Financial Accounting and Accounting Standards

The Size of the New York City Phone Book . . .

Enron, Global Crossing, Kmart, WorldCom, Williams Co., and Xerox are examples of companies that have come under the scrutiny of the Securities and Exchange Commission recently because of accounting issues. Share prices of all these companies have declined substantially, as investors punish any company whose quality of earnings is in doubt.

The unfortunate part of accounting scandals is that we all pay. Enron, for example, at one time had a market capitalization of $80 billion before disclosure of its accounting irregularities. Today it is bankrupt. Employees have lost their pension money, investors have lost their savings, and the entire stock market has become caught up in “Enronitis,” which has led to substantial declines in the overall stock market. At one point, there were at least 10 congressional committees involved in inquiries regarding corporate governance issues, and over 30 Enron-related bills have addressed matters such as regulation of derivative securities, auditor-client conflicts, and development of an oversight body to regulate the accounting profession.

As a result of the many concerns expressed by investors about the completeness and the reliability of the accounting numbers, many companies have expanded their financial disclosures in their annual reports. For example, General Electric’s CEO Jeffery Immelt stated, “I want people to think about GE as we think of GE—as a transparent company.” He noted that GE’s annual report will be “the size of New York City’s phone book, if necessary” to provide the information necessary to help investors and creditors make the proper investing decisions.

It is our hope that meaningful reform will come out of these recent investigations into sloppy or fraudulent accounting. Although the U.S. is still considered to have the finest reporting system in the world, we must do better. As former chair of the FASB Ed Jenkins recently remarked, “If anything positive results . . . it may be that [these accounting issues] serve as an indelible reminder to all that transparent financial reporting does matter and that lack of transparency imposes significant costs on all who participate [in our markets].”
As the opening story indicates, relevant and reliable financial information must be provided so that our capital markets work efficiently. This chapter explains the environment of financial reporting and the many factors affecting it. The content and organization of this chapter are as follows.

### PREVIEW OF CHAPTER 1

**FINANCIAL ACCOUNTING AND ACCOUNTING STANDARDS**

- Financial Statements and Financial Reporting
  - Accounting and capital allocation
  - Challenges
  - Objectives
  - Need to develop standards

- Parties Involved in Standards Setting
  - Securities and Exchange Commission
  - American Institute of CPAs
  - Financial Accounting Standards Board
  - Governmental Accounting Standards Board
  - The Role of the AICPA

- Generally Accepted Accounting Principles
  - Political environment
  - Expectations gap
  - International accounting standards
  - Ethics

- Issues in Financial Reporting
  - SEC
  - American Institute of CPAs
  - Financial Accounting Standards Board
  - Governmental Accounting Standards Board
  - The Role of the AICPA

### FINANCIAL STATEMENTS AND FINANCIAL REPORTING

The essential characteristics of accounting are: (1) identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties. Financial accounting is the process that culminates in the preparation of financial reports on the enterprise as a whole for use by both internal and external parties. Users of these financial reports include investors, creditors, managers, unions, and government agencies. In contrast, managerial accounting is the process of identifying, measuring, analyzing, and communicating financial information needed by management to plan, evaluate, and control an organization’s operations.

Financial statements are the principal means through which financial information is communicated to those outside an enterprise. These statements provide the company’s history quantified in money terms. The financial statements most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners’ or stockholders’ equity. In addition, note disclosures are an integral part of each financial statement.

Some financial information is better provided, or can be provided only, by means of financial reporting other than formal financial statements. Examples include the president’s letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management’s forecasts, and certifications regarding internal controls and fraud. Such information may be required by authoritative pronouncement, regulatory rule, or custom. Or it may be supplied because management wishes to disclose it voluntarily.

The primary focus of this textbook concerns the development of two types of financial information: (1) the basic financial statements and (2) related disclosures.
Accounting and Capital Allocation

Because resources are limited, people try to conserve them, to use them effectively, and to identify and encourage those who can make efficient use of them. Through an efficient use of resources, our standard of living increases.

Markets, free enterprise, and competition determine whether a business is to be successful and thrive. This fact places a substantial burden on the accounting profession to measure performance accurately and fairly on a timely basis, so that the right managers and companies are able to attract investment capital. For example, relevant and reliable financial information enables investors and creditors to compare the income and assets employed by such companies as IBM, McDonald’s, Microsoft, and Ford. As a result, they can assess the relative return and risks associated with investment opportunities and so channel resources more effectively. This process of capital allocation works as follows.

An effective process of capital allocation is critical to a healthy economy. It promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. As indicated in our opening story, unreliable and irrelevant information leads to poor capital allocation, which adversely affects the securities markets.

It’s not the economy anymore. It’s the accounting. That’s what many investors seem to be saying these days. As indicated in our opening story, even the slightest hint of any type of accounting irregularity at a company leads to a subsequent pounding of the company’s stock. For example, a recent Wall Street Journal had the following headlines related to accounting and its effects on the economy.

Stocks take a beating as accounting worries spread beyond Enron
Williams Cos. delays earnings release to review a unit’s obligations
Global Crossing’s accounting method now being called aggressive
Bank stocks fall as investors take issue with PNC’s accounting
Investors, skeptical of Tyco’s breakup plan, send shares down 20%

It now has become clear that there must be trust in the numbers or investors will abandon the market and put their resources elsewhere. That is why overseas investors are pulling their money out of the U.S. market and why the dollar is dropping relative to other currencies. With investor uncertainty, the cost of capital increases for companies who need additional resources. In short, relevant and reliable financial information is necessary for markets to be efficient.

The Challenges Facing Financial Accounting

Although there is a crisis of confidence regarding corporate governance issues, of which one is proper accounting, much is right about financial reporting in the United States. The U.S. markets are still the most liquid, deep, secure, and efficient public capital markets of any country. One reason for this success is that our financial statements and related disclosures have captured and organized financial information in a useful and reliable fashion. However, much still needs to be done. For example, suppose you could move to the year 2020 and look back at financial reporting today. Here is what you might read:

• **Non-financial Measurements.** Financial reports failed to provide some key performance measures widely used by management. For example, nonfinancial measures such as customer satisfaction indexes, backlog information, and reject rates on goods purchased, all now used to evaluate the long-term stability of the company, were provided on an ad hoc basis, if at all.

• **Forward-looking Information.** Financial reports failed to provide forward-looking information needed by present and potential investors and creditors. One individual noted that financial statements in 2000 should have started with the phrase, “Once upon a time,” to signify their use of historical cost and their accumulation of past events.

• **Soft Assets.** Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information on a company’s soft assets (intangibles). For example, often the best assets are intangible, such as Microsoft’s know-how and market dominance, Dell’s unique marketing setup and well-trained employees, and J.Crew’s brand image.

• **Timeliness.** Financial statements were prepared only quarterly, and audited financials were provided annually. Little to no real-time financial statement information was available.

We believe each of these challenges must be met for the accounting profession to continue to provide the type of information needed for an efficient capital allocation process. We are confident that changes will occur. Here are some positive signs:

• Already some companies are making voluntary disclosures on information deemed relevant to investors. Often such information is of a non-financial nature. Regional banking companies, like BankOne Corp., Fifth Third Bancorp, Sun Trust Banks, and others, for example, now include, in addition to traditional financial information, data on loan growth, credit quality, fee income, operating efficiency, capital management, and management strategy.

• The World Wide Web was first used to provide limited financial data. Now most companies offer their annual reports in several formats on the Web. The most innovative companies are now offering sections of their annual reports in a format that can be readily manipulated by the user, such as in an Excel spreadsheet format.

• More accounting standards are now requiring the recording or disclosing of fair value information. For example, either investments in stocks and bonds, debt obligations, and derivatives are recorded at fair value, or information related to fair values is shown in the notes to the financial statements.

