https://selldocx.com/products
/solution-manual-intermediate-accounting-principles-and-analysis-2e-warfield

CHAPTER 1

Financial Accounting and Accounting Standards

ASSIGNMENT CLASSIFICATION TABLE

Topics	Questions
1. Subject matter of accounting.	1
2. Environment of accounting.	2, 3, 4
3. Role of principles, objectives, standards, and accounting theory.	5, 6, 7
4. Historical development of accounting standards.	8, 9, 10, 11
5. Authoritative pronouncements and standards-setting bodies.	12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23
6. Role of pressure groups.	23, 24, 25, 26, 27, 28
7. International accounting.	29, 30
8. Ethical issues.	31

ANSWERS TO QUESTIONS

1. Financial accounting measures, classifies, and summarizes in report form those activities and that information which relate to the enterprise as a whole for use by parties both internal and external to a business enterprise. Managerial accounting also measures, classifies, and summarizes in report form enterprise activities, but the communication is for the use of internal, managerial parties, and relates more to subsystems of the entity. Managerial accounting is management decision oriented and directed more toward product line, division, and profit center reporting.

2. Financial statements generally refer to the four basic financial statements: balance sheet, income statement, statement of cash flows, and statement of changes in owners' or stockholders' equity. Financial reporting is a broader concept; it includes the basic financial statements and any other means of communicating financial and economic data to interested external parties. Examples of financial reporting other than financial reports are annual reports, prospectuses, reports filed with the government, news releases, management forecasts or plans, and descriptions of an enterprise's social or environmental impact.

3. If a company's financial performance is measured accurately, fairly, and on a timely basis, the right managers and companies are able to attract investment capital. To provide unreliable and irrelevant information leads to poor capital allocation which adversely affects the securities market.

4. Some major challenges facing the accounting profession relate to the following items:
   Non-financial measurement—how to report significant key performance measurements such as customer satisfaction indexes, backlog information and reject rates on goods purchased.
   Forward-looking information—how to report more future oriented information.
   Soft assets—how to report on intangible assets, such as market know-how, market dominance, and well-trained employees.
   Timeliness—how to report more real-time information.

5. In general, the objectives of financial reporting are to provide (1) information that is useful in investment and credit decisions, (2) information that is useful in assessing cash flow prospects, and (3) information about enterprise resources, claims to those resources, and changes in them. More specifically these objectives state that financial reporting should provide information:
   a. that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
   b. to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and other users assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.
   c. about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities), owners' equity, and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

6. A common set of standards applied by all businesses and entities provides financial statements which are reasonably comparable. Without a common set of standards, each enterprise could, and would, develop its own theory structure and set of practices, resulting in noncomparability among enterprises.

7. General-purpose financial statements are not likely to satisfy the specific needs of all interested parties. Since the needs of interested parties such as creditors, managers, owners, governmental agencies, and financial analysts vary considerably, it is unlikely that one set of financial statements is equally appropriate for these varied uses.

8. The SEC has the power to prescribe, in whatever detail it desires, the accounting practices and principles to be employed by the companies that fall within its jurisdiction. Because the SEC receives audited financial statements from nearly all companies that issue securities to the public or are listed on the stock exchanges, it is greatly interested in the content, accuracy, and credibility of the statements. For many years the SEC relied on the AICPA to regulate the profession and develop and enforce accounting principles. Lately, the SEC has assumed a more active role in the development of accounting standards, especially in the area of disclosure requirements. In December 1973, in ASR No. 150 (affirmed following passage of the Sarbanes-Oxley Act in 2002) the SEC said the FASB's statements would be presumed to carry substantial authoritative support and anything contrary to them to lack such support. It thereby supports the development of accounting principles in the private sector.

9. The Committee on Accounting Procedure was a special committee of the American Institute of CPAs that, between the years of 1939 and 1959, issued 51 **Accounting Research Bulletins** dealing with a wide variety of timely accounting problems. These bulletins provided solutions to immediate problems and narrowed the range of alternative practices. But, the Committee's problem-by-problem approach failed to provide a well-defined and well-structured body of accounting theory that was so badly needed. The Committee on Accounting Procedure was replaced in 1959 by the Accounting Principles Board.

10. The creation of the Accounting Principles Board was intended to advance the written expression of accounting principles, to determine appropriate practices, and to narrow the differences and inconsistencies in practice. To achieve its basic objectives, its mission was to develop an overall conceptual framework to assist in the resolution of problems as they became evident and to do substantive research on individual issues before pronouncements were issued.

11. **Accounting Research Bulletins** were pronouncements on accounting practice issued by the Committee on Accounting Procedure between 1939 and 1959; since 1964 they have been recognized as accepted accounting practice unless superseded in part or in whole by an opinion of the APB or an FASB standard. **APB Opinions** were issued by the Accounting Principles Board during the years 1959 through 1973 and, unless superseded by FASB Statements, are recognized as accepted practice and constitute the requirements to be followed by all business enterprises. **FASB Statements** are pronouncements of the Financial Accounting Standards Board and currently represent the accounting profession's authoritative pronouncements on financial accounting and reporting practices.

12. The explanation should note that generally accepted accounting principles or standards have "substantial authoritative support." They consist of accounting practices, procedures, theories, concepts, and methods which are recognized by a large majority of practicing accountants as well as other members of the business and financial community. Bulletins issued by the Committee on Accounting Procedure, opinions rendered by the Accounting Principles Board, and statements issued by the Financial Accounting Standards Board constitute "substantial authoritative support."

13. It was believed that FASB Statements would carry greater weight than APB Opinions because of significant differences between the FASB and the APB, namely: (1) The FASB has a smaller membership of full-time compensated members; (2) the FASB has greater autonomy and increased independence; and (3) the FASB has broader representation than the APB.

