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Financial Reporting & Analysis

Using Financial Accounting Information

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Chapter 1

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Introduction to Financial Reporting

Users of financial statements include a company's managers, stockholders, bondholders, security analysts, suppliers, lending institutions, employees, labor unions, regulatory authorities, and the general public. These are internal and external stakeholder groups. They use the financial reports to make decisions. For example, potential investors use the financial reports as an aid in deciding whether to buy the stock. Suppliers use the financial reports to decide whether to sell merchandise to a company on credit. Labor unions use the financial reports to help determine their demands when they negotiate for employees. Management could use the financial reports to determine the company's profitability.

Demand for financial reports exists because users believe that the reports help them in decision making. In addition to the financial reports, users often consult competing information sources, such as new wage contracts and economy-oriented releases.

This book concentrates on using financial accounting information properly. It introduces a basic understanding of generally accepted accounting principles and traditional assumptions of the accounting model. This aids the user in recognizing the limits of financial reports.

The ideas that underlie financial reports have developed over several hundred years. This development continues today to meet the needs of a changing society. A review of the evolution of generally accepted accounting principles and the traditional assumptions of the accounting model should help the reader understand financial reports and thus analyze them better.

Development of Generally Accepted Accounting Principles (GAAP) in the United States

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Generally accepted accounting principles are accounting principles that have substantial authoritative support. The formal process of developing the accounting principles that exist today in the United States began with the Securities Acts of 1933 and 1934. Prior to these laws, the New York Stock Exchange (NYSE), which was established in 1792, was the primary mechanism for establishing specific requirements for the disclosure of financial information. These requirements could be described as minimal and only applied to corporations

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whose shares were listed on the NYSE. The prevailing view of management was that financial information was for management's use.

The stock market crash of 1929 provoked widespread concern about external financial disclosure. Some alleged that the stock market crash was substantially influenced by the lack of adequate financial reporting requirements to investors and creditors. The Securities Act of 1933 was designed to protect investors from abuses in financial reporting that developed in the United States. This Act was intended to regulate the initial offering and sale of securities in interstate commerce.

In general, the Securities Exchange Act of 1934 was intended to regulate securities trading on the national exchanges, and it was under this authority that the Securities and Exchange Commission (SEC) was created. In effect, the SEC has the authority to determine GAAP and to regulate the accounting profession. The SEC has elected to leave much of the determination of GAAP and the regulation of the accounting profession to the private sector. At times, the SEC will issue its own standards.

Currently, the SEC issues Regulation S-X, which describes the primary formal financial disclosure requirements for companies. The SEC also issues Financial Reporting Releases (FRRs) that pertain to financial reporting requirements. Regulation S-X and FRRs are part of GAAP and are used to give the SEC's official position on matters relating to financial statements. The formal process that exists today is a blend of the private and public sectors.

A number of parties in the private sector have played a role in the development of GAAP. The American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB) have had the most influence.

American Institute of Certified Public Accountants

The AICPA is a professional accounting organization whose members are certified public accountants (CPAs). During the 1930s, the AICPA had a special committee working with the New York Stock Exchange on matters of common interest. An outgrowth of this special committee was the establishment in 1939 of two standing committees, the Committee on Accounting Procedures and the Committee on Accounting Terminology. These committees were active from 1939 to 1959 and issued 51 Accounting Research Bulletins (ARBs). These committees took a problem-by-problem approach because they tended to review an issue only when there was a problem related to that issue. This method became known as the brush fire approach. The committees were only partially successful in developing a well-structured body of accounting principles. ARBs are part of GAAP unless they have been superseded.

In 1959, the AICPA replaced the two committees with the Accounting Principles Board (APB) and the Accounting Research Division. The Accounting Research Division provided research to aid the APB in making decisions regarding accounting principles. Basic postulates would be developed that would aid in the development of accounting principles, and the entire process was intended to be based on research prior to an APB decision. However, the APB and the Accounting Research Division were not successful in formulating broad principles.

The combination of the APB and the Accounting Research Division lasted from 1959 to 1973. During this time, the Accounting Research Division issued 14 Accounting Research Studies. The APB issued 31 Opinions (APBOs) and 4 Statements (APBSs). The Opinions represented official positions of the Board, whereas the Statements represented the views of the Board but not the official opinions. APBOs are part of GAAP unless they have been superseded.

Various sources, including the public, generated pressure to find another way of developing GAAP. In 1972, a special study group of the AICPA recommended another approach—the establishment of the Financial Accounting Standards Board (FASB). The AICPA adopted these recommendations in 1973.

Financial Accounting Standards Board

The structure of the FASB is as follows: A panel of electors is selected from nine organizations. They are the AICPA, the Financial Executives Institute, the Institute of Management Accountants, the Financial Analysts Federation, the American Accounting Association, the Security Industry Association, and three not-for-profit organizations. The electors appoint the board of trustees that governs the Financial Accounting Foundation (FAF). There are 16 trustees.

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The FAF appoints the Financial Accounting Standards Advisory Council (FASAC) and the FASB.

The FASAC has approximately 30 members. This relatively large number is designed to obtain representation from a wide group of interested parties. The FASAC is responsible for advising the FASB. There are seven members of the FASB. Exhibit 1-1 illustrates the structure of the FASB.

The FASB issues four types of pronouncements:

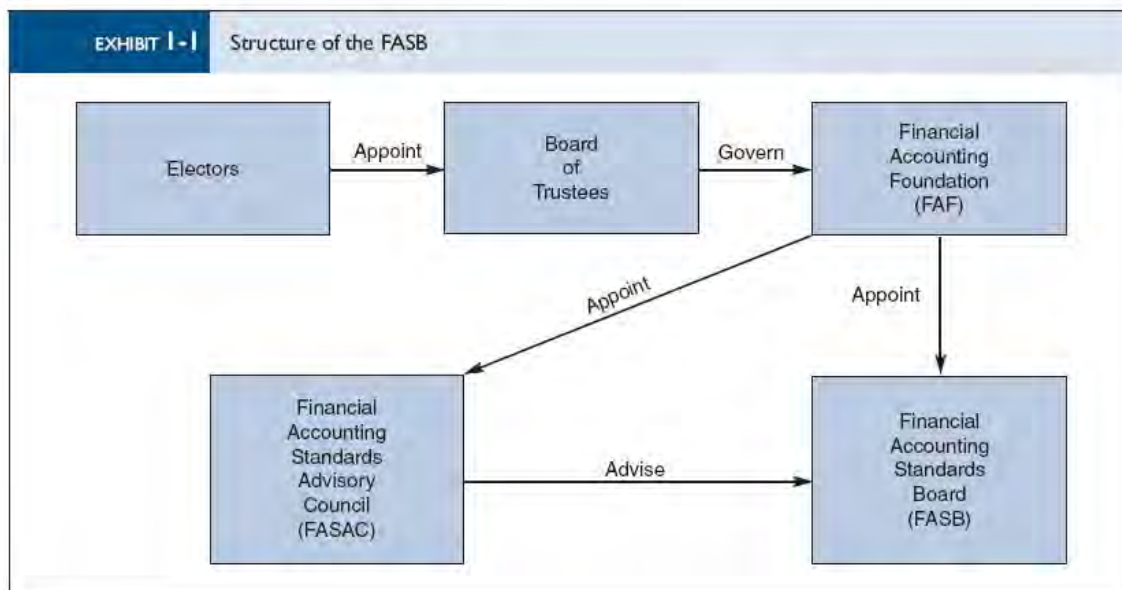
1. STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS (SFAS). These Statements establish GAAP for specific accounting issues. SFASs are part of GAAP unless they have been superseded.
2. INTERPRETATIONS. These pronouncements provide clarifications to previously issued standards, including SFASs, APB Opinions, and Accounting Research Bulletins. The interpretations have the same authority and require the same majority votes for passage as standards (a supermajority of five or more of the seven members). Interpretations are part of GAAP unless they have been superseded.
3. TECHNICAL BULLETINS. These bulletins provide timely guidance on financial accounting and reporting problems. They may be used when the effect will not cause a major change in accounting practice for a number of companies and when they do not conflict with any broad fundamental accounting principle. Technical bulletins are part of GAAP unless they have been superseded.
4. STATEMENTS OF FINANCIAL ACCOUNTING CONCEPTS (SFACs). These Statements provide a theoretical foundation on which to base GAAP. They are the output of the FASB's Conceptual Framework project, but they are not part of GAAP.

Operating Procedure for Statements of Financial Accounting Standards

The process of considering an SFAS begins when the Board elects to add a topic to its technical agenda. The Board receives suggestions and advice on topics from many sources, including the FASAC, the SEC, the AICPA, and industry organizations.

For its technical agenda, the Board considers only "broken" items. In other words, the Board must be convinced that a major issue needs to be addressed in a new area or an old issue needs to be reexamined.

EXHIBIT 1-1 Structure of the FASB



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The Board must rely on staff members for the day-to-day work on projects. A project is assigned a staff project manager, and informal discussions frequently take place among Board members, the staff project manager, and staff. In this way, Board members gain an understanding of the accounting issues and the economic relationships that underlie those issues.

On projects with a broad impact, a Discussion Memorandum (DM) or an Invitation to Comment is issued. A Discussion Memorandum presents all known facts and points of view on a topic. An Invitation to Comment sets forth the Board's tentative conclusions on some issues related to the topic or represents the views of others.

The Discussion Memorandum or Invitation to Comment is distributed as a basis for public comment. There is usually a 60-day period for written comments, followed by a public hearing. A transcript of the public hearing and the written comments become part of the public record. Then the Board begins deliberations on an Exposure Draft (ED) of a proposed Statement of Financial Accounting Standards. When completed, the Exposure Draft is issued for public comment. The Board may call for written comments only, or it may announce another public hearing. After considering the written comments and the public hearing comments, the Board resumes deliberations in one or more public Board meetings. The final Statement must receive affirmative votes from five of the seven members of the Board. The Rules of Procedure require dissenting Board members to set forth their reasons in the Statement. Developing a Statement on a major project generally takes at least two years, and sometimes much longer. Some people believe that the time should be shortened to permit faster decision making.

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The FASB standard-setting process includes aspects of accounting theory and political aspects. Many organizations, companies, and individuals have input into the process. Some input is directed toward achieving a standard less than desirable in terms of a strict accounting perspective. Often, the result is a standard that is not the best representation of economic reality.

FASB Conceptual Framework

The Conceptual Framework for Accounting and Reporting was on the agenda of the FASB from its inception in 1973. The Framework is intended to set forth a system of interrelated objectives and underlying concepts that will serve as the basis for evaluating existing standards of financial accounting and reporting.

Under this project, the FASB has established a series of pronouncements, SFACs, that are intended to provide the Board with a common foundation and the basic reasons for considering the merits of various alternative accounting principles. SFACs do *not* establish GAAP; rather, the FASB eventually intends to evaluate current principles in terms of the concepts established.

To date, the Framework project has issued seven Concepts Statements:

1. *STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1*, "Objectives of Financial Reporting by Business Enterprises"
2. *STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2*, "Qualitative Characteristics of Accounting Information"
3. *STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 3*, "Elements of Financial Statements of Business Enterprises"
4. *STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 4*, "Objectives of Financial Reporting by Nonbusiness Organizations"
5. *STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5*, "Recognition and Measurement in Financial Statements of Business Enterprises"
6. *STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6*, "Elements of Financial Statements" (a replacement of No. 3)
7. *STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 7*, "Using Cash Flow Information and Present Value in Accounting Measurements"

Concepts Statement No. 1, issued in 1978, deals with identifying the objectives of financial reporting for business entities and establishes the focus for subsequent concept projects for business entities. Concepts Statement No. 1 pertains to general-purpose external financial

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reporting and is not restricted to financial statements. The following is a summary of the highlights of Concepts Statement No. 1.[1]

1. Financial reporting is intended to provide information useful in making business and economic decisions.
2. The information should be comprehensible to those having a reasonable understanding of business and economic activities. These individuals should be willing to study the information with reasonable diligence.
3. Financial reporting should be helpful to users in assessing the amounts, timing, and uncertainty of future cash flows.
4. The primary focus is on information about earnings and its components.
5. Information should be provided about the economic resources of an enterprise and the claims against those resources.

Issued in May 1980, "Qualitative Characteristics of Accounting Information" (SFAC No. 2) examines the characteristics that make accounting information useful for investment, credit, and similar decisions. Those characteristics of information that make it a desirable commodity can be viewed as a hierarchy of qualities, with *understandability* and *usefulness for decision making* of most importance (see Exhibit 1-2).

Relevance and reliability, the two primary qualities, make accounting information useful for decision making. To be relevant, the information needs to have *predictive* and feedback value and must be *timely*. To be reliable, the information must be *verifiable*, subject to representational faithfulness, and *neutral*. Comparability, which includes consistency, interacts with relevance and reliability to contribute to the usefulness of information.

The hierarchy includes *two constraints*. First, to be useful and worth providing, the information should have *benefits that exceed its cost*. Second, all of the qualities of information shown are *subject to a materiality threshold*.

SFAC No. 6, "Elements of Financial Statements," which replaced SFAC No. 3 in 1985, defines 10 interrelated elements directly related to measuring the performance and financial status of an enterprise. The 10 elements are defined as follows:[2]

1. ASSETS. Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. LIABILITIES. Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
3. EQUITY. Equity is the residual interest in the assets of an entity that remains after deducting its liabilities:

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

4. INVESTMENTS BY OWNERS. Investments by owners are increases in the equity of a particular business enterprise resulting from transfers to the enterprise from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets, most commonly received as investments by owners, may also include services or satisfaction or conversion of liabilities of the enterprise.
5. DISTRIBUTION TO OWNERS. Distribution to owners is a decrease in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.
6. COMPREHENSIVE INCOME. Comprehensive income is the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.
7. REVENUES. Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

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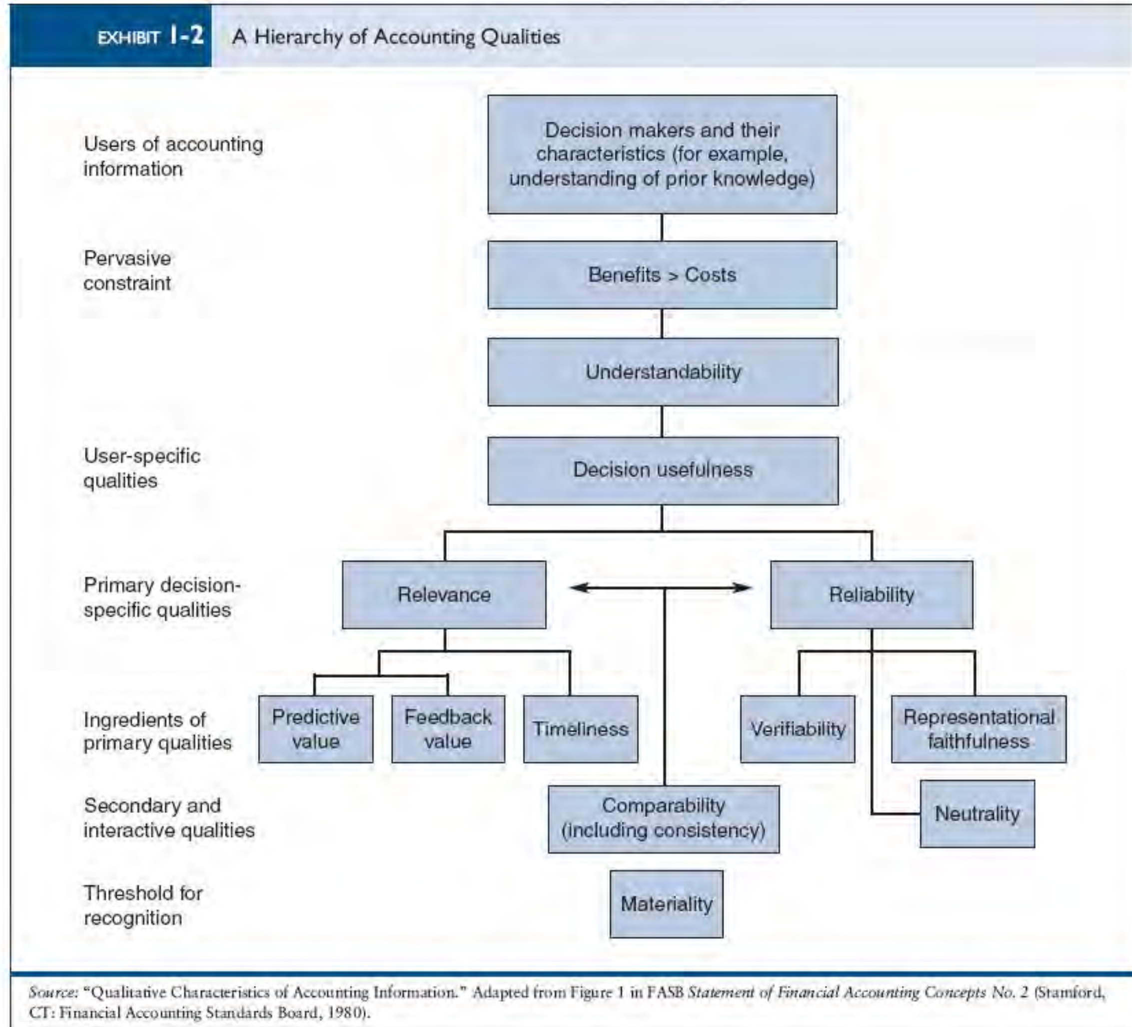
EXHIBIT 1-2 A Hierarchy of Accounting Qualities



Source: "Qualitative Characteristics of Accounting Information." Adapted from Figure 1 in FASB *Statement of Financial Accounting Concepts No. 2* (Stamford, CT: Financial Accounting Standards Board, 1980).

