100 Introduction

100.1 In many places in this *Guide*, reference is made to the “basic financial statements.” Likewise, the term “Generally Accepted Accounting Principles” (GAAP) is frequently used. This chapter defines the two terms and discusses applying GAAP and other professional standards while preparing financial statements.

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101 Basic Financial Statements

101.1 The concept of “basic financial statements” is important because the basic financial statements represent what is generally accepted as the end product of a company's financial accounting process. This *Guide* is designed to assist accountants in preparing the basic financial statements and other financial information that may be presented with the basic financial statements.

101.2 At the present time, GAAP does not define what comprises a complete set of basic financial statements for business entities. (GAAP does, however, address the components of a complete set of financial statements for certain specific types of entities such as nonprofit organizations and employee benefit plans.) Although it is not authoritative, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts (SFAC) No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses the contents of a full set of financial statements. According to Paragraph 13 of SFAC No. 5, a full set of financial statements should present the following:

- Financial position at the end of the period.

- Earnings (net income) for the period.

- Comprehensive income (total nonowner changes in equity) for the period.

- Cash flows for the period.

- Investments by and distributions to owners during the period.

101.3 This *Guide* discusses the following basic financial statements in separate chapters with each chapter including detailed guidance on the form of the statement and on applying GAAP to specific accounts in the statement:

- The balance sheet (Chapter 3).

- Statements of income and comprehensive income (Chapter 4).

- Statements of retained earnings and stockholders' equity (Chapter 5).

- The statement of cash flows (Chapter 6).

- Notes to financial statements (Chapter 7).

101.4 Additionally, Chapter 8 discusses supplementary information, other financial information, additional information, and similar items that are presented along with the basic financial statements but are not required for a fair presentation in conformity with GAAP and are not a part of the basic financial statements. Also, Chapter 9 discusses preparing financial statements on a basis of accounting other than GAAP.

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102 An Overview of Standards

102.1 Standards of the accounting profession are established by the American Institute of Certified Public Accountants (AICPA) and the FASB. As they relate to financial statement engagements, standards of the accounting profession may be classified into five general categories:

a. Generally accepted accounting principles (GAAP)

b. Performance standards

c. Reporting standards

d. Quality control standards

e. Ethics standards

GAAP

102.2 Generally accepted accounting principles (GAAP) apply to all financial statements (unless they are prepared on an other comprehensive basis—see Chapter 9) and are relevant to all accountants (whether in industry or public accounting) who are concerned with producing meaningful financial statements. GAAP is discussed in more depth in section 103.

Performance Standards

102.3 Performance standards are the principles and procedures that a CPA in *public accounting* must follow when associated with the financial statements (or, in some cases, financial information that is less than complete financial statements) of a client. In general, the extent of procedures is related to the level of assurance the CPA will express on the financial statements.

102.4 There are three basic services that CPAs in public practice render with regard to financial statements. In order of highest assurance to lowest assurance, they are:

- audit,
- review, and
- compilation.

102.5 Discussion of performance standards is beyond the scope of this *Guide*. The following other guides in the PPC library provide practical guidance on performance standards: [1]

- *PPC's Guide to Audits of Nonpublic Companies*
- *PPC's Guide to Compilation and Review Engagements*

Reporting Standards

102.6 Reporting standards also apply only to CPAs in public practice. (See, however, section 204 for guidance on CPAs in industry who issue reports on their employers' financial statements.) They differ for each level of service—audit, review, or compilation. Reporting standards are also outside the scope of this *Guide* and are covered by the following PPC guides:

- *PPC's Guide to Auditor's Reports*
- *PPC's Guide to Compilation and Review Engagements*
- *PPC's Guide to Single Audits*

Quality Control Standards

102.7 Quality control standards of the profession relate to the internal system that a CPA firm uses to provide itself with reasonable assurance of meeting its responsibility to conform with professional standards in all financial statement engagements. Each of the elements of quality control and illustrative policies and procedures are covered in *PPC's Guide to Quality Control*.

Ethics Standards

102.8 The principles and rules of the AICPA *Code of Professional Conduct* and related ethics interpretations and rulings govern the conduct of all AICPA members. The *Code of Professional Conduct* provides guidance and rules to members in public practice, industry, government, and education in the performance of their professional responsibilities. Based on an Ethics Interpretation at ET 91, AICPA members are responsible for the conduct of all individuals that are associated with their public accounting practices. As a result, the *Code of Professional Conduct* also applies to non-AICPA members who are under a member's supervision or are partners or shareholders in a member's practice.

102.9 The *Code of Professional Conduct* consists of two sections: (a) the principles and (b) the rules. The principles provide the framework for the rules, which govern the performance of professional services by AICPA members. In addition, ethics interpretations and rulings provide guidance in specific circumstances and should be consulted if a member has a question about a particular rule.

102.10 All CPAs should also be familiar with the ethical standards of their state CPA society, state board of accountancy, and other applicable regulations.

Summary

102.11 In preparing financial statements, accountants (whether in public practice or industry) are concerned primarily with applying generally accepted accounting principles. (See section 103.) Performance and reporting standards generally only apply to accountants in public practice, vary with the level of service offered, and are beyond the scope of this *Guide*. Quality control standards are used by nearly all accountants. Similarly, the *Code of Professional Conduct* has a direct effect on all AICPA members, whether in public practice or in industry.

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[1] The Tax and Accounting business of Thomson Reuters also has many industry-specific guides (e.g., *PPC's Guide to Construction Contractors*) that provide both performance and reporting guidance for financial statements in specialized areas.

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103 Generally Accepted Accounting Principles (GAAP)

Why Is GAAP Important?

