TOP ACCOUNTING ISSUES FOR 2012

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CCH Editorial Staff Publication

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TOP ACCOUNTING ISSUES FOR 2012 CPE COURSE

Introduction

CCH's *Top Accounting Issues for 2012 CPE Course* helps CPAs stay abreast of the most significant new accounting standards and important projects. It does so by identifying the events of the past year that have developed into hot issues and reviewing the opportunities and pitfalls presented by these changes. The topics reviewed in this course were selected because of their impact on financial reporting and because of the role they play in understanding the accounting landscape in the year ahead.

Module 1 of this course reviews ongoing issues.

Chapter 1 focuses on the long-awaited Report to the Board of Trustees of the Financial Accounting Foundation issued in January 2011 by the Blue Ribbon Panel on Standard Setting for Private Companies. This Report provides recommendations on how to deal with accounting standards for private companies. This chapter distills the recommendations into a digestible source that is designed to assist accounting practitioners in putting these proposed principles into practice.

Chapter 2 discusses ASC 740, Income Taxes (formerly FAS 109), which has been around for almost two decades. Yet, there are several key issues related to deferred income taxes that exist because of the recent economic climate and changes proposed by health care reform. This chapter addresses those issues which consist of deferred income tax assets from net operating losses (NOLs) and the need for valuation accounts, and deferred income taxes due to the change in the Patient Protection and Affordable Care Act (PPACA).

Chapter 3 covers the Statement of Cash Flows, which over the past decade, has come under scrutiny by investors and other third parties. Once focusing on the statement of income as the primary course of assessing financial performance, greater emphasis has been placed on cash flow. This chapter explains some of the most common complaints and what the problem is with existing practice when reporting the Statement of Cash Flows.

Chapter 4 distills the proposed changes to loss contingency disclosures, climate change disclosures and the overall politics regarding disclosures and is designed to assist accounting practitioners in putting these principles into practice.

Module 2 of this course reviews financial statement reporting.

Chapter 5 discusses the recently proposed authoritative literature regarding financial performance reporting and is designed to assist accounting practitioners in putting these proposed principles into practice.

Chapter 6 focuses on the authoritative literature on the fair value option for financial assets and financial liabilities and is designed to assist accounting practitioners in putting these principles into practice.

Chapter 7 reviews the recently proposed authoritative literature regarding lease accounting to assist accounting practitioners in putting these proposed principles into practice.

Module 3 of this course covers current developments.

Chapter 8 distills an analysis of selected ASUs issued in 2009-2011 and is designed to assist accounting practitioners in putting these principles into practice.

Chapter 9 reviews how since 1980, there has been a significant shift away from defined benefit plans with a drop to less than 20 percent of the workforce currently covered by such plans. The move was gradual until two significant changes occurred that have motivated companies to eliminate or freeze their defined benefit plans. This chapter distills these changes into a digestible source that is designed to assist accounting practitioners in better understanding the demise of defined benefit pension plans.

Chapter 10 discusses how the FASB is suggesting that the historical cost model no longer works and needs to be replaced or repaired with a fair value model whenever assets and liabilities can be reliably measured at fair value. However, there are arguments for and against a fair value system. This chapter distills an analysis of those arguments and is designed to assist accounting practitioners in understanding this controversy.

Throughout this course you will find Examples and Observations to illustrate the topics covered and assist you with comprehension of the course material, as well as Study Questions to help you test your knowledge. Answers to the Study Questions, with feedback on both correct and incorrect responses, are provided in a special section beginning on page 271. To assist you in your later reference and research, a detailed topical index has been included for this course, beginning on page 295.

This course is divided into three Modules. Take your time and review each course Module. When you feel confident that you thoroughly understand the material, turn to the CPE Quizzer. Complete one or all Module Quizzers for Continuing Professional Education credit. You can complete and return the Quizzers to CCH for grading at an additional charge. If you receive a grade of 70 percent or higher on the Quizzers, you will receive CPE credit for the Modules graded. Further information is provided in the CPE Quizzer Instructions on page 305.

