The Development of Accounting Theory

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In its simplest form, theory may be just a belief, but for a theory to be useful, it must have wide acceptance. Webster defined *theory* as:

> *Systematically organized knowledge, applicable in a relatively wide variety of circumstances; a system of assumptions, accepted principles and rules of procedure to analyze, predict or otherwise explain the nature of behavior of a specified set of phenomena.*[1]

The objective of theory is to explain and predict. Consequently, a basic goal of the theory of a particular discipline is to have a well-defined body of knowledge that has been systematically accumulated, organized, and verified well enough to provide a frame of reference for future actions.

Theories may be described as normative or positive. *Normative theories* explain what should be, whereas *positive theories* explain what is. Ideally, there should be no such distinction, because a well-developed and complete theory encompasses both what should be and what is.

The goal of accounting theory is to provide a set of principles and relationships that explains observed practices and predicts unobserved practices. That is, accounting theory should be able to explain why companies elect certain accounting methods over others and should enable users to predict the attributes of firms that elect various accounting methods. As in other disciplines, accounting theory should also be verifiable through accounting research.

The development of a general theory of accounting is important because of the role accounting plays in our economic society. We live in a capitalistic society, which is characterized by a self-regulated market that operates through the forces of supply and demand. Goods and services are available for purchase in markets, and individuals are free to enter or exit the market to pursue their economic goals. All societies are constrained by scarce resources that limit the attainment of all individual or group economic goals. In our society, the role of accounting is to report how organizations use scarce resources and to report on the status of resources and claims to resources.

As discussed in Chapter 4, there are various theories of accounting and the uses of accounting information, including the fundamental analysis model, the efficient markets hypothesis, the behavioral finance model, the capital asset pricing model, the positive accounting theory model, the human information processing model, the critical perspective model, and the value creation model. These, often competing, theories exist because accounting theory has not yet developed into the state described by Webster's definition. Accounting research is needed to attain a more general theory of accounting, and in this regard, the various theories of accounting that have been posited must be subjected to verification. A critical question concerns the usefulness of accounting data to users. That is, does the use of a theory help individual decision-makers make more correct decisions? Various suggestions on the empirical testing of accounting theories have

[1] *Webster's 11th New Collegiate Dictionary* (Boston: Houghton Mifflin, 1999).

been offered.[2] As theories are tested and are either confirmed or discarded, we move closer to a general theory of accounting.

The goal of this text is to provide a user perspective on accounting theory. To this end, we first review the development of accounting theory to illustrate how investors' needs have been perceived over time. Next, we review the current status of accounting theory with an emphasis on how investors and potential investors use accounting and other financial information. Finally, we summarize current disclosure requirements for various financial statement items and provide examples to show how companies comply with these disclosure requirements.

The Early History of Accounting

The work of Denise Schmandt-Besserat suggests that the origins of writing are actually found in counting. This assertion is based on the fact that at nearly every Middle Eastern archeological site, the researchers found little pieces of fired clay that they could not identify. Subsequently, Schmandt-Besserat's research found that the tokens composed of an elaborate system of accounting that was used throughout the Middle East from approximately 8000–3000 B.C. Each token stood for a specific item, such as a sheep or a jar of oil, and it was used to take inventory and keep accounts.[3]

Other accounting records dating back several thousand years have been found in various parts of the world. These records indicate that at all levels of development, people desire information about their efforts and accomplishments. For example, the Zenon papyri,[4] which were discovered in 1915, contain information about the construction projects, agricultural activities, and business operations of the private estate of Apollonius for a period of about 30 years during the third century B.C.

According to Hain, "The Zenon papyri give evidence of a surprisingly elaborate accounting system which had been used in Greece since the fifth century B.C. and which, in the wake of Greek trade or conquest, gradually spread throughout the Eastern Mediterranean and Middle East."[5] Zenon's accounting system contained provisions for responsibility accounting, a written record of all transactions, a personal account for wages paid to employees, inventory records, and a record of asset acquisitions and disposals. In addition, there is evidence that all the accounts were audited.[6]

Later, the Romans kept elaborate records, but because they expressed numbers through letters of the alphabet, they were not able to develop any structured system of accounting. It was not until the Renaissance – approximately 1300–1500, when the Italians were vigorously pursuing trade and commerce – that the need to keep accurate records arose. Italian merchants borrowed the Arabic numeral system and the basis of arithmetic, and an evolving trend toward the double-entry bookkeeping system we now use developed.

In 1494, an Italian monk, Fra Luca Pacioli, wrote a book on arithmetic that included a description of double-entry bookkeeping. Pacioli's work, *Summa de Arithmetica Geometria Proportioni et Proportionalita*, did not fully describe double-entry bookkeeping; rather, it formalized the practices and ideas that had been evolving over the years. Double-entry bookkeeping enabled

[2] See, for example, Robert Sterling, "On Theory Structure and Verification," *The Accounting Review* (July 1970): 444–457 and Qi Chen and Katherine Schipper, "Comments and Observations Regarding the Relation Between Theory and Empirical Research in Contemporary Accounting Research," paper presented at the 2014 Graduate School of Business Causality Conference. November 2015. Retrieved at: https://www.uts.edu.au/sites/default/files/Chen_%202016%20Accounting%20Researcher%20Consortium.pdf.

[3] Denise Schmandt-Besserat, *Before Writing: From Counting to Cuneiform*, Vols. I and II (Austin, TX: University of Texas Press, 1992).

[4] Zenon worked as a private secretary for Apollonius in Egypt in approximately 260 B.C.

[5] H. P. Hain, "Accounting Control in the Zenon Papyri," *The Accounting Review* (October 1966): 699.

[6] Ibid., 700–701.

business organizations to keep complete records of transactions and ultimately resulted in the ability to prepare financial statements.

Statements of profit and loss and statements of balances emerged in about 1600.[7] Initially, the primary motive for separate financial statements was to obtain information regarding capital. Consequently, balance sheet data were stressed and refined in various ways, and expense and income data were viewed as incidental.[8]

As ongoing business organizations replaced isolated ventures, it became necessary to develop accounting records and reports that reflected a continuing investment of capital employed in various ways and to periodically summarize the results of activities. By the nineteenth century, bookkeeping expanded into accounting, and the concept that the owner's original contribution, plus or minus profits or losses, indicated net worth emerged. However, profit was considered an increase in assets from any source, because the concepts of cost and income were yet to be fully developed.

Another factor that influenced the development of accounting during the nineteenth century was the evolution in England of joint ventures into business corporations. Under the corporate form of business, owners (stockholders) are not necessarily the company's managers. Thus, many people external to the business itself needed information about the corporation's activities. Moreover, owners and prospective owners wanted to evaluate whether stockholder investments had yielded a return. Therefore, the emerging existence of corporations created a need for periodic reporting as well as a need to distinguish between capital and income.

The statutory establishment of corporations in England in 1845 stimulated the development of accounting standards, and laws were subsequently designed to safeguard shareholders against improper actions by corporate officers. Dividends were required to be paid from profits, and accounts were required to be kept and audited by persons other than the directors. The Industrial Revolution and the succession of the Companies Acts in England[9] also increased the need for professional standards and accountants.

In the later part of the nineteenth century, the Industrial Revolution arrived in the United States, bringing the need for more formal accounting procedures and standards. Railroads became a major economic influence that created the need for supporting industries. This led to increases in the market for corporate securities and an increased need for trained accountants as the separation of the management and ownership functions became more distinct.

At the end of the nineteenth century, widespread speculation in the securities markets, watered stocks, and large monopolies that controlled segments of the US economy resulted in the establishment of the progressive movement. In 1898, the Industrial Commission was formed to investigate questions relating to immigration, labor, agriculture, manufacturing, and business. Although no accountants were either on the commission or used by the commission, a preliminary report issued in 1900 suggested that an independent public accounting profession should be established to curtail observed corporate abuses.

Although most accountants did not necessarily subscribe to the desirability of the progressive reforms, the progressive movement conferred specific social obligations on accountants.[10] As a result, accountants generally came to accept three general levels of progressiveness: (1) a fundamental faith in democracy, a concern for morality and justice, and a broad acceptance of the efficiency of education as a major tool in social amelioration; (2) an increased awareness of

[7] A. C. Littleton, *Accounting Evolution to 1900* (New York: AICPA, 1933).
[8] John L. Carey, *The Rise of the Accounting Profession* (New York: AICPA, 1969): 5.
[9] Companies Act is a short title used for legislation in the United Kingdom relating to company law.
[10] Gary John Previts and Barbara Dubis Merino, *A History of Accounting in America* (Columbus: Ohio State University Press, 1979): 177.

the social obligation of all segments of society and introduction of the idea of the public accountability of business and political leaders; and (3) an acceptance of pragmatism as the most relevant operative philosophy of the day.[11]

The major concern of accounting during the early 1900s was the development of a theory that could cope with corporate abuses that were occurring at that time, and capital maintenance emerged as a concept. This concept evolved from maintaining invested capital intact to maintaining the physical productive capacity of the firm to maintaining real capital. In essence, this last view of capital maintenance was an extension of the economic concept of income (see Chapter 5) that there could be no increase in wealth unless the stockholders or the firm were better off at the end of the period than at the beginning.

The accounting profession also evolved over time. Initially, anyone could claim to be an accountant, for there were no organized standards of qualifications, and accountants were trained through an apprenticeship system. Later, private commercial colleges began to emerge as the training grounds for accountants.

The last quarter of the nineteenth century was a period of economic change that provided the impetus for the establishment of the accounting profession in the United States. The Institute of Accountants of New York, formed in 1882, was the first professional accounting organization. In 1887, a national organization, the American Association of Public Accountants (AAPA), was formed. The goal of these two organizations was to obtain legal recognition for the public practice of accounting.[12] In 1902, the Federation of Societies of Public Accountants in the United States was organized. Subsequently, in 1904, the United States International Congress of Accountants was convened and resulted in the merger of the AAPA and the Federation into the American Association of Public Accountants. In 1916, after a decade of bitter interfactional disputes, this group was reorganized into the American Institute of Accountants (AIA).

