

CHAPTER 1

THE ENVIRONMENT OF FINANCIAL REPORTING

CONTENT ANALYSIS OF CASES

<u>Number</u>	<u>Content</u>	<u>Time Range (minutes)</u>
C1-1	<u>Pronouncements</u> . Matching a list of descriptive statements with a list of pronouncements establishing or related to generally accepted accounting principles.	5-10
C1-2	<u>Accounting Organizations</u> . Matching of a list of descriptive statements with a list of abbreviations of accounting organizations. Identify complete name of each organization.	10-15
C1-3	<u>History of Establishment of GAAP</u> . Discuss CAP, APB, FASB, and related pronouncements.	15-30
C1-4	(AICPA adapted). <u>Accounting Principles</u> . Define accounting principles. Discuss sources of GAAP.	10-20
C1-5	(CMA adapted). <u>Standard Setting</u> . Describe why there is political action and social involvement in the standard setting process.	10-20
C1-6	<u>Organization of the FASB</u> . Summarize the structure of the FASB, its documents (GAAP pronouncements), and its operating procedures.	10-20
C1-7	<u>GAAP and the AICPA</u> . Summarize the GAAP-related documents published by the AICPA.	5-10
C1-8	<u>Code of Professional Conduct</u> . Identify, briefly discuss, and provide examples to illustrate the first five principles of CPC.	10-20
C1-9	<u>GAAP Hierarchy</u> . Define GAAP, indicate where to find GAAP, and identify which GAAP are more important (hierarchy).	10-20
C1-10	<u>Lobbying the FASB</u> . Discuss pros and cons of lobbying FASB by interested parties.	5-15
C1-11	<u>Ethical Dilemma</u> . Discuss steps to take in an ethical dilemma ("misplaced" book in library).	10-20
C1-12	<u>Ethical Responsibilities</u> . Discuss steps to take in an ethical dilemma (cheating by friend on exam).	10-20
C1-13	(Appendix) <u>International Convergence</u> . Discuss convergence of U.S. GAAP and international accounting standards. Include discussion of SEC and its role in this convergence.	15-30

ANSWERS TO QUESTIONS

- Q1-1 Primary markets are those capital markets where the exchanges of stocks and bonds are directly between a corporation and investors. Secondary markets are those where the exchanges are among the investors themselves.
- Q1-2 The users of financial information can be divided into two major categories: external users and internal users. These two groups do not have the same decision making information needs because of their differing relationships with the company providing economic information. External users need information for three basic decisions--whether to buy, to hold, or to sell (or in the case of creditors, whether to extend credit, maintain the credit relationship, or not extend credit). These users rely mainly on financial statements in their decision processes. Internal users (i.e., a company's management) need information to make planning and operating decisions, and may request any information they need which the accounting system is capable of providing.
- Q1-3 Financial accounting is the information accumulation, processing, and communication system designed to provide investment and credit decision-making information for external users of accounting information. Financial accounting information is communicated 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 constrained by how useful the information is for a specific decision and by the cost of providing that information.
- Q1-4 Financial reporting is the process of communicating financial accounting information about a company to external users. An important way a company's financial accounting information is reported is in its annual report.
- Q1-5 The three major financial statements of a company and what they show are: (1) the balance sheet (or statement of financial position) which shows the company's financial position at a given date, (2) the income statement which shows the results of the company's income-producing activities for a period of time, and (3) the statement of cash flows which shows the cash inflows and cash outflows for a period of time. Many companies also present 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.
- Q1-6 Generally accepted accounting principles (GAAP) are the guidelines, procedures, and practices that a company is required to use in recording and reporting the accounting information in its audited financial statements. The four accounting bodies that have established GAAP in the U.S. are the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB), American Institute of Certified Public Accountants (AICPA), and the Committee on Accounting Procedure (CAP). The Securities and Exchange Commission (SEC) also establishes GAAP.

