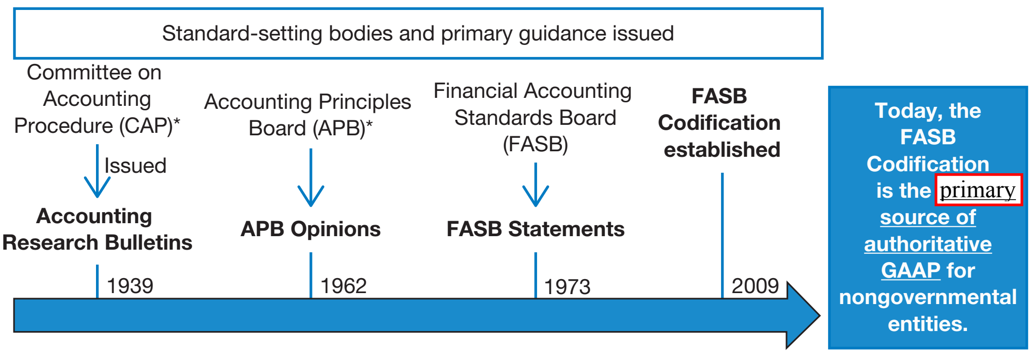
primarily responsible for establishing U.S. accounting guidance. Having a basic familiarity with these standard setters provides context for understanding the accounting guidance applicable today.

This history follows a chronological order, beginning with the SEC—the first entity given formal authority to establish U.S. accounting standards. Figure 1-7 illustrates a timeline of key U.S. accounting standard setters.



* A committee formed by the AICPA

Figure 1-7

Brief timeline of key U.S. accounting standard setters

The Securities and Exchange Commission

Following a crisis in investor confidence resulting from the Great Depression, the Securities Exchange Act of 1934 (the "1934 Act") created the SEC with the objective of providing investors with reliable financial information about public companies. First and foremost, the SEC's role is to act as a law enforcement agency, tasked with the authority to enforce securities laws in order to protect the investing public. The SEC describes the work of its Division of Enforcement, in part, as follows:

> *Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violation of the securities laws. Typical infractions include insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them.*[4]

A second authority granted to the SEC in the 1934 Act was the authority to establish accounting standards. The SEC elected to delegate this responsibility—first to the AICPA (American Institute of Certified Public Accountants) and later to the FASB. (Notably, the Sarbanes-Oxley Act of 2002 established criteria—such as funding and independence requirements—related to the SEC's choice of standard-setter.) The FASB website describes its relationship to the SEC as follows:

> *The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.*[5]

As noted, the SEC relies on the private sector to establish accounting guidance, on condition that the private sector demonstrates its "ability to fulfill" this responsibility. Accordingly,

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[4] www.sec.gov, "About" - "What We Do." Accessed July 13, 2012

[5] www.fasb.org, "Facts about FASB." Accessed June 14, 2012.

WHAT IS THE FASB CODIFICATION?

The FASB *Accounting Standards Codification* ("ASC" or the "Codification") is considered the primary source of **authoritative**, generally accepted accounting principles (GAAP) for nongovernmental entities. The Codification became effective in 2009, and its primary objective is to simplify research. Prior to the issuance of the Codification, accounting guidance in the form of individual standards had piled up for nearly a century. Accounting practitioners often had to search several different standards to find guidance on a single topic. This created the risk that practitioners could miss important sources when searching for guidance. The Codification reduces that risk by organizing accounting guidance by topic, within a single research source.

> What does it mean for the Codification's guidance to be *authoritative*? It means that the Codification establishes GAAP. In order to receive an unqualified audit opinion, U.S. nongovernmental entities must prepare their financial statements in accordance with Codification guidance.

The FASB gets its authority to set GAAP primarily from two sources.

- First, the SEC, acting in its authority under the Securities Exchange Act and Sarbanes-Oxley, has identified the FASB as the designated private sector standard setter with authority to establish GAAP.[1]
- Second, in Rule 203-2 of its Code of Professional Conduct, the AICPA recognizes the FASB as the organization with the authority to establish GAAP for nongovernmental entities. An auditor may not issue an unqualified opinion for financial statements containing a material departure from GAAP.[2, 3]

Using this authority, the FASB has designated the Codification as the sole source of its authoritative guidance.