Changes in these directions will enhance the relevance of financial reporting and provide useful information to users of the financial statements.

Objectives of Financial Reporting

In an attempt to establish a foundation for financial accounting and reporting, a set of objectives of financial reporting by business enterprises has been identified. Financial reporting should provide information that:
Is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

Helps present and potential investors, creditors, and other users assess the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors’ and creditors’ cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.

Clearly portrays the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners’ equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources.2

In brief, the objectives of financial reporting are to provide (1) information that is useful in investment and credit decisions, (2) information that is useful in assessing cash flow prospects, and (3) information about enterprise resources, claims to those resources, and changes in them. The emphasis on “assessing cash flow prospects” might lead one to suppose that the cash basis is preferred over the accrual basis of accounting. That is not the case. Information based on accrual accounting generally provides a better indication of an enterprise’s present and continuing ability to generate favorable cash flows than does information limited to the financial effects of cash receipts and payments.3

Recall from your first accounting course that the objective of accrual basis accounting is to ensure that events that change an entity’s financial statements are recorded in the periods in which the events occur, rather than only in the periods in which the entity receives or pays cash. Using the accrual basis to determine net income means recognizing revenues when earned rather than when cash is received, and recognizing expenses when incurred rather than when paid. Under accrual accounting, revenues, for the most part, are recognized when sales are made so they can be related to the economic environment of the period in which they occurred. Over the long run, trends in revenues are generally more meaningful than trends in cash receipts.

The Need to Develop Standards

The main controversy in setting accounting standards is, “Whose rules should we play by, and what should they be?” The answer is not immediately clear because the users of financial accounting statements have both coinciding and conflicting needs for information of various types. To meet these needs, and to satisfy the fiduciary4 reporting responsibility of management, a single set of general-purpose financial statements is prepared. These statements are expected to present fairly, clearly, and completely the financial operations of the enterprise.

As a result, the accounting profession has attempted to develop a set of standards that are generally accepted and universally practiced. Without these standards, each

---


3SFAC No. 1, p. iv. As used here, cash flow means “cash generated and used in operations.” The term cash flows is frequently used also to include cash obtained by borrowing and used to repay borrowing, cash used for investments in resources and obtained from the disposal of investments, and cash contributed by or distributed to owners.

4Management’s responsibility to manage assets with care and trust is its fiduciary responsibility.
enterprise would have to develop its own standards, and readers of financial statements would have to familiarize themselves with every company’s peculiar accounting and reporting practices. It would be almost impossible to prepare statements that could be compared.

This common set of standards and procedures is called generally accepted accounting principles (GAAP). The term “generally accepted” means either that an authoritative accounting rule-making body has established a principle of reporting in a given area or that over time a given practice has been accepted as appropriate because of its universal application. Although principles and practices have provoked both debate and criticism, most members of the financial community recognize them as the standards that over time have proven to be most useful. A more extensive discussion of what constitutes GAAP is presented later in this chapter.

PARTIES INVOLVED IN STANDARDS SETTING

A number of organizations are instrumental in the development of financial accounting standards (GAAP) in the United States. Four major organizations are as follows.

- Securities and Exchange Commission (SEC)
- American Institute of Certified Public Accountants (AICPA)
- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)

Securities and Exchange Commission (SEC)

External financial reporting and auditing developed and evolved in tandem with the growth of America’s industrial economy and its capital markets. However, when the stock market crashed in 1929 and the nation’s economy plunged into the Great Depression, there were calls for increased government regulation and supervision of business generally and especially financial institutions and the stock market.

As a result, the federal government established the Securities and Exchange Commission (SEC) to help develop and standardize financial information presented to stockholders. The SEC is a federal agency. It administers the Securities Exchange Act of 1934 and several other acts. Most companies that issue securities to the public or are listed on a stock exchange are required to file audited financial statements with the SEC. In addition, the SEC has broad powers to prescribe, in whatever detail it desires, the accounting practices and standards to be employed by companies that fall within its jurisdiction. As a result, the SEC exercises oversight over 12,000 companies that are listed on the major exchanges (such as the New York Stock Exchange and Nasdaq).

Public/Private Partnership

At the time the SEC was created, no group—public or private—was issuing accounting standards. The SEC encouraged the creation of a private standards-setting body because it believed that the private sector had the resources and talent to develop appropriate accounting standards. As a result, accounting standards have generally developed in the private sector either through the American Institute of Certified Public Accountants (AICPA) or the Financial Accounting Standards Board (FASB).

The SEC has affirmed its support for the FASB by indicating that financial statements conforming to standards set by the FASB will be presumed to have substantial authoritative support. In short, the SEC requires registrants to adhere to GAAP. In addition, it has indicated in its reports to Congress that “it continues to believe that the

---

5The terms principles and standards are used interchangeably in practice and throughout this textbook.
initiative for establishing and improving accounting standards should remain in the private sector, subject to Commission oversight.”

**SEC Oversight**

The SEC’s partnership with the private sector has worked well. The SEC has acted with remarkable restraint in the area of developing accounting standards. Generally, the SEC has relied on the AICPA and FASB to regulate the accounting profession and develop and enforce accounting standards.

Over its history, however, the SEC’s involvement in the development of accounting standards has varied. In some cases the private sector has attempted to establish a standard, but the SEC has refused to accept it. In other cases the SEC has prodded the private sector into taking quicker action on certain reporting problems, such as accounting for investments in debt and equity securities and the reporting of derivative instruments. In still other situations the SEC communicates problems to the FASB, responds to FASB exposure drafts, and provides the FASB with counsel and advice upon request.

The SEC has the mandate to establish accounting principles. The private sector, therefore, must listen carefully to the views of the SEC. In some sense the private sector is the formulator and the implementor of the standards. While the partnership between the SEC and the private sector has worked well, it can be strained when accounting problems are not addressed as quickly as the SEC would like. This was apparent in the recent deliberations on the accounting for business combinations and intangible assets and concerns over the accounting for special-purpose entities, highlighted in the failure of Enron.

**Enforcement**

As indicated earlier, companies listed on a stock exchange are required to submit their financial statements to the SEC. If the SEC believes that an accounting or disclosure irregularity exists regarding the form or content of the financial statements, it sends a deficiency letter to the company. Usually these deficiency letters are resolved quickly. However, if disagreement continues, the SEC has the power to issue a “stop order,” which prevents the registrant from issuing securities or trading securities on the exchanges. Criminal charges may also be brought by the Department of Justice for violations of certain laws. The SEC program, private sector initiatives, and civil and criminal litigation help to ensure the integrity of financial reporting for public companies.

**American Institute of Certified Public Accountants (AICPA)**

As indicated earlier, the American Institute of Certified Public Accountants (AICPA), which is the national professional organization of practicing Certified Public Accountants (CPAs), has been vital to the development of GAAP. Various committees and boards established since the founding of the AICPA have contributed to this effort.

**Committee on Accounting Procedure**

At the urging of the SEC, the AICPA appointed the Committee on Accounting Procedure in 1939. The Committee on Accounting Procedure (CAP), composed of practicing CPAs, issued 51 Accounting Research Bulletins during the years 1939 to 1959. (See

---

*One writer has described the relationship of the FASB and SEC and the development of financial reporting standards using the analogy of a pearl. The pearl (financial reporting standard) is formed by the reaction of certain oysters (FASB) to an irritant (the SEC)—usually a grain of sand—that becomes embedded inside the shell. The oyster coats this grain with layers of nacre, and ultimately a pearl is formed. The pearl is a joint result of the irritant (SEC) and oyster (FASB); without both, it cannot be created.” John C. Burton, “Government Regulation of Accounting and Information,” *Journal of Accountancy* (June 1982).
list at the back of the book.) These bulletins deal with a variety of accounting problems. But this problem-by-problem approach failed to provide the structured body of accounting principles that was both needed and desired. In response, in 1959 the AICPA created the Accounting Principles Board.

