1 RESEARCHING GAAP MATTERS

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 142. 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. The Board's authority was enforced primarily through prestige and Rule 203 of the AICPA Code of Professional Conduct. Furthermore, formal approval of Board issuances by the Securities and Exchange Commission (SEC) gave additional support to its activities.

During the Board's 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 Francis M. Wheat, a former SEC commissioner. 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. The Board consists of seven full-time members; they have diverse backgrounds with three coming from public accounting, two from private industry, and one each from academia and from an oversight body. The Board is assisted by a staff of professionals who conduct research and work directly with the Board.

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. (The imposition of this fee was established by the Sarbanes-Oxley Act and replaces the voluntary private-sector contributions that previously supported the Foundation. The change was made to allay any public concerns about the FASB's perceived independence from contributors.) The Board of Trustees of the Foundation is composed of members of

American Accounting Association
American Institute of Certified Public Accountants
CFA Institute
Financial Executives International
Government Finance Officers Association
Institute of Management Accountants
National Association of State Auditors, Comptrollers, and Treasurers
Securities Industry Association

The Board issues several types of pronouncements.[1] The most important of these are Statements of Financial Accounting Standards and Interpretations, which are used to clarify or elaborate on existing Statements or pronouncements of predecessor bodies. Standards and Interpretations constitute category A GAAP, which also includes FASB staff positions—a relatively new form of guidance—and the Board's FAS 133 implementation issues. Technical Bulletins, which are category B GAAP, usually address issues not covered directly by existing standards and are primarily used to provide guidance where it is not expected to be costly or create a major change. Bulletins are discussed at Board meetings and subject to Board veto. Both Bulletins and Interpretations are designed to be responsive to implementation and practice problems on relatively narrow subjects (the last Bulletin was issued in 2001; that role will now apparently be filled by FASB staff positions, a substantial number of which have already been produced).

The FASB staff can issue implementation guides and staff positions, which are category D GAAP. In a question-and-answer format, implementation guides address specific questions that arise when a standard is initially issued. Staff positions are responses to questions on appropriate application of FASB literature that are expected to have widespread relevance. The questions addressed in implementation guides and staff positions are submitted by phone, letter, or through the FASB Web site's technical inquiry service. Implementation guides and staff positions are drafted by the staff and issued provided that a majority of the FASB Board members do not object. In addition, staff positions must be exposed on the FASB Web site for a 30-day comment period before issuance.

American Institute of Certified Public Accountants (AICPA). The Accounting Standards Executive Committee (AcSEC) is 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 is authorized to set accounting standards and to speak for the AICPA on accounting matters. The accounting standards that AcSEC issues are prepared largely through the work of AICPA committees and task forces. AcSEC issues Statements of Position (SOPs) and industry audit and accounting guides, which are reviewed and cleared by the FASB and thus constitute category B GAAP. SOPs provide guidance on financial accounting and reporting issues. Industry audit and accounting guides provide guidance to auditors in examining and reporting on financial statements of entities in specific industries and provide standards on accounting problems unique to a particular industry. AcSEC Practice Bulletins (category C GAAP) usually provide guidance on very narrowly defined accounting issues. Until recently, the standards issued by AcSEC addressed topics broadly applicable to all industries in addition to industry-specific topics. Effective November 2002, FASB reclaimed the sole authority to promulgate general-purpose GAAP, relegating AcSEC to the issuance of industry-specific accounting and auditing standards.

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[1] *To date, the FASB has issued 161 Statements on Financial Accounting Standards, 48 Interpretations, 51 Technical Bulletins, as well as over 60 Staff Positions and over 30 implementation compilations. In addition, FASB has devoted substantial time and resources toward developing a Conceptual Framework for Financial Accounting, which has resulted in the issuance of 7 Concepts Statements, 6 of which are still in effect and discussed later in this chapter. (FASB is currently pursuing a complete review of the Concepts Statements as part of its convergence efforts with IASB.) (Since a number of standards have been superseded or withdrawn, the number of standards, interpretations, etc., which remain in force are somewhat fewer than the total issued. The preponderance of currently effective GAAP is the product of the FASB, and not of its predecessors, although a number of such older standards remain in effect.)*

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 is often on narrow issues that are of immediate interest and importance. Task Force members are drawn primarily from public accounting firms but also include individuals who would be aware of issues and practices that should be considered by the group. The Task Force meets every other month with nonvoting representatives of the SEC and the FASB attending for discussion purposes.

For each 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 problem 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.

FASB publishes a volume of EITF Abstracts, which are summaries of each issue paper and the results of Task Force discussion.

Although EITF pronouncements are technically category C GAAP, they are so specialized that generally there is no category A or B GAAP covering the respective topics. The SEC believes that a Task Force consensus is GAAP for public companies, and they will question any accounting that differs from it. In addition, the SEC believes that the EITF supplies a public forum to discuss accounting concerns and assist in providing advice. Thus, they are supportive of the Task Force's work.

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. It is anticipated that no further discussion issues will be issued by EITF, however.

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 adopted standards. For example, depreciation methods such as straight-line and declining balance are both acceptable, as are 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 balance sheets and income statements has evolved over the years without adopted standards.

Following about five years' effort, FASB has completed its project to codify GAAP, which will eliminate the multilevel hierarchy in favor of a bifurcation between authoritative and nonauthoritative guidance. In early 2008, FASB initiated a one-year verification phase of this Codification, during which time its constituents were encouraged to provide feedback on whether its content accurately reflects existing US GAAP for nongovernmental entities. Following completion of this trial period, pending any final revisions, FASB intends to release this by mid-2009, at which time all existing authoritative literature will be withdrawn. This book is based on the structure of the Codification as it exists in late 2008, which is not anticipated to change much, if at all.

