

CHAPTER 1

Financial Accounting and Accounting Standards

ASSIGNMENT CLASSIFICATION TABLE (By Topic)

Topics	Questions	Cases
1. Subject matter of accounting.	1, 2	4
2. Environment of accounting.	3, 29	6, 7
3. Role of principles, objectives, standards, and accounting theory.	4, 5, 6, 7	1, 2, 3, 5
4. Historical development of GAAP.	8, 9, 10, 11	8, 9
5. Authoritative pronouncements and rule-making bodies.	12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 24	3, 9, 11, 12, 13, 14, 16, 17
6. Role of pressure groups.	22, 23, 26, 27, 28	10, 15, 16, 17
7. Ethical issues.	25, 27, 29	15

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Concepts for Analysis
1. Describe the financial reporting environment.	2, 3, 4, 5, 6, 7, 9
2. Identify the major policy-setting bodies and their role in the standard-setting process.	1, 2, 3, 7, 8, 9, 10, 11, 12, 13, 14
3. Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.	2, 3, 7, 12
4. Describe major challenges in the financial reporting environment.	6, 10, 11, 13, 15, 16, 17

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
CA1-1	FASB and standard-setting.	Simple	15–20
CA1-2	GAAP and standard-setting.	Simple	15–20
CA1-3	Financial reporting and accounting standards.	Simple	15–20
CA1-4	Financial accounting.	Simple	15–20
CA1-5	Objective of financial reporting.	Moderate	20–25
CA1-6	Accounting numbers and the environment.	Simple	10–15
CA1-7	Need for GAAP.	Simple	15–20
CA1-8	AICPA's role in rule-making.	Simple	20–25
CA1-9	FASB role in rule-making.	Simple	20–25
CA1-10	Politicalization of GAAP.	Complex	30–40
CA1-11	Models for setting GAAP.	Simple	15–20
CA1-12	GAAP terminology.	Moderate	30–40
CA1-13	Rule-making Issues.	Complex	20–25
CA1-14	Securities and Exchange Commission.	Moderate	30–40
CA1-15	Financial reporting pressures.	Moderate	25–35
CA1-16	Economic consequences.	Moderate	25–35
CA1-17	GAAP and economic consequences.	Moderate	25–35

LEARNING OBJECTIVES

1. Describe the financial reporting environment.
2. Identify the major policy-setting bodies and their role in the standard-setting process.
3. Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.
4. Describe major challenges in the financial reporting environment.
- *5. Compare the procedures related to financial accounting and accounting standards under GAAP and IFRS.

CHAPTER REVIEW

1. Chapter 1 describes the environment that has influenced both the development and use of the financial accounting process. The chapter traces the development of financial accounting standards, focusing on the groups that have had or currently have the responsibility for developing such standards. Certain groups other than those with direct responsibility for developing financial accounting standards have significantly influenced the standard-setting process. These various pressure groups are also discussed.

Financial Reporting Environment

2. (L.O. 1) The essential characteristics of accounting are (1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties. **Financial accounting** is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties.
3. **Financial statements** are the principal means through which a company communicates its financial information to those outside it. The financial statements most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners' or stockholders' equity. Other means of financial reporting include the president's letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management forecasts, and social or environmental impact statements.

Accounting and Capital Allocation

4. Accounting is important for markets, free enterprise, and competition because it assists in providing information that leads to capital allocation. The better the information, the more effective the process of capital allocation and then the healthier the economy.

Objective of Financial Reporting

5. The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in decisions about providing resources to the company. **General-purpose financial statements** provide financial reporting information to a wide variety of users.
6. The objective of financial reporting identifies investors and creditors as the primary users for general-purpose financial statements. As part of the objective of general-purpose financial reporting, an **entity perspective** is adopted. Companies are viewed as separate and distinct from their owners. When making decisions, investors are interested in assessing (1) the company's ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments.

7. The accounting profession has developed a common set of standards and procedures known as **generally accepted accounting principles (GAAP)**. These principles serve as a general guide to the accounting practitioner in accumulating and reporting the financial information of a business enterprise.