8. EXPENSES. Expenses are outflows or other consumption or using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
9. GAINS. Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.
10. LOSSES. Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

"Objectives of Financial Reporting by Nonbusiness Organizations" (SFAC No. 4) was completed in 1980. Organizations that fall within the focus of this statement include churches, foundations, and human-service organizations. Performance indicators for

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nonbusiness organizations include formal budgets and donor restrictions. These types of indicators are not ordinarily related to competition in markets.

Issued in 1984, "Recognition and Measurement in Financial Statements of Business Enterprises" (SFAC No. 5) indicates that in order to be recognized an item should meet four criteria, subject to the cost-benefit constraint and materiality threshold:[3]

1. DEFINITION. The item fits one of the definitions of the elements.
2. MEASURABILITY. The item has a relevant attribute measurable with sufficient reliability.
3. RELEVANCE. The information related to the item is relevant.
4. RELIABILITY. The information related to the item is reliable.

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This concepts statement identifies *five* different *measurement attributes* currently used in practice and recommends the composition of a full set of financial statements for a period.

The following are five different measurement attributes currently used in practice:[4]

1. Historical cost (historical proceeds)
2. Current cost
3. Current market value
4. Net realizable (settlement) value
5. Present (or discounted) value of future cash flows

This concepts statement probably accomplished little relating to measurement attributes because a firm, consistent position on recognition and measurement could not be agreed upon. It states: "Rather than attempt to select a single attribute and force changes in practice so that all classes of assets and liabilities use that attribute, this concepts statement suggests that use of different attributes will continue."[5]

SFAC No. 5 recommended that a full set of financial statements for a period should show the following:[6]

1. Financial position at the end of the period
2. Earnings (net income)
3. Comprehensive income (total nonowner change in equity)
4. Cash flows during the period
5. Investments by and distributions to owners during the period

At the time SFAC No. 5 was issued, financial position at the end of the period and earnings (net income) were financial statements being presented. Comprehensive income, cash flows during the period, and investments by and distributions to owners during the period are financial statements (disclosures) that have been subsequently developed. All of these financial statements (disclosures) will be covered extensively in this book.

SFAC No. 7, issued in February 2000, provides general principles for using present values for accounting measurements. It describes techniques for estimating cash flows and interest rates and applying present value in measuring liabilities.

The FASB Conceptual Framework for Accounting and Reporting project represents the most extensive effort undertaken to provide a conceptual framework for financial accounting. Potentially, the project can have a significant influence on financial accounting.

Additional Input—American Institute of Certified Public Accountants (AICPA)

As indicated earlier, the AICPA played the primary role in the private sector in establishing GAAP prior to 1973. It continues to play a part, primarily through its Accounting Standards Division. The Accounting Standards Executive Committee (AcSEC) serves as the official voice of the AICPA in matters relating to financial accounting and reporting standards.

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The Accounting Standards Division has published numerous documents considered as sources of GAAP. These include Industry Audit Guides, Industry Accounting Guides, and Statements of Position (SOPs).

Industry Audit Guides and Industry Accounting Guides are designed to assist auditors in examining and reporting on financial statements of companies in specialized industries, such as insurance. SOPs were issued to influence the development of accounting standards. Some SOPs were revisions or clarifications of recommendations on accounting standards contained in Industry Audit Guides and Industry Accounting Guides.

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Industry Audit Guides, Industry Accounting Guides, and SOPs were once considered a lower level of authority than FASB Statements of Financial Accounting Standards, FASB Interpretations, APB Opinions, and Accounting Research Bulletins. However, since the Industry Audit Guides, Industry Accounting Guides, and SOPs deal with material not covered in the primary sources, they, in effect, have become the guide to standards for the areas they cover. They are part of GAAP unless they have been superseded.

Emerging Issues Task Force (EITF)

The FASB established the EITF in July 1984 to help identify emerging issues affecting reporting and problems in implementing authoritative pronouncements. The Task Force has 15 members—senior technical partners of major national CPA firms and representatives of major associations of preparers of financial statements. The FASB's Director of Research and Technical Activities serves as Task Force chairperson. The SEC's Chief Accountant and the chairperson of the AICPA's Accounting Standards Executive Committee participate in EITF meetings as observers.

The SEC's Chief Accountant has stated that any accounting that conflicts with the position of a consensus of the Task Force would be challenged. Agreement of the Task Force is recognized as a consensus if no more than two members disagree with a position.

Task Force meetings are held about once every six weeks. Issues come to the Task Force from a variety of sources, including EITF members, the SEC, and other federal agencies. The FASB also brings issues to the EITF in response to issues submitted by auditors and preparers of financial statements.

The EITF statements have become a very important source of GAAP. The Task Force has the capability to review a number of issues within a relatively short time, in contrast to the lengthy deliberations that go into an SFAS.

EITF statements are considered to be less authoritative than the sources previously discussed in this chapter. However, since the EITF addresses issues not covered by the other sources, its statements become important guidelines to standards for the areas they cover.

A New Reality

In November 2001, Enron, one of the largest companies in the United States, recognized in a federal filing that it had overstated earnings by nearly $600 million since 1997. Within a month, Enron declared bankruptcy. The Enron bankruptcy probably received more publicity than any prior bankruptcy in U.S. history. This attention was influenced by the size of Enron, the role of the auditors, the financial loss of investors, and the losses sustained by Enron employees. Many Enron employees lost their jobs and their pensions as well. There were approximately two dozen guilty pleas or convictions in the Enron case including Ken Lay, former Enron chair. Ken Lay died before he was sentenced; therefore, Judge Sim Lake erased his convictions.

In June 2002, WorldCom announced that it had inflated profits by $3.8 billion over the previous five quarters. This represented the largest financial fraud in corporate history. Soon after the WorldCom fraud announcement, WorldCom declared bankruptcy. (In November 2002, a special bankruptcy court examiner indicated that the restatement would likely exceed $7.2 billion.) On July 13, 2005, Bernard J. Ebbers, founder and former chief executive officer (CEO) of WorldCom, was sentenced to 25 years in prison for orchestrating the biggest corporate accounting fraud in U.S. history.

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The WorldCom fraud compelled Congress and President George W. Bush to take action. Congress, with the support of President Bush, acted swiftly to pass legislation now known as the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act has many provisions and clearly has far-reaching consequences for financial reporting and the CPA profession. While it is not practical to review the Act in detail, because of its importance to financial reporting, some additional comments are in order.

Sarbanes-Oxley Section 404 requires companies to document adequate internal controls and procedures for financial reporting. They must be able to assess the effectiveness of the internal controls and financial reporting.

Companies have found it difficult to comply with Section 404 for many reasons. Internal auditing departments have been reduced or eliminated at many companies. Some companies do not have the personnel to confront complex accounting issues. This lack of adequate competent personnel to confront complex accounting issues in itself represents an internal control weakness.

Sarbanes-Oxley makes it an administrative responsibility to have adequate internal controls and procedures in place. Management must acknowledge its responsibility and assert the effectiveness of internal controls and procedures in writing.

The SEC requires companies to file an annual report on their internal control systems. The report should contain the following:[7]

1. A statement of management's responsibilities for establishing and maintaining an adequate system
2. Identification of the framework used to evaluate the internal controls
3. A statement as to whether or not the internal control system is effective as of year-end
4. The disclosure of any material weaknesses in the system
5. A statement that the company's auditors have issued an audit report on management's assessment

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The financial statements auditor must report on management's assertion as to the effectiveness of the internal controls and procedures as of the company's year-end. Sarbanes-Oxley has changed the relationship between the company and the external auditor. Prior to Sarbanes-Oxley, some companies relied on the external auditor to determine the accounting for complex accounting issues. This was a form of conflict of interest, as the auditor surrendered independence in assessing the company's controls, procedures, and reporting.

Not only have some companies found that they do not have adequately trained personnel to confront complex accounting issues, but external auditors have also been pressed to provide trained accounting personnel. This has led some auditing firms to reduce the number and type of companies they will audit.

The spring of 2005 represented the first reporting season under Sarbanes-Oxley. Hundreds of companies acknowledged that they had "material weaknesses" in their controls and processes. In some cases, this led to financial statements being restated.

Implementing Sarbanes-Oxley has resulted in several benefits. Companies have improved their internal controls, procedures, and financial reporting. Many companies have also improved their fraud prevention procedures. Systems put in place to review budgets will enable companies to be more proactive in preventing potential problems. Users of financial statements benefit from an improved financial product that they review and analyze to make investment decisions.

Unfortunately, implementing Sarbanes-Oxley has been quite costly. Some firms question the cost-benefit of compliance with Sarbanes-Oxley. In time, we will know how much of the cost was represented by start-up cost and how much was annual recurring costs. The substantial cost of implementing Sarbanes-Oxley will likely result in future changes to this law.

Publicly held companies are required to report under Sarbanes-Oxley, whereas private companies are not. Many state-level legislators have proposed extending certain provisions of Sarbanes-Oxley to private companies. Such proposals are controversial because of the cost. Some private companies support these proposals.

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Most of the publicity relating to Sarbanes-Oxley has been related to Section 404, but the Act includes many other sections. This book will revisit Sarbanes-Oxley when covering other areas, such as ethics, in Chapter 2.

Sarbanes-Oxley created a five-person oversight board, the Public Company Accounting Oversight Board (PCAOB). The PCAOB consists of five members appointed by the SEC. Two must be CPAs, but the others cannot be CPAs.

Among the many responsibilities of the PCAOB is to adopt auditing standards. This will materially decrease or eliminate the role of the AICPA in setting auditing standards.

The PCAOB sets an annual accounting support fee for the standard-setting body (FASB). The PCAOB also establishes an annual accounting support fee for the PCAOB. These fees are assessed against each issuer.

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The CEO and the chief financial officer (CFO) of each issuer must prepare a statement to accompany the audit report to certify that disclosures fairly present, in all material respects, the operations and financial condition of the issuer.

In addition to appointing the five members of the PCAOB, the SEC is responsible for oversight and enforcement authority over the Board. In effect, the PCAOB is an arm of the SEC.

As described in this chapter, the setting of accounting standards has been divided among the SEC, FASB, EITF, and AcSEC. By law, the setting of accounting standards is the responsibility of the SEC. The SEC elected to have most of the accounting standards developed in the private sector with the oversight of the SEC. This substantially meant that the SEC allowed the FASB to determine accounting standards. The FASB allowed some of the standards to be determined by the EITF and the AcSEC of the AICPA.

The FASB has announced that it is streamlining the accounting rule-making process by taking back powers it had vested to AcSEC (an arm of the AICPA). The AcSEC will be allowed to continue with industry-specific accounting and audit guides (A&A guides). The AICPA is to stop issuing general-purpose accounting SOPs.

The FASB has also streamlined the accounting rule-making process by taking back powers it had vested to the EITF (an arm of the FASB). Two FASB members will be involved in the agenda-setting process of the EITF. Statements of the EITF will go to the FASB before release.

FASB Accounting Standards Codification™ (Codification)

As indicated in this chapter, there have been many sources of authoritative U.S. GAAP. This has resulted in thousands of pages addressing U.S. GAAP and some confusion as to the level of authoritative GAAP.

To provide a single source of authoritative U.S. GAAP, the FASB released a Codification of U.S. GAAP in 2009. With the Codification, all other literature is considered nonauthoritative. The Codification excludes governmental accounting standards.

The Codification substantially improves the ease of researching U.S. GAAP. Preparers and auditors of financial statements need to reference the Codification when dealing with GAAP. The Codification does not change GAAP.

The Codification arranges U.S. GAAP into approximately 90 accounting topics. A separate section on the Codification includes relevant SEC guidance using the same topical structure.

> The Codification is organized in a tiered structure. Information is organized into eight areas ranging from industry-specific to general financial statement matters. Within each area are topics, subtopics, sections, subsections, and paragraphs, where details of the technical content reside.[8]

The Codification provides electronic real-time updates as new standards are released. The Codification is a fee-based service. A no-frills version is free.

Traditional Assumptions of the Accounting Model

The FASB's Conceptual Framework was influenced by several underlying assumptions. Some of these assumptions were addressed in the Conceptual Framework, and others are implicit in the Framework. These assumptions, along with the Conceptual Framework, are considered when a GAAP is established. Accountants, when confronted with a situation

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lacking an explicit standard, should resolve the situation by considering the Conceptual Framework and the traditional assumptions of the accounting model.

In all cases, the reports are to be a "fair representation." Even when there is an explicit GAAP, following the GAAP is not appropriate unless the result is a "fair representation." Following GAAP is not an appropriate legal defense unless the statements represent a "fair representation."

Business Entity

The concept of separate entity means that the business or entity for which the financial statements are prepared is separate and distinct from the owners of the entity. In other words, the entity is viewed as an economic unit that stands on its own.

For example, an individual may own a grocery store, a farm, and numerous personal assets. To determine the economic success of the grocery store, we would view it separately from the other resources owned by the individual. The grocery store would be treated as a separate entity.

A corporation such as Ford Motor Company has many owners (stockholders). The entity concept enables us to account for the Ford Motor Company entity separately from the transactions of the owners of Ford Motor Company.

Going Concern or Continuity

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The going-concern assumption, that the entity in question will remain in business for an indefinite period, provides perspective on the future of the entity. The going-concern assumption deliberately disregards the possibility that the entity will go bankrupt or be liquidated. If a particular entity is in fact threatened with bankruptcy or liquidation, then the going-concern assumption should be dropped. In such a case, the reader of the financial statements is interested in the liquidation values, not the values that can be used when making the assumption that the business will continue indefinitely. If the going-concern assumption has not been used for a particular set of financial statements, because of the threat of liquidation or bankruptcy, the financial statements must clearly disclose that the statements were prepared with the view that the entity will be liquidated or that it is a failing concern. In this case, conventional financial report analysis would not apply.

Many of our present financial statement figures would be misleading if it were not for the going-concern assumption. For instance, under the going-concern assumption, the value of prepaid insurance is computed by spreading the cost of the insurance over the period of the policy. If the entity were liquidated, then only the cancellation value of the policy would be meaningful. Inventories are basically carried at their accumulated cost. If the entity were liquidated, then the amount realized from the sale of the inventory, in a manner other than through the usual channels, usually would be substantially less than the cost. Therefore, to carry the inventory at cost would fail to recognize the loss that is represented by the difference between the liquidation value and the cost.

The going-concern assumption also influences liabilities. If the entity were liquidating, some liabilities would have to be stated at amounts in excess of those stated on the conventional statement. Also, the amounts provided for warranties and guarantees would not be realistic if the entity were liquidating.

The going-concern assumption also influences the classification of assets and liabilities. Without the going-concern assumption, all assets and liabilities would be current, with the expectation that the assets would be liquidated and the liabilities paid in the near future.

The audit opinion for a particular firm may indicate that the auditors have reservations as to the going-concern status of the firm. This puts the reader on guard that the statements are misleading if the firm does not continue as a going concern. For example, the annual report of Phoenix Footwear Group, Inc. indicated an uncertainty about the company's ability to continue as a going concern.

The Phoenix Footwear Group, Inc. annual report included the following comments in Note 2 and the auditor's report.

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PHOENIX FOOTWEAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—Note 2
January 3, 2009

2. GOING CONCERN

The consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has incurred net losses for the last two fiscal years and has been in continuing default on its existing credit facility. As of December 29, 2007, the Company was not in compliance with the financial covenants under its credit facility. The Company did not request a waiver for the respective defaults as it was in the process of replacing the existing facility with a new lender. In June 2008, the Company entered into a Credit and Security Agreement with Wells Fargo Bank, N.A. ("Wells Fargo") for a three-year revolving line of credit and letters of credit collateralized by all of the Company's assets and those of its subsidiaries. Under the facility, the Company can borrow up to $17.0 million (subject to a borrowing base which includes eligible receivables and eligible inventory), which, subject to the satisfaction of certain conditions, may be increased to $20.0 million. The credit facility also includes a $7.5 million letter of credit sub facility. The Company has been in continuing default under the Wells Fargo credit facility since September 27, 2008 by failing to meet the financial covenant for income before income taxes. Additionally, the Company expects that it will not meet this financial covenant as of the end of the first quarter of fiscal 2009 or thereafter unless this financial covenant is amended. Because of the Company's current defaults, its current lender can demand immediate repayment of all debt and the bank can foreclose on the Company's assets. The Company presently has insufficient cash to pay its bank debt in full. The Company has been in continuing discussions with Wells Fargo regarding its restructuring activities in an effort to obtain a waiver of the past financial covenant default and amend future financial covenants. The bank is continuing to evaluate the Company's restructuring activities and has provided no assurance that it will provide a waiver or amend the Company's agreement. Accordingly, there can be no assurance when, or if, an amendment or waiver will be provided. This raises substantial doubt about the Company's ability to continue as a going concern. The accompanying financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should the Company be unable to continue as a going concern.

