Financial Accounting and Accounting Standards

CHAPTER STUDY OBJECTIVES

1. Describe the essential characteristics of accounting.
2. Identify the major financial statements and other means of financial reporting.
3. Explain how accounting assists in the efficient use of scarce resources.
4. Identify some of the challenges facing accounting.
5. Identify the objectives of financial reporting.
6. Explain the need for accounting standards.
7. Identify the major policy-setting bodies and their role in the standard-setting process.
8. Explain the meaning of generally accepted accounting principles.
9. Describe the impact of user groups on the standard-setting process.
10. Understand issues related to ethics and financial accounting.

CHAPTER REVIEW

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

Nature of Financial Accounting

2. (S.O. 1) Accounting may best be defined by describing the three essential characteristics of accounting: (1) identification, measurement, and communication of financial information about (2) economic entities to (3) interested persons. Financial accounting is the process that culminates in the preparation of financial reports on the enterprise as a whole for use by parties both internal and external to the enterprise.

3. (S.O. 2) Financial statements are the principal means through which financial information is communicated to those outside an enterprise. The financial statements most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners’ or stockholders’ equity. Other means of financial reporting include the president’s letter or supplementary schedules in the corporate annual report, prospectuses, and reports filed with government agencies.

4. (S.O. 3) Accounting is important for markets, free enterprise, and competition because it assists in providing information that leads to capital allocation. The better the information, the more effective the process of capital allocation and then the healthier the economy.
5. (S.O. 4) The challenges facing financial accounting are the following:
   a. **Non-financial measurements** such as customer satisfaction indexes, backlog information, and reject rates on goods purchased.
   b. **Forward-looking information.**
   c. **Soft assets.**
   d. **Timeliness.**

6. (S.O. 5) The objectives of financial accounting are to provide information:
   a. that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions;
   b. to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of perspective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans; and
   c. about the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

7. (S.O. 6) The accounting profession has developed a common set of standards and procedures known as **generally accepted accounting principles (GAAP).** These principles serve as a general guide to the accounting practitioner in accumulating and reporting the financial information of a business enterprise. Although the adoption of some generally accepted accounting principles has caused controversy among accountants as well as members of the financial community, a majority of the members in each group recognize the ultimate benefit an accepted set of accounting principles can bring to the financial reporting process.

**Accounting Organizations**

8. (S.O. 7) Financial accounting standards in use at this time in the United States are primarily a result of the accounting profession’s efforts during the past 75 years. Prior to that time accounting practices were relatively unsophisticated owing to the lack of extensive economic development in the United States. The **American Institute of Certified Public Accountants (AICPA),** the national professional organization of practicing Certified Public Accountants (CPAs), has been a catalyst in the development of GAAP in the United States. Although the responsibility for setting accounting standards now rests with the FASB, the Securities and Exchange Commission (SEC), the Governmental Accounting Standards Board (GASB), and other organizations can and do influence the standards-setting process.

9. The **SEC** takes a great deal of interest in the standards developed by the accounting profession. The SEC is an agency of the federal government that monitors the activities of corporate enterprises whose stock is publicly held. The SEC requires each corporate entity under its jurisdiction to **file a set of annual audited financial statements.** The SEC has the mandate to establish accounting principles; however, the SEC’s involvement in the development of accounting standards has varied. In general, the SEC has supported the development of accounting standards by the private sector, however, there have been times when they have stepped in and prodded the private sector into a different direction.

10. The first group appointed by the AICPA to address the issue of uniformity in accounting practice was the **Committee on Accounting Procedure (CAP).** This group served the accounting profession from 1939 to 1959. During that period they issued 51 **Accounting Research Bulletins (ARBs)** that narrowed the wide range of alternative accounting practices then in existence. Even though the work of the Committee on Accounting Procedure was a valuable aid to accounting practitioners, the authority for their pronouncements rested solely on general acceptance by the accounting profession.

11. In 1959, the AICPA created the **Accounting Principles Board (APB).** The major purposes of this group were (a) to advance the written expression of accounting principles, (b) to determine
appropriate practices, and (c) to narrow the areas of difference and inconsistency in practice. The APB was designated as the AICPA's sole authority for public pronouncements on accounting principles. Their pronouncements, known as APB Opinions, were intended to be based mainly on research studies and be supported by reasons and analysis. The APB Opinions constituted GAAP until superseded by subsequent pronouncements of the body designated by the accounting profession to issue such pronouncements. Although the AICPA recognized other sources as providing substantial authoritative support for accounting practices, the burden for justifying a departure from financial accounting standards rests with the reporting member.