In the interim, the GAAP hierarchy, which had been defined for decades in the auditing literature, has been moved from SAS 69 to a new FASB standard, FAS 162. This was issued in May 2008, to become effective when the PCAOB, responsible for public company auditing rules, takes action to amend its version of SAS 69 (as of year-end 2008, this has not been done). The only changes from the present hierarchy made were to include within category A GAAP virtually all accounting principles that are issued after being subject to FASB's due process; EITF consensuses were not moved to category A, however.

According to the FASB, the new hierarchy was considered because of the complexity of the long-standing hierarchy set forth by SAS 69, because that hierarchy was directed to auditors rather than reporting entities, and because of the anomaly of ranking FASB concepts statements lower than industry practices, although the former are subject to due process while the latter are not. The new standard still relegates concepts statements to the lowest level in the five-level hierarchy, but gives these primacy over all others in that level.

A further provision of FAS 162 holds that financial statements that depart materially from principles set forth in the GAAP hierarchy could not be represented as being in conformity with GAAP. While this does not (and, as an accounting standard, could not) alter the auditing rule known as the "Rule 203 exception" which allows for rare situations where departure from GAAP actually is believed warranted in the interest of fair presentation of the reporting entity's financial position or results of operations, it probably makes it a near-certainty that the Rule 203 exception will never be invoked, as indeed it has almost never been used historically. (A similar "true and fair view" exception exists under IFRS.)

How Is GAAP Created?

The FASB and AICPA adhere to rigorous "due process" when creating new guidance in category A and category B GAAP. The goal is 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.

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 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 additional 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. Four votes are required for adoption of a pronouncement. Once issued, the standards become GAAP after the effective date stated in the pronouncement.

The Hierarchy of GAAP

Under GAAP as it has been constituted over a number of decades, a number of standard-setting and standard-interpreting bodies (including, as of early-2009, FASB, AICPA's AcSEC, and EITF) issue pronouncements which have, to varying degrees, the force of requirements that financial statement preparers must follow. The multiplicity of standard-setting entities made it necessary to set forth a hierarchy, so that preparers and auditors would have a set of behavioral rules to follow in selecting from overlapping or seemingly contradictory rules. This hierarchy was first set forth by the auditing literature, but has been replaced by an interim accounting standard (FAS 162) and, shortly thereafter, will be made moot by the promulgation of the codification of GAAP. Under the forthcoming codification, all extant standards will be incorporated into a single document, and former distinctions among levels of the GAAP hierarchy will be eliminated. Future GAAP pronouncements will be styled as modifications to or replacements of existing portions of this codification, and will not exist as freestanding standards, interpretations, amendments, or staff positions. This will represent a very fundamental change to the structure of the body of GAAP, and will require substantial changes to how preparers and others undertake to stay abreast of evolving GAAP.

Under precodification GAAP, the determination of which accounting principle is applicable under a particular set of conditions requires an appreciation of the hierarchy of GAAP. The hierarchy was developed to assist the researcher in identifying the different sources of GAAP and to provide a means of resolving potential conflicts between standards by providing differing levels of authority. In FAS 162, FASB has identified the following as the sources of established generally accepted accounting principles:

A. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 [ET section 203.01] of the AICPA Code of Professional Conduct.
B. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category A.
C. Pronouncements of bodies, organized by a body referred to in category A and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category B that have been cleared by a body referred to in category A but have not been exposed for public comment.
D. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

Compliance with accounting pronouncements included in category A is mandatory. Auditors are not to express an unqualified opinion on financial statements if the financial statements contain a material departure from category A pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 implies that application of officially established accounting principles almost always results in fair presentation in conformity with generally accepted accounting principles, but this is not an absolute prohibition of departures from promulgated GAAP.

If an accounting treatment is not specified by a pronouncement covered by Rule 203, accountants and auditors are required to progress through the hierarchy to categories B, C, or D, in that sequence, and use the treatment specified by the source in the highest category. If an accounting pronouncement in category B, C, or D is relevant to the circumstances, accountants or auditors must follow that pronouncement or be able to justify the conclusion that another treatment is generally accepted.

Departures from promulgated GAAP justified as being necessary in order for the financial statements to not be misleading (the so-called "Rule 203 exception") have been very rarely observed in practice, but are clearly permitted under current standards. As of mid-2008, survival of this exception is in doubt, since the proposed FASB statement on the GAAP hierarchy would eliminate this exception. That is, departures from promulgated GAAP would cause financial statements to be deemed not in conformity with GAAP and, if the effect of the departure is material, not worthy of an unqualified auditors' opinion. Note that there are two reasons for the likely removal of this option. First, it pertains to the auditors' expression of an opinion, and not, as currently constituted, to the preparers' selection among accounting principles or methods. Second, in order for US GAAP to converge with IFRS (which does not have an exact equivalent to this exception), it was deemed necessary to eliminate it.

For financial statements of entities other than governmental entities[2]

a. Category A, officially established accounting principles, consists of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (denoted as FAS in this book) and Interpretations (denoted as FIN), Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins (ARB). As discussed later in this chapter, FASB has proposed that its FASB Staff Positions (FSP) and Derivatives Implementation Group Issues (DIG) also be classified in Category A.
b. Category B consists of FASB Technical Bulletins (FTB) and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position (SOP).
c. Category C consists of AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins (PB) that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force (EITF).
d. Category D includes AICPA accounting interpretations (AIN), implementation guides (Qs and As) published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

If financial statement preparers are unable to locate relevant guidance using one of the above sources of established accounting principles, other accounting literature may be con-

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[2] *The description of a governmental entity, which was agreed to in a joint meeting of the FASB and GASB Boards in 1996, states*

> *Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:*
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> *a. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;*
> *b. The potential for unilateral dissolution by a government with the net assets reverting to a government; or*
> *c. The power to enact and enforce a tax levy.*
>
> *Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling relevant evidence.*

This publication does not describe GAAP for governmental entities. Readers interested in learning more should consult the publication ***Wiley GAAP for Governments****.*

sidered. These sources include FASB Statements of Financial Accounting Concepts, AICPA Issues Papers, International Financial Reporting Standards of the International Accounting Standards Board and of its predecessor, the International Accounting Standards Committee, Governmental Accounting Standards Board (GASB) Statements, Interpretations and Technical Bulletins, Federal Accounting Standards Advisory Board (FASAB) Statements, Interpretations, and Technical Bulletins, pronouncements of other professional associations or regulatory agencies, Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids, and accounting textbooks, handbooks and articles. The use of those other sources depends upon their relevance to the particular circumstances, the specificity of the guidance, and the general recognition of the author or issuing organization as an authority. This would mean that FASB publications in this category are to be considered more influential in establishing an acceptable accounting practice than an accounting textbook. Relying on guidance in this category requires the exercise of professional judgment and a broader search of literature sources than would be true in the other four categories.

