CHAPTER 1

FINANCIAL ACCOUNTING AND AUDITING ORGANIZATIONS

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1.1 ROLE OF FINANCIAL ACCOUNTING AND AUDITING IN THE U.S. ECONOMY

This chapter provides background on the environment in which financial accountants carry on their activities, including the specific organizations that regulate or otherwise affect those activities. Auditing is the attestation of independent certified public accountants (CPAs) to third parties that the financial accounting presentation is "fairly presented" and free of material misstatement. Although the accounting and auditing profession were for many years largely self-regulated, major events such as the stock market crash of 1929 and the more recent implosion of a number of megacompanies such as Enron and WorldCom have led to regulatory oversight of the accounting and auditing professions. No financial accountant or manager can practice properly without understanding these organizations and how they not only constrain but also assist the performance of financial accounting and reporting services.

The globalization of accounting and auditing is a major trend that will impact the practice of accounting in profound ways. While a point of discussion for decades, the current movement of U.S. accounting practice toward an international set of accounting standards and auditing practice is a reality today. The questions seem to be how far and how fast this transition will go, and what the consequences to preparers and users of financial statements will be.

(a) OBJECTIVE OF FINANCIAL ACCOUNTING. An important beginning point for understanding the social role and importance of financial accounting is identifying the objective that it should meet. Although there are many opinions, the most authoritative and influential is this definition provided by the Financial Accounting Standards Board (FASB) in its Conceptual Framework project, which was intended to develop a unified theory of accounting (see Section 1.3(a)(v)):

> Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

Thus, according to this definition, the goal is to provide information that allows users to reach better decisions than they would without it. For simplicity, the FASB uses the term *financial reporting* to encompass the activities of financial accounting and reporting, which includes presenting both financial statements and the additional financial information that accompanies them.

Usefulness may exist at the individual company level if management provides reports to investors and creditors when seeking financing or fulfilling various stewardship reporting responsibilities. Although this perspective undoubtedly explains why some aspects of accounting are regulated, it does not really provide an adequate basis for understanding the substantial governing structure. Instead, an economy-wide perspective is needed.

(b) A WIDER ECONOMIC PERSPECTIVE. Two key points help explain why financial accounting is important for the entire economy. The first point is the connection between the general benefit to society from the information that is presented in financial statements. The second point is that effective capital markets are central to an efficient and healthy economy and explains how effective capital markets are efficient processors of information.

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(i) Linking the Economy to Fair Financial Statements. Exhibit 1.1 shows the links between economy and the benefit to society and the availability of useful financial statements. A sound economy is an important ingredient in providing for the benefit of society's members.

Although a variety of factors contribute to a sound economy, such as an abundance of natural resources, a stable political system, and an appropriate work ethic, one of the most critical is the availability of sufficient capital resources. Without adequate capital markets, manufactured goods and services cannot be produced or distributed to persons who want or need them at prices that are reasonable.

In turn, sufficient capital resources are made available through effective and efficient capital markets in which those who need capital can obtain it from those who are ready to provide it. If these market participants can conduct their activities in an environment based on fair financial reporting and correct data, they are able to establish fair prices for the capital in the form of expected returns. Consequently, fair reporting will encourage the flow of more capital into the markets.

In order for the markets to be effective, their participants must reach good decisions about where to invest or obtain capital under appropriate terms for the risks involved. If decisions are made haphazardly, capital will not be allocated in a reasonable fashion, and the economy will not perform as well because of the misallocation of resources.

Naturally, many different kinds of information are useful to decision makers. Some may relate to a particular company, an industry, or the national and world economies. Some types of information may be rooted in past events, whereas others are predictions of future events and conditions. Of particular importance to the capital markets is company financial information.

A significant source of financial information is the financial statements (and accompanying information) that are published for market participants. Although this information by itself is insufficient for making the capital markets work well, the absence of reliable financial information makes the allocation of resources and capital into guesswork.

The important economic role of financial statements causes society to be concerned about the activities of financial accountants and justifies setting up controls and other regulatory devices to

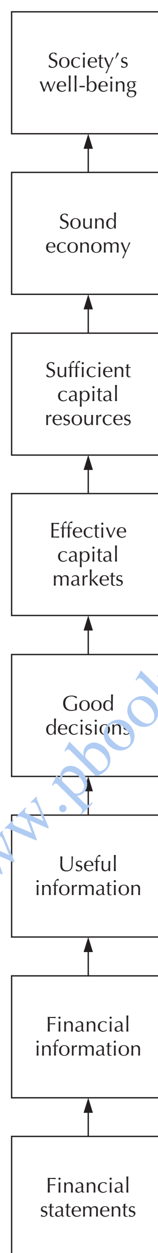

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Exhibit 1.1 Role of Financial Accounting in Society

help ensure the availability and usefulness of the information. As should be expected, these controls are aimed at preventing irregularities in the financial reporting system. Every significant study of business and audit failures of the past half century has concluded that lapses in internal controls were a major contributor to the calamity. Chapter 7 in this *Handbook* is devoted to the reporting on internal controls that was made mandatory for public companies by the Sarbanes-Oxley Act of 2002.

(ii) Market Efficiency. The word *efficiency* is used in two different ways to describe markets. In economic theory, an efficient market is capable of allocating resources quickly and without friction. These allocations are efficient because equilibrium prices (where supply and demand curves cross) are reached quickly and uniformly across the entire market. In order to be efficient in allocating resources, a market must have a number of characteristics, including competition among a large number of buyers and sellers. Perhaps most important, it must have large amounts of useful information about the resources that are being traded. As described, a role for financial accounting is to provide this information to the capital markets.

A second meaning of *efficiency* refers to a market's ability to gather and process this information. In this sense, an efficient market is able to respond quickly and appropriately to new relevant and reliable information, without regard to its source. This concept has been developed and advanced over the last 30 years in finance and accounting research into the functioning of U.S. capital markets, especially the New York Stock Exchange (NYSE).

On one level, this proposition that capital markets are efficient processors of information makes a great deal of sense because there are large incentives for market participants to gather and analyze useful information and then react to it quickly before others learn about it. These incentives also encourage participants to seek out information wherever it can be found, even (perhaps especially) if it is not in published financial statements. In fact, the most useful information is that which no one else knows.

This point does not mean that financial statements are not useful to the capital markets; however, it does suggest that financial statements play a different role from the one that has traditionally been attributed to them. While criticized as not being timely for making some investment decisions, financial statements still serve a role in confirming, with an independent auditor's opinion, the financial position and performance of the company. The knowledge that such confirmation is forthcoming is a deterrent to exaggerated press releases and unreasonably optimistic forecasts.

This point means that sophisticated market participants must clearly understand accounting principles and the impact of management's choices among the available alternative principles. Because of this understanding, the market is able to react appropriately to the signals that it receives. As a result of this sophistication, the market does not react naively to accounting choices that present differing results. For example, a decision by management of one company to use last-in, first out (LIFO) inventory costing and a similar-size company to use the first-in, first-out (FIFO) method in a period of rising prices will lead to higher reported earnings for the FIFO entity. An efficient market should be able to see through this difference, and because the tax bill for the higher-income entity would be higher, the market might even penalize the FIFO company for its choice of accounting principle. An efficient capital market should not be misled by accounting policy choices. In addition, an efficient market would be able to understand and act on the effects of unreported revenues and expenses. For example, a major controversy was created by a 1993 proposal (eventually leading to Statement of Financial Accounting Standards [SFAS] No. 123 *Accounting for Stock-Based Compensation*) that would cause companies to report compensation expense equal to the value of stock options granted to their employees. A naive view of the market would argue that recognizing this expense would produce lower stock prices because it would cause reported income to be lower. This view assumes that the market is either unaware of or oblivious to the effects of the compensation because such effects are not currently included in the earnings calculation. Some opponents of the proposal argued that this expense should not be reported because it is not a real cost. If they are right in the sense that the expense does not really exist, then the act of reporting it would not affect stock prices because the efficient capital market would simply ignore the reported amount and establish appropriate stock prices despite the noise in the financial statements.

In addition to the logical arguments in favor of the proposition that U.S. capital markets are efficient, a great deal of academic research has generated evidence that suggests that they are generally *quite* efficient. While markets are not perfectly efficient, there is abundant support for the broad notion that they are savvy in considering differences generated solely by choosing different accounting methods.

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(c) PARTICIPANTS IN THE FINANCIAL REPORTING SYSTEM. Financial accounting does not take place in a sterile arena; rather, the people who conduct it have very real but quite different interests in the process and its outcome.

The primary communication channel is between financial statement preparers and financial statement users. Generally, preparers are accountants who work for corporations or other entities that need capital resources or that have stewardship reporting responsibilities. Users are investors, creditors, or advisors to those who want to commit resources to an entity or who have already done so. The self-interests of preparers and users clearly are in potential conflict. Management also has an interest in reliable financial information in managing the business. Indeed, an important component in the Internal Controls Framework of the Committee of Sponsoring Organizations (COSO) is Information and Communication, and that includes managerial and financial information. A weakness in this component alone would require that a company assert its internal control is ineffective.

Preparers want the reporting system to provide information that will help them get low-cost capital or that will cause them to appear to have lived up to their responsibilities. However, the efficiency of the capital markets suggests that preparers (and the stockholders of their companies) are likely to be better off if more information is reported. The size of many 10-K (Securities and Exchange Commission [SEC] filings) Annual reports attests to the volumes of information our regulators and standard setters consider "important."

Users, in contrast, are looking for inexpensive, timely, and dependable information that will enable them to make new decisions or evaluate old ones. As described, they are not well served by information that misleads them through bias. If users receive unreliable information, the cost of capital will rise to compensate them for the added but unknown risks. If this mistrust is widespread, the economy will suffer because the capital markets will not be as efficient. Users also tend to want readily available, abundant information. This tendency is counterbalanced by the desire to have unique information or insight, which is important to earning higher returns (because no one else is privy to it).

To reduce the uncertainty about the dependability of the financial statements, the services of auditors provide independent assurance that the financial statements are fairly presented and a free of material misstatement of amounts or disclosures. In effect, auditors add credibility to the financial statements. However, like the other participants, auditors have self-interests. In particular, they prefer dealing with information that is objective and can be verified because they are concerned (and reasonably so) about the possibility of second guessing by users who suffer losses after using audited information that turns out to have been incorrect. The trend in financial accounting standards to make broader use of fair values in lieu of historical costs and to recognize gains and losses through income based on market valuations rather than objective transactions exacerbate their concerns. This work contains several chapters devoted to fair value and issues surrounding their use. Many chapters have expanded coverage of the use of fair values in specific accounts and industries. In summary, the three main participating groups have conflicting interests. In general, preparers want information that can be cheaply produced and will reflect their stewardship in the best light; users want timely, accurate, and (if possible) unique information or insight that no one else has; and auditors want information that can be audited and objectively supported. In contrast, society needs the capital market to have widely available and inexpensive decision-useful information. Because of these conflicts, financial accounting and auditing will continue to be subject to regulation and oversight.

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1.2 ACCOUNTING STANDARDS IN THE UNITED STATES

Three primary bodies are involved in the development of U.S. accounting standards: the SEC, the FASB, and the Governmental Accounting Standards Board (GASB). Organizations such as the American Institute of Certified Public Accountants (AICPA) have influence over the standards but not standard-setting authority.

1.3 ROLE OF THE SECURITIES AND EXCHANGE COMMISSION

Although the SEC's jurisdiction is limited to publicly held corporations, its role as the primary regulator and protector of the country's capital markets has given it substantial influence over all financial accounting practice. A more thorough discussion of the role of the SEC can be found in Chapter 5 of this *Handbook* by Wendy Hambleton.

(a) BACKGROUND OF THE SECURITIES AND EXCHANGE COMMISSION. The SEC was established by the Securities Exchange Act of 1934 and was charged with enforcing not only that statute but also the Securities Act of 1933. Previously, the 1933 Act had been administered by the Federal Trade Commission.

The SEC's prime mission is to achieve and maintain stable and effective capital markets for securities traded in interstate commerce. The nature of today's capital markets and communications networks makes it difficult to issue a security that is *not* traded across state borders. The SEC uses a variety of methods to accomplish its mission. The most basic is regulation of the activities of those corporations that have issued or would like to issue securities.

Under the 1933 Act, securities must be "registered" before they can be issued to the public. The purpose of registration is to establish a complete and widely available public record of information about the registrant and the securities. For example, registration creates a substantial amount of public information about the officers, directors, and other agents of the corporation, including promoters and underwriters. It also publicizes the company's plans for using the capital raised by issuing the securities. In the case of a company that has existed previously, registration also requires the presentation of financial statements and other financial data.

If the company meets the reporting requirements, the securities are allowed to "go public," regardless of their inherent riskiness. Thus, the registration process is designed to accomplish disclosure about the securities rather than to evaluate their merits. Although some states conduct merit reviews for securities traded within their borders, this approach would be very difficult to accomplish on a national level. Furthermore, many individuals believe that the capital markets should be as free as possible, as long as fraud and other forms of deceit are prohibited.

The 1934 Act went beyond the initial registration to require substantial ongoing disclosures about the corporation, its officers and directors, and its financial condition and results of operations and other activities. Thus, companies that have securities registered under the 1933 Act must provide quarterly and annual reports to the SEC as well as ad hoc reports when crucial events occur. Again, the goal is to allow the capital markets to work effectively by getting information to market participants. The SEC Staff may review the filed information for its compliance with the disclosure requirements, but there is no review of the merits of the management's behavior as described in the reports. For example, nothing in the SEC's processes prevents managers from paying large salaries to themselves, as long as the amount is disclosed. The idea is that disclosure will allow the market itself to discipline those managers who abuse their fiduciary duties. Of course, the disclosure requirement may very well have been designed to deter inappropriate behavior, because management would expect to have to suffer the consequences of publishing information about their activities. Nevertheless, the excesses of top corporate executive compensation is a contemporary topic of debate in the media and has raised the interest of regulators.

The 1934 Act also gave authority to the SEC to regulate securities exchanges (such as the NYSE and the American Stock Exchange) and those brokers and dealers who belong to them or otherwise conduct business for buyers and sellers of securities. This authority was expanded through the Investment Advisers Act of 1940 to encompass all who offer investment counseling. The fundamental goal of this arena of regulation is to increase market participants' confidence by reducing the likelihood of incompetence, fraud, or deceit. The line of reasoning is that if these problems can be reduced, more people are likely to invest, and if more people invest, the competition will bring about a more efficient allocation of capital.

Other legislation has given the SEC additional authorities and jurisdiction in the capital markets, but their contents are generally beyond the scope of this discussion, which focuses on the effect of

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the SEC on financial accounting. Specific categories of regulations and publications affect financial accountants and their clients.

It is especially important to note that the 1934 Act gave the SEC specific authority to establish accounting principles to be used by registrants in filed financial statements. This authority led to the issuance of Accounting Series Release (ASR) No. 4, *Administrative Policy on Financial Statements,* in 1938, which stated that the principles used in the filings would have to enjoy "substantial authoritative support." It also stated that disclosure of a departure from such supported principles would not be an acceptable substitute for applying them.

