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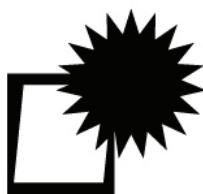
**Barry J. Epstein**  
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# **GAAP Codification Enhanced**

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Barry J. Epstein  
Ralph Nach  
Steven M. Bragg



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## PREFACE

*GAAP 09: Codification Edition* provides analytical explanations and copious illustrations of all current generally accepted accounting principles. The book integrates principles promulgated by all the relevant standard-setting bodies—the FASB, including its Emerging Issues Task Force’s consensus summaries and discussion issues and staff positions, and the AICPA’s Accounting Standards Executive Committee (AcSEC),

With the completion and public release of the FASB’s codification project, virtually all extant U.S. GAAP has been superseded by a unified, codified set of standards. All such guidance is now presented in a single, integrated set of materials, and former individual standards, interpretations, and other requirements are to be withdrawn. This book represents a complete integration of the new Accounting Standards Codification (ASC) references into the Wiley GAAP reference work that is now in its 25<sup>th</sup> annual edition.

The principal intended audience for the book is the practitioner, with the primary objective being to assist in resolving the myriad practical problems faced in applying GAAP. Accordingly, meaningful, realistic examples abound, guiding users in the application of GAAP to complex fact situations that must be dealt with in the real world practice of accounting. In addition to this emphasis, a major strength of the book is that it does explain the theory of GAAP in sufficient detail to serve as a valuable adjunct to accounting textbooks. Much more than merely a reiteration of currently promulgated GAAP, it provides the user with the underlying conceptual bases for the rules, in order to facilitate the process of reasoning by analogy that is so necessary in dealing with the complicated, fast-changing world of commercial arrangements and transaction structures. It is based on the authors’ belief that proper application of GAAP demands an understanding of the logical underpinnings of all its technical requirements.

Each chapter of this book, or major section thereof, provides an overview discussion of the perspective and key issues associated with the topics covered; a listing of the professional pronouncements which guide practice; and a detailed discussion of the concepts and the accompanying examples. A comprehensive disclosure checklist, following the main text, offers practical guidance to preparing financial statements in accordance with GAAP, with supplemental insights into SEC-mandated disclosures as needed. Also included is a comprehensive comparison of GAAP to International (IFRS) standards, increasingly the norm for entities reporting outside the US, and soon, for U.S.-based entities as well.

The authors’ wish is that this book will serve preparers, practitioners, faculty, and students, as a reliable reference tool to facilitate their understanding of, and ability to apply, the complexities of the authoritative literature. Comments from readers, both as to errors and omissions and as to proposed improvements for future editions, should be addressed to Barry J. Epstein, c/o John Wiley & Sons, Inc., 155 N. 3rd Street, Suite 502, DeKalb, Illinois 60115.

Barry J. Epstein  
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March 1, 2009



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## DEVELOPMENT OF GAAP

### What Is GAAP?

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

Generally accepted accounting principles (GAAP) are concerned with the measurement of economic activity, the time when such measurements are to be made and recorded, the disclosures surrounding this activity, and the preparation and presentation of summarized

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

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

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

### **Who Created GAAP?**

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

**Committee on Accounting Procedure.** The first serious attempt to create formalized generally accepted accounting principles began in 1930, primarily as a consequence of the stock market crash of 1929 and the widespread perception that an absence of uniform and stringent financial reporting requirements had contributed to the rampant stock market speculation of the preceding decade that culminated with that crash. (Previously, GAAP had largely been defined by academic writings and general industry practices.) The American Institute of Accountants, (which in 1957 was renamed the American Institute of Certified Public Accountants [AICPA]), created a special committee to work with the New York Stock Exchange toward the goal of establishing standards for accounting procedures. The special committee recommended five rules to the Exchange that were published in 1938 as Accounting Research Bulletin (ARB) 1 of the Committee on Accounting Procedure. The Committee subsequently published 51 such bulletins, including Accounting Research Bulletin 43, which consolidated and superseded Bulletins 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 find-

ings, 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.<sup>1</sup> 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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<sup>1</sup> *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 re-deliberate 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<sup>2</sup>

- 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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<sup>2</sup> *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:*

- 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. Manage-