OBJECTIVES

After reading this chapter, you will be able to:

1. Understand capital markets and decision making.
2. Know what is included in financial reporting.
3. Explain generally accepted accounting principles (GAAP) and the sources of GAAP.
4. Identify the types of pronouncements issued by the 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.
SYNOPSIS

Accounting Information

1. Accounting is the process of identifying, measuring, recording, and communicating economic information to help users of the information make informed decisions and judgments. Accounting provides a link between the economic activities of a company and decision makers who are interested in the company. These decision makers can be divided into two major groups: external users (such as investors) and internal users (the company's management). Because of their different relationships to the company, the two groups have somewhat different needs.

2. In capital markets, investors exchange capital for the stocks and bonds of companies. Exchanges between individual investors are made in secondary markets, such as the New York and American Stock Exchanges and NASDAQ. Companies deal directly with investors in primary markets by borrowing from lending institutions or issuing capital stock or bonds. Primary markets include both public offerings and private placements. Public offerings involve advertising and sales of stocks or bonds to the general public, while in private placements, advertising and sales are directed to a limited number of institutions, such as insurance companies and pension funds, or employees.

3. External users can include actual and potential investors, creditors, employees, government agencies, financial analysts, and the general public. All of these users depend on timely information. Investors need the information to make buy, hold, or sell decisions. Creditors need the information for decisions on extending or continuing credit. The primary source of this information for external users is published financial statements.

4. Internal users are the company's managers and employees. Managers may use any information that the accounting system can provide to help make short-term and long-term decisions.

5. Financial accounting is the information accumulation, processing, and communication system designed to provide the investment and credit decision-making information for external users. Financial accounting information is reported in published financial statements.

6. Managerial accounting is the information accumulation, processing, and communication system designed to provide decision-making information for internal users. There is no set format for internal reports. The system is only limited by the need for information and the cost of providing that information.

7. A company's management is often evaluated and rewarded based on financial reports. Agency theory suggests that agents (the company's managers) may not always act in the best interest of their principals (the company's stockholders). This implies that basing management's compensation on company performance would be an effective way to encourage management to act in the best interest of the stockholders.

8. Financial reporting is the process of communicating financial accounting information about a company to external users, primarily through the company's annual report. The annual report includes at least three major financial statements: the balance sheet, income statement, and statement of cash flows. Most companies also include a statement of changes in stockholders' equity as a fourth major financial statement. In addition, notes, with supporting schedules, provide further explanations of the financial statement information. Most financial statements are audited by an independent certified public accountant, who expresses an opinion as to the fairness, in accordance with generally accepted accounting principles, of the financial statements and accompanying notes.
Generally Accepted Accounting Principles

9. In its audited financial statements, a company must follow generally accepted accounting principles (GAAP). GAAP are the guidelines, procedures, and practices required for recording and reporting accounting information and have evolved over many years. In other words, GAAP are the rules that must be followed in financial reporting.

10. There is no single document that includes all of the standards for accounting, although an electronic database produced by the Financial Accounting Standards Board (FASB) called the Financial Accounting Research System (FARS) includes most accounting standards. Sources of GAAP, in descending order of importance, are:


   (b) Pronouncements issued by bodies of expert accountants after exposure for public comment, including FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position.

   (c) Pronouncements issued by bodies of expert accountants without exposure for public comment, including FASB Emerging Issues Task Force Consensus Positions and AICPA Practice Bulletins.

   (d) Widely accepted practices and pronouncements of practices prevalent in a particular industry or applied to specific circumstances, such as AICPA Accounting Interpretations, FASB Q's and A's, and AICPA Accounting Trends and Techniques.


The Establishment of Accounting Standards

11. From 1938 to 1959 the Committee on Accounting Procedure (CAP) of the AICPA issued 51 Accounting Research Bulletins, which are still part of GAAP unless specifically superseded or amended. The CAP had no enforcement authority.