The role the SEC has historically played in resisting attempts to introduce fair value into the accounting process is interesting. First arising in rate-regulated entities as a means to ask for rate increases, the suggestion of fair values continued to be pressed until the door was opened to the practice in recent years. This is detailed in an excellent article by Steve Zeff.[1] The acceptance of fair values and recognition of income and expense based on fluctuations in market values continues to be controversial since it creates income effects based on temporal situations and often requires the use of imprecise measurement techniques to determine values. Chapter 24, "Fair Value Measurements," by Mark L. Zyla, and Chapter 25, "Valuation of Assets and Liabilities in Nonpublic Companies," by Neil J. Beaton, in this *Handbook* provide additional insight into the theory and application of fair value principles in the modern accounting environment.

Due to resource and expertise constraints, the SEC takes an oversight role in today's accounting standard-setting process, preferring on occasion to exercise its right to overrule the standards proposed by the FASB or its predecessor, the Accounting Principles Board (APB). The SEC is an active observer of the accounting standard–setting process.

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(b) STRUCTURE OF THE SECURITIES AND EXCHANGE COMMISSION. Because the SEC is an independent agency, it does not exist within any of the three traditional branches of government (executive, legislative, or judicial). All five commissioners are appointed by the president and are confirmed by the Senate. In order to help maintain balance and thereby boost public confidence in the capital markets, no more than three commissioners can be members of the same political party. The basic term for a commissioner is five years with the possibility of unlimited reappointments. However, history shows that it is unusual for a commissioner to complete an entire term. Most commissioners are attorneys by training, although some have had other backgrounds. One commissioner is designated by the president to serve as the chairperson and has special administrative responsibilities and acts as a spokesperson for the entire commission. However, the chairperson has only one vote and thus actually has no more authority than the other commissioners.

As is true with most major organizations, a large professional staff supports the work of the commissioners. The SEC has approximately 3,500 employees at its Washington, DC, headquarters and its 11 regional offices across the country. A number of divisions and offices deal with particular regulatory activities. The three that financial accountants are most likely to come into contact with are:

- Division of Corporation Finance (DCF)
- Office of the Chief Accountant (OCA)
- Division of Enforcement

In dealing with their responsibilities, all three report directly and independently to the SEC. However, they also work closely with one another to coordinate their activities and to avoid contradictions and confusion. Exhibit 1.2 is a diagram of their interrelationships and the points of usual interface with the public.

(c) DIVISION OF CORPORATION FINANCE. The largest of these three sections of the SEC is the DCF, or Corp Fin. Its fundamental responsibility is to process filed documents received from registrants

[1] S. Zeff, "The SEC Rules Historical Cost Accounting: 1934 to the 1970s," *Accounting and Business Research,* International Accounting Policy Forum (2007).

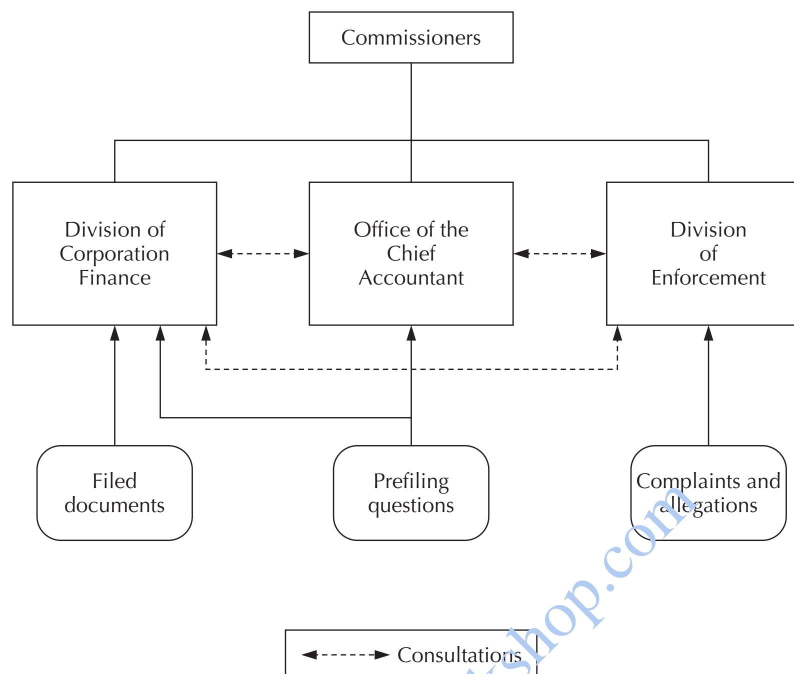

Exhibit 1.2 SEC Accounting Activities and Suborganizations

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to determine whether they comply with the appropriate disclosure regulations. The DCF staff consists of attorneys, accountants, and financial analysts and is organized by industry specialties. The director is advised by a chief accountant for the division, who is not the same person as the SEC's chief accountant.

In the process of reviewing filings, the DCF Staff encounters questions about the suitability of the accounting principles applied to registrants' transactions or situations. Some registrants are careful to raise these kinds of questions before they file documents in order to determine the principles that the staff believes are applicable. In either situation, the DCF Staff often resolves these questions using published generally accepted accounting principles (GAAP) or precedents established in earlier cases. In more complicated or groundbreaking situations, the DCF chief accountant consults with the SEC's OCA.

(d) OFFICE OF THE CHIEF ACCOUNTANT. The SEC's primary adviser on financial accounting issues and policy is the chief accountant, who is appointed by the chairperson and serves at his or her discretion. The OCA is supported by a professional staff, all of whom are experienced accountants, except for one attorney. As indicated in Exhibit 1.2, the OCA works with the DCF chief accountant to resolve issues raised in filings or by prefiling questions. The diagram also shows that some of these prefiling questions may come directly to the OCA.

In order to identify the accounting and auditing practices that have "substantial authoritative support," the OCA first tries to determine what the authoritative literature says about the issue, turning to its own pronouncements and interpretations only when that literature is silent or ambiguous. In conducting their research, the OCA Staff members frequently consult with the FASB Staff. It is also common for the registrant who raised the question to meet with the SEC Staff to explain the facts and circumstances surrounding the issue and to present its point of view. When the question cannot be resolved satisfactorily from the literature, the OCA develops an answer with the goal of providing "full and fair disclosure." To present a united position on the issue, the OCA and DCF

establish together what ought to be done. If the registrant does not agree with the answer, SEC procedures allow it to appeal to the full SEC. However, as a practical matter, registrants seldom make this appeal because the commissioners virtually always support the Staff.

A significant source of information about the likely views of the Staff and the likely acceptable accounting treatments are precedence established by other published reports that have been filed with the SEC. Precedence is not the final determination, but it is a consideration when the issuer can identify similar situations where the proposed accounting practice was followed. The Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) electronic database maintained by the SEC is a readily available source of SEC filings for research and the determination of precedence.

In addition to dealing with situation-specific issues, OCA also advises the SEC on major policy matters affecting financial reporting. This role involves preparing recommendations that new SEC rules be created for registrants. It also involves overseeing standard setters, such as the FASB and the Public Company Accounting Oversight Board (PCAOB).

(e) DIVISION OF ENFORCEMENT. The third segment of the SEC staff that commonly interfaces with financial accountants is the Division of Enforcement, which is charged with investigating violations of the statutes and regulations and recommending disciplinary action. Information about possible violations comes from a wide variety of sources, including the OCA and DCF, as well as news reports and direct complaints from individuals. When violations appear to be other than merely inadvertent or technical, the Division of Enforcement is responsible for determining whether and how to pursue a case and for discovering the facts. In some situations, the division may recommend that the Commission reach a settlement with the alleged offenders without a judicial finding. Although the findings are made public, the subjects generally neither admit nor deny the allegations, even though some discipline may be accepted (such as suspension or permanent disbarment from practicing before the Commission). In far fewer situations, the Commission orders cases to be turned over to a U.S. Attorney's Office for prosecution in a federal court. Naturally, the Division of Enforcement Staff cooperates fully with the U.S. attorneys in pursuing these cases.

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For violations of statutes or regulations involving accountants, Commission procedures require that the chief accountant of the Division of Enforcement consult with the OCA to ensure that the proper facts have been uncovered and that the authoritative literature has indeed been violated. These violations typically include failure to maintain proper books and records, preparing financial statements that do not comply with GAAP, issuing an unqualified audit opinion on statements that do not comply with GAAP, or conducting an audit without complying with generally accepted auditing standards (GAAS). Although the Division of Enforcement does not have to obtain concurrence from the OCA to go ahead with a case involving accounting or accountants, a lack of concurrence would make it difficult to persuade the SEC that a violation occurred.

(f) REGULATIONS AND PUBLICATIONS. Because the SEC is a government agency, its accounting literature is structured differently from the pronouncements published by the FASB and other standard setters. This discussion provides an overall view of that structure in order to help the reader understand the SEC's regulations and publications. Those interested in more detailed descriptions of SEC financial reporting requirements will need to consult materials developed by one of several reporting services or large accounting firms. Like other agencies, the Commission publishes its pronouncements in the daily *Federal Register,* copies of which are then compiled and republished by proprietary organizations for sale to practicing accountants and attorneys, as well as libraries and others. Today, electronic services that maintain the current SEC literature are widely used by corporations and auditors to ensure that changes to the rules and regulations are properly considered.

The two main sources of the SEC's authority over accounting are the Securities Act of 1933 and the Securities Exchange Act of 1934. Five other statutes also affect accounting, but less directly. They include the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisor Act of 1940, and the Security Investor

Protection Act of 1970, and, most recently, the Sarbanes-Oxley Act of 2002. These statutes give the SEC the authority to create rules and regulations that interpret the requirements to be met by companies under its jurisdiction.

For accountants, the most familiar regulations under the 1933 and 1934 Securities Acts are Regulation S-X (17 Code of Federal Regulations [CFR] 210) and Regulation S-K (17 CFR 229). Regulation S-X describes the accounting and auditing requirements that registrants must meet, including not only the financial statements but also the qualifications of (including independence) and reports filed by accountants who practice before the SEC.

Some registrants are not required to comply with Regulation S-K; for example, small companies that fall under Regulation D of 17 CFR 230 are exempt, as are investment advisers.

At the next level below regulations and forms are SEC Releases, which are essentially official communications between the SEC and the public. They announce changes in the regulations and forms, interpret the regulations, describe various SEC enforcement activities, or declare general SEC policy. The SEC issues these publications only after a majority vote of the commissioners.

Several types of releases are related to the statutes and regulations. Releases concerning matters under the 1933 Act are called *Securities Releases.* When they are published in the *Federal Register,* they are given a number with a "33-" prefix. Releases concerning the 1934 Act are called *Exchange Act Releases* and have a "34-" prefix in the *Register.* Releases concerned with Regulations S-X and S-K fall into two categories. As might be expected, Financial Reporting Releases (FRR) announce changes and interpretations of these two Regulations. They are published with an "FR-" prefix, although they are commonly identified in the accounting literature as "FRR." It is possible for a single release to have more than one designation. In fact, it is not uncommon to find a release carrying all three.

Accounting and Auditing Enforcement Releases (AAER) announce enforcement or other disciplinary actions against individuals, firms, and registrants who have been alleged or proven to be in violation of the federal securities laws or who have otherwise fallen under the SEC's disciplinary powers. They are published under the prefix of "AAER."

Until 1982, the SEC issued ASRs, concerning both financial reporting matters and enforcement actions. In that year, the separate FR and AAER series were created to avoid the confusion of dealing with the two different kinds of actions in one series. The effective portions of the ASRs were codified in FR-1.

The fourth level of literature, Staff advice, is directed from the SEC Staff to registrants and other interested parties with regard to its interpretation of the regulations and forms. To help avoid arbitrary or otherwise inconsistent policies, these communications are generally subjected to substantial internal review involving two or more divisions or offices, including, for example, the OCA, DCF, and the Office of the General Counsel.

Although Staff advice lacks the official standing of SEC releases, a registrant faces substantial difficulty in successfully opposing it in a filing. As with every Staff decision, the registrant can appeal to the commissioners for an exception, but history has shown that few are willing to go to the expense and trouble, and fewer still succeed in overturning the Staff's position.

Three categories of Staff advice are of interest to accountants. Staff Accounting Bulletins (SABs) are probably the most familiar. They are issued by DCF and the OCA. An SAB is published to describe an interpretation that the Staff has made either for a series of filings with similar facts and situations or for one filing that dealt with an unusual situation or that took a novel approach to the authoritative literature. The SAB assists registrants through a troubled area or lets them know that a particular approach will not pass Staff review.

(g) SUMMARY. Even though the SEC has jurisdiction over public corporations only, without doubt it has exerted, and will continue to exert, a substantial influence on financial accounting by private corporations as well. The philosophy of fair and full disclosure permeates the practice of financial accounting for all companies, and the SEC's standards for independence and competence of auditors are fairly well established throughout the profession. The enforcement activities of the SEC are also important because they establish and defend norms of behavior expected of financial accountants.

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A major issue in today's marketplace is how the SEC will weigh in on the issue of convergence of U.S. GAAP with International Accounting Standards (IAS). This work discusses this issue in more detail, as we look forward into the future of financial reporting in Chapter 3 in this Handbook.

Affiliating with a corporation registered with the SEC puts special demands on its internal and external accountants. No one should venture into this type of practice without substantial training and experience or without competent legal counsel. The requirements are extensive and complicated, and the penalties for not meeting the standards are considerable.

1.4 FINANCIAL ACCOUNTING STANDARDS BOARD

The Financial Accounting Standards Board (FASB) has a unique status as a private organization charged with protecting the public interest. (The GASB, a related organization, is discussed in Section 1.5) The SEC endorses it through its 1973 ASR No. 150 (now codified within FR-1) as the source of "substantial authoritative support" for determining the acceptability of accounting practices for filings with the SEC. It has also been endorsed at the state level to the extent that state boards of accountancy include a requirement for complying with FASB pronouncements in their ethics codes. The FASB does not receive funds directly from either the SEC or state boards.

Although other private sector bodies, such as the AICPA and Financial Executives International (FEI), endorse and finance the FASB, it is, by intent and design, independent of any of them. Of course, these endorsements are contingent on the FASB's maintaining an attitude of protecting the public interest.

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(a) BRIEF HISTORY. Beginning in 1938 with the issuance of ASR No. 4, the SEC has given the accounting profession the task to deliberate and propose GAAP.

Shortly after ASR No. 4's release, the American Institute of Accountants (the forerunner of the AICPA) upgraded the level of funding, staffing, and activity of its Committee on Accounting Procedures (CAP). Over the next 20 years, it produced 51 Accounting Research Bulletins (ARBs), including the all-encompassing ARB No. 43, *Restatement and Revision of Accounting Research Bulletins.* The CAP did not survive because it suffered from two political shortcomings.

1. It never was given authority by the institute's council to establish standards that would be binding on the membership.
2. It existed within the institute, a fact that created at least the appearance that auditors' interests (and their clients' interests) were likely to be preferred to the public interest.