- Q1-7 There are four categories of GAAP in the hierarchy of sources of GAAP. The pronouncements included in Category A are FASB Statements of Financial Accounting Standards and Interpretations, FASB Statement 133 Implementation Issues, FASB Staff Positions, and APB Opinions and AICPA Accounting Research Bulletins not superceded by actions of the FASB (as well as SEC Regulation S-X and Financial Reporting Releases for companies that file with the SEC).
- Q1-8 The CAP was the Committee on Accounting Procedure. This group issued pronouncements on accounting procedures and practice. These pronouncements were published as Accounting Research Bulletins. The CAP was replaced by the APB in 1959.
- The APB was the Accounting Principles Board. It was formed as an attempt to create a policy-making body whose rules would be binding rather than optional. The pronouncements of the APB were termed Opinions of the Accounting Principles Board. The APB was phased out and replaced in 1973 by the FASB.
- The FASB is the Financial Accounting Standards Board. This Board was formed upon the recommendations of the Wheat Committee. The FASB issues four types of documents which constitute GAAP: Statements of Financial Accounting Standards, Interpretations, Staff Positions, and Technical Bulletins. Statements of Financial Accounting Concepts constitute GAAP in some instances.
- Q1-9 Before issuing a Statement of Concepts or Standards, the FASB generally completes a multistage process as follows:
- (1) identifies topic
 - (2) appoints task force
 - (3) conducts research
 - (4) issues Discussion Memorandum or Invitation to Comment
 - (5) holds public hearings
 - (6) deliberates on findings
 - (7) issues Exposure Draft
 - (8) holds public hearings
 - (9) modifies Exposure Draft
 - (10) votes
- After a 4-3 simple majority vote is attained, the Statement is issued.
- Q1-10 The FASB issues five types of pronouncements:
1. Statements of Financial Accounting Standards. These pronouncements are releases indicating the methods and procedures required on specific accounting issues.
 2. Interpretations. These pronouncements provide clarifications of conflicting or unclear issues relating to previously issued FASB Statements, APB Opinions, or Accounting Research Bulletins.
 3. Staff Positions. The staff of the FASB issues these pronouncements to provide more timely and consistent application guidance in regard to FASB literature.
 4. Technical Bulletins. These pronouncements are issued by the staff of the FASB to provide guidance on accounting and reporting problems related to Statements of Standards or Interpretations.

Q1-10 (continued)

5. Statements of Financial Accounting Concepts. These pronouncements are a series establishing a theoretical foundation upon which to base financial accounting and reporting standards. They are the output of the FASB's "conceptual framework" project.

Q1-11 The organizations other than the FASB that have had an impact on the development of generally accepted accounting principles are the: (1) Securities' and Exchange Commission, (2) American Institute of Certified Public Accountants, (3) FASB Emerging Issues Task Force, (4) International Accounting Standards Board, (5) Governmental Accounting Standards Board, (6) Public Company Accounting Oversight Board, (7) Cost Accounting Standards Board, (8) Internal Revenue Service, and (9) American Accounting Association.

Q1-12 The IASB is the International Accounting Standards Board. The IASB has 12 full-time members (and 2 part-time members) from various countries. It issues International Financial Reporting Standards (IFRS). 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 9 members of the IASB, the International Financial Reporting Standard is issued.

Q1-13 The professional organizations that play an important role in the accounting standard-setting process include the: (1) Financial Executives Institute, (2) Institute of Management Accountants, and (3) CFA Institute.

Q1-14 The Code of Professional Conduct is a document published by the AICPA to help guide members in public practice, industry, government, and education in performing their responsibilities in an ethical and professional manner. The six areas covered by the Principles include: (1) responsibilities, (2) public interest, (3) integrity, (4) objectivity and independence, (5) due care, and (6) scope and nature of services.

Q1-15 The steps a person should follow to determine whether an action is ethical include: (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 based on an evaluation of the applicable ethical criteria.