**Accounting Principles Board**

The major purposes of the Accounting Principles Board (APB) were (1) to advance the written expression of accounting principles, (2) to determine appropriate practices, and (3) to narrow the areas of difference and inconsistency in practice. To achieve these objectives, the APB’s mission was to develop an overall conceptual framework to assist in the resolution of problems as they become evident and to do substantive research on individual issues before pronouncements were issued.

The Board’s 18 to 21 members, selected primarily from public accounting, also included representatives from industry and the academic community. The Board’s official pronouncements, called APB Opinions, were intended to be based mainly on research studies and be supported by reasons and analysis. Between its inception in 1959 and its dissolution in 1973, the APB issued 31 opinions. (See complete list at the back of the book.)

Unfortunately, the APB came under fire early, charged with lack of productivity and failing to act promptly to correct alleged accounting abuses. Later the APB tackled numerous thorny accounting issues, only to meet a buzz saw of opposition from industry and CPA firms and occasional governmental interference. In 1971 the accounting profession’s leaders, anxious to avoid governmental rule-making, appointed a Study Group on Establishment of Accounting Principles. Commonly known as the Wheat Committee for its chair Francis Wheat, this group was to examine the organization and operation of the APB and determine what changes would be necessary to attain better results. The Study Group’s recommendations were submitted to the AICPA Council in the spring of 1972, adopted in total, and implemented by early 1973.

**Financial Accounting Standards Board (FASB)**

The Wheat Committee’s recommendations resulted in the demise of the APB and the creation of a new standards-setting structure composed of three organizations—the Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB), and the Financial Accounting Standards Advisory Council (FASAC). The Financial Accounting Foundation selects the members of the FASB and the Advisory Council, funds their activities, and generally oversees the FASB’s activities.

The major operating organization in this three-part structure is the Financial Accounting Standards Board (FASB). Its mission is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information. The expectations of success and support for the new FASB were based upon several significant differences between it and its predecessor, the APB:

1. **Smaller Membership.** The FASB is composed of seven members, replacing the relatively large 18-member APB.
2. **Full-time, Remunerated Membership.** FASB members are well-paid, full-time members appointed for renewable 5-year terms. The APB members were unpaid and part-time.
3. **Greater Autonomy.** The APB was a senior committee of the AICPA, whereas the FASB is not an organ of any single professional organization. It is appointed by and answerable only to the Financial Accounting Foundation.
4. **Increased Independence.** APB members retained their private positions with firms, companies, or institutions. FASB members must sever all such ties.
5. **Broader Representation.** All APB members were required to be CPAs and members of the AICPA. Currently, it is not necessary to be a CPA to be a member of the FASB.

---

**International Insight**

The U.S. legal system is based on English common law, whereby the government generally allows professionals to make the rules. These rules (standards) are therefore developed in the private sector. Conversely, some countries follow codified law, which leads to government-run accounting systems.
In addition to research help from its own staff, the FASB relies on the expertise of various task force groups formed for various projects and on the Financial Accounting Standards Advisory Council (FASAC). FASAC consults with the FASB on major policy and technical issues and also helps select task force members.

**Due Process**

In establishing financial accounting standards, two basic premises of the FASB are:

1. The FASB should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession.
2. It should operate in full view of the public through a “due process” system that gives interested persons ample opportunity to make their views known. To ensure the achievement of these goals, the steps shown in Illustration 1-2 are taken in the evolution of a typical FASB Statement of Financial Accounting Standards.

The passage of a new FASB Standards Statement requires the support of four of the seven Board members. FASB Statements are considered GAAP and thereby binding in practice. All ARBs and APB Opinions that were in effect in 1973 when the FASB became effective continue to be effective until amended or superseded by FASB pronouncements. In recognition of possible misconceptions of the term “principles,” the FASB uses the term financial accounting standards in its pronouncements.

**Types of Pronouncements**

The major types of pronouncements that the FASB issues are:

1. Standards and Interpretations.
3. Technical Bulletins.

**Standards and Interpretations.** Financial accounting standards issued by the FASB are considered generally accepted accounting principles. In addition, the FASB also issues interpretations that represent modifications or extensions of existing standards. The
interpretations have the same authority as standards and require the same votes for passage as standards. However, interpretations do not require the FASB to operate in full view of the public through the due process system that is required for FASB Standards. The APB also issued interpretations of APB Opinions. Both types of interpretations are now considered authoritative support for purposes of determining GAAP. Since replacing the APB, the FASB has issued 147 standards and 44 interpretations. (See list at the back of the book.)

**Financial Accounting Concepts.** As part of a long-range effort to move away from the problem-by-problem approach, the FASB in November 1978 issued the first in a series of **Statements of Financial Accounting Concepts** as part of its conceptual framework project. (See list at the back of the book.) The purpose of the series is to set forth fundamental objectives and concepts that the Board will use in developing future standards of financial accounting and reporting. They are intended to form a cohesive set of interrelated concepts, a conceptual framework, that will serve as tools for solving existing and emerging problems in a consistent manner. Unlike a Statement of Financial Accounting Standards, a **Statement of Financial Accounting Concepts does not establish GAAP.** Concepts statements, however, pass through the same due process system (discussion memo, public hearing, exposure draft, etc.) as do standards statements.

**FASB Technical Bulletins.** The FASB receives many requests from various sources for guidelines on implementing or applying FASB Standards or Interpretations, APB Opinions, and Accounting Research Bulletins. In addition, a strong need exists for timely guidance on financial accounting and reporting problems. For example, in one tax law change, certain income taxes that companies had accrued as liabilities were forgiven. The immediate question was: How should the forgiven taxes be reported—as a reduction of income tax expense, as a prior period adjustment, or as an extraordinary item? A technical bulletin was quickly issued that required the tax reduction be reported as a reduction of the current period’s income tax expense. A technical bulletin is issued only when (1) it is not expected to cause a major change in accounting practice for a number of enterprises, (2) its cost of implementation is low, and (3) the guidance provided by the bulletin does not conflict with any broad fundamental accounting principle.7

**Emerging Issues Task Force Statements.** In 1984 the FASB created the **Emerging Issues Task Force (EITF).** The EITF is composed of 13 members, representing CPA firms and preparers of financial statements. Also attending EITF meetings are observers from the SEC and AICPA. The purpose of the task force is to reach a consensus on how to account for new and unusual financial transactions that have the potential for creating differing financial reporting practices. Examples include how to account for pension plan terminations; how to account for revenue from barter transactions by Internet companies; and how to account for excessive amounts paid to takeover specialists. The EITF also provided timely guidance for the reporting of the losses arising from the terrorist attacks on the World Trade Center on 9/11/01.

We cannot overestimate the importance of the EITF. In one year, for example, the task force examined 61 emerging financial reporting issues and arrived at a consensus on approximately 75 percent of them. The SEC has indicated that it will view consensus solutions as preferred accounting and will require persuasive justification for departing from them.

The EITF helps the FASB in many ways. For example, emerging issues often attract public attention. If they are not resolved quickly, they can lead to financial crises and scandal and can undercut public confidence in current reporting practices. The next step, possible governmental intervention, would threaten the continuance of standards setting in the private sector. In addition, the EITF identifies controversial accounting

---

problems as they arise and determines whether they can be quickly resolved, or whether the FASB should become involved in solving them. In essence, it becomes a “problem filter” for the FASB. Thus, it is hoped that the FASB will be able to work on more pervasive long-term problems, while the EITF deals with short-term emerging issues.