In response to criticism, the AICPA formed the APB in 1958 and again increased the funding and staffing over the previous levels. During the next 15 years, the APB issued 31 opinions and 4 statements. In an effort to establish credibility, the APB's initial membership consisted of the top managing partners of major firms and other comparably influential accountants. Over time, the membership level slipped somewhat into lower levels of management, but highly competent technical experts continued to serve on the APB. In 1964, the AICPA council acted to correct one of the deficiencies carried forward from the CAP by requiring members of the institute to identify and justify their clients' departures from principles established by the APB. However, the second weakness still existed in that the APB was perceived as elevating auditors' and clients' interests above the interest of the general public in achieving full and fair disclosure for more effective capital markets.

In 1971, in response to growing sentiments and suggestions that the APB needed to be replaced by a government agency, the AICPA organized the Study Group on Establishing Financial Accounting Standards, under the chairmanship of Francis M. Wheat. The following year, the study group recommended creating an autonomous standard-setting body that would overcome the weaknesses of the CAP and the APB. That is, it would be granted authority to establish binding GAAP, but it would not be housed within the AICPA. Thus, it would be more likely to escape the appearance of dominance by the interests of auditors and their clients. The proposal was accepted by

six sponsoring organizations that provided adequate funding and other support to get the FASB established and operating in 1973. The original six sponsors were the AICPA, the FEI, the Institute of Management Accountants (IMA), the American Accounting Association (AAA), the Securities Industry Association, and the Association for Investment Management and Research (AIMR). A critical event of the first year was the SEC's issuance of ASR No. 150.

Initially, the APB was still heavily dependent on the IMA and auditors for its funding and credibility. However, the previous concerns of dominance were raised in congressional hearings in 1975 and 1976, and the APB's bylaws were changed to make it less subject to the appearance of control by auditors and preparers.

The first chair was a respected practitioner, Marshall Armstrong, who had been a member of the APB from 1963 through 1969. He was succeeded in 1978 by Donald J. Kirk, who had been a charter member of the FASB. Kirk served as chair through the end of 1986, when he was replaced by Denny Beresford, who served until June 30, 1997. Edmund Jenkins, formerly of Arthur Andersen & Company, took over as the chair on July 1, 1997. Robert Herz, formerly of PricewaterhouseCoopers, became chair on July 1, 2002. The current chair as of December 23, 2010, is Leslie Seidman.

A more in-depth history of U.S. financial accounting standard setting from a technical perspective is provided in Chapter 2 in this work by Reed K. Storey, which is brought forward from previous editions of the *Accountant's Handbook*.

(b) STRUCTURE OF THE FINANCIAL ACCOUNTING STANDARDS BOARD. The FASB is actually only one part of a three-part organization, which also consists of the Financial Accounting Foundation (FAF) and the Financial Accounting Standards Advisory Council (FASAC). The relationships among these entities, the GASB, and the Governmental Accounting Standards Advisory Council (GASAC) are diagrammed in Exhibit 1.3.

The FAF is a nonprofit, tax-exempt Delaware corporation, managed by a 16-member board of trustees. The FAF is responsible primarily for raising operating funds and appointing members of the two boards and their Advisory Councils. A third unofficial function of the FAF is to shield board members from the kinds of pressures to compromise the public interest that shut down

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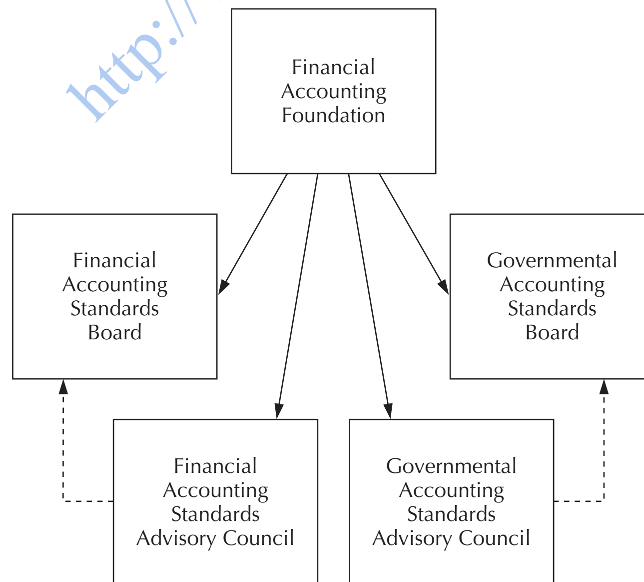

Exhibit 1.3 Structure of the Financial Accounting Foundation and the Standards Boards

the CAP and the APB. Eleven trustees are appointed by the governing boards of the sponsoring organizations, and the rest are selected by the other trustees. The creation of the GASB caused expansion of the FAF board to include three trustees selected by a consortium of organizations involved with local and state governments.

The FAF bylaws strictly forbid trustees from tampering with the boards' procedures in order to affect the standards that they issue. Of course, their control of appointments and reappointments gives the trustees substantial indirect influence.[2] A major controversy arose in 1996 concerning the composition of the FAF board after SEC chair Arthur Levitt grew dismayed by the lack of any kind of defense by the FAF against public claims by some leaders in the FEI that the FASB was "broken and in need of substantive repair."[3] He began to privately urge the FAF to voluntarily restructure itself to have a majority of its 16 members consist of individuals who unquestionably represent the public. (At the time, at least eight of the trustees, and possibly one other, were members of the preparer community.) When the negotiations broke down, Levitt took the issue public, first with a speech and then with a widely distributed letter that threatened to reconsider the standing of the SEC's ASR No. 150. This release delegates rule-making authority to the FASB.

As a result of the controversy, the FAF and SEC issued a joint press release in July 1996 that announced the appointment of four new trustees, all of whom met Levitt's criterion of being public representatives. Levitt accomplished his goal that preparers would no longer dominate the trustees or the FASB.

The FASAC was conceived as an experienced and informed microcosm of constituencies with the sole duty of providing feedback. It has operated that way with a membership ranging from 20 to 35 members who serve up to three one-year terms. Only the full-time chair receives compensation. The FASAC has no fundraising responsibilities and does not attempt to take a vote or reach a consensus on the issues. Rather, its job is to offer advice on projects that might be added to the agenda and on preliminary positions for existing projects.

The FASB itself is comprised of full-time members who must sever their relationships with their previous employers or partnerships. Each is appointed for a five-year term and can be reappointed for another. A member appointed to fill an unscheduled vacancy is eligible to serve up to two additional full terms. The FAF trustees designate the chair, who has significant administrative responsibilities, including the leadership of FASB Board meetings. In addition, the chair is the FASB's most visible spokesperson.

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(c) BOARD PUBLICATIONS. Although the FASB exists primarily to create financial accounting standards, it also provides interpretations. In addition, it was given the assignment of developing broad theoretical concepts of financial accounting. Its position in the regulatory process and the demand from many accountants for detailed rules combine to create the need for implementation guidance. As might be expected, the FASB's publications reflect these tasks.

The main category of publications consists of SFASs. They are numbered consecutively, and 175 SFASs were issued before the Codification was issued on July 1, 2009, and became effective for financial reports issued after September 15, 2009. The Codification brought together all the related authoritative literature at the time into a single document, arranged by topic and subtopic.

The FASB's implemented Codification of existing accounting pronouncements also exists as a searchable database of accounting standards at *http://asc.fasb.org/home*. Seventeen Accounting Standards Updates (ASUs) were issued in 2009 and 29 were issued in 2010. Going forward, the ASUs will be the mechanism to update the Codification. Practitioners continue to transition to this dramatic change in the professional literature, For purposes of this edition, most references in the various chapters will be to the historical releases (e.g., SFASs) with disclosure of the relevant Codification topical sections.

ASR No. 150 specifically recognizes the authority of these pronouncements, and they receive similar support in state accountancy statutes and regulations. In addition, they are recognized by

[2] See P. B. W. Miller, R. J. Redding, and P. R. Bahnson, *The FASB: The People, the Process and the Politics,* 4th ed. (Burr-Ridge, IL: Irwin-McGraw-Hill, 1998), pp. 183–186.
[3] Ibid., pp. 186–192.

the council of the AICPA as GAAP for the membership; any member not treating them as such will have violated Ethics Rule 203. Thus, financial statements must be prepared in accordance with these standards if they are to receive an unqualified audit opinion.

Another category of publication, Financial Interpretations (FINs), also establishes GAAP. However, relatively few have been issued since 1984, primarily because of the emphasis placed on other media for providing the kind of guidance that Interpretations were initially created to provide. Interpretations are numbered consecutively, and 48 have been issued.

A third category of FASB document is the Statement of Financial Accounting Concepts (SFAC). These statements describe broader underlying concepts that the FASB has determined to use in developing its Standards. The statements do not constitute GAAP; accordingly, they are not identified as such by regulatory bodies or ethics codes. Nonetheless, knowledge of these Statements is helpful for understanding the content of Standards and for anticipating the direction of future Standards. Concepts Statements are also numbered consecutively, and seven have been issued. SFAC No. 6, *Elements of Financial Statements,* replaced SFAC No. 3, *Elements of Financial Statements of Business Enterprises,* with the result that only six are in effect. These Concepts Statements have also been merged into the Codification.

A fourth FASB category of publication comprises Financial Technical Bulletins (FTBs), which are actually issued by the FASB Research Staff. They are narrow in scope and interpret the existing authoritative literature (i.e., ARBs, Accounting Principles Board Opinions [APBOs], SFASs, and FINs) to apply to situations not covered in it directly. Although FASB members have the ability to prevent issuance of proposed FTBs, they do not formally vote to authorize their publication. FTB are numbered in annual series, such as "85-3"; this number is the third one issued in 1985. The FASB initiated FTBs in order to systematize informal advice that its staff was disseminating by telephone and letters; the use of FTBs expanded in the mid-1980s to reduce the earlier practice of issuing many highly detailed standards and interpretations. This change also allowed FASB members to focus their efforts on more substantive issues.

To mitigate the need for narrow FASB pronouncements while still providing quick responses to new problems (called *timely guidance* in FASB jargon), the Emerging Issues Task Force (EITF) was created in 1984. The director of the FASB's Research Staff chairs this group, which consists of about 15 technical experts from major and regional accounting firms and large corporations. It meets periodically to tackle complex new problems by applying the existing literature. Transactions and events that have already transpired are the source of some issues, whereas others are based on proposed transactions. The SEC's chief accountant is an active participant in the discussions, despite being officially identified as only an observer. The chief accountant and the OCA Staff are the prime beneficiaries of the EITF's activity because it often addresses issues that were brought to the OCA by registrants and their accountants.

When the EITF faces an issue, it seeks a consensus, which is considered to exist if no more than two or three members object to a proposed solution. If more object, there is no consensus, with the consequence that the OCA is left to implement its own views. Alternatively, the task force may recommend that the full FASB consider dealing with the issue. Prior to 1988, EITF consensuses were not published, although minutes of the meetings were available from the FASB. In 1988, the FASB began to publish highly condensed summaries of the issues and their resolutions. These summaries are presented as a public service because the outcomes are not necessarily the opinion of either a majority of the FASB or the FASB's Staff. Nevertheless, they hold a position in the GAAP hierarchy. A consensus is acceptable for SEC filings as long as the OCA does not have a serious objection to its outcome. Like FTBs, EITF issues are numbered in annual series. While assigned status first by the auditing profession in Statement of Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles,* to fill a void in the accounting literature, the implementation of a GAAP hierarchy by the FASB (SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*) recently obviated the need for this SAS in the auditing literature.

In addition to the documents just mentioned, the FASB also produces numerous other publications. Its Staff sometimes issues implementation guides, in the form of questions and answers, on

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more complex financial accounting standards. These implementation guides are yet another level in the GAAP hierarchy. Research Reports are developed in response to Staff or consultant efforts to identify a problem, review the literature related to a set of issues, or propose answers. Discussion Memorandums and Invitations to Comment solicit views from the FASB's constituents in early stages of deliberations. Three newsletters inform the public of the FASB's activities: *Action Alert, Status Report,* and *Highlights.* Another widely distributed item is Facts about FASB, which describes the organization's mission, procedures, and membership.

Like many other organizations, the FASB has a site on the World Wide Web (*www.fasb.org*) that it uses for a variety of purposes. The site provides the public with access to press releases, major FASB communications (including letters to the FASB from prominent commentators and responses from the FASB), and e-mail access to board and staff members. FASB exposure drafts can be downloaded from the FASB Web site.

(d) DUE PROCESS PROCEDURES. Like many other regulatory agencies, the FASB has established procedures to ensure that parties affected by new regulations have an opportunity to express their views on the issues and positions on the issues are identified. Another desirable effect is that the public's participation bolsters the credibility of the output. Although the term *due process* may imply a rigid set of procedures, there is actually enough flexibility to allow the FASB some freedom in determining how extensively to pursue various activities. These six steps, however, are followed:

1. Admission to the agenda
2. Preliminary deliberations
3. Tentative resolution
4. Further deliberations
5. Final resolution
6. Subsequent review

All six steps are public. Board meetings take place at the headquarters in Norwalk, Connecticut, and are open to all who want to attend, up to the room's capacity. Under the FASB's sunshine policy, FASB members are not allowed to discuss the issues privately in groups consisting of more than three persons. This arrangement was adopted in the mid-1970s after criticism that the previous policy of closed-door meetings caused some constituents to feel that their views were not being considered.

A project is admitted to the agenda only after substantial preliminary debate. The set of problems to be addressed in the project must meet three criteria.

1. There must be diverse practice.
2. The diversity must create significant differences in financial statements, such that there is a potential for users to be misled or to incur excessive analysis costs.
3. There must be a sufficiently high probability that the issues can be resolved in a manner that justifies using FASB resources.

Problems are identified by the FASB and Staff but more often come from constituents and the SEC. The EITF deliberations have also created some projects.

The next step is to engage in early deliberations. Early during this stage, the Research Staff attempts to frame the issues and sound out FASB members and constituents. For major projects, the Staff may create a task force of interested experts from various constituencies to assist its inquiries. Occasionally the FASB will publish a Discussion Memorandum or an Invitation to Comment at this phase. There may be public hearings for especially significant or controversial projects in order to allow constituents to express their views and to allow board members and Staff to question persons who testify. Board meetings will generally be devoted to questions from the members to the Staff and to each other. As the phase draws to a close, the Staff efforts turn to helping the members find the common ground on which to build a majority vote.

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The third phase is the tentative resolution. At this point in the process, the FASB has voted to issue an Exposure Draft (ED), which is a proposed Standard, Concepts Statement, or Interpretation. More controversial projects may have another round of public hearings. Dissenting board members' views are included in the ED, as is a summary of the basis for the majority's conclusions.

During the further deliberations step of the due process, the Staff and FASB attempt to digest the comments received in response to the ED. During this phase, FASB members generally aim at fine-tuning the proposal to deal with unanticipated minor glitches. If significant changes are needed, a second ED may be necessary.

The final resolution phase is short and consists merely of taking votes from the FASB members either for or against the ballot draft of the Standard (or other pronouncement). The published document includes not only the majority's view but also the dissenters', if any. It describes the comments from the constituents and the FASB's reactions to them. Many Standards include an appendix illustrating the application of the requirements. Once this point is reached, the Staff's efforts turn to responding to implementation problems.