103.1 Generally accepted accounting principles are applicable to all financial statements [except statements presented on an other comprehensive basis of accounting (see Chapter 9)] and are important to accountants in industry as well as accountants in public practice. [2] But why?

103.2 Accountants in public practice give varying degrees of assurance on the financial statements with which they are associated. That assurance is expressed in terms of whether the statements are, in all material respects, presented in conformity with generally accepted accounting principles. Thus, a thorough knowledge of GAAP is critical.

103.3 Industry accountants also are concerned with preparing financial statements in accordance with GAAP for several reasons:

- Ethics Interpretation 203-4 (ET 203.05) states that Rule 203 of the AICPA *Code of Professional Conduct* applies to all members, thus clarifying that members in industry may not represent to auditors, regulators, creditors, or others that the company's financial statements are prepared in accordance with GAAP when the statements contain GAAP departures.

- Some third-party users of financial statements lose confidence in company-prepared financial statements if they contain material departures from GAAP.

- GAAP generally reflects economic reality. Financial statements presented in conformity with GAAP generally provide management with one of its best tools. In contrast, departures from GAAP may mislead an owner or manager of a closely held business.

• Financial statements prepared in conformity with GAAP are a sign of professionalism that most industry accountants value.

The FASB Accounting Standards Codification

103.4 The FASB Accounting Standards Codification (FASB ASC or the Codification) is the single source of authoritative accounting principles recognized by the FASB to be used by nongovernmental entities when preparing financial statements in accordance with GAAP in the United States. [3]

103.5 Except for certain grandfathered standards (see further discussion of those standards at paragraph 103.7), non-SEC accounting literature that is not contained in the Codification is considered nonauthoritative. In creating the Codification, the FASB arranged the existing sources of historical GAAP, such as Statements of Financial Accounting Standards (SFASs), Statements of Position (SOPs), and other pronouncements into a topical structure maintained in an online research platform. The Codification superseded those prior sources of accounting standards.

103.6 All guidance in the Codification is deemed to have the same level of authority. If the accounting treatment for a transaction or event is not covered by a source of authoritative GAAP for a reporting entity, the entity should first consider accounting principles for similar transactions or events within a source of GAAP applicable to the entity before giving consideration to nonauthoritative guidance from other sources. Nonauthoritative accounting guidance and literature includes the following:

• Practices widely recognized and generally prevalent or prevalent in the industry.

• FASB Concepts Statements.

• AICPA Issues Papers.

• International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB).

• Pronouncements of professional associations or regulatory agencies.

• Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids.

- Accounting textbooks, handbooks, and articles.

Entities are prohibited from following the accounting treatment specified in accounting guidance for similar transactions or events in situations where the accounting principle prohibits its application to the particular transaction or event or where the accounting principle indicates it should not be applied by analogy.

103.7 **Grandfathered Guidance**

Prior to the Codification, the sources of generally accepted accounting principles were categorized in a hierarchical structure with differing levels of authority. The structure consisted of levels (a) through (d) with level (a) having the highest authority. The Codification allows for certain grandfathered material. If an entity has followed and continues to follow accounting guidance that was set forth in either category (c) or (d) of the previous GAAP hierarchy as of March 15, 1992, that entity is not required to change to an accounting treatment in a higher category [category (b) or (c) of that hierarchy now included in the Codification] if its effective date was prior to March 15, 1992. For example, if an entity followed prevalent industry practice as of March 15, 1992 [which was previously included in category (d) of the GAAP hierarchy], that entity does not have to change to a pronouncement that was previously in category (b) or (c) which had an effective date prior to March 15, 1992. An entity should follow the guidance in the Codification for standards with an effective date after March 15, 1992, and when initially applying a principle after March 15, 1992 (except for certain EITF consensus positions).

103.8 Additionally, in the past some accounting standards have permitted an entity to continue applying superseded accounting standards for transactions that have an ongoing impact on an entity's financial statements, such as a business combination. That guidance is considered grandfathered and remains authoritative for those transactions even though it has not been integrated into the Codification. The following list, while not comprehensive, represents examples of such grandfathered guidance:

- Pooling of interests in a business combination described in SFAS No. 141, *Business Combinations*, Paragraph B217.

- Pension transition assets or obligations described in SFAS No. 87, *Employer's Accounting for Pensions*, Paragraph 77.

- Employee stock ownership plan shares purchased and held as of December 31, 1992, as described in AICPA SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, Paragraphs 97 and 102.

• Loans restructured in a troubled debt restructuring before the effective date of SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, described in SFAS No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, Paragraph 24.

• Stock compensation for nonpublic and other entities described in SFAS No. 123R, *Share-Based Payment*, Paragraph 83.

• For business combinations with an acquisition date prior to the first annual reporting period beginning on or after December 15, 2008, SFAS No. 141 and related standards.

103.9 **The Organization of the Codification**

The Codification is organized by subject matter in a hierarchy using areas, topics, subtopics, and sections as follows:

a. *Areas.* Areas represent large collections of accounting guidance. The following are the nine areas of the Codification:

(1) General Principles.

(2) Presentation.

(3) Assets.

(4) Liabilities.

(5) Equity.

(6) Revenue.

(7) Expenses.

(8) Broad Transactions.

(9) Industry.

b. *Topics.* Topics reside in areas and represent a collection of related guidance, such as leases. The following are the main types of topics by area:

(1) *General Principles (Topic Codes 105-199).* These topics relate to broad conceptual matters, such as generally accepted accounting principles.

(2) *Presentation (Topic Codes 205-299).* These topics relate only to presentation matters and do not address recognition, measurement, or derecognition matters. Such topics include income statement, balance sheet, statement of cash flows, etc.