14. The technical staff of the FASB conducts research on an identified accounting topic and prepares a "discussion memorandum" that is released by the Board for public reaction. The Board analyzes and evaluates the public response to the discussion memorandum, deliberates on the issues, and issues an "exposure draft" for public comment. The discussion memorandum merely presents all facts and alternatives related to a specific topic or problem, whereas the exposure draft is a tentative "statement." After studying the public's reaction to the exposure draft, the Board may reevaluate its position, revise the draft, and vote on the issuance of a final statement.

15. Statements of financial accounting **standards** constitute generally accepted accounting principles and dictate acceptable financial accounting and reporting practices as promulgated by the FASB. The first standards statement was issued by the FASB in 1973.

    Statements of financial accounting **concepts** do not establish generally accepted accounting principles. Rather, the concepts statements set forth fundamental objectives and concepts that the FASB intends to use as a basis for developing future standards. The concepts serve as guidelines in solving existing and emerging accounting problems in a consistent, sound manner. Both the standards statements and the concepts statements may develop through the same process from discussion memorandum, to exposure draft, to a final approved statement.

16. Rule 203 of the Code of Professional Conduct prohibits a member of the AICPA from expressing an opinion that financial statements conform with GAAP if those statements contain a material departure from an accounting principle promulgated by the FASB, or its predecessors, the APB and the CAP, unless the member can demonstrate that because of unusual circumstances the financial statements would otherwise have been misleading. Failure to follow Rule 203 can lead to a loss of a CPA's license to practice. This rule is extremely important because it requires auditors to follow FASB standards.

17. FASB Standards, FASB Technical Bulletins, AICPA Practice Bulletins.

18. The chairman of the FASB was indicating that too much attention is put on the bottom line and not enough on the development of quality products. Managers should be less concerned with short-term results and be more concerned with the long-term results. In addition, short-term tax benefits often lead to long-term problems.

    The second part of his comment relates to accountants being overly concerned with following a set of rules, so that if litigation ensues, they will be able to argue that they followed the rules exactly. The problem with this approach is that accountants want more and more rules with less reliance on professional judgment. Less professional judgment leads to inappropriate use of accounting procedures in difficult situations.

    In the accountants' defense, recent legal decisions have imposed vast new liability on accountants. The concept of accountant's liability that has emerged in these cases is broad and expansive; the number of classes of people to whom the accountant is held responsible are almost limitless.

19. FASB Staff Positions (FSP) are used to provide interpretive guidance and to make minor amendments to existing standards. The due process used to issue a FSP is the same used to issue a new standard.

20. The Emerging Issues Task Force often arrives at consensus conclusions on certain financial reporting issues. These consensus conclusions are then looked upon as GAAP by practitioners because the SEC has indicated that it will view consensus solutions as preferred accounting and will require persuasive justification for departing from them. Thus, at least for public companies which are subject to SEC oversight, consensus solutions developed by the Emerging Issues Task Force are followed unless subsequently overturned by the FASB. It should be noted that the FASB took greater direct ownership of GAAP established by the EITF by requiring that consensus positions be ratified by the FASB.

21. The Governmental Accounting Standards Board, under the oversight of the Financial Accounting Foundation, was created in 1984 to address state and local governmental reporting issues. The new board has replaced a number of organizations that set rules for government accounting. The National Council on Governmental Accounting, a voluntary body affiliated with the Municipal Finance Officers Association, was the primary standard setter for about 100,000 government units. But many other organizations also offered guidance for government accounting. The GASB will consolidate the rules into one body.

22. Possible reasons might be:
    1. The objectives of financial reporting for other types of enterprises (government, railroads, etc.) are not sufficiently different from those established by the FASB to warrant a separate standard-setting structure.
    2. The existence of competing standard-setting bodies would create serious jurisdictional conflicts.
    3. The framework is already in place within the existing structure to enforce the standards promulgated by the FASB.
    4. The FASB already has significant support from user groups of external financial reports. Uncertainty exists concerning the ability of any other standard-setting body to gain such support.

23. The sources of pressure are innumerable, but the most intense and continuous pressure to change or influence accounting principles or standards come from individual companies, industry associations, governmental agencies, practicing accountants, academicians, professional accounting organizations, and public opinion.

24. Economic consequences means the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact. In other words, accounting information impacts various users in many different ways which leads to wealth transfers among these various groups.

    If politics plays an important role in the development of accounting standards, standards will be subject to manipulation for the purpose of furthering whatever policy prevails at the moment. No matter how well intentioned the standards setter may be, if information is designed to indicate that investing in a particular enterprise involves less risk than it actually does, or is designed to encourage investment in a particular segment of the economy, financial reporting will suffer an irreplaceable loss of credibility.

25. No one particular proposal is expected in answer to this question. The students' proposals, however, should be defensible relative to the following criteria:
    1. The method must be efficient, responsive, and expeditious.
    2. The method must be free of bias and be above or insulated from pressure groups.
    3. The method must command widespread support if it does not have legislative authority.
    4. The method must produce sound yet practical accounting principles or standards.

    The students' proposals might take the form of alterations of the existing methodology, an accounting court (as once proposed by Leonard Spacek), or governmental device.

26. Concern exists about fraudulent financial reporting because it can undermine the entire financial reporting process. Failure to provide information to users that is accurate can lead to inappropriate allocations of resources in our economy. In addition, failure to detect massive fraud can lead to additional governmental oversight of the accounting profession.

27. The expectations gap is the difference between what people think accountants should be doing and what accountants think they can do. It is a difficult gap to close. The accounting profession recognizes it must play an important role in narrowing this gap. To meet the needs of society, the profession is continuing its efforts in developing accounting standards, such as numerous pronouncements issued by the FASB, to serve as guidelines for recording and processing business transactions in the changing economic environment.

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

    In addition, Section 404 of the Sarbanes-Oxley Act requires public companies to attest to the effectiveness of their internal controls over financial reporting.