In summary, the due process is molded to fit the situation. The FASB specifically disavows any notion that the due process allows it to "count noses" to determine what a majority of the constituency wants. Its role is more judicial than legislative, and the FASB members must reach a conclusion about what is best, even if particular groups are strongly opposed to the new accounting Standard.

(e) CONCEPTUAL FRAMEWORK. An important key to understanding the overall direction of the FASB's efforts to reform financial accounting is its project to identify a coherent theory of financial reporting, called the *conceptual framework.*

Because the CAP and APB were criticized for not developing a unified theoretical basis for resolving issues, the FASB's inaugural agenda included the task of identifying concepts that it could use in setting standards.

A critical initial decision in the project was to develop the framework from the top down by identifying the objectives of financial reporting and then working down to more specific concepts. This approach (also called *deductive*) had been tried before, most notably by Sprouse and Moonitz in the AICPA's Accounting Research Study (ARS) No. 3, *A Tentative Set of Broad Accounting Principles for Business Enterprises* (1962) and by the Trueblood Study Group in its report *Objectives of Financial Statements* (1973).[4] The opposite approach (called *bottom-up or inductive*) of looking at practice and identifying common threads had also been tried, most notably in APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (1970). APB Statement No. 4 also used the top-down approach. Although there are several advantages and disadvantages to the two approaches, the main difference between them is that the bottom-up approach tends to encourage applying old solutions for new problems, whereas the top-down approach tends to lead to new solutions for old problems. Thus, the determination of the FASB to pursue a top-down framework created a substantially greater likelihood that significant changes in GAAP could be supported. Accordingly, the framework project was (and has continued to be) controversial.

SFAC No. 1, *Objectives of Financial Reporting by Business Enterprises,* was issued in 1978. It presented a hierarchy of objectives, the most important being the provision of "information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and other decisions."

SFAC No. 1 is significant because it establishes that the interests of the public and financial statement users are to be ranked above the interests of auditors and preparers. User needs are also the compass auditors use in determining materiality, a critical auditing concept that shapes the nature and scope of auditing procedures applied.

SFAC No. 2, *Qualitative Characteristics of Accounting Information,* was issued in 1980. It identifies qualities of information that make it useful for meeting the objective described in SFAC

[4] AICPA Trueblood Study Group, *Objectives of Financial Statements* (New York: AICPA, 1973).

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No. 1. The three primary qualities are relevance, reliability, and comparability. The important point to observe is that the FASB chose qualities that reflect user needs instead of the needs of auditors (who prefer defensible information) and preparers (who prefer controllable and inexpensive information).

The third phase of the framework culminated in 1980 with the issuance of SFAC No. 3 was superseded in 1985 by SFAC No. 6, which also encompasses the elements of financial statements issued by not-for-profit entities. The business elements identified by the FASB included the familiar assets, liabilities, owners' equity, revenues, expenses, gains, and losses; however, the FASB's decision to make the assets and liabilities the keystone elements was enormously significant. That is, it defined all the other elements, including "comprehensive income," that were defined in terms of assets and liabilities. With this decision, the FASB essentially turned away from the familiar matching concept of income that had dominated practice for decades with its emphasis on the income statement and its deemphasis of the balance sheet. Instead, under the conceptual framework, income is measured by changes in assets and liabilities because both the income statement and the balance sheet are considered useful and important.

SFAC No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations,* was also issued in 1980. (Subsequent to issuing SFAC No. 4 but before issuing SFAC No. 6, the FASB determined that the term *not-for-profit* was preferable to *nonbusiness.* In particular, the managers of a number of these entities complained that they did not like the inference that they were not "businesslike" in the way they operated.) It was the outgrowth of the FASB's decision to deal with all entities, public or private. This Statement broke new ground because there had not been a significant effort to establish top-down concepts in this area. As might be expected, the main objective is similar to the one in SFAC No. 1; specifically, it says that the financial statements of not-for-profit organizations should provide "information that is useful to present and potential resource providers and other users in making rational decisions about the allocation of resources to those organizations."

By starting with this objective, the FASB again put into place the potential for substantial reform because it would be necessary to show how existing practices met this objective.

The FASB encountered major roadblocks when it entered into the project's next phase, "recognition and measurement," because it was here that decisions would be reached on whether, when, and at what amount assets, liabilities, and changes in them should be reflected in the financial statements. The fundamental issue was whether there should be a movement toward including more market value information in the statements. Naturally, this phase of the project attracted much attention and created substantial controversy. In 1985, after more than three years of debate, six FASB members agreed to issue SFAC No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* which was clearly a compromise. It says that things recognized in the statements should be elements and that the amount reported for them should be relevant and reliable. In effect, all that was accomplished was to affirm the contents of the preceding concepts statements. SFAC No. 5 also identified the cash flow statement as a conceptual member of the set of financial statements, and the FASB eventually issued SFAS No. 95, *Statement of Cash Flows,* which requires its presentation. SFAC No. 5 also identified two possible income statements, one of which would focus on earnings, whereas the other would report comprehensive income, which might include changes in current value. In 1997, after two years of deliberations, the FASB issued SFAS No. 130, *Reporting Comprehensive Income,* which requires companies to report the amount of comprehensive income, either at the bottom of its regular income statement or in a separate statement. This amount equals the reported net income plus and minus the changes in various unrealized changes in equity that are reported on the balance sheet. The Standard addresses only the display of comprehensive income and does not introduce any new measurement requirements. However, the Standard does set into place a means for reporting other components of comprehensive income.

In 2000, the FASB issued SFAC No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements.* Although accounting measurements are best determined using observable exchange transactions, sometimes measurements must be based on estimated cash flows. This Concepts Statement provides a framework for using cash-flow- based techniques for accounting

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measurements. SFAC No. 7 specifies that accounting measurements based on present value concepts should reflect the uncertainties associated with the underlying cash flows. SFAC No. 7 also introduces the expected cash flow approach to present value calculations. Present value calculations historically often are based on a single set of estimated cash flows and a single discount rate, where the discount rate reflects the uncertainties associated with the cash flows. Concept Statement No. 7 states that a range of estimated cash flows should be considered and that this range of cash flows should be assigned their respective probabilities and then discounted. Measurement of the fair value of an entity's liabilities is to reflect the credit standing of the entity.

What, then, is the significance of the conceptual framework?

1. It sets in place the possibility for significant changes in GAAP.
2. It puts users' needs (and thus the public interest) at the highest priority level.
3. It establishes that the statement of financial position should not be merely a resting place for debit and credit balances waiting to be "matched" in the future; rather, it should provide useful information about assets and liabilities.
4. It rejects matching in favor of reporting changes in assets and liabilities as income, thus raising the possibility that gains and losses from fair value changes could be recognized as income.
5. It defines a number of important terms that are used in the FASB's communications with its constituents and in its internal discussions. Far from being an empty academic theoretical exercise, the framework is perhaps the most significant set of pronouncements that the FASB has issued. The more that practitioners know about it, the more they will be capable of dealing with the FASB and the changes that its pronouncements will bring about.

(f) STANDARDS OVERLOAD. One pervasive problem that just will not go away is *standards overload.* Originally this phrase described the issuance of numerous detailed standards, but more recently it has come to encompass the issuance of complex standards that are difficult to implement, especially by smaller nonpublic companies. Exhibit 1.4 symbolizes this situation, showing that the FASB has received rule-making authority from the SEC to establish GAAP for use by public companies while, at the same time, it has received rule-making authority from state boards and the AICPA to establish GAAP for use by private companies. It should be noted that these delegations of authority

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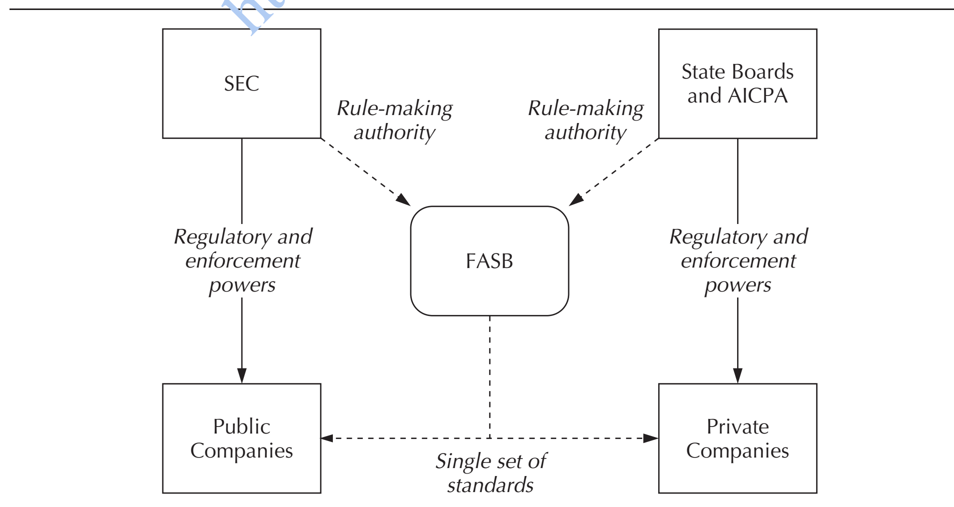

Exhibit 1.4 Conflicting Authorities and Standards Overload

do not grant the FASB any enforcement or broad policy-making powers. In fact, they have created the narrow but complex task of developing a single set of financial accounting standards that apply to both public and private companies.

The FASB's dilemma is that too much emphasis on the information needs of public companies ignores the practical constraints affecting private companies. Because the SEC exerts the greatest political influence, it seems likely that FASB will continue to focus on the needs of more sophisticated users and will issue Standards that may be difficult for private companies to implement. This choice leaves the state boards and the AICPA in a difficult relationship with some of their constituents and members, but there does not appear to be any way out of this dilemma.

Under active study and debate today is the application of different standards according to whether the company is private or public. Survey responses have consistently shown that a different set of GAAP for private companies would be perceived as inferior and that users probably would demand that public company principles be applied in private companies' statements. The IAS arena may provide some clues as to how standards for larger and smaller entities might coexist.

Apart from the issue of private and public company standards is the ever present debate over principles versus rules-based standards. Little can be added to that debate at this point. One can see from litigation and the analysis of failed audits that detailed accounting standards in themselves do not prevent bad things from happening. Some feel that detailed rules invite a gaming of structuring the transactions that seem to meet the letter of the standard. However, does that mean that less precise standards would be better? Would the SEC and auditors have more or less ammunition to urge a more "fair" presentation with less precise standards? If companies and their auditors cannot interpret the spirit of the rules when more detail is provided, are they likely to be more insightful and forceful with less? These questions plague concerned managements as well as auditors.

(g) SOME CRITICISMS OF THE STANDARDS. The failure of Enron, largely due to the disclosure of financial reporting improprieties, resulted in some criticism of the FASB. Enron transferred nonperforming assets and liabilities into various special-purpose entities (SPEs). The objective of these maneuvers was to shield the company from recognizing losses on these nonperforming assets and to reduce its perceived risk by reducing its reported debt level. At the time, accounting rules for SPEs did not require consolidation of assets and liabilities transferred to the SPE with the financial statements of the sponsoring entity if an outside investor made an equity contribution of 3 percent or more of the SPE's total capitalization. Enron did not meet this requirement because some of the outside capital allegedly contributed to the SPE was not really at risk. Enron had guaranteed some of the capital investments made by outside investors using its own stock as the form of guarantee.

Although Enron did not comply with the existing accounting requirements, the FASB still was subject to stinging criticism because a number of parties alleged that the current accounting rules for SPEs were too lax, and the FASB's Standards are too detailed, and detailed Standards provide incentives for preparers to design transactions that meet their letter but not their spirit. The FASB has issued an Interpretation (*Consolidation of Variable Interest Entities,* Interpretation No. 46 to ARB No. 51, *Consolidated Financial Statements*) to tighten the rules related to nonconsolidation of SPEs. Moreover, the FASB historically has been criticized for failing to require companies to expense stock options. Changes in the Standards require more companies to record compensation as a result of granting stock options. The implementation of the 2004 revisions (FASB No. 123R) on stock compensation requires the use of the fair value method in measuring the expensing stock options.

While a goal has been to isolate the FASB from political and constituent pressure, the economic downturn in 2009 prompted the FASB to issue some additional guidance regarding the reaction to market conditions. Some of that guidance had the effect of softening the landing that otherwise the existing rules might require. Because accounting is linked to our economy and society, it is difficult to insulate it from the pressures that extraordinary times can place on it. It is a continuing challenge to maintain the integrity of the accounting standard-setting process.

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1.5 GOVERNMENTAL ACCOUNTING STANDARDS BOARD

In response to needs expressed by various groups, a study was undertaken in the early 1980s to consider how to establish financial accounting standards for state and local governmental units. (The federal government's uniqueness has caused the application of governmental accounting standards to be limited to state and local entities.) Standards were being established through professional organizations composed of governmental accountants, but they had not been endorsed by the Council of the AICPA; consequently there was some concern over whether they constituted GAAP. The study group's report recommended the creation of the GASB that would be under the administration of the FAF. After several years of discussion and opposition, the trustees agreed to set up the GASB, and it began operations in 1984.

The constituencies of GASB overlap those of the FASB to a limited extent. The preparers consist of elected and appointed officials who are accountable to the voting public for the use and safekeeping of funds appropriated or otherwise entrusted to them, and thus they do not coincide with the preparers regulated by the FASB. The auditor constituency is essentially the same as for the FASB, although the actual individuals are different because of specialization issues. Users of the financial statements of governmental units are different from users of business statements. In effect, when governmental units go into the capital markets to obtain debt funding, they are competing with corporations for investors' attention. There is no regulatory agency comparable to the SEC with jurisdiction over governmental units; consequently the GASB has no constituent like the SEC. State boards are interested in the GASB's efforts because their licensees act as auditors for governmental units.

Without an endorsement by the SEC, the authority of GASB for setting standards is not quite as clear-cut as that of the FASB. It does have power, however, because a variety of professional societies, including the AICPA, endorse its efforts. It also has increased influence because of its affiliation with the FASB.

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(a) STRUCTURE OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD. The GASB has five members, with only the chair serving on a full-time basis. The other four members serve part time and meet as needed for formal meetings and consultations. In addition, the GASB has a full-time director of research and technical activities. The GASB's headquarters are located in the same building as the FASB and the FAF. Although the FASB and GASB operate independently, they do share some facilities, including the board meeting room and the library, as well as their accounting and human resource management staff.

The Governmental Accounting Standards Advisory Committee serves the same purpose as the FASAC, but it is not as large and does not have a full-time chair.

The GASB's due process procedures are essentially the same as the FASB's and include similar steps. Some of the deliberations are more difficult to accomplish because of the geographical dispersion of the part-time members.

(b) JURISDICTION ISSUE. A persistent problem in the relationship between the FASB and the GASB has been the overlapping of their jurisdictions in some segments of the economy. In fact, the issue of which board should provide standards for these segments was the major stumbling block to the GASB's establishment.

Some organizations subject to the overlapping jurisdiction are utilities and providers of educational and health services. For example, some universities are operated by governments, others are private, and still others are combinations. The same situation exists for utilities, hospitals, and nursing homes. The jurisdiction issue turned first on the question of whether all these entities should be required to use the same accounting principles in order to achieve comparability. If so, the next question was which board should establish those principles.

