CHAPTER 1

FINANCIAL ACCOUNTING REGULATIONS AND ORGANIZATIONS

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1.1 THE SOCIAL ROLE OF FINANCIAL ACCOUNTING

This chapter provides background on the environment in which financial accountants carry on their activities, including the specific organizations that regulate or otherwise affect those activities. Although the accounting profession has historically largely been self-regulated, the collapse of Enron and WorldCom has led to the passage of the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB), which is charged with overseeing the accounting profession. No financial accountant can practice properly without understanding these organizations and how they not only constrain but also assist the performance of financial accounting and reporting services.

(a) THE OBJECTIVE OF FINANCIAL ACCOUNTING. An important beginning point for understanding the social role and importance of financial accounting is identifying the objective that it should meet. Although there are many opinions as to what the objective should be, the most authoritative and influential is this definition provided by the Financial Accounting Standards Board (FASB) in its Conceptual Framework project, which was intended to develop a unified theory of accounting (see Subsection 1.3(a)(v)):

> Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

Thus, according to this definition, the goal is to provide information that allows users to reach better decisions than they would without it. (For simplicity, the FASB uses the term *financial reporting* to encompass the activities of "financial accounting and reporting," which includes presenting both financial statements and the additional financial information that accompanies them. This chapter uses the term *financial accounting* in this broader sense.)

Usefulness may exist at the individual company level if management provides reports to investors and creditors when seeking financing or fulfilling various stewardship reporting responsibilities. Although this perspective undoubtedly explains why some aspects of accounting are regulated, it does not really provide an adequate basis for understanding the substantial governing structure. Instead, an economy-wide perspective is needed.

(b) AN ECONOMY-WIDE PERSPECTIVE. This section addresses two key points that are helpful for understanding why financial accounting is important for the entire economy. The first section explains the connection between the well-being of society and the information that is presented in financial statements. The second section expands on the point in the first section that effective capital markets are central to an efficient economy. It also explains how effective capital markets are efficient processors of information.

(i) From Society's Well-Being to the Financial Statements. The diagram in Exhibit 1.1 summarizes the following discussion by showing the links between a society's well-being and the availability of useful financial statements. An important ingredient in providing for the well-being of society's members is a sound economy.

Although a variety of factors contribute to a sound economy, such as an abundance of natural resources, a stable political system, and an appropriate work ethic, one of the most critical is

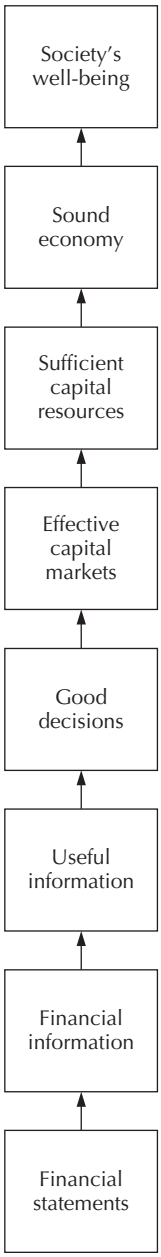

Exhibit 1.1 The role of financial accounting in society.

the availability of sufficient capital resources. Without adequate capital, manufactured goods and services cannot be produced or distributed to persons who want or need them.

In turn, sufficient capital resources are made available through effective capital markets in which those who need capital can obtain it from those who are ready to provide it. If these market participants can conduct their activities in an environment free from excessive mistrust or other

similar uncertainties, they are able to establish fair prices for the capital in the form of expected returns. Consequently, fair prices will encourage the flow of more capital into the markets.

In order for the markets to be effective, their participants must reach good decisions about where to invest or obtain capital under appropriate terms for the risks involved. If decisions are made haphazardly, capital will not be allocated at a fair price to those who will use it most appropriately, and the economy will not contribute as much to social well-being.

A number of elements affect the ability to reach good decisions, and one of these is useful information. If capital market participants have no information or only false, misleading, or late information, then their decisions are not likely to be good. With useful information, they can assess the risks associated with alternative strategies and establish the appropriate price for the capital.

Naturally, many different kinds of information are useful to decision makers. Some may relate to a particular company, an industry, or the national and world economies. Some types of information may be rooted in past events, whereas others are predictions of future events and conditions. Of particular importance to the capital markets is financial information, which consists of monetary measures of factors related to alternative strategies.

Finally, one source of financial information is the financial statement (and other information) that users of capital resources distribute to capital market participants. Although this information by itself is insufficient for making the capital markets work well, it is generally considered to be helpful. Furthermore, the existence of a regular reporting system brings discipline to the process. Because corporate managers know that efforts to mislead the market will generally be revealed when the statements are published, they are less likely to present fabrications.

The important economic role of financial statements causes society to be concerned about the activities of financial accountants and justifies setting up controls and other regulatory devices to help ensure the availability and usefulness of the information. As should be expected, these controls are aimed at preventing irregularities in the financial reporting system.

(ii) Market Efficiency. The word *efficiency* is used in two different ways to describe markets. In economic theory, an efficient market is capable of allocating resources quickly and without friction. These allocations are efficient because equilibrium prices (where supply and demand curves cross) are reached quickly and uniformly across the entire market. In order to be efficient in allocating resources, a market must have a number of characteristics, including competition among a large number of buyers and sellers. Perhaps most importantly, it must have large amounts of useful information about the resources that are being traded. As described, the primary social role for financial accounting is to provide this information to the capital markets.

The second meaning of *efficiency* refers to a market's ability to gather and process this information. In this sense, an *efficient market* is able to respond quickly and appropriately to new relevant and reliable information, without regard to its source. This concept has been developed and advanced over the last 30 years in finance and accounting research into the functioning of U.S. capital markets, especially the New York Stock Exchange (NYSE).

On one level, this proposition that capital markets are efficient processors of information makes a great deal of sense because there are large incentives for market participants to gather and analyze useful information and then react to it quickly before others learn about it. These incentives also encourage the participants to seek out information wherever it can be found, even (perhaps especially) if it is not in published financial statements. In fact, the most useful information is that which no one else knows.

This point does not mean that financial statements are not useful to the capital markets; however, it does suggest that financial statements play a different role than the one that has traditionally been attributed to them.

This point does mean that sophisticated market participants must clearly understand accounting principles and the impact of management's choices among the available alternative principles. Because of this understanding, the market is able to react appropriately to the signals that it receives. As a result of this sophistication, the market does not react naively to accounting choices that are intended to present favorable results. For example, a decision by management to change

from last in, first out (LIFO) inventory costing to first in, first out (FIFO) in a period of rising prices will lead to higher reported earnings. It would be naive to expect the company's stock price to increase because of the higher reported earnings because, in fact, its future cash outflows have been increased by the larger income tax payments resulting from the change. In the same way, an efficient capital market would not be misled by other accounting policy choices. In addition, an efficient market would be able to understand and act on the effects of unreported revenues and expenses. For example, a major controversy was created by a 1993 proposal (eventually leading to Statement of Financial Accounting Standards No. 123, SFAS 123) that would cause companies to report compensation expense equal to the value of stock options granted to their employees. A naive view of the market would argue that recognizing this expense would produce lower stock prices because it would cause reported income to be lower. This view assumes that the market is either unaware of or oblivious to the effects of the compensation because they are not presently included in the earnings calculation. Some opponents of the proposal argued that this expense should not be reported because it is not a real cost. If they are right in the sense that the expense does not really exist, then the act of reporting it would not affect stock prices because the efficient capital market would simply ignore the reported amount and establish appropriate stock prices despite the "noise" in the financial statements.

In addition to the logical arguments in favor of the proposition that U.S. capital markets are efficient, a great deal of systematic research has generated evidence that suggests that they are generally quite efficient. Although there is evidence that the markets are not perfectly efficient, there is abundant support for the broad notion that they cannot be fooled by differences generated solely by choosing different accounting methods.

(c) THE PARTICIPANTS IN THE FINANCIAL REPORTING SYSTEM. Financial accounting does not take place in a sterile arena; rather, the people who conduct it have very real but quite different interests in the process and its outcome.

The primary communication channel is between financial statement preparers and financial statement users. Generally, preparers are accountants who work for corporations or other entities that need capital resources or that have stewardship reporting responsibilities. Users are investors, creditors, or advisors to those who want to commit resources to an entity or who have already done so. The self-interests of preparers and users clearly are in potential conflict.

Preparers want the reporting system to provide information that will help them get low-cost capital or that will cause them to appear to have lived up to their responsibilities. Preparers are also concerned about the costs of preparing and distributing reports and thus prefer reporting less information to fewer people. However, the efficiency of the capital markets suggests that preparers (and the stockholders of their companies) are likely to be better off if more information is reported.

Users, in contrast, are looking for truthful, inexpensively obtained, and dependable information that will enable them to make new decisions or evaluate old ones. As described above, they are not well served by information that misleads them through deliberate or inadvertent bias. If users receive unreliable information, the cost of capital will rise to compensate them for the added risks. If this mistrust is widespread, the economy will suffer because the capital markets will not be as efficient. Users also tend to want readily available, abundant information. This tendency is counterbalanced by the desire to have unique information, which is key to earning higher returns (because no one else is privy to it).

To reduce the uncertainty about the dependability of the financial statements, the services of auditors partially assure users that the preparers have not abused the reporting system by providing biased, incomplete, or otherwise misleading information. In effect, the auditors increase the credibility of financial statements. However, like the other participants, auditors have self-interests. In particular, they prefer dealing with information that is objective and can be verified because they are concerned (and reasonably so) about the possibility of second guessing by users who suffer losses after using audited information that turns out to have been incorrect. The trend in financial accounting standards to use fair values in lieu of historical costs can only exacerbate their concerns.

In summary, the three main participating groups have highly conflicting interests. In general, preparers want information that can be cheaply produced and will make them look good; users want

unique information that no one else has; and auditors want information that can be successfully defended. In contrast, society needs the capital market to have widely available and inexpensive decision-useful information. Because of these conflicts, financial accounting and financial accountants have been and will continue to be subject to regulation.

This need for protecting society's interest has also led to regulating the activities of users through prohibitions against trading securities on the basis of inside or other misappropriated information. These rules are designed to assure that all market participants are playing a fair game, so that they are less likely to add undeserved risk penalties to the returns that they will accept from their investments.

(d) TYPES OF REGULATIONS FOR ACCOUNTANTS. There are three general categories of regulations for financial accounting: standards for practice, standards for competence, and standards for behavior.

(i) Standards for Practice. One effective regulatory policy is to establish rules governing the choice of accounting practices used in preparing financial statements. When companies use uniform accounting practices, they generate more comparable information than when each company makes its own choices. Reduction or elimination of alternative practices will also reduce or eliminate discretionary choices by preparers who are trying to present more favorable pictures. In addition, a set of practice standards gives auditors a basis for questioning or defending their clients' choices.

The standards used in financial accounting are known collectively as generally accepted accounting principles (GAAP). Originally, *general acceptance* denoted a consensus among a relatively small population of accountants that one particular practice was more common than others and therefore was presumably more useful. However, as practices grew more complex and required effective regulation, *general acceptance* has come to include designation by an authoritative body that particular accounting principles are suitable for use. Principles lacking this authoritative support are considered inappropriate.

A similar need exists for the conduct of audit procedures. Correspondingly, the practices to be applied in audits are known collectively as generally accepted auditing standards (GAAS). *General acceptance* here was also originally indicative of a consensus among practitioners but has come to mean *authoritatively mandated*. However, the PCAOB dropped the term *generally accepted auditing standards* from its vocabulary. Since its Standards are not based on the same process by which AICPA auditing standards had been set, it uses the term *rules*. The AICPA continues to use the term GAAS for standards issued for audits (private company, government and not for profit audits) that are not subject to PCAOB oversight.

Although the obvious main purpose of GAAP and GAAS is to provide guidance to practitioners, the standards also provide some assurance to statement users about the quality of the information they receive. In addition, they serve as an after-the-fact basis for evaluating the decisions of preparers or auditors. If accounting policies or practices prove to have been contrary to generally accepted standards, the persons who chose to use them can be more easily held responsible for injury resulting from those choices. Knowledge of GAAP and GAAS should help users understand (1) what the statements do and do not describe and (2) how much reliance should be placed on them.

(ii) Standards for Competency. In addition to controlling accountants' practices, society also regulates the competence of individual accountants. By distinguishing between those who are or are not competent and by empowering only the competent accountants to perform critical tasks, useful information is more likely to be delivered to the capital markets. In addition, providing unique identification of competent accountants simplifies the search for them.