12. Because of criticisms regarding the formulation of accounting principles, the AICPA replaced the CAP with the Accounting Principles Board in 1959, which consisted of 17 to 21 part-time volunteers. From 1959 to 1973 the APB issued 31 Opinions, many based on Accounting Research Studies. Like the Accounting Research Bulletins issued by CAP, APB Opinions, unless amended or rescinded, are also still part of GAAP.

13. Development of accounting principles by the APB was criticized, with that criticism centered on three factors: (a) lack of independence of members of the APB from their business, governmental, or academic employers, (b) overrepresentation of public accounting firms and the AICPA on the APB, and (c) slow response time in solving problems. The structure of the Financial Accounting Standards Board (FASB), which replaced the APB in 1973, was designed to meet these criticisms. The parent Financial Accounting Foundation (FAF) is governed by sixteen 16 trustees appointed from the membership of 9 specified organizations. The FAF appoints the seven members of the FASB, raises
funds for the operation of the FASB, and provides general oversight. FASB appointees are full-time, fully paid members, representing a wide cross-section of interests. The FAF, in addition, appoints members of the Financial Accounting Standards Advisory Council (FASAC), which advises the FASB.

14. The FASB issues several types of pronouncements, including Statements of Financial Accounting Standards, Interpretations, Technical Bulletins, and Statements of Financial Accounting Concepts. A multistage process is used by FASB to ensure that standards are created efficiently and with input from the public. The process includes research leading to a Discussion Memorandum or Invitation to Comment, public hearings, issuance of an Exposure Draft, more public hearings, modification of the Exposure Draft, and a vote (simple majority) of the Board resulting in a Statement. Because accounting policy decisions are complex and part of a broader social system, input from interested parties is important. Negotiation and compromise are often necessary during the development of standards but the overall intent is to issue standards that provide users with credible information to make decisions.

15. In response to concerns regarding the increasing complexity in standards, the FASB is moving toward an Objectives-Oriented Standard Setting process. This process would base future standards on accounting objectives with fewer details and exceptions. These new standards would allow both the preparers and auditors more room for professional judgment in determining how to apply the standards.

16. The Securities and Exchange Commission has the legal authority to prescribe accounting principles and reporting practices for all companies issuing publicly traded securities. The SEC has usually allowed accounting principles to be formulated in the private sector, and has stated that standards set by the FASB are considered to have substantial authoritative support. However, the commission has occasionally exerted pressure on the CAP, APB, and FASB. In addition, the SEC administers the extensive disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1934 Act requires companies to file a number of reports, which are available to users on the Internet in the SEC’s Electronic Data Gathering, Analysis, and Retrieval System (EDGAR).

17. The American Institute of Certified Public Accountants is the professional organization for all certified public accountants in the United States. The AICPA issues numerous publications, including Industry Audit Guides, Industry Accounting Guides, Statements of Position, Practice Bulletins, Issue Papers, and Accounting Trends and Techniques.

18. The FASB Emerging Issues Task Force (EITF) identifies significant emerging accounting issues and develops consensus positions on accounting for these issues.

19. The Cost Accounting Standards Board (CASB), a congressional agency, is charged with setting standards of accounting for negotiated federal contracts and subcontracts exceeding $500,000.

20. The Internal Revenue Service (IRS) administers the provisions of the Internal Revenue Code. These provisions do not always reflect the goals of financial accounting. However, they do at times influence the choice of accounting methods and procedures.

21. The American Accounting Association (AAA) is an organization comprised primarily of academic and practicing accountants. The AAA attempts to influence the development of formal accounting pronouncements through research, education, and persuasion.