As long as there were no conflicts over the principles to be used, the jurisdiction dispute did not cause a practical problem. However, that situation did not exist for long because the two boards reached opposing conclusions concerning the recognition of depreciation. Thus, the unresolved issue continued to chafe both organizations and to confuse their constituents.

It was resolved in late 1989 when the FAF's trustees first voted to implement and then shortly thereafter rejected a recommendation offered by two special committees that reviewed the structures of the FASB and the GASB. The final resolution left the jurisdiction as it had originally been defined, with the GASB holding power over state and local government entities, whereas the FASB was given responsibility for all others. In addition, it was agreed that the GASB would give careful consideration to the need for comparability when setting standards for public sector entities in industries that also include private companies.

For those readers interested in state and local government issues, Chapter 33 of this *Handbook,* by Cynthia Pon, Richard A. Green, and Caroline H. Walsh, will be of interest.

1.6 FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The needs of users of public, private, and state and local government financial reports can differ from the needs of the users of federal reports. Before the establishment of a separate body to consider GAAP in the context of federal financial accounting issues, the practice of federal accounting was a loose confederation of laws and federal directives and accounting principles drawn from the private sector and the state and local government sector.

However, since October 1999, the Federal Accounting Standards Advisory Board (FASAB) has been the body designated by the AICPA Council to establish GAAP and the GAAP hierarchy for federal reporting entities.

The federal GAAP hierarchy includes a priority sequence of documents and releases that guide accounting and reporting practice. That hierarchy includes FASAB Statements of Federal Financial Accounting Standards (SFFAS) and Interpretations, Technical Bulletins, Technical Releases of the Accounting and Auditing Policy Committee, and implementation guides. For further information see SFFAS No. 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board,* paragraph 5. Like the other standard setters, the FASAB operates in the sunshine with a structured due process from reaching decisions.

Volume Two of this work contains Chapter 32 by David M. Zavata, which provides a fuller summary of the development of federal accounting principles and how the myriad of constituencies and agencies interact within the federal environment. While the general financial statement reader does not confront reports prepared under federal accounting guidelines often, these principles govern an immense and growing portion of U.S. economic dollars. The Web site *www.fasab.gov/* may also be a helpful source of information about this important body and its activities.

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1.7 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Prior to 1973, the role of accounting standard setter was held by the AICPA or its predecessor body. After the formation of the FASB, the AICPA continued to play a role in accounting standard setting through the occasional issuance of Statements of Position (SOPs) through the Accounting Standards Executive Committee (AcSEC) and the issuance of Accounting and Audit Guides for various industries.

Prior to 2002, AcSEC examined accounting issues, generally ones with more narrow industry implications, that had not reached the FASB's agenda or that the FASB had decided against adding to its agenda. Accordingly, AcSEC and the FASB were in frequent contact, and FASB Staff members attend AcSEC meetings. The primary form of output from AcSEC was an SOP, which must be followed by institute members. Under SAS No. 69, AcSEC SOPs were considered "level b" pronouncements in the GAAP hierarchy. SOPs constitute GAAP if no "level a" pronouncement existed.

In response to FASB concerns about the nature and development process surrounding various the standard-setting activities, and a recognition that the EITF was also a mechanism for addressing narrow issues that the Board did not place on its agenda, AcSEC discontinued issuing SOPs.

AcSEC and the AICPA will no longer issue general-purpose SOPs or ask the FASB to clear SOPs or practice bulletins.

The AICPA and AcSEC will continue to issue Accounting and Audit Guides. These Guides are a very valuable and unique service to members as they focus on interpreting auditing and accounting literature for company accountants and auditors with a topical (e.g., Audit Sampling) or industry (e.g., Airline Industry) focus. The practices described in the Guides should be followed or departures should be justified. No other accounting or auditing standard setter or professional organization issues authoritative guides such as these.

Today, the AICPA actively participates in commentary on various accounting issues before the FASB and professional issues that reach congressional attention. However, today the AICPA has a negligible role in directly setting accounting standards.

1.8 U.S. AUDITING STANDARDS

The field of U.S. auditing standards dramatically changed with the implementation of the Sarbanes-Oxley Act of 2002. Before that the AICPA, through the ASB and a variety of committees, had been primarily responsible for setting auditing standards for both public and private companies. The Sarbanes-Oxley Act established that the newly created PCAOB would have the authority to establish auditing standards (after SEC clearance) and conduct CPA firm inspections for public company auditors. Those companies not required to follow PCAOB jurisdiction (e.g., private companies, nonprofit entities, and governmental entities) could continue to follow AICPA auditing standards.

Since the PCAOB is a newer organization and its charge is over a vast amount of capital in the U.S. economy, it will receive considerable discussion in this chapter.

The influence of International Audit and Attest Standards Board (IAASB) is also a strong force in current standard-setting activity and will be discussed with the AICPA role.

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1.9 PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

(a) BACKGROUND. Congress created the PCAOB as a response to various accounting-related scandals including Enron, WorldCom and others. The state of outrage in the country to these allegations of financial reporting fraud is reflected by the overwhelming votes in favor of Sarbanes-Oxley in both houses of Congress. The Act passed the Senate 99 to 0, and only 3 votes were cast against it in the House of Representatives.

The Sarbanes-Oxley Act has 11 sections. These sections address:

1. The PCAOB
2. Auditor independence
3. Corporate responsibility
4. Enhanced financial disclosures
5. Analyst conflicts of interest
6. Commission resources and authority
7. Studies and reports
8. Corporate and criminal fraud accountability
9. White-collar crime penalty enhancements
10. Corporate tax returns
11. Corporate fraud and accountability

The first four and the last four sections are likely to be of greatest interest to practicing CPAs.

The Sarbanes-Oxley Act created new requirements for publicly held companies and others and revamped the regulatory system for auditors of public companies. For decades, various studies of

accounting and auditing failures had concluded that deficiencies in internal controls were at the root of these failures. In addition, recently there was a noted increase in the frequency of restatements of the financial reports of public companies, leading to concerns that faith in the securities markets could be undermined by frequent errors in reported earnings, financial position, or disclosures.

The AICPA has retained the authority for standard setting for audits of financial statements of privately held companies and governments and for quality control for firms that perform those audits, where it has been since the 1930s. While there was no prohibition on the PCAOB working in some way with the existing U.S. auditing standard setter, the AICPA Auditing Standards Board (ASB), the PCAOB decided to maintain a very independent position in fulfilling its mission directed to public companies. This has led to increasing divergence in the auditing standards and independent quality inspections for public and nonpublic companies and is an important practice issue for auditors with public and nonpublic clients.

The AICPA has issued an auditing interpretation (AU 9508.89) explaining that if an auditor applies PCAOB Standards in the audit of a nonpublic company, the auditor must also comply with generally accepted auditing standards and the audit report should refer to both sets of standards.

Despite the use of the word *accounting* in its name, the focus of the PCAOB is on the auditing of public companies.

The PCAOB opened its doors in January 2003 and held its first meeting that month. The SEC reported, on April 25, 2003, that the PCAOB was organized and had the capacity to carry out its legislated duties, the final critical step in its establishment.

(b) AUTHORITY. Sarbanes-Oxley defines the PCAOB's authority and revises the Securities Act of 1934 to recognize it. PCAOB was established to

> oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors. (Section 101(a))

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The PCAOB's authority is subordinate to that of the SEC. Sarbanes-Oxley did not affect the SEC's authority to enforce the nation's securities laws, including regulating auditors, taking action against them, or setting accounting, auditing, or independence standards. The SEC maintains budgetary authority over the PCAOB and must approve proposed substantive rules before they take effect.

The PCAOB regulates auditors of issuers, which are described under Sarbanes-Oxley in this way:

> The term "issuer" means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 USC 78(c)), the securities of which are registered under section 12 of that Act (15 USC 78l), or that is required to file reports under section 15(d) (15 USC 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 USC 77a et seq.), and that it has not withdrawn. (Section 2(a)(7))

It has authority over both domestic and foreign auditing firms that prepares or issue audit reports on U.S. public companies or that play a substantial role in the preparation or issuance of such reports.

The PCAOB's primary public-interest functions include:

- Registering accounting firms that audit public companies
- Establishing and maintaining standards for auditing, quality control, ethics, and independence related to the preparation of audit reports for public companies
- Conducting inspections of registered firms
- Conducting investigations and disciplinary proceedings against registered firms and associated individuals, including imposing sanctions when justified

Although state boards of accountancy can choose to adopt PCAOB Standards instead of those of the AICPA, Sarbanes-Oxley Section 209 explicitly notes that "the standards approved by the [PCAOB] should not be presumed to be applicable . . . for small and medium sized nonregistered public accounting firms."

The PCAOB's Practice Standards apply to all auditors, including staff and independent contractors (called *associated persons*), who participate in an audit of a public company. Registered firms also must comply with the board's Quality Control Standards.

(c) STRUCTURE. The PCAOB is not an agency of the U.S. government, and its Staff members are not government employees. It is a nonprofit corporation that can be dissolved only by an act of Congress.

The PCAOB's Washington office is home to the board, the executive staff, and the standard-setting function. Its Web site is *www.pcaobus.org*. It has several satellite offices around the country, primarily focused on inspections.

The PCAOB's budget is subject to SEC approval. The bulk of its funding comes from an allocation of accounting support fees assessed on public companies and from registration and annual fees from the registered auditing firms.

The PCAOB has the authority to assess monetary penalties against auditors, but any amounts collected are donated to a merit scholarship program for undergraduate and graduate students in accredited accounting degree programs.

(i) Board Members, Staff, and Advisory Groups. There are five members of the board. The board members serve full time and cannot engage in any other professional or business activity. They are appointed by the SEC, in consultation with the chair of the Federal Reserve and the secretary of the Treasury. To ensure the oversight group includes representation of various user groups and not just accountants, only two of the members can be current or former CPAs; however, a CPA cannot be appointed chairperson if he or she practiced as a CPA within five years of appointment to the board. Board members serve five-year terms, and no member can serve more than two terms.

The board is supported by a staff of several hundred accountants, attorneys, and others. Many of the accountants were partners or staff in auditing firms before joining the PCAOB Staff.

The board has established organizational functions in this way:

- The Division of Registration and Inspections creates the registry of accounting firms and performs inspections of the firms.
- The Office of the Chief Auditor and Professional Standards advises the board on standard setting.
- The Division of Enforcement and Investigations performs investigations of possible violations of law or professional standards and recommends disciplinary actions to the board.
- The Office of General Counsel provides legal advice and assists the board's rulemaking functions.
- The Office of Operations is responsible for information technology, human resources, and finance.
- The Office of Research and Analysis provides the PCAOB with assessment of risk and related insights.
- The Offices of Public Affairs and Government Relations assist the PCAOB in communications with the public, Congress, and the news media.
- The international affairs staff advises the PCAOB on international issues.

The PCAOB has the authority to create advisory groups to make recommendations regarding standards. It has officially convened a Standing Advisory Group (SAG) to assist the board in reviewing existing standards, in formulating new ones, and in evaluating proposed standards projects. Periodically, the PCAOB convenes ad hoc groups to advise Staff on specific practice issues.

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(d) FIRM REGISTRATION. Under Sarbanes-Oxley, only firms registered with PCAOB may “prepare or issue, or . . . participate in the preparation or issuance of, any audit report with respect to any issuer” (section 102(a)). Thus, any firm—domestic or foreign—that plays a substantial role in an audit of a public company must be registered. However, a firm can voluntarily register with the PCAOB even if it does no audits of public clients.

It is illegal for a nonregistered firm to audit or participate in the audit of a public company. Accordingly, a firm must maintain its registration and needs to consider whether other firms that it relies on for the audits of subsidiaries or other elements of the company are registered.

Registered firms must:

- Follow the PCAOB Standards in auditing, quality control, and independence.
- Pay the required registration fees.
- Undergo periodic inspections.
- Cooperate with PCAOB-initiated investigations.

The application form for registration, called *Form 1,* asks for a substantial amount of information. While Sarbanes-Oxley calls for some of this information to be publicly available, firms can request that certain proprietary or confidential information be protected from public disclosure.

The registration fee and annual fee are assessed based on the number of public clients the firm audits.

A firm may withdraw from PCAOB registration, but the PCAOB may delay the withdrawal for up to 18 months while it carries out inspection, investigation, or disciplinary proceedings.

(e) STANDARDS. Sarbanes-Oxley gave the PCAOB the authority to approve, modify, or establish its own standards for auditing, quality control, and independence. The PCAOB determined that it would establish its own standards. The PCAOB Standards are not characterized as generally accepted because their authority does not derive from general acceptance but rather from regulatory authority.

To provide initial, transitional standards for the PCAOB, it adopted the existing AICPA SASs (through SAS No. 101, *Auditing Fair Value Estimates and Disclosures*), Attest Standards, Quality Control Standards, and Rules 101 and 102 of the Code of Professional Conduct as of April 16, 2003. The PCAOB also adopted the existing Independence Standards Board pronouncements and interpretations. Since that date, the PCAOB has been editing and replacing elements of those transitional Standards and issuing its own Standards for public company audit practice.

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(i) Sarbanes-Oxley Mandated Provisions. Although the PCAOB will issue new Standards and amend or replace the interim ones, Sarbanes-Oxley explicitly calls for the PCAOB to require:

- Audit firms to prepare work papers and other information related to the audit report, in sufficient detail to support the auditor’s conclusions, and to maintain them for at least seven years.
- A concurring or second-partner review and approval of audit reports.
- An audit report that includes a description of tests and findings related to the entity’s internal control, including an evaluation of the effectiveness of internal control, an evaluation of the assessment of internal control made by management, and a description of material weaknesses in control or material noncompliance with controls the auditor discovered. This provision only applies today to the accelerated SEC filers. Nonaccelerated filers were exempted from separate auditor attestation by the Financial Reform Act of 2010. Chapter 7 in this *Handbook* on internal controls reporting provides additional detail regarding company responsibilities under the Sarbanes-Oxley Act of 2002.
- Quality control standards that deal with:
  - Monitoring of professional ethics and independence
  - Consultation on accounting and auditing questions
  - Supervision of audit work
  - Hiring, professional development, and advancement of personnel

  - Acceptance and continuation of engagements
  - Internal inspection

Sarbanes-Oxley requires auditors to report directly to the audit committee or, when there is none, the board of directors. It also requires the auditor to report on a timely basis to the audit committee all critical accounting policies and procedures used; alternative accounting treatments discussed with management, along with their ramifications and the treatment the auditor preferred; and other written communications between the firm and management, such as management letters or schedules of unadjusted differences.

The auditor of a public company, under the law, may also provide to that company nonaudit services, such as tax services, only with the advance approval of the company's audit committee. However, the law specifically prohibits auditors of public companies from also providing these services to those companies:

- Bookkeeping or other accounting services
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management or human resource functions
- Broker or dealer, investment advisor, or investment banking services
- Legal services and expert services unrelated to the audit

Sarbanes-Oxley requires that partners on an audit rotate off after performing audit services for that company for five consecutive years. It also prohibits auditors from taking certain senior financial positions with the companies they audit if they worked on the audit less than a year before the initiation of the current audit.

