**Revised Chapter 1**

Please replace Chapter 1 in your book with the revised Chapter 1 on the following pages.
After reading this chapter, you will be able to:

1. Understand capital markets and decision making.
2. Know what is included in financial reporting.
3. Explain generally accepted accounting principles (GAAP) and the sources of authoritative GAAP.
4. Identify the types of pronouncements that have been issued by the Financial Accounting Standards Board (FASB).
5. Understand how the FASB operates.
6. Describe the relationship between the Securities and Exchange Commission (SEC) and the FASB.
7. Use ethical models for decision making about ethical dilemmas.
8. Understand creative and critical thinking.
9. Describe the joint convergence project of the FASB and the IASB (Appendix).
10. Understand SEC reporting under U.S. GAAP and IFRS (Appendix).
The Future Is Bright!

The accounting profession can trace its roots back to the earliest civilizations. As history unfolded, accountants often played critical roles in commerce and business. With the increasing pace of technological advance, you might wonder what the future has in store for the accounting profession. More importantly, as you consider accounting as a major, you might ask what the future holds for you upon graduation. Let’s take a look at some recent evidence that may yield some answers.

As the regulatory environment has become more dynamic over the last several years, companies are faced with an increasing number of new accounting rules that pose a significant challenge for financial reporting, including the adoption of International Financial Reporting Standards. All indications are that future years will present even greater challenges. To deal with this changing environment, more and more companies are turning to accountants for assistance. In one recent survey of small business owners, accountants were viewed as one of the most trusted business advisers. In addition, many companies have increased the importance of accounting skills in their executive training programs while other companies have emphasized the certified public accountant (CPA) credential in their executive searches. The trend toward increased hiring of individuals possessing accounting skills is expected to continue. According to the Bureau of Labor Statistics, the employment of accountants and auditors is expected to grow faster than the average for all occupations through the year 2014. To further support this expectation, a recent survey by the American Institute of Certified Public Accountants (AICPA) noted that hiring of accounting graduates by public accounting firms increased by approximately 83% between 2004 and 2007. When asked about projections of hiring trends, 91% of all of the firms surveyed expect to hire the same number or more of accounting graduates.
In another recent survey, public accounting ranked as one of the top 5 jobs for people who “want more pay, more upside, and more control over where they are going” with a projected 10-year growth rate of 22%. Finally, accounting has traditionally been listed as one of the top majors on college campuses. By all indications, accounting skills appear in high demand, and your future professional career in accounting appears bright!

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

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

**Accounting Information: Users, Uses, and GAAP**

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

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

External and Internal Users

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

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

Lenders and other creditors are also capital providers and also have a direct relationship with companies. Although creditors do not purchase securities, they make similar decisions that require accounting information. The decisions in this case are to extend credit, to
Accounting Information: Users, Uses, and GAAP

Accounting Information: Users, Uses, and GAAP


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

Financial and Managerial Accounting Information Systems

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

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

In other words, the amounts reported or methods used for financial accounting may influence management decisions. Or, the management of a company (perhaps in its own self-interest) may use the managerial accounting system to influence financial reporting. In this regard, the term agency theory describes the relationship between the manager (the “agent”) and the stockholder (the “principal”). The theory suggests that agents do not...
EXHIBIT 1-3  Comparison of Financial and Managerial Accounting

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

always act in the best interests of the principals. For example, managers might make a decision that increases their compensation while reducing the wealth of the company and its stockholders. Research suggests that an effective way to align the interests of the agent and the principal is to base the manager’s compensation on the performance of the company. Examples include the payment of bonuses that are a percentage of the company’s income, and the awarding of share (stock) options. We discuss bonuses and share options in Chapters 13 and 16. In other chapters, we discuss the effects on financial reporting from actual or potential agency theory relationships.

Financial Reporting

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

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

3. Some companies include a statement of comprehensive income as another major financial statement. We discuss this statement in Chapter 5.
Accounting information aids in the efficient allocation of resources in capital markets.

External users (investors, creditors, and others) use financial accounting information to make investment and credit decisions.

Internal users (company management) use managerial accounting information to plan and control a company’s operations.

Financial reporting is the process of communicating financial information about a company to external users and includes the financial statements and the related notes to the financial statements.

**Generally Accepted Accounting Principles**

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

The evolution of GAAP in the United States took place over many years. It involved several accounting policy-making bodies, including the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB), Committee on Accounting Procedure (CAP), and Securities and Exchange Commission (SEC). Until mid-2009, the accounting standards issued by these organizations were not located in a single document. GAAP was located in hundreds of different documents (called “pronouncements”) issued (“promulgated”) by the FASB, APB, CAP, and SEC. These pronouncements (which we discuss later in this chapter) contained over 2,000 standards, which were unwieldy, difficult to understand, hard to use, and sometimes conflicting. The FASB did create a “hierarchy of GAAP” with four categories of pronouncements in descending order of importance to help users identify which standards were more authoritative. However, accountants still found that the standards lacked a consistent and logical structure, which made it difficult and time-consuming for them to determine the “right” answer to an accounting issue. To rectify these problems, the FASB conducted a four-year project that resulted in the FASB Accounting Standards Codification™.

**Authoritative GAAP: FASB Accounting Standards Codification**

The FASB Accounting Standards Codification (or, simply, the Codification) is an electronic database that integrates and topically organizes the U.S. accounting standards (GAAP). Over 200 people worked on the project team from 2004 through mid-2009 to incorporate the more than 2,000 standards from the original pronouncements into this database. After a year-long testing and verification process, the Codification became effective on July 1, 2009.

The FASB Accounting Standards Codification is the only source of authoritative U.S. GAAP for companies to determine how to record their transactions, events, or circumstances, and how to report the results in their financial statements. The Codification includes selected portions of GAAP issued by the SEC for publicly traded companies. The Codification, however, does not contain all the SEC’s rules and regulations that constitute GAAP.

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

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4. “The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles,” FASB Statement of Financial Accounting Standards No. 165 (Norwalk, Conn.: FASB, 2009), par. 6 (FASB Cod. # 105-10-05). An exception to this GAAP are the rules and interpretive releases of the SEC, which are sources of authoritative GAAP for publicly traded companies that are required to file their financial statements with the SEC. For convenience, the Codification includes selected portions of GAAP issued by the SEC for publicly traded companies. The Codification, however, does not contain all the SEC’s rules and regulations that constitute GAAP.
does not change GAAP. However, in contrast to the hierarchy of GAAP that preceded the Codification, all GAAP in the Codification has an equal level of authority.

As an accountant, you must have a good understanding of GAAP. Throughout this book, we discuss GAAP for many topics to help you develop this understanding. However, we cannot discuss all the possible complex accounting issues that companies face today. Therefore, you must know how to find the authoritative source(s) of GAAP in the Codification to aid in recording and reporting a particular transaction, event, or circumstance. In the following paragraphs, we briefly discuss the key elements of the Codification. At the end of this chapter, we provide selected homework items to help you become familiar with the Codification. Then, at the ends of many chapters, we include “Researching GAAP” homework, which requires you to search the Codification to determine the “right” answer for a more complex accounting issue.

The Codification is located at http://asc.fasb.org (or http://aaahq.org/ascLogin.cfm, if your institution participates in the American Accounting Association’s academic access initiative). All users must register before they can log in. After logging in, the “home page” provides a notice to constituents, links to tutorials, instructions on how to “join sections,” and explanations of how to cross-reference the Codification sections to the original pronouncements. The framework of the Codification contains six components or levels: (1) Areas, (2) Topics, (3) Subtopics, (4) Sections, (5) Subsections, and (6) Paragraphs containing GAAP. The Areas component is located on the left side of the home page and contains links to seven accounting subjects, which include Assets, Liabilities, Equity, Revenue, Expenses, Broad Transactions, and Industry, along with a Master Glossary link and a “Go To” box for users familiar with the Codification numbering system. The home page also has a “Search” box at the top.