August 2011

COURSE OBJECTIVES

This course provides an overview of important accounting developments. At the completion of the course, the reader will be able to:

- Compare the arguments in favor of and against Big GAAP-Little GAAP and the Blue Ribbon Panel Report
- Discuss deferred income tax assets from NOLs and the need for valuation accounts, and
- Describe the impact on accounting for deferred income taxes due to the change in the Patient Protection and Affordable Care Act (PPACA).
- Describe the difference between using the direct and the indirect method
- List some of the more common criticisms regarding existing cash flow reporting practices
- Discuss some of the most common abuses in the statement of cash flows
- Discuss the presentation of cash from operations versus working capital flow
- Describe the proposed changes to loss contingency disclosures
- List and discuss the 12 recommended principles for the Comprehensive Business Reporting Model
- Identify the formula used to compute free cash flow
- Compute the four key ratios used to analyze working capital
- Compute days sales outstanding (DSO) and average days delinquent (ADD)
- Describe how core earnings is computed
- List ways in which companies recognize revenue prematurely
- Describe the three-level fair value hierarchy for valuation
- Describe the general rules of the fair value measurement option
- Identify the disclosure requirements for fair value measurements
- Describe the effect of the proposed new lease standard on financial statements
- Explain how a lessee must account for initial direct costs incurred in connection with a lease under the proposed standards
- Explain how the proposed new lease standard may affect financial ratios
- Describe the accounting for fair value measurements and disclosures for investments in certain entities that calculate net asset value per share
- Recite the requirements of the selected ASUs in this course including the accounting for revenue recognition with multiple-deliverable revenue arrangements, revenue arrangements that contain tangible products and software, noncontrolling interests and changes in ownership interests of a subsidiary, subsequent events, loans to participants by defined contribution pension plans and disclosure requirements related to fair value measurements.
- Discuss the U.S. shift away from company pensions toward IRAs
- Discuss the status of the FASB fair value project
- Argue for and against fair value measurement

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MODULE 1: ONGOING ISSUES — CHAPTER 1

Big GAAP- Little GAAP- Blue Ribbon Panel Recommendations

LEARNING OBJECTIVES

Upon completion of this chapter, the reader will be able to do:

- Describe the background which led to the establishment of the Blue Ribbon Panel
- Recite the recommendations made in the Blue Ribbon Panel report
- Compare the arguments in favor of and against Big GAAP-Little GAAP and the Blue Ribbon Panel Report

BACKGROUND

For years there has been discussion about establishing two sets of generally accepted accounting principles (GAAP) rules; one for private companies and the other for larger SEC companies. Yet, each time the discussion has fallen into oblivion with no real support from the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB).

The Big GAAP-Little GAAP issue has been around since 1974 and still has not been resolved. There is a long history of various attempts to develop two sets of rules for GAAP, one for private and the other for public companies. For purposes of this discussion, the term "Big-GAAP" references to GAAP for public companies while "Little GAAP" references to a modified version applicable to private (nonpublic) companies.

Because the continued start and stop of Big GAAP-Little GAAP issue has yielded little change, small businesses such as Joe's Pizza Shop and Mary's Office Supply Store and their accountants have had to apply the same standards used by IBM and Microsoft.

Nevertheless, the Big GAAP-Little GAAP movement has received new impetus over the past few years due to several reasons:

- In the past few years, the FASB has issued several extremely controversial FASB statements and interpretations that are costly and difficult for nonpublic entities to implement and not meaningful to the third parties they serve.
- The Sarbanes-Oxley Act of 2002 mandates that the FASB's funding come primarily from SEC registrants, thereby suggesting that the FASB's focus will continue to be on issues important to public entities.

- The FASB and International Accounting Standards Board (IASB) in Europe continue to work on an international standards convergence project that will ultimately result in one set of international GAAP standards. Changes will be required to existing U.S. GAAP standards and many of those changes will not be important to nonpublic entities.
- Presently, accountants from smaller CPA firms or from nonpublic companies are not serving as FASB staff or board members, which will result in no small business representation or perspective in the FASB.
- On the auditing side, the role of the Auditing Standards Board (ASB) has diminished to issuing auditing standards for nonpublic entities only. The Public Company Accounting Oversight Board (PCAOB) is now the standard-setter for SEC auditors. Thus, the AICPA's ASB has a closer focus on the needs of nonpublic audits.

In the past few years, there has been sharp criticism pointed toward the FASB in their issuance of several very controversial statements that are extremely difficult to implement for smaller closely held companies including:

- *Consolidation of Variable Interest Entities* (ASC 810) (formerly FIN 46R): Requires all entities (large and small) to consolidate their operating entities with their off-balance-sheet real estate leasing entities, in certain circumstances.
- *Accounting for Uncertainty in Income Tax (An Interpretation of FAS 109)* (ASC 740) (formerly FIN 48): Clarifies the accounting for uncertainty in tax positions related to income taxes recognized in an entity's financial statements.

In addition, layers of disclosures have been added to GAAP over the past decade, many of which are targeted at larger publicly held entities. Yet, the FASB and AICPA have not exempted nonpublic or smaller entities from the application of those disclosures.