Q1-16 Creative thinking is the process of finding new relationships or ideas among items of information that potentially can be used to solve a problem. It involves using imagination and insight in order to view issues in a different light.

A creative thinker may be described as being insightful, intuitive, imaginative, sensitive, flexible, original, adaptable, and tolerant of ambiguity.

- Q1-17 Critical thinking is the process of testing new relationships or ideas in order to determine how well they will work. It involves the use of inductive or deductive reasoning to analyze an issue in a logical manner.
- A critical thinker may be described as being objective, independent, analytical, logical, rational, able to synthesize, consistent, and organized.
- Q1-18 The FASB and the IASB entered into the "Norwalk Agreement" to work toward the development of high-quality, compatible accounting standards. They entered into this agreement so that these standards could be used for both "domestic" and "cross-border" financial reporting.
- Q1-19 The four related long-term convergence projects of the FASB and IASB deal with business combinations, revenue recognition, a conceptual framework, and financial statement presentation.
- Q1-20 The SEC is considering requiring U.S. companies to use IFRS in preparing their financial statements that they file with the SEC.

ANSWERS TO CASES

C1-1

 E 1. B 3. G 5. F 7. C 2. D 4. A 6.

C1-2

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|--------------|-----|--|
| <u> C </u> | 1. | Committee on Accounting Procedure (CAP) |
| <u> G </u> | 2. | Cost Accounting Standards Board (CASB) |
| <u> A </u> | 3. | Internal Revenue Service (IRS) |
| <u> D </u> | 4. | International Accounting Standards Board (IASB) |
| <u> J </u> | 5. | Governmental Accounting Standards Board (GASB) |
| <u> H </u> | 6. | Financial Accounting Standards Board (FASB) |
| <u> I </u> | 7. | Public Company Accounting Oversight Board (PCAOB) |
| <u> F </u> | 8. | Financial Accounting Standards Advisory Council (FASAC) |
| <u> B </u> | 9. | Accounting Principles Board (APB) |
| <u> E </u> | 10. | Securities and Exchange Commission (SEC) |
| <u> K </u> | 11. | American Institute of Certified Public Accountants (AICPA) |
| <u> L </u> | 12. | Emerging Issues Task Force (EITF) |

C1-3

Three organizations primarily have been responsible for the establishment of generally accepted accounting principles in the private sector of the U.S. These organizations are the Committee on Accounting Procedure (CAP), the Accounting Principles Board (APB), and the Financial Accounting Standards Board (FASB).

In 1938, the AICPA formed the CAP. This group was responsible for issuing pronouncements to narrow the differences in accounting procedures and practice. These pronouncements were published as Accounting Research Bulletins. From the CAP's inception until 1953, it issued 42 Accounting Research Bulletins, and in 1953 these pronouncements were reviewed and codified into Accounting Research Bulletin No. 43. The CAP subsequently issued eight more Accounting Research Bulletins, ending with No. 51. The CAP was replaced by the APB in 1959, but all Accounting Research Bulletins still constitute generally

C1-3 (continued)

accepted accounting principles unless specifically superseded or amended by other authoritative bodies.

In 1959, the APB was formed by the AICPA as an attempt to (1) alleviate the criticism of the methods of formulating accounting principles, and (2) create a policy-making body whose rules would be binding rather than optional. The pronouncements of the APB were termed Opinions of the Accounting Principles Board, and ultimately 31 of these Opinions were issued. All APB Opinions are sources of generally accepted accounting principles, unless specifically amended or rescinded. Many of these Opinions were based upon Accounting Research Studies which were written by individuals commissioned by the APB.

By the late 1960s criticism again arose about the development of accounting principles. This criticism centered on independence, representation, and response time. As a result, the AICPA appointed the Wheat Committee which recommended that the APB be abolished and that a new full-time body be established.

