Twelfth Edition

RICHARD G. SCHROEDER | MYRTLE W. CLARK | JACK M. CATHEY

FINANCIAL ACCOUNTING THEORY AND ANALYSIS

Text and Cases

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TWELFTH EDITION

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Preface

Accounting education has experienced many dramatic changes over the life of this accounting theory text. The publication of the twelfth edition represents forty years in its evolution. At its inception, much of what was then considered theory was in reality rote memorization of rules. In recent years, the globalization of the economy has affected the skills necessary to be a successful accountant and has caused accounting educators to develop new methods of communicating accounting education. Emphasis is now being given to the incorporation of ethics into the curriculum, the analysis of a company's quality of earnings and sustainable income, the use of the World Wide Web as a source of information, the international dimensions of accounting, the development of critical thinking skills, the development of communication skills, and the use of group projects to develop cooperative skills.

This edition of the text is a further extension of the refocusing of the material to suit the needs of accounting professionals into the twenty-first century. Among the new features in this edition that were designed to accomplish this objective are

- Expanded use of the Web by including cases and updates on the textbook companion site
- A tutorial on the use of the FASB ASC in the solutions manual.
- A test bank containing more than 250 multiple-choice and more than 200 essay questions.
- Updated disclosure examples throughout the chapters and updated financial analysis sections of each chapter using Hershey and Tootsie Roll as the example companies.
- New FASB ASC cases.
- New Web cases.
- A discussion of the FASB's proposed change in the definition of materiality in Chapter 2.
- A discussion of the conceptual framework project on measurement, presentation, and disclosure in Chapter 2.
- A discussion of the status of the conceptual framework projects—elements and recognition, and reporting entity in Chapter 2.
- A summary of the status of the remaining joint FASB–IASB convergence projects in Chapter 2.
- A discussion of the IASB's decision to proceed independent of the FASB on the Conceptual Framework Project in Chapter 3.
- A discussion of the IASB new Conceptual Framework Exposure Draft in Chapter 3.
- A discussion of the IASB's The Agenda Consultation Initiative and the IASB's future work program in Chapter 3.
- An expanded discussion of behavioral finance in Chapter 4.
- A discussion of FASB EITF issues *No. 00-21*, "Revenue Arrangements with Multiple Deliverables," and *No. 09-1*, "Revenue Arrangements with Multiple Deliverables," in Chapter 5.

- A discussion of *FASB ASC 606*, "Revenue from Contracts with Customers," in Chapter 5.
- A discussion of *IFRS No. 16*, "Revenue from Contracts with Customers," in Chapter 5.
- A discussion of The Joint Transition Resource Group in Chapter 5.
- A discussion of the FASB's simplification initiative in Chapter 6.
- A discussion of the two issues addressed by the simplification initiative—discontinued operations and extraordinary items—in Chapter 6.
- A discussion of *Accounting Standards Update 2011-04*, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements," in Chapter 7.
- A discussion of Accounting Standards Update 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," in Chapters 7, 8, 10, and 11.
- A discussion of *Accounting Standards Update 2015-01*, "Simplifying the Measurement of Inventory," in Chapter 8.
- A discussion of working capital management in Chapter 8.
- A discussion of inventory management in Chapter 8.
- A discussion of *Accounting Standards Update No. 2012-02*, "Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment," in Chapter 10.
- Add a discussion of *Accounting Standards Update No. 2011-08*, "Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment," in Chapter 10.
- A discussion of accounting for financial assets contained in *IFRS No. 9*, "Financial Instruments," in Chapter 10.
- A discussion of *Accounting Standards Update No. 2015-03*, "Interest—Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs," in Chapter 11.
- A discussion of the recognition and measurement requirements for financial liabilities contained in *IFRS No. 9*, "Financial Instruments," in Chapter 11.
- A discussion of *Accounting Standards Update No. 2013-11*, "Income Taxes: Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," in Chapter 12.
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- A discussion of the proposed ASU, "Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715- 20)," in Chapter 14.
- A discussion of the proposed ASU, "Compensation—Retirement Benefits (Topic 715)," in Chapter 14.
- A discussion of the amendment to *IAS No. 19*, "Retirement Benefit Costs," in Chapter 14.
- A discussion of the FASB's Exposure Draft, "Simplifying the Accounting for Measurement Period Adjustments," in Chapter 16.
- A discussion of *Accounting Standards Update No. 2014-15*, "Presentation of Financial Statements—Going Concern: Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern to the section on Going Concern," in Chapter 17.