The FASB

12. The APB operated in a somewhat hostile environment for 13 years. Early in its existence it was criticized for overreacting to certain issues. A committee, known as the Study Group on Establishment of Accounting Principles (Wheat Committee), was set up to study the APB and recommend changes in its structure and operation. The result of the Study Group’s findings was the demise of the APB and the creation of the Financial Accounting Standards Board (FASB). The FASB represents the current rule-making body within the accounting profession.

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

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

14. The FASB issues Statements of Financial Accounting Standards and Interpretations. Both the Standards and the Interpretations are considered GAAP and must be followed in practice in the same manner as APB Opinions. The FASB also issues Statements of Financial Accounting Concepts (SFAC) and Technical Bulletins. The SFAC represent and attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a body of theory, or conceptual framework, that will serve as a tool for solving existing and emerging problems in a consistent, sound manner. Unlike FASB Statements, the Concept Statements do not establish GAAP. Technical Bulletins provide answers to specific questions related to the application and implementation of FASB Statement or Interpretations, APB Opinions, and ARBs. Technical Bulletins do not alter GAAP; they merely provide guidance on questions related to existing GAAP.
15. In 1984, the FASB created the **Emerging Issues Task Force (EITF)**. The purpose of the Task Force is to reach a consensus (15 of 17 members must agree) on how to account for new and unusual financial transactions that have the potential for creating diversity in financial reporting practices. The EITF can deal with short-term accounting issues by reaching a consensus and thus avoiding the need for deliberation by the FASB and the issuance of an FASB Statement. The Governmental Accounting Standards Board (GASB) was created in 1984 to address state and local governmental reporting issues. The operational structure of the GASB is similar to that of the FASB.

16. There are other professional groups and agencies that have influenced accounting theory and the development of accounting standards. These groups include: The **American Accounting Association (AAA)**, the **Institute of Management Accountants (IMA)**, the **Financial Executives Institute (FEI)** and the **Internal Revenue Service (IRS)**. These groups influence the standard-setting process because of their expressed interest in accounting, their extensive use of the reports generated by the accounting process, or both.

17. Even though the FASB has assumed primary responsibility for the development of accounting and reporting standards, the AICPA has remained quite active in making known its views on major issues. The **Accounting Standards Executive Committee (AcSEC)** informs the FASB of financial reporting problems that are emerging in practice through the development of **issue papers**. Issue papers identify the problem, suggest alternative treatments, and recommend preferred solutions. The AICPA’s **Auditing Standards Board** remains the leader in the development of auditing standards and other issues related to the practice of public accounting.

18. (S.O. 8) Generally accepted accounting principles (GAAP) are those principles that have **substantial authoritative support**. Accounting principles that have substantial authoritative support are those found in FASB Statements and Interpretations, APB Opinions and Accounting Research Bulletins (ARBs). If an accounting transaction is not covered in any of these documents, the accountant may look to other authoritative accounting literature for guidance.

19. (S.O. 9) Although accounting standards are developed by using careful logic and empirical findings, a certain amount of pressure and influence is brought to bear by groups interested in or affected by accounting standards. The FASB does not exist in a vacuum, and politics and special-interest pressures remain a part of the standard-setting process.

20. (S.O. 10) In accounting ethical dilemmas are encountered frequently. The steps that might apply in the process of ethical awareness and decision making are as follows:
   a. Recognize an ethical situation or ethical dilemma.
   b. Move toward an ethical resolution by identifying and analyzing the principal elements in the situation.
   c. Identify the alternatives and weigh the impact of each alternative.
   d. Select the best or most ethical alternative.
# GLOSSARY

