Financial Accounting Theory and Analysis - Text and Cases 15th edition Schroeder Test Bank

SKU: 9781394336531-TEST-BANK

Accounting Theory and Analysis

14th Edition

Test Bank

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Chapter 1

Multiple Choice:

1. Which of the following bodies has the ultimate authority to issue accounting pronouncements in the United States?
   a. Securities and Exchange Commission
   b. Financial Accounting Standards Board
   c. International Accounting Standards Committee
   d. Internal Revenue Service

Answer a

2. What historical evidence of the business operations of the private estate of Apollonius was discovered early in the 20th century?
   a. The Iliad
   b. Plato's *Republic*
   c. The Zenon papyri
   d. Pacioli's work, *Summa de Arithmetica Geometria Proportioni et Proportionalita*,

Answer c

3. Who has been given credit or developing the double-entry system of bookkeeping?
   a. Francis Wheat
   b. Fra Luca Pacioli
   c. A. C. Littleton
   d. William Paton

Answer b

4. Which of the following events marked the beginning of efforts to improve accounting after the Great Depression?

   a. The American Accounting Association (AAA) published "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements" in 1936.
   b. The Securities Act of 1933 and the Securities Exchange Act of 1934 were passed, establishing the Securities and Exchange Commission (SEC).
   c. Representatives of the New York Stock Exchange (NYSE) and the AIA began meeting to discuss investor, NYSE, and accountant interests in financial statement preparation.
   d. Legislation was introduced in Congress to require auditors to be licensed by the federal government after passing a civil service examination.

Answer c

5. Which organization was responsible for issuing Accounting Research Bulletins?
   a. The Committee on Accounting Procedure

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b. The Accounting Principles board
c. The Financial Accounting Standards Board
d. The Securities and Exchange Commission

Answer a

6. Which of the following pronouncements were issued by the Accounting Principles Board?
   a. Accounting Research Bulletins
   b. APB Opinions
   c. Statements of Financial Accounting Concepts
   d. Accounting Standards Updates

Answer b

7. Which of the following was not a criticism of the development of accounting standards by the Accounting Principles Board?
   a. 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.
   b. 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.
   c. Harmonization. The accounting standards developed were dissimilar to those developed by the International Accounting Standards Committee.
   d. Response time. The emerging accounting problems were not being investigated and solved quickly enough by the part-time members.

Answer c

8. What was the key outcome of the SEC's Accounting Series Release No. 4 issued in 1938?
   a. It mandated that the SEC would develop all accounting standards internally.
   b. It required that reports filed with the SEC must be prepared in accordance with accounting principles that have "substantial authoritative support."
   c. It stated that financial statements with full disclosure of incorrect accounting practices were acceptable.
   d. It led to the immediate establishment of the Financial Accounting Standards Board (FASB).

Answer b

9. Which of the following is the professional organization of university accounting professors?
   a. American Accounting Association
   b. American Institute of Certified Public Accountants
   c. American Institute of Accountants
   d. Financial Executives Institute

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Answer a

10. What was the main reason for the controversy over APB Opinion No. 2?

    a. The APB's decision to treat the investment tax credit using the flow-through method.
    b. The issuance of APB Opinion No. 4 and its partial retraction of APB Opinion No. 2.
    c. The lack of authority of the APB to mandate accounting standards.
    d. The proper method to use in accounting for the investment tax credit, either the flow-through or deferred method.

Answer d

11. What controversy originally highlighted the need for standard setting groups to have more authority?
    a. Accounting for stock options
    b. Accounting for derivatives
    c. Accounting for marketable securities
    d. Accounting for the investment tax credit

Answer d

12. Which of the following committees recommended abolishing the Accounting Principles Board and replacing it with the Financial Accounting Board?
    a. Wheat
    b. Cohen
    c. Trueblood
    d. Anderson

Answer a

13. Which of the following is a public sector accounting standard setter?
    a. FASB
    b. SEC
    c. APB
    d. CAP

Answer b

14. Which of the following types of pronouncements now establishes generally accepted accounting principles?
    a. Statements of Concepts
    b. Statements of Financial Accounting Standards
    c. APB Opinions
    d. Accounting Standards Updates

