

CHAPTER 1

FINANCIAL ACCOUNTING AND ACCOUNTING STANDARDS

OVERVIEW

Accounting is the language of business. As such, accountants collect and communicate economic information about business enterprises or other entities to a wide variety of persons. To be useful, financial statements must be clearly understandable and comparable so that users may compare the performance of one business with the performance of the same business for a prior period or with the performance of another similar business. Therefore, all general purpose financial statements should be prepared in accordance with the same uniform guidelines. In this chapter, we will examine the history and sources of current financial accounting standards (generally accepted accounting principles).

SUMMARY OF LEARNING OBJECTIVES

1. **Describe the essential characteristics of accounting.** The essential characteristics of accounting are: (1) identification, measurement, and communication of financial information about (2) economic entities to (3) interested persons.
2. **Identify the major financial statements and other means of financial reporting.** 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. Financial reporting other than financial statements may take various forms. Examples include the president's letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management's forecasts, and descriptions of an enterprise's social or environmental impact.
3. **Explain how accounting assists in the efficient use of scarce resources.** Accounting provides reliable, relevant, and timely information to managers, investors, and creditors so that resources are allocated to the most efficient enterprises. Accounting also provides measurements of efficiency (profitability) and financial soundness.
4. **Identify some of the challenges facing accounting.** Financial reports fail to provide (1) some key performance measures widely used by management, (2) forward-looking information needed by investors and creditors, (3) sufficient information about a company's soft assets (intangibles) and (4) real-time financial information.
5. **Identify the objectives of financial reporting.** The objectives of financial reporting are to provide (1) information that is useful in investment and credit decisions, (2) information that is useful in assessing cash flow prospects, and (3) information about enterprise resources, claims to those resources, and changes in the resources and claims to resources.

6. **Explain the need for accounting standards.** In preparing financial statements, accountants are confronted with the potential dangers of bias, misinterpretation, inexactness, and ambiguity. In order to minimize these dangers, the accounting profession has attempted to develop a set of standards that is generally accepted and universally practiced. Without this set of standards, each accountant or enterprise would have to develop its own standards, and readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.
7. **Identify the major policy-setting bodies and their role in the standard-setting process.** The **Securities and Exchange Commission (SEC)** is an agency of the federal government that has the broad powers to prescribe, in whatever detail it desires, the accounting standards to be employed by companies that fall within its jurisdiction. The **American Institute of Certified Public Accountants (AICPA)** issued standards through its Committee on Accounting Procedure (CAP) and Accounting Principles Board (APB). The **Financial Accounting Standards Board (FASB)** establishes and improves standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information. The **Governmental Accounting Standards Board (GASB)** establishes and improves standards of financial accounting for state and local governments.
8. **Explain the meaning of "generally accepted accounting principles."** Generally accepted accounting principles are those principles that have substantial authoritative support, such as FASB Standards and Interpretations, APB Opinions and Interpretations, AICPA Accounting Research Bulletins, and other authoritative pronouncements.
9. **Describe the impact of user groups on the standard-setting process.** User groups may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. Therefore, the FASB has become the target of many pressures and efforts to influence changes in the existing standards and the development of new ones. Because of the accelerated rate of change and the increased complexity of our economy, these pressures have been multiplying. As a result, accounting standards are as much a product of political action as they are of careful logic or empirical findings.
10. **Understand issues related to ethics and financial accounting.** Financial accountants in the performance of their professional duties are called on for moral discernment and ethical decision making. Decisions are more difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines in making ethical judgments.

TIPS ON CHAPTER TOPICS

TIP:	The accounting profession has adopted a common set of standards and procedures called generally accepted accounting principles (often referred to as GAAP). The term "generally accepted" can mean either that an authoritative accounting rule-making body has established a principle of reporting in a given area or that over time a given practice has been accepted as appropriate because of its universal application.
TIP:	Because most business owners (stockholders of corporations) are not involved with the operation of the business, the stewardship function —measuring and reporting data to absentee owners—has emerged as a critical role for accounting. This situation greatly increases the need for accounting standards.