Source: Phoenix Footwear Group, Inc., 2009 10-K

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
(In Part)

To the Board of Directors and Stockholders of Phoenix Footwear Group, Inc.
Carlsbad, California

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company incurred a net loss of $19,460,000 for the year ended January 3, 2009 and the Company is not in compliance with financial covenants under its current credit agreement as of January 3, 2009. These factors, among others, as discussed in Note 2 to the financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are described in Note 2 to the financial statements. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Mayer Hoffman McCann P.C.
San Diego, California
April 20, 2009

Source: Phoenix Footwear Group, Inc., 2009 10-K

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Time Period

The only accurate way to account for the success or failure of an entity is to accumulate all transactions from the opening of business until the business eventually liquidates. Many years ago, this time period for reporting was acceptable because it would be feasible to account for and divide up what remained at the completion of the venture. Today, the typical business has a relatively long duration, so it is not feasible to wait until the business liquidates before accounting for its success or failure.

This presents a problem: Accounting for the success or failure of the business in midstream involves inaccuracies. Many transactions and commitments are incomplete at any particular time between the opening and the closing of business. An attempt is made to eliminate the inaccuracies when statements are prepared for a period of time short of an entity's life span, but the inaccuracies cannot be eliminated completely. For example, the entity typically carries accounts receivable at the amount expected to be collected. Only when the receivables are collected can the entity account for them accurately. Until receivables are collected, there exists the possibility that collection cannot be made. The entity will have outstanding obligations at any time, and these obligations cannot be accurately accounted for until they are met. An example would be a warranty on products sold. An entity may also have a considerable investment in the production of inventories. Usually, until the inventory is sold in the normal course of business, the entity cannot accurately account for the investment in inventory.

With the time period assumption, we accept some inaccuracies of accounting for the entity short of its complete life span. We assume that the entity can be accounted for with reasonable accuracy for a particular period of time. In other words, the decision is made to accept some inaccuracy, because of incomplete information about the future, in exchange for more timely reporting.

Some businesses select an accounting period, known as a natural business year, that ends when operations are at a low ebb in order to facilitate a better measurement of income and financial position. In many instances, the natural business year of a company ends on December 31. Other businesses use the calendar year and thus end the accounting period on December 31. Thus, for many companies that use December 31, we cannot tell if December 31 was selected because it represents a natural business year or if it was selected to represent a calendar year. Some select a 12-month accounting period, known as a fiscal year, which closes at the end of a month other than December. The accounting period may be shorter than a year, such as a month. The shorter the period of time, the more inaccuracies we typically expect in the reporting.

At times, this text will refer to *Accounting Trends & Techniques*, a book compiled annually by the American Institute of Certified Public Accountants, Inc. *Accounting Trends & Techniques* "is a compilation of reporting and disclosure data obtained from a survey of the annual reports to stockholders of 600 publicly traded companies. This AICPA publication is produced for the purpose of providing accounting professionals with an invaluable resource for incorporating new and existing accounting and reporting guidance into financial statements using presentation techniques adopted by some of the most recognized companies headquartered in the United States. The annual reports surveyed were those of selected industrial, merchandising, technology, and service companies for fiscal periods ending between February and January 2008."[9]

Exhibit 1-3 summarizes month of fiscal year-end from a financial statement compilation in *Accounting Trends & Techniques*.

In Exhibit 1-3 for 2009, 141 survey companies were on a 52- to 53-week fiscal year.[10]

Monetary Unit

Accountants need some standard of measure to bring financial transactions together in a meaningful way. Without some standard of measure, accountants would be forced to report in such terms as 5 cars, 1 factory, and 100 acres. This type of reporting would not be very meaningful.

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EXHIBIT 1-3 Month of Fiscal Year-End*

	2009	2008	2007	2006
January	26	27	28	27
February	7	8	8	8
March	17	17	17	17
April	8	9	9	9
May	16	15	19	17
June	33	33	40	42
July	8	8	9	10
August	14	13	14	14
September	37	31	43	47
October	14	14	17	16
November	10	9	13	12
Subtotal	190	184	217	219
December	310	316	383	381
Total Entities	500	500	600	600

*2008–2009 based on 500 entities surveyed; 2006–2007 based on 600 entities surveyed.
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There are a number of standards of measure, such as a yard, a gallon, and money. Of the possible standards of measure, accountants have concluded that money is the best for the purpose of measuring financial transactions.

Different countries call their monetary units by different names. For example, Japan uses the yen. Different countries also attach different values to their money—1 dollar is not equal to 1 yen. Thus, financial transactions may be measured in terms of money in each country, but the statements from various countries cannot be compared directly or added together until they are converted to a common monetary unit, such as the U.S. dollar.

In various countries, the stability of the monetary unit has been a problem. The loss in value of money is called inflation. In some countries, inflation has been more than 300 percent per year. In countries where inflation has been significant, financial statements are adjusted by an inflation factor that restores the significance of money as a measuring unit. However, a completely acceptable restoration of money as a measuring unit cannot be made in such cases because of the problems involved in determining an accurate index. To indicate one such problem, consider the price of a car in 2001 and in 2011. The price of the car in 2011 would be higher, but the explanation would not be simply that the general price level has increased. Part of the reason for the price increase would be that the type and quality of the equipment changed between 2001 and 2011. Thus, an index that relates the 2011 price to the 2001 price is a mixture of inflation, technological advancement, and quality changes.

The rate of inflation in the United States prior to the 1970s was relatively low. Therefore, an adjustment of money as a measuring unit was thought to be inappropriate because the added expense and inaccuracies of adjusting for inflation were greater than the benefits. During the 1970s, however, the United States experienced double-digit inflation. This made it increasingly desirable to implement some formal recognition of inflation.

In September 1979, the FASB issued *Statement of Financial Accounting Standards No. 33*, "Financial Reporting and Changing Prices," which required that certain large, publicly held companies disclose certain supplementary information concerning the impact of changing prices in their annual reports for fiscal years ending on or after December 25, 1979. This disclosure later became optional in 1986. Currently, no U.S. company provides this supplementary information.

Historical Cost

SFAC No. 5 identified five different measurement attributes currently used in practice: historical cost, current cost, current market value, net realizable value, and present value.

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Often, historical cost is used in practice because it is objective and determinable. A deviation from historical cost is accepted when it becomes apparent that the historical cost cannot be recovered. This deviation is justified by the conservatism concept. A deviation from historical cost is also found in practice where specific standards call for another measurement attribute such as current market value, net realizable value, or present value.

Conservatism

The accountant is often faced with a choice of different measurements of a situation, with each measurement having reasonable support. According to the concept of conservatism, the accountant must select the measurement with the least favorable effect on net income and financial position in the current period.

To apply the concept of conservatism to any given situation, there must be alternative measurements, each of which must have reasonable support. The accountant cannot use the conservatism concept to justify arbitrarily low figures. For example, writing inventory down to an arbitrarily low figure in order to recognize any possible loss from selling the inventory constitutes inaccurate accounting and cannot be justified under the concept of conservatism. An acceptable use of conservatism would be to value inventory at the lower of historical cost or market value.

The conservatism concept is used in many other situations, such as writing down or writing off obsolete inventory prior to sale, recognizing a loss on a long-term construction contract when it can be reasonably anticipated, and taking a conservative approach toward determining the application of overhead to inventory. Conservatism requires that the estimate of warranty expense reflects the least favorable effect on net income and the financial position of the current period.

Realization

Accountants face a problem of when to recognize revenue. All parts of an entity contribute to revenue, including the janitor, the receiving department, and the production employees. The problem becomes how to determine objectively the contribution of each segment to revenue. Since this is not practical, accountants must determine *when* it is practical to recognize revenue.

In practice, revenue recognition has been the subject of much debate, which has resulted in fairly wide interpretations. The issue of revenue recognition has represented the basis of many SEC enforcement actions. In general, the point of recognition of revenue should be the point in time when revenue can be reasonably and objectively determined. It is essential that there be some uniformity regarding when revenue is recognized, so as to make financial statements meaningful and comparable.

Point of Sale

Revenue is usually recognized at the point of sale. At this time, the earning process is virtually complete, and the exchange value can be determined.

There are times when use of the point-of-sale approach does not give a fair result. An example would be the sale of land on credit to a buyer who does not have a reasonable ability to pay. If revenue were recognized at the point of sale, there would be a reasonable chance that sales had been overstated because of the material risk of default. Many other acceptable methods of recognizing revenue should be considered, such as the following:

1. End of production
2. Receipt of cash
3. During production
4. Cost recovery

End of Production

The recognition of revenue at the completion of the production process is acceptable when the price of the item is known and there is a ready market. The mining of gold or silver is an example, and the harvesting of some farm products would also fit these criteria. If corn is

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harvested in the fall and held over the winter in order to obtain a higher price in the spring, the realization of revenue from the growing of corn should be recognized in the fall, at the point of harvest. The gain or loss from holding the corn represents a separate consideration from the growing of the corn.

Receipt of Cash

The receipt of cash is another basis for revenue recognition. This method should be used when collection is not capable of reasonable estimation at the time of sale. The land sales business, where the purchaser makes only a nominal down payment, is one type of business where the collection of the full amount is especially doubtful. Experience has shown that many purchasers default on the contract.

During Production

Some long-term construction projects recognize revenue as the construction progresses. This exception tends to give a fairer picture of the results for a given period of time. For example, in the building of a utility plant, which may take several years, recognizing revenue as work progresses gives a fairer picture of the results than does having the entire revenue recognized in the period when the plant is completed.

Cost Recovery

The cost recovery approach is acceptable for highly speculative transactions. For example, an entity may invest in a venture search for gold, the outcome of which is completely unpredictable. In this case, the first revenue can be handled as a return of the investment. If more is received than has been invested, the excess would be considered revenue.

In addition to the methods of recognizing revenue described in this chapter, there are many other methods that are usually industry-specific. Being aware of the method(s) used by a specific firm can be important to your understanding of the financial reports.

The FASB and the International Accounting Standards Board (IASB) have been working on a new standard to make revenue recognition more consistent in practice (the IASB is introduced later in this chapter). It appears that a new SFAS will be approved in 2012 with an effective date in a subsequent year.

Matching

The revenue realization concept involves when to recognize revenue. Accountants need a related concept that addresses when to recognize the costs associated with the recognized revenue: the **matching concept**. The basic intent is to determine the revenue first and then match the appropriate costs against this revenue.

Some costs, such as the cost of inventory, can be easily matched with revenue. When we sell the inventory and recognize the revenue, the cost of the inventory can be matched against the revenue. Other costs have no direct connection with revenue, so some systematic policy must be adopted in order to allocate these costs reasonably against revenues. Examples are research and development costs and public relations costs, both of which are charged off in the period incurred. This is inconsistent with the matching concept because the cost would benefit beyond the current period, but it is in accordance with the concept of conservatism.

Consistency

The **consistency concept** requires the entity to give the same treatment to comparable transactions from period to period. This adds to the usefulness of the reports, since the reports from one period are comparable to the reports from another period. It also facilitates the detection of trends.

Many accounting methods could be used for any single item, such as inventory. If inventory were determined in one period on one basis and in the next period on a different basis, the resulting inventory and profits would not be comparable from period to period.

Entities sometimes need to change particular accounting methods in order to adapt to changing environments. If the entity can justify the use of an alternative accounting method,

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the change can be made. The entity must be ready to defend the change—a responsibility that should not be taken lightly in view of the liability for misleading financial statements. Sometimes the change will be based on a new accounting pronouncement. When an entity makes a change in accounting methods, the justification for the change must be disclosed, along with an explanation of the effect on the statements.

Full Disclosure

The accounting reports must disclose all facts that may influence the judgment of an informed reader. If the entity uses an accounting method that represents a departure from the official position of the FASB, disclosure of the departure must be made, along with the justification for it.

Several methods of disclosure exist, such as parenthetical explanations, supporting schedules, cross-references, and notes. Often, the additional disclosures must be made by a note in order to explain the situation properly. For example, details of a pension plan, long-term leases, and provisions of a bond issue are often disclosed in notes.

The financial statements are expected to summarize significant financial information. If all the financial information is presented in detail, it could be misleading. Excessive disclosure could violate the concept of full disclosure. Therefore, a reasonable summarization of financial information is required.

Because of the complexity of many businesses and the increased expectations of the public, full disclosure has become one of the most difficult concepts for the accountant to apply. Lawsuits frequently charge accountants with failure to make proper disclosure. Since disclosure is often a judgment decision, it is not surprising that others (especially those who have suffered losses) would disagree with the adequacy of the disclosure.

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Materiality

The accountant must consider many concepts and principles when determining how to handle a particular item. The proper use of the various concepts and principles may be costly and time-consuming. The materiality concept involves the relative size and importance of an item to a firm. An item that is material to one entity may not be material to another. For example, an item that costs $100 might be expensed by General Electric, but the same item might be carried as an asset by a small entity.

It is essential that material items be properly handled on the financial statements. Immaterial items are not subject to the concepts and principles that bind the accountant. They may be handled in the most economical and expedient manner possible. However, the accountant faces a judgment situation when determining materiality. It is better to err in favor of an item being material than the other way around.

A basic question when determining whether an item is material is: "Would this item influence an informed reader of the financial statements?" In answering this question, the accountant should consider the statements as a whole.

The Sarbanes-Oxley Act has materiality implications. "The Sarbanes-Oxley Act of 2002 has put demands on management to detect and prevent material control weaknesses in a timely manner. To help management fulfill this responsibility, CPAs are creating monthly key control processes to assess and report on risk. When management finds a key control that does not meet the required minimum quality standard, it must classify the result as a key control exception."[11]

Industry Practices

Some industry practices lead to accounting reports that do not conform to the general theory that underlies accounting. Some of these practices are the result of government regulation. For example, some differences can be found in highly regulated industries, such as insurance, railroad, and utilities.

In the utility industry, an allowance for funds used during the construction period of a new plant is treated as part of the cost of the plant. The offsetting amount is reflected as other income. This amount is based on the utility's hypothetical cost of funds, including funds from debt and stock. This type of accounting is found only in the utility industry.

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In some industries, it is very difficult to determine the cost of the inventory. Examples include the meat-packing industry, the flower industry, and farming. In these areas, it may be necessary to determine the inventory value by working backward from the anticipated selling price and subtracting the estimated cost to complete and dispose of the inventory. The inventory would thus be valued at a net realizable value, which would depart from the cost concept and the usual interpretation of the revenue realization concept. If inventory is valued at net realizable value, then the profit has already been recognized and is part of the inventory amount.

The accounting profession is making an effort to reduce or eliminate specific industry practices. However, industry practices that depart from typical accounting procedures will probably never be eliminated completely. Some industries have legitimate peculiarities that call for accounting procedures other than the customary ones.

Transaction Approach

The accountant records only events that affect the financial position of the entity and, at the same time, can be reasonably determined in monetary terms. For example, if the entity purchases merchandise on account (on credit), the financial position of the entity changes. This change can be determined in monetary terms as the inventory asset is obtained and the liability, accounts payable, is incurred.

Many important events that influence the prospects for the entity are not recorded and, therefore, are not reflected in the financial statements because they fall outside the transaction approach. The death of a top executive could have a material influence on future prospects, especially for a small company. One of the company's major suppliers could go bankrupt at a time when the entity does not have an alternative source. The entity may have experienced a long strike by its employees or have a history of labor problems. A major competitor may go out of business. All these events may be significant to the entity. They are not recorded because they are not transactions. When projecting the future prospects of an entity, it is necessary to go beyond current financial reports.

Some of the items not recorded will be disclosed. This is done under the full disclosure assumption.

Cash Basis

The cash basis recognizes revenue when cash is received and recognizes expenses when cash is paid. The cash basis usually does *not* provide reasonable information about the earning capability of the entity in the short run. Therefore, the cash basis is usually *not* acceptable.

Accrual Basis

The accrual basis of accounting recognizes revenue when realized (realization concept) and expenses when incurred (matching concept). If the difference between the accrual basis and the cash basis is not material, the entity may use the cash basis as an alternative to the accrual basis for income determination. Usually, the difference between the accrual basis and the cash basis is material.

A modified cash basis is sometimes used by professional practices and service organizations. The modified cash basis adjusts for such items as buildings and equipment.

The accrual basis requires numerous adjustments at the end of the accounting period. For example, if insurance has been paid for in advance, the accountant must determine the amounts that belong in prepaid insurance and insurance expense. If employees have not been paid all of their wages, the unpaid wages must be determined and recorded as an expense and as a liability. If revenue has been collected in advance, such as rent received in advance, this revenue relates to future periods and must, therefore, be deferred to those periods. At the end of the accounting period, the unearned rent would be considered a liability.

The use of the accrual basis complicates the accounting process, but the end result is more representative of an entity's financial condition than the cash basis. Without the accrual basis, accountants would not usually be able to make the time period assumption—that the entity can be accounted for with reasonable accuracy for a particular period of time.