Note, in particular, that the FASB Concepts Statements are not included in the levels A-D of the GAAP hierarchy, at present. Thus, the guidance in those statements do not take precedence over the various promulgated GAAP. Nonetheless, SAS 69 (current source of the hierarchy) identifies the Concepts Statements as the first of the group of other literature that should be consulted to guide practice in the absence of definitive guidance from a source explicitly cited in the hierarchy. The proposed adoption of a GAAP hierarchy by FASB, superseding that found in the current auditing literature, would effectively elevate the Concepts Statements to level A GAAP. (Note further that FASB is currently reviewing the six extant Concepts Statements with the announced intention of producing a new conceptual framework document.)

Readers should pay close attention to both the relocation of the GAAP hierarchy from the auditing to the accounting literature, and to the replacement of the GAAP hierarchy by the codification. If (as expected) the codification is approved by FASB, all GAAP references will change, not merely for new pronouncements, but for the entire extant body of GAAP. Future editions of this book will reflect such changes when they become official.

Materiality

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

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 FAS 131, *Disclosures about Segments of an Enterprise and Related Information*, 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 regarding their settlement can have a material impact on the enterprise's future profitability and, thus, are all examples of items that would not be capable of being evaluated for materiality based solely 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.)

The Crisis of Confidence Regarding GAAP

Over approximately the past decade, GAAP as a body of standards, and the standard-setting process itself, have increasingly come under attack. A notable string of accounting scandals unfolded in the late 1990s and early 2000s, and as one consequence the entire US financial reporting system was put under the microscope by the nation's leaders, the international financial community, the media, and the general public. What resulted was not only landmark legislation in the form of the Sarbanes-Oxley Act, but also a thorough and ongoing self-examination undertaken by all accountants—from CEOs to auditors to regulators to standard setters.

In 2001, Enron Corp., one of the world's biggest companies at the time, publicly acknowledged that it had failed to comply with existing accounting requirements in at least two areas—sales of stock to special-purpose entities (SPE) and nonconsolidation of certain SPE. This noncompliance caused material overstatements of assets, shareholders' equity, and net income, and the concealment of substantial debt obligations for several years. As a result, Enron's stock price fell to under twenty-five cents per share. As the ensuing events unfolded, public policy discussions and media criticisms of GAAP, of standard setting in the private sector, and of the accounting profession reached unprecedented levels. The criticisms centered primarily on the failure of financial statements to warn investors of the impending collapse of Enron, and on the lack of independence and objectivity of a self-regulating profession that offers both consulting and auditing services to its clients.

Numerous other high-profile business failures and accounting scandals also occurred or came to light during this period. Many involved aggressive accounting by large, formerly well-regarded entities. A watershed event was the revelation of massive $11 billion fraud by WorldCom, which led directly to the enactment of the far-reaching Sarbanes-Oxley Act.

The Sarbanes-Oxley Act of 2002. The result of these business failures and accounting scandals was the Sarbanes-Oxley Act, which included among its provisions the following sweeping changes:

1. Established the Public Company Accounting Oversight Board (PCAOB), to oversee the audits of public companies that are subject to the securities laws of the United States (referred to as "issuers") and to establish auditing, quality control, ethics, independence, and other standards relating to the auditing of the financial statements of issuers. Three of the five PCAOB members cannot be and must not have been certified public accountants.
2. Placed severe limits on an audit firm's ability to provide nonaudit services to its issuer audit clients.
3. Established a requirement that the CEO and the CFO of each issuer certify in each periodic report to the SEC
   a. The appropriateness of the financial statements and disclosures and
   b. That those financial statements and disclosures fairly present, in all material respects, the operational and financial condition of the issuer.
4. Required the SEC to conduct a study of off-balance-sheet transactions and the use of special-purpose entities, and to report its recommendations to Congress.
5. Required the GAO to conduct a study regarding the consolidation of public accounting firms since 1989, including the present and future impact of the consolidation, and the solutions to any problems it discovers.

Another important provision of the Sarbanes-Oxley Act, set forth in Section 404, increases corporate management's responsibility for assessing the effectiveness of internal control over financial reporting. Operational management, as well as financial management, must be more cognizant of their joint responsibility for quality financial reporting. Management's methods for assessing internal control will, and should, vary from company to company. Corporate management must assess the risk of material financial statement misstatement along two dimensions: (1) Inherent risk—the susceptibility of one or more financial statement assertions to a material misstatement, and (2) Fraud risk—the risk of material misstatement due to fraudulent financial reporting or theft of assets.

The principal regulatory focus of the Sarbanes-Oxley Act is on auditors and corporate management, which is appropriate because the Enron, WorldCom, and other scandals were primarily the result of management fraud and audit failures, rather than faulty accounting standards. However, there are several requirements of the Act that have the possibility of affecting GAAP and its standards setters.

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

Second, the Act requires that the SEC conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system. The study

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

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

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

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

If a principles-based approach were implemented by FASB, accounting standards would continue to be developed from the conceptual framework (which is currently under revision), but the principles would apply more broadly than under existing standards. That is, there would be fewer exceptions to the principles in the standards. In addition, FASB, EITF, and AICPA would provide less interpretive and implementation guidance for applying the standards because the overall principle would ostensibly provide the necessary foundation for the answer with such guidance being considered superfluous. Exceptions would be extremely limited under a principles-based approach. In addition, a principles-based approach requires accountants to exercise good professional judgment and to resist the urge to seek specific answers and rulings on every implementation issue. It also would require that the SEC and users of financial information accept the consequences of applying professional judgment, which means there would undoubtedly be some divergence in practice, resulting in some loss of comparability of the financial statements of reporting enterprises.

