

[By-Lined Article]

What Lawyers Need to Know About the Codification of Accounting Standards

By Michael A. Gillen And Steven M. Packer

July 7, 2009

The Legal Intelligencer

Financial statements play an integral role in business as well as a multitude of legal matters, including, but not limited to, bankruptcy, mergers and acquisitions, shareholder disputes, fraud and class action activities. As a result of the widespread use of financial statements, lawyers should be aware of a major change in structure and hierarchy of accounting standards occurring this month. These changes will affect auditors, preparers of financial statements and educators as well as lawyers counseling clients in many areas including regulatory, transactional and litigation matters.

Background

On July 1, the Financial Accounting Standards Board, or FASB, launched its new Accounting Standards Codification, or ASC, as the sole authoritative source for U.S. Generally Accepted Accounting Principles, or GAAP. The ASC does not change the GAAP, but rather alters its organization and presentation by providing all information in a single, topically organized structure and enables preparers, users and others who rely on or have an interest in the GAAP to quickly and efficiently identify relevant accounting standards.

The ASC consolidates the complex and onerous mix of accounting standards developed over the past 50 years and is the first major overhaul of the GAAP in many years. The ASC is now the sole source of authoritative guidance for all companies, both public and private, purporting to issue financial statements in conformity with GAAP, except governmental entities, which will continue to prepare their financial statements in accordance with governmental accounting standards, also known as the yellow book.

Prior to the ASC, there were more than 20 sources of U.S. GAAP consisting of thousands of individual pronouncements, including those of the FASB, the AICPA's Accounting Standards Executive Committee, the Emerging Issues Task Force and the Securities and Exchange Commission.

Effective Date

The ASC is effective for financial statements that cover interim and annual periods ending after Sept. 15, 2009. It is important to note that the ASC renders all prior accounting literature non-authoritative, and if relied upon as support for accounting positions taken either in policy decisions or in the preparation of financial statements, could draw the attention of the SEC and other regulators and trigger an array of legal implications, including financial statement restatements and fines.

The ReOrganization of ASC

The ASC reorganization consists of roughly 90 topics and presents them in a uniform structure. The topics represent a collection of related accounting guidance and typically deal with financial statement presentation, financial statement accounts, transactions or industries. The structure also includes SEC accounting guidance in a separate section. The ASC will significantly affect the manner

in which private and public companies reference and apply U.S. GAAP in financial statements and in their accounting policies. Improper referencing and use, not in accordance with the ASC, could easily prompt legal disputes in an array of areas.

As a result of ASC, the FASB will no longer issue statements, interpretations, staff positions or EITF abstracts, irrespective of how they would have been issued prior to the current structure. All changes to GAAP will take the form of codification updates (i.e., they will be organized under the same section headings as those in the codification) although new guidance will be issued in a format similar to the pre-July 1 publishing style under FASB authority, which included a basis for conclusions and an appendix containing instructions for codification updates.

Authoritative v. Non-Authoritative Guidance

Other than elucidating certain minor inconsistencies in current U.S. GAAP, the ASC is not intended to change or initiate new GAAP. Subsequent to the ASC, there will now be only two levels of U.S. GAAP (as opposed to the previous multi-tiered GAAP hierarchy) — authoritative and non-authoritative. It is critical to recognize that non-authoritative guidance will likely not be deemed to be credible support in cases surrounding financial statement reporting improprieties. The differentiation between various levels of guidance is explained in FASB issued Exposure Draft No. 1690-100, "The Hierarchy of Generally Accepted Accounting Principles," which is incorporated into the codification.

SEC Accounting Rules

Relevant portions of authoritative content issued by the SEC and selected SEC staff interpretations and administrative guidance are in the ASC for reference purposes only. The SEC content includes Regulation S-X, Financial Reporting Releases/Accounting Series Releases, interpretive releases and SEC staff guidance in staff accounting bulletins, EITF Topic D and SEC staff observer comments. The ASC does not replace or affect requirements or guidance issued by the SEC or its staff for public companies in their filings with the SEC.

The SEC frequently reminds public companies and investors that interpretations and no-action letters issued by the staff are not official agency rules, and should not be relied upon as basis for financial reporting or accounting positions taken by registrants. It is crucial that those counseling businesses or developing strategy for cases related to financial reporting fraud or misapplication of GAAP comprehend the differences between SEC rules and mere interpretations. Additionally, the ASC does not include all SEC guidance. For example, the ASC excludes content related to matters outside of the basic financial statements, such as management's discussion and analysis, auditing or independence matters.

SEC registrants and their advisers must ensure that their accounting policies and footnotes properly reference the ASC rather than the original accounting pronouncements, which are no longer authoritative as of July 1. Companies should consider conducting an impact study to determine the effect these changes will have on accounting policies and disclosures for financial reporting, and to ensure that the registrant, through internal documentation, is properly referencing the ASC. Consultation with appropriate legal and accounting professionals is critical during this process.

