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.

END OF DOCUMENT -

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 special purpose framework.

END OF DOCUMENT -

---

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 a special purpose framework—see Chapter 9) and are relevant to all accountants (whether in business 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 four 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,
- compilation, and
- preparation.

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*
- *PPC's Guide to SSARS Preparation Engagements*

Reporting Standards

102.6 Reporting standards also apply only to CPAs in public practice. (See discussion of this topic in section 204.) The reporting standards differ for each level of service—audit, review, compilation, or preparation. 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 SSARS Preparation Engagements*

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*.

AICPA Code of Professional Conduct

102.8 The AICPA *Code of Professional Conduct* (the Code) governs the conduct of all AICPA members. The Code provides guidance to members in public practice, industry or business, government, and education in the performance of their professional responsibilities. Based on ET 0.200.020, AICPA members are responsible for the conduct of all individuals that are associated with their public accounting practices. As a result, the Code 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 consists of four sections (a preface and three parts) as follows:

- Preface: Applicable to All Members.

- Part 1: Members in Public Practice.

- Part 2: Members in Business.

- Part 3: Other Members (e.g., members who are retired or unemployed).

102.10 The Code incorporates three conceptual frameworks:

- *Conceptual Framework for Independence*, which should be used to analyze relationships and circumstances that are not specifically addressed in the Code but may present a threat to the member's independence.

• *Conception Framework for Members in Public Practice*, a conceptual framework that should be used by members in public practice to analyze relationships and circumstances that are not specifically addressed in the Code but may present a threat to the member's compliance with the Rules of Conduct other than Independence.

• *Conceptual Framework for Members in Business*, a conceptual framework that should be used by members in business to analyze relationships and circumstances that are not specifically addressed in the Code but may present a threat to the member's compliance with the Rules of Conduct other than Independence.

102.11 The Code and its rules and interpretations have been incorporated throughout this *Guide* where relevant. All CPAs should also be familiar with the ethical standards of their state CPA society, state board of accountancy, and other applicable regulations.

Summary

102.12 In preparing financial statements, accountants (whether in public practice or business) are concerned primarily with applying generally accepted accounting principles. (See section 103.) Performance and reporting standards 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 business.

---

[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.

END OF DOCUMENT -

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 a special purpose framework (see Chapter 9)] and are important to accountants in business 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 Accountants in business also are concerned with preparing financial statements in accordance with GAAP for several reasons:

- ET 2.320.010 states that members in business 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 accountants in business 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 Questions and Answers of the AICPA.

- 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 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 SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality*, provides 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.

Special Purpose Frameworks

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, special purpose frameworks (also known as other comprehensive bases of accounting, or OCBOA) are recognized in professional literature and are used as a basis of accounting for financial statements in certain circumstances. Examples of special purpose frameworks include the income tax basis and the modified cash basis. The Codification does not include guidance for special purpose financial statements. Special purpose financial statements, including the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, 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 ET 1.310.001, *Compliance With Standards Rule*, and ET 1.320.001, *Accounting Principles Rule*, 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 previously existed 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*. SSARS No. 21 does not include much of the guidance in these interpretations. The AICPA Guide, *Preparation, Compilation, and Review Engagements*, paragraph 1.188, indicates that an accountant may be engaged to review financial statements in accordance with a financial reporting framework that is generally accepted in another country, such as IFRS. In addition, SSARS No. 21 includes IFRS as a financial reporting framework for general purpose financial statements. Given previous interpretations, the guidance in the AICPA Guide on review reports, and the definition of financial reporting frameworks included in SSARS No. 21, the authors believe that an accountant could also be engaged to compile or prepare financial statements in accordance with IFRS.

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. IFRS for SMEs is *not* a comprehensive basis of accounting other than GAAP, and 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 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.