FASB issued for public comment a proposal for a principles-based approach to US standard setting in 2002, followed by a public roundtable meeting with respondents to the proposal. Many respondents agreed on the need for standards that emphasize principles over detailed rules and report the economic substance of transactions or events. However, many concluded that complex rules are primarily driven by increasingly complex economic transactions (e.g., the explosive growth in the use of hedging and financial derivatives), and that there is no way to return to a simpler time or to simpler GAAP. Also, many respondents expressed concern about using principles-based standards in the current legal and regulatory environment. The well-known penchant for litigation means that, as former Federal Reserve Board Chairman Paul Volcker observed, "(T)he American tradition is to have clear and definite rules, so firms can defend themselves from the hoards of lawyers who stand ready to sue auditors for making a bad judgment."

As of early-2009, it appears that the debate over rules- or principles-based standards may be implicitly resolved by either the full convergence of US GAAP with IFRS or, in what was formerly thought to be unlikely but which is now deemed to be a very real possibility, having IFRS supersede US GAAP. The fact that well over 100 other nations have opted to endorse IFRS (at least for publicly held companies' financial reporting), with as many as another 50 taking steps to have IFRS supersede their respective national GAAP regimes, coupled with the possible granting of permission for IFRS-based reporting by US companies registered with the SEC, makes this further development increasingly probable, in the authors' view.

Standards overload. The recent criticisms of rules-based standards join earlier criticisms about the complexity of accounting standards. Some accountants complain about "standards overload," saying that there are too many accounting standards, which are individually too complex to be understood and implemented, and that too many organizations (SEC, FASB, EITF, AICPA, etc.) are empowered to issue these pronouncements. Complaints regarding standards overload are not new, and with about 163 FASB Statements and myriad other standards (including hundreds of EITF Issues), these complaints must be given credence. However, the solution, if there is one, is not obvious. Nor is it clear that financial reporting frauds, audit failures, or other such phenomena have been the result of this overload. Overwhelmingly, frauds result from the deliberate misapplication of GAAP, and not from an inability on the part of preparers and auditors to comprehend the requirements of the standards.

Some say that a solution would be to reduce and simplify GAAP, especially for entities having characteristics suggesting that the risk of misleading the users of the financial statements might be low. For example, some recommend a size test, with smaller entities following a subset of the standards that are mandated for larger entities (a system now used in the UK, and being proposed by IASB as well). Even this simple suggestion has complications, however; size could arguably be determined by assets, revenues, net worth, or number of owners. Others recommend that public entities, regardless of size, follow a more comprehensive set of standards than privately owned businesses.

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

This so-called "big GAAP vs. little GAAP" debate has raged off and on for many decades. When advocates of differential standards are challenged, however, they typically have been unable to identify alternative recognition or measurement principles for large (or public) entities vs. those for smaller (or privately held) entities. Generally, at best, certain disclosures are cited as candidates for slimming down in financial statements of the smaller or private companies. The proposed IASB standard for nonpublicly accountable reporting entities (inaccurately being referred to as smaller and medium-sized entities) would eliminate some alternative but acceptable practices, but would nonetheless allow those entities access to the full range of acceptable practices if so desired. In short, there may be less than meets the eye to this entire controversy.

In fact, the FASB has endeavored in recent years to offer somewhat differentiated standards for disclosures. FAS 126 exempts nonpublic companies from certain financial instrument disclosures if the entity's total assets are less than $100 million and the entity has not held or issued any derivative financial instruments. Nonpublic companies also are not required to disclose earnings per share (FAS 128), segment information (FAS 131), or certain pension and postretirement information (FAS 132R). These exemptions have not, however, been widely hailed as representing significant progress against the perceived problem of standards overload.

To obtain better insight into these issues, in early 2004, the AICPA formed a Private Company Financial Reporting Task Force and charged it with conducting empirical research on the needs of preparers and users of private company financial statements and how well GAAP was meeting those needs, and developing recommendations based upon the results of the study.

The results of its research were mixed. As should have been expected, there were significant perceptual differences between the owner/managers of reporting entities, independent CPA practitioners, and external users. For example, when asked if they would consider it useful for GAAP reporting to be different in certain respects for small companies, the owner/managers' "yes" responses averaged between 57% and 62% (depending on size of their companies), the practitioners' responses between 73% and 77%, the sureties 44%, investors/venture capital firms 46%, and lender/creditors 69%. These results show the tension that exists in the marketplace between financial statement users' voracious needs for information provided for their decision-making purposes on the one hand, and the expense borne by the reporting entities responsible for preparing those financial statements and for obtaining independent assurance on them on the other hand.

The results of the Task Force's research indicated a moderately high to high rating regarding the overall value of GAAP financial statements to users (primarily lenders, sureties, and equity investors). However, many GAAP accounting or disclosure requirements were rated low by all of the constituents with respect to relevance or usefulness in decision making. These included such topics as pension and postretirement plans; variable interest entities, and share-based payments (FAS123[R] had not yet become effective when the survey was conducted). Based on this and other data revealed by their study, the Task Force concluded that these particular requirements were not meeting the needs of the various constituents of private company reporting and that this would support the need for development of differential GAAP.

In the authors' opinion, this conclusion is based on incomplete information, and we believe that if a similar research study were conducted by polling preparers, auditors, and users of large and public company financial statements, most or all of these same GAAP requirements would be identified as being of limited relevance and usefulness. That is, the authors believe the fundamental problem to be more universal than just "big GAAP/little GAAP." A more holistic reexamination of the GAAP reporting model is necessary in the light of an environment that includes such rampant abuses as earnings manipulation and many other visible failures of GAAP financial statements to fully and truthfully inform stakeholders about the precariousness of their investments.