In the early 1900s, many universities began offering accounting courses. At this time, no standard accounting curriculum existed.[13] In an attempt to alleviate this problem, in 1916, the American Association of the University Instructors in Accounting (AAUIA) was also formed. Because curriculum development was the major focus at this time, it was not until much later that the AAUIA attempted to become involved in the development of accounting theory.

World War I changed the public's attitude toward the business sector. Many people believed that the successful completion of the war could at least partially be attributed to the ingenuity of American business. Therefore, the public perceived that business had reformed and that external regulation was no longer necessary. The accountant's role changed from protector of third parties to protector of business interests. This change in emphasis probably contributed to the events that followed in the 1920s.

Critics of accounting practice during the 1920s suggested that accountants abdicated the stewardship role, placed too much emphasis on the needs of management, and permitted too much flexibility in financial reporting. During this time, financial statements were viewed as the representations of management, and accountants did not have the ability to require businesses to use accounting principles they did not wish to employ. The result of this attitude is well known. In 1929, the stock market crashed and, as a result, the Great Depression ensued. Although accountants were not initially blamed for these events, the possibility of government intervention in the corporate sector loomed.

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[11] Richard Hofstadter, *Social Darwinism in American Thought* (Philadelphia: University of Pennsylvania Press, 1944).

[12] Previts and Marino, op. cit., p. 135.

[13] For example, students now taking such accounting courses as intermediate, cost, or auditing are exposed to essentially the same material in all academic institutions, and textbooks offering the standard material for these classes are available from several publishers.

Accounting in the United States Since 1930

The Great Depression caused business interests to become increasingly concerned about government intervention and looked for ways to self-reform. One of the first attempts to improve accounting began shortly thereafter with a series of meetings between representatives of the New York Stock Exchange (NYSE) and the AIA. The purpose of these meetings was to discuss problems pertaining to the interests of investors, the NYSE, and accountants in the preparation of external financial statements.

Also, in 1935, the American Association of University Instructors in Accounting changed its name to the American Accounting Association (AAA) and announced its intention to expand its activities in the research and development of accounting principles and standards. The first result of these expanded activities was the publication, in 1936, of a brief report cautiously titled "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements." The four-and-one-half-page document summarized the significant concepts underlying financial statements at that time.

The cooperative efforts between the members of the NYSE and the AIA were well received. However, the postdepression atmosphere in the United States was characterized by regulation. There was even legislation introduced in Congress that would have required auditors to be licensed by the federal government after passing a civil service examination.

Two of the most important pieces of Congressional legislation passed at this time were the Securities Act of 1933 and the Securities Exchange Act of 1934, which established the Securities and Exchange Commission (SEC). Subsequently, the SEC began reviewing the registrations required by these Acts. Despite the absence of a body of well-established accounting principles, the SEC begin to challenge accounting practices they considered inaccurate or misleading and a recurring issue emerged. Many companies were increasing assets to current or appraisal value with commensurate increases in reserves or equity (surplus) accounts. Expenses that should have been charged against earnings were then offset against those surplus accounts. The SEC believed this practice was incorrect but the securities laws were disclosure laws. It questioned whether a presentation it believed to be wrong could be accepted if fully disclosed, particularly if the SEC had not previously stated that the practice was incorrect. That is, at what point do accounting presentations that are not correct, though disclosed, amount to violations of the security laws?

The security acts gave the SEC the authority to prescribe accounting principles and reporting practices and the SEC Commissioners attempted to persuade Chief Accountant Carman Blough to develop and promulgate accounting rules. However, Blough convinced the Commission that he lacked the staff and time to perform the research necessary to formulate broad accounting standards. However, the SEC authorized him to issue releases interpreting accounting matters to "contribute to the development" of uniform standards in the form of Accounting Series Releases (ASR).

In January 1937, ASR No. 1 was issued in response to the appraisal value and other questionable accounting practices prevalent at that time. This release announced that opinions on accounting principles would be published periodically for the purpose of contributing to the development of uniform standards and practices on major accounting questions and specifically stated that losses properly chargeable against income should not be charged against surplus.

The SEC continued to be engaged in an internal debate over whether it should develop accounting standards. However, in 1938, it decided in *Accounting Series Release No. 4* to allow accounting principles to be set in the private sector. *ASR No. 4* stated that reports filed with the SEC must be prepared in accordance with accounting principles that have "substantial

authoritative support."[14] If financial statements were prepared in accordance with principles for which there was no substantial authoritative support, the SEC would presume that the statements were misleading or inaccurate, despite disclosures. If the SEC differed with a registrant on an accounting practice, disclosure in lieu of correction would be accepted only if there were substantial authoritative support for the registrant's practice.

While ASR No. 4 clarified that disclosure could not cure accounting deficiencies, the question of which accounting principles were considered to have substantial authoritative support had not been answered. Chief Accountant Blough had been urging accountants to be more involved in the development of accounting principles and ASR No. 4 was an invitation to the accounting profession to become more active in the process.

Nevertheless, the accounting profession was convinced that it did not have the time needed to develop a theoretical framework of accounting. As a result, the AIA published a study by Sanders, Hatfield, and Moore titled *A Statement of Accounting Principles*.[15] The publication of this work was quite controversial in that it was simply a survey of existing practice that was seen as telling practicing accountants "do what you think is best." Some accountants also used the study as an authoritative source that justified current practice.

Earlier in 1936, the AIA had merged with the American Society of Certified Public Accountants, forming a larger organization later named the American Institute of Certified Public Accountants (AICPA). This organization has had increasing influence on the development of accounting theory. For example, over the years, the AICPA established several committees and boards to deal with the need to further develop accounting principles. The first was the Committee on Accounting Procedure (CAP). It was followed by the Accounting Principles Board (APB), which was replaced by the Financial Accounting Standards Board. Each of these bodies has issued pronouncements on accounting issues, which have become the primary source of generally accepted accounting principles that guide accounting practice today.

Committee on Accounting Procedure

Professional accountants became more actively involved in the development of accounting principles following the meetings between members of the NYSE and the AICPA and the controversy surrounding the publication of the Sanders, Hatfield, and Moore study. In 1936, the AICPA's CAP was formed and the AICPA responded to SEC Chief Accountant Blough's invitation to participate by expanding the CAP from its original 8 to 22 members, all accounting practitioners except for three academicians. This body was given the responsibility for issuing pronouncements on matters of accounting practice and procedure in order to establish generally accepted practices (US GAAP). The CAP became more active in response to the SEC's release of ASR No. 4 which gave it the de facto recognition as the source of *substantial authoritative support*.[16]

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[14] This term, initially proposed by Carman Blough, the first chief accountant of the SEC, is meant to mean authority of "substantial weight" or importance, and not necessarily a majority view. Thus, there might be three authoritative positions, all of which are appropriate at a point in time before some standard is established. The majority might have gone in one direction, but the minority who were also considered "authoritative" and could be used. See William D. Cooper, "Carman G. Blough's Contributions to Accounting: An Overview," *Accounting Historians Journal* 9, no. 2 (Fall 1982): 61–67.

[15] Thomas H. Sanders, Henry Rand Hatfield, and William Underhill Moore, *A Statement of Accounting Principles* (New York, AICPA, 1938).

[16] Lynn E. Turner, The Future Is Now, Keynote Address, Accounting Hall of Fame-Association of Accounting Historians, Ohio State University, Columbus, Ohio, November 10, 2000.

One of the first issues the CAP addressed was the use of the historical cost model of accounting. The then-accepted definition of assets as unamortized cost was seen by some critics as allowing management too much flexibility in deciding when to charge costs to expense. This practice was seen as allowing earnings management[17] to occur.

Another area of controversy was the impact of inflation on reported profits. During the 1940s, several companies lobbied for the use of replacement cost depreciation. These efforts were rejected by both the CAP and the SEC, who both maintained that income should be determined on the basis of historical cost. This debate continued over a decade, ending only when Congress passed legislation in 1954 amending the IRS Tax Code to allow accelerated depreciation.

The works of the CAP were originally published in the form of *Accounting Research Bulletins* (*ARB*s); however, these pronouncements did not dictate mandatory practice, and they received authority only from their general acceptance. The *ARB*s were consolidated in 1953 into *Accounting Terminology Bulletin No. 1*, "Review and Resume," and *ARB No. 43*. *ARB*s *No. 44* through *No. 51* were published from 1953 until 1959. The recommendations of these bulletins that have not been superseded are contained in the FASB Accounting Standards Codification (FASB ASC; discussed below) and referenced throughout this text where the specific topics covered by the *ARB*s are discussed. Those not superseded can be accessed through the cross-reference option on the FASB ASC website (https:// asc.fasb.org).

Accounting Principles Board

In October 1957, the AICPA's new president, Alvin R. Jennings, called for the reorganization and strengthening of the AICPA's standard setting process, and by 1959, the methods of formulating accounting principles were being questioned as not arising from research or based on theory. The CAP was also criticized for acting in a piecemeal fashion and issuing standards that in many cases were inconsistent. Additionally, all its members were part-time, and as a result, their independence was questioned. Finally, the fact that all the CAP members were required to be AICPA members prevented many financial executives, investors, and academics from serving on the committee. As a result, accountants and users of financial statements were calling for wider representation in the development of accounting principles.

In 1959, the AICPA responded to the alleged shortcomings of the CAP by forming the APB. The objectives of this body were to advance the written expression of generally accepted accounting principles (US GAAP), to narrow areas of difference in appropriate practice, and to discuss unsettled controversial issues. However, the expectation of a change in the method of establishing accounting principles was quickly squelched when the first APB chairman, Weldon Powell, voiced his belief that accounting research was more applied than pure and that the usefulness of the end product was a major concern.[18]

The APB was comprised of 17–21 members, who were selected primarily from the accounting profession but also included individuals from industry, government, and academia. Initially, the pronouncements of the APB, termed "Opinions," were not mandatory practice; however, the issuance of *APB Opinion No. 2* (see *FASB ASC 740-10-25* and *45*) and a subsequent partial retraction contained in *APB Opinion No. 4* (see *FASB ASC 740-10-50*) highlighted the need for standard-setting groups to have more authority.