In the United States, the most common competence indicator is the license to practice as a certified public accountant (CPA). This license is granted by individual states and other jurisdictions, such as the District of Columbia, through an agency often called the State Board of Accountancy. Even though each state requires a candidate to pass the Uniform CPA Examination, there is substantial diversity in the additional requirements. Most states, but not all, require 150 hours of college

education for licensure. Most states, but not all, grant certificates only after a candidate completes one, two, or more years of experience in public accounting. Some states also distinguish between certification and the license to practice. Aside from a generally recognized credential indicating a skill set in accounting, auditing, taxes and related subjects, the CPA designation permits the accountant to sign audit opinions on audits of public companies and practice before the SEC. In addition to the initial hurdles, most states impose "continuing professional education" (CPE) requirements designed to maintain the quality and the most up-to-date status of the CPA's competence. Some accountants in some states carry the designations Public Accountant or Registered Accountant. These individuals hold licenses that predate the creation of existing CPA requirements, particularly those involving formal education. In effect, these individuals were "grandfathered" when new laws were passed and were allowed to continue holding this designation. (*Public accounting* has been difficult to define precisely, but it is generally recognized as the offering of accounting services for fees to the public in general as opposed to the performing of accounting services solely for a single employer, whether a business, a not-for-profit entity, or a government agency.)

The CPA designation is not lost when the individual leaves public practice and is an important credential on the resumes of many accountants who work for corporations and government agencies. Other designations have been developed to provide additional evidence of the competence (or to provide evidence for those who choose not to qualify as CPAs) of accountants who are not in public practice.

The Certified Management Accountant certificate was developed by the Institute of Management Accountants (IMA). Although there is a rigorous examination and a requirement for experience as a management accountant to hold the CMA certificate, this designation does not grant the holder any special privileges or licenses to do anything not granted to ordinary citizens. Nonetheless, it is sought after and respected. CMAs are also required to complete ongoing CPE requirements in order to maintain their competency.

The Certified Internal Auditor (CIA) certificate is similar to the CMA, and is administered by The Institute of Internal Auditors. This designation does not grant any special statutory rights or responsibilities to persons who hold it. It is proving to be an important credential for advancement in the internal auditing profession.

(iii) Standards for Behavior. In addition to standards for practice and competence, financial accountants are also subject to standards for behavior in the form of codes of ethics or codes of conduct. These standards distinguish between good and bad actions by accountants. To be meaningful, the codes must require more of accountants than other laws or morals demand of nonaccountants.

The accountancy laws in the various states generally incorporate a set of ethical standards. If the state authority determines that a CPA has violated these standards, it may revoke or suspend the license to practice. In other situations (generally involving some technical error), the authority may merely require remedial education.

Nongovernmental professional organizations have also established ethics codes to apply to their members. Under this arrangement, membership carries a higher standard of performance than would be faced without it. It also exposes the member to another investigative and sanctioning authority. The return to the member is a higher perceived level of ethics and some protection against the misdeeds of other less ethical practitioners. The most significant of these bodies is the American Institute of Certified Public Accountants (AICPA). There are other societies (also associations and institutes) at the state level. The Institute of Management Accounting also sanctions unethical CMAs, and The Institute of Internal Auditors sanctions unethical CIAs.

(e) REGULATORY AGENCIES AND ORGANIZATIONS. Regulations and standards concerning practices and behavior are created by various agencies and organizations, some of which have already been mentioned. They often have the power to enforce the rules that they (or other organizations) have produced. These agencies can be classified into three categories: governmental agencies, standard setting organizations, and professional societies.

(i) Governmental Agencies. The greatest regulatory power over financial accountants is held by governmental agencies established by legislative action to protect the public interest.

The most significant of these agencies is the federal Securities and Exchange Commission (SEC), which was created by the Securities Exchange Act of 1934. Among other powers, it was granted authority to establish accounting and auditing standards, and to discipline accountants (including preparers and auditors) who do not live up to those standards or to other professional standards of conduct. Although the SEC's jurisdiction extends only to the management, accountants, and other agents of companies whose securities are registered with it (approximately 17,000 in 2002), its influence is great because these registrants include the largest corporations in the United States. Furthermore, their accountants (internal and external) compose the most influential and powerful segments of the profession. Substantial additional information about the SEC is presented in Subsection 1.2(a) of this chapter.

As mentioned previously, the Sarbanes-Oxley Act of 2002 establishes a new entity, the PCAOB, to oversee the audit of public companies. Although the PCAOB is not an agency or establishment of the U.S. government, its existence and statutory authority is codified in federal law. The PCAOB duties include: (1) accepting the registration of all accounting firms that audit one or more SEC registrants, (2) establishing or adopting auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for SEC registrants, (3) conducting inspections of accounting firms that audit one or more SEC registrants, and (4) investigating and, if necessary, sanctioning accounting firms that audit one or more SEC registrants for substandard practice. The PCAOB will function subject to SEC oversight. Substantial additional information about the PCAOB is presented in Subsection 1.2(b).

As mentioned earlier, each CPA falls under the jurisdiction of a state board of accountancy (see Subsection 1.2(c)). A CPA must meet the ethical requirements established at this level in order to obtain or keep the license.

(ii) Accounting Standard Setting Organizations. In a unique blend of public statutory authority and private voluntary submission, two nongovernmental, nonprofit organizations—the FASB and the Governmental Accounting Standards Board (GASB)—create financial accounting standards. Both organizations are located in Norwalk, Connecticut, and operate under the funding and management of the Financial Accounting Foundation (FAF).

The FASB has power and influence through its designation in 1973 by the SEC as the authoritative source of accounting principles to be used in financial statements filed by SEC registrants. The FASB also gains authority through other organizations' endorsements, most notably state boards of accountancy, the AICPA, and state professional societies. An additional source of influence is participation in its deliberative processes by others affected by financial accounting, most notably statement preparers and users. Despite the importance of the FASB to the SEC (and to the effectiveness of capital markets), the Board does not receive funds directly from the federal government. However, contributions to the FASB by individuals and corporations are tax deductible, with the result that the Board is essentially subsidized through reduced costs for the donors. The PCAOB has continued to support the FASB as the source of financial accounting standards.

The GASB's influence is limited to establishing accounting principles used by state and local (but not federal) government entities. Its power comes through its endorsement by a variety of professional organizations composed of governmental accountants and governmental agencies, including state legislators and state auditors. Unlike the FASB, the GASB is partially funded through amounts appropriated by a number of state legislatures. It also receives some funds from the federal government, specifically the General Accounting Office (GAO).

More details about these unique and important Boards are presented in Subsections 1.3(a) and 1.3(b).

(iii) Professional Societies. Of the voluntary professional societies regulating the practices of accountants, the largest by far is the AICPA, with approximately 330,000 members. This size allows it to have a large permanent staff of several hundred individuals who are responsible for

regulating and providing services to the membership. The AICPA also depends on an even larger number of members to carry out its tasks through various committees. Institute membership is entirely voluntary but is virtually obligatory for CPAs who wish to stay informed and to practice at the highest levels in the profession. The auditing standards of the AICPA are set by the Auditing Standards Board, a 19-member board representing large and small audit practices, academic, government, and user groups. Estimates are that over 300,000 non-public company audit reports are issued annually. In contrast, there are less than 15,000 public companies, but the capitalization of the largest 20 percent of these public companies dwarfs the value of the smaller public and private entities that are audited.

Although similar to the AICPA, state societies of CPAs are separately funded and operated entities. They are also a curious blend of regulatory authority and service providers. Individuals who want to influence the profession in their state consider membership to be essential. All states also have their own professional organizations, which are called societies, associations, or institutes, according to local preference. They duplicate and complement the activities of the AICPA by offering CPE, publishing newsletters and journals, and providing opportunities for service and leadership through committee membership. Substantial ethics enforcement activity occurs at the state level and is controlled through a cooperative agreement with the AICPA, company referred to as JEEP. Recent years have seen state organizations playing a more active part in representing the profession's interests in state legislatures.

Through the Joint Ethics Enforcement Program (JEEP), the Ethics Division of the AICPA staff works with state societies and members of Institute ethics subcommittees to conduct investigations of alleged violations or to concur with findings conducted at the state level. These investigations attempt to establish only prima facie evidence that a section of the Code of Conduct was violated without trying to determine whether the member intended to violate it. JEEP leverages the expertise of the Institute staff to improve the overall quality and efficiency of the work that would otherwise have to be separately performed at the state level. This quality control helps ensure that the investigations protect the rights of the respondents while gathering appropriate evidence. Information about possible violations comes from other CPAs, clients, enforcement agencies, and public information, such as the *Wall Street Journal*, the *Public Accounting Report*, and SEC Accounting and Auditing Enforcement Releases. Despite the large investment in ethics enforcement, the most extreme disciplinary action that the AICPA can take is to revoke membership, in which case the CPA is no longer subject to the Institute's authority. However, the embarrassment may be substantial.

Other national societies exist, including several that are fairly large. Two of these are the IMA and the Financial Executives International (FEI), both of which generally consist of individuals who are not in public practice. Indeed, they can be characterized as organizations representing the interests of statement preparers. The Institute of Management Accountants (IMA) was originally called the National Association of Cost Accountants, and still draws most of its membership from management accountants. Nonetheless, it has played a leadership role in financial accounting standards setting through its position as one of the sponsoring organizations of the FASB. The primary units of IMA are its local chapters, which operate autonomously in order to best meet the interests of their own members. The Association also has developed a set of Standards of Ethical Conduct for Management Accountants, which requires the accountant to tell the truth to all who receive financial reports, including management and external users. The IMA administers the CMA examination and awards the CMA certificate to persons meeting all the requirements.

The Financial Executives International (FEI) is smaller than the IMA because it draws its membership from only those accountants who have substantial responsibilities in the financial area of their companies, including reporting. In addition, the FEI limits the number of members from any given company. However, because FEI members occupy higher level positions in large entities, the FEI often has more influence, particularly in dealing with the FASB as another of the sponsoring organizations. Another national organization is the American Accounting Association (AAA), which was originally created as a professional society for accounting educators. Through the middle of the twentieth century, the membership was more eclectic and included not only

instructors but many practitioners. However, during the 1970s and 1980s, the AAA lost a large number of its members who were practicing accountants and became more and more oriented toward academic issues and services. Apart from the influence of individual members and the AAA's participation as a "sponsoring organization" of the FASB, it does not affect financial accounting practice to any great degree. As the major organization of accounting educators, the American Accounting Association (AAA) hopes to influence the long-term development of financial and other kinds of accounting. To this end, the greatest emphasis of the Association has been on promoting and disseminating research in accounting and finance. The AAA publishes three journals, *The Accounting Review*, *Accounting Horizons*, and *Issues in Accounting Education*. *The Accounting Review* tends to include the most rigorous and highest quality research articles published by the AAA. *Accounting Horizons* tends to publish more applied research articles. The AAA is a sponsoring organization of the FASB, and one Board member seat has always been occupied by an academic accountant. However, the Association does not have substantial influence on accounting standards because its members have not had the financial or political power possessed by others, such as the AICPA, the FEI, and the Business Roundtable.

1.2 GOVERNMENTAL AGENCIES

(a) SECURITIES AND EXCHANGE COMMISSION. Although the Securities and Exchange Commission's (SEC's) jurisdiction is limited to publicly held corporations meeting minimum size criteria (registration is required for companies having at least $10 million in assets and at least 500 stockholders), its role as the primary regulator and protector of the country's capital markets has given it substantial influence over financial accounting practice.

(i) Background of the Securities and Exchange Commission. The Commission was established by the Securities Exchange Act of 1934 and was charged with enforcing not only that statute but also the Securities Act of 1933. Previously, the 1933 Act had been administered by the Federal Trade Commission.

The SEC's prime mission is to achieve and maintain stable and effective capital markets for securities traded in interstate commerce. The nature of today's capital markets and communications networks makes it difficult to issue a security that is *not* traded across state borders. The SEC uses a variety of methods to accomplish its mission. The most basic is regulation of the activities of those corporations that have issued or would like to issue securities.

Under the 1933 Act, securities must be "registered" before they can be issued to the public. The purpose of registration is to establish a complete and widely available public record of information about the registrant and the securities. For example, registration creates a substantial amount of public information about the officers, directors, and other agents of the corporation, including promoters and underwriters. It also publicizes the company's plans for using the capital raised by issuing the securities. In the case of a company that has existed previously, registration also requires the presentation of financial statements and other financial data.

