

Financial Reporting: Concepts, Financial Statements, and Related Disclosures

CHAPTER 1

The Environment of Financial Reporting

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OBJECTIVES

After reading this chapter, you will be able to:

- 1 Understand capital markets and decision making.
- 2 Know what is included in financial reporting.
- 3 Explain generally accepted accounting principles (GAAP) and the sources of GAAP.
- 4 Identify the types of pronouncements issued by the FASB.
- 5 Understand how the Financial Accounting Standards Board (FASB) operates.
- 6 Describe the relationship between the Securities and Exchange Commission (SEC) and the FASB.
- 7 Use ethical models for decision making about ethical dilemmas.
- 8 Understand creative and critical thinking.

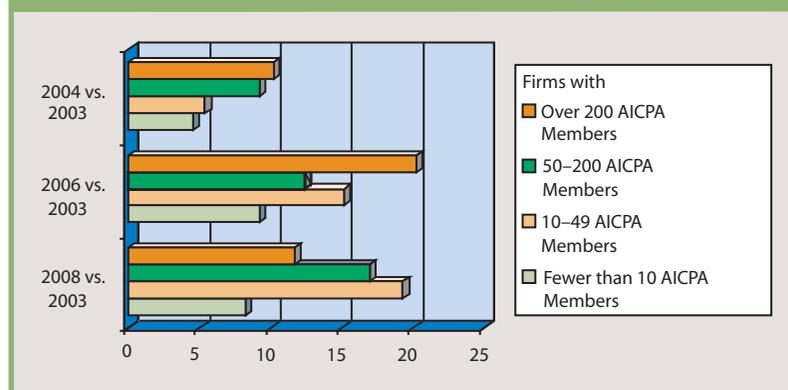
The Environment of Financial Reporting

The Future Is Bright!

With the accounting difficulties at **Enron**, **WorldCom**, **HealthSouth**, and others, the accounting profession has come under intense scrutiny from regulatory agencies and has become the subject of late-night talk show jokes. As a future accounting professional, a natural question is what the future holds for you upon graduation. Let's take a look at some recent evidence that may yield some answers.

As the regulatory environment has become more dynamic over the last several years, companies are faced with an increasing number of new accounting rules that pose a significant challenge for financial reporting. All indications are that future years will present even greater challenges. To deal with this changing environment, more and more companies are turning to accountants

Estimated Percentage Increase in Future Hiring



Source: Adapted from "The Supply of Accounting Graduates and the Demand for Public Accounting Recruits - 2004."



Credit: Stockbyte

for assistance. Many companies have increased the importance of accounting skills in their executive training programs while other companies have emphasized the certified public accountant (CPA) credential in their executive searches. The trend toward increased hiring of individuals possessing accounting skills is not confined to industry. According to the 2004 American Institute of Certified Public Accountants (AICPA) survey, hiring of accounting graduates by public accounting firms increased approximately 10% in 2003. Future projections of hiring trends for accounting graduates (shown in the figure) are indicative of continued positive growth.

Finally, in a recent survey conducted by the National Association of Colleges and Employers, accounting was listed as the number one major on college campuses. By all indications, accounting skills appear in high demand, and your future professional career in accounting appears bright!

FOR FURTHER INVESTIGATION

For a discussion of the demand for accounting, consult the Business & Company Resource Center (BCRC) or the Internet for:

- CPA Ascendant. Kate O'Sullivan, CFO, *The Magazine for Senior Financial Executives*, 8756-7113, June 2004, v20, p102(2).
- American Institute of Certified Public Accountants. "The Supply of Accounting Graduates and the Demand for Public Accounting Recruits – 2004," <http://www.aicpa.org/members/div/career/edu/sagdpar.htm>.

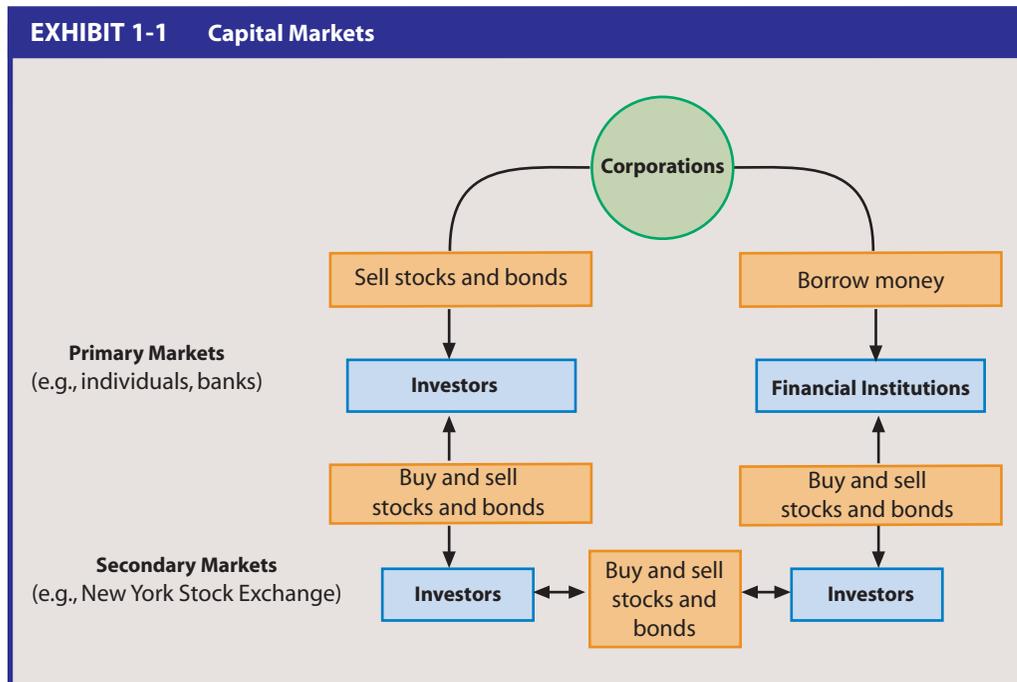
Accounting is the process of identifying, measuring, recording, and communicating economic information to enable users to make informed judgments and decisions. It is also called the “language of business.” In the U.S. economy, most published accounting information is about different types of companies (primarily corporations). Companies engage in many transactions and generate large amounts of data. Since people can absorb only limited amounts of information, accounting systems are designed to report information in a concise, understandable format. In this sense, accounting is the link between a company’s economic activities and decision makers.

In this chapter we review the uses of accounting information and who uses it, the development of principles for accumulating and communicating accounting information, and the ethical framework within which these accounting principles are applied.

ACCOUNTING INFORMATION: USERS , USES, AND GAAP

The U.S. economy is a free-market economy. In this type of economy, the decisions of many buyers and sellers influence the demand for and supply of products and services offered by companies. Individuals acting in this economy have limited resources to consume or to invest. But typically companies need large amounts of capital for their operations. Companies may obtain this capital from the issuance of capital stock (equity) and bonds (debt), from other borrowings, or from resources generated by their operations. The exchange of capital by investors for the stocks and bonds of companies occurs in **capital markets**, as we show in Exhibit 1-1. There are organized capital markets, such as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the Nasdaq Stock Market, Inc. (NASDAQ). In these markets the capital stock and bonds of many corporations are purchased and sold daily. These corporations are called *publicly-held* (or *publicly-traded*) companies. These markets sometimes are referred to as *secondary markets* because the sales and purchases are among the investors themselves. That is, the corporation that initially issued the capital stock or bonds is not involved in the exchange.

There also are more loosely organized capital markets in which fewer exchanges occur. For instance, corporations may borrow from lending institutions or may issue new



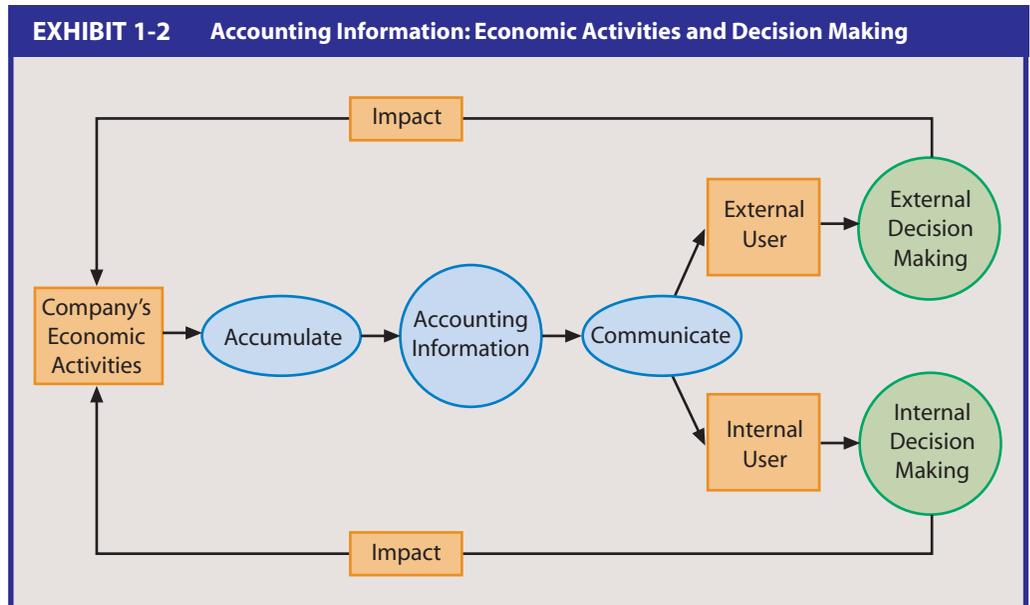
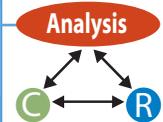
capital stock or bonds, either through “public offerings” or through “private placements.” Public offerings involve the sale to many investors (i.e., the general public). Private placements involve the sale to a few private institutions such as insurance companies and pension funds, or to employees. These markets sometimes are called *primary markets* because the exchange is directly between a corporation and the investors. Whether investors or lending institutions are involved in primary or secondary markets, they are interested in earning dividends and interest, and in a safe return of their resources. Investors in publicly traded securities participate in the increase (or decrease) in the market price of the capital stock and bonds. These investors are concerned with the efficient allocation of their scarce resources to achieve these objectives. Accounting information is useful in making decisions for this allocation process within these capital markets. It is also useful for other purposes.

