

Center for Financial and Accounting Literacy

Accounting Standards Codification: Will it improve financial reporting?

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Now that the US Accounting Standards Codification is live and operational, investors in companies that report under US generally accepted accounting principles (GAAP) can look forward to subtle but important improvements in financial reporting. The Codification could lead to more plain-English explanations and less technical jargon in the notes to the statements starting with quarterly reports for third quarter 2009. Public companies are weighing the merits of a move in that direction now. The shift is raising questions for management and boards of directors, and the answers that emerge could well lay the groundwork for better financial reporting, both in the US and around the world.

Overview of the changes

When the Codification went live on July 1, 2009, it altered four fundamental aspects of US accounting standards.

1. *The Codification reorganized GAAP into a more logical framework.* The Codification reorganized the US accounting standards, but, with minor exceptions, it did not change them. In the past, the documents that comprised US GAAP were ranked in a hierarchy (from most to least authoritative) and organized according to a veritable alphabet soup of abbreviations or acronyms. The acronyms were derived from the types of pronouncements used by the Financial Accounting Standards Board (FASB) and others to issue accounting standards. Examples include FASB Statements, FASB Interpretations, Emerging Issues Task Force (EITF) Issues, and Accounting Principles Board (APB) Opinions. The Codification replaced the hierarchy with a single source of authoritative GAAP and reorganized the literature into logical topics (receivables, investments, inventory, etc.)
2. *The new framework led to a new shorthand for GAAP.* The Codification changes the shorthand for referring to GAAP, starting with financial statements for periods ending after September 15, 2009. Under the old system, each pronouncement was numbered sequentially when it was issued and subsequently referred to by its number, (e.g., FASB Statement No. 157, *Fair Value Measurements*). The complete list of pre-Codification standards is still available on the FASB's website. But, today, if companies wish to use technical references, all the references will begin with FASB ASC, (e.g., the receivables topic is FASB ASC 310 and a specific paragraph of that topic is FASB ASC 310-10-16-2). Importantly, the SEC's rules do not require that companies refer to specific standards or that they use any shorthand. But many companies used the old-style references in their reports, and they may choose to replace the old references with new ones for a variety of reasons.

3. *The new style prompted the FASB to modernize the update process.* Starting July 1, 2009 when the Codification went live, the FASB began a new system of issuing all new or revised standards as updates to the Codification. These updates are announced in a series of communications known as accounting standards updates (ASUs). The ASUs are like press releases that describe changes in laws but are not part of the law. Because the ASUs are not an official part of US GAAP, they will not be revised when portions are superseded by future changes, and they should not be cited as authoritative in SEC filings or other reports.
4. *Technology took GAAP to a whole new level.* Accounting principles have always resisted technology because, unlike laws, they are not in the public domain. With the exceptions of certain materials authored by the SEC, US accounting standards are copyrighted by the FASB. This makes them vulnerable to plagiarism and the kind of abuses that plagued the music industry. To keep control in the changing Internet environment, the FASB offers a combination of click-through copyright acknowledgements and a pay-for-use technology that requires users to register and log in. This system offers users two general options, one of which (the basic view) is free. The other (the professional view) is typically based on the number of concurrent users with nominal rates for qualified academics and students. The bottom line for investors is that: (a) investors will likely need basic computer literacy, along with access to a computer connected to the Internet to understand the technical ASC references, and (b) the cost of a professional view is relatively high for an individual investor who is not part of a group (\$850 per year).

The corporate response

The new reporting frontier opened up by the Codification will provide investors with a convenient way to test how committed a company's management and audit committee are to the kinds of plain-English explanations that can help simplify financial reporting and foster a better understanding of their financial statements. No doubt, some companies will choose to use only plain-English explanations with no ASC references, while others will opt for the ASC references or a mix of the two. The overall trend is not yet clear. Currently, companies seem to be weighing the risks and opportunities in a series of three questions.

1. *How, if at all, should we use the ASC references?* Companies and their audit committees have considerable latitude in making this decision. It is up to them to decide whether or not they will use the new references. If the answer is yes, then they will need to decide how far down to go for each reference. For example, will it suffice to simply reference the receivables topic (FASB ASC 310)? Or should they drill down to a specific paragraph within that topic, such as FASB ASC 310-10-16-2? To answer these questions, companies need to consider any penalties for making the wrong decision. This typically means the company will need to check with its external auditor. It also means the company will need to anticipate the reactions of its investor base.
2. *What should financial reports say about the switch?* Whether or not a company decides to use the ASC references, management may wonder what, if anything, should be disclosed in the financial reports about the switch to the new system of reorganized US GAAP. While there are no specific requirements to explain anything about the new system (except in the unlikely event that its adoption has a material effect on the financial statements), some investors may be unaware of the changes

and they may appreciate a brief explanation. This might be especially important if the company's stock is attracting non-US investors in today's global markets.

3. *What kinds of legal advice does the company need?* Another question that seems to be on the minds of management of some public companies, particularly smaller public companies, is whether they should engage legal counsel to prepare (or provide advice on) any conversions of references from the old-style references to the new ones. Responses from the SEC have been reassuring but informal. No formal guidance has been issued on the subject, but speeches by the SEC staff indicate they support the plain-English disclosures and view them as an improvement. For example, see the comments to that effect in the Center for Audit Quality's (CAQ's) Alert No. 2009-76. This Alert describes the views shared by the SEC staff with the CAQ SEC Regulations Committee.