If the company meets the reporting requirements, the securities are allowed to "go public," regardless of their inherent riskiness. Thus, the registration process is designed to accomplish disclosure about the securities rather than to evaluate their merits. Although some states conduct merit reviews for securities traded within their borders, this approach would be very difficult to accomplish on a national level. Furthermore, many individuals believe that the capital markets should be as free as possible, as long as fraud and other forms of deceit are prohibited.

The 1934 Act went beyond the initial registration to require substantial ongoing disclosures about the corporation, its officers and directors, and its financial condition and results of operations and other activities. Thus, companies that have securities registered under the 1933 Act must provide quarterly and annual reports to the Commission, as well as ad hoc reports when crucial events occur. Again, the goal is to allow the capital markets to work effectively by getting information to market participants. The Commission staff may review the filed information for its compliance with the disclosure requirements, but there is no review of the merits of the management's behavior as

described in the reports. For example, nothing in the SEC's processes prevents managers from paying large salaries to themselves, as long as the amount is disclosed. The idea is that disclosure will allow the market itself to discipline those managers who abuse their fiduciary duties. Of course, the disclosure requirement may very well have been designed to deter inappropriate behavior, because management would expect to have to suffer the consequences of publishing information about their activities. Nevertheless, the excesses of corporate top executive compensation is a contemporary topic of debate in the media, and has raised the interest of regulators.

The 1934 Act also gave authority to the Commission to regulate securities exchanges (such as the NYSE and the American Stock Exchange [ASE]) and those brokers and dealers who belong to them or otherwise conduct business for buyers and sellers of securities. This authority was expanded through the Investment Advisers Act of 1940 to encompass all who offer investment counseling. The fundamental goal of this arena of regulation is to increase market participants' confidence by reducing the likelihood of incompetence, fraud, or deceit. The line of reasoning is that if these problems can be reduced, more people are likely to invest, and if more people invest, the competition will bring about a more efficient allocation of capital.

Other legislation has given the SEC additional authorities and jurisdiction in the capital markets, but their contents are generally beyond the scope of this discussion, which focuses on the effect of the SEC on financial accounting. Subsection 1.2(a)(vi) of this chapter identifies the specific categories of regulations and publications that affect financial accountants and their clients.

It is especially important to note that the 1934 Act gave the SEC specific authority to establish accounting principles to be used by registrants in filed financial statements. This authority led to the issuance of Accounting Series Release (ASR) No. 4 in 1938, which stated that the principles used in the filings would have to enjoy "substantial authoritative support." It also stated that disclosure of a departure from such supported principles would not be an acceptable substitute for applying them. The effect of ASR No. 4 on the accounting profession is described in Subsection 1.3(a)(i) of this chapter.

(ii) Structure of the Securities and Exchange Commission. Because the SEC is an independent agency, it does not exist within any of the three traditional branches of government (executive, legislative, or judicial). All five commissioners are appointed by the President and are confirmed by the Senate. In order to help maintain balance, and thereby boost public confidence in the capital markets, no more than three commissioners can be members of the same political party. The basic term for a commissioner is five years with the possibility of unlimited reappointments. However, history shows that it is unusual for a commissioner to complete an entire term. Most commissioners are attorneys by training, although some have had other backgrounds. One commissioner is designated by the President to serve as the chairman and has special administrative responsibilities and acts as a spokesperson for the entire commission. However, the chairman has only one vote, and thus actually has no more authority than the other commissioners.

As is true with most major organizations, a large professional staff supports the work of the commissioners. The SEC has over 2,900 employees at its Washington, D.C., headquarters and its regional offices in New York, Miami, Chicago, Denver, and Los Angeles. A number of divisions and offices deal with particular regulatory activities. The three that financial accountants are most likely to come into contact with are:

- The Division of Corporation Finance (DCF)
- The Office of the Chief Accountant (OCA)
- The Division of Enforcement

In dealing with their responsibilities, all three report directly and independently to the Commission. However, they also work closely with one another to coordinate their activities and to avoid contradictions and confusion. Exhibit 1.2 is a diagram of their interrelationships and the points of usual interface with the public.

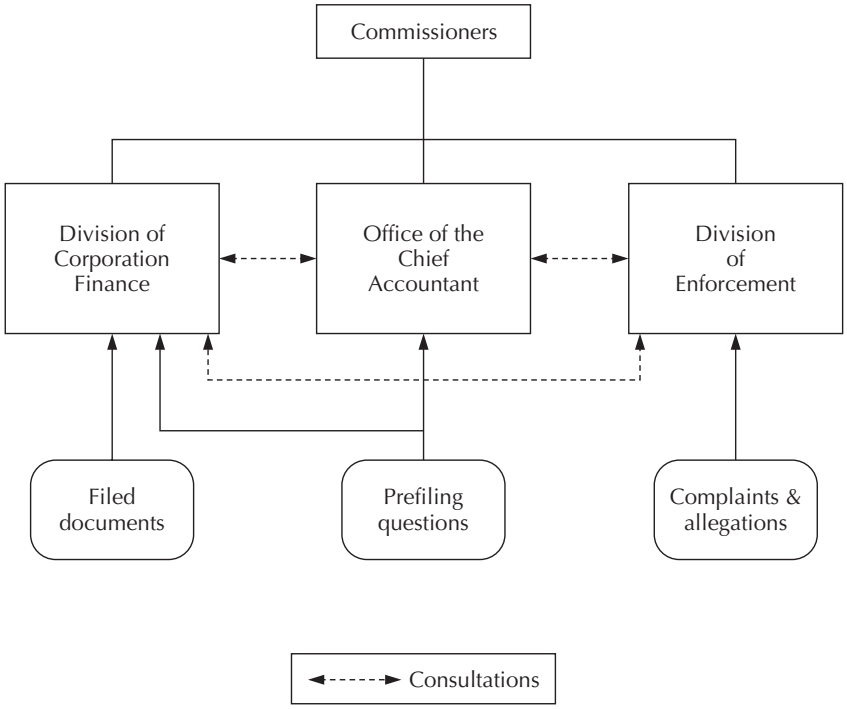

Exhibit 1.2 SEC accounting activities and suborganizations.

(iii) Division of Corporation Finance. With a staff of several hundred people, the largest of these three sections of the SEC is the DCF, or Corp Fin. Its fundamental responsibility is to process filed documents received from registrants to determine whether they comply with the appropriate disclosure regulations. The DCF staff consists of attorneys, accountants, and financial analysts, and is organized by industry specialties. The Director is advised by a Chief Accountant for the Division, who is not the same person as the Commission's Chief Accountant.

In the process of reviewing filings, the DCF staff encounters questions about the suitability of the accounting principles applied to registrants' transactions or situations. Some registrants are careful to raise these kinds of questions before they file documents in order to determine the principles that the staff believes are applicable. In either situation, the DCF staff often resolves these questions using published GAAP or precedents established in earlier cases. In more complicated or groundbreaking situations, the DCF chief accountant consults with the Commission's OCA.

(iv) Office of the Chief Accountant. The Commission's primary adviser on financial accounting issues and policy is the Chief Accountant, who is appointed by the Chairman and serves at his or her discretion. The OCA is supported by a professional staff, all of whom are experienced accountants, except for one attorney. As indicated in Exhibit 1.2, the OCA works with the DCF chief accountant to resolve issues raised in filings or by prefiling questions. The diagram also shows that some of these prefiling questions may come directly to the OCA.

In order to identify the accounting and auditing practices that have "substantial authoritative support," the OCA first tries to determine what the authoritative literature says about the issue, turning to its own pronouncements and interpretations only when that literature is silent or ambiguous. In conducting their research, the OCA staff members frequently consult with the FASB staff. It is also common for the registrant who raised the question to meet with the SEC staff to explain the facts and circumstances surrounding the issue and to present its point of view. When the question

cannot be resolved satisfactorily from the literature, the OCA develops an answer with the goal of providing "full and fair disclosure." To present a united position on the issue, the OCA and DCF establish together what ought to be done. If the registrant does not agree with the answer, SEC procedures allow it to appeal to the full Commission. However, as a practical matter, registrants seldom make this appeal because the Commissioners virtually always support the staff.

In addition to dealing with situation-specific issues, OCA also advises the Commission on major policy matters affecting financial reporting. This role involves preparing recommendations that new SEC rules be created for registrants. It also involves overseeing standard setters, specifically the FASB. The OCA is heavily involved in overseeing the PCAOB.

(v) Division of Enforcement. The third segment of the SEC staff that commonly interfaces with financial accountants is the Division of Enforcement, which is charged with investigating violations of the statutes and regulations and recommending disciplinary action. Information about possible violations comes from a wide variety of sources, including the OCA and DCF, as well as news reports and direct complaints from individuals. When violations appear to be other than merely inadvertent or technical, the Division of Enforcement is responsible for determining whether and how to pursue a case and for discovering the facts. In some situations, the division may recommend that the Commission reach a settlement with the alleged offenders without a judicial finding. Although the findings are made public, the subjects neither admit nor deny the allegations, even though some discipline may be accepted (such as suspension or permanent disbarment from practicing before the Commission). In far fewer situations, the Commission orders cases to be turned over to a U.S. Attorney's Office for prosecution in a federal court. Naturally, the Enforcement staff cooperates fully with the U.S. attorneys in pursuing these cases.

For violations of statutes or regulations involving accountants, Commission procedures require that the Chief Accountant of Enforcement consult with the OCA to ensure that the proper facts have been uncovered and that the authoritative literature has indeed been violated. These violations typically include failure to maintain proper books and records, preparing financial statements that do not comply with GAAP, issuing an unqualified audit opinion on statements that do not comply with GAAP, or conducting an audit without complying with GAAS. Although Enforcement does not have to obtain concurrence from the OCA to go ahead with a case involving accounting or accountants, a lack of concurrence would make it difficult to persuade the Commission that a violation occurred.

(vi) Regulations and Publications. Because the SEC is a government agency, its accounting literature is structured differently from the pronouncements published by the FASB and other standards setters. This discussion provides an overall view of that structure in order to help the reader understand the SEC's regulations and publications. Those interested in more detailed descriptions of SEC financial reporting requirements will need to consult materials developed by one of several reporting services or large accounting firms. Like other agencies, the Commission publishes its pronouncements in the *Federal Register*, which are then compiled and republished by proprietary organizations for sale to practicing accountants and attorneys, as well as libraries and others.

The two main sources of the SEC's authority over accounting are the Securities Act of 1933 and the Securities Exchange Act of 1934. Five other statutes also affect accounting, but less directly. They include the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisor Act of 1940, and the Security Investor Protection Act of 1970. These statutes give the SEC the authority to create rules and regulations that interpret the requirements to be met by companies under its jurisdiction. (As a matter of terminology, a regulation is merely a set of related rules.)

For accountants, the most familiar regulations under the 33 and 34 Securities Acts are Regulation S-X (17 CFR 210) and Regulation S-K (17 CFR 229). Regulation S-X describes the accounting and auditing requirements that registrants must meet, including not only the financial statements but also the qualifications of (including independence) and reports filed by accountants who practice before the Commission. It consists of 13 Articles, including:

1	Application of Regulation S-X
2	Qualifications and reports of accountants
3	General instructions for financial statements
3A	Consolidated and combined financial statements

Regulation S-K includes a large number of "Items" about which a registrant must provide information (in addition to the financial statements) in registration statements, annual reports, and proxy solicitations. Some of the Items are:

101	Description of business
201	Market price of and dividends on common equity
303	Management's discussion and analysis
304	Changes in and disagreements with accountants
402	Executive compensation
404	Certain relationships and related party transactions
504	Use of proceeds
702	Indemnification of officers and directors

Some registrants are not required to comply with Regulation S-K; for example, small companies that fall under Regulation D of 17 CFR 230 are exempt, as are investment advisers.

At the next level below regulations and forms are Commission Releases, which are essentially official communications between the SEC and the public. They announce changes in the regulations and forms, interpret the regulations, describe various Commission enforcement activities, or declare general Commission policy. The SEC issues these publications only after a majority vote of the Commissioners.

Several types of releases are related to the statutes and regulations. Releases concerning matters under the 1933 Act are called *Securities Releases*. When they are published in the *Federal Register*, they are given a number with a "33-" prefix. Releases concerning the 1934 Act are called *Exchange Act Releases*, and have a "34-" prefix in the *Register*. Releases concerned with Regulations S-X and S-K fall into two categories. As might be expected, Financial Reporting Releases (FRR) announce changes and interpretations of these two Regulations. They are published with an "FR-" prefix, although they are commonly identified in the accounting literature as "FRR." It is possible for a single release to have more than one designation. In fact, it is not uncommon to find a release carrying all three.