- A discussion of *Accounting Standards Update No. 2013-07*, "Presentation of Financial Statements: Liquidation Basis of Accounting," to the section on Going Concern in Chapter 17.
- A discussion of the exposure draft on financial statement disclosures and materiality in Chapter 17.
- A discussion of the SEC's Disclosure Effectiveness Project in Chapter 17.
- A discussion of the PCAOB's new amendments to its auditing standards that require the disclosure of: the name of the engagement partner; and the names, locations, and extent of participation of other accounting firms that took part in a group audit in Chapter 17.
- A discussion of the revised AICPA Code of Professional Conduct that restructures the Code to improve its readability and converges the Code with international standards in Chapter 17
- A discussion of the IASB's "Management Commentary—A Framework for Presentation, in Chapter 17.

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The Development of Accounting Theory

CHAPTER 1

In its simplest form, theory may be just a belief, but for a theory to be useful, it must have wide acceptance. Webster defined *theory* as:

> *Systematically organized knowledge, applicable in a relatively wide variety of circumstances; a system of assumptions, accepted principles and rules of procedure to analyze, predict or otherwise explain the nature of behavior of a specified set of phenomena.*[1]

The objective of theory is to explain and predict. Consequently, a basic goal of the theory of a particular discipline is to have a well-defined body of knowledge that has been systematically accumulated, organized, and verified well enough to provide a frame of reference for future actions.

Theories may be described as either normative or positive. *Normative theories* explain what should be, whereas *positive theories* explain what is. Ideally, there should be no such distinction because a well-developed and complete theory encompasses both what should be and what is.

The goal of accounting theory is to provide a set of principles and relationships that explain observed practices and predict unobserved practices. That is, accounting theory should be able to explain why companies elect to use certain accounting methods over others and should enable users to predict the attributes of firms that elect to use various accounting methods. As in other disciplines, accounting theory should also be verifiable through accounting research.

The development of a general theory of accounting is important because of the role accounting plays in our economic society. We live in a capitalistic society, which is characterized by a self-regulated market that operates through the forces of supply and demand. Goods and services are available for purchase in markets, and individuals are free to enter or exit the market to pursue their economic goals. All societies are constrained by scarce resources that limit the attainment of all individual or group economic goals. In our society, the role of accounting is to report how organizations use scarce resources and to report on the status of resources and claims to resources.

As will be discussed in Chapter 4, there are various theories of accounting and the uses of accounting information, including the fundamental analysis model, the efficient markets hypothesis, the behavioral finance model, the capital asset pricing model, the positive accounting theory model, the human information processing model, and the critical perspective model. These often competing theories exist because accounting theory has not yet developed into the state described by Webster's definition. Accounting research is needed to attain a more general theory of accounting, and in this regard the various theories of accounting that have been posited must be subjected to verification. A critical question concerns the usefulness of accounting data to users. That is, does the use of a theory help individual decision makers make more correct decisions? Various suggestions on the empirical testing of accounting theories have been offered.[2] As theories are tested and are either confirmed or discarded, we move closer to a general theory of accounting.

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[1] *Webster's 11th New Collegiate Dictionary* (Boston: Houghton Mifflin, 1999).

[2] See, for example, Robert Sterling, "On Theory Structure and Verification," *The Accounting Review* (July 1970): 444–457.

The goal of this text is to provide a user perspective on accounting theory. To this end, we first review the development of accounting theory to illustrate how investors' needs have been perceived over time. Next we review the current status of accounting theory with an emphasis on how investors and potential investors use accounting and other financial information. Finally, we summarize current disclosure requirements for various financial statement items and provide examples to show how companies comply with these disclosure requirements.

