

1 Financial Accounting and Accounting Standards

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

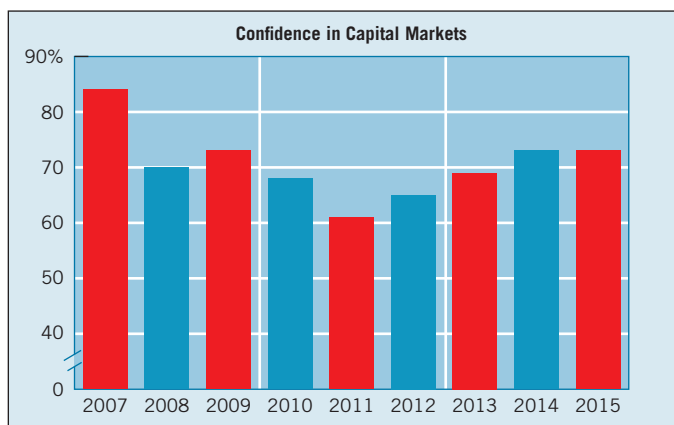
- 1 Understand the financial reporting environment.
- 2 Identify the major policy-setting bodies and their role in the standard-setting process.
- 3 Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.
- 4 Describe major challenges in the financial reporting environment.

WE CAN DO BETTER


A recent report says it best: “Accounting information is central to the functioning of international capital markets and to managing small businesses, conducting effective government, understanding business processes, and . . . how economic decisions are made. . . . Across the globe, a common characteristic of economies that flourish is the presence of reliable accounting information.”

Many in the United States take pride in our system of financial reporting as being the most robust and transparent in the world. But most would also comment that we can do better, particularly in light of the many accounting scandals that have occurred at companies like **AIG**, **WorldCom**, and **Lehman Brothers**, and the financial crisis of 2008.

To better understand where we are today, the Center for Audit Quality conducts a yearly survey that measures investor confidence in such categories as U.S. capital markets, audited financial information, and U.S. publicly traded companies. As shown in the chart on the right, the results indicate that the 2008 financial crisis took a bite out of investor confidence. While investor confidence in U.S. markets has stabilized, it has not returned to pre-crisis levels. So the question is, how can we improve? Here are some possibilities on how we can enhance the existing system of financial reporting.



1. Today, equity securities are broadly held, with approximately half of American households investing in stocks. This presents a challenge—investors have expressed concerns that **one-size-fits-all financial reports do not meet the needs of the spectrum of investors** who rely on those reports. While many individual investors are more interested in summarized, plain-English reports, market analysts and other investment professionals may desire information at a far more detailed level than is currently provided. Technology may help customize the information that the different types of investors desire.
2. Companies also express concerns with the complexity of the financial reporting system. Companies assert that **when preparing financial reports, it is difficult to ensure compliance with the voluminous and complex requirements contained in U.S. GAAP and SEC reporting rules**. This is a particularly heavy burden on smaller, non-public companies, which may have fewer resources to comply with the wide range of rules.
3. We also need to consider the broader array of information that investors need to make informed decisions. As some have noted, the percentage of a company's market value that can be attributed to accounting book value has declined significantly from the days of a bricks-and-mortar economy. **Thus, we may want to**



consider a more comprehensive business reporting model, including both financial and nonfinancial key performance indicators.

4. Finally, we must also consider **how to deliver all of this information in a timelier manner.** In a world where messages can be sent across the world in a blink of an eye, it is ironic that the analysis of financial information is still subject to many manual processes, resulting in delays, increased costs, and errors.

Thus, improving financial reporting involves more than simply trimming or reworking the existing accounting literature. In some cases, major change is already underway. For example:

- The FASB and IASB are working on a convergence project, which will contribute to less-complex, more-understandable standards in the important areas of revenue recognition, leasing, and financial instruments.
- Standard-setters are exploring expanded reporting of key performance indicators, including reports on sustainability and a disclosure framework project to improve the effectiveness of disclosures to clearly communicate the information that is most important to users of financial statements. This project, combined with the introduction of a private-company reporting framework, could go a long way to address one-size-fits-all challenges.
- The SEC now requires the delivery of financial reports using eXtensible Business Reporting Language (XBRL). Reporting through XBRL allows timelier reporting via the Internet and allows statement users to transform accounting reports to meet their specific needs.

Each of these projects will hopefully support improvements in the quality of financial reporting and increase confidence in U.S. capital markets.

Sources: Adapted from The Pathways Commission, “Charting a National Strategy for the Next Generation of Accountants” (AAA, AICPA, July 2012); Conrad W. Hewitt, “Opening Remarks Before the Initial Meeting of the SEC Advisory Committee on Improvements to Financial Reporting,” U.S. Securities and Exchange Commission, Washington, D.C. (August 2, 2007); and Center for Audit Quality, *Main Street Investor Survey* (September 2015). See www.fasb.org for updates on FASB/IASB convergence, disclosure, and private company decision-making projects.

PREVIEW OF CHAPTER 1 As our opening story indicates, the U.S. system of financial reporting has long been the most robust and transparent in the world. However, to ensure that it continues to provide the most relevant and reliable financial information to users, a number of financial reporting issues must be resolved. These issues include such matters as evaluating global standards, increasing fair value reporting, and meeting multiple user needs. This chapter explains the environment of financial reporting and the many factors affecting it, as follows.

This chapter also includes numerous **conceptual and international discussions** that are integral to the topics presented here.

FINANCIAL ACCOUNTING AND ACCOUNTING STANDARDS

FINANCIAL REPORTING ENVIRONMENT

- Accounting and capital allocation
- Objective of financial reporting
- Need to develop standards

PARTIES INVOLVED IN STANDARD-SETTING

- Securities and Exchange Commission
- American Institute of CPAs
- Financial Accounting Standards Board

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

- FASB Codification

MAJOR CHALLENGES IN FINANCIAL REPORTING

- Political environment
- Expectations gap
- Financial reporting issues
- International accounting standards
- Ethics

REVIEW AND PRACTICE

Go to the REVIEW AND PRACTICE section at the end of the chapter for a targeted summary review and practice problem with solution. Multiple-choice questions with annotated solutions as well as additional exercises and practice problem with solutions are also available online.

LEARNING OBJECTIVE 1

Understand the financial reporting environment.

FINANCIAL REPORTING ENVIRONMENT

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

Financial statements are the principal means through which a company communicates its financial information to those outside it. These statements provide a company's history quantified in money terms. The **financial statements** most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners' or stockholders' equity. Note disclosures are an integral part of each financial statement.

Some financial information is better provided, or can be provided only, by means of **financial reporting** other than formal financial statements. Examples include the president's letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management's forecasts, and social or environmental impact statements. Companies may need to provide such information because of authoritative pronouncement, regulatory rule, or custom. Or they may supply it because management wishes to disclose it voluntarily.

In this textbook, we focus on the development of two types of financial information: (1) the basic financial statements and (2) related disclosures.

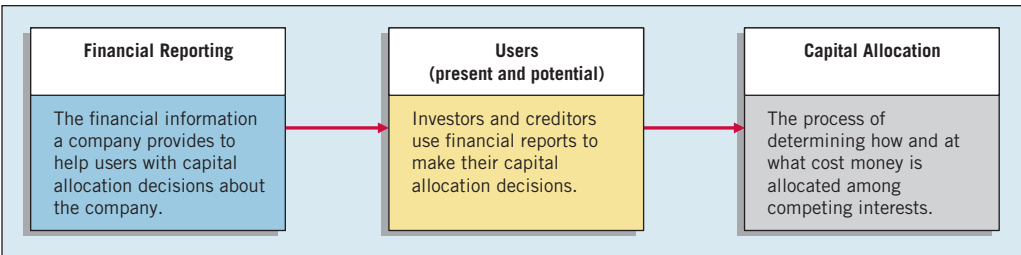
Accounting and Capital Allocation

Resources are limited. As a result, people try to conserve them and ensure that they are used effectively. Efficient use of resources often determines whether a business thrives. This fact places a substantial burden on the accounting profession.

Accountants must measure performance accurately and fairly on a timely basis, so that the right managers and companies are able to attract investment capital. For example, relevant and reliable financial information allows investors and creditors to compare the income and assets employed by such companies as **Nike**, **McDonald's**, **Microsoft**, and **Berkshire Hathaway**. Because these users can assess the relative return and risks associated with investment opportunities, they channel resources more effectively. Illustration 1-1 shows how this process of capital allocation works.

ILLUSTRATION 1-1

Capital Allocation Process



An effective process of capital allocation is critical to a healthy economy. It promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Unreliable and

irrelevant information leads to poor capital allocation, which adversely affects the securities markets.

WHAT DO THE NUMBERS MEAN?

IT'S THE ACCOUNTING

"It's the accounting." That's what many investors seem to be saying these days. Even the slightest hint of any accounting irregularity at a company leads to a subsequent pounding of the company's stock price. For example, the *Wall Street Journal* has run the following headlines related to accounting and its effects on the economy:

- Stocks take a beating as accounting woes spread beyond **Enron**.
- Quarterly reports from **IBM** and **Goldman Sachs** sent stocks tumbling.

- **VeriFone** finds accounting issues; stock price cut in half.
- **Bank of America** admits hiding debt.
- **Facebook, Zynga, Groupon**: IPO drops due to accounting, not valuation.

It now has become clear that investors must trust the accounting numbers, or they will abandon the market and put their resources elsewhere. With investor uncertainty, the cost of capital increases for companies who need additional resources. In short, relevant and reliable financial information is necessary for markets to be efficient.

Objective of Financial Reporting

What is the **objective (or purpose) of financial reporting**? The objective of general-purpose financial reporting is to **provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors** in decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit. Information that is decision-useful to capital providers (investors) may also be helpful to other users of financial reporting who are not investors. Let's examine each of the elements of this objective.¹

General-Purpose Financial Statements

General-purpose financial statements provide financial reporting information to a wide variety of users. For example, when **The Hershey Company** issues its financial statements, these statements help shareholders, creditors, suppliers, employees, and regulators to better understand its financial position and related performance. Hershey's users need this type of information to make effective decisions. To be cost-effective in providing this information, general-purpose financial statements are most appropriate. In other words, general-purpose financial statements provide at the **least cost the most useful information possible**.

Equity Investors and Creditors

The objective of financial reporting **identifies investors and creditors as the primary users for general-purpose financial statements**. Identifying investors and creditors as the primary users provides an important focus of general-purpose financial reporting. For example, when Hershey issues its financial statements, its primary focus is on investors and creditors because they have the most critical and immediate need for information in financial reports. Investors and creditors need this financial information to assess Hershey's ability to generate net cash inflow and to understand management's ability to protect and enhance the assets of the company, which will be used to generate future

UNDERLYING CONCEPTS

While the objective of financial reporting is focused on investors and creditors, financial statements may still meet the needs of others.

¹Chapter 1, "The Objective of General Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information," *Statement of Financial Accounting Concepts No. 8* (Norwalk, Conn.: FASB, September 2010), par. OB2.

net cash inflows. As a result, the primary user groups are not management, regulators, or some other non-investor group.

Entity Perspective

As part of the objective of general-purpose financial reporting, an **entity perspective** is adopted. Companies are viewed as separate and distinct from their owners (present shareholders) using this perspective. The assets of Hershey are viewed as assets of the company and not of a specific creditor or shareholder. Rather, these investors have claims on Hershey's assets in the form of liability or equity claims. The entity perspective is consistent with the present business environment where most companies engaged in financial reporting have substance distinct from their investors (both shareholders and creditors). Thus, a perspective that financial reporting should be focused only on the needs of shareholders—often referred to as the **proprietary perspective**—is not considered appropriate.

WHAT DO THE NUMBERS MEAN?

DON'T FORGET STEWARDSHIP

In addition to providing decision-useful information about future cash flows, management also is accountable to investors for the custody and safekeeping of the company's economic resources and for their efficient and profitable use. For example, the management of **The Hershey Company** has the responsibility for protecting its economic resources from unfavorable

effects of economic factors, such as price changes, and technological and social changes. Because Hershey's performance in discharging its responsibilities (referred to as its **stewardship** responsibilities) usually affects its ability to generate net cash inflows, financial reporting may also provide decision-useful information to assess management performance in this role.

Source: Chapter 1, "The Objective of General Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information," *Statement of Financial Accounting Concepts No. 8* (Norwalk, Conn.: FASB, September 2010), paras. OB4–OB10.

Decision-Usefulness

Investors are interested in financial reporting because it provides information that is useful for making decisions (referred to as the **decision-usefulness** approach). As indicated earlier, when making these decisions, investors are interested in assessing (1) the company's ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. In order for investors to make these assessments, the economic resources of an enterprise, the claims to those resources, and the changes in them must be understood. Financial statements and related explanations should be a primary source for determining this information.