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Answer d

15. Which of the following types of pronouncements are intended to establish the objectives and concepts that the FASB will use in developing standards of financial accounting and reporting?
    a. Statements of Concepts
    b. Statements of Financial Accounting Standards
    c. APB Opinions
    d. Accounting Standards Updates

Answer a

16. What is the purpose of Emerging Issues Task Force?
    a. Provide interpretation of existing standards.
    b. Provide timely guidance on select issues.
    c. Provide implementation guidance within the Codification framework to reduce diversity in practice on a timely basis.
    d. Provide interpretive guidance

Answer c

17. What is one of the main criticisms regarding the standard-setting process for small businesses?

    a. US GAAP requirements are developed primarily for large international firms.
    b. US GAAP requirements are often irrelevant to small business financial reporting needs and can violate the cost-benefit constraint.
    c. US GAAP requirements are based solely on the needs of government agencies.
    d. US GAAP requirements exclusively focus on differential disclosure standards for small businesses.

Answer b

18. Which of the following is not a consequence of the standards overload problem to small businesses?

    a. If a small business omits a GAAP requirement from audited financial statements, a qualified or adverse opinion may be rendered.
    b. Small businesses do not need to keep financial records
    c. The cost of complying with GAAP requirements may cause a small business to forgo the development of other, more relevant information.
    d. Small CPA firms that audit smaller companies must keep up to date on all the same requirements as large international firms, but they cannot afford the specialists that are available on a centralized basis in the large firms.

Answer b

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19. Some accountants maintain that accounting standards are as much a product of political action as they are of careful logic or empirical findings. This belief is an example of the concept of
    a. Standard setting as a political process
    b. Standards overload
    c. Economic consequences
    d. The role of ethics in accounting

Answer a

20. Financial accounting standard-setting in the United States can be described as:
    a. A democratic process in the sense that a majority of accountants must agree with a standard before it becomes enforceable.
    b. A research process based on empirical findings
    c. A political process which reflects actions of various interested user groups as well as a product of research and logic.
    d. A legalistic process based on rules promulgated by governmental agencies

Answer c

21. The impact of accounting reports on various segments of our economic society is the definition of the concept of
    a. Standard setting as apolitical process
    b. Standards overload
    c. Economic consequences
    d. The role of ethics in accounting

Answer c

22. Considering and understanding how business decisions affect the financial statements is
    a. The sole responsibility of the Securities and Exchange Commission.
    b. Provided in the auditor's report.
    c. Referred to as an economic consequence perspective.
    d. Interpreted strictly by the company's suppliers.

Answer c

23. Economic consequences of accounting standard-setting means:
    a. Standard-setters must give first priority to ensuring that companies do not suffer any adverse effect as a result of a new standard.
    b. Standard-setters must ensure that no new costs are incurred when a new standard is issued.
    c. The objective of financial reporting should be politically motivated to ensure acceptance by the general public.
    d. Accounting standards can have detrimental impacts on the wealth levels of the providers of financial information.

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Answer d

24. Which of the following companies was involved in an accounting failure that caused the public accounting firm Arthur Andersen to go out of business?
    a. Goldman Sachs
    b. Wachovia
    c. Enron
    d. AIG

Answer c

25. The mission of the International Accounting Standards Board (IASB) is to
    a. Develop a uniform currency in which the financial transactions of companies throughout the world would be measured.
    b. Issue enforceable standards which regulate the financial accounting and reporting of multinational corporations.
    c. Develop a single set of high-quality and understandable IFRS for general-purpose financial statements.
    d. Arbitrate accounting disputes between auditors and international companies.