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 from the Tax and Accounting business of Thomson Reuters, including *PPC's Practice Aids for Audits Performed Under International Standards* at **tax.thomsonreuters.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. [For information, call (800) 431-9025 or visit **tax.thomsonreuters.com**.] The FASB's website contains information about Board actions and upcoming meetings, the 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 **tax.thomsonreuters.com**.

GAAP for Private Companies

103.29 Over the years, the SEC, FASB, and AICPA formed various committees and task forces to try and address the needs of private companies and the users of the financial statements. The following paragraphs include a brief discussion of the significant bodies formed as well as the current status of GAAP modifications for private companies.

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. 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/**.

103.31 **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 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 was 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 ceased to exist as of December 31, 2012, after it was replaced by the Private Company Council (PCC). See further discussion of the PCC beginning at paragraph 103.34.

103.32 **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.

103.33 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 report recommended the following:

- Base accounting standards for private companies on existing U.S. GAAP, but with exceptions or modifications in measurement, recognition, presentation, and disclosure requirements for private companies.

- Establish 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 for private companies.

- Create a separate accounting standards board, distinct from the existing FASB, but subject to oversight by the FAF, with the authority to determine and establish exceptions or modifications to current and future U.S. GAAP for private companies.

These recommendations led to the eventual creation of the Private Company Council.

103.34 **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] The PCC has the following two primary responsibilities:

- To jointly establish, with the FASB, criteria for determining 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. (See status of criteria in paragraph 103.41.)

- 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.

103.35 The authors' believe it is important to note that while many groups formed in the past have had similar purposes, the PCC has the ability to influence GAAP for private companies. (The proposal and approval process for PCC/FASB projects is discussed further beginning at paragraph 103.37.) As such, there will not be a separate body of authoritative literature for private companies but rather private companies will be afforded certain exceptions and/or modifications within the existing body of GAAP.

103.36 The PCC is composed of a chair and nine members including users, preparers, and practitioners with experience in private company financial reporting. The PCC works closely with the FASB. A FASB member is designated as a FASB Liaison between the two boards and specific members of the FASB's staff support the PCC. All FASB members are expected to attend and participate in PCC deliberative meetings. PCC meetings are generally open to the public with agenda, materials, minutes, and live broadcast of meetings available at **www.fasb.org/pcc/meetings**.

103.37 Proposed exceptions or modifications to existing GAAP require approval of two-thirds of all PCC members. If approved, the proposed modifications or exceptions are 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 are exposed for public comment.

103.38 After the exposure period, the PCC considers any comments received, redeliberates the issues, and takes a final vote. If approved, the final recommendation is forwarded to the FASB for a final endorsement decision. If the FASB votes to endorse the modifications or exceptions, they are 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 must be published publicly and include recommendations for the PCC to consider that could result in FASB endorsement.

103.39 The PCC may 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 is required to document, in the basis for conclusions of proposed and final Accounting Standards Updates, consideration of the needs of private companies, as well as any PCC recommendations.

103.40 The PCC is overseen by a committee of the FAF Trustees, the Private Company Review Committee. The PCC has completed its initial three years of operation, and the FAF Trustees are currently performing an overall assessment of the PCC to consider whether the PCC's mission is being achieved and whether additional changes to the private company standard setting process are warranted. A new chair and two additional new members have been appointed to the PCC to serve three-year terms, indicating that the PCC will continue for at least three more years.

103.41 The FASB and PCC issued the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (PCDM Framework) for use by both the FASB and PCC when considering GAAP alternatives for private companies. In addition, the FASB issued ASU 2013-12, *Definition of a Public Business Entity: An Addition to the Master Glossary*, which defines *public business entity* and allows entities to determine whether they may apply accounting and reporting alternatives within GAAP. The definition excludes the following entities from applying private company GAAP alternatives:

- Entities required to file financial statements with the SEC or are required by the Securities Exchange Act of 1934 to file financial statements with another regulatory agency. [5]

- Entities required to file financial statements with a regulatory agency (foreign or domestic) for the purpose of issuing or selling securities that have no contractual restrictions on transfer.

