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FINANCIAL ACCOUNTING THEORY AND ANALYSIS
TEXT AND CASES

THIRTEENTH EDITION

WILEY

RICHARD G. SCHROEDER | MYRTLE W. CLARK
JACK M. CATHEY

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Financial Accounting Theory and Analysis

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Preface

Accounting education has experienced many dramatic changes over the life of this accounting theory text. The publication of the thirteenth edition represents over forty years in its evolution. At its inception, much of what was then considered theory was, in reality, rote memorization of rules. In recent years, the globalization of the economy has affected the skills necessary to be a successful accountant and has caused accounting educators to develop new methods of communicating accounting education. Emphasis is now being given to the incorporation of ethics into the curriculum, the analysis of a company's quality of earnings and sustainable income, the use of the World Wide Web as a source of information, the international dimensions of accounting, the development of critical thinking skills, the development of communication skills, and the use of group projects to develop cooperative skills.

This edition of the text is a further extension of the refocusing of the material to suit the needs of accounting professionals into the twenty-first century. Among the new features in this edition that were designed to accomplish this objective are as follows:

- Expanded use of the Web by including cases and updates on the textbook companion site.
- A tutorial on the use of the FASB ASC in the solutions manual.
- A test bank containing more than 250 multiple-choice and more than 200 essay questions.
- Updated disclosure examples throughout the chapters and updated financial analysis sections of each chapter using Hershey and Tootsie Roll as the example companies.
- Over 50 new cases including 10 illustrating the application of the new revenue recognition standard, 8 illustrating the application of fair value and 15 illustrating the application of the new lease standard.
- Updated the international accounting section in each chapter to incorporate recent amendments to IASB standards.
- A discussion of the FASB's proposed change in the definition of materiality and subsequent retraction in Chapters 2 and 17.
- A discussion of the conceptual framework projects on measurement, presentation, and disclosure in Chapter 2.
- A discussion of the status of the conceptual framework projects—elements and recognition and reporting entity in Chapter 2.
- A summary of the status of the remaining joint FASB–IASB convergence projects in Chapter 2.
- A discussion of the IASB's decision to proceed independent of the FASB on the Conceptual Framework Project in Chapter 3.
- A discussion of the IASB new Conceptual Framework in Chapter 3.
- An expanded discussion of behavioral finance in Chapter 4.
- A discussion of value creation reporting in Chapter 4.

- A discussion of sustainability accounting in Chapter 5.
- An expanded discussion of *FASB ASC 606*, "Revenue from Contracts with Customers," in Chapter 5.
- A discussion of The Joint Transition Resource Group in Chapter 5.
- A discussion of how revenues were impacted by the implementation of FASB ASC 606.
- An expanded discussion of Accounting Standards Update 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," in Chapters 7, 8, 10, and 11.
- A discussion of ASU 2016-13 on credit losses in Chapter 8.
- A discussion of ASU 2016-01 relating to the deterioration of a company's own credit risk in Chapter 11.
- A discussion of the accounting implications of the Tax Cuts and Jobs Act of 2017 and its related implementation issues in Chapter 12.
- A discussion of deferred tax assets and liabilities that are all now disclosed as long-term items on the balance sheet Chapter 12.
- A discussion of ASU 2018-02 pertaining to the tax impact of items included in OCI and backward tracing Chapter 12.
- An expanded discussion of ASU 2016-02 on accounting for leases in Chapter 13.
- A discussion of ASU 2016-07, Improving the Presentation of Net Pension and Net Postretirement Benefit Costs in Chapter 14.
- A discussion of the amendments to FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 3, "Qualitative Characteristics of Useful Financial Information" in Chapter 17.

The publication of this text would not be possible without the assistance of many individuals. We are indebted to many colleagues whose comments and criticisms have contributed to the evolution of this text since its inception including Professors Peter Aghimien, James Bannister, Alan Bizzell, Linda Bowen, Gyan Chandra, Nancy Christie, Keith Ehrenreich, Robert Fahnestock, Howard Felt, Susan Hamlen, Joseph Hilmy, Gurav Kumar, Orville Keister, Wilda Meixner, Gary Previts, Doug Schneider, Suzanne Sevin, Katheryn Yarborough, Stephen Zeff, and Ronald Zhao.

CONTENTS

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

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

more correct decisions? Various suggestions on the empirical testing of accounting theories have 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 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*

[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.

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 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.

[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). The SEC was created to administer various securities acts. Under powers provided by Congress, the SEC was given the authority to prescribe accounting principles and reporting practices. Nevertheless, because the SEC has generally acted as an overseer and allowed the private sector to develop accounting principles, this authority has seldom been used. However, the SEC has exerted pressure on the accounting profession and has been especially interested in narrowing areas of difference in accounting practice. (The role of the SEC is discussed in more detail in Chapter 17).

From 1936 to 1938, the SEC was engaged in an internal debate over whether it should develop accounting standards. Even though William O. Douglas (then the SEC chairman and later a Supreme Court justice) disagreed, in 1938, the SEC decided in *Accounting Series Release (ASR No. 4)* to allow accounting principles to be set in the private sector. *ASR No. 4* indicated that reports filed with the SEC must be prepared in accordance with accounting principles that have "substantial authoritative support."[14]

The profession was convinced that it did not have the time needed to develop a theoretical framework of accounting. As a result, the AIA agreed to publish 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

[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).

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. This committee had the authority to issue pronouncements on matters of accounting practice and procedure in order to establish generally accepted practices (US GAAP).

The CAP was relatively inactive during its first two years but became more active in response to the SEC's release of ASR No. 4. The release of ASR No. 4 gave the CAP de facto recognition as the source of *substantial authoritative support,*[16] and one of its first responses was to expand from its original 7–21 members.

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, which 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,

[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.
[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.

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.

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*

[18] Weldon Powell, "Report on the Accounting Research Activities of the American Institute of Certified Public Accountants," *The Accounting Review* (January 1961): 26–31.
[19] The AICPA's Professional Code of Ethics is discussed in more detail in Chapter 17.

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.

