiality

Materiality as a concept has great significance in understanding, researching, and implementing GAAP. Each Statement of Financial Accounting Standards (FAS) that has been issued by the FASB concludes by stating that the provisions of the statement are not applicable 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 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.

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 Securities and Exchange Commission 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 have traditionally 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 can usually 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 regard-

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ing 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 upon 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. Given the epidemic of financial reporting frauds in the late 1990s and early 2000s, it became clear that a more nuanced and complex definition of materiality was probably 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. More recently, Staff Accounting Bulletin 108 (SAB 108) has added to the literature of materiality with its discussion of considerations applicable to prior period restatements. (See discussion in Chapter 5.)

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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, as well. 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 cir-

cumstances 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, Business Week*) 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.

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
- What are the goals of the transaction? Are these goals compatible with full and transparent disclosure and recognition?
- 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 5-7 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 and, 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 literature to search. This requires access to, and an understanding of, 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, and

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- 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 (described in additional detail below)

- This step involves implementation of the research strategy through searching, identifying, and locating applicable information.
  - Research published GAAP.
  - 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 3-7 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.

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Search Authoritative Literature (Step 6) —Further Explanation

The following sections discuss in more detail how to search authoritative literature as outlined in Step 6.

Researching of the GAAP Codification. The structure of the new Accounting Standards Codification™ was discussed above, and can be used to research GAAP via FASB and other commercial sources in the manner prescribed. Researching GAAP using this publication is explained in the following section.

Researching using *Wiley GAAP*. This publication can assist in researching generally accepted accounting principles for the purpose of identifying technical answers to specific inquiries. You can begin your search in one of two ways: by using the contents page at the front of this book to determine the chapter in which the answer to your question is likely to be discussed, or by using the index at the back of this publication to identify specific pages of the publication that discuss the subject matter relating to your question. The path chosen depends in part on how specific the question is; an initial reading of the chapter or relevant section thereof will provide a broader perspective on the subject. For example, if one wanted to know how to account for receivables pledged as collateral, it would be best to start with Chapter 5. However, if one's interest was limited to securitizations of credit card portfolios, it might be better to search the index, because securitizations are a very specialized type of transaction involving receivables, addressed in only a few pages of the text.

Each chapter in this publication is organized in the following manner:

- A chapter table of contents on the first page of the chapter
- Perspective and Issues, providing an overview of the chapter contents and noting any current controversy or proposed GAAP changes affecting the chapter's topics
- Definition of Terms, defining any specialized terms unique to the chapter's subject matter
- Concepts, Rules, and Examples, setting forth the detailed guidance and examples

After reading the relevant portions of this publication, the Sources of GAAP box can be used to find the sections in the Codification that are related to the topic, so that these can be appropriately understood and cited in documenting your research findings and conclusions. Readers familiar with the professional literature can use the listing of Codification sections to quickly locate the pages in this publication relevant to each specific pronouncement. The reader can therefore locate more detail on each topic covered in this publication, and also be aware of those few, highly specialized topics and pronouncements not covered within this publication.

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 upon 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.)

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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.

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 follows:

Accounting Web sites

AICPA Online	http://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	http://www.aaahq.org	Accounting news; publications; faculty information; searchable; links to other sites
FASB	http://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	http://asc.fasb.org/home	Searchable database using the new accounting codification; includes cross-referencing and tutorials
GASB	http://www.gasb.org	Information on GASB; new GASB documents; summaries/status of all GASB statements; proposed Statements; Technical Bulletins; Interpretations
International Accounting Standards Board (IASB)	http://www.iasb.org.uk	Information on the IASB; lists of Pronouncements, Exposure Drafts, project summaries, and conceptual framework
NASBA	http://www.nasba.org	National State Boards of Accountancy; 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	http://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	http://www.accounting.rutgers.edu	Includes links to journals and publications, software, publishers, educational institutions, government agencies, and information regarding continuous auditing initiatives
SEC	http://www.sec.gov	SEC digest and statements; EDGAR searchable database; information on current SEC rulemaking; links to other sites

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The 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.*

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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.