(3) *Assets (Topic Codes 305-399).* These topics relate to asset accounts, such as cash, receivables, investments, etc.

(4) *Liabilities (Topic Codes 405-499).* These topics include liability accounts, such as debt, guarantees, commitments, etc.

(5) *Equity (Topic Codes 505-599).* These topics contain guidance about equity accounts.

(6) *Revenue (Topic Codes 605-699).* These topics contain guidance about revenues, such as revenue recognition.

(7) *Expenses (Topic Codes 705-799).* The expenses topics include cost of sales, compensation, incomes taxes, etc.

(8) *Broad Transactions (Topic Codes 805-899).* These topics relate to multiple financial statement accounts and are generally transaction-oriented. Such topics include leases, business combinations, derivatives, nonmonetary transactions, etc.

(9) *Industry (Topic Codes 905-999).* These topics relate to accounting that is unique to an industry or type of activity. Such topics include airlines, software, real estate, etc.

c. *Subtopics.* Subtopics represent subsets of a topic and are generally distinguished by type or by scope. For example, operating leases and capital leases are two subtopics of the leases topic distinguished by type of lease. Each topic contains an overall subtopic that generally represents the pervasive guidance for the topic. Each additional subtopic represents incremental or unique guidance not contained in the overall subtopic. Subtopics unique to a topic use classification numbers between 00 and 99.

d. *Sections.* Sections represent the nature of the content in a subtopic such as recognition, measurement, disclosure, and so forth. Every subtopic uses the same sections, unless there is no content for a particular section. The sections of each subtopic are as follows, where XXX = topic, YY = subtopic, and ZZ = section:

XXX-YY-00	Status
XXX-YY-05	Overview and Background
XXX-YY-10	Objectives
XXX-YY-15	Scope and Scope Exceptions
XXX-YY-20	Glossary
XXX-YY-25	Recognition
XXX-YY-30	Initial Measurement
XXX-YY-35	Subsequent Measurement
XXX-YY-40	Derecognition
XXX-YY-45	Other Presentation Matters
XXX-YY-50	Disclosure
XXX-YY-55	Implementation Guidance and Illustrations

XXX-YY-60	Relationships
XXX-YY-65	Transition and Open Effective Date Information
XXX-YY-70	Grandfathered Guidance
XXX-YY-75	XBRL Definitions

An “S” precedes the section number in the case of SEC content. Within sections, paragraphs are numbered with a two-part number in which the first part represents the section and the second part is a sequential number. The content of a paragraph may be amended, but the paragraph number will remain constant. For example, some of the classification codes for leases are as follows:

840	Leases (Topic)
840-10	Overall (Subtopic)
840-10-15	Scope and Scope Exceptions (Section)
840-10-50	Disclosure (Section)
840-20	Operating Leases (Subtopic)
840-20-15	Scope and Scope Exceptions (Section)
840-20-50	Disclosure (Section)
840-30	Capital Leases (Subtopic)
840-30-15	Scope and Scope Exceptions (Section)
840-30-50	Disclosure (Section)

103.10 The FASB revises the Codification through the issuance of Accounting Standards Updates (ASUs), which generally include background information, basis for conclusions, and the amendments to the Codification. The title of the ASUs are Accounting Standards Update YYYY-XX, where YYYY is the year issued and XX is the sequential number for each Update, such as 2009-01, 2009-02, etc. All Codification revisions are issued in this format, regardless of the form in which such guidance may have been issued previously (for example, EITF Abstracts, FASB Staff Positions, FASB Statements, FASB Interpretations, etc.).

103.11 Upon its release, an Accounting Standards Update is not authoritative but is merely a transient document to initiate the FASB's process of amending the Codification. ASUs are available on Checkpoint, the Codification, and the FASB websites. As the FASB amends existing Codification paragraphs, both the current paragraph and the updated paragraph reside in the Codification until such time that the new guidance is completely effective. The FASB identifies amended guidance as “Pending Content” within the Codification. The Pending Content generally includes information regarding the transition date, a link to any transition guidance, and the text of the content that will be effective upon transition. When the newly amended

paragraph is fully effective, the outdated guidance is removed from the paragraph and the amended paragraph remains.

103.12 **How This *Guide* Presents Codification Information**

Codification references have been fully integrated into this *Guide* and are preceded by the label *FASB ASC*. In addition, practitioners who subscribe to the electronic versions of this *Guide* and the FASB Reference Materials may link directly from the summarized guidance in the *Guide* to the related authoritative literature in the Codification.

Measurement Principles versus Disclosure Principles

103.13 Generally accepted accounting principles include both measurement principles and disclosure principles. Measurement principles are those principles that govern the recognition of transactions, for example, the period in which a transaction will be recorded and the amounts to be recorded. Measurement principles include the following:

- The cost of property and equipment should be depreciated over the estimated useful life of the asset.

- Marketable equity securities classified as “available-for-sale” should be carried at fair value.

- Liabilities should be recorded for expenses incurred but not paid as of the balance sheet date.

103.14 Disclosure principles are those principles that determine what specific numbers and other information must be presented in the financial statements. The following are examples of disclosure principles:

- Depreciation expense for the period should be disclosed.

- Aggregate amounts of maturities of long-term debt for each of the five years following the latest balance sheet presented should be disclosed.

- The current and deferred portion of the provision for income taxes should be disclosed.

This *Guide* provides in-depth guidance on both measurement and disclosure principles.

GAAP and Materiality

103.15 *Materiality* is a term used to describe the significance of a departure from generally accepted accounting principles. Only material departures require correction.