External and Internal Users

Users of accounting information can be divided into two major categories, external users and internal users, as we show in Exhibit 1-2. These two user groups do not have the same information needs because of their different relationships to the company providing the economic information. **External users are actual or potential investors (stockholders and bondholders) and creditors (such as suppliers and lending institutions).** There are also other external users, such as employees, financial analysts, advisers, brokers, underwriters, stock exchanges, taxing and regulatory authorities, labor unions, and the general public. (Note that bondholders are “creditors” by contract and legal definition, but are considered “investors” as this term is commonly used.) Investors have a direct relationship with the company. Their capital market information needs revolve around three basic decisions:

1. *Buy*. A potential investor decides to purchase a particular security (e.g., a stock or bond) based on communicated accounting information.
2. *Hold*. An actual investor decides to retain a particular security based on communicated accounting information.
3. *Sell*. An actual investor decides to sell a particular security based on communicated accounting information.

1 Understand capital markets and decision making.



Creditors, such as suppliers and lending institutions, also have a direct relationship with companies. Although creditors do not purchase securities, they make similar decisions that require accounting information. The decisions in this case are to extend credit, to maintain the credit relationship, or not to extend credit. Other users use accounting information in their decision making. For instance, stock exchanges use accounting information for listings, cancellations, and rule-making decisions. Labor unions use accounting information in negotiating wage agreements. Financial analysts use accounting information for making investment and credit recommendations.

Investment and credit decisions should be continuously reevaluated. Timely communication of information to external decision makers is very important. The publication of financial statements (e.g., in “hard copy” or on a company’s web site) is a primary method by which relevant information is communicated. Studies have shown, however, that decision makers also use other reporting sources to satisfy their information needs.¹ We discuss this area of study, known as efficient capital markets research, in Chapter 6.

Internal users are the company managers who plan and control its operations on a day-by-day and a long-term basis. Internal users may request any information that the accounting system is capable of providing to help them make decisions on internal operations. For example, internal users may ask for information relating specifically to the purchase of new equipment or the addition of a new product.

Financial and Managerial Accounting Information Systems

Two branches of accounting are used to meet the needs of external and internal users. **Financial accounting is the information accumulation, processing, and communication system designed to provide investment and credit decision-making information for external users.** Financial accounting information is communicated (reported) through published financial statements and must follow the pronouncements of several policy-making groups. **Managerial accounting is the information accumulation, processing, and communication system designed to provide decision-making information for internal users.** Managerial accounting information is communicated via internal company reports and is not subject to the policy standards for externally communicated information. It is restricted by how useful the information is for a specific decision, and by the cost of providing that information. Financial and managerial accounting thus have somewhat different objectives because they provide information for different decisions. Exhibit 1-3 summarizes some of the more important differences.

The company’s accountants prepare both the financial accounting and the managerial accounting reports, and the information comes from the same information system. The differences lie in selecting and presenting the communicated information. This book focuses on financial accounting and its usefulness in investors’, creditors’, and other users’ decision making. We generally do not discuss managerial accounting information. On the other hand, the rules of a game influence how the game is played. The management of a company often is evaluated based on “performance criteria” (e.g., net income, rate of return) that are based on the accounting measures used in financial accounting reports. Thus, the financial accounting system may influence the managerial accounting system, or vice versa.

1. In addition to the use of published financial statements, accounting information may be communicated to external users by other methods, such as reports filed with the Securities and Exchange Commission (discussed later in the chapter), news releases, and management forecasts. Evidence from capital markets research studies tends to show that security prices fully reflect all *publicly* available information. For a more detailed discussion, see T. R. Dyckman and D. Morse, *Efficient Capital Markets and Accounting: A Critical Analysis*, 2nd ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1986), R. L. Watts and J. R. Zimmerman, *Positive Accounting Theory* (Englewood Cliffs, N.J.: Prentice Hall, 1986), W. H. Beaver, *Financial Reporting: An Accounting Revolution*, 3rd ed. (Upper Saddle River, N.J.: Prentice Hall, 1998), or J. R. Macey, “Efficient Capital Markets, Corporate Disclosure, and Enron,” *Cornell Law Review* (January 2004), p. 394–403.

EXHIBIT 1-3 Comparison of Financial and Managerial Accounting

	Financial Accounting	Managerial Accounting
1. Source of authority	Generally accepted accounting principles (GAAP)	Internal needs
2. Time frame of reported information	Primarily historical	Primarily present and future
3. Scope	Mainly total company	Individual departments, divisions, and total company
4. Type of information	Primarily quantitative	Qualitative as well as quantitative
5. Statement format	Prescribed by GAAP; oriented toward investment and credit decisions	Determined by company; focused on specific decisions being made
6. Decision focus	External	Internal

In other words, the amounts reported or methods used for financial accounting may influence management decisions. Or, the management of a company (perhaps in its own self-interest) may use the managerial accounting system to influence financial reporting. In this regard, the term *agency theory* describes the relationship between the manager (the “agent”) and the stockholder (the “principal”). The theory suggests that agents do not always act in the best interests of the principals. For example, managers might make a decision that increases their compensation while reducing the wealth of the company and its stockholders. Research suggests that an effective way to align the interests of the agent and the principal is to base the manager’s compensation on the performance of the company. Examples include the payment of bonuses that are a percentage of the company’s income, and the awarding of stock options. We discuss bonuses and stock options in Chapters 13 and 16. In other chapters we discuss the effects on financial reporting from actual or potential agency theory relationships.

Financial Reporting

Financial reporting is the process of communicating financial accounting information about a company to external users. A company may report its financial accounting information in several ways. One important way is through its *annual report*. The financial reporting section of a company’s annual report includes the company’s financial statements and the notes to the financial statements. Companies present at least three major financial statements: (1) the *balance sheet* (or statement of financial position), which shows a company’s financial position at a given date, (2) the *income statement*, which shows the results of a company’s income-producing activities for a period of time, and (3) the *statement of cash flows*, which shows a company’s cash inflows and cash outflows for a period of time. Many companies include the *statement of changes in stockholders’ equity*, which shows the changes in each item of stockholders’ equity for a period of time, as a fourth major financial statement.²



2. Some companies include a *statement of comprehensive income* as another major financial statement. We discuss this statement in Chapter 5.

2 Know what is included in financial reporting.

The *notes* to the financial statements include discussions that further explain items shown in the financial statements. Many of these notes also include supporting schedules of computations (some companies include the statement of changes in stockholders' equity here). The information in the notes is essential to understanding a company's activities. Most financial statements and accompanying notes presented to external users are *audited* by an independent certified public accountant (CPA). As we discuss in Chapters 4 and 6, after completion of the audit, the CPA expresses an opinion as to the fairness, in accordance with *generally accepted accounting principles*, of the financial statements and accompanying notes. These financial statements and notes (and supporting schedules) to the financial statements are the subject of this book.



SECURE YOUR KNOWLEDGE 1-1

- Accounting information aids in the efficient allocation of resources in capital markets.
- External users (investors, creditors, and others) use financial accounting information to make investment and credit decisions.
- Internal users (company management) use managerial accounting information to plan and control a company's operations.
- Financial reporting is the process of communicating financial information about a company to external users and includes the financial statements and the related notes to the financial statements.

Generally Accepted Accounting Principles

The information communicated to external users in financial reporting is based on standards that establish generally accepted accounting principles (GAAP). **Generally accepted accounting principles are the guidelines, procedures, and practices that a company is required to use in recording and reporting the accounting information in its audited financial statements.** GAAP define accepted accounting practices and provide a standard by which to report financial results. They are like laws and are the rules that must be followed in financial reporting.

3 Explain generally accepted accounting principles (GAAP) and the sources of GAAP.

The evolution of GAAP took place over many years. It involved several accounting policy-making bodies, including the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB), American Institute of Certified Public Accountants (AICPA), and Securities and Exchange Commission (SEC). Unfortunately, there is no single document that includes all the accounting standards. [There are electronic databases such as the FASB *Financial Accounting Research System (FARS)* that include most accounting standards.] Nonetheless, an accountant must be able to determine the procedure for recording a transaction that is acceptable under GAAP. Accountants, therefore, must know the sources of generally accepted accounting principles. They must also know how to find authoritative sources to aid in recording and reporting a particular transaction. Throughout this book we discuss GAAP for various transactions, events, and circumstances. However, to aid in researching the sources of generally accepted accounting principles, Exhibit 1-4 provides a "hierarchy" of four categories of GAAP and the authoritative sources applicable to each category for companies.³

These categories are listed in descending order of importance, with Category A as the most important. Companies must follow the GAAP established by the pronouncements

3. See "The Hierarchy of Generally Accepted Accounting Principles," *Proposed FASB Statement of Financial Accounting Standards* (April 28, 2005). This document will move the GAAP hierarchy contained in *AICPA Statement on Auditing Standards No. 69* into the FASB literature. The Proposed Statement is not controversial, but the timing of its release is dependent on the issuance of similar documents by the PCAOB and AICPA. Until its release, the hierarchy (which is essentially identical to that in the Proposed Statement) listed in the *AICPA Statement No. 69* applies.

EXHIBIT 1-4 Hierarchy of Sources of GAAP

Categories	Authoritative Sources (Pronouncements)
A	FASB Statements of Financial Accounting Standards and Interpretations, FASB Staff Positions, FASB Statement 133 Implementation Issues, APB Opinions, and CAP (AICPA) Accounting Research Bulletins (as well as SEC releases such as Regulation S-X, Financial Reporting Releases, and Staff Accounting Bulletins for companies that file with the SEC)
B	FASB Technical Bulletins, and, if cleared* by the FASB, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position
C	FASB Emerging Issues Task Force Consensus Positions and, if cleared* by the FASB, AICPA Practice Bulletins
D	FASB Q's and A's (Implementation Guides), AICPA Accounting Interpretations, AICPA Industry and Audit Guides, and AICPA Statements of Position not cleared by the FASB, and practices that are widely recognized and prevalent either generally or in the industry (e.g., AICPA Accounting Trends and Techniques)

****Cleared** means that the FASB does not object to the pronouncement's issuance.**

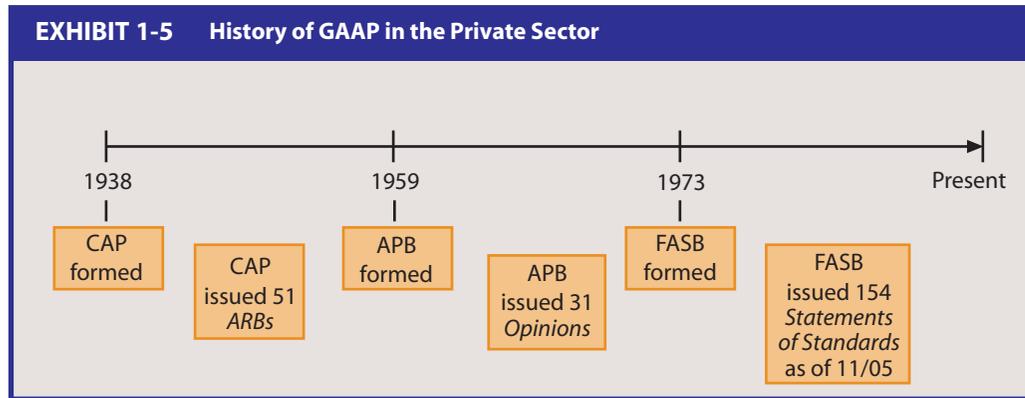
in this category unless, in unusual circumstances, they result in misleading financial statements. In situations where the accounting for a transaction or event is not specified by a pronouncement in Category A, then pronouncements in Categories B through D may be used in that order to identify GAAP. When none of the pronouncements in Categories A through D apply, then the company may consider other accounting literature such as FASB *Statements of Concepts*, AICPA *Issues Papers*, IASB *International Financial Reporting Standards*, AICPA *Technical Practice Aids*, and accounting textbooks, handbooks, and articles for GAAP guidance.