22. The International Accounting Standards Committee Foundation is the parent organization of the International Accounting Standards Board (IASB), and has as its goals to develop and promote the use of global accounting standards, and to bring national accounting standards into agreement with international standards. The IASB has 12 full-time members (and 2 part-time members) from various countries. It issues International Accounting Standards. To do so, its operating procedures include
study of the topic, issuance of an Exposure Draft, evaluation of comments, and consideration of a revised draft. If approved by at least 8 members of the IASB, the International Financial Accounting Standard (IFRS) is issued. The FASB is working with the IASB to harmonize accounting standards. However, financial statements prepared according to international standards may not comply with U.S. GAAP. The FASB and IASB are working together to harmonize accounting standards.

23. The Governmental Accounting Standards Board (GASB) operates under the auspices of the Financial Accounting Foundation. It establishes accounting standards for certain state and local governmental entities.

24. The Public Company Accounting Oversight Board (PCAOB) was created by Congress in the Sarbanes-Oxley Act of 2002 in response to accounting scandals such as Enron and WorldCom. While the PCAOB does not generally set accounting standards, it indirectly influences financial accounting through its oversight of the auditors of public companies.

25. Several professional associations also influence the development of accounting standards. The Financial Executives Institute (FEI) is composed mainly of high-level financial executives. The Institute of Management Accountants (IMA) emphasizes managerial and cost accountancy. The CFA Institute (CFAI) is made up of financial analysts. Each of the three organizations provides input to the FASB through the FAF and the public hearings process.

Ethics in the Accounting Environment

26. In their professional roles, accountants are often faced with ethical dilemmas (ethical conflicts). The AICPA Code of Professional Conduct (CPC) includes six basic principles: members should (a) exercise sensitive professional and moral judgments in carrying out their responsibilities; (b) serve the public interest, honor the public trust, and demonstrate commitment to professionalism; (c) perform professional responsibilities with the highest sense of integrity; (d) maintain objectivity, be free from conflicts of interest, and be independent in fact and appearance; (e) observe due care in practice; and (f) follow CPC principles in determining the scope and nature of services to be provided.

27. The CPC provides guidelines for practicing accountants, but does not present a structured approach to resolving ethical dilemmas. Three basic approaches to moral reasoning have been identified by the noted ethicist Velasquez: (a) the utilitarian model, emphasizing the greatest good for the greatest number; (b) the rights model, emphasizing individual moral rights; and (c) the justice model, emphasizing the fair distribution of benefits and burdens. Velasquez combines the three approaches in a system for moral reasoning.

28. Because of the important role of accounting in society, accountants must maintain high ethical standards.

Creative and Critical Thinking in Accounting

29. The global business environment is continually becoming more complex, with new products, services, and methods of production, distribution, and communication. To establish and maintain accounting systems that meet the needs of users, accountants must be both creative and critical thinkers. Creative thinking involves the use of imagination and insight to solve problems by finding new relationships (ideas) among items of information. Critical thinking involves the logical analysis of issues, using inductive or deductive reasoning to test new relationships (ideas) to determine their effectiveness.
True-False Questions

Determine whether each of the following statements is true or false.

1. Financial accounting is the information accumulation, processing, and communication system designed to meet the decision-making information needs of external users.
   
   **Answer: True**
   
   Financial accounting is designed to aid external users. It is the information accumulation, processing, and communication system designed to meet the decision-making information needs of external users.

2. The three basic decisions of investors are the buy, hold, and sell decisions.
   
   **Answer: True**
   
   Investors have a direct relationship with a company and are concerned with buying, selling, and holding a company's stock.

3. APB Opinions and AICPA Accounting Research Bulletins are sources of generally accepted accounting principles.
   
   **Answer: True**
   
   The FASB currently performs the functions that were previously performed by the APB and CAP; however, any Opinions and Research Bulletins that have not been superseded are still sources of GAAP.

4. One goal of the FASB is to bring generally accepted principles into conformity with tax laws.
   
   **Answer: False**
   
   FASB is responsible for establishing accounting principles for financial accounting. While accounting for taxes is important, it is a separate area of accounting.