103.16 Determining what is material to the financial statements taken as a whole is one of the most difficult decisions in the accounting profession. Statement of Financial Accounting Concepts (SFAC) No. 8, *Conceptual Framework for Financial Reporting—Chapter 1, "The Objective of General Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information,"* states the following regarding materiality:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the [FASB] cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

103.17 Accordingly, there are no quantitative guidelines in authoritative accounting literature for determining materiality. However, in practice, accountants often use benchmarks to assist in determining materiality. (See paragraphs beginning at 300.14 for discussion of applying the benchmark in the balance sheet and guidance on determining materiality if income before tax is zero or there is a loss.) Although benchmarks may serve as guidelines, it cannot be overemphasized that the use of a benchmark is not a substitute for professional judgment. A benchmark used by some accountants follows:

Effect of Departure on Income before Tax	Materiality to Financial Statements
1-5%	Not material
6-9%	Danger area—could be material
10% or greater	Probably is material

103.18 The SEC staff has issued Staff Accounting Bulletin (SAB) No. 99, *Materiality*, to provide additional guidance on applying materiality thresholds to financial statements. Although SABs are not applicable to the financial statements of nonpublic entities, the guidance in FASB ASC 250-10-S99-1 may be useful to all financial statement preparers. The view of the SEC staff is that exclusive reliance on certain quantitative benchmarks to assess materiality is not appropriate. In other words, it is not acceptable to assess materiality purely on a quantitative threshold, such as 5% of net income. The financial statement preparers and auditors also must assess qualitative considerations when determining whether or not a misstatement is material. In addition to assessing whether the financial misstatements are materially misstated after considering the effect of aggregating all misstatements, the guidance requires assessing whether each individual misstatement is material. If the misstatement individually is considered material, the effect cannot be eliminated by other misstatements that diminish the effect of the misstatement on other financial statement items. FASB ASC 250

-10-S99-1 also states that management should not make intentional immaterial misstatements to manage earnings.

Other Comprehensive Bases of Accounting (OCBOA)

103.19 The conventions, rules, and procedures that define generally accepted accounting principles (GAAP) constitute the comprehensive basis of accounting that is considered the norm. Both accountants and users of financial statements generally expect financial statements to be prepared in conformity with GAAP. However, other comprehensive bases of accounting (OCBOA), for example, the income tax basis and the modified cash basis, are recognized in professional literature and are used as a basis of accounting for financial statements in certain circumstances. The Codification does not include guidance for OCBOA financial statements. OCBOA financial statements are discussed in Chapter 9.

International Financial Reporting Standards

103.20 International accounting standards are prescribed by different groups, but one group is becoming widely recognized as the primary standard-setter. That group is the International Accounting Standards Board (IASB), and it prescribes International Financial Reporting Standards (IFRS). The AICPA Council has designated the IASB as the body to establish professional standards regarding international financial accounting and reporting principles pursuant to Rule 202, *Compliance With Standards*, and Rule 203, *Accounting Principles*, of the AICPA Code of Professional Conduct.

103.21 As a result, auditing standards generally accepted in the United States of America permit the expression of audit assurance on financial statements prepared in conformity with IFRS. The audit opinion would be on the fairness of the presentation in conformity with IFRS as issued by the IASB, rather than on the fairness of the presentation in conformity with accounting principles generally accepted in the United States.

103.22 Similar guidance exists for compiled and reviewed financial statements in Interpretation 13 of AR 9080, *Compilations of Financial Statements Prepared in Accordance With International Financial Reporting Standards*, and Interpretation 8 of AR 9090, *Reviews of Financial Statements Prepared in Accordance With International Financial Reporting Standards*.

103.23 **IFRS for Small and Medium-sized Entities (SMEs)**

The IASB has recognized that users of financial statements have different needs based on the overall characteristics of the entity. Accordingly, the IASB has designated a subset of IFRS as an option for entities with certain characteristics. That subset is referred to as *IFRS for small and medium-sized entities* or *IFRS for SMEs*.

103.24 The IASB has defined a *SME* as an entity that does not have public accountability and publishes general purpose financial statements for external users.

a. An entity is considered to have public accountability if it meets either of the following criteria:

(1) its debt or equity is traded in a public market or

(2) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses, such as a bank.

b. External users generally include non-manager owners, existing and potential creditors, and credit rating agencies.

103.25 IFRS for SMEs is approximately 230 pages long, which is about one-tenth the length of full IFRS. The authors believe small and midsize nonpublic entities in the U.S. should not adopt IFRS for SMEs without careful consideration. There are significant differences from U.S. GAAP that should be considered. For example, IFRS for SMEs does not permit using the last-in, first out (LIFO) method for inventory; and goodwill and indefinite life intangible assets are amortized over a period not exceeding 10 years. So far, there has been little, if any, indication that users of the financial statements of small and midsize nonpublic entities would accept financial statements based on IFRS for SMEs. In addition, a blue-ribbon that considered the future of accounting standards for private companies in the U.S. did not favor IFRS for SMEs as an alternative to U.S. GAAP (see further discussion of the blue-ribbon panel beginning at paragraph 103.36). IFRS for SMEs is not a comprehensive basis of accounting other than GAAP.

103.26 This *Guide* is not designed to address issues related to financial statements prepared in accordance with IFRS or IFRS for SMEs. However, a number of resources are available for learning more about those standards. For example, the IFRS for SMEs, together with the basis for conclusions, illustrative financial statements, and a presentation and disclosure checklist, can be obtained without charge from the IASB website at **www.ifrs.org**. In addition, a number of IFRS-related products can be obtained on Checkpoint at **www.checkpoint.riag.com**.