Accounting and Auditing Enforcement Releases (AAER) announce enforcement or other disciplinary actions against individuals, firms, and registrants who have been alleged or proven to be in violation of the federal securities laws or who have otherwise fallen under the SEC's disciplinary powers. They are published under the prefix of "AAER."

Until 1982, the Commission issued ASR, concerning both financial reporting matters and enforcement actions. In that year, the separate FR and AAER series were created to avoid the confusion of dealing with the two different kinds of actions in one series. The effective portions of the ASRs were codified in FR-1.

The fourth level of literature, staff advice, is directed from the SEC staff to registrants and other interested parties with regard to its interpretation of the regulations and forms. To help avoid arbitrary or otherwise inconsistent policies, these communications are generally subjected to substantial internal review involving two or more divisions or offices, including, for example, the OCA, DCF, and the Office of the General Counsel.

Although staff advice lacks the official standing of Commission releases, a registrant faces substantial difficulty in successfully opposing it in a filing. As with every staff decision, the registrant can appeal to the Commissioners for an exception, but history has shown that few are willing to go to the expense and trouble, and fewer still succeed in overturning the staff's position.

Three categories of staff advice are of interest to accountants. Staff Accounting Bulletins (SAB) are probably the most familiar. They are issued by DCF and the OCA. A SAB is published to

describe an interpretation that the staff has made either for a series of filings with similar facts and situations or for one filing that dealt with an unusual situation or that took a novel approach to the authoritative literature. The SAB assists registrants through a troubled area or lets them know that a particular approach will not pass the staff's review.

(vii) Summary. Even though the SEC has jurisdiction over only public corporations, without doubt it has exerted, and will continue to exert, a substantial influence on financial accounting by private corporations as well. The philosophy of "fair and full disclosure" permeates the practice of financial accounting for all companies, and the SEC's standards for independence and competence of auditors are fairly well established throughout the profession. The enforcement activities of the SEC are also important because they establish and defend norms of behavior expected of financial accountants.

Affiliating with a corporation registered with the SEC puts special demands on its internal and external accountants. No one should venture into this type of practice without substantial training and experience or without competent legal counsel. The requirements are extensive and complicated, and the penalties for not meeting the standards are considerable.

(b) SARBANES-OXLEY ACT OF 2002 AND THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD. The most far-reaching piece of federal legislation affecting the accounting profession since the securities acts of the 1930s, the Sarbanes-Oxley Act, was passed and signed into law in the summer of 2002. The Sarbanes-Oxley Act is a direct result of the allegations of financial reporting fraud at a large number of major corporations beginning in the fall of 2001 (e.g., Enron, Global Crossing, Qwest, Adelphia Communications, Tyco, and WorldCom, among others). The state of outrage in the country to these allegations of financial reporting fraud is reflected by the overwhelming votes in favor of Sarbanes-Oxley in both houses of Congress. The Sarbanes-Oxley Act passed the Senate 99 to 0, and only three votes were cast against the Act in the House of Representatives.

The Sarbanes-Oxley Act has 11 sections. These sections address: (1) the PCAOB, (2) auditor independence, (3) corporate responsibility, (4) enhanced financial disclosures, (5) analyst conflicts of interest, (6) commission resources and authority, (7) studies and reports, (8) corporate and criminal fraud accountability, (9) white-collar crime penalty enhancements, (10) corporate tax returns, and (11) corporate fraud and accountability. The first four and the last four sections are likely to be of greatest interest to practicing CPAs.

(i) Public Company Accounting Oversight Board. The Public Company Accounting Oversight Board (PCAOB) is charged with overseeing the audits of SEC registrants (hereafter public companies). All accounting firms auditing public companies must register with the PCAOB. The PCAOB is required to establish or adopt auditing, quality control, ethics, and independence standards for auditors of public companies. In addition, the PCAOB conducts inspections of registered public accounting firms. Finally, the PCAOB will investigate accounting firms for allegations of substandard performance and will have the power to discipline accounting firms and individual auditors.

The PCAOB has five full-time members, only two of whom can be licensed CPAs. Board members will be appointed by the SEC, after consulting with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of Treasury. The term of service is five years and board members are limited to two terms.

The PCAOB assesses and collect a registration fee and an annual fee from each registered public accounting firm. These fees are to be sufficient to recover the cost of both processing registrations and the required annual report that each registered accounting firm is to file with the PCAOB.

Although the PCAOB is charged with promulgating auditing standards, the Sarbanes-Oxley Act specifically requires that these standards include the following provisions:

- Registered public accounting firms must maintain work papers in sufficient detail to support their conclusions in the audit report, and these work papers must be retained for at least seven years.

- The issuance of an audit report must be approved by a concurring or second partner.
- Each audit report must describe the scope of the auditor's internal control testing. The auditor must include, either in the audit report or in a separate report, the following items: (1) the auditor's findings from the internal control testing, (2) an overall evaluation of the entity's internal control structure and procedures, and (3) a description of any material weaknesses in internal controls.
- Quality control standards related to required internal firm consultations on accounting and auditing questions.

In partial response to these requirements, the PCAOB implemented three auditing standards, effective in 2004. One on the auditor's report (AS 1), one on audits of internal control (AS 2), and one on audit documentation (AS 3).

The PCAOB inspects public accounting firms that regularly audit more than 100 public companies on an annual basis. It is intended that other public accounting firms be inspected no less often than once every three years. Inspections involve reviews of audit engagements and of the firm's quality control system. The PCAOB can report any violation of: (1) the Sarbanes-Oxley Act, (2) PCAOB and SEC rules, (3) the firm's own quality control standards, and (4) professional standards, to the SEC and to each appropriate state regulatory authority. The auditor's specific State regulations and a company's stock exchange regulations are also included in the scope of the inspections.

Registered public accounting firms and their employees are required to cooperate with PCAOB investigations. Firms that fail to cooperate in PCAOB investigations can be suspended, or disbarred, from being able to audit public companies, as can individual CPAs. Although the PCAOB does not have subpoena power (the PCAOB is specifically designated as a nongovernmental entity), there are procedures for the PCAOB to obtain needed information for an investigation via an SEC-issued subpoena. Documents and information gathered by the PCAOB in the course of an investigation are not subject to civil discovery. PCAOB sanctions include the ability to suspend or disbar firms or individual CPAs from auditing public companies, as well as monetary penalties as high as $750,000 for individuals and $15 million for firms.

The Sarbanes-Oxley Act amends the Securities Acts of 1933 and 1934 to define as GAAP those principles promulgated by a standard-setting body where the standard-setting body meets a number of requirements set out in the Act. The FASB's current structure meets the requirements set out in the Sarbanes-Oxley Act.

The PCAOB's funding, as well as the funding of the accounting standard-setting body (currently the FASB), are to be recoverable from annual accounting support fees. These annual accounting support fees are to be assessed against and recoverable from public companies, where the amount of the fee due from each issue is a function of the issuer's relative market capitalization.

(ii) Auditor Independence. The Sarbanes-Oxley Act specifically prohibits accounting firms from performing any of the following services for a public company audit client:

- Bookkeeping services
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management or human resources functions
- Broker or dealer, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit

The provision of any other nonaudit services for an audit client, including tax work, is allowed only if approved in advance by the audit committee. In addition, certain audit services (e.g., comfort letters for underwriters, statutory audits) must also be preapproved by the audit committee.

The Sarbanes-Oxley Act requires that audit partners on audits of public companies be rotated every five years. Also required is a timely report to the audit committee containing the following information: (1) a discussion of critical accounting policies and practices; (2) alternative accounting treatments discussed with management, the ramifications of these alternatives, and the auditor's preferred treatment; and (3) other material communications between the auditor and management (e.g., the management letter, schedule of unadjusted audit differences). Finally, a registered public accounting firm cannot perform an audit of a public company if that company's CEO, CFO, controller, chief accounting officer, or others serving in equivalent positions, were employed by the registered public accounting firm and worked on the audit engagement within one year prior to the beginning of the current year's audit.

(iii) Corporate Responsibility. The Act specifies that the audit committee is to be directly responsible for the appointment, compensation, and oversight of the external auditor. The Act also requires that all members of the audit committee be independent. Audit committees are to establish procedures for handling complaints related to accounting, internal controls, and auditing matters, including complaints that may be submitted anonymously. Audit committees are to be given the authority to retain independent counsel and other advisers, if they deem this to be necessary. Finally, each public company must provide the funding the audit committee believes is necessary to compensate the registered public accounting firm.

The Sarbanes-Oxley Act requires the CEO and CFO of each public company to certify, in each annual and quarterly report filed with the SEC, the following conditions:

- That the CEO and CFO have reviewed the report
- To the best of the officer's knowledge, the report does not contain any material omissions or misstatements
- That the financial statements and other financial information included in the report fairly presents the entity's financial condition and results of operations[1]

[1] The authors of several chapters in the 11th Edition, for example, indicate in effect that some GAAP requirements cause financial statements prepared in conformity with those requirements not to fairly present results of operations or financial position. Based on those views, that places CEOs and CFOs in untenable situations. The financial statements that Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to certify fairly present the company's results of operations and financial position are required to conform with GAAP, but preparing financial statements in conformity with GAAP would, based on those views, often result in financial statements that do not present fairly the company's results of operations or financial position.

Outside auditors avoid this problem by always linking the expression present fairly the financial position and results operations of the company with the expression in conformity with generally accepted accounting principles. Their message is that the financial statements fairly present only to the extent that financial statements that conform with current GAAP fairly present.

The reason the drafters of the Act omitted a reference to GAAP in the required certification apparently was to avoid the situation in U.S. v. Simon (425 F.2 d 796, Fed. Sec. L. Rep P92,511). In that case, the defendants contended that the financial statements conformed with GAAP and that their audit conformed with GAAS. They asked for instructions to the jury that a defendant could be found guilty only if, according to GAAP, the financial statements as a whole did not fairly present the financial condition of the company and then only if the departure from professional standards was due to willful disregard of those standards with knowledge of the falsity and intent to deceive. The court declined and stated that the critical test was whether the financial statements as a whole were fairly presented and, if not, the basic test was whether the defendants acted in good faith. It found that an accountant is under a duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is not being operated to carry out its business in the interest of all the stockholders but for the private benefit of its president. The ultimate test is whether the auditor has told the truth as the auditor knows it.

The Act avoided that problem, but in doing so it introduced the risks of purportedly untenable situations. (This footnote was drafted with the assistance of the editors.)

- That the signing officers are responsible for the entity's internal control system, that the internal control system is appropriately designed, that the effectiveness of the internal control system has been evaluated within 90 days of the report, and that the officers' conclusions about the effectiveness of internal controls are included within the report
- That the signing officers have disclosed to their auditors and the audit committee significant deficiencies in the design or operation of the entity's internal control, and any fraud (even if immaterial) involving management or employees with a significant role in the entity's internal control structure
- Whether there have been any significant changes in internal control subsequent to the date of its evaluation

The Act makes it unlawful for any officer or director, or for any other person operating under their direction, to fraudulently influence, coerce, manipulate, or mislead the external auditor in the audit of financial statements.

The Act also requires the CEO and CFO of any issuer restating its financial statements due to material noncompliance with SEC financial reporting requirements to forfeit any bonus or incentive-based or equity-based compensation received within one year of the filing date of the financial statements that are subsequently restated. Profits realized from the sale of securities during this 12-month period also must be forfeited.

(iv) Enhanced Financial Disclosures. The Sarbanes-Oxley Act requires public companies to reflect all material adjusting entries identified by the external auditor. The Act calls for the SEC to issue final rules requiring issuers to disclose all material off-balance sheet transactions, arrangements, and obligations.

The Act specifically prohibits misleading pro forma financial information. Pro forma financial information must also be reconciled with what would be required under GAAP.

The Sarbanes-Oxley Act generally prohibits personal loans to executives. In addition, stock transactions by directors, officers, and principal stockholders must be disclosed by the close of the second business day after the date of the stock transaction.

The Act requires internal control reports in each annual report. Management must state that it is responsible for the internal control structure and also provide an assessment of the effectiveness of that structure. Moreover, the external auditor must attest to the internal control assessment made by management. Audits of internal control are the subject of a subsequent Chapter in this book.

Public companies are required to state whether they have a code of ethics for senior financial officers and, if not, why not. Also, any changes, or waivers to, the code of ethics for senior financial officers must be disclosed in a Form 8-K filing. Finally, the issuer must disclose whether the audit committee contains at least one financial expert and, if not, why not.