Securities and Exchange Commission (SEC)

8. (L.O. 2) After the stock market crash in 1929 and the Great Depression, there were calls for increased government regulation and supervision—especially of financial institutions and the stock market. As a result, the federal government established the Securities and Exchange Commission (**SEC**) to help develop and standardize financial information presented to stockholders. The SEC is a federal agency and administers the Securities Exchange Act of 1934 and several other acts. Most companies that issue securities to the public or are listed on a stock exchange are required to file audited financial statements with the SEC. In addition, the SEC has broad powers to prescribe the accounting practices and standards to be employed by companies that fall within its jurisdiction.
9. At the time the SEC was created, it encouraged the creation of a private standards-setting body. As a result, accounting standards have generally been developed in the private sector either through the American Institute of Certified Public Accountants (**AICPA**) or the Financial Accounting Standards Board (**FASB**). The SEC has affirmed its support for the FASB by indicating that financial statements conforming to standards set by the FASB will be presumed to have substantial authoritative support.
10. Over its history, the SEC's involvement in the development of accounting standards has varied. In some cases, the private sector has attempted to establish a standard, but the SEC has refused to accept it. In other cases, the SEC has prodded the private sector into taking quicker action on setting standards.
11. If the SEC believes that an accounting or disclosure irregularity exists regarding a company's financial statements, the SEC sends a deficiency letter to the company. If the company's response to the deficiency letter proves unsatisfactory, the SEC has the power to issue a "stop order," which prevents the registrant from issuing securities or trading securities on the exchanges. Criminal charges may also be brought by the Department of Justice.

The AICPA and Development of Accounting Principles

12. The first group appointed by the AICPA to address the issue of uniformity in accounting practice was the **Committee on Accounting Procedure (CAP)**. This group served the accounting profession from 1939 to 1959. During that period, it issued 51 **Accounting Research Bulletins (ARBs)** that narrowed the wide range of alternative accounting practices then in existence.

13. In 1959, the AICPA created the **Accounting Principles Board (APB)**. The major purposes of this group were (a) to advance the written expression of accounting principles, (b) to determine appropriate practices, and (c) to narrow the areas of difference and inconsistency in practice. The APB was designated as the AICPA's sole authority for public pronouncements on accounting principles. Its pronouncements, known as **APB Opinions**, were intended to be based mainly on research studies and be supported by reason and analysis.

Transition to FASB

14. The APB operated in a somewhat hostile environment for 13 years. Early in its existence it was criticized for lack of productivity and failing to act promptly, then it was criticized for overreacting to certain issues. A committee, known as the **Study Group on Establishment of Accounting Principles (Wheat Committee)**, was set up to study the APB and recommend changes in its structure and operation. The result of the Study Group's findings was the demise of the APB and the creation of the Financial Accounting Standards Board (FASB).

The FASB

15. The FASB represents the current rule-making body within the accounting profession. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information. The FASB differs from the predecessor APB in the following ways:
- a. Smaller membership (7 versus 18 on the APB).
 - b. Full-time remunerated membership (APB members were unpaid and part-time).
 - c. Greater autonomy (APB was a senior committee of the AICPA).
 - d. Increased independence (FASB members must sever all ties with firms, companies, or institutions).
 - e. Broader representation (it is not necessary to be a CPA to be a member of the FASB).

Two basic premises of the FASB are that in establishing financial accounting standards: (a) it should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (b) it should operate in full view of the public through a "due process" system that gives interested persons ample opportunity to make their views known.

Due Process

16. The FASB issues two major types of pronouncements:
- a. **Accounting Standards Updates.** The Updates amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC. Each Update explains how the Codification has been amended and also includes information to help the reader understand the

changes and when those changes will be effective. They are considered GAAP and must be followed in practice.

- b. **Financial Accounting Concepts.** The SFACs represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework that will serve as tools for solving existing and emerging problems in a consistent manner. Unlike FASB statements, the Concept Statements do not establish GAAP.

- 17. In 1984, the FASB created the **Emerging Issues Task Force (EITF)**. The purpose of the Task Force is to reach a consensus on how to account for new and unusual financial transactions that have the potential for creating differing financial reporting practices. The EITF can deal with short-term accounting issues by reaching a consensus and thus avoiding the need for deliberation by the FASB and the issuance of an FASB Statement.

GAAP

- 18. (L.O. 3) Generally accepted accounting principles (GAAP) are those principles that have **substantial authoritative support**. Accounting principles that have substantial authoritative support are those found in FASB Statements, Interpretations, and Staff Positions; APB Opinions; and Accounting Research Bulletins (ARBs). If an accounting transaction is not covered in any of these documents, the accountant may look to other authoritative accounting literature for guidance.
- 19. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("**the Codification**") to provide in one place all the authoritative literature related to a particular topic. The Codification changes the way GAAP is documented, presented, and updated. The Financial Accounting Standards Board Codification Research System (CRS) is an online real-time database that provides easy access to the Codification.

Impact of User Groups

- 20. (L.O. 4) Although accounting standards are developed by using careful logic and empirical findings, a certain amount of pressure and influence is brought to bear by groups interested in or affected by accounting standards. The FASB does not exist in a vacuum, and politics and special-interest pressures remain a part of the standard-setting process.
- 21. Along with establishing the PCAOB, the **Sarbanes-Oxley Act** implements stronger independence rules for auditors, requires CEOs and CFOs to personally certify that financial statements and disclosures are accurate and complete, requires audit committees to be comprised of independent members, and requires a code of ethics for senior financial officers. In addition, the Sarbanes-Oxley Act requires public companies to attest to the effectiveness of their internal controls over financial reporting.