Thus, the APB was phased out and replaced in 1973 by the FASB. Appointees to the FASB are full-time members with no other organizational ties and are selected to represent a wider cross section of interests. The FASB issues four types of pronouncements: Statements of Financial Accounting Standards, Interpretations, Technical Bulletins, and Statements of Financial Accounting Concepts.

Statements of Financial Accounting Standards are releases indicating the methods and procedures required on specific accounting issues. Interpretations provide clarification of conflicting or unclear issues relating to previously issued FASB Statements of Standards, APB Opinions, or Accounting Research Bulletins. Technical Bulletins are issued by the staff of the FASB to provide guidance on accounting and reporting problems related to Statements of Standards or Interpretations. Statements of Financial Accounting Concepts are a series establishing a theoretical foundation upon which to base financial accounting and reporting standards. They are the output of the FASB's "conceptual framework" project. All of these pronouncements are sources of generally accepted accounting principles.

C1-4 (AICPA adapted solution)

1. The term "accounting principles" in the auditor's report includes not only accounting principles but also practices and the methods of applying them. Though the term quite naturally emphasizes the primary or fundamental character of some principles, it includes general rules adopted or professed as guides to action in practice. The term does not connote, however, rules from which there can be no deviation. In some cases, the question is which of several partially relevant principles has determining applicability. Neither is the term "accounting principles" necessarily synonymous with accounting theory. Accounting theory is the broad area of inquiry devoted to the definition of objectives to be served by accounting, the development and elaboration of relevant concepts, the promotion of consistency through logic, the elimination of faulty reasoning, and the evaluation of accounting practice.
2. Generally accepted accounting principles are those principles (whether or not they have only limited usage) that have substantial authoritative support. Whether a given principle has authoritative support is a question of fact and a matter of judgment. The CPA is responsible for collecting the available evidence of authoritative support and judging whether it is sufficient to bring the practice within the bounds of generally accepted accounting practices.

C1-4 (continued)
2. (continued)

Pronouncements of the FASB, APB, AICPA, and SEC, if there are any on the subject in question, would be given greater weight than other single sources. Pronouncements of the FASB, APB, and AICPA constitute substantial authoritative support, and the evidence would tend to be conclusive if the SEC has issued an affirmative opinion on the same subject. These pronouncements include FASB Statements of Standards, Interpretations, and Staff Positions, APB Opinions, AICPA Accounting Research Bulletins, and SEC Regulation S-X, Financial Reporting Releases, and Staff Accounting Bulletins for companies that file with the SEC. However, substantial authoritative support also can exist for accounting principles in other pronouncements.

Other evidence of authoritative support may be found in the FASB's Technical Bulletins, Questions and Answers, and Statements of Concepts, the AICPA's Interpretations, Audit Guides, Accounting Guides, Issue Papers, Technical Practice Aids, and, Practice Bulletins, the FASB EITF Consensus Positions and the IASB International Financial Reporting Standards. The affirmative opinions of practitioners and academicians in articles, textbooks, and expert testimony may also provide evidence. Similarly, the views of stock exchanges, commercial and investment bankers, and regulatory commissions influence the general acceptance of accounting principles and hence are considered in determining whether an accounting principle has substantial authoritative support. Business practice also is a source of evidence. Finally, because they influence business practice, the tax code and state laws are also sources of evidence.

C1-5 (CMA adapted)

Financial accounting standards inspire or encourage political action and social involvement during the standard setting process because the effects of accounting standards are wide-ranging and impact many varying groups. The setting of accounting standards is a social decision and the user groups play a significant role and have considerable influence.

The economic consequences of financial accounting standards inspire special interest groups to become vocal and critical when standards are being formulated. The reporting of financial information impacts organizations' financial statements and the wealth and decision-making of organizations in differing ways. In addition, some important components of financial information, e.g., net income, cannot be verified empirically. The way financial data is presented impacts user perceptions and influences investment decisions. User groups may want particular economic events accounted for in particular ways, and are willing to fight for what they want.