The FASB is currently working on a project that modifies the hierarchy so that it consists of only two levels—an “authoritative” level and a “nonauthoritative” level. The authoritative literature will be referred to as the “Codification.” This Codification will be a compilation of existing U.S. GAAP, organized according to accounting topics, regardless of the authoritative pronouncement. This Codification project will be a multi-year effort.

THE ESTABLISHMENT OF ACCOUNTING STANDARDS

Accounting records dating back thousands of years have been discovered in various parts of the world. However, there was little organized effort to develop accounting standards in the United States prior to the 1930s. One of the most important initial attempts to develop standards began shortly after the onset of the Great Depression in 1929. In the early 1930s there were a series of meetings between representatives of the New York Stock Exchange and the American Institute of Accountants (later to become the American Institute of Certified Public Accountants). The goal was to discuss accounting and reporting issues involving the interests of investors, the New York Stock Exchange, and accountants.

The result of these meetings was a form of the auditor's opinion similar to the one used today. Specifically, the concepts of *fairness* and *consistency* in applying accounting principles were introduced into the auditor's opinion. Here, fairness means that the accounting methods and procedures adopted by a company comply with traditional practice and that they adequately portray the economic reality of the company. Since these meetings, several groups have been responsible for setting generally accepted accounting principles in the private sector of the United States. Exhibit 1-5 shows a “time-line” of the establishment of GAAP (Category A of Exhibit 1-4) in the private sector.



Committee on Accounting Procedure (CAP)

In 1938, the AICPA formed the **Committee on Accounting Procedure (CAP)**. This group issued pronouncements to narrow the differences in accounting procedures and practice. Its conclusions were published as **Accounting Research Bulletins (ARBs)**. However, because at that time the AICPA did not have the authority to require compliance, the CAP could not enforce its pronouncements and their application was optional. By 1953, the CAP had issued 42 *Accounting Research Bulletins*. It then reviewed these pronouncements and codified them into **Accounting Research Bulletin No. 43**. The CAP issued eight more *Accounting Research Bulletins*, ending with No. 51 before it was replaced by the Accounting Principles Board in 1959. All *Accounting Research Bulletins* are now sources of generally accepted accounting principles unless specifically superseded or amended.

Accounting Principles Board (APB)

After World War II the process of setting accounting principles was increasingly criticized and wider representation in rule making was sought. In 1959 the AICPA formed the **Accounting Principles Board (APB)** as an attempt to (1) alleviate this criticism and (2) create a policy-making body whose rules would be binding on companies rather than optional. The APB had between 17 and 21 members, selected primarily from the accounting profession. Representatives from industry, the government, and academia also served on the Board. The pronouncements of the APB were called **Opinions of the Accounting Principles Board**, and 31 of these Opinions were issued. *APB Opinions* are sources of generally accepted accounting principles unless specifically amended or rescinded. Some of these Opinions were based upon *Accounting Research Studies*. However, the conclusions in these studies were the opinion of the individuals commissioned by the APB to write them. In several cases the APB either did not act on the recommendations or came to different conclusions.

The members of the APB were volunteers whose employers allowed them time to serve on the Board. But by the late 1960s, many people again criticized the development of accounting principles. This criticism centered on three factors:

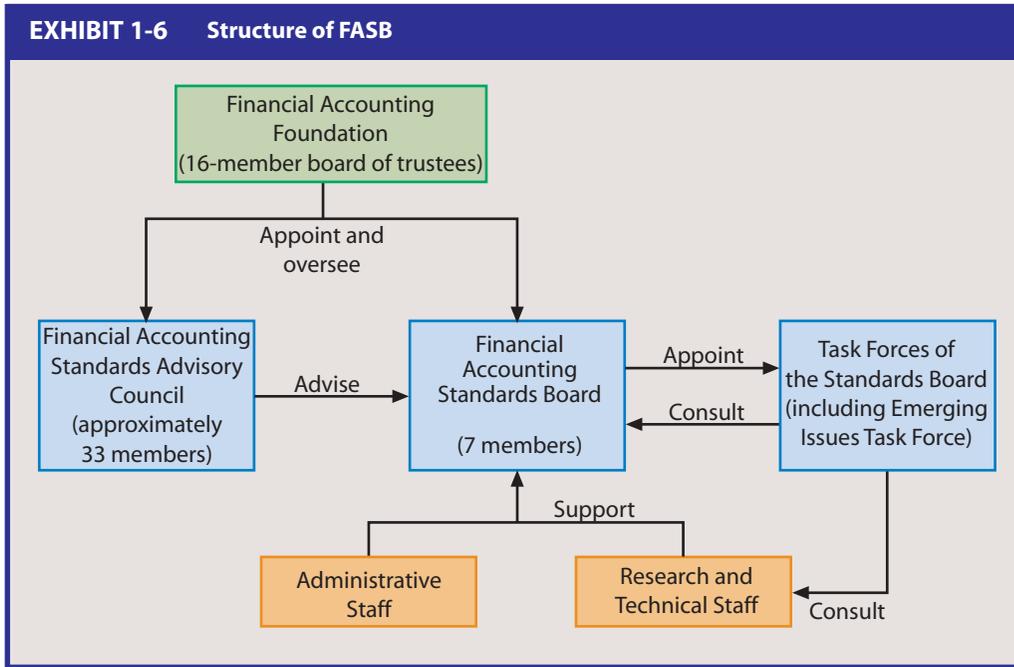
1. *Independence*. The members of the APB were part-time volunteers whose major responsibilities were to the business, governmental, or academic organizations employing them.
2. *Representation*. The public accounting firms and the AICPA were too closely associated with the development of accounting standards.
3. *Response time*. Emerging problems were not solved quickly enough by the part-time members of the APB.

The AICPA reacted to those criticisms by appointing a committee to evaluate the method of establishing accounting principles. This committee, called the Wheat Committee after

its chairman Francis Wheat, recommended that the APB be abolished and that a new full-time body be created with even wider representation.

Financial Accounting Standards Board (FASB)

The AICPA adopted the recommendations of the Wheat Committee. The APB was phased out and replaced in 1973 by the **Financial Accounting Standards Board (FASB)**. Exhibit 1-6 shows the current structure of the FASB.



Organization

The Financial Accounting Foundation is the parent organization of the FASB. It is governed by a 16-member Board of Trustees appointed from the memberships of eight organizations interested in the establishment of accounting principles. These organizations are the AICPA, Financial Executives International, Institute of Management Accountants, CFA Institute, American Accounting Association, Securities Industry Association, Government Finance Officers Association, and National Association of State Auditors (Comptrollers and Treasurers).⁴ The primary responsibilities of the Financial Accounting Foundation are to provide general oversight to its operations and to appoint the members of the Financial Accounting Standards Advisory Council (FASAC) and the FASB. The FASAC has about 33 influential members. It is responsible for advising the FASB about major policy issues, the priority of topics, the selection of task forces, the suitability of tentative decisions, and other matters.

There are seven members of the FASB. Appointees to the FASB are full-time, fully paid members with no other organizational ties. They are selected to represent a wide cross-section of interests. Each Board member is required to have a knowledge of accounting, finance, and business; high intelligence, integrity, and discipline; and a concern for the

4. The Financial Accounting Foundation also is the parent organization of the Governmental Accounting Standards Board (GASB), which establishes accounting principles for state and local governmental entities. We briefly discuss the GASB later in the chapter.

public interest regarding financial reporting. Currently, the FASB includes four members who are CPAs and who have been in public practice and three members from other areas related to accounting (e.g., academia and industry). The FASB is responsible for identifying financial accounting issues, conducting research to address these issues, and resolving them. The FASB is supported by a research and technical staff that researches issues, communicates with constituents, and drafts preliminary findings. The administrative staff assists the FASB by handling library, publications, personnel, and other activities.⁵

The FASB issues several types of pronouncements:

4 Identify the types of pronouncements issued by the FASB.

1. *Statements of Financial Accounting Standards*. These pronouncements establish generally accepted accounting principles. They indicate the methods and procedures required on specific accounting issues and are included in Category A of Exhibit 1-4.
2. *Interpretations*. These pronouncements provide clarification of conflicting or unclear issues relating to previously issued *FASB Statements of Financial Accounting Standards*, *APB Opinions*, or *Accounting Research Bulletins*. Interpretations also establish or clarify generally accepted accounting principles. They are included in Category A of Exhibit 1-4.
3. *Staff Positions*. The staff of the FASB issues these pronouncements to provide more timely and consistent application guidance in regard to FASB literature. In addition, at the direction of the FASB, the staff may issue *Staff Positions* to make narrow and limited revisions of *FASB Statements of Financial Accounting Standards* or *Interpretations* that previously would have been made through *Technical Bulletins*. They are included in Category A of Exhibit 1-4.
4. *Technical Bulletins*. The staff of the FASB issues these pronouncements to provide guidance on accounting and reporting problems related to *Statements of Financial Accounting Standards* or *Interpretations*. The guidance may clarify, explain, or elaborate upon an underlying standard. They are included in Category B of Exhibit 1-4.
5. *Statements of Financial Accounting Concepts*. These pronouncements establish a theoretical foundation on which to base financial accounting and reporting standards. They are the output of the FASB's "Conceptual Framework" project (which we discuss in Chapter 2).⁶ They are not included in Exhibit 1-4 but are considered "other accounting literature" for GAAP guidance.
6. *Other Pronouncements*. On a major topic, the FASB staff also may issue a *Guide for Implementation*, which is in the form of questions and answers (referred to as *FASB Q's and A's*). These are included in Category D of Exhibit 1-4.