- Entities with securities that have no contractual restrictions on transfer required by law, contract, or regulation to issue financial statements prepared on U.S. GAAP and make them publicly available periodically.

- Entities that have issued (or are conduit bond obligors for) securities, which are traded, listed, or quoted on an exchange or over-the-counter (OTC) market.

- Nonprofit entities.

- Employee benefit plans.

[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**.

[5] Consolidated subsidiaries of a public company are not considered a public business entity when preparing standalone financial statements that are not included in an SEC filing.

END OF DOCUMENT -

104 SIGNIFICANT PROPOSED ACCOUNTING STANDARDS

104.1 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 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

104.2 The goal of this project is to ensure that all assets and liabilities arising from lease contracts with a term of more than 12 months are recognized in the balance sheet. The proposed guidance provides both lessee and lessor accounting requirements. It would apply to all leases except leases of intangible assets, minerals, natural gas and similar exploration leases, and biological asset leases, such as timber.

104.3 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 issued a revised exposure draft in May 2013 and is currently drafting the final standard, which is expected to be issued in the fourth quarter of 2015 or early 2016.

104.4 The FASB has decided on a dual approach model for lessee accounting that would require a lessee to classify the lease, as type A or type B depending on whether the lease is effectively an installment purchase. Under the proposed guidance, most leases currently classified as a capital lease would be a type A lease while most leases currently classified as an operating lease would be a type B lease. Both type A and type B leases would result in the lessee recognizing a right-of-use asset and a lease liability. For type A leases, entities would recognize amortization of the right-of-use asset in the income statement separately from the interest on the lease liability. For type B leases, entities would recognize only a total lease expense in the income statement.

104.5 The FASB has decided on a dual approach for lessor accounting as well. Lessors would evaluate leases for a type A or B classification based on whether the risks and rewards of the leased asset have transferred to the lessee and for which collectibility of the lease payments is probable. The Type A approach is substantially the same as IFRS lease accounting and U.S. GAAP sales-type, direct financing lease accounting. The FASB's intent is to align revenue recognition for lessors with FASB ASC 606. (See further discussion of FASB ASC 606 beginning at paragraph 402.13.)

104.6 The proposed changes are significant and will affect nearly all entities. Entities will need to be prepared not only for the effect the changes will have on their balance sheets but also on the resulting financial ratios. The FASB is aware of the implications of the standard and has indicated they will consider this in determining the effective dates. No proposed effective dates have been released as of the date of this update.

Accounting for Financial Instruments

104.7 This project is a 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, which has recently been added to the FASB's agenda from a research project.

104.8 **Impairment** In December 2012, the FASB issued an exposure draft, *Financial Instruments—Credit Losses*, addressing the impairment of financial instruments. The proposed standard addressing the impairment of financial instruments introduces a current expected credit loss model (CECL model), which would replace the existing incurred loss impairment model. The CECL model requires management to estimate the cash flows of current contractual arrangements that the company does *not* expect to collect based on past events, current conditions, and forecasts that are reasonable and supportable. As a result of the new CECL model, the income statement would reflect the changes of credit deterioration or improvement, and the balance sheet would reflect the current estimate of expected credit losses. The FASB is currently drafting the final standard, with expected issuance in the fourth quarter of 2015, and plans to discuss the effective date after the ASU is drafted.

104.9 **Classification and Measurement** *Financial Instruments—Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued in February 2013. This proposed ASU includes classification and measurement guidance. In addition, a companion ASU was issued in April 2013 to address related amendments to ASC Topics impacted by the February 2013 proposed ASU. Since the issuance of the proposed ASU in 2013, the FASB has made numerous decisions. According to the FASB tentative project decisions, all investments in equity securities would be measured at fair value with changes in fair value recognized in the income statement. Some exceptions exist for equity method investments and equity securities without readily determinable fair values. A practicability exception is provided for the latter to be measured at cost plus or minus observable price changes in orderly transactions for identical or similar investments less any impairment, which would be assessed under a one-step impairment model. The FASB is currently drafting the final standard, with expected issuance in the fourth quarter of 2015, and plans to discuss the effective date after the ASU is drafted.