Financial Reporting Issues

23. Some of the challenges facing financial reporting in the future include:
- a. **Nonfinancial measurements**, which include customer satisfaction indexes, backlog information, and reject rates on goods purchased.
 - b. **Forward-looking information**.
 - c. **Soft assets**, include such intangibles as market dominance, expertise in supply chain management, and brand image.
 - d. **Timeliness**, including real-time financial statement information.
 - e. **Understandability**, including concerns about the complexity and lack of understandability of financial reports raised by investors and market regulators.
24. Most countries have recognized the need for more global standards. The **International Accounting Standards Board (IASB)** and U.S. rule-making bodies are working together to reconcile U.S. GAAP with the IASB International Financial Reporting Standards (IFRS). The FASB and the IASB agreed to make their existing financial reporting standards fully compatible as soon as practicable, and coordinate their future work programs to ensure that once achieved, compatibility is maintained.
25. In accounting, ethical dilemmas are encountered frequently. The whole process of ethical sensitivity and selection among alternatives can be complicated by pressures that may take the form of time pressures, job pressures, client pressures, personal pressures, and peer pressures. Throughout the textbook, ethical considerations are presented to sensitize you to the type of situations you may encounter in your profession.

LECTURE OUTLINE

The material in this chapter usually can be covered in one class session. The issues in this chapter can be addressed by organizing a lecture around the following.

A. (L.O. 1) Major financial statements and financial reporting.

1. **Identification, measurement, and communication** of financial information (discuss differences between financial statements and financial reporting).
 - a. Financial statements:
 - (1) Income statement.
 - (2) Balance sheet.
 - (3) Statement of cash flows.
 - (4) Statement of owners' or stockholders' equity.
 - b. Other financial reporting means:
 - (1) President's letter or supplementary schedules in the annual report.
 - (2) Prospectuses.
 - (3) Reports filed with the SEC and other government agencies.
 - (4) News releases and management forecasts.
 - (5) Social or environmental impact statements.
2. About **economic entities**.
3. To **interested parties** (including stockholders, creditors, government agencies, management, employees, consumers, labor unions, etc.).

B. Accounting and capital allocations.

1. A world of scarce resources. Accounting helps to identify efficient and inefficient users of resources.
2. Capital allocation. Accounting assists in the effective capital allocation process by providing financial reports to interested users.
3. Changing user needs. Accounting will continue to be faced with challenges to providing information needed for an efficient capital allocation process.

C. Objective of financial reporting.

1. To provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity.
 - a. General-purpose financial statements.
 - b. Equity investors and creditors.
 - c. Entity perspective.
 - d. Decision-usefulness.

D. Need for accounting standards.

1. To meet the various needs of users, companies prepare a single set of general-purpose financial statements.
2. Users expect financial statements to present fairly, clearly, and completely the company's financial operations.
3. The accounting profession has developed a set of standards and procedures called **generally accepted accounting principles (GAAP)**.

E. (L.O. 2) Parties involved in standard-setting.

1. Standard setting in the public sector:
 - a. The role of the SEC, reasons for its establishment, SEC jurisdiction.
 - b. Delegation of SEC's authority to the private sector (AICPA and FASB).
2. Standard setting in the private sector.
 - a. History of private-sector standard setting:
 - (1) Committee on Accounting Procedure (CAP).
 - a. This group served the accounting profession from 1939 to 1959. During that period, it issued 51 **Accounting Research Bulletins (ARBs)** that narrowed the wide range of alternative accounting practices then in existence.

(2) Accounting Principles Board (APB).

- a. The major purposes of this group were (a) to advance the written expression of accounting principles, (b) to determine appropriate practices, and (c) to narrow the areas of difference and inconsistency in practice. Its pronouncements, known as **APB Opinions**, were intended to be based mainly on research studies and be supported by reason and analysis.

(3) Financial Accounting Standards Board (FASB).

- a. Reasons for establishment of the FASB.
- b. Composition, membership, and voting rules of the FASB.
- c. Organization and funding of the FASB.

b. Description of the FASB's "due process" system in setting standards.

c. Two major types of pronouncements issued by FASB:

- (1) **Accounting Standards Updates** amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC.

- (2) **Financial Accounting Concepts** represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework.

d. **Emerging Issues Task Force** were created by FASB for the purpose of reaching a consensus on how to account for new and unusual financial transactions that have a potential for creating differing financial reporting practices.