The emphasis on "assessing cash flow prospects" does not mean that the cash basis is preferred over the accrual basis of accounting. Information based on accrual accounting better indicates a company's present and continuing ability to generate favorable cash flows than does information limited to the financial effects of cash receipts and payments.

Recall from your first accounting course the objective of **accrual-basis accounting**: It ensures that a company records events that change its financial statements in the periods in which the events occur, rather than only in the periods in which it receives or pays cash. Using the accrual basis to determine net income means that a company recognizes revenues when it provides the goods or services rather than when it receives cash. Similarly, it recognizes expenses when it incurs them rather than when it pays them. Under accrual accounting, a company generally recognizes revenues

when it makes sales. The company can then relate the revenues to the economic environment of the period in which they occurred. Over the long run, trends in revenues and expenses are generally more meaningful than trends in cash receipts and disbursements.²

The Need to Develop Standards

The main controversy in setting accounting standards is, “Whose rules should we play by, and what should they be?” The answer is not immediately clear. Users of financial accounting statements have both coinciding and conflicting needs for information of various types. To meet these needs, and to satisfy the stewardship reporting responsibility of management, companies prepare a single set of **general-purpose financial statements**. Users expect these statements to present fairly, clearly, and completely the company’s financial operations.

The accounting profession has attempted to develop a set of standards that are generally accepted and universally practiced. Otherwise, each company would have to develop its own standards. Further, readers of financial statements would have to familiarize themselves with every company’s peculiar accounting and reporting practices. It would be almost impossible to prepare statements that could be compared.

This common set of standards and procedures is called **generally accepted accounting principles (GAAP)**. The term “generally accepted” means either that an authoritative accounting rule-making body has established a principle of reporting in a given area or that over time a given practice has been accepted as appropriate because of its universal application.³ Although principles and practices continue to provoke both debate and criticism, most members of the financial community recognize them as the standards that over time have proven to be most useful. We present a more extensive discussion of what constitutes GAAP later in this chapter.

UNDERLYING CONCEPTS

Preparing financial statements according to accepted accounting standards contributes to the comparability of accounting information.

PARTIES INVOLVED IN STANDARD-SETTING

Three organizations are instrumental in the development of financial accounting standards (GAAP) in the United States:

1. Securities and Exchange Commission (SEC)
2. American Institute of Certified Public Accountants (AICPA)
3. Financial Accounting Standards Board (FASB)

Securities and Exchange Commission (SEC)

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

As a result of these events, the federal government established the **Securities and Exchange Commission (SEC)** to help develop and standardize financial information

LEARNING OBJECTIVE 2

Identify the major policy-setting bodies and their role in the standard-setting process.

INTERNATIONAL PERSPECTIVE



The International Organization of Securities Commissions (IOSCO), established in 1987, consists of more than 100 securities regulatory agencies or securities exchanges from all over the world. Collectively, its members represent a substantial proportion of the world’s capital markets. The SEC is a member of IOSCO.

²As used here, cash flow means “cash generated and used in operations.” The term *cash flows* also frequently means cash obtained by borrowing and used to repay borrowing, cash used for investments in resources and obtained from the disposal of investments, and cash contributed by or distributed to owners.

³The terms *principles* and *standards* are used interchangeably in practice and throughout this textbook.

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

Public/Private Partnership

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

The SEC has affirmed its support for the FASB by indicating that financial statements conforming to standards set by the FASB are presumed to have substantial authoritative support. In short, the **SEC requires registrants to adhere to GAAP**. In addition, the SEC indicated in its reports to Congress that “it continues to believe that the initiative for establishing and improving accounting standards should remain in the private sector, subject to Commission oversight.”

SEC Oversight

The SEC’s partnership with the private sector works well. The SEC acts with remarkable restraint in the area of developing accounting standards. Generally, **the SEC relies on the FASB to develop accounting standards**.

The SEC’s involvement in the development of accounting standards varies. In some cases, the SEC rejects a standard proposed by the private sector. In other cases, the SEC prods the private sector into taking quicker action on certain reporting problems, such as accounting for investments in debt and equity securities and the reporting of derivative instruments. In still other situations, the SEC communicates problems to the FASB, responds to FASB exposure drafts, and provides the FASB with counsel and advice upon request.

The SEC’s mandate is to establish accounting principles. The private sector, therefore, must listen carefully to the views of the SEC. In some sense, the private sector is the formulator and the implementor of the standards.⁴ However, when the private sector fails to address accounting problems as quickly as the SEC would like, the partnership between the SEC and the private sector can be strained. This occurred in the deliberations on the accounting for business combinations and intangible assets. It is also highlighted by concerns over the accounting for off-balance-sheet, special purpose entities. Examples include the failure of **Enron** and the subprime crises that led to the failure of **IndyMac Bank**.

Enforcement

As we indicated earlier, companies listed on a stock exchange must submit their financial statements to the SEC. If the SEC believes that an accounting or disclosure



INTERNATIONAL PERSPECTIVE

The U.S. legal system is based on English common law, whereby the government generally allows professionals to make the rules. The private sector, therefore, develops these rules (standards). Conversely, some countries have followed codified law, which leads to government-run accounting systems.

⁴One writer described the relationship of the FASB and SEC and the development of financial reporting standards using the analogy of a pearl. The pearl (a financial reporting standard) “is formed by the reaction of certain oysters (FASB) to an irritant (the SEC)—usually a grain of sand—that becomes embedded inside the shell. The oyster coats this grain with layers of nacre, and ultimately a pearl is formed. The pearl is a joint result of the irritant (SEC) and oyster (FASB); without both, it cannot be created.” John C. Burton, “Government Regulation of Accounting and Information,” *Journal of Accountancy* (June 1982).

irregularity exists regarding the form or content of the financial statements, it sends a deficiency letter to the company. Companies usually resolve these deficiency letters quickly. If disagreement continues, the SEC may issue a “stop order,” which prevents the registrant from issuing or trading securities on the exchanges. The Department of Justice may also file criminal charges for violations of certain laws. The SEC process, private sector initiatives, and civil and criminal litigation help to ensure the integrity of financial reporting for public companies.

American Institute of Certified Public Accountants (AICPA)

The **American Institute of Certified Public Accountants (AICPA)**, which is the national professional organization of practicing Certified Public Accountants (CPAs), has been an important contributor to the development of GAAP. Various committees and boards established since the founding of the AICPA have contributed to this effort.

Committee on Accounting Procedure

At the urging of the SEC, the AICPA appointed the Committee on Accounting Procedure in 1939. The **Committee on Accounting Procedure (CAP)** composed of practicing CPAs, issued 51 **Accounting Research Bulletins** during the years 1939 to 1959. These bulletins dealt with a variety of accounting problems. But this problem-by-problem approach failed to provide the needed structured body of accounting principles. In response, in 1959 the AICPA created the Accounting Principles Board.

Accounting Principles Board

The major purposes of the **Accounting Principles Board (APB)** were to (1) advance the written expression of accounting principles, (2) determine appropriate practices, and (3) narrow the areas of difference and inconsistency in practice. To achieve these objectives, the APB’s mission was twofold: to develop an overall conceptual framework to assist in the resolution of problems as they become evident and to substantively research individual issues before the AICPA issued pronouncements. The Board’s 18 to 21 members, selected primarily from public accounting, also included representatives from industry and academia. The Board’s official pronouncements, called **APB Opinions**, were intended to be based mainly on research studies and be supported by reason and analysis. Between its inception in 1959 and its dissolution in 1973, the APB issued 31 opinions.

Unfortunately, the APB came under fire early, charged with lack of productivity and failing to act promptly to correct alleged accounting abuses. Later, the APB tackled numerous thorny accounting issues, only to meet a buzz saw of opposition from industry and CPA firms. It also ran into occasional governmental interference. In 1971, the accounting profession’s leaders, anxious to avoid governmental rule-making, appointed a Study Group on Establishment of Accounting Principles. Commonly known as the **Wheat Committee** for its chair Francis Wheat, this group examined the organization and operation of the APB and determined the necessary changes to attain better results. The Study Group submitted its recommendations to the AICPA Council in the spring of 1972, which led to the replacement of the APB with the Financial Accounting Standards Board (FASB) in 1973.

Financial Accounting Standards Board (FASB)

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

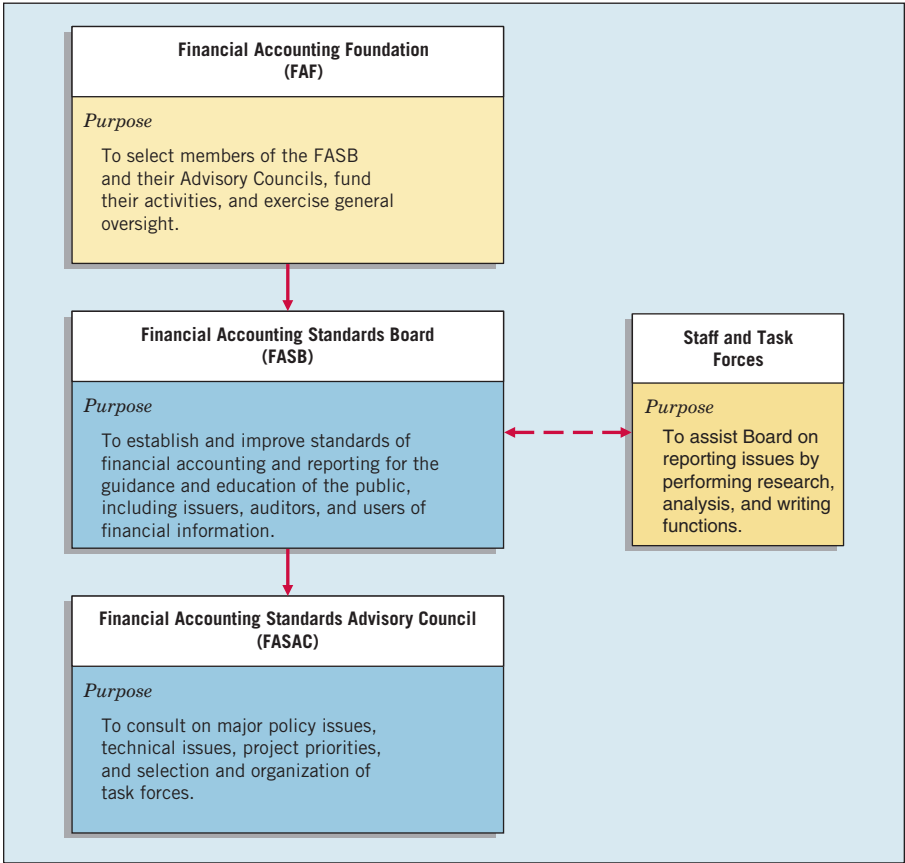
The major operating organization in this three-part structure is the **Financial Accounting Standards Board (FASB)**. Its mission is to establish and improve standards

of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information. The expectations of success and support for the new FASB relied on several significant differences between it and its predecessor, the APB:

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

In addition to research help from its own staff, the FASB relies on the expertise of various task force groups formed for various projects and on the **Financial Accounting Standards Advisory Council (FASAC)**. The FASAC consults with the FASB on major policy and technical issues and also helps select task force members. Illustration 1-2 shows the current organizational structure for the development of financial reporting standards.⁵

ILLUSTRATION 1-2
Organizational Structure for
Setting Accounting
Standards



⁵Other advisory groups, such as the Investors Technical Advisory Committee (ITAC), the Not-for-Profit Advisor Committee (NAC), the Valuation Resource Group (VRG), and the recently established Private Company Council (PCC), share their views and experience with the Board on matters related to projects on the Board’s agenda, from the perspective of various constituencies and/or in areas of specific expertise.

Due Process

In establishing financial accounting standards, the FASB relies on two basic premises. (1) The FASB should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession. (2) It should operate in full view of the public through a “due process” system that gives interested persons ample opportunity to make their views known. To ensure the achievement of these goals, the FASB follows specific steps to develop a typical FASB pronouncement, as Illustration 1-3 shows.