104.10 **Hedging** The hedging project was added to the FASB's technical agenda with the goal of making improvements to the hedge accounting model. Discussion topics have included the effectiveness threshold, timing and presentation of changes in fair value, hedges of nonfinancial items, effectiveness testing, benchmark interest rates, shortcut and long-haul methods, documentation requirements, and disclosures. The FASB is currently drafting a proposed ASU and expects to issue an exposure draft in the first quarter of 2016.

Nonprofit Financial Statements

104.11 The objective of this project is to examine existing standards for financial statement presentation by nonprofit organizations and focus on improving (a) net asset classification requirements, and (b) information provided in financial statements and notes about liquidity, financial performance, and cash flows. In April 2015, the FASB issued a proposed ASU, *Presentation of Financial Statements of Not-for-Profit Entities*, which proposes the most substantial changes to nonprofit financial reporting since SFAS No. 116 and 117.

104.12 While the proposed ASU includes numerous changes, the most significant items include—

- Two classes of net assets reported in the statement of financial position: net assets with donor restrictions and net assets without donor restrictions.

- Reformatted activities statement with required subtotals designed to provide information about operating and nonoperating activities.

- Required presentation of a direct method statement of cash flows.

- Additional disclosures designed to give quantitative and qualitative information to stakeholders concerning the organization's liquidity as well as enhanced disclosures concerning donor restrictions, allocation of costs, and underwater endowment funds.

104.13 Given the significance of the possible changes, the FASB is conducting extensive outreach activities to obtain feedback on the proposed ASU. It will take time for stakeholders to understand

and evaluate the proposal and for the FASB to evaluate the feedback.

Simplification Initiative

104.14 In June 2014, the FASB began an initiative to reduce the complexity in accounting standards. Several ASUs have already been issued from this initiative that have eliminated the concept of extraordinary items (see paragraph 403.3), changed debt issuance costs to be presented as a reduction of debt rather than an asset (see the discussion beginning at paragraph 309.28), and changed the subsequent measurement of certain inventories to the lower of cost or net realizable value (see discussion beginning at paragraph 302.101). Additional projects include—

- Income Taxes. Two proposed ASUs were issued in January 2015 related to income taxes. The proposals would eliminate classification of deferred income taxes between current and noncurrent. Instead, deferred income tax assets and liabilities would be presented as noncurrent. In addition, an entity would recognize the current and deferred income tax consequences of an intra-entity asset transfer at the time of the transfer.

- Business Combination Adjustments. In May 2015, the FASB issued a proposed ASU related to business combinations. Adjustments related to business combinations that are incomplete at the end of a period would be recognized in the period the amount is determined, including any net income effect, rather than as an adjustment to provisional amounts with a corresponding adjustment to goodwill.

- Equity Method Accounting. A proposed ASU was issued in June 2015 to eliminate the requirement for an equity method investor to account for any basis differences. The investor would instead recognize the equity method investment at cost with no requirement to determine the acquisition date fair value of the identifiable assets and liabilities assumed.

- Stock Compensation. The proposed ASU, issued in June 2015, would make numerous changes to share-based payment transactions. The proposal addresses eight aspects of share-based payment accounting, some of which are provided only to nonpublic entities. The proposed simplifications include amendments to income taxes, forfeitures, statement of cash flows classification, intrinsic value, classification of awards, and estimated expected term.

104.15 The FASB has not indicated expected issuance dates of final ASUs on these projects. Given how quickly the ASUs discussed in the previous paragraph were issued, the authors expect many, if not all, of these projects to be completed in 2016.

END OF DOCUMENT -