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U.S. GAAP vs. IFRS*

GAAP 2011

Interpretation and Application of
GENERALLY ACCEPTED
ACCOUNTING PRINCIPLES

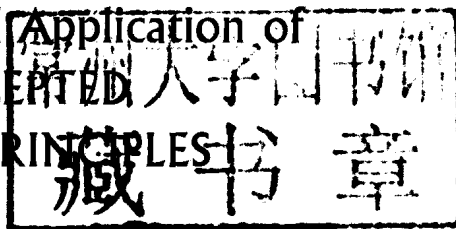
Steven M. Bragg

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GAAP

2011

Interpretation and Application of
GENERALLY ACCEPTED
ACCOUNTING PRINCIPLES



Steven M. Bragg



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PREFACE

GAAP: Interpretation and Application provides analytical explanations and copious illustrations of all current generally accepted accounting principles. The book integrates principles promulgated by all the relevant standard-setting bodies—the FASB, including its Emerging Issues Task Force’s consensus summaries and discussion issues and staff positions, and the AICPA’s Accounting Standards Executive Committee (AcSEC)—which have now been officially withdrawn and integrated into the FASB’s recently released *Accounting Standards Codification*.TM

With the completion and public release of the FASB’s codification project, virtually all formerly promulgated and still-extant US GAAP has been superseded by a unified, codified set of standards. All such guidance is now presented in a single, integrated set of materials, and former individual standards, interpretations, and other requirements have been withdrawn. This book represents a complete integration of the new Accounting Standards Codification (ASC) references into the *Wiley GAAP* reference work that is now in its 27th annual edition.

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

Each chapter of this book, or major section thereof, provides an overview discussion of the perspective and key issues associated with the topics covered; a listing of the professional pronouncements which guide practice; and a detailed discussion of the concepts and the accompanying examples. A comprehensive disclosure checklist, following the main text, offers practical guidance to preparing financial statements in accordance with GAAP, with supplemental insights into SEC-mandated disclosures as needed.

The author’s wish is that this book will serve preparers, practitioners, faculty, and students, as a reliable reference tool to facilitate their understanding of, and ability to apply, the complexities of the authoritative literature. Comments from readers, both as to errors and omissions and as to proposed improvements for future editions, should be addressed to Steven Bragg at bragg.steven@gmail.com.

Steven M. Bragg
July 2010

ABOUT THE AUTHOR

Steven Bragg, CPA, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been the two-time President of the Colorado Mountain Club, and is an avid alpine skier, mountain biker, and certified diver. Mr. Bragg resides in Centennial, Colorado. He has written the following books:

Accounting and Finance for Your Small Business

Accounting Best Practices

Accounting Control Best Practices

Accounting Policies and Procedures Manual

Advanced Accounting Systems

Billing and Collections Best Practices

Business Ratios and Formulas

Controller's Guide to Costing

Controller's Guide to Planning and

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Controller's Guide: Roles and

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Controllershship

Cost Accounting

Cost Reduction Analysis

Essentials of Payroll

Fast Close

Financial Analysis

GAAP Guide

GAAP Policies and Procedures Manual

GAAS Guide

Inventory Accounting

Inventory Best Practices

Investor Relations

Just-in-Time Accounting

Management Accounting Best Practices

Managing Explosive Corporate Growth

Mergers and Acquisitions

Outsourcing

Payroll Accounting

Payroll Best Practices

Revenue Recognition

Run the Rockies

Running a Public Company

Sales and Operations for Your Small Business

The Controller's Function

The New CFO Financial Leadership Manual

The Ultimate Accountants' Reference

Throughput Accounting

Treasury Management

Vest Pocket Controller

Vest Pocket GAAP

Vest Pocket IFRS Guide

FREE ONLINE RESOURCES BY STEVE BRAGG

Steve issues a free accounting best practices podcast. You can sign up for it at www.accountingtools.com, or access it through iTunes. The www.accountingtools.com Web site also contains hundreds of articles about a broad range of accounting topics.

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DEVELOPMENT OF GAAP

What Is GAAP?

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

Generally accepted accounting principles (GAAP) are concerned with the measurement of economic activity, the time when such measurements are to be made and recorded, the disclosures surrounding this activity, and the preparation and presentation of summarized economic information in the form of financial statements. GAAP develops when questions

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

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

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

Who Created GAAP?

