

ACCOUNTING ALTERNATIVES AND CHANGES IN ACCOUNTING PRINCIPLES
JOINT SESSION OF THE PRIVATE COMPANY COUNCIL (PCC) AND THE SMALL BUSINESS
ADVISORY COMMITTEE (SBAC)
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Session Objective

In various areas of generally accepted accounting principles (GAAP), entities are required or permitted to choose among different acceptable accounting alternatives. The purpose of this session is to discuss accounting alternatives,¹ including options and practical expedients, in GAAP.

For this session, PCC and SBAC members will be asked for their views about what circumstances and factors the Board should consider when determining whether to provide accounting alternatives in GAAP. The session also will seek PCC and SBAC members' views on what challenges, if any, exist in applying the changes in accounting principles guidance in Topic 250, Accounting Changes and Error Corrections.

Overview of Materials

These materials include the following:

1. Background on accounting alternatives in GAAP
2. Examples of accounting alternatives in GAAP
3. GAAP requirements for accounting for a change in accounting principle.

Discussion questions are on page 10.

Background on Accounting Alternatives in GAAP

Accounting alternatives in GAAP include alternatives that allow entities to select among accounting requirements provided in GAAP (for example, accounting policy elections) and alternatives that are intended to allow entities to select a more cost-effective way of achieving the same or similar accounting results (for example, practical expedients). GAAP also includes private company alternatives (both accounting policy elections and practical expedients) that allow private companies to apply different recognition, measurement, disclosure, presentation, effective date, and transition requirements. This session focuses on GAAP alternatives within recognition, measurement, disclosure, and presentation guidance.

¹ For purposes of this discussion, the term *accounting alternative* is all-inclusive and intended to encompass terms used in GAAP and in practice such as accounting principles, accounting policies, elections, options, and practical expedients.

There are different reasons that accounting alternatives exist in GAAP. A 2008 report² of the Advisory Committee on Improvements to Financial Reporting broadly summarized some of those historical reasons:

[The reasons that alternative accounting policies arise] include circumstances in which the pros and cons of competing policies may be balanced and thus do not result in a single, clearly preferable approach. Other causes encompass [stakeholders' conflicting points of view] that results in standards-setters providing for a preferred and an alternative accounting method, high administrative costs of the preferred alternative to preparers (e.g., cost-benefit considerations), and a portrayal of differences in management intent.

In addition, the FASB and the PCC issued the [Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies](#) (PCDMF) in 2013. The primary purpose of the PCDMF is to assist the FASB and the PCC in determining whether (and in what circumstances) to provide alternative recognition, measurement, disclosure, display, effective date, and transition guidance for private companies reporting under GAAP.³ The PCDMF provides considerations for the PCC and the FASB in evaluating whether information is relevant to users and cost-benefit evaluations for private companies. The PCDMF uses the term *practical expedient* to mean a more cost-effective way of achieving the same or a similar accounting or reporting objective.

Practical expedients existed in some areas of GAAP before the term was used in the PCDMF in 2013. (Other types of accounting alternatives, such as options, have been consistently used by the Board over time.) However, the use of practical expedients in GAAP has generally increased for public companies as well as other entities over the past decade. For example, as discussed further below, the Board included multiple practical expedients in the revenue recognition guidance (issued in 2014) and leases guidance (issued in 2016). In addition, the Board has in some cases asked stakeholders

² From the Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission, August 1, 2008; <https://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf>

³ The PCDMF describes the following factors that the Board and the PCC consider when determining whether and when an accounting alternative should be provided for private companies:

1. Number of primary users and their access to management
2. Investment strategies of primary users
3. Ownership and capital structure
4. Accounting resources
5. Learning about new financial reporting guidance.

in exposure documents whether any potential practical expedients could simplify application of the guidance or reduce the costs of applying the guidance (see, for example, Question 11 in the proposed Accounting Standards Update on disaggregation of income statement expenses issued in July 2023).