The Topics, Subtopics, Sections, Subsections, and Paragraphs are considered descending “levels” of the Codification database, and each item in each level is numbered for reference and search purposes. The Topics level is accessed by clicking on one of the Area “subject” links on the Codification home page. The following is an explanation of the descending order of the levels.

- **Topics** involve a collection of related guidance on a particular subject area (e.g., Assets).
- **Subtopics** are subsets of a Topic and generally are distinguished by “type” or by “scope” (e.g., under the Leases Topic, there are Subtopics for Operating Leases and Capital Leases, because they are different types of Leases).
- **Sections** characterize the nature of the content in a Subtopic (e.g., Recognition, Measurement, Disclosure).
- **Paragraphs** contain the guidance that constitutes GAAP.

In some cases, another component, **Subsections**, is necessary to filter the content related to multiple Sections. If a Subsection is necessary, it is not numbered but does include the Paragraphs that contain the guidance that constitutes GAAP.

**Using the Codification**

Let’s try an example. Suppose you wanted to determine the dollar amount a company would record for the purchase of inventory. Exhibit 1-4 shows the process (steps) you would complete to find the answer (GAAP) in the Codification, as well as the reference numbers. We will discuss each of the steps in the following paragraphs. You may want to go to the Codification web site and complete the steps as we discuss them.

After logging in, you would go to the Area links in the left column of the home page and click on Assets. This would bring you to a menu of nine Topics of assets, after which you would click on Inventory (note that its Codification number is 330). This would bring you to a menu containing one Subtopic, Overall (note that its number is 10, so that the combined Topic/Subtopic Codification number is 330-10), along with numerous links relating to various industries. After clicking on Overall, this would bring you to a menu

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5. The following discussion is primarily a summary of that presented in the Codification’s Notice to Constituents, January 16, 2009, pp. 12–20.
containing more than a dozen Sections. Here, you would have to decide which Section is most likely to contain the answer to your question. In this case you would click on Initial Measurement (note that its number is 30), which brings you to the paragraphs containing the answer (GAAP) for your question. Note that paragraph 30-1 indicates that “The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset . . . .” This completes your search. If you wanted to reference this answer, you would indicate that it can be found in FASB Cod. # 330-10-30-1. Now, suppose you had left this screen and wanted to go back to this paragraph. To save time, you could enter 330-10-30-1 in the “Go To” box on the home page, and it would bring you directly to the paragraph.

Alternatively, instead of the search process we discussed above, you could have found the same guidance by entering “purchase inventory” in the “Search” box. However, our example involved a relatively simple question. Even this simple search would bring up numerous “inventory” references that you would have to sort through to determine the answer. As you become more familiar with the Codification, for more complicated searches, the more specific your query, the more specific will be the results from this search.

Throughout this book, we discuss the GAAP related to a particular issue and provide a footnote that identifies the paragraph(s) of the original pronouncements from which our discussion was taken. To aid you in understanding the Codification numbering structure, in each of the footnotes we will also provide you with the Codification topic number, subtopic number, and section number that contains the paragraphs from the original pronouncement (e.g., FASB Cod. # 850-10-50).

**Nonauthoritative Guidance**

A company may need to determine how to record a specific transaction or event when the Codification does not include relevant GAAP. To do so, first the company must determine whether the Codification contains GAAP for similar transactions or events for that company. If so, it applies this GAAP. If not, the company then considers nonauthoritative guidance that may relate to the transaction or event.

There are numerous sources of nonauthoritative guidance. These include, but are not limited to, documents such as FASB Statements of Concepts, AICPA Issues Papers, International Accounting Standards Board (IASB) International Financial Reporting Standards, AICPA Technical Practice Aids, and accounting textbooks, handbooks, and articles. When reviewing nonauthoritative guidance, a company must consider the relevance of the guidance to its particular circumstances, the specificity of the guidance, and the reputation of the issuer or author as an “authority.” FASB Statements of Concepts (which we
briefly discuss later in this chapter and in more depth in Chapter 2) would normally be more relevant than other sources of nonauthoritative guidance.

**HISTORY OF U.S. GAAP**

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

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

**EXHIBIT 1-5  History of GAAP in the Private Sector**

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1938</td>
<td>CAP formed</td>
</tr>
<tr>
<td>1959</td>
<td>APB formed, issued 31 Opinions</td>
</tr>
<tr>
<td>1973</td>
<td>FASB formed, issued 168 Statements of Standards as of 08/09</td>
</tr>
</tbody>
</table>

**Committee on Accounting Procedure (CAP)**

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

**Accounting Principles Board (APB)**

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

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

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

The AICPA reacted to those criticisms by appointing a committee to evaluate the method of establishing accounting principles. This committee, called the Wheat Committee after its chairman Francis Wheat, recommended that the APB be abolished and that a new full-time body be created with even wider representation.

### Financial Accounting Standards Board (FASB)

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

**EXHIBIT 1-6  Structure of the FASB**

<table>
<thead>
<tr>
<th>Financial Accounting Foundation (14–18 member board of trustees)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Appoint and oversee</strong></td>
</tr>
<tr>
<td>Financial Accounting Standards Advisory Council (approximately 33 members)</td>
</tr>
<tr>
<td><strong>Advis</strong>e</td>
</tr>
<tr>
<td>Financial Accounting Standards Board (5 members)</td>
</tr>
<tr>
<td><strong>Appoint</strong> Consult</td>
</tr>
<tr>
<td>Task Forces of the Standards Board (including Emerging Issues Task Force)</td>
</tr>
<tr>
<td><strong>Support</strong></td>
</tr>
<tr>
<td>Administrative Staff</td>
</tr>
<tr>
<td>Research and Technical Staff</td>
</tr>
<tr>
<td><strong>Consult</strong></td>
</tr>
</tbody>
</table>

**Organization**

The Financial Accounting Foundation (FAF) is the parent organization of the FASB. It is governed by a 14- to 18-member Board of Trustees appointed from the memberships of eight organizations interested in the establishment of accounting principles. These organizations are the AICPA, Financial Executives International, Institute of Management
Accountants, CFA Institute, American Accounting Association, Securities Industry and Financial Markets Association, Government Finance Officers Association, and National Association of State Auditors, Comptrollers, and Treasurers. The primary responsibilities of the Financial Accounting Foundation are to oversee the effectiveness and efficiency of the standard setting process, and to appoint the members of the Financial Accounting Standards Advisory Council (FASAC) and the FASB. The FASAC has about 33 influential members. It is responsible for advising the FASB about major policy issues, the priority of topics, the selection of task forces, the suitability of tentative decisions, and other matters.

There are five members of the FASB. Appointees to the FASB are full-time, fully paid members with no other organizational ties. They are selected to represent a wide cross-section of interests. Each Board member is required to have a knowledge of, and experience in, investing, accounting, finance, business, and accounting education and research; high intelligence, integrity, and discipline; and a concern for the public interest regarding investing, financial accounting, and financial reporting. The FASB is responsible for identifying financial accounting issues, conducting research to address these issues, and resolving them. The FASB is supported by a research and technical staff that researches issues, communicates with constituents, and drafts preliminary findings. The administrative staff assists the FASB by handling library, publications, personnel, and other activities.

**Pronouncements**

Prior to the Codification, the FASB issued several types of pronouncements. Exhibit 1-7 lists these pronouncements. The GAAP from these pronouncements (except Statements of Concepts) is now included in the Codification. However, as we discuss later, it is still important for you to know about these documents.

**EXHIBIT 1-7  Historical FASB Pronouncements**

**Statements of Financial Accounting Standards.** These pronouncements established GAAP. They indicated the methods and procedures required on specific accounting issues.