[17] Earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a predetermined target. See Chapter 5 for a detailed discussion.

[18] Weldon Powell, "Report on the Accounting Research Activities of the American Institute of Certified Public Accountants," *The Accounting Review* (January 1961): 26–31.

This controversy was over the proper method to use in accounting for the investment tax credit. In the early 1960s, the country was suffering from the effects of a recession. After President John F. Kennedy took office, his advisors suggested an innovative fiscal economic policy that involved a direct income tax credit (as opposed to a tax deduction) based on a percentage of the cost of a qualified investment. Congress passed legislation creating the investment tax credit in 1961.

The APB was then faced with deciding how companies should record and report the effects of the investment tax credit. It considered two alternative approaches:

1. The *flow-through* method, which treated the tax credit as a decrease in income tax expense in the year it occurred.
2. The *deferred* method, which treated the tax credit as a reduction in the cost of the asset and therefore was reflected over the life of the asset through reduced depreciation charges.

The APB decided that the tax credit should be accounted for by the deferred method and issued *APB Opinion No. 2*. This pronouncement stated that the tax reduction amounted to a cost reduction, the effects of which should be amortized over the useful life of the asset acquired. The reaction to this decision was quite negative on several fronts. Members of the Kennedy administration considered the flow-through method more consistent with the goals of the legislation, and three of the then Big Eight accounting firms advised their clients not to follow the recommendations of *APB Opinion No. 2*. In 1963, the SEC issued *Accounting Series Release No. 96*, allowing firms to use either the flow-through or the deferred method in their SEC filings.

The fact that the SEC had the authority to issue accounting pronouncements, and the lack of general acceptance of *APB Opinion No. 2*, resulted in the APB's partially retreating from its previous position. Though reaffirming the previous decision as being the proper and most appropriate treatment, *APB Opinion No. 4* approved the use of either of the two methods.

The lack of support for some of the APB's pronouncements and concern over the formulation and acceptance of US GAAP caused the Council of the AICPA to adopt Rule 203 of the Code of Professional Ethics.[19] This rule requires departures from accounting principles published in *APB Opinions* or *Accounting Research Bulletins* (or subsequently *FASB Statements* and now the FASB ASC) to be disclosed in footnotes to financial statements or in independent auditors' reports when the effects of such departures are material. This action has had the effect of requiring companies and public accountants who deviate from authoritative pronouncements to justify such departures.

In addition to the difficulties associated with passage of *APB Opinions No. 2* and *No. 4*, the APB encountered other problems. The members of the APB were, in effect, volunteers. These individuals had full-time responsibilities to their employers; therefore, the performance of their duties on the APB became secondary. By the late 1960s, criticism of the development of accounting principles again arose. This criticism centered on the following factors:

1. *The independence of the members of the APB.* The individuals serving on the Board had full-time responsibilities elsewhere that might influence their views of certain issues.
2. *The structure of the Board.* The largest eight public accounting firms (at that time) were automatically awarded one member, and there were usually five or six other public accountants on the APB.
3. *Response time.* The emerging accounting problems were not being investigated and solved quickly enough by the part-time members.

[19] The AICPA's Professional Code of Ethics is discussed in more detail in Chapter 17.

The Financial Accounting Standards Board

Owing to the growing criticism of the APB, in 1971, the board of directors of the AICPA appointed two committees. The Wheat Committee, chaired by Francis Wheat, was to study how financial accounting principles should be established. The Trueblood Committee, chaired by Robert Trueblood, was asked to determine the objectives of financial statements.

The Wheat Committee issued its report in 1972 recommending that the APB be abolished, and the Financial Accounting Standards Board (FASB) be created. In contrast to the APB, whose members were all from the AICPA, this new board was to comprise representatives from various organizations. The members of the FASB were also to be full-time paid employees, unlike the APB members, who served part-time and were not paid.

The Trueblood Committee, formally known as the Study Group on Objectives of Financial Statements, issued its report in 1973 after substantial debate – and with considerably more tentativeness in its recommendations about objectives than the Wheat Committee had with respect to the establishment of principles. The study group requested that its report be regarded as an initial step in developing objectives and that significant efforts should be made to continue progress on refining and improving accounting standards and practices. The specific content of the Trueblood Report is discussed in Chapter 2.

The AICPA quickly adopted the Wheat Committee recommendations, and the FASB became the official body charged with issuing accounting standards. The structure of the FASB is as follows. A board of trustees is nominated by organizations whose members have special knowledge and interest in financial reporting. The organizations originally chosen to select the trustees were the American Accounting Association, the AICPA, the Financial Executives Institute, the National Association of Accountants (the NAA's name was later changed to Institute of Management Accountants in 1991), and the Financial Analysts Federation. In 1997, the board of trustees added four members from public interest organizations. The board that governs the FASB is the Financial Accounting Foundation (FAF). The FAF appoints the Financial Accounting Standards Advisory Council (FASAC), which advises the FASB on major policy issues, the selection of task forces, and the agenda of topics. The number of members on the FASAC varies from year to year. The bylaws call for at least 20 members to be appointed. However, the actual number of members has grown to about 30 in recent years to obtain representation from a wider group of interested parties.

The FAF is also responsible for appointing the members of the FASB and raising the funds to operate the FASB. Until 2001, most of the funds raised by the FAF came from the AICPA and the largest public accounting firms. However, the Sarbanes–Oxley Act of 2002 (discussed later in the chapter) required the FASB to be financed by fees assessed against publicly traded companies and other sources, instead of by donations from the interested parties in the private sector. The purpose of this action was to increase the independence of the FASB from the constituents it serves. The FAF currently collects more than $60 million a year from a combination of publishing revenue, accounting support fees, and investment income to support the activities of the FASB. Figure 1.1 on page 10 illustrates the current structure of the FASB.

Both the FAF and the FASB have a broader representation of the total profession than did the APB; however, most of the members are usually CPAs from public practice. The structure of the FAF has also come under scrutiny by the SEC. In 1996, Arthur Levitt, chairman of the SEC, voiced concern that the FAF's public interest objectives were at risk. He suggested that the FAF be reorganized so that most of its members would be individuals with strong public service backgrounds who are better able to represent the public free of any conflict of interest. He suggested that the SEC should approve the appointments to the FAF.[20] Subsequently, in 2002, the FAF amended the trustee appointment process. It required the trustees to consider up to two

[20] R. Abelson, "Accounting Group to Meet with SEC in Rules Debate," *New York Times* (May 5, 1996): D5.

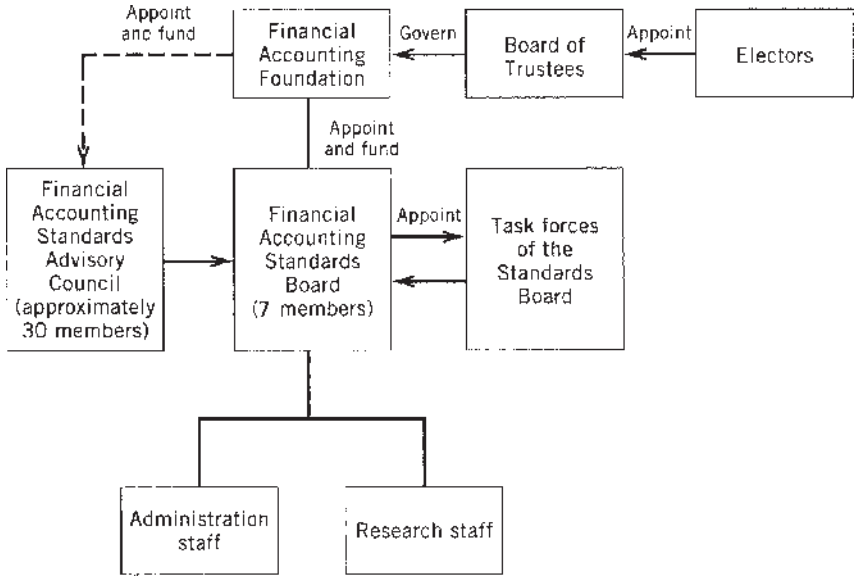

FIGURE 1.1
Structure of the FASB.

nominees from the constituent organizations for each seat and for the appointment to be made by the trustees. Under this system, if the trustees did not find the nominees acceptable, they could consult with the nominating organization and appoint a person of their own choosing as long as the individual's background matches the requirements for that particular seat.

Later in 2008, the FAF decided to expand the number and breadth of investors, accounting, business, financial and government organizations, and entities invited to nominate FAF Trustees; however, the final authority for all appointments rests solely with the discretion of the Board of Trustees. The FAF also:

- changed the term of the Trustees from one three-year term with a possible second three-year term to one five-year term;
- changed the size of the Board of Trustees from a fixed 16 Trustees to a flexible range of 14–18 Trustees, the size to be fixed by Board resolution from time to time;
- increased the Trustee governance activities, including its level of formal review, analysis, and oversight of the data and materials regularly provided by FASB and the other organizations it oversees.

Section 108 of Sarbanes–Oxley gave added prominence to the FASB by establishing criteria that must be met for the work product of an accounting standard-setting body to be recognized as "generally accepted." The SEC responded by issuing a policy statement stating that the FASB and its parent organization, the FAF, satisfy the criteria in Section 108 of the Sarbanes–Oxley Act and, accordingly, the FASB's financial accounting and reporting standards are recognized as "generally accepted" for purposes of the federal securities laws.[21] Consequently, the FASB is the organization having the authority to issue standards for financial accounting. Thus, throughout this book, pronouncements of the FASB and those of its predecessor organizations not superseded or amended are presented as US GAAP.

[21] The AICPA's Professional Code of Ethics is discussed in more detail in Chapter 17.