TIP: The financial statements most frequently provided by an entity (often called the basic financial statements or general purpose financial statements) are: (1) the income statement, (2) the statement of owners' equity (or statement of stockholders' equity), (3) the balance sheet, and (4) the statement of cash flows. In addition, note disclosures are an integral part of the financial statements.
TIP: The primary focus of this textbook concerns the development of two types of financial information which are governed by generally accepted accounting principles: (1) the basic financial statements and (2) the related note disclosures.
TIP: The terms principles and standards are used interchangeably in practice and throughout this book.
TIP: The accrual basis of accounting is used in preparing the basic financial statements. The accrual basis provides for (1) reporting revenues in the period they are earned (which may not be the same period in which the related cash is received), and (2) reporting expenses in the period they are incurred (which may not be the same period in which the related cash is paid).

CASE 1-1

Purpose: (L.O.7) This case will identify the organizations responsible for various accounting documents.

Instructions

Presented below are a number of accounting organizations and the type of documents they have issued. Match the appropriate document to the organization involved. Note that more than one document may be issued by the same organization. If no document is provided for an organization, write in "None."

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Organization	Document
1. _____ Internal Revenue Service	(a) Practice Bulletins
2. _____ AICPA Committee on Accounting Procedure	(b) Accounting Research Bulletins
	(c) Opinions
	(d) Invitations to Comment
3. _____ Financial Accounting Standards Board	(e) Financial Reporting Releases
	(f) Statements of Financial Accounting Standards
	(g) Technical Bulletins
4. _____ Securities and Exchange Commission	(h) Statements of Position
	(i) Regulations S-X
	(j) Industry Accounting and Auditing Guides
5. _____ Accounting Standards Executive Committee of the AICPA	(k) Statements of Financial Accounting Concepts
6. _____ Accounting Principles Board	

Solution to Case 1-1

- | | | |
|---------|---------------|------------|
| 1. None | 3. d, f, g, k | 5. a, h, j |
| 2. b | 4. e, i | 6. c |

CASE 1-2

Purpose: (L.O.8) This case will review the meaning of generally accepted accounting principles and their significance.

All publicly-held companies must have their annual financial statements audited by an independent CPA. In accordance with generally accepted auditing standards (which you will study in an auditing class), the auditor expresses an opinion regarding the fairness of the financial statements which are to be in conformity with generally accepted accounting principles.

Instructions

- (a) Define generally accepted accounting principles and explain their significance to an auditor of financial statements.
- (b) Reconstruct the "House of GAAP" which displays the hierarchy of sources of generally accepted accounting principles.

Solution to Case 1-2

- (a) The accounting profession has adopted a common set of standards and procedures called **generally accepted accounting principles** (often referred to as GAAP). The word "principles" refers to methods or procedures or standards. The phrase "generally accepted" means having "substantial authoritative support." A method has substantial authoritative support if it has been approved by a rule-making body or if it has gained acceptance over time because of its universal application.