29. Some of the reasons for difference are:
    1. The objectives of financial reporting are often different in foreign countries.
    2. The institutional structures are often not comparable.
    3. Strong national tendencies are pervasive and therefore there is reluctance to adopt any one country's approach.

30. Relevant and reliable financial information is a necessity for viable capital markets. Unfortunately, financial statements from companies outside the United States are often prepared using different financial statements than U.S. GAAP. As a result, international companies have to develop financial information in different ways. Beyond the additional costs these companies incur, users of financial statements are often forced to understand at least two sets of GAAP. It is not surprising that there is a growing demand for one set of high quality international standards.

31. Accountants must perceive the moral dimensions of some situations because GAAP does not define or cover all specific features that are to be reported in financial statements. In these instances accountants must choose among alternatives. These accounting choices influence whether particular stakeholders may be harmed or benefited. Moral decision-making involves awareness of potential harm or benefit and taking responsibility for the choices.

(a) The key organizations involved in standard setting in the U.S. are the AICPA, FASB, and SEC. See also (c).

(b) Different authoritative literature pertaining to methods recording accounting transactions exists today. Some authoritative literature has received more support from the profession than other literature. The literature that has substantial authoritative support is the one most supported by the profession and should be followed when recording accounting transactions. These standards and procedures are called generally accepted accounting principles (GAAP). There are four different levels, and the first level is the one with the most authoritative support. It consists of FASB Standards Interpretations and Staff Positions, APB Opinions and Interpretations, and CAP Accounting Research Bulletins. The second level consists of AICPA Industry Audit and Accounting Guides, AICPA Statements of Position, and FASB Technical Bulletins. The third level consists of AICPA Practice Bulletins and EITF documents, Concepts Statements, and other authoritative pronouncements. The fourth level (least authoritative) involves AICPA Accounting Interpretations, prevalent industry practices and FASB Implementation Guides.

(c) Standards setting in the U.S. has evolved through the work of the following organizations:

1. **American Institute of Certified Public Accountants (AICPA)—it is the national professional organization of practicing Certified Public Accountants (CPAs). Outgrowths of the AICPA have been the Committee on Accounting Procedure (CAP) which issued Accounting Research Bulletins and the Accounting Principles Board (APB) whose major purposes were to advance written expression of accounting principles, determine appropriate practices, and narrow the areas of difference and inconsistency in practice.**

2. **Financial Accounting Standards Board (FASB)—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 the financial information.**

3. **Securities and Exchange Commission (SEC)—the SEC is an independent regulatory agency of the United States government which administers the Securities Act of 1933, the Securities Exchange Act of 1934, and several other acts. The SEC has broad power to prescribe the accounting practices and standards to be employed by companies that fall within its jurisdiction.**

(d) The SEC and the AICPA have been the authority for compliance with GAAP. The SEC has indicated that financial statements conforming to standards set by the FASB will be presumed to have authoritative support. The AICPA, in Rule 203 of the Code of Professional Ethics, requires that members prepare financial statements in accordance with GAAP. Failure to follow Rule 203 can lead to the loss of a CPA's license to practice.

AIA 1-2 INTERNATIONAL REPORTING PROBLEM

(a) The International Accounting Standards Board is an independent, privately funded accounting standards setter based in London, UK. The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the Board cooperates with national accounting standards setters to achieve convergence in accounting standards around the world.

(b) In summary, the following groups might gain most from harmonization of financial reporting:

- **Investors, investment analysts and stockbrokers: to facilitate international comparisons for investment decisions.**
- **Credit grantors: for similar reasons to bullet point above.**
- **Multinational companies: as preparers, investors, appraisers of products or staff, and as movers of staff around the globe; also, as raisers of finance on international markets (this also applies to some companies that are not multinationals).**
- **Governments: as tax collectors and hosts of multinationals; also interested are securities markets regulators and governmental and nongovernmental rule makers.**

(c) The fundamental argument against harmonization is that, to the extent that international differences in accounting practices result from underlying economic, legal, social, and other environmental factors, harmonization may not be justified. Different accounting has grown up to serve the different needs of different users; this might suggest that the existing accounting practice is "correct" for a given nation and should not be changed merely to simplify the work of multinational companies or auditors. There does seem to be strength in this point particularly for smaller companies with no significant multinational activities or connections. To foist upon a small private family company in Luxembourg lavish disclosure requirements and the need to report a "true and fair" view may be an expensive and unnecessary piece of harmonization.

The most obvious obstacle to harmonization is the sheer size and deep-rootedness of the differences in accounting. These differences have grown up over the previous century because of differences in users, legal systems, and so on. Thus, the differences are structural rather than cosmetic, and require revolutionary action to remove them.

<u>Note to instructor</u>: For a more complete treatment of international accounting standards, students should read the expanded discussion on, "International Accounting Standards."

SOLUTIONS TO CONCEPTS FOR ANALYSIS

AIA 1-3

(a) Financial accounting is the process that culminates in the preparation of financial reports relative to the enterprise as a whole for use by parties both internal and external to the enterprise. In contrast, managerial accounting is the process of identification, measurement, accumulation, analysis, preparation, interpretation, and communication of financial information used by the management to plan, evaluate, and control within an organization and to assure appropriate use of, and accountability for, its resources.

(b) The financial statements most frequently provided are the balance sheet, the income statement, the statement of cash flows, and the statement of changes in owners' or stockholders' equity.

(c) Financial statements are the principal means through which financial information is communicated to those outside an enterprise. As indicated in (b), there are four major financial statements. However, some financial information is better provided, or can be provided only, by means of financial reporting other than formal financial statements. Financial reporting (other than financial statements and related notes) may take various forms. Examples include the company president's letter or supplementary schedules in the corporate annual reports, prospectuses, reports filed with government agencies, news releases, management's forecasts, and descriptions of an enterprise's social or environmental impact.