The Mission of the FASB

The FASB's mission is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. In attempting to accomplish this mission, the FASB seeks to

1. improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and faithful representation and on the qualities of comparability and consistency (discussed in Chapter 2);
2. keep standards current to reflect changes in methods of doing business and changes in the economic environment;
3. consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;
4. promote the international comparability of accounting standards concurrent with improving the quality of financial reporting;
5. improve the common understanding of the nature and purposes of information contained in financial reports.

Types of Pronouncements

Originally, the FASB issued two types of pronouncements: *Statements of Financial Accounting Standards* (*SFAS*s) and *Interpretations*. Subsequently, the FASB established two new series of releases: *Statements of Financial Accounting Concepts* (*SFAC*s) and *Technical Bulletins*. *SFAS*s conveyed required accounting methods and procedures for specific accounting issues and officially created US GAAP. *Interpretations* were modifications or extensions of issues pronouncements. *SFAC*s constitute the FASBs conceptual framework (discussed in Chapter 2) and are intended to establish the objectives and concepts that the FASB will use in developing standards of financial accounting and reporting. To date, the FASB has issued eight *SFAC*s, which are discussed in depth in Chapters 2, 6, 7, 14, and 17. *SFAC*s differ from *SFAS*s in that they do not establish US GAAP. Similarly, they are not intended to invoke Rule 203 of the Rules of Conduct of the Code of Professional Ethics. It is anticipated that the major beneficiary of these *SFAC*s will be the FASB itself. However, knowledge of the objectives and concepts the Board uses should enable users of financial statements to better understand the content and limitations of financial accounting information. *Technical Bulletins* were strictly interpretive in nature and did not establish new standards or amend existing standards. They were intended to provide guidance on financial accounting and reporting problems on a timely basis.

FASB Accounting Standards Codification

On July 1, 2009, the FASB Accounting Standards Codification (FASB ASC) became the single source of generally accepted accounting principles. The FASB ASC (the codification) became effective for interim and annual periods ending after September 15, 2009. On that date, all pronouncements issued by previous standard setters were superseded. The FASB had three primary goals in developing the codification:

1. Simplify user access by codifying all authoritative US GAAPs in one spot.
2. Ensure that the codified content accurately represented authoritative US GAAPs as of July 1, 2009.

3. Create a codification research system that is up to date for the released results of standard-setting activity.

The codification is expected to

1. reduce the amount of time and effort required to solve an accounting research issue;
2. mitigate the risk of noncompliance through improved usability of the literature;
3. provide accurate information with real-time updates as Accounting Standards Updates are released;
4. assist the FASB with the research and convergence efforts.

The FASB ASC is composed of the following literature issued by various standard setters:

1. Financial Accounting Standards Board (FASB)
   a. Statements (FAS)
   b. Interpretations (FIN)
   c. Technical Bulletins (FTB)
   d. Staff Positions (FSP)
   e. Staff Implementation Guides (Q&A)
   f. Statement No. 138 Example
2. Emerging Issues Task Force (EITF)
   a. Abstracts
   b. Topic D
3. Derivative Implementation Group (DIG) Issues
4. Accounting Principles Board (APB) Opinions
5. Accounting Research Bulletins (ARB)
6. Accounting Interpretations (AIN)
7. American Institute of Certified Public Accountants (AICPA)
   a. Statements of Position (SOP)
   b. Audit and Accounting Guides (AAG) – only incremental accounting guidance
   c. Practice Bulletins (PB), including the Notices to Practitioners elevated to Practice Bulletin status by Practice Bulletin 1
   d. Technical Inquiry Service (TIS) – only for Software Revenue Recognition

Additionally, in an effort to increase the utility of the codification for public companies, relevant portions of authoritative content issued by the SEC and selected SEC staff interpretations and administrative guidance have been included for reference in the codification, such as the following:

1. Regulation S-X (SX)
2. Financial Reporting Releases (FRR)/Accounting Series Releases (ASR)
3. Interpretive Releases (IR)
4. SEC Staff guidance in
   a. Staff Accounting Bulletins (SAB)
   b. EITF Topic D and SEC Staff Observer comments

Effective July 1, 2009, the FASB no longer issues Statements of Financial Accounting Standards. Changes to authoritative US US GAAP, the *FASB ASC,* are publicized through an Accounting Standards Update (ASU). Each ASU

1. summarizes the key provisions of the project that led to the ASU;
2. details the specific amendments to the FASB Codification;
3. explains the basis for the Board's decisions.

Emerging Issues

One of the first criticisms of the FASB was for failing to provide timely guidance on emerging implementation and practice problems. During 1984, the FASB responded to this criticism by (1) establishing a task force, the Emerging Issues Task Force (EITF), to assist in identifying issues and problems that might require action and (2) expanding the scope of the *FASB Technical Bulletins* in an effort to offer quicker guidance on a wider variety of issues.

The EITF was formed in response to two conflicting issues. On the one hand, accountants are faced with a variety of issues that are not fully addressed in accounting pronouncements, such as interest rate swaps or new financial instruments. These and other new issues need immediate resolution. On the other hand, many accountants maintain that the ever-increasing body of professional pronouncements has created a standards overload problem (discussed in more detail later). The FASB established the EITF in an attempt to simultaneously address both issues. The goal of the EITF is to provide timely guidance on new issues while limiting the number of issues whose resolutions require formal pronouncements by the FASB.

All members of the task force occupy positions that make them aware of emerging issues. Current members include the directors of accounting and auditing from the largest CPA firms, representatives from smaller CPA firms, and the FASB's director of research, who serves as chairman. It is also expected that the chief accountant of the SEC will attend task force meetings and participate in the deliberations.

The EITF discusses current accounting issues that are not specifically addressed by current authoritative pronouncements and advises the FASB staff on whether an issue requires FASB action. Emerging issues arise because of new types of transactions, variations in accounting for existing types of transactions, new types of securities, and new products and services. They frequently involve a company's desire to achieve "off-balance sheet" financing or "off-income statement" accounting.

Issues may come to the EITF from a variety of sources. Many are raised by members of the task force themselves; others come from questions asked by auditors. Occasionally, an issue arises because of a question from the SEC or another federal agency. An issue summary is prepared, providing the basis for each issue brought before the EITF. Issue summaries generally include a discussion of the issue, alternative approaches to the resolution of the issue, available references pertaining to the issue, and examples of the transaction in question. An issue summary is not an authoritative pronouncement – it merely represents the views of the EITF members at that time.

The task force attempts to arrive at a consensus on each issue. A consensus is defined as 13 of the 15 voting members. A consensus results in the establishment of US GAAP and constitutes an ASU to the FASB ASC.

Standards Overload

Over the years, the FASB, the SEC, and the AICPA have been criticized for imposing too many accounting standards on the business community. This *standards overload* problem has been

particularly burdensome for small businesses that do not have the economic resources to research and apply all the pronouncements issued by these authoritative bodies. Those who contend that there is a standards overload problem base their arguments on two allegations: Not all US GAAP requirements are relevant to small business financial reporting needs, and even when US GAAP requirements are relevant, they often violate the pervasive cost–benefit constraint.[22]

Critics of the standard-setting process for small businesses also assert that US GAAP were developed primarily to serve the needs of the securities market. Many small businesses do not raise capital in these markets; therefore, it is contended that US GAAP were not developed with small business needs in mind.

The standards overload problem has several consequences for small business:

1. If a small business omits a US GAAP requirement from audited financial statements, a qualified or adverse opinion may be rendered.
2. The cost of complying with US GAAP requirements can cause a small business to forgo the development of other, more relevant information.
3. Small CPA firms that audit smaller companies must keep up to date on all the same requirements as large international firms, but they cannot afford the specialists who are available on a centralized basis in the large firms.

Many accountants have argued for differential disclosure standards as a solution to the standards overload problem. That is, standards might be divided into two groups. One group would apply to businesses regardless of size. The second group would apply only to large businesses, small businesses, or particular industries. For example, the disclosure of significant accounting policies would pertain to all businesses, whereas a differential disclosure such as earnings per share would apply only to large businesses.

The FASB and various other organizations have studied but have not reached a consensus. A special committee of the AICPA favored differential reporting standards.[23] The FASB had historically taken the position that financial statement users might be confused when two different methods are used to describe or disclose the same economic event, but in 2009, the International Accounting Standards Board (IASB) issued a pronouncement that omits or simplifies the applicability of its standards and disclosure requirements for small- and medium-sized companies (see Chapter 3). The attempt to harmonize US and international US GAAP can result in the adoption of a similar FASB standard; however, bankers (a major source of capital for small businesses) and financial analysts have fairly consistently criticized differential reporting requirements as a solution to the standards overload problem.[24]

Standard Setting as a Political Process

A highly influential academic accountant stated that accounting standards are as much a product of political action as they are of careful logic or empirical findings.[25] This phenomenon exists because a variety of parties are interested in and affected by the development of accounting standards. Various users of accounting information have found that the best way to influence the formulation of accounting standards is to attempt to influence the standard setters.

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[22] Cost is described in *SFAC No. 8* as a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. See Chapter 2 for a further discussion of this issue.

[23] Special Committee on Accounting Standards Overload, *Report on the Special Committee on Accounting Standards Overload* (New York: AICPA, 1983).

[24] Barbara J. Shildneck and Lee Berton "The FASB's Second Decade," *Journal of Accountancy* (November 1983): 94–102.

[25] Charles T. Horngren, "The Marketing of Accounting Standards," *Journal of Accountancy* (October 1973): 61–66.

The CAP, APB, and FASB have all come under a great deal of pressure to develop or amend standards so as to benefit a particular user group. For example, the APB had originally intended to develop a comprehensive theory of accounting before attempting to solve any current problems; however, this approach was abandoned when it was determined that such an effort might take up to five years and that the SEC would not wait that long before taking action. The Business Roundtable engaged in what initially was a successful effort (later reversed) to increase the required consensus for passage of a *SFAS* from a simple majority to five of the seven members of the FASB. Congressional action was threatened over several FASB pronouncements.