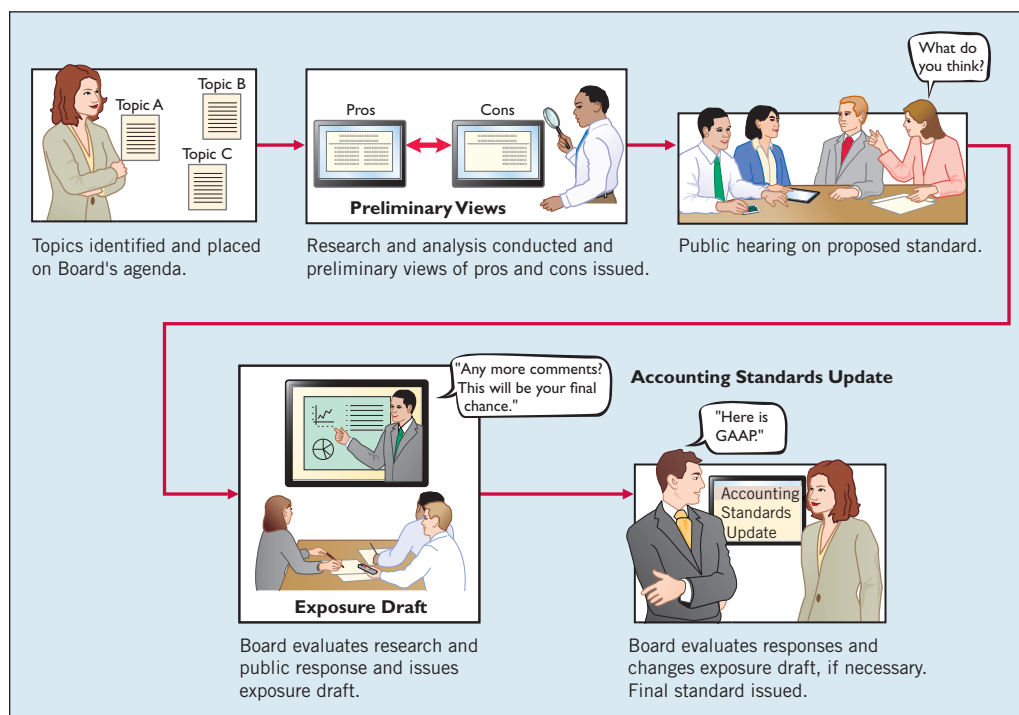


ILLUSTRATION 1-3
The Due Process System of the FASB

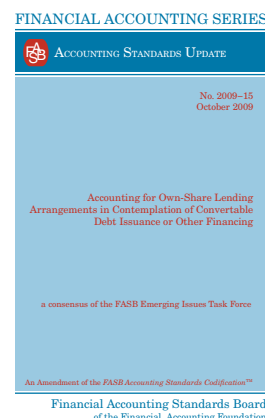
The passage of new FASB guidance in the form of an Accounting Standards Update requires the support of four of the seven Board members. FASB pronouncements are considered GAAP and thereby binding in practice. All ARBs and APB Opinions implemented by 1973 (when the FASB formed) continue to be effective until amended or superseded by FASB pronouncements. In recognition of possible misconceptions of the term “principles,” the FASB uses the term **financial accounting standards** in its pronouncements.

Types of Pronouncements

The FASB issues two major types of pronouncements:

1. Accounting Standards Updates
2. Financial Accounting Concepts

Accounting Standards Updates. The FASB issues accounting pronouncements through **Accounting Standards Updates** (Updates). These Updates amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC. (We discuss the Codification in more detail later in the chapter.) Each Update explains how the Codification has been amended and also includes information to help the reader understand the changes and when those changes will be effective. Common forms of amendments are accounting standards issued that address a broad area of accounting practice (such as the accounting for leases) or

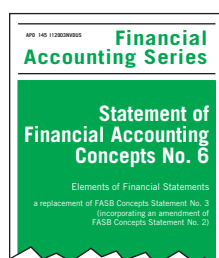


interpretations that modify or extend existing standards. Prior standard-setters such as the APB also issued interpretations of APB Opinions.

A second type of Update is a consensus of the **Emerging Issues Task Force (EITF)**, created in 1984 by the FASB. The EITF provides implementation guidance within the framework of the Codification to reduce diversity in practice on a timely basis. The EITF was designed to minimize the need for the FASB to spend time and effort addressing narrow implementation, application, or other emerging issues that can be analyzed within existing GAAP. Examples include accounting for pension plan terminations, revenue from barter transactions by Internet companies, and excessive amounts paid to takeover specialists. The EITF also provided timely guidance for the accounting for loans and investments in the wake of the credit crisis.

The EITF helps the FASB in many ways. The EITF identifies controversial accounting problems as they arise. The EITF determines whether it can quickly resolve them or whether to involve the FASB in solving them. In essence, it becomes a “problem filter” for the FASB. Thus, the FASB will hopefully work on more pervasive long-term problems, while the EITF deals with short-term emerging issues.

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




Financial Accounting Concepts. As part of a long-range effort to move away from the problem-by-problem approach, the FASB in November 1978 issued the first in a series of **Statements of Financial Accounting Concepts** as part of its conceptual framework project. (The Concepts Statements can be accessed at <http://www.fasb.org/>.) The series sets forth fundamental objectives and concepts that the Board uses in developing future standards of financial accounting and reporting. The Board intends to form a cohesive set of interrelated concepts—a conceptual framework—that will serve as tools for solving existing and emerging problems in a consistent manner. Unlike an **Accounting Standards Update**, a **Statement of Financial Accounting Concepts does not establish GAAP**. Concepts statements, however, pass through the same due process system (preliminary views, public hearing, exposure draft, etc.) as do standards updates.

Changing Role of the AICPA

At one time, the AICPA developed accounting standards, which were considered GAAP. The role of the AICPA in standard-setting is now diminished. The FASB and the AICPA agreed that the AICPA should no longer issue authoritative guidance for public companies. The AICPA does have a Financial Reporting Executive Committee (FinREC), which is authorized to make public statements on behalf of the AICPA on financial reporting matters. The mission of FinREC is to determine the AICPA’s technical policies regarding financial reporting standards, with the ultimate purpose of serving the public interest by improving financial reporting. FinREC also issues audit and accounting guides, which address particular areas in financial reporting that require attention, such as specialized accounting practices, significant or unique accounting issues, and unique regulatory considerations within the construction, casino, and airline industries. These guides provide specific direction on matters not addressed by the FASB.

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



INTERNATIONAL PERSPECTIVE

The CPA exam is administered internationally at testing sites in Bahrain, Kuwait, Japan, Lebanon, United Arab Emirates (UAE), and Brazil. The CPA exam now has some coverage of IFRS knowledge as part of the financial reporting section of the exam (see www.aicpa.org/cpa-exam).

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Generally accepted accounting principles (GAAP) have substantial authoritative support. The AICPA's Code of Professional Conduct requires that members prepare financial statements in accordance with GAAP. Specifically, Rule 203 of this Code prohibits a member from expressing an unqualified opinion on financial statements that contain a material departure from generally accepted accounting principles.

What is GAAP? The major sources of GAAP come from the organizations discussed earlier in this chapter. It is composed of a mixture of over 2,000 documents that have been developed over the last 70 years or so. It includes APB Opinions, FASB Standards, and AICPA Research Bulletins. In addition, the FASB has issued **interpretations** and **FASB Staff Positions** that modified or extended existing standards. The APB also issued interpretations of APB Opinions. Both types of interpretations are considered authoritative for purposes of determining GAAP.

LEARNING OBJECTIVE 3

Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.

WHAT DO THE NUMBERS MEAN?

YOU HAVE TO STEP BACK

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

Instead, these critics say, standard-setters have moved toward drafting voluminous rules that, if technically followed in "check-box" fashion, may shield auditors and companies from legal liability. That has resulted in companies creating complex capital structures that comply with GAAP but hide

billions of dollars of debt and other obligations. To add fuel to the fire, the chief accountant of the enforcement division of the SEC noted, "One can violate SEC laws and still comply with GAAP."

In short, what he is saying is that it is not enough just to check the boxes. This point was reinforced by the chief accountant of the SEC, who remarked that judgments should result in "accounting that reflects the substance of the transaction, as well as being in accordance with the literature." That is, you have to exercise judgment in applying GAAP to achieve high-quality reporting.

Sources: Adapted from S. Liesman, "SEC Accounting Cop's Warning: Playing by the Rules May Not Head Off Fraud Issues," *Wall Street Journal* (February 12, 2002), p. C7. See also "Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System," SEC (July 25, 2003); and E. Orenstein, "Accounting as Art vs. Science, and the Role of Professional Judgment," *Accounting Matters*, FEI Financial Reporting Blog (November 2009).

FASB Codification

Historically, the documents that comprised GAAP varied in format, completeness, and structure. In some cases, these documents were inconsistent and difficult to interpret. As a result, financial statement preparers sometimes were not sure whether they had the right GAAP. Determining what was authoritative and what was not became difficult.

In response to these concerns, the FASB developed the **Financial Accounting Standards Board Accounting Standards Codification** (or more simply, "the Codification"). The FASB's primary goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic. This will simplify user access to all authoritative U.S. generally accepted accounting principles. The Codification changes the way GAAP is documented, presented, and updated. It explains what GAAP is and eliminates nonessential information such as redundant document summaries, basis for conclusion sections, and historical content. In short, the Codification integrates and synthesizes existing GAAP; it does not create new GAAP. It creates one level of GAAP, which is considered authoritative. All other accounting literature is considered non-authoritative.⁶

⁶The FASB Codification can be accessed at <http://asc.fasb.org/home>. Access to the full functionality of the Codification Research System requires a subscription. Reduced-price academic access is available through the American Accounting Association (see aaahq.org/FASB/Access.cfm). Prior to the Codification, the profession relied on FASB 162, "The Hierarchy of Generally Accepted Accounting Principles," which defined the meaning of generally accepted accounting principles. In that document, certain documents were deemed more authoritative than others, which led to various levels of GAAP. Fortunately, the Codification does not have different levels of GAAP.

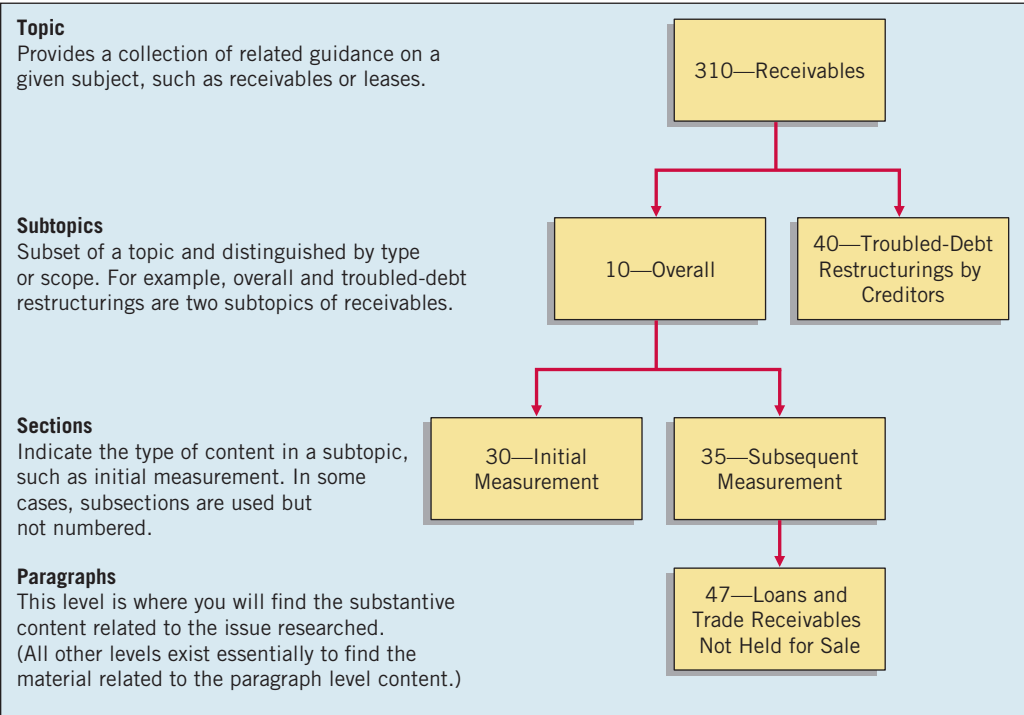
To provide easy access to this Codification, the FASB also developed the **Financial Accounting Standards Board Codification Research System (CRS)**. CRS is an online, real-time database that provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure, subdivided into topic, subtopics, sections, and paragraphs, using a numerical index system.

For purposes of referencing authoritative GAAP material in this textbook, we will use the Codification framework. Here is an example of how the Codification framework is cited, using receivables as the example. The purpose of the search shown below is to determine GAAP for accounting for loans and trade receivables not held for sale subsequent to initial measurement.

Topic	Go to FASB ASC 310 to access the Receivables topic.
Subtopics	Go to FASB ASC 310-10 to access the Overall Subtopic of the Topic 310.
Sections	Go to FASB ASC 310-10-35 to access the Subsequent Measurement Section of the Subtopic 310-10.
Paragraph	Go to FASB ASC 310-10-35-47 to access the Loans and Trade Receivables not Held for Sale paragraph of Section 310-10-35.

Illustration 1-4 shows the Codification framework graphically.

ILLUSTRATION 1-4
FASB Codification
Framework



What happens if the Codification does not cover a certain type of transaction or event? In that case, other accounting literature should be considered, such as FASB Concept Statements, international financial reporting standards, and other professional literature. This will happen only rarely.