5. The AICPA Code of Professional Conduct (CPC) provides a structured system for accountants to use in the resolution of ethical conflicts.
   
   **Answer: False**
   
   The AICPA CPC includes six principles that express the basic tenets of ethical and professional conduct. It establishes guidelines for accountants in performing their duties, but does not provide a structured approach for "moral reasoning" in ethical dilemmas.

6. The International Accounting Standards Board (IASB), with members from various countries, often uses compromise while promoting the adoption of sound, comparable accounting standards internationally.
   
   **Answer: True**
   
   The IASB operates in an environment that requires the use of compromise to achieve its objectives.

7. The utilitarian model, an approach to moral reasoning, emphasizes actions that protect individual moral rights.
   
   **Answer: False**
   
   The utilitarian model, developed by Velasquez, emphasizes the greatest good for the greatest number. The rights model is the one that emphasizes actions that protect individual rights.
8. Managerial accounting is the information system primarily designed to meet the needs of investment analysts. 

   Answer: False

   Financial accounting provides external users accounting information while managerial accounting provides information for internal users. Investment analysts are external users of accounting information.

9. The New York Stock Exchange (NYSE), the largest stock exchange in the United States, is designated as the primary market, while the American Stock Exchange (ASE) is a secondary market.

   Answer: False

   The NYSE and ASE are both secondary markets. A secondary market is one in which investors buy and sell stock among themselves. A primary market is one in which a corporation borrows or issues stock through either public offerings or private placements.

10. The SEC, which has the authority to prescribe accounting principles, has usually allowed accounting principles to be formulated in the private sector.

    Answer: True

    While the SEC has the legal authority to prescribe accounting principles, it has seldom used this authority. Instead the SEC has been content to allow standard setting to occur in the private sector, with oversight maintained by the SEC.

11. Accounting literature, such as texts and articles, is not considered to be a source of GAAP.

    Answer: False

    Accounting literature may be used by accountants when other pronouncements are unavailable.

12. The Accounting Research Bulletins issued by the AICPA's Committee on Accounting Procedure are still considered sources of GAAP.

    Answer: True

    Accounting Research Bulletins that have not been specifically superseded or amended are still considered sources of GAAP.

13. The Financial Accounting Standards Board (FASB) appoints the seven members of the Financial Accounting Standards Advisory Council (FASAC), which oversees the Financial Accounting Foundation (FAF).

    Answer: True

    The FAF is the parent organization of both the FASAC and the FASB. The FAF appoints the members of both the FASAC and the FASB. The FASAC advises the FASB on priorities and suitability of tentative decisions among other items.

14. The Accounting Principles Board (APB) was criticized for lack of independence, over-representation by public accounting firms and the AICPA, and slow response time.

    Answer: True

    These were the major criticisms of the APB that lead to the creation of the FASB in 1973.
15. Agency theory implies that it is effective for a company to base management compensation on company performance. **Answer: True**

Agency theory suggests that the company’s managers may not always act in the best interest of the company’s stockholders. This implies that basing management's compensation on company performance is an effective way to encourage management to act in the best interest of the stockholders.

16. An independent auditor expresses an opinion on the fairness, in accordance with GAAP, of a company’s financial statements and accompanying notes. **Answer: True**

An auditor does not prepare the financial statements and notes that companies prepare. Instead, the auditor’s responsibility is to verify that the company has followed GAAP in the preparation of the financial statements and accompanying notes.

17. The FASB restricts public input during the development of new accounting standards in order to enhance efficiency and preserve the Board’s independence. **Answer: False**

The current FASB process involves direct solicitation of public comments twice during the process; first after the issuance of a Discussion Memorandum, and second after the issuance of an Exposure Draft.

18. Financial statements prepared according to international (IASB) standards are automatically considered to be in compliance with U.S. GAAP. **Answer: False**

While the FASB and IASB are working together on many fronts to “harmonize” financial accounting standards, there are still differences between U.S. GAAP and IASB standards.