Many of these documents may be downloaded for free from the FASB web site (<http://www.fasb.org>) or may be purchased individually from the FASB. As a service to its constituency, the FASB also offers other publications. Two of these, published each year as part of the FASB's *Accounting Standards* series, are useful references for accountants. One three-volume set, titled *Original Pronouncements*, includes all of the first four types of pronouncements as of its date of publication. Another two-volume set, titled *Current Text (General Standards and Industry Standards)*, is a topical integration of currently effective accounting and reporting standards as of its date of publication. These documents are also available on the *FARS* electronic database.

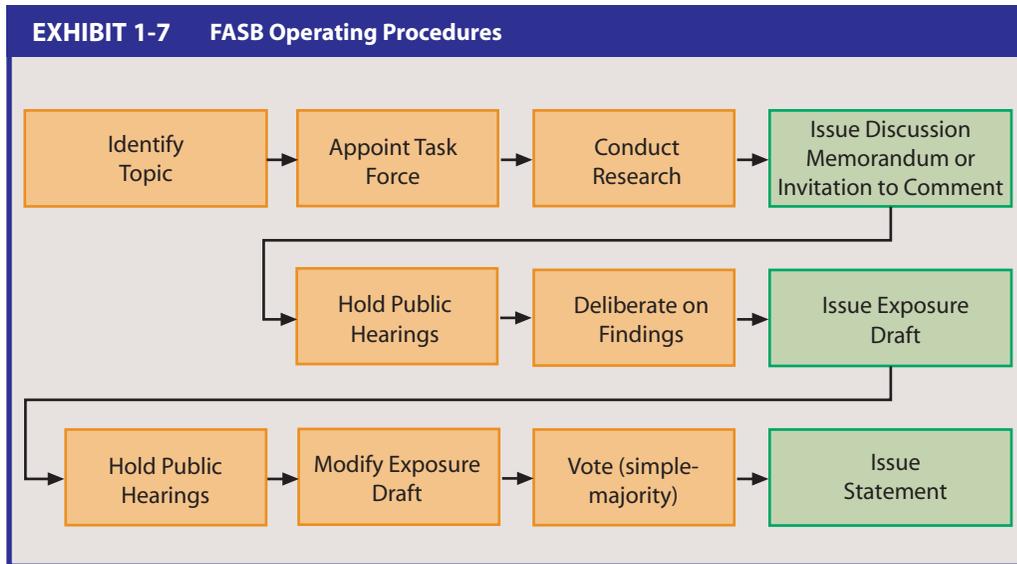
5. For a more detailed look at the FASB's operations, see P. B. Miller, R. J. Redding, and P. R. Bahnson, *The FASB: The People, the Process, and the Politics*, 4th ed. (Boston: The McGraw-Hill Companies, Inc., 1998).

6. The similarity in the titles *Statement of Financial Accounting Concepts* and *Statement of Financial Accounting Standards* makes an abbreviated reference to each potentially ambiguous. To avoid confusion, throughout this book a reference to **FASB Statement No. ___** in the body of the text will always refer to a statement of *standards*, while a full reference will be presented for each statement of *concepts*.

Operating Procedures

Before issuing a statement of concepts or standards, the FASB generally completes a multi-stage process as outlined in Exhibit 1-7. Initially, a topic or project is identified and placed on the FASB’s agenda. This topic may be the result of suggestions from the FASAC, the accounting profession, industry, or other interested parties. On major issues a Task Force may be appointed to advise and consult with the FASB’s Research and Technical Staff. This may involve, for instance, the scope of the project and the nature and extent of additional research. The Staff conducts any research specifically related to the project.

5 Understand how the Financial Accounting Standards Board (FASB) operates.



Then the FASB usually publishes a Discussion Memorandum or Invitation to Comment (which outlines the research related to the issues) and sets a public comment period. During this period, the FASB may hold public hearings similar to those conducted by Congress. The intent is to receive information from and views of interested individuals and organizations on the issues. Many parties submit written comments (“position papers”) or make oral presentations. These parties include representatives of CPA firms and interested corporations, security analysts, members of professional accounting associations, and academics. After deliberating on the views expressed and the information collected, the FASB issues an Exposure Draft of the proposed Statement. Interested parties generally have 30 to 90 days to provide written comments of reaction. On major issues, the FASB may hold more public hearings. Sometimes, the FASB conducts “field tests” of the proposed standards with selected companies to evaluate implementation issues. A modified draft is prepared, if necessary, and brought to the FASB for a final vote. After a *simple-majority* (i.e., 4 to 3) vote is attained, the *Statement* is issued.

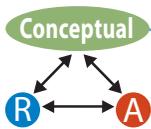
The time involved to complete each of the steps varies depending on the complexity of the topic. For some complex topics it takes several years; for other, less complex topics only a few months are needed. For instance, the FASB deliberated on basic conceptual and practical issues involving the statement of cash flows for more than 10 years. The board issued a Discussion Memorandum in 1980, but then deferred consideration of cash flows reporting until it dealt with related theoretical issues in its Conceptual Framework project. In 1985 the FASB reactivated the topic. It held public hearings and received more than 450 comment letters in response to its Exposure Draft. *FASB Statement No. 95*, entitled “Statement of Cash Flows,” was issued in November 1987, as shown in the following summary.

Step in Procedures	FASB Statement No. 95	FASB Statement No. 145
Issue <i>Discussion Memorandum</i>	Dec. 1980	None
Receive public comments	May 1981	None
Appoint Task Force	May 1985	None
Issue <i>Exposure Draft</i>	July 1986	Nov. 2001
Receive public comments	Through Mar. 1987	Through Jan. 14, 2002
Issue <i>Statement</i>	Nov. 1987	April 2002

On the other hand, *FASB Statement No. 145*, which rescinded *FASB Statement No. 4* in regard to reporting gains and losses from the extinguishment of debt, was issued within eight months after the related *Exposure Draft* was issued. In this case the FASB concluded that it could reach an informed decision without a public hearing. During the public comment period it did receive 30 comment letters, which were used in the deliberation process.

Sociopolitical Environment

As Exhibit 1-7 and the related discussion show, the operating procedures of the FASB are designed so that accounting standards are developed in an efficient manner, with due process, and in a public forum. The FASB is concerned that it considers all related research on a particular topic, as well as the views of all interested parties, before coming to a logical conclusion about the appropriate accounting standard for the topic. Its intent is to develop accounting standards that provide users with thorough, neutral, and credible information to help allocate capital as efficiently as possible.⁷



An inexperienced viewer of the FASB operating procedures might think that accounting standards are always “ideal” because they are the result of “rational policy making,” where there are clearly defined objectives, an integrated body of theory, and known consequences of the actions. Yet this may not always be the case because accounting is part of a broader social system. Often, objectives are not clear, research results are conflicting, and only “best guesses” can be made of the future consequences of current standards.

Because the FASB has such a wide constituency and focuses on general purpose financial reporting, it often must establish accounting standards that are the result of *compromise*. To achieve “acceptable decisions” it is only natural for any affected parties to attempt to influence the FASB’s decisions. Since the FASB holds public hearings and open meetings, it is relatively easy for various external user groups (e.g., investors and creditors) and other interested groups (e.g., affected corporations and CPA firms) to try to influence the FASB to develop new standards, continue existing standards, or change existing standards in their own best interests. These groups often hold conflicting views. For instance, in 1995 the FASB decided that a new accounting standard for “stock options” was desirable, but it could not get enough support from external user groups. Therefore, it issued a standard that allowed companies to use either the new standard or the existing standard. In this case, compromise led to a lack of “comparability” across companies as to the effect of stock option accounting on their financial statements. The serious financial reporting failures (e.g., Enron) that occurred in the early 2000s led to a review of this accounting. As a result, the FASB (despite opposition from some members of Congress) issued a new standard *requiring* the use of one method to account for stock options.

Compromise is inevitable as the FASB responds to the “globalization” of industry. In this regard, the FASB has been working with the International Accounting Standards Board (discussed later) and the accounting rule-making bodies of other countries to “harmonize” accounting standards among different countries. As Dennis Beresford (former Chair of the FASB) states: “Different countries have different domestic concerns that

7. J. M. Foster, “The FASB and Capital Markets,” *The FASB Report No. 245* (June 30, 2003). p. 3.



Credit: ©Getty Images/PhotoDisc

are reflected in the way they think about financial reporting. None of the viewpoints are more 'right' than one another, just different. Compromises are an inevitable part of harmonization."⁸

In regard to U.S. standards, for a given topic each FASB member will have certain issues of high priority and others of lower priority. In the FASB's deliberation process each Board member will attempt to persuade the other members to accept the important issues and to drop the less important ones. This negotiation is necessary to reach a consensus so that a majority vote may be attained on the topic.⁹ Whenever a compromise is reached, some in the FASB's constituency may be unhappy because they perceive that the new GAAP is somehow "unfair" to them. In such a situation, many in the constituency have criticized the FASB for failing to listen to them, not considering the cost/benefit issues, creating logically inconsistent rules, and establishing complex standards that are too hard to implement. To help overcome these criticisms, the FASB now includes a discussion of its reasoning in each pronouncement it issues.

The Financial Accounting Foundation, in overseeing the FASB, has implemented procedures to overcome these criticisms. These procedures include use of an oversight committee to monitor the FASB's standard-setting process, periodic Financial Accounting Foundation and FASB discussions, stronger input by the FASAC on agenda determination and task force use, and additional publication and field testing of preliminary views. Furthermore, it is considering moving toward "objectives-oriented" rather than "rule-based" accounting standards, which we will discuss in Chapter 2.