The Act requires the SEC to review the filings of each issuer at least once every three years. And issuers are required to disclose, in plain English, on a rapid and current basis any material changes in the issuers' financial condition and results of operations.

(v) Corporate and Criminal Fraud Accountability. The Sarbanes-Oxley Act imposes severe criminal penalties for prohibited forms of document destruction and for violations of the securities laws. Prison sentences of up to 20 years can be imposed for the destruction, alteration, or falsification of records in federal investigations and bankruptcy. The Act requires the SEC to promulgate rules relative to the retention of documents (including electronic records) by external auditors. Failure to comply with these SEC rules and regulations can lead to prison terms of up to 10 years. Finally, an individual who knowingly executes, or attempts to execute, a scheme or artifice to defraud any person relative to the securities laws faces prison sentences of up to 25 years.

The Sarbanes-Oxley Act also changes the bankruptcy laws to specify that debts incurred as a result of violations of the securities laws are not dischargeable in bankruptcy. In addition, the length of time to file a civil suit under the securities laws has been extended to two years after discovering the violation or five years after the violation occurred.

Finally, the Act provides whistleblowers certain protections against retaliation by the public company or its agents. For example, parties who knowingly retaliate against an individual for providing truthful information to a law enforcement officer relative to the commission of any federal offense can be imprisoned for up to 10 years.

(vi) White-Collar Crime Penalty Enhancements. The Act amends the U.S. Code by increasing both the criminal penalties for mail and wire fraud from five years to 20 years. In addition, the Act imposes criminal penalties on CEOs and CFOs when they certify financial reports that do not comport with the requirements of the Sarbanes-Oxley Act. The penalties are a fine up to $1 million and imprisonment for up to 10 years for improper certifications, and a fine up to $5 million and imprisonment up to 20 years for *willfully* improper certifications.

(vii) Corporate Tax Returns. The Sarbanes-Oxley Act contains a sense of the Senate—which is not a legal requirement—that CEOs should sign the corporate tax return.

(viii) Corporate Fraud and Accountability. The Act imposes fines and potential prison terms of up to 20 years for tampering with a record, document, or other object or otherwise impeding an official proceeding. Also, criminal penalties available under the Securities and Exchange Act of 1934 have been increased.

In some cases, public companies attempt to make large payments to officers, directors, and others during the period of time the company is under investigation for possible violations of securities laws. The Act empowers the SEC to petition a federal district court to restrain a public company from making extraordinary payments to officers, directors, and others during the course of the investigation. The proposed payments would be placed in escrow for 45 days, and one extension of this 45-day period could be obtained. If the company is charged with a securities law violation, the contemplated extraordinary payments would continue to be held in escrow until the case was resolved.

The Act makes it easier for the SEC to suspend or permanently prohibit the ability of individuals to serve as officers or directors of public companies, if the individual has violated Section 10(b) of the 1934 Securities and Exchange Act or Section 17(a) of the 1933 Securities Act. Currently the SEC has to bring an action in federal court to bar individuals from serving as an officer or director of a public company.

(c) STATE BOARDS OF ACCOUNTANCY. The other main category of governmental agencies affecting the practice of financial accounting comprises the 54 State Boards of Accountancy in the United States. (One board exists in each of the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, and Guam.) They have three primary regulatory missions: granting the initial license to practice public accounting, ensuring the maintenance of competency through continuing education, and disciplining licensees who fail to maintain their competency or who act in an unethical manner. States can also designate an authority to be followed for auditing (e.g., AICPA) or promulgate their own requirements. For example, New York and California adopted audit documentation regulations in advance of the new requirements in Statement on Auditing Standards No. 103, "Audit Documentation."

Because of the variety of forms (and names) for the boards, it is difficult to draw generalities. Some boards are separate freestanding agencies, whereas others are part of larger state regulatory bodies that license other professions and service providers. Funding for boards comes from general budget appropriations, dedicated credits from licensing fees, or some combination. Some boards are permanent and others are subject to periodic "sunset" reviews designed to avoid overregulation.

An accountancy board's first responsibility is to award the license to practice, which may do no more than allow the licensees to identify themselves as CPAs. In many states, the license is a legal requirement for performing the attest function (audit or review) for financial statements. The Internal Revenue Service accepts the CPA's license as sufficient qualification to practice before it by representing clients in the audit and appeals procedures.

All states require candidates to successfully complete the Uniform CPA Examination prepared, administered, and graded by the AICPA. In a few states, it is possible to pass the CPA exam and be certified without being licensed. The license is granted only after the candidate has completed an experience requirement. Other states do not differentiate between certification and licensing. Most states have an experience requirement, but some do not. Over 40 states have passed laws that do or will require the completion of an additional year's course work beyond the bachelor's degree before certification (the 150 hours requirement).

Most state boards require their licensees to participate in formal CPE. Typically, CPAs need 40 hours of class time (or its equivalent) per year to continue practicing. Some boards regulate CPE by specifying minimum hours in certain topics or by recognizing only courses offered by authorized providers, whereas others require only a report of hours completed.

A majority of state boards promulgate ethical standards of conduct through regulations interpreting the authorizing statutes; others have incorporated the ethics rules directly into their statutes. By and large, the ethics codes of state boards are the same as the AICPA's Code of Conduct, although local political factors often create differences. Because most states do not grant their boards sufficient funds to support a full-time staff for investigating allegations of unethical behavior, they must compete with other agencies for investigators' time and effort. In extreme cases, a finding of a violation will lead to revoking the individual's CPA license; however, boards do not mete out this punishment very often. Rather, they impose some rehabilitative discipline, such as a temporary suspension or the completion of additional CPE. In virtually all states, individuals automatically lose their licenses if they are convicted of a felony.

State boards are typically composed of unpaid volunteer practitioners who serve for three to five years. It is often true that at least one of the board members is not an accountant but represents the general public. This arrangement lends more credibility to the board, which may suffer from a "fox in the hen house" image caused by having only accountants regulate accountants. A difficulty in using volunteers is that the boards tend to get only part-time effort. Larger states achieve more continuity and sustained effort by having a full-time executive director and staff.

In order to gain by shared effort and to provide services efficiently, state boards have formed their own trade organization, the National Association of State Boards of Accountancy (NASBA). This group (which includes all 54 U.S. licensing authorities) provides a forum for developing unified positions on issues that can be used in individual states more effectively. For example, the NASBA directors agreed in 1989 to change the specifications for the Uniform CPA Examination. They also have developed a model code of ethics and a model accountancy law to apply in each state. These documents could be (and were) used to persuade state lawmakers to bring their statutes and regulations up to a national norm. NASBA also assists state boards faced by legislative threats of closure under sunset reviews.

Although the dispersion of certification authority across all states creates inefficiencies and inconsistencies, this arrangement is compatible with the policy of protecting states' rights against federal domination. Some professionals believe that this arrangement has outlived its usefulness, particularly for disciplining unethical accountants. Until such time as a federal agency is given a national licensing authority, however, financial accountants wanting to practice as auditors will need to be certified by one or more state boards.

1.3 STANDARD-SETTING ORGANIZATIONS

(a) FINANCIAL ACCOUNTING STANDARDS BOARD. The Financial Accounting Standards Board (FASB) has a unique status as a private organization charged with protecting the public interest (the GASB, a related organization, is discussed in Subsection 1.3(b)). The SEC endorses it through ASR No. 150 (now codified within FR-1) as the source of "substantial authoritative support" for determining the acceptability of accounting practices for filings with the Commission. It has also been endorsed at the state level to the extent that state boards of accountancy include a requirement for complying with FASB pronouncements in their ethics codes. The FASB does not

receive funds directly from either the SEC or state boards, but the tax deductibility of contributions acts as a de facto subsidy.

Although other private sector bodies, such as the AICPA and the FEI, endorse and finance the FASB, it is, by intent and design, independent of any of them. Of course, the governmental endorsements are contingent on the Board's maintaining an attitude of protecting the public interest.

(i) Brief History. Beginning in 1938 with the issuance of ASR No. 4, the SEC has given the accounting profession a loose rein to establish GAAP.

Shortly after ASR No. 4's release, the American Institute of Accountants (the forerunner of the AICPA) upgraded the level of funding, staffing, and activity of its Committee on Accounting Procedures (CAP). Over the next 20 years, it produced 51 Accounting Research Bulletins (ARB), including the all-encompassing ARB No. 43. The CAP did not survive because it suffered from two political shortcomings. First, it never was given authority by the Institute's council to establish standards that would be binding on the membership. Second, it existed within the Institute, which created at least the appearance that auditors' interests (and their clients' interests) were likely to be preferred to the public interest.

In response to criticism, the AICPA formed the Accounting Principles Board (APB) in 1958 and again increased the funding and staffing over the previous levels. During the next 15 years, the APB issued 31 Opinions and 4 Statements. In an effort to establish credibility, the APB's initial membership consisted of the top managing partners of major firms and other comparably influential accountants. Over time, the membership level slipped somewhat into lower levels of management, but highly competent technical experts continued to serve on the Board. In 1964, the AICPA Council acted to correct one of the deficiencies carried forward from the CAP by requiring members of the Institute to identify and justify their clients' departures from principles established by the APB. However, the second weakness still existed in that the Board was perceived as elevating auditors' and clients' interests above the interest of the general public in achieving full and fair disclosure for more effective capital markets.

In 1971, in response to growing sentiments and suggestions that the APB needed to be replaced by a government agency, the AICPA organized the Study Group on Establishing Financial Accounting Standards, under the chairmanship of Francis M. Wheat. During the following year, the Wheat Study Group recommended creating an autonomous standard setting body that would overcome the weaknesses of the CAP and the APB. That is, it would be granted authority to establish binding GAAP but it would not be housed within the AICPA. Thus, it would be more likely to escape the appearance of dominance by the interests of auditors and their clients. The proposal was accepted by six sponsoring organizations that provided adequate funding and other support to get the FASB established and operating in 1973. The original six sponsors were the AICPA, the FEI, the IMA, the AAA, the Securities Industry Association, and the Association for Investment Management and Research (AIMR). A critical event of the first year was the SEC's issuance of ASR No. 150.

Initially, the Board was still heavily dependent on the Institute and auditors for its funding and credibility. However, the previous concerns of dominance were raised in congressional hearings in 1975 and 1976, and the Board's bylaws were changed to make it less subject to the appearance of control by auditors and preparers.

The first chairman was a respected practitioner, Marshall Armstrong, who had been a member of the APB from 1963 through 1969. He was succeeded in 1978 by Donald J. Kirk, who had been a charter member of the FASB. Kirk served as chairman through the end of 1986, when he was replaced by Denny Beresford, who served until June 30, 1997. Edmund Jenkins, formerly of Arthur Andersen & Company, took over as the chairman on July 1, 1997. Robert Herz, formerly of PricewaterhouseCoopers, became chairman on July 1, 2002.

(ii) Structure of the Financial Accounting Standards Board. The FASB is actually only one part of a three-part organization, which also consists of the FAF and the Financial Accounting Standards Advisory Council (FASAC). The relationships among these entities, the GASB, and the Governmental Accounting Standards Advisory Council (GASAC) are diagrammed in Exhibit 1.3.

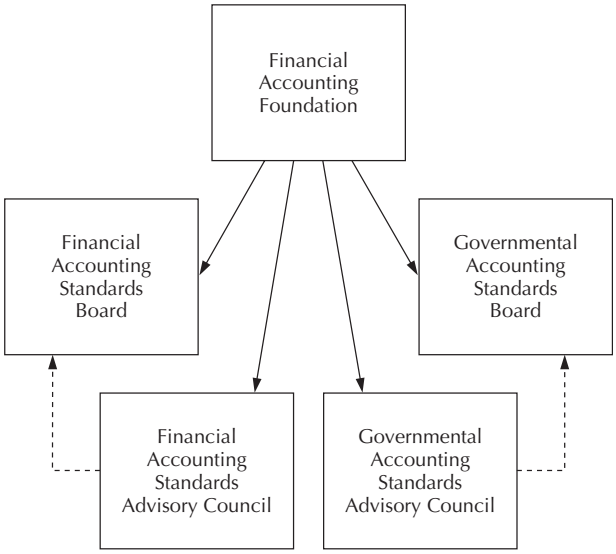

Exhibit 1.3 The structure of the Financial Accounting Foundation and the Standards Boards.

The Foundation is a nonprofit, tax-exempt Delaware corporation, managed by a 16-member Board of Trustees. They are responsible primarily for (1) raising operating funds and (2) appointing members of the two Boards and their Advisory Councils. A third unofficial function of the FAF is to shield the Board members from the kinds of pressures to compromise the public interest that shut down the CAP and the APB. Eleven trustees are appointed by the governing boards of the sponsoring organizations, and the remainder are selected by the other trustees. The creation of the GASB caused expansion of the Board to include three trustees selected by a consortium of organizations involved with local and state governments.