19. Many companies present a statement of changes in stockholders’ equity as a major financial statement, in addition to a balance sheet, income statement, and statement of cash flows. **Answer: True**

While not required, most companies include the statement of changes in stockholders’ equity along with the three required financial statements.

20. The FASB’s Financial Accounting Research System (FARS) is an electronic database that includes most accounting standards. **Answer: True**

Unfortunately, there is no one location that includes all accounting standards; however, FARS contains most of the standards.
Multiple Choice Questions

Select the one best answer for each of the following questions.

1. External users of a company's reports do not include
   (a) union representatives.
   (b) government regulators.
   (c) management.
   (d) bank loan officers.

   Answer: (c) management

   External users are not employees of the company. All of the answers are external to the company except for management.

2. Sources of generally accepted accounting principles do not include
   (a) widely accepted practices.
   (b) SEC regulations.
   (c) AICPA Accounting Research Bulletins.
   (d) formal pronouncements of the Internal Revenue Service (IRS).

   Answer: (d) formal pronouncements of the Internal Revenue Service (IRS)

   There are many different sources of GAAP, however GAAP applies to financial accounting. While companies are required to follow the pronouncements of the IRS when preparing their tax returns and filings, these pronouncements do not affect financial accounting or GAAP.

3. Which of the following statements about the AICPA Code of Professional Conduct (CPC) is true?
   (a) The CPC provides accountants with step-by-step procedures for resolving ethical conflicts.
   (b) The CPC requires that accountants be independent in appearance as well as fact.
   (c) The CPC requires that accountants give priority to their responsibilities toward their clients when ethical conflicts arise.
   (d) The CPC recognizes that, given the factual nature of accounting, accountants seldom face ethical dilemmas in their profession.

   Answer: (b) The CPC requires that accountants be independent in appearance as well as fact.

   The AICPA CPC is a guide to help CPAs perform their responsibilities. While a step-by-step guide to resolve ethical conflicts would be nice, it is impossible to foresee every ethical situation. For this reason the guidelines must be broad enough to apply in many different situations, therefore (a) is incorrect. Answer (b) is incorrect because ethical dilemmas are present in almost every facet of an accountant’s work. The CPC requires that accountants should serve the public interest. In many situations these interests may differ from their clients, therefore (c) is incorrect.

4. The Committee on Accounting Procedure (CAP)
   (a) had no authority to enforce its pronouncements.
   (b) raises funds for the operation of the FASB.
   (c) is a governmental agency with the legal authority to prescribe accounting procedures.
   (d) issued 31 Opinions between 1959 and 1973.

   Answer: (a) had no authority to enforce its pronouncements

   The AICPA, which formed the CAP, did not have the authority to enforce its pronouncements, therefore their application was optional. The Financial Accounting Foundation (FAF) funds the FASB, not the CAP; therefore (b) is incorrect. The SEC is legally authorized to prescribe accounting standards, but has chosen to allow the private sector to set standards; therefore (c) is incorrect. The CAP was in place from 1938 to 1959. The Accounting Principles Board (APB) was in place from 1959 to 1973; therefore (d) is incorrect.
5. The Accounting Principles Board was criticized for
   (a) its lack of independence.
   (b) the complexity of its pronouncements.
   (c) its failure to represent accounting practitioners and their professional organizations.
   (d) all of the above.

   **Answer: (a)** its lack of independence

   The APB was criticized for a lack of independence because members were only part-time volunteers. Representation was also another problem with the APB because of the closeness of the APB and the AICPA and the public accounting firms; therefore (c) is incorrect.

6. Which of the following statements describing approaches to moral reasoning is true?
   (a) The utilitarian model stresses the greatest good for the greatest number.
   (b) The justice model is based on service in the public interest and a commitment to professionalism.
   (c) The utilitarian model and the rights model both emphasize the fair distribution of benefits and burdens.
   (d) The utilitarian, rights, and justice models are all based on the six basic principles of the AICPA Code of Professional Conduct (CPC).