**Interpretations.** These pronouncements provided clarifications of conflicting or unclear issues relating to previously issued FASB Statements of Financial Accounting Standards, APB Opinions, or Accounting Research Bulletins.

**Staff Positions.** The staff of the FASB issued these pronouncements to provide more timely and consistent application guidance in regard to FASB literature, as well as to make narrow and limited revisions of Statements of Financial Accounting Standards or Interpretations that previously would have been made through Technical Bulletins.

**Technical Bulletins.** The staff of the FASB issued these pronouncements to explain or elaborate on accounting and reporting issues related to Statements of Financial Accounting Standards or Interpretations.

**Statements of Financial Accounting Concepts.** These pronouncements established a theoretical foundation on which to base GAAP. They are the output of the FASB’s “Conceptual Framework” project (which we discuss in Chapter 2). They are not included in the Codification, but are considered to be the most relevant of the nonauthoritative guidance.

**Other Pronouncements.** On a major topic, the staff of the FASB may have issued a Guide for Implementation, which was in the form of questions and answers (referred to as FASB Q’s and A’s).

Except for Statements of Financial Accounting Concepts, the FASB no longer issues these pronouncements. Instead, for each standard, it issues an FASB Accounting Standards Update which includes the new accounting standard (and when it will become effective), as well as the Codification topic, subtopic, section, and paragraph numbers affected. It also

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

7. Previously, the FASB consisted of seven members. To increase the FASB’s efficiency and effectiveness, the FAF reduced the size of the Board to five members, effective July 1, 2008.
includes background information about the standard and provides the bases for conclusions on the change(s) in the Codification. The Codification database is updated and, until the new standard becomes effective, the Codification includes both the current paragraph and the updated paragraph. When the new GAAP becomes effective, the outdated paragraph is removed. Under this approach, GAAP is updated in real time as new standards are issued.

Although the FASB no longer issues the original pronouncements discussed in Exhibit 1-7, it is important that you are familiar with these pronouncements because they are cited in previous accounting literature that you may read and in companies’ documentation of how/why they recorded transactions, events, and circumstances prior to the Codification. Earlier, we mentioned that the home page of the Codification has a link that allows a user to cross-reference the Codification sections to the original pronouncements. This Cross Reference feature works in two ways. First, a user may enter a Codification number to find the original pronouncement from which the related GAAP was promulgated. Or, a user may enter an FASB pronouncement number, or a pronouncement number from another GAAP promulgating body (e.g., APB), to identify the location in the Codification in which to find the related GAAP. For example, recall that the answer to the Inventory question we posed earlier was located in the Codification at #330-10-30-1. If you enter this number in the Cross Reference function, it tells you that this GAAP originally was promulgated in ARB (Accounting Research Bulletin) No. 43, ch 4, par. 5. This function is useful when conducting research related to a previous accounting issue that may have been based on an original pronouncement.

**Operating Procedures**

Before issuing an Accounting Standards update, the FASB generally completes a multi-stage process as outlined in Exhibit 1-8. Initially, a topic or project is identified and placed on the FASB’s agenda. This topic may be the result of suggestions from the FASAC, the accounting profession, industry, or other interested parties. On major issues, a Task Force may be appointed to advise and consult with the FASB’s Research and Technical Staff. This may involve, for instance, the scope of the project and the nature and extent of additional research. The Staff conducts any research specifically related to the project.

EXHIBIT 1-8  FASB Operating Procedures

<table>
<thead>
<tr>
<th>Identify Topic</th>
<th>Appoint Task Force</th>
<th>Conduct Research</th>
<th>Issue Preliminary Views or Invitation to Comment</th>
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<td>Hold Public Hearings</td>
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<tr>
<td>Hold Public Hearings</td>
<td>Modify Exposure Draft</td>
<td>Vote (simple-majORITY)</td>
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</table>

*Prior to July 1, 2009, the standard was included in a FASB Statement of Financial Accounting Standards. Subsequently, the standard is included in a FASB Accounting Standards Update.

Then the FASB usually publishes a Preliminary Views document or Invitation to Comment (which outlines the research related to the issues) and sets a public comment period. During this period, the FASB may hold public hearings similar to those
conducted by Congress. The intent is to receive information from and views of interested individuals and organizations on the issues. Many parties submit written comments ("position papers") or make oral presentations. These parties include representatives of CPA firms and interested corporations, security analysts, members of professional accounting associations, and academics. After deliberating on the views expressed and the information collected, the FASB issues an Exposure Draft of the proposed Accounting Standards Update. Interested parties generally have 30 to 90 days to provide written comments of reaction. On major issues, the FASB may hold more public hearings. Sometimes, the FASB conducts a "field test" of the proposed GAAP with selected companies to evaluate implementation issues. A modified draft is prepared, if necessary, and brought to the FASB for a final vote. After a simple-majority (i.e., 3 to 2) vote is attained, the FASB Accounting Standards Update is issued.

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

On the other hand, FASB Statement No. 145, which rescinded FASB Statement No. 4 in regard to reporting gains and losses from the extinguishment of debt, was issued within eight months after the related Exposure Draft was issued. In this case, the FASB concluded that it could reach an informed decision without a public hearing. During the public comment period, it did receive 30 comment letters, which were used in the deliberation process. Note that FASB Statements Nos. 95 and 145 were issued prior to the Codification. The GAAP that they promulgated is now included in the Codification.

Sociopolitical Environment

As Exhibit 1-8 and the related discussion show, the operating procedures of the FASB are designed so that accounting standards are developed in an efficient manner, with due process, and in a public forum. The FASB is concerned that it considers all related research on a particular topic, as well as the views of all interested parties, before coming to a logical conclusion about the appropriate accounting standard for the topic. Its intent is to develop accounting standards that provide users with thorough, neutral, and credible information to help allocate capital as efficiently as possible.\(^8\)

An inexperienced viewer of the FASB operating procedures might think that accounting standards are always "ideal" because they are the result of "rational policy making," where there are clearly defined objectives, an integrated body of theory, and known consequences of the actions. Yet this may not always be the case because accounting is part of a broader social system. Often, objectives are not clear, research results are conflicting, and only "best guesses" can be made of the future consequences of current standards. Because the FASB has such a wide constituency and focuses on general purpose financial reporting, it often must establish accounting standards that are the result of compromise. To achieve "acceptable decisions," it is only natural for any affected parties to attempt to influence the FASB’s decisions. Since the FASB holds public hearings and open meetings, it is relatively easy for various external user groups (e.g., investors and creditors) and other interested groups (e.g., affected corporations and CPA firms) to try to influence the FASB to develop new standards, continue existing standards, or change existing standards in their own best interests. These groups often hold conflicting views. For instance, in 1995 the FASB decided that a new accounting standard for "stock options" was desirable, but it could not get enough support from external user groups. Therefore, it issued a standard

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that allowed companies to use either the new standard or the existing standard. In this case, compromise led to a lack of “comparability” across companies as to the effect of stock option accounting on their financial statements. The serious financial reporting failures (e.g., Enron) that occurred in the early 2000s led to a review of this accounting. As a result, the FASB (despite opposition from some members of Congress) issued a new standard requiring the use of one method to account for share (stock) options.

Compromise is inevitable as the FASB responds to the “globalization” of industry. In this regard, the FASB has been working with the International Accounting Standards Board to converge (“harmonize”) accounting standards among different countries. (We discuss this “convergence project” in an Appendix at the end of this chapter.) As Dennis Beresford (former Chair of the FASB) states: “Different countries have different domestic concerns that are reflected in the way they think about financial reporting. None of the viewpoints are more ‘right’ than one another, just different. Compromises are an inevitable part of harmonization.”