The term **nongovernmental entities** encompasses both public and nonpublic (private) entities, as well as not-for-profit entities. However, these entities are not always treated as equals within the Codification. That is, due to resource constraints and perceived lesser demand for nonpublic entity financial statements, nonpublic entities are exempt from some requirements (such as segment reporting requirements) and are frequently given longer transition periods for adopting new guidance. As noted in Chapter 1, the Private Company Council (PCC) was created in 2012 and has already begun to identify possible new exceptions and modifications within U.S. GAAP for nonpublic companies. Over the next few years, the work of the PCC is expected to increase the number of differences within U.S. GAAP between public and nonpublic entities.

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[1] SEC Release No. 33-8221, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*. April 25, 2003.

[2] AICPA Code of Professional Conduct, Rule 203—*Accounting Principles*, par. 01: "A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole."

[3] AICPA Code of Professional Conduct, Rule 203-2—*Status of FASB, GASB and FASAB interpretations*, par. 03: "Council is authorized under Rule 203 [sec. 203 par. .01] to designate bodies to establish accounting principles. Council has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB Accounting Standards Codification™ (ASC) constitutes accounting principles as contemplated in Rule 203 [sec. 203 par. .01]."

TIP from the Trenches

Caution—As with other sources of nonauthoritative guidance, firm guidance is helpful for *interpreting* the Codification, but it should not *replace* your use of authoritative guidance. Guidance citations in accounting memos should primarily come from authoritative sources.

EXAMPLE

Using Accounting Firm Resources

Imagine a scenario in which you are evaluating a contract for the purchase of all output from a manufacturing plant to determine whether it is a lease. In the contract, the term "contract price" is defined as the sum of

1. A fee based on the variable operating costs of the plant (such as electricity / water usage of the plant), plus
2. An amount based on the current market price of the output.

In the Codification, one of the conditions necessary for an arrangement to qualify as a lease is, in part[10]

> ". . . the price that the purchaser (lessee) will pay for the output is . . . [not] equal to the current market price per unit of output as of the time of delivery of the output" (ASC 840-10-15-6c). [Emphasis added]

Assume that you are unsure how the term "market price per unit" is defined, and interpretive guidance for this is not available within the Codification. You turn to Ernst & Young's guide book, *Lease Accounting* (2011) for additional guidance on this issue (see excerpted table of contents in Figure 4-8).

Contents

Continued

Figure 4-8
Excerpted table of contents from Ernst & Young's guide book, *Lease Accounting* (2011)

[10] ASC 840-10-15-6, Leases—Overall—Scope, identifies three conditions, and if any one of these conditions is met, the contract meets the definition of a lease. This example illustrates just part of one of these three conditions. The full condition reads:

> c. Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant, or equipment during the term of the arrangement, and the price that the purchaser (lessee) will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

8. Name three examples of organizations that are within the scope of not-for-profit entities industry guidance.
9. Locate Deloitte's most recent guide to income tax accounting, *A Roadmap to Accounting for Income Taxes*. Does Deloitte believe that not-for-profit foundation excise taxes (e.g., taxes on the sale of goods or production of income) are within the scope of Topic 740 (Income Taxes)? Why or why not?

CASE STUDY QUESTION

Asset Exchange (Drafting an Issues Memo)—Advanced Material 5.1

Facts: Acer Corp transfers factory equipment to Theta Corp in exchange for the receipt of $1 million cash and a 25% equity ownership stake in Theta. Acer's book basis in the transferred equipment was $6 million, and the equipment was recently appraised for $6.5 million. The fair value of the investment in Theta is $5.5 million, and this fair value was reliably determined. The investment gives Acer significant influence over Theta but is not a controlling financial interest in Theta. Theta is in the business of making and selling tissues (such as Kleenex) and will use the equipment for tissue production.

Prior to transferring the equipment, Acer used the equipment to produce paper plates and napkins. However, significant overseas competition has caused profit margins and demand for the domestic production of paper plates and napkins to fall. Production using the equipment had recently been cut down to only 1 × 8-hr shift per day. Tissues are expected to be a more profitable output, with steady consumer demand. Theta expects to run the equipment for 3 × 8-hr shifts per day. Acer hopes the investment in Theta will revive its slowing growth prospects.

Required: You are in the controller's group of Acer and need to determine the appropriate accounting for this transaction.

First, evaluate whether this transaction is within the scope of the applicable topic. In doing so, please also evaluate whether this transaction is a monetary or nonmonetary exchange, based on the cash exchanged.