Two of the most notable examples of the politicizing of accounting standards involved the issues of employee stock options and fair value accounting. By the early 1990s, the awarding of employee stock options to company executives had become widespread. This was especially true in the new technology companies, where stock options were a major component of employee compensation. As a result, the FASB developed a preliminary standard that would have required companies to expense the fair value of the stock options granted to executives and other employees.

The proposed standard was met with widespread opposition. Companies in the high-technology industry expressed the most vocal objections. Many of these companies had been reporting no earnings, and they feared that a required expensing of stock options would greatly increase their losses or lessen whatever earnings they might ever report. When it became evident that the FASB was determined to proceed with the standard, they appealed to members of Congress. Subsequently, proposed legislation was introduced in both the House and the Senate that ordered the SEC not to enforce the FASB's proposed standard on expensing stock options. As the FASB continued toward issuing a standard, the Senate responded by passing a resolution that urged the FASB not to move ahead with its standard. One senator even introduced legislation that would have required the SEC to hold a public hearing and cast a vote on each future standard issued by the FASB, a procedure that probably would have led to the demise of the FASB. At that point, SEC Chairman Arthur Levitt, who had been on record as strongly favoring the FASB's proposed standard, counseled the FASB not to issue a standard that required the expensing of the fair value of stock options in the income statement; otherwise, its future existence might be at risk.[26] A watered-down version of the stock option standard was passed in 1995; however, a standard based on the original FASB proposal was later adopted.[27]

The fair value controversy was just as contentious. In September 2006, the FASB published *Statement of Financial Accounting Standards No. 157*, "Fair Value Measurements," now contained in *FASB ASC 820-10*, which outlined the method to be used when determining fair values such as is required by *FASB ASC 320-10* for marketable securities. Later in 2008, a market crisis occurred that resulted in a credit crunch for banks. Critics maintained that the requirement to use fair value to measure investments caused or exacerbated the market crisis by forcing a downward spiral of valuations based on distressed institutions. The SEC responded with a study that recommended retaining the fair value requirements.[28] This did not silence the critics, and the *Wall Street Journal* reported that its analysis of public filings revealed that 31 financial firms and trade groups had formed a coalition in early 2009 and spent $27.6 million to lobby legislators about the fair value requirement.[29] Subsequently, public hearings were held in Congress that resulted in several heated

[26] The events surrounding this controversy are documented in Steven A. Zeff, "The Evolution of U.S. U.S. GAAP: The Political Forces Behind Professional Standards (Part II)," *CPA Journal Online* (February 2005), http://www.nysscpa.org /cpajournal/2005/205/ index.htm.

[27] See Chapter 15 for a further discussion of accounting for stock options.

[28] *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting* (Washington, DC: Securities and Exchange Commission, 2008).

[29] Susan Pulliam and Tom McGinty, "Congress Helped Banks Defang Key Rule," *Wall Street Journal* (June 3, 2009), http://online .wsj.com/article/SB124396078596677535.html.

exchanges – including one congressman telling FASB Chairman Robert Herz, "Don't make us tell you what to do, just do it," and another stating, "If you don't act, we will."[30] The outcome was that the FASB issued a modification *FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (see *FASB ASC 820-10-65*), that was generally thought to lessen the impact of the fair value requirements. However, a subsequent study of the impact of *FAS ASC 820-10-65* on 73 of the largest banks in the United States found that a large majority of the banks reported that the adoption of the new requirements did not have a material impact.[31]

Economic Consequences

The increased pressure on the standard-setting process is not surprising, considering that many accounting standards have significant economic consequences. *Economic consequences* refer to the impact of accounting reports on various segments of our economic society. This concept holds that the accounting practices a company adopts affect its security price and value. Consequently, the choice of accounting methods influences decision-making rather than just reflecting the results of these decisions.

Consider the release of the FASB's pronouncement on other postretirement benefits (OPRBs), *FASB Statement No. 106*, "Other Post Retirement Benefits" (see *FASB ASC 715-10-30*, *60*, and *80*). The accounting guidelines for OPRBs required companies to change from a pay-as-you-go basis to an accrual basis for health care and other benefits that companies provide to retirees and their dependents. The accrual basis requires companies to measure the obligation to provide future services and accrue these costs during the years employees provide service. This change in accounting caused a large increase in recorded expenses for many companies. Consequently, a number of companies simply ceased providing such benefits to their employees, at a large social cost.

The impact on our economic society of accounting for OPRBs illustrates the need for the FASB to fully consider both the necessity to further develop sound reporting practices and the possible economic consequences of new codification content. Accounting standard setting does not exist in a vacuum. It cannot be completely insulated from political pressures, nor can it avoid carefully evaluating the possible ramifications of standard setting.

Evolution of the Phrase "Generally Accepted Accounting Principles"

One result of the meetings between the AICPA and members of the NYSE following the onset of the Great Depression was a revision in the wording of the certificate issued by CPAs. The opinion paragraph formerly stated that the financial statements had been examined and were accurate. The terminology was changed to say that the statements are "fairly presented in accordance with generally accepted accounting principles." This expression is now interpreted as encompassing the conventions, rules, and procedures that are necessary to explain accepted accounting practice at a given time. Therefore, financial statements are fair only to the extent that the principles are fair, and the statements comply with the principles.

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[30] Financial Executives Institute, "Levitt, Beresford on Congress, FASB and Fair Value; Breeden Calls for Merger of SEC," *CFTC and PCAOB FEI Financial Reporting Blog* (March 26, 2009), http://financialexecutives.blogspot.com/2009/03/levitt-beresford-on-congress-fasb-and.html.

[31] Jack M. Cathey, David Schauer, and Richard G. Schroeder, "The Impact of FSP FAS 157-4 on Commercial Banks," *International Advances in Economic Research* 18, no. 1 (January 2012): 15–27.

The expression "generally accepted accounting principles" (US GAAP) has thus come to play a significant role in the accounting profession. The precise meaning of the phrase, however, evolved rather slowly. In 1938, the AICPA published a monograph titled *Examinations of Financial Statements*, which first introduced the expression. Later, in 1939, an AICPA committee recommended including the wording, "present fairly . . . in conformity with generally accepted accounting principles" in the standard form of the auditor's report.[32]

The meaning of US GAAP was not specifically defined at that time, and no single source exists for all established accounting principles. However, later Rule 203 of the AICPA Code of Professional Ethics required compliance with accounting principles promulgated by the body designated by the Council of the Institute to establish such principles, except in unusual circumstances. Currently, that body is the FASB.

The guidance for determining authoritative literature was originally outlined in *Statement of Auditing Standards (SAS) No. 5*.[33] Later, *SAS No. 5* was amended by *SAS No. 43*. This amendment classified the order of priority that an auditor should follow in determining whether an accounting principle is generally accepted. Also, it added certain types of pronouncements that did not exist when *SAS No. 5* was issued to the sources of established accounting principles. *SAS No. 43* was further amended by *SAS No. 69*, whose stated purpose was to explain the meaning of the phrase "present fairly . . . in conformance with generally accepted accounting principles" in the independent auditor's report.[34] *SAS No. 69* noted that determining the general acceptance of a particular accounting principle is difficult because no single reference source exists for all such principles. In July 2003, the SEC issued the *Study Pursuant to Section 108(d) of the Sarbanes–Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (the Study). Consistent with the recommendations presented in the Study, the FASB undertook several initiatives aimed at improving the quality of standards and the standard-setting process, including improving the conceptual framework, codifying existing accounting literature, transitioning to a single standard-setter regime, and converging FASB and IASB standards.

In 2008, the FASB issued *SFAS No. 162*, *The Hierarchy of Generally Accepted Accounting Principles*.[35] *SFAS No. 162* categorized the sources of accounting principles that are generally accepted into descending order of authority. Previously, the US GAAP hierarchy had drawn criticism because it was directed toward the auditor rather than the enterprise, it was too complex, and it ranked FASB Concepts Statements, which are subject to the same level of due process as FASB Statements, below industry practices that are widely recognized as generally accepted but are not subject to due process.[36]

According to *SFAS No. 162*, the sources of generally accepted accounting principles were:

1. AICPA Accounting Research Bulletins and Accounting Principles Board Opinions that are not superseded by action of the FASB, FASB Statements of Financial Accounting Standards and Interpretations, *FASB Statement 133* Implementation Issues, and FASB Staff Positions
2. FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and Statements of Position

[32] Zeff, "The Evolution of U.S. U.S. GAAP."
[33] The American Institute of Accountants authorized the appointment of a standing committee on auditing procedure which issued the first auditing standards in 1939. Two years later, it released a series of statements designed to guide the independent auditor.
[34] *Statement on Auditing Standards No. 69*, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report" (New York, 1993), para. 1.
[35] *Statement of Financial Accounting Standards No. 162: The Hierarchy of Generally Accepted Accounting Principles* (Norwalk, CT: FASB, 2008).
[36] *Study Pursuant to Section 108(d) of the Sarbanes–Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (Washington, DC: SEC, July 2003).

3. AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force (EITF)
4. Implementation guides published by the FASB staff, AICPA accounting interpretations, and practices that are widely recognized and prevalent either generally or in the industry

Finally, in 2009, the FASB issued *SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles—A replacement of FASB Statement No. 162. SFAS No. 168* identified the FASB ASC (discussed below) as the official source of US US GAAP.

In this chapter and throughout much of the book, special attention is given to the pronouncements referred to in Rule 203 of the AICPA Code of Professional Ethics. The reason for this special attention is apparent. Practicing CPAs have an ethical obligation to consider such pronouncements as the primary source of US GAAP in their exercise of judgment as to the fairness of financial statements. Opposing views as well as alternative treatments are considered in the text narrative; however, the reader should keep in mind that the development of US GAAP has been narrowly defined by the AICPA.

Despite the continuing effort to narrow the scope of US GAAP, critics maintain that management is allowed too much leeway in the selection of the accounting procedures used in corporate financial reports. These criticisms revolve around two issues that are elaborated on later in the text: (1) Executive compensation is often tied to reported earnings, so management is inclined to adopt accounting principles that increase current revenues and decrease current expenses and (2) the value of a firm in the marketplace is determined by its stock price. This value is highly influenced by financial analysts' quarterly earnings estimates. Managers are fearful that failing to meet these earnings estimates will trigger a sell-off of the company's stock and a resultant decline in the market value of the firm.