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, 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 $23 million a year to support the activities of the FASB. Figure 1.1 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 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;

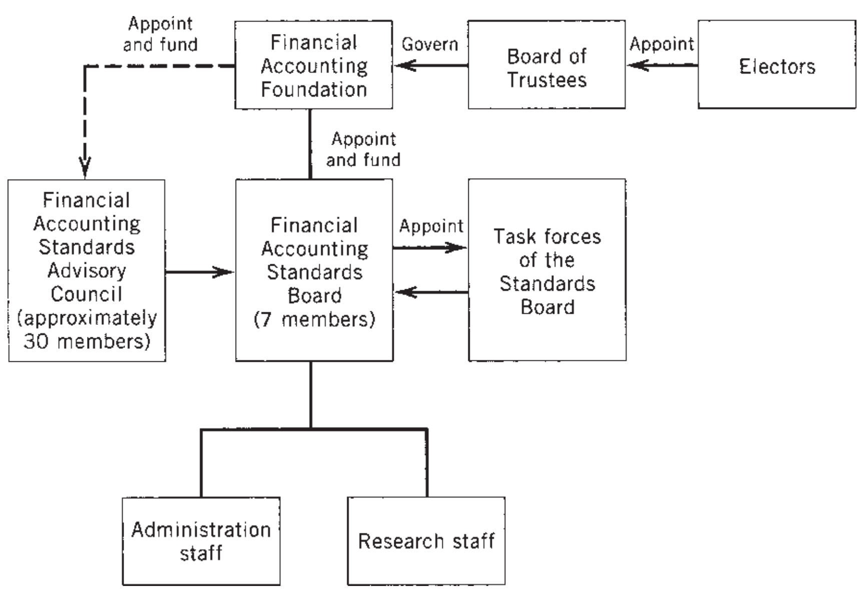

FIGURE 1.1
Structure of the FASB.

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

- 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.

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*. The *SFASs* constitute the FASBs conceptual framework (discussed in Chapter 2). *SFAS*s convey 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

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

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 US GAAPs in one spot.
2. Ensure that the codified content accurately represented authoritative US 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)

[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).

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.

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,"

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[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.
[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.

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 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.

[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.
[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.

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.

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*. 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.[33] *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*.[34] *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

[32] Zeff, "The Evolution of U.S. U.S. GAAP."
[33] *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.
[34] *Statement of Financial Accounting Standards No. 162: The Hierarchy of Generally Accepted Accounting Principles* (Norwalk, CT: FASB, 2008).

FASB Statements, below industry practices that are widely recognized as generally accepted but are not subject to due process.[35]

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
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."[36] 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.[37]

[35] *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).
[36] Arthur Levitt, *The "Numbers Game*" (NYU Center for Law and Business, September 28, 1998).
[37] E. McDonald, "SEC's Levitt Pushes Harder for Changes in Fiscal Reporting and Some Cry Foul," *Wall Street Journal* (November 17, 1998): A2.

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 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 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 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.[38]

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

[38] *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.

had given it a "strong buy" recommendation, while five others had recommended it as "buy."[39] 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.[40] By using SPEs such as limited partnerships with outside parties, a company may be permitted to increase its financial leverage and return on assets without reporting debt on its balance sheet.[41] 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

[39] 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.
[40] 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.
[41] 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.

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.

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.[42]

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

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

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.

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.[43]

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.[44] 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. But the fees are to be collected by the PCAOB, and the SEC oversees the PCAOB. Some

[43] 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.

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

have called SOX one of the most significant legislative reform packages since the New Deal of Franklin D. Roosevelt,[45] 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.[46] 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.

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[47]

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*.[48] 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),[49] which contains a comprehensive set of concepts for financial reporting. (See Chapter 3 for a discussion of the CFFR).

[45] R. R. Miller and Pashkoff P. H., "Regulations under the Sarbanes–Oxley Act," *Journal of Accountancy* (October 2002): 33–36.
[46] 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.
[47] *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 1989).
[48] *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 1989).
[49] *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 2018).

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.[50] In 2018, over 400 multinational companies filed their financial reports with the SEC using IFRS. As noted in Chapters 2 and 3, there is also a movement to have IASB standards become US GAAP for US companies. The emergence of multinational corporations has resulted in a need for the increased harmonization of worldwide accounting standards.[51]

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 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 1-3 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).

[50] See Chapter 3 for a further discussion of this issue.
[51] 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.

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 1-4 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 1-5 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 1-6 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 1-7 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.

The Pursuit of the Conceptual Framework

2

The Conceptual Framework Project (CFP) is contained in the various FASB *Statements of Financial Accounting Concepts* (SFACs) and represents an attempt by the Financial Accounting Standards Board (FASB) to develop concepts useful in guiding the Board in establishing standards and in providing a frame of reference for resolving accounting issues. Chapter 1 summarized the development of accounting from its early stages until the present. This review revealed that accounting practices were initially developed in response to changing economic conditions, and no attempts were made to establish a "theory of accounting" prior to the twentieth century. Subsequently, individual writers and authoritative bodies undertook efforts to explain the goals of accounting. Most of the initial approaches were more descriptive of existing practice than normative in nature. Later efforts have attempted to develop and build on a normative theory of accounting.

The Early Theorists

Although debates about issues such as the existence of a science of accounting and the need to develop a theoretical framework began to appear in the early 1900s,[1] the first attempts to develop accounting theory in the United States have been attributed to William A. Paton and John B. Canning.[2] Paton's work, based on his doctoral dissertation, was among the first to express the view that all changes in the value of assets and liabilities should be reflected in the financial statements and that such changes should be measured on a current-value basis.[3] He also maintained that all returns to investors (both dividends and interest) were distributions of income, and consequently, he espoused the entity concept rather than the prevailing proprietary concept.[4] An additional contribution of this work was an outline of what Paton believed to be the basic assumptions or postulates underlying the accounting process. Paton's basic assumptions and postulates can be viewed as the first step in the development of the conceptual framework of accounting. Canning's work suggested a framework for asset valuations and measurement based on future expectations as well as a model to match revenues and expenses.[5] At this time, the balance sheet was viewed as the principal financial statement, and the concept of capital maintenance was just emerging.

During this early period, significant contributions to the development of a conceptual framework of accounting were also made by DR Scott.[6] Scott was viewed as an outsider; however, his writings have proved to be quite insightful. Scott was originally trained as an economist and

[1] See, for example, A. Smith, "The Abuse of Audits in Selling Securities," *AAPA Year Book* (1912): 169–180; and H. R. Hatfield, *Modern Accounting: Its Principles and Some of Its Problems* (New York: Appleton, 1909).
[2] S. A. Zeff, "The Evolution of the Conceptual Framework for Business in the United States," *Accounting Historians Journal* 26, no. 2 (December 1999): 89–131.
[3] W. A. Paton, *Accounting Theory - with Special Reference to Corporate Enterprises* (New York: Roland Press, 1922).
[4] The proprietary theory holds that a firm's assets belong to its owners, whereas under the entity theory the firm and its owners are viewed as separate. See Chapter 15 for a discussion of this issue.
[5] J. B. Canning, *The Economics of Accountancy* (New York: Roland Press, 1929).
[6] Scott had no first name. He was named DR and used the two initials without spacing or punctuation in his publications.

was heavily influenced by the views of his colleague, the economist, and philosopher Thorstein Veblen. He adopted Veblen's view that many academics were overly occupied with refining the details of existing theories when there was a need for the reexamination of fundamental assumptions. Both Scott and Veblen viewed the Industrial Revolution as changing the fundamental fabric of our society. An example of the way Veblen influenced Scott is contained in Lawrence and Stewart[7]:

> *Veblen believed men acquired habits of thought unconsciously and the thoughts men get are shaped by their daily activities. Any change in daily activities, such as that occasioned by the Industrial Revolution, would be expected to lead to a major shift in previous habits of thought. Scott saw the scientific method as the new habit of thought coming to dominance.*

Scott believed the Industrial Revolution caused managers to look for new methods of maintaining organizational control. As a result, scientific methods such as accounting and statistics became tools of organizational control.