Next, determine the appropriate accounting for this transaction. In doing so, please be sure to evaluate whether the transaction has commercial substance (you may evaluate just one of the two conditions for commercial substance, of your choice).

Organize Acer's accounting issues into a memo, including journal entries for this transaction, and explain the authoritative basis for all journal entries recorded. Consider including a picture to enhance the "Background" section of the memo.

Note: Par. 25-6 (of the relevant topic) may be used to consider whether a transaction is "monetary" or "nonmonetary." However, do not look to this paragraph when determining how to account for the value exchanged in this transaction.

Also, assume that Acer will account for the ownership stake in Theta using the equity method.

7. Once an entity has determined that it is probable of having an environmental remediation liability, what costs must the entity initially include in its estimated environmental remediation liability (an "environmental obligation")?
8. In periods subsequent to the acquisition date in a business combination, what guidance is available regarding the measurement (by an acquirer) of contingent liabilities assumed? Assume the contingencies were recognized as of the acquisition date.
9. Under Topic 835-20 (Capitalization of Interest), what amount of interest may initially be capitalized as part of the initial investment in an asset, for certain qualifying assets? How should a company determine its "capitalization rate" for capitalizing interest?
10. When should an investor, applying the "equity method" of accounting for an investment, recognize equity method income—in the period the investee reports earnings, or in the period the investee declares a dividend?

CASE STUDY QUESTIONS

Accrual for a Lawsuit, Writing an Issues Memo Your company has just been named as defendant in a lawsuit related to a leak of chemicals, from one of your company's plants onto private property. The plaintiff is suing for $5 million in damages; your company's attorneys believe the ultimate amount of loss could range between $1 million and $3 million, with no amount in the range more likely than other amounts in the range. The lawsuit is expected to be resolved in the middle of next year. 7.1

Citing from authoritative literature, prepare a brief accounting issues memo to the files addressing (1) whether a loss should be accrued, and for what amount, and (2) what disclosures should be made in the company's financial statements.

Determining Whether an Impairment Is "Other Than Temporary," Writing an Email Assume you are an auditor, and your client is a public company with a large portfolio of available-for-sale equity securities. The client reports these securities at fair value, with unrealized gains and losses recognized in "other comprehensive income," an equity account, each period. 7.2

The client is preparing its quarterly financial statements and is again—for the second consecutive quarter—recording a decline in market value for several of the securities. These securities' fair values are now below their cost. From experience, you know that losses on available-for-sale securities must be recognized in *earnings* if (1) the securities are considered *impaired* (i.e., cost basis in excess of fair value) and (2) if the impairment is considered "other than temporary." Your client has asserted that it has the ability and intent to hold the securities, at least until their value recovers, and believes that the losses need only be recognized in OCI.

Locate the relevant accounting guidance, then draft an email to your audit supervisor (Sean) that

- tells him about this issue,
- explains the general requirement regarding impairment of available-for-sale securities, describes your evaluation of whether the change in security values should be considered an other-than-temporary impairment (and therefore recognized in earnings), and
- suggests next steps.

It may be difficult to reach a definitive conclusion regarding whether impairment is required; however, it is important that you make your supervisor aware of this issue and the relevant guidance. Consider all sources of "required reading" in your response. Try to be succinct, while fully addressing the issue (try not to overwhelm your supervisor with an overly lengthy email).

Measurement attributes used in public company balance sheets Working with a group, choose a U.S. public company, and locate its most recent year-end balance sheet in the company's 10-K. Your goal is to understand, and describe, how each <u>asset on the balance sheet</u> is measured, citing guidance from the Codification indicating the requirements for the measurement. 7.3

The following table and notes show an example of the deliverable you should provide. Follow this format, listing the balance sheet item, amount, and a brief summary of its measurement basis. Use additional notes to show (concisely) the Codification justification for this measurement, as well as to add any discussion that helps a reader's understanding of the item, or to share any facts you find interesting.

Use your own words in your explanations; do not copy directly from the company's financial statements. If you must use the company's words, provide a reference (cite the financial statements, and specific page number, as a source). In particular, when you come across assets that are industry- or company-specific, provide additional discussion of the items.

Do not choose a company just because its balance sheet is short. Aim for a minimum of seven assets on the balance sheet. You may elect to take a "pass" on up to two assets, for example, if you have difficulty locating, understanding, or explaining the item's measurement basis. However, please explain your rationale for any "passes" you elect to take.

