Conceptual Framework and Financial Reporting
Financial Accounting Standards Board (FASB)

Role and Standard-Setting Process

FASB and Standard Setting

This lesson presents an overview of the standard-setting process in the United States.

After studying this lesson, you should be able to:

1. Describe the role of the Financial Accounting Standards Board.
2. Describe the primary purpose of financial reporting.
3. List the three aspects of financial reporting addressed by GAAP.
4. Identify the major organizations in U.S. accounting standards.

I. Introduction

A. Financial accounting and reporting is concerned with providing relevant information to all users of the financial statements: investors, creditors, competitors, employees, and regulatory bodies. Financial statement information is used to make informed decisions regarding allocation of resources. A common use is whether to invest in a firm or to lend money to it.

B. Financial information is disseminated in many forms including news releases, prospectuses for future securities offerings, filings with the Securities and Exchange Commission (SEC), and annual reports to shareholders. Financial statements are the culmination of the accounting process and represent the most comprehensive financial information disclosures made by firms. The footnotes and other textual and tabular information provide supplementary information and help to explain the amounts disclosed in those statements.

II. Generally Accepted Accounting Principles (GAAP)

Definition
Generally Accepted Accounting Principles (GAAP): The rules of financial reporting for business enterprises. GAAP are also called accounting standards.

A. What GAAP Addresses—GAAP is a set of reporting rules to address three aspects of financial reporting:

1. Recognition—A recognized item is recorded in an account and ultimately affects the financial statements.

Note
Recognition is an accounting concept that indicates that the item is recorded on the financial statements. In contrast, realization is an economic concept that indicates that cash is paid or received. GAAP focuses on accrual accounting and therefore is concerned with recognition more than with realization.

2. Measurement—Concerns the dollar amount assigned to an item.

3. Disclosure—Many unrecognized amounts are reported in the footnotes to complete the portrayal of the firm’s financial position and performance.

B. GAAP affects what is disclosed in financial statements and in what amount. For example, GAAP requires that many assets be reported at their historical cost, rather than at current market value.
Without a relatively uniform set of GAAP, business entities would be free to report whatever amounts they desired.

III. Organizations Involved in Developing Accounting Standards

A. Financial Accounting Standards Board (FASB)—The FASB is currently the standard-setting body in the United States.

B. The Securities and Exchange Commission (SEC) is the federal government agency that administers the securities laws of the United States. These laws affect firms that issue debt and equity securities to the public. Such firms register with the SEC and are called registrants. The financial statements of these firms must be filed with the SEC and must be audited by independent third parties (CPA firms).

C. Congress granted the SEC the authority to establish GAAP for the firms within its jurisdiction (publicly traded firms) but generally has ceded this authority to a private sector body (currently, the FASB). In a few instances, the SEC has exercised its right to reverse or modify an accounting standard adopted by the private sector body. The SEC also has pressured the FASB to establish certain principles more quickly.

D. The FASB considers the potential reaction of the SEC to its proposed standards. The SEC frequently responds to the FASB’s initial “exposure” draft providing useful commentary for the final pronouncement.

E. The American Institute of Certified Public Accountants (AICPA) is the national professional organization for practicing CPAs and has had a great impact on accounting principles over the years. The mission of the AICPA is to provide its members with resources, information, and leadership so that they may in turn provide valuable services for the benefit of their clients, employers, and the general public.

F. In 1939, the AICPA appointed its Committee on Accounting Procedure (CAP), the first private sector body charged with the responsibility of promulgating GAAP. CAP issued 51 Accounting Research Bulletins (ARBs). To the extent that an ARB has not been rescinded or superseded, it constitutes GAAP.

G. In 1959, the AICPA created the Accounting Principles Board (APB), another committee, to take over the work of CAP. The APB is the second private sector group designated to formulate GAAP. Members were required to be CPAs. The APB issued 31 opinions, many of which remain as GAAP, in whole or in part.

H. In 1971, the AICPA appointed the Wheat Committee, which recommended the formation of yet another private sector body—the FASB—to take over the reins from the APB. In 1973, the FASB assumed the role of standard setter for the accounting profession. The FASB is not affiliated with the AICPA.

I. The FASB is one of three parts of the current accounting standard-setting mechanism in the United States. The other two are the Financial Accounting Foundation (FAF)—the parent body, and the Financial Accounting Standards Advisory Council (FASAC):

   1. FAF—Appoints the members of the FASB and its advisory councils, ensures adequate funding for the FASB, and exercises oversight over the FASB. Funding sources include fees levied on publicly traded firms under the Sarbanes-Oxley Act, contributions, and publication sales. The trustees of the FAF are appointed from organizations with an interest in accounting standards.

   2. FASB—Establishes financial accounting standards for business entities. The FASB is an independent body, subject only to the FAF.

   3. FASAC—Provides guidance on major policy issues, project priorities, and the formation of task forces.

J. The FASB is the current private-sector body that establishes GAAP for business entities. The mission of the FASB (in brief) is to:

   1. Improve the usefulness of financial reporting
   2. Maintain current accounting standards
   3. Promptly address deficiencies in accounting standards

Note

The FASB operated with seven Board members from its inception in 1973 until 2008 when the Board was reduced to five members. The Board membership increased back to seven in early 2011. The FAF Chairman, Jack Brennan, gave this rationale for the change: “Returning the Board to the seven-member structure will enhance the FASB’s investment in the convergence agenda with the International Accounting Standards Board (IASB), while addressing the unprecedented challenges facing the American capital markets in the months and years ahead.”
4. Promote international convergence of accounting standards
5. Improve the common understanding of the nature and purposes of information in financial reports

K. Facts in Brief about the FASB
1. Seven full-time members with renewable (for one additional term) and staggered 5-year terms
2. Subject to FAF policies and oversight
3. Members cannot have employment or investment ties with other entities.
4. Members need not be CPAs although typically the public accounting profession is represented; also the preparer (reporting firm) and investor communities are represented.