**Governmental Accounting Standards Board (GASB)**

Financial statements prepared by state and local governments are not comparable with financial reports prepared by private business organizations. This lack of comparability was highlighted in the 1970s when a number of large U.S. cities such as New York and Cleveland faced potential bankruptcy. As a result, the Governmental Accounting Standards Board (GASB), under the oversight of the Financial Accounting Foundation, was created in 1984 to address state and local governmental reporting issues.

The operational structure of the GASB is similar to that of the FASB. That is, it has an advisory council called the Governmental Accounting Standards Advisory Council (GASAC), and it is assisted by its own technical staff and task forces.

The creation of GASB was controversial. Many believe that there should be only one standards-setting body—the FASB. It was hoped that partitioning standards setting between the GASB, which deals only with state and local government reporting, and the FASB, which addresses reporting for all other entities, would not lead to conflict. Since we are primarily concerned with financial reports prepared by profit-seeking organizations, this textbook will focus on standards issued by the FASB only.

The formal organizational structure as it currently exists for the development of financial reporting standards is presented in Illustration 1-3.

**ILLUSTRATION 1-3**

Organizational Structure for Setting Accounting Standards
The Role of the AICPA

For several decades the AICPA provided the leadership in the development of accounting principles and rules. It regulated the accounting profession and developed and enforced accounting practice more than did any other professional organization. When the Accounting Principles Board was dissolved and replaced with the FASB, the AICPA established the Accounting Standards Division to act as its official voice on accounting and reporting issues.

The Accounting Standards Executive Committee (AcSEC) was established within the Division and was designated as the senior technical committee authorized to speak for the AICPA in the area of financial accounting and reporting. It does so through various written communications:

Audit and Accounting Guidelines summarize the accounting practices of specific industries and provide specific guidance on matters not addressed by the FASB. Examples are accounting for casinos, airlines, colleges and universities, banks, insurance companies, and many others.

Statements of Position (SOP) provide guidance on financial reporting topics until the FASB sets standards on the issue in question. SOPs may update, revise, and clarify audit and accounting guides or provide free-standing guidance.

Practice Bulletins indicate AcSEC’s views on narrow financial reporting issues not considered by the FASB.

The AICPA has been the leader in developing auditing standards through its Auditing Standards Board. However, the Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board to oversee the development of future auditing standards. The AICPA will continue to develop and grade the CPA examination, which is administered in all 50 states.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Generally accepted accounting principles are those principles that have “substantial authoritative support.” The AICPA’s Code of Professional Conduct requires that members prepare financial statements in accordance with generally accepted accounting principles. Specifically, Rule 203 of this Code prohibits a member from expressing an opinion that financial statements conform with GAAP if those statements contain a material departure from a generally accepted accounting principle, unless the member can demonstrate that because of unusual circumstances the financial statements would otherwise have been misleading. Failure to follow Rule 203 can lead to loss of a CPA’s license to practice.

The meaning of generally accepted accounting principles is defined by Statement on Auditing Standards (SAS) No. 69, “The Meaning of ‘Present Fairly in Conformity With Generally Accepted Accounting Principles’ in the Independent Auditor’s Report.” Under this standard, generally accepted accounting principles covered by Rule 203 are construed to be FASB Standards and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins.

Often, however, a specific accounting transaction occurs that is not covered by any of these documents. In this case, other authoritative literature is used. Major examples are: FASB Technical Bulletins; AICPA Industry Auditing and Accounting Guides; and Statements of Position that have been “cleared” by the FASB. These documents are considered to have substantial authoritative support because the recognized professional bodies, after giving interested and affected parties the opportunity to react to exposure drafts and respond at public hearings, have voted their issuance. If these pro-

---

8SAS No. 69 states that Audit Guides and Statements of Position are assumed to be cleared (approved) by the FASB unless the pronouncement states otherwise.
nouncements are lacking in guidance, then other sources might be considered. The hierarchy of these sources is presented in Illustration 1-4. If the accounting treatment of an event is not specified by a category (a) pronouncement, then categories (b) through (d) should be investigated. If there is a conflict between pronouncements in (b) through (d), the higher category is to be followed. For example, (b) is higher than (c).

Illustartion 1-4
The House of GAAP

If none of these pronouncements addresses the event, the support is sought from other accounting literature. Examples of other accounting literature include FASB Concepts Statements, International Accounting Standards, and accounting articles.

Should the accounting profession have principle-based standards or rule-based standards? Critics of the profession today say that over the past three decades the standards-setters have moved away from establishing broad accounting principles aimed at ensuring that companies’ financial statements are fairly presented.

Instead, these critics say, the standards-setters have moved toward drafting voluminous rules that may shield auditors and companies from legal liability if technically followed in check-box fashion. That can result in companies creating complex capital structures that technically comply with GAAP but hide billions of dollars of debt and other obligations. To add fuel to the fire, the chief accountant of the enforcement division of the SEC recently noted, “One can violate the SEC laws and still comply with GAAP.”

In short, what he is saying is that it’s not enough to check the boxes and do everything that GAAP requires. You have to then step back and determine whether the overall impression created by GAAP fairly portrays the underlying economics of the company. It is a tough standard and one that auditors and corporate management should work to achieve.


ISSUES IN FINANCIAL REPORTING

Since many interests may be affected by the implementation of an accounting standard, it is not surprising that there is much discussion about who should develop these standards and to whom they should apply. Some of the major issues are discussed below.

Standards Setting in a Political Environment

Possibly the most powerful force influencing the development of accounting standards is user groups. User groups consist of the parties who are most interested in or affected by accounting standards, rules, and procedures. Like lobbyists in our state and national capitals, user groups play a significant role. Accounting standards are as much a product of political action as they are of careful logic or empirical findings.

User groups may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. They know that the most effective way to influence the standards that dictate accounting practice is to participate in the formulation of these standards or to try to influence or persuade the formulator of them. Therefore, the FASB has become the target of many pressures and efforts to influence changes in the existing standards and the development of new ones. To top it off, these pressures have been multiplying. Some influential groups demand that the accounting profession act more quickly and decisively to solve its problems and remedy its deficiencies. Other groups resist such action, preferring to implement change more slowly, if at all. Illustration 1-5 shows the various user groups that apply pressure.

Should there be politics in setting standards for financial accounting and reporting? We have politics at home; at school; at the fraternity, sorority, and dormitory; at the office; at church, temple, and mosque—politics is everywhere. The FASB does not exist in a vacuum. Standards setting is part of the real world, and it cannot escape politics and political pressures.

FOOTNOTE 10FASB board members have acknowledged that many of the Board’s projects, such as “Accounting for Contingencies,” “Accounting for Pensions,” “Statement of Cash Flows,” and “Accounting for Derivatives,” were targets of political pressure.
That is not to say that politics in standards setting is evil. Considering the economic consequences of many accounting standards, it is not surprising that special interest groups become vocal (some supporting, some opposing) when standards are being formulated. The Board must be attentive to the economic consequences of its actions. What the Board should not do is issue pronouncements that are primarily politically motivated. While paying attention to its constituencies, the Board should base its standards on sound research and a conceptual framework that has its foundation in economic reality. Even so, the FASB can continue to expect politics and special interest pressures, since as T. S. Eliot said, “Humankind cannot bear very much reality.”

The Expectations Gap

All professions have come under increasing scrutiny by the government, whether it be the investment banking profession because of insider trading, the medical profession because of high costs and Medicare or Medicaid frauds, or engineers because of their failure to consider environmental consequences in their work.