Viewpoint

The trend toward plain-English disclosures is particularly important for US companies and investors. The US differs from other countries in that more half of our population is invested in the stock market, and there is considerable diversity among the users of financial statements. At one end of the spectrum are sophisticated financial analysts and big institutional investors who may be fully conversant with the underlying accounting standards. At the other end are individual investors, some of whom may have a tougher time sorting through the notes and references to related standards. The latter would benefit greatly from the types of plain-English explanations that enhance transparency and understanding. Because of their unique position in the global markets, US companies should take the lead in the area of plain-English disclosures and fight to make their financial reports as meaningful as possible to as many users as possible.

Answers to Frequently Asked Questions (FAQs)

What is the US Accounting Standards Codification?

The Codification is an interactive web-based tool that provides the current text of US accounting standards. Currently, it cannot be downloaded in its entirety in a format like a Microsoft Word or pdf document. The FASB expects to make a print version available in late August or early September 2009, but Board members have cautioned the print format can be awkward due to the need for page flipping in lieu of links.

Why did the FASB develop and issue the Codification?

The interactive format is designed to improve access to US accounting standards and simplify the sometimes tedious process that companies and auditors must go through to research the standards that apply to a particular situation.

Is the Codification investor-friendly?

The Codification itself is reasonably investor-friendly. You will need to register and log in to the FASB's website to use the free version, and you will need some basic computer literacy, along with access to a computer connected to the Internet. The cost of a professional view is relatively high for an individual investor who is not part of a group. Companies can make their reports even more user-friendly for investors by providing plain-English explanations of the accounting standards rather than technical references, whenever possible.

Has the SEC issued any guidance to companies on the use of the Codification or references to it?

The SEC issued an interpretive release on August 18, 2009, and the SEC Staff shared their views with the CAQ SEC Regulations Committee. The staff's views are summarized in CAQ Alert No. 2009-76 dated August 17, 2009.

Will the Codification be integrated with XBRL reporting for future SEC filings?

Yes. On August 4, 2009, the FASB, together with XBRL US, issued a set of extensions to the US GAAP taxonomy that are available for use by companies that are required to furnish reports in XBRL format or that choose to do so voluntarily.

Has the PCAOB issued any guidance to auditors on the Codification?

On September 2, 2009, the PCAOB issued Staff Q&As on references to the Codification. The Q&A indicates that the audit documentation for reviews or audits of financial statements for periods ending after September 15, 2009 should use the Codification (ASC) references. The Q&A also says it is desirable but not necessary to update existing audit documentation containing pre-Codification references to US GAAP. Questions may be sent to Greg Scates (scatescq@pcaobus.org) or Barbara Vanich (vanich@pcaob.org).

Should private companies use the same Codification?

Yes. The Codification prefaces any reference to an accounting requirement that applies only to public companies with an "S" which short for SEC. Thus, the same interactive tool can be used by both public and private companies that use US GAAP. The International Accounting Standards Board has issued a separate standard on International Financial Reporting Standards (IFRS) for Private Entities. But the US has not yet decided whether it will follow suit.

Is there a comparable Codification of IFRS?

Not at this time. The Codification is a strength of US accounting standards and a source of comparative advantage, at least for the time being.

Because there is no strictly comparable codification of IFRS, the use of the Codification and references to it may require some explanations for the benefit of non-US investors. A good source of background information is ASU No. 2009-01, *Topic 105 - Generally Accepted Accounting Principles - amendments based on Statement of Financial Accounting Standards No. 168, "The FASB Accounting Standards CodificationTM and the Hierarchy of Generally Accepted Accounting Principles."* This ASU is available on the FASB's website without the need to register or log in.

Helpful Links

List and links to text of Pre-Codification Accounting Standards

<http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137031>

Current Accounting Standards Codification <http://asc.fasb.org/>

(You must be registered and logged in to use the Codification.)

Accounting Standards Updates (ASUs) issued to date

<http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156316498>

Cross Reference Table - to convert old references to new

http://asc.fasb.org/crossref&analyticsAssetName=home_page_crossreference

(You must be logged in to use the cross reference table.)

SEC Interpretive Release, "Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification," August 19, 2009

<http://www.sec.gov/rules/interp/2009/33-9062a.pdf>

Center for Audit Quality (CAQ) Alert No. 2009-76 describing the SEC Staff's views on the application of the FASB Codification, August 17, 2009

http://thecaq.org/members/alerts/CAQAlert2009_76_08172009.pdf

PCAOB Staff Questions and Answers, "References to Authoritative Accounting Guidance in PCAOB Standards, September 2, 2009.

http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2009/09-02_FASB_Codification.pdf

XBRL/ Codification Alignment Announcement

<http://www.xbrl.us/News/Pages/20090804.aspx>

XBRL US GAAP Taxonomy Extensions

http://www.xbrl.us/taxonomies/Pages/FASBCodification_2009.aspx