AIA 1-4

(a) In accordance with **Statement of Financial Accounting Concepts No. 1**, "Objectives of Financial Reporting by Business Enterprises," the objectives of financial reporting are to provide information to investors, creditors, and others

1. that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
2. to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.
3. about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

(b) **Statement of Financial Accounting Concepts No. 1** established standards to meet the information needs of large groups of external users such as investors, creditors, and their representatives. Although the level of sophistication related to business and financial accounting matters varies both within and between these user groups, users are expected to possess a reasonable understanding of accounting concepts, financial statements, and business and economic activities and are expected to be willing to study and interpret the information with reasonable diligence.

AIA 1-5

Accounting numbers affect investing decisions. Investors, for example, use the financial statements of different companies to enhance their understanding of each company's financial strength and operating results. Because these statements follow generally accepted accounting principles, investors can make meaningful comparisons of different financial statements to assist their investment decisions.

Accounting numbers also influence creditors' decisions. A commercial bank usually looks into a company's financial statements and past credit history before deciding whether to grant a loan and in what amount. The financial statements provide a fair picture of the company's financial strength (for example, short-term liquidity and long-term solvency) and operating performance for the current period and over a period of time. The information is essential for the bank to ensure that the loan is safe and sound.

AIA 1-6

It is not appropriate to abandon mandatory accounting standards and allow each company to voluntarily disclose the type of information it considered important. Without a coherent body of accounting theory and standards, each accountant or enterprise would have to develop its own theory structure and set of practices, and readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

In addition, voluntary disclosure may not be an efficient way of disseminating information. A company is likely to disclose less information if it has the discretion to do so. Thus, the company can reduce its cost of assembling and disseminating information. However, an investor wishing additional information has to pay to receive additional information desired. Different investors may be interested in different types of information. Since the company may not be equipped to provide the requested information, it would have to spend additional resources to fulfill such needs; or the company may refuse to furnish such information if it's too costly to do so. As a result, investors may not get the desired information or they may have to pay a significant amount of money for it. Furthermore, redundancy in gathering and distributing information occurs when different investors ask for the same information at different points in time. To the society as a whole, this would not be an efficient way of utilizing resources.

AIA 1-7

(a) One of the committees that the AICPA established prior to the establishment of the FASB was the Committee on Accounting Procedures (CAP). The CAP, during its existence from 1939 to 1959, issued 51 Accounting Research Bulletins (ARB). In 1959, the AICPA created the Accounting Principles Board (APB) to replace the CAP. Before being replaced by the FASB, the APB released 31 official pronouncements, called APB Opinions.

(b) Although the ARBs issued by the CAP helped to narrow the range of alternative practices to some extent, the CAP's problem-by-problem approach failed to provide the well-defined, structured body of accounting principles that was both needed and desired. As a result, the CAP was replaced by the APB.

The APB had more authority and responsibility than did the CAP. Unfortunately, the APB was beleaguered throughout its 14-year existence. It came under fire early, charged with lack of productivity and failing to act promptly to correct alleged accounting abuses. The APB also met a lot of industry and CPA firm opposition and occasional governmental interference when tackling numerous thorny accounting issues. In fear of governmental rule-making, the accounting profession investigated the ineffectiveness of the APB and replaced it with the FASB.

AIA 1-7 (Continued)

Learning from prior experiences, the FASB has several significant differences from the APB. The FASB has: (1) smaller membership, (2) full-time, compensated membership, (3) greater autonomy, (4) increased independence, and (5) broader representation. In addition, the FASB has its own research staff and relies on the expertise of various task force groups formed for various projects. These features form the bases for the expectations of success and support from the public. In addition, the due process taken by the FASB in establishing financial accounting standards gives interested persons ample opportunity to make their views known. Thus, the FASB is responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession.

(c) The AICPA has supplemented the FASB's efforts in the present standard-setting environment. The issue papers, which are prepared by the Accounting Standards Executive Committee (AcSEC), identify current financial reporting problems for specific industries and present alternative treatments of the issue. These papers provide the FASB with an early warning device to insure timely issuance of FASB standards, Interpretations, and Staff Positions. In situations where the FASB avoids the subject of an issue paper, AcSEC may issue a Statement of Position to provide guidance for the reporting issue. AcSEC also issues Practice Bulletins which indicate how the AICPA believes a given transaction should be reported.

Recently, the role of the AICPA in standard-setting has diminished. The FASB and the AICPA agreed, that after a transition period, the AICPA and AcSEC no longer will issue authoritative accounting guidance for public companies.

AIA 1-8

(a) The Financial Accounting Foundation (FAF) is the sponsoring organization of the FASB. The FAF selects the members of the FASB and its Advisory Council, funds their activities, and generally oversees the FASB's activities.

The FASB follows a due process in establishing a typical FASB Statement of Financial Accounting Standards. The following steps are usually taken: (1) A topic or project is identified and placed on the Board's agenda. (2) A task force of experts from various sectors is assembled to define problems, issues, and alternatives related to the topic. (3) Research and analysis are conducted by the FASB technical staff. (4) A discussion memorandum is drafted and released. (5) A public hearing is often held, usually 60 days after the release of the memorandum. (6) The Board analyzes and evaluates the public response. (7) The Board deliberates on the issues and prepares an exposure draft for release. (8) After a 30-day (minimum) exposure period for public comment, the Board evaluates all of the responses received. (9) A committee studies the exposure draft in relation to the public responses, reevaluates its position, and revises the draft if necessary. (10) The full Board gives the revised draft final consideration and votes on issuance of a Standards Statement. The passage of a new accounting standard in the form of an FASB Statement requires the support of five of the seven Board members.

(b) The FASB issues three major types of pronouncements: Standards and Interpretations, Financial Accounting Concepts, and Technical Bulletins. Financial accounting standards issued by the FASB are considered GAAP. In addition, the FASB also issues interpretations that represent modifications or extensions of existing standards and APB Opinions. These interpretations have the same authority as standards and APB Opinions in guiding current accounting practices.