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
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<tbody>
<tr>
<td>Accounting.</td>
<td>The identification, measurement, and communication of financial information about economic entities to interested users.</td>
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<tr>
<td>Accounting Research Bulletins (ARBs).</td>
<td>Pronouncements issued by CAP dealing with a variety of timely accounting problems during the years 1939 to 1959.</td>
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<td>Accounting Standards Executive Committee (AcSEC).</td>
<td>The senior technical committee authorized to speak for the AICPA in the area of financial accounting and reporting.</td>
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<td>American Accounting Association (AAA).</td>
<td>An organization, whose members are primarily accounting academics, which encourages the development of accounting theory by encouraging and sponsoring accounting research.</td>
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<td>American Institute of Certified Public Accountants (AICPA).</td>
<td>The national professional organization of practicing Certified Public Accountants.</td>
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<tr>
<td>APB Opinions.</td>
<td>The APB’s official pronouncements issued from 1959 through 1973 which were intended to be based mainly on research studies and be supported by reasons and analysis.</td>
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<td>Committee on Accounting Procedure (CAP).</td>
<td>An organization composed of practicing CPAs which issued Accounting Research Bulletins dealing with a variety of accounting problems during the years 1939 to 1959.</td>
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<td>Emerging Issues Task Force (EITF).</td>
<td>Created by the FASB with the purpose of having 15 or 17 members reach a consensus on how to account for new and unusual financial transactions that have the potential for creating differing financial reporting practices.</td>
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<td>Emerging Issues Task Force Statements.</td>
<td>Pronouncements issued by the EITF which examine emerging financial reporting issues and state how to account for new and unusual accounting transactions.</td>
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<td>FASB Technical Bulletins.</td>
<td>Pronouncements issued by the FASB which are guidelines on implementing or applying FASB Standards or Interpretations, APB Opinions, and Accounting Research Bulletins.</td>
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<td>Financial Accounting Concepts.</td>
<td>A series of pronouncements issued by the FASB with the purpose of setting forth fundamental objectives and concepts that the FASB will use in developing future standards of financial accounting and reporting.</td>
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<td>Financial Accounting Foundation.</td>
<td>The organization that selects the members of the FASB and the FASAC, funds their activities, and generally oversees the FASB’s activities.</td>
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<td>Financial Accounting Interpretations.</td>
<td>Pronouncements issued by the FASB which represent modifications or extensions of existing standards.</td>
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<tr>
<td>Financial Accounting Standards.</td>
<td>Pronouncements issued by the FASB which are considered generally accepted accounting principles.</td>
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<tr>
<td>Financial Accounting Standards Advisory Council (FASAC).</td>
<td>A council responsible for consulting with the FASB on both major policy and technical issues.</td>
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<tr>
<td>Financial Executives Institute (FEI).</td>
<td>An organization, whose members are primarily financial executives, which is interested in research studies on the impact of financial reporting at the corporate level.</td>
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<tr>
<td>Generally accepted accounting principles (GAAP).</td>
<td>A common set of standards and procedures adopted by the accounting profession.</td>
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<td>Governmental Accounting Standards Board (GASB).</td>
<td>Created in 1984 by the Financial Accounting Foundation to address state and local governmental reporting issues.</td>
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<tr>
<td>Institute of Management Accountants (IMA).</td>
<td>An organization, whose members are primarily internal accountants, which is primarily interested in cost and managerial accounting issues.</td>
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<tr>
<td>Internal Revenue Service (IRS).</td>
<td>A federal government agency which enforces the Internal Revenue Code.</td>
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CHAPTER OUTLINE

Fill in the outline presented below.

(S.O. 1) The Environment of Financial Accounting

(S.O. 2) Financial Statements and Financial Reporting

(S.O. 3) Accounting and Capital Allocation

(S.O. 4) The Challenges Facing Financial Accounting

(S.O. 5) Objectives of Financial Reporting

(S.O. 6) The Need to Develop Standards

(S.O. 7) Parties Involved in Standard Setting

   The Securities and Exchange Commission

   The American Institute of Certified Public Accountants

   The Financial Accounting Standards Board
Chapter Outline (continued)

Standards and Interpretations

Financial Accounting Concepts

FASB Technical Bulletins

Emerging Issues Task Force Statements

The Governmental Accounting Standards Board

Other Influential Organizations

(S.O. 8) Generally Accepted Accounting Principles

(S.O. 9) Standard Setting in a Political Environment

International Accounting Standards

(S.O. 10) Ethics in Financial Accounting
REVIEW QUESTIONS

TRUE-FALSE

Indicate whether each of the following is true (T) or false (F) in the space provided.

_____ 1. (S.O. 1) The purpose of accounting is to provide quantitative financial information about an economic entity to persons interested in the activities of that entity.