   **Answer: (a)** the utilitarian model stresses the greatest good for the greatest number

   According to Manuel Velasquez, there are three basic approaches to moral reasoning. These approaches include: (1) the utilitarian model, which evaluates actions based on the extent to which they achieve the greatest good for the greatest number; (2) the rights model, which protects individual moral rights; and (3) the justice model, which emphasizes a fair distribution of benefits and burdens. The AICPA CPC establishes guidelines for accountants in performing their responsibilities and is not based on a specific moral reasoning philosophy.

7. Which of the following statements regarding the FASB is true?
   (b) Members of the FASB are appointed by the Financial Accounting Foundation, which also provides general oversight.
   (c) The seven FASB appointees are full-time members, representing a wide cross-section of interests.
   (d) All of the above.

   **Answer: (d) all of the above**

   All of these statements are true.
8. In primary markets,
   (a) investors make exchanges with other investors.
   (b) companies borrow from lending institutions or issue capital stocks or bonds.
   (c) U.S. companies operate under regulations established by the International Accounting Standards Board.
   (d) managerial accounting statements are the primary source of information for investors making the buy, hold, and sell decisions.

   **Answer: (b)** companies borrow from lending institutions or issue capital stocks or bonds

   In a primary market, companies directly borrow or issue capital stocks and bonds. In a secondary market, investors make exchanges with each other; therefore (a) is incorrect. While the FASB and IASB are attempting to bring U.S. and international standards closer together, at the current time U.S. companies are required to adhere to U.S. GAAP, not international standards; therefore (c) is incorrect. Managerial accounting is used by internal users. Investors are external users, therefore (d) is incorrect.

9. Financial accounting information is
   (a) prepared to meet the decision-making information needs of internal users.
   (b) presented in published financial statements.
   (c) determined on a case-by-case basis by the management of each company.
   (d) seldom useful in the decision making of investors in primary markets.

   **Answer: (b)** presented in published financial statements

   Financial accounting is presented to external users via published financial statements that include notes to the statements; therefore (b) is correct and (a) is incorrect. This information is of vital importance to investors when they are making decisions about a company; therefore (d) is incorrect. Managerial accounting needs can be determined by each company, but financial accounting needs are determined and prescribed in accordance with GAAP; therefore (c) is incorrect.

10. The Financial Accounting Foundation
    (a) exercises general oversight over the FASB.
    (b) consists of seven full-time members appointed by the FASB.
    (c) issues Opinions that are considered to be a source of GAAP.
    (d) is governed by the 16-member FASAC.

   **Answer: (a)** exercises general oversight over the FASB

   The Financial Accounting Foundation is the parent organization that funds and oversees the FASB. It is governed by a 16-member board of trustees appointed by several organizations. The FAF appoints the seven members of the FASB; therefore (b) is incorrect. The FAF also appoints a 33-member FASAC that advises the FASB about policy issues and sets the priorities of topics the FASB considers; therefore (d) is incorrect. Opinions were issued by the APB from 1959 to 1973; therefore (c) is incorrect.

11. Investors need accounting information for which basic decision(s)?
    (a) to help determine when to sell stock
    (b) make decisions regarding buying stock
    (c) help in determining whether to remain invested in a company’s stock
    (d) all of the above.

   **Answer: (d)** all of the above

   Investors primarily use financial accounting information to make decisions regarding investing in a company's stock. The three basic decisions that an investor faces are whether to: buy, sell, or hold a company's stock.
12. Companies are not required to produce which of the following in their annual report?
   (a) the statement of cash flows
   (b) the balance sheet
   (c) the statement of changes in stockholders’ equity
   (d) All of the above are required to be presented in a company’s annual report.