L. In promulgating GAAP, the FASB applies the following principles:
1. Accounting standards should be unbiased and not favor any particular industry; standards are for the benefit of financial statement users;
3. The needs and views of the economic community should be considered; the views of the accounting profession should not take precedence;
4. The process of developing standards should be open to the public and allow due process to provide opportunity for interested parties to make their views known;
5. The benefits of accounting standards should exceed their cost.

M. The FASB Uses the Following Process when Issuing an Accounting Standard—The FASB:
1. Considers whether to add a project to its agenda, in consultation with the FAF—the FASB receives many requests from its constituencies including the SEC, auditing firms, investors, and reporting firms to address new financial reporting issues and clarify existing standards
2. Conducts research on the topic and issues a Discussion Memorandum detailing the issues surrounding the topic; the FASB's conceptual framework plays a role in this process by providing a theoretical structure for guiding the development of a specific standard
3. Holds public hearings on the topic
4. Evaluates the research and comments from interested parties and issues an Exposure Draft—the initial accounting standard
5. Solicits additional comments, modifies the Exposure Draft if needed
6. Finalizes the new accounting guidance and approves with a majority vote (four of seven affirmative votes)
7. Issues an Accounting Standards Update (ASU). The section on FASB Codification discusses the nature of an ASU in greater detail

N. FASB's Emerging Issues Task Force (EITF)—This group was formed to consider emerging reporting issues and to accelerate the process of establishing rulings on such issues. In this sense, the EITF acts as a “filter” for the FASB, enabling the FASB to focus on more pervasive issues. When a consensus of the 15 members is reached on an issue, no further action by the FASB is required. EITF pronouncements are included in GAAP. If the EITF is unable to reach a consensus, the FASB may become involved, ultimately revising an existing standard or adopting a new one.

IV. The Political Nature of the Accounting Standard-Setting Process
A. Parties, Preferences, and Outcomes—The parties interested in the outcome of the standard-setting process may have opposing preferences and interests. Firm managers (referred to as “preparers” or “preparer firms”) often prefer standards with lower compliance costs and that tend to portray their firms in a more positive light (higher earnings and assets, lower liabilities).
B. Financial statement users, on the other hand, prefer unbiased, transparent reporting. They want the facts. Investors also want conservative reporting-disclosure of less positive results under
conditions of uncertainty or where the firm has a choice of reporting alternatives under GAAP. The FASB has pledged to adopt unbiased accounting standards, and thus has the interests of financial statement users in mind when developing accounting standards.

C. The FASB considers its conceptual framework, the collection of Statements of Financial Accounting Concepts (SFACs), a "constitution" or underlying set of theoretical concepts in its deliberations. However, the FASB does not create GAAP in a vacuum. Historically, the Board has been very responsive to the views of affected parties through its due diligence process and actively solicits public comment before adopting a final accounting standard.

D. User groups (e.g., industry associations, financial institutions) influence the outcome of FASB standards by:
   1. Making their views public through the financial press
   2. Providing input during the due process procedure
   3. Putting pressure on the SEC directly to change a proposed standard, or through the U.S. Congress

E. The Board is careful to pay attention to this type of input, particularly when it helps clarify the issues. However, although the FASB has pledged to be unbiased rather than promulgate standards favoring a particular reporting position or industry, it has admitted to responding to pressure from interested parties.

F. For example, negative economic consequences is often the argument of an interested party. Economic consequences refers to the effect of a proposed standard on a firm's financial statements. A common argument against a proposed standard is that it will cause earnings to decline, thus reducing the firm's ability to raise capital. Although some observers believe that the FASB should not be sensitive to the views of reporting firms, there have been some spectacular cases in which the FASB has delayed an accounting standard or even reversed itself in light of the concerns reporting firms have had about the "economic consequences" of a proposed standard.

V. Enforcement of GAAP

A. Methods of Enforcement

   1. Accounting standards are not laws; they are not determined by legislatures but rather by private sector bodies. They are generally accepted. GAAP are a type of regulation, imposed on the economic system by its constituents. Without GAAP, the economy and capital markets as we know them would not work. Investors need to have confidence in the numbers they receive. Without some kind of common language, the system could not function. Corruption would become much more prevalent than it is today.

   2. However, the private-sector bodies that contribute to the formulation of GAAP have no enforcement authority. Rather, there are economic sanctions for firms not complying with GAAP. These sanctions include increased difficulty in raising debt and equity capital.

   3. The SEC, however, does have the authority to penalize firms and managers subject to its jurisdiction when financial statements do not comply with GAAP. Public companies are violating the securities laws if they publish financial statements that materially depart from GAAP.

   4. The SEC sends a deficiency letter to a registrant when an accounting irregularity is found. If the firm disagrees, the SEC may issue a "stop order" preventing trading in the firm's securities until the disagreement is resolved. Outright violations of the securities laws may result in criminal sanctions against managers, or fines against the company.

   5. The enactment of the Sarbanes-Oxley Act of 2002 significantly affects the enforcement procedures relating to audits of public companies, and penalties for noncompliance with GAAP. The Auditing section of CPAexcel* covers the implications of this Act in depth.