In addition to the recommendation regarding differential GAAP, the Task Force also recommended changes to the standard-setting model to address the needs of private companies and offered alternatives such as

- Changing the composition of FASB and the Financial Accounting Foundation (FAF) to increase participation from the private company financial statement community
- FAF establishment of a private company standards setter under its jurisdiction
- Creation of a private company standards setter outside the jurisdiction of the FAF

In early 2008, certain of these changes came to fruition, when FAF announced that, as of mid-2008, membership of FASB was to be reduced to five from seven, with simple majority voting being retained. The issue of greater involvement by the financial statement community has been dealt with, in a fashion, by requiring that board members possess investment experience broadly defined. The membership of the oversight body, FAF, is to be optionally increased, and the number and breadth of organizations invited to nominate their trustees will be expanded.

FASB initiatives. In 2002, FASB embarked on a multiple-year, phased initiative to simplify and codify GAAP and make it more easily searchable and retrievable. As noted above, this effort has resulted in a draft codification being made available for user testing in 2008, with implementation now promised for mid-2009.

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

FASB also wants to more thoroughly assess the cost-benefit relationships of proposed standards; presumably, complex standards are more costly to implement, and thus the costs are more likely to outweigh the expected benefits to users. If so, enactment would be less probable. To understand the costs of a proposed standard, FASB intends to actively engage its constituents in a discussion of the costs as a formal step in the Board's due process. To understand more fully the benefits of a proposed standard, FASB has created a User Advisory Council, a group of forty professionals representing a variety of investment and analytical disciplines, which will be consulted on specific projects as well as helping the Board formulate its overall agenda. During 2004, FASB also established a Small Business Advisory Committee (SBAC) in order to obtain additional needed input from its small business constituents.

In 2005, the FASB and AICPA separately issued Exposure Drafts proposing to move the nongovernmental GAAP Hierarchy, discussed earlier in this chapter, from the auditing literature to the accounting literature. In connection with this change, the Exposure Drafts also designated FASB Staff Positions (FSP) and Derivatives Implementation Group Issues (DIG) as "Level A" GAAP. This resulted in FAS 162, issued in May 2008.

FASB acknowledged that this standard is only transitional in nature. Its long-range plan is to reduce the number of levels in the hierarchy to just two, authoritative and nonauthoritative, and this will be achieved when the codification is finally promulgated. In addition, at the conclusion of its current projects on codification and retrieval and on its conceptual framework, FASB expects to address any inconsistencies in guidance that make the current four-tier structure necessary and to address the role of its Statements of Financial Accounting Concepts in the hierarchy.

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

IASB initiatives. While the debate in the US continues over the need for simplified "small GAAP," the international standard setter, IASB, has proposed a comprehensive standard that would (much like an earlier, and apparently successful, UK GAAP initiative) capture the key guidance for entities having no public reporting responsibilities (of whatever size), streamlining some existing standards and culling alternatives that are deemed, for whatever reason, nonapplicable to these nonpublic reporting entities. A controversial proposal, the Exposure Draft (available at www.iasb.org/Current+Projects/IASB+Projects/Small +Mediumsized+Entities/Exposure+Drafts+forSmall+Mediumsized+Entities.htm) was open for comments until October 1, 2007, and is still being debated as of early-2009. It is highly likely that the SME proposal, or a close approximation thereof, will be enacted before year-end 2009. The strongest argument against this (or any similar) proposal is that it is the natures of the business transactions (e.g., those involving derivatives, guarantees, compound instruments having attributes of debt and equity) that should dictate the required accounting, and that even smaller or nonpublic entities engaging in such transactions should be bound by proper financial reporting standards. On the other side of the argument are those who claim that modern GAAP has become too complex for preparers, auditors, and users, particularly when addressing financial statements of smaller, less-sophisticated companies, thus justifying the use of streamlined standards.

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

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

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

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

In two recent cases, dissatisfaction with proposed standards escalated to the point where the business community asked the federal government to intervene. When, in the mid-1990s, FASB proposed that the value of stock options granted to employees be reflected as an expense in the financial statements, the business community, and particularly technology firms, loudly claimed that the proposed recognition would have a dramatic and negative economic effect. First, the argument went, it would force them to discontinue issuing stock options, which would prevent the companies from compensating valuable employees. Second, to the extent options were granted and reflected in expense, it would cause the firms' costs of capital to increase significantly because of lower levels of reported profitability. Finally, it would put US firms at a competitive disadvantage to foreign companies that did not have to expense the value of stock options (or were not offering this benefit to employees).

Before that battle ended, "sense of the House" and "sense of the Senate" resolutions had been introduced, objecting to FASB's tentative conclusions, and a bill had been introduced that would have, if enacted, precluded the recognition of the value of stock options as an expense as a matter of law. This debate threatened not only the stock-based compensation standard, but also the future of accounting standard setting in the private sector itself. That concern contributed to FASB's decision to issue FAS 123 with only a requirement for disclosure of the value of stock options, with recognition and measurement optionally continuing under prior (APB 25) rules. Not surprisingly, virtually all publicly held companies continued to utilize the "implicit value" approach of APB 25, even though FAS 123 clearly stated that the "fair value" approach was preferable GAAP. (Interestingly, after the Enron and WorldCom scandals, and the resulting Sarbanes-Oxley legislation, some companies began to voluntarily expense options, and FASB responded by issuing an Exposure Draft in March 2004, later finalized as FAS123(R), that requires companies to expense share-based compensation.

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

The Business Reporting Research Project

Beginning in 1998, FASB undertook research on business reporting (which has been defined to include both financial and nonfinancial information), with the goal of identifying the types of information businesses were already voluntarily providing, and the means used to deliver it.