In general, there have been few instances in which the FASB has issued standards that exempt private companies. A few of those instances include:

- ASC 260 (formerly FAS 128: *Earnings Per Share*)
- ASC 280 (formerly FAS 131: *Disclosures about Segments of an Enterprise and Related Information*)
- ASC 825 (formerly FAS 107: *Disclosure about Fair Value of Financial Instruments*)

In fact, the extent to which the FASB has carved out GAAP exclusions for private companies is limited to delaying the effective date of a new standard and, in very limited cases, exempting private companies from one or two disclosures. Otherwise, private companies have had to adopt the same standards as public companies.

Consequently, accountants and their clients have defaulted to using several techniques to avoid the burdensome task of having to comply with recently issued, difficult, and irrelevant accounting standards, including:

- Using OCBOA (e.g., income tax basis financial statements)
- Including a GAAP exception in the accountant's/auditor's report
- Ignoring the new GAAP standards

However, some third parties have not been receptive to using OCBOA financial statements, and issuing a GAAP exception could be a red flag. Simply ignoring the new GAAP standards has its obvious problems.

Adding to the difficulty has been the AICPA and the FASB's unwillingness to focus on the needs of private companies. For years, critics have suggested that the AICPA focuses its efforts on the "Big Four" and ignores the concerns of smaller firms and their clients. With respect to the FASB, prior to the issuance of Sarbanes-Oxley in 2002, the FASB received most its funding from the SEC's Fortune 500 companies. After the Sarbanes-Oxley Act, essentially all of the FASB's funding is financed by the SEC registrant community so that the FASB's emphasis is in serving the public company arena.

PRIOR ATTEMPTS AT LITTLE GAAP

Over the past 40 years, there have been 12 studies and reports on some version of Big GAAP-Little GAAP conducted by committees on behalf of the FASB and the AICPA. No action was taken on any of the studies' recommendations.

In March 2004, the AICPA announced that it was developing a *Private Company Financial Reporting Task Force* to discuss the reporting issues for private companies in the post- Sarbanes-Oxley Act period.

In particular, the AICPA announced that some of the concerns noted by members include (AICPA Task Force to Explore Financial Reporting for Private Companies, AICPA):

- There is frustration with the current body of GAAP and its relevance to smaller, private companies.
- There is a belief that lenders do not typically use all of the GAAP information required in financial statements of private companies.
- There is a cost-benefit distortion for some financial reporting and disclosures required by private companies.
- There is a trend by the FASB toward one set of international accounting standards and fair value accounting, both of which may be less relevant to private companies.

In October 2004, an AICPA Task Force issued a report entitled *2004 Private Company Financial Reporting Study*. That report was followed by a May

2005 AICPA Council passage of a resolution endorsing an effort to explore potential changes to GAAP for private companies.

Findings from the 2004 report concluded that GAAP for private companies should be developed based on concepts and accounting that are appropriate for the distinctly different needs of constituents of financial reporting.

The report further stated that although GAAP with exceptions and OCBOA are being used for private companies, the Task Force did not believe that these exceptions and OCBOA are the best response to private company financial reporting.

In June 2006, the FASB and AICPA issued a joint proposal entitled, *Enhancing the Financial Accounting and Reporting Standard Setting Process for Private Companies.* The Proposal had, as its primary basis, a mechanism by which the FASB can be more reflective of the needs of nonpublic entities during the FASB's deliberation process.

Specifically, the document proposed that the FASB do the following:

- Make certain improvements to the FASB's current processes for determining whether differences are needed in prospective and existing accounting standards for private company financial reporting
- Sponsor a committee designed to increase private company constituent input in the standard-setting process
- During the standard-setting process, have FASB staff provide the FASB members with alternatives for private companies based on differences in user needs and cost-benefit considerations
- Articulate within the basis for conclusions section of standard-setting documents the basis for its decisions on whether differences should exist for recognition, measurement, disclosure, transition, or effective-date for private companies
- Co-sponsor and co-fund, with the AICPA, a committee (Private Company Financial Reporting Committee [PCFRC]) to provide recommendations that will help the FASB Board determine whether there should be differences in prospective and existing accounts standards for private companies

Throughout 2010 and into 2011, the PCFRC held several meetings. Although the PCFRC was supposed to provide the FASB with input on modifying new GAAP statements for the needs of private companies, its efforts to date have fallen flat. Instead of making modification or exceptions for private companies, the extent to which the FASB has actually taken action for private companies is to delay the effective date of new FASB statements and, in limited cases, eliminated some of the disclosures in those statements. No actions have been taken to exempt private companies from recently issued FASB statements.

STUDY QUESTIONS

1. Why has the Big GAAP-Little GAAP movement received new impetus over the past few years?
   a. Many changes that will be required by the single set of international GAAP standards will not be important to public entities.
   b. Recent controversial FASB statements and interpretations are costly and difficult for nonpublic entities to implement.
   c. The Sarbanes-Oxley Act mandates that the FASB's funding come from nonpublic entities.
   d. There is no large business representation or perspective on the FASB.