Scott contributed to the development of accounting theory by recognizing the need for a normative theory of accounting. This view, described in several publications from 1931 to 1941, evolved into a description of his conceptual framework in "The Basis for Accounting Principles."[8]

In his first important work, *The Cultural Significance of Accounts*, Scott argued that accounting theory was not a progression toward a static ideal but rather a process of continually adapting to an evolving environment.[9] The notion of adaptation later became one of Scott's principles in his conceptual framework. He approached accounting from a sociological perspective. The basic premise presented in *Cultural Significance* was that the economic basis of any culture is shaped by the institutional superstructure of the society in question. This view later evolved into his orientation postulate.

Scott's next important work was a response to the American Accounting Association's (AAA) "A Tentative Statement of Principles Underlying Corporate Financial Statements" (discussed later in the chapter). Scott criticized the AAA monograph as having a too-narrow view of accounting in that it addressed only accounting's transaction function.[10] Rather, he saw accounting as encompassing other important functions, such as managerial control and the protection of the interests of equity holders. He also viewed accounting as having both an internal control function and an external function to act for the protection of various economic interests such as stockholders, bond holders, and the government.

Although Scott's first two works contain what were to become elements of his conceptual framework, the first step in its articulation is contained in "Responsibilities of Accountants in a Changing Environment."[11] In this work, he again alluded to the influence of the Industrial Revolution on a changing economy and saw it as requiring improved financial reporting to meet the needs of all investors. Scott supported Paton's earlier acceptance of the entity theory and went on to emphasize that accounting must meet the needs of external users. This view is an example of why Scott was considered an outsider because the prevailing view was that accounting should be designed to benefit the firm's management or proprietor (the proprietary theory).

In 1941, Scott unveiled his conceptual framework in "The Basis for Accounting Principles."[12] He maintained that it could serve as a vehicle for the development of internally consistent

[7] C. Lawrence and J. P. Stewart, "DR Scott's Conceptual Framework," *Accounting Historians Journal* 20, no. 2 (December 1993): 104.
[8] DR Scott, "The Basis for Accounting Principles," *The Accounting Review* (December 1941): 341–349.
[9] DR Scott, *The Cultural Significance of Accounts* (Lawrence, KS: Scholars Book Co., 1973).
[10] DR Scott, "The Tentative Statement of Principles," *The Accounting Review* (September 1937): 296–303.
[11] DR Scott, "Responsibilities of Accountants in a Changing Environment," *The Accounting Review* (December 1939): 396–401.
[12] Scott, "The Basis for Accounting Principles."

accounting principles. Scott's framework includes the following hierarchy of postulates and principles to be used in the development of accounting rules and techniques.

- *Orientation Postulate.* Accounting is based on a broad consideration of the current social, political, and economic environment.
- *The Pervasive Principle of Justice.* The second level in Scott's conceptual framework was justice, which was seen as developing accounting rules that offer equitable treatment to all users of financial statements.
- *The Principles of Truth and Fairness.* Scott's third level contained the principles of truth and fairness. Truth was seen as an accurate portrayal of the information presented. Fairness was viewed as containing the attributes of objectivity, freedom from bias, and impartiality.
- *The Principles of Adaptability and Consistency.* The fourth level of the hierarchy contained two subordinate principles, adaptability and consistency. Adaptability was viewed as necessary because society and economic conditions change; consequently, accounting must also change. However, Scott indicated a need to balance adaptability with consistency by stating that accounting rules should not be changed to serve the temporary purposes of management.

Even a cursory review of Scott's framework reveals how far ahead of his time he was. His ideas were later incorporated by Moonitz in "Accounting Research Study No. 1" and by the AAA in *A Statement of Basic Accounting Theory* (both discussed later). It was not until much later that the deductive approach to accounting theory that Scott had advocated since the early 1930s began to be employed by authoritative standard-setting bodies.

Early Authoritative and Semiauthoritative Organizational Attempts to Develop the Conceptual Framework of Accounting

In the mid-1930s, professional organizations became interested in formulating a theory of accounting. In 1936 the American Accounting Association released a monograph titled "A Tentative Statement of Accounting Principles Affecting Annual Corporate Reports."[13] The monograph's goal was to provide guidance to the recently established Securities and Exchange Commission (SEC); however, it was widely criticized by academics as relying too heavily on the historical cost model and the convention of conservatism.[14] To its credit, the AAA statement highlighted the distinction between the current operating performance and all-inclusive concepts of income, which continues to be discussed today as the issue of sustainable income.[15]

In 1938, the American Institute of Accountants (AIA)[16] also published a monograph, *A Statement of Accounting Principles*, written by Thomas H. Sanders, Henry Rand Hatfield, and Underhill Moore, that ostensibly described accounting theory.[17] The goal of this publication was to provide guidance to the SEC on the best accounting practices. However, the study did not accomplish its objective because it was viewed as a defense of accepted practices rather than an attempt

[13] American Accounting Association, *A Tentative Statement of Accounting Principles Affecting Corporate Annual Reports* (Evanston, IL: AAA, 1936).
[14] See, for example, Scott, "The Tentative Statement of Principles"; and G. Husband, "Accounting Postulate: An Analysis of the Tentative Statement of Accounting Principles," *Accounting Review* (December 1937): 386–410.
[15] See Chapter 5 for a discussion of this issue.
[16] The AIA was later renamed the American Institute of Certified Public Accountants (AICPA).
[17] T. H. Sanders, H. R. Hatfield, and U. Moore, *A Statement of Accounting Principles* (New York: AICPA, 1938).

to develop a theory of accounting.[18] In 1940, the AAA published a benchmark study by Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards*.[19] Although this study continued to embrace the use of historical cost, its major contribution was the further articulation of the entity theory. It also described the matching concept, whereby management's accomplishments (revenue) and efforts (expenses) could be evaluated by investors. This monograph was later cited as developing a theory that has been used in many subsequent authoritative pronouncements.[20]

Standard-setting bodies were initially reluctant to deal with the issue of accounting theory. At its inception, the Committee on Accounting Procedure (CAP) had considered developing a comprehensive set of accounting principles but dropped the idea because of the belief that the SEC might not be patient enough to allow the CAP sufficient time to develop the project and, therefore, might decide to develop its own accounting standards. Subsequently, the CAP had both internal disagreements and disagreements with the SEC over a number of issues. These disagreements were at least partially caused by the CAP's case-by-case issuance of accounting standards that in many instances were inconsistent owing to the lack of an overall theory of accounting.