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

Committee on Accounting Procedure. The first serious attempt to create formalized generally accepted accounting principles began in 1930, primarily as a consequence of the stock market crash of 1929 and the widespread perception that an absence of uniform and stringent financial reporting requirements had contributed to the rampant stock market speculation of the preceding decade that culminated with that crash. (Previously, GAAP had largely been defined by academic writings and general industry practices.) The American Institute of Accountants, (which in 1957 was renamed the American Institute of Certified Public Accountants [AICPA]), created a special committee to work with the New York Stock Exchange toward the goal of establishing standards for accounting procedures. The special committee recommended five rules to the Exchange that were published in 1938 as Accounting Research Bulletin (ARB) 1 of the Committee on Accounting Procedure. The Committee subsequently published 51 such bulletins, including Accounting Research Bulletin 43, which consolidated and superseded Bulletins 1–42. The Committee also attempted to achieve uniformity in accounting terminology. However, the Committee's limited resources and lack of serious research efforts in support of its pronouncements were questioned in the late 1950s, particularly as a number of very complex controversial topics loomed on the horizon.

Accounting Principles Board. The profession's response was to substitute, under its auspices, the Accounting Principles Board (APB) for the Committee on Accounting Procedure. This was done to facilitate the development of principles, which were to be based primarily on the research of a separate division of the AICPA, the Accounting Research Division. Under this strategy, the Division was to undertake extensive research, publish its

findings, and then permit the Accounting Principles Board to take the lead in the discussions that would ensue concerning accounting principles and practices.

During the Board's fourteen years of existence, it issued 31 authoritative opinions and 4 nonauthoritative statements. They dealt with amendments of Accounting Research Bulletins, opinions on the form and content of financial statements, and issuances requiring changes in both the recognition and disclosure principles of the profession. However, the Board did not make use of the efforts of the Accounting Research Division, which published fifteen research studies during its lifetime. Both the Board and the Division acted independently in selecting topics for their respective agendas. The Board issued pronouncements in areas where little research had been done, and the Division performed research studies without seeking to be all-inclusive or exhaustive in analysis. The Accounting Principles Board did not, ultimately, operate differently or more effectively than had the Committee on Accounting Procedure.

Financial Accounting Standards Board. As a result of these operational problems, in 1971 the AICPA appointed the "Wheat Study Group," chaired by former SEC commissioner Francis M. Wheat. The Wheat Study Group was charged with examining the standard-setting process and making recommendations regarding the form and structure of the standard-setting process as well as whether standard setting should reside in the government or in the private sector. Based on the recommendations of this group, the Financial Accounting Standards Board (FASB) was formed in 1972.

FASB is recognized as authoritative through Financial Reporting Release 1 of the Securities and Exchange Commission and through Rule 203 of the AICPA Code of Professional Conduct.

FASB is an independent body relying on the Financial Accounting Foundation for selection of its members and approval of its budgets. FASB is supported by the sale of its publications and by fees assessed on all public companies based on their market capitalizations.

From its inception through the mid-2009 implementation of the Accounting Standards Codification (discussed below), the Board issued several types of pronouncements. The most important of these are Statements of Financial Accounting Standards and the FASB Interpretations, the latter of which are used to clarify or elaborate on existing Statements or pronouncements of predecessor bodies. Prior to mid-2009, Standards and Interpretations constituted category A GAAP, which also included FASB staff positions—a relatively recent form of guidance—and the Board's FAS 133 implementation issues. Technical Bulletins, which were formerly category B GAAP, usually addressed issues not covered directly by existing standards, and were primarily used to provide guidance where it was not expected to be costly or require a major change in practice. Bulletins were discussed at Board meetings and subject to Board veto. Both Bulletins and Interpretations were designed to be responsive to implementation and practice problems on relatively narrow subjects.

The FASB staff was empowered to issue implementation guides and staff positions, which were included in category D of the former GAAP hierarchy. In a question-and-answer format, these implementation guides addressed specific questions that arose when a standard was initially issued. Staff positions, of which many were produced in the past several years, were responses to questions on appropriate application of FASB literature that were expected to have widespread relevance. Implementation guides and staff positions were drafted by the staff and then issued, provided that a majority of the FASB Board members did not object. In addition, staff positions were required to be exposed on the FASB Web site for a 30-day comment period before issuance.

Beginning July 1, 2009, all codified GAAP was placed in a single level of the hierarchy (the second, lower level will contain what formerly was defined as category E, consisting of scholarly writings, texts and guides by private-sector authors, guidance by other relevant bodies, and so forth), so the formerly important distinctions among categories A-D were eliminated.

American Institute of Certified Public Accountants (AICPA). The Accounting Standards Executive Committee (AcSEC) has been the senior technical committee at the AICPA. It is composed of fifteen volunteer members, representative of industry, academia, analysts, and both national and regional public accounting firms. All AcSEC members are CPAs and members of the AICPA.

AcSEC has been authorized to set accounting standards and to speak for the AICPA on accounting matters. The accounting standards that AcSEC issued were prepared largely through the work of various AICPA committees and task forces. AcSEC issued Statements of Position (SOPs) and industry audit and accounting guides, which were reviewed and cleared by the FASB and thus constituted category B GAAP under the former hierarchy. SOPs provided guidance on financial accounting and reporting issues. Industry audit and accounting guides were intended to provide guidance to auditors in examining and reporting on financial statements of entities in specific industries and provided standards on accounting problems unique to a particular industry. AcSEC Practice Bulletins (formerly category C GAAP) usually provided guidance on very narrowly defined accounting issues. Until relatively recently, the standards issued by AcSEC addressed topics broadly applicable to all industries in addition to industry-specific topics.