The Board communicates the reasons for an accounting alternative to stakeholders as part of its decision-making process. For example, when the Board issued the fair value option, which permitted entities to choose to measure certain financial assets and liabilities at fair value, the basis for conclusions⁴ included the following rationale:

A fair value option would enable entities to mitigate the volatility in earnings that results from using different measurement attributes in reporting related financial assets and financial liabilities.

A fair value option would enable entities to achieve consistent accounting and, potentially, an offsetting effect for the changes in the fair values of related assets and liabilities without having to apply complex hedge accounting provisions, thereby providing greater simplicity in the application of accounting guidance.

A fair value option would achieve further convergence with the IASB....

In some more recent accounting standards, such as leases and revenue recognition, the Board provided multiple practical expedients. Consistent with the usage of this term in the PCDMF, those practical expedients were primarily developed to provide companies with the ability to reduce the costs and complexity of applying the guidance while maintaining the quality of information reported to investors. For example, in lease accounting, the Board provided a practical expedient for a lessee to account for a lease component and its related nonlease components (which are often services) on a combined basis and included the following rationale in the basis for conclusions:⁵

The practical expedient... was provided by the Board on the basis that the costs and administrative burden of allocating consideration to separate lease and nonlease components may not be justified by the benefit of more precisely reflecting

⁴ Paragraph A3 of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*

⁵ Paragraph BC150 of Update Standards Update No. 2016-02, *Leases (Topic 842)*.

the right-of-use asset and the lease liability.

Accounting alternatives have different requirements for how they are applied depending on the facts and circumstances of the alternative and how the Board decides the alternative should be structured. Some alternatives have a default option or encourage one particular treatment; for example, paragraph 230-10-45-25 states that the direct method of presentation cash flows is “encouraged.” Some accounting alternatives have conditions that must be met in order for them to be applied, such as the conditions to apply a different amortization method for pension plans in paragraph 715-30-35-25. In addition, some accounting alternatives specify on what basis or at which level they are required to be applied; for example, on an entity-wide basis, to a class of underlying assets, or to an individual asset or transaction.

Some accounting alternatives are widely selected and applied by many entities, such as presenting the statement of cash flows using the indirect method, while other accounting alternatives are selected less frequently, such as applying Topic 255, Changing Prices. Entities are generally required to disclose significant accounting policies or elections to explain the information that is included in financial statements.

Examples of Accounting Alternatives in GAAP

Below are some examples of common accounting alternatives in GAAP.

Recognition and Measurement Alternatives

Some common examples of accounting alternatives in recognition and measurement guidance include:

1. *Financial Instruments (Topic 825)*: Entities have an option to elect to measure certain financial assets and liabilities at fair value. That election is applied on an instrument-by-instrument basis, is made on specified election dates, and is irrevocable.
2. *Inventory (Topic 330)*: Cost for inventory may be determined under any one of several assumptions about the flow of cost factors (such as first-in, first-out (FIFO), average, and last-in, first-out (LIFO)). The objective is for the entity to choose the method which, under the circumstances, most clearly reflects periodic income (paragraph 330-10-30-9).
3. *Compensation— Stock Compensation (Topic 718)*: Entities can make an entity-wide accounting policy election to account for the effect of award forfeitures. This is a separate election for all employee awards and all nonemployee awards. Entities can either account for forfeitures (a) as they occur by reversing the previously recognized compensation cost or (b) by estimating expected forfeitures.

4. *Business Combinations— Related Issues (Subtopic 805-50)*: An acquiree has the option to apply pushdown accounting in its separate financial statements. The option may be elected each time there is a change-in-control event in which an acquirer obtains control of the acquiree, and the election must be made before financial statements are issued or available to be issued and applied as of the acquisition date.
5. *Compensation—Retirement Benefits—Defined Benefit Plans— Pension (Subtopic 715-30)*: Paragraph 715-30-35-24 specifies a minimum amortization method referred to as the corridor approach. Paragraph 715-30-35-25 permits the use of any systematic method of amortizing unrecognized gains and losses instead of the minimum amortization method if all of the following conditions are met: (a) the minimum amortization method must be used in any period in which the minimum amortization is greater than the amortization resulting from the alternative method (reduces the net balance subject to amortization by more), (b) the alternative method must be applied consistently, and (c) the alternative method must be applied similarly to both gains and losses.