Reference Sources for GAAP

103.27 This *Guide* answers many questions concerning the application of GAAP and should greatly facilitate the process of preparing financial statements in conformity with GAAP. However, it is not a substitute for the authoritative literature. To have access to the technical pronouncements that constitute GAAP, accountants should obtain access to the FASB Accounting Standards Codification.

103.28 The Tax and Accounting business of Thomson Reuters offers all the authoritative literature issued by the FASB and the AICPA (all hyperlinked to PPC's guides) on Checkpoint. The AICPA literature is also available on *PPC's Accounting and Auditing* CD-ROM. [For information, call (800) 431-9025.] The FASB's website contains information about Board actions and upcoming meetings, the quarterly plan for FASB technical activities, membership information, and ordering information and prices for FASB products. In addition, the full text of all FASB Statements of Financial Accounting Standards, Statements of Financial

Accounting Concepts, FASB Interpretations, FASB Technical Bulletins, FASB Staff Positions, and EITF Abstracts are available on the FASB website. However, as discussed beginning at paragraph 103.5, that literature has been superseded by the Codification. Although the FASB generally will no longer update or maintain the superseded standards, they will remain available for reference on the FASB website. The FASB home page can be found at **www.fasb.org**. The Codification can be found at **http://asc.fasb.org/home** and is also available on Checkpoint at **checkpoint.riag.com**. The PPC product line website is updated weekly with news articles on accounting, auditing, industry, tax, and technology topics, and can be accessed at **ppc.thomsonreuters.com**.

Separate Accounting Standards for Public and Private Companies

103.29 For the past several years, there has been an ongoing debate within the accounting profession about the need for separate generally accepted accounting principles for public and private companies. This debate over separate standards is often referred to as the “Big GAAP versus Little GAAP” debate. Over the years, various professional and regulatory bodies (such as the FASB and the AICPA) have appointed numerous task forces and conducted surveys and focus groups in an effort to assess the need for separate accounting standards. Until recently, those efforts apparently did not provide compelling evidence supporting different accounting and financial reporting standards for public and private reporting entities. However, recent information suggests certain interested parties (such as users of financial statements) now support separate standards. As a result, the SEC, the FASB, and the AICPA have initiated efforts to address the needs of small businesses and private companies. For example, the SEC formed the Advisory Committee on Smaller Public Companies; the FASB formed the Small Business Advisory Committee; the FASB and the AICPA collaborated to form the Private Company Financial Reporting Committee; the AICPA, the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA) established the Blue Ribbon Panel on Standard Setting for Private Companies; and most recently the FAF formed the Private Company Council. The following paragraphs provide a brief overview of the committees most applicable to preparers of financial statements of nonpublic reporting entities: the Small Business Advisory Committee, the Private Company Financial Reporting Committee, the Blue Ribbon Panel on Standard Setting for Private Companies, and the Private Company Council.

103.30 **Small Business Advisory Committee**

The FASB's Small Business Advisory Committee (SBAC) was formed in early 2004 to more actively involve the small business community in the development of financial accounting and reporting standards. The SBAC is made up of approximately 20 users, preparers, and auditors from the small business community. Since its formation, the SBAC has discussed the impact of current and proposed FASB projects on small businesses, both public and private, with the FASB. The SBAC has also discussed the issue of separate accounting standards for public and private companies. In addition, the SBAC occasionally meets with the Private Company Financial Reporting Committee (PCFRC) to discuss matters of common interest to both committees. The FASB has historically taken the position that there should be only one set of GAAP that applies to both public and private entities, but that GAAP could allow for differences for private entities driven by the differing needs of users and cost/benefit considerations. In addition, the FASB has made changes to its

standard-setting process to require formal consideration of whether there should be a difference in measurement, recognition, effective date, or transition for private companies in all major projects.

103.31 The SBAC generally meets twice a year, and the materials and the minutes from the committee's meetings are available on the FASB website at **www.fasb.org/small_business_advisory_committee/**. While the Committee has recently spent a great deal of time discussing the future of private company financial reporting, it has not been able to form a clear consensus on the matter.

103.32 **Private Company Financial Reporting Committee**

In 2006, the Private Company Financial Reporting Committee (PCFRC) was formed as part of a joint initiative of the AICPA and the FASB to improve the FASB's current standard-setting process to better meet the financial reporting needs of private companies and the users of private company financial statements. The primary objective of the PCFRC is to provide recommendations to the FASB to help the Board determine if and where there should be explicit differences in existing and future accounting standards for private companies. The PCFRC is comprised of a chairperson and four CPA practitioners, four preparers of financial statements, and four users of private company financial statements.

103.33 The PCFRC strives to carry out its mission with an eye toward user needs and cost/benefit considerations. The Committee meets four to six times per year, and meetings are generally open to the public. Meeting materials and other information related to the PCFRC are available on the Committee's website, **www.pcfr.org**. Interested parties may also join the PCFRC resource group through the Committee's website. The Committee's resource group was formed to allow interested parties to share their thoughts on issues being considered by the PCFRC and to receive information from the Committee about its activities. The PCFRC recently formed a financial statement user panel comprised of users of private company financial statements (bankers, sureties, venture capitalists, non-management shareholders, etc). The Committee solicits feedback from the user panel on specific questions or issues brought before the PCFRC. Interested parties may join the user panel through the Committee's website.

103.34 In November 2009, the PCFRC sent a letter to the chairman of the Financial Accounting Foundation (FAF) regarding accounting standards for private companies. The FAF is the organization with responsibility for the oversight, administration, and finances of the FASB. In its letter, the PCFRC recommended that FAF consider the issue of U.S. private company accounting in the context of the FASB's mission. Further, the Committee indicated a preference for a separate, stand-alone set of accounting standards for private companies in the U.S. focused on the needs of the users of private company financial statements.