The Statements of Financial Accounting Concepts (SFAC) help the FASB to avoid the "problem-by-problem approach." These statements set forth fundamental objectives and concepts that the Board will use in developing future standards of financial accounting and reporting. They are intended to form a cohesive set of interrelated concepts, a body of theory or a conceptual framework, that will serve as tools for solving existing and emerging problems in a consistent, sound manner.

AIA 1-8 (Continued)

The FASB may issue a technical bulletin when there is a need for guidelines on implementing or applying FASB Standards or Interpretations, APB Opinions, Accounting Research Bulletins, or emerging issues. A technical bulletin is issued only when (1) it is not expected to cause a major change in accounting practice for a number of enterprises, (2) its cost of implementation is low, and (3) the guidance provided by the bulletin does not conflict with any broad fundamental accounting principle.

In addition, the FASB's Emerging Issues Task Force (EITF) issues statements to provide guidance on how to account for new and unusual financial transactions that have the potential for creating diversity in reporting practices. The EITF identifies controversial accounting problems as they arise and determines whether they can be quickly resolved or whether the FASB should become involved in solving them. In essence, it becomes a "problem filter" for the FASB. Thus, it is hoped that the FASB will be able to work on more pervasive long-term problems, while the EITF deals with short-term emerging issues.

AIA 1-9

The Securities and Exchange Commission (SEC) is the governmental entity that provides oversight over the accounting standards-setting process. Until the 1960s, the SEC acted with remarkable restraint in the area of developing accounting standards. Generally, it relied on the AICPA to regulate the accounting profession and develop and enforce accounting standards.

During the APB era, however, the SEC took a more active interest in the development of accounting standards, pressing for quicker action, specific pronouncements, and eventually for the demise of the APB. Recently, the SEC has interacted with the FASB as both a supporter and a prodder. Because it confronts the financial accounting and reporting practices of U.S. business on a daily basis, the SEC frequently identifies emerging problems for the FASB to address. The Commission communicates these problems to the FASB, responds to FASB drafts and exposures, and provides the FASB with counsel and advice upon request.

The SEC has reaffirmed its support for the FASB, indicating that "financial statements conforming to standards set by the FASB will be presumed to have authoritative support." In short, the SEC requires public companies to adhere to GAAP.

AIA 1-10

(a) **CAP**. The Committee on Accounting Procedure, CAP, which was in existence from 1939 to 1959, was a natural outgrowth of AICPA committees which were in existence during the period 1933 to 1938. The committee was formed in direct response to the criticism received by the accounting profession during the financial crisis of 1929 and the years thereafter. The authorization to issue pronouncements on matters of accounting principles and procedures was based on the belief that the AICPA had the responsibility to establish practices that would become generally accepted by the profession and by corporate management.

As a general rule, the CAP directed its attention, almost entirely, to resolving specific accounting problems and topics rather than to the development of generally accepted accounting principles. The committee voted on the acceptance of specific Accounting Research Bulletins published by the committee. A two-thirds majority was required to issue a particular research bulletin. The CAP did not have the authority to require acceptance of the issued bulletins by the general membership of the AICPA, but rather received its authority only upon general acceptance of the pronouncement by the members. That is, the bulletins set forth normative accounting procedures that "should be" followed by the accounting profession, but were not "required" to be followed.

It was not until well after the demise of the CAP, in 1964, that the Council of the AICPA adopted recommendations that departures from effective CAP Bulletins should be disclosed in financial statements or in audit reports of members of the AICPA. The demise of the CAP could probably be traced to four distinct factors: (1) the narrow nature of the subjects covered by the bulletins issued by the CAP, (2) the lack of any theoretical groundwork in establishing the procedures presented in the bulletins, (3) the lack of any real authority by the CAP in prescribing adherence to the procedures described by the bulletins, and (4) the lack of any formal representation on the CAP of interest groups such as corporate managers, governmental agencies, and security analysts.

APB. The objectives of the APB were formulated mainly to correct the deficiencies of the CAP as described above. The APB was thus charged with the responsibility of developing written expression of generally accepted accounting principles through consideration of the research done by other members of the AICPA in preparing Accounting Research Studies. The committee was in turn given substantial authoritative standing in that all opinions of the APB were to constitute substantial authoritative support for generally accepted accounting principles. If an individual member of the AICPA decided that a principle or procedure outside of the official pronouncements of the APB had substantial authoritative support, the member had to disclose the departure from the official APB opinion in the financial statements of the firm in question.

The membership of the committee comprising the APB was also extended to include representation from industry, government, and academe. The opinions were also designed to include minority dissents by members of the board. Exposure drafts of the proposed opinions were readily distributed.

The demise of the APB occurred primarily because the purposes for which it was created were not being accomplished. Broad generally accepted accounting principles were not being developed. The research studies supposedly being undertaken in support of subsequent opinions to be expressed by the APB were often ignored. The committee in essence became a simple extension of the original CAP in that only very specific problem areas were being addressed. Interest groups outside of the accounting profession questioned the appropriateness and desirability of having the AICPA directly responsible for the establishment of GAAP. Politicization of the establishment of GAAP had become a reality because of the far-reaching effects involved in the questions being resolved.

FASB. The formal organization of the FASB represents an attempt to vest the responsibility of establishing GAAP in an organization representing the diverse interest groups affected by the use of GAAP. The FASB is independent of the AICPA. It is independent, in fact, of any private or governmental organization. Individual CPAs, firms of CPAs, accounting educators, and representatives of private industry will now have an opportunity to make known their views to the FASB through their membership on the Board. Independence is facilitated through the funding of the organization and payment of the members of the Board. Full-time members are paid by the organization and the organization itself is funded solely through contributions. Thus, no one interest group has a vested interest in the FASB.