Recently, it has been the accounting profession’s turn. As indicated earlier, accounting scandals at companies like Enron, Cendant, Sunbeam, Rite Aid, Xerox, and WorldCom have attracted the attention of Congress. In 2002, legislation—the Sarbanes-Oxley Act—was enacted; the new law increases the resources for the SEC to combat fraud and curb poor reporting practices. And the SEC has increased its policing efforts, approving new auditor independence rules and materiality guidelines for financial reporting. In addition, the Sarbanes-Oxley Act introduces sweeping changes to the institutional structure of the accounting profession. The following are some key provisions of the legislation:

- An accounting oversight board is being established. It will have oversight and enforcement authority and will establish auditing, quality control, and independence standards and rules.
- Stronger independence rules for auditors are now in place. Audit partners, for example, will be required to rotate every five years.

11 “Economic consequences” in this context means the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact. The resulting behavior of these individuals and groups could have detrimental financial effects on the providers of the financial information (enterprises). For a more detailed discussion of this phenomenon, see Stephen A. Zeff, “The Rise of ‘Economic Consequences,’” Journal of Accountancy (December 1978), pp. 56–63. Special appreciation is extended to Professor Zeff for his insights on this chapter.

CEOs and CFOs must forfeit bonuses and profits when there is an accounting re-
statement.

CEOs and CFOs are required to certify that the financial statements and company
disclosures are accurate and complete.

Audit committees will need independent members and members with financial
expertise.

Codes of ethics must be in place for senior financial officers.

Will these changes be enough? The expectations gap—what the public thinks ac-
countants should be doing and what accountants think they can do—is a difficult one
to close. The instances of fraudulent reporting have caused some to question whether
the profession is doing enough. Although the profession can argue rightfully that they
cannot be responsible for every financial catastrophe, it must continue to strive to meet
the needs of society. Efforts to meet these needs will become more costly to society be-
cause the development of a highly transparent, clear, and reliable system will require
considerable resources.

International Accounting Standards

Lawrence Summers, former Secretary of the Treasury, indicated that the single most
important innovation shaping the capital market was the idea of generally accepted ac-
counting principles. Summers went on to say that we need something similar interna-
tionally.

Most countries have recognized the need for more global standards. As a result,
the International Accounting Standards Committee (IASC) was formed in 1973—the
same year the FASB was born—to attempt to narrow the areas of divergence between
standards of different countries.

The objective of the IASC in terms of standards setting was “to work generally for
the improvement and harmonization of regulations, accounting standards and proce-
dures relating to the presentation of financial statements.” Eliminating differences is
not easy. The objectives of financial reporting in the United States often differ from
those in foreign countries, the institutional structures are often not comparable, and
strong national tendencies are pervasive. Nevertheless, much headway has been made
since IASC’s inception.

Recently, the IASC has been restructured and renamed the International Ac-
counting Standards Board (IASB). This new body will work toward the development
of a single set of high-quality global standards. The IASB has a structure similar to
that of the FASB. It is hoped that the establishment of a fully independent international
accounting standards setter will provide the essential convergence needed as we move
to a global capital market system.

It should be emphasized that the United States has a major voice in how interna-
tional standards are being developed. As a result, there are many similarities between
IASB- and U.S.-based standards. Throughout this textbook, international considerations
are presented to help you understand the international reporting environment. In ad-
dition, as noted by the icon in the margin, there is an expanded discussion of interna-
tional accounting on the Take Action! CD that accompanies this textbook. We strongly
encourage you to access the material available on the CD.

Ethics in the Environment of Financial Accounting

Robert Sack, a commentator on the subject of accounting ethics, noted that, “Based on
my experience, new graduates tend to be idealistic . . . thank goodness for that! Still it
is very dangerous to think that your armor is all in place and say to yourself ‘I would
have never given in to that.’ The pressures don’t explode on us; they build, and we of-
ten don’t recognize them until they have us.”
As indicated in this chapter, businesses’ concentration on “maximizing the bottom line,” “facing the challenges of competition,” and “stressing short-term results” places accountants in an environment of conflict and pressure. Basic questions such as, “Is this way of communicating financial information good or bad?” “Is it right or wrong?” “What should I do in the circumstance?” cannot always be answered by simply adhering to GAAP or following the rules of the profession. Technical competence is not enough when ethical decisions are encountered.

Doing the right thing, making the right decision, is not always easy. Right is not always obvious. And the pressures “to bend the rules,” “to play the game,” “to just ignore it” can be considerable. For example, “Will my decision affect my job performance negatively?” “Will my superiors be upset?” “Will my colleagues be unhappy with me?” are often questions faced in making a tough ethical decision. The decision is more difficult because a public consensus has not emerged to formulate a comprehensive ethical system to provide guidelines. As discussed earlier, the issue has become of such importance that Congress has legislated that companies must develop a code of ethics for their senior financial officers.

This whole process of ethical sensitivity and selection among alternatives can be complicated by pressures that may take the form of time pressures, job pressures, client pressures, personal pressures, and peer pressures. Throughout this textbook, ethical considerations are presented for the purpose of sensitizing you to the type of situations you may encounter in the performance of your professional responsibility.

Issues in Financial Reporting

Expanded Discussion of Ethical Issues in Financial Accounting

Here come the politics

Given the current number of accounting scandals mentioned so far in the text, it is not surprising that both political parties are working hard to ensure that corporate management be ethical. President Bush, for example, has announced a set of proposals to crack down on unethical behavior by corporate officials, expanding the offenses subject to criminal and civil penalties. And both the SEC and the Justice Department are budgeted to get more funds to combat financial fraud. Bush has indicated “that the federal government will be vigilant in prosecuting wrongdoers” in American business. At the same time, the Democratic Party also is pushing for more corporate-reform initiatives. One thing is certain—recent events have undermined consumer confidence regarding corporate America and the capital markets. Because these issues are hurting the U.S. economy, politicians are now trying to find answers.

Conclusion

The FASB is in its thirtieth year as this textbook is written. Will the FASB survive in its present state, or will it be restructured or changed as its predecessors were? The next ten years will be interesting ones in the standards-setting arena. The possibility of global standards, the crisis of confidence in the capital markets caused by Enron, Tyco, WorldCom, and other accounting failures, and the issue of principle-based versus rule-based standards are major issues that will affect standards-setting in the United States.

At present, we believe that the accounting profession is reacting responsibly to remedy identified shortcomings. Because of its substantive resources and expertise, the private sector should be able to develop and maintain high standards. But it is a difficult process requiring time, logic, and diplomacy. By a judicious mix of these three ingredients, the profession should continue to develop its own reporting standards with SEC oversight.
KEY TERMS
Accounting Principles Board (APB), 8
Accounting Research Bulletins, 7
accrual basis accounting, 5
American Institute of Certified Public Accountants (AICPA), 7
APB Opinions, 8
Auditing Standards Board, 12
Committee on Accounting Procedure (CAP), 7
economic consequences, 15
Emerging Issues Task Force (EITF), 10
expectations gap, 16
financial accounting, 2
Financial Accounting Standards Board (FASB), 8
financial reporting, 2
financial statements, 2
generally accepted accounting principles (GAAP), 6
Governmental Accounting Standards Board (GASB), 11
International Accounting Standards Board (IASB), 16
interpretations, 9
objectives of financial reporting, 4
Securities and Exchange Commission (SEC), 6
standards, 9
Statements on Financial Accounting Concepts, 10
technical bulletin, 10
Wheat Committee, 8

SUMMARY OF LEARNING OBJECTIVES

1. Identify the major financial statements and other means of financial reporting. The financial statements most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners’ or stockholders’ equity. Financial reporting other than financial statements may take various forms. Examples include the president’s letter and supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management’s forecasts, and certifications regarding internal controls and fraud.

2. Explain how accounting assists in the efficient use of scarce resources. Accounting provides reliable, relevant, and timely information to managers, investors, and creditors so that resources are allocated to the most efficient enterprises. Accounting also provides measurements of efficiency (profitability) and financial soundness.

