A BRIEF OVERVIEW OF US GAAP REPORTING

Prepared by: Rudy Soobaroyen

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Purpose

The purpose of this paper is to provide some guidance regarding the implications of US GAAP reporting for public listed entities in North America.

Background

The Securities Exchange Commission requires that US companies comply with US GAAP for initial listing purposes and to retain public listing on the New York Stock Exchange. The Financial Accounting Standards Board (FASB) administers the issue of accounting standards in the US. The submission of an accounting standard is preceded by an issue of exposure drafts to invite views of various stakeholders on the particular standard. The exposure draft seeks to assess the impact of the standard on the evolving business environment. The conceptual framework underlying the US GAAP is underpinned by a set of ten principles.

These are the principles of regularity (adequate rules and regulations), periodicity (time-period recording), consistency (application of standards), continuity (unchanged procedures), permanence of methods (consistent valuation methodologies), sincerity (honesty), prudence (overstatement of expenses/liabilities and understatement of asset/income), utmost good faith (integrity), no compensation (disclosure regardless of positive or negative information) and materiality (size and nature).

Appendix 1 contains a list of relevant Accounting Standard Codes in reference to US GAAP financial statements.

The General Basis

In the United States, a Public Listed Company (PLC) is required to prepare its financial statements in accordance with US GAAP accounting standards. The set of financial statements includes a balance sheet, statement of changes in shareholder equity, comprehensive income, income statement, statement of cash flows and notes to the financial statements. An entity must fairly present its financial statements in compliance with ASC 205 Presentation of Financial Statements and in line with the underlying ongoing assumption unless the entity is no more a going concern. The financial statements are prepared for a reporting period of one year with two year comparatives. These financial statements also known as general purpose financial statements must contain useful information to assist investors, creditors and lenders in their economic decision-making. The usefulness of information must carry fundamental qualitative characteristics and may display enhancing qualitative characteristics. Financial statements bear fundamental qualitative information when that information is relevant and is faithfully represented. Information is not useful unless it bears fundamental qualitative characteristics.

A PLC does not comply with US GAAP unless it complies with all the standards of the US GAAP. The five key elements making up the financial statements include income, expense, asset, liability and equity. Where a corporate structure consists of a parent entity owning shares in its subsidiaries and associates, consolidated financial statements are prepared and presented under the application of rules contained in ASC 810 Consolidation. A PLC has recourse to applying the principles prevalent in ASC 805 Business Combination to record any goodwill on acquisition of new entities or derecognition of assets and liabilities resulting from disposal of wholly-owned subsidiaries. A PLC may also own enter in joint arrangements where there is unanimous consent for joint venture partners to share control of jointly controlled ventures. The ASC 323 Joint Venture and Equity Method provides guidance with regards to the recognition of joint ventures in a PLC's balance sheet using the equity method.

The Balance Sheet – A Practical View for Assets

A PLC's balance sheet must comply with ASC 210 in relation of the presentation of the company's financial position as at the end of a reporting period; usually 31 December. The balance sheet consists of long-lived assets, current assets, current liabilities, non-current liabilities and equity. The elements of the balance sheet are reported at historical cost, market value and in limited circumstances at discounted values.

The main component of a balance sheet's assets is generally Property Plant and Equipment. A piece of equipment, land, machinery or plant is recognized under ASC 360 Property Plant and Equipment (PPE) as a long lived asset when it has the potential of producing future economic benefits and can be reliably measured at cost. These benefits flow through to the entity which has access to the right to use the asset. This right of use of economic resource originates from a historical event which can, for instance, be the endorsement of a contract. According to ASC 360, PPE can only be measured using the historical cost convention basis also known as the cost model. The revaluation model is prohibited. ASC 360 requires that PPE are depreciated to reflect their pattern of consumption over their useful life. A PPE's useful life can change depending on the manner and frequency with which it is used. Depreciation charges for similar class of PPE may vary from one company to another. This variation may be attributed to the frequency of repairs and maintenance costs incurred on the PPE. A review of a PPE's useful life and residual value is only contingent on the specific needs of the entity for a review. There are no requirements for the PPE's life to be reassessed yearly. Where the PPE is a qualifying asset, the borrowing and finance costs, incurred in obtaining or acquiring the asset, must be capitalized so long the asset is not ready for use. Where separate components can be identified in a piece of PPE, the company can elect to adopt a component's approach to accounting for depreciation; i.e. different depreciation charges can be applied to each component based on its consumption pattern of the asset component's economic benefits. This component depreciation principle is however not compulsory. A company might elect to depreciate its long-lived asset as a whole.