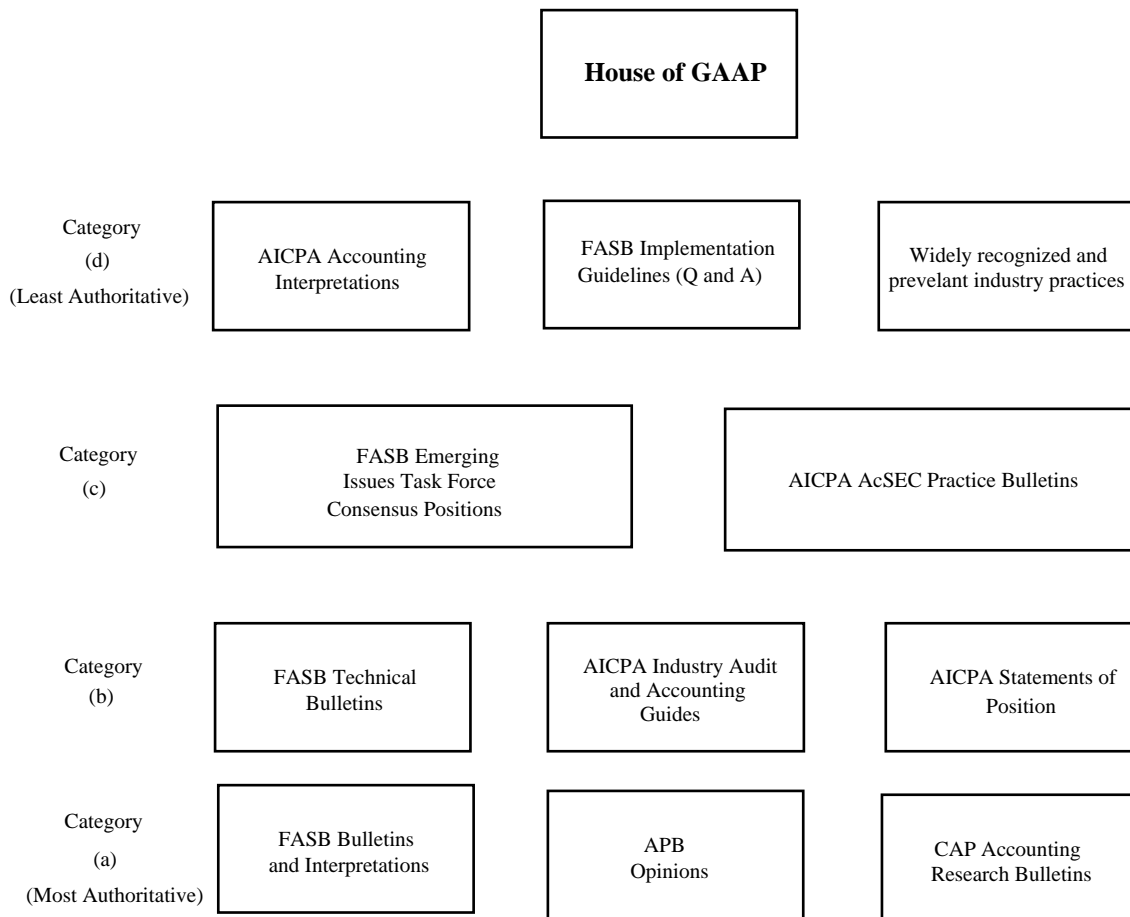
The AICPA's Code of Professional Conduct requires that members prepare financial statements in accordance with generally accepted accounting principles. Specifically, Rule 203 of this Code prohibits a member from expressing an opinion that financial statements conform with GAAP if those statements contain a material departure from a generally accepted accounting principle, unless the member can demonstrate that because of unusual circumstances the financial statements would otherwise have been misleading. Failure to follow Rule 203 can lead to loss of a CPA's license to practice.

The meaning of generally accepted accounting principles is defined by *Statement on Auditing Standards (SAS) No. 69*, "The Meaning of 'Present Fairly in Conformity With Generally Accepted Accounting Principles' in the Independent Auditor's Report." Under this standard, generally accepted accounting principles covered by Rule 203 are construed to be FASB Standards and Interpretations, APB Opinions, and AICPA (CAP) Accounting Research Bulletins.

Oftentimes, however, a specific accounting transaction that occurs is not covered by any of these documents. In this case, other authoritative literature is used. Major examples are: FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and Statements of Position that have been "cleared" by the FASB (these are assumed to be cleared—approved—by the FASB unless the pronouncement states otherwise). These documents are considered to have substantial authoritative support because the recognized professional bodies, after giving interested and affected parties the opportunity to react to exposure drafts and respond at public hearings, have voted their issuance. If these pronouncements are lacking in guidance, then other sources might be considered. The hierarchy of these sources is presented in the House of GAAP [see part (b) of this Solution]. If the accounting treatment of an event is not specified by a category (a) pronouncement, then categories (b) through (d) should be investigated. If there is a conflict between pronouncements in (b) through (d), the higher category [for example (b) is higher than (c)] is to be followed.

In the event that none of these pronouncements addresses the transaction, the accountant should seek support from other accounting literature. Examples of other accounting literature include FASB Concepts Statements; International Accounting Standards Committee Statements; AICPA Issues Papers; and accounting textbooks, handbooks, and articles.