THE EARLY HISTORY OF ACCOUNTING

The work of Denise Schmandt-Besserat suggests that that the origins of writing are actually found in counting. This assertion is based on the fact that at nearly every Middle Eastern archeological site the researchers have found little pieces of fired clay that they could not identify. Subsequently, Schmandt-Besserat's research found that the tokens composed an elaborate system of accounting that was used throughout the Middle East from approximately 8000 to 3000 BC. Each token stood for a specific item, such as a sheep or a jar of oil, and it was used to take inventory and keep accounts.[3]

Other accounting records dating back several thousand years have been found in various parts of the world. These records indicate that at all levels of development, people desire information about their efforts and accomplishments. For example, the Zenon papyri,[4] which were discovered in 1915, contain information about the construction projects, agricultural activities, and business operations of the private estate of Apollonius for a period of about thirty years during the third century BC.

According to Hain, "The Zenon papyri give evidence of a surprisingly elaborate accounting system which had been used in Greece since the fifth century BC and which, in the wake of Greek trade or conquest, gradually spread throughout the Eastern Mediterranean and Middle East."[5] Zenon's accounting system contained provisions for responsibility accounting, a written record of all transactions, a personal account for wages paid to employees, inventory records, and a record of asset acquisitions and disposals. In addition, there is evidence that all the accounts were audited.[6]

Later, the Romans kept elaborate records, but because they expressed numbers through letters of the alphabet, they were not able to develop any structured system of accounting. It was not until the Renaissance—approximately 1300–1500, when the Italians were vigorously pursuing trade and commerce—that the need to keep accurate records arose. Italian merchants borrowed the Arabic numeral system and the basis of arithmetic, and an evolving trend toward the double-entry bookkeeping system we now use developed.

In 1494 an Italian monk, Fra Luca Pacioli, wrote a book on arithmetic that included a description of double-entry bookkeeping. Pacioli's work, *Summa de Arithmetica Geometria Proportioniet Proportionalita*, did not fully describe double-entry bookkeeping; rather, it formalized the practices and ideas that had been evolving over the years. Double-entry bookkeeping enabled business organizations to keep complete records of transactions and ultimately resulted in the ability to prepare financial statements.

Statements of profit and loss and statements of balances emerged in about 1600.[7] Initially, the primary motive for separate financial statements was to obtain information regarding capital.

---

[3] Denise Schmandt-Besserat, *Before Writing: From Counting to Cuneiform* Vols. I and II (Austin, TX: University of Texas Press, 1992).
[4] Zenon worked as a private secretary for Apollonius in Egypt in approximately 260 BC.
[5] H. P. Hain, "Accounting Control in the Zenon Papyri," *The Accounting Review* (October 1966): 699.
[6] Ibid., 700–701.
[7] A. C. Littleton, *Accounting Evolution to 1900* (New York: AICPA, 1933).

Consequently, balance sheet data were stressed and refined in various ways, and expense and income data were viewed as incidental.[8]

As ongoing business organizations replaced isolated ventures, it became necessary to develop accounting records and reports that reflected a continuing investment of capital employed in various ways and to periodically summarize the results of activities. By the nineteenth century, bookkeeping had expanded into accounting, and the concept that the owner's original contribution, plus or minus profits or losses, indicated net worth emerged. However, profit was considered an increase in assets from any source because the concepts of cost and income were yet to be fully developed.

Another factor that influenced the development of accounting during the nineteenth century was the evolution in England of joint ventures into business corporations. Under the corporate form of business, owners (stockholders) are not necessarily the company's managers. Thus many people external to the business itself needed information about the corporation's activities. Moreover, owners and prospective owners wanted to evaluate whether stockholder investments had yielded a return. As a consequence, the emerging existence of corporations created a need for periodic reporting as well as a need to distinguish between capital and income.

The statutory establishment of corporations in England in 1845 stimulated the development of accounting standards, and laws were subsequently designed to safeguard shareholders against improper actions by corporate officers. Dividends were required to be paid from profits, and accounts were required to be kept and audited by persons other than the directors. The Industrial Revolution and the succession of the Companies Acts in England[9] also increased the need for professional standards and accountants.

During this period commerce was expanding in the United States and by the later part of the nineteenth century, the Industrial Revolution had arrived, bringing the need for more formal accounting procedures and standards. Railroads became a major economic influence that created the need for supporting industries. This led to increases in the market for corporate securities and an increased need for trained accountants as the separation of the management and ownership functions became more distinct.