The expectations for the Codification are high. It is hoped that the Codification will enable users to better understand what GAAP is. As a result, the time to research accounting issues and the risk of noncompliance with GAAP will be reduced,

sometimes substantially. In addition, the Web-based format will make updating easier, which will help users stay current with GAAP.⁷

For individuals (like you) attempting to learn GAAP, the Codification will be invaluable. It streamlines and simplifies how to determine what GAAP is, which will lead to better financial accounting and reporting. We provide references to the Codification throughout this textbook, using a numbering system. For example, a bracket with a number, such as **[1]**, indicates that the citation to the FASB Codification can be found in the **Bridge to the Profession** section at the end of the chapter.

See the Bridge to the Profession section at the end of each chapter for Codification references, exercises, and a research case.

MAJOR CHALLENGES IN FINANCIAL REPORTING

Since the implementation of GAAP may affect many interests, much discussion occurs about who should develop GAAP and to whom it should apply. We discuss some of the major issues below.

LEARNING OBJECTIVE 4

Describe major challenges in the financial reporting environment.

GAAP in a Political Environment

User groups are possibly the most powerful force influencing the development of GAAP. User groups consist of those most interested in or affected by accounting rules. Like lobbyists in our state and national capitals, user groups play a significant role. **GAAP is as much a product of political action as it is of careful logic or empirical findings.** User groups may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. They know that the most effective way to influence GAAP is to participate in the formulation of these rules or to try to influence or persuade the formulator of them.

These user groups often target the FASB, to pressure it to influence changes in the existing rules and the development of new ones.⁸ In fact, these pressures have been multiplying. Some influential groups demand that the accounting profession act more quickly and decisively to solve its problems. Other groups resist such action, preferring to implement change more slowly, if at all. Illustration 1-5 shows the various user groups that apply pressure.

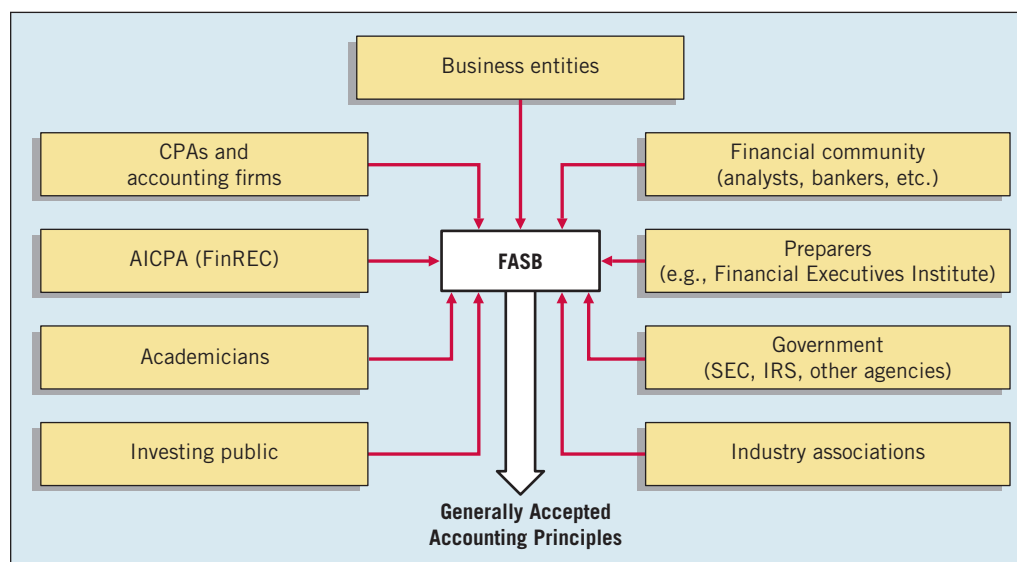


ILLUSTRATION 1-5

User Groups that Influence the Formulation of Accounting Standards

⁷To increase the usefulness of the Codification for public companies, relevant authoritative content issued by the SEC is included in the Codification. In the case of SEC content, an "S" precedes the section number.

⁸FASB board members acknowledged that they undertook many of the Board's projects, such as "Accounting for Contingencies," "Accounting for Pensions," "Statement of Cash Flows," and "Recognition and Measurement of Financial Assets and Liabilities," due to political pressure.

Should there be politics in establishing GAAP for financial accounting and reporting? Why not? We have politics at home; at school; at the fraternity, sorority, and dormitory; at the office; and at church, temple, and mosque. Politics is everywhere. GAAP is part of the real world, and it cannot escape politics and political pressures.

That is not to say that politics in establishing GAAP is a negative force. Considering the **economic consequences**⁹ of many accounting rules, special interest groups should vocalize their reactions to proposed rules. What the Board should *not* do is issue pronouncements that are primarily politically motivated. While paying attention to its constituencies, the Board should base GAAP on sound research and a conceptual framework that has its foundation in economic reality.

EVOLVING ISSUE

No recent accounting issue better illustrates the economic consequences of accounting than the current debate over the use of fair value accounting for financial assets. Both the FASB and the International Accounting Standards Board (IASB) have standards requiring the use of fair value accounting for financial assets, such as investments and other financial instruments. Fair value provides the most relevant and reliable information for investors about these assets and liabilities. However, in the wake of the credit crisis of 2008, some countries, their central banks, and bank regulators want to suspend fair value accounting, based on concerns that use of fair value accounting, which calls for recording significant losses on poorly performing loans and investments, could scare investors and depositors and lead to a “run on the bank.”

For example, in 2009, Congress ordered the FASB to change its accounting rules so as to reduce the losses banks reported, as the values of their securities had crumbled. These changes were generally supported by banks. But these changes produced a strong reaction from some investors, with one investor group complaining that the changes would “effectively gut the transparent application of fair value measurement.” The group also says suspending fair value accounting would delay the recovery of the banking system.

Sources: Adapted from Ben Hall and Nikki Tait, “Sarkozy Seeks EU Accounting Change,” *The Financial Times Limited* (September 30, 2008); Floyd Norris, “Banks Are Set to Receive More Leeway on Asset Values,” *The New York Times* (March 31, 2009); E. Orenstein, “G20 Finance Ministers Urge FASB, IASB Converge Key Standards by Mid-2013 at the Latest,” *FEI Financial Reporting Blog* (April 2012); and Speech at the Paris IFRS Conference, <http://www.ifrs.org/Alerts/Conference/Documents/2015/Hans-Hoogervorst-speech-Paris-June-2015.pdf> (June 2015).

FAIR VALUE, FAIR CONSEQUENCES?

Such political pressure on accounting standard-setters is not confined to the United States. For example, French President Nicolas Sarkozy urged his European Union counterparts to back changes to accounting rules and give banks and insurers some breathing space amid the market turmoil. And more recently, international finance ministers are urging the FASB and IASB to accelerate their work on accounting standards, including the fair value guidance for financial instruments.

Most recently, IASB chair Hans Hoogervorst indicated that work remains to be done in the fair value debate and that “the dichotomy between historical cost and fair value is not as stark as one would expect.” Mr. Hoogervorst noted that while historical cost is to some extent based on fair value, it needs a degree of current measurement to maintain its relevance. It is not free from subjective updating requirements, and it is not necessarily stable. Moreover, historical cost is also vulnerable to abuse. In sum, all the vulnerabilities that are often attributed to fair value accounting can be equally pertinent to historical cost.

It is unclear whether these political pressures will have an effect on fair value accounting, but there is no question that the issue has stirred significant worldwide political debate. In short, the numbers have consequences.

The Expectations Gap

The **Sarbanes-Oxley Act** was passed in response to a string of accounting scandals at companies like **Enron**, **Cendant**, **Sunbeam**, **Rite-Aid**, **Xerox**, and **WorldCom**. This law increased the resources for the SEC to combat fraud and curb poor reporting practices.¹⁰ And the SEC has increased its policing efforts, approving new auditor independence rules and materiality guidelines for financial reporting. In addition, the Sarbanes-Oxley



INTERNATIONAL PERSPECTIVE

Foreign accounting firms that provide an audit report for a U.S.-listed company are subject to the authority of the accounting oversight board (mandated by the Sarbanes-Oxley Act).

⁹*Economic consequences* means the impact of accounting reports on the wealth positions of issuers and users of financial information, and the decision-making behavior resulting from that impact. The resulting behavior of these individuals and groups could have detrimental financial effects on the providers of the financial information. See Stephen A. Zeff, “The Rise of ‘Economic Consequences’,” *Journal of Accountancy* (December 1978), pp. 56–63. We extend appreciation to Professor Zeff for his insights on this chapter.

¹⁰*Sarbanes-Oxley Act of 2002*, H. R. Rep. No. 107-610 (2002).

Act introduced sweeping changes to the institutional structure of the accounting profession. The following are some of the key provisions of the legislation.

- Establishes an oversight board, the **Public Company Accounting Oversight Board (PCAOB)**, for accounting practices. The PCAOB has oversight and enforcement authority and establishes auditing, quality control, and independence standards and rules.
- Implements stronger independence rules for auditors. Audit partners, for example, are required to rotate every five years, and auditors are prohibited from offering certain types of consulting services to corporate clients.
- Requires CEOs and CFOs to personally certify that financial statements and disclosures are accurate and complete, and requires CEOs and CFOs to forfeit bonuses and profits when there is an accounting restatement.
- Requires audit committees to be comprised of independent members and members with financial expertise.
- Requires codes of ethics for senior financial officers.

In addition, Section 404 of the Sarbanes-Oxley Act requires public companies to attest to the effectiveness of their internal controls over financial reporting. **Internal controls** are a system of checks and balances designed to prevent and detect fraud and errors. Most companies have these systems in place, but many have never completely documented them. Companies are finding that it is a costly process but perhaps badly needed.

While there continues to be debate about the benefits and costs of Sarbanes-Oxley (especially for smaller companies), studies at the time of the act's implementation provide compelling evidence that there was much room for improvement. For example, one study documented 424 companies with deficiencies in internal control.¹¹ Many problems involved closing the books, revenue recognition deficiencies, reconciling accounts, or dealing with inventory. **SunTrust Bank**, for example, fired three officers after discovering errors in how the company calculates its allowance for bad debts. And **Visteon**, a car parts supplier, said it found problems recording and managing receivables from its largest customer, **Ford Motor**.

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

Financial Reporting Issues

While our reporting model has worked well in capturing and organizing financial information in a useful and reliable fashion, much still needs to be done. For example, if we move to the year 2030 and look back at financial reporting today, we might read the following.

- **Nonfinancial measurements.** Financial reports failed to provide some key performance measures widely used by management, such as customer satisfaction indexes, backlog information, reject rates on goods purchased, as well as the results of companies' sustainability efforts.

¹¹Leah Townsend, "Internal Control Deficiency Disclosures—Interim Alert," *Yellow Card—Interim Trend Alert* (April 12, 2005), Glass, Lewis & Co., LLC.

- **Forward-looking information.** Financial reports failed to provide forward-looking information needed by present and potential investors and creditors. One individual noted that financial statements in 2017 should have started with the phrase, “Once upon a time,” to signify their use of historical cost and accumulation of past events.
- **Soft assets.** Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information about a company’s soft assets (intangibles). The best assets are often intangible. Consider **Microsoft’s** know-how and market dominance, **Wal-Mart’s** expertise in supply chain management, and **Procter & Gamble’s** brand image.
- **Timeliness.** Companies only prepared financial statements quarterly and provided audited financials annually. Little to no real-time financial statement information was available.
- **Understandability.** Investors and market regulators were raising concerns about the complexity and lack of understandability of financial reports.

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

- Already, some companies voluntarily disclose information deemed relevant to investors. Often such information is nonfinancial. For example, banking companies now disclose data on loan growth, credit quality, fee income, operating efficiency, capital management, and management strategy. Increasingly, companies are preparing reports on their sustainability efforts by reporting such information as water use and conservation, carbon impacts, and labor practices. In some cases, “integrated reports” are provided, which incorporate sustainability reports into the traditional annual report, leading some to call for standards for sustainability reporting.
- Initially, companies used the Internet to provide limited financial data. Now, most companies publish their annual reports in several formats on the Web. The most innovative companies offer sections of their annual reports in a format that the user can readily manipulate, such as in an electronic spreadsheet format. Companies also format their financial reports using eXtensible Business Reporting Language (XBRL), which permits quicker and lower-cost access to companies’ financial information.
- More accounting standards now require the recording or disclosing of fair value information. For example, companies either record investments in stocks and bonds, debt obligations, and derivatives at fair value, or companies show information related to fair values in the notes to the financial statements. The FASB and the IASB have a converged standard on fair value measures, which should enhance the usefulness of fair value measures in financial statements.
- The FASB is now working on projects that address disclosure effectiveness, a reporting framework for non-public companies, and a simplification initiative. The projects could go a long way toward addressing complexity and understandability of the information in financial statements, allowing for more-effective, less-complex, and flexible reporting to meet the needs of investors.

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

International Accounting Standards

As indicated by Lawrence Summers, former Secretary of the Treasury, the single most important innovation shaping the capital markets was the idea of generally accepted accounting principles. He went on to say that we need something similar internationally.