3. Identify some of the challenges facing accounting. Financial reports fail to provide (1) some key performance measures widely used by management, (2) forward-looking information needed by investors and creditors, (3) sufficient information on a company’s soft assets (intangibles), and (4) real-time financial information.

4. Identify the objectives of financial reporting. The objectives of financial reporting are to provide (1) information that is useful in investment and credit decisions, (2) information that is useful in assessing cash flow prospects, and (3) information about enterprise resources, claims to those resources, and changes in them.

5. Explain the need for accounting standards. The accounting profession has attempted to develop a set of standards that is generally accepted and universally practiced. Without this set of standards, each enterprise would have to develop its own standards, and readers of financial statements would have to familiarize themselves with every company’s peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

6. Identify the major policy-setting bodies and their role in the standards-setting process. The Securities and Exchange Commission (SEC) is an agency of the federal government that has the broad powers to prescribe, in whatever detail it desires, the accounting standards to be employed by companies that fall within its jurisdiction. The American Institute of Certified Public Accountants (AICPA) issued standards through its Committee on Accounting Procedure and Accounting Principles Board. The Financial Accounting Standards Board (FASB) establishes and improves standards of financial accounting and reporting for the guidance and education of the public. The Governmental Accounting Standards Board (GASB) establishes and improves standards of financial accounting for state and local governments.

7. Explain the meaning of generally accepted accounting principles. Generally accepted accounting principles are those principles that have substantial authoritative support, such as FASB Standards and Interpretations, APB Opinions and Interpretations, AICPA Accounting Research Bulletins, and other authoritative pronouncements.

8. Describe the impact of user groups on the standards-setting process. User groups may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. The FASB has become the target of many pressures and efforts to influence changes in the existing standards and the development of new ones. Because of the accelerated rate of change and the increased complexity of our economy, these pressures have been multiplying. Accounting standards are as much a product of political action as they are of careful logic or empirical findings.
Understand issues related to ethics and financial accounting. Financial accountants are called on for moral discernment and ethical decision making. The decision is more difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines in making ethical judgments.

**QUESTIONS**

2. Differentiate between “financial statements” and “financial reporting.”
3. How does accounting help the capital allocation process?
4. What are some of the major challenges facing the accounting profession?
5. What are the major objectives of financial reporting?
6. Of what value is a common set of standards in financial accounting and reporting?
7. What is the likely limitation of “general-purpose financial statements”?
8. What are some of the developments or events that occurred between 1900 and 1930 that helped bring about changes in accounting theory or practice?
9. In what way is the Securities and Exchange Commission concerned about and supportive of accounting principles and standards?
10. What was the Committee on Accounting Procedure, and what were its accomplishments and failings?
11. For what purposes did the AICPA in 1959 create the Accounting Principles Board?
13. If you had to explain or define “generally accepted accounting principles or standards,” what essential characteristics would you include in your explanation?
14. In what ways was it felt that the statements issued by the Financial Accounting Standards Board would carry greater weight than the opinions issued by the Accounting Principles Board?
15. How are FASB discussion memoranda and FASB exposure drafts related to FASB “statements”?
17. What is Rule 203 of the Code of Professional Conduct?
18. Rank from the most authoritative to the least authoritative, the following three items: FASB Technical Bulletins, AICPA Practice Bulletins, and FASB Standards.
19. The chairman of the FASB at one time noted that “the flow of standards can only be slowed if (1) producers focus less on quarterly earnings per share and tax benefits and more on quality products, and (2) accountants and lawyers rely less on rules and law and more on professional judgment and conduct.” Explain his comment.
20. What is the purpose of FASB Technical Bulletins? How do FASB Technical Bulletins differ from FASB Interpretations?
22. What is the purpose of the Governmental Accounting Standards Board?
23. What are some possible reasons why another organization, such as the Governmental Accounting Standards Board, should not issue financial reporting standards?
24. What is AcSEC and what is its relationship to the FASB?
25. What are the sources of pressure that change and influence the development of accounting principles and standards?
26. Some individuals have indicated that the FASB must be cognizant of the economic consequences of its pronouncements. What is meant by “economic consequences”? What dangers exist if politics play too much of a role in the development of financial reporting standards?
27. If you were given complete authority in the matter, how would you propose that accounting principles or standards should be developed and enforced?
28. One writer recently noted that 99.4 percent of all companies prepare statements that are in accordance with GAAP. Why then is there such concern about fraudulent financial reporting?
29. What is the “expectations gap”? What is the profession doing to try to close this gap?
30. A number of foreign countries have reporting standards that differ from those in the United States. What are some of the main reasons why reporting standards are often different among countries?
31. How are financial accountants challenged in their work to make ethical decisions? Is technical mastery of GAAP not sufficient to the practice of financial accounting?
CONCEPTUAL CASES

C1-1 (Financial Accounting) Alan Rodriguez has recently completed his first year of studying accounting. His instructor for next semester has indicated that the primary focus will be the area of financial accounting.

Instructions
(a) Differentiate between financial accounting and managerial accounting.
(b) One part of financial accounting involves the preparation of financial statements. What are the financial statements most frequently provided?
(c) What is the difference between financial statements and financial reporting?

C1-2 (Objectives of Financial Reporting) Celia Cruz, a recent graduate of the local state university, is presently employed by a large manufacturing company. She has been asked by Angeles Ochoa, controller, to prepare the company’s response to a current Discussion Memorandum published by the Financial Accounting Standards Board (FASB). Cruz knows that the FASB has issued seven Statements of Financial Accounting Concepts, and she believes that these concept statements could be used to support the company’s response to the Discussion Memorandum. She has prepared a rough draft of the response citing Statement of Financial Accounting Concepts No. 1, “Objectives of Financial Reporting by Business Enterprises.”

Instructions
(a) Identify the three objectives of financial reporting as presented in Statement of Financial Accounting Concepts No. 1 (SFAC No. 1).
(b) Describe the level of sophistication expected of the users of financial information by SFAC No. 1.

(CMA adapted)

C1-3 (Accounting Numbers and the Environment) Hardly a day goes by without an article appearing on the crises affecting many of our financial institutions in the United States. It is estimated that the savings and loan (S&L) debacle of the 1980s, for example, ended up costing $500 billion ($2,000 for every man, woman, and child in the United States). Some argue that if the S&Ls had been required to report their investments at market value instead of cost, large losses would have been reported earlier, which would have signaled regulators to close those S&Ls and, therefore, minimize the losses to U.S. taxpayers.

Instructions
Explain how reported accounting numbers might affect an individual’s perceptions and actions. Cite two examples.

C1-4 (Need for Accounting Standards) Some argue that having various organizations establish accounting principles is wasteful and inefficient. Rather than mandating accounting standards, each company could voluntarily disclose the type of information it considered important. In addition, if an investor wants additional information, the investor could contact the company and pay to receive the additional information desired.

Instructions
Comment on the appropriateness of this viewpoint.

C1-5 (AICPA’s Role in Standards Setting) One of the major groups involved in the standards-setting process is the American Institute of Certified Public Accountants. Initially it was the primary organization that established accounting principles in the United States. Subsequently it relinquished most of its power to the FASB.

Instructions
(a) Identify the two committees of the AICPA that established accounting principles prior to the establishment of the FASB.
(b) Speculate as to why these two organizations failed. In your answer, identify steps the FASB has taken to avoid failure.
(c) What is the present role of the AICPA in the standards-setting environment?

C1-6 (FASB Role in Standards Setting) A press release announcing the appointment of the trustees of the new Financial Accounting Foundation stated that the Financial Accounting Standards Board (to be appointed by the trustees) “...will become the established authority for setting accounting principles under which corporations report to the shareholders and others” (AICPA news release July 20, 1972).