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

The Financial Accounting Foundation, in overseeing the FASB, has implemented procedures to overcome these criticisms. These procedures include use of an oversight committee.

to monitor the FASB’s standard-setting process, periodic Financial Accounting Foundation and FASB discussions, stronger input by the FASAC on agenda determination and task force use, and additional publication and field testing of preliminary views. Furthermore, it is considering moving toward “objectives-oriented” rather than “rule-based” accounting standards, which we will discuss in Chapter 2.

Accounting standards are not unchangeable. The FASB fulfills its responsibility by (1) establishing standards that are the most acceptable, given the various affected constituencies, and (2) continually monitoring the consequences of its actions so that revised standards can be issued where appropriate. As Beresford points out, the FASB carries out its public responsibility in an environment characterized by subtlety, complexity, and an absence of clear-cut answers. The FASB works hard to develop accounting standards that can be defended in terms of facts and circumstances, logic, and the fairness of the process that produces them. Reinforcing this fairness idea in testimony before Congress, Robert Herz (Chair of the FASB) stated that neutrality is a fundamental element of the FASB’s standard-setting process. The Board strongly opposes any legislation that would impair its independent, objective, and open standard-setting process.11

Objectives-Oriented Standard Setting

As we noted in the preceding section, many constituents have said that they are concerned about the increasing level of detail (“rules-based” approach), lack of consistency, and complexity in the standards set by the FASB. As a result, the Board has begun a process whereby in the future, standards will be based on an internally consistent conceptual framework (we discuss the current conceptual framework in Chapter 2). Each “objectives-oriented” standard would: (1) clearly state the accounting objective of the standard, (2) provide enough (but not too much) detail so that the standard could be applied on a consistent basis, and (3) minimize exceptions to the standard. The intent is to allow preparers and auditors to exercise professional judgment in determining how to apply accounting standards to show the economic substance of transactions and events. It is likely that this process will take several years because, among other things, preparers and auditors have become less willing to exercise professional judgments due to increasing litigation risks.12

Other Organizations Currently Influencing Generally Accepted Accounting Principles

Several other organizations have had an impact on the development of GAAP during the past several decades.

Securities and Exchange Commission (SEC)

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

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

12. For a more complete summary of the FASB’s activities on objectives-oriented standards, see “On the Road to an Objectives-Oriented Accounting System,” The FASB Report No. 259 (August 31, 2004), pp. 1–7.
Form S-1. A registration statement.
Form 10-K. An annual report.
Form 10-Q. A quarterly report of operations.
Form 8-K. A report used to describe any significant events that may affect the company.
Proxy Statement. A report used when management requests the right to vote through proxies for shareholders at stockholders’ meetings.

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

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

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

However, the SEC has been criticized for not exercising its responsibility, and there is no assurance that this position will remain in effect. In fact, during 1978 the SEC refused to support GAAP, requiring the use of the successful-efforts method in the oil and gas industry, and the FASB reacted by suspending the effective date of this release. Then, in the late 1980s the House Energy and Commerce Committee’s Oversight and Investigations Subcommittee was critical of the SEC for its alleged failure to monitor the detection of fraud and to establish an “early warning” system for identifying potential business failures. Although these hearings did not result in changes involving the establishment of GAAP, they did have an impact on auditing standards. Furthermore, the SEC pressured the FASB to adopt an accounting standard requiring the use of fair values by companies for reporting certain types of investments, and the Board issued revised GAAP in response to this pressure. Recently, the SEC decided to allow foreign companies to use international accounting standards (rather than U.S. accounting standards) in the forms they file with it, as we discuss later.

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

To fulfill this purpose, the AICPA publishes numerous documents that, in certain circumstances, may be considered as sources of GAAP. Industry Audit Guides and Industry Accounting

Guides are publications designed to assist independent auditors in examining and reporting on financial statements of various types of entities in specialized industries (e.g., banking). Statements of Position are publications intended to influence the development of financial accounting principles that best serve the public interest. Practice Bulletins are publications that provide guidance on specific technical issues. The relevant portions of these documents that constitute GAAP are included in the Codification.

During the tenure of the Accounting Principles Board, the AICPA issued numerous AICPA Accounting Interpretations to provide timely guidance on accounting issues without the formal procedures needed for an APB Opinion. These Interpretations are still sources of GAAP unless specifically rescinded or amended, and are included in the Codification. The AICPA also annually publishes Accounting Trends and Techniques, which provides a study of the latest accounting practices and trends identified from a survey of 600 published annual reports. This publication may be used to identify a consensus about GAAP for a particular issue or methods of disclosure. It is considered as a source of nonauthoritative guidance for GAAP. In this book, we often cite disclosure information from Accounting Trends and Techniques that applies to a specific accounting practice. Finally, the AICPA develops Issue Papers to help the FASB identify accounting areas that need to be addressed and clarified.

**FASB Emerging Issues Task Force (EITF)**

The EITF was established in 1984 as a response by the FASB to criticisms that the Board did not always provide timely guidance on new accounting issues. Members of the EITF meet four to six times a year; they include technical experts from all the major CPA firms and representatives from smaller CPA firms and from industry. These individuals are knowledgeable in accounting and financial reporting and are in positions to be aware of emerging problems. The Chief Accountant of the SEC also participates in EITF meetings. The primary objectives of the EITF are (1) to identify significant emerging accounting issues (i.e., unique transactions and accounting problems) that it feels the FASB should address and (2) to develop consensus positions on the implementation issues involving the application of accounting standards. In some cases these consensus positions may be viewed as the “best available guidance” on GAAP, particularly as they relate to new accounting issues. These standards are included in the Codification.

**International Accounting Standards Board (IASB)**

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

The operating structure of the IASC Foundation consists of (1) a group of Trustees that is responsible for fund-raising, appointing IASB members, and overseeing the effectiveness of the IASB, (2) the IASB, which issues International Financial Reporting Standards and includes 12 full-time members (and 2 part-time members) from various countries, (3) an International Financial Reporting Interpretations Committee to interpret the application of the Standards, and (4) a Standards Advisory Council to give advice to the IASB on priorities and views of organizations on major standard-setting projects. The operating procedure of the IASB is somewhat similar to that of the FASB and includes study of the topic, issuance of a discussion paper, issuance of an Exposure Draft, evaluation of comments, and consideration of a revised draft. If approved by at least nine members of the IASB, the revised
draft becomes an *International Financial Reporting Standard (IFRS)*. To date, the IASB (and its predecessor, the International Accounting Standards Committee) have issued 49 Standards. IFRS are considered to be nonauthoritative guidance for U.S. GAAP and are not included in the Codification.

There are important differences between the environments in which the FASB and the IASB operate. The FASB operates as a private standard-setting organization, and focuses on setting accounting standards in the United States to improve the usefulness of accounting information to investors and creditors. On the other hand, in many other countries, the emphasis in financial reporting is on meeting legal (e.g., tax) requirements, so that standard setting has evolved as a governmental, rather than a private, function. A role of the IASB, then, is to consolidate many countries' accounting regulations into international standards. In this regard, in response to an appeal from the International Organization of Securities Commissions, the IASB has developed a set of “core standards” of accounting principles for the financial statements of companies making “crossborder” offerings of their securities. As a result, the European Commission requires that listed European companies use IFRS. Although there are areas of difference, financial statements prepared according to U.S. GAAP usually will comply with international accounting standards. Furthermore, as we discuss in an Appendix at the end of this chapter, the FASB and IASB are working together to converge (harmonize) accounting standards. The AICPA also recognizes the IASB as an approved accounting body for establishing international GAAP (IFRS), and gives its members the option of using IFRS as an alternative to U.S. GAAP. The IASB is taking an increasingly important role in the development of GAAP. In later chapters, where U.S. GAAP differs from IFRS, we discuss those differences briefly as they relate to the topics being covered.