At the end of the nineteenth century, widespread speculation in the securities markets, watered stocks, and large monopolies that controlled segments of the U.S. economy resulted in the establishment of the progressive movement. In 1898 the Industrial Commission was formed to investigate questions relating to immigration, labor, agriculture, manufacturing, and business. Although no accountants were either on the commission or used by the commission, a preliminary report issued in 1900 suggested that an independent public accounting profession should be established to curtail observed corporate abuses.

Although most accountants did not necessarily subscribe to the desirability of the progressive reforms, the progressive movement conferred specific social obligations on accountants.[10] As a result, accountants generally came to accept three general levels of progressiveness: (1) a fundamental faith in democracy, a concern for morality and justice, and a broad acceptance of the efficiency of education as a major tool in social amelioration; (2) an increased awareness of the social obligation of all segments of society and introduction of the idea of the public accountability of business and political leaders; and (3) an acceptance of pragmatism as the most relevant operative philosophy of the day.[11]

The major concern of accounting during the early 1900s was the development of a theory that could cope with corporate abuses that were occurring at that time, and capital maintenance emerged as a concept. This concept evolved from maintaining invested capital intact to

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[8] John L. Carey, *The Rise of the Accounting Profession* (New York: AICPA, 1969), 5.
[9] Companies Act is a short title used for legislation in the United Kingdom relating to company law.
[10] Gary John Previts and Barbara Dubis Merino, *A History of Accounting in America* (Columbus: Ohio State University Press, 1979), 177.
[11] Richard Hofstadter, *Social Darwinism in American Thought* (Philadelphia: University of Pennsylvania Press, 1944).

maintaining the physical productive capacity of the firm to maintaining real capital. In essence, this last view of capital maintenance was an extension of the economic concept of income (see Chapter 5) that there could be no increase in wealth unless the stockholder or the firm were better off at the end of the period than at the beginning.

The accounting profession also evolved over time. Initially anyone could claim to be an accountant, for there were no organized standards of qualifications, and accountants were trained through an apprenticeship system. Later, private commercial colleges began to emerge as the training grounds for accountants.

The last quarter of the nineteenth century was a period of economic change that provided the impetus for the establishment of the accounting profession in the United States. The Institute of Accountants of New York, formed in 1882, was the first professional accounting organization. In 1887, a national organization, the American Association of Public Accountants (AAPA) was formed. The goal of these two organizations was to obtain legal recognition for the public practice of accounting.[12] In 1902, the Federation of Societies of Public Accountants in the United States was organized. Subsequently, in 1904 the United States International Congress of Accountants was convened and resulted in the merger of the AAPA and the Federation into the American Association of Public Accountants. In 1916, after a decade of bitter interfactional disputes, this group was reorganized into the American Institute of Accountants (AIA).

In the early 1900s, many universities began offering accounting courses. At this time no standard accounting curriculum existed.[13] In an attempt to alleviate this problem, in 1916 the American Association of the University Instructors in Accounting (AAUIA) was also formed. Because curriculum development was the major focus at this time, it was not until much later that the AAUIA attempted to become involved in the development of accounting theory.

World War I changed the public's attitude toward the business sector. Many people believed that the successful completion of the war could at least partially be attributed to the ingenuity of American business. As a consequence, the public perceived that business had reformed and that external regulation was no longer necessary. The accountant's role changed from protector of third parties to protector of business interests. This change in emphasis probably contributed to the events that followed in the 1920s.

Critics of accounting practice during the 1920s suggested that accountants abdicated the stewardship role, placed too much emphasis on the needs of management, and permitted too much flexibility in financial reporting. During this time financial statements were viewed as the representations of management, and accountants did not have the ability to require businesses to use accounting principles they did not wish to employ. The result of this attitude is well known. In 1929 the stock market crashed, and as a result, the Great Depression ensued. Although accountants were not initially blamed for these events, the possibility of government intervention in the corporate sector loomed.