FASB produced four reports setting forth results of this project as follows:

1. *Update of Electronic Distribution of Business Reporting Information—Survey of Business Reporting Research Information on Companies' Internet Sites (May 2002)*, an update of the report issued in 2000, which describes the reporting of business information over the Internet and identifies notable practices.
2. *Improving Business Reporting: Insights into Voluntary Disclosures* (January 2001), which identifies the kinds of business information that corporations in eight selected industries are reporting outside of their financial statements.
3. *GAAPSEC Disclosure Requirements* (March 2001), which identifies redundancies between GAAP and SEC disclosure requirements and ways to eliminate them.
4. *Business and Financial Reporting: Challenges from the New Economy* (April 2001), which examines the perceived "disconnect" between information provided in financial statements ("old economy" financial reporting) and the information needs of investors and creditors ("new economy" financial reporting).

The FASB business reporting research project appears, as of early-2009, to no longer be an active undertaking.

Other projects and proposals have followed, produced by accounting standards-related bodies and others, including a number of private-sector and academic proposals worthy of attention. Most recently, a far-reaching set of changes to financial reporting has been proposed by the CFA Institute (*A Comprehensive Business Reporting Model: Financial Reporting for Investors* [draft, October 2005], which, among other things, strongly endorses universal use of fair value information). However, to this date, there have been no fundamental changes in financial reporting requirements or expectations. Perhaps the most promising currently ongoing effort is FASB's *Financial Statement Presentation* (originally, *Financial Performance Reporting*) project, preliminary views on which are expected to be unveiled in late 2008. A joint undertaking with the International Accounting Standards Board (IASB), this is intended to establish standards for the presentation of information in financial statements that would improve the usefulness of that information in assessing the financial performance of an entity.

This project is to focus on form and content, classification and aggregation, and display of specified items and summarized amounts on the face of the financial statements. That includes determining whether to require the display of certain items determined to be key measures or necessary for the calculation of key measures. The project will not address management discussion and analysis (MD&A found in SEC filings) or the reporting of pro forma earnings in press releases or other communications outside financial statements. Also, it will not address segment information or matters of recognition or measurement of items in financial statements. As of mid-2008, a number of tentative decisions have been made by FASB and IASB, but much work remains to be done on this project.

This project is discussed in somewhat more detail in Chapter 3.

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 act of defining a problem provides a large fraction of the solution to 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 circumstances are anticipated, more deliberate attention can be directed at finding the correct solution, and certain proposed transactions having deleterious reporting consequences might be avoided altogether or structured more favorably.
- If little is known about the subject area, it may be useful to consult general reference sources (e.g., *Journal of Accountancy, CPA Journal, 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.
- With the ongoing process of convergence with IFRS (and possible IFRS adoption) a reality, it will be wise to consider not merely short-term implications under US GAAP, but longer-term potential ramifications if changes are made to existing GAAP.

Step 2: Analyze the Problem

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

Step 3: Refine the Problem Statement

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

Step 4: Identify Plausible Alternatives

- Plausible alternative solutions are based upon prior knowledge or theory.
- Additional alternatives may be identified as steps 5-7 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 authorities or literature need to be searched. Often it will be necessary to search all authoritative literature (FASB, EITF, SEC, AICPA, etc.) as well as current reporting practices (e.g., annual reports).
- 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
  - 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.

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 authoritative sources of GAAP. Begin with the publications that set forth the accounting standards in the GAAP hierarchy—the FASB, the AICPA, and the EITF (and for public companies, the SEC).

FASB publishes both loose leaf and bound sets of books, as well as CDROMs, of the *Current Text* and the *Original Pronouncements*. The former integrates all of the currently recognized category A GAAP alphabetically in topic order (e.g., Accounting Changes, Business Combinations, etc.). The AICPA Research Bulletins, APB Opinions, and FASB Statements and Interpretations have been combined in this integrated document. Supplemental guidance from the AICPA Accounting Interpretations and FASB Technical Bulletins is also incorporated. All these materials have been edited down from the original pronouncements and thus may lack the precision that can be obtained only from the unedited version. Each paragraph in the *Current Text* is referenced to the pronouncement from which it is drawn, which is useful for research or follow-up. The first volume of the *Current Text* deals with general standards, while the second contains standards for specialized industries. Descriptive materials, including reasons for conclusions, are absent from the *Current Text*.

The *Original Pronouncements* contains all of the AICPA Accounting Research Bulletins, APB Opinions, the FASB Standards, Interpretations, Concepts Statements, and Technical Bulletins. Paragraphs containing accounting principles that have been superseded or dropped are shaded to alert the user. All changes are identified in detail on a status page placed at the beginning of each pronouncement, which can also assist the user in finding other relevant materials.

Generally, if a quick answer to a specific question is needed, the *Current Text* can be accessed readily. If a fuller understanding of the answer and the reasons underlying it are required, the *Original Pronouncements* may be preferable. In many cases, both sources should be consulted.

FASB also publishes the *EITF Abstracts* (category C GAAP). Each EITF issue discussed by the Task Force is included in the book, regardless of whether a consensus was reached, in the order in which they were added to the EITF agenda. A status section at the end of each issue indicates whether the consensus has been superseded or remains relevant and whether any additional EITF discussion is planned. Many issues are discussed a number of times, and in some cases consensuses are withdrawn or modified in subsequent considerations of a given issue. Accordingly, care must be exercised because, unlike FASB Statements, for example, issues addressed in EITF consensuses can evolve without adequate notice that they have been affected by subsequently issued standards.

EITF Abstracts also includes EITF Discussion Issues, which are FASB or SEC staff announcements of positions taken on issues that have yet to be resolved, or even addressed, by the EITF or other standard-setting bodies. While not within the GAAP hierarchy, these do represent current thinking on the particular topic and should be given due consideration in resolving practice problems. The more important of these are covered in this book.

FASB staff issues application guidance (like that found in FASB Staff Implementation Guides and EITF Discussion Issues) through FASB Staff Positions (which it intends to belong to category A GAAP). The staff positions are initially communicated through the FASB Web site (www.fasb.org) and remain there until incorporated into printed FASB literature. FASB staff positions are answers to questions about appropriate application of FASB literature expected to be of widespread relevance to constituents and for which the FASB staff believes that there is only one acceptable answer. The more important of these are covered in this book.