The illustration on the following page indicates why the accrual basis is generally regarded as a better measure of a firm's performance than the cash basis.

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Assumptions:

1. Sold merchandise (inventory) for $25,000 on credit this year. The merchandise cost $12,500 when purchased in the prior year.
2. Purchased merchandise this year in the amount of $30,000 on credit.
3. Paid suppliers of merchandise $18,000 this year.
4. Collected $15,000 from sales.

Accrual Basis		Cash Basis	
Sales	$ 25,000	Receipts	$ 15,000
Cost of sales (expenses)	(12,500)	Expenditures	(18,000)
Income	$ 12,500	Loss	$ (3,000)

The accrual basis indicates a profitable business, whereas the cash basis indicates a loss. The cash basis does not reasonably indicate when the revenue was earned or when to recognize the cost that relates to the earned revenue. The cash basis does indicate when the receipts and payments (disbursements) occurred. The points in time when cash is received and paid do not usually constitute a good gauge of profitability. However, knowing the points in time is important; the flow of cash will be presented in a separate financial statement (statement of cash flows).

In practice, the accrual basis is modified. Immaterial items are frequently handled on a cash basis, and some specific standards have allowed the cash basis.

Harmonization of International Accounting Standards

The impetus for changes in accounting practice has come from the needs of the business community and governments. With the expansion of international business and global capital markets, the business community and governments have shown an increased interest in the harmonization of international accounting standards.

Suggested problems caused by the lack of harmonization of international accounting standards include the following:

1. A need for employment of key personnel in multinational companies to bridge the "gap" in accounting requirements between countries.
2. Difficulties in reconciling local standards for access to other capital markets.
3. Difficulties in accessing capital markets for companies from less developed countries.[12]
4. Negative effect on the international trade of accounting practice and services.[13]

Domestic accounting standards have developed to meet the needs of domestic environments. A few of the factors that influence accounting standards locally are as follows:

1. A litigious environment in the United States that has led to a demand for more detailed standards in many cases.
2. High rates of inflation in some countries that have resulted in periodic revaluation of fixed assets and other price-level adjustments or disclosures.
3. More emphasis on financial reporting/income tax conformity in certain countries (for example, Japan and Germany) that no doubt greatly influences domestic financial reporting.
4. Reliance on open markets as the principal means of intermediating capital flows that has increased the demand for information to be included in financial reports in the United States and some other developed countries.[14]

The following have been observed to have an impact on a country's financial accounting operation:

1. Who the investors and creditors – the information users – are (individuals, banks, the government).
2. How many investors and creditors there are.

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3. How close the relationship is between businesses and the investor/creditor group.
4. How developed the stock exchanges and bond markets are.
5. The extent of use of international financial markets.[15]

With this backdrop of fragmentation, it has been difficult, if not impossible, in the short run to bring all national standards into agreement with a meaningful body of international standards. But many see benefits to harmonization of international accounting standards and feel that accounting must move in that direction.

The United Nations (UN) has shown a substantial interest in the harmonization of the international accounting standards. The UN appointed a group to study harmonization of the international accounting standards in 1973. This has evolved into an ad hoc working group. Members of the working group represent governments and not the private sector. The working group does not issue standards but rather facilitates their development. The UN's concern is with how multinational corporations affect the developing countries.[16]

Many other organizations, in addition to the UN, have played a role in the harmonization of international accounting standards. Some of these organizations include the Financial Accounting Standards Board (FASB), the European Economic Community (EEC), the Organization for Economic Cooperation and Development (OECD), and the International Federation of Accountants (IFAC).

In 1973, nine countries, including the United States, formed the International Accounting Standards Committee (IASC). The IASC included approximately 100 member nations and well over 100 professional accounting bodies. The IASC was the only private-sector body involved in setting international accounting standards. International Accounting Standards (IAS) were issued by the IASC from 1973 to 2000.

The IASC's objectives included the following:

1. Developing international accounting standards and disclosure to meet the needs of international capital markets and the international business community.
2. Developing accounting standards to meet the needs of developing and newly industrialized countries.
3. Working toward increased comparability between national and international accounting standards.[17]

The International Accounting Standards Board (IASB) was established in January 2001 to replace the IASC. The IASB arose from a review of the structure of the IASC. The new structure has characteristics similar to those of the FASB. The IASB basically continues the objectives of the IASC.

The IASB does not have authority to enforce its standards, but these standards have been adopted in whole or in part by approximately 100 countries. Some see the lack of enforcement authority as a positive factor because it enables the passing of standards that would not have had the necessary votes if they could be enforced. This allows standards to be more ideal than they would otherwise be if they were enforceable. The IASB issues International Financial Reporting Standards (IFRSs). The term *IFRSs* now refers to the entire body of international standards. The IASB lacks an independent and assured source of funding. The FASB has a dependent and assured source of funding by way of an issuer accounting support fee.

The IASB follows a due-process procedure similar to that of the FASB. This includes Exposure Drafts and a comment period. All proposed standards and guidelines are exposed for comment for about six months.

The Financial Accounting Standards Board and the International Accounting Standards Board met jointly in Norwalk, Connecticut, on September 18, 2002. They acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. (This is known as the Norwalk Agreement.)

Since the Norwalk Agreement, the FASB and IASB have made significant progress. In joint meetings in April and October 2005, the FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and International Financial Reporting Standards. In a joint meeting held on February 27, 2006, they agreed on a road map for convergence

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between U.S. GAAP and IFRS. The road map has resulted in many standards being issued where the U.S. and international standards are similar.

In 2007, President Bush signed an agreement between the United States and the European Union that sets the stage to allow many public companies to drop U.S. GAAP in favor of more flexible international rules. Also in 2007, the SEC announced that it would accept financial statements from private issuers without reconciliation to U.S. GAAP if they are prepared using IFRSs as issued by the International Accounting Standards Board.

The American Accounting Association has a Financial Reporting Policy Committee that is charged with responding to Discussion Memoranda and Exposure Drafts on financial accounting and reporting issues. In responding to the SEC release, this committee stated that, "Based on our review of the literature, the committee concluded that eliminating the reconciliation requirement was premature."[18] They offered points in support of their conclusion. Several of these points follow:[19]

1. Material reconciling items exist between U.S. GAAP and IFRS, and the reconciliation currently reflects information that participants in U.S. stock markets appear to impound to stock prices.
2. Cross-country institutional differences will likely result in differences in the implementation of any single set of standards. Thus, IFRS may be a high-quality set of reporting standards (pre-implementation), but the resulting published financial statement information could be of low quality, given inconsistent cross-border implementation practices.
3. Legal and institutional obstacles inhibit private litigation against foreign firms in the United States, and the SEC rarely undertakes enforcement actions against cross-listed firms. In the absence of a reliable enforcement mechanism, even high-quality accounting standards can yield low-quality financial reporting.
4. Differential implementation of standards across countries and differential enforcement efforts directed toward domestic and cross-listed firms create differences in financial reporting even with converged standards. Whether the required reconciliation mitigates differences in implementation or improves compliance is an open issue. However, the SEC should understand the role of the reconciliation in mitigating differences in implementation and compliance before it is eliminated.
5. Harmonization of accounting standards could be beneficial to U.S. investors if it yields greater comparability and if IFRS provides information U.S. investors prefer for their investment decisions. Harmonization appears to be occurring via the joint standard-setting activities of the FASB and the IASB; thus, special, statutory intervention by the SEC appears to be unnecessary.

Ray Ball, a professor of accounting at the University of Chicago, noted a number of problems with implementing IFRS. Several of his comments follow:

1. "On the con side, a deep concern is that the differences in financial reporting quality that are inevitable among countries have been pushed down to the level of implementation, and now will be concealed by a veneer of uniformity."[20]
2. "Despite increased globalization, most political and economic influences on financial reporting practice remain local. It is reinforced by a brief review of the comparatively toothless body of international enforcement agencies currently in place."[21]
3. "The fundamental reason for being skeptical about uniformity of implementation in practice is that the incentives of preparers (managers) and enforcers (auditors, courts, regulators, boards, block shareholders, politicians, analysts, rating agencies, the press) remain primarily local."[22]
4. "Under its constitution, the IASB is a standard setter and does not have an enforcement mechanism for its standards."[23]
5. "Over time the IASB risks becoming a politicized, polarized, bureaucratic, UN-style body."[24]

In 2009, the SEC released for public comment a proposed road map for adoption of IFRS by public companies in the United States. "While many expressed support for the goal of high-quality globally accepted accounting standards, the request for comments produced

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numerous critics of the SEC's proposed road map. Commentators have serious concerns about the cost of adoption, the benefits of adoption, compared to convergence, and whether IFRSs were in fact as good as or better than U.S. GAAP.[25]

On the cost of adoption there are a number of issues, notably the upfront tax issues, the cost to implement, and additional taxes from increased reported income. These costs likely exceed hundreds of billions of dollars. There are also likely substantial legal costs from the United States changing from a rules-based standard to a principles-based approach.[26] The IFRS principles-based approach allows more latitude in using and applying professional judgment.

The FASB and the IASB had been using a convergence approach to international accounting, especially since 2002. This approach had widespread support in the United States. When the SEC proposed a road map that would require U.S. companies to adopt IASB standards, substantial opposition arose. It appears that the United States will be moving toward using some form of international standards. It is not certain how that will be achieved. In 2011, the SEC presented the ideas that a 'condorsement' approach may be the way for the U.S. to move to IFRS. As of early 2012, the SEC had not made a decision on this issue, and if adopted, the details of implementation.

It was envisioned that the 'condorsement' approach would take five to seven years to implement, with the IFRS as the reference point.

Under the 'condorsement' approach, the FASB and the IASB would continue to work on the memorandum of understanding projects. The FASB would not likely undertake new projects.

The FASB would evaluate the differences between U.S. GAAP and IFRS, and determine whether IFRS standards are suitable for U.S GAAP, considering U.S. capital markets.

The FASB would participate in the process for developing IFRS, but U.S. GAAP would continue to be controlled by U.S. regulation.

Financial Reporting Standards for Small and Medium-Sized Entities (SMEs)

In the United States the issue of financial reporting standards for small and medium-sized entities has been debated for many years. These debates did not result in separate standards for SMEs.

International separate standards for SMEs was an issue going back to the IASC. The IASB carried this project forward when it replaced the IASC. After a 5-year study of the topic, the IASB published an IFRS for SMEs in 2009.

Many jurisdictions under the IFRS have adopted or plan to adopt IFRS for SMEs.

The issue of SMEs is not part of the road map of convergence between IFRS and U.S. GAAP.

In the United States there have been numerous studies and reports on GAAP for private companies. These studies and reports go back approximately 40 years. This issue has again become a major issue for U.S. GAAP.

In 2010 a Blue Ribbon Panel on Private Company Financial Reporting was appointed. This panel represented a cross-section of financial reporting constituencies.

In January, 2011 this panel submitted a report on the future of standard setting for private companies to the Financial Accounting Foundation (FAF). The FAF oversees the Financial Accounting Standards Board.

The two most significant blue ribbon panel recommendations are that:[27]

- A new, separate board with standard setting authority be established under the oversight of the FAF. The board would coordinate activities with the FASB but not be subject to FASB approval.
- Changes and modifications be made to existing and future GAAP that recognize the unique needs of users of private company financial statements. All such changes would reside in the FASB Accounting Standards Codification®.

The FAF trustees formed a Trustee Working Group in March, 2011 to address accounting standard setting for nonpublic entities.

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Using the Internet

The Internet is a global collection of computer networks linked together and available for your use. Information passes easily among these networks because all connected networks use a common communication protocol. The Internet includes local, regional, national, and international backbone networks.

There are many reasons for using the Internet. Some of these reasons include (1) retrieving information, (2) finding information, (3) sending and receiving electronic mail, (4) conducting research, and (5) accessing information databases.

Companies' Internet Web Sites

The majority of publicly held companies in the United States have established a Web site on the Internet. The contents of these Web sites vary. A few companies only provide advertisements and product information. In these cases, a phone number may be given to ask for more information. Other companies provide limited financial information, such as total revenues, net income, and earnings per share. These companies may also provide advertisements and a phone number for more information. Many companies provide comprehensive financial information and possibly advertisements. The comprehensive financial information may include the annual report and quarterly reports. It may also include the current stock price and the history of the stock price.

Helpful Web Sites

A number of Web sites can be very useful when performing analysis. Many of these Web sites have highlighted text or graphics that can be clicked to go to another related site. Several excellent Web sites follow:

1. SEC EDGAR DATABASE: www.sec.gov. The Securities and Exchange Commission provides a Web site that includes its Edgar Database. This site allows users to download publicly available electronic filings submitted to the SEC from 1994 to the present. By citing the company name or ticker symbol, you can select from a menu of recent filings. This will include the 10-K report and the 10-Q.
2. FASB: www.fasb.org. Many useful items can be found here, including publications, technical projects, and international activities.
3. FEDERAL CITIZEN INFORMATION CENTER: www.info.gov. This site serves as an entry point to find state, federal, and foreign government information.
4. U.S. GOVERNMENT ACCOUNTABILITY OFFICE (GAO): www.gao.gov/. This is an independent, nonpartisan agency that works for Congress. The GAO issues more than 1,000 reports each year.
5. VIRTUAL FINANCE LIBRARY: http://fisher.osu.edu/fin/overview.htm. This site contains substantial financial information.
6. FINANCIAL MARKETS/STOCK EXCHANGES
   a. NYSE EURONEXT: www.nyse.com
   b. CME GROUP: www.cmegroup.com
   c. NASDAQ STOCK MARKET: www.nasdaq.com
   d. NYSE: www.nyse.com
   e. CHICAGO BOARD OF TRADE: www.cbot.com. The contents of the financial markets/stock exchange sites vary and are expanding.
7. NEWSPAPERS
   a. *THE WALL STREET JOURNAL:* www.wsj.com
   b. *THE NEW YORK TIMES:* www.nytimes.com
   c. *FINANCIAL TIMES:* http://news.ft.com
   d. *INVESTOR'S BUSINESS DAILY:* www.investors.com

   These sites contain substantial financial information, including information on the economy, specific companies, and industries.

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8. AICPA: www.aicpa.org. The AICPA is the national organization for U.S. certified public accountants. This site contains substantial information relating to the accounting profession.
9. INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB): www.iasb.org. The IASB sets global financial accounting and reporting standards. This site helps accountants keep abreast of financial accounting and reporting standards worldwide.
10. PCAOB: www.pcaobus.org. The PCAOB is the private-sector corporation created by the Sarbanes-Oxley Act of 2002. This Board is responsible for overseeing the audits of public companies and has broad authority over public accounting firms and auditors. Its actions are subject to the approval of the Securities and Exchange Commission.
11. FINANCIAL PORTALS
    a. THE STREET.COM: www.thestreet.com
    b. SMART MONEY'S MAP OF THE MARKET: www.smartmoney.com
    c. YAHOO! FINANCE: http://finance.yahoo.com
    d. MORNINGSTAR.COM: www.morningstar.com
    e. MSN MONEY: http://moneycentral.msn.com
    f. MARKETWATCH.COM: www.marketwatch.com
    g. BRIEFING.COM: www.briefing.com
    h. ZACKS INVESTMENT RESEARCH: www.zacks.com
    i. BIGCHARTS: www.bigcharts.com
    j. DOW JONES INDEXES: www.djindexes.com
    k. RUSSELL INVESTMENTS: www.russell.com
    l. STANDARD & POOR'S: www.standardandpoors.com
    m. WILSHIRE ASSOCIATES: www.wilshire.com
    n. BLOOMBERG.COM: www.bloomberg.com

    These financial portals provide information on stock quotes, individual companies, industries, and much more.

5348270 Jon Hobart

Summary

This chapter has reviewed the development of U.S. generally accepted accounting principles and the traditional assumptions of the accounting model. You need a broad understanding of GAAP and the traditional assumptions to reasonably understand financial reports. The financial reports can be no better than the accounting principles and the assumptions of the accounting model that are the basis for preparation.

This chapter introduced "Harmonization of International Accounting Standards" and Financial Reporting Standards for Small and Medium-Sized Entities (SMEs). It also introduced helpful Web sites that can be very useful when performing analysis.

Questions

Q 1-1 Discuss the role of each of the following in the formulation of accounting principles:

a. American Institute of Certified Public Accountants
b. Financial Accounting Standards Board
c. Securities and Exchange Commission

Q 1-2 How does the concept of consistency aid in the analysis of financial statements? What type of accounting disclosure is required if this concept is not applied?

Q 1-3 The president of your firm, Lesky and Lesky, has little background in accounting. Today, he walked into your office and said, "A year ago we bought a piece of land for $100,000. This year, inflation has driven prices up by 6%, and an appraiser just told us we could easily resell the land for $115,000. Yet our balance sheet still shows it at $100,000. It should be valued at $115,000. That's what it's worth. Or, at a minimum, at $106,000." Respond to this statement with specific reference to the accounting principles applicable in this situation.

