

Client Alert

Latham & Watkins Corporate Department

The Codification of GAAP

Be Careful What You Wish For

On July 1, 2009, the Financial Accounting Standards Board (FASB) responded to the many requests over the years for a single source of all accounting standards, interpretations and other guidance by adopting the FASB Accounting Standards Codification™ (the Codification) as the single source for non-governmental US generally accepted accounting principles (GAAP). The Codification must be used for all financial statements for periods ending after September 15, 2009. This means that calendar year filers must apply the Codification to their third quarter 2009 reports and all subsequent reports. Furthermore, all Securities and Exchange Commission (SEC) comment letters will now refer to the Codification and not to the old accounting standards. Thus, familiar terms like SFAS 141, FIN 48 and SFAS 5 are no longer the source of accounting principles on business combinations, uncertainty in income tax and contingencies, respectively. The Codification is now the only authoritative source for such guidance.

What Exactly is the Codification?

The Codification places all previously issued accounting standards into code form, much like the Uniform

Commercial Code. The Codification organizes GAAP into 90 Topics and a plethora of Subtopics, Sections, Paragraphs and Subparagraphs. The chart provided at the end of this *Client Alert* lists the Codification's primary Topics.

The Codification is not intended to change GAAP (with limited exceptions noted later), but rather introduces a new, unified structure that supersedes all previously issued non-SEC accounting literature. It includes most previously issued accounting guidance from FASB, the American Institute of Certified Public Accountants (AICPA), the Emerging Issues Task Force (EITF), the Accounting Standards Executive Committee and the Accounting Principles Boards. All non-SEC accounting literature not included in the Codification is now considered non-authoritative. Additionally, the Codification eliminates the five-level GAAP hierarchy. Under the Codification, there are only two levels: authoritative and non-authoritative. All standards in the Codification are authoritative and have equal weight. Standards or guidance that are not included in the Codification are non-authoritative.

SEC accounting guidance remains authoritative and binding on companies reporting to the SEC. The Codification incorporates relevant SEC guidance, which is displayed below the related topic in the Codification. This includes portions of Regulation S-X, certain

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guidance from Staff Accounting Bulletins and other materials. However, the Codification contains only those matters where the SEC has issued guidance relating to financial statements. It does not incorporate guidance related to matters outside the financial statements, such as auditing and independence matters or Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

What's the Big Deal?

At the most basic level, the Codification should have little effect on the preparation of financial statements and the accompanying footnotes since the substance of GAAP remains unchanged. For most companies, the initial transition will involve little more than converting citations from the old "FASB Statement No. XXX" to the plain English version of the Codification's citation format that is discussed later in more detail.

However, practitioners can use this transition as an opportunity to update disclosure, correct errors, reevaluate policies and generally refine legacy disclosure that may not have been altered in years past. For most companies, disclosure in the financial statements has evolved organically. There was no reason or inclination to revise disclosure, even where it may have become cumbersome or difficult to read. Thus, companies can use the Codification and the requisite revisions to the accompanying footnotes to conduct a thorough review of their disclosure.

Preparing the First Post-Codification Report

As previously discussed, calendar year filers will apply the Codification to their third quarter 2009 reports filed on Form 10-Q and to all subsequent reports. The Staff of the SEC's Division of Corporation Finance (the Staff) has

issued interpretive guidance to clarify that references in SEC rules to pre-Codification GAAP standards should be understood to refer to the corresponding reference in the Codification.¹ The first step in preparing a Codification report is knowing where to find the newly codified GAAP that replaces the previous standards.

Where to Look For Guidance

The Codification is available at FASB's Accounting Standards Codification Web site, <http://asc.fasb.org>. Once logged in, the most useful tool will likely be the "FASB Cross-Reference" link. This tool allows a user to cross-reference the old standard type and number against a list showing the topic, subtopic and paragraph where the old standard's paragraphs and guidance can be found.