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

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

**Cost Accounting Standards Board (CASB)**
The CASB was established in 1970 as an agency of the U.S. Congress. In 1980, Congress did not vote funds for its continuance, but it was reinstated in 1988. The CASB is responsible only for negotiated federal contracts and subcontracts exceeding $500,000 and has issued several related *Cost Accounting Standards*. Since internal cost accounting procedures often affect externally reported financial information, these cost accounting standards occasionally influence external reporting. In the past, Congress considered replacing the FASB with a governmental board like the CASB. Although this change has not been made, the possibility of additional governmental involvement in setting accounting principles should not be discounted.
Internal Revenue Service (IRS)
The IRS administers the Internal Revenue Code enacted by Congress. Federal income tax laws have had a significant impact on financial reporting practices since they were first enacted in 1913. Although the Internal Revenue Code generally does not affect financial accounting practice directly, managers often prefer to lessen its impact on the accounting systems within their companies. The result in many cases has been that they have used accounting methods and procedures that result in the lowest taxable income, without considering the proper financial accounting theory and practice.

You should understand that accounting for income tax purposes and accounting for financial reporting purposes are and should be different. The goal of financial accounting is to provide information to financial statement users so that they may make decisions. The goal of income tax accounting is to legally minimize or postpone the payment of income taxes. Frequently, the goals of financial reporting and income tax reporting conflict. For this reason, in this book we are concerned with determining the proper financial accounting recording and reporting procedures. What is, or should be, proper under the Internal Revenue Code is an entirely different question, which we only discuss when it has an impact on financial accounting and reporting. We discuss the impact of the Internal Revenue Code on financial accounting for income taxes in Chapter 19.

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

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

Relationship of Organizations in Current Standard-Setting Environment
As we discussed earlier, accounting standards are set in a sociopolitical environment. Currently there are three major organizations in the private and public sector that develop
U.S. and international GAAP for companies: the SEC, the FASB, and the IASB. To a lesser extent, the other organizations we discussed in this section also are influential in the standard-setting process. We illustrate the relationship of the various participants in this process in Exhibit 1-9.

**Quick Check 1-2**

- The guidelines, procedures, and practices that a company is required to use in recording and reporting accounting information in its financial statements (GAAP) have evolved over many years and were set by several policy-making bodies.
- The major standard-setting bodies responsible for the establishment of U.S. and international GAAP include the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the International Accounting Standards Board.
- The *FASB Accounting Standards Codification* is the only source of authoritative U.S. GAAP for companies (except for publicly traded companies that file with the SEC).
- Before the FASB issues a final standard, a proposed topic undergoes an extensive due process procedure that includes considerable research, numerous public hearings, and frequent deliberations.
- While final standards are intended to provide users with relevant and reliable information for their decision-making needs, social and political differences in the FASB's constituency often result in final standards that are a result of compromise.
- Numerous other bodies (shown in Exhibit 1-9) have also impacted the development of GAAP.

**Ethics in the Accounting Environment**

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

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

We also mentioned that in the FASB's public hearings and open meetings, various parties attempt to influence the Board in their own self-interest. These are just a few examples of situations in which accountants may be faced with ethical dilemmas (ethical conflicts), situations in which an accountant must make a decision about what is the “right” (ethical) action to take in a given set of circumstances. Because accounting is a service activity that plays an important role in society, professional accounting organizations have established “codes of ethics” for their members. One of these applies to members of the AICPA.14

Members of the AICPA recognize that they have an obligation of self-discipline above and beyond the requirements of laws and regulations. To help guide members in public practice, industry, government, and education in performing their responsibilities, the AICPA adopted the Code of Professional Conduct (CPC). The CPC includes six Principles that express the basic tenets of ethical and professional conduct and call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage. Exhibit 1-10 summarizes these Principles.15

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**EXHIBIT 1-10 Principles of the AICPA Code of Professional Conduct**

I. **Responsibilities:** In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

II. **The Public Interest:** Members should act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

III. **Integrity:** To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

IV. **Objectivity and Independence:** A member should be objective and free from conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

V. **Due Care:** A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member’s ability.

VI. **Scope and Nature of Services:** A member in public practice should observe the Principles of the CPC in determining the scope and nature of services to be provided.

14. For the code of ethics of the IMA, another professional accounting organization, see Ethics Center, IMA: http://www.imanet.org.

While this code of ethics establishes guidelines for accountants in performing their responsibilities, it does not provide a structured approach for “moral reasoning” in ethical dilemmas. Ethical behavior may be different from legally acceptable behavior. What is legal may still be unethical in certain circumstances. Ethicists have developed alternative “models” to help individuals make sound moral judgments and guide their behavior when faced with ethical dilemmas involving various stakeholders. In the business environment of a company, the stakeholders may include past, current, and potential investors; creditors; employees; suppliers; competing companies; local, state, and federal governments; and citizens in the local, regional, national, and even international communities.

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

1. gathering the facts (e.g., Who are the “stakeholders?” What are my responsibilities?);
2. asking whether the action is acceptable according to three ethical criteria:
   a. utility: Does the action optimize the satisfactions of all stakeholders?
   b. rights: Does the action respect the rights of all individuals? and
   c. justice: Is the action fair and just?
3. considering whether there are any “overwhelming factors,” such as conflicts between criteria that may justify disregarding one or more of the ethical criteria; and
4. deciding whether the action is ethical (or what ethical action to take) based on an evaluation of the applicable ethical criteria.16

Accountants are noted to have high ethical standards.17 Acting ethically is not always easy; sometimes it is very difficult. However, because of the important role of accounting in society, every accountant must have high moral standards and strive to behave at the highest ethical level. Throughout this book, you will be exposed to ethical dilemmas that we urge you to consider using the framework we just discussed.

**Creative and Critical Thinking in the Accounting Environment**

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

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In response to these changes, companies are becoming more innovative in the ways they manage their businesses, how they finance their activities, what they invest in to expand their operating capabilities, and what approaches they use in their credit and collection processes. They are restructuring their organizations and operations to increase efficiency, and are more sensitive to changing technology and product obsolescence. They are more creative in the ways they structure their executive and employee compensation packages. Accounting systems that are designed to accumulate, process, and communicate information for decision making in this changing environment must change to satisfy the needs of users. Accounting principles must evolve to reflect this changing environment. Accountants responsible for operating these systems, as well as for establishing and applying accounting principles, must be both creative thinkers and critical thinkers.

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

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

In financial accounting, accountants tend to be “problem solvers.” When an accounting issue or problem arises, the accountant is responsible for its resolution. Several steps have been identified in the problem-solving process, as we show in Exhibit 1-11. These steps include:

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

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

The degree of complexity may differ from one problem to another. Problems can range from structured problems to unstructured problems. For structured problems, virtually complete information is known about the alternatives (in fact, there may be only one alternative) so that identifying, evaluating, selecting, and implementing an alternative is straightforward. At the other extreme are unstructured problems where even the basic issue may not be readily apparent, the alternative solutions are unclear once the problem is identified, and there is a lack of information about the alternatives. Here the identification, evaluation, selection, and implementation process is much more complex. Between these extremes is the partially structured problem, where either the alternative solutions are unclear or there is a lack of information about the alternative solutions.