ACCOUNTING IN THE UNITED STATES SINCE 1930

The Great Depression caused business interests to become increasingly concerned about government intervention, and they looked for ways to self-reform. One of the first attempts to improve accounting began shortly after the inception of the Great Depression with a series of meetings between representatives of the New York Stock Exchange (NYSE) and the American Institute of Accountants. The purpose of these meetings was to discuss problems pertaining to

[12] Previts and Marino, op cit, 135.

[13] For example, students now taking such accounting courses as intermediate, cost, or auditing are exposed to essentially the same material in all academic institutions, and textbooks offering the standard material for these classes are available from several publishers.

the interests of investors, the NYSE, and accountants in the preparation of external financial statements.

Similarly, in 1935 the American Association of University Instructors in Accounting changed its name to the American Accounting Association (AAA) and announced its intention to expand its activities in the research and development of accounting principles and standards. The first result of these expanded activities was the publication, in 1936, of a brief report cautiously titled, "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements." The four-and-one-half-page document summarized the significant concepts underlying financial statements at that time.

The cooperative efforts between the members of the NYSE and the AIA were well received. However, the post-Depression atmosphere in the United States was characterized by regulation. There was even legislation introduced in Congress that would have required auditors to be licensed by the federal government after passing a civil service examination.

Two of the most important pieces of congressional legislation passed at this time were the Securities Act of 1933 and the Securities Exchange Act of 1934, which established the Securities and Exchange Commission (SEC). The SEC was created to administer various securities acts. Under powers provided by Congress, the SEC was given the authority to prescribe accounting principles and reporting practices. Nevertheless, because the SEC has generally acted as an overseer and allowed the private sector to develop accounting principles, this authority has seldom been used. However, the SEC has exerted pressure on the accounting profession and has been especially interested in narrowing areas of difference in accounting practice. (The role of the SEC is discussed in more detail in Chapter 17.)

From 1936 to 1938 the SEC was engaged in an internal debate over whether it should develop accounting standards. Even though William O. Douglas (then the SEC chairman, and later a Supreme Court justice) disagreed, in 1938 the SEC decided in *Accounting Series Release (ASR No. 4)* to allow accounting principles to be set in the private sector. *ASR No. 4* indicated that reports filed with the SEC must be prepared in accordance with accounting principles that have "substantial authoritative support."[14]

The profession was convinced that it did not have the time needed to develop a theoretical framework of accounting. As a result, the AIA agreed to publish a study by Sanders, Hatfield, and Moore titled *A Statement of Accounting Principles*.[15] The publication of this work was quite controversial in that it was simply a survey of existing practice that was seen as telling practicing accountants "do what you think is best." Some accountants also used the study as an authoritative source that justified current practice.

Earlier in 1936, the AIA had merged with the American Society of Certified Public Accountants, forming a larger organization later named the American Institute of Certified Public Accountants (AICPA). This organization has had increasing influence on the development of accounting theory. For example, over the years, the AICPA established several committees and boards to deal with the need to further develop accounting principles. The first was the Committee on Accounting Procedure. It was followed by the Accounting Principles Board, which was replaced by the Financial Accounting Standards Board. Each of these bodies has issued pronouncements on accounting issues, which have become the primary source of generally accepted accounting principles that guide accounting practice today.

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[14] This term, initially proposed by Carman Blough, the first chief accountant of the SEC, is meant to mean authority of "substantial weight" or importance, and not necessarily a majority view. Thus there might be three authoritative positions, all of which are appropriate at a point in time before some standard is established. The majority might have gone in one direction, but the minority were also considered "authoritative" and could be used. See William D. Cooper, "Carman G. Blough's Contributions to Accounting: An Overview," *Accounting Historians Journal* 9, no. 2 (Fall 1982): 61–67.

[15] Thomas H. Sanders, Henry Rand Hatfield and William Underhill Moore, *A Statement of Accounting Principles* (New York: AICPA, 1938).

COMMITTEE ON ACCOUNTING PROCEDURE

Professional accountants became more actively involved in the development of accounting principles following the meetings between members of the NYSE and the AICPA and the controversy surrounding the publication of the Sanders, Hatfield, and Moore study. In 1936 the AICPA's Committee on Accounting Procedure (CAP) was formed. This committee had the authority to issue pronouncements on matters of accounting practice and procedure in order to establish generally accepted practices (GAAP).