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Q 1-4 Identify the accounting principle(s) applicable to each of the following situations:

a. Tim Roberts owns a bar and a rental apartment and operates a consulting service. He has separate financial statements for each.
b. An advance collection for magazine subscriptions is reported as a liability titled Unearned Subscriptions.
c. Purchases for office or store equipment for less than $25 are entered in Miscellaneous Expense.
d. A company uses the lower of cost or market for valuation of its inventory.
e. Partially completed television sets are carried at the sum of the cost incurred to date.
f. Land purchased 15 years ago for $40,500 is now worth $346,000. It is still carried on the books at $40,500.
g. Zero Corporation is being sued for $1 million for breach of contract. Its lawyers believe that the damages will be minimal. Zero reports the possible loss in a note.

Q 1-5 A corporation like General Electric has many owners (stockholders). Which concept enables the accountant to account for transactions of General Electric separate and distinct from the personal transactions of the owners of General Electric?

Q 1-6 Zebra Company has incurred substantial financial losses in recent years. Because of its financial condition, the ability of the company to keep operating is in question. Management prepares a set of financial statements that conform to generally accepted accounting principles. Comment on the use of GAAP under these conditions.

Q 1-7 Because of assumptions and estimates that go into the preparation of financial statements, the statements are inaccurate and are, therefore, not a very meaningful tool to determine the profits or losses of an entity or the financial position of an entity. Comment.

Q 1-8 The only accurate way to account for the success or failure of an entity is to accumulate all transactions from the opening of business until the business eventually liquidates. Comment on whether this is true. Discuss the necessity of having completely accurate statements.

Q 1-9 Describe the following terms, which indicate the period of time included in the financial statements:

a. Natural business year
b. Calendar year
c. Fiscal year

Q 1-10 Which standard of measure is the best for measuring financial transactions?

Q 1-11 Countries have had problems with the stability of their money. Briefly describe the problem caused for financial statements when money does not hold a stable value.

Q 1-12 In some countries where inflation has been material, an effort has been made to retain the significance of money as a measuring unit by adjusting the financial statements by an inflation factor. Can an accurate adjustment for inflation be made to the statements? Can a reasonable adjustment to the statements be made? Discuss.

Q 1-13 An arbitrary write-off of inventory can be justified under the conservatism concept. Is this statement true or false? Discuss.

Q 1-14 Inventory that has a market value below the historical cost should be written down in order to recognize a loss. Comment.

Q 1-15 There are other acceptable methods of recognizing revenue when the point of sale is not acceptable. List and discuss the other methods reviewed in this chapter, and indicate when they can be used.

Q 1-16 The matching concept involves the determination of when to recognize the costs associated with the revenue that is being recognized. For some costs, such as administrative costs, the matching concept is difficult to apply. Comment on when it is difficult to apply the matching concept. What do accountants often do under these circumstances?

Q 1-17 The consistency concept requires the entity to give the same treatment to comparable transactions from period to period. Under what circumstances can an entity change its accounting methods, provided it makes full disclosure?

Q 1-18 Discuss why the concept of full disclosure is difficult to apply.

Q 1-19 No estimate or subjectivity is allowed in the preparation of financial statements. Discuss.

Q 1-20 It is proper to handle immaterial items in the most economical, expedient manner possible. In other words, generally accepted accounting principles do not apply. Comment, including a concept that justifies your answer.

Q 1-21 The same generally accepted accounting principles apply to all companies. Comment.

Q 1-22 Many important events that influence the prospects for the entity are not recorded in the financial records. Comment and give an example.

Q 1-23 Some industry practices lead to accounting reports that do not conform to the general theory that underlies accounting. Comment.

Q 1-24 An entity may choose between the use of the accrual basis of accounting and the cash basis. Comment.

Q 1-25 Why did the FASB commence the Accounting Standards Codification™ project?

Q 1-26 Would an accountant record the personal assets and liabilities of the owners in the accounts of the business? Explain.

Q 1-27 At which point is revenue from sales on account (credit sales) commonly recognized?

Q 1-28 Elliott Company constructed a building at a cost of $50,000. A local contractor had submitted a bid to construct it for $60,000.

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a. At what amount should the building be recorded?
b. Should revenue be recorded for the savings between the cost of $50,000 and the bid of $60,000?

Q 1-29 Dexter Company charges to expense all equipment that costs $25 or less. What concept supports this policy?

Q 1-30 Which U.S. government body has the legal power to determine generally accepted accounting principles?

Q 1-31 What is the basic problem with the monetary assumption when there has been significant inflation?

Q 1-32 Explain the matching principle. How is the matching principle related to the realization concept?

Q 1-33 Briefly explain the term *generally accepted accounting principles.*

Q 1-34 Briefly describe the operating procedure for Statements of Financial Accounting Standards.

Q 1-35 What is the FASB Conceptual Framework for Accounting and Reporting intended to provide?

Q 1-36 Briefly describe the following:

a. Committee on Accounting Procedures
b. Committee on Accounting Terminology
c. Accounting Principles Board
d. Financial Accounting Standards Board

Q 1-37 The objectives of general-purpose external financial reporting are primarily to serve the needs of management. Comment.

Q 1-38 Financial accounting is designed to measure directly the value of a business enterprise. Comment.

Q 1-39 According to SFAC No. 2, relevance and reliability are the two primary qualities that make accounting information useful for decision making. Comment on what is meant by relevance and reliability.

Q 1-40 SFAC No. 5 indicates that, to be recognized, an item should meet four criteria, subject to the cost-benefit constraint and materiality threshold. List these criteria.

Q 1-41 There are five different measurement attributes currently used in practice. List these measurement attributes.

Q 1-42 Briefly explain the difference between an accrual basis income statement and a cash basis income statement.

Q 1-43 The cash basis does not reasonably indicate when the revenue was earned and when the cost should be recognized. Comment.

Q 1-44 It is not important to know when cash is received and when payment is made. Comment.

Q 1-45 Comment on what Section 404 of the Sarbanes-Oxley Act requires of companies.

Q 1-46 Under the Sarbanes-Oxley Act, what must the financial statement auditor do in relation to the company's internal control?

Q 1-47 Comment on perceived benefits from Section 404 of the Sarbanes-Oxley Act.

Q 1-48 Comment on the responsibility of private companies under the Sarbanes-Oxley Act.

Q 1-49 If its accounting period ends December 31, would a company be using a natural business year or a fiscal year?

Q 1-50 Describe the book *Accounting Trends & Techniques.*

Q 1-51 Comment on the materiality implications of the Sarbanes-Oxley Act.

Q 1-52 Briefly describe the PCAOB.

Q 1-53 The SEC released for public comment a proposed road map for adoption of IFRS by public companies in the United States. What were the serious concerns?

Q 1-54 Describe the Norwalk Agreement.

Q 1-55 The SEC announced that it would accept financial statements from private issuers without reconciliation to U.S. GAAP if they are prepared using IFRS, as issued by the International Accounting Standards Board. Comment on possible problems with this position.

Q 1-56 Professor Ball noted a number of problems with implementing IFRS. What were the problems noted by Professor Ball?

Q 1-57 In what year did the IASB publish an IFRS for SMEs? How did this impact the road map of convergence between IFRSs and U.S. GAAP?

Problems

P 1-1 FASB Statement of Financial Accounting Concepts No. 2 indicates several qualitative characteristics of useful accounting information. Following is a list of some of these qualities, as well as a list of statements and phrases describing the qualities.

a. Benefits > costs
b. Decision usefulness
c. Relevance
d. Reliability
e. Predictive value, feedback value, timeliness
f. Verifiability, neutrality, representational faithfulness
g. Comparability
h. Materiality
i. Relevance, reliability

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_____ 1. Without usefulness, there would be no benefits from information to set against its cost.
_____ 2. Pervasive constraint imposed on financial accounting information.
_____ 3. Constraint that guides the threshold for recognition.
_____ 4. A quality requiring that the information be timely and that it also have predictive value, feedback value, or both.
_____ 5. A quality requiring that the information have representational faithfulness and that it be verifiable and neutral.
_____ 6. These are the two primary qualities that make accounting information useful for decision making.
_____ 7. These are the ingredients needed to ensure that the information is relevant.
_____ 8. These are the ingredients needed to ensure that the information is reliable.
_____ 9. Includes consistency and interacts with relevance and reliability to contribute to the usefulness of information.

Required Place the appropriate letter identifying each quality on the line in front of the statement or phrase describing the quality.

P 1-2 Certain underlying considerations have had an important impact on the development of generally accepted accounting principles. Following is a list of these underlying considerations, as well as a list of statements describing them.

a. Going concern or continuity
b. Monetary unit
c. Conservatism
d. Matching
e. Full disclosure
f. Materiality
g. Transaction approach
h. Accrual basis
i. Industry practices
j. Verifiability
k. Consistency
l. Realization
m. Historical cost
n. Time period
o. Business entity

_____ 1. The business for which the financial statements are prepared is separate and distinct from the owners.

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_____ 2. The assumption is made that the entity will remain in business for an indefinite period of time.
_____ 3. Accountants need some standard of measure to bring financial transactions together in a meaningful way.
_____ 4. Revenue should be recognized when the earning process is virtually complete and the exchange value can be objectively determined.
_____ 5. This concept deals with when to recognize the costs that are associated with the recognized revenue.
_____ 6. Accounting reports must disclose all facts that may influence the judgment of an informed reader.
_____ 7. This concept involves the relative size and importance of an item to a firm.
_____ 8. The accountant is required to adhere as closely as possible to verifiable data.
_____ 9. Some companies use accounting reports that do not conform to the general theory that underlies accounting.
_____ 10. The accountant records only events that affect the financial position of the entity and, at the same time, can be reasonably determined in monetary terms.
_____ 11. Revenue must be recognized when it is realized (realization concept), and expenses are recognized when incurred (matching concept).
_____ 12. The entity must give the same treatment to comparable transactions from period to period.
_____ 13. The measurement with the least favorable effect on net income and financial position in the current period must be selected.

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(P 1-2 CONTINUED)

____ 14. Of the various values that could be used, this value has been selected because it is objective and determinable.

____ 15. With this assumption, inaccuracies of accounting for the entity short of its complete life span are accepted.

Required Place the appropriate letter identifying each quality on the line in front of the statement describing the quality.

P 1-3

Required Answer the following multiple-choice questions:

a. Which of the following is a characteristic of information provided by external financial reports?

1. The information is exact and not subject to change.
2. The information is frequently the result of reasonable estimates.
3. The information pertains to the economy as a whole.
4. The information is provided at the least possible cost.
5. None of the above.

b. Which of the following is *not* an objective of financial reporting?

1. Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
2. Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans.
3. Financial reporting should provide information about the economic resources of an enterprise, the claims against those resources, and the effects of transactions, events, and circumstances that change the resources and claims against those resources.
4. Financial accounting is designed to measure directly the value of a business enterprise.
5. None of the above.

c. According to FASB Statement of Financial Accounting Concepts No. 2, which of the following is an ingredient of the quality of relevance?

1. Verifiability
2. Representational faithfulness
3. Neutrality
4. Timeliness
5. None of the above.

d. The primary current source of generally accepted accounting principles for nongovernment operations is the

1. New York Stock Exchange
2. Financial Accounting Standards Board
3. Securities and Exchange Commission
4. American Institute of Certified Public Accountants
5. None of the above.

e. What is the underlying concept that supports the immediate recognition of a loss?

1. Matching
2. Consistency
3. Judgment
4. Conservatism
5. Going concern

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f. Which statement is *not* true?

1. The Securities and Exchange Commission is a source of some generally accepted accounting principles.
2. The American Institute of Certified Public Accountants is a source of some generally accepted accounting principles.
3. The Internal Revenue Service is a source of some generally accepted accounting principles.
4. The Financial Accounting Standards Board is a source of some generally accepted accounting principles.
5. Numbers 1, 2, and 4 are correct.

g. Which pronouncements are *not* issued by the Financial Accounting Standards Board?

1. Statements of Financial Accounting Standards
2. Statements of Financial Accounting Concepts
3. Technical bulletins
4. Interpretations
5. Opinions

P 1-4

Required Answer the following multiple-choice questions:

a. Which of the following does the Financial Accounting Standards Board *not* issue?

1. SOPs
2. SFASs
3. Interpretations
4. Technical bulletins
5. SFACs

b. According to SFAC No. 6, assets can be defined by which of the following?

1. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events
2. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events
3. Residual interest on the assets of an entity that remains after deducting its liabilities
4. Increases in equity of a particular business enterprise resulting from transfers to the enterprise from other entities of something of value to obtain or increase ownership interests (or equity) in it
5. Decrease in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise

c. According to SFAC No. 6, expenses can be defined by which of the following?

1. Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations
2. Outflows or other consumption or using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations
3. Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from revenues or investments
4. Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from expenses or distributions to owners
5. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

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(P 1-4 CONTINUED)

d. SFAC No. 5 indicates that an item, to be recognized, should meet four criteria, subject to the cost-benefit constraint and the materiality threshold. Which of the following is *not* one of the four criteria?

1. The item fits one of the definitions of the elements.
2. The item has a relevant attribute measurable with sufficient reliability.
3. The information related to the item is relevant.
4. The information related to the item is reliable.
5. The item has comparability, including consistency.

e. SFAC No. 5 identifies five different measurement attributes currently used in practice. Which of the following is *not* one of the measurement attributes currently used in practice?

1. Historical cost
2. Future cost
3. Current market value
4. Net realizable value
5. Present, or discounted, value of future cash flows

f. Which of the following indicates how revenue is usually recognized?

1. Point of sale
2. End of production
3. Receipt of cash
4. During production
5. Cost recovery

g. *Statement of Financial Accounting Concepts No. 1*, "Objectives of Financial Reporting by Business Enterprises," includes all of the following objectives, except one. Which objective does it *not* include?

1. Financial accounting is designed to measure directly the value of a business enterprise.
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2. Investors, creditors, and others may use reported earnings and information about the elements of financial statements in various ways to assess the prospects for cash flows.
3. The primary focus of financial reporting is information about earnings and its components.
4. Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
5. The objectives are those of general-purpose external financial reporting by business enterprises.

P 1-5 The following data relate to Jones Company for the year ended December 31, 2011:

Sales on credit	$80,000
Cost of inventory sold on credit	65,000
Collections from customers	60,000
Purchase of inventory on credit	50,000
Payment for purchases	55,000
Cash collections for common stock	30,000
Dividends paid	10,000
Payment to salesclerk	10,000

Required

a. Determine income on an accrual basis.
b. Determine income on a cash basis.

P 1-6 Matching Acronyms

Required Listed on the following page are phrases with the appropriate acronym. Match the letter that goes with each definition.

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a. Generally accepted accounting principles (GAAP)
b. Securities and Exchange Commission (SEC)
c. Financial Reporting Releases (FRRs)
d. American Institute of Certified Public Accountants (AICPA)
e. Certified public accountants (CPAs)
f. Accounting Principles Board (APB)
g. Accounting Principles Board Opinions (APBOs)
h. Accounting Principles Board Statements (APBSs)
i. Financial Accounting Standards Board (FASB)
j. Financial Accounting Foundation (FAF)
k. Financial Accounting Standards Advisory Council (FASAC)
l. Statements of Financial Accounting Standards (SFASs)
m. Statements of Financial Accounting Concepts (SFACs)
n. Discussion Memorandum (DM)
o. Exposure Draft (ED)
p. Accounting Standards Executive Committee (AcSEC)
q. Statements of Position (SOP)
r. Emerging Issues Task Force (EITF)
s. Public Company Accounting Oversight Board (PCAOB)

____ 1. Accounting principles that have substantial authoritative support
____ 2. A task force of representatives from the accounting profession created by the FASB to deal with emerging issues of financial reporting
____ 3. A proposed Statement of Financial Accounting Standards
____ 4. Issued by the Accounting Standards Division of the AICPA to influence the development of accounting standards
____ 5. Created by the Securities Exchange Act of 1934
____ 6. A professional accounting organization whose members are certified public accountants
____ 7. Issued official opinions on accounting standards between 1959 and 1973
____ 8. Represent views of the Accounting Principles Board but not the official opinions
____ 9. This Board issues four types of pronouncements: (1) Statements of Financial Accounting Standards, (2) Interpretations, (3) Technical bulletins, and (4) Statements of Financial Accounting Concepts
____ 10. Governs the Financial Accounting Standards Board
____ 11. These statements are issued by the Financial Accounting Standards Board and establish GAAP for specific accounting issues
____ 12. Statements issued by the Financial Accounting Standards Board to provide a theoretical foundation on which to base GAAP; they are not part of GAAP
____ 13. Serves as the official voice of the AICPA in matters relating to financial accounting and reporting standards
____ 14. Presents all known facts and points of view on a topic; issued by the FASB
____ 15. Responsible for advising the FASB
____ 16. Represented official positions of the APB
____ 17. An accountant who has received a certificate stating that he or she has met the requirements of state law
____ 18. Issued by the SEC and give the SEC's official position on matters relating to financial statements
____ 19. Adopts auditing standards

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Cases

Case 1-1 STANDARD SETTING: "A POLITICAL ASPECT"

This case consists of a letter from Dennis R. Beresford, chairperson of the Financial Accounting Standards Board, to Senator Joseph I. Lieberman. The specific issue was proposed legislation relating to the accounting for employee stock options.

Permission to reprint the following letter was obtained from the Financial Accounting Standards Board.