   Answer: (c) the statement of changes in stockholders’ equity

   The statements that companies are required to present in their annual reports are (1) the statement of cash flows; (2) the balance sheet; and (3) the income statement. While most companies do present a statement of changes in stockholders’ equity, it is not required; therefore (b) is the correct answer.

13. IFRS:
   (a) are issued by the FASB.
   (b) is an abbreviation for International Financial Reports Subsection.
   (c) are considered to be a source of GAAP.
   (d) none of the above.

   Answer: (d) none of the above.

   IFRS, or International Financial Reporting Standards, are issued by the International Accounting Standards Board (IASB). The IASB is somewhat similar to the FASB and includes a 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.

14. During the FASB’s procedures for issuing accounting standards, several public hearings are held. These hearings are typically held following:
   (a) identification of a topic.
   (b) the issuance of an exposure draft.
   (c) the issuance of the final statement.
   (d) the appointment of a task force.

   Answer: (b) the issuance of an exposure draft

   The two periods when public hearings are generally held during standard setting are after the issuance of a discussion memorandum and after the issuance of an exposure draft. After a topic is identified, members of the task force are appointed and then research is conducted on the topic; therefore (a) and (d) are incorrect. After the research is conducted, the FASB issues a discussion memorandum and requests public comments. Based on these comments and research, the FASB deliberates and issues an exposure draft. Public hearings are held in response to the contents of the exposure draft. Based on these comments, changes are made in the exposure draft and voted on before the issuance of the final statement; therefore (c) is incorrect.
15. The organization tasked by Congress with the legal authority to prescribe accounting principles is:
(a) the Securities and Exchange Commission (SEC).
(b) the Financial Accounting Standards Board (FASB).
(c) the Financial Accounting Foundation (FAF).
(d) the Accounting Principles Board (APB).

Answer: (a) the Securities and Exchange Commission (SEC)
Congress, through passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, gave the SEC the authority to prescribe accounting principles and reporting practices for all companies issuing publicly traded securities. While the SEC has this authority they have deferred this authority to the private sector. FASB currently sets accounting principles, but is not legally authorized by Congress for this purpose; therefore (b) is incorrect. The FAF appoints and funds FASB and does not set principles; therefore (c) is incorrect. The APB was dissolved in 1973 when the FASB was created; therefore (d) is incorrect.

16. The group charged with setting accounting standards for negotiated federal contracts and subcontracts exceeding $500,000 is
(a) the Securities and Exchange Commission (SEC).
(b) the Financial Accounting Standards Board (FASB).
(c) the Cost Accounting Standards Board (CASB).
(d) the Governmental Accounting Standards Board (GASB).

Answer: (c) the Cost Accounting Standards Board (CASB)
Congress established the CASB in 1970, although it was inactive from 1980 to 1988, to set standards for federal contracts and subcontracts exceeding $500,000. The GASB is similar to the FASB under the auspices of the FAF to establish financial accounting standards for certain state and local governmental entities; therefore (d) is incorrect. The SEC is responsible for matters dealing with publicly traded companies; therefore (a) is incorrect. FASB is responsible for setting GAAP for financial accounting; therefore (b) is incorrect.

17. The Public Company Accounting Oversight Board (PCAOB) is tasked with:
(a) setting accounting principles.
(b) approving SEC regulations and releases.
(c) overseeing auditors of public companies and the audits they conduct.
(d) all of the above.

Answer: (c) overseeing auditors of public companies and the audits they conduct
Congress established the PCAOB with passage of the Sarbanes-Oxley Act of 2002 to oversee auditors and the audits they conduct of public companies after the accounting scandals at Enron and WorldCom. Any standard that the PCAOB passes must be approved by the SEC; therefore (b) is incorrect. The SEC is tasked with the legal authority to establish accounting principles; therefore (a) is incorrect.
Matching

1. Each of the organizations listed below has been a source of generally accepted accounting principles. Following the list is a series of descriptive statements. Match each descriptive statement with an organization by placing the appropriate letter in the space provided.

   a. Committee on Accounting Procedure
   b. Accounting Principles Board
   c. Financial Accounting Standards Board
   d. Securities and Exchange Commission
   e. American Institute of Certified Public Accountants

   ____ 1. Recognizing that accounting is part of a broad social system, this organization attempts to develop standards fairly, with due process, in a public forum.