Answer c

26. The Financial Accounting Standards Board (FASB) was proposed by the
    a. American Institute of Certified Public Accountants.
    b. Study Group on establishment of Accounting Principles (Wheat Committee).
    c. Accounting Principles Board.
    d. Study Group on the Objectives of Financial Statements (Trueblood Committee)

Answer c

27. The body that has the ultimate power to prescribe the accounting practices and standards to be employed by companies that fall under its jurisdiction is the
    a. SEC
    b. APB.
    c. FASB.
    d. AICPA.

Answer a

28. Which of the following organizations was established by the federal government to help develop and standardize financial information presented to stockholders?
    a. AICPA (American Institute of Certified Public Accountants).
    b. SEC (Securities and Exchange Commission).
    c. FASB (Financial Accounting Standards Board).
    d. CAP (Committee on Accounting Procedure)

Answer b

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29. What was one of the primary goals of the FASB in developing the Accounting Standards Codification (ASC)?
    a. To delay the implementation of new accounting standards.
    b. To create a codification research system that remains up to date with released standard-setting activity.
    c. To replace the need for any accounting research system.
    d. To eliminate the requirement for financial statements to follow US GAAP.

Answer b

30. All the following are true regarding the FASB Accounting Standards Codification except:
    a. The Codification changes the way GAAP is documented, presented, and updated.
    b. The goal of the Codification was to provide one place where all authoritative literature about a particular topic could be found.
    c. The purpose of the Codification is to create new GAAP.
    d. The Codification was created to simplify user access.

Answer c

31. International Financial Reporting Standards (IFRS) are issued by the:
    a. EU (European Union).
    b. SEC (Securities and Exchange Commission).
    c. FASB (Financial Accounting Standards Board).
    d. IASB (International Accounting Standards Board).

Answer d

Essay

1. What is the difference between normative and positive theory?

   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.

2. Why is the development of a general theory of accounting important?

   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.

3. Discuss the evolution of accounting during the 1930s.

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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 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 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 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 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.

From 1936 to 1938 the SEC was engaged in an internal debate over whether it should develop accounting standards. Despite the fact that the then–SEC chairman, and later Supreme Court justice, William O. Douglas 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."

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*. 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.

In 1936 the AIA merged with the American Society of Certified Public Accountants, forming a larger organization later named the American Institute of Certified Public Accountants (AICPA).

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This organization has had increasing influence over 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.

4. Discuss the evolution of the three private sector accenting standard setting organizations.

Professional accountants became more actively involved in the development of accounting principles following the meetings between members of the New York Stock Exchange 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.

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* and voiced concerns that the SEC would become more active if the committee did not respond more quickly. One of the first responses was to expand the CAP's membership from seven to twenty-one members.
A major concern over the use of the historical cost model of accounting arose. 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 was seen as allowing earnings management 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 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 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). Those not superseded can be accessed through the cross reference option on the FASB ASC website (asc.fasb.org).

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. Additionally, all of its members were

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part time and as a result their independence was questioned. Finally, the fact that all of the CAP members were required to be members of the AICPA prevented many financial executives, investors, and academics from serving on the committee. As a result, accountants and financial statement users were calling for wider representation in the development of accounting principles. 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 and controversial 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 and pure, with the usefulness of the end product being a major concern. The APB was composed of from seventeen to twenty-one members, who were selected primarily from the accounting profession but also included individuals from industry, government, and academia.

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. 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. The members of the APB were, in effect, volunteers. 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:

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

As a result of 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. This new board was to comprise representatives from various organizations, in contrast to the APB, whose members were all from the AICPA. 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.

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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 the refinement and improvement of accounting standards and practices.

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 nominated by organizations whose members have special knowledge and interest in financial reporting is selected. 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

5. What were the purposes of the Wheat and Trueblood 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.

6. What was the purpose of the GAAP Hierarchy?

   The purpose of the GAAP Hierarchy was to categorize the sources of accounting principles1 that were generally accepted into descending order of authority.