The formulation of accounting standards has political roots in the Securities and Exchange Acts of 1933 and 1934. Although the SEC was vested with complete authority to define and formulate accounting standards, it has, for the most part, delegated this authority to the private sector. The SEC supports the FASB in this endeavor and encourages its "due process" system of standard setting. Financial accounting standards issued are considered to be "generally accepted accounting principles" and, as such, they must be followed in the preparation of financial statements. Public accounting firms and independent CPAs are prohibited from expressing opinions on financial statements unless they conform to these principles. Therefore, the formulation of standards is of vital interest to these groups as well as the client organizations responsible for the financial statements.

C1-6

The Financial Accounting Foundation 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 (the AICPA, Financial Executives Institute, 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 interested in the formulation of accounting principles. The primary responsibilities of the Financial Accounting Foundation are to provide general oversight to its operations and appoint the members of the Financial Accounting Standards Advisory Council (FASAC) and the FASB. The FASAC consists of 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 and are selected to represent a wide cross-section of interests. Each Board member is required to have a knowledge of, and experience in, accounting, finance, investing, 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 performs numerous functions such as researching issues, communicating with constituents, and drafting preliminary findings. The administrative staff assists the FASB by handling library, publications, personnel, and other activities.

The FASB issues several types of pronouncements:

1. Statements of Financial Accounting Standards. These pronouncements establish generally accepted accounting principles. They indicate the methods and procedures required on specific accounting issues.
2. Interpretations. These pronouncements provide clarification of conflicting or unclear issues relating to previously issued FASB Statements of Standards, APB Opinions, or Accounting Research Bulletins. Interpretations also establish or clarify generally accepted accounting principles.
3. Staff Positions. The staff of the FASB issues these pronouncements to provide more timely and consistent application guidance in regard to FASB literature. In addition, at the direction of the FASB, the staff may issue Staff Positions to make narrow and limited revisions of FASB Statements of Financial Accounting Standards or Interpretations that previously would have been made through Technical Bulletins.
4. Technical Bulletins. These pronouncements are issued by the staff of the FASB to provide guidance on accounting and reporting problems related to Statements of Standards or Interpretations. The guidance may clarify, explain, or elaborate upon an underlying standard.
5. Statements of Financial Accounting Concepts. These pronouncements establish a theoretical foundation upon which to base financial accounting and reporting standards. These Statements are the output of the FASB's "Conceptual Framework" project.
6. Other Pronouncements. On a major topic, the FASB staff may also issue a Guide for Implementation which is in the form of questions and answers (referred to as FASB Q's and A's).

C1-6 (continued)

Before issuing a statement of concepts or standards, the FASB generally completes a multistage process, although the sequence and numbers of steps may vary. 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 on such matters as the scope of the project and the nature and extent of additional research. The Staff then conducts any research specifically related to the project.

A Preliminary Views document or Invitation to Comment, which outlines the research related to the issues, is then usually published and a public comment period is set. During this period, public hearings, similar to those conducted by Congress, may be held. 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 academicians, to name a few. After deliberating on the views expressed and information collected, the FASB issues an Exposure Draft of the proposed Statement. Interested parties generally have 30-90 days to provide written comments of reaction. On major issues, more public hearings may be held. Sometimes, "field tests" of the proposed standards are conducted with selected companies to evaluate implementation issues. A modified draft is prepared, if necessary, and brought to the FASB for a final vote. After 3 to 2 simple-majority vote is attained, the Statement is issued.

C1-7

The AICPA publishes numerous documents that may be considered as sources of GAAP. For example, 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. 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. Issue Papers help the FASB identify accounting areas that need to be addressed and clarified.

The AICPA also annually publishes Accounting Trends and Techniques which provides a study of the latest accounting practices and trends, as identified from a survey of 600 published annual reports. The AICPA has also issued numerous Accounting Interpretations to provide timely guidance on accounting issues without the formal procedures necessary for an APB Opinion.