The CAP was relatively inactive during its first two years but became more active in response to the SEC's release of *ASR No. 4*. The release of ASR No. 4, gave the CAP de facto recognition as the source of *substantial authoritative support,*[16] and one of its first responses was to expand from its original seven to twenty-one members.

One of the first issues the CAP addressed was the use of the historical cost model of accounting. The then-accepted definition of assets as unamortized cost was seen by some critics as allowing management too much flexibility in deciding when to charge costs to expense. This practice was seen as allowing earnings management[17] to occur.

Another area of controversy was the impact of inflation on reported profits. During the 1940s several companies lobbied for the use of replacement cost depreciation. These efforts were rejected by both the CAP and the SEC, which maintained that income should be determined on the basis of historical cost. This debate continued over a decade, ending only when Congress passed legislation in 1954 amending the IRS Tax Code to allow accelerated depreciation.

The works of the CAP were originally published in the form of *Accounting Research Bulletins* (*ARB*s); however, these pronouncements did not dictate mandatory practice, and they received authority only from their general acceptance. The *ARB*s were consolidated in 1953 into *Accounting Terminology Bulletin No. 1*, "Review and Resume," and *ARB No. 43. ARB*s *No. 44* through *No. 51* were published from 1953 until 1959. The recommendations of these bulletins that have not been superseded are contained in the FASB Accounting Standards Codification (FASB ASC; discussed later) and referenced throughout this text where the specific topics covered by the *ARB*s are discussed. Those not superseded can be accessed through the cross-reference option on the FASB ASC website (https://asc.fasb.org).

ACCOUNTING PRINCIPLES BOARD

In October 1957, the AICPA's new president, Alvin R. Jennings, called for the reorganization and strengthening of the AICPA's standard setting process, and by 1959 the methods of formulating accounting principles were being questioned as not arising from research or based on theory. The CAP was also criticized for acting in a piecemeal fashion and issuing standards that in many cases were inconsistent. In addition, all its members were part-time, and as a result their independence was questioned. Finally, the fact that all the CAP members were required to be AICPA members prevented many financial executives, investors, and academics from serving on the committee. As a result, accountants and users of financial statements were calling for wider representation in the development of accounting principles. In 1959 the AICPA responded to the alleged shortcomings of the CAP by forming the Accounting Principles Board (APB). The objectives of this body were to advance the written expression of generally accepted accounting principles (GAAP), to narrow areas of difference in appropriate practice, and to discuss unsettled controversial

[16] Lynn E. Turner, The Future is Now, Keynote Address, Accounting Hall of Fame-Association of Accounting Historians, Ohio State University, Columbus, Ohio, November 10, 2000.

[17] Earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a predetermined target. See Chapter 5 for a detailed discussion.

issues. However the expectation of a change in the method of establishing accounting principles was quickly squelched when the first APB chairman, Weldon Powell, voiced his belief that accounting research was more applied than pure and that the usefulness of the end product was a major concern.[18]

The APB was comprised of from seventeen to twenty-one members, who were selected primarily from the accounting profession but also included individuals from industry, government, and academia. Initially, the pronouncements of the APB, termed "Opinions," were not mandatory practice; however, the issuance of *APB Opinion No. 2* (see FASB ASC 740-10-25 and 45) and a subsequent partial retraction contained in *APB Opinion No. 4* (see FASB ASC 740-10-50) highlighted the need for standard-setting groups to have more authority.

This controversy was over the proper method to use in accounting for the investment tax credit. In the early 1960s the country was suffering from the effects of a recession. After President John F. Kennedy took office, his advisors suggested an innovative fiscal economic policy that involved a direct income tax credit (as opposed to a tax deduction) based on a percentage of the cost of a qualified investment. Congress passed legislation creating the investment tax credit in 1961.

The APB was then faced with deciding how companies should record and report the effects of the investment tax credit. It considered two alternative approaches:

1. The *flow-through* method, which treated the tax credit as a decrease in income tax expense in the year it occurred.
2. The *deferred* method, which treated the tax credit as a reduction in the cost of the asset and therefore was reflected over the life of the asset through reduced depreciation charges.