Some examples of practical expedients include:

1. *Leases (Topic 842)*:
 - a. *Lease and nonlease components*: Lessees can combine lease and nonlease components and account for them as a single combined lease component. This practical expedient is required to be elected by class of underlying asset.
2. *Revenue from Contracts with Customers (Topic 606)*:
 - a. *Portfolio approach (paragraph 606-10-10-4)*: An entity is permitted to apply the recognition and measurement guidance to a portfolio of similar contracts or performance obligations, rather than on an individual contract basis, if the entity reasonably expects that the effects on the financial statements of applying the guidance to the portfolio would not differ materially from applying the guidance to the individual contracts within that portfolio.
 - b. *Measuring progress toward complete satisfaction of a performance obligation (paragraph 606-10-55-18)*: An entity is permitted to recognize revenue in an amount to which the entity has the right to invoice if the amount of consideration that the entity has a right to invoice corresponds directly with the value to the entity's performance completed to date.
 - c. *Significant financing component (paragraph 606-10-32-18)*: If the period between the transfer of a good or service and payment for that good or service is less than one year, as a practical expedient, an entity does not

need to adjust the transaction price for the effects of a significant financing component.

Some examples of private company alternatives (accounting policy elections and practical expedients) include:

1. *Goodwill (Topic 350)*: Private companies and not-for-profit entities are permitted to make an accounting policy election for the following alternatives for goodwill:
 - a. Amortize goodwill on a straight-line basis over 10 years, or less than 10 years if the company demonstrates that another useful life is more appropriate.
 - b. Evaluate goodwill impairment triggering events as of the end of a reporting period (whether interim or annual), rather than throughout the reporting period.
2. *Leases (Topic 842)*: A lessee that is not a public business entity is permitted to make an accounting policy election to use:
 - a. A risk-free rate as a discount rate (by class of underlying asset) to measure the present value of the lease payments not yet paid, instead of its incremental borrowing rate
 - b. The written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, the classification of and accounting for that lease. This practical expedient must be elected on an arrangement-by-arrangement basis.
3. *Compensation—Stock Compensation (Topic 718)*: As a practical expedient, private companies are allowed to measure equity classified share-based payment awards using “the reasonable application of a reasonable valuation method” to determine the current price input of equity-classified share-based payment awards issued in exchange for goods or services.

Presentation and Disclosure Alternatives

Some common examples of alternative accounting policies for presentation and disclosure guidance include:

- a. *Statement of Cash Flows (Topic 230)*: An entity can elect to present the statement of cash flows by applying either the indirect method or the direct method.
- b. *Statement of Comprehensive Income (Topic 220)*: A entity can report comprehensive income using a one-step income statement or a two-step income statement.

Changes in Accounting Principles

The guidance in Topic 250 presumes that once an entity adopts an accounting principle, that accounting principle should be used consistently in accounting for similar events and transactions.⁶ That presumption exists because consistent use of the same accounting principle from one accounting period to another enhances the utility of financial statements for investors by facilitating analysis and understanding of comparative accounting data.⁷

A change in accounting principle is defined in Topic 250 as:

A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.

Topic 250 specifies that neither of the following is a change in accounting principle:⁸

- a. Initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect.
- b. Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

Topic 250 also specifies that a reporting entity shall change an accounting principle only if either of the following apply:⁹

- a. The change is required by a newly issued Codification update.
- b. The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable.

Topic 250 includes the following guidance related to assessing preferability:¹⁰

250-10-45-12 An entity may change an accounting principle only if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable.

250-10-45-13 The issuance of a Codification update that

⁶ Paragraphs 250-10-45-1 and 250-10-45-11

⁷ Paragraph 250-10-45-1

⁸ Paragraph 250-10-45-1

⁹ Paragraph 250-10-45-2

¹⁰ See paragraph 250-10-S99-4 for SEC staff views regarding preferability among accounting alternatives and requirements to file an accountant's preferability letter.

requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle may require an entity to change an accounting principle. The issuance of such an update constitutes sufficient support for making such a change.