Relevant and reliable financial information is a necessity for viable capital markets. Unfortunately, companies outside the United States often prepare financial statements using standards different from U.S. GAAP (or simply GAAP). As a result, international companies such as **Coca-Cola**, **Microsoft**, and **IBM** have to develop financial information in different ways. Beyond the additional costs these companies incur, users of the financial statements often must understand at least two sets of accounting standards. (Understanding one set is hard enough!) It is not surprising, therefore, that there is a growing demand for one set of high-quality international standards.

Current Environment

Presently, there are two sets of rules accepted for international use—GAAP and **International Financial Reporting Standards (IFRS)**, issued by the London-based **International Accounting Standards Board (IASB)**. U.S. companies that list overseas are still permitted to use GAAP, and foreign companies listed on U.S. exchanges are permitted to use IFRS. As you will learn, there are many similarities between GAAP and IFRS.

Already over 115 countries use IFRS, and the European Union now requires all listed companies in Europe (over 7,000 companies) to use it. Most parties recognize that global markets will best be served if only one set of accounting standards is used. For example, the FASB and the IASB formalized their commitment to the convergence of GAAP and IFRS by issuing a memorandum of understanding (often referred to as the Norwalk agreement). The two Boards agreed to use their best efforts to:

- Make their existing financial reporting standards fully compatible as soon as practicable, and
- Coordinate their future work programs to ensure that once achieved, compatibility is maintained.

As a result of this agreement, the two Boards identified a number of short-term and long-term projects that would lead to convergence. For example, one short-term project was for the FASB to issue a rule that permits a fair value option for financial instruments. This rule was issued in 2007, and now the FASB and the IASB follow the same accounting in this area. Conversely, the IASB completed a project related to borrowing costs, which makes IFRS consistent with GAAP. Long-term convergence projects relate to such issues as revenue recognition and leases.

Will Convergence Happen?

Everyone seems to agree that the FASB and the IASB need to work together toward the goal of a single set of high-quality, global accounting standards. By doing so, unnecessary differences between standards used internationally can be reduced or avoided. However, it seems likely that there will continue to be two sets of financial reporting standards in the world for the foreseeable future. For example, the United States is reluctant to fully adopt IFRS. As the chief accountant of the SEC recently noted, there is virtually no support for having the SEC mandate IFRS for public companies, and there is little support for the SEC to provide an option allowing U.S. companies to prepare their financial statements under IFRS. In addition, both the FASB and the IASB seem to be taking different approaches to various financial reporting problems, such as the measurement and recognition of financial instruments. Further, the IASB has decided to move forward on the conceptual framework project independent of the FASB.

Because convergence is such an important issue, we provide a discussion of international accounting standards at the end of each chapter called **IFRS Insights**. This feature will help you understand the changes that are taking place in the financial reporting area. In addition, throughout the textbook, we provide *International Perspectives* in the margins to help you understand the international reporting environment.

INTERNATIONAL PERSPECTIVE



IFRS includes the standards, referred to as International Financial Reporting Standards (IFRS), developed by the IASB. The predecessor to the IASB issued International Accounting Standards (IAS).

INTERNATIONAL PERSPECTIVE



The adoption of IFRS by U.S. companies would make it easier to compare U.S. and foreign companies, as well as for U.S. companies to raise capital in foreign markets.

WHAT DO THE NUMBERS MEAN?

CAN YOU DO THAT?

One of the more difficult issues related to convergence and international accounting standards is that countries have different cultures and customs. For example, the former chair of the IASB explained it this way regarding Europe:

“In the U.K. everything is permitted unless it is prohibited. In Germany, it is the other way around; everything is prohibited unless it is

permitted. In the Netherlands, everything is prohibited even if it is permitted. And in France, everything is permitted even if it is prohibited. Add in countries like Japan, the United States and China, it becomes very difficult to meet the needs of each of these countries.”

With this diversity of thinking around the world, it understandable why accounting convergence has been so elusive.

Source: Sir D. Tweedie, “Remarks at the Robert P. Maxon Lectureship,” George Washington University (April 7, 2010).

Ethics in the Environment of Financial Accounting

Robert Sack, a noted commentator on the subject of accounting ethics, observed, “Based on my experience, new graduates tend to be idealistic . . . thank goodness for that! Still it is very dangerous to think that your armor is all in place and say to yourself, ‘I would have never given in to that.’ The pressures don’t explode on us; they build, and we often don’t recognize them until they have us.”

These observations are particularly appropriate for anyone entering the business world. In accounting, as in other areas of business, we frequently encounter ethical dilemmas. Some of these dilemmas are simple and easy to resolve. However, many are not, requiring difficult choices among allowable alternatives.

Companies that concentrate on “maximizing the bottom line,” “facing the challenges of competition,” and “stressing short-term results” place accountants in an environment of conflict and pressure. Basic questions such as, “Is this way of communicating financial information good or bad?” “Is it right or wrong?” and “What should I do in this circumstance?” cannot always be answered by simply adhering to GAAP or following the rules of the profession. Technical competence is not enough when encountering ethical decisions.

Doing the right thing is not always easy or obvious. The pressures “to bend the rules,” “to play the game,” or “to just ignore it” can be considerable. For example, “Will my decision affect my job performance negatively?” “Will my superiors be upset?” and “Will my colleagues be unhappy with me?” are often questions business people face in making a tough ethical decision. The decision is more difficult because there is no comprehensive ethical system to provide guidelines.

Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives. Throughout this textbook, **we present ethical considerations to help sensitize you** to the type of situations you may encounter in the performance of your professional responsibility.

Conclusion

Bob Herz, a former FASB chair, believes that there are three fundamental considerations the FASB must keep in mind in its rule-making activities: (1) improvement in financial reporting, (2) simplification of the accounting literature and the rule-making process, and (3) international convergence. These are notable objectives, and the Board is making good progress on all three dimensions. Issues such as off-balance-sheet financing, measurement of fair values, enhanced criteria for revenue recognition, and stock option accounting are examples of where the Board has exerted leadership. Improvements in financial reporting should follow.

Also, the Board is making it easier to understand what GAAP is. GAAP has been contained in a number of different documents. The lack of a single source makes it difficult to access and understand generally accepted principles. As discussed earlier, the Codification now organizes existing GAAP by accounting topic regardless of its source (FASB Statements, APB Opinions, and so on). The codified standards are then

considered to be GAAP and to be authoritative. All other literature will be considered nonauthoritative.

Finally, international convergence is underway. Some projects already are completed and differences eliminated. Many more are on the drawing board. The profession has many challenges, but it has responded in a timely, comprehensive, and effective manner.

**YOU WILL
WANT TO
READ
THE IFRS
INSIGHTS ON
PAGES 29–35**

For discussion of IFRS and the international reporting environment.



REVIEW AND PRACTICE

KEY TERMS REVIEW

Accounting Principles Board (APB), 9	entity perspective, 6	financial reporting, 4	Public Company Accounting Oversight Board (PCAOB), 17
Accounting Research Bulletins, 9	expectations gap, 17	financial statements, 4	Sarbanes-Oxley Act, 16
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decision-usefulness, 6			
Emerging Issues Task Force (EITF), 12			

LEARNING OBJECTIVES REVIEW

1 Understand the financial reporting environment. Companies provide **four primary financial statements** of financial reporting: (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners' or stockholders' equity. Financial reporting other than financial statements may take various forms. Examples include the president's letter and supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management's forecasts, and descriptions of a company's social or environmental impact.

The **objective of general-purpose financial reporting** is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in decisions about providing resources to the entity through equity investments and loans or other forms of credit. Information that is decision-useful to investors may also be helpful to other users of financial reporting who are not investors.

To achieve this objective, the accounting profession has attempted to **develop a set of standards that is generally accepted** and universally practiced. Without this set of standards, each company would have to develop its own standards. Readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

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

3 Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP. Generally accepted accounting principles (GAAP) are those principles that have substantial authoritative support, such as FASB standards, interpretations, and Staff Positions, APB Opinions and interpretations, AICPA Accounting Research Bulletins, and other authoritative pronouncements. All these documents and others are now classified in one document referred to as the Codification. The purpose of the Codification is to simplify user access to all authoritative U.S. GAAP. The Codification changes the way GAAP is documented, presented, and updated.

4. Describe major challenges in the financial reporting environment. One major challenge is that user groups may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. They especially target the FASB to influence changes in existing GAAP and in the development of new rules. A second challenge is that financial reports fail to provide (1) some key performance measures widely used by management, (2) forward-looking information needed by investors and creditors, (3) sufficient information on a company's soft assets (intangibles), (4) real-time financial information, and (5) easy-to-comprehend information. Finally, financial accountants are called on for moral discernment and ethical decision-making. Decisions sometimes are difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines in making ethical judgments.

ENHANCED REVIEW AND PRACTICE

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QUESTIONS

- Differentiate broadly between financial accounting and managerial accounting.
- Differentiate between "financial statements" and "financial reporting."
- How does accounting help the capital allocation process?
- What is the objective of financial reporting?
- Briefly explain the meaning of decision-usefulness in the context of financial reporting.
- Of what value is a common set of standards in financial accounting and reporting?
- What is the likely limitation of "general-purpose financial statements"?
- In what way is the Securities and Exchange Commission concerned about and supportive of accounting principles and standards?
- What was the Committee on Accounting Procedure, and what were its accomplishments and failings?
- For what purposes did the AICPA create the Accounting Principles Board?
- Distinguish between Opinions of the Accounting Principles Board and Accounting Standards Updates.
- If you had to explain or define "generally accepted accounting principles or standards," what essential characteristics would you include in your explanation?
- In what ways was it felt that the pronouncements issued by the Financial Accounting Standards Board would carry greater weight than the opinions issued by the Accounting Principles Board?
- How are FASB preliminary views and FASB exposure drafts related to FASB "statements"?
- Distinguish between FASB Accounting Standards Updates and FASB Statements of Financial Accounting Concepts.
- What is Rule 203 of the Code of Professional Conduct?
- The chair of the FASB at one time noted that "the flow of standards can only be slowed if (1) producers focus less on quarterly earnings per share and tax benefits and more on quality products, and (2) accountants and lawyers rely less on rules and law and more on professional judgment and conduct." Explain his comment.
- Explain the role of the Emerging Issues Task Force in establishing generally accepted accounting principles.

19. What is the difference between the Codification and the Codification Research System?
20. What are the primary advantages of having a Codification of generally accepted accounting principles?
21. What are the sources of pressure that change and influence the development of GAAP?
22. Some individuals have indicated that the FASB must be cognizant of the economic consequences of its pronouncements. What is meant by “economic consequences”? What dangers exist if politics play too much of a role in the development of GAAP?
23. If you were given complete authority in the matter, how would you propose that GAAP should be developed and enforced?
24. One writer recently noted that 99.4 percent of all companies prepare statements that are in accordance with GAAP. Why then is there such concern about fraudulent financial reporting?
25. What is the “expectations gap”? What is the profession doing to try to close this gap?
26. The Sarbanes-Oxley Act was enacted to combat fraud and curb poor reporting practices. What are some key provisions of this legislation?
27. What are some of the major challenges facing the accounting profession?
28. How are financial accountants challenged in their work to make ethical decisions? Is technical mastery of GAAP not sufficient to the practice of financial accounting?

CONCEPTS FOR ANALYSIS

CA1-1 (FASB and Standard-Setting) Presented below are four statements which you are to identify as true or false. If false, explain why the statement is false.

1. GAAP is the term used to indicate the whole body of FASB authoritative literature.
2. Any company claiming compliance with GAAP must comply with most standards and interpretations but does not have to follow the disclosure requirements.
3. The primary governmental body that has influence over the FASB is the SEC.
4. The FASB has a government mandate and therefore does not have to follow due process in issuing a standard.

CA1-2 (GAAP and Standard-Setting) Presented below are four statements which you are to identify as true or false. If false, explain why the statement is false.

1. The objective of financial statements emphasizes a stewardship approach for reporting financial information.
2. The purpose of the objective of financial reporting is to prepare a balance sheet, an income statement, a statement of cash flows, and a statement of owners' or stockholders' equity.
3. Because they are generally shorter, FASB interpretations are subject to less due process, compared to FASB standards.
4. The objective of financial reporting uses an entity rather than a proprietary approach in determining what information to report.

CA1-3 (Financial Reporting and Accounting Standards) Answer the following multiple-choice questions.

1. GAAP stands for:
 - (a) governmental auditing and accounting practices.
 - (b) generally accepted attest principles.
 - (c) government audit and attest policies.
 - (d) generally accepted accounting principles.
2. Accounting standard-setters use the following process in establishing accounting standards:
 - (a) Research, exposure draft, discussion paper, standard.
 - (b) Discussion paper, research, exposure draft, standard.
 - (c) Research, preliminary views, discussion paper, standard.
 - (d) Research, discussion paper, exposure draft, standard.
3. GAAP is comprised of:
 - (a) FASB standards, interpretations, and concepts statements.
 - (b) FASB financial standards.
 - (c) FASB standards, interpretations, EITF consensuses, and accounting rules issued by FASB predecessor organizations.
 - (d) any accounting guidance included in the FASB Codification.
4. The authoritative status of the conceptual framework is as follows.
 - (a) It is used when there is no standard or interpretation related to the reporting issues under consideration.
 - (b) It is not as authoritative as a standard but takes precedence over any interpretation related to the reporting issue.
 - (c) It takes precedence over all other authoritative literature.
 - (d) It has no authoritative status.