Instructions
(a) Identify the sponsoring organization of the FASB and the process by which the FASB arrives at a decision and issues an accounting standard.
Indicate the major types of pronouncements issued by the FASB and the purposes of each of these pronouncements.

C1-7 (Government Role in Standards Setting) Recently an article stated “the setting of accounting standards in the United States is now about 60 years old. It is a unique process in our society, one that has undergone numerous changes over the years. The standards are established by a private sector entity that has no dominant sponsor and is not part of any professional organization or trade association. The governmental entity that provides oversight, on the other hand, is far more a friend than a competitor or an antagonist.”

Instructions
Identify the governmental entity that provides oversight and indicate its role in the standards-setting process.

C1-8 (Politicization of Standards Setting) Some accountants have said that politicization in the development and acceptance of generally accepted accounting principles (i.e., standards setting) is taking place. Some use the term “politicalization” in a narrow sense to mean the influence by governmental agencies, particularly the Securities and Exchange Commission, on the development of generally accepted accounting principles. Others use it more broadly to mean the compromise that results when the bodies responsible for developing generally accepted accounting principles are pressured by interest groups (SEC, American Accounting Association, businesses through their various organizations, Institute of Management Accountants, financial analysts, bankers, lawyers, and so on).

Instructions
(a) The Committee on Accounting Procedures of the AICPA was established in the mid- to late 1930s and functioned until 1959, at which time the Accounting Principles Board came into existence. In 1973, the Financial Accounting Standards Board was formed and the APB went out of existence. Do the reasons these groups were formed, their methods of operation while in existence, and the reasons for the demise of the first two indicate an increasing politicization (as the term is used in the broad sense) of accounting standards setting? Explain your answer by indicating how the CAP, the APB, and the FASB operated or operate. Cite specific developments that tend to support your answer.
(b) What arguments can be raised to support the “politicalization” of accounting standards setting?
(c) What arguments can be raised against the “politicalization” of accounting standards setting?

(CMA adapted)

C1-9 (Models for Setting Accounting Standards) Presented below are three models for setting accounting standards.

1. The purely political approach, where national legislative action decrees accounting standards.
2. The private, professional approach, where financial accounting standards are set and enforced by private professional actions only.
3. The public/private mixed approach, where standards are basically set by private-sector bodies that behave as though they were public agencies and whose standards to a great extent are enforced through governmental agencies.

Instructions
(a) Which of these three models best describes standards setting in the United States? Comment on your answer.
(b) Why do companies, financial analysts, labor unions, industry trade associations, and others take such an active interest in standards setting?
(c) Cite an example of a group other than the FASB that attempts to establish accounting standards. Speculate as to why another group might wish to set its own standards.

C1-10 (Standards-Setting Terminology) Andrew Wyeth, an administrator at a major university, recently said, “I’ve got some CDs in my IRA, which I set up to beat the IRS.” As elsewhere, in the world of accounting and finance, it often helps to be fluent in abbreviations and acronyms.

Instructions
Presented below is a list of common accounting acronyms. Identify the term for which each acronym stands, and provide a brief definition of each term.

(a) AICPA (b) CAP (c) ARB (d) APB (e) FAF (f) FASAC (g) CPA (h) GAAP (i) CPA (j) FASB (k) SOP (l) IASB (m) GASB (n) SEC (o) SOP (p) SEC (q) FASB
22 • Chapter 1 Financial Accounting and Accounting Standards

C1-11 (Accounting Organizations and Documents Issued) Presented below are a number of accounting organizations and type of documents they have issued.

Instructions
Match the appropriate document to the organization involved. Note that more than one document may be issued by the same organization. If no document is provided for an organization, write in “0.”

<table>
<thead>
<tr>
<th>Organization</th>
<th>Document</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Securities and Exchange Commission</td>
<td>(a) Opinions</td>
</tr>
<tr>
<td>2. Accounting Standards Executive Committee</td>
<td>(b) Practice Bulletins</td>
</tr>
<tr>
<td>3. Accounting Principles Board</td>
<td>(c) Accounting Research Bulletins</td>
</tr>
<tr>
<td>4. Committee on Accounting Procedure</td>
<td>(d) Financial Reporting Releases</td>
</tr>
<tr>
<td>5. Financial Accounting Standards Board</td>
<td>(e) Financial Accounting Standards</td>
</tr>
</tbody>
</table>

C1-12 (Accounting Pronouncements) A number of authoritative pronouncements have been issued by standards-setting bodies in the last 50 years. A list is provided on the left, below, with a description of these pronouncements on the right.

Instructions
Match the description to the pronouncements.

<table>
<thead>
<tr>
<th>Document</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Opinions</td>
<td>Official pronouncements of the APB.</td>
</tr>
<tr>
<td>(b) Practice Bulletins</td>
<td>Sets forth fundamental objectives and concepts that will be used in developing future standards.</td>
</tr>
<tr>
<td>(c) Accounting Research Bulletins</td>
<td>Primary document of the FASB that establishes GAAP.</td>
</tr>
<tr>
<td>(d) Financial Reporting Releases</td>
<td>Provides additional guidance on implementing or applying FASB Standards or Interpretations.</td>
</tr>
<tr>
<td>(e) Financial Accounting Standards</td>
<td>Provides guidance on how to account for new and unusual financial transactions that have the potential for creating diversity in financial reporting practices.</td>
</tr>
<tr>
<td>(f) Statements of Position</td>
<td>Represent extensions or modifications of existing standards.</td>
</tr>
<tr>
<td>(g) Technical Bulletins</td>
<td></td>
</tr>
</tbody>
</table>

C1-13 (Issues Involving Standards Setting) When the FASB issues new standards, the implementation date is usually 12 months from date of issuance, with early implementation encouraged. Paula Popovich, controller, discusses with her financial vice president the need for early implementation of a standard that would result in a fairer presentation of the company’s financial condition and earnings. When the financial vice president determines that early implementation of the standard will adversely affect the reported net income for the year, he discourages Popovich from implementing the standard until it is required.

Instructions
Answer the following questions.
(a) What, if any, is the ethical issue involved in this case?
(b) Is the financial vice president acting improperly or immorally?
(c) What does Popovich have to gain by advocacy of early implementation?
(d) Which stakeholders might be affected by the decision against early implementation?

(CMA adapted)

C1-14 (Securities and Exchange Commission) The U.S. Securities and Exchange Commission (SEC) was created in 1934 and consists of five commissioners and a large professional staff. The SEC professional staff is organized into five divisions and several principal offices. The primary objective of the SEC is to support fair securities markets. The SEC also strives to foster enlightened stockholder participation in corporate decisions of publicly traded companies. The SEC has a significant presence in financial markets, the development of accounting practices, and corporation-shareholder relations, and has the power to exert influence on entities whose actions lie within the scope of its authority.
Instructions
(a) Explain from where the Securities and Exchange Commission receives its authority.
(b) Describe the official role of the Securities and Exchange Commission in the development of financial accounting theory and practices.
(c) Discuss the interrelationship between the Securities and Exchange Commission and the Financial Accounting Standards Board with respect to the development and establishment of financial accounting theory and practices.

(CMA adapted)

C1-15 (Standards-Setting Process) In 1973, the responsibility for developing and issuing rules on accounting practices was given to the Financial Accounting Foundation and, in particular, to an arm of the foundation called the Financial Accounting Standards Board (FASB). The generally accepted accounting principles established by the FASB are enunciated through a publication series entitled Statements of Financial Accounting Standards. These statements are issued periodically, and over 140 are currently in force. The statements have a significant influence on the way in which financial statements are prepared by U.S. corporations.