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

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

As a step in helping you develop your higher-level creative and critical thinking skills, there are also cases at the end of each chapter. These cases may require you to explain your understanding of interrelated concepts and practices. They may also require you to determine solutions to issues for which specific generally accepted accounting principles do not apply directly. These cases may deal with accounting issues that are emerging because of changes in the business environment we discussed earlier. They may focus on topics that are too “industry specific” to be included in the chapter material. In these latter situations, the cases (“research simulations”) will require you to “research GAAP” in the FASB Accounting Standards Codification and, in so doing, stimulate your higher-level creative and critical thinking as you complete the problem-solving process. If your instructor does not assign these cases, you may still want to analyze them as a way of practicing creative and critical thinking. Your ability to think creatively and critically will be very important in your future accounting and business (as well as personal) activities.
Chapter 1 • The Environment of Financial Reporting

APPENDIX: CONVERGENCE OF FASB AND IASB ACCOUNTING STANDARDS

As we discussed earlier in the chapter, many companies have become “globalized” as they sell their products internationally and integrate their production facilities across many different countries. These companies include both U.S. corporations and foreign corporations. For instance, the Coca-Cola Company (see Appendix A at the end of this book) and McDonald’s Corporation make more than 70% and 65% of their sales, respectively, in countries other than the United States. Similarly, Toyota Corporation makes more than 64% of its sales in countries other than Japan. Currently, U.S. corporations are subject to the accounting standards established by the FASB, while foreign corporations are subject to international financial reporting standards (IFRS) established by the IASB or by accounting standards set by their national accounting standards boards. These differences in accounting standards have led to differences among U.S. and foreign corporations’ financial statements. These differences, in turn, have made it difficult for investors and creditors to make valid comparisons across corporations and to make effective buy-sell-hold decisions in the U.S. and foreign capital markets.

JOINT CONVERGENCE PROJECT OF THE FASB AND IASB

To resolve this issue, in 2002 the FASB and the IASB entered into the “Norwalk Agreement.” In this agreement, each Board acknowledged its commitment to the development of high-quality, compatible accounting standards that could be used for both “domestic” and “cross-border” financial reporting. To achieve this compatibility, the Boards agreed to work together to achieve “short-term” convergence on a number of individual differences between U.S. and international accounting standards. They also agreed to coordinate their future agendas on substantial long-term projects which both Boards would address concurrently. Finally, they agreed to continue working on joint projects they were currently undertaking. This overall collaboration is sometimes referred to as the convergence or harmonization of accounting standards.

KEY FASB INITIATIVES

The FASB believes that the ideal result of cooperative international standard setting would be a single set of high-quality accounting standards that would be used by all corporations on a worldwide basis. In accordance with its agreement with the IASB, the FASB has undertaken six key initiatives to help attain the goal of convergence of U.S. accounting standards with international accounting standards. We identify these initiatives below and then briefly discuss the progress in the first two initiatives in later sections of this Appendix.

- Conducting long-term joint projects with the IASB. These major joint projects involve complex issues which the Boards are addressing in a coordinated manner. The processes involve the sharing of staff resources, while (to the extent possible) maintaining a similar time schedule.
- Participating in the short-term convergence project. These joint projects are limited to resolving differences between U.S. GAAP and IFRS in which convergence of a high-quality standard appears achievable in the short run.
- Monitoring of IASB projects. The FASB monitors IASB projects involving topics that are of great interest to the FASB. These projects may be important to the FASB because they (1) have potentially significant implications for convergence, (2) relate to a topic for which there is no U.S. standards (or the standards are deemed to be less than optimal), or (3) address issues that are fundamental to the U.S. financial reporting model.

9 Describe the joint convergence project of the FASB and the IASB (Appendix).

20. This and the following discussion summarizes several FASB Project Updates listed on its website. For more details, see the International link at http://www.fasb.org.
• **Conducting a convergence research project.** The FASB staff is currently working on a research project related to the convergence of accounting standards. The project involves identifying all of the significant differences between U.S. GAAP and IFRS, and then categorizing these differences according to the Board’s strategy for resolving them. Of particular importance are those topics where an accounting practice or procedure is permissible under either an FASB or IASB standard, but not permissible under both Boards’ standards.

• **Explicitly considering the convergence potential in all of the Board’s agenda decisions.** When setting its agenda of issues to address, the FASB considers (1) the possibility that resolution of the issue would increase convergence, (2) the opportunities an issue presents for cooperation with other standard-setting bodies, and (3) whether sufficient resources are available for a joint or other cooperative effort.

• **Having a Liaison IASB member on site at the FASB offices.** The liaison’s role is to facilitate information exchange and increased cooperation between the FASB and the IASB.

**Long-Term Joint Projects**

The FASB and the IASB have been cooperating for several years on four long-term joint projects. These include: (1) business combinations, (2) revenue recognition, (3) a conceptual framework, and (4) financial statement presentation. Although you now have limited exposure to these topics, you will be able to understand the “basics” involved in each issue. We will discuss several of these issues in later chapters.

- The **business combinations** convergence project is the only long-term project that has been completed. This project took over five years to complete and resulted in two revised U.S. standards (included in the Codification) and two revised *International Financial Reporting Standards*. This project resulted in the convergence of accounting principles dealing with the accounting by a company for the assets and liabilities it acquires when it purchases another company. This topic is beyond the scope of this book and discussed in an advanced accounting textbook.

- The **revenue recognition** convergence project involves determining when and how a company should record revenue. This joint project was begun in 2004, although both Boards previously had been independently studying this issue. The intent of this project is to eliminate inconsistencies in the existing conceptual guidance on revenues, fill voids in revenue recognition guidance, and establish a single, comprehensive standard on revenue recognition. To date, only a Preliminary Views document has been issued. We discuss revenue recognition issues in several chapters later in this book.

- The **conceptual framework** convergence project involves developing a common conceptual framework that is both complete and internally consistent. This joint project was begun in 2005. The intent is to provide a solid foundation for the establishment of future accounting standards. The Boards decided to split this project into eight phases: objective and qualitative characteristics, elements and recognition, measurement, reporting entity, presentation and disclosure, framework for a GAAP hierarchy, applicability to the not-for-profit sector, and remaining issues. To date, Chapters of the conceptual framework dealing with the objective and qualitative characteristics and a Preliminary Views document dealing with the reporting entity have been issued. We discuss the objective and qualitative characteristics Chapters in Chapter 2 dealing with the FASB conceptual framework.

- The **financial statement presentation** convergence project involves developing a common, high-quality standard for the presentation of information in a company’s financial statements. This joint project was begun in 2004, although both Boards previously had been independently studying this issue. This project includes the classification and aggregation of items in each of the financial statements. The objective is to improve the ability of investors and creditors to evaluate different aspects of the company. To date, a Preliminary Views document has not been issued.

**Short-Term Joint Projects**

The overall objective of the short-term convergence joint projects is to improve financial reporting by eliminating a variety of individual differences between U.S. GAAP and IFRS.
Usually, this involves selecting a “best” standard between existing U.S. and international standards on a particular topic. Each Board has identified a number of topics for which modifications in its standards will move toward convergence.

For instance, the FASB has issued standards relating to:

- **Inventory costs**: FASB Statement No. 151 was issued to bring U.S. GAAP regarding a component of inventory cost into agreement with IAS 2.
- **Asset exchanges**: FASB Statement No. 153 was issued to bring U.S. GAAP for non-monetary exchanges into agreement with IAS 16.
- **Accounting changes**: FASB Statement No. 154 was issued to bring U.S. GAAP for reporting accounting changes and errors into agreement with IAS 8.

The U.S. GAAP from each of these Statements has been incorporated into the Codification. We discuss the U.S. GAAP in later chapters of the book related to the topics they address. The IASB has also adjusted or is planning to adjust several standards that we do not discuss here. The FASB and IASB have also agreed to examine a number of topics for short-term convergence. These include:

**To Be Examined by the FASB**
- Impairment (jointly with the IASB)
- Income taxes (jointly with the IASB)
- Investment properties
- Research and development
- Subsequent events

**To Be Examined by the IASB**
- Impairment (jointly with the FASB)
- Income taxes (jointly with the FASB)
- Government grants
- Joint ventures
- Segment reporting

As you can see, some of these projects will be worked on jointly by the Boards, while others will be worked on individually by each Board.