5. The objective of financial reporting places most emphasis on:
 - (a) reporting to capital providers.
 - (b) reporting on stewardship.
 - (c) providing specific guidance related to specific needs.
 - (d) providing information to individuals who are experts in the field.
6. General-purpose financial statements are prepared primarily for:
 - (a) internal users.
 - (b) external users.
 - (c) auditors.
 - (d) government regulators.
7. Economic consequences of accounting standard-setting means:
 - (a) standard-setters must give first priority to ensuring that companies do not suffer any adverse effect as a result of a new standard.
 - (b) standard-setters must ensure that no new costs are incurred when a new standard is issued.
 - (c) the objective of financial reporting should be politically motivated to ensure acceptance by the general public.
 - (d) accounting standards can have detrimental impacts on the wealth levels of the providers of financial information.
8. The expectations gap is:
 - (a) what financial information management provides and what users want.
 - (b) what the public thinks accountants should do and what accountants think they can do.
 - (c) what the governmental agencies want from standard-setting and what the standard-setters provide.
 - (d) what the users of financial statements want from the government and what is provided.

CA1-4 (Financial Accounting) Omar Morena has recently completed his first year of studying accounting. His instructor for next semester has indicated that the primary focus will be the area of financial accounting.

Instructions

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

CA1-5 (Objective of Financial Reporting) Karen Sepan, a recent graduate of the local state university, is presently employed by a large manufacturing company. She has been asked by Jose Martinez, controller, to prepare the company's response to a current Preliminary Views published by the Financial Accounting Standards Board (FASB). Sepan knows that the FASB has a conceptual framework, and she believes that these concept statements could be used to support the company's response to the Preliminary Views. She has prepared a rough draft of the response citing the objective of financial reporting.

Instructions

- (a) Identify the objective of financial reporting.
- (b) Describe the level of sophistication expected of the users of financial information by the objective of financial reporting.

CA1-6 (Accounting Numbers and the Environment) Hardly a day goes by without an article appearing on the continuing fallout from the financial crisis of 2008. An overheated real estate market, fueled by home purchase incentives, poor lending practices, and securitization through high-risk, mortgage-backed securities, led to a near collapse of global capital markets. As a consequence, many have argued that if the financial institutions had been required to report their loans (and loan-backed investments) at fair value instead of cost, large losses would have been reported earlier. This would have signaled regulators to the problems in the mortgage markets and therefore minimized the losses to U.S. taxpayers.

Instructions

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

CA1-7 WRITING (Need for GAAP) Some argue that having various organizations establish accounting principles is wasteful and inefficient. Rather than mandating accounting rules, each company could voluntarily disclose the type of information it considered important. In addition, if an investor wants additional information, the investor could contact the company and pay to receive the additional information desired.

Instructions

Comment on the appropriateness of this viewpoint.

CA1-8 (AICPA's Role in Rule-Making) One of the major groups that has been involved in the standard-setting process is the American Institute of Certified Public Accountants. Initially, it was the primary organization that established accounting principles in the United States. Subsequently, it relinquished its power to the FASB.

Instructions

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

CA1-9 (FASB Role in Rule-Making) A press release announcing the appointment of the trustees of the new Financial Accounting Foundation stated that the Financial Accounting Standards Board (to be appointed by the trustees) “. . . will become the established authority for setting accounting principles under which corporations report to the shareholders and others” (AICPA news release July 20, 1972).

Instructions

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

CA1-10 WRITING (Politicization of GAAP) Some accountants have said that politicization in the development and acceptance of generally accepted accounting principles (i.e., rule-making) is taking place. Some use the term “politicization” in a narrow sense to mean the influence by governmental agencies, particularly the Securities and Exchange Commission, on the development of generally accepted accounting principles. Others use it more broadly to mean the compromise that results when the bodies responsible for developing generally accepted accounting principles are pressured by interest groups (SEC, American Accounting Association, businesses through their various organizations, Institute of Management Accountants, financial analysts, bankers, lawyers, and so on).

Instructions

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

(CMA adapted)

CA1-11 (Models for Setting GAAP) Presented below are three models for setting GAAP.

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

Instructions

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

CA1-12 GROUPWORK (GAAP Terminology) Wayne Rogers, an administrator at a major university, recently said, “I’ve got some CDs in my IRA, which I set up to beat the IRS.” As elsewhere, in the world of accounting and finance, it often helps to be fluent in abbreviations and acronyms.

Instructions

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

- | | | |
|-----------|-----------|----------|
| (a) AICPA | (e) FAF | (i) FASB |
| (b) CAP | (f) FASAC | (j) SEC |
| (c) EITF | (g) GAAP | (k) IASB |
| (d) APB | (h) CPA | |

CA1-13 ETHICS (Rule-Making Issues) When the FASB issues new pronouncements, the implementation date is usually 12 months from date of issuance, with early implementation encouraged. Karen Weller, controller, discusses with her financial vice president the need for early implementation of a rule that would result in a fairer presentation of the company’s financial condition and earnings. When the financial vice president determines that early implementation of the rule will adversely affect the reported net income for the year, he discourages Weller from implementing the rule until it is required.

Instructions

Answer the following questions.

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

(CMA adapted)

CA1-14 (Securities and Exchange Commission) The U.S. Securities and Exchange Commission (SEC) was created in 1934 and consists of five commissioners and a large professional staff. The SEC professional staff is organized into five divisions and several principal offices. The primary objective of the SEC is to support fair securities markets. The SEC also strives to foster enlightened stockholder participation in corporate decisions of publicly traded companies. The SEC has a significant presence in financial markets, the development of accounting practices, and corporation-shareholder relations, and has the power to exert influence on entities whose actions lie within the scope of its authority.

Instructions

- (a) Explain from where the Securities and Exchange Commission receives its authority.
- (b) Describe the official role of the Securities and Exchange Commission in the development of financial accounting theory and practices.
- (c) Discuss the interrelationship between the Securities and Exchange Commission and the Financial Accounting Standards Board with respect to the development and establishment of financial accounting theory and practices.

(CMA adapted)

CA1-15 ETHICS (Financial Reporting Pressures) Presented below is abbreviated testimony from Troy Normand in the **WorldCom** case. He was a manager in the corporate reporting department and is one of five individuals who pleaded guilty. He is testifying in hopes of receiving no prison time when he is ultimately sentenced.

Q. Mr. Normand, if you could just describe for the jury how the meeting started and what was said during the meeting?

A. I can't recall exactly who initiated the discussion, but right away Scott Sullivan acknowledged that he was aware we had problems with the entries, David Myers had informed him, and we were considering resigning.

He said that he respected our concerns but that we weren't being asked to do anything that he believed was wrong. He mentioned that he acknowledged that the company had lost focus quite a bit due to the preparations for the Sprint merger, and that he was putting plans in place and projects in place to try to determine where the problems were, why the costs were so high.

He did say he believed that the initial statements that we produced, that the line costs in those statements could not have been as high as they were, that he believed something was wrong and there was no way that the costs were that high.

I informed him that I didn't believe the entry we were being asked to do was right, that I was scared, and I didn't want to put myself in a position of going to jail for him or the company. He responded that he didn't believe anything was wrong, nobody was going to be going to jail, but that if it later was found to be wrong, that he would be the person going to jail, not me.

He asked that I stay, don't jump off the plane, let him land it softly, that's basically how he put it. And he mentioned that he had a discussion with Bernie Ebbers, asking Bernie to reduce projections going forward and that Bernie had refused.

Q. Mr. Normand, you said that Mr. Sullivan said something about don't jump out of the plane. What did you understand him to mean when he said that?

A. Not to quit.

Q. During this meeting, did Mr. Sullivan say anything about whether you would be asked to make entries like this in the future?

A. Yes, he made a comment that from that point going forward we wouldn't be asked to record any entries, high-level late adjustments, that the numbers would be the numbers.

Q. What did you understand that to be mean, the numbers would be the numbers?

A. That after the preliminary statements were issued, with the exception of any normal transaction, valid transaction, we wouldn't be asked to be recording any more late entries.

Q. I believe you testified that Mr. Sullivan said something about the line cost numbers not being accurate. Did he ask you to conduct any analysis to determine whether the line cost numbers were accurate?

A. No, he did not.

Q. Did anyone ever ask you to do that?

A. No.

Q. Did you ever conduct any such analysis?

A. No, I didn't.

Q. During this meeting, did Mr. Sullivan ever provide any accounting justification for the entry you were asked to make?

A. No, he did not.

Q. Did anything else happen during the meeting?

A. I don't recall anything else.

Q. How did you feel after this meeting?

A. Not much better actually. I left his office not convinced in any way that what we were asked to do was right. However, I did question myself to some degree after talking with him wondering whether I was making something more out of what was really there.

Instructions

Answer the following questions.

- (a) What appears to be the ethical issue involved in this case?
- (b) Is Troy Normand acting improperly or immorally?
- (c) What would you do if you were Troy Normand?
- (d) Who are the major stakeholders in this case?

CA1-16 (Economic Consequences) Presented below are comments made in the financial press.

Instructions

Prepare responses to the requirements in each item.

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

CA1-17 GROUPWORK (GAAP and Economic Consequences) The following letter was sent to the SEC and the FASB by leaders of the business community.

Dear Sirs:

The FASB has been struggling with accounting for derivatives and hedging for many years. The FASB has now developed, over the last few weeks, a new approach that it proposes to adopt as a final standard. We understand that the Board intends to adopt this new approach as a final standard without exposing it for public comment and debate, despite the evident complexity of the new approach, the speed with which it has been developed and the significant changes to the exposure draft since it was released more than one year ago. Instead, the Board plans to allow only a brief review by selected parties, limited to issues of operationality and clarity, and would exclude questions as to the merits of the proposed approach.

As the FASB itself has said throughout this process, its mission does not permit it to consider matters that go beyond accounting and reporting considerations. Accordingly, the FASB may not have adequately considered the wide range of concerns that have been expressed about the derivatives and hedging proposal, including concerns related to the potential impact on the capital markets, the weakening of companies' ability to manage risk, and the adverse control implications of implementing costly and complex new rules imposed at the same time as other major initiatives, including the Year 2000 issues and a single European currency. We believe that these crucial issues must be considered, if not by the FASB, then by the Securities and Exchange Commission, other regulatory agencies, or Congress.

We believe it is essential that the FASB solicit all comments in order to identify and address all material issues that may exist before issuing a final standard. We understand the desire to bring this process to a prompt conclusion, but the underlying issues are so important to this nation's businesses, the customers they serve and the economy as a whole that expediency cannot be the dominant consideration. As a result, we urge the FASB to expose its new proposal for public comment, following the established due process procedures that are essential to acceptance of its standards, and providing sufficient time to affected parties to understand and assess the new approach.

We also urge the SEC to study the comments received in order to assess the impact that these proposed rules may have on the capital markets, on companies' risk management practices, and on management and financial controls. These vital public policy matters deserve consideration as part of the Commission's oversight responsibilities.

We believe that these steps are essential if the FASB is to produce the best possible accounting standard while minimizing adverse economic effects and maintaining the competitiveness of U.S. businesses in the international marketplace.

Very truly yours,

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

Instructions

Answer the following questions.

- (a) Explain the “due process” procedures followed by the FASB in developing a financial reporting standard.
- (b) What is meant by the term “economic consequences” in accounting standard-setting?
- (c) What economic consequences arguments are used in this letter?
- (d) What do you believe is the main point of the letter?
- (e) Why do you believe a copy of this letter was sent by the business community to influential members of the U.S. Congress?

USING YOUR JUDGMENT

Financial Reporting Problem

Beverly Crusher, a new staff accountant, is confused because of the complexities involving accounting standard-setting. Specifically, she is confused by the number of bodies issuing financial reporting standards of one kind or another and the level of authoritative support that can be attached to these reporting standards. Beverly decides that she must review the environment in which accounting standards are set, if she is to increase her understanding of the accounting profession.

Beverly recalls that during her accounting education there was a chapter or two regarding the environment of financial accounting and the development of GAAP. However, she remembers that her instructor placed little emphasis on these chapters.

Instructions

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

BRIDGE TO THE PROFESSION

Codification Exercises

Academic access to the FASB Codification is available through university subscriptions, obtained from the American Accounting Association (at <http://aaahq.org/FASB/Access.cfm>), for an annual fee of \$150. This subscription covers an unlimited number of students within a single institution. Once this access has been obtained by your school, you should log in (at <http://aaahq.org/ascLogin.cfm>) to prepare responses to the following exercises.