Your group's final deliverable should be no more than 4 ~~to 5~~ pages (including roughly 1 page for the table). Present a deliverable that is polished. Also, feel free to be creative with your explanations/value add in your notes. For example, you can contrast your company's practices to other companies', point out items unique to your company's industry, highlight any recent changes in measurement method, and so on.

Once your group has selected a company, post your selection on the class discussion board, if available. Once a company is chosen by a group, other groups should not choose this company.

Example:

ABC Company, year-end 20X1 balance sheet

Financial Statement Item	Amount	Basis of measurement	Reference (to notes below)
Inventory	100,000	Lower of cost or market	Note 1
Loans receivable, net	200,000	Cost less uncollectible accounts reserve	Note 2

Note 1:

ABC Company has inventory, primarily in the form of purchased fuel, which it carries at cost. This is appropriate in accordance with ASC XXX-XX, which states: " ". One thing that is unique about ABC Company's inventory is that the Company . . .

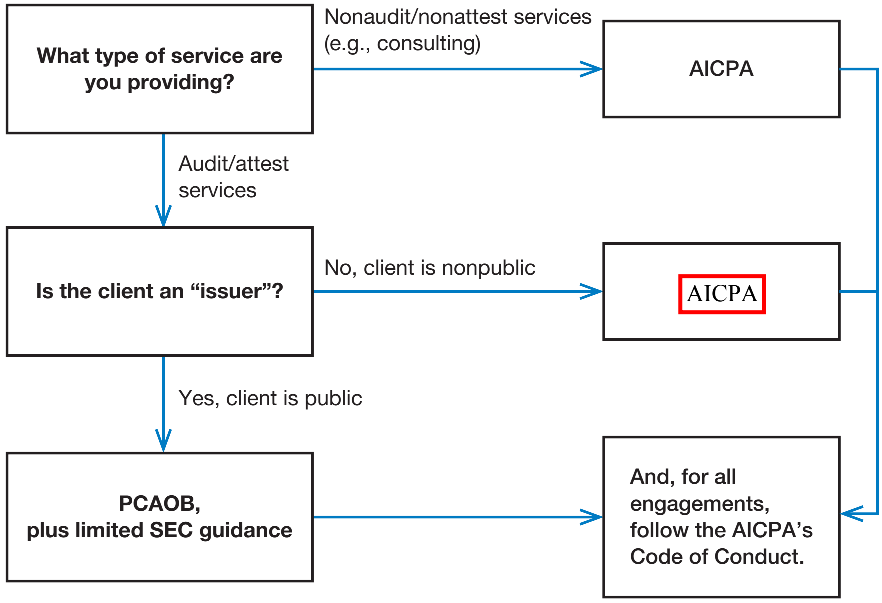
Note 2:

ABC Company, through its Finance division, routinely makes loans to customers. These loans are carried at cost less a reserve for uncollectible accounts. ASC XXX-XX permits this practice, stating: " ". In 20X1, the auditors for ABC Company found that the Company's uncollectible accounts reserve policy was insufficient and issued a qualified audit opinion.

. . . and so on.

Figure 9-5

Decision tree for identifying the applicable standard setter



Understanding relevant sources of professional standards will improve both (1) your ability to comply with these professional standards and (2) your efficiency in researching issues as a professional. The next section of this chapter introduces professional standards and other interpretive publications issued by the AICPA.

AICPA PROFESSIONAL STANDARDS

The AICPA refers to its body of professional services guidance as **professional standards.** These include, for example, standards for client service engagements (such as audit and consulting standards) and independence and ethics standards.

We will begin our discussion of the AICPA's professional standards with the Code of Conduct.

Code of Professional Conduct (ET)

The AICPA's **Code of Professional Conduct** (the “Code of Conduct” or the “Code”) establishes mandatory ethics requirements applicable to all CPAs, regardless of the type of service being performed or the type of client being served. Individuals who violate provisions of the Code can be sanctioned by the AICPA.

Maintained by the Professional Ethics Executive Committee (PEEC) of the AICPA, the Code is divided into multiple sections, abbreviated “ET” for ethics. Periodically, the PEEC updates the Code as necessary to clarify its provisions or to reflect new ethics interpretations and rulings. For example, in 2013, the Committee revised Ethics Interpretation No. 102-4, *Subordination of Judgment*, to clarify how AICPA members should respond to potential compliance threats. An example illustrating this revised interpretation is provided at the end of this chapter. As changes to the Code are approved and implemented, AICPA members are notified through updates in the AICPA's *Journal of Accountancy*.