### Cooperative Efforts with Other Standard-Setting Groups

The FASB is not the only national accounting standard-setting group that is working with the IASB on the convergence of international accounting standards. There are seven others that include:

- **Australia and New Zealand**
  - Australian Accounting Standards Board (AASB)
  - Financial Reporting Standards Board (FRSB)
- **Canada**
  - Accounting Standards Board (AcSB)
- **France**
  - Conseil Nationale de la Comptabilité (CNC)
- **Germany**
  - German Accounting Standards Committee (DRSC)
- **Japan**
  - Accounting Standards Board (ASBJ)
- **United Kingdom**
  - Accounting Standards Board (ASB)

Many of the accounting standards established by these standard-setting bodies involve similar issues to those of U.S. GAAP or to IFRS. However, there are some differences in the accounting treatments due to many national factors such as taxing authorities. Where there are differences, members of the IASB, FASB, and this group meet twice a year to work toward convergence of worldwide accounting standards.

### THE SEC AND FUTURE ACCOUNTING STANDARDS

The SEC has long been an advocate of the establishment of mutually accepted international accounting standards to reduce inefficiencies in the capital markets without compromising investor and creditor protection. However, the SEC makes clear that it only endorses high-quality accounting standards that consist of neutral principles resulting in consistent, comparable, relevant, and reliable information useful to external users who make capital allocation decisions. Also, these accounting standards must be rigorously interpreted and applied. As you can see from the preceding discussion, over a number of years the progress of the FASB and the IASB has been slow and very few accounting standards have been issued in regard to both the long-term major joint projects and the short-term convergence projects. Therefore, the SEC has stepped in on two fronts: (1) changing

10 Understand SEC reporting under U.S. GAAP and IFRS (Appendix).
its filing regulations for foreign companies, and (2) considering changing its filing requirements for U.S. companies.

For companies issuing securities to raise capital in more than one country, the SEC feels (as do many others) that requiring companies to apply different accounting standards to prepare their financial statements is inefficient and costly. Over 100 countries now either require or allow companies to use IFRS for preparing their financial statements.

In the past, a foreign company filing with the SEC that used accounting standards other than U.S. GAAP had to file a form (Form 20-F) which “reconciled” certain amounts reported in its financial statements with the amounts that would have been reported using U.S. GAAP. However, in late 2007 the SEC rescinded this rule for foreign companies that use English-language IFRS (with no exceptions) to prepare their financial statements. These companies no longer have to file a reconciliation. This new rule is consistent with other countries such as Australia, New Zealand, and Canada, which now require the use of IFRS for regulatory filings. This new SEC rule has caused an increasing number of foreign companies to use IFRS in their filing with the SEC.

The movement by more foreign companies to use IFRS has created two potential problems for U.S. companies filing with the SEC (“regulated companies”) that use U.S. GAAP and that operate globally. First, their financial statements are likely to be different from the foreign companies with which they are competing for capital, creating difficulties for investors in comparing companies. Second, if U.S. companies have subsidiaries operating in foreign countries, they may be required to prepare their subsidiaries’ financial statements according to IFRS for local filings. Since they still have to prepare their financial statements using U.S. GAAP to file with the SEC, this creates potential costly inefficiencies. As a result, the SEC has begun a study of whether it should require or allow U.S. companies to use IFRS in their financial statements filed with it. The issues related to this possible change are very complex and far reaching. We identify some of these issues below.21

- Many U.S. companies (particularly smaller ones) filing with the SEC do not operate globally so they would not see any advantage to using IFRS. If IFRS were required, it would likely be very costly for them to switch from U.S. GAAP to IFRS, thereby affecting their profitability during the conversion period.
- If IFRS were allowed rather than required and some regulated companies did not switch to IFRS, then there would be differences in the financial statements of regulated companies that used U.S. GAAP and those that used IFRS. These differences potentially affect the ability of external users in U.S. capital markets to compare different companies’ operating performances.
- More than 99% of U.S. corporations do not issue publicly traded securities and therefore are not regulated by the SEC. These corporations use U.S. GAAP in preparing their financial statements. A switch to IFRS for regulated U.S. companies would create a “dual-GAAP” system in the United States.
- Investors, creditors, financial analysts, and other external users would have to “retrain” to be able to evaluate the financial statements of companies using IFRS. Also, those external users who have more resources to learn about analyses under IFRS may be at a competitive advantage.
- High-quality, international auditing standards and practices would have to be developed to ensure that the IFRS are rigorously interpreted and applied.
- Accountants and auditors would have to be trained and/or retrained to understand the impact of IFRS on the preparation of financial statements and the related audits of companies using IFRS. Larger auditing firms with more resources for training may be at a competitive advantage over smaller auditing firms.
- The United States is a litigious society. Some mechanism would need to be established to protect companies and auditors acting in good faith during the transition to using IFRS in the preparation and auditing of financial statements.

Many companies which have borrowed money have “debt covenants” based on U.S. GAAP that restrict their financing activities. Modifications in existing IFRS may have to be made to maintain (or modify) these debt covenants.

Some accounting issues (e.g., for extractive industries) are not covered by IFRS. New high-quality IFRS would have to be established to address these issues.

If financial reporting under IFRS were required or allowed, it is unclear whether/how the “convergence projects” would proceed, and what would be the role of the FASB and SEC in the standard-setting (and enforcement) process.

The IASB is currently funded primarily by voluntary contributions by companies, accounting firms, central banks, and other organizations. With the increased dependence on the establishment of IFRS, a higher level of staffing and funding on a mandatory basis would be necessary.

If U.S. companies used IFRS, then they may be subject not only to SEC regulations, but may also be subject to rules of foreign regulatory bodies.

The SEC must consider these and many other issues as it studies whether it should continue to require the use of U.S. GAAP, whether it should require the use of IFRS, or whether it should allow the use of IFRS in financial statements filed with it. As you can see, some of the preceding issues relate to whether or not the use of IFRS would be required, while others relate to the use of IFRS in general.

The FASB has indicated that it favors the required use of IFRS by all U.S. companies in preparing their financial statements. However, it advocates an “improve and adopt” approach to implementing IFRS. It also sees the need for a transition plan, or “blueprint,” for moving U.S. companies to IFRS. This blueprint is necessary because:

- the transition would need to be a multiyear effort because elements of the U.S. financial system (e.g., auditing rules, education systems, licensing requirements) would need to change.
- it would provide for an orderly move by U.S. companies to IFRS so as to minimize the disruptions and costs to participants (e.g., users, auditors, analysts) in the capital markets.
- certain IFRS would need to be improved through an ongoing convergence effort.