Previously, SEC Chairman Levitt noted these issues and indicated his belief that financial reports were descending "into the gray area between illegitimacy and outright fraud."[37] As a consequence, the SEC has set up an earnings management task force to uncover accounting distortions. Some companies voluntarily agreed to restructure their financial statements as a result of this new effort by the SEC. For example, SunTrust Bank, Inc., of Atlanta, though not accused of any wrongdoing, agreed to a three-year restructuring of earnings for the period ended December 31, 1996.[38]

The FASB's Accounting Standards Codification

Over the past 50 years, financial accounting professionals have had to manage hundreds of accounting standards promulgated by several different accounting standard setters. Many of these accounting professionals became convinced that accounting standards had evolved to the point that they could not keep up. The large number of standards was not a new issue, but the issue was becoming more unmanageable with each passing year. The members of FASAC recognized the problem and in 2001 suggested that the FASB address the issue of efficient access to US US GAAP by initiating a simplification and codification project. During 2002 and 2003, the FASB began various projects to address these issues, and in early 2004, the FASB accelerated its efforts on the codification and retrieval project. In September 2004, the FAF trustees approved

[37] Arthur Levitt, *The "Numbers Game"* (NYU Center for Law and Business, September 28, 1998).
[38] E. McDonald, "SEC's Levitt Pushes Harder for Changes in Fiscal Reporting and Some Cry Foul," *Wall Street Journal* (November 17, 1998): A2.

funding for the FASB's codification and retrieval project. In June 2009, the FASB announced that the codification would be the single source of authoritative nongovernment US US GAAP effective for all interim and annual periods ending after September 15, 2009.

The concept is relatively simple and involved the following steps:

1. Restructure all US US GAAP literature by topic into a single authoritative codification.
2. Modify the standard-setting process to focus on updating the codification.

The major reason for embarking on the codification process was that researching multiple authoritative sources complicated the research process. For example, using the previously existing structure, an individual needed to review existing FASB, EITF, AICPA, and SEC literature to resolve even a relatively simple issue. As a result, it was easy to inadvertently overlook relevant guidance. Codifying all existing US US GAAP literature into one authoritative source eliminates the previous need to research multiple sources. In addition, creating one source allows the FASB to more easily isolate differences in its ongoing effort to converge with international accounting standards. The codification represents the sole authoritative source of US GAAP. Creating the codification is only the first step, and it is only part of the overall solution; the standard-setting process was changed to focus on the codification text. By implementing this approach, constituents will know the revised codification language as soon as the standard setter issues the standard. This approach eliminates delays and ensures an integrated codification. The FASB has also developed a searchable retrieval system to provide greater functionality and timeliness to constituents.

The FASB ASC contains all current authoritative accounting literature. However, if the guidance for a particular transaction or event is not specified within it, the first source to consider is accounting principles for similar transactions or events within a source of authoritative US GAAP. If no similar transactions are discovered, nonauthoritative guidance from other sources may be considered. Accounting and financial reporting practices not included in the codification are nonauthoritative. Sources of nonauthoritative accounting guidance and literature include, for example, the following:

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

The FASB ASC stipulates that the appropriateness of other sources of accounting guidance depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice (*FASB ASC 105-10-05-3*).

This text takes a historical approach to the development of accounting theory that traces the evolution of accounting standards. As such, we refer to all authoritative pronouncements by their original titles with a parenthetical reference to either the fact that they have been superseded or where they are now contained in the FASB ASC. In the assignment material, for each chapter we have included several cases that utilize the FASB ASC.

The Agenda Consultation Initiative

In August 2016, the FASB issued an invitation to comment (ITC) to solicit feedback about the financial reporting issues that it should consider adding to its agenda. The ITC requested feedback about the following:

1. Are the financial reporting issues described in this ITC areas for which there is potential for significant improvement?
2. What is the priority of addressing each issue?
3. What approach should the FASB take to address each issue?
4. Are there other major areas of financial reporting not described in this ITC that the FASB should consider adding to its agenda?

The FASB noted that it had recently completed many of the major projects on its agenda including Revenue from Contracts with Customers, Recognition and Measurement of Financial Assets and Financial Liabilities, Leases and Measurement of Credit Losses on Financial Instruments. Consequently, the FASB had begun to consider other major areas of financial reporting for which improvement might be warranted and was seeking feedback from stakeholders about financial reporting issues that it should address.

Prior to issuing the ITC, the FASB has received feedback from the Academic Resource Group, which is composed of five accounting academics and the participants at its annual Financial Reporting Issues Conference. These consultations resulted in the FASB identifying four major financial reporting topics to include in the ITC:

1. Intangible assets (including research and development)
2. Pensions and other postretirement benefit plans
3. Distinguishing liabilities from equity
4. Reporting performance and cash flows (including the income statement, segment reporting, other comprehensive income, and the statement of cash flows).

The FASB noted the major financial reporting topics discussed in the ITC will require deliberations on some troubling issues, which will take time to address in a thoughtful manner; consequently, the Board will need to be thoughtful in identifying which financial reporting topics to add to its agenda. The FASB stated that it would consider its current agenda and the feedback collected through the agenda consultation to determine which projects it should address in its future agenda.

Later, in 2017 the Board discussed the results of the staff analysis on the projects included in the ITC and made the following decisions:

- Remove the project on intangibles from its research agenda.
- Remove from its research agenda a project on pensions and other postretirement benefit plans.
- Add to its agenda a project on distinguishing liabilities from equity.
- Add a project to its agenda to focus on the disaggregation of performance information.
- Retain a project associated with improving the structure of the performance statement and developing an operating performance measure.
- Add a project to its agenda on segment reporting.
- Continue its research on potential targeted improvements to the statement of cash flows.

In December 2020, FASB Chair Richard R. Jones announced that the FASB would undertake another agenda consultation process in 2021. To begin the process, the FASB staff sought input from numerous stakeholder groups. During those outreach meetings, stakeholders identified more than 40 topics of potential improvements for the FASB to consider as part of its standard-setting efforts.

On June 24, 2021, the FASB staff issued an ITC. The comment period for the ITC ended on September 22, 2021. Subsequently, the Board summarized the comments received as follows:

- Stakeholders generally agreed that greater disaggregation of financial reporting information – in the income statement, in the statement of cash flows, or in the notes to financial statements – should be a top priority.
- Almost all stakeholders suggested that adding a project that would permit or require companies to account for certain digital assets at fair value should be a top priority.
- The other most frequently cited top priority technical areas by respondents were environmental, social, and governance related transactions and disclosures, intangible assets (including software costs), recognition and measurement of government grants for business entities, and consolidation guidance.
- A majority of respondents supported the Board prioritizing the FASB standard-setting process improvements, particularly as it relates to Codification accessibility, interpretive process, and cost-benefit analysis.
- The most frequently cited low priority technical areas by respondents were materiality consideration for disclosures, balance sheet classification of assets and liabilities, and financial key performance indicators or non-GAAP metrics.

In response to this feedback in December 2021 the FASB announced its research agenda will be comprised of the following projects:

- **Accounting for Exchange-Traded Digital Assets and Commodities** – Explore accounting for and disclosure of a subset of exchange-traded digital assets and exchange-traded commodities.
- **Accounting for and Disclosure of Intangibles** – Potential ways to improve the accounting for and disclosure of intangibles, including software costs, internally developed intangibles, and research and development.
- **Hedge Accounting Phase 2** – Seek stakeholder feedback that could bring further alignment of hedge accounting with risk management activities beyond the targeted improvements made to the hedge accounting model in *ASU No. 2017-12*, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities" and consider changes to the definition of a derivative.
- **Accounting for Financial Instruments with Environmental, Social, and Governance (ESG)-Linked Features and Regulatory Credits** – Explore accounting for and disclosure of financial instruments with ESG-linked features and regulatory credits.
- **Accounting for Government Grants, Invitation to Comment** – Solicit feedback on whether the requirements in *IAS No. 20*, "Accounting for Government Grants and Disclosure of Government Assistance," should be incorporated into GAAP.
- **Agenda Consultation** – Continue to solicit feedback about the financial reporting issues that the Board should consider adding to its agenda and the priority of those issues.

Additionally, the Board will consider adding new projects to the technical agenda, as well as potential changes to existing projects based on feedback received. No further action had been reported at the time this text went to press.

The Role of Ethics in Accounting

Ethics are concerned with the types of behavior society considers right and wrong. Accounting ethics incorporate social standards of behavior as well as behavioral standards that relate specifically to the profession. The environment of public accounting has become ethically complex. The accountants' Code of Professional Ethics developed by the AICPA has evolved over time, and as business transactions have become more and more complex, ethical issues have also become more complex.

The public accountant has a Ralph Nader–type[39] overseer role in our society. This role was described by Chief Justice of the Supreme Court Warren Burger, who maintained that corporate financial statements are the primary source of information available to assist the decisions of the investing public. Consequently, various provisions of the federal securities laws require publicly held corporations to file their financial statements with the Securities and Exchange Commission to control the accuracy of information made available to the public. SEC regulations stipulate that these financial reports must be audited by an independent certified public accountant. The auditor then issues an opinion as to whether the financial statements fairly present the financial position and operations of the corporation for the relevant period.[40]

By certifying the public reports that collectively depict a corporation's financial status, the independent accountant assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders as well as the investing public. This public-watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

The SEC requires the filing of audited financial statements to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries. It is therefore not enough that financial statements be accurate; the public must perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of an outside auditor as an independent professional.

Justice Burger outlined the very important role accountants play in our society. This role requires highly ethical conduct at all times. The role of ethics in accounting is discussed in detail in Chapter 17.