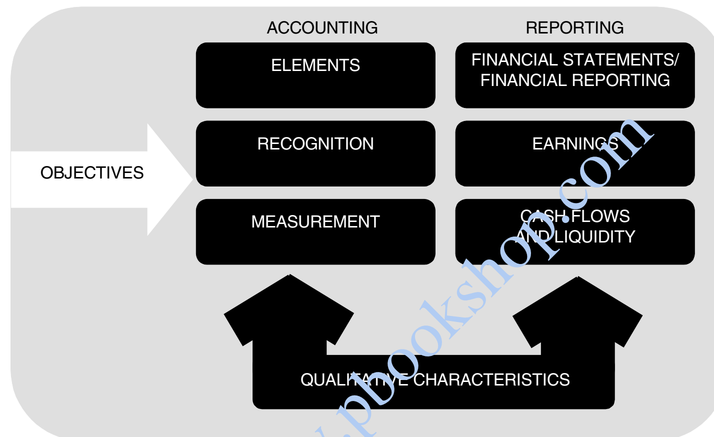
Components of the conceptual framework. The components of the conceptual framework for financial accounting and reporting include objectives, qualitative characteristics, elements, recognition, measurement, financial statements, earnings, funds flow, and liquidity. The relationship between these components 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



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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 Statement of Financial Accounting Concepts (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.

CON 1: Objectives of Financial Reporting by Business Enterprises

CON 1 identifies the objectives (purposes) of financial reporting and indicates that these objectives apply to all financial reporting; they are not limited to financial statements. Financial reporting includes the financial statements and other forms of communication that provide accounting information (corporate annual reports, prospectuses, annual reports filed with the Securities and Exchange Commission, news releases, and management forecasts).

CON 1 identifies three objectives of financial reporting. The first objective is to provide information that is useful in making business and economic decisions. Users of financial information are divided into internal and external groups. Internal users include management and directors of the business enterprise. Internal reports tend to provide information that is more detailed than the information available to or used by external users. External users in-

clude both individuals who have or intend to have a direct economic interest in a business and those who have an indirect interest because they advise or represent those individuals with a direct interest. These users include owners, lenders, suppliers, potential investors and creditors, employees, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labor unions, trade associations, business researchers, teachers, students, and the public. CON 1 is directed at general-purpose external financial reporting by a business enterprise as it relates to the ability of that enterprise to generate favorable cash flows. External users' needs are emphasized because these users lack the authority to obtain the financial information they want and need from an enterprise. Thus, external users must rely on the information provided to them by management.

The second objective of financial reporting is to provide understandable information that will aid investors and creditors in predicting the future cash flows of a firm. Investors and creditors want information about cash flows because the expectation of cash flows affects a firm's ability to pay interest and dividends, which in turn affects the market price of that firm's stocks and bonds.

The third objective of financial reporting is to provide information relative to an enterprise's economic resources, the claims to those resources (obligations), and the effects of transactions, events, and circumstances that change resources and claims to resources. A description of these informational needs follows:

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- **Economic resources, obligations, and owners' equity.** This information provides the users of financial reporting with a measure of future cash flows and an indication of the firm's strengths, weaknesses, liquidity, and solvency.
- **Economic performance and earnings.** Past performance provides an indication of a firm's future performance. Furthermore, earnings based upon accrual accounting provide a better indicator of economic performance and future cash flows than do current cash receipts and disbursements. Accrual basis earnings are a better indicator because a charge for recovery of capital (depreciation/amortization) is made in determining these earnings. The relationship between earnings and economic performance results from matching the costs and benefits (revenues) of economic activity during a given period by means of accrual accounting. Over the life of an enterprise, economic performance can be determined by net cash flows or by total earnings since the two measures would be equal.
- **Liquidity, solvency, and funds flows.** Information about cash and other funds flows from borrowings, repayments of borrowings, expenditures, capital transactions, economic resources, obligations, owners' equity, and earnings may aid the user of financial reporting information in assessing a firm's liquidity or solvency.
- **Management stewardship and performance.** The assessment of a firm's management with respect to the efficient and profitable use of the firm's resources is usually made on the basis of economic performance as reported by periodic earnings. Because earnings are affected by factors other than current management performance, earnings may not be a reliable indicator of management performance.
- **Management explanations and interpretations.** Management is responsible for the efficient use of a firm's resources. Thus, it acquires knowledge about the enterprise and its performance that is unknown to the external user. Explanations by management concerning the financial impact of transactions, events, circumstances, uncertainties, estimates, judgments, and any effects of the separation of the results of operations into periodic measures of performance enhance the usefulness of financial information.

CON 2: Qualitative Characteristics of Accounting Information

The purpose of financial reporting is to provide decision makers with useful information. When accounting choices are to be made by individuals or by standard-setting bodies, those choices should be based upon the usefulness of that information to the decision-making process. This CON identifies the qualities or characteristics that make information useful in the decision making process. It also establishes a terminology and set of definitions to provide a greater understanding of the characteristics. The diagram below from CON 2 summarizes the qualitative characteristics of accounting information.