Accounting standards are not unchangeable. The FASB fulfills its responsibility by (1) establishing standards that are the most acceptable, given the various affected constituencies, and (2) continually monitoring the consequences of its actions so that revised standards can be issued where appropriate. As Beresford points out, the FASB carries out its public responsibility in an environment characterized by subtlety, complexity, and an absence of clear-cut answers. The FASB works hard to develop accounting standards that can

8. D. R. Beresford, "Notes from the Chairman," *FASB Status Report No. 282* (November 18, 1996), p. 2.

9. For additional discussion of the FASB's political process, see Miller, Redding, and Bahnson, *op. cit.*, chap. 1.

be defended in terms of facts and circumstances, logic, and the fairness of the process that produces them. Reinforcing this fairness idea in testimony before Congress, Robert Herz (Chair of the FASB) stated that neutrality is a fundamental element of the FASB's standard-setting process. The Board strongly opposes any legislation that would impair its independent, objective, and open standard-setting process.¹⁰

Objectives-Oriented Standard Setting

As we noted in the preceding section, many constituents have said that they are concerned about the increasing level of detail ("rules-based" approach), lack of consistency, and complexity in the standards set by the FASB. As a result, the Board has begun a process whereby in the future, standards will be based on an internally consistent conceptual framework (we discuss the current conceptual framework in Chapter 2). Each "objectives-oriented" standard would: (1) clearly state the accounting objective of the standard, (2) provide enough (but not too much) detail so that the standard could be applied on a consistent basis, and (3) minimize exceptions to the standard. The intent is to allow preparers and auditors to exercise professional judgment in determining how to apply accounting standards to show the economic substance of transactions and events. It is likely that this process will take several years because, among other things, preparers and auditors have become less willing to exercise professional judgments due to increasing litigation risks.¹¹

Other Organizations Currently Influencing Generally Accepted Accounting Principles

Several other organizations have had an impact on the development of generally accepted accounting principles during the past several decades.

Securities and Exchange Commission (SEC)

The SEC was created by Congress to administer the Securities Act of 1933 and the Securities Exchange Act of 1934. Under these Acts, **the SEC has the legal authority to prescribe accounting principles and reporting practices for all corporations issuing publicly traded securities.** About 17,000 (less than 1%) of the 4.9 million corporations in the United States are subject to the SEC's authority. Although this percentage is small, these corporations (e.g., Wal-Mart) are the major companies in our economy. While the SEC has seldom used this authority, from time to time the SEC has exerted pressure on the CAP, the APB, and the FASB. It has been especially interested in narrowing differences in accounting practice and in increasing disclosures.

The 1933 Act requires each company offering securities for sale to the public in the primary and secondary markets to file a registration statement. It also requires these "publicly-held" companies to provide each investor with a proxy statement prior to each stockholders' meeting. The 1934 Act established extensive reporting requirements to aid in full disclosure. Among the most commonly required reports are:

Form S-1. A registration statement.

Form 10-K. An annual report.

Form 10-Q. A quarterly report of operations.

Form 8-K. A report used to describe any significant events that may affect the company.

Proxy Statement. A report used when management requests the right to vote through proxies for shareholders at stockholders' meetings.

10. R. H. Herz, "FASB Chairman Appears before Congress on Stock Option Accounting," *The FASB Report No. 245* (June 30, 2003), p. 11.

11. For a more complete summary of the FASB's activities on objectives-oriented standards, see "On the Road to an Objectives-Oriented Accounting System," *The FASB Report No. 259* (August 31, 2004), pp. 1–7.

Companies are required to file these forms electronically with the SEC. These forms are located in the SEC's Electronic Data Gathering Analysis and Retrieval System (commonly known as EDGAR) on the Internet (<http://www.sec.gov/edgar.shtml>).

The SEC establishes accounting principles with respect to the information contained within the preceding reports. It issues reporting guidelines in its *Regulation S-X*, its *Financial Reporting Releases*, and its *Staff Accounting Bulletins* for companies that file with the SEC. In some instances the SEC has required the disclosure of information not typically found in published financial reports. We discuss these disclosures further in Chapters 4 and 6.

The impact of the SEC generally has been through its informal approval of *APB Opinions* and *FASB Statements* before their issuance. While the SEC has the authority to decide what constitutes "generally accepted accounting principles," in many cases it has exercised this authority through persuasion rather than edict. The SEC has endorsed the concept of "substantial authoritative support" by asserting that "principles, standards, and practices promulgated by the FASB in its *Statements* and *Interpretations* will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."¹² The result of this position has been to *allow accounting principles to be formulated in the private sector* rather than by the government.

However, the SEC has been criticized for not exercising its responsibility, and there is no assurance that this position will remain in effect. In fact, during 1978 the SEC refused to support **FASB Statement No. 19** requiring the use of the successful-efforts method in the oil and gas industry, and the FASB reacted by suspending the effective date of this release. Then, in the late 1980s the House Energy and Commerce Committee's Oversight and Investigations Subcommittee was critical of the SEC for its alleged failure to monitor the detection of fraud and to establish an "early warning" system for identifying potential business failures. Although these hearings did not result in changes involving the establishment of generally accepted accounting principles, they did have an impact on *auditing* standards. Furthermore, the SEC pressured the FASB to adopt a standard requiring the use of market values by companies for reporting certain types of investments, and the Board issued **FASB Statement No. 115** in response to this pressure.

American Institute of Certified Public Accountants (AICPA)

The AICPA dates back to 1887 and is the professional organization for all certified public accountants in the United States. To be a member of the AICPA, an individual must have passed the Uniform CPA Examination, hold a CPA certificate, agree to abide by its bylaws and Code of Professional Ethics, and have 150 hours of higher education. The primary purpose of the AICPA is to provide the necessary technical support to assure that CPAs serve the public interest in performing quality professional services.

To fulfill this purpose, the AICPA publishes numerous documents that, in certain circumstances, may be considered as sources of generally accepted accounting principles, as listed in Exhibit 1-4. *Industry Audit Guides* and *Industry Accounting Guides* (Category B of Exhibit 1-4) are publications designed to assist independent auditors in examining and reporting on financial statements of various types of entities in specialized industries (e.g., banking). *Statements of Position* (Category B of Exhibit 1-4) are publications intended to influence the development of financial accounting principles that best serve the public interest. *Practice Bulletins* (Category C of Exhibit 1-4) are publications that provide guidance on specific technical issues.

During the tenure of the Accounting Principles Board, the AICPA issued numerous *AICPA Accounting Interpretations* to provide timely guidance on accounting issues without

6 Describe the relationship between the SEC and the FASB.

12. "Codification of Financial Reporting Policies," *SEC Accounting Rules* (Chicago: Commerce Clearing House, 2005), sec. 101. This Codification contains the accounting principles and reporting guidelines issued prior to 1982 in the SEC's *Accounting Series Releases*. In 1982, the name was changed to *Financial Reporting Releases* to better reflect the nature of the documents.

the formal procedures needed for an APB *Opinion*. These *Interpretations* (Category D of Exhibit 1-4) are still sources of generally accepted accounting principles unless specifically rescinded or amended. The AICPA also annually publishes *Accounting Trends and Techniques* (Category D of Exhibit 1-4), which provides a study of the latest accounting practices and trends identified from a survey of 600 published annual reports. This publication may be used to identify a consensus about generally accepted accounting principles for a particular issue or methods of disclosure. In this book we often cite disclosure information from *Accounting Trends and Techniques* that applies to a specific accounting practice. Finally, the AICPA develops *Issue Papers* to help the FASB identify accounting areas that need to be addressed and clarified.

FASB Emerging Issues Task Force (EITF)

The EITF was established in 1984 as a response by the FASB to criticisms that the Board did not always provide timely guidance on new accounting issues. Members of the EITF meet every six weeks; they include technical experts from all the major CPA firms and representatives from smaller CPA firms and from industry. These individuals are knowledgeable in accounting and financial reporting and are in positions to be aware of emerging problems. The Chief Accountant of the SEC also participates in EITF meetings. The primary objectives of the EITF are (1) to identify significant emerging accounting issues (i.e., unique transactions and accounting problems) that it feels the FASB should address and (2) to develop *consensus positions* on the implementation issues involving the application of standards. As shown in Category C of Exhibit 1-4, in some cases these consensus positions may be viewed as the “best available guidance” on generally accepted accounting principles, particularly as they relate to new accounting issues. The FASB publishes a summary of the proceedings of the EITF in a loose-leaf service and in an annual bound version titled *EITF Abstracts*. The summary is also available electronically on the FASB web site and the *FARS* database.

Cost Accounting Standards Board (CASB)

The CASB was established in 1970 as an agency of the U.S. Congress. In 1980, Congress did not vote funds for its continuance, but it was reinstated in 1988. The CASB is responsible only for negotiated federal contracts and subcontracts exceeding \$500,000 and has issued several related *Cost Accounting Standards*. Since internal cost accounting procedures often affect externally reported financial information, these cost accounting standards occasionally influence external reporting. In the past, Congress considered replacing the FASB with a governmental board like the CASB. Although this change has not been made, the possibility of additional governmental involvement in setting accounting principles should not be discounted.

Internal Revenue Service (IRS)

The IRS administers the Internal Revenue Code enacted by Congress. Federal income tax laws have had a significant impact on financial reporting practices since they were first enacted in 1913. Although the Internal Revenue Code generally does not affect financial accounting practice directly, managers often prefer to lessen its impact on the accounting systems within their companies. The result in many cases has been that they have used accounting methods and procedures that result in the lowest taxable income, without considering the proper financial accounting theory and practice.

You should understand that accounting for income tax purposes and accounting for financial reporting purposes *are* and *should be* different. The goal of financial accounting is to provide information to financial statement users so that they may make decisions. The goal of income tax accounting is to legally minimize or postpone the payment of income taxes. Frequently, the goals of financial reporting and income tax reporting conflict. For this reason, in this book we are concerned with determining the proper *financial* accounting recording and reporting procedures. What is, or should be, proper under the

Internal Revenue Code is an entirely different question, which we only discuss when it has an impact on financial accounting and reporting. We discuss the impact of the Internal Revenue Code on financial accounting for income taxes in Chapter 19.

American Accounting Association (AAA)

The AAA is an organization primarily of academics and practicing accountants. The mission of the AAA is to foster worldwide excellence in the creation, dissemination, and application of accounting knowledge and skills. Its goals are to encourage excellence in accounting research and accounting instruction, and to contribute to excellence in accounting practice. These goals are primarily implemented through various meetings; the AAA's journals—*The Accounting Review*, *Issues in Accounting Education*, and *Accounting Horizons*; and the work of various committees such as the AAA Financial Accounting Standards Committee (FAS). The FAS responds to various documents of the FASB relating to proposed statements of concepts and standards. The AAA has no official stature in the development of financial accounting practice, so its impact is through education and persuasion. However, its members have served on the APB, FAF, and the FASB, and have appeared before the FASB in its hearings on particular issues.