The APB decided that the tax credit should be accounted for by the deferred method and issued *APB Opinion No. 2*. This pronouncement stated that the tax reduction amounted to a cost reduction, the effects of which should be amortized over the useful life of the asset acquired. The reaction to this decision was quite negative on several fronts. Members of the Kennedy administration considered the flow-through method more consistent with the goals of the legislation, and three of the then–Big Eight accounting firms advised their clients not to follow the recommendations of *APB Opinion No. 2*. In 1963, the SEC issued *Accounting Series Release No. 96*, allowing firms to use either the flow-through or deferred method in their SEC filings.

The fact that the SEC had the authority to issue accounting pronouncements, and the lack of general acceptance of *APB Opinion No. 2*, resulted in the APB partially retreating from its previous position. Though reaffirming the previous decision as being the proper and most appropriate treatment, *APB Opinion No. 4* approved the use of either of the two methods.

The lack of support for some of the APB's pronouncements and concern over the formulation and acceptance of GAAP caused the Council of the AICPA to adopt Rule 203 of the Code of Professional Ethics.[19] This rule requires departures from accounting principles published in *APB Opinions* or *Accounting Research Bulletins* (or subsequently *FASB Statements* and now the FASB ASC) to be disclosed in footnotes to financial statements or in independent auditors' reports when the effects of such departures are material. This action has had the effect of requiring companies and public accountants who deviate from authoritative pronouncements to justify such departures.

In addition to the difficulties associated with passage of *APB Opinions No. 2* and *No. 4*, the APB encountered other problems. The members of the APB were, in effect, volunteers.

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[18] Weldon Powell, "Report on the Accounting Research Activities of the American Institute of Certified Public Accountants," *The Accounting Review* (January 1961): 26–31.
[19] The AICPA's Professional Code of Ethics is discussed in more detail in Chapter 17.

These individuals had full-time responsibilities to their employers; therefore, the performance of their duties on the APB became secondary. By the late 1960s, criticism of the development of accounting principles again arose. This criticism centered on the following factors:

1. *The independence of the members of the APB.* The individuals serving on the Board had full-time responsibilities elsewhere that might influence their views of certain issues.

2. *The structure of the Board.* The largest eight public accounting firms (at that time) were automatically awarded one member, and there were usually five or six other public accountants on the APB.

3. *Response time.* The emerging accounting problems were not being investigated and solved quickly enough by the part-time members.

THE FINANCIAL ACCOUNTING STANDARDS BOARD

Due to the growing criticism of the APB, in 1971 the board of directors of the AICPA appointed two committees. The Wheat Committee, chaired by Francis Wheat, was to study how financial accounting principles should be established. The Trueblood Committee, chaired by Robert Trueblood, was asked to determine the objectives of financial statements.

The Wheat Committee issued its report in 1972 recommending that the APB be abolished and the Financial Accounting Standards Board (FASB) be created. In contrast to the APB, whose members were all from the AICPA, this new board was to comprise representatives from various organizations. The members of the FASB were also to be full-time paid employees, unlike the APB members, who served part-time and were not paid.

The Trueblood Committee, formally known as the Study Group on Objectives of Financial Statements, issued its report in 1973 after substantial debate—and with considerably more tentativeness in its recommendations about objectives than the Wheat Committee had with respect to the establishment of principles. The study group requested that its report be regarded as an initial step in developing objectives and that significant efforts should be made to continue progress on refining and improving accounting standards and practices. The specific content of the Trueblood Report is discussed in Chapter 2.

The AICPA quickly adopted the Wheat Committee recommendations, and the FASB became the official body charged with issuing accounting standards. The structure of the FASB is as follows. A board of trustees is nominated by organizations whose members have special knowledge and interest in financial reporting. The organizations originally chosen to select the trustees were the American Accounting Association, the AICPA, the Financial Executives Institute, the National Association of Accountants (the NAA's name was later changed to Institute of Management Accountants in 1991), and the Financial Analysts Federation. In 1997 the board of trustees added four members from public interest organizations. The board that governs the FASB is the Financial Accounting Foundation (FAF). The FAF appoints the Financial Accounting Standards Advisory Council (FASAC), which advises the FASB on major policy issues, the selection of task forces, and the agenda of topics. The number of members on the FASAC varies from year to year. The bylaws call for at least twenty members to be appointed. However, the actual number of members has grown to about thirty in recent years to obtain representation from a wider group of interested parties.