C1-8

The first five principles of the AICPA's Code of Professional Conduct are as follows:

1. Responsibilities: In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities. For example, when a member chooses a depreciation method, she must carefully analyze each alternative based upon well-defined criteria before making a final choice.
2. The Public Interest: Members should act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism. When a member refuses to ignore internal control deficiencies in a company with publicly traded stock, but instead enumerates these deficiencies in the Auditor's report, she is adhering to the public interest principle.

C1-8 (continued)

3. Integrity: To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity. For example, a member who carefully and conscientiously performs each step of an audit without skipping those steps that are tedious or of less interest is exercising the integrity principle.
4. Objectivity and Independence: A member should be objective and be 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. For example, a member who declines to audit the financial statements of the company for which his father is a marketing vice president is adhering to this principle.
5. Due Care: A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability. When a member reads current accounting literature and strives to employ current principles and procedures, she is exercising due care.

C1-9

The "rules" for financial accounting are called generally accepted accounting principles. Generally accepted accounting principles (GAAP) are the guidelines, procedures, and practices that a company is required to use in recording and reporting the accounting information in its audited financial statements. GAAP define accepted accounting practices at a particular time and provide a standard by which to report financial results. They are like laws that must be followed in financial reporting.

There are several accounting policy-making bodies that have established GAAP, including the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB), American Institute of Certified Public Accountants (AICPA), and Securities and Exchange Commission (SEC). Currently, there is no single document that includes all the accounting standards. However, the FASB has released its FASB Accounting Standards Codification for verification by its constituents. When finalized, this Codification will be electronic and will integrate and topically organize U.S. accounting standards. In the meantime, there are electronic data bases, such as the FASB Financial Accounting Research System (FARS) that include most accounting standards. In addition, the FASB standards are published each year as part of the FASB's Accounting Standards series. These standards are included in three-volume set entitled Original Pronouncements which contains each major pronouncement as of its date of publication. Another two-volume set entitled Current Text (General Standards and Industry Standards), is a topical integration of currently effective accounting and reporting standards as of its date of publication. The AICPA and SEC standards are also published on an annual basis.

C1-9 (continued)

The following is a "hierarchy" of four categories of GAAP and the authoritative sources applicable to each category for companies:

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

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

These categories are listed in descending order of importance, with Category A as the most important. Companies must follow the GAAP established by the pronouncements in this category unless, in unusual circumstances, they result in misleading financial statements. In these situations where the accounting for a transaction or event is not specified by a pronouncement in category A, then pronouncements in categories B through D may be used in that order to identify GAAP. Generally, pronouncements in category B take precedence over those in category C which, in turn, take precedence over those in category D. When none of the pronouncements in categories A through D are applicable, then the company may consider other accounting literature such as FASB Statements of Concepts, AICPA Issues Papers, IASB International Financial Reporting Standards, AICPA Technical Practice Aids, and accounting textbooks, handbooks, and articles for GAAP guidance.

C1-10

On balance, most people would agree that it is a good idea for the FASB to allow written comments and oral presentations in which interested parties can lobby for a particular ruling. However, there are both pros and cons to allowing interested parties to provide input to its deliberation process. They include:

Advantages

- Enables FASB to get input from different perspectives
- Provides users a forum to express concerns
- Provides preparers a forum to express concerns
- Provides auditors a forum to express concerns
- Overcomes criticism of failing to listen to constituencies
- Allows for consideration of views of all interested parties
- Rulings appear more fair to all constituencies
- Rulings consider the costs and benefits of implementation
- Standards are established that are the most acceptable
- Allows for clarification of rules
- Allows for corrections of any errors
- Allows for consideration of implementation issues

Disadvantages

- Rulings sometimes appear to be biased in favor of certain user group
- Rulings sometimes are inconsistent with other Statements of Standards
- Rulings sometimes are inconsistent with Statements of Concepts
- Rulings sometimes appear illogical
- FASB is too slow in establishing standards
- Standards are too complex and difficult to implement