Where a PPE's recoverable amount through use and sale is less than its carrying amount, the PPE is impaired. The PPE's recoverability is determined using a market value approach of summing the asset's undiscounted future cash flows generated through use and its effective disposition. The impairment loss is recognized as an expense in the income statement. It is then applied against the impaired asset. If the PPE cannot be clearly identified, the impairment loss is then applied against a reporting unit. The reporting unit is a unit that generates cash inflows that are largely distinct from those of other assets or reporting units. Impairment losses cannot be reversed.

Companies are also required to follow standards governing investments where they hold debt and equity investments. This includes the application of ASC 320 Investment – Debt and Equity Investments and ASC 325 Investment- Other. Under ASC 320, investment in securities are classified and measured into three categories namely Fair Value Through Net Income (FVTNI), Available for Sale (AFS) and Held to Maturity (HTM) instruments. AC 310 Receivables also adds two categories to classify loans namely Held for Investment and Held for Sale. FVTNI, AFS and Held for Sale Investments are measured at Fair Value. HTM and Held for Investments instruments are measured at amortized costs. Non derivative financial liabilities are measured at amortized cost unless fair value is elected. Embedded derivatives are separated from the host contract and accounted for at FVTNI. Companies must closely follow the principles underlying the valuation methodologies as contained in ASC 820 Fair Value Measurement. Companies holding investment securities are also required to adhere to clauses contained in ASC 825 Financial Instruments and where relevant ASC 815 Derivatives and Hedging. Derivatives are not necessarily held for hedging purposes but could well be held as fair value through the profit and loss instruments. This determination should be made in consultation with the application of the relevant standards and consideration of contracts underlying financial assets and financial liabilities. Entities that have an international exposure, being in the nature of economic operations based overseas, are required to comply with ASC 830 Foreign Currency Transactions. This includes transactional and translational exposure to foreign exchange.

A company might also hold identifiable non-monetary long lived assets without physical substance. These include intangible assets whose accounting treatments are governed under ASC 350 Intangibles – Goodwill and Other. It is important to note that companies undertaking R&D activities cannot capitalize the associated costs. Instead, R&D expenses must be written off through the application of ASC 730 Research and Developments.

Companies must also report on their cash status by following guidelines contained in ASC 305 Cash and Cash Equivalents. Where companies trade on credit, they will be required to clearly identify the amounts of debtors per ASC 310 Receivables.

Companies must also adequately and accurately report on its inventory figures. ASC 330 Inventory provides for a selection of inventory valuation techniques namely LIFO, FIFO and AVCO. Where LIFO is used, a PLC must value its inventory at the lower of cost and market value. LIFO reserves must also be maintained to allow for transition from LIFO to FIFO methodology. Any loss in inventory value attributable to normal or abnormal circumstances must be charged to the income statement. Reversals of inventory written down amounts are not permitted.

In the context of entities entering into lease arrangements, they are required to report a lease liability and a right of use asset in their balance sheet regardless of whether the lease is an operating or finance lease. ASC 842 Leases requires that companies report all leased assets at cost and recognize a corresponding liability using the discounted method. Future lease payments are discounted using an effective rate of interest; being the rate implicit in the lease. Where such rate is not available, an implicit borrowing rate on a similar loan contract can be used. The depreciation charges and finance cost must be accounted for separately on the face of the income statement where the lease is a finance lease. But these expenses must be aggregated where the lease is an operating lease.