By 1958, the CAP's problems caused the president of the American Institute of CPAs (AICPA), Alvin R. Jennings, to voice the belief that additional research was needed to examine accounting assumptions and develop authoritative pronouncements.[21] Jennings established the Special Committee on Research Programs to review and make recommendations on the AICPA's role in establishing accounting principles. The committee's report proposed the establishment of the Accounting Principles Board (APB) to replace the CAP.[22] It also proposed the establishment of a research division to assist the APB. The committee report identified four broad levels that the development of financial accounting should address: postulates, principles, rules for the application of principles to specific situations, and research.[23]

The committee's definition of these levels avowed that "postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment of the business community."[24] The committee report stated that a fairly broad set of coordinated accounting principles should be formulated based on postulates. The committee's first charge to the APB's research division was to commission studies on the postulates and principles that would serve as the foundation for future authoritative pronouncements. This can be viewed as the first real attempt to establish a conceptual framework of accounting by an authoritative body.

The AICPA accepted the committee's recommendations, and in 1959, the APB replaced the CAP. An accounting professor, Maurice Moonitz, was chosen as the APB's director of research. He took on the responsibility of developing the accounting postulates and appointed another accounting professor, Robert T. Sprouse, to collaborate with him on the principles research study. The outcome was a disaster.

The postulates study, *The Basic Postulates of Accounting*, "Accounting Research Study No. 1," was published in 1961.[25] It consisted of a hierarchy of postulates encompassing the environment, accounting, and the imperatives as summarized in Box 2.1 on page 31.

[18] See, for example, W. A. Paton, "Comments on 'A Statement of Accounting Principles,'" *Journal of Accountancy* (March 1938): 196–207; and A. Barr, "Comments on 'A Statement of Accounting Principles,'" *Journal of Accountancy* (April 1938): 318–323.
[19] W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Sarasota, FL: American Accounting Association, 1940).
[20] R. K. Storey, "Conditions Necessary for Developing a Conceptual Framework," *Journal of Accountancy* (June 1981): 84–96.
[21] A. R. Jennings, "Recent Day Challenges to Financial Reports," *Journal of Accountancy* (January 1958): 28–34.
[22] American Institute of Certified Public Accountants, *Report of the Special Committee on Research* (New York: AICPA, 1959).
[23] Ibid., 63.
[24] Ibid.
[25] M. Moonitz, *The Basic Postulates of Accounting*, "Accounting Research Study No. 1" (New York: AICPA, 1961).

BOX 2.1 Basic Postulates of Accounting

Group A: Economic and Political Environmental Postulates

This group is based on the economic and political environment in which accounting exists. They represent descriptions of those aspects of the environment that Sprouse and Moonitz presumed to be relevant for accounting.

A-1. Quantification
Quantitative data are helpful in making rational economic decisions. Stated differently, quantitative data aid the decision-maker in making choices among alternatives so that the actions are correctly related to consequences.

A-2. Exchange
Most of the goods and services that are produced are distributed through exchange and are not directly consumed by the producers.

A-3. Entities
Economic activity is carried on through specific units of entities. Any report on the activity must identify clearly the particular unit or entity involved.

A-4. Time Period (Including Specification of the Time Period)
Economic activity transpires during specifiable time periods. Any report on that activity must specify the period involved.

A-5. Unit of Measure (Including Identification of the Measuring Unit)
Money is the common denominator in terms of which goods and services, including labor, natural resources, and capital, are measured. Any report must clearly indicate which monetary unit is being used.

Group B: Accounting Postulates

The second group of postulates focuses on the field of accounting. They are designed to act as a foundation and assist in constructing accounting principles.

B-1. Financial Statements (Related to A-1)
The results of the accounting process are expressed in a set of fundamentally related financial statements that articulate with each other and rest on the same underlying data.

B-2. Market Prices (Related to A-2)
Accounting data are based on prices generated by past, present, or future exchanges that have actually taken place or are expected to.

B-3. Entities (Related to A-3)
The results of the accounting process are expressed in terms of specific units or entities.

B-4. Tentativeness (Related to A-4)
The results of operations for relatively short periods are tentative whenever allocations between past, present, and future periods are required.

Group C: Imperative Postulates

The third group differs fundamentally from the first two groups. They are not primarily descriptive statements; instead, they represent a set of normative statements of what should be rather than statements of what is.

C-1. Continuity (Including the Correlative Concept of Limited Life)
In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

C-2. Objectivity
Changes in assets and liabilities and the related effect (if any) on revenues, expenses, retained earnings, and the like should not be given formal recognition in the accounts earlier than the point of time at which they can be measured objectively.

C-3. Consistency
The procedures used in accounting for a given entity should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period.

C-4. Stable Unit
Accounting reports should be based on a stable measuring unit.

C-5. Disclosure
Accounting reports should disclose that which is necessary to make them not misleading.

The general reaction to the release of *ARS No. 1* was that the results were self-evident and consequently didn't serve any useful purpose.[26] It was also not possible to determine whether the postulates could be transferred into a useful set of principles, because the principles study was not published until the next year.

The principles study, *Accounting Research Study No.* 3, "A Tentative Set of Broad Accounting Principles for Business Enterprises" (published in 1962), argued for the use of current values in accounting measurements.[27] The authors advocated different methods of determining current value for various balance sheet items such as replacement cost for inventories and plant and equipment and the use of discounted present values for receivables and payables. Although the use of discounted present values for accounting measurements is widely accepted today and guidelines for its use are outlined in *Statement of Financial Accounting Concepts No. 7* (discussed later in the chapter), this concept was foreign to most accountants in the early 1960s. These views were also in conflict with the SEC's long-term advocacy of historical cost accounting. The result was that the APB dismissed the two studies as too radically different from U.S. GAAP for acceptance at that time. In fact, *ARS No. 3* was published with what amounted to a de facto disclaimer by the APB, which stated: "The Board believes . . . that while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time."[28]

Consequently, the APB was again faced with the same problems that daunted its predecessor, the CAP, when it dealt with issues case by case without an underlying foundation on which to base decisions. In an attempt to solve this problem, the APB commissioned another study by a retired practitioner, Paul Grady. The result, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, was, in essence, a summary of the then-accepted current U.S. GAAP.[29] Therefore, the APB still had little in the way of a foundation on which to base its decisions on current issues.