(ii) Standard-Setting Process. Standards are approved on a majority vote of PCAOB members. The members are assisted by the chief auditor's staff and, as necessary, ad hoc participation from outsiders.

The PCAOB is assisted by its SAG. Chaired by the chief auditor, the SAG reviews existing Standards, evaluates proposals to amend them, and recommends new ones to the PCAOB. Its contribution is advisory only, but it provides the views of a diverse spectrum of backgrounds and viewpoints.

The PCAOB's standard-setting process involves these six steps:

1. The proposed Standard is discussed by the board at an open meeting. The briefing papers that provide background and recommendations are available on the PCAOB Web site, and the meetings are Webcast and archived on the Web site.
2. The proposed Standard is issued for comment. An ED is made available on the PCAOB Web site for at least 21 days. Hard copies of the ED are generally not produced or mailed out for comment.
3. The draft, revised as appropriate following exposure, is discussed and approved for issuance by the PCAOB at a public meeting. The approved rule is made available on the PCAOB Web site.
4. The final rule is filed with the SEC for its review. The SEC has the final approval power over PCAOB Standards.
5. The SEC publishes a notice of filing for the PCAOB's rule in the *Federal Register,* and comments are received for at least 35 days.
6. The SEC decides whether to approve the PCAOB Standard. The SEC can only accept or reject the rule; it cannot make revisions. If the rule is approved, it is printed in the *Federal Register* and becomes a PCAOB Standard.

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PCAOB Standards contain three parts: a release, the standard, and the background and basis for conclusions. The PCAOB Staff has indicated that all three sections, having been approved by the PCAOB, are authoritative, and auditors are required to follow the guidance in any of these sections.

The PCAOB Staff also issues interpretive guidance in the form of Staff Questions and Answers or other Staff releases on specific topics. Although this guidance does not constitute PCAOB rules and is not approved by the PCAOB, the Staff considers it in interpreting the rules when questions arise in inspections or investigations.

(f) REQUIRED INSPECTIONS. The PCAOB is charged by Congress with conducting:

> a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with [Sarbanes-Oxley], the rules of the [PCAOB], the rules of the [SEC], or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers. (Sarbanes-Oxley Section 104(a)).

The Division of Registration and Inspection is responsible for the inspection program.

All firms that audit public companies are required to undergo PCAOB inspection. A registered firm with no public clients is not subject to inspection.

Foreign registered firms may request that the board rely on a non-U.S. inspection. In that case, PCAOB will determine the degree, if any, to which it will rely on the non-U.S. inspection. The PCAOB considers the level of the non-U.S. inspection program's independence, rigor, and inspection work program.

Sarbanes-Oxley calls for annual inspections of firms with more than 100 public clients and inspections at least every three years for firms with 100 or fewer public clients, although it allows the PCAOB to adjust this schedule. In addition, the PCAOB may also conduct special inspections at its own discretion or SEC request. Since inception, the PCAOB has not been able to meet the targeted audit schedule for firms with 100 or fewer public clients, as there are far more firms with only one or a few public clients[5] than were expected.

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(i) Inspection Scope. The PCAOB inspection is similar in concept to the peer reviews of public company auditors that had been administered by the AICPA, but there are some significant differences. The inspection is not done by another public accounting firm but by the PCAOB Staff. Whereas peer reviews were intended primarily as a way to improve the firm's practice, inspections can be more punitive: Negative results may be communicated to the SEC or state boards of accountancy and disclosed to the public. In addition, an identified deficiency might lead to a PCAOB investigation.

Inspections focus on two general aspects of a firm's practice: practice management and individual audits. The focus for smaller firms is different from that for larger ones, taking into account the structural differences resulting from smaller size.

In assessing the firm's practice management, the inspectors review policies and procedures and interview personnel. They focus on seven significant areas:

1. The tone at the top—that is, management's commitment to quality auditing practices—and whether the expectation for quality practices is communicated unambiguously to the partners and staff
2. Whether compensation and promotion within the firm are driven by technical proficiency, not just the ability to generate new business
3. How the firm monitors compliance with applicable independence rules, including those related to nonaudit services both for the firm and those in its alliances and joint ventures

[5] In 2006, it was anecdotally reported that there were nearly 1,000 such CPA firms.

4. What factors the firm considers in client acceptance and continuance, including whether the engagements accepted are within the firm's competence and how the audit work addresses identified risks
5. The effectiveness of the firm's internal inspection process, including consideration of actions the firm takes to address identified problems
6. The effectiveness of the firm's audit policies and procedures, including how policies are identified, developed, and communicated
7. How the firm coordinates the use of foreign affiliates for audits of foreign subsidiaries of U.S. clients, including how the firm satisfies itself about the foreign affiliates' knowledge of U.S. technical requirements

The inspection involves detailed review of the work papers and interviews with those who did the work, including staff at all levels and nonaudit personnel, such as tax or information technology specialists. PCAOB inspectors also selectively interview members of the engagement clients' audit committees to gain their perspectives on the audit and auditor communications.

The tone-at-the-top and compensation review aspects of inspections are beyond what practitioners experienced in the past peer review program of the AICPA. This important expansion in the inspection program addresses issues faced by some CPA firms when business considerations impinge on professionalism. While these topics are difficult to inspect, the fact that they are part of the inspection program provides a strong deterrent to adopting policies and practices that may negatively impact the profession as a whole.

(ii) Inspection Results. At the conclusion of the inspection, the PCAOB prepares a draft report, which is made available to the firm. A firm that disagrees with the findings can file a response within 30 days. The PCAOB then reviews the draft report and the firm's response, if any, and after due consideration, issues a final report. A firm that continues to disagree with the findings can appeal to the SEC to review the PCAOB report.

The final inspection report is sent to the SEC. The report is made available to the public except that criticisms or defects identified in the firm's quality control system are not made public unless they are not corrected to the PCAOB's satisfaction within a year of the inspection report. The public disclosure excludes certain confidential or proprietary information and information privileged under the rules of evidence.

The PCAOB may refer information emanating from the review, along with the firm's response to the report, to relevant state licensing authorities.

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(g) INVESTIGATIONS. The PCAOB's Office of Investigations and Enforcement can investigate possible violations of accounting and auditing standards by registered firms. Allegations of potential violations might come from PCAOB inspections, information forwarded to the PCAOB (its Web site has a facility for such reporting), or public information that comes to the PCAOB's attention.

Informal inquiries and formal investigations, along with related documents provided to PCAOB, are confidential until presented in connection with a public proceeding. Thus, until made public, they are protected from discovery by plaintiffs' counsel. The PCAOB may, however, make such documents available to the SEC, U.S. or state attorneys general, or other applicable federal or state regulatory authorities.

In conducting an investigation, the PCAOB can call for testimony, audit work papers, or other documents from a firm or other person involved in the audit. Registered firms are required to cooperate with the investigation; failure to do so can be the basis for disciplinary action.

The PCAOB has the authority to sanction any registered firm or associated individual who it determines violated Sarbanes-Oxley, PCAOB rules, securities laws relating to the preparation and issuance of audit reports, or professional standards. Sanctions may include:

- Suspension or revocation of registration
- Temporary or permanent suspension or bar of a person from further association with any registered public accounting firm.

- Temporary or permanent limitation on the activities, functions, or operations of the firm or person (e.g., prohibiting a firm from accepting new audit clients for a period of time; requiring a firm to assign a reviewer or supervisor to an associated person, to terminate one or more audit engagements, and to make functional changes in the firm or the engagement team)
- A civil money penalty for each such violation to a maximum of $100,000 for an individual and $2 million for a firm or, if the violation is intentional, reckless, or knowing or involves repeated instances of negligence, $750,000 for an individual and $15 million for a firm
- Censure
- Additional professional education or training
- Requiring the firm to engage an independent monitor, subject to PCAOB approval, to observe and report on the firm's future compliance with relevant laws or standards
- Requiring the firm to engage counsel or another consultant to design policies to comply with relevant laws or standards
- Requiring the firm or associated person to adopt or implement policies, or to undertake other actions, to improve audit quality or to comply with relevant laws or standards
- Requiring a firm to obtain an independent review and report on one or more engagements

Any sanctions imposed can be appealed to the SEC.

In an early poster-boy case, a small firm was suspended from public practice as a result of the PCAOB program. That decision was subsequently upheld when challenged.

For investigations of foreign firms, the PCAOB may rely on the investigation or sanction of the firm by a non-U.S. authority.

The PCAOB reports the name of the individual or firm sanctioned, a description of the sanction and the basis for its imposition, and other information it deems appropriate to the SEC, the appropriate state or foreign licensing authority, and the public.

Since inception, the PCAOB has withstood a challenge to the constitutionality of the Sarbanes-Oxley Act of 2002 and thus its authority. The Dodd-Frank Financial Reform Act of 2010 suspended the Sarbanes-Oxley requirement that auditors of nonaccelerated filers file a separate report on internal controls along with the required 10-K reports. (Note that this provision had never been implemented and had been the source of SEC deferrals since inception.) The 2010 Act retained the requirement that managements of all public companies report on the effectiveness of their internal controls annually. For additional information on these current requirements, see Chapter 7 in this *Handbook*.

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(h) WHITE-COLLAR CRIME PENALTY ENHANCEMENTS. The Sarbanes-Oxley Act amends the U.S. Code by increasing both the criminal penalties for mail and wire fraud from 5 years to 20 years. In addition, the Act imposes criminal penalties on chief executive officers (CEOs) and chief financial officers when they certify financial reports that do not comport with the requirements of the Sarbanes-Oxley Act. The penalties are a fine up to $1 million and imprisonment for up to 10 years for improper certifications and a fine up to $5 million and imprisonment up to 20 years for *willfully* improper certifications. For example, making misrepresentations or lying to an auditor can be a serious offense and has led to the imprisonment of a CEO.

1.10 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The largest and still most influential of the professional accounting trade organizations is the AICPA. The AICPA has approximately 330,000 members, a size that permits a large professional staff to provide member services and assist volunteers that serve on professional committees. Each member must be licensed as a CPA by some jurisdiction but need not practice as a public accountant. Less than half of the AICPA's membership is in public practice; the majority of members are in industry, government, or education. Membership in the AICPA is voluntary.

In response to assertions from congressional staff, the AICPA undertook a major restructuring in 1977 to establish a more rigorous self-regulatory system. Even though concern over alleged shortcomings was not backed up by enacted legislation, the AICPA created the Division for CPA Firms, whereas previously it had only individual memberships. Members of this division commit themselves to standards of quality and quality control, including triennial peer reviews of their quality control systems. Subsequent to the Sarbanes-Oxley Act, the AICPA created a structure of "centers" to improve member service. The former SEC Practice Section became the Center for Public Company Accounting Firms. These centers continue to evolve in terms of member composition and organization.

As a result of a major change in policy approved by AICPA membership in 1988, all members in public practice will be subject to quality control reviews, even if they do not belong to the Division for CPA Firms. However, these reviews will not be as extensive as full peer reviews, and the AICPA will not release the results to the public.

Despite efforts to raise the perceived quality of AICPA self-monitoring and peer review, the failures of Enron, WorldCom, and other entities in the late 1990s and early 2000s led to a serious erosion of AICPA authority and influence over setting standards and self-monitoring through peer reviews. The Sarbanes-Oxley Act has replaced the AICPA's system of self-regulation and peer reviews for public companies with Standards and inspections by the PCAOB. The PCAOB inspection process is an examination by independent professionals in the employ of the PCAOB, not an examination by "peers." The peer system was criticized when obvious firm deficiencies were revealed after a firm had "passed" a peer review.

The AICPA continues with its programs to nonissuers (private, not-for-profit, and government groups) of setting auditing standards through the ASB, an expanded 19-member panel with representation from the major CPA firms, and specific representation from user groups, government, and academia.

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(a) TECHNICAL AUDITING STANDARDS. The auditing standards of the AICPA are set today by the ASB. Estimates are that over 300,000 nonpublic company audit reports are issued annually. In contrast, there are fewer than 15,000 public companies, but the capitalization of the largest 20 percent of these public companies dwarfs the value of the smaller public and private entities that are audited.

The ASB uses a thorough due process, including the issuance of EDs of proposed Standards and its ASB meetings are open to the public. Beginning in the late 1990s, the ASB actively participated in the standard-setting activities of the International Auditing and Attest Standards Board (IAASB), and has initiated the process of converging U.S. and international auditing standards.

(i) Risk Assessment Standards. In 2005–2006, the ASB issued a series of new pervasive Standards designed to enhance the risk assessment process and to clarify numerous auditor responsibilities. The Risk Assessment Standards[6] were mostly a refinement of existing literature, but by defining and distinguishing more carefully between suggestions and requirements in the Standards, they sought more uniform application of the Standards in practice.[7]

A simple example of the seeking of uniform implementation is the restated need for the auditor to assess the adequacy of the design of internal controls over financial reporting in all audits as a basis for the required risk assessment. Under prior Standards, it had become a practice to assess

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[6] Technically, the Risk Assessment Standards were defined by the AICPA as SASs Nos. 104 through 111. However, SAS Nos. 102 and 103 contained important definitions of the words *must* and *should* in the new Standards and important documentation guidance regarding these Standards. In addition, SAS No. 112, later reissued as SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit,* provided important guidance regarding auditor communication of internal control deficiencies to management and governance. In a practical sense, SAS Nos. 102 through 112 were part of the same project and are often viewed in practice as part of the Risk Assessment suite of Standards.

[7] See J. Fogarty, L. Graham, and D. Schubert, "Assessing and Responding to Risks in a Financial Statement Audit" (and Part 2), *Journal of Accountancy* (July 2006, January 2007).

internal controls only when the audit strategy called for placing reliance on them. A pivotal point in the change introduced by SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* in this respect was what the definition of *should* means in the Standards: Is it a wise suggestion or a requirement? That issue was resolved in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards,* which established the term *should* as a presumptive requirement.

Another important point was the clarification in SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit,* that required communications regarding weakness and significant deficiencies in internal control should be communicated annually and in writing to management and those in the governance function. This change was mandated to reduce the risk of misunderstanding and any confusion between voluntary "management comments" with ancillary efficiency suggestions, and important, required auditor communications. SAS No. 112 also reminded auditors that it was the company's responsibility to design, document, and maintain the system of internal control, not the auditor's responsibility

Some of the other noteworthy conclusions and matters of emphasis in the risk assessment suite include:

- A reminder that the term *reasonable assurance* indicates a "high" level of assurance in the context of the Standards (e.g., 90% or greater assurance)
- A reminder that materiality, a cornerstone of audit planning, is based on user needs and should be related to a logical base (e.g., revenues, expenses, net income, etc.) respective to the user(s) of the financial statements
- A reminder that macro- and microeconomic and industry and business risks be considered (including internal control) as part of the audit and that such assessments can be considered when determining the nature and extent of other procedures to be performed
- An explicit statement that controls tests can be carried forward for two additional periods when there are no changes in the control
- A clarification that inquiry alone is not sufficient as evidence
- A reminder that sample results need to be projected to the population from which they were drawn and aggregated for purposes of determining whether adjustments to the financial statements are required to fairly present the financial statements and as a benchmark to assess the sufficiency of audit procedures and results in achieving a low-risk opinion that the financial statements are not materially misstated

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The genesis of the Risk Assessment Standards was a joint project undertaken with the IAASB to bring the core auditing Standards of the two bodies into greater alignment. Included in that suite of joint Standards was SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.* In the United States, the existing SAS No. 82 (also *Consideration of Fraud in a Financial Statement Audit*) and the proposed revisions to that document were further enhanced based on the early findings from Enron and other period frauds and audit failures and released as a separate SAS (SAS No. 99) in advance of the other Standards. The Sarbanes-Oxley Act caused the AICPA to delay the finalization of the Risk Assessment Standards in the United States pending possible PCAOB collaboration with that effort. However the PCAOB decided not to collaborate with the AICPA but to create a separate body of audit literature. A risk standards suite for audits of public companies was released in 2010 by the PCAOB.