Accounting in Crisis: The Events of the Early 2000s

On January 1, 2001, Enron's stock was selling for more than $90 per share. From that time until the early summer of 2001, 19 investment research firms reviewed its performance and 12 had given it a "strong buy" recommendation, while five others had recommended it as "buy."[41] Additionally, the company's year 2000 annual report indicated that its auditor had not found any significant accounting problems. However, on August 14, 2001, it was announced that the company's president, Jeffery Skilling, had resigned after only six months on the job for "purely personal reasons."

Enron used what were termed *special-purpose entities* (SPEs) to access capital and hedge risk.[42] By using SPEs such as limited partnerships with outside parties, a company may be

[39] Ralph Nadar is an American attorney and political activist noted for his involvement in consumer protection, environmentalism, and government reform causes. He first came to prominence in 1965 with the publication of the bestselling book "Unsafe at Any Speed," a critique of the safety record of American automobile manufacturers. He later leveraged his growing popularity to establish a number of advocacy and watchdog groups.

[40] *U.S. v. Arthur Young and Co. et al.*, U.S. Supreme Court No. 8206871 U.S.L.W. 4355 (U.S. March 21, 1984): 1.

[41] Analysts' recommendations take different forms but can be generally categorized as strong buy, buy, hold, underperform, and sell. This issue is covered in more depth in Chapter 17.

[42] Accounting for SPEs is now guided by the requirements for variable interest entities (VIEs) contained in *FASB ASC 810*. See Chapter 16 for a discussion of VIEs.

permitted to increase its financial leverage and return on assets without reporting debt on its balance sheet.[43]

The arrangement works as follows: An entity contributes fixed assets and related debt to an SPE in exchange for an ownership interest. The SPE then borrows large sums of money from a financial institution to purchase assets or conduct other business without the debt or assets showing up on the originating company's financial statements. The originating company can also sell leveraged assets to the SPE and record a profit. At the time these transactions took place, the FASB required that only 3% of a SPE be owned by an outside investor. If this guideline was met, the SPE did not need to be consolidated and the SPE's debt was not disclosed on the originating company's financial statements.

Enron used SPEs to new degrees of complexity and sophistication, capitalizing them with not only a variety of fixed assets and liabilities but also extremely complex derivative financial instruments, its own restricted stock, rights to acquire its stock, and related liabilities. Additionally, as Enron's financial dealings became more complicated, the company apparently also transferred troubled assets that were falling in value, such as certain overseas energy facilities, its broadband operation, or stock in companies that had been spun off to the SPEs. Consequently, the losses on these assets were kept off Enron's books.

To compensate partnership investors for assuming downside risk, Enron promised to issue additional shares of its stock. As the value of the assets in these partnerships fell, Enron began to incur larger and larger obligations to issue its own stock farther down the road. The problem was later compounded as the value of Enron's stock declined.

On October 16, 2001, the company reported a third-quarter loss and its stock dropped to about $33 a share. On October 28, as some of the problems with the SPEs were made public, a special committee of the board of directors of Enron was established under the chairmanship of William C. Powers, dean of the University of Texas Law School. The Powers Committee Report concluded that some Enron employees were directly involved in the SPEs and were enriched by tens of millions of dollars they never should have received. The committee also found that many of the transactions were designed to achieve favorable financial statement results and were not based on legitimate economic objectives or to transfer risk.

In the meantime, the company's stock went into a free fall. On October 22, 2001, the SEC requested information about the company's off-balance sheet entities, and its stock price fell to just above $20. On November 12, the company announced restated earnings for the period 1997–2000 that resulted in $600 million in losses, and its stock price fell to about $8 per share. On December 2, the company filed for bankruptcy and its stock became virtually worthless. How did this happen? What can be done to prevent similar episodes in the future?

The Enron case was just one in a series of accounting and auditing failures that include HealthSouth, WorldCom, and Tyco. These failures were triggered by a series of events that critics have attributed to the change from a manufacturing to a service economy in the United States and the resulting large increase in consulting services by public accounting firms.

Historically, accounting has been considered a highly trustworthy profession. Public accounting firms trained new accountants in the audit function with oversight from senior partners who believed that their firm's integrity rode on every engagement. That is, new auditors were assigned client responsibility after minimal formal audit training. Most of the training of new accountants took place on-site, and the effectiveness of the new auditor depended on the effectiveness of the instructor.

CPA firms have always called their customers "clients" and have worked hard to cultivate them. Partners routinely entertained clients at sporting events, country clubs, and restaurants, and many CPA firm employees later moved on to work in their clients' firms. Any conflicts in these relationships were at least partially offset by the CPA firm's commitment to professional ethics.

[43] Financial leverage involves the use of debt financing as described in Chapter 11. Return on assets is calculated as net income divided by total assets and is discussed in more detail in Chapter 7.

These relationships changed as information technology advisory services grew in the late 1970s and early 1980s. Also, in the mid-1980s, the AICPA lifted its ban on advertising. As a result, revenue generation became more critical to partners' compensation. Thereafter, the profit structure of CPA firms changed dramatically, and in 1999, revenues for management consulting accounted for more than 50% of the then Big Five's revenue.

As a result, the audit function evolved into a loss leader that public accounting firms offered in conjunction with vastly more lucrative consulting engagements. But as public accounting firms competed more aggressively on price for audit engagements, they were forced by cost considerations to reduce the number of procedures performed for each client engagement. This resulted in increased tests of controls and statistical models and in fewer of the basic, time-consuming tests of transactions that increase the likelihood of detecting fraud. In addition, junior auditors were often assigned the crucial oversight roles usually filled by senior partners, who were otherwise engaged in marketing activities to prospective clients. This reduced the effectiveness of the instructor–new accountant training process.

Two major changes in the accounting profession have taken place in the wake of the accounting scandals:

1. Arthur Andersen, formerly one of the Big Five audit firms, has gone out of business.
2. In July 2002, President George W. Bush signed into law the Sarbanes–Oxley Bill, which imposed a number of corporate governance rules on publicly traded companies.[44]

Enron was the fourth major audit failure affecting Arthur Andersen (AA) since 1999. In May 2001, AA paid $110 million to settle Sunbeam's shareholders' lawsuit. In June 2001, AA agreed to pay a $7 million fine to the SEC in the Waste Management case. AA had already agreed to pay part of a $220 million suit to settle a class action case related to Waste Management, which had overstated income by approximately $1 billion. On May 7, 2002, AA agreed to pay $217 million to settle civil litigation over its audits of the Baptist Foundation of Arizona.

The demise of AA was felt by its employees and across the economy. The company was the fifth-largest auditing firm in the world, employing 85,000 people in 84 countries. In 2001, AA reported US revenues of $9.3 billion. But during that year, the company began to unravel. AA was fined or paid more than $100 million to settle lawsuits for audit problems concerning two clients, Waste Management and Sunbeam. After Enron's October 2002 third-quarter earnings announcement, AA's independence from Enron began to be questioned because the firm had provided significant nonaudit services to Enron in addition to its fees associated with the Enron audit. Andersen received $52 million in fees from Enron. Of this amount, $25 million, or 48%, was for audit-related work. Total fees for other services totaled $27 million. Also, Enron had outsourced some internal audit functions to AA, a practice that is now specifically prohibited by Sarbanes–Oxley.

On January 10, 2002, AA notified the SEC and the Department of Justice that its personnel involved with the Enron engagement had disposed of a significant number of documents and correspondence related to the Enron engagement. Five days later, AA dismissed the lead partner and placed three other partners involved with the engagement on leave. AA also placed a new management team in charge of the Houston office. These moves were in an apparent attempt to distance the firm's home office from the problems concerning Enron.

On February 2, 2002, the Powers report was released. It suggested that the home office of AA was well aware of accounting problems at Enron. As the report stated, the evidence suggested that AA did not function as an effective check on the disclosures reported by Enron. Also, the report noted that AA expressed no concerns to Enron's board of directors about accounting problems at Enron.

[44] The act is discussed in depth in Chapter 17.

In response, on February 3, 2002, AA announced that former Federal Reserve Board Chairman Paul Volcker had agreed to chair an independent oversight board (IOB). The objective of the IOB was to review all policies and procedures of the firm and to ensure the quality and credibility of the firm's auditing process. The IOB had authority to mandate any changes in policies and procedures needed to ensure quality.

In March 2002, the Justice Department openly questioned AA's involvement with Enron and the eventual document shredding. Following a week of negotiations between AA and the US Justice Department concerning a possible criminal indictment for obstructing justice, a criminal indictment against AA was unsealed on March 15. On May 2, a federal jury trial began in Houston. Finally, on June 15, AA was convicted of a single count of obstructing justice. AA was barred from conducting and reporting on the audits of SEC-registered companies after August 2002 and subsequently went out of business.[45]

The Sarbanes–Oxley Public Company Accounting Reform and Investor Protection Act of 2002 (SOX) was passed by Congress to address corporate accountability in response to the financial scandals that had begun to undermine citizens' confidence in US business.[46] In summary, SOX established the Public Company Accounting Oversight Board (PCAOB). The PCAOB has the responsibility of setting auditing standards, reviewing the practices and procedures used by public accounting firms in conducting audits, and ensuring compliance with the provision of the legislation.

SOX also places new legal constraints on corporate executives by requiring corporate presidents and chief financial officers to certify the accuracy of a company's financial statements. Specifically, they are required to indicate that they have reviewed both quarterly and annual filings and that based on their knowledge, the reports do not contain any untrue statements or material misstatements of facts; also, based on their knowledge, the financial information in the reports is fairly presented. Additionally, SOX puts the accounting profession under tightened federal oversight and establishes a regulatory board – with broad power to punish corruption – to monitor the firms and establishes stiff criminal penalties, including long jail terms, for accounting fraud.