Later, in the mid-1960s, the APB engaged in another attempt to develop a theory of accounting. A committee was formed and given the charge to enumerate and describe the basic concepts to which accounting principles should be oriented and to state the accounting principles to which practices and procedures should conform. The original intention of this project was to develop a comprehensive theory of accounting. The published statement, *Accounting Principles Board Statement No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,"[30] started off well by advocating the user approach suggested by the AAA's "A Statement of Basic Accounting Theory" (discussed later in the chapter) and defined accounting as a service activity whose function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.[31]

APB Statement No. 4 also addressed a new issue, the sophistication of users. It concluded that "users of financial statements should be knowledgeable and understand the characteristics and limitations of financial statements."[32] Unfortunately, the definition provided for the

[26] W. Vatter, "Postulates and Principles," *Journal of Accounting Research* (Autumn 1963): 163–76.
[27] R. T. Sprouse and M. Moonitz, *A Tentative Set of Broad Accounting Principles for Business Enterprises* (New York: AICPA, 1962).
[28] "News Report," *Journal of Accountancy* (April 1962): 9–10.
[29] P. Grady, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, "Accounting Research Study No. 7" (New York: AICPA, 1965).
[30] *Accounting Principles Board Statement No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (New York: APB, 1965).
[31] Ibid., para. 9.
[32] Ibid., para. 131.

elements of the financial statements was again based on current accepted practice in that assets and liabilities were defined as being "recognized and measured in conformity with generally accepted accounting principles,"[33] and U.S. GAAP was defined as being the consensus at a particular time.

As a result, the committee worked for five years before once again coming up with what was basically a description of existing practices. In addition, the APB's report was published as a statement rather than as an opinion; consequently, its recommendations did not encompass U.S. GAAP and could be ignored without violating Rule 203 of the AICPA Code of Ethics, which requires compliance with accounting principles promulgated by an authoritative body.

It should be noted that the members of the CAP and APB were mainly accounting practitioners who apparently had little interest in developing a normative theory of accounting. In an attempt to fill this void, the AAA published *A Statement of Basic Accounting Theory (ASOBAT)* in 1966.[34] This monograph defined accounting as "the process of identifying, measuring and communicating economic information to permit informed judgments and decision by users of the information."[35]

The members of the committee were mainly academics, so they looked on accounting as an information system. Therefore, they saw communication as an integral part of the accounting process. In addition, the inclusion of the term *economic income* broadened the scope of the type of information to be provided to assist in the allocation of scarce resources. The committee also embraced the entity concept by indicating that the purpose of accounting was to allow users to make decisions. In essence, they were defining accounting as a behavioral science whose main function was to assist in decision-making. Consequently, the committee adopted a decision-usefulness approach and identified four standards to be used in evaluating accounting information: relevance, verifiability, freedom from bias, and quantifiability. *ASOBAT* maintained that if these four standards could not be attained, the information was not useful and should not be communicated. *ASOBAT* noted the inherent conflicts between relevance and verifiability in making one final recommendation. The monograph called for the reporting of both historical cost (verifiable) and current cost (relevant) measures in financial statements. The current cost measures to be used included both replacement cost and price-level adjustments.

The publication of *ASOBAT* resulted in diverse opinions. Robert Morrison, the committee's only practitioner, voted for the monograph's release but requested that his concerns be published as a commentary at the end of the document. Morrison indicated that *ASOBAT* did not fulfill the committee's charge because it offered little in the way of basic accounting theory as the foundation for accounting principles. He also disagreed with the reporting of current cost information on the basis that it lacks verifiability.[36] On the other hand, another committee member, George Sorter, objected to the user needs approach because it assumed that user needs are known and well specified enough to allow information to be supplied to meet those needs.[37] Finally, one of the leading accounting theorists of the time, Robert Sterling, stated that *ASOBAT* contained very little that was new. He also found it to be inconsistent and not completely logical. For example, he questioned the committee's rationale for reporting current costs because historical cost was deficient. He asked, "If historical cost is so inadequate, why report it at all?"[38]

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[33] Ibid.
[34] American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston, IL: AAA, 1966).
[35] Ibid., 1.
[36] Ibid., 07.
[37] G. Sorter, "An Events Approach to Basic Accounting Theory," *The Accounting Review* (January 1969): 12–19.
[38] R. Sterling, "*ASOBAT:* A Review Article," *Journal of Accounting Research* (Spring 1967): 95–112.

The criticism of the APB resulted in yet another attempt to develop a conceptual framework of accounting. In a manner similar to *ASOBAT*, the Trueblood Committee's report on the objectives of financial statements (see Chapter 1) embraced the decision-usefulness criteria as the primary basis for the preparation and presentation of financial information. This committee was charged by the AICPA with proposing fundamental objectives of financial statements to guide the improvement of financial reporting. It was to find the answers to four questions:

1. Who needs financial statements?
2. What information do they need?
3. How much of the needed information can be provided by accountants?
4. What framework is needed to provide the needed information?

The Trueblood Committee adopted a normative approach as well as a user orientation in maintaining that financial statements should serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities. The committee report specified the following four information needs of users:

1. Making decisions concerning the use of limited resources
2. Effectively directing and controlling organizations
3. Maintaining and reporting on the custodianship of resources
4. Facilitating social functions and controls.[39]

Like its predecessors, the Trueblood Committee had difficulty agreeing on the answers to the questions proposed by the AICPA. As a result, it indicated that its final report be regarded as a first step in the process. The report summarized the following objectives for financial reporting:

1. The basic objective of financial statements is to provide information useful for making economic decisions.
2. An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.
3. An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows in terms of amount, timing, and related uncertainty.
4. An objective of financial statements is to provide users with information for predicting, comparing, and evaluating enterprise earning power.
5. An objective of financial statements is to supply information useful in judging management's ability to use enterprise resources effectively in achieving its primary enterprise goal.

[39] American Institute of Certified Public Accountants, *Objectives of Financial Statements* (New York: AICPA, 1973). The fourth purpose can be seen as derived from the work of Scott.

6. An objective of financial statements is to provide factual and interpretative information about transactions and other events that is useful for predicting, comparing, and evaluating enterprise earning power. Basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction, or estimation should be disclosed.
7. An objective is to provide a statement of financial position useful for predicting, comparing, and evaluating enterprise earning power.
8. An objective is to provide a statement of periodic earnings useful for predicting, comparing, and evaluating enterprise earning power.
9. Another objective is to provide a statement of financial activities useful for predicting, comparing, and evaluating enterprise earning power. This statement should report mainly on factual aspects of enterprise transactions having or expecting to have significant cash consequences. This statement should report data that require minimal judgment and interpretation by the preparer.
10. An objective of financial statements is to provide information useful for the predicting process. Financial forecasts should be provided when they will enhance the reliability of the users' predictions.
11. An objective of financial statements for governmental and not-for-profit organizations is to provide information useful for evaluating the effectiveness of the management of resources in achieving the organization's goals. Performance measures should be quantified in terms of identified goals.
12. An objective of financial statements is to report on the enterprise's activities affecting society that can be determined and described or measured and that are important to the role of the enterprise in its social environment. This objective was an attempt to draw attention to those enterprise activities that require sacrifices from members of society who do not benefit from those activities.[40]

In addition, the Trueblood Committee report addressed the issues of the fallibility of single numbers in the financial statements and current costs. With respect to the former, the committee suggested that single number measurements that do not indicate possible ranges and dispersions in describing events that are subject to uncertainty. With respect to current costs, the committee maintained that the stated objectives of financial reporting could not be achieved by using a single valuation basis such as historical cost. It concluded that different valuation bases should be used for different assets. The objectives enumerated by the Trueblood Committee became the basis for the first release in the FASB's Conceptual Framework Project, *Statement of Financial Accounting Concepts No. 1*.