The Sarbanes-Oxley Act charges the PCAOB with establishing or adopting auditing standards applicable to audits of SEC registrants. The Act clearly permits the PCAOB to adopt or modify auditing standards issued by the ASB. In the period subsequent to the PCAOB's formation in 2002-2003, it was not clear whether it would work with or independently of the ASB going forward. Pending resolution of that issue, the proposed suite of AICPA risk assessment standards from 2002 was placed on hold.

After formation, the chief auditor of the PCAOB, Dr. Douglas Carmichael, made it clear that the PCAOB intended to rewrite all the existing auditing standards for public companies. As a

starting point for the auditing literature going forward, the PCAOB adopted the AICPA authoritative literature as it stood in April 2003 and then began to write its own Standards, modifying that literature going forward.

Since the PCAOB has so far not adopted any of the ASB Standards subsequent to SAS No. 101, the auditing Standards literature is diverging at a rapid rate. Representatives of the ASB, PCAOB and Government Accountability Office (GAO) meet periodically to discuss issues of mutual interest. In addition, the PCAOB regularly monitors the activities of the IAASB. Many auditors of private and public companies are concerned today about the complexity and confusion of working in an environment where there are two main bodies of auditing literature.

In 2011, the PCAOB implemented its own suite of the risk assessment standards

CPAs with practices spanning public and nonpublic clients need to adapt their audit practices to cope with multiple literatures and requirements that are similar but not the same. Inspections carried out by the PCAOB only relate to public clients and the PCAOB Standards literature.

(ii) Clarity and Convergence. The joint projects between the IAASB and the ASB continued during the transitional implementation period for public company auditing. Beginning in 2004, the ASB initiated the Clarity Project, based on a proposal to the membership and a comment letter process. In 2007, it issued a Discussion Paper for public comment.[8] One purpose for this project was to provide a consistent format for all Auditing Standards going forward, clarifying the requirements in a standard from the suggestions and context guidance material that SASs often contain. Another purpose was to align U.S. GAAS with the format adopted by the IAASB for its Standards.

In order to continue to participate in deliberations with the IAASB, convergence of U.S. GAAS with the International Standards of Auditing (ISAs) was expected by the International Federation of Accountants (IFAC). There are and there may remain some differences between the Standards of the two bodies, such as U.S. requirements for performing group audits, but the Clarity Project has further narrowed any perceived differences in the two bodies of literature.

While no material differences were intended to be introduced with the recently issued Risk Assessment suite of Standards, some aspects of the literature have been modified. For example, some elements such as the illustration of the SAS No. 39 (*Audit Sampling*) and SAS No. 47 (*Audit Risk and Materiality in Conducting an Audit*) audit risk model, as modified by SAS No. 111, (*Audit Sampling*) were removed from the clarified Standard and will be resident only in related audit guides.

The format of the newly clarified Standards will be:

- Introduction and objective of the Standard
- Definitions
- Requirements
- Application material (“A” paragraphs)
- Special considerations—government and smaller entities
- Differences from IAASB Standards

Once implemented, the 10 “general standards,” long a cornerstone of U.S. auditing practice, will disappear. The individual SASs will describe the specific objectives of the respective Standards. Users of the newly formatted Standards should not confuse “A” paragraphs with appendix or material of lesser importance. Users are required to read both the requirements and “A” paragraphs when comprehending and following GAAS. Of further note, the Standards will identify differences not from past U.S. Standards but from the ISAs of the IAASB.[9]

[8] AICPA, “Improving the Clarity of ASB Standards: Discussion Paper,” March 20, 2007.

[9] See AICPA, “The AICPA’s Guide to Clarified and Converged Standards for Auditing and Quality Control” AICPA, 2011.

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(iii) Technical Assistance. In addition to these activities, the AICPA Staff also provides technical assistance to members who have encountered questions in conducting their accounting, auditing, and tax practices. Specifically, members can call or write the AICPA Staff with their questions and receive guidance on how to resolve them. In many cases, all that is needed is to steer the member to the right portion of the authoritative literature. In other cases, the members are seeking concurrence with a position they have reached on their own. Both services are especially valuable to sole practitioners because they do not have the resources to provide a double check on their research and conclusions.

(b) SERVICES OFFERED BY CERTIFIED PUBLIC ACCOUNTANTS. The term *independent accountant* is used interchangeably with "independent auditor" and "independent public accountant." Generally, the term is limited to either CPAs or public accountants licensed to perform audits and express opinions on financial statements under applicable state accountancy laws.

Only licensed CPAs who are independent of the client can issue audit opinions on public companies (SEC registrants). That is the one unique privilege held by CPAs. In other areas such as tax, consulting, and valuation, the service space is shared with other professionals.

Because they are knowledgeable about accounting principles and accounting systems, tax matters, and the like, independent accountants provide a wide range of services in addition to audits. These include accounting and review services, tax services, consulting services, personal financial planning, and others. Recently the range of their services has become contentious because of potential conflicts of interests with auditing and other professional services.

(i) Auditing. An audit involves the application of a variety of procedures and techniques to obtain evidential matter sufficient for the independent accountant to express an informed opinion about whether the financial statements conform to GAAP. When serving as an auditor, the independent accountant is guided by the AICPA's Code of Professional Conduct and a variety of Standards promulgated by professional bodies established for that purpose.

Rule of Conduct 202 of the AICPA's Code of Professional Conduct provides: "A member who performs auditing, review, compilation, management consulting, tax or other professional services shall comply with standards promulgated by bodies designated by [the AICPA]."

SASs are pronouncements issued by the ASB of the AICPA to guide auditing practice. As Rule 202 indicates, SASs are enforceable under the Code; but perhaps of equal importance, courts generally view adherence to SASs as the standard for assessing an auditor's liability.

For audits of nonpublic companies, the SASs specify required auditing procedures, provide guidance on important areas of judgment often encountered in audits, and establish the form and content of the auditor's report. They are issued individually in a numbered series and are codified periodically. Today, electronic versions of the Standards often provide the most convenient form for use in practice. The Standards are published annually in hard copy.

The Auditor's Standard Report on Comparative Financial Statements Independent Auditor's Report

> We have audited the accompanying balance sheets of ABC Company as of December 31, 2012, and 2011, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of ABC Company as of [at] December 31, 2012, and 2011, and the results of

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its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signed]

[Date]

A number of points in the auditor's report deserve special attention.

- First and perhaps foremost is the requirement that auditors be independent of the client on which an opinion is rendered. The AICPA has extensive literature defining personal and familial relationships that can impair independence. The SEC has also developed an extensive literature that applies to public companies. An auditor's need to be independent limits his or her involvement in accounting for transactions, preparing financial statements, and performing certain services such as the design and implementation of accounting information systems. Regulatory agencies, such as the Department of Labor, may impose additional constraints on the auditor beyond the AICPA literature when auditing entities under their jurisdiction.
- The term *reasonable assurance* has been clarified to mean a high level of assurance in both the AICPA and PCAOB literature. The term *reasonable* is used in the context of delivering a professional service.
- Misstatements can occur because of inadvertent error or fraud. SASs Nos. 82 and 99 clarified that the auditor plans the audit to detect material misstatement whether due to error or fraud.
- The profession continues to struggle to convince the public that the financial statements are the responsibility of management, despite an explicit statement of that today in the auditor's opinion. Previously, the heavy involvement of the auditor in creating the financial statements when companies were incapable of doing so lent some legitimacy to this general misunderstanding. Today such a situation would be noted as a material weakness in internal controls. Auditors are cautious not to cross the line regarding auditing their own work.
- "Presenting fairly, in all material respects" does not mean the financial statements are accurate to the penny. Such precision would rarely be achievable. The concept of materiality is used to set the scope of the audit procedures to detect material misstatement whether they are individual or aggregate misstatements.
- The opinion also extends to the footnote disclosures in the financial statements.

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Modifications to and Departures from the Standard Report. The auditor's Standard Report is called a "clean opinion" since it does not raise any specific issues regarding the fairness of the presented financial statements. Users have to be alert if the auditor includes an "emphasis" paragraph into the opinion that directs readers to some matter, often already disclosed in the financial statements, such as a contingent liability arising from related party transactions, litigation, or regulation that may be important to the user. This matter of emphasis does not change the meaning of the opinion to users.

When management is faced with liquidity or regulatory challenges such that the entity's continuance as a going concern is threatened, the auditor may insert a specific paragraph into the report noting this. In general, if management has a plausible plan for addressing the issue, such a warning might not be issued. While neither management nor the auditor can use a crystal ball to predict future events, the timeline in the Standards for making judgments regarding the need for such disclosures is within one year. In such situations, users should be particularly alert to the reasons that might be disclosed in the auditor's report as well as relationships and disclosures in the financial statement that are relevant to the issue of going concern. Forced liquidations in bankruptcy can depress the marketability and market prices of assets, resulting in more exposure to shareholders than that indicated by the financial statement amounts, many of which may be stated on a basis that the entity is a going concern. Management resistance to such disclosures on the basis that they might create a self-fulfilling prophecy unfortunately results in fewer of these disclosures than might serve users better. This is all the more reason for users to pay special attention to these disclosures when they do occur.

Occasionally, an auditor judges an item in the financials as not accounted for according to GAAP, so he or she may issue an "except for" opinion ("In our opinion except for the [e.g., insert departure from GAAP] . . . "). Nevertheless, the issue may not distort the overall fairness of the financial statements, and thus the auditor can still provide assurance on the overall financial statements. Since such situations often create an environment where the auditor and management reach a common conclusion that avoids the disclosure, users need to be especially mindful of these types of disclosures. Careful reading of the footnotes may also reveal areas where management and the auditor might not agree. Litigation experience has shown that the unintelligible footnote is often an indicator of an important issue.

While less common, adverse or disclaimer opinions can be issued. When an entity is required to be audited by creditor or contractual provisions, the auditor may have to say something, even if a clean opinion cannot be obtained. In an *adverse* opinion, the auditor states that the accompanying statements "do not present fairly . . . " and goes on to identify the reasons. Thus, sufficient evidence is obtained to make such a statement. Occasionally, a *disclaimer* opinion is necessary when the auditor cannot obtain sufficient information on which to base an opinion. Significant uncertainties caused by weather (e.g., earthquakes or floods) or political unrest or war may preclude gathering sufficient evidence on which to base an opinion on the overall financial statements.

(ii) Accounting Services. Accounting services include all forms of involvement with financial statements or financial information other than an audit, such as bookkeeping, compilation of financial statements from a trial balance, and review of financial statements. The accountant's responsibilities for the unaudited financial statements of a nonpublic company are set forth in the Statements on Standards for Accounting and Review Services (SSARS) services, a numbered series of pronouncements issued by the Accounting and Review Services Committee of the AICPA.

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The accountant should not submit unaudited financial statements of a nonpublic entity to the client or others unless, as a minimum, he or she complies with the provisions of the Statement applicable to a compilation engagement. Thus, the only types of report an accountant may issue in connection with the unaudited financial statements of a nonpublic company are for the accounting services of a compilation or review.

In general, the public needs to be informed of the differences between these services and an audit and the specific assurance the report is providing.

(iii) Tax Services. The accountant may be called on to deal with a variety of tax problems, including those involving federal and state income taxes, estate and inheritance taxes, sales and use taxes, payroll taxes, and property taxes. The field of *income taxes* is especially important. The services rendered by the accountant in this area include determination of taxable income, preparation of tax returns and claims for refunds, representation of clients before taxing authorities, and cooperation with lawyers in the settlement of tax suits by litigation. The AICPA publishes Statements on Standards for Tax Services (SSTSs) that are enforceable tax practice standards for members of the AICPA. These Standards apply to all members regardless of the jurisdictions in which they practice and the types of taxes with respect to which they are providing services.

(iv) Consulting and Other Services. The AICPA's Management Consulting Services Executive Committee issues pronouncements related to the conduct of a variety of consulting services. Statement on Standards for Consulting Services, *Consulting Services: Definitions and Standards,* describes the consulting process as "activities relating to the determination of client objectives, fact-finding, definition of the problems or opportunities, evaluation of alternatives, formulation of proposed action, communication of results, implementation, and follow-up." The process includes:

- Counseling management in its analysis, planning, organizing, operating, and controlling functions
- Conducting special studies, preparing recommendations, proposing plans and programs, and providing advice and technical assistance in their implementation

- Reviewing and suggesting improvement of policies, procedures, systems, methods, and organizational relationships
- Introducing new ideas, concepts, and methods to management

The independent public accountant may be called on to make special investigations or to report in connection with the special requirements of a government agency. Those services may require aspects of tax, consulting, and accounting and auditing skills. Newer services that are supported by the AICPA via credentials and guidance include elder care services and personal financial planning.

Special services often involve those other than an audit of one or more financial statements. These services also include application of agreed-on procedures to specified elements, accounts, or items of a financial statement or to nonfinancial information or preparing a valuation report.

Valuation services performed by CPAs are guided by Statements of Standards of Valuation Services (SSVSs) authored by the AICPA Consulting Services Executive Committee. SSVS No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (2007), and provides guidance in performing procedures and reporting on valuation services.

Objectivity is required in all professional services; the valuation analyst must comply with AICPA Code of Professional Conduct Rule 102, *Integrity and Objectivity,* and be impartial, intellectually honest, disinterested, and free from conflicts of interest.

(c) CPA EXAMINATIONS. The AICPA produces, administers, and grades the Uniform CPA Examination under contract to individual state boards of accountancy. This service includes writing the exam to specifications established through the National Association of State Boards of Accountancy (NASBA), maintaining security over the questions, delivering the exams to the sites, and reading and grading the exam. The AICPA then sends the results to the state board, which, in turn, notifies the candidates.

Today the CPA Examination is administered as a 14-hour computerized exam. It is offered periodically throughout the year, rather than only in May and November as was the case previously. The exam covers auditing and attestation, financial accounting and reporting, regulation, and business environment and concepts.