The Foundation bylaws strictly forbid trustees from tampering with the Boards' procedures in order to affect the standards that they issue. Of course, their control of appointments and reappointments gives the trustees substantial indirect influence. However, two of the more prominent trustees acted contrary to the spirit, if not the letter, of this restriction in 1992 through letters to the Board and other parties.[2] A major controversy arose in 1996 concerning the composition of the FAF Board after SEC chairman Arthur Levitt grew dismayed by the lack of any kind of defense by the FAF against public claims by some leaders in the FEI that the FASB was "broken and in need of substantive repair."[3] He began to privately urge the Foundation to voluntarily restructure itself to have a majority of its 16 members consist of individuals who unquestionably represent the public. (At the time, at least eight of the trustees, and possibly one other, were members of the preparer community.) When the negotiations broke down, Levitt took the issue public, first with a speech and then with a widely distributed letter that threatened to reconsider the standing of the Commission's ASR 150. As mentioned earlier, this release delegates rule-making authority to the FASB. There was no doubt that he was serious about change.

In a surprise move, the trustees engaged the services of a well-known public relations firm that specializes in fighting hostile takeovers and fired back at Levitt with a public letter that basically refused to acknowledge that the composition was a problem. Their recalcitrance provoked another public and prompt response by the SEC chairman that again threatened the Board's standing by

[2] Miller, Paul B. W., Redding, Rodney, J., and Bahnson, Paul R., *The FASB: The People, the Process and the Politics,* Fourth Edition. (Irwin-McGraw Hill, Burr-Ridge, IL: 1998), pp. 183–186.
[3] Id., pp. 186–192.

saying that the Commission was "required to take whatever steps [are] necessary to discharge our mandate." Private negotiations again resumed, and the FAF and SEC issued a joint press release in July 1996 that announced the appointment of four new trustees, all of whom met the chairman's criterion of being public representatives. He accomplished his goal that preparers would no longer dominate the trustees or the FASB. Levitt's sense of urgency was heightened by the fact that the trustees were about to initiate the search for a new FASB chair to succeed Dennis Beresford.

The FASAC was conceived as an experienced and informed microcosm of the Board's constituencies with the sole duty of providing feedback. It has operated that way with a membership ranging from 20 to 35 members who serve up to three one-year terms. Only the full-time chairman receives compensation. The Council has no fund-raising responsibilities and does not attempt to take a vote or reach a consensus on the issues. Rather, its job is to offer advice on projects that might be added to the agenda and on preliminary positions for existing projects.

The FASB itself has seven full-time members who must sever their relationships with their previous employers or partnerships. Each is appointed for a five-year term and can be reappointed for another. A member appointed to fill an unscheduled vacancy is eligible to serve up to two additional full terms. The FAF trustees designate the chairman, who has significant administrative responsibilities, including the leadership of Board meetings. In addition, the chairman is the Board's most visible spokesperson.

(iii) Board Publications. Although the FASB exists primarily to create financial accounting standards, it also interprets standards where they are not completely clear. In addition, it was given the assignment of developing broad theoretical concepts of financial accounting. Its position in the regulatory process and the demand from many accountants for detailed rules combine to create the need for implementation guidance. As might be expected, the FASB's publications reflect these tasks.

The main category of publications consists of Statements of Financial Accounting Standards (SFASs). They are numbered consecutively and, as of 2006, 158 SFASs had been issued. The ASR No. 150 specifically recognizes the authority of these pronouncements, and they receive similar support in state accountancy statutes and regulations. In addition, they are recognized by the Council of the AICPA as GAAP for the membership; any member not treating them as such will have violated Ethics Rule 203. Thus, financial statements must be prepared in accordance with these standards if they are to receive an unqualified audit opinion. The FASB recently adopted simple majority votes for issuance of a SFAS. Previously, five of the seven FASB members had to vote in favor of a proposed FASB standard.

Another category of publication, Interpretations (FINs), also establishes GAAP. However, relatively few have been issued since 1984, primarily because of the emphasis placed on other media for providing the kind of guidance that Interpretations were initially created to provide. Interpretations are numbered consecutively, and 48 have been issued.

A third category of Board document is the Statement of Financial Accounting Concepts (SFAC). These statements describe broader underlying concepts that the Board has determined to use in developing its standards. The statements do not constitute GAAP, and accordingly they are not identified as such by regulatory bodies or ethics codes. Nonetheless, knowledge of these statements is helpful for understanding the content of standards and for anticipating the direction of future standards. For these reasons, the Board's conceptual framework is described in Subsection 1.3(a)(v). Concepts statements are also numbered consecutively, and seven have been issued. SFAC No. 6 replaced SFAC No. 3, with the result that only six are in effect.

A fourth FASB category of publication comprises Technical Bulletins (FTBs), which are actually issued by the Board Research staff. They are narrow in scope and interpret the existing authoritative literature (i.e., ARBs, APBOs, SFASs, and FINs) to apply to situations not covered in it directly. Although Board members have the ability to prevent issuance of proposed FTBs, they do not formally vote to authorize their publication. Technical Bulletins are numbered in annual series, such as "85-3," which was the third one issued in 1985. The Board initiated FTBs in order to systematize informal advice that its staff was disseminating by telephone and letters; the use of FTBs expanded in the mid-1980s to reduce the earlier practice of issuing many highly detailed

standards and interpretations. This change also allowed Board members to focus their efforts on more substantive issues.

To mitigate the need for narrow Board pronouncements while still providing quick responses to new problems (called *timely guidance* in FASB jargon), the Emerging Issues Task Force (EITF) was created in 1984. The director of the Board's research staff chairs this group, which consists of approximately 15 technical experts from major and regional accounting firms and large corporations. It meets periodically to tackle complex new problems by applying the existing literature. Transactions and events that have already transpired are the source of some issues, whereas others are based on proposed transactions. The SEC's Chief Accountant is an active participant in the discussions, despite being officially identified as only an *observer*. The Chief Accountant and the OCA staff are the prime beneficiaries of the EITF's activity because it addresses the issues that previously were brought to the OCA by registrants and their accountants.

When the EITF faces an issue, it seeks a "consensus," which is considered to exist if no more than two or three members object to a proposed solution. If more object, there is no consensus, with the consequence that the OCA is left to implement its own views. Alternatively, the Task Force may recommend that the full Board consider dealing with the issue. Prior to 1988, EITF Consensuses were not published, although minutes of the meetings were available from the Board. In 1988, the FASB began to publish highly condensed summaries of the issues and their resolutions. These summaries are presented as a public service because the outcomes are not necessarily the opinion of either a majority of the Board or the Board's staff. Under SAS No. 69, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles," EITF consensus positions are considered level c pronouncements in the GAAP hierarchy. EITF consensus positions constitute GAAP if no level a or level b pronouncement exists. A consensus is acceptable for SEC filings as long as the OCA does not have a serious objection to its outcome. Like TBs, EITF issues are numbered in annual series. While adopted first by the auditing profession in SAS 69 to fill a void in the accounting literature, the implementation of a GAAP hierarchy by the FASB (currently on Exposure) will allow the AICPA auditing standards group to remove the GAAP hierarchy from its literature.

In addition to the above documents, the FASB also produces numerous other publications. The Board's staff sometimes issues implementation guides, in the form of questions and answers, on more complex financial accounting standards. These implementation guides are considered level d pronouncements in the GAAP hierarchy. Research Reports are developed in response to staff or consultant efforts to identify a problem, review the literature related to a set of issues, or propose answers. Discussion Memorandums and Invitations to Comment solicit views from the Board's constituents in early stages of deliberations. Three newsletters inform the public of the Board's activities: Action Alert, Status Report, and Highlights. Another widely distributed item is Facts about FASB, which describes the Board's mission, procedures, and membership.

Like many other organizations, the FASB has a site on the World Wide Web (*www.fasb.org*) that it uses for a variety of purposes. The site provides the public with access to press releases, major Board communications (including letters to the Board from prominent commentators and responses from the Board), and e-mail access to Board and staff members. FASB exposure drafts can be downloaded from the Board's Web site.

(iv) Due Process Procedures. Like many other regulatory agencies, the FASB has established procedures to ensure that (1) parties affected by new regulations have an opportunity to express their views on the issues and (2) all possible positions on the issues are uncovered. Another desirable effect is that the public's participation bolsters the credibility of the output. Although the term *due process* may imply a rigid set of procedures, there is actually enough flexibility to allow the Board some freedom in determining how extensively to pursue various activities. Certain steps, however, must always be followed.

The following six basic steps take place:

1. Admission to the agenda
2. Preliminary deliberations

3. Tentative resolution
4. Further deliberations
5. Final resolution
6. Subsequent review

All six steps are public. Board meetings take place at the headquarters in Norwalk, Connecticut, and are open to all who want to attend, up to the room's capacity. Under the FASB's "sunshine" policy, Board members are not allowed to discuss the issues privately in groups consisting of more than three persons. This arrangement was adopted in the mid-1970s after criticism that the previous policy of "closed door" meetings caused some constituents to feel that their views were not being considered. The following paragraphs describe these six steps.

A project is admitted to the agenda only after substantial preliminary debate. The set of problems to be addressed in the project must meet several criteria. First, there must be diverse practice. Second, the diversity must create significant differences in financial statements, such that there is a potential for users to be misled or to incur excessive analysis costs. Third, there must be a sufficiently high probability that the issues can be resolved in a manner that justifies using Board resources. Of course, the agenda decision involves a certain amount of political activity. Ideas for problems come from the Board and staff, but more often from constituents and the SEC. The EITF deliberations have also created some projects. Apart from a Research Report, it is unusual for a publication to be issued in this phase.

The next step is to engage in early deliberations. Early during this stage, the research staff attempts to frame the issues and sound out Board members and constituents. For major projects, the staff may create a Task Force of interested experts from various constituencies to assist its inquiries. Occasionally, the Board will publish a Discussion Memorandum or an Invitation to Comment at this phase. There may be public hearings for especially significant or controversial projects in order to allow constituents to express their views and to allow Board members and staff to question persons who testify. Board meetings will generally be devoted to questions from the members to the staff and to each other. As the phase draws to a close, the staff efforts turn to helping the members find the common ground on which to build a majority vote.

The third phase is the tentative resolution. At this point in the process, a majority of the Board has voted to issue an Exposure Draft (ED), which is a proposed standard, concepts statement, or interpretation. The ED is exposed for comment for at least six weeks and occasionally for a longer period. More controversial projects may have another round of public hearings. Dissenting Board members' views are included in the ED, as well as a summary of the basis for the majority's conclusions.

During the further deliberations step of the due process, the staff and Board attempt to digest the comments received in response to the ED. Because the prior efforts have been thorough, it is very unusual for the comments to bring anything really new to the table. Many people who do not understand this situation often react negatively, particularly if they offered views that are subsequently not incorporated in the final standard. The Board's decision not to incorporate these views may be misinterpreted as failing to listen when, in fact, the presentation simply failed to persuade the Board. During this phase, Board members generally aim at fine-tuning the proposal to deal with unanticipated minor glitches. If significant changes are needed, a second ED may be necessary.

The final resolution phase is short and consists merely of taking votes from the Board members either for or against the "ballot draft" of the standard (or other pronouncement). The published document includes not only the majority's view but also the dissenters', if any. It describes the comments from the constituents and the Board's reactions to them. Many standards include an appendix illustrating the application of the requirements. Once this point is reached, the staff's efforts turn to responding to implementation problems.

In summary, the due process is molded to fit the situation. It can be prolonged to help the Board find its consensus and to gain the support of the constituency. It can also be accelerated to get an answer on the street as quickly as possible. Nonetheless, the purposes remain the same: to

identify the problem, to uncover the answers, to develop a majority view, and to develop constituent support for that view. The Board specifically disavows any notion that the due process allows it to "count noses" to determine what a majority of the constituency wants. Its role is more judicial than legislative, and the Board members must reach a conclusion about what is best for the economy as a whole, even if particular groups are strongly opposed to the new accounting standard.

(v) The Conceptual Framework. An important key to understanding the overall direction of the FASB's efforts to reform financial accounting is its project to identify a coherent theory of financial reporting, called the conceptual framework.

Because the CAP and APB were criticized for not developing a unified theoretical basis for resolving issues, the FASB's inaugural agenda included the task of identifying concepts that it could use in setting standards.