Instructions
(a) Describe the process by which a topic is selected or identified as appropriate for study by the Financial Accounting Standards Board (FASB).
(b) Once a topic is considered appropriate for consideration by the FASB, a series of steps is followed before a Statement of Financial Accounting Standards is issued. Describe the major steps in the process leading to the issuance of a standard.
(c) Identify at least three other organizations that influence the setting of generally accepted accounting principles (GAAP).

(CMA adapted)

C1-16 (History of Standards-Setting Organizations) Beta Alpha Psi, your university’s accounting society, has decided to publish a brief pamphlet for seniors in high school, detailing the various facets of the accounting profession. As a junior accounting major, you have been asked to contribute an article for this publication. Your topic is the evolution of accounting standards-setting organizations in the United States.

Instructions
Write a 1–2 page article on the historical development of the organizations responsible for giving us GAAP. (The most appropriate introduction would explain the increasing need for a more standardized approach to accounting for a company’s assets.)

C1-17 (Economic Consequences) Presented below are comments made in the financial press.

Instructions
Prepare responses to the requirements in each item.
(a) Rep. John Dingell, the ranking Democrat on the House Commerce Committee, threw his support behind the FASB’s controversial derivatives accounting standard and encouraged the FASB to adopt the rule promptly. Indicate why a member of Congress might feel obligated to comment on this proposed FASB standard.
(b) In a strongly worded letter to Senator Lauch Faircloth (R-NC) and House Banking Committee Chairman Jim Leach (R-IA), the American Institute of Certified Public Accountants (AICPA) cautioned against government intervention in the accounting standards-setting process, warning that it had the potential of jeopardizing U.S. capital markets. Explain how government intervention could possibly affect capital markets adversely.

C1-18 (Standards-Setting Process, Economic Consequences) The following letter was sent to the SEC and the FASB by leaders of the business community.

Dear Sirs:
The FASB has been struggling with accounting for derivatives and hedging for many years. The FASB has now developed, over the last few weeks, a new approach that it proposes to adopt as a final standard. We understand that the Board intends to adopt this new approach as a final standard without exposing it for public comment and debate, despite the evident complexity of the new approach, the speed with which it has been developed and the significant changes to the exposure draft since it was released more than one year ago. Instead, the Board plans to allow only a brief review by
Chapter 1  Financial Accounting and Accounting Standards

selected parties, limited to issues of operationality and clarity, and would exclude questions as to the merits of the proposed approach.

As the FASB itself has said throughout this process, its mission does not permit it to consider matters that go beyond accounting and reporting considerations. Accordingly, the FASB may not have adequately considered the wide range of concerns that have been expressed about the derivatives and hedging proposal, including concerns related to the potential impact on the capital markets, the weakening of companies’ ability to manage risk, and the adverse control implications of implementing costly and complex new rules imposed at the same time as other major initiatives, including the Year 2000 issues and a single European currency. We believe that these crucial issues must be considered, if not by the FASB, then by the Securities and Exchange Commission, other regulatory agencies, or Congress. We believe it is essential that the FASB solicit all comments in order to identify and address all material issues that may exist before issuing a final standard. We understand the desire to bring this process to a prompt conclusion, but the underlying issues are so important to this nation’s businesses, the customers they serve and the economy as a whole that expediency cannot be the dominant consideration. As a result, we urge the FASB to expose its new proposal for public comment, following the established due process procedures that are essential to acceptance of its standards, and providing sufficient time to affected parties to understand and assess the new approach.

We also urge the SEC to study the comments received in order to assess the impact that these proposed rules may have on the capital markets, on companies’ risk management practices, and on management and financial controls. These vital public policy matters deserve consideration as part of the Commission’s oversight responsibilities. We believe that these steps are essential if the FASB is to produce the best possible accounting standard while minimizing adverse economic effects and maintaining the competitiveness of U.S. businesses in the international marketplace.

Very truly yours,

(This letter was signed by the chairs of 22 of the largest U.S. companies.)

Instructions
Answer the following questions.

(a) Explain the “due process” procedures followed by the FASB in developing a financial reporting standard.

(b) What is meant by the term “economic consequences” in accounting standards setting?

(c) What economic consequences arguments are used in this letter?

(d) What do you believe is the main point of the letter?

(e) Why do you believe a copy of this letter was sent by the business community to influential members of the United States Congress?

USING YOUR JUDGMENT

FINANCIAL REPORTING PROBLEM

Kate Jackson, a new staff accountant, is confused because of the complexities involving accounting standards setting. Specifically, she is confused by the number of bodies issuing financial reporting standards of one kind or another and the level of authoritative support that can be attached to these reporting standards. Kate decides that she must review the environment in which accounting standards are set, if she is to increase her understanding of the accounting profession.
Kate recalls that during her accounting education there was a chapter or two regarding the environment of financial accounting and the development of accounting standards. However, she remembers that little emphasis was placed on these chapters by her instructor.

Instructions
(a) Help Kate by identifying key organizations involved in accounting standards setting.
(b) Kate asks for guidance regarding authoritative support. Please assist her by explaining what is meant by authoritative support.
(c) Give Kate a historical overview of how standards setting has evolved so that she will not feel that she is the only one to be confused.
(d) What authority for compliance with GAAP has existed throughout the period of standards setting?

INTERNATIONAL REPORTING CASE
Michael Sharpe, former Deputy Chairman of the International Accounting Standards Committee (IASC), made the following comments before the 63rd Annual Conference of the Financial Executives Institute (FEI).

There is an irreversible movement towards the harmonization of financial reporting throughout the world. The international capital markets require an end to:

1. The confusion caused by international companies announcing different results depending on the set of accounting standards applied. Recent announcements by Daimler-Benz [now DaimlerChrysler] highlight the confusion that this causes.
2. Companies in some countries obtaining unfair commercial advantages from the use of particular national accounting standards.
3. The complications in negotiating commercial arrangements for international joint ventures caused by different accounting requirements.
4. The inefficiency of international companies having to understand and use a myriad of different accounting standards depending on the countries in which they operate and the countries in which they raise capital and debt. Executive talent is wasted on keeping up to date with numerous sets of accounting standards and the never-ending changes to them.
5. The inefficiency of investment managers, bankers, and financial analysts as they seek to compare financial reporting drawn up in accordance with different sets of accounting standards.
6. Failure of many stock exchanges and regulators to require companies subject to their jurisdiction to provide comparable, comprehensive, and transparent financial reporting frameworks giving international comparability.
7. Difficulty for developing countries and countries entering the free market economy such as China and Russia in accessing foreign capital markets because of the complexity of and differences between national standards.
8. The restriction on the mobility of financial service providers across the world as a result of different accounting standards.

Clearly the elimination of these inefficiencies by having comparable high-quality financial reporting used across the world would benefit international businesses.

Instructions
(a) What is the International Accounting Standards Board, and what is its relation to the International Accounting Standards Committee?
(b) What stakeholders might benefit from the use of International Accounting Standards?
(c) What do you believe are some of the major obstacles to harmonization?
PROFESSIONAL SIMULATION

Accounting — Generally Accepted Accounting Principles

Directions
In this simulation, you will be asked various questions regarding accounting principles. Prepare responses to all parts.

Situation
At the completion of Bloom Company’s audit, the president, Judy Bloom, asks about the meaning of the phrase "in conformity with generally accepted accounting principles" that appears in your audit report on the management’s financial statements. Judy observes that the meaning of the phrase must include something more and different than what she thinks of as “principles.”

Explanation
(a) Explain the meaning of the term "accounting principles" as used in the audit report. (Do not discuss in this part the significance of “generally accepted.”)
(b) President Bloom wants to know how you determine whether or not an accounting principle is generally accepted. Discuss the sources of evidence for determining whether an accounting principle has substantial authoritative support. Do not merely list the titles of publications.

Remember to check the Take Action! CD and the book’s companion Web site to find additional resources for this chapter.