C1-11

Note to Instructor: Listed below are some possible findings that students may discuss at each step in the moral reasoning process:

- I. Gather facts: (A) What has occurred? (1) there is only one copy of the needed book, (2) everyone in my class is required to use the book to write a report, (3) the book has been intentionally misfiled. (B) Who are the stakeholders? (1) me, (2) classmate who has misfiled the book, (3) other member of the class, (4) the professor, (5) other students wanting to use the book, (6) library staff. (C) What are my responsibilities? (1) to write a report (2) to be socially responsible.

C1-11 (continued)

- II. Ask whether the action (my classmate misfiling the book) is acceptable according to three ethical criteria: (A) Utility: Does the action optimize the satisfactions of all stakeholders? (1) the classmate who misfiled the book can satisfactorily use the book without having to wait his turn, (2) I am unable to use the book to finish my report, (3) the rest of the class cannot use the book to finish their reports, (4) the professor cannot collect the assignment on the regularly scheduled due date, (5) others wanting to use the book cannot find it, (6) library staff will be forced to search for the book. (B) Rights: Does the action respect the rights of all? (1) the classmate who misfiled the book has the right to use the book, (2) other members of the class as well as other students have the right to use the book, but cannot if it is misfiled, (3) the professor cannot exercise his/her right to set due dates and expect them to be adhered to, (4) the library staff cannot effectively and efficiently perform its job. (C) Justice: Is the act fair and just? (1) purposely preventing others from completing an assignment is not fair, (2) making it difficult for others to find a book is not just, (3) inhibiting the library staff's ability to perform its job is not fair, (4) forcing the professor to accept late reports is not just.
- III. Consider whether there are any overwhelming factors affecting criteria: In this situation, there do not appear to be overwhelming factors but students may bring up issues like: (1) classmate has full-time job, (2) classmate is disabled, (3) classmate has family (or other) obligations, (4) library has limited hours.
- IV. Decide what ethical action to take: Students may decide on a number of alternative courses of action, including: (1) doing nothing, (2) discussing with classmate, (3) discussing with other students to exert pressure on classmate to refile book, (4) reporting to professor (in person or anonymously).

C1-12

Note to Instructor: Listed below are some possible findings that students may discuss at each step in the moral reasoning process:

- I. Gather facts: (A) What has occurred? (1) my friend copied an answer, (2) she received an A on the test, (3) I received a B on the test, (4) our professor is unaware that she cheated, (5) I am aware that she cheated. (B) Who are the stakeholders: (1) my friend who cheated, (2) me, (3) student from whom my friend copied the answer, (4) our professor, (5) other members of the class, (6) all students in other sections of the same course, (7) all accounting students at my school who have taken the same class, (8) all students who will be competing with my friend for jobs, (9) all accountants, (10) company that hires her.

C1-12 (continued)

- II. Ask whether the action (my friend's cheating) is acceptable according to three ethical criteria: (A) Utility: Does the action optimize the satisfaction of all stakeholders? (1) her copying led to a short-term satisfaction in the form of an A. However, in the long-run, this A may prove to be harmful to her if she views the A as a reward for cheating and continues to cheat in the future, (2) my receipt of a lower grade puts her at an unfair advantage over me, (3) others in the class who received the same grade as her had to rely on their own effort and intelligence, whereas she was rewarded with the same grade for relying on someone else's work, (4) others in the class who received a lower grade than her are at a disadvantage to her even though they may be equally intelligent, (5) because recruiters compare the grades of all their applicants, she will appear more qualified because her A will cause her GPA to increase, (6) the professor may be placed in a position of giving her a higher recommendation than warranted, (7) her future employer may be depending on higher qualifications than she has. (B) Rights: Does the action respect the rights of all? (1) my friend forfeited her right to a good grade by cheating, (2) others in the class had their rights violated because they can no longer compete fairly, (3) the professor can no longer exercise his/her right to distribute grades fairly, (4) recruiters cannot exercise their right to use GPA as a quantitatively reliable guide for selecting employees. (C) Justice: Is the act fair and just? (1) cheating is not generally accepted as being fair, (2) receiving a better grade through deceit is not just, (3) having an advantage in recruiting due to dishonesty is not fair.
- III. Consider whether there are any overwhelming factors between criteria: In this situation, there do not appear to be overwhelming factors but students may bring up issues like: (1) friend has full-time job, (2) friend is disabled, (3) friend has family (or other) obligations, (4) friend was sick before class, (5) friend was an athlete.
- IV. Decide what ethical action to take: Students may decide on a number of alternative courses of action, including: (1) doing nothing, (2) discussing with friend, (3) discussing with student from whom friend copied (or other students) to exert pressure on friend to confess action to professor, (4) reporting to professor (in person or anonymously).