Understanding the nature of liabilities

Liabilities are present obligation arising from past events the settlement of which results in an outflow of resources embodying future economic benefits. ASC 405 Liabilities provides some guidance with regards to the timing and amount of recognition of these obligations. Provisions are liabilities of uncertain timing and amount. US GAAP requires provisions be recognized when the probability of occurrence of an event exceeds 70%. In the event where a reliable estimate cannot be made, a contingent liability, governed by ASC 450 Contingencies, is disclosed by way of notes to the financial statements.

Companies often receive revenue prior to providing the associated goods and services. ASC 430 Deferred Revenue requires that these companies report a present obligation attributed to the unearned revenue. The obligation is reversed into the income statement as revenue, once the service or good has been delivered by the vendor.

Where companies have financial commitments towards their stakeholders, other than contributors of capital, they are required to report the respective obligations under the application of ASC 440 Commitments. These commitments can also result in outstanding debts and guarantees which companies are required to report under ASC 470 Debt and ASC 460 Guarantees respectively.

Equity element of Balance Sheet

The shareholder's component, in the nature of their capital contribution, is contained in ASC 215 Statement of Changes in Shareholder Equity. Equity is the net residual interest in the net assets of an entity after deducting all liabilities. This statement reports changes in the entity's equity capital, reserves and retained earnings. Any change in accounting treatment of a transaction that requires retrospective application is reported in the statement of changes in shareholder equity. ASC 250 Error Correction and Accounting Change provide effective guidance in relation to the treatment of prior-period errors and changes in accounting policies and estimates. The US GAAP also permits recognition of extraordinary gains and losses which might impact the statement of changes in shareholder equity. ASC 505 Equity provides further guidance relating to items that make up a balance sheet's net assets.

Recognition of Income and Expenses

Income is an increase in the equity of a company resulting from enhancement of assets or reduction in liabilities other than those attributed from contributions by equity participants. An expense is a reduction in the equity of a company resulting from depletion of assets or increase in liabilities other than those attributed to distributions to equity participants. Income (gains) and expenses (losses) are recognized in ASC 225 Income Statements and ASC 220 Comprehensive Income. An Income Statement provides information about the financial performance of a company over a particular reporting period.

A comprehensive income statement will include the income statement and any other comprehensive income not reported through the income statement.

ASC 606 Revenue from Contracts with Customers provides the basis for recognition of revenue. There must be evidence of a contract arrangement (written or verbal) defining the terms and clauses for both the vendor and buyer. The contract must clearly bind the vendor to meet specific performance obligations. These obligations are in the form of distinct goods and services or distinct classes of goods and services. The buyer's obligation is that of settling the payment for obtaining those goods and services. A stand-alone transaction price must be determined. This price must then be linked to each of the performance obligations contained in the contract. Where a stand-alone price cannot be determined, the standard offers some approaches for an effective transaction-price determination. Revenue is then recognized as the economic ownership of the goods and services passes from the vendor to the buyer. Companies also generate other sources of income either in the ordinary or the non-ordinary course of business. ASC 610 Other Income guides companies in properly recognizing these other gains.

In the normal course of business, companies generally largely incur expenses attributed to cost of sales. ASC 705 Cost of Sales and Services provides guidance as to the presentation of cost of sales figures in the income statement. Cost of sales consists of opening inventory and purchases net of closing inventory. ASC 705 requires that cost of sales be presented separately as the first expense item following revenue from contract with customers. ASC 720 Other Expenses sets the tone for presentation and recognition of other expenses in the income statement. Companies generally hire employees and contractors. They must follow the principles contained in ASC 710 Compensation- General to adequately report for any employee obligations accruing during the year. These generally include salaries and wages, bonuses, emoluments and fringe benefits. Companies must also report under ASC 715 Compensation- Retirement Benefits, any 401k pension contribution payments made through either voluntary or automatic enrolment schemes. Companies are required to strictly follow the Pension Accounting guidelines contained in ASC 962 Defined Contribution Pension Plan and ASC 960 Defined Benefit Pension Plan. Besides, public companies sometimes offer stock options or stock appreciation rights to their employees in lieu of wages. Where companies have recourse to such compensation practices, they must follow the guidelines contained in ASC 718 Compensation – Stock Compensation. Finally, companies are required to file their financial statements with their form-10K return with the Internal Revenue Service and report on any tax payable. These companies must adhere to the clauses contained in ASC 740 Income Taxes when reporting for current and deferred taxes.