Statement on Accounting Theory and Theory Acceptance

The unsettled standard-setting process in the early 1970s caused the AAA to again consider accounting theory. In 1973, the AAA Committee on Concepts and Standards for External Financial Reports was charged with updating *ASOBAT* in light of the many changes in accounting that had taken place since it was originally issued. The committee deliberated over a four-year period. Because appointments to the committee were for two years, the committee membership changed

[40] Ibid.

during the second two-year period; however, six original members remained on the committee. Its report, *Statement on Accounting Theory and Theory Acceptance* (*SATTA*), turned out not to be an update of *ASOBAT*, but rather a review of the status of accounting theory and its acceptance.[41]

The committee's rationale for this approach was stated as follows:

> *Fundamental changes have occurred since the publication of ASOBAT. The basic disciplines traditionally utilized by accounting theory have been altered considerably, and accounting researchers have enthusiastically employed their new tools, perspectives and analytical techniques to explore a wide range of accounting issues from new directions.*[42]

The committee's conclusion was that a single, universally accepted basic accounting theory did not exist. The committee's basis for this conclusion is examined in the following paragraphs.

SATTA first embarked on a review of accounting theories and found that many theories explained narrow areas of accounting. The committee noted that although there was general agreement that the purpose of financial accounting is to provide economic data about accounting entities, divergent theories had emerged because of the way different theorists specified users of accounting data and the environment. For example, *users* might be defined either as the owners of the accounting entity or, more broadly, to include creditors, employees, regulatory agencies, and the general public. Similarly, the environment might be specified as a single source of information or as one of several sources of financial information. The various approaches to accounting theory were condensed into three categories: classical, decision usefulness, and information economics.

The Classical Approach

The studies grouped into this category covered the period from 1922 to 1962, with the exception of one monograph from 1975. *SATTA* maintained that all these works were deductive in nature and criticized them as generally disconnected in that they did not cite or build on previous work. It was noted that many of the authors of these works were trained in economics because at the time, most universities did not offer PhD degrees in business, and those that did required much work in economic theory. As a consequence, many authors included in this category were influenced by the neoclassical economic "theory of the firm," which ignores historical cost and generally advocates the use of current values. *SATTA* subclassified the studies in this group into the deductive (true income) school and the inductive school. The deductive school theorists held that income measuring a single valuation base would meet the needs of all users. Studies included under this category were those by Paton, Moonitz and Sprouse, and Moonitz. Inductive school studies were viewed by *SATTA* as attempting to rationalize or justify existing accounting practice. The studies under this category included those by Hatfield and Littleton.[43]

The Decision-Usefulness Approach

The decision-usefulness category studies, which include the AAA's "Tentative Statement," the Sanders, Hatfield, and Moore monograph, *ASOBAT*, and the Trueblood Report, were seen as focusing on the recognition that usefulness is a basic objective of accounting. This approach stresses the use of decision models. Once a particular decision model is chosen, information relevant to the model is specified, and accounting alternatives are compared to the data necessary

[41] American Accounting Association, Committee on Concepts and Standards for External Financial Reports, *Statement on Accounting Theory and Theory Acceptance* (Sarasota, FL: AAA, 1977).
[42] Ibid., ix.
[43] It is interesting to note that DR Scott was not even mentioned in *SATTA*.

for implementing the model. For example, the Trueblood Report stated that the basic objective of financial accounting is to provide information useful for making economic decisions.

A second focus of studies included under this category revolves around research that examined the reactions by decision-makers to reporting alternatives. Examples include the behavioral accounting studies discussed in Chapter 4 and a classic study by Ball and Brown investigating the information content of accounting numbers.[44]

Information Economics

The studies grouped into this category were viewed as using economic theory to specify the information necessary to make economic decisions. They treat information as a commodity that has costs and prices and examine whether regulation of external financial reporting is desirable. *SATTA* apparently included this category as an emerging method of developing accounting theory; however, information economics has not gained the prominence *SATTA* anticipated.

Criticisms of the Approaches to Theory

SATTA next embarked on a discussion of why none of the approaches to theory had gained general acceptance and raised six issues.

1. *The problem with relating theory to practice.* The real world is much more complex than the world specified in most accounting theories. For example, most theory descriptions begin with unrealistic assumptions, such as holding several variables constant.
2. *Allocation problem.* Allocation is an arbitrary process. For example, the definition of depreciation as a *rational* and *systematic* method of allocation has led to a variety of interpretations of these terms.
3. *The difficulty with normative standards.* Normative standards are desired states; however, different users of accounting information have different desired states. As a result, no set of standards can satisfy all users.
4. *The difficulties in interpreting security price behavior research.* Market studies (such as the efficient market studies discussed in Chapter 4) attempt to determine how users employ accounting numbers. These studies have attempted to control for all variables except the one of interest, but there have been disagreements over whether their research designs have actually accomplished this goal.
5. *The problem of cost–benefit considerations accounting theories.* A basic assumption of accounting is that the benefits derived from adopting a particular accounting alternative exceed its costs. However, most existing theories do not indicate how to measure benefits and costs.
6. *Limitations of data expansion.* At the time *SATTA* was published, a view was emerging that more information is preferable to less. Subsequent research has indicated that users have a limited ability to process accounting information. (The issue of human information processing is discussed in Chapter 4.)

The next section of *SATTA* noted that although the evolutionary view of accounting had considerable appeal, the evidence suggests that the existing accounting literature was inconsistent with that view. It suggested that the process of theorizing in accounting was more revolutionary

[44] R. Ball and P. Brown, "An Empirical Evaluation of Accounting Income Numbers," *Journal of Accounting Research* (Autumn 1968): 159–178.

than evolutionary and turned to a perspective developed by Kuhn.[45] He suggested scientific progress proceeds in the following order:

1. Acceptance of a paradigm[46]
2. Working with that paradigm by doing normal science
3. Becoming dissatisfied with that paradigm
4. Searching for a new paradigm
5. Accepting a new paradigm.

SATTA suggested that accounting theory at that time was in step 3 of this process because a number of theorists had become dissatisfied with the matching approach to specifying the content of financial reports.

Evaluation of SATTA

If the newly formed FASB was looking for a sense of direction from *SATTA*, they were undoubtedly disappointed. *SATTA*'s contention that no universally accepted theory of accounting was then in existence in essence left it up to the FASB to develop one. The FASB responded with its Conceptual Framework (discussed in the next section). *SATTA*'s focus on the philosophy of science perspective is not without its detractors. Peasnell concluded that *SATTA*'s theory approaches do not constitute paradigms,[47] because a paradigm is much more than a set of hypotheses. He also doubted the appropriateness of applying Kuhn's theory to accounting:

> *Accounting is not a science, it is a service activity. Accounting, therefore, should be equated not with the sciences, but with fields like medicine, technology and law, of which the principal raison d'être is an external social need.*[48]

Peasnell also criticized *SATTA*'s distinction between the classical and decision-usefulness approaches as "artificial."[49] Finally, he suggested that the inability of *SATTA* to reach a consensus was influenced by the committee that wrote *SATTA* because it was composed of several members who had strong advocacy positions on various approaches to theory development.