Guidance in the Code of Conduct is organized as follows:

- Introduction
- Section 50—Principles of Professional Conduct
- Section 90—Rules: Applicability and Definitions
- Section 100—Independence, Integrity and Objectivity

EXERCISES

The following exercises require students to access information and guidance using the following websites, as appropriate: GASB standards and GASB Codification (www.gasb.org or www.aaahq.org), FASAB (www.fasab.gov), GAO (www.gao.gov/yellowbook).

1. Assume that the Jones County Water Authority (JCWA), New York, a public utility, has undergone budget cuts and must lay off a number of employees.
   a. Which standard setter has authority to set accounting principles for the JCWA? Explain.
   b. Search for guidance issued by this standard setter, then describe when the JCWA should record a liability and expense for estimated termination benefits (such as severance benefits) payable to its terminated employees.
2. Locate the Status page for GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans.* When did this standard initially become effective? What GASB Statement superseded this standard?
3. Assume the Town of Hampton is undergoing a bankruptcy, and a bankruptcy "plan of adjustment," restructuring the town's debt, has been confirmed by a court. Locate the appropriate accounting guidance, then respond to the following questions.
   a. *When* (i.e., at what date) is it appropriate for the town to recognize gains from adjustments to its prebankruptcy debt? Cite your source.
   b. Locate the summary of the original standard for this issue, and describe the objective of this standard.
4. Locate the preamble to FASAB's Statements of Federal Financial Accounting Concepts. Are Statements of Federal Financial Accounting Concepts considered "GAAP"? If they are not considered GAAP, then how should the Concepts Statements be used? Explain.
5. Locate the FASAB's accounting standard on "fiduciary" activities.
   a. What are fiduciary activities, and what are examples of these? Cite your sources for these responses.
   b. According to the Introduction of this standard, should fiduciary assets be recorded on government entities' balance sheets? If not, how should they be addressed in the financial statements?
   c. Using the standard's table of contents, determine whether (and if applicable, identify) any Interpretations or Technical Releases relate to this standard.
6. Locate SFFAS 24, *Selected Standards for the Consolidated Financial Report of the United States Government.* Read, then summarize the discussion in par. 1–3; should researchers assume that new FASAB guidance applies just to federal "component entities" or also to the consolidated federal financial report?
7. Locate SFFAS 5, *Accounting for Liabilities of the Federal Government*, then respond to the following:
   a. How does the FASAB define a "nonexchange transaction"? Provide an example of a nonexchange transaction. Cite your sources for these responses.
   b. Should a liability be recognized for federal nonexchange transactions? Cite your source.
8. Imagine you are writing a memo and including the following quote from FASAB guidance:

   "MD&A should discuss important problems that need to be addressed, and actions that have been taken or planned."

   Locate this quote in the FASAB Handbook and write out the full source citation for this quote. Assume this is the first reference to FASAB guidance that you have included in your memo.
9. Locate the "Yellow Book", *Government Auditing Standards*, 2011 Revision (or more recent if available). What *types of audits* does the Yellow Book say the requirements and guidance in GAGAS apply to?
10. What are the five categories of GAGAS requirements for performing government financial audits, which should be applied in addition to AICPA standards?
11. Locate the 80-hour and 24-hour training requirement (within the Yellow Book) for government auditors. Explain this requirement, citing your source.
12. Locate the auditor's report included within the 2011 federal government-wide financial statements.
    a. On the first page of the auditor's report, what three management responsibilities are described?
    b. Identify one of the auditor's summary findings, on the second page of the audit report.

databases. The table of contents of each database may be viewed by clicking on the "Table of Contents" tab followed by clicking on "Federal Library" and then "Federal Editorial Materials." From there, the researcher can click on a database, such as the "United States Tax Reporter" and see its table of contents by groups of Code sections. The researcher can go further, and ultimately access the material in the United States Tax Reporter, by continuing to click onto more and more specific content headings such as one for a particular Code section or its related annotations and explanations. Figure 11-17 illustrates how a table of contents search through the United States Tax Reporter can ultimately lead to accessing its listings for Code Section 61, including the Code section itself, regulations, explanations and annotations.