Emerging Issues Task Force (EITF). The Emerging Issues Task Force (EITF) was formed in 1984 by the FASB in order to assist the Board in identifying current or emerging issues and implementation problems before divergent practices become entrenched. The guidance provided has often been restricted to narrow issues that were of immediate interest and importance. Task Force members have been drawn primarily from public accounting firms but also included individuals who would be aware of issues and practices that should be considered by the group.

For each EITF agenda item, an issues paper is developed by members, their firms, or the FASB staff. After discussion by the Task Force, a consensus may be reached on the issue, in which case the consensus is referred to the FASB for ratification at its next scheduled meeting. If no consensus is reached, the matter may end up on the Board agenda or be resolved by the SEC, or the issue will remain unresolved with no standard-setting organization currently considering it. These issues may be in especially narrow areas having little broad-based interest. Occasionally, FASB may include a narrow issue in the scope of a broader project and reaffirm or supersede the work of the Task Force.

Although EITF pronouncements were technically category C GAAP, they were so specialized that generally there had been no category A or B GAAP covering the respective topics, making the consensus the highest ranking guidance on the issue. The SEC was of the view that a Task Force consensus constituted GAAP for public companies, and it would question any accounting that differed from it.

The EITF also previously published Discussion Issues, which are FASB staff announcements and SEC staff announcements regarding technical matters that are deemed important by the FASB or SEC staff, but that do not relate specifically to a numbered EITF issue. These announcements were designed to help provide guidance on the application of relevant accounting pronouncements. Production of discussion issues declined over recent years and it was not anticipated that further discussion issues would be produced.

Other sources. Not all GAAP has resulted from a deliberative process and the issuance of pronouncements by authoritative bodies. Certain principles and practices evolved into current acceptability without formally adopted standards. For example, depreciation methods such as straight-line and declining balance have both long been acceptable, as are alternative inventory costing methods such as LIFO and FIFO. There are, however, no definitive pronouncements that can be found to state this. Furthermore, there are many disclosure principles that evolved into general accounting practice because they were originally required by the SEC in documents submitted to them. Among these are reconciling the actual rate with the statutory rate used in determining income tax expense, when not otherwise obvious from the financial statements themselves. Even much of the content of statements of financial position and income statements has evolved over the years in the absence of adopted standards. These other sources of GAAP remain relevant and are found in the second level (of the two levels) of the new hierarchy.

Accounting Standards Codification. FASB completed its project to codify GAAP in 2009 and released it in mid-2009; at that time, all existing GAAP literature was officially withdrawn.

The accounting standards codification eliminates the multilevel hierarchy in favor of a bifurcation between authoritative and nonauthoritative guidance. The Codification does not change GAAP, per se, but instead introduces a new structure—one that is organized into a more readily accessible, user-friendly online research system. It thus reorganizes the multitude of GAAP pronouncements into about 90 accounting Topics, and displays all Topics using a consistent structure. The Codification also includes relevant SEC guidance, which follows the same topical structure used in the Codification. According to FASB, this new system should reduce the amount of time and effort required to solve an accounting research issue; mitigate the risk of noncompliance with standards through improved usability of the literature; provide accurate information with real-time updates as new standards are released; and assist the FASB with the research and convergence efforts required during the standard-setting process.

How Is GAAP Created?

For many decades, until the changes being wrought by the new Codification begin to be felt, GAAP has been created by the promulgation of standards and interpretations by the bodies granted statutory and professional authority to make such rules. The FASB and AICPA both long adhered to rigorous “due process” when creating new guidance in category A and category B GAAP. The goal was, and will continue to be, to involve constituents who would be affected by the newly issued guidance so that the standards created will result in information that reports economic activity as objectively as possible without attempting to influence behavior in any particular direction. Ultimately, however, the guidance is the judgment of the FASB or the AICPA, based on research, public input, and deliberation. The FASB’s due process procedures are described below. The AICPA follows similar procedures in its projects, but may have a reduced role in the future. “Due process,” however, will remain as a guiding principle in the overall development of GAAP.

The FASB receives requests for new standards from all parts of its diverse constituency, including auditors, industry groups, the EITF, and the SEC. Requests for action include both suggestions for new topics and suggestions for reconsideration of existing pronouncements. For each major project it adds to its technical agenda, the FASB begins by appointing an advisory task force of approximately fifteen outside experts. Care is taken to ensure that various points of view are represented on the task force. The task force meets with and advises the Board and staff on the definition and scope of the project and the nature and extent