CE1-1 Describe the main elements of the link labeled “Help, FAQ, Learning Guide, and About the Codification.”

CE1-2 Describe the procedures for providing feedback.

CE1-3 Briefly describe the purpose and content of the “What’s New” link.

Codification Research Case

As a newly enrolled accounting major, you are anxious to better understand accounting institutions and sources of accounting literature. As a first step, you decide to explore the FASB Conceptual Framework.

Instructions

Go to the FASB website, <http://www.fasb.org>, to access the FASB Concepts Statements. When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following items. (Provide paragraph citations.)

- (a) What is the objective of financial reporting?
- (b) What other means are there of communicating information, besides financial statements?
- (c) Indicate some of the users and the information they are most directly concerned with in economic decision-making.

ADDITIONAL PROFESSIONAL RESOURCES

Go to **WileyPLUS** for other career-readiness resources, such as career coaching, internship opportunities, and CPAexcel prep.



IFRS Insights

Most agree that there is a need for one set of international accounting standards. Here is why:

- **Multinational corporations.** Today's companies view the entire world as their market. For example, **Coca-Cola**, **Intel**, and **McDonald's** generate more than 50 percent of their sales outside the United States, and many foreign companies, such as **Toyota**, **Nestlé**, and **Sony**, find their largest market to be the United States.
- **Mergers and acquisitions.** The mergers between **Fiat/Chrysler** and **Vodafone/Mannesmann** suggest that we will see even more such business combinations in the future.
- **Information technology.** As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.
- **Financial markets.** Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

LEARNING OBJECTIVE 5

Compare the procedures related to financial accounting and accounting standards under GAAP and IFRS.

RELEVANT FACTS

Following are the key similarities and differences between GAAP (the standards issued by the Financial Accounting Standards Board) and IFRS related to the financial reporting environment.

Similarities

- Generally accepted accounting principles (GAAP) for U.S. companies are developed by the Financial Accounting Standards Board (FASB). The FASB is a private organization. The Securities and Exchange Commission (SEC) exercises oversight over the actions of the FASB. The IASB is also a private organization. Oversight over the actions of the IASB is regulated by IOSCO.
- Both the IASB and the FASB have essentially the same governance structure, that is, a Foundation that provides oversight, a Board, an Advisory Council, and an Interpretations Committee. In addition, a general body that involves the public interest is part of the governance structure.
- The FASB relies on the SEC for regulation and enforcement of its standards. The IASB relies primarily on IOSCO for regulation and enforcement of its standards.
- Both the IASB and the FASB are working together to find common grounds for convergence. A good example is the recent issuance of a new standard on revenue recognition that both organizations support. Also, the Boards are working together on other substantial projects, such as the accounting for leases.

Differences

- GAAP is more detailed or rules-based. IFRS tends to be simpler and more flexible in its accounting and disclosure requirements. The difference in approach has resulted in a debate about the merits of principles-based versus rules-based standards.
- Differences between GAAP and IFRS should not be surprising because standard-setters have developed standards in response to different user needs. In some countries, the primary users of financial statements are private investors. In others, the primary users are tax authorities or central government planners. In the United States, investors and creditors have driven accounting-standard formulation.

ABOUT THE NUMBERS

World markets are becoming increasingly intertwined. International consumers drive Japanese cars, wear Italian shoes and Scottish woolens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, watch U.S. movies, and use Arabian oil. The tremendous variety and volume of both exported and imported goods indicates the extensive involvement in international trade—for many companies, the world is their market. To provide some indication of the extent of globalization of economic activity, Illustration IFRS1-1 (page 30) provides a listing of the top 20 global companies in terms of sales.

ILLUSTRATION IFRS1-1

Global Companies

Rank	Company	Country	Revenues (\$ millions)	Rank	Company	Country	Revenues (\$ millions)
1	Wal-Mart Stores	U.S.	476,294	11	Total	France	227,882
2	Royal Dutch Shell	Netherlands	459,599	12	Chevron	U.S.	220,356
3	Sinopec Group	China	457,201	13	Samsung Electronics	South Korea	208,938
4	China National Petroleum	China	432,007	14	Berkshire Hathaway	U.S.	182,150
5	ExxonMobil	U.S.	407,666	15	Apple	U.S.	170,910
6	BP	U.K.	396,217	16	AXA	France	165,893
7	State Grid	China	333,386	17	Gazprom	Russia	165,016
8	Volkswagen	Germany	261,539	18	E.ON	Germany	162,560
9	Toyota Motor	Japan	256,454	19	Phillips 66	U.S.	161,175
10	Glencore International	Switzerland	232,694	20	Daimler	Germany	156,628

As capital markets are increasingly integrated, companies have greater flexibility in deciding where to raise capital. In the absence of market integration, there can be company-specific factors that make it cheaper to raise capital and list/trade securities in one location versus another. With the integration of capital markets, the automatic linkage between the location of the company and location of the capital market is loosening. As a result, companies have expanded choices of where to raise capital, either equity or debt. The move toward adoption of International Financial Reporting Standards has and will continue to facilitate this movement.

International Standard-Setting Organizations

For many years, many nations have relied on their own standard-setting organizations. For example, Canada has the Accounting Standards Board, Japan has the Accounting Standards Board of Japan, Germany has the German Accounting Standards Committee, and the United States has the Financial Accounting Standards Board (FASB). The standards issued by these organizations are sometimes principles-based, rules-based, tax-oriented, or business-based. In other words, they often differ in concept and objective. Starting in 2000, two major standard-setting bodies have emerged as the primary standard-setting bodies in the world. One organization is based in London, United Kingdom, and is called the **International Accounting Standards Board (IASB)**. The IASB issues **International Financial Reporting Standards (IFRS)**, which are used on most foreign exchanges. These standards may also be used by foreign companies listing on U.S. securities exchanges. As indicated earlier, IFRS is presently used in over 115 countries and is rapidly gaining acceptance in other countries as well.

It is generally believed that IFRS has the best potential to provide a common platform on which companies can report and investors can compare financial information. As a result, our discussion focuses on IFRS and the organization involved in developing these standards—the International Accounting Standards Board (IASB). (A detailed discussion of the U.S. system is provided in the chapter.) The two organizations that have a role in international standard-setting are the **International Organization of Securities Commissions (IOSCO)** and the IASB.

International Organization of Securities Commissions (IOSCO)

The International Organization of Securities Commissions (IOSCO) does not set accounting standards. Instead, this organization is dedicated to ensuring that the global markets can operate in an efficient and effective basis. The member agencies (such as from France, Germany, New Zealand, and the SEC) have resolved to:

- Cooperate to promote high standards of regulation in order to maintain just, efficient, and sound markets.
- Exchange information on their respective experiences in order to promote the development of domestic markets.
- Unite their efforts to establish standards and an effective surveillance of international securities transactions.
- Provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

A landmark year for IOSCO was 2005 when it endorsed the IOSCO Memorandum of Understanding (MOU) to facilitate cross-border cooperation, reduce global systemic risk, protect

investors, and ensure fair and efficient securities markets. (For more information, go to <http://www.iosco.org/>.)

International Accounting Standards Board (IASB)

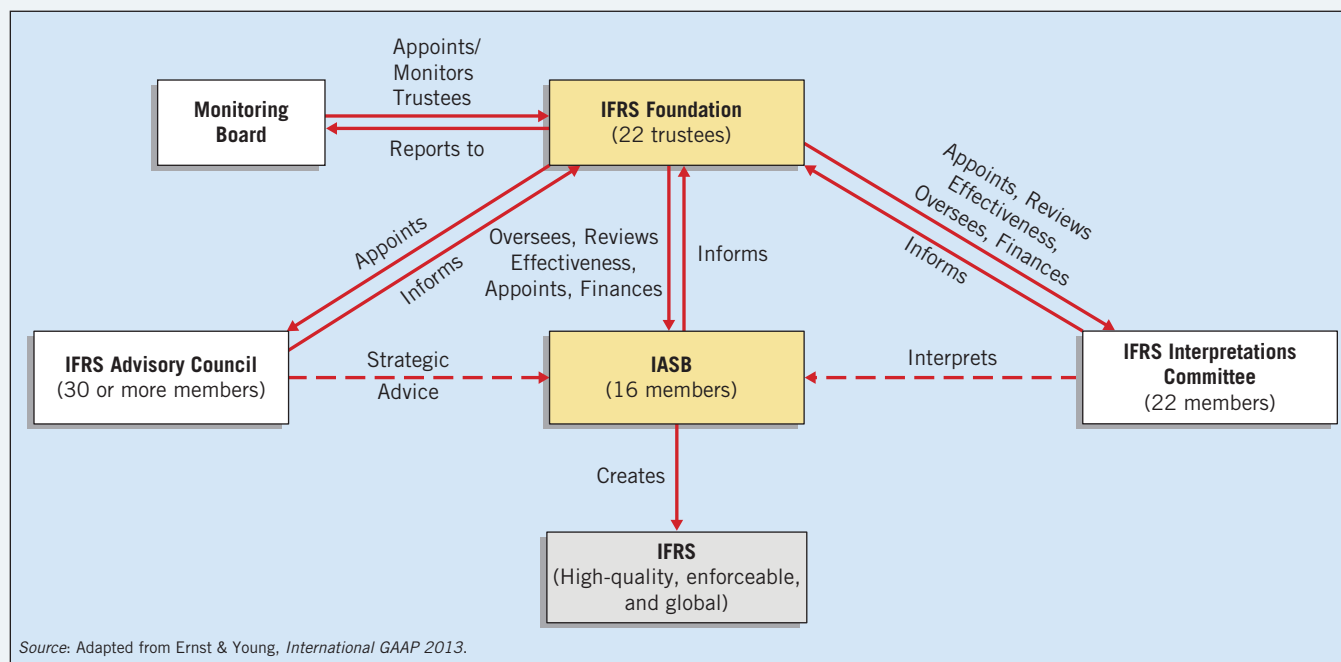
The standard-setting structure internationally is composed of four organizations—the International Accounting Standards Committee Foundation, the International Accounting Standards Board (IASB), a Standards Advisory Council, and an International Financial Reporting Interpretations Committee (IFRIC). The trustees of the **International Accounting Standards Committee Foundation (IASCF)** select the members of the IASB and the Standards Advisory Council, fund their activities, and generally oversee the IASB's activities. The IASB is the major operating unit in this four-part structure. Its mission is to develop, in the public interest, a single set of high-quality and understandable IFRS for general-purpose financial statements.

In addition to research help from its own staff, the IASB relies on the expertise of various task force groups formed for various projects and on the **Standards Advisory Council (SAC)**. The SAC consults with the IASB on major policy and technical issues and also helps select task force members. IFRIC develops implementation guidance for consideration by the IASB. Illustration IFRS1-2 shows the current organizational structure for the setting of international standards.

As indicated, the standard-setting structure internationally is very similar to the standard-setting structure in the United States (see Illustration 1-2 on page 10). One notable difference is the size of the Board—the IASB has 16 members, while the FASB has just seven members. The larger IASB reflects the need for broader geographic representation in the international setting.

ILLUSTRATION IFRS1-2

International Standard-Setting Structure



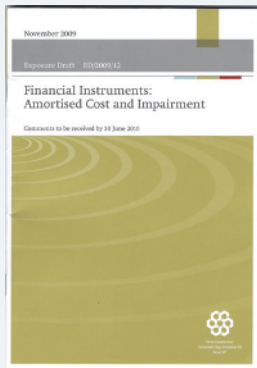
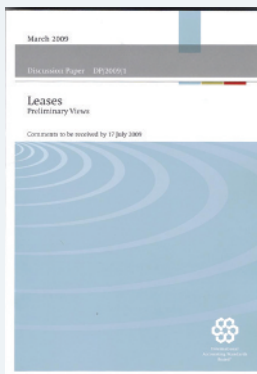
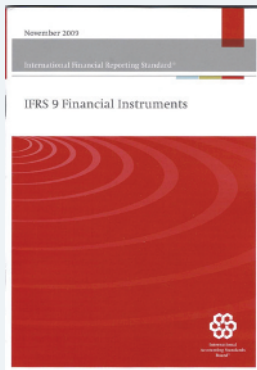
Types of Pronouncements

Following a due process very similar to that used by the FASB, the IASB issues three major types of pronouncements:

1. International Financial Reporting Standards
2. The Conceptual Framework for Financial Reporting
3. International Financial Reporting Interpretations

International Financial Reporting Standards. Financial accounting standards issued by the IASB are referred to as International Financial Reporting Standards (IFRS). The IASB has issued 15 of these standards to date, covering such subjects as business combinations and share-based payments. Prior to the IASB (formed in 2001), standard-setting on the international level was

done by the International Accounting Standards Committee, which issued International Accounting Standards (IAS). The committee issued 41 IASs, many of which have been amended or superseded by the IASB. Those still remaining are considered under the umbrella of IFRS.