7. What were the four types of pronouncements originally issued by the FASB prior to the adoption of the FASB ASC?

   1. *Statements of Financial Accounting Concepts (SFAC*s) and conveyed required accounting methods and procedures for specific accounting issues and officially created GAAP.
   2. *Interpretations* were modifications or extensions of issues pronouncements. *SFAC*s are intended to establish the objectives and concepts that the FASB will use in developing standards of financial accounting and reporting. To date, the FASB has issued seven
   3. *Statements of Financial Accounting Concepts* which differed from *Statements of Financial Accounting Standards* in that they did not establish GAAP. Similarly, they were not intended

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to invoke Rule 203 of the Rules of Conduct of the Code of Professional Ethics. It is anticipated that the major beneficiary of these *SFAC*s will be the FASB itself. However, knowledge of the objectives and concepts the board uses should enable financial statement users to better understand the content and limitations of financial accounting information.

4. *Technical Bulletins* were strictly interpretive in nature and did not establish new standards or amend existing standards. They were intended to provide guidance on financial accounting and reporting problems on a timely basis.

8. Discuss why standard setting may be viewed as a political process.

A highly influential academic accountant stated that accounting standards are as much a product of political action as they are of careful logic or empirical findings. This phenomenon exists because a variety of parties are interested in and affected by the development of accounting standards. Various users of accounting information have found that the best way to influence the formulation of accounting standards is to attempt to influence the standard setters.

The CAP, APB, and FASB have all come under a great deal of pressure to develop or amend standards so as to benefit a particular user group. For example, the APB had originally intended to develop a comprehensive theory of accounting before attempting to solve any current problems; however, this approach was abandoned when it was determined that such an effort might take up to five years and that the SEC would not wait that long before taking action. The Business Roundtable engaged in what initially was a successful effort (later reversed) to increase the required consensus for passage of a SFAS from a simple majority to five of the seven members of the FASB. Congressional action was threatened over the FASB's proposed elimination of the pooling of interest method of accounting for business combinations.

9. Define the following terms

a. Economic consequences

Economic consequences refers to the impact of accounting reports on various segments of our economic society. This concept holds that the accounting practices a company adopts affect its security price and value. Consequently, the choice of accounting methods influences decision making rather than just reflecting the results of these decisions.

b. Standards overload

Over the years, the FASB, the SEC, and the AICPA have been criticized for imposing too many accounting standards on the business community. This *standards overload* problem has been particularly burdensome for small businesses that do not have the economic resources to research and apply all the pronouncements issued by these authoritative bodies. Those who contend that there is a standards overload problem base their arguments on two allegations: (1) Not all GAAP requirements are relevant to small business financial reporting needs and (2)

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even when GAAP requirements are relevant, they frequently violate the pervasive cost–benefit constraint.

Critics of the standard-setting process for small businesses also assert that GAAP were developed primarily to serve the needs of the securities market. Many small businesses do not raise capital in these markets; therefore, it is contended that GAAP were not developed with small business needs in mind.

10. Discuss the evolution of the phrase "generally accepted accounting principles".

One result of the meetings between the AICPA and members of the NYSE following the onset of the Great Depression was a revision in the wording of the certificate issued by CPAs. The opinion paragraph formerly stated that the financial statements had been examined and were accurate. The terminology was changed to say that the statements are "fairly presented in accordance with generally accepted accounting principles." This expression is now interpreted as encompassing the conventions, rules, and procedures that are necessary to explain accepted accounting practice at a given time. Therefore, financial statements are fair only to the extent that the principles are fair and the statements comply with the principles.

The expression *generally accepted accounting principles* (GAAP) has thus come to play a significant role in the accounting profession. The precise meaning of the term, however, evolved rather slowly. In 1938 the AICPA published a monograph titled *Examinations of Financial Statements*, which first introduced the term. Later, in 1939, an AICPA committee recommended including the wording, 'present fairly…in conformity with generally accepted accounting principles' in the standard form of the auditor's report.
The meaning of the term was not specifically defined at that time, and no single source exists for all established accounting principles. However, later Rule 203 of the AICPA Code of Professional Ethics required compliance with accounting principles promulgated by the body designated by the Council of the Institute to establish such principles, except in unusual circumstances. Currently, that body is the FASB.

