Bruce Pounder, CMA, CFM, Editor

Practical Lessons in Applying Accounting Standards

A case study in applying accounting standards carries practical lessons for accountants.

Recently I participated in an online discussion with colleagues about how U.S. Generally Accepted Accounting Principles (GAAP) should be applied to a specific real-world situation. We researched the issue and reached a conclusion that we believed to be correct. But we could have easily reached an incorrect conclusion if we hadn't done three particular things in the course of our research. In this month's column, I'll describe the situation we addressed, identify the three key things we did to arrive at our conclusion, and explain why each was critical to the correctness of our conclusion. The practical lessons you'll learn from this case study will help you correctly apply U.S. GAAP—or other accounting standards—to many other situations.

The Situation

In the United States, accounting for income tax purposes differs significantly from financial accounting. Yet income taxes represent an economic reality that must be reflected in a company's financial accounting. Earlier this year, my colleagues and I sought to answer a question regarding the application of financial accounting standards—specifically, U.S. GAAP—to an actual situation involving corporate income taxes, which I'll now summarize.

A reporting entity, "Company X," prepares financial statements and files income tax returns on a calendar-year basis. During 2012, the company incurred research and development (R&D) costs for which no special treatment was required or allowed under enacted tax laws. At year-end, those costs were properly reflected in the company's estimate of its taxable income for 2012. For financial accounting purposes, the company estimated its liability for income taxes at year-end based on its estimated taxable income for the year.

In January 2013, a new tax law was enacted. The law, which was retroactively effective for 2012, allows Company X to claim a tax credit on its 2012 tax return for the R&D costs that it incurred in 2012. At the time the new law was enacted, the company hadn't filed its 2012 tax return nor had it issued its 2012 financial statements.

Company X intends to claim the tax credit on its 2012 tax return. As a result, the actual amount of the company's tax liability would be lower than the amount it had estimated at the end of 2012. The financial accounting question that arose from this situation was "Should the tax liability to be reported in Company X's 2012 financial statements reflect the tax credit or not?"

Initial Analysis

What first came to mind for my colleagues and me was the accounting concept of "subsequent events." Under U.S. GAAP, subsequent events are events that occur after the end of a fiscal year but before financial statements for that year are issued (or are available to be issued). In some cases, subsequent events provide the reporting entity with additional information about the existence and/or amounts of its assets and liabilities as of year-end. In such cases, U.S. GAAP generally requires the reporting entity to use that information in reporting its year-end assets and liabilities (see my April 2010 column, "The Benefit of Hindsight").

The main subsequent events provisions of U.S. GAAP are documented in Topic 855, *Subsequent Events*, of the Financial Accounting Standards Board's (FASB's) *Accounting Standards Codification*®

(ASC). My colleagues and I perceived the retroactively effective tax law to be the kind of subsequent event that ASC Topic 855 would require Company X to consider when measuring its 2012 year-end tax liability. As such, it seemed correct to conclude that the tax liability to be reported in Company X's 2012 financial statements *should* reflect the new R&D tax credit because the company's reported liability would then match its actual liability more closely.

We had arrived at a simple, obvious answer to our question. But you may have heard an old saying often attributed to Mark Twain, Albert Einstein, and others: "For every problem there is always a solution that is simple, obvious, and wrong." So my colleagues and I took the first critical step toward making sure our answer was correct: We looked beyond ASC Topic 855 for other guidance that might apply to our situation.

In U.S. GAAP, as in many other sets of accounting standards, there often are multiple sources of guidance that might apply to a given situation. For example, ASC Topic 740, *Income Taxes*, provides financial accounting guidance for situations that involve income taxes. Thus, in seeking an answer to our question about reporting Company X's income tax liability, it would have been foolish for our group to ignore Topic 740.

When we reviewed the guidance in ASC Topic 740, we found that it led to a very different answer to our question. Topic 740 explicitly, repeatedly, and consistently emphasizes that a reporting entity must refer to tax laws *enacted* as of the balance-sheet date when recognizing and measuring tax liabilities and assets—even for retroactively effective changes in tax laws. Because enacted tax laws on December 31, 2012, didn't include the R&D tax credit, the guidance in Topic 740 indicates that the year-end tax liability reported in Company X's 2012 financial statements *shouldn't* reflect the new R&D tax credit.

Resolving the Conflict

At that point, our group had identified two ASC topics that seemed to apply to our situation. Each topic, however, indicated a different answer to our question. It wouldn't be possible to apply the two conflicting sources of guidance at the same time.