The FASB argues that this blueprint should identify a target date for completing the transition to IFRS so that affected constituents can set their timetables. Also, the blueprint should identify the areas of IFRS that need to be improved during the transition process. The FASB also suggests that the SEC seek international cooperation to identify and implement the changes necessary to staff and fund the IASB as an independent global body to develop future high-quality IFRS.22

In response, the SEC has issued a proposal that would require U.S. companies filing with it to use IFRS beginning in 2014. If approved, this proposal would have major consequences. As we mentioned earlier, U.S. companies, their auditors, educators, accounting students, analysts, actuaries, valuation experts, and investors and creditors in the U.S. capital markets are among the groups that would be affected. In the transition period, U.S. companies will continue to use U.S. GAAP. Therefore, in this book we will continue to discuss U.S. GAAP (or simply GAAP). However, for each major topic where there are differences between U.S. GAAP and IFRS, we will identify those differences (in an IFRS versus U.S. GAAP box, as well as Appendix D at the end of the book) and indicate how accounting by U.S. companies would have to change to be in compliance with IFRS. Under this approach, you will be well informed about both U.S. GAAP and IFRS when you enter the accounting profession.23


Questions

1. Distinguish between primary markets and secondary markets.
2. Distinguish between the categories of users of financial statements. Why might their decision-making needs be different?
4. What is financial reporting and what is an important way a company’s financial information is reported?
5. What are the three major financial statements of a company and what do they show? What is the fourth major financial statement that many companies present, and what does it show?
6. What are generally accepted accounting principles (GAAP)? What is the only source of authoritative U.S. GAAP for companies? Is there any exception?
7. What are the three major financial statements of a company and what do they show? What is the fourth major financial statement that many companies present, and what does it show?
8. Describe the relationship between the Securities and Exchange Commission (SEC) and the FASB. The SEC has the legal authority to prescribe accounting principles and practices for all publicly traded companies. It, however, endorsed the workings of the FASB by stating that the standards set by the FASB will be considered by the SEC to have substantial authoritative support.
9. Describe the joint convergence project of the FASB and the IASB (Appendix). The FASB and IASB are working together to converge (harmonize) U.S. GAAP and IFRS. Their long-range projects involve business combinations, revenue recognition, a conceptual framework, and financial statement preparation.
10. Understand SEC reporting under U.S. GAAP and IFRS (Appendix). The SEC allows foreign companies to use IFRS in their financial statements filed with the SEC. The SEC is considering requiring or allowing U.S. companies to use IFRS. If adopted, this will likely take several years to implement because of its effect on U.S. companies, external users, and others.
Q1-8 List the sources of nonauthoritative guidance that a company might consult if it cannot find the applicable GAAP for a transaction in the Codification.

Q1-9 What are (were) the CAP, APB, and FASB? What documents that established GAAP have been issued by each of these organizations?

Q1-10 Briefly discuss the procedures followed by the FASB for issuing an accounting standards update.

Q1-11 List and briefly discuss the types of pronouncements that the FASB issued prior to the Codification.

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

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

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

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

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

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

Q1-18 What agreement did the FASB enter into with the IASB? Why did it enter into this agreement?

Q1-19 What are the four related long-term convergence projects of the FASB and IASB?

Q1-20 What is the SEC considering doing in regard to U.S. companies filing with it and their use of international accounting standards?

**C A S E S**

**C1-1 Historical Pronouncements**

Several accounting groups have issued various pronouncements establishing or relating to generally accepted accounting principles that are now included in the Codification. The following is a list of seven pronouncements, as well as a list of statements describing each pronouncement.

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

1. Pronouncements that provided clarifications of conflicting or unclear issues relating to previously issued FASB Statements of Standards, APB Opinions, or Accounting Research Bulletins.

2. Issued by the FASB to explain or elaborate on accounting and reporting issues related to Statements of Standards or Interpretations.

3. Pronouncements of the APB that established generally accepted accounting principles, many of which were based on Accounting Research Studies.

4. Issued by the FASB as a series establishing a theoretical foundation upon which to base financial accounting and reporting standards.

5. Pronouncements of the Committee on Accounting Procedure (CAP) that established generally accepted accounting principles.

**COMMUNICATION**

**C1-2 Organizations**

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

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

1. First organization in United States to be given authority to issue pronouncements on accounting procedures and practice. Issued Accounting Research Bulletins.


3. Administers the provisions of the Internal Revenue Code.
5. Establishes accounting standards for state and local governmental entities.
6. Establishes generally accepted accounting principles in the private sector of the United States.
7. Created by Congress in response to fraudulent accounting practices.
8. Responsible for advising the FASB about technical areas, task forces, and other matters.
9. Issued 31 Opinions to establish generally accepted accounting principles.
10. Has legal authority to prescribe accounting principles and reporting practices for all corporations issuing publicly traded securities.
11. Professional organization for all CPAs in the United States.
12. Develops consensus positions on the implementation issues involving the application of standards.

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

**C1-3 History of U.S. GAAP**
Since the late 1930s, three organizations have been primarily responsible for the establishment of generally accepted accounting principles in the private sector of the United States.

**Required**
Write a brief report that identifies the three organizations and provides a brief chronological history of each, including the pronouncements issued that established generally accepted accounting principles that are included in the Codification.

**C1-4 Standard Setting**
When the Accounting Principles Board was founded in 1959, it planned to establish financial accounting standards using empirical research and logical reasoning only; the role of political action was little recognized at that time. Today, there is wide acceptance of the view that political action is as much an ingredient of the standard-setting process as is research evidence. Considerable political and social influence is wielded by user groups—those parties who are most interested in or affected by accounting standards.

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

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

**C1-5 Organization of the FASB**
The FASB is organized to establish generally accepted accounting principles. It is assisted by various groups and operates under a set of procedures.

**Required**
Prepare a short written report that summarizes the structure and operating procedures of the FASB.

**C1-6 Code of Professional Conduct**
In a few years, you may become a member of the AICPA and be subject to its Code of Professional Conduct (CPC).

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

**C1-7 The Codification: Overview**
A friend of yours who is not an accounting major says, "I understand that there is something called 'The Codification," which is some sort of database that contains the accounting rules. What is this Codification, why is it important, and how does it work?"

**Required**
Prepare a written response to your friend.

**C1-8 The Codification: Current Assets**
A manager for a company with which you are consulting asks you, "What are ‘current assets’ and what specific items are included in the ‘presentation’ of current assets on a company’s balance sheet?"

**Required**
Search the Codification and provide answers for the manager that define current assets and summarize the related GAAP. Include a Codification reference number for verification.

**C1-9 The Codification: Revenue Recognition**
A manager for a new company with which you are consulting states, "We will soon be making sales, and I was wondering when we should recognize the revenue from these sales?"
Required:  
Search the Codification and provide an answer for the manager that summarizes the related GAAP. Include a Codification reference number for verification.

C1-10 The Codification: Recording Costs  
The president for a new company with which you are consulting states, “We have undertaken some activities to start our business, and have incurred some related costs. I have heard of ‘start-up activities,’ but what does this mean? And, if our activities qualify as start-up activities, how should we account for these costs?”

Required  
Search the Codification and provide an answer for the manager that summarizes the related GAAP. Include a Codification reference number for verification.

C1-11 The Codification: Property, Plant, and Equipment  
A plant manager for a company with which you are consulting states, “The company purchased this machine that we are using in the factory and recorded it at cost. Since we are now using the machine in our production, how should we account for the cost of the machine as we use it?”

Required  
Search the Codification and provide an answer for the manager that summarizes the related GAAP. Include a Codification reference number for verification.

C1-12 Lobbying the FASB  
One of your friends remarks, “I understand that before voting on a standard, the FASB allows written comments and oral presentations in which interested parties can lobby for a particular ruling. Do you think this is a good idea?”

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

C1-13 Ethical Responsibilities  
Each person in one of your accounting classes is required to write a report on an accounting topic. Included in the report must be a discussion from a specific library book. When you go to the library, you find that the only copy of the book is missing. While sitting at a study desk, you overhear one of your classmates say that he has “misfiled” the book in the library so he can use it again later without having to wait for other students to finish using it.

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

C1-14 Ethical Responsibilities  
You and a friend are in the same accounting class. During the first test, you observe that your friend cheated by copying one of her answers from another student (who was unaware of the copying). When the exams are returned, your grade is a B, while your friend’s grade is an A.

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

C1-15 International Convergence  
Your friend who is taking his first accounting course says to you, “We live in the United States. I thought that companies in the United States would follow U.S. accounting rules for preparing their financial statements. I also thought that foreign companies would follow international accounting rules. Now I hear something about the “convergence” of U.S. accounting rules and international accounting rules. And, I hear that the SEC is thinking about requiring U.S. companies to use international accounting rules for financial statements filed with it. What is going on and how will it be resolved?”

Required  
Prepare a memo that provides an in-depth answer to your friend’s question.