August 3, 1993

Senator Joseph I. Lieberman
United States Senate
Hart Senate Office Building
Room 316
Washington, DC 20510

Dear Senator Lieberman:

Members of the Financial Accounting Standards Board (the FASB or the Board) and its staff routinely consult with members of Congress, their staffs, and other government officials on matters involving financial accounting. For example, FASB members and staff met with Senator Levin both before and after the introduction of his proposed legislation, Senate Bill 259, which also addresses accounting for employee stock options.

The attachment to this letter discusses the accounting issues (we have not addressed the tax issues) raised in your proposed legislation, Senate Bill 1175, and issues raised in remarks introduced in the *Congressional Record*. My comments in this letter address an issue that is more important than any particular legislation or any particular accounting issue: why we have a defined process for setting financial reporting standards and why it is harmful to the public interest to distort accounting reports in an attempt to attain other worthwhile goals.

Financial Reporting

Markets are enormously efficient information processors—when they have the information and that information faithfully portrays economic events. Financial statements are one of the basic tools for communicating that information. The U.S. capital market system is well-developed and efficient because of users' confidence that the financial information they receive is reliable. Common accounting standards for the preparation of financial reports contribute to their credibility. The mission of the FASB, an organization designed to be independent of all other business and professional organizations, is to establish and improve financial accounting and reporting standards in the United States.

Investors, creditors, regulators, and other users of financial reports make business and economic decisions based on information in financial statements. Credibility is critical whether the user is an individual contemplating a stock investment, a bank making lending decisions, or a regulatory agency reviewing solvency. Users count on financial reports that are evenhanded, neutral, and unbiased.

An efficiently functioning economy requires credible financial information as a basis for decisions about allocation of resources. If financial statements are to be useful, they must report economic activity without coloring the message to influence behavior in a particular direction. They must not intentionally favor one party over another. Financial statements must provide a neutral scorecard of the effects of transactions.

Economic Consequences of Accounting Standards

The Board often hears that we should take a broader view, that we must consider the economic consequences of a new accounting standard. The FASB should not act,

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critics maintain, if a new accounting standard would have undesirable economic consequences. We have been told that the effects of accounting standards could cause lasting damage to American companies and their employees. Some have suggested, for example, that recording the liability for retiree health care or the costs for stock-based compensation will place U.S. companies at a competitive disadvantage. These critics suggest that because of accounting standards, companies may reduce benefits or move operations overseas to areas where workers do not demand the same benefits. These assertions are usually combined with statements about desirable goals, like providing retiree health care or creating employee incentives.

There is a common element in those assertions. The goals are desirable, but the means require that the Board abandon neutrality and establish reporting standards that conceal the financial impact of certain transactions from those who use financial statements. Costs of transactions exist whether or not the FASB mandates their recognition in financial statements. For example, not requiring the recognition of the cost of stock options or ignoring the liabilities for retiree health benefits does not alter the economics of the transactions. It only withholds information from investors, creditors, policy makers, and others who need to make informed decisions and, eventually, impairs the credibility of financial reports.

One need only look to the collapse of the thrift industry to demonstrate the consequences of abandoning neutrality. During the 1970s and 1980s, regulatory accounting principles (RAP) were altered to obscure problems in troubled institutions. Preserving the industry was considered a "greater good." Many observers believe that the effect was to delay action and hide the true dimensions of the problem. The public interest is best served by neutral accounting standards that inform policy rather than promote it. Stated simply, truth in accounting is always good policy.

Neutrality does not mean that accounting should not influence human behavior. We expect that changes in financial reporting will have economic consequences, just as economic consequences are inherent in existing financial reporting practices. Changes in behavior naturally flow from more complete and representationally faithful financial statements. The fundamental question, however, is whether those who measure and report on economic events should somehow screen the information before reporting it to achieve some objective. In FASB Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information" (paragraph 102), the Board observed:

> Indeed, most people are repelled by the notion that some "big brother," whether government or private, would tamper with scales or speedometers surreptitiously to induce people to lose weight or obey speed limits or would slant the scoring of athletic events or examinations to enhance or decrease someone's chances of winning or graduating. There is no more reason to abandon neutrality in accounting measurement.

The Board continues to hold that view. The Board does not set out to achieve particular economic results through accounting pronouncements. We could not if we tried. Beyond that, it is seldom clear which result we should seek because our constituents often have opposing viewpoints. Governments, and the policy goals they adopt, frequently change.

Standard Setting in the Private Sector

While the SEC and congressional committees maintain active oversight of the FASB to ensure that the public interest is served, throughout its history the SEC has relied on the Board and its predecessors in the private sector to establish and improve financial accounting and reporting standards. In fulfilling the Board's mission of improving financial reporting, accounting standards are established through a system of due process and open deliberation. On all of our major projects, this involves open Board meetings, proposals published for comment, "field testing" of proposals, public hearings, and redeliberation of the issues in light of comments.

Our due process has allowed us to deal with complex and highly controversial accounting issues, ranging from pensions and retiree health care to abandonment of

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(CASE 1-1 CONTINUED)

nuclear power plants. This open, orderly process for standard setting precludes placing any particular special interest above the interests of the many who rely on financial information. The Board believes that the public interest is best served by developing neutral accounting standards that result in accounting for similar transactions similarly and different transactions differently. The resulting financial statements provide as complete and faithful a picture of an entity as possible.

Corporations, accounting firms, users of financial statements, and most other interested parties have long supported the process of establishing accounting standards in the private sector without intervention by Congress or other branches of government. Despite numerous individual issues on which the FASB and many of its constituents have disagreed, that support has continued. The resulting system of accounting standards and financial reporting, while not perfect, is the best in the world.

Conclusion

We understand that there are a number of people who believe that their particular short-term interests are more important than an effectively functioning financial reporting system. We sincerely hope, however, that you and others in the Congress will review the reasons that have led generations of lawmakers and regulators to conclude that neutral financial reporting is critical to the functioning of our economic system and that the best way to achieve that end is to allow the existing private sector process to proceed. We respectfully submit that the public interest will be best served by that course. As former SEC Chairman Richard Breeden said in testimony to the Senate Banking Committee in 1990:

5348270

> The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose.

The attachment to this letter discusses your proposed legislation. It also describes some aspects of our project on stock compensation and the steps in our due process procedures that remain before the project will be completed. In your remarks in the *Congressional Record*, you said that you will address future issues, including an examination of the current treatment of employee stock options, over the next weeks and months. We would be pleased to meet with you or your staff to discuss these topics and the details of our project. I will phone your appointments person in the next two weeks to see if it is convenient for you to meet with me.

Sincerely,

Dennis R. Beresford

Dennis R. Beresford

Enclosure

cc: The Honorable Connie Mack
The Honorable Dianne Feinstein
The Honorable Barbara Boxer
The Honorable Carl S. Levin
The Honorable Christopher J. Dodd
The Honorable Arthur J. Levitt

Required

a. "Financial statements must provide a neutral scorecard of the effects of transactions." Comment.
b. "Costs of transactions exist whether or not the FASB mandates their recognition in financial statements." Comment.
c. In the United States, standard setting is in the private sector. Comment.
d. Few, if any, accounting standards are without some economic impact. Comment.

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CASE 1-2 POLITICIZATION OF ACCOUNTING STANDARDS—A NECESSARY ACT?

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008. This Act mandated that the SEC conduct a study on mark-to-market accounting standards. The SEC had a 90-day period in which to conduct the study.

On December 30, 2008, the SEC released the "Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting."

The Executive Summary of the SEC report included these comments:

> The events leading up to the Congressional call for this study illustrated the need for identifying and understanding the linkages that exist between fair value accounting standards and the usefulness of information provided by financial institutions. In the months preceding passage of the Act, some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under SFAS No. 157, contributed to instability in our financial markets. According to these critics, fair value accounting did so by requiring what some believed were potentially inappropriate write-downs in the value of investments held by financial institutions, most notably due to concerns that such write-downs were the result of inactive, illiquid, or irrational markets that resulted in values that did not reflect the underlying economics of the securities. These voices pointed out the correlation between U.S. GAAP reporting and the regulatory capital requirements of financial institutions, highlighting that this correlation could lead to the failure of long-standing financial institutions if sufficient additional capital is unavailable to offset investment write-downs. Further, they believed the need to raise additional capital, the effect of failures, and the reporting of large write-downs would have broader negative impact on markets and prices, leading to further write-downs and financial instability.
>
> Just as vocal were other market participants, particularly investors, who stated that fair value accounting serves to enhance the transparency of financial information provided to the public. These participants indicated that fair value information is vital in times of stress, and a suspension of this information would weaken investor confidence and result in further instability in the markets. These participants pointed to what they believe are the root causes of the crisis, namely poor lending decisions and inadequate risk management, combined with shortcomings in the current approach to supervision and regulation, rather than accounting. Suspending the use of fair value accounting, these participants warned, would be akin to "shooting the messenger" and hiding from capital providers the true economic condition of a financial institution.

The recommendations and related key findings of the SEC report were the following:

1. Recommendation—SFAS No. 157 Should Be Improved, but Not Suspended
2. Recommendation—Existing Fair Value and Mark-to-Market Requirements Should Not Be Suspended
3. Recommendation—Additional Measures Should Be Taken to Improve the Application of Existing Fair Value Requirements
4. Recommendation—The Accounting for Financial Asset Impairments Should Be Readdressed
5. Recommendation—Implement Further Guidance to Foster the Use of Sound Judgment
6. Recommendation—Accounting Standards Should Continue to Be Established to Meet the Needs of Investors
7. Recommendation—Additional Formal Measures to Address the Operation of Existing Accounting Standards in Practice Should Be Established
8. Recommendation—Address the Need to Simplify the Accounting for Investments in Financial Assets

In April 2009, the FASB issued three staff positions intended to provide additional application guidance and enhance disclosures regarding fair value measurement and impairments of securities.

The new rules made it easier for banks to limit losses. The FASB in effect ratified proposals it had put out for comment two weeks earlier.

Source: Financial Accounting Standards Board

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(CASE 1-2 CONTINUED)

The FASB was criticized for politicization of accounting standards. Some saw it as an erosion of the independence of the accounting standard-setting process.

Required

a. The Emergency Economic Stabilization Act of 2008 was passed during a time of substantial stock market declines in the United States and the world. In your opinion, was Congress correct in directing a review of an accounting standard? Discuss.
b. Did the SEC play a proper role in addressing the standards that governed mark-to-market accounting? Discuss.
c. Did the SEC have the authority to change mark-to-market accounting for U.S. GAAP? Discuss.
d. Did the FASB follow its usual procedures in addressing the mark-to-market issue? Discuss.
e. Is politicization of accounting standards justified under material economic turmoil? Comment.

CASE 1-3 INDEPENDENCE OF ACCOUNTING STANDARD SETTERS

Speech by SEC Chairman:
Remarks before the AICPA National Conference on Current SEC and PCAOB Developments

by

Chairman Christopher Cox
U.S. Securities and Exchange Commission
Washington, DC
December 8, 2008

Note: Selected comments from Chairman Christopher Cox's speech are the basis for this case.

Good morning to all of you, and let me add my welcome to the AICPA's National Conference on Current SEC and PCAOB Developments. It is a pleasure to join you at this Conference once again. And while the Conference topics this year are focused as always on the cutting-edge issues that concern you in your practice, more than ever before the subjects that you'll cover this week are of great importance to our nation and the economy as a whole.

From issues such as fair value measurement, to the future of international accounting and reporting, to corporate governance and MD&A and the SEC's coming interactive data revolution, the Conference agenda is truly cutting edge and consequential. As leaders in your profession, I am especially grateful that you have taken the time to be here, in order to carry forward this important work and to help confront these challenges that concern not only our nation's economy but the world's.

I want you to know that the Securities and Exchange Commission is a strong supporter of your efforts, and that's why not only I, but also a range of top staff from the SEC, including our Chief Accountant, Conrad Hewitt; John White, the Director of the Division of Corporation Finance; Linda Thomsen, Director of the Division of Enforcement; and Jim Kroeker and Paul Beswick, our Deputy Chief Accountants, will be participating with you in this event.

The timing for the presentations you will hear could not be more critical. And since the issues you are addressing in your daily work go far beyond the normal conference agenda, to the very core of the financial turmoil in our financial system, it's fitting that the people who will be speaking are leading the efforts to help investors and markets manage through that turmoil with sound and consistent accounting standards.

The AICPA's 121-year history, dating back to 1887, makes this one of the oldest professional organizations in the country. From the founding of the American Association of Public Accountants, as it was then called, with a membership of only a few hundred to your more than a third of a million members today, the accounting profession has been vital to our nation's economic health and prosperity. Americans have always entrusted you with great responsibility, both individually and as a profession. And through thick and thin you have maintained their confidence.

Source: U.S. Securities and Exchange

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Even in the post–Sarbanes Oxley, post–Enron environment, accountants have continued to enjoy a solid reputation among the public, and among business decision makers. That's a testament to your integrity and professional competence. Business executives—your clients—give you a favorability rating of 95%. At the SEC, where we're focused on investor protection, we're most impressed that investors give you a favorability rating of 97%. That's as close to perfect as you're likely to get in this life. None of this means that anyone in this room can afford to be complacent. You have a reputation, and a future, to protect. Together, we've all got to remain vigilant.

The role of the accounting profession, at its core, is parallel to that of the SEC. We both have the goal of ensuring full and accurate financial information is reported by companies. And in fact, given that the AICPA's history dates back even further than the SEC's, it was left for accountants to handle the Panic of 1884 on their own when this market crash hit the country.

Like the current global financial turmoil, America's Panic of 1884 was also precipitated by a credit crisis. When New York's national banks refused to lend any additional money and began calling in their loans from borrowers in the West and South, at a time when the nation didn't have the central bank policy levers that are used today, it caused a dramatic spike in interest rates. One contemporary commentator noted that loans at the time "commanded three percent interest and commission per day on call"—or a staggering annualized compound interest rate of several hundred thousand percent. Although the aftermath of the panic was less serious than some other economic shocks, nearly 11,000 businesses failed in 1884 alone.

In those the early days of organized accounting in America, the profession was small. A quarter-century before, city directories listed just 14 accountants offering services to the public in New York City, four in Philadelphia, and one in Chicago—a far cry from AICPA's 350,000 members today.

As one who formerly taught federal income tax, I'm obliged to point out that what really sparked the growth of the accounting profession in the early 20th century was the ratification of the 16th Amendment to the Constitution in 1913. The adoption of a federal income tax suddenly gave rise to the new field of tax preparation. Accountants quickly asserted their authority in this new field—in competition with law firms, of course, which also touted their expertise.

But the defining moment for the nascent field of modern accounting came in the aftermath of the Great Depression. As some of the largest and most profitable companies in the world fell victim to the crushing financial impact, much of the blame was directed at members of the accounting profession, who were accused in court and in the press of negligence, incompetence, and fraud.

In hindsight, we know that the fault did not lie so much with the practitioners of accounting, but with the lack of objective and widely accepted accounting standards. In the absence of industry-wide standards, accountants were forced to make ad hoc determinations across a range of business situations. Ten companies in the same industry could, and often did, use ten different standards. Clearly something had to change, and AICPA led the charge.

This history is directly relevant to us today, when accounting standard setting is at the center of the debate over how banks and financial firms got into—and how they can get out of—the current financial turmoil. It was to solve the problem of accounting improvisation that in 1939, AICPA created its own rule-making body, the Committee on Accounting Procedure, to help set industry-wide standards on contentious issues. The industry also accepted government licensing for CPAs, who were made responsible—and personally liable—for the auditing of publicly-traded companies.

The Committee on Accounting Procedure was a huge improvement on the lack of process and procedure that had existed before. But because it dealt with standards on an issue-by-issue basis as they arose, rather than offering a comprehensive framework for all accounting standards, there was still more work to be done. To address those concerns the AICPA replaced the Committee on Accounting Procedure, 20 years after it was formed, with the Accounting Principles Board, and gave it a broader mandate. It is from the opinions of the Accounting Principles Board between 1959 and 1973 that much of U.S. GAAP has evolved.

(continued)

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(CASE 1-3 CONTINUED)

The Accounting Principles Board, in turn, was succeeded by a fully independent Financial Accounting Standards Board in 1973, under the oversight of the SEC.

The reasons for creating a non governmental body are completely familiar to us today—to be fair and objective, based on expert analysis and judgment, and free of both political and business influence so that accounting standards could be applied consistently across all situations in thousands of different companies. Those reasons for independent private sector standard setting are as relevant and important today as they ever were.

Since then, Congress has consistently restated its purpose in providing the SEC with oversight responsibility for the FASB's independent standard-setting activities. In the Sarbanes-Oxley Act of 2002, the Congress recognized the importance of having an independent standard-setting process in order to facilitate accurate and effective financial reporting, and to protect investors. In the Emergency Economic Stabilization Act of 2008, the Congress described the SEC's role as ensuring that accounting standards work in the public interest and are consistent with the protection of investors.

In creating the first body to set such standards, AICPA and the accounting profession helped America emerge from its darkest economic hour, and you and your peers set down a structural foundation for the economic growth and success of the past 70 years. Now we find ourselves in another economic crisis, and once again the role of accounting standards and the accounting profession is being challenged. As we respond to these new challenges, we must continue to protect the independence of the standard-setting process.