(b)



ANALYSIS OF MULTIPLE-CHOICE TYPE QUESTIONS

QUESTION

1. (L.O.1) The process of identifying, measuring, analyzing, and communicating financial information needed by management to plan, evaluate, and control an organization's operations is called:
 - a. financial accounting.
 - b. managerial accounting.
 - c. tax accounting.
 - d. auditing.

Approach and Explanation: Define each answer selection. Select the answer item for which your definition matches the stem of the question. **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. (Users of these financial reports include investors, creditors, managers, unions, and government agencies.) **Managerial accounting** is the process of identifying, measuring, analyzing, and communicating financial information needed by management to plan, evaluate, and control an organization's operations. (These reports are only for the use of parties internal to the enterprise.) **Tax accounting** usually refers

to tax planning, advising on tax matters, and/or preparing tax returns. **Auditing** refers to the examination of financial statements by a certified public accountant in order to express an opinion on their fairness. An auditor attests to the fairness of financial statements and their conformity to generally accepted accounting principles. (Solution = b.)

QUESTION

2. (L.O.6) The measuring and reporting of data to absentee owners of a corporation is referred to as management's:
- fiduciary responsibility.
 - stewardship function.
 - accounting standard-setting function.
 - audit function.

Explanation: Management's responsibility to manage assets with care and trust is its **fiduciary responsibility**. Management does not set accounting standards. Audits are conducted by independent CPAs, not management. The **stewardship function** involves measuring and reporting data to absentee owners. (Solution = b.)

QUESTION

3. (L.O.7) The most significant current source of generally accepted accounting principles in the nongovernmental sector is the:
- NYSE.
 - SEC.
 - APB.
 - FASB.

Explanation: The mission of the Financial Accounting Standards Board (FASB) is to establish and improve standards of financial accounting and reporting. The Governmental Accounting Standards Board (GASB) is responsible for developing standards to regulate state and local government reporting. The Accounting Principles Board (APB) was the predecessor of the FASB. The New York Stock Exchange (NYSE) has nothing to do with the development of generally accepted accounting principles. Generally, the Securities and Exchange Commission (SEC) has relied on the AICPA and the FASB to develop and enforce accounting standards. (Solution = d.)

QUESTION

4. (L.O.7) Members of the Financial Accounting Standards Board are:
- employed by the American Institute of Certified Public Accountants (AICPA).
 - part-time employees.
 - required to hold a CPA certificate.
 - independent of any other organization.

Explanation: The members of the FASB are well-paid, full-time members. The FASB is not affiliated with the AICPA; it is not associated with any single professional organization. The FASB is answerable only to the Financial Accounting Foundation. It is not necessary to be a CPA or a member of the AICPA to be a member of the FASB. FASB members must sever all ties with CPA firms, companies, or institutions. (Solution = d.)

QUESTION

5. (L.O.7) Which of the following pronouncements were issued by the Accounting Principles Board?
- Accounting Research Bulletins
 - Opinions
 - Statements of Position
 - Statements of Financial Accounting Concepts

Explanation: The Accounting Principles Board issued 31 APB Opinions between the years 1962-1973. Accounting Research Bulletins (51 of them) were issued by the Committee on Accounting Procedure between 1953 and 1959. Statements of Position are issued by the AICPA (but not the APB). The FASB issues Statements on Financial Accounting Concepts (there are 6 of these to date and five of them relate to financial reporting for business enterprises). (Solution = b.)

QUESTION

6. (L.O.7) The body charged with the mission of establishing and improving standards of financial accounting and reporting for business enterprises is the:
- Financial Accounting Foundation (FAF).
 - Financial Accounting Standards Board (FASB).
 - Financial Accounting Standards Advisory Council (FASAC).
 - Governmental Accounting Standards Board (GASB).

Explanation: The FASB is responsible for establishing and improving GAAP. The FAF selects the members of the FASB, and the FASAC funds their activities and generally oversees the FASB's activities (from an operational rather than from a technical standpoint). The GASB deals only with standards pertaining to state and local government reporting. (Solution = b.)

QUESTION

7. (L.O.7) The demise of the APB and the creation of the FAF, FASB, and FASAC are largely and most directly attributed to the:
- IRS.
 - Great Depression.
 - Securities Exchange Act.
 - recommendations of the Wheat Committee.

