# 1 ASC 105 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES





## AUTHORITATIVE LITERATURE

Accounting Standards Codification (ASC) Topic 105 establishes the FASB Accounting Standards Codification™ (the Codification) as the source of authoritative GAAP. ASC 105 contains no disclosure or presentation requirements.

### What Is GAAP?

The Codification (ASC) is the:

> *. . . source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. In addition to the SEC's rules and interpretive releases, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements, and it utilizes SEC Staff Announcements and Observer comments made at Emerging Issues Task Force meetings to publicly announce its views on certain accounting issues for SEC registrants. ASC 105-10-05-1*

In the absence of authoritative guidance, the Codification offers the following approach:

> *If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources. An entity shall not follow the accounting treatment specified in accounting guidance for similar transactions or events in cases in which those accounting principles either prohibit the application of the accounting treatment to the particular transaction or event or indicate that the accounting treatment should not be applied by analogy. ASC 105-10-05-2*

The Codification lists some possible nonauthoritative sources:

- Practices that are widely recognized and prevalent either generally or in the industry
- FASB Concepts Statements
- American Institute of Certified Public Accountants (AICPA) Issues Papers
- International Financial Reporting Standards of the International Accounting Standards Board
- Pronouncements of professional associations or regulatory agencies
- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- Accounting textbooks, handbooks, and articles
  (ASC 105-10-05-3)

GAAP is 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.

## Accounting Principles and Concepts

There are two broad categories of accounting principles—recognition and disclosure.

**Recognition Principles** Recognition principles determine the timing and measurement of items that enter the accounting cycle and impact the financial statements. These are reflected in quantitative standards that require economic information to be reflected numerically.

**Disclosure Principles** Disclosure principles deal with factors that are not always quantifiable. 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 also complement recognition principles by dictating that disclosures:

- Expand on some quantitative data,
- Explain assumptions underlying the numerical information, and
- Provide additional information on accounting policies, contingencies, uncertainties, etc.

These are essential to fully understand the performance and financial condition of the reporting enterprise.

## The Concept of Materiality

Chapter 3 of CON 8 discusses how materiality differs from relevance and that materiality assessments can be properly made only by those with an understanding of the entity's facts and circumstances. Following are the relevant passages:

> *QC11. Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker; however, these two concepts can be distinguished from each other. Relevance is a general notion about what type of information is useful to investors. Materiality is entity specific. The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.*

*QC11A. A decision not to disclose certain information or recognize an economic phenomenon may be made, for example, because the amounts involved are too small to make a difference to an investor or other decision maker (they are immaterial). However, magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, generally is not a sufficient basis for a materiality judgment.*

*QC11B. No general standards of materiality could be formulated to take into account all the considerations that enter into judgments made by an experienced reasonable provider of financial information. This is because materiality judgments can properly be made only by those that understand the reporting entity's pertinent facts and circumstances. Whenever an authoritative body imposes materiality rules or standards, it is substituting generalized collective judgments for specific individual judgments, and there is no reason to suppose that the collective judgments always are superior.*

**Descriptions of Materiality**

Materiality has great significance in understanding, researching, and implementing GAAP and affects the entire scope of financial reporting. Disputes over financial statement presentations often turn on the materiality of items that were, or were not, recognized, measured, and presented in certain ways.

Materiality is described by the FASB in Statement of Financial Concepts 8 (CON 8), *Qualitative Characteristics of Accounting Information*:

*Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the contest of an individual entity's financial report.*

The Supreme Court has held that a fact is material if there is:

*a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.*

Due to its inherent subjectivity, the FASB definition does not provide specific or quantitative guidance in distinguishing material information from immaterial information. The individual accountant must exercise professional judgment in evaluating information and concluding on its materiality. Materiality as a criterion has both quantitative and qualitative aspects, and items should not be deemed *immaterial* unless all potentially applicable quantitative and qualitative aspects are given full consideration and found not relevant.

SAB Topics 1.M (SAB 99) and 1.N (SAB 108) contain guidance from the SEC staff on assessing materiality during the preparation of financial statements. That guidance references the Supreme Court opinion and the definition in CON 2, which has been superseded by CON 8. The SEC in Staff Accounting Bulletin (SAB) Topics 1.M (SAB 99) and 1.N (SAB 108) provides useful discussions of this issue. SAB Topic 1.M indicates that:

*a matter is material if there is a substantial likelihood that a reasonable person would consider it important.*

Although not strictly applicable to nonpublic preparers of financial statements, the SEC guidance is worthy of consideration by all accountants and auditors. Among other things, Topic 1.M notes that deliberate application of nonacceptable accounting methods cannot be justified merely because the impact on the financial statements is deemed to be immaterial. Topic 1.N also usefully reminds preparers and others that materiality has both quantitative and qualitative dimensions, and both must be given full consideration. Topic 1.N has added to the literature of materiality with its discussion of considerations applicable to prior period restatements.

**Quantitative Factors** Quantitatively, materiality has been defined in relatively few pronouncements, which speaks to the great difficulty of setting precise measures for materiality. For example, in ASC 280-10-50, which addresses segment disclosures, a material segment or customer is defined in ASC 280-10-50-12 as representing 10% or more of the reporting entity's revenues (although, even given this rule, qualitative considerations may cause smaller segments to be deemed reportable). The Securities and Exchange Commission has, in several of its pronouncements, defined materiality as 1% of total assets for receivables from officers and stockholders, 5% of total assets for separate balance sheet disclosure of items, and 10% of total revenue for disclosure of oil and gas producing activities.

**Qualitative Factors** In addition to quantitative assessments, preparers should consider qualitative factors, such as company-specific trends and performance metrics. Information from analysts' reports and investor calls may provide an indication of what is important to reasonable investors and should be considered.

Although materiality judgments have traditionally been primarily based on quantitative assessments, the nature of a transaction or event can affect a determination of whether that transaction or event is material. Examples of items that involve an otherwise immaterial amount but that would be material include:

- A transaction that, if recorded, changes a profit to a loss or changes compliance with ratios in a debt covenant to noncompliance,
- A transaction that might be judged immaterial if it occurred as part of routine operations may be material if its occurrence helps meet certain objectives. For example, a transaction that allows management to achieve a target or obtain a bonus that otherwise would not become due would be considered material, regardless of the actual amount involved.
- Offers to buy or sell assets for more or less than book value, and
- Litigation proceedings against the company pursuant to price-fixing or antitrust allegations, and active negotiations regarding their settlement.

**Degree of Precision** Another factor in judging materiality is the degree of precision that may be attained when making an estimate. For example, accounts payable can usually be estimated more accurately than a possible loss from the incurrence of an asset retirement obligation. An error amount that would be material in estimating accounts payable might be acceptable in estimating the retirement obligation.

## DISCLOSURE AND PRESENTATION REQUIREMENTS

This topic has no disclosure and presentation Subtopics.