A critical initial decision in the project was to develop the framework from the "top down" by identifying the objectives of financial reporting and then working down to more specific concepts. This approach (also called *deductive*) had been tried before, most notably by Sprouse and Moonitz in the AICPA's ARS No. 3, "A Tentative Set of Broad Accounting Principles for Business Enterprises" (1962), and by the Trueblood Study Group in its report, "Objectives of Financial Statements" (AICPA, 1973). The opposite approach (called *bottom-up or inductive*) of looking at practice and identifying common threads had also been tried, most notably in APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (1970). Statement No. 4 also used the "top-down" approach. Although there are several advantages and disadvantages to the two approaches, the main difference between them is that the bottom-up tends to encourage applying old solutions for new problems, whereas the top-down tends to lead to new solutions for old problems. Thus, the determination of the Board to pursue a top-down framework created a substantially greater likelihood that significant change in GAAP could be created. Accordingly, the framework project was (and has continued to be) controversial.

The SFAC No. 1, "Objectives of Financial Reporting by Business Enterprises," was issued in 1978. It presented a hierarchy of objectives, the most important being the providing of:

> . . . information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and other decisions.

However obvious this objective might seem on the surface, it is politically significant because it establishes that the interests of the public and financial statement users are to be ranked above the interests of auditors and preparers.

The SFAC No. 2, "Qualitative Characteristics of Accounting Information," was issued in 1980. It identifies qualities of information that make it useful for meeting the objective described in SFAC No. 1. The three primary qualities are relevance, reliability, and comparability. The important point to observe is that the Board chose qualities that reflect the users' needs instead of the needs of auditors (who prefer defensible information) and preparers (who prefer controllable and inexpensive information).

The third phase of the framework culminated in 1980 with the issuance of SFAC No. 3, "Elements of Financial Statements of Business Enterprises." It was superseded in 1985 by SFAC No. 6, "Elements of Financial Statements," which also encompasses the elements of financial statements issued by not-for-profit entities. The business elements identified by the Board included the familiar assets, liabilities, owners' equity, revenues, expenses, gains, and losses; however, its decision to make the assets and liabilities the keystone elements was enormously significant. That is, all the other elements, including "comprehensive income," were defined in terms of assets and liabilities. With this decision, the Board essentially turned away from the familiar matching concept of income that had dominated practice for decades with its emphasis on the income statement and its deemphasis of the balance sheet. Instead, under the conceptual framework, income is measured by changes in assets and liabilities because both the income statement and balance sheet are considered useful and important. There are tremendous practical implications in this choice, some of which have already been seen in SFAS No. 87 on accounting for pensions by employers, in

SFAS No. 106 on employee benefits, and in SFAS No. 109 on accounting for income taxes. In these cases, the reporting company looks to changes in assets and liabilities to determine its income instead of attempting to match costs with revenues in accordance with a predetermined or otherwise systematic or desired fashion.

SFAC No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations," was also issued in 1980. (Subsequent to issuing SFAC No. 4 but before issuing SFAC No. 6, the FASB determined that the term *not-for-profit* was preferable to *nonbusiness*. In particular, the managers of a number of these entities complained that they did not like the inference that they were not "businesslike" in the way they operated.) It was the outgrowth of the FASB's decision to deal with all private entities, even though there had been no mandate from the SEC for doing so. This statement broke new ground because there had not been a significant effort to establish top-down concepts in this area. As might be expected, the main objective is similar to the one in SFAC No. 1; specifically, it says that the financial statements of not-for-profit organizations should provide:

> . . . information that is useful to present and potential resource providers and other users in making rational decisions about the allocation of resources to those organizations.

By starting with this objective, the Board again put into place the potential for substantial reform because it would be necessary to show how existing practices met this objective.

The Board encountered major roadblocks when it entered into the project's next phase, "recognition and measurement," because it was here that decisions would be reached on whether, when, and at what amount assets, liabilities, and changes in them should be reflected in the financial statements. The fundamental issue was whether there should be a movement toward including more market value information in the statements. Naturally, this phase of the project attracted much attention and created substantial controversy. In 1985, after more than three years of debate, six Board members (one dissented because he wanted to go back to the matching concept of earnings) agreed to issue SFAC No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," which was clearly a compromise. It says that things recognized in the statements should be elements and that the amount reported for them should be relevant and reliable. In effect, all that was accomplished was to affirm the contents of the preceding concepts statements. SFAC No. 5 also identified the cash flow statement as a conceptual member of the set of financial statements, and the Board eventually issued SFAS No. 95, which requires its presentation. SFAC No. 5 also identified two possible income statements, one of which would focus on earnings, whereas the other would report comprehensive income, which might include changes in current value. In 1997, after two years of deliberations, the Board issued SFAS 130, which requires companies to report the amount of comprehensive income, either at the bottom of its regular income statement or in a separate statement. This amount equals the reported net income plus and minus the changes in various unrealized changes in equity that are reported on the balance sheet. The standard addresses only the display of comprehensive income and does not introduce any new measurement requirements. However, the standard does set into place a means for reporting other components of comprehensive income, including changes in the fair market values of assets and liabilities that are currently carried at their historical costs or proceeds.

In 2000, the Board issued SFAC No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements." Although accounting measurements are best determined using observable exchange transactions, sometimes measurements must be based on estimated cash flows. This concept statement provides a framework for using cash-flow based techniques for accounting measurements. SFAC No. 7 specifies that accounting measurements based on present value concepts should reflect the uncertainties associated with the underlying cash flows. SFAC No. 7 also introduces the expected cash flow approach to present value calculations. Present value calculations historically have often been based on a single set of estimated cash flows and a single discount rate, where the discount rate reflects the uncertainties associated with the cash flows. Concept Statement No. 7 states that a range of estimated cash flows should be considered and that this range of cash

flows should be assigned their respective probabilities and then discounted. Measurement of the fair value of an entity's liabilities is to reflect the credit standing of the entity.

What, then, is the significance of the conceptual framework? It really needs to be interpreted from a political perspective more than from a theoretical one. First, it sets in place the possibility for significant changes in GAAP. Second, it puts users' needs (and thus the public interest) at the highest priority level. Third, it establishes that the statement of financial position should not be merely a resting place for debit and credit balances waiting to be "matched" in the future; rather, it should provide useful information about assets and liabilities. Fourth, the framework rejects matching in favor of reporting changes in assets and liabilities as income, thus raising the possibility that gains and losses from price changes could be recognized as income. Finally, it defines a number of important terms that are used in the Board's communications with its constituents and in its internal discussions. Far from being an empty academic theoretical exercise, the framework is perhaps the most significant set of pronouncements that the FASB has issued. The more that practitioners know about it, the more they will be capable of dealing with the Board and the changes that its pronouncements will bring about.

(vi) The Political Environment and the Financial Accounting Standards Board's Future. As established in the opening section of this chapter, and confirmed above, political factors very much affect financial accounting. Because accounting standards have the potential for changing the allocation of wealth among various groups and individuals in society, people are willing to spend time, effort, and money to try to establish the standards that they find advantageous. Because the interests of preparers, users, auditors, regulators, and the public can be in serious conflict, efforts to create or change standards naturally create disagreement, controversy, and dissatisfaction.

One pervasive political problem that just will not go away is standards overload. Originally, this phrase described the issuance of numerous detailed standards, but more recently it has come to encompass the issuance of complex standards that are difficult to implement, especially by smaller nonpublic companies. Exhibit 1.4 symbolizes the politics of this situation, showing that the FASB has received rule-making authority from the SEC to establish GAAP for use by public companies while, at the same time, it has received rule-making authority from state Boards and the AICPA to establish GAAP for use by private companies. It should be noted that these delegations of authority do not grant the Board any enforcement or broad policy-making powers. In fact, they have created the narrow but complex task of developing a single set of financial accounting standards that apply to both public and private companies.

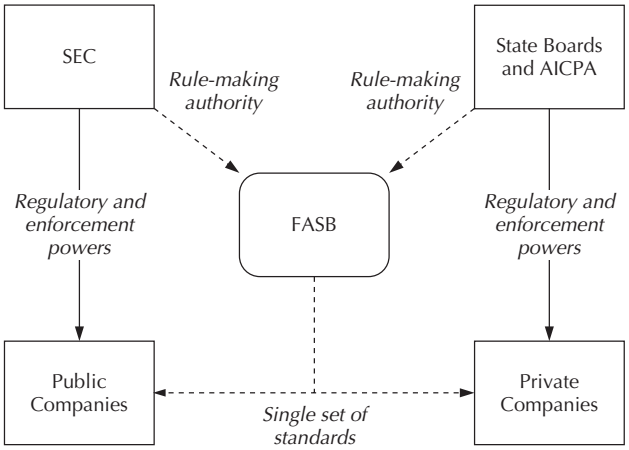

Exhibit 1.4 Conflicting authorities and standards overload.

The FASB's dilemma is that too much emphasis on SEC registrants seems to ignore the constraints affecting private companies, yet too much emphasis on private companies ignores the needs of the SEC and the public for effective capital markets. Because the SEC exerts the greatest political influence, it seems likely that FASB will continue to focus on the needs of more sophisticated users and will issue standards that may be difficult for private companies to implement. This choice leaves the state Boards and the AICPA in a difficult relationship with some of their constituents and members, but there does not appear to be any way out of this dilemma. Some have suggested applying different standards according to whether the company is private or public, but survey responses have consistently shown that a different set of GAAP for private companies would be perceived as inferior, and that users would probably demand that public company principles be applied in private companies' statements. Thus, it does not appear as if the Board will be able to change its position.

Another political problem for the FASB exists in its relationships with the SEC, Congress, and the preparer community. Beginning with ASR No. 150, the SEC has virtually always supported the FASB's efforts, with the exception of SFAS No. 19 on oil and gas accounting. The Board's existence allows the Commission to meet its own needs without appropriating public funds. It also allows the SEC to divert criticism to the FASB while a problem is being solved, or even after a standard has been issued. Thus, it seems unlikely that the SEC will seek to move standard setting authority into the federal government. Two particularly strong statements were issued by federal officials in 1988 and 1989 in support of the present arrangement. One came from SEC Chairman David Ruder when he expressed great satisfaction with the Board's efforts and results in a speech to an AICPA conference on SEC matters and in a letter to the Business Roundtable. (The Roundtable is an association of the chief executive officers of approximately 200 of the largest corporations in the United States. It is primarily a lobbying organization to help ensure the protection and promotion of the member companies' interests.) The other came from Congressman John Dingell of Michigan in a letter to Ruder, in which he fundamentally stated that he liked the existing system, and if the SEC did not protect FASB against attack, then the Congress would.

Despite this support, members of the Roundtable continued to call for fundamental reform in FASB's structure and activities on the basis that it was "too theoretical" for practice, "unresponsive to its constituents," and "out of control." In reaction to these pressures, the Groves Committee was formed by the FAF trustees to identify weaknesses and to recommend changes. In 1989, the trustees accepted a recommendation that they engage in more active supervision of the Board's activities. The specific response was to form an Oversight Subcommittee that will meet with Board members and others to assess performance of both the organization and individual members.

As briefly mentioned earlier in the chapter in the context of capital market efficiency, the FASB faced a major controversy from 1993 through 1995 in completing its project on stock-based compensation. The pivotal issue in the project was the question of whether employers would be required to report an expense for employee compensation paid with stock options. This particular controversy went to new heights when opponents of the ED took their grievances to some key members of Congress, who then drafted legislation that would instruct the SEC to reject the proposal if it was actually passed by the Board. Many other members of Congress also sent letters to the Board or otherwise expressed their deep concerns about the effect of the standard on American business. In light of the near certainty that sophisticated capital market participants were aware of the expense and were already estimating its amount, these efforts to squelch the FASB proposal were actually futile. Nonetheless, the pressure was unrelenting, and the Board announced in December 1994 that it would withdraw its proposal and substitute another alternative that would allow companies to choose between putting the expense on the income statement or disclosing its estimated amount and a pro forma measure of net income and earnings per share in a footnote to the statements. This alternative eventually was implemented in SFAS 123. The basis for conclusions section of the standard frankly proclaims that a majority of the Board voted for this compromise first because "the nature of the debate threatened the future of accounting standards setting in the private sector" and then states that the majority wanted "to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting

and reporting." The victory for the Board's opponents was hollow because the information is there in the footnote for the market to see and use.