If you know the section of the Codification you are trying to reach, you can type it in the "GO TO" box. Alternatively, you can use the pop-up menus that appear if you hover over the nine topic categories on the left side of the screen. Hovering over a category will display the Topics and hovering over a Topic will reveal the Subtopics.

How to Cite the Codification

FASB has suggested the following method for citing the Codification: "FASB ASC AAA-BB-CC," where AAA is the Topic, BB is the Subtopic and CC is the Section. For example:

- "FASB ASC 310" refers to topic 310, *Receivables*.
- "FASB ASC 310-10" refers to the *Overall* subtopic in the *Receivables* topic.
- "FASB ASC 310-10-15" refers to the *Scope* section of the *Overall* subtopic in the *Receivables* topic.
- "FASB ASC 310-10-15-2" refers to paragraph 2 of the *Scope* section of the *Overall* subtopic in the *Receivables* topic.

To assist readers in the transition to the Codification, companies may present

both the Codification citation and former reference. If companies use this presentation, citations to the former reference must appear in parentheses following the Codification reference. For example, a reference to the former FASB Statement No. 141R, *Business Combinations* (SFAS 141(R)), could appear as, "FASB ASC 805-10, *Business Combinations* (SFAS 141(R))."

For clarity, companies may wish to include the title of the cited Codification section. "FASB ASC Topic 310" would appear as "FASB ASC Topic 310, *Receivables*," and "FASB ASC Section 310-10-15" would appear as "FASB ASC paragraph 310-10-15, *Receivables—Overall—Scope* (SFAS 131)."

Using Plain English

Companies may use this transition as an opportunity to switch to plain English disclosure by removing all technical references to FASB Statements, EITFs and FINs from quarterly and annual reports. FASB and the SEC have recommended that companies use plain English in their financial statement disclosures by avoiding specific GAAP references and more clearly explaining the accounting concepts.² For example, rather than refer to "SFAS 5, *Accounting for Contingencies*" or "FASB ASC 450, *Contingencies*," a company could write, "as required by the Contingencies topic of the FASB Accounting Standards Codification," or describe the principles as applied without reference to the Topics, Subtopics or Sections of the Codification: "as required by the general accepted accounting principles for contingency reporting." Time will tell whether companies will follow this guidance and whether the Staff will comment in the review process if a company does not do so.

Additions to the Periodic Reports

Adoption of the Codification should be noted in both the "Recent Accounting Pronouncements" footnote to a company's financial statements and

in the "Accounting Pronouncements" section of the MD&A. An explanatory note may also be included at the beginning of the report or the beginning of the footnotes and the MD&A. Such a note may read as follows:

On July 1, 2009, the FASB Accounting Standards Codification™ (the Codification) became the authoritative source of accounting principals to be applied to financial statements prepared in accordance with GAAP. In accordance with the Codification, citations to accounting literature in this report are to the relevant Topic of the Codification or are presented in plain English. For convenience, we have also included a corresponding reference to the pre-Codification literature.

If implementation of the Codification results in making an accounting change or recognizing an error from a prior period, the company should disclose the nature and reason for the change in accounting principle pursuant to FASB ASC 250-10-50, *Accounting Changes—Change in Accounting Principle* (SFAS 154). When disclosing a change, the company should disclose the standard that was used before and after the Codification and the reason that the Codification resulted in a change of accounting principle or correction of an error.

What is New in the Codification

Users of the Codification may notice subtle differences from the pre-Codification language to which they have become accustomed. The Codification does not require companies to adopt this new terminology in their non-GAAP disclosure. Companies may continue to use terms that have otherwise been changed in the Codification as appropriate for the company. Even though the Codification does not mandate the use of this new terminology, it will be interesting to see

whether companies adopt these new terms.

Some changes that FASB made in the Codification include:

Entities

The Codification will use the term "entity" to describe all business organizations. Previous uses of "company," "organization," "enterprise," "firm" and "preparer" have all been replaced by "entity." Because of this change, the term, "Intercompany" has also been eliminated from the Codification and replaced with "intra-entity."