If we learned one painful lesson from the events of the 1930s, and from the more recent scandals of the S&L crisis in the 1980s and Enron, WorldCom, and the rest in the 1990s and the first part of this decade, it is how vitally important it is to protect the independence of accounting standard setters and ensure that their work remains free of distortions from self-serving influences.

That priority must also be reflected in any regulatory reform undertaken by the next Congress and the new administration. Accounting standards-setting should remain an independent function, and regulatory oversight of the independent private-sector standard setter should not become entangled with the competing priorities of evaluating and addressing systemic risk. Accounting standards should not be viewed as a fiscal policy tool to stimulate or moderate economic growth, but rather as a means of producing neutral and objective measurements of the financial performance of public companies.

Accounting standards aren't just another financial rudder to be pulled when the economic ship drifts in the wrong direction. Instead they are the rivets in the hull, and you risk the integrity of the entire economy by removing them.

There are those who say that independent standard setting is important, and who will agree that private-sector standard setting is preferable to ensure that the process is not detached from reality—but who nonetheless say that while these things are true in ordinary times, these are not ordinary times. Therefore, they argue for setting aside the normal approach to standard setting, which identifies issues for consideration, gives the public exposure documents, includes outreach efforts, and then solicits comments on the exposure documents, and finally considers all of the resulting comments in finalizing and issuing new accounting standards. All of that, they say, should be set aside and replaced with a quick fix, whether the standard setters agree or not.

This view gives short shrift not only to the principle of independence, but also to the credibility of the standard-setting process and investor confidence in it.

The truth is that the value of independent standard setting is greatest when the going gets tough. The more serious the stresses on the market, the more important it is to maintain investor confidence.

A few years ago, during the consideration of a particularly contentious and important accounting rule, the then-Comptroller General, David Walker, wrote a letter on this very point to the Chairman and Ranking Member of the Senate Banking Committee, who were then Richard Shelby and Paul Sarbanes. "[T]he principle of independence," he said, "both in fact and in appearance, is essential to the credibility of and confidence in any authoritative standard-setting processes."

And about the FASB's role as the SEC's designated independent private-sector standard-setting body, the GAO had this to say:

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This time-tested and proven deliberative process has served to strengthen financial reporting and ensure general acceptance of the nation's accounting standards. This process is especially important given the complexity and controversial nature of some accounting standards.

The established process that the GAO was referring to includes important safeguards for all users of financial statements, including obtaining feedback from groups such as financial statement preparers, auditors, individual investors, institutional investors, lenders, creditors, professional analysts, and various other parties. These processes are designed to ensure that the competing interests and demands of the various groups are carefully and independently balanced. And that, in turn, is absolutely essential to ensuring that accounting standards promote transparent, credible, and comparable financial information.

None of this is to say that standard setters can or should turn a blind eye to the events in the world around us; or ignore the valid criticism and input of leaders in business, politics, and academia; or endlessly debate and deliberate instead of act when action is required. To the contrary, that is what the transparent process is for. It is meant to achieve results, and to keep standards current.

Standards must keep pace with the real world to stay relevant, and they must be refined over time to better address weaknesses, as we have recently seen with the problems in valuing assets in illiquid markets. I believe it is critical that FASB complete its analysis of the SEC's request for expeditious improvement in the impairment model in FAS 115, made formally last October, in accordance with its established independent standard-setting process.

As we have learned, illiquid markets bring new challenges to the measurement of fair value that could not have been fully appreciated in past years. These challenges have brought into focus the need for further work on improving the tools that companies have at their disposal to achieve transparent, decision-useful financial reporting.

Transparency is the cornerstone of world-class financial reporting. Transparent and unbiased financial reporting allows investors to make informed decisions based on a company's financial performance and disclosures. A clear, concise, and balanced view into the companies that participate in our capital markets is fundamentally important to those who choose to invest in our markets. Informed decision making results in efficient capital allocation.

Required

a. "Accounting standards should not be viewed as a fiscal policy tool to stimulate or moderate economic growth, but rather as a means of providing neutral and objective measurements of the financial performance of public companies." Comment.
b. Letter of David Walker, then-Comptroller General (in Part).
"This time-tested and proven deliberate process has served to strengthen this financial reporting and ensure general acceptance of the nation's accounting standards. This process is especially important given the complexity and controversial nature of some accounting standards." Comment.

CASE 1-4 LOOKING OUT FOR INVESTORS

Speech by SEC Chairman:
Address to the Council of Institutional Investors

by

Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission
Council of Institutional Investors—Spring 2009 Meeting
Washington, DC
April 6, 2009

Note: Selected comments from Chairman Mary L. Schapiro's speech are the basis of this case.

Thank you, Joe, for that lovely introduction, and I want to thank you and Ann for inviting me to join you today. It's really an honor to be here.

Source: U.S. Securities and Exchange

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(CASE 1-4 CONTINUED)

When I first arrived at the SEC two months ago, I noticed a very large, framed quote prominently displayed outside the Chairman's Office. It's a quote from former Chairman (and later Supreme Court Justice) William O. Douglas. And, it says, "We are the investor's advocate."

Usually, that's the only part of his quote we ever hear. But the full statement is more enlightening. It reads:

We have got brokers' advocates; we have got Exchange advocates; we have got investment banker advocates; and WE are the investors' advocate.

The date of that quote is 1937. Seventy-two years later, there are even more advocates for all of the various participants in our markets, but the SEC remains the only federal agency dedicated to looking out for investors. And surely there has been no time in history that investors have been more in need of an advocate than today.

You—the trillions of dollars that are represented in this room—need an advocate that is strong and effective. In our time together this morning, I'd like to share with you my plans for ensuring both.

The Role of Regulation in Our Markets

5348270 Jon Hobart

Now over the past many months, there's been much talk in Washington and around the globe, about the need to rethink our regulatory system. It is a discussion that has been given urgency by the financial crisis we face—and the quest for solutions.

But as we consider how to address this crisis, I think it is useful to remember that there are myriad reasons for how we got here. The ink on the Sarbanes-Oxley Act of 2002 was hardly dry before we began to hear concerns from some quarters about the costs of "over-regulation," the stifling of innovation, and the superior ability of markets to protect themselves from excesses.

Over the last 15 years, regulations that had once walled off the less risky from more risky parts of our financial system were incrementally weakened. Competition for market-based financing among banks, securities firms and finance companies resulted in a dramatic increase in leverage and risk for both corporate and consumer borrowers.

Standards deteriorated and financial activity moved away from regulated and transparent markets and institutions, into "shadow markets." Regulatory and enforcement resources, most notably at the SEC, declined.

Regulatory reform will seek to address these and the many other causes of the weaknesses in our system and the broader economy.

The SEC's Role

But, fixing all of these problems—whether it's the state of our automobile industry, the soundness of our banking system, or the integrity of our credit or derivatives markets—will take time and involve many moving parts. I'd like to outline how I see the SEC's role and, as I mentioned, my plans for ensuring that the SEC is a strong and effective advocate for investors.

Investor protection starts with fair and efficient capital markets. The SEC's job is to ensure that these markets are:

- First, structured effectively. This means that customer orders are priced, processed, and cleared in an orderly and fair way.
- Second, that they're fed by timely and reliable information. This is imperative whether that information is provided through words or numbers.
- Third, that they're well served by financial intermediaries and other market professionals. These professionals must be competent, financially capable, and honest.
- And fourth, that they're supported by a strong and focused enforcement arm. Returning to former Chairman Douglas' words, we need to have the "shotgun-behind-the-door … loaded, well-oiled, cleaned, ready for use, but with the hope that it will never have to be used."

In each of the following four areas, the SEC has recently experienced both successes and challenges.

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Required

a. Comment on the costs of overregulation.
b. Comment on the costs of underregulation.
c. In your opinion, will the SEC now move toward overregulation or underregulation?

CASE 1-5 FLYING HIGH*

Note 1

Summary of Significant Accounting Policies (in Part)

Contract accounting—Contract accounting is used for development and production activities predominately by the Aircraft and Weapons Systems (A&WS), Network Systems, Support Systems, and Launch and Orbital Systems (L&OS) segments within Integrated Defense Systems (IDS). These activities include the following products and systems: military aircraft, helicopters, missiles, space systems, missile defense systems, satellites, rocket engines, and information and battle management systems. The majority of business conducted in these segments is performed under contracts with the U.S. government and foreign governments that extend over a number of years. Contract accounting involves a judgmental process of estimating the total sales and costs for each contract, which results in the development of estimated cost of sales percentages. For each sale contract, the amount reported as cost of sales is determined by applying the estimated cost of sales percentage to the amount of revenue recognized.

Sales related to contracts with fixed prices are recognized as deliveries are made, except for certain fixed-price contracts that require substantial performance over an extended period before deliveries begin, for which sales are recorded based on the attainment of performance milestones. Sales related to contracts in which we are reimbursed for costs incurred plus an agreed upon profit are recorded as costs are incurred. The majority of these contracts are with the U.S. government. The Federal Acquisition regulations provide guidance on the types of cost that will be reimbursed in establishing contract price. Contracts may contain provisions to earn incentive and award fees if targets are achieved. Incentive and award fees that can be reasonably estimated are recorded over the performance period of the contract. Incentive and award fees that cannot be reasonably estimated are recorded when awarded.

Program accounting—We use program accounting to account for sales and cost of sales related to all our commercial airplane programs by the Commercial Airplanes segment. Program accounting is a method of accounting applicable to products manufactured for delivery under production-type contracts where profitability is realized over multiple contracts and years. Under program accounting, inventoriable production costs, program tooling costs, and warranty costs are accumulated and charged as cost of sales by program instead of by individual units or contracts. A program consists of the estimated number of units (accounting quantity) of a product to be produced in a continuing, long-term production effort for delivery under existing and anticipated contracts. To establish the relationship of sales to cost of sales, program accounting requires estimates of (a) the number of units to be produced and sold in a program, (b) the period over which the units can reasonably be expected to be produced, and (c) the units' expected sales prices, production costs, program tooling, and warranty costs for the total program.

5349270 Jon Hobart

We recognize sales for commercial airplane deliveries as each unit is completed and accepted by the customer. Sales recognized represent the price negotiated with the customer, adjusted by an escalation formula. The amount reported as cost of sales is determined by applying the estimated cost of sales percentage for the total remaining program to the amount of sales recognized for airplanes delivered and accepted by the customer.

Service revenue—Service revenue is recognized when the service is performed. This method is predominately used by our Support Systems, L&OS, and Commercial Airplanes segments.

(continued)

*"The Boeing Company, together with its subsidiaries ... is one of the world's major aerospace firms." 10-K

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(CASE 1-5 CONTINUED)

Service activities include the following: Delta launches, ongoing maintenance of International Space Station, Space Shuttle and explosive detection systems, support agreements associated with military aircraft and helicopter contracts, and technical and flight operation services for commercial aircraft. BCC lease and financing revenue is also included in "Service revenue" on the Consolidated Statements of Operations. See the "Lease and financing arrangements" section below for a discussion of BCC's revenue recognition policies.

Notes receivable—At commencement of a note receivable issued for the purchase of aircraft or equipment, we record the note and any unamortized discounts. Interest income and amortization of any discounts are recorded ratably over the related term of the note.

Required

a. Contract Accounting (in Part)
"Contracts may contain provisions to earn incentive and award fees if targets are achieved. Incentive and award fees that can be reasonably estimated are recorded over the performance period of the contract. Incentive and award fees that cannot be reasonably estimated are recorded when awarded."
Comment on the difficulty in determining which incentive and award fees can be reasonably estimated.

b. Program Accounting (in Part)
"We recognize sales for commercial airplane deliveries as each unit is completed and accepted by the customer. Sales recognized represent the price negotiated with the customer, adjusted by an escalation formula."
Comment on the difficulty in determining the sales amount.
"The amount reported as cost of sales is determined by applying the estimated cost of sales percentage for the total remaining program to the amount of sales recognized for airplanes delivered and accepted by the customer."
Does it appear more difficult to determine the sales or cost of sales? Comment.

c. Service Revenue (in Part)
"Service revenue is recognized when the service is performed."
Is it difficult to determine service revenue? Comment.

d. Notes Receivable
"At commencement of a note receivable issued for the purchase of aircraft or equipment, we record the note and any unamortized discounts. Interest income and amortization of any discounts are recorded ratably over the related term of the note."
Is it difficult to determine revenue from notes receivable? Comment.

CASE 1-6 CENTERED IN HAWAII

Alexander and Baldwin, Inc.*

Notes to Consolidated Financial Statements (In Part)
Summary of Significant Accounting Policies (In Part)
December 31, 2010

Revenue Recognition: The Company has a wide variety of revenue sources, including shipping revenue, logistics services revenue, property sales, rental income, and sales of raw sugar, molasses and coffee. Before recognizing revenue, the Company assesses the underlying terms of the transaction to ensure that recognition meets the requirements of relevant accounting standards. In general, the Company recognizes revenue when persuasive evidence of an arrangement exists, delivery of the service or product has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured.

*"Alexander & Baldwin, Inc. ("A&B") is a multi-industry corporation with its primary operations centered in Hawaii. It was founded in 1870 and incorporated in 1900. Ocean transportation operations, related shoreside operations in Hawaii, and intermodal, truck brokerage and logistics services are conducted by a wholly-owned subsidiary, Matson Navigation Company, Inc. ("Matson"), and two Matson subsidiaries. Property development and agribusiness operations are conducted by A&B and certain other subsidiaries of A&B." 10-K
Source: Alexander and Baldwin, Inc. 2010, 10-K

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Voyage Revenue Recognition: Voyage revenue is recognized ratably over the duration of a voyage based on the relative transit time in each reporting period, commonly referred to as the percentage-of-completion method. Voyage expenses are recognized as incurred.

Logistics Services Revenue Recognition: The revenue for logistics services includes the total amount billed to customers for transportation services. The primary costs include purchased transportation services. Revenue and the related purchased transportation costs are recognized based on relative transit time, commonly referred to as the percentage-of-completion method. The Company reports revenue on a gross basis. The Company serves as principal in transactions because it is responsible for the contractual relationship with the customer, has latitude in establishing prices, has discretion in supplier selection, and retains credit risk.

Real Estate Sales Revenue Recognition: Sales are recorded when the risks and rewards of ownership have passed to the buyers (generally on closing dates), adequate initial and continuing investments have been received, and collection of remaining balances, if any, is reasonably assured. For certain development projects that have material continuing post-closing involvement and for which total revenue and capital costs are reasonably estimable, the Company uses the percentage-of-completion method for revenue recognition. Under this method, the amount of revenue recognized is based on development costs that have been incurred through the reporting period as a percentage of total expected development cost associated with the development project. This generally results in a stabilized gross margin percentage, but requires significant judgment and estimates.

Real Estate Leasing Revenue Recognition: Real estate leasing revenue is recognized on a straight-line basis over the terms of the related leases, including periods for which no rent is due (typically referred to as "rent holidays"). Differences between revenues recognized and amounts due under respective lease agreements are recorded as increases or decreases, as applicable, to deferred rent receivable. Also included in rental revenue are certain tenant reimbursements and percentage rents determined in accordance with the terms of the leases. Income arising from tenant rents that are contingent upon the sales of the tenant exceeding a defined threshold are recognized only after the contingency has been resolved (e.g., sales thresholds have been achieved).

Required

a. In general, what is the policy of Alexander & Baldwin for recognizing revenue?
b. Voyage Revenue Recognition: Revenue recognition – "commonly referred to as the percentage-of-completion method." "Voyage expenses are recognized as incurred." Could this represent a challenge when matching cost with revenue?
c. Logistics Services Revenue Recognition: "Revenue and the related purchased transportation are recognized based on relative transit time, commonly referred to as the percentage-of-completion method." Does this appear to be reasonable?
d. Real Estate Sales Revenue Recognition: There appear to be two methods used for revenue recognition for real estate sales. Describe these methods.
e. Real Estate Leasing Revenue Recognition: Describe this method.

Case 1-7 CONTINUE AS A GOING CONCERN

Report of Independent Registered Public Accounting Firm

To the Board of Director and shareholders

We have audited the accompanying balance sheet of Indestructible I, Inc. as of December 31, 2009 and 2008 and the related statement of operations, stockholders' equity, and cash flows for the twelve months ended December 31, 2009 and 2008 and from inception (September 19, 2003) through the year then ended December 31, 2009. These financial statements are the responsibility of company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Source: Independent Registered Public Accounting Firm

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(CASE 1-7 CONTINUED)

We conducted our audits in accordance with standards of The Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Indestructible I, Inc. at December 31, 2009 and 2008 and the results of its operations and its cash flows for the twelve months ended December 31, 2009 and 2008 and from inception (September 19, 2003) through December 31, 2009 in conformity with U.S. Generally Accepted Accounting Principles.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company has suffered losses from operations and has a net capital deficiency that raises substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Gately & Associates, L.L.C.
Lake Mary, FL
February 2, 2010

Required

a. What is the going-concern assumption?

b. Have the financial statements used the going-concern assumption?

c. What is the significance of the disclosure that this company may not be able to continue as a going concern?