The FASB's Conceptual Framework Project

A motivating factor in the development of the CFP was the FASB's observation about the difficulties its predecessor, the APB, had experienced. As discussed earlier, the APB commissioned two studies on postulates and broad principles of accounting that were rejected as too radically different. Later, another committee was commissioned that produced *APB Statement No. 4*, which also was not fully accepted because it was viewed as a list of current practices rather than as a guide.

The CFP initially attempted to develop principles or broad qualitative standards to permit the making of systematic rational choices among alternative methods of financial reporting. Subsequently, the project focused on how these overall objectives could be achieved. As a result, the CFP is a body of interrelated objectives and fundamentals. The objectives identify the goals and

[45] T. Kuhn, *The Structure of Scientific Revolutions*, 2nd ed. (Chicago: University of Chicago Press, 1970).
[46] *SATTA* defined a paradigm as "a kind of world view and focus for research" (*SATTA*, p. 42).
[47] K. Peasnell, "Statement on Accounting Theory and Theory Acceptance: A Review Article," *Accounting and Business Research* (Summer 1978): 217–228.
[48] Ibid., 220.
[49] Ibid., 222.

purposes of financial accounting, whereas the fundamentals are the underlying concepts that help achieve those objectives. These concepts are designed to provide guidance in three areas:

1. Selecting the transactions, events, and circumstances to be accounted for
2. Determining how the selected transactions, events, and circumstances should be measured
3. Determining how to summarize and report the results of events, transactions, and circumstances.

The FASB intends the CFP to be viewed not as a package of solutions to problems but rather as a common basis for identifying and discussing issues, for asking relevant questions, and for suggesting avenues for research.

Initially, the CFP was developed solely by the FASB who initially issued seven SFACs. At the same time – as discussed in Chapter 3 – the International Standards Board was developing its own CFP titled *Framework for the Preparation of Financial Statements*. In October 2004, the FASB and IASB announced a joint project aimed at developing an improved common conceptual framework that was to build on their existing frameworks. The project work plan consisted of a set of stages or phases. The project

1. focused on changes in the environment since the original frameworks were issued, as well as omissions in the original frameworks, in order to efficiently and effectively improve, complete, and converge the existing frameworks;
2. gaged priority to addressing and deliberating those issues within each phase that were likely to yield benefits to the Boards in the short term – that is, cross-cutting issues that affect a number of their projects for new or revised standards. Consequently, work on several phases of the project was to be conducted simultaneously, and the Boards expected to benefit from work being conducted on other projects;
3. initially considered concepts applicable to private-sector business entities. Later, the Boards were to jointly consider the applicability of those concepts to private-sector not-for-profit organizations.

The project work plan had a total of eight phases. Each of the first seven phases was expected to involve planning, research, and initial Board deliberations on major aspects of the Boards' frameworks and to result in an initial document that would seek comments on the Boards' tentative decisions for that phase. This was to be followed by a period of redeliberations – the Boards' consideration of constituents' comments and redeliberations of the tentative decisions. Although the Boards might have sought comments on each phase separately, they did not preclude seeking comments on several phases concurrently. An eighth phase was to be used to address any remaining issues.

The eight phases of the CFP, discussed in greater detail later in the chapter, are as follows:

A. Objectives and qualitative characteristics
B. Definitions of elements, recognition, and derecognition
C. Measurement
D. Reporting entity concept
E. Boundaries of financial reporting, and presentation and disclosure
F. Purpose and status of the framework
G. Application of the framework to not-for-profit entities
H. Remaining issues, if any.

This single conceptual framework was to serve as the foundation for the development of financial accounting and reporting. In 2010, the FASB and IASB issued two chapters as part of this joint project to develop an improved, converged conceptual framework for financial accounting and reporting.

The initial and joint CFPs have resulted in the issuance of eight *Statements of Financial Accounting Concepts* (*SFACs*)*: No. 1:* "Objectives of Financial Reporting by Business Enterprises" (superseded); *No. 2:* "Qualitative Characteristics of Accounting Information" (superseded); *No. 3:* "Elements of Financial Statements of Business Enterprises" (superseded); *No. 4:* "Objectives of Financial Reporting by Nonbusiness Organizations" (because the focus of this text is financial accounting, *SFAC No. 4* will not be discussed here); *No. 5:* "Recognition and Measurement in Financial Statements of Business Enterprises"; *No. 6:* "Elements of Financial Statements" (*SFAC No. 6* replaced *SFAC No. 3*); *No. 7:* "Using Cash Flow Information and Present Value in Accounting Measurements"; and *No. 8*: Conceptual Framework for Financial Reporting (Chapters 1 and 3), which replaces *SFAC No. 1* and *SFAC No. 2* and marks the completion of the first phase of the new joint CFP. Additional chapters were to be added to *SFAC No. 8* as additional phases of the CFP were completed.

The CFP does not directly affect practice, and the SFACs are not intended to invoke application of Rules 203 or 204 of the Code of Professional Ethics, which specify how deviations from U.S. GAAP are to be disclosed. *SFAC*s affect practice only by means of their influence on the development of new accounting standards.

The FASB itself is the most direct beneficiary of the CFP. SFACs provide the Board with a foundation for setting standards and tools to use in resolving accounting and reporting questions. They also provide a framework that can be used to consider the merits of alternatives and promote greater efficiency in internal and external communications. The FASB staff is guided by pertinent concepts in the SFACs that might provide guidance in developing its analysis of issues for consideration by the Board. Discussion of the CFP concepts used was included in the basis for conclusions section of every new SFAS before the Accounting Standards Codification was adopted in 2009. Although the CFP does not provide all of the answers, it narrows the alternatives and eliminates those that are inconsistent with it. It is also used to guide the development of neutral standards, which aid in the allocation of scarce resources and the efficient function of capital markets.

An additional benefit of the CFP is reduction of the influence of personal bias on standard setting. Without the guidance provided by the conceptual framework, standard setting would be based on the individual personal frameworks of the members of the Board. This could result in inconsistent standards over time as the members and their individual frameworks change. Without a frame of reference, a rational debate cannot occur, and the appropriate treatment is in the eye of the beholder. The CFP also helps users of financial information better understand that information and its limitations because it provides a frame of reference for preparers, auditors, students, and faculty. A common conceptual framework should also be useful to facilitate the convergence of U.S. and International accounting standards. Figure 2.1, on page 41, provides an overview of the FASB's conceptual framework for financial accounting and reporting.[50]

The conceptual framework contains three levels. The apex, the first level, identifies the **objective of financial reporting** – that is, the purpose of financial reporting. The second level outlines the fundamentals, which are the **qualitative characteristics** that make accounting information useful, and the **elements of financial statements** (assets, liabilities, and so on). The third level identifies the implementation guidelines of **recognition, measurement, and disclosure** used in establishing and applying accounting standards and the specific concepts to put into

[50] Adapted from William C. Norby, "FASB Exposure Draft: 'Reporting Income, Cash Flows, and Financial Position of Business Enterprises," *Financial Analysts Journal* 38, no. 2 (March–April 1982): 22.