2. Which of the following is one of the extremely controversial statements that is difficult to implement for smaller closely held companies?
   a. Consolidation of Variable Interest Entities
   b. Disclosure about Fair Value of Financial Instruments
   c. Earnings Per Share
   d. Segment Reporting

BLUE RIBBON PANEL TO THE RESCUE IN 2011

Perhaps the most promising move toward GAAP for private companies is the Blue Ribbon Panel on Standard Setting for Private Companies (the Panel).

In December 2009, a group of organizations led by the AICPA, the Financial Accounting Foundation (FAF, the parent organization of the FASB), and other organizations, established a blue ribbon panel to address accounting standards of private companies. The Panel was comprised of 18 members, all senior leaders including lenders, investors, owners, accountants and auditors. The Panel also invited regulators and other stakeholders to participate (but not vote) in the discussions of the Panel.

Although this effort appeared to be more *déjà vu*, and redundant with the actions of many other panels and committees, the Panel issued a report in January 2011 to the FAF (Report to the Board of Trustees of the Financial Accounting Foundation, issued January 2011). That report made drastic recommendations as to how to resolve the accounting standards challenges for private companies.

Unlike previous panels and committees, the Panel made the following recommendations to the FAF:

Problems with the current system. There are urgent and growing systemic issues that need to be addressed in the current system of U.S. accounting standard setting.

Systemic issues include:

- An insufficient understanding of the needs of users of private company financial statements and how the needs of private companies differ from those of public companies
- An insufficient weighing of the costs and benefits of GAAP for use in private company financial reporting, such as those on:
  - Variable interest entities
  - Uncertain tax positions
  - Fair value measurements
  - Goodwill impairment

There is a lack of relevance in a number of accounting standards as they relate to private company financial statements, including an overall level of complexity and unnecessary cost. Because of the lack of relevance and the complexity surrounding some GAAP standards, many private companies have chosen alternatives to GAAP including:

- Receiving a qualified or except-for opinion
- Using OCBOA (income tax or cash basis)

The FASB will not be able to fully assess and respond sufficiently and appropriately to the needs of the private company sector. Despite there being approximately 14,000 public companies in the United States as compared with 28 million private companies, the FASB's focus has been limited to public company sector.

Previous studies were practitioner-driven and the FASB did not formally research the needs of private companies:

- The last time that the FASB formally researched the needs of private companies was in 1983
- Since the AICPA's Private Company Financial Reporting Task Force started working with the FASB in 2007, the FASB has not shown a willingness to carve any private company differences out of new standards.
  - The Task Force has submitted 40 recommendation letters to the FASB since 2007
  - The FASB's modifications for private companies generally have been limited to allowing different effective dates, and in some cases, different disclosures

International standards for private companies. Standard setters outside the United States have come to believe that there should be significant differences for private company reporting:

- Many countries around the world have adopted the International Financial Reporting Standards for Small and Medium-sized Entities (IFRS for SMEs) for their private companies

- The UK is planning to adopt the IFRS for SMEs for use by its private companies
- Canada has created a standalone set of accounting standards for private companies

Recommendations by the Panel. The Panel recommends that in the near term, the system should focus on making *exceptions and modifications to U.S. GAAP* for private companies that better respond to the needs of the private company sector rather than move toward a separate, self-contained GAAP for private companies or a wholesale reorganization of GAAP.

The Panel recommends that the private company model consist of *U.S. GAAP with Exceptions and Modifications (with Process Enhancements).*

This new model should *retain existing GAAP* for both private and public companies, but there would be carve-out exceptions and modifications for private companies. The exceptions and modifications would result in financial statements that provide relevant, decision-useful information that meets the needs of private company financial statement users in a cost-effective manner.

There should be a *new separate private company standards board* to help ensure that appropriate and sufficient exceptions and modifications are made for private companies, for both new and existing standards.

- The new board would:
  - Consist of five to seven members that are representative of the private company sector and would work closely with the FASB to achieve a coordinated and efficient standard-setting process
  - Work closely with the FASB
  - Have final authority over establishing GAAP exceptions and modifications for private companies
  - Have the power to initiate its own projects
  - Go through a comprehensive review to be conducted in three to five years to evaluate its effectiveness and make additional process improvements to it, if needed
- The FASB would be able to promulgate a GAAP exception or modification in a GAAP standard (with the support of the new board) or the new board would have authority to promulgate a difference if the FASB chose not to allow a difference.
- Most of the cost of the new board and staff would have to be funded by a viable, new source, such as mandatory annual or one-time (endowment) contributions from stakeholders and maybe a state board licensing fee allocation. The annual budget is estimated at $4 to 6 million.