103.35 The FAF recently announced the formation of a new group to improve the process of setting accounting standards for private companies. The new group has been named the Private Company Council (PCC) and will replace the PCFRC following a brief transition period. See further discussion of the PCC beginning at paragraph 103.42.

103.36 **Blue-Ribbon Panel on Standard Setting for Private Companies**

In December 2009, the AICPA and the FAF announced the formation of a Blue-Ribbon Panel to address how accounting standards in the U.S. can best meet the needs of users of private company financial statements.

The National Association of State Boards of Accountancy (NASBA) was also a sponsor of the panel. The Blue-Ribbon Panel was formed to provide recommendations on the future of accounting standard-setting for private companies in the U.S., including whether there was a need for a separate set of accounting standards for private companies. The panel was comprised of 18 members representing various constituencies of private company financial reporting, including preparers, auditors, lenders, investors, and owners. In addition, a number of participating observers were involved with the Blue-Ribbon Panel, including the chair of the PCFRC and a member of the SBAC.

103.37 The Blue-Ribbon Panel met several times during 2010 and issued a report to the Board of Trustees of the FAF in January 2011. The Blue-Ribbon Panel concluded that the current system of U.S. accounting standard-setting has done an insufficient job in the following areas:

- Understanding the information needs of users of the financial statements of private companies and how those needs differ from those of users of public company financial statements.

- Considering the costs and benefits of GAAP for private company financial reporting.

103.38 To address those deficiencies, the Blue-Ribbon Panel recommended that accounting standards for private companies be based on existing U.S. GAAP, but with exceptions and modifications made for private companies. The recommended model could produce different measurement, recognition, presentation, and disclosure standards for private companies. The report also recommended the creation of a set of decision criteria, referred to in the report as a *differential framework*, to enhance the ability of a standard-setter to make appropriate, justifiable exceptions and modifications to current GAAP. The report did not promote moving toward a separate, self-contained set of GAAP for private companies or a comprehensive reorganization of GAAP, at least in the near term.

103.39 The Blue-Ribbon Panel also recommended the creation of a separate accounting standards board with the authority to determine and establish exceptions and modifications to current and future U.S. GAAP for private companies. The report suggested that the new board be subject to oversight by the FAF. The new board would, however, be separate from the existing FASB. Additionally, the report suggested that the FAF conduct a comprehensive review of the new board after 3-5 years to evaluate the effectiveness of the board.

103.40 Upon issuance of the report, the FAF stated its intent to consider the panel's recommendations and to seek additional input from constituents as it deliberates improvements to the standard-setting process. In March 2011, the FAF announced the formation of a Trustee Working Group (Working Group) to address accounting standard-setting for nonpublic entities. The Working Group solicited input from key stakeholders on suggested improvements, including the recommendations of the Blue-Ribbon Panel. In announcing the formation of the Working Group, the FAF indicated that this was the next phase of the FAF's review of the adequacy and effectiveness of the FASB's standard-setting efforts as they relate to the U.S. private company and nonprofit sectors.

103.41 Response to the creation of the Working Group was generally positive; however, there was some concern that the formation of the Working Group added complexity to the issue of accounting standard-setting for private companies. For example, the AICPA expressed concern about the inclusion of nonprofit entities in the scope of the Working Group's efforts. The AICPA noted that the Blue-Ribbon Panel specifically excluded nonprofit entities from its scope. The AICPA strongly urged the FAF to adopt the Blue-Ribbon Panel's recommendations and urged the Working Group to “move briskly” in making changes to current and future accounting standards by establishing a new board in accordance with the recommendations of the Blue-Ribbon Panel. The full report of the Blue-Ribbon Panel is available on the FAF website at **www.accountingfoundation.org**.

103.42 **Private Company Council**

In May 2012, the FAF announced the formation of the Private Company Council (PCC) to improve the process of establishing accounting standards for private companies.[4] According to the FAF, the PCC will have the following two primary responsibilities:

- To determine whether exceptions or modifications to existing nongovernmental U.S. GAAP are necessary to address the needs of users of the financial statements of private companies.

- To serve as the main advisory group to the FASB on the proper treatment for private companies for items being actively considered by the FASB.

103.43 In September 2012, the FAF announced the inaugural appointment of a chair and nine members to the PCC. Members of the PCC, including the chair, were appointed to an initial term of three years, with each member eligible for reappointment. The members include users, preparers, and practitioners with experience with private company financial statements. The PCC members and chair will not be compensated for their service.

103.44 The PCC plans to meet a minimum of five times annually during its initial three years, with its first meeting in December 2012. Most of the PCC meetings will be held at the FASB's Norwalk, Connecticut, office, but a maximum of two meetings annually may be held in different locations. The meetings will generally be open to the public. In addition, all FASB members are expected to attend and participate in all deliberative meetings of the PCC, and a FASB member has been assigned as a liaison to the PCC.

103.45 The PCC will generally be able to set its own agenda, but it will do so in consultation with the FASB and with input from stakeholders. Further, the PCC and the FASB will establish criteria to use when deciding whether and when exceptions or modifications to GAAP are necessary. The PCC will then use that criteria to review existing GAAP and to identify standards to consider for possible exceptions or modifications. Accounting for uncertainty in income taxes, fair value, consolidation of variable interest entities, and derivatives are areas of current GAAP that may be considered by the PCC when it meets.