The Conceptual Framework for Financial Reporting. As part of a long-range effort to move away from the problem-by-problem approach, the International Accounting Standards Committee (predecessor to the IASB) issued a document entitled “The Conceptual Framework for the Preparation and Presentation of Financial Statements” (also referred to simply as the Framework). This Framework sets forth fundamental objectives and concepts that the Board uses in developing future standards of financial reporting. The intent of the document is to form a cohesive set of interrelated concepts—a conceptual framework—that will serve as tools for solving existing and emerging problems in a consistent manner. For example, the objective of general-purpose financial reporting discussed earlier is part of this Framework. The Framework and any changes to it pass through the same due process (discussion paper, public hearing, exposure draft, etc.) as an IFRS. However, this Framework is not an IFRS and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific international accounting standard.

International Financial Reporting Interpretations. Interpretations issued by the **International Financial Reporting Interpretations Committee (IFRIC)** are also considered authoritative and must be followed. These interpretations cover (1) newly identified financial reporting issues not specifically dealt with in IFRS, and (2) issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop, in the absence of authoritative guidance. The IFRIC has issued over 20 of these interpretations to date. In keeping with the IASB’s own approach to setting standards, the IFRIC applies a principles-based approach in providing interpretative guidance. To this end, the IFRIC looks first to the Framework for the Preparation and Presentation of Financial Statements as the foundation for formulating a consensus. It then looks to the principles articulated in the applicable standard, if any, to develop its interpretative guidance and to determine that the proposed guidance does not conflict with provisions in IFRS.

IFRIC helps the IASB in many ways. For example, emerging issues often attract public attention. If not resolved quickly, they can lead to financial crises and scandal. They can also undercut public confidence in current reporting practices. Similar to the EITF in the United States, IFRIC can address controversial accounting problems as they arise. It determines whether it can resolve them or whether to involve the IASB in solving them. In essence, it becomes a “problem filter” for the IASB. Thus, the IASB will hopefully work on more pervasive long-term problems, while the IFRIC deals with short-term emerging issues.

Hierarchy of IFRS

Because it is a private organization, the IASB has no regulatory mandate and therefore no enforcement mechanism. Similar to the U.S. setting, in which the Securities and Exchange Commission enforces the use of FASB standards for public companies, the IASB relies on other regulators to enforce the use of its standards. For example, effective January 1, 2005, the European Union required publicly traded member country companies to use IFRS.

Certain changes have been implemented with respect to use of IFRS in the United States. For example, under American Institute of Certified Public Accountants (AICPA) rules, a member of the AICPA can only report on financial statements prepared in accordance with standards promulgated by standard-setting bodies designated by the AICPA Council. In May 2008, the AICPA Council voted to designate the IASB in London as an international accounting standard-setter for purposes of establishing international financial accounting and reporting principles, and to make related amendments to its rules to provide AICPA members with the option to use IFRS.

Any company indicating that it is preparing its financial statements in conformity with IFRS must use all of the standards and interpretations. The following **hierarchy** is used to determine what recognition, valuation, and disclosure requirements should be used. Companies first look to:

1. International Financial Reporting Standards;
2. International Accounting Standards; and
3. Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

In the absence of a standard or an interpretation, the following sources in descending order are used: (1) the requirements and guidance in standards and interpretations dealing with similar and related issues; (2) the Framework for financial reporting; and (3) most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting

standards, other accounting literature, and accepted industry practices, to the extent they do not conflict with the above. The overriding requirement of IFRS is that the financial statements provide a fair presentation (often referred to as a “true and fair view”). Fair representation is assumed to occur if a company follows the guidelines established in IFRS.

International Accounting Convergence

The SEC recognizes that the establishment of a single, widely accepted set of high-quality accounting standards benefits both global capital markets and U.S. investors. U.S. investors will make better-informed investment decisions if they obtain high-quality financial information from U.S. companies that is more comparable to the presently available information from non-U.S. companies operating in the same industry or line of business. Thus, the SEC appears committed to move to IFRS, assuming that certain conditions are met. These conditions are spelled out in a document, referred to as the “**Roadmap**” and in a policy statement issued by the SEC in early 2010.¹²

The FASB and the IASB have been working diligently to (1) make their existing financial reporting standards fully compatible as soon as is practicable, and (2) coordinate their future work programs to ensure that once achieved, compatibility is maintained. This process is referred to as *convergence*, and the Boards have made significant progress in developing high-quality converged standards. However, much work needs to be done. The Boards have identified the issuance of converged standards on financial instruments (investments), revenue, and leases as a key milestone in the convergence process.

SEC Staff Paper on Incorporation of IFRS

The SEC has monitored the convergence process through a staff Work Plan, which considers specific areas and factors relevant to a commission determination as to whether, when, and how the current financial reporting system for U.S. companies should be transitioned to a system incorporating IFRS. Execution of the Work Plan (which addresses such areas as independence of standard-setting, investor understanding of IFRS, and auditor readiness), combined with the completion of the convergence projects of the FASB and the IASB according to their current working agreement, will position the SEC to make a decision on required use of IFRS by U.S. issuers.

In July 2012, the SEC staff issued its final report related to the Work Plan elements.¹³ The main thrust of the report is that we will have to wait and see for a commission decision on required use of IFRS in the United States. Although the Staff Report did not set out to answer the fundamental question of whether transitioning to IFRS is in the best interests of the U.S. securities markets generally and U.S. investors specifically, it appears that it is unlikely companies would be required to change to IFRS in the near future. Rather, there would be a transition period in which this would be accomplished. With respect to this transition, the SEC staff has suggested gradual incorporation of IFRS into the U.S. financial reporting system.¹⁴

The approach to incorporation is an “endorsement approach.” Rather than adopting IFRS at a point in time (sometimes referred to as a “big bang”), the endorsement approach specifies that the FASB and IASB continue their convergence efforts (over a 5–7-year transition period) to align GAAP and IFRS. As a result, these converged standards (which are also IFRS) could be incorporated into GAAP.

The Way Forward

The endorsement framework is the last SEC staff proposal with respect to a possible use of IFRS in the United States. It is understandable that there has been little movement in the SEC position, as there is a new chair and chief accountant at the SEC and given the continuing focus at the SEC on rule-making and other follow-up to the financial crisis of 2008.

Nonetheless, in a speech to the AICPA National Conference, the SEC chief accountant reiterated the SEC’s support of the FASB’s and IASB’s efforts to date. He also indicated that the SEC staff will build on its prior work and will be renewing its efforts to help clarify what action, if any, the SEC will take regarding the further incorporation of IFRS into U.S. capital markets.¹⁵

¹²“Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers,” *SEC Release No. 33-8982* (November 14, 2008), and “Statement in Support of Convergence and Global Accounting Standards,” *SEC Release Nos. 33-9109; 34-61578* (February 24, 2010).

¹³“Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Final Staff Report SEC” (July 13, 2012), <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf>.

¹⁴SEC Staff Paper, “Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation” (May 26, 2011), available at www.sec.gov.

¹⁵J. Schnurr, Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments, <http://www.sec.gov/News/Speech/Detail/Speech/1370543609306#.VOT39S4yjNQ> (December 8, 2014).

Since the publication of the Staff Paper in 2012, the SEC staff has received input from various constituents on the desirability and feasibility of a full movement, optional or otherwise, to IFRS for domestic issuers. To date, that feedback indicates that **U.S. constituents generally are not supportive of full adoption of IFRS** for a variety of reasons, including legal issues and general cost-benefit concerns. U.S. constituents have also raised similar issues with respect to an option to adopt IFRS. These issues include legal impediments, practical challenges, and an impact on comparability that does not currently exist in the domestic reporting environment.

Given this feedback, the SEC is seeking input on other approaches to further incorporation of, or alignment with, IFRS for domestic issuers. In addition to the endorsement framework, the SEC chief accountant posed the possible development of rules that would allow U.S. companies to report IFRS-based financial information in addition to the GAAP-based information that they use for purposes of SEC filings. The rules would be needed because such additional disclosures currently would be considered a “non-GAAP” financial measure for a domestic issuer. This change in rules would permit companies who wish to report IFRS-based information to do so without affecting their GAAP-based information. The chief accountant noted that this supplemental IFRS reporting option is just one example of a path toward further incorporation of IFRS into GAAP and would complement the convergence efforts of the FASB and the IASB, indicating that, “Whatever the ultimate result is with respect to IFRS in the U.S., the Boards should continue to strive where practicable for aligned high-quality global standards.”

ON THE HORIZON

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported. In fact, beginning in 2010, the IASB (and the FASB on its joint projects with the IASB) started its policy of phasing in adoption of new major standards over several years. The major reason for this policy is to provide companies time to translate and implement international standards into practice. Much has happened in a very short period of time in the international accounting environment. While adoption of IFRS in the United States is an unlikely avenue to achieve a single set of high-quality accounting standards, there continues to be strong support for the Boards to continue their work to narrow the differences between GAAP and IFRS.

IFRS SELF-TEST QUESTIONS

1. IFRS stands for:
 - (a) International Federation of Reporting Services.
 - (b) Independent Financial Reporting Standards.
 - (c) International Financial Reporting Standards.
 - (d) Integrated Financial Reporting Services.
2. The major key players on the international side are the:
 - (a) IASB and FASB.
 - (b) IOSCO and the SEC.
 - (c) SEC and FASB.
 - (d) IASB and IOSCO.
3. IFRS is comprised of:
 - (a) International Financial Reporting Standards and FASB Financial Reporting Standards.
 - (b) International Financial Reporting Standards, International Accounting Standards, and International Accounting Interpretations.
 - (c) International Accounting Standards and International Accounting Interpretations.
 - (d) FASB Financial Reporting Standards and International Accounting Standards.
4. The authoritative status of The Conceptual Framework for Financial Reporting is as follows:
 - (a) It is used when there is no standard or interpretation related to the reporting issues under consideration.
 - (b) It is not as authoritative as a standard but takes precedence over any interpretation related to the reporting issue.
 - (c) It takes precedence over all other authoritative literature.
 - (d) It has no authoritative status.
5. Which of the following statements is **true**?
 - (a) The IASB has the same number of members as the FASB.
 - (b) The IASB structure has both advisory and interpretation functions, but no trustees.
 - (c) The IASB has been in existence longer than the FASB.
 - (d) The IASB structure is quite similar to the FASB's, except the IASB has a larger number of board members.

IFRS CONCEPTS AND APPLICATION

IFRS1-1 What organizations are the two key international players in the development of international accounting standards? Explain their role.

IFRS1-2 What might explain the fact that different accounting standard-setters have developed accounting standards that are sometimes quite different in nature?

IFRS1-3 What is the benefit of a single set of high-quality accounting standards?

IFRS1-4 Briefly describe the FASB/IASB convergence process and the principles that guide their convergence efforts.

Financial Reporting Case

IFRS1-5 The following comments were made at an Annual Conference of the Financial Executives Institute (FEI).

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

1. The confusion caused by international companies announcing different results depending on the set of accounting standards applied.
2. Companies in some countries obtaining unfair commercial advantages from the use of particular national accounting standards.
3. The complications in negotiating commercial arrangements for international joint ventures caused by different accounting requirements.
4. The inefficiency of international companies having to understand and use a myriad of different accounting standards depending on the countries in which they operate and the countries in which they raise capital and debt. Executive talent is wasted on keeping up to date with numerous sets of accounting standards and the never-ending changes to them.
5. The inefficiency of investment managers, bankers, and financial analysts as they seek to compare financial reporting drawn up in accordance with different sets of accounting standards.

Instructions

- (a) What is the International Accounting Standards Board?
- (b) What stakeholders might benefit from the use of International Accounting Standards?
- (c) What do you believe are some of the major obstacles to convergence?

Professional Research

IFRS1-6 As a newly enrolled accounting major, you are anxious to better understand accounting institutions and sources of accounting literature. As a first step, you decide to explore the IASB's The Conceptual Framework for Financial Reporting.

Instructions

Access the IASB Framework at the IASB website (<http://eifrs.iasb.org/>). (Click on the IFRS tab and then register for free eIFRS access if necessary.) When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following items. (Provide paragraph citations.)

- (a) What is the objective of general-purpose financial reporting?
- (b) What other means are there of communicating information, besides financial statements?
- (c) Indicate some of the users and the information they are most directly concerned with in economic decision-making.

International Financial Reporting Problem

Marks and Spencer plc (M&S)

IFRS1-7 The financial statements of **M&S** are presented in Appendix E. The company's complete annual report, including the notes to the financial statements, is available online.

Instructions

Refer to M&S's financial statements and the accompanying notes to answer the following questions.

- (a) What is the company's main line of business?
- (b) In what countries does the company operate?
- (c) What is the address of the company's corporate headquarters?
- (d) What is the company's reporting currency?

ANSWERS TO IFRS SELF-TEST QUESTIONS

1. c 2. d 3. b 4. a 5. d