Usefulness for decision making. This is the most important characteristic of information. Information must be useful to be beneficial to the user. To be useful, accounting information must be both relevant and reliable. Both of these characteristics are affected by the completeness of the information provided.

Relevance. Information is relevant to a decision if it makes a difference to the decision maker in his/her ability to predict events or to confirm or correct expectations. Relevant information will reduce the decision maker's assessment of the uncertainty of the outcome of a decision even though it may not change the decision itself. Information is relevant if it provides knowledge concerning past events (feedback value) or future events (predictive value) and if it is timely. Disclosure requirement information is relevant because it provides information about past events and it improves the predictability of future events. The predictive value of accounting information does not imply that such information is a prediction. The predictive value refers to the utility that a piece of information has as an input into a predictive model. Although timeliness alone will not make information relevant, information must be timely to be relevant. It must be available before it loses its ability to influence the decision maker.

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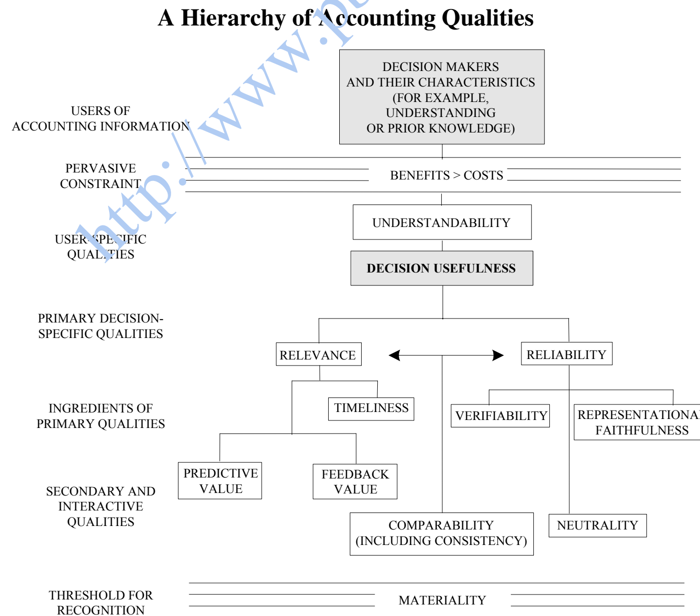
A Hierarchy of Accounting Qualities



Reliability. Financial statements are an abstraction of the activities of a business enterprise. They simplify the activities of the actual firm. To be reliable, financial statements must portray the important financial relationships of the firm itself. Information is reliable if

it is verifiable and neutral and if users can depend on it to represent that which it is intended to represent (representational faithfulness).

Information may not be representationally faithful if it is biased. Bias is the tendency for an accounting measure to be consistently too high or too low. Bias may arise because the measurer does not use the measurement method properly or because the measurement method does not represent what it purports to represent.

Verifiability means that several independent measures will obtain the same accounting measure. An accounting measure that can be repeated with the same result (consensus) is desirable because it serves to detect and reduce measurer bias. Cash is highly verifiable. Inventories and depreciable assets tend to be less verifiable because alternative valuation methods exist. The direct verification of an accounting measure would serve to minimize measurer bias and measurement bias. The verification of the procedures used to obtain the measure would minimize measurer bias only. Finally, verifiability does not guarantee representational faithfulness or relevance.

The characteristic of neutrality means that accounting information should serve to communicate without attempting to influence behavior in a particular direction. This does not mean that accounting should not influence behavior or that it should affect everyone in the same way. It means that information should not favor certain interest groups.

To be useful, accounting information should be comparable. The characteristic of comparability allows the users of accounting information to assess the similarities and differences either among different entities for the same time period or for the same entity over different time periods. Comparisons are usually made on the basis of quantifiable measurements of a common characteristic. Therefore, to be comparable, the measurements used must be reliable with respect to the common characteristic. Noncomparability can result from the use of different inputs, procedures, or systems of classification. Noncomparability can also arise when the data measurements lack representational faithfulness.

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The characteristic of consistency also contributes to information usefulness. Consistency is an interperiod comparison that requires the use of the same accounting principles from one period to another. Although a change of an accounting principle to a more preferred method results in inconsistency, the change is acceptable if the effect of the change is disclosed. Consistency does not insure comparability. If the measurements used are not representationally faithful, comparability will not be achieved.