Finally, SOX changes the way the FASB is funded. Previously, about a third of FASB's annual budget came from voluntary contributions from public accounting firms, the AICPA, and about one thousand individual corporations. Under SOX, those voluntary contributions are replaced by mandatory fees from all publicly owned corporations based on their individual market capitalization. Additionally, the FASB receives publishing revenue and investment income. Some have called SOX one of the most significant legislative reform packages since the New Deal of Franklin D. Roosevelt,[47] others have likened it to medical history, when a correct diagnosis was followed by an inappropriate or even harmful therapy such as the nineteenth-century practice of bleeding patients who were suffering from fever. This therapy turned out to be the opposite of what is necessary and beneficial because it weakened patients precisely when they needed strength to combat the cause of the fever.[48] The critics of SOX see a flaw in the system in that the auditor is retained and paid by the client, thereby making the auditor beholden to the client and its management. Therefore, the auditor, though he or she might not realize it, ends up seeing things through the eyes of management. While there is still a debate over its impact, SOX has significantly affected the accounting profession.

[45] The conviction was later overturned by the US Supreme Court on the grounds that the federal judge's instructions to the jury were too vague and failed to demand that jurors conclude Andersen knew its actions were illegal. The court did not acquit Andersen, but it sent the case back to the lower court for a retrial. However, the case has not been retried because the firm no longer exists as a viable entity.

[46] Specific provisions of the legislation are discussed in depth in Chapter 17.

[47] R. R. Miller and Pashkoff P. H., "Regulations under the Sarbanes–Oxley Act," *Journal of Accountancy* (October 2002): 33–36.

[48] J. Ronen, Cherny J., and Morris T. W., "A Prognosis for Restructuring the Market for Audit Services," *CPA Journal* 73, no. 5 (May 2003): 6–8.

International Accounting Standards

A truly global economy emerged during the 1990s, as many US companies generated significant amounts of revenue and profits in foreign markets. These multinational companies are faced with decisions on the allocation of resources to their most efficient uses. These allocations cannot be accomplished without accurate and reliable financial information. Companies seeking capital or investment opportunities across national boundaries face cost and time issues. Capital-seeking firms must reconcile their financial statements to the accounting rules of the nation in which they are seeking capital, and investors must identify foreign reporting differences. The increasingly global economy requires that this process be simplified. Thus, there is a push to harmonize international accounting standards.

The IASB is an independent private-sector body that was formed in 1973 to achieve this purpose. Its objectives are as follows:

1. To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance
2. To work generally for the improvement and harmonization of regulations, accounting standards, and procedures relating to the presentation of financial statements.[49]

These objectives have resulted in attempts to coordinate and harmonize the activities of the many countries and agencies engaged in setting accounting standards. The IASB standards also provide a useful starting point for developing countries wishing to establish accounting standards.

The IASB has also developed a conceptual framework originally titled the *Framework for the Preparation and Presentation of Financial Statements*.[50] Later, the FASB and IASB began coordinating their efforts to develop a new conceptual framework and in 2010 issued a revision to their conceptual frameworks that was titled The Conceptual Framework for Financial Reporting by the IASB. However, in late 2010, the FASB deferred further work on the joint project until after other more urgent convergence projects were finalized. Subsequently, in 2012, the IASB decided to reactivate the Conceptual Framework project as an IASB-only project. Subsequently, in 2018, the IASB issued a revised Conceptual Framework for Financial Reporting (CFFR),[51] which contains a comprehensive set of concepts for financial reporting. The publication of CFFR effectively ended the FASB – IASB joint project. (See Chapter 3 for a discussion of the CFFR.)

At the time this book was published, the IASB had issued 41 Statements of Accounting Standards (IASs) and 17 Statements of Financial Reporting Standards (IFRSs). Since it has no enforcement authority, the IASB must rely on the best endeavors of its members. Neither the FASB nor the SEC is a member of the IASB, so its standards have no authority for US companies registered with the SEC at present. However, in 2007, the SEC voted to accept financial statements from foreign private issuers prepared in accordance with IFRSs without reconciliation to generally accepted accounting principles.[52] In 2020, over 500 multinational companies filed their financial reports with the SEC using IFRS.[53] The emergence of multinational corporations resulted in a need for the increased harmonization of worldwide accounting standards.[54] As a result, there was a movement to have IASB standards become US GAAP for US companies. However, the movement stalled in the 2010s and no further work in this area is expected in the near future.

[49] *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 1989).
[50] *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 1989).
[51] *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 2018).
[52] See Chapter 3 for a further discussion of this issue.
[53] https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/view-jurisdiction/united-states/
[54] The role of the IASB is discussed in more detail in Chapter 3, and the IASB standards are reviewed throughout this text in chapters dealing with the issues addressed by each IAS or IFRS.

Cases

Case 1-1 Sources of US GAAP

The FASB ASC is now the sole authoritative source for all US US GAAP.

Required:

a. What are the major goals of the FASB ASC?

b. How is the FASB ASC expected to improve the practice of accounting?

c. What literature is now contained in the FASB ASC?

d. What should an accountant do if the guidance for a particular transaction or event is not specified within the FASB ASC?

Case 1-2 Sources of US GAAP

In 1933 the United States Congress passed the Securities Act of 1933 and in 1934 the Securities Exchange Act of 1934 was enacted. These two pieces of legislation established the Securities and Exchange Commission (SEC) and gave it the authority to prescribe accounting principles and reporting practices. Subsequently, the SEC authorized its Chief Accountant to issue releases interpreting accounting matters to "contribute to the development" of uniform standards in the form of Accounting Series Releases (ASR). Two of the most important of these ASRs were No. 1 and No. 4.

Required:

a. Why was ASR No. 1 issued and what was its main provision?

b. What was the debate surrounding the release of ASR No. 4 and how did this pronouncement resolve that debate?

Case 1-3 Accounting Ethics

When the FASB issues new standards, the implementation date is often 12 months from date of issuance, and early implementation is encouraged. Becky Hoger, 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 Hoger from implementing the standard until it is required.

Required:

a. What, if any, ethical issue is involved in this case?

b. Is the financial vice president acting improperly or immorally?

c. What does Hoger have to gain by advocacy of early implementation?

d. Who might be affected by the decision against early implementation? (CMA adapted)

Case 1-4 Politicalization of Accounting Standards

Some accountants have said that politicalization in the development and acceptance of generally accepted accounting principles (i.e., standard setting) is taking place. Some use the term politicalization in a narrow sense to mean the influence by government agencies, particularly the SEC, on the development of generally accepted accounting principles. Others use it more broadly to mean the compromise that takes place in bodies responsible for developing these principles because of the

influence and pressure of interested groups (SEC, American Accounting Association, businesses through their various organizations, Institute of Management Accountants, financial analysts, bankers, lawyers).

Required:

a. The Committee on Accounting Procedure 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 politicalization (as the term is used in the broad sense) of accounting standard setting? Explain your answer by indicating how the CAP, APB, and 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 standard setting?

c. What arguments can be raised against the politicalization of accounting standard setting? (CMA adapted)

Case 1-5 Generally Accepted Accounting Principles

At the completion of the Darby Department Store audit, the president asks about the meaning of the phrase "in conformity with generally accepted accounting principles," which appears in your audit report on the management's financial statements. He observes that the meaning of the phrase must include more than what he thinks of as "principles."

Required:

a. Explain the meaning of the term *accounting principles* as used in the audit report. (Do not in this part discuss the significance of "generally accepted.")

b. The president 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.

c. The president believes that diversity in accounting practice will always exist among independent entities despite continual improvements in comparability. Discuss the arguments that support his belief.

Case 1-6 The Evolution of the Accounting Profession

The nineteenth century witnessed the evolution of joint ventures into business corporations.

Required:

Discuss how the emergence and growth of the corporate form of business affected perceptions regarding the role of the accounting profession in financial reporting in England and the United States.

Case 1-7 Accounting in Crisis

During the early 2000s, the role of accounting and the auditing profession changed, and several accounting scandals were uncovered.

Required:

a. What conditions caused accounting and the auditing profession role to change during this time?

b. What major changes occurred as a result of the accounting scandals at that time?

Case 1-8 The FASB

The FASB is the official body charged with issuing accounting standards.

Required:

a. Discuss the structure of the FASB.

b. How are the Financial Accounting Foundation members nominated?

FASB ASC RESEARCH

For each of the following research cases, search the FASB ASC database for information to address the issues. Copy and paste the FASB ASC paragraphs that support your responses. Then summarize briefly what your responses are, citing the paragraphs used to support your responses.

FASB ASC 1-1 Variable Interest Entities

In this chapter, we discuss how Enron and other companies used special-purpose entities (SPEs) to keep the effects of transactions and events off corporate balance sheets. Accounting for SPEs is now guided by the requirements for variable interest entities (VIEs).

1. How does the FASB define a VIE? In other words, how does an entity qualify to be a VIE?
2. Is a company that meets the definition of a VIE required to consolidate the VIE?

FASB ASC 1-2 Status of *Accounting Research Bulletins*

Portions of *ARB No. 43* are still considered US GAAP. Three of the most important issues covered in *ARB No. 43* are revenue recognition, treasury stock, and comparative financial statements. Find the appropriate sections of the FASB ASC, originally contained in *ARB No. 43*, that address these issues. Cite the sources and copy the relevant information.

FASB ASC 1-3 Accounting for the Investment Tax Credit

The accounting alternative treatments for the investment tax credit originally outlined in *APB Opinions No. 2* and *No. 4* are still considered US GAAP. Find and cite the FASB ASC paragraphs and copy the relevant information.

FASB ASC 1-4 Securities and Exchange Commission Comments

SEC observers often provide comments at EITF meetings. Find, cite, and copy the observer comments on

1. Revenue recognition – customer payments and incentives
2. Debt with conversions and other options
3. Software cost of sales and services

FASB ASC 1-5 Generally Accepted Accounting Principles Guidelines

Find the guidelines for determining US GAAP in the FASB ASC.

ROOM FOR DEBATE

Debate 1-1 Which Body Should Set Accounting Standards in the United States?

Team Debate:

Team 1: Argue that the SEC should set accounting standards in the United States.
Team 2: Argue that the FASB should set accounting standards in the United States.

Debate 1-2 Should the Scope of Accounting Standards Be Narrowed Further?

Team Debate:

Team 1: Assume you are management. Argue against the narrowing of accounting choices.
Team 2: Assume you are a prospective investor. Argue for the narrowing of accounting choices.