250-10-55-1 ... [P]referability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone.

The SEC also has addressed changes to an alternative accounting principle in SAB Topic 6.G.2.b, Reporting Requirements for Accounting Changes, including changes in accounting methods.

Topic 250 provides guidance on the difference between changes in accounting principles and changes in accounting estimates, which includes the following:

250-10-45-17 A change in accounting estimate shall be accounted for in the period of change if the change affects that period only or in the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

250-10-45-18 Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. In some cases, a change in accounting estimate is effected by a change in accounting principle. One example of this type of change is a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets (hereinafter referred to as depreciation method). The new depreciation method is adopted in partial or complete recognition of a change in the estimated future benefits inherent in the asset, the pattern of consumption of those benefits, or the information available to the entity about those benefits. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Changes of that type often are related to the continuing process of obtaining additional information and revising estimates and, therefore, shall be considered changes in estimates for purposes of applying this Subtopic.

250-10-45-19 Like other changes in accounting principle, a change in accounting estimate that is effected by a change in

accounting principle may be made only if the new accounting principle is justifiable on the basis that it is preferable. For example, an entity that concludes that the pattern of consumption of the expected benefits of an asset has changed, and determines that a new depreciation method better reflects that pattern, may be justified in making a change in accounting estimate effected by a change in accounting principle.

250-10-45-20 However, a change to the straight-line method at a specific point in the service life of an asset may be planned at the time some depreciation methods, such as the modified accelerated cost recovery system, are adopted to fully depreciate the cost over the estimated life of the asset. Consistent application of such a policy does not constitute a change in accounting principle for purposes of applying this Subtopic.

If transition requirements are not provided by other GAAP, Topic 250 requires retrospective application of the change (unless impracticable) and disclosure about the nature and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

Comparative Financial Statements

In addition to the guidance in Topic 250, the Codification recognizes that reclassifications in presentation may occur for reasons other than those articulated in Topic 250. The importance of comparative financial statements and presentation and disclosure requirements are discussed in Topic 205, Presentation of Financial Statements, including the following:

205-10-50-1 If, because of reclassifications or for other reasons, changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, information shall be furnished that will explain the change. This procedure is in conformity with the well recognized principle that any change in practice that affects comparability of financial statements shall be disclosed.

205-10-45-3 Prior-year figures shown for comparative purposes shall in fact be comparable with those shown for the most recent period. Any exceptions to comparability shall be clearly brought out as described in Topic 250.

Discussion Questions

Accounting Alternatives

Question 1 (All)

What circumstances and factors (such as the benefits and costs, including the effect on key financial metrics; system constraints; better representation of the underlying economics; sector specific needs; etc.) should the Board consider when determining:

- a. Type of accounting alternative (for example, an accounting policy election or a practical expedient)
- b. Alternatives that relate to recognition and measurement versus alternatives that relate to presentation and disclosure
- c. Whether an accounting alternative should apply to all entities
- d. The level at which an entity should apply an accounting policy election or practical expedient (for example, an entity-wide policy election, by asset class, individual transaction, or otherwise)?

Question 2 (Investors/Users)

- a. How do accounting alternatives affect the information used by investors in their models and analyses?
- b. What changes do investors make to their analysis to reflect options or alternatives that have been applied?

Changes in Accounting Principles

Question 3 (Preparers/Practitioners)

- a. Do you apply the guidance on a change in accounting principle in Topic 250 to changes in all types of accounting alternatives, including practical expedients?
- b. Are there any types of changes that create challenges in determining whether the guidance on a change in accounting principle in Topic 250 should be applied?

Question 4 (Investors/Users)

- a. What information is most useful for investors when an entity applies the guidance on a change in accounting principle in Topic 250?
- b. Are the existing disclosures clear and understandable?