_____ 2. (S.O. 2) Financial accounting is the process that culminates in the preparation of financial reports that are relative to the enterprise as a whole and that are used by parties both internal and external to the enterprise.

_____ 3. (S.O. 3) The environment of accounting is unaffected by social-economic-political-legal conditions, restraints, and influences that vary from time to time.

_____ 4. (S.O. 3) The principal role of accounting is to furnish investors and lenders information that is useful in assessing the prospective risks and returns associated with an investment.

_____ 5. (S.O. 5) Accounting is responsible for providing standards that ensure accurate financial information that cannot be manipulated or improperly reported.

_____ 6. (S.O. 5) Accounting provides measures of the changes in economic resources, economic obligations, and residual interests of a business enterprise as a basis for comparison and evaluation.

_____ 7. (S.O. 5) One of the objectives of financial reporting is to provide information that is useful in assessing cash flow prospects of the entity being reported on.

_____ 8. (S.O. 6) The difference between generally accepted accounting principles (GAAP) and specifically accepted accounting principles concerns the degree of authority each possess.

_____ 9. (S.O. 7) The American Institute of Certified Public Accountants (AICPA) is the national professional organization of practicing Certified Public Accountants (CPAs).

_____ 10. (S.O. 7) The SEC has been the principal organization in the development of accounting standards.


_____ 12. (S.O. 7) The Accounting Principles Board (APB) replaced the Committee on Accounting Procedure (CAP) and was designated as the AICPA’s sole authority for public pronouncements on accounting principles.

_____ 13. (S.O. 7) The difference between Accounting Research Bulletins (ARBs) and Accounting Principles Board Opinions is that ARBs deal with accounting theory and the APB Opinions deal with accounting practice.

_____ 14. (S.O. 7) The major purpose of the APB during its 13-year existence was to develop a single set of accounting standards useful to all business entities.
15. (S.O. 7) The Accounting Principles Board (APB) was replaced in 1973 by the Financial Accounting Standards Board (FASB), which now is responsible for setting accounting standards.

16. (S.O. 7) All those who serve on the FASB must be Certified Public Accountants.

17. (S.O. 7) FASB Interpretations represent modifications or extensions of existing FASB Standards and have the same authority as Standards.

18. (S.O. 7) FASB Technical Bulletins are designed to provide guidance on the implementation or application of FASB Statements or Interpretations.

19. (S.O. 7) A major role of the Accounting Standards Executive Committee (AcSEC) is to inform the FASB of financial reporting problems that are developing in practice.

20. (S.O. 8) Generally accepted accounting principles (GAAP) are defined, in part, as those principles that have substantial authoritative support.

SOLUTIONS TO REVIEW QUESTIONS

TRUE-FALSE

1. (T)  
2. (T)  
3. (F) Accounting standards are as much a product of political action as they are of careful logic or empirical findings. Standard-setting is part of the real world and, as such, cannot escape politics and political pressure. Also, accounting objectives and practices are not the same today as they were in the past because accounting theory has evolved to meet changing demands and influences.

4. (T)  
5. (F) Accounting standards are designed to act as a general guide in developing financial information about an economic entity. Such standards can always be misinterpreted or intentionally violated, thus producing unreliable financial information.

6. (T)  
7. (T)  
8. (F) The term "specifically accepted accounting principles" has no meaning in accounting.

9. (T)  
10. (F) The SEC has the mandate to establish accounting principles but has acted with remarkable restraint in the area of developing accounting standards. Generally, it has relied on the AICPA and FASB to regulate the accounting profession and develop and enforce accounting standards.
11. (F) The SEC is empowered to administer the 1933 and 1934 Securities Acts. The SEC was given broad powers to prescribe the accounting practices and standards to be employed by companies that issue securities to the public or are listed on a stock exchange.

12. (T)

13. (F) Both ARBs and APB Opinions represent authoritative pronouncements designed to establish principles of accounting. The major difference is that ARBs were issued by the Committee on Accounting Procedure (CAP) and APB Opinions were issued by the Accounting Principles Board.

14. (F) The major purposes of the APB were (a) to advance the written expression of accounting principles, (b) to determine appropriate practices, and (c) to narrow the areas of difference and inconsistency in practice.

15. (T)

16. (F) At the present time it is not necessary to be a CPA to be a member of the FASB.

17. (T)

18. (T)

19. (T)

20. (T)