Explanation: The Great Depression of the 1930s resulted in the Securities Exchange Act of 1934 which led to the formation of the Securities and Exchange Commission (SEC). These developments prompted the formation of the Committee on Accounting Procedure (CAP) which was replaced by the Accounting Principles Board (APB). When the APB needed an overhaul, it was the recommendations of the Wheat Committee that resulted in the demise of the APB and the creation of the new standard-setting structure composed of three organizations—the Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB), and the Financial Accounting Standards Advisory Council (FASAC). (Solution = d.)

QUESTION

8. (L.O.7) The American Institute of Certified Public Accountants (AICPA) continues to be the leader in:
- developing financial accounting standards.
 - developing auditing standards.
 - developing and enforcing professional ethics.
 - providing professional education programs.
 - all of the above, except a.

Approach and Explanation: Before you read the alternative answers, mentally list the facts you know about the AICPA. Its Accounting Standards Executive Committee is involved in assisting the development of financial accounting and reporting guidelines through (1) Issues Papers, (2) Statements of Position, (3) Practice Bulletins, and (4) Industry Accounting and Auditing Guides. The AICPA develops and grades the CPA Examination. It is still the leader in developing auditing standards through its *Auditing Standards Board*, in regulating auditing practices, in developing and enforcing professional ethics, and in providing continuing professional education (CPE) programs. (Solution = e.)

QUESTION

9. (L.O.7) The following published documents are part of the "due process" system used by the FASB in the evolution of a typical FASB Statement of Financial Accounting Standards:
- Exposure Draft
 - Statement of Financial Accounting Standards
 - Discussion Memorandum
- The chronological order in which these items are released is as follows:
- 1, 2, 3.
 - 1, 3, 2.
 - 2, 3, 1.
 - 3, 1, 2.

Explanation: The following steps are taken in the evolution of a typical FASB Statement of Financial Accounting Standards:

- A topic or project is identified and placed on the Board's agenda.
- A task force of experts from various sectors is assembled to define problems, issues, and alternatives related to the topic.
- Research and analysis are conducted by the FASB technical staff.
- A **discussion memorandum** is drafted and released.
- A public hearing is often held, usually 60 days after release of the memorandum.
- The Board analyzes and evaluates the public response.
- The Board deliberates on the issues and prepares an **exposure draft** for release.
- After a 30-day (minimum) exposure period for public comment, the Board evaluates all of the responses received.
- A committee studies the exposure draft in relation to the public responses, reevaluates its position, and revises the draft if necessary.
- The full Board gives the revised draft final consideration and votes on issuance of a **Standards Statement**. (Solution = d.)

QUESTION

10. (L.O.7) All of the following organizations are directly involved in the development of financial accounting standards (GAAP) in the United States, except the:
- Internal Revenue Service (IRS).
 - Financial Accounting Standards Board (FASB).
 - American Institute of Certified Public Accountants (AICPA).
 - Securities and Exchange Commission (SEC).

Explanation: The Internal Revenue Service (IRS) is responsible for federal income tax rules and administration. Although the IRS and its Internal Revenue Code are influences on accounting practice, they are not directly involved in the development of accounting standards (for financial statements) as are the other organizations listed. (Solution = a.)

QUESTION

11. (L.O.8) In the House of GAAP, is the following on the highest level of authoritative status (meaning among the most authoritative)?

	FASB Technical Bulletin	FASB Statement of Financial Accounting Standards	FASB Interpre- tation	FASB Statement of Financial Accounting Concepts
a.	Yes	Yes	Yes	Yes
b.	Yes	Yes	Yes	No
c.	No	Yes	No	No
d.	No	Yes	Yes	No

Approach and Explanation: Visualize the House of GAAP [see **Solution to Case 1-2, part (b)**]. The accounting guidelines that have the most authoritative status are those in category (a) which are the FASB Statements of Financial Accounting Standards, the FASB Interpretations, the APB Opinions, and the AICPA (CAP) Accounting Research Bulletins. The FASB Technical Bulletins are in category (b), not (a) and the FASB Statements of Financial Accounting Concepts are not even in the House. They would be used to support an accounting treatment only if none of the pronouncements in the House of GAAP contradicted that treatment. (Solution = d.)