Disclosure Requirements

Companies must adequately disclose any additional useful information by way of explanatory notes to the financial statements. ASC 235 Notes to the Financial Statements strictly requires that entities disclose any material information not otherwise disclosed anywhere else in the Financial Statements. They must observe ASC 850 Related Party Disclosures to report on the nature of any known identifiable related party dealings and transactions. They are also required to report on any adjusting and non-adjusting events that may have a material impact on the information contained in the financial statements in line with ASC 855 Subsequent Events. Companies must also follow ASC 250 Accounting Change and Error Correction in reporting for any changes in accounting policies in the form of changes in presentation, recognition and measurement. Finally companies must adhere to APS 260 Earnings Per Share when presenting diluted and basic earnings per share.

Conclusion

The US GAAP has additional reporting requirements which vary depending on the nature of the industry in which the entity operates. For instance, ASC 905 Agriculture supports companies operating in the agro-industry and animal rearing industry. Companies involved in mining are required to also observe the guidelines contained in ASC 930 Extracting Activities – Mining and/or ASC 932 Extracting Activities – Oil and Gas. Financial Services are also required to observe the relevant industry ASC standards (ASC 940 – ASC 950). The US GAAP provides effective guidance to assist public companies in their timely and accurate reporting of day-to-day transactions. By complying with the US GAAP, public companies meet the key requirements of the Securities Exchange Commission for public listing on the New York Stock Exchange.

In this research paper, the author only seeks to provide a broad overview of the operation of US GAAP. For a more comprehensive understanding of the US GAAP mechanism, readers are encouraged to refer to the information contained on the Financial Accounting Standards Board website.

Appendix 1

Fair Presentation of Financial Statements per ASC 205

Complete Sets of Financial Statements

ASC 210 Balance Sheet	
Long Lived Assets	ASC 360
Intangible - Goodwill and others	ASC 350
Leases - Right of Use Assets	ASC 842
Debt and Equity Instruments	ASC 320
Joint Venture and Equity Method	ASC 323
Derivatives and Hedging	ASC 815
Other Investments	ASC 325
Agriculture	ASC 905
Receivables - Loans and Trade	ASC 310
Inventory	ASC 330
Other Assets and Deferred Costs	ASC 340
Cash and Cash Equivalents	ASC 305
Liabilities	ASC 405
Commitments	ASC 440
Debt	ASC 470
Guarantees	ASC 460
Deferred Revenue	ASC 430
Lease Liability	ASC 842
Equity	ASC 505
ASC 225 Income Statement	
ASC 220 Comprehensive Income	
Revenue from Contract with Customers	ASC 606
Other Income	ASC 610
Cost of Sales and Services	ASC 705
Compensation - General	ASC 710
Stock Compensation	ASC 718
Compensation - Retirement Benefits	ASC 715
Research and Development	ASC 730
Depreciation and Impairment losses	ASC 360

Depreciation and Lease Finance Costs	ASC 842
Other Expenses	ASC 720
Income Taxes	ASC 740
Earnings Per Share	ASC 260

ASC 215 Statement of Changes in Shareholder Equity

ASC 230 Statement of Cash Flows

ASC 235 Notes to Financial Statements

Contingencies	ASC 450
Subsequent Events	ASC 855
Related Party Disclosures	ASC 850
Measurement Basis - Fair Value	ASC 820
Foreign Currency Transactions	ASC 830
Financial Instruments	ASC 825
Credit Losses	ASC 326
Business Combinations	ASC 805
Consolidations	ASC 810
Defined Benefit Pension Plan	ASC 960
Defined Contribution Pension Plan	ASC 962
Extracting Activities - Mining	ASC 930
Extracting Activities - Oil and Gas	ASC 932

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