International Accounting Standards Board (IASB)

Companies are becoming more international in their operations by producing, selling, and buying products and services in other countries. This globalization of business activity has led to increased information in a company's financial statements about its international operations. Investors and creditors in international markets, in turn, prefer that the information they use for decisions be internationally comparable from company to company across countries. The International Accounting Standards Committee (IASC) foundation is the parent organization of the International Accounting Standards Board (IASB). The objectives of the foundation are to: (1) develop high-quality, understandable, and enforceable global accounting standards that lead to useful, comparable financial reporting to help users in the world's capital markets make informed economic decisions, (2) promote the use and rigorous application of these standards, and (3) bring national accounting standards into agreement with international accounting standards.

The operating structure of the IASC Foundation consists of (1) a group of *Trustees* that is responsible for fund-raising, appointing IASB members, and overseeing the effectiveness of the IASB, (2) the *IASB*, which issues *International Financial Reporting Standards* and includes 12 full-time members (and 2 part-time members) from various countries, (3) an *International Financial Reporting Interpretations Committee* to interpret the application of the Standards, and (4) a *Standards Advisory Council* to give advice to the IASB on priorities and views of organizations on major standard setting projects. The operating procedure of the IASB is somewhat similar to that of the FASB and includes study of the topic, issuance of an Exposure Draft, evaluation of comments, and consideration of a revised draft. If approved by at least eight members of the IASB, the revised draft becomes an *International Financial Reporting Standard*. To date, the IASB (and its predecessor, the International Accounting Standards Committee) have issued 48 Standards.

There are, however, important differences between the environments in which the FASB and the IASB operate. The FASB operates as a private standard-setting organization, and focuses on setting accounting standards in the United States to improve the usefulness of accounting information to investors and creditors. On the other hand, in many other countries the emphasis in financial reporting is on meeting legal (e.g., tax) requirements, so that standard setting has evolved as a governmental rather than a private function. A role of the IASB, then, is to consolidate many countries' accounting regulations into international standards. In this regard, in response to an appeal from the International Organization of Securities Commissions, the IASB has developed a set of "core standards" of accounting principles for the financial statements of companies making "crossborder" offerings of their securities. As a result, the European Commission requires that listed European companies must

use international accounting standards. Although there are areas of difference, financial statements prepared according to U.S. generally accepted accounting principles usually will comply with international accounting standards. Furthermore, as we noted earlier, the FASB and IASB are working together to harmonize accounting standards. However, financial statements prepared according to international accounting standards may *not* comply with U.S. GAAP. In later chapters, where U.S. accounting principles differ from international principles, we will discuss those differences briefly as they relate to the topics being covered.

Governmental Accounting Standards Board (GASB)

The GASB was established in 1984 and operates under the auspices of the Financial Accounting Foundation. The GASB operates in a manner similar to the FASB. It consists of a full-time chair and six other members, plus a supporting staff. The GASB's responsibility is to establish financial accounting standards for certain state and local governmental entities. Its impact on accounting principles for the private sector is minimal.

Public Company Accounting Oversight Board (PCAOB)

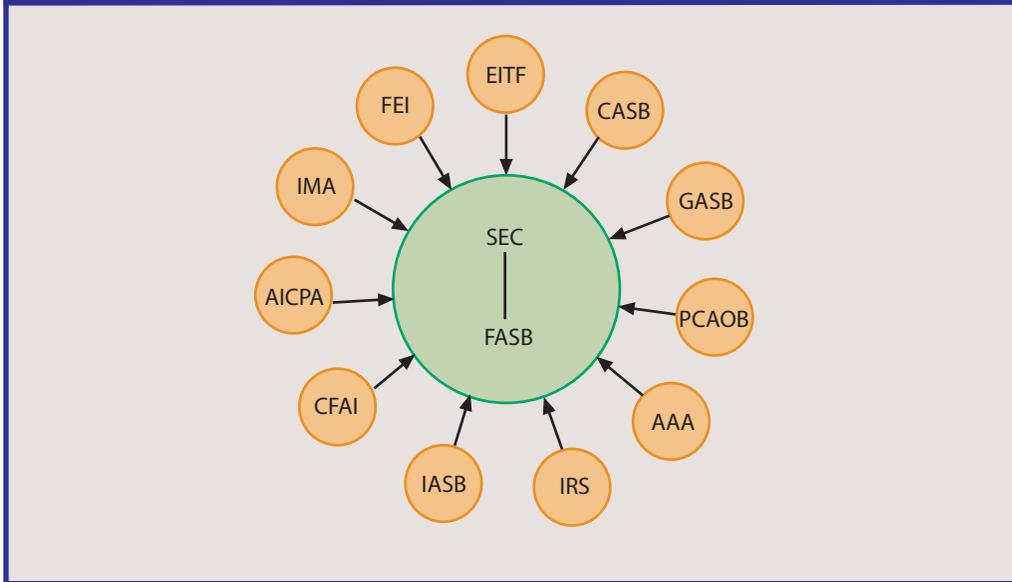
The PCAOB is a non-profit corporation that was created by Congress in the Sarbanes-Oxley Act of 2002. This was in response to fraudulent or misleading accounting practices by companies such as Enron and WorldCom. The PCAOB does not set generally accepted accounting principles. However, it indirectly influences public financial statements issued using GAAP. Its purpose is to protect the interests of investors by overseeing auditors of public companies in the preparation of informative, accurate, and independent audit reports for companies that sell securities to the public. The Board's responsibilities include registering public auditing firms; establishing auditing, quality control, and ethics standards; promoting high professional standards and improving the quality of audit services; and enforcing compliance with the securities laws as they relate to the preparation and issuance of audit reports. Any standards that the PCAOB proposes must be approved by the SEC.

Professional Associations

There are also several professional organizations that play an important role in the accounting standard-setting process. The **Financial Executives International (FEI)** consists primarily of high-level financial executives (such as financial vice presidents, treasurers, and controllers) of major corporations. The FEI publishes a monthly journal called the *Financial Executive* and has sponsored research projects dealing with financial reporting issues. Membership in the **Institute of Management Accountants (IMA)** is open to anyone, although its primary focus is on management accounting and financial management issues. The IMA publishes a monthly journal called *Strategic Finance*, which includes articles involving strategies in accounting, finance, and information management. Members of the **CFA Institute (CFAI)** are financial analysts who use accounting information in various investment management and security analysis decisions. The CFAI publishes the *Financial Analysts Journal*, and its members participate in FASB research studies that deal with the impact of proposed accounting standards on users of financial accounting information. As we noted earlier, each of these organizations is also a member of the Financial Accounting Foundation. They provide input to the FASB through position papers and oral presentations in the public hearings process.

Relationship of Organizations in Current Standard-Setting Environment

As we discussed earlier, accounting standards are set in a sociopolitical environment. Currently there are three major organizations in the private and public sector that develop GAAP for companies: the FASB, the AICPA, and the SEC. To a lesser extent, the other organizations we discussed in this section also are influential in the standard-setting process. We illustrate the relationship of the various participants in this process in Exhibit 1-8.

EXHIBIT 1-8 Participants in the Development of GAAP

SECURE YOUR KNOWLEDGE 1-2

- The guidelines, procedures, and practices that a company is required to use in recording and reporting accounting information in its financial statements (GAAP) have evolved over many years and were set by several policy-making bodies.
- The major standard-setting bodies responsible for the establishment of GAAP include the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB).
- Before issuing a final standard, a proposed topic undergoes an extensive due process procedure that includes considerable research, numerous public hearings, and frequent deliberations.
- While final standards are intended to provide users with relevant and reliable information for their decision-making needs, social and political differences in FASB's constituency often result in final standards that are a result of compromise.
- Numerous other bodies (shown in Exhibit 1-8) have also impacted the development of GAAP.

ETHICS IN THE ACCOUNTING ENVIRONMENT

In recent years there have been an increasing number of news reports about unethical behavior on the part of companies or individuals acting in their own self-interest without regard to the impact on society. These unethical actions include, for instance, polluting lakes and streams, illegal shipments of weapons to foreign countries, savings and loan scandals, selling products that are hazardous to users' health, overcharging on government contracts, securities fraud, accounting fraud, false advertising, and "insider trading" activities. All of these unethical behaviors have a common theme: increased profits at the expense of some aspect of society. While these unethical actions often are sensational and capture the national headlines, there are also many situations of a smaller scale in which accountants face ethical dilemmas.

7 Use ethical models for decision making about ethical dilemmas.

Earlier we mentioned that accountants who record and report financial information must follow generally accepted accounting principles, and that auditors must express an opinion as to the fairness (in accordance with GAAP) of the financial statements. Among other things, the financial statements of a company communicate how well the employees of the company at the department, division, and corporate levels have performed in operating the company. The results reported in the audited financial statements are likely to have an effect on the company's ability to sell stock or borrow money, as well as on employees' compensation and promotion opportunities. Consequently, these employees have a vested interest in showing their performances in the best light and may pressure accountants to do so. For instance, executives at Enron and WorldCom were successful at defrauding the public.

We also mentioned that in the FASB's public hearings and open meetings various parties attempt to influence the Board in their own self-interest. These are just a few examples of situations in which accountants may be faced with *ethical dilemmas* (*ethical conflicts*), situations in which an accountant must make a decision about what is the "right" (ethical) action to take in a given set of circumstances. Because accounting is a service activity that plays an important role in society, professional accounting organizations have established "codes of ethics" for their members. One of these applies to members of the AICPA.¹³

Members of the AICPA recognize that they have an obligation of self-discipline above and beyond the requirements of laws and regulations. To help guide members in public practice, industry, government, and education in performing their responsibilities, the AICPA adopted the **Code of Professional Conduct (CPC)**. The CPC includes six *Principles* that express the basic tenets of ethical and professional conduct and call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage. Exhibit 1-9 summarizes these Principles.¹⁴

EXHIBIT 1-9 Principles of the AICPA Code of Professional Conduct

- I. **Responsibilities:** In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
- II. **The Public Interest:** Members should act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
- III. **Integrity:** To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
- IV. **Objectivity and Independence:** A member should be objective and free from conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.
- V. **Due Care:** A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.
- VI. **Scope and Nature of Services:** A member in public practice should observe the Principles of the CPC in determining the scope and nature of services to be provided.