CASE 1-8 ECONOMICS AND ACCOUNTING: THE UNCONGENIAL TWINS*

"Economics and accountancy are two disciplines which draw their raw material from much the same mines. From these raw materials, however, they seem to fashion remarkably different products. They both study the operations of firms; they both are concerned with such concepts as income, expenditure, profits, capital, value, and prices. In spite of an apparently common subject-matter, however, they often seem to inhabit totally different worlds, between which there is remarkably little communication."

"It is not surprising that the economist regards much accounting procedure as in the nature of ritual. To call these procedures ritualistic is in no way to deny or decry their validity. Ritual is always the proper response when a man has to give an answer to a question, the answer to which he cannot really know. Ritual under these circumstances has two functions. It is comforting (and in the face of the great uncertainties of the future, comfort is not to be despised), and it is also an answer sufficient for action. It is the sufficient answer rather than the right answer which the accountant really seeks. Under these circumstances, however, it is important that we should know what the accountant's answer means, which means that we should know what procedure he has employed. The wise businessman will not believe his accountant although he takes what his accountant tells him as important evidence. The quality of that evidence, however, depends in considerable degree on the simplicity of the procedures and the awareness which we have of them. What the accountant tells us may not be true, but, if we know what he has done, we have a fair idea of what it means. For this reason, I am somewhat suspicious of many current efforts to reform accounting in the direction of making it more 'accurate.'"

*Source: Quotes from the article "Economics and Accounting: The Uncongenial Twins," in *Accounting Theory*, edited by W. T. Baxter and Sidney Davidson (Homewood, IL: R. D. Irwin, 1962), pp. 44–55.

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"If accounts are bound to be untruths anyhow, as I have argued, there is much to be said for the simple untruth as against a complicated untruth, for if the untruth is simple, it seems to me that we have a fair chance of knowing what kind of an untruth it is. A known untruth is much better than a lie, and provided that the accounting rituals are well known and understood, accounting may be untrue but it is not lies; it does not deceive because we know that it does not tell the truth, and we are able to make our own adjustment in each individual case, using the results of the accountant as evidence rather than as definitive information."

Required

a. Assume that accounting procedures are in the form of ritual. Does this imply that the accountant's product does not serve a useful function? Discuss.
b. Does it appear that Kenneth Boulding, the author of this article, would support complicated procedures and a complicated end product for the accountant? Discuss.
c. Accounting reports must be accurate in order to serve a useful function. Discuss.

Case 1-9 I OFTEN PAINT FAKES*

An art dealer bought a canvas signed "Picasso" and traveled all the way to Cannes to discover whether it was genuine. Picasso was working in his studio. He cast a single look at the canvas and said, "It's a fake."

A few months later, the dealer bought another canvas signed "Picasso." Again he traveled to Cannes, and again Picasso, after a single glance, grunted: "It's a fake."

"But cher maitre," expostulated the dealer, "it so happens that I saw you with my own eyes working on this very picture several years ago."

Picasso shrugged: "I often paint fakes."

Required

a. Assume that the accounting report was prepared using generally accepted accounting principles. Does this imply that the report is exactly accurate? Discuss.
b. In your opinion, do accountants paint fakes? Discuss.

*This case consists of a quote from Arthur Koestler, *The Act of Creation* (New York: Macmillan, 1964), p. 82.
Source: Arthur Koestler, The Act of Creation (New York: Macmillan, 1964), p. 82.

Case 1-10 OVERSIGHT

Selected sections of the Sarbanes-Oxley Act follow:

Public Law 107-204—July 30, 2002
Section 1. Short title. This Act may be cited as the "Sarbanes-Oxley Act of 2002"

TITLE I—Public Company Accounting Oversight Board

Sec. 101. Establishment; Administrative Provisions

(a) Establishment of Board—There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.
(b) Duties of the Board—The Board shall, subject to action by the Commission under section 107, and once a determination is made by the Commission under subsection (d) of this section—
    (1) register public accounting firms that prepare audit reports for issuers, in accordance with section 102;
    (2) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, in accordance with section 103;

Source: U.S. Securities and Exchange

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(CASE 1-10 CONTINUED)

(3) conduct inspections of registered public accounting firms, in accordance with section 104 and the rules of the Board;

(4) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms, in accordance with section 105;

(5) perform such other duties or functions as the Board (or the Commission, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof, or otherwise to carry out this Act, in order to protect investors, or to further the public interest;

(6) enforce compliance with this Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof; and

(7) set the budget and manage the operations of the Board and the staff of the Board.

Sec. 102. Registration with the Board

(a) Mandatory Registration—Beginning 180 days after the date of the determination of the Commission under section 101(d), it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer.

Sec. 103. Auditing, Quality Control, and Independence Standards and Rules

(a) Auditing, quality control, and ethics standards

(1) In General—The Board shall, by rule, establish, including, to the extent it determines appropriate, through adoption of standards proposed by 1 or more professional groups of accountants designated pursuant to paragraph (3)(A) or advisory groups convened pursuant to paragraph (4), and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.

Sec. 104. Inspections of Registered Public Accounting Firms

(a) In General—The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

Sec. 105. Investigations and Disciplinary Proceedings

(a) In General—The Board shall establish, by rule, subject to the requirements of this section, fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.

(3) Noncooperation with Investigations

(A) In General—If a registered public accounting firm or any associated person thereof refuses to testify, produce documents, or otherwise cooperate with the Board in connection with an investigation under this section, the Board may—

(i) suspend or bar such person from being associated with a registered public accounting firm, or require the registered public accounting firm to end such association;

(ii) suspend or revoke the registration of the public accounting firm; and

(iii) invoke such other lesser sanctions as the Board considers appropriate, and as specified by rule of the Board.

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Sec. 106. Foreign Public Accounting Firms

(a) Applicability to Certain Foreign Firms

(1) In General—Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act and the rules of the Board and the Commission issued under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States or any State, except that registration pursuant to section 102 shall not by itself provide a basis for subjecting such a foreign public accounting firm to the jurisdiction of the Federal or State courts, other than with respect to controversies between such firms and the Board.

Sec. 107. Commission Oversight of the Board

(a) General Oversight Responsibility—The Commission shall have oversight and enforcement authority over the Board, as provided in this Act.

Sec. 108. Accounting Standards

(a) Amendment to Securities Act of 1933—Section 19 of the Securities Act of 1933 (15 U.S. C. 77s) is amended

(b) Recognition of Accounting Standards

(1) In General—In carrying out its authority under subsection (a) and under section 13(b) of the Securities Exchange Act of 1934, the Commission may recognize, as "generally accepted" for purposes of the securities laws, any accounting principles established by a standard setting body—

(A) that—

(i) is organized as a private entity;

(ii) has, for administrative and operational purposes, a board of trustees (or equivalent body) serving in the public interest, the majority of whom are not, concurrent with their service on such board, and have not been during the 2-year period preceding such service, associated persons of any registered public accounting firm;

(iii) is funded as provided in section 109 of the Sarbanes-Oxley Act of 2002;

(iv) has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; and

(v) considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors; and

(B) that the Commission determines has the capacity to assist the Commission in fulfilling the requirements of subsection (a) and section 13(b) of the Securities Exchange Act of 1934, because, at a minimum, the standard setting body is capable of improving the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws.

5548270 Jon Hobart

Sec. 109. Funding

(a) In General—The Board, and the standard setting body designated pursuant to section 19(b) of the Securities Act of 1933, as amended by section 108, shall be funded as provided in this section.

(d) Annual Accounting Support Fee for the Board

(1) Establishment of Fee—The Board shall establish, with the approval of the Commission, a reasonable annual accounting support fee (or a formula for the computation thereof), as may be necessary or appropriate to establish and maintain the Board. Such fee may also cover costs incurred in the Board's first fiscal year (which may be a short fiscal year), or may be levied separately with respect to such short fiscal year.

(continued)

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(CASE 1-10 CONTINUED)

(2) Assessments—The rules of the Board under paragraph (1) shall provide for the equitable allocation, assessment, and collection by the Board (or an agent appointed by the Board) of the fee established under paragraph (1), among issuers, in accordance with subsection (g), allowing for differentiation among classes of issuers, as appropriate.

(e) Annual Accounting Support Fee for Standard Setting Body—The annual accounting support fee for the standard setting body referred to in subsection (a)—

(1) shall be allocated in accordance with subsection (g), and assessed and collected against each issuer, on behalf of the standard setting body, by 1 or more appropriate designated collection agents, as may be necessary or appropriate to pay for the budget and provide for the expenses of that standard setting body, and to provide for an independent, stable source of funding for such body, subject to review by the Commission; and

(2) may differentiate among different classes of issuers.

TITLE II—Auditor Independence

Sec. 201. Services Outside the Scope of Practice of Auditors

(a) Prohibited Activities—Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1) is amended by adding at the end the following:

(g) Prohibited Activities—Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the "Board"), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including—

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(2) financial information systems design and implementation;

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(4) actuarial services;

(5) internal audit outsourcing services;

(6) management functions or human resources;

(7) broker or dealer, investment adviser, or investment banking services;

(8) legal services and expert services unrelated to the audit; and

(9) any other service that the Board determines, by regulation, is impermissible.

(h) Preapproval Required for Non-Audit Services—A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).

TITLE IV—Enhanced Financial Disclosures

Sec. 404. Management Assessment of Internal Controls

(a) RULES REQUIRED—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78m or 78o(d)] to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

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(b) INTERNAL CONTROL EVALUATION AND REPORTING—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Required

a. The Sarbanes-Oxley Act refers to "the Commission" in several sections. To what Commission is the Sarbanes-Oxley Act referring?
b. Describe the responsibility of the Commission in relation to the "Board."
c. Describe the Board.
d. Describe the duties of the Board.
e. Who must register with the Board?
f. Describe the Board's responsibility as to the inspection of those registered with the Board.
g. Describe the responsibilities of the Board in relation to auditing standards.
h. Contrast the applicability of the Sarbanes-Oxley Act to domestic public accounting firms versus foreign public accounting firms.
i. Describe the recognition of accounting standards by the Commission as provided.
j. Comment on the funding for the:
   1. Board.
   2. Financial Accounting Standards Board.
k. Describe prohibited activities of the independent auditor. Can the independent auditor perform tax services for an audit client?
l. Describe management's responsibility in relation to internal controls.
m. Speculate on why Title IV, Section 404, "Management Assessment of Internal Controls," has received substantial criticism.

CASE 1-11 REGULATION OF SMALLER PUBLIC COMPANIES

The U.S. Securities and Exchange Commission (SEC) chartered the Advisory Committee on Smaller Public Companies on March 23, 2005. The charter provided an objective of assessing the regulatory system for smaller companies under the securities laws of the United States and makes recommendations for changes.

The SEC Advisory Committee gave its final recommendations to the SEC in April 2006. These recommendations included several primary recommendations, such as establish a scaled or proportional securities regulation for smaller public companies based on a stratification of smaller public companies into two groups; micro cap companies and small cap companies.*

The report indicates that a scales or proportional securities regulation for smaller public companies assures the full benefits and protection of federal securities regulation for investors in large companies that make up 94% of the total public U.S. equity capital markets....[†]

The committee acknowledges the relative risk to investors and the capital markets as it's currently used by professional investors when using proportional securities regulations.

Required It is perceived that the risk is greater when investing in smaller public companies with proportional securities regulations than in larger companies. Speculate on why the committee considers this risk worth taking.

*Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (April 23, 2006), p. 4.
[†]Ibid., p. 16.

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Case 1-12 STABLE FUNDING

Speech by SEC Chairman: (In Part)
Remarks Before the Financial Accounting Foundation's 2011 Annual Board of Trustees Dinner

by

Chairman Mary L. Shapiro
U.S. Securities and Exchange Commission
Washington, D.C.
May 24, 2011

"Funding for the GASB and IASB

In addition to the quality of its board and staff, one reason the FASB is able to maintain its position as a world leader is the independent and stable funding it has received, through the issuer accounting support fee, since enactment of Sarbanes-Oxley.

And this brings me to a third area in which I believe change would benefit investors: stable funding for other standard-setting boards.

The Governmental Accounting Standards Board establishes standards that state and local governments may elect to use when raising funds through issuance of municipal securities. And it is a leader in studying how well those standards work. Just last week, the FAF announced that GASB has commissioned an independent study on the purposes of financial accounting and reporting by state and local governments.

Designed to examine how GASB guidelines and standards help investors assess the accountability of local governments and their offerings, it is a timely reminder of the important and unique role that GASB fills.

I am pleased that the Dodd-Frank Act recognized the importance of sufficient and stable resources by authorizing the Commission to require a national securities association to fund the GASB by establishing an annual fee. The Commission recently directed FINRA to establish this fee which will strengthen the independence of the GASB as the Trustees will no longer need to solicit contributions from the very people who must apply the standards that the GASB develops.

Yet another important standard-setter, the IASB, lacks an independent and assured source of funding, as the IFRS Foundation has no authority to impose funding requirements. The threats of interference during the financial crisis serve as a continued reminder of the importance of financial independence for the IFRS Foundation and the IASB.

I know from my role as a member of the Monitoring Board that the trustees of the IFRS Foundation are working closely with regulatory and other public authorities and key stakeholder groups to explore more stable funding mechanisms. Until then, however, funding for the IASB will remain a challenge. And so the SEC's staff continues to evaluate short-and long-term options for assisting the IFRS Foundation. I would like to thank the FAF and its leadership for their continued input and support on this important issue."

Note: GASB is a branch of the Financial Accounting Foundation. The GASB is covered in Chapter 13 Personal Financial Statements and Accounting for Governments and Not-for-Profit Organizations.

Required

5348270 Jon Hobart

a. How is the FASB funded?
b. How is the GASB funded?
c. How is the IASB funded?

Source: U.S. Securities and Exchange

Case 1-13 RULES OR FEEL?

The FASB and the IASB have made progress toward convergence. The IFRS standards are considered to be more principles based than the U.S. rules-based GAAP. As of 2007, the IFRSs filled approximately 2,000 pages of accounting regulations.* When an IFRS or interpretation does not exist, then judgment must be used when applying an accounting policy.

*Lawrence M. Gill, "IFRS: Coming to America," Journal of Accounting (June 2007), p. 71

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As of 2007, U.S. GAAP comprised over 2,000 separate pronouncements.** Many of the U.S. pronouncements were dozens of pages issued by numerous bodies.***

**Ibid.
***Ibid.

Required

a. "The IFRS standards are considered to be more principles based than the U.S. rules-based GAAP." Comment on the implications of this statement, including the legal implications.
b. U.S. GAAP has been considered by many to be the best GAAP in the world. Should the United States give up its GAAP?

Case 1-14 PCAOB ENFORCEMENT – IFRS STANDARDS

"The PCAOB has authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes-Oxley Act of 2002, the rules of the PCAOB and the Securities and Exchange Commission, and other laws, rules, and professional standards governing the audits of public companies, brokers, and dealers. When violations are found, the PCAOB can impose appropriate sanctions." (http://pcaobus.org/enforcement)

The IFRS standards are considered to be more principles based than the U.S. rules-based GAAP. The IASB does not have authority to enforce its standards.

Required

a. In your opinion, will it be more difficult for the PCAOB to enforce standards under an IFRS environment? Comment.
b. To the extent that the PCAOB attempts enforcement in an IFRS environment, will companies in the United States be at a disadvantage? Comment.

5348270 PCAOBbart

Source: U.S. Securities and Exchange

Web Case THOMSON ONE *Business School Edition*

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To the Net Case

1. Go to the FASB site (www.fasb.org).
   a. Click on "About FASB." Click on "Facts About FASB." Be prepared to discuss the mission of the Financial Accounting Standards Board.
   b. Under the "About FASB" tab, click on "FASAC." Read "An Overview." Be prepared to discuss.
2. Go to the SEC site (www.sec.gov).
   a. Under "Filings & Forms (Edgar)," click on "Search for Company Filings."
   b. Click on "Company or fund, etc."
   c. Enter the name of a company of your choice. Use this site to obtain the address of the company. Contact the company requesting a copy of its annual report, 10-K, and proxy. Compare the annual report with the 10-K.
3. Go to the IASB site (www.ifrs.org).
   a. Click on "About Us." Click on "About the Organisation." Be prepared to discuss.
   b. Click on "Standards Development." Click on "Standard-Setting Process." Be prepared to discuss.

(continued)

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(To The Net continued)

4. Go to the PCAOB site (www.pcaobus.org).
   a. Comment on the PCAOB OVERSEES.
   b. Click on "About the PCAOB." Comment.
5. Go to the AICPA site (www.aicpa.org).
   a. Click on "Career." Click on "Career Paths." Comment on "Common Career Paths."
   b. Click on "Career." Click on "Diversity Initiatives." Comment on "Diversity Initiatives."
6. Go to the Yahoo! Finance site (http://finance.yahoo.com).
   a. Enter the name of a company in the "Get Quotes" box. Click on "Get Quotes." Comment on what you found.

Endnotes

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7. Release No. 33-8238, February 24, 2004, Securities and Exchange Commission, Final Rule: "Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," www.sec.gov.
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23. Ibid., 17.
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26. Ellen M. Heffes, "Legal Considerations in the Proposed Transition to International Financial Reporting Standards." *Financial Executive* (May 2009), pp. 14–15.

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