The failure of Enron Corporation, largely due to the disclosure of financial reporting improprieties, has resulted in fresh criticism of the FASB. Enron transferred nonperforming assets and liabilities into various special-purpose entities (SPEs). The objective of these maneuvers was to shield Enron from recognizing losses on these nonperforming assets, and to reduce Enron's perceived risk by reducing its reported debt level. Former accounting rules for SPEs did not require consolidation of assets and liabilities transferred to the SPE with the financial statements of the sponsoring entity if an outside investor made an equity contribution of 3 percent or more of the SPEs' total capitalization. Enron did not meet this requirement because some of the outside capital allegedly contributed to the SPE was not really at risk. Enron had guaranteed some of the capital investments made by outside investors using Enron's own stock as the form of guarantee.

Although Enron did not comply with the existing accounting requirements, the FASB was still subject to stinging criticism because a number of parties alleged that: (1) the current accounting rules for SPEs are too lax, and (2) the FASB's standards are too detailed and detailed standards provide incentives for preparers to design transactions that meet the letter, but not the spirit, of the standard. The FASB has issued an interpretation ("Consolidation of Variable Interest Entities"—Interpretation No. 46 to ARB No.51) to tighten the rules related to nonconsolidation of SPEs. Moreover, the Board has been criticized for failing to require companies to expense stock options, ironically by some of the same politicians who undermined the FASB's attempt to require the expensing of stock options in the 1990s. In recent years, a number of high-profile companies announced that they would voluntarily deduct the value of employee stock options in determining net income (e.g., Coca-Cola, General Electric, General Motors). Changes in the Standards require more companies to record compensation as a result of granting stock options. The implementation of the 2004 revisions to FAS 123 on Stock Compensation requires the use of the fair value method in measuring the expensing stock options.

The Sarbanes-Oxley Act includes a provision that provides funding to the FASB. This provision should serve to strengthen the FASB's independence, particularly from pressure brought to bear by issuers.

Beginning in the late 1990s and continuing with greater intensity today is a cooperative effort to converge world accounting standards. While a difficult task to accomplish in the short run, bringing accounting standards closer together facilitates international business and the comparability of financial reporting around the world. The International Accounting Standards Board and the FASB work together to narrow the differences between accounting standards, particularly on major issues.

(b) GOVERNMENTAL ACCOUNTING STANDARDS BOARD. In response to needs expressed by various groups, a study was undertaken in the early 1980s to consider how to establish financial accounting standards for state and local governmental units. (The federal government's uniqueness has caused the application of governmental accounting standards to be limited to state and local entities.) Standards were being established through professional organizations composed of governmental accountants, but they had not been endorsed by the Council of the AICPA, with the consequence that there was some concern over whether they constituted GAAP. The study group's report recommended the creation of the Governmental Accounting Standards Board (GASB) that would be under the administration of the FAF. After several years of discussion and opposition, the trustees agreed to set up the GASB, and it began operations in 1984.

The constituencies of GASB overlap those of the FASB, but only to a limited extent. The preparers consist of elected and appointed officials who are accountable to the voting public for the use and safekeeping of funds appropriated or otherwise entrusted to them, and thus they do not coincide with the preparers regulated by the FASB. The auditor constituency is essentially the same as for the FASB, although the actual individuals are likely to be different because of specialization. Some users of the financial statements of governmental units are different from users of business

statements, whereas others are the same. In effect, when governmental units go into the capital markets to obtain debt funding, they are competing with corporations for investors' attention. There is no regulatory agency comparable to the SEC with jurisdiction over governmental units, with the consequence that the GASB has no constituent like the Commission. State Boards are interested in the GASB's efforts because their licensees act as auditors for governmental units.

Without an endorsement by the SEC, the authority of GASB for setting standards is not quite as clear-cut as that of the FASB. It does have power, however, because a variety of professional societies, including the AICPA, endorse its efforts. It also has increased influence because of its affiliation with the FASB.

(i) The Structure of the Governmental Accounting Standards Board. The GASB has five members, with only the chairman serving on a full-time basis. The other four members serve part time and commute to Connecticut as needed for meetings and consultations. In addition, the Board has a full-time director of Research and Technical Activities. The GASB's headquarters are located in the same building as the FASB and the FAF. Although the two Boards operate independently, they do share some facilities, including the Board meeting room and the library, as well as their accounting and human resource management staff.

The Governmental Accounting Standards Advisory Committee serves the same purpose as the FASAC, but it is not as large and does not have a full-time chairman.

The GASB's due process procedures are essentially the same as the FASB's and include similar steps. Some of the deliberations are more difficult to accomplish because of the geographical dispersion of the part-time members, but they nonetheless take place.

(ii) The Jurisdiction Issue. A persistent problem in the relationship between FASB and GASB has been the overlapping of their jurisdictions in some segments of the economy. In fact, the issue of which Board should provide standards for these segments was the major stumbling block to the GASB's establishment.

Some organizations subject to the overlapping jurisdiction are utilities and providers of educational and health services. For example, some universities are operated by governments, others are private, and still others are combinations. The same situation exists for utilities, hospitals, and nursing homes. The jurisdiction issue turned first on the question of whether all these entities should be required to use the same accounting principles in order to achieve comparability. If so, the next question was which Board should establish those principles.

As long as there were no conflicts over the principles to be used, the jurisdiction dispute did not cause a practical problem. However, that situation did not exist for long because the two Boards reached opposing conclusions concerning the recognition of depreciation. Thus, the unresolved issue continued to chafe both organizations and to confuse their constituents.

It was resolved in late 1989 when the FAF's trustees first voted to implement and then shortly thereafter rejected a recommendation offered by two Special Committees that reviewed the structures of FASB and GASB. The final resolution left the jurisdiction as it had originally been defined, with GASB holding power over state and local government entities, whereas the FASB was given responsibility for all others. In addition, it was agreed that GASB would give careful consideration to the need for comparability when setting standards for public sector entities in industries that also include private companies.

1.4 PROFESSIONAL ORGANIZATIONS

(a) AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS. Of the several professional accounting organizations, the largest and most influential is the American Institute of Certified Public Accountants (AICPA). Each member must be licensed as a CPA by some jurisdiction, but need not practice as a public accountant. Less than half of the AICPA's membership is in public practice; the majority of members are in industry, government, or education.

(i) Structure. In response to assertions from congressional staff, the AICPA undertook a major restructuring in 1977 to establish a more rigorous self-regulatory system. Even though concern over alleged shortcomings was not backed up by enacted legislation, the Institute created a Division for CPA Firms, whereas previously it had only individual memberships. Members of this division commit themselves to higher standards of quality and quality control, including triennial peer reviews of their quality control systems. Subsequent to the Sarbanes-Oxley Act, the AICPA created a structure of "Centers" to improve member service. The former Securities and Exchange Commission Practice Section (SECPS) became the Center for Public Company Accounting Firms. These Centers continue to evolve in terms of member composition and organization.

As a result of a major change in policy approved by the Institute membership in 1988, all members in public practice will be subject to quality control reviews, even if they do not belong to the Division for CPA Firms. However, these reviews will not be as extensive as full peer reviews, and the AICPA will not release the results to the public.

As discussed previously, the Sarbanes-Oxley Act has replaced the AICPA's system of self-regulation and peer reviews for public companies with inspections by the newly created Public Company Accounting Oversight Board (PCAOB).The AICPA continues with its programs for audits and auditors not subject to PCAOB jurisdiction. The most significant services provided by the AICPA to its members and the public are discussed below.

(ii) Technical Standards. Despite the discontinuation of the APB and the creation of the FASB, the Institute still carries on limited accounting guidance through the Accounting Standards Executive Committee (AcSEC) and sets auditing standards for non-issuers through the Auditing Standards Board (ASB).

Prior to 2002, AcSEC examined accounting issues that had not reached the FASB's agenda, or that the FASB had decided against adding to its agenda. Accordingly, AcSEC and the FASB were in frequent contact, and FASB staff members attend AcSEC meetings. The primary form of output from AcSEC was a Statement of Position (SOP), which must be followed by Institute members. Under SAS No. 69, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles," AcSEC SOPs are considered level b pronouncements in the GAAP hierarchy. SOPs constitute GAAP if no level a pronouncement exists. The Committee is composed of between 15 and 18 individuals representing various levels and segments of the profession. AcSEC issued an ED of a proposed SOP before issuing the final standard. In response to FASB concerns about the nature and authoritativeness of various standard-setting activities, AcSEC discontinued issuing SOPs. Subject to a transition plan accepted by both the FASB and the AICPA during the fall of 2002 regarding AcSEC projects in process, AcSEC and the AICPA will no longer issue general-purpose SOPs or ask the FASB to clear SOPs or practice bulletins. However, AcSEC will continue to issue Audit and Accounting Guides, which have an industry focus.

The ASB is the organization that creates authoritative GAAS. It does so by issuing Statements on Auditing Standards (SAS). This 19-member group is composed of senior auditing specialists from major and small auditing firms, as well as from industry, government, user groups and education. It uses a thorough due process, including the issuance of exposure drafts of proposed standards and its ASB meetings are open to the public. Beginning in the late 1990s, the ASB actively participated in the Standards setting activities of the International Auditing and Attest Standards Board (IAASB), and has initiated the process of converging US and International Auditing Standards. In 2006, the ASB issued a series of new pervasive standards designed to enhance the risk assessment process and to clarify numerous auditor responsibilities. A motivating factor for the standards was the increased amount of public concern over the reliability of audit reports, in the wake of the Enron and Worldcom scandals, and litigation alleging auditors' failures to protect the public against fraud and business collapses.

The Sarbanes-Oxley Act charges the PCAOB with establishing or adopting auditing standards applicable to audits of SEC registrants. The Sarbanes-Oxley Act clearly permits the PCAOB

to adopt auditing standards issued by the ASB. The PCAOB adopted the AICPA authoritative literature as it stood in April 2003, and then began to write its own Standards, modifying that literature going forward. The PCAOB announced its vision of re-writing the entirety of existing auditing standards at some point. Since the PCAOB has so far not adopted any of the ASB Standards subsequent to SAS 101 on "Auditing Fair Value Measurements and Disclosures," the two bodies of auditing Standards literature are now diverging at a rapid rate. Representatives of the ASB, PCAOB and GAO meet periodically to discuss issues of mutual interest. In addition, the PCAOB regularly monitors the activities of the IAASB. Many auditors of private and public companies are concerned today about the complexity and confusion of working in the long run in an environment where there are two main bodies auditing literature.

Senior AICPA committees for specific industries provide other technical guidance. Their output is in the form of Industry Accounting and Auditing Guides. A member of the Institute is obliged to follow the provisions of these guides in auditing a client that belongs to one of the covered industries. Under SAS No. 69, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles," Industry Accounting and Auditing Guides (A&A) are considered level b pronouncements in the GAAP hierarchy. These A&A Guides constitute GAAP if no level a pronouncement exists. The PCAOB has indicated that it does not have an interest in publishing its own guides at this time.

In addition to these activities, the Institute staff also provides technical assistance to members who have encountered questions in conducting their accounting, auditing, and tax practices. Specifically, members can call or write the Institute staff with their questions and receive guidance on how to resolve them. In many cases, all that is needed is to steer the member to the right portion of the authoritative literature. In other cases, the members are seeking concurrence with a position they have reached on their own. Both services are especially valuable to sole practitioners because they do not have colleagues to double check their research.

(iii) Examinations. The AICPA produces, administers, and grades the Uniform CPA Examination under contract to individual state Boards of accountancy. This service includes writing the exam to specifications established through NASBA, maintaining security over the questions, delivering the exams to the sites, and reading and grading the exam. The Institute then sends the results to the state Board, which, in turn, notifies the candidates.

The CPA Examination is today administered as a 14 hour computerized exam. The exam is offered periodically throughout the year, rather than only in May and November as previously was the case. The CPA exam covers: Auditing and Attestation, Financial Accounting and Reporting, Regulation, and Business Environment and Concepts.

1.5 SUMMARY

This chapter has shown how financial accounting is important to society because of its contribution to the economy by helping the capital markets operate more effectively. Because of the importance of this social goal, and because history has shown that abusive accounting tends to occur as preparers attempt to gain unfair advantages, financial accounting is significantly regulated by governmental agencies, by private standard setting bodies that are endorsed and supported by governmental agencies, and by professional organizations. This regulation deals with reporting standards, competency standards, and ethical standards.

The regulation of accounting involves politics because of the conflicting interests among financial statement preparers, auditors, users, and regulators. The tension among these interests helps bring about change and improvement, but only at the risk of not fully serving the public interest. The present structure has evolved with what appears to be the central goal of protecting the public, but that mission will be attained only through careful vigilance and oversight.

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