While this code of ethics establishes guidelines for accountants in performing their responsibilities, it does not provide a structured approach for "moral reasoning" in ethical dilemmas. Ethical behavior may be different from legally acceptable behavior. What is

13. For the code of ethics of the IMA, another professional accounting organization, see *Ethics Center*, IMA: www.imanet.org.

14. *AICPA Code of Professional Conduct*, AICPA: www.aicpa.org.

legal may still be unethical in certain circumstances. Ethicists have developed alternative “models” to help individuals make sound moral judgments and guide their behavior when faced with ethical dilemmas involving various stakeholders. In the business environment of a company, the *stakeholders* may include past, current, and potential investors; creditors; employees; suppliers; competing companies; local, state, and federal governments; and citizens in the local, regional, national, and even international communities.

According to Manuel Velasquez, a noted ethicist, there are three basic approaches to moral reasoning. Each of these approaches uses a different set of moral standards in distinguishing between right and wrong. These approaches include (1) the *utilitarian* model, which evaluates actions based on the extent to which they result in the “greatest good for the greatest number,” (2) the *rights* model, which embraces actions that protect individual moral rights, and (3) the *justice* model, which emphasizes a fair distribution of benefits and burdens. In determining if an action is ethical or which of several alternative behaviors is the most ethical, Velasquez says that no single set of moral standards is sufficient. Instead, he recommends a several-step process that combines all three types of moral standards. This process includes

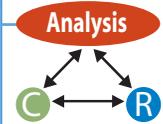
1. gathering the facts (e.g., Who are the “stakeholders?” What are my responsibilities?);
2. asking whether the action is acceptable according to three ethical criteria:
 - a. utility: Does the action optimize the satisfactions of all stakeholders?
 - b. rights: Does the action respect the rights of all individuals? and
 - c. justice: Is the action fair and just?;
3. considering whether there are any “overwhelming factors,” such as conflicts between criteria that may justify disregarding one or more of the ethical criteria; and
4. deciding whether the action is ethical (or what ethical action to take) based on an evaluation of the applicable ethical criteria.¹⁵

Accountants are noted to have high ethical standards.¹⁶ Acting ethically is not always easy; sometimes it is very difficult. However, because of the important role of accounting in society, every accountant must have high moral standards and strive to behave at the highest ethical level. Throughout this book, you will be exposed to ethical dilemmas that we urge you to consider using the framework we just discussed.

CREATIVE AND CRITICAL THINKING IN THE ACCOUNTING ENVIRONMENT

The business environment in which accountants work is constantly changing and becoming more complex. New products and services are continually introduced, and existing products are modified. Production techniques are changing, as are the channels of distribution and the approaches to promoting these products. There is an explosion of information technology as computers are networked, satellites allow global audiovisual communication, fax machines, the Internet, and e-mail enable nearly instantaneous information transmittal, and cell phones link customers and suppliers. More and more companies are becoming international in their operating activities by buying, producing, and selling products in foreign countries. Government regulations are increasing, as more concern is given to such issues as worker safety and environmental impacts.

In response to these changes, companies are becoming more innovative in the ways they manage their businesses, how they finance their activities, what they invest in to expand their operating capabilities, and what approaches they use in their credit and collection processes. They are restructuring their organizations and operations to increase



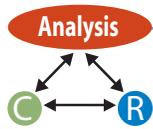
8 Understand creative and critical thinking.

15. M. Velasquez, *Business Ethics: Concepts and Cases*, 4th ed. (Englewood Cliffs, N.J.: Prentice Hall, 1998), ch. 2.

16. “The CPA Span of Influence Study,” Research Study for AICPA by Peter W. Hart Research Associates (March 16, 2000).

efficiency, and are more sensitive to changing technology and product obsolescence. They are more creative in the ways they structure their executive and employee compensation packages. Accounting systems that are designed to accumulate, process, and communicate information for decision making in this changing environment must change to satisfy the needs of users. Accounting principles must evolve to reflect this changing environment. Accountants responsible for operating these systems, as well as for establishing and applying accounting principles, must be both *creative* thinkers and *critical* thinkers.

Research in psychology has found that each side of the brain deals with a different type of thinking. The right side focuses on creative thinking, involving visualizing and developing ideas. The left side focuses on critical thinking, involving analyzing and evaluating ideas. All individuals think creatively and critically, but they differ regarding the degree to which they use each side of the brain. However, through practice, it is possible for individuals to increase their ability to think creatively and critically.



Different aspects of creative thinking and critical thinking have been studied and discussed for many years and in numerous areas. Here, we discuss briefly what role these concepts play in financial accounting. There are many ways creative thinking and critical thinking are defined, in part because they are not mutually exclusive and the differences between the two types of thinking are not clear-cut. For our purposes, **creative thinking is the process of finding new relationships (ideas) among items of information that potentially can be used to solve a problem.** Creative thinking involves using imagination and insight to see issues in a different light. Terms that are used to describe a creative thinker include insightful, intuitive, imaginative, sensitive, flexible, original, adaptable, and tolerant of ambiguity.¹⁷ In contrast, **critical thinking is the process of testing these new relationships (ideas) to determine how well they will work.** Critical thinking involves using inductive or deductive reasoning to analyze an issue logically. Terms that are used to describe a critical thinker include objective, independent, analytical, logical, rational, able to synthesize, consistent, and organized.¹⁸

In financial accounting, accountants tend to be “problem solvers.” When an accounting issue or problem arises, the accountant is responsible for its resolution. Several steps have been identified in the problem-solving process, as we show in Exhibit 1-10. These steps include

1. recognizing a problem,
2. identifying alternative solutions,
3. evaluating the alternatives,
4. selecting a solution from among the alternatives, and
5. implementing the solution.

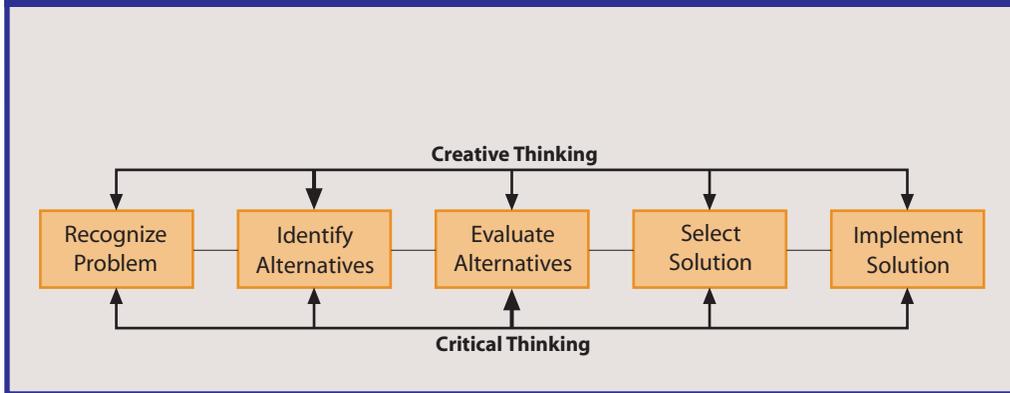
Creative thinking and critical thinking both play a role in each step of the problem-solving process. However, creative thinking is probably most critical in the *identification* of alternative solutions, while critical thinking is most critical in the *evaluation* of the alternative solutions.

The degree of complexity may differ from one problem to another. Problems can range from structured problems to unstructured problems. For *structured* problems, virtually complete information is known about the alternatives (in fact, there may be only one alternative) so that identifying, evaluating, selecting, and implementing an alternative is straightforward. At the other extreme are *unstructured* problems where even the basic issue may not be readily apparent, the alternative solutions are unclear once the problem is

17. For a more extensive discussion of creative thinking, see S. F. Isaksen, K. Dorval, and D. Treffinger, *Creative Approaches to Problem Solving*, 2nd ed. (Williamsville, NY: Creative Problem Solving Group-Buffalo, 2000).

18. For a more extensive discussion of critical thinking, see J. Chaffee, *Thinking Critically*, 6th ed. (New York: Houghton Mifflin Company, 2000).

EXHIBIT 1-10 Creative and Critical Thinking: Impact on Problem Solving



identified, and there is a lack of information about the alternatives. Here the identification, evaluation, selection, and implementation process is much more complex. Between these extremes is the *partially structured* problem, where either the alternative solutions are unclear or there is a lack of information about the alternative solutions.

At the policy-making level, the FASB deals with complex unstructured problems. The Board members engage in higher-order creative thinking and critical thinking in their problem-solving processes involving the *establishment* of generally accepted accounting principles. In this book we discuss the major issues faced by the FASB in setting standards. However, our primary focus is on the *application* of generally accepted accounting principles in the recording and reporting of various topics. These topics may be general (e.g., income measurement) or specific (e.g., inventory). For each topic, we identify GAAP, discuss the related conceptual issues, and explain the recording and reporting procedures.

In the exercises and problems at the end of each chapter, we focus primarily on assignments intended to help you reinforce your understanding of the topical material. We do so by requiring you to prepare solutions to issues related to the chapter topics. These assignments generally involve structured problems for which there are only one or two correct solutions. Here the steps of identification, evaluation, and selection of alternatives in the problem-solving process are reduced or omitted. This approach does not mean that your creative thinking and critical thinking processes are not at work, however. In solving these assignments, you are practicing both creative and critical thinking, but at a lower level. It is important to master the understanding of basic recording and reporting issues in financial accounting. Then you can move on to more complex accounting issues that involve less structured problems and entail higher-level creative and critical thinking.

As a step in helping you develop your higher-level creative and critical thinking skills, there are also cases at the end of each chapter. These cases may require you to explain your understanding of interrelated concepts and practices. They may also require you to determine solutions to issues for which specific generally accepted accounting principles do not apply directly. These cases may deal with accounting issues that are emerging because of changes in the business environment we discussed earlier. They may focus on topics that are too “industry specific” to be included in the chapter material. In these latter situations, the cases (“research simulations”) will require you to “research GAAP” in documents such as the FASB’s *Current Text* or *Original Pronouncements* (or FARS) and, in so doing, stimulate your higher-level creative and critical thinking as you complete the problem-solving process. If your instructor does not assign these cases, you may still want to analyze them as a way of practicing creative and critical thinking. Your ability to think creatively and critically will be very important in your future accounting and business (as well as personal) activities.

SUMMARY

At the beginning of the chapter, we identified several objectives you would accomplish after reading the chapter. The objectives are listed below, each followed by a brief summary of the key points in the chapter discussion.