The AICPA publishes all its outstanding Statements of Position and Practice Bulletins in *AICPA Technical Practice Aids.* That book is organized in a manner similar to FASB's *Original Pronouncements*, with the SOP and Practice Bulletins included in the order in which they were issued. There are 26 audit and accounting guides, which are listed at the front of this publication following the AICPA Statements of Position. These publications are available in soft-cover, loose-leaf binder, and electronically on the Internet or CD-ROM.

There are also several commercial services that provide electronic Web-based access to all promulgated GAAP. The great advantage of electronic access is that information can be randomly accessed, so a search by topic will yield a plethora of potentially useful leads. The "fuzzy search" option is quite forgiving of poorly articulated search terms, most often leading the researcher to relevant materials even when the seeker is not clear about what is actually being sought.

Researching using *Wiley GAAP Codification Edition*. 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 authoritative pronouncements related to the topic so that these can be appropriately understood and cited in documenting your research findings and conclusions. Upon identifying these pronouncements, refer to the Authoritative Accounting Pronouncements section preceding this chapter, which lists all authoritative pronouncements currently in effect in numerical order. The listed pronouncements are referenced both to the *Current Text* published by FASB and to pages in this publication. Using this list, one can crossreference to or from this publication to both the original pronouncements and/or the *Current Text*. Likewise, the reader familiar with the professional literature can use the listing of authoritative accounting pronouncements 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.

The current status of each EITF Issue is indicated—that is, whether superseded, resolved, or consensus reached by the EITF, or whether further discussion is pending. Explanations of EITF Issues are integrated in the chapter text to facilitate a logical flow, enhance readability, and increase the likelihood that the researcher will find the information relevant to his or her issue logically grouped together in the most easily retrievable manner.

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" to be used when sources at levels A through D do not exist, 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.)

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

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

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

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

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

Internet-based research sources. There has been and continues to be an information revolution affecting the exponential growth in the volume of materials, authoritative and nonauthoritative, that are available on the Internet. A listing of just a small cross-section of these sources 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
WebCPA	http://www.webcpa.com	Breaking news regarding the profession, links to regulators, taxing agencies, associations, and agencies

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

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

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

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

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

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

Paragraph 40 of CON 6 provides further insight. It states

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

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

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

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

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

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

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

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.*

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

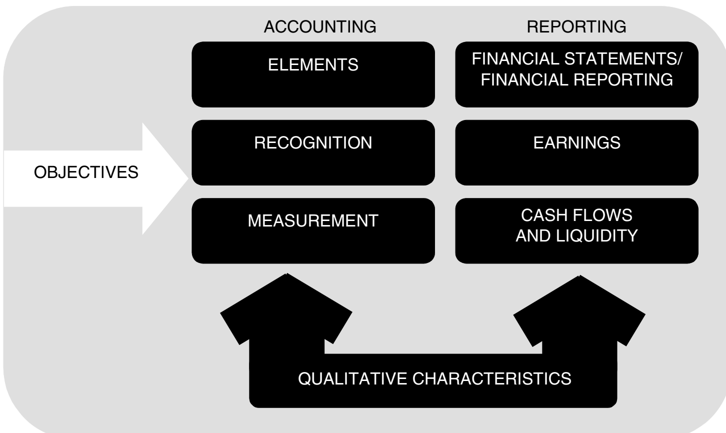
Components of the conceptual framework. The components of the conceptual framework for financial accounting and reporting include objectives, qualitative characteristics, elements, recognition, measurement, financial statements, earnings, funds flow, and liquidity. The relationship between these components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

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

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

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

Conceptual Framework
for Financial Accounting and Reporting



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

A 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.

FASB is currently pursuing several projects affecting the conceptual framework and the GAAP hierarchy. As to the latter, FASB expects to revise the existing hierarchy, now consisting of four levels or categories (plus a catchall fifth level of nonpromulgated guidance, such as from textbooks or scholarly writings, but also including the concepts statements) to a dichotomy between authoritative and nonauthoritative guidance. In the near term, FASB intends to elevate concepts statements to "level A" GAAP. This is indicative of a greater awareness of the relevance of the concepts statements as guidance for making accounting decisions. As numerous older accounting standards have evolved and been superseded by new requirements, such as mandates for the wider use of fair value information within the financial statements, the principles espoused in CON no longer seem as divergent from actual practice, and may more usefully serve as actual, authoritative guides to practice.

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 include 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:

- **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.

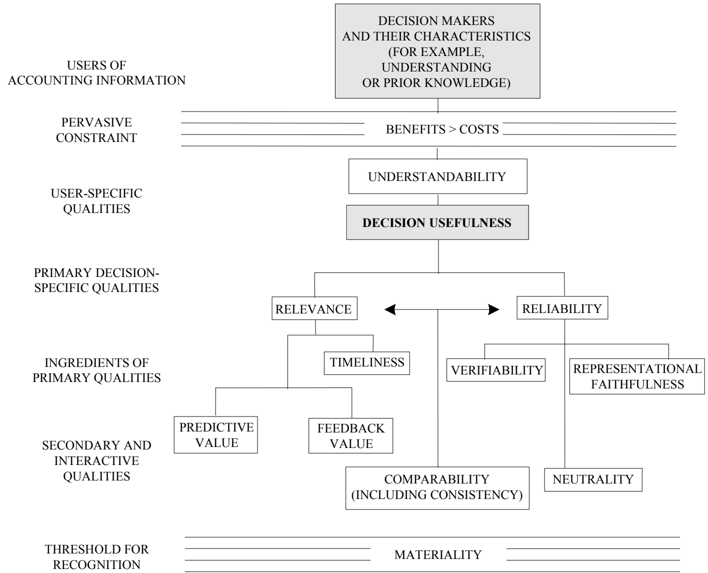
CON 2: Qualitative Characteristics of Accounting Information

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.