The guidance for determining authoritative literature was originally outlined in Statement of Auditing Standards (SAS) No. 5. Later, *SAS No. 5* was amended by *SAS No. 43*. This amendment classified the order of priority that an auditor should follow in determining whether an accounting principle is generally accepted. Also, it added certain types of pronouncements that did not exist when *SAS No. 5* was issued to the sources of established accounting principles. *SAS No. 43* was further amended by *SAS No. 69*; whose stated purpose was to explain the meaning of the phrase "present fairly … in conformance with generally accepted accounting principles" in the independent auditor's report. *SAS No. 69* noted that the determination of the general acceptance of a particular accounting principle is difficult because no single reference source exists for all such principles. In July 2003, the SEC issued the *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (the Study). Consistent with the recommendations presented in the Study, the FASB undertook a number of initiatives aimed at improving the quality of standards and the

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standard-setting process, including improving the conceptual framework, codifying existing accounting literature, transitioning to a single standard-setter regime, and converging FASB and International Accounting Standards Board (IASB) standards.

In 2008, the FASB issued SFAS No 162 *The Hierarchy of Generally Accepted Accounting Principles*. SFAS No 162 categorized the sources of accounting principles1 that are generally accepted into descending order of authority. Previously, the GAAP hierarchy had drawn criticism because it was directed toward the auditor rather than the enterprise, it was too complex, and it ranked FASB Concepts Statements, which are subject to the same level of due process as FASB Statements, below industry practices that are widely recognized as generally accepted but are not subject to due process.
According to SFAS No 162, the sources of generally accepted accounting principles were:

a. AICPA Accounting Research Bulletins and Accounting Principles Board Opinions that are not superseded by action of the FASB, FASB Statements of Financial Accounting Standards and Interpretations, FASB Statement 133 Implementation Issues, and FASB Staff Positions.
b. FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and Statements of Position.
c. AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force (EITF).
d. Implementation guides published by the FASB staff, AICPA accounting interpretations, and practices that are widely recognized and prevalent either generally or in the industry.

Finally, in 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*. SFAS No. 168 identified the FASB ASC as the official source of U. S. GAAP.

Despite the continuing effort to narrow the scope of GAAP, critics maintain that management is allowed too much leeway in the selection of the accounting procedures used in corporate financial reports. These criticisms revolve around two issues that are elaborated on later in the text: (1) Executive compensation is frequently tied to reported earnings, so management is inclined to adopt accounting principles that increase current revenues and decrease current expenses and (2) the value of a firm in the marketplace is determined by its stock price. This value is highly influenced by financial analysts' quarterly earnings estimates. Managers are fearful that failing to meet these earnings estimates will trigger a sell-off of the company's stock and a resultant decline in the market value of the firm.

Previously, SEC Chairman Levitt noted these issues and indicated his belief that financial reports were descending "into the gray area between illegitimacy and outright fraud." As a consequence, the SEC has set up an earnings management task force to uncover accounting distortions. Some companies have already voluntarily agreed to restructure their financial statements as a result of this new effort by the SEC. For example, SunTrust Bank, Inc., of Atlanta, though not accused of any wrongdoing, agreed to a three-year restructuring of earnings for the period ended December 31, 1996.

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11. What controversy caused the AICPA to issue Rule 203 that requires companies to use GAAP when issuing financial statements?

    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*, and 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.

12. Discuss the FASB ASC including the reasons for its adoption and the FASB's goals in developing it.

    On July 1, 2009 the FASB ASC became the single source of generally accepted accounting principles. The FASB ASC became effective for interim and annual periods ending after September 15, 2009. On that date, all pronouncements issued by previous standard setters were superseded.