Figure 11-17
Sample table of contents search on RIA Checkpoint

Editorial materials may also be accessed by an index search. This is akin to performing a Master Glossary search within the FASB Codification. To begin an index search on RIA Checkpoint, a tax researcher would again click on the "Table of Contents" tab, followed by "Federal Library," then "Federal Editorial Materials," and then "Federal Indexes." From there the researcher can click on a database, such as the "Code Arranged Annotations & Explanations" or the "Federal Tax Coordinator 2d Topical Index," to see the alphabetical index for that database.

When searching in RIA Checkpoint's Editorial Materials, it is important to remember that the results of the search (such as in the form of annotations or explanations) are secondary sources. However, they generally provide links to connect to the primary sources that are annotated or explained in the Editorial Material.

Keyword Searching

An important method for accessing the information on an online tax research service is by searching for keywords in one or more selected databases. This can include primary source material databases, such as "Federal Tax Cases," "Internal Revenue Code, Treasury Regulations, Committee Reports," or "IRS Rulings & Releases," or the databases in RIA's Editorial Materials, or a combination of both. On RIA Checkpoint, a **keyword search** involves using its Search screen (see Figure 11-16), selecting the databases to be searched and entering words (which can be entered using either natural language or Boolean terms and connectors) that one would expect to find in the expected search result documents. The search results will include all documents within the selected database(s) in which the searched words appear and should then be reviewed for relevance and analyzed.

Updating research findings is part of the third step in the research process (finding, analyzing, and updating applicable sources of tax law). Each time the researcher finds a relevant tax authority, it is necessary to update it to make sure that it is still reliable and authoritative. Tax advice must be current as of the date it is provided to the client. Consider the following **TIP from the Trenches** regarding updating the client on subsequent tax law developments.

TIP from the Trenches

Absent an agreement to provide updates to a client, once tax advice has been provided to the client, a CPA is generally not required to provide the client with updates for subsequent tax law developments affecting that advice. From a client relations standpoint, however, it may be advisable to at least alert the client if it appears that a new development could put the client in a worse tax position (or could give the client a more positive tax result) than indicated in the predevelopment advice. It is then the client's decision whether to engage the CPA's services for a more thorough analysis of the affects of the new development on the client's situation. By contrast, in-house corporate tax accountants are generally expected to update the tax advice provided to their employers for relevant tax law developments.

Citators

It is not enough to just locate a case or ruling that is on point. Researchers must also understand whether the case or ruling is still "good law" and whether and how it has been discussed in subsequent cases and rulings. **Citators** are used to update court decisions and IRS Revenue Rulings and Revenue Procedures. For court decisions, a tax researcher can use a citator to learn whether the decision has been affirmed, reversed, modified, or remanded (sent back to the trial court or a lower appellate court) by an appellate court, whether the U.S. Supreme Court has granted or denied certiorari in the case, and whether the IRS has issued an AOD acquiescing or nonacquiescing in the court's decision. Relying on a case that has already been reversed is relying on a discredited authority and can amount to malpractice. Therefore, the tax researcher must check a citator for the subsequent history of the case. The citator will also indicate the other subsequent cases in which the case being checked has been cited and, if so, whether a subsequent case approved, criticized, or otherwise commented on the decision. This information may indicate how reliable the case is. For example, it may not be advisable to rely too strongly on a case that has been criticized in several subsequent court decisions. Citators can also be used to learn the prior history of the case checked on and to access the lower court's decision in the same case.

Similarly, IRS Revenue Rulings and Revenue Procedures can be updated using a citator. In this case, the citator will indicate whether the ruling or procedure has been cited in a court decision, and whether the IRS has clarified, modified, superseded, revoked, or declared the ruling or procedure obsolete. Again, the tax researcher should use this information to determine whether he or she is relying on current, good law or whether it is necessary to look further, such as at a more recent ruling that may have superseded the prior one found by the researcher.

Online tax research services have citators that make updating the law relatively easy. On RIA Checkpoint, the citator is known as "RIA Citator 2nd" and can be accessed in two ways. One way to use RIA's citator is by pushing the "Citator" button when viewing a court decision or ruling. This gives the researcher access to the citator information related to that case or ruling. For example, you might try finding Revenue Procedure 99-14 (hint—the quickest way to do this would be through a Citation Search described above) on RIA Checkpoint and clicking on the "Citator" button. Figure 11-21 shows part of Revenue Procedure 99-14 with the Citator button circled.

Clicking on the Citator button will bring up a reference to the procedure on the right-hand side of the screen. If you click on this reference, you will see the citator results listed for Rev. Proc. 99-14, which are shown in Figure 11-22.