Shall, Should and Must

The Codification uses the term "shall" throughout where there is a requirement to apply a standard. This change replaces the pre-Codification use of "should," "shall," "is required" and "must." In example scenarios included in the Implementation Guidance and Illustrations sections of the Codification, the terms "would" and "should" are used to indicate hypothetical scenarios.

Generally Speaking

Generic qualifying terms, such as "usually," "ordinarily" and "generally," have been eliminated from the Codification.

Changes From Pre-Codification GAAP

Certain inconsistencies which arose in pre-Codification accounting literature have been resolved with the publication of the Codification.

Grandfathered Accounting Standards

The Codification does not include certain grandfathered accounting standards that have continued applications. They include:

- pooling of interests in a business combination;
- pension transition assets or obligations;

- accounting for employee stock ownership plan shares;
- loans restructured in a troubled debt restructuring before the effective date of FASB Statement No. 114;
- stock compensation for nonpublic and other entities; and
- business combinations with an acquisition date before the first annual reporting period beginning on or after December 15, 2008 under SFAS 141.

These grandfathered accounting standards remain authoritative for companies eligible to use them. These standards are only available in their pre-Codification form.

Updates to the Codification

FASB will no longer issue EITF Abstracts, Staff Positions, Statements or Interpretations. New pronouncements on accounting principles will be issued in Accounting Standards Updates. Each Accounting Standards Update will be numbered in YYYY-XX format, where YYYY is the year of the update and XX is the sequential number of the update within that year. For example, the first update was Accounting Standards Update No. 2009-01, *Topic 105—Generally Accepted Accounting Principles*. Proposed updates will appear in the relevant place in the Codification in special boxes labeled "Proposed Text." Once it becomes effective, the proposed text will be integrated into the text and outdated text will be removed.

Other Considerations

Company accounting policy manuals or audit committee documents that refer to the pre-Codification accounting standard should be updated for the Codification. To enhance clarity and avoid ambiguity, companies may consider adopting a committee resolution stating that references to pre-Codification standards should be understood to refer to the corresponding

reference in the Codification. Companies should also consider updating manuals or other documents to insert proper Codification references. Additionally, current disclosure should be reviewed under the Codification so that accounting principles are being correctly applied. The reorganization of accounting literature may reveal other standards or considerations companies did not consider or utilize under the prior GAAP hierarchy.

Conclusion

The transition to the Codification may be challenging for practitioners accustomed to the pre-Codification standards. However, the benefits of the Codification are capable of outweighing the inconveniences associated with the transition if practitioners take advantage of this opportunity to reevaluate and redraft current accounting disclosure in terms of content and style. In terms of content, companies and practitioners will only need to reference one source for guidance on accounting principles. This single source for accounting principles will increase efficiencies and reduce complexities—and reduce the risk of missing or failing to locate important guidance amid the multiple sources. The Codification will also be updated with new guidance almost instantly, providing companies and practitioners with ready access to the most recent FASB decisions and deliberations. Further, the Codification's Master Glossary can be a useful tool in drafting disclosure. In terms of style, organizing and simplifying GAAP in the Codification has the potential to result in more plain English disclosure and better communication with the users of financial statements. For all of these reasons, the Codification can be a positive development as companies and practitioners become familiar and comfortable with its structure and content.

Endnotes

- ¹ SEC Interpretation (Release Nos. 33-9062; 34-60519; FR-80) (August 18, 2009) *available at* <http://www.sec.gov/rules/interp/2009/33-9062.pdf>.
- ² See AICPA, FASB Accounting Standards Codification, "Q & A," (July 1, 2009), *available at* <http://www.aicpa.org/download/fasb/Q&A-FASB-ASC-FINAL.pdf>.

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Organization of the Codification

The primary Topics of the Codification are listed in the table on the below.

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