Conclusion. The evolution of the current FASB certainly does represent "increasing politicization of accounting standards setting." Many of the efforts extended by the AICPA can be directly attributed to the desire to satisfy the interests of many groups within our society. The FASB represents, perhaps, just another step in this evolutionary process.

AIA 1-10 (Continued)

(b) Arguments for politicalization of the accounting rule-making process:

1. Accounting depends in large part on public confidence for its success. Consequently, the critical issues are not solely technical, so all those having a bonafide interest in the output of accounting should have some influence on that output.
2. There are numerous conflicts between the various interest groups. In the face of this, compromise is necessary, particularly since the critical issues in accounting are value judgments, not the type which are solvable, as we have traditionally assumed, using deterministic models. Only in this way (reasonable compromise) will the financial community have confidence in the fairness and objectivity of accounting rule-making.
3. Over the years, accountants have been unable to establish, on the basis of technical accounting elements, rules which would bring about the desired uniformity and acceptability. This inability itself indicates rule-setting is primarily consensual in nature.
4. The public accounting profession, through bodies such as the Accounting Principles Board, made rules which business enterprises and individuals "had" to follow. For many years, these businesses and individuals had little say as to what the rules would be, in spite of the fact that their economic well-being was influenced to a substantial degree by those rules. It is only natural that they would try to influence or control the factors that determine their economic well-being.

(c) Arguments against the politicalization of the accounting rule-making process:

1. Many accountants feel that accounting is primarily technical in nature. Consequently, they feel that substantive, basic research by objective, independent and fair-minded researchers ultimately will result in the best solutions to critical issues, such as the concepts of income and capital, even if it is accepted that there isn't necessarily a single "right" solution.
2. Even if it is accepted that there are no "absolute truths" as far as critical issues are concerned, many feel that professional accountants, taking into account the diverse interests of the various groups using accounting information, are in the best position, because of their independence, education, training, and objectivity, to decide what generally accepted accounting principles ought to be.
3. The complex situations that arise in the business world require that trained accountants develop the appropriate accounting principles.
4. The use of consensus to develop accounting principles would decrease the professional status of the accountant.
5. This approach would lead to "lobbying" by various parties to influence the establishment of accounting principles.

AIA 1-11

(a) The public/private mixed approach appears to be the way standards are established in the United States. In many respects, the FASB is a quasi-governmental agency in that its standards are required to be followed because the SEC has provided support for this approach. The SEC has the ultimate power to establish standards but has chosen to permit the private sector to develop these standards. By accepting the standards established by the FASB as authoritative, it has granted much power to the FASB. (It might be useful to inform the students that not all countries follow this model. For example, the purely political approach is used in France and West Germany. The private, professional approach is employed in Australia, Canada, and the United Kingdom.)

(b) Publicly reported accounting numbers influence the distribution of scarce resources. Resources are channeled where needed at returns commensurate with perceived risk. Thus, reported accounting numbers have economic effects in that resources are transferred among entities and individuals as a consequence of these numbers. It is not surprising then that individuals affected by these numbers will be extremely interested in any proposed changes in the financial reporting environment.

AIA 1-11 (Continued)

(c) The Accounting Standards Executive Committee (AcSEC of the AICPA), among other groups, has presented a potential challenge to the exclusive right of the FASB to establish accounting principles. Also, Congress has been attempting to legislate certain accounting practices, particularly to help struggling industries.

Some possible reasons why other groups might wish to establish standards are:

1. As indicated in the previous answer, standards have economic effects and therefore certain groups would prefer to make their own standards to ensure that they receive just treatment.
2. Some believe the FASB does not act quickly to resolve accounting matters, either because it is not that interested in the subject area or because it lacks the resources to do so.
3. Some argue that the FASB does not have the competence to legislate standards in certain areas. For example, many have argued that the FASB should not legislate standards for not-for-profit enterprises because the problems are unique and not well known by the FASB.

AIA 1-12

(a) **AICPA**. American Institute of Certified Public Accountants. The national organization of practicing certified public accountants.

(b) **CAP**. Committee on Accounting Procedure. A committee of practicing CPAs which issued 51 Accounting Research Bulletins between 1939 and 1959 and is a predecessor of the FASB.

(c) **ARB**. Accounting Research Bulletins. Official pronouncements of the Committee on Accounting Procedure which, unless superseded, remain a primary source of GAAP.

(d) **APB**. Accounting Principles Board. A committee of public accountants, industry accountants and academicians which issued 31 Opinions between 1959 and 1973. The APB replaced the CAP and was itself replaced by the FASB. Its opinions, unless superseded, remain a primary source of GAAP.

(e) **FAF**. Financial Accounting Foundation. An organization whose purpose is to select members of the FASB and its Advisory Councils, fund their activities, and exercise general oversight.

(f) **FASAC**. Financial Accounting Standards Advisory Council. An organization whose purpose is to consult with the FASB on issues, project priorities, and select task forces.

(g) **SOP**. Statements of Position. Statements issued by the AICPA (through the Accounting Standards Executive Committee of its Accounting Standards Division) which are generally devoted to emerging problems not addressed by the FASB or the SEC.

(h) **GAAP**. Generally accepted accounting principles. A common set of standards, principles, and procedures which have substantial authoritative support and have been accepted as appropriate because of universal application.

(i) **CPA**. Certified public accountant. An accountant who has fulfilled certain education and experience requirements and passed a rigorous examination. Most CPAs offer auditing, tax, and management consulting services to the general public.

(j) **FASB**. Financial Accounting Standards Board. The primary body which currently establishes and improves financial accounting and reporting standards for the guidance of issuers, auditors, users, and others.

AIA 1-12 (Continued)

(k) **SEC**. Securities and Exchange Commission. An independent regulatory agency of the United States government which administers the Securities Acts of 1933 and 1934 and other acts.

(l) **IASB**. International Accounting Standards Board. An international group, formed in 1973, that is actively developing and issuing accounting standards that will have international appeal and hopefully support.