3. The SEC continues to play an active role in influencing standards, e.g., accounting for business combinations and intangible assets; and concerns about the accounting for off-balance sheet items raised by the failure of Enron.

F. (L.O. 3) Meaning of GAAP.

- 1. Generally accepted accounting principles (GAAP) have substantive authoritative support.
- 2. The AICPA's Code of Professional Conduct requires that members prepare financial statements in accordance with GAAP.
- 3. GAAP includes:
 - a. FASB Standards and Interpretations, APB Opinions, AICPA Accounting Research Bulletins. (Most authoritative.)

- b. AICPA Industry Audit and Accounting Guides, AICPA Statements of Position, FASB Technical Bulletins.
 - c. FASB Emerging Issues Task Force, AICPA AcSEC Practice Bulletins, widely recognized/prevalent industry practices.
 - (1) The AICPA no longer issues authoritative accounting guidance for public companies.
 - d. AICPA Accounting Interpretations, FASB Implementation Guides (Q and A)
 - 4. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("the Codification").
 - a. The Codification changes the way GAAP is documented, presented and updated.
 - b. Explains what GAAP is and eliminates nonessential information.
- G. (L.O. 4) Major challenges in the financial reporting environment.
- 1. **Politicization** and the impact of various user groups on the development of GAAP
 - 2. The **expectations gap**.
 - a. What people think accountants should do vs. what accountants think they can do.
 - b. Sarbanes-Oxley Act and the Public Company Accounting Oversight Board.
 - 3. Financial reports fail to report:
 - a. Nonfinancial measurements. Financial reports failed to provide some key performance measures widely used by management.
 - b. Forward-looking information. Financial reports failed to provide forward-looking information needed by present and potential investors and creditors
 - c. Soft assets. Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information about a company's soft assets (intangibles).
 - d. Timeliness. Generally only historical information is provided with little to no real-time financial statement information available.
 - e. Understandability. Financial reports are often complex and hard to understand.
 - f. International accounting standards.
 - 1) Companies outside the U.S. often prepare financial statements using standards different from GAAP.
 - 2) There is a growing demand for one set of high-quality international standards.

3) There are two sets of acceptable rules for international use—GAAP and International Financial Reporting Standards issued by the International Accounting Standards Board (IASB).

4) The FASB and the IASB have agreed to use their best efforts to:

a) Make their existing financial reporting standards fully compatible as soon as practicable, and

b) Coordinate their future work programs to ensure that once achieved, compatibility is maintained.

H. Ethics and financial accounting.

1. In accounting, companies frequently encounter ethical dilemmas. Some of these dilemmas are easy to resolve but many are not, requiring difficult choices among allowable alternatives.
2. Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives.
3. Decisions are sometimes difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines in making ethical judgments.

*I. (L.O. 5) IFRS Insights.

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

2. Relevant Facts

- a. International standards are referred to as *International Financial Reporting Standards (IFRS)*, developed by the International Accounting Standards Board (IASB). As a result of recent events in the global capital markets, many are examining which accounting and financial disclosure rules should be followed.
 - b. U.S. standards, referred to as generally accepted accounting principles (GAAP), are developed by the Financial Accounting Standards Board (FASB). The fact that there are differences between what is in this textbook (which is based on U.S. standards) and IFRS should not be surprising because the FASB and IASB have responded to different user needs. It appears that the United States and the international standard-setting environment are primarily driven by meeting the needs of investors and creditors.
 - c. The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation as it will generate higher costs.
 - d. A number of ethics violations have occurred.
 - e. IFRS tends to be simpler in its accounting and disclosure requirements; some people say more “principles-based.” GAAP is more detailed; some people say more “rules-based.” This difference in approach has resulted in a debate about the merits of “principles-based” versus “rules-based” standards.
3. International Standards-Setting Organizations.
- a. **International Organization of Securities Commissions (IOSCO)** is dedicated to ensuring that the global markets can operate in an efficient and effective basis.
 - b. **International Accounting Standards Boards** issues International Financial Reporting Standards (IFRS) which are used on most foreign exchanges.
 - c. Three types of pronouncements.
 - (1) International Financial Reporting Standards.
 - (2) Framework for financial reporting. This Framework sets forth fundamental objectives and concepts that the Board uses in developing future standards of financial reporting.
 - (3) International financial reporting interpretations. These interpretations cover (1) newly identified financial reporting issues not specifically dealt with in IFRS, and (2) issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop, in the absence of authoritative guidance.
4. International Accounting Convergence.

- a. The FASB and the IASB have been working diligently to (1) make their existing financial reporting standards fully compatible as soon as is practicable, and (2) coordinate their future work programs to ensure that once achieved, compatibility is maintained.