103.46 Any proposed exceptions or modifications to existing GAAP will require approval of two-thirds of all PCC members. If approved, the proposed modifications or exceptions will be forwarded to the FASB for potential endorsement. The FASB will generally act on proposals within 60 days from submission. If a simple majority of FASB members endorse the modifications or exceptions, those modifications or exceptions will be exposed for public comment.

103.47 After the exposure period, the PCC will consider any comments received, redeliberate the issues, and take a final vote. If approved, the final recommendation will be forwarded to the FASB for a final endorsement decision. If the FASB votes to endorse the modifications or exceptions, they will be incorporated into GAAP. If the FASB fails to endorse the changes, the FASB chair must provide the PCC chair with a written explanation for the decision not to endorse the changes. The explanation will include recommendations for the PCC to consider that could result in FASB endorsement. The written communication will be publicly available.

103.48 The PCC will also advise the FASB about implications to private companies of accounting issues under active consideration by the FASB. The PCC may vote on recommendations to the FASB regarding such issues. Any recommendations from the PCC will be considered during FASB deliberations. The FASB also will be required to document in the basis for conclusions of proposed and final Accounting Standards Updates how it considered the needs of private companies, as well as any PCC recommendations.

103.49 The PCC will be overseen by a committee of the FAF Trustees, the Private Company Review Committee. After the initial three years of operation of the PCC, the FAF Trustees will make an overall assessment of the PCC. At that time, the FAF will consider whether the PCC's mission is being achieved and whether additional changes to the private company standard setting process are warranted. In addition, the PCC will replace the PCFRC (see discussion of the PCFRC beginning at paragraph 103.32) after a transition period.

103.50 **AICPA Financial Reporting Framework for Small and Medium-Sized Entities**

Shortly after the announcement of the formation of the PCC (see the discussion of the PCC beginning at paragraph 103.42), the AICPA announced its intention to develop an other comprehensive basis of accounting (OCBOA) financial reporting framework to meet the needs of certain private small and medium-sized entities (SMEs) and the users of the financial statements of those entities. The framework is currently being referred to as the *Financial Reporting Framework for Small and Medium-Sized Entities* (FRF-SME).

103.51 The AICPA has said the FRF-SME would be a less complicated and less costly alternative to U.S. GAAP for SMEs that do not require GAAP financial statements. It will be developed for for-profit entities that are owner-managed and require reliable financial statements in situations where internal or external users of the financial statements have direct access to the owner-manager and GAAP financial statements are not required. The FRF-SME is expected to blend accrual income tax methods with other traditional accounting methods. In addition, it will be considered nonauthoritative and will not be acted upon, approved, or disapproved by any senior technical committee of the AICPA or FASB.

103.52 The AICPA plans to expose the FRF-SME for public comment in the fall of 2012 and to issue it in final form in the first half of 2013. The FRF-SME will have no effective date and could be used immediately upon

issuance. The AICPA has produced a frequently asked questions document about its FRF-SME project. The document is available on the AICPA website at **www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/PCFR/Pages/PCFR.aspx**.

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[2] See the discussion of differential accounting standards beginning at paragraph 103.29.

[3] SEC registrants must also follow rules and interpretive releases of the Securities and Exchange Commission (SEC). The Codification includes certain SEC rules, regulations, interpretive releases, and staff guidance that are relevant only to SEC registrants. Such guidance is segregated within the Codification and does not represent the authoritative sources of such content.

[4] Additional details about the responsibilities and operating procedures of the PCC, as well as information about the issues considered by the FAF Trustees in the formation of the PCC, are available in the final report of the FAF Board of Trustees, *Establishment of the Private Company Council*. The final report may be obtained from the FAF website at **www.accountingfoundation.org**.

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104 SIGNIFICANT PROPOSED ACCOUNTING STANDARDS

104.1 For several years, the FASB and the International Accounting Standards Board (IASB) have been working toward converging U.S. GAAP with International Financial Reporting Standards (IFRS). Those efforts are aimed at reducing the differences between U.S. GAAP and IFRS with the ultimate goal of having a single set of high-quality globally accepted accounting standards. The convergence efforts are expected to produce fairly substantial changes to present-day U.S. GAAP that will have wide-ranging implications for preparers and users of financial statements of nonpublic entities.

104.2 This *Guide* generally does not address the FASB's ongoing projects and proposed standards in significant detail because FASB projects do not change current accounting until after extensive due process and deliberations. Furthermore, tentative decisions reached during the course of a project can, and often do, change quite significantly prior to issuance of final guidance. However, the authors believe that practitioners should be aware of certain projects on the FASB's agenda that could significantly impact virtually all of their clients. The guidance in the proposed standards is extensive and this section highlights only a few of the important aspects of each project. Additional information may be obtained from the FASB website at **www.fasb.org**. Future editions of this *Guide* will be updated for any final standards issued as a result of these projects.

Accounting for Leases

104.3 The goal of this project is to ensure that all assets and liabilities arising from lease contracts are recognized in the balance sheet. The proposed guidance would provide both lessee and lessor accounting requirements. It would apply to assets considered property, plant, and equipment, and would include a number of scope exceptions, including leases of intangible assets and exploration or use leases for resources such as minerals, oil, and natural gas.

104.4 In August 2010, the FASB released an exposure draft of a proposed ASU, *Leases*. The FASB also held several public roundtables and other types of workshops to get feedback from a variety of constituents. Because of the extent of changes made to the initial exposure draft during redeliberations, the FASB is

planning to issue a revised exposure draft in the first quarter of 2013. Following is a brief discussion of some of the tentative decisions reached to date on lessee and lessor accounting for leases.