Trade-offs. Although it is desirable that accounting information contain the characteristics that have been identified above, not all of these characteristics are compatible. Often, one characteristic may be obtained only by sacrificing another. The trade-offs that must be made are determined on the basis of the relative importance of the characteristics. This relative importance, in turn, is dependent upon the nature of the users and their particular needs.

Constraints. The qualitative characteristics of useful accounting information are subject to two constraints: the materiality and the relative cost benefit of that information. An item of information is material and should be reported if it is significant enough to have an effect on the decision maker. Materiality requires judgment. It is dependent upon the relative size of an item, the precision with which the item can be estimated, and the nature of the item. No general standards of materiality are provided (although an appendix to CON 2 lists several guidelines that have been applied).

Accounting information provides the user with certain benefits. Associated with this benefit, however, is the cost of using that information and of providing it to the user. Information should be provided only if its benefits exceed its cost. Unfortunately, it is difficult to value the benefit of accounting information. It is also difficult to determine whether the burden of the cost of disclosure and the benefits of such disclosure are distributed fairly.

Role of conservatism. Conservatism is a reaction to uncertainty. For many years, accountants have been influenced by conservatism. Conservatism in accounting may mislead users if it results in a deliberate understatement of net assets and net income. Such understatement is undertaken to minimize the risk of uncertainty to outside lenders. Unfortunately, such understatements often lead to overstatements in subsequent years, produce biased financial statements, and conflict with the characteristics of representational faithfulness, neutrality, and comparability.

CON 3: Elements of Financial Statements of Business Enterprises

CON 3 was replaced by CON 6. CON 6 carried forward essentially all of the concepts in CON 3, then added the elements unique to the financial statements of not-for-profit organizations.

CON 5: Recognition and Measurement in Financial Statements of Business Enterprises

CON 5 indicates that financial statements are the principal means of communicating useful financial information. A full set of such statements contains

- Financial position at end of the period
- Earnings for the period
- Comprehensive income for the period
- Cash flows during the period
- Investments by and distributions to owners during the period

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Financial statements result from simplifying, condensing, and aggregating transactions. Therefore, no one financial statement provides sufficient information by itself and no one item or part of each statement can summarize the information.

A statement of financial position provides information about an entity's assets, liabilities, and equity. Earnings is a measure of entity performance during a period. It is similar to net income but excludes accounting adjustments from earlier periods such as cumulative effect changes in accounting principles. Comprehensive income comprises all recognized changes in equity other than those arising from investments by and distributions to owners. A statement of cash flows reflects receipts and payments of cash by major sources and uses including operating, financing, and investing activities. The investments by and distributions to owners reflect the capital transactions of an entity during a period.

Income is determined by the concept of financial capital maintenance which means that only if the money amount of net assets increases during a period (excluding capital transactions) is there a profit. For recognition in financial statements, subject to both cost benefit and materiality constraints, an item must meet the following criteria:

1. Definition—Meet the definition of an element in financial statements
2. Measurability—Have a relevant attribute measurable with sufficient reliability
3. Relevance
4. Reliability

Items reported in the financial statements are based on historical cost, replacement cost, market value, net realizable value, and present value of cash flows. Price level changes are not recognized in these statements and conservatism guides the application of recognition criteria.

CON 6: Elements of Financial Statements

CON 6 defines ten interrelated elements that are used in the financial statements of business enterprises.

1. Assets—Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events
2. Liabilities—Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events
3. Equity (net assets) —The residual interest in the assets that remains after deducting its liabilities. In a business enterprise, equity is the ownership interest.
4. Revenues—Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major and central operations
5. Expenses—Outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major and central operations
6. Gains—Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners
7. Losses—Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners
8. Comprehensive income—The change in equity of a business enterprise during a period from transactions and other events and circumstances from sources other than investments by owners or distributions to owners
9. Investments by owners—Increases in equity of a particular business enterprise resulting from transfers to it for the purpose of increasing ownership interests
10. Distributions to owners—Decreases in the equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities to owners