The FAF is also responsible for appointing the members of the FASB and raising the funds to operate the FASB. Until 2001 most of the funds raised by the FAF came from the AICPA and the largest public accounting firms. However, the Sarbanes–Oxley Act of 2002 required the FASB to be financed by fees assessed against publicly traded companies, instead of by donations from the interested parties in the private sector. The purpose of this action was to increase the independence of the FASB from the constituents it serves. The FAF currently collects more than

$23 million a year to support the activities of the FASB. Figure 1.1 illustrates the current structure of the FASB.

Both the FAF and the FASB have a broader representation of the total profession than did the APB; however, most of the members are usually CPAs from public practice. The structure of the FAF has also come under scrutiny by the SEC. In 1996, Arthur Levitt, chairman of the SEC, voiced concern that the FAF's public interest objectives were at risk. He suggested that the FAF be reorganized so that most of its members would be individuals with strong public service backgrounds who are better able to represent the public free of any conflict of interest. He suggested that the SEC should approve the appointments to the FAF.[20] To date there has been no substantial change in the method of appointing FAF members, although in 2002 the FAF amended the trustee appointment process. It now requires the trustees to consider up to two nominees from the constituent organizations for each seat and for the appointment to be made by the trustees. Under the new system, if the trustees do not find the nominees acceptable, they may consult with that particular organization and appoint a person of their own choosing as long as the individual's background matches the requirements for that particular seat. Additional changes in the structure of either the FAF or the FASB are likely to be evolutionary.

Section 108 of Sarbanes–Oxley established criteria that must be met for the work product of an accounting standard-setting body to be recognized as "generally accepted." The SEC responded by issuing a policy statement stating that the FASB and its parent organization, the FAF, satisfy the criteria in Section 108 of the Sarbanes–Oxley Act, and accordingly, the FASB's financial accounting and reporting standards are recognized as "generally accepted" for purposes of the federal securities laws.[21] Consequently, the FASB is the organization having the authority to issue standards for financial accounting. Thus, throughout this book, pronouncements of the FASB and those of its predecessor organizations not superseded or amended are presented as GAAP.

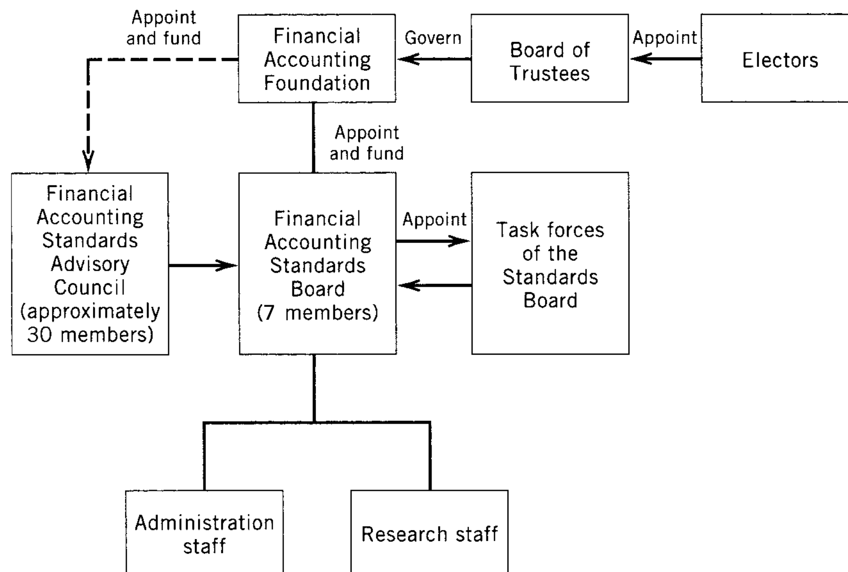

FIGURE 1.1 Structure of the FASB

[20] R. Abelson, "Accounting Group to Meet with SEC in Rules Debate," *New York Times*, 5 May 1996, D5.
[21] The AICPA's Professional Code of Ethics is discussed in more detail in Chapter 17.