In my experience, this kind of dilemma often arises in the course of researching accounting standards. Fortunately, when it does, it can usually be overcome by a review of the declared scope of each source of guidance. So my colleagues and I took the next critical step toward formulating our conclusion: We carefully reviewed the scope of the guidance in ASC Topics 740 and 855.

The scope of the guidance that we had found in ASC Topic 740 is detailed in ASC Section 740-10-15. When we were reviewing that section, we found a broadly inclusive scope declaration. As a result, our situation appeared to be within the scope of the guidance in Topic 740.

The scope of the guidance that we had found in ASC Topic 855 is detailed in ASC Section 855-10-15. Our review of that section resolved the conflict between the two ASC topics. Section 855-10-15 states: "The guidance in the *Subsequent Events* Topic shall be applied in the accounting for, and disclosure of, subsequent events *not addressed in other Topics of the Codification* [emphasis added]. Other Topics may address the accounting treatment of events or transactions that occur after the balance sheet date. If an event or transaction is within the scope of another Topic, then an entity shall follow the guidance in that Topic, rather than the guidance in this Topic." The section's scope declarations even explicitly cited the guidance on income taxes in Topic 740 as an example of "other subsequent events guidance that is not consistent with the principles in this Topic." It was therefore clear to us that, in our situation, the guidance in Topic 740 should take precedence over the guidance in Topic 855.

Another Dilemma, Another Resolution

My colleagues and I were confident that U.S. GAAP required Company X to ignore the new R&D tax credit when reporting its tax liability in its 2012 financial statements. But we were also somewhat disturbed by that conclusion. We believed that strict compliance with GAAP might violate an important legal and ethical principle of financial reporting, that is, to "present fairly" and not mislead users of financial statements. Specifically, we believed that if the company complied with the guidance in ASC Topic 740, then it would knowingly and materially misstate its tax liability in its 2012 financial statements.

You may be aware that financial-statement preparers and auditors can invoke an "override" of GAAP if they believe that compliance with

GAAP would result in misleading financial statements. But for many legitimate reasons, such overrides are extremely rare in practice. And when an override is invoked, it often leads to adverse consequences for the party who invoked it. So once again my colleagues and I faced a dilemma: Should we advocate strict compliance with ASC Topic 740, or should we conclude that a GAAP override is needed?

In my experience, when preparers or auditors are inclined to invoke a GAAP override, it's because their understanding of GAAP is limited. Therefore, my colleagues and I returned to the guidance we had previously identified as potentially relevant—and expanded our review beyond the recognition and measurement provisions to include presentation and disclosure provisions. Doing so enabled us to resolve our dilemma.

The disclosure provisions of Section 855-10-50 state: "Some nonrecognized subsequent events may be of such a nature that they must be disclosed to keep the financial statements from being misleading. For such events, an entity shall disclose…[t]he nature of the event [and an] estimate of its financial effect, or a statement that such an estimate cannot be made." Thus, by including such disclosure in the notes that accompany its financial statements, Company X could fully comply with GAAP and prevent its financial statements from being considered misleading.

Takeaway Lessons

This case study contains three important lessons that will help you apply accounting standards correctly to any given situation that you may encounter. First, after you identify guidance that seems to be relevant to your situation, keep looking for additional guidance that may also be relevant. Had my colleagues and I stopped looking after initially focusing on the subsequent events guidance of ASC Topic 855, we would have reached a wrong conclusion.

Second, scope declarations are essential to ensuring that you apply appropriate accounting standards to your situation and avoid applying inappropriate accounting standards to it. Had my colleagues and I failed to review the scope of the two potentially relevant sources of guidance that we eventually identified, we would have either been stuck—not knowing which to apply—or we would have risked choosing an inappropriate source by some means unrelated to the declared scopes.

Third, it's almost always possible to achieve fair presentation of financial statements without violating accounting standards. Had my colleagues and I failed to consult the presentation and disclosure provisions of relevant ASC topics when addressing what seemed to be a recognition/measurement question, we would have advocated either (1) an unnecessary GAAP override, accompanied by adverse consequences, or (2) the issuance of misleading financial statements.

In summary, when seeking an answer to a question about the application of accounting standards to a particular situation, there's no substitute for reading the standards broadly, systematically, and thoroughly. **SF**

Bruce Pounder, CMA, CFM, DipIFR (ACCA), is director of Professional Programs for Loscalzo Associates, Ltd., a division of SmartPros Ltd. You can reach him at BrucePounder@Loscalzo.com.