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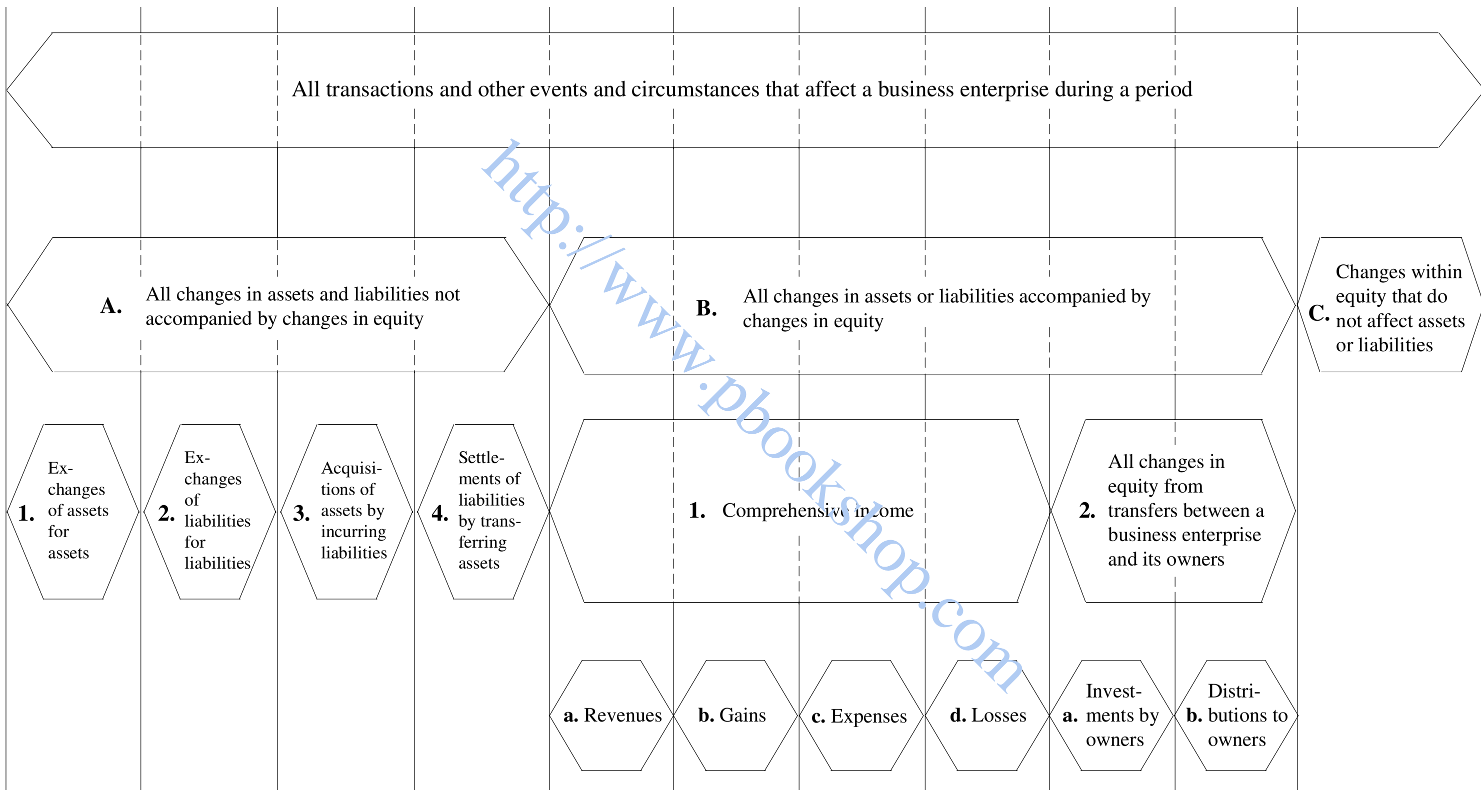
The various elements articulate; that is, a change in one element causes an offsetting change in another item of the same type or causes another element to change by the same amount. For example, a purchase of a building for cash and a mortgage note increases an asset (building), decreases another asset (cash), and increases a liability (mortgage note). A diagram from CON 6 that illustrates the articulation of the elements is included below.

In this publication, assets, liabilities, and equity are described more fully in Chapter 2. Revenues, expenses, gains, losses, and comprehensive income are described in Chapter 3. Investments by owners and distributions to owners are described in Chapter 17.

CON 6 also defines several significant financial accounting and reporting terms that are used in the Concepts Statements (and FASB pronouncements issued after the Concepts Statements). An event is a happening of consequence to an entity. It can be an internal event (the use of raw materials) or an external event with another entity (the purchase of labor) or with the environment in which the business operates (a technological advance by a competitor). A transaction is a particular kind of event. It is an external event that involves transferring something of value to another entity. Circumstances are a condition, or set of conditions, that create situations that might otherwise have not occurred and might not have been anticipated. Accrual accounting attempts to record the financial effects on a entity of transactions and of other events and circumstances that have consequences for the entity in the periods in which those transactions, events, and circumstances occur rather than in the periods in which cash is received or paid by the entity. Thus, accrual accounting is based not