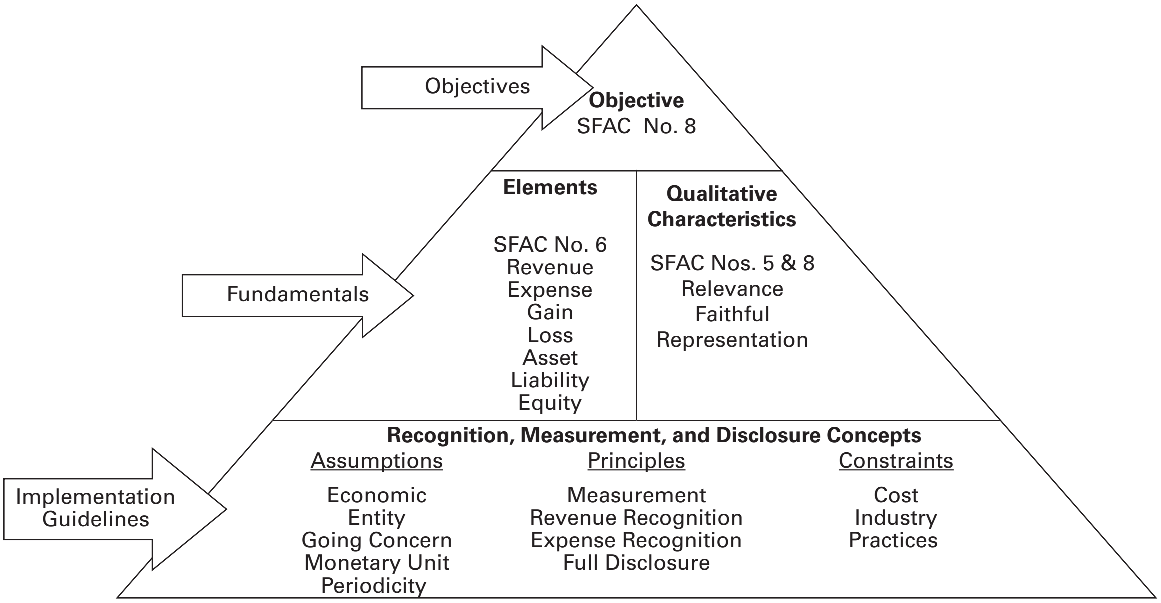

FIGURE 2.1 **The FASB's Conceptual Framework for Financial Accounting and Reporting.**

practice the objective. These guidelines include the assumptions, principles, and constraints that describe the present reporting environment. The specific content of *SFAC Nos. 8, 5, 6,* and *7* as currently constituted is summarized in the following paragraphs.

Statement of Financial Accounting Standards No. 8

Chapter 1 of *SFAC No. 8* states that the objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to current and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not capital providers.

The objective of financial reporting is the foundation of the conceptual framework. Other aspects of the framework – qualitative characteristics, elements of financial statements, recognition, measurement, and disclosure – flow logically from the objective. Those aspects of the framework help to ensure that financial reporting achieves its objective.

The second level of the CFP contains the fundamental concepts. They provide the conceptual building blocks and include the qualitative characteristics of accounting information and the elements of financial statements.

Chapter 3 of *SFAC No. 8* identifies the *qualitative characteristics* of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes. These characteristics may be viewed as a hierarchy as illustrated in Figure 2.2.

Primary Users

The primary users of financial information are existing or potential investors, lenders, and other creditors, that is, its capital providers.

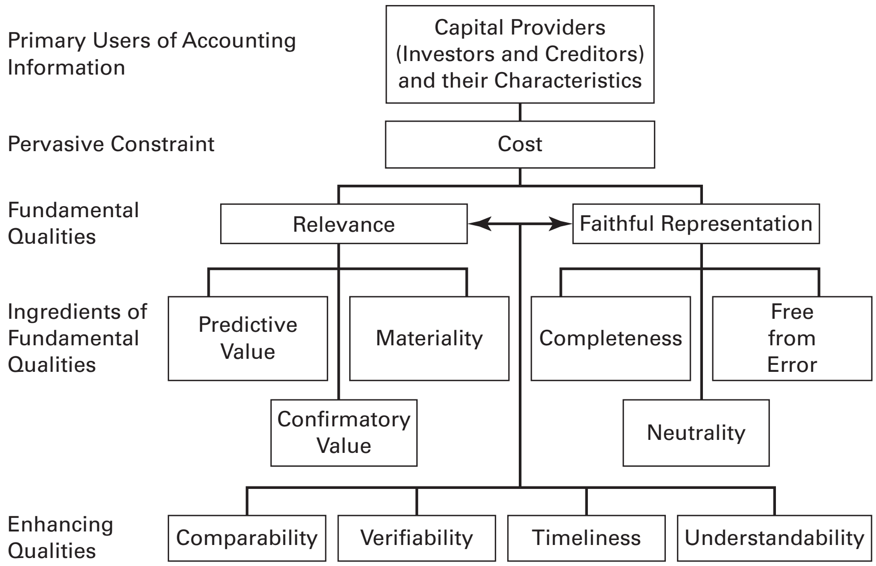

FIGURE 2.2 The Qualitative Characteristics of Accounting Information.

Cost Constraint

Cost is described in *SFAC No. 8* as a pervasive constraint on the information that can be provided by financial reporting. The measurement, summarization, and reporting of financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.[51] This type of analysis is made on several levels. Companies must decide whether the benefits of providing financial information outweigh the costs involved in collecting, processing, verifying, and disseminating that information. Users of financial information must decide whether the benefits of analyzing and interpreting the information provided outweigh their costs. Regulators must assess whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. For example, the FASB, in applying the cost constraint in developing a proposed financial reporting standard, seeks information from providers of financial information, users, auditors, academics, and others about the expected nature and quantity of the benefits and costs of that standard. This assessment is generally based on a combination of both quantitative and qualitative information.

Qualitative Characteristics

The qualitative characteristics are described in Chapter 3 of *SFAC No. 8* and outlined above in Figure 2.2. They distinguish between better (more useful) information and inferior (less useful) information. These qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision usefulness of information. The two fundamental qualities that make accounting information useful for decision-making are *relevance* and *faithful representation*.

Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value and confirmatory value and is material. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena but also must faithfully represent the phenomena that it purports to represent. A perfectly faithful representation has three

[51] This is termed cost–benefit analysis.