    The major reason for embarking on the codification process was that researching multiple authoritative sources complicated the research process. For example, using the previously existing structure, an individual needed to review existing FASB, EITF, AICPA, and SEC literature to resolve even a relatively simple issue. As a result, it was easy to inadvertently overlook relevant guidance. Codifying all existing U.S. GAAP literature into one authoritative source eliminates the previous need to research multiple sources. In addition, creating one source will allow the FASB

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to more easily isolate differences in its ongoing effort to converge with international accounting standards. The codification represents the sole authoritative source of U.S. GAAP. Creating the codification is only the first step but is only part of the overall solution. Going forward, the standard setting process will be changed to focus on the codification text. By implementing such an approach, constituents immediately will know the revised codification language as soon as the standard setter issues the standard. This approach eliminates delays and ensures an integrated codification. The FASB has also developed a searchable retrieval system to provide greater functionality and timeliness to constituents.

The FASB had three primary goals in developing the Codification:

1. Simplify user access by codifying all authoritative US GAAP in one spot.
2. Ensure that the codified content accurately represented authoritative US GAAP as of July1, 2009.
3. Create a codification research system that is up to date for the released results of standard-setting activity.

The Codification is expected to:

1. Reduce the amount of time and effort required to solve an accounting research issue
2. Mitigate the risk of noncompliance through improved usability of the literature
3. Provide accurate information with real-time updates as Accounting Standards Updates are released
4. Assist the FASB with the research and convergence efforts.

13. Discuss the role of ethics in accounting.

Ethics are concerned with the types of behavior society considers right and wrong. Accounting ethics incorporate social standards of behavior as well as behavioral standards that relate specifically to the profession. The environment of public accounting has become ethically complex. The accountants' Code of Professional Ethics developed by the AICPA has evolved over time, and as business transactions have become more and more complex, ethical issues have also become more complex.

The public accountant has a Ralph Nader–type overseer role in our society. This role was described by former Chief Justice of the United States Warren Burger:
Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public. In an effort to control the accuracy of their financial data available to investors in the securities markets, various provisions of the federal securities laws require publicly held corporations to file their financial statements with the Securities and Exchange Commission. Commission regulations stipulate that these financial reports must be audited by an independent certified public accountant.

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By certifying the public reports that collectively depict a corporation's financial status, the independent accountant assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders as well as the investing public. This "public watchdog" function demands that the accountant maintains total independence from the client at all times and requires complete fidelity to the public trust.

The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries. It is, therefore, not enough that financial statements be accurate; the public must perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of an outside auditor as an independent professional.

14. What is a special purpose entity and how do they work?

A special purpose entity (SPE) is used to access capital and hedge risk. By using SPEs such as limited partnerships with outside parties, a company may be permitted to increase its financial leverage and return on assets without reporting debt on its balance sheet. The arrangement works as follows: An entity contributes fixed assets and related debt to an SPE in exchange for an ownership interest. The SPE then borrows large sums of money from a financial institution to purchase assets or conduct other business without the debt or assets showing up on the originating company's financial statements. The originating company can also sell leveraged assets to the SPE and record a profit. At the time these transactions took place, the FASB required that only 3 percent of a SPE be owned by an outside investor. If this guideline is met, the SPE didn't need to be consolidated and the SPE's debt was not disclosed on the originating company's financial statements.

15. How did the Sarbanes-Oxley Act change the way the FASB is funded?

The Sarbanes-Oxley Act changed the way the FASB is funded. Previously, about a third of FASB's annual budget came from voluntary contributions from public accounting firms, the AICPA, and about one thousand individual corporations. Under SOX, those voluntary contributions are replaced by mandatory fees from all publicly owned corporations based on their individual market capitalization. But the fees are to be collected by the PCAOB. The SEC oversees the PCAOB. As a result, some fear that SOX has inadvertently made FASB more vulnerable to political pressure

16. Discuss the objectives of the International Accounting Standards Board.

The International Accounting Standards Board is an independent private-sector body that was formed in 1973 to achieve this purpose. Its objectives are:

1. To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance;

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2. To work generally for the improvement and harmonization of regulations, accounting standards, and procedures relating to the presentation of financial statements.

These objectives have resulted in attempts to coordinate and harmonize the activities of the many countries and agencies engaged in setting accounting standards. The IASB standards also provide a useful starting point for developing countries wishing to establish accounting standards.

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