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only on cash transactions but also on credit transactions, bartering, changes in prices, changes in the form of assets or liabilities, and other transactions, events and circumstances that involve no current cash transfers but will have cash consequences in the future. Accrual is the accounting process of recognizing the effects of future cash receipts and payments in the current period. Deferral is the accounting process of recognizing a liability resulting from a current cash receipt or an asset resulting from a current cash payment. Realization is the process of converting noncash assets into cash. Recognition is the process of formally incorporating a transaction or other event into the financial statements. Matching is the simultaneous recognition of the revenues and expenses that result directly and jointly from the same transaction or other event. Allocation is the process of assigning expenses to periods when the transactions or events that cause the using up of the benefits cannot be identified or when the cause can be identified but the actual amount of benefit used up cannot be reliably measured.

CON 6 also discusses the elements used in the financial statements of not-for-profit organizations. Of the ten elements, seven are used by not-for-profit organizations. The three elements omitted are investments by owners, distributions to owners, and comprehensive income. They are omitted because not-for-profit organizations do not have owners. The seven remaining elements are defined for not-for-profit organizations the same as they are for business enterprises. The net assets (equity) of not-for-profit organizations is divided into three classes—unrestricted, temporarily restricted, and permanently restricted—based on the existence or absence of donor-imposed restrictions. A portion of Chapter 24 describes the accounting and reporting of not-for-profit organizations.

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CON 7: Using Cash Flow Information and Present Value in Accounting Measurements

CON 7 provides a framework for using estimates of future cash flows as the basis for accounting measurements either at initial recognition or when assets are subsequently remeasured at fair value (fresh-start measurements). It also provides a framework for using the interest method of amortization. It provides the principles that govern measurement using present value, especially when the amount of future cash flows, their timing, or both are uncertain. However, it does not address recognition questions, such as which transactions and events should be valued using present value measures or when fresh-start measurements are appropriate.

Fair value is the objective for most measurements at initial recognition and for fresh-start measurements in subsequent periods. At initial recognition, the cash paid or received (historical cost or proceeds) is usually assumed to be fair value, absent evidence to the contrary. For fresh-start measurements, a price that is observed in the marketplace for an essentially similar asset or liability is fair value. If purchase prices and market prices are available, there is no need to use alternative measurement techniques to approximate fair value. However, if alternative measurement techniques must be used for initial recognition and for fresh-start measurements, those techniques should attempt to capture the elements that when taken together would comprise a market price if one existed. The objective is to estimate the price likely to exist in the marketplace if there were a marketplace—fair value.

CON 7 states that the only objective of using present value in accounting measurements is fair value. It is necessary to capture, to the extent possible, the economic differences in the marketplace between sets of estimated future cash flows. A present value measurement that fully captures those differences must include the following elements:

1. An estimate of the future cash flow, or in more complex cases, series of future cash flows at different times

2. Expectations about possible variations in the amount or timing of those cash flows
3. The time value of money, represented by the risk-free rate of interest
4. The risk premium—the price for bearing the uncertainty inherent in the asset or liability
5. Other factors, including illiquidity and market imperfections

How CON 7 measures differ from previously utilized present value techniques. Previously employed present value techniques typically used a single set of estimated cash flows and a single discount (interest) rate. In applying those techniques, adjustments for factors 2. through 5. described in the previous paragraph are incorporated in the selection of the discount rate. In the CON 7 approach, only the third factor listed (the time value of money) is included in the discount rate; the other factors cause adjustments in arriving at risk-adjusted expected cash flows. CON 7 introduces the probability-weighted, expected cash flow approach, which focuses on the range of possible estimated cash flows and estimates of their respective probabilities of occurrence.

Previous techniques used to compute present value used estimates of the cash flows most likely to occur. CON 7 refines and enhances the precision of this model by weighting different cash flow scenarios (regarding the amounts and timing of cash flows) by their estimated probabilities of occurrence and factoring these scenarios into the ultimate determination of fair value. The difference is that values are assigned to the cash flows other than the most likely one. To illustrate, a cash flow might be $100, $200, or $300 with probabilities of 10%, 50%, and 40%, respectively. The most likely cash flow is the one with 50% probability, or $200. The expected cash flow is $230 [=($100 × .1) + ($200 × .5) + ($300 × .4)].