(m) **GASB.** Governmental Accounting Standards Board. The primary body that currently establishes accounting and reporting standards for state and local governments.

AIA 1-13

1. (b), (e)
2. (a)
3. (c)
4. (d)

AIA 1-14

1. (d)
2. (f)
3. (c)
4. (e)
5. (a)
6. (b)

AIA 1-15

(a) The Securities and Exchange Commission (SEC) is an independent federal agency that receives its authority from federal legislation enacted by Congress. The Securities and Exchange Act of 1934 created the SEC.

(b) As a result of the Securities and Exchange Act of 1934, the SEC has legal authority relative to accounting practices. The U.S. Congress has given the SEC broad regulatory power to control accounting principles and procedures in order to fulfill its goal of full and fair disclosure.

(c) There is no direct relationship as the SEC was created by Congress and the Financial Accounting Standards Board (FASB) was created by the private sector. However, the SEC historically has followed a policy of relying on the private sector to establish financial accounting and reporting standards known as generally accepted accounting principles (GAAP). The SEC does not necessarily agree with all of the pronouncements of the FASB. In cases of unresolved differences, the SEC rules take precedence over FASB rules for companies within SEC jurisdiction.

AIA 1-16

(a) The process by which a topic is selected or identified as appropriate for study by the Financial Accounting Standards Board (FASB) is described below.

- Problems or issues come to the attention of the FASB from

  – the Emerging Issues Task Force which may identify significant emerging accounting issues that it feels the FASB should address.

  – the Financial Accounting Standards Advisory Council which addresses the FASB on the priority of problems and encourages the FASB to undertake new projects.

  – the Research and Technical Activities Staff of the FASB, which monitors business periodicals for stories concerning unusual transactions or events and may detect an emerging problem.

  – the close contact it maintains with various business, industry, government, professional financial groups, and the SEC.

  – its staff which may learn of emerging problems as it responds to technical inquiries received from preparers and auditors.

- Topics are then placed on the FASB agenda.

- The plan for major technical agenda projects is given prompt public notice in the FASB's newsletter "Status Report."

- A task force of experts from various sectors is assembled to define problems, issues, and alternatives related to the topic.

- The task force inputs are submitted to the FASB's Technical Activities Division for research and analysis.

(b) Once a topic is considered appropriate for consideration by the FASB, major steps in the process leading to the issuance of a **Statement of Financial Accounting Standards** include the following:

- Research and analysis is conducted by the FASB Technical Staff.

- A discussion memorandum (or an invitation to comment) is drafted and released for written comments.

- Written comments are submitted and a public hearing is held approximately 60 days after the memorandum is released.

- The Board analyzes and evaluates the public responses.

- The Board deliberates on the issues and prepares an exposure draft which is released for public comment.

- After a 30-day (minimum) exposure period and possible public hearings from industry groups, the Board evaluates all comments received.

AIA 1-16 (Continued)

- A committee studies the exposure draft in relation to the public responses, reevaluates its position, and revises the draft if necessary.
- The full Board gives the revised final draft consideration and votes on the issuance of a **Standards Statement**.

(c) At least three other organizations who can influence the setting of generally accepted accounting principles include the

- American Institute of Certified Public Accountants.
- Securities and Exchange Commission.
- Financial Executives Institute.

AIA 1-17

(a) Considering the economic consequences of many accounting standards, it is not surprising that special interest groups become vocal and critical (some supporting, some opposing) when standards are being formulated. The FASB's derivative accounting standard is no exception. Many from the banking industry, for example, criticized the standard as too complex and leading to unnecessary earnings volatility. They also indicated that the proposal may discourage prudent risk management activities and in some cases could present misleading financial information.

As a result, Congress is often approached to put pressure on the FASB to change its rulings. In the stock option controversy, industry was quite effective in going to Congress to force the FASB to change its conclusions. In the derivative controversy, Rep. Richard Baker introduced a bill which would force the SEC to formally approve each standard issued by the FASB. Not only would this process delay adoption, but could lead to additional politicalization of the standards-setting process. Dingell commented that Congress should stay out of the standards-setting process and defended the FASB's approach to establishing generally accepted accounting standards.

(b) Attempting to set standards by a political process will probably lead to the following consequences:
(a) Too many alternatives.
(b) Lack of clarity that will lead to inconsistent application.
(c) Lack of disclosure that reduces transparency.
(d) Not comprehensive in scope.

Without an independent process, standards will be based on political compromise. A classic illustration is what happened in the savings and loan industry. Applying generally accepted accounting principles to the S&L industry would have forced regulators to restrict activities of many S&Ls. Unfortunately, accounting principles were overridden by regulatory rules and the resulting lack of transparency masked the problems. William Siedman, former FDIC Chairman noted later that it was "the worst mistake in the history of government."

Another indication of the problem of government intervention is shown in the accounting standards used by some countries around the world. Completeness and transparency of information needed by investors and creditors is not available in order to meet or achieve other objectives.

AIA 1-18

(a) The "due process" system involves the following:
   (1) Identifying topics and placing them on the Board's agenda.
   (2) Research and analysis is conducted and discussion memorandum of pros and cons issued.
   (3) A public hearing is often held.
   (4) Board evaluates research and public responses and issues exposure draft.
   (5) Board evaluates responses and changes exposure draft, if necessary. Final statement is then issued.

(b) Economic consequences mean the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact.

(c) Economic consequences indicated in the letter are: (1) concerns related to the potential impact on the capital markets, the weakening of companies' ability to manage risk, and the adverse control implications of implementing costly and complex new rules imposed at the same time as other major initiatives, including the Year 2000 issues and a single European currency.