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.

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

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

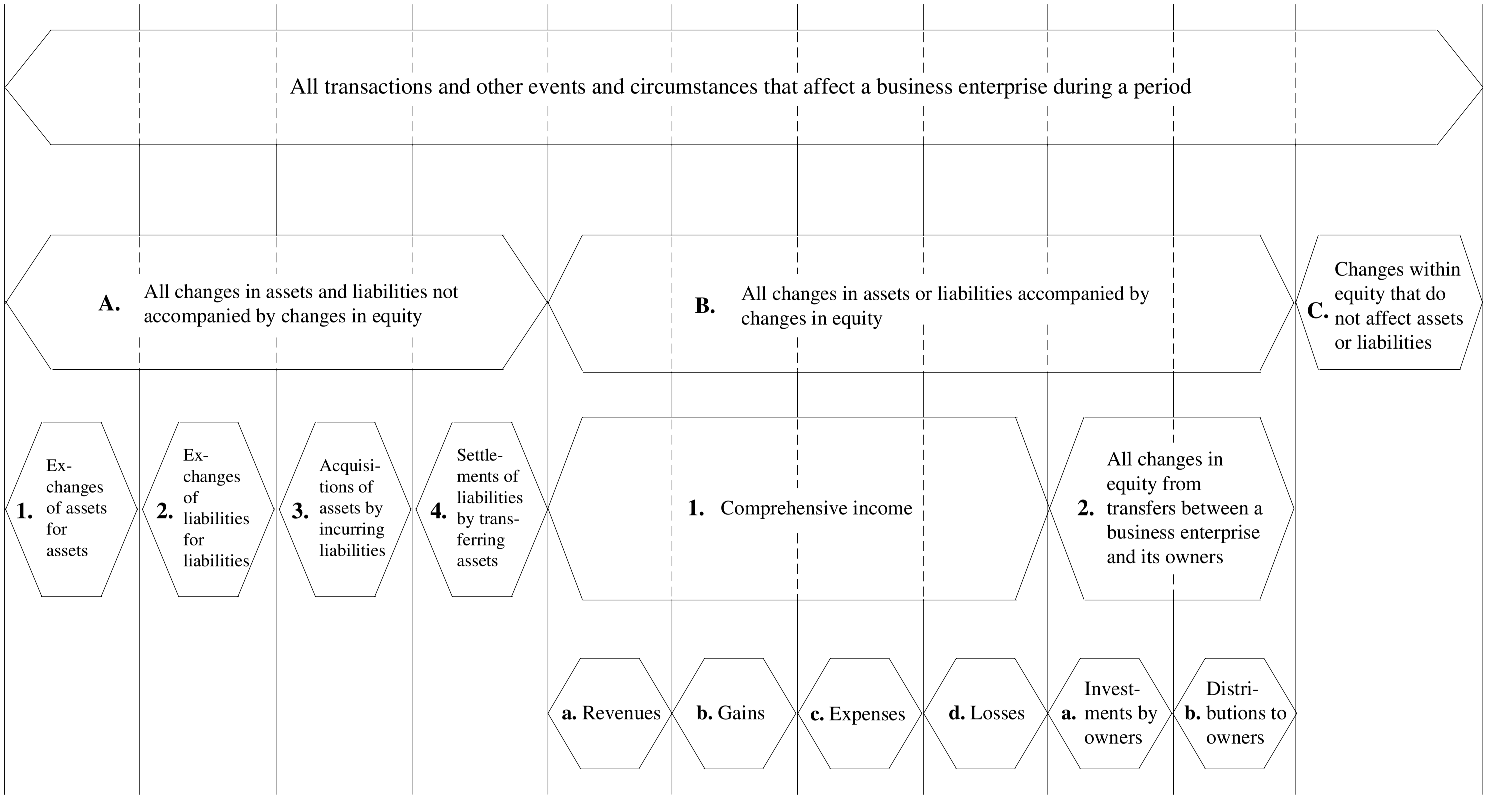
9. Investments by owners—Increases in equity of a particular business enterprise resulting from transfers to it for the purpose of increasing ownership interests
10. Distributions to owners—Decreases in the equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities to owners

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 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.


All transactions and other events and circumstances that affect a business enterprise during a period
A. All changes in assets and liabilities not accompanied by changes in equity
B. All changes in assets or liabilities accompanied by changes in equity
C. Changes within equity that do not affect assets or liabilities
1. Exchanges of assets for assets
2. Exchanges of liabilities for liabilities
3. Acquisitions of assets by incurring liabilities
4. Settlements of liabilities by transferring assets
1. Comprehensive income
2. All changes in equity from transfers between a business enterprise and its owners
a. Revenues
b. Gains
c. Expenses
d. Losses
a. Investments by owners
b. Distributions to owners

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, 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

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.

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

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

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

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 $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 \times .8 + 80{,}000 \times .2)/(1 + .05)^{20}$]
4. Asset D has a present value of $37,689 [$(\$120{,}000 \times .25 + 100{,}000 \times .5 + 80{,}000 \times .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 \times .25 + 100{,}000 \times .5 + 80{,}000 \times .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.

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 14 subcategories, numbered from 205 (for Presentation of Financial Statements) to 280 (for Segment Reporting). The entire numbering system is noted in Appendix C.

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 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. If the resulting set of links are too voluminous, then use the Narrow by Topic option on the right side of the page. This option allows the researcher to reduce the number of selections to only certain topic areas. For example, to determine the appropriate presentation of cash on the balance sheet, search on the word Cash, and then narrow the selection to just the Presentation topic, and then narrow further to just the Balance Sheet subtopic.
- *Advanced search.* The most detailed researching method is the Advanced Search option, which is located below the search bar in the upper right corner of any site page. The resulting search page reveals a combination of options; the researcher can use text, Codification numbers, document titles, and topics to prepare a more refined search.

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