Additional Benefits of and Updates to the Codification

The codification is expected to reduce the amount of time and effort required to research and resolve accounting and financial reporting issues, thereby mitigating the risk that a relevant standard or guidance is overlooked, which, in turn, may reduce the risk of significant legal implications such as litigation surrounding improper financial reporting, fraud, class action litigation, etc.

Existing guidance will be updated and new guidance incorporated into the ASC in real time, providing users with near immediate access to the most recent information stemming from the FASB's deliberations. As the FASB amends existing ASC paragraphs, both the current paragraph and the updated paragraph will reside in the ASC until the new guidance becomes effective. During this update and amendment process, the new guidance will be titled "Pending Text." Once the new guidance is effective, the outdated guidance will be removed. All guidance in the ASC will be updated through "Codification Update Instructions" and the FASB will no longer issue FASB statements, FASB staff positions, FASB interpretations or emerging issues task force abstracts and previous technical guidance should no longer be relied upon or cited as reference for positions taken.

Additionally, the technological platform and format of the ASC will be consistent with the online International Financial Reporting Standards system. This will assist the FASB with research and convergence efforts during its standard-setting process.

Technical Content of the Codification

It includes all standards issued by a standard setter within the pre-July 1 GAAP hierarchy including:

- Financial Accounting Standards Board.
- Emerging Issues Task Force.
- Derivative Implementation Group Issues.
- Accounting Principles Board Opinions.
- Accounting Research Bulletins.
- Accounting Interpretations.
- American Institute of Certified Public Accountants.

The ASC will continue to provide a basis for conclusions, evidencing the FASB's rationale in reaching conclusions on new accounting standards. Additionally, users will still have access to archived standards and archived bases for conclusions through the ASC Web site.

Items Excluded from Codification

The following have been excluded from the codification:

- Standards that have been outdated or superseded as of Dec. 31, 2008.
- All governmental accounting standards.
- Grandfathered materials. Grandfathered materials will only be accessible in original standards. Some examples of grandfathered materials excluded by the ASC relate to the pooling of interests in a business combination, qualifying special-purpose entities and pension transition assets or obligations.

Topical Format of the Codification

The codification is presented in a hierarchy with four basic levels: topics, subtopics, sections and sub-sections. Topics are aggregated into the following four accounting areas:

- Presentation, which only includes presentation matters and does not include topics that address recognition or measurement, such as the balance sheet, income statement, statement of cash flows and notes to financial statements.
- Financial statement accounts organizes topics into financial statement order, including assets, liabilities, equity, revenue and expenses, which include topics such as cash, receivables, debt, revenue recognition and income taxes.
- Broad transactions, which relate to multiple financial statement accounts and are generally transaction oriented. Topics include business combinations, derivatives and hedging and leases.
- Industries, which provides specific accounting guidance that is unique to a particular industry or activity, such as airlines, entertainment and real estate.

Subtopics represent a subset of a topic and are dependent on that topic (e.g., subtopics labeled "overall," "operating leases" and "capital leases" are the three subtopics that fall under the topic "leasing"). Sections are a subset of subtopics (e.g., sections labeled scope, recognition, measurement, disclosure, etc. are some of the sections that fall under the subtopics for leasing). Sections are broken down further into subsections, paragraphs and subparagraphs.

Next Steps

Lawyers should become familiar with the codification and should, with their clients, ascertain that internal policy development is occurring and that proper financial reporting systems will be in place so that clients do not run the risk of financial reporting errors, irregularities, and lawsuits. Currently, the FASB maintains a codification Web site at <http://asc.fasb.org/home> (which users need to register to utilize) that offers the following tools to help with the transition:

- A "Notice to Constituents," which provides background on the overall project and other important information on the ASC's structure and Web site tools.
- An embedded master glossary, which defines terms used throughout the ASC.
- Tutorials and help pages to facilitate research.
- A cross-reference tool to enable users to identify where current accounting standards reside in the ASC.
- Functionality to join sections, which allows users to select multiple sections from different topics and subtopics and join them into a single document.

The FASB intends to release a printed version of the ASC, however details have not yet been finalized. It is interesting to note that the most significant change in accounting standard restructuring that has occurred in two decades is occurring at the forefront of another major change, namely, the convergence of U.S. accounting standards with international financial reporting standards, which are already in use in European Union countries.

These significant changes demand that companies, accountants and lawyers be prepared for increased levels of focus by regulators, corporate boards and shareholders, particularly in light of the recent era of troubled worldwide economies and increases in the number of financial statement frauds. It is virtually guaranteed that federal regulators and shareholders alike will be watching financial reporting practices closely and will likely pursue any financial reporting impropriety, whether perceived or actual.

Michael A. Gillen is the director of the [tax accounting group](#) of Duane Morris, a group of certified public accountants providing tax, accounting and consulting services as an ancillary business of the firm, where he devotes his practice to federal, state and local income taxation and a variety of litigation consulting services including, but not limited to, fraud and embezzlement detection and forensic and investigative accounting.

Steven M. Packer is a manager in the tax accounting group of the firm, where he devotes his practice to federal, state and local income taxation, fraud and embezzlement detection and investigative accounting.

This article originally appeared in *The Legal Intelligencer* and is republished here with permission from [law.com](#).