(d) The principal point of this letter is to delay the finalization of the derivatives standard. As indicated in the letter, the authors of this letter urge the FASB to expose its new proposal for public comment, following the established due process procedures that are essential to acceptance of its standards and providing sufficient time for affected parties to understand and assess the new approach. (Authors note: The FASB indicated in a follow-up letter that all due process procedures had been followed and all affected parties had more than ample time to comment. In addition, the FASB issued a follow-up standard, which delayed the effective date of the standard, in part to give companies more time to develop the information systems needed for implementation of the standard.)

(e) The reason why the letter was sent to Congress was to put additional pressure on the FASB to delay or drop the issuance of a standard on derivatives. Unfortunately, in too many cases, when the business community does not like the answer proposed by the FASB, it resorts to lobbying members of Congress. The lobbying efforts usually involve developing some type of legislation that will negate the standard. In some cases, efforts involve challenging the FASB's authority to develop rules in certain areas with additional Congressional oversight.

AIA 1-19 ETHICAL DECISION MAKING

(a) Inclusion or omission of information that materially affects net income harms particular stakeholders. Accountants must recognize that their decision to implement (or delay) reporting requirements will have immediate consequences for some stakeholders.

(b) Yes. Because the FASB standard results in a fairer representation, it should be implemented as soon as possible—regardless of its impact on net income. SEC Staff Bulletin No. 74 (December 30, 1987) requires a statement as to what the expected impact of the standard will be.

(c) The accountant's responsibility is to provide financial statements that present fairly the financial condition of the company. By advocating early implementation, Popovich fulfills this task.

(d) Potential lenders and investors, who read the financial statements and rely on their fair representation of the financial condition of the company, have the most to gain by early implementation. A stockholder who is considering the sale of stock may be harmed by early implementation that lowers net income (and may lower the value of the stock).

AIA 1-20 ETHICAL DECISION MAKING

(a) The ethical issue in this case relates to making questionable entries to meet expected earnings forecasts. As indicated in this chapter, businesses' concentration on "maximizing the bottom line," "facing the challenges of competition," and "stressing short-term results" places accountants in an environment of conflict and pressure.

(b) Given that Normand has pleaded guilty, he certainly acted improperly. Doing the right thing, making the right decision, is not always easy. Right is not always obvious, and the pressures to "bend the rules," "to play the game," "to just ignore it" can be considerable.

(c) No doubt, Normand was in a difficult position. I am sure that he was concerned that if he failed to go along, it would affect his job performance negatively or that he might be terminated. These job pressures, time pressures, peer pressures often lead individuals astray. Can it happen to you? One individual noted that at a seminar on ethics sponsored by the CMA Society of Southern California, attendees were asked if they had ever been pressured to make questionable entries. This individual noted that to the best of his recollection, everybody raised a hand, and more than one had eventually chosen to resign.

(d) Major stakeholders are: (1) Troy Normand, (2) present and potential stockholders and creditors of WorldCom, (3) employees, and (4) family. Recognize that WorldCom is the largest bankruptcy in United States history, so many individuals are affected.

(a) Three ways:
1. Use the main menu following Original Pronouncements and then Statement of Financial Accounting Concepts.
2. Query: "CON 1", "Objectives of Financial Reporting"
3. Search: Search within a single OP document type, Document title: Statement of accounting concepts, Query for: No. 1 or 1

(b) CON 1, Par. 7. Financial reporting includes not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system—that is, information about an enterprise's resources, obligations, earnings, etc. Management may communicate information to those outside an enterprise by means of financial reporting other than formal financial statements either because the information is required to be disclosed by authoritative pronouncement, regulatory rule, or custom or because management considers it useful to those outside the enterprise and discloses it voluntarily. Information communicated by means of financial reporting other than financial statements may take various forms and relate to various matters. Corporate annual reports, prospectuses, and annual reports filed with the Securities and Exchange Commission are common examples of reports that include financial statements, other financial information, and nonfinancial information. News releases, management's forecasts or other descriptions of its plans or expectations, and descriptions of an enterprise's social or environmental impact are examples of reports giving financial information other than financial statements or giving only nonfinancial information.

(c) CON 1, Par, 24 and 25: 24. Many people base economic decisions on their relationships to and knowledge about business enterprises and thus are potentially interested in the information provided by financial reporting. Among the potential users are owners, lenders, suppliers, potential investors and creditors, employees, management, directors, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labor unions, trade associations, business researchers, teachers and students, and the public. Members and potential members of some groups—such as owners, creditors, and employees—have or contemplate having direct economic interests in particular business enterprises. Managers and directors, who are charged with managing the enterprise in the interest of owners (paragraph 12), also have a direct interest. Members of other groups—such as financial analysts and advisors, regulatory authorities, and labor unions—have derived or indirect interests because they advise or represent those who have or contemplate having direct interests.

Potential users of financial information most directly concerned with a particular business enterprise are generally interested in its ability to generate favorable cash flows because their decisions relate to amounts, timing, and uncertainties of expected cash flows. To investors, lenders, suppliers, and employees, a business enterprise is a source of cash in the form of dividends or interest and perhaps appreciated market prices, repayment of borrowing, payment for goods or services, or salaries or wages. They invest cash, goods, or services in an enterprise and expect to obtain sufficient cash in return to make the investment worthwhile. They are directly concerned with the ability of the enterprise to generate favorable cash flows and may also be concerned with how the market's perception of that ability affects the relative prices of its securities. To customers, a business enterprise is a source of goods or services, but only by obtaining sufficient cash to pay for the resources it uses and to meet its other obligations can the enterprise provide those goods

or services. To managers, the cash flows of a business enterprise are a significant part of their management responsibilities, including their accountability to directors and owners. Many, if not most, of their decisions have cash flow consequences for the enterprise. Thus, investors, creditors, employees, customers, and managers significantly share a common interest in an enterprise's ability to generate favorable cash flows. Other potential users of financial information share the same interest, derived from investors, creditors, employees, customers, or managers whom they advise or represent or derived from an interest in how those groups (and especially stockholders) are faring.