1. **Understand capital markets and decision making.** Capital markets are organized exchanges such as the NYSE, AMEX, and NASDAQ, where the capital stock and bonds of publicly held corporations are purchased and sold. Investors make buy-hold-sell decisions in regard to securities traded on these capital markets based on accounting information.
2. **Know what is included in financial reporting.** Financial reporting involves communicating financial accounting information about a company to external users. An important way to do so is in a company's annual report. In its annual report, a company includes at least three financial statements—a balance sheet, income statement, and statement of cash flows—and may include a statement of changes in stockholders' equity. It also includes notes to the financial statements.
3. **Explain GAAP and its sources.** GAAP are the guidelines, procedures, and practices that a company is required to use in recording and reporting the accounting information in its audited financial statements. The sources of GAAP included pronouncements by the FASB, APB, CAP, and SEC in four categories of descending order of importance.
4. **Identify the types of pronouncements issued by the FASB.** The FASB issues several types of pronouncements including *Statements of Financial Accounting Standards*, *Interpretations*, *Staff Positions*, *Technical Bulletins*, *Statements of Financial Accounting Concepts*, and other pronouncements, such as *Guides for Implementation* and *FASB Q's and A's*.
5. **Understand how the FASB operates.** The FASB is a seven-member board. Before issuing a statement of concepts or standards, the FASB goes through several steps which include conducting research and issuing a Discussion Memorandum or Invitation to Comment, holding public hearing and deliberating on findings before issuing an Exposure Draft, holding more public hearings, modifying its tentative conclusions, voting (simple-majority), and issuing the Statement.
6. **Describe the relationship between the SEC and the FASB.** The SEC has the legal authority to prescribe accounting principles and practices for all publicly traded companies. It, however, endorsed the workings of the FASB by stating that the standards set by the FASB will be considered by the SEC to have substantial authoritative support.
7. **Use ethical models for decision making about ethical dilemmas.** Models for ethical decision making include the *utilitarian* model, the *rights* model, and the *justice* model. In using these models, one several-step approach includes (1) gathering the facts; (2) asking whether the action is acceptable according to utility, rights, and justice ethical criteria; (3) considering any "overwhelming factors"; and (4) deciding whether the action is ethical.
8. **Understand creative and critical thinking.** Creative thinking is the process of finding new relationships (ideas) among items of information that potentially can be used to solve a problem. Critical thinking is the process of testing these new relationships (ideas) to determine how well they will work. In problem solving, creative thinking is most important in the *identification* of alternative solutions, while critical thinking is most important in the *evaluation* of the alternative solutions.

QUESTIONS

- Q1-1** Distinguish between primary markets and secondary markets.
- Q1-2** Distinguish between the categories of users of financial statements. Why might their decision-making needs be different?
- Q1-3** Compare and contrast financial and managerial accounting.
- Q1-4** What is financial reporting and what is an important way a company's financial information is reported?
- Q1-5** What are the three major financial statements of a company and what do they show? What is the fourth major financial statement that many companies present, and what does it show?
- Q1-6** What are generally accepted accounting principles? List the four accounting bodies that have established generally accepted accounting principles.
- Q1-7** How many "categories" are in the hierarchy of generally accepted accounting principles? List the pronouncements that are included in Category A.
- Q1-8** What are (were) the CAP, APB, and FASB? What documents that constitute generally accepted accounting principles have been issued by each of these organizations?
- Q1-9** Briefly discuss the procedures followed by the FASB for issuing a statement of concepts or standards.
- Q1-10** List and briefly discuss the types of pronouncements issued by the FASB.

Q1-11 List several organizations other than the FASB that have had an impact on the development of generally accepted accounting principles.

Q1-12 What is the IASB and how does it operate?

Q1-13 List several professional organizations that play an important role in the accounting standard-setting process.

Q1-14 What is the *Code of Professional Conduct* and what are the six areas covered in the Principles of this code?

Q1-15 List the steps a person should follow to determine whether an action is ethical.

Q1-16 What is creative thinking? How would you describe a creative thinker?

Q1-17 What is critical thinking? How would you describe a critical thinker?

CASES

COMMUNICATION

C1-1 Pronouncements

Several accounting groups have issued various pronouncements establishing or relating to generally accepted accounting principles. The following is a list of six pronouncements, as well as a list of statements describing each pronouncement.

- A. Statements of Financial Accounting Standards
- B. Opinions
- C. Technical Bulletins
- D. Statements of Financial Accounting Concepts
- E. Interpretations
- F. Staff Positions
- G. Accounting Research Bulletins

- _____ 1. Pronouncements that provide clarification of conflicting or unclear issues relating to previously issued FASB *Statements of Standards*, APB *Opinions*, or *Accounting Research Bulletins*.
- _____ 2. Issued by the FASB to provide guidance on accounting and reporting problems related to *Statements of Standards* or *Interpretations*.
- _____ 3. Pronouncements of the APB that constitute generally accepted accounting principles unless specifically amended or rescinded, many of which were based on *Accounting Research Studies*.
- _____ 4. Issued by the FASB as a series establishing a theoretical foundation upon which to base financial accounting and reporting standards.
- _____ 5. Pronouncements of the Committee on Accounting Procedure (CAP) that constitute generally accepted accounting principles unless superseded or amended by other authoritative bodies.
- _____ 6. Pronouncements issued by the FASB that establish generally accepted accounting principles and indicate the methods and procedures required on specific accounting issues.
- _____ 7. Pronouncements issued to provide more timely and consistent application guidance in regard to FASB literature.

Required

Place the appropriate letter (A–G) identifying each pronouncement on the line in front of the statement describing the pronouncement.

C1-2 Organizations

Certain organizations have been influential in the establishment of accounting principles. The following is a list of abbreviations for several of these organizations, as well as a list of statements describing the organizations.

- | | |
|----------|----------|
| A. IRS | G. CASB |
| B. APB | H. FASB |
| C. CAP | I. PCAOB |
| D. IASB | J. GASB |
| E. SEC | K. AICPA |
| F. FASAC | L. EITF |

- _____ 1. First organization in United States to be given authority to issue pronouncements on accounting procedures and practice. Issued *Accounting Research Bulletins*.
- _____ 2. Establishes cost accounting standards for U.S. government contracts.
- _____ 3. Administers the provisions of the Internal Revenue Code.
- _____ 4. Helps establish internationally comparable accounting principles.
- _____ 5. Establishes accounting standards for state and local governmental entities.
- _____ 6. Establishes generally accepted accounting principles in the private sector of the United States.
- _____ 7. Created by Congress in response to fraudulent accounting practices.
- _____ 8. Responsible for advising the FASB about technical areas, task forces, and other matters.
- _____ 9. Established 31 *Opinions*, many of which still constitute generally accepted accounting principles.

- _____ 10. Has legal authority to prescribe accounting principles and reporting practices for all corporations issuing publicly traded securities.
- _____ 11. Professional organization for all CPAs in the United States.
- _____ 12. Develops consensus positions on the implementation issues involving the application of standards.

Required

Place the appropriate letter (A–L) for each organization in front of the statement describing the organization. In addition, write out the full name of the organization.

C1-3 Establishment of GAAP

Since the late 1930s, three organizations have been primarily responsible for the establishment of generally accepted accounting principles in the private sector of the United States.

Required

Write a brief report that identifies the three organizations and provides a brief chronological history of each, including the pronouncements issued that still constitute generally accepted accounting principles.

C1-4 Accounting Principles

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

Required

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

C1-5 Standard Setting

CMA Adapted When the Accounting Principles Board was founded in 1959, it planned to establish financial

accounting standards using empirical research and logical reasoning only; the role of political action was little recognized at that time. Today, there is wide acceptance of the view that political action is as much an ingredient of the standard-setting process as is research evidence. Considerable political and social influence is wielded by user groups—those parties who are most interested in or affected by accounting standards.

Two basic premises of the Financial Accounting Standards Board (FASB) are (1) that it should be responsive to the needs and viewpoints of the entire economic community, and (2) that it should operate in full view of the public, affording interested parties ample opportunity to make their views known. The extensive procedural steps employed by the FASB in the standard-setting process support these premises.

Required

Write a brief report that describes why financial accounting standards inspire or encourage political action and social involvement during the standard-setting process.

C1-6 Organization of the FASB

The FASB is organized to establish generally accepted accounting principles. It is assisted by various groups and operates under a set of procedures.

Required

Prepare a short written report that summarizes the structure, types of pronouncements, and operating procedures of the FASB.

C1-7 GAAP and the AICPA

The American Institute of Certified Public Accountants (AICPA) has been in existence for many years to help CPAs provide high-quality professional services. Among other activities, in certain circumstances the AICPA establishes or provides guidance on generally accepted accounting principles (GAAP).

Required

Summarize the GAAP-related documents that the AICPA publishes.

C1-8 Code of Professional Conduct

In a few years, you may become a member of the AICPA and be subject to its Code of Professional Conduct (CPC).

Required

Identify and briefly discuss the first five principles of the CPC. Provide examples that illustrate each principle.

CREATIVE AND CRITICAL THINKING**C1-9 GAAP Hierarchy**

A friend of yours says, “I understand there are ‘rules’ for financial reporting. But what are these rules, where can a person find them, and which ones are more important?”

Required

Prepare an answer for your friend.

C1-10 Lobbying the FASB

One of your friends remarks, “I understand that before voting on a Statement of Standards the FASB allows written comments and oral presentations in which interested parties can lobby for a particular ruling. Do you think this is a good idea?”

Required

Prepare a written response that discusses the advantages and disadvantages of the FASB's allowing interested parties to provide input to its deliberative process.

**C1-11 Ethical Responsibilities**

Each person in one of your accounting classes is required to write a report on an accounting topic. Included in the report must be a discussion from a specific library book. When you go to the library, you find that the only copy of the book is missing. While sitting at a study desk, you overhear one of your classmates say that he has "misfiled" the book in the library so he can use it again later without having to wait for other students to finish using it.

Required

Discuss the steps you would take to address this ethical dilemma. It is not necessary to state what ethical action you

would take, but be prepared to discuss your reasoning for each step.

**C1-12 Ethical Responsibilities**

You and a friend are in the same accounting class. During the first test, you observe that your friend cheated by copying one of her answers from another student (who was unaware of the copying). When the exams are returned, your grade is a B, while your friend's grade is an A.

Required

Discuss the steps you would take to address this ethical dilemma. It is not necessary to state what ethical action you would take, but be prepared to discuss your reasoning for each step.