   ____ 2. This AICPA organization, which had no enforcement authority, issued Accounting Research Bulletins.

   ____ 3. The 17 to 21 members of this group, working part-time, issued Opinions.

   ____ 4. This organization has seldom used its congressional authority to prescribe accounting principles and practice.

   ____ 5. The seven full-time members of this group issue several types of pronouncements, including Statements of Financial Accounting Concepts and Statements of Financial Accounting Standards.

   ____ 6. This group was criticized for lack of independence, overrepresentation of public accounting firms, and slow response time.

   ____ 7. This organization issues numerous publications, including Industry Audit Guides and Industry Accounting Guides.

   ____ 8. Members of this organization are appointed by the Financial Accounting Foundation, which raises funds and provides oversight.


   ____ 10. This is the professional organization for certified public accountants in the United States.
2. Below is a list of words or terms. Following the list is a series of descriptive phrases. Match each word or term with its descriptive phrase by placing the appropriate letter in the space provided.

a. primary markets  
g. AICPA Code of Professional Conduct  
b. internal users  
h. buy, hold, and sell  
c. justice model  
i. secondary markets  
d. annual report  
j. GAAP  
e. accounting  
k. FASB Financial Accounting Research System  
f. financial accounting  
l. creative thinking

_____ 1. A critical link between a company’s economic activities and decision makers who are interested in the company.

_____ 2. The information accumulation, processing, and communication system designed to satisfy the investment and credit decision-making information needs of external users.

_____ 3. Include both public offerings and private placements.

_____ 4. Accepted accounting practices and standards of reporting at a particular time.

_____ 5. Includes six basic principles for use as guidelines for ethical dilemmas by practicing accountants.

_____ 6. A company’s management.

_____ 7. The three basic decisions of investors.

_____ 8. Includes at least three major financial statements (balance sheet, income statement, and statement of cash flows), as well as notes, sometimes with supporting schedules.

_____ 9. Emphasizes the fair distribution of benefits and burdens.

_____ 10. Involves the use of imagination and insight to solve problems.

_____ 11. Includes the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation System.

_____ 12. Includes most accounting standards in its electronic database.
Below is a list of organizations that have influenced the development of accounting standards. Following the list is a series of descriptive phrases. Match each organization with a phrase by placing the appropriate letter in the space provided.

a. Emerging Issues Task Force
b. Cost Accounting Standards Board
c. Internal Revenue Service
d. American Accounting Association
e. International Accounting Standards Board
f. Government Accounting Standards Board
g. Association for Investment Management and Research
h. Financial Executives Institute
i. American Institute of Certified Public Accountants
j. Financial Accounting Standards Board
k. Securities and Exchange Commission
l. Institute of Management Accountants

___ 1. An association of financial analysts.
___ 2. Composed of 12 full-time (and 2 part-time) members from various countries.
___ 3. Identifies significant emerging accounting issues.
___ 4. Charged with developing accounting principles for negotiated federal contracts and subcontracts exceeding $500,000.
___ 5. Issues rules that sometimes conflict with the goals of financial accounting.
___ 6. Influences the development of accounting standards through education and persuasion.
___ 7. Establishes accounting standards for certain state and local government entities.
___ 8. Made up mainly of high-level financial executives.
___ 9. Formed the CAP and the APB.
___ 10. Emphasizes managerial and cost accountancy.
___ 11. Composed of seven full-time, fully paid members.
___ 12. Has the legal authority to prescribe accounting principles for publicly traded companies.
Answers to Matching

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