The CON 7 method, unlike previous present value techniques, can also accommodate uncertainty in the timing of cash flows. For example, a cash flow of $10,000 may be received in one year, two years, or three years with probabilities of 15%, 60%, and 25%, respectively. Traditional present value techniques would compute the present value using the most likely timing of the payment—two years. The example below shows the computation of present value using the CON 7 method. Again, the expected present value of $9,030 differs from the traditional notion of a best estimate of $9,070 (the 60% probability) in this example.

Present value of $10,000 in 1 year discounted at 5%	$9,523	
Multiplied by 15% probability		$1,428
Present value of $10,000 in 2 years discounted at 5%	$9,070	
Multiplied by 60% probability		5,442
Present value of $10,000 in 3 years discounted at 5%	$8,638	
Multiplied by 25% probability		2,160
Probability weighted expected present value		$9,030

Measuring liabilities. The measurement of liabilities involves different problems from the measurement of assets; however, the underlying objective is the same. When using present value techniques to estimate the fair value of a liability, the objective is to estimate the value of the assets required currently to (1) settle the liability with the holder or (2) transfer the liability to an entity of comparable credit standing. To estimate the fair value of an entity's notes or bonds payable, accountants look to the price at which other entities are willing to hold the entity's liabilities as assets. For example, the proceeds of a loan are the price that a lender paid to hold the borrower's promise of future cash flows as an asset.

The most relevant measurement of an entity's liabilities should always reflect the credit standing of the entity. An entity with a good credit standing will receive more cash for its promise to pay than an entity with a poor credit standing. For example, if two entities both promise to pay $750 in three years with no stated interest payable in the interim, Entity A,

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with a good credit standing, might receive about $630 (a 6% interest rate). Entity B, with a poor credit standing, might receive about $533 (a 12% interest rate). Each entity initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates that entity's credit standing.

Present value techniques can also be used to value a guarantee of a liability. Assume that Entity B in the above example owes Entity C. If Entity A were to assume the debt, it would want to be compensated $630—the amount that it could get in the marketplace for its promise to pay $750 in three years. The difference between what Entity A would want to take the place of Entity B ($630) and the amount that Entity B receives ($533) is the value of the guarantee ($97).

Interest method of allocation. CON 7 describes the factors that suggest that an interest method of allocation should be used. It states that the interest method of allocation is more relevant than other methods of cost allocation when it is applied to assets and liabilities that exhibit one or more of the following characteristics:

a. The transaction is, in substance, a borrowing and lending transaction.
b. Period-to-period allocation of similar assets or liabilities employs an interest method.
c. A particular set of estimated future cash flows is closely associated with the asset or liability.
d. The measurement at initial recognition was based on present value.

Accounting for changes in expected cash flows. If the timing or amount of estimated cash flows changes and the asset or liability is not remeasured at a fresh-start measure, the interest method of allocation should be altered by a catch-up approach. That approach adjusts the carrying amount to the present value of the revised estimated future cash flows, discounted at the original effective interest rate.

Application of present value tables and formulas.

Present value of a single future amount. To take the present value of a single amount that will be paid in the future, apply the following formula; where *PV* is the present value of $1 paid in the future, *r* is the interest rate per period, and *n* is the number of periods between the current date and the future date when the amount will be realized.

$$PV = \frac{1}{(1+r)^n}$$

In many cases the results of this formula are summarized in a present value factor table.

(n) Periods	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	0.9612	0.9426	0.9246	0.9070	0.8900	0.8734	0.8573	0.8417	0.8265
3	0.9423	0.9151	0.8890	0.8638	0.8396	0.8163	0.7938	0.7722	0.7513
4	0.9239	0.8885	0.8548	0.8227	0.7921	0.7629	0.7350	0.7084	0.6830
5	0.9057	0.8626	0.8219	0.7835	0.7473	0.7130	0.6806	0.6499	0.6209

Example of a present value calculation

Suppose one wishes to determine how much would need to be invested today to have $10,000 in 5 years if the sum invested would earn 8%. Looking across the row with n = 5 and finding the present value factor for the r = 8% column, the factor of 0.6806 would be identified. Multiplying $10,000 by 0.6806 results in $6,806, the amount that would need to be invested today to have $10,000 at the end of 5 years. Alternatively, using a calculator and applying the present value of a single sum formula, one could multiply $10,000 by $1/(1+.08)^5$, which would also give the same answer—$6,806.