C1-13

Currently, U.S. corporations are subject to the accounting "rules" or accounting standards (called U.S. GAAP) established by the Financial Accounting Standards Board (FASB), while foreign corporations are subject to international standards called IFRS (international financial reporting standards) established by the International Accounting Standards Board (IASB) or 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.

To overcome this problem, in 2002 the FASB and the IASB entered into an agreement in which each Board acknowledged their 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

C1-13 (continued)

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.

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 world-wide basis. In accordance with its agreement with the IASB, the FASB has undertaken six key initiatives to help attain the goal of convergence (harmonization) of U.S. accounting standards with international accounting standards. These initiatives include: (1) conducting long-term joint projects with the IASB, (2) participating in the short-term convergence project, (3) monitoring of IASB projects, (4) conducting a convergence research project, (5) explicitly considering the convergence potential in all of the Board's agenda decisions, and (6) having a liaison IASB member on site at the FASB offices.

The FASB and the IASB have been cooperating for several years on four long-term joint convergence projects. These include: (1) business combinations, (2) revenue recognition, (3) a conceptual framework, and (4) financial statement presentation. They are also cooperating on several short-term convergence projects. For instance, the FASB has issued standards relating to: (1) inventory costs, (2) asset exchanges, (3) accounting changes, and (4) earnings per share.

The progress of the FASB and the IASB has been slow and very few converged 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 its filing regulations for foreign companies, and (2) considering changing its filing requirements for U.S. companies.

In the past, a foreign company filing its financial statements with the SEC that used accounting standards other than U.S. GAAP had to file a form 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.

The movement by more foreign companies to using IFRS has created two potential problems for U.S. companies using U.S. GAAP ("regulated companies") 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 they 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 the SEC. There are many issues related to this possible change and they are very complex and far reaching. These include:

C1-13 (continued)

- (1) 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.
- (2) 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, potentially affecting the ability of external users in U.S. capital markets to evaluate different companies' operating performances.
- (3) More than 99 percent 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 U.S.
- (4) Investors, creditors, financial analysts, and other external users would have to "restrain" 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.
- (5) High-quality, international auditing standards and practices would have to be developed to ensure that the IFRS are rigorously interpreted and applied.
- (6) 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.
- (7) 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.
- (8) 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.
- (9) Some accounting issues (e.g., related to extractive industries) are not covered by IFRS. New high-quality IFRS would have to be established to address these issues.
- (10) 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 the SEC) in the standard-setting (and enforcement) process.
- (11) 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.
- (12) 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.

C1-13 (continued)

The FASB has indicated that it favors the required use of IFRS by all U.S. firms 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 certain IFRS would need to be improved through an ongoing convergence effort. This blueprint should identify a target date for completing the transition to IFRS so that affected constituents can set their timetables. And, the blueprint should identify the areas of IFRS that should 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.

In response, the SEC has issued a proposal that would require U.S. companies filing with it to use IFRS beginning in 2014. 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.