104.5 **Accounting by Lessees**

Following the general premise that assets and liabilities arising from leases should be recognized in the balance sheet, lessees would be required to recognize an asset representing their right to use the leased item for the term of the lease. The proposed ASU refers to that asset as a *right-of-use asset*. The lessee would also be required to recognize a liability for its obligation to make lease payments. The asset and liability would be measured using the present value of the lease payments. The proposed ASU essentially eliminates the operating lease accounting method currently allowed under existing U.S. GAAP and will likely represent a significant change for nonpublic entities.

104.6 Determining the lease term for many leases will require judgment to properly measure the asset and liability. The proposed definition of *lease term* is the non-cancellable period that a lessee has committed to lease the asset. Renewal options should be considered, and if there is a significant incentive for the lessee to extend the lease, that renewal period should also be included in the lease term. The lease term would only be reassessed if there are significant changes in factors that would impact the initial decision.

104.7 The FASB has tentatively decided that these accounting requirements would not apply to any leases with a maximum possible term of 12 months or less. Those leases would be accounted for much like an operating lease in the current authoritative accounting literature.

104.8 As proposed, assets and liabilities under existing operating leases must be measured and recognized when this guidance is implemented. Thus, entities must be prepared for significant changes to their balance sheets and the resulting changes to the related ratios, such as debt-to-equity. The authors expect that many debt covenants will have to be modified prior to implementing these proposed requirements.

104.9 **Accounting by Lessors**

The FASB has tentatively decided on two approaches to be used by lessors to account for leases: (a) a receivable and residual approach and (b) an operating lease approach. The lessor would use the receivable and residual approach for leases where the lessee acquires and uses more than an insignificant portion of the leased asset over the lease term. For leases where the lessee consumes only an insignificant portion of the leased asset, the lessor would use an approach similar to current operating lease accounting.

104.10 Lessors that account for leases under the receivable and residual approach would derecognize the underlying leased asset and recognize a lease receivable and a residual asset in its place. The lease receivable would be measured at the present value of the lease payments to be received, discounted at the rate charged to the lessee. The receivable would subsequently be measured at amortized cost using the effective interest method. The residual asset would initially be measured as an allocation of the carrying amount of the leased asset and would subsequently be measured by accreting it to the estimated residual value at the end of the lease term.

104.11 For leases not accounted for using the receivable and residual approach, lessors would use an approach similar to current operating lease accounting. Accordingly, the lessor would not derecognize the leased asset and would continue to recognize it in its balance sheet. The lessor would recognize lease income using a straight-line method and depreciation expense for the leased asset using an appropriate depreciation method.

Revenue Recognition

104.12 In June 2010, the FASB released an exposure draft of a proposed ASU, *Revenue from Contracts with Customers*. The FASB subsequently held several roundtable discussions regarding the proposal. Based on the comments received and the other feedback received from constituents, the FASB made significant changes to the exposure draft. As a result, in November 2011, the FASB issued a revised exposure draft, *Revenue from Contracts with Customers*, and in January 2012, issued another revision of the exposure draft to add information about proposed amendments to the FASB Accounting Standards Codification. The comment deadline for the latest exposure draft ended in March 2012.

104.13 The proposed guidance would establish a single revenue recognition standard that would apply across various industries and capital markets. It would also eliminate inconsistencies in current revenue recognition standards and practices and remove existing industry-specific revenue recognition requirements. The proposed guidance is based on the principle that revenue from contracts with customers should be recognized when an entity transfers goods or services to the customer. The *revenue* is the amount the entity receives or expects to receive from the customer in exchange for transferring those goods or services.

104.14 Under the proposed guidance, an entity would be required to identify its performance obligations in a contract and would only recognize revenue when the entity satisfies each performance obligation. An entity satisfies a performance obligation when it transfers a good or service to a customer, and a good or service would be considered transferred when the customer obtains control of the good or service.

104.15 The FASB has indicated that the expected effective date for public entities would be no earlier than annual periods beginning on or after January 1, 2015. For nonpublic entities, the FASB decided that the effective date of this guidance should be at least one year after the effective date for public entities. However, these dates are tentative and will be reconsidered before the guidance is issued in final form.

Accounting for Financial Instruments

104.16 This project is another joint project between the FASB and IASB to reconsider the recognition and measurement guidance for financial instruments and to address impairment of financial instruments. Another portion of the project is to re-address the accounting for hedging activities; however, that portion of the project is not proceeding as quickly. Thus, this discussion only addresses the progress on the recognition, measurement, and impairment of financial instruments.

104.17 The FASB issued an exposure draft in May 2010 that addressed the recognition and measurement issues, and in January 2011 issued a supplementary document to address impairment accounting. The FASB plans to issue exposure drafts related to impairment of financial instruments and classification and measurement of financial instruments in the fourth quarter of 2012.

104.18 Under the proposed guidance, trade accounts receivable and payable would continue to be recognized at amortized cost. Investments in nonmarketable equity securities by nonpublic entities will continue to be accounted for using the cost method, with any permanent impairment recognized in earnings. The recognition and measurement guidance for investments accounted for using the equity method would also be unchanged. The accounting for other types of financial instruments will be based on the characteristics of the instruments and the entity's business strategy. Some existing disclosures are expected to be revised and new disclosures on liquidity risk are also expected to be required.

104.19 The new guidance, when effective, is expected to have a significant impact on banks and other financial institutions, while the impact on entities other than financial institutions is not expected to be as severe.

Inactive and Closed FASB Projects

104.20 Previous editions of this *Guide* have included discussions of three FASB projects that are no longer under active consideration by the FASB. The FASB's projects on financial statement presentation and reporting discontinued operations have been assessed as lower priority projects. The FASB does not expect further action on those projects in the near term. The FASB has also removed from its agenda the project on disclosure of certain loss contingencies.

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