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Present value of a series of equal payments (an annuity). Many times in business situations a series of equal payments paid at equal time intervals is required. Examples of these include payments of semiannual bond interest and principal or lease payments. The present value of each of these payments could be added up to find the present value of this annuity, or alternatively a much simpler approach is available. The formula for calculating the present value of an annuity of $1 payments over *n* periodic payments, at a periodic interest rate of *r* is

$$\text{PV Annuity} = \frac{\left(1 - \dfrac{1}{(1+r)^n}\right)}{r}$$

The results of this formula are summarized in an annuity present value factor table.

(n) Periods	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	1.9416	1.9135	1.8861	1.8594	1.8334	1.8080	1.7833	1.7591	1.7355
3	2.8839	2.8286	2.7751	2.7233	2.6730	2.6243	2.5771	2.5313	2.4869
4	3.8077	3.7171	3.6299	3.5460	3.4651	3.3872	3.3121	3.2397	3.1699
5	4.7135	4.5797	4.4518	4.3295	4.2124	4.1002	3.9927	3.8897	3.7908

Example of an annuity present value calculation

Suppose four annual payments of $1,000 will be needed to satisfy an agreement with a supplier. What would be the amount of the liability today if the interest rate the supplier is charging is 6% per year? Using the table to get the present value factor, the n = 4 periods row, and the 6% column, gives you a factor of 3.4651. Multiply this by $1,000 and you get a liability of $3,465.10 that should be recorded. Using the formula would also give you the same answer with r = 6% and n = 4.

Caution must be exercised when payments are not to be made on an annual basis. If payments are on a semiannual basis n = 8, but *r* is now 3%. This is because *r* is the periodic interest rate, and the semiannual rate would not be 6%, but half of the 6% annual rate. Note that this is somewhat simplified, since due to the effect of compound interest 3% semiannually is slightly more than a 6% annual rate.

Example of the relevance of present values. A measurement based on the present value of estimated future cash flows provides more relevant information than a measurement based on the undiscounted sum of those cash flows. For example, consider the following four future cash flows, all of which have an undiscounted value of $100,000:

1. Asset A has a fixed contractual cash flow of $100,000 due tomorrow. The cash flow is certain of receipt.
2. Asset B has a fixed contractual cash flow of $100,000 due in twenty years. The cash flow is certain of receipt.
3. Asset C has a fixed contractual cash flow of $100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is an 80% probability that the entire $100,000 will be received. There is a 20% probability that $80,000 will be received.
4. Asset D has an *expected* cash flow of $100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is a 25% probability that

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$120,000 will be received. There is a 50% probability that $100,000 will be received. There is a 25% probability that $80,000 will be received.

Assuming a 5% risk-free rate of return, the present values of the assets are

1. Asset A has a present value of $99,986. The time value of money assigned to the one-day period is $14 [$100,000 × .05/365 days]
2. Asset B has a present value of $37,689 [$100,000/(1 + .05)^{20}]
3. Asset C has a present value of $36,181 [(100,000 × .8 + 80,000 × .2)/(1 + .05)^{20}]
4. Asset D has a present value of $37,689 [($120,000 × .25 + 100,000 × .5 + 80,000 × .25)/(1 + .05)^{20}]

Although each of these assets has the same undiscounted cash flows, few would argue that they are economically the same or that a rational investor would pay the same price for each. Investors require compensation for the time value of money. They also require a risk premium. That is, given a choice between Asset B with expected cash flows that are certain and Asset D with cash flows of the same expected amount that are uncertain, investors will place a higher value on Asset B, even though they have the same expected present value. CON 7 says that the risk premium should be subtracted from the expected cash flows before applying the discount rate. Thus, if the risk premium for Asset D was $500, the risk-adjusted present values would be $37,500 {[($120,000 × .25 + 100,000 × .5 + 80,000 × .25) – 500]/(1 + .05)^{20}}.

Practical matters. Like any accounting measurement, the application of an expected cash flow approach is subject to a cost-benefit constraint. The cost of obtaining additional information must be weighed against the additional reliability that information will bring to the measurement. As a practical matter, an entity that uses present value measurements often has little or no information about some or all of the assumptions that investors would use in assessing the fair value of an asset or a liability. Instead, the entity must use the information that is available to it without undue cost and effort when it develops cash flow estimates. The entity's own assumptions about future cash flows can be used to estimate fair value using present value techniques, as long as there are no contrary data indicating that investors would use different assumptions. However, if contrary data exist, the entity must adjust its assumptions to incorporate that market information.

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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 the following 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 above 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 15 subcategories, numbered from 205 (for Presentation of Financial Statements) to 280 (for Segment Reporting). The entire numbering system is noted in the Codification Taxonomy section that precedes Chapter 1.

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

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she 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.

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 search tools.

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