The AICPA does not license CPAs to practice; states do. States also determine the number of CPAs that will be licensed in that state and determine the number and composition of hours of education required before candidates can be licensed in their state. Some years ago, a move was started to require 150 hours of college education before a candidate could become a CPA. This extra year of college was a hardship for many, and a number of states do not have the 150-hour requirement. States also determine the required hours and composition of hours of continuing professional education (CPE) that qualify a CPA to maintain a current license. For example, states may set a specific minimum number of hours of tax, ethics, or accounting and auditing within the licensing period. States may also terminate a CPA's license to practice in that state. The AICPA may censure or expel a member from the association but cannot remove a CPA's license.

A majority of states have adopted official cross-state recognition of licensing to facilitate commerce in their states. Certain "retirement" states have long been reluctant to recognize out-of-state licenses to avoid a glut of part-time practitioners within the state depressing the local demand for professional services. Overall, the states' licensing system has worked well but is cumbersome when a CPA practice spans various states.

1.11 STATE BOARDS AND OTHER ORGANIZATIONS

(a) ROLE OF THE STATE BOARDS OF ACCOUNTANCY. The other main category of governmental agencies affecting the practice of financial accounting comprises the 54 state boards of accountancy in the United States. (One board exists in each of the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, and Guam.) They have three primary regulatory missions: granting the initial license to practice public accounting, ensuring the maintenance of competency through

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continuing education, and disciplining licensees who fail to maintain their competency or who act in an unethical manner. States can also designate an authority to be followed for auditing (e.g., AICPA, PCAOB) or promulgate their own requirements. For example, New York and California adopted audit documentation regulations in advance of the new requirements in SAS No. 103, *Audit Documentation.*

Because of the variety of forms (and names) for the boards, it is difficult to draw generalities. Some boards are separate freestanding agencies, whereas others are part of larger state regulatory bodies that license other professions and service providers. Funding for boards comes from general budget appropriations, dedicated credits from licensing fees, or some combination. Some boards are permanent, and others are subject to periodic sunset reviews designed to avoid overregulation.

An accountancy board's first responsibility is to award the license to practice, which may do no more than allow the licensees to identify themselves as CPAs. In many states, the license is a legal requirement for performing the attest function (audit or review) for financial statements. The Internal Revenue Service accepts the CPA's license as sufficient qualification to practice before it by representing clients in the audit and appeals procedures. The SEC requires a CPA to sign the audit opinion on public company financial statements.

All states require candidates to successfully complete the Uniform CPA Examination prepared, administered, and graded by the AICPA. In a few states, it is possible to pass the CPA exam and be certified without being licensed. The license is granted in some states only after the candidate has completed an experience requirement. Other states do not differentiate between certification and licensing. Most states have an experience requirement (e.g., two years or one year with a master's degree), but some do not. Over 40 states have passed laws that do or will require the completion of an additional year's course work beyond the bachelor's degree before certification (the 150-hour requirement). The additional credits do not have to result in an additional degree, but most programs are set up to issue some sort of degree.

Most state boards require their licensees to participate in formal CPE. Typically, CPAs need 40 hours of class time (or its equivalent) per year to continue practicing. Some boards regulate CPE by specifying minimum hours in certain topics or by recognizing only courses offered by authorized providers, whereas others require only a report of hours completed.

Most states now require peer reviews on a periodic basis for firms and practitioners performing assurance services. These requirements differ by state, and the Web site of the licensing authority of each state is the best source of information regarding the program. California, despite its size and proportion of economic activity, recently has enacted a mandatory peer review program.

A majority of state boards promulgate ethical standards of conduct through regulations interpreting the authorizing statutes; others have incorporated the AICPA ethics rules directly into their statutes. By and large, the ethics codes of state boards are the same as the AICPA's Code of Conduct, although local political factors often create differences. Because most states do not grant their boards sufficient funds to support a full-time staff for investigating allegations of unethical behavior, they must compete with other agencies for investigators' time and effort. In extreme cases, a finding of a violation will lead to revoking the individual's CPA license; however, boards do not mete out this punishment very often. Rather, they impose some rehabilitative discipline, such as a temporary suspension or the completion of additional CPE. In virtually all states, individuals automatically lose their licenses if they are convicted of a felony.

State boards typically are composed of unpaid volunteer practitioners who serve for three to five years. Often at least one of the board members is not an accountant but represents the general public. This arrangement lends more credibility to the board, which may suffer from a fox-in-the-henhouse image caused by having only accountants regulate accountants. A difficulty in using volunteers is that the boards tend to get only part-time effort. Larger states achieve more continuity and sustained effort by having a full-time executive director and staff.

Substantial ethics enforcement activity occurs at the state level and is controlled through a cooperative agreement with the AICPA, referred to as JEEP (Joint Ethics Enforcement Program). Recent years have seen state organizations playing a more active part in representing the profession's interests in state legislatures. Through the JEEP, the Ethics Division of the AICPA Staff works with

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state societies and members of AICPA ethics subcommittees to conduct investigations of alleged violations or to concur with findings conducted at the state level. These investigations attempt to establish only prima facie evidence that a section of the Code of Conduct was violated without trying to determine whether the member intended to violate it. JEEP leverages the expertise of the AICPA Staff to improve the overall quality and efficiency of the work that would otherwise have to be separately performed at the state level. This quality control helps ensure that the investigations protect the rights of the respondents while appropriate evidence is gathered. Information about possible violations comes from other CPAs, clients, enforcement agencies, and public information, such as the *Wall Street Journal,* the *Public Accounting Report,* and SEC Accounting and Auditing Enforcement Releases. Despite the large investment in ethics enforcement, the most extreme disciplinary action that the AICPA can take is to revoke membership, in which case the CPA is no longer subject to the AICPA's authority. However, the public embarrassment and negative press may be substantial. States can and do revoke licenses to practice.

Although the dispersion of certification authority across all states creates inefficiencies and inconsistencies, this arrangement is compatible with the policy of protecting states' rights against federal domination. Some professionals believe that this arrangement has outlived its usefulness, particularly for disciplining unethical accountants. Until such time as a federal agency is given a national licensing authority, however, financial accountants wanting to practice as auditors will need to be certified by one or more state boards.

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(b) ROLE OF PROFESSIONAL SOCIETIES. Although similar to the AICPA, state societies of CPAs are separately funded and operated entities. They are also a curious blend of regulatory authority and service providers. Individuals who want to influence the profession in their state consider membership to be essential. All states also have their own professional organizations, which are called societies, associations, or institutes, according to local preference. In many cases, they duplicate and complement the activities of the AICPA by offering CPE, publishing newsletters and journals, and providing opportunities for service and leadership through committee membership.

In order to gain by shared effort and to provide services efficiently, state boards have formed their own trade organization, the NASBA. This group (which includes all 54 U.S. licensing authorities) provides a forum for developing unified positions on issues that can be used in individual states more effectively. For example, the NASBA directors agreed in 1989 to change the specifications for the Uniform CPA Examination. They also have developed a model code of ethics and a model accountancy law to apply in each state. These documents could be (and were) used to persuade state lawmakers to bring their statutes and regulations up to a national norm. NASBA also assists state boards faced by legislative threats of closure under sunset reviews. NASBA has taken on a broader role in certifying CPE, which is important when CPAs take education courses in different jurisdictions or where states have not developed their own detailed standards for CPE.

Other national societies exist, including several that are fairly large. Two of these are the IMA and the FEI, both of which generally consist of individuals who are not in public practice. Indeed, they can be characterized as organizations representing the interests of statement preparers. The IMA was originally called the National Association of Cost Accountants and still draws most of its membership from management accountants. Nonetheless, it has played a leadership role in financial accounting standard setting through its position as one of the sponsoring organizations of the FASB. The primary units of the IMA are its local chapters, which operate autonomously in order to best meet the interests of their own members. The association also has developed a set of Standards of Ethical Conduct for Management Accountants, which requires the accountant to tell the truth to all who receive financial reports, including management and external users. The IMA administers the CMA (Certified Management Accountant) examination and awards the CMA certificate to persons meeting all the requirements. (See *www.imanet.org*.)

The FEI is smaller than the IMA because it draws its membership from those accountants who have substantial responsibilities in the financial area of their companies (e.g., chief financial officers, controllers), including reporting. In addition, the FEI limits the number of members from any given company. However, because FEI members occupy higher-level positions in large entities,

the FEI often has more influence, particularly in dealing with the FASB as another of the sponsoring organizations.

Another national organization is the AAA, which was originally created as a professional society for accounting educators. Through the middle of the twentieth century, the membership was more eclectic and included not only instructors but many practitioners. However, during the 1970s and 1980s, the AAA lost a large number of its members who were practicing accountants and became more and more oriented toward academic issues and services. Apart from the influence of individual members and the AAA's participation as a "sponsoring organization" of the FASB (and COSO), it does not affect financial accounting practice to any great degree. Some issues that relate to market reactions to accounting treatments may be of interest to standard setters when forming opinions on accounting treatments. Additionally, the AAA through its committee structure may issue comment letters on pending matters in accounting and auditing.

As the major organization of accounting educators, the AAA hopes to influence the long-term theoretical development of financial and other kinds of accounting. To this end, its greatest emphasis has been on promoting and disseminating research in accounting and finance. The AAA publishes three main journals, *The Accounting Review, Accounting Horizons,* and *Issues in Accounting Education. The Accounting Review* tends to include the most rigorous research articles published by the AAA. *Accounting Horizons* tends to publish more applied research articles. There are various sections with specialized focus in research and education, such as the Auditing Section, Information Systems Section and the Taxation Section. The AAA is a sponsoring organization of the FASB, and one FASB member seat has always been occupied by an academic accountant. Additionally, the ASB generally has at least one academic member. The SEC has a fellowship program where one or two academic fellows may serve for a year to assist the SEC and help academics who may not be steeped in recent public practice experience to understand the workings of the SEC and its mission. However, the AAA does not have substantial influence on accounting standards.

1.12 GOVERNMENT ACCOUNTABILITY OFFICE

Two chapters in this work are devoted to accounting in the state and local environment (Chapter 33, Pon, et.al.) and in the federal government environments (see Chapter 32 in this *Handbook*). These chapters provide additional insight into the GAO and other audit agencies that are relevant to audits of these entities. This chapter provides a general description of the role of the GAO.

After World War I, the Budget and Accounting Act of 1921 transferred auditing responsibilities and accounting functions from the Treasury Department to a new agency, the General Accounting Office. Independent of the executive branch, the GAO was given broad responsibilities to investigate the efficiency and effectiveness of federal spending. The agency is considered a part of the legislative branch and is an audit and investigative arm of the U.S. Congress. It has been characterized as a congressional watchdog because of its mission to evaluate the effectiveness of financial reporting in the public sector as well as evaluate and measure performance audits that evaluate the effectiveness of various government programs. On July 7, 2004, the agency took the new name of the Government Accountability Office as a result of the GAO Human Capital Reform Act of 2004, Public Law 108–271, 118 Stat. 811 (2004). David Walker, then comptroller general, noted that the name change better reflected the role of the agency.

The agency is headed by the comptroller general of the United States, a nonpartisan and professional position, who is appointed by the president for a single 15-year term. This helps insulate the agency from temporal political pressures. The GAO states in its mission statement on its Web site: "We provide Congress with timely information that is objective, fact-based, nonpartisan, non-ideological, fair, and balanced." As of December 22, 2010, the comptroller general is Gene L. Dodaro, an internal appointment from within the GAO. The GAO's updated Strategic Plan (e.g., 2010–2015) for serving the Congress is made publicly available by the Web site posting (e.g., *www.gao.gov/new.items/d10559sp.pdf*).

Annually, the GAO issues an audit report on the U.S. government. The 2010 Financial Report of the United States Government, like prior reports, resulted in a disclaimer of opinion because of

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various limitations, including significant uncertainties and a lack of a cost basis for many assets included in the asset base.

The GAO operates in what might be classified as three major areas:

1. Financial statement audits
2. Compliance audits
3. Operational audits

(a) FINANCIAL STATEMENT AUDITS. The GAO establishes Standards for audits of government organizations, programs and activities, and federal assistance received by various organizations. Generally accepted government auditing standards (GAGAS) are to be followed by auditors when auditing relevant entities. Generally, these Standards track with the SASs issued by the AICPA for nonpublic audits with some extensions of requirements, often due to the dual compliance objectives of the audits. The extensions beyond GAAS are more noticeable in the documentation and reporting areas, but SAS No. 103 considerably narrowed the differences in documentation.[10] The GAGAS Standards are often referred to as the "Yellow Book" due to the color of the cover of the published Standards. These Standards extend GAAS by adding additional guidance, such as requiring:

- That the reader be informed of the relevant accounting standards used and GAGAS is the relevant audit standard used
- Follow-up on prior audit findings and issues
- Reporting on noncompliance that was encountered
- That material weaknesses and reportable conditions be communicated to relevant users (e.g., granting agencies) outside of management and governance.

The GAO Yellow Book is a public document and can be obtained on the Web at (*www.gao.gov/yellowbook*). Additional information regarding the GAO and its Standards are also available at this and the general GAO Web site (*www.gao.gov*).

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(b) COMPLIANCE AUDITS. AICPA Standards guide CPAs in the performance of audits that have a compliance component as well as a financial statement audit component or when engaged to report on compliance. AU 801, *Compliance Audits,* was recently clarified by SAS No. 117 (also *Compliance Audits*) to be more explicit about which provisions in GAAS also applied when an auditor is engaged to perform a compliance audit. This clarification was prompted by a 2007 GAO review of a sample of Office of Management and Budget (OMB) A-133Single Audit Act compliance audits where confusion was noted regarding the applicability of some general GAAS Standards in the performance of compliance audits by CPAs.

When the audit falls under the Single Audit Act of 1984 (amended in 1996), additional guidance on auditing federal programs is set forth in an annual release from the OMB.[11] A Single Audit engagement includes three elements:

1. A financial statement audit under GAGAS for fair presentation
2. A report on the Schedule of Federal Awards
3. Reporting on compliance with relevant laws and regulations and grant terms

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[10] See R. Whittington, L. Graham, G. Fischbach, and J. Ahern, "Advancing the Audit Documentation Standard," *Journal of Accountancy* (June 2006).

[11] Broadly, the provisions apply when an entity receives $500,000 or more in federal funding. Monies expended under the American Recovery and Reinvestment Act of 2009 are also included. Depending on the risks associated with the program, between 25 and 50 percent of the aggregate award amounts should be included in the tested populations. Thus, some awards may not be subject to auditor testing.

This annual OMB A-133 circular, "Audits of States, Local Governments, and Non-Profit Organizations," adds further to the Yellow Book standards. The purpose of the Single Audit Act was to reduce the number of audits of entities by government and auditor organizations for various purposes, therefore achieving more synergism and efficiency in the process.

In practice, financial and compliance audits have different objectives. The financial audit, like the GAAS audit, seeks high assurance that the financial statements are free of material misstatement. The auditor strategy for achieving that objective is a matter of judgment. A controls-based or substantive-based audit can be designed, subject to the minimum requirements that govern controls assessment and the performance of some substantive tests. The compliance audit seeks assurance that the entity has complied with the various laws and regulations surrounding the expenditure of federal funds. Consequently, regulations may require certain tests and extents of testing of controls over compliance as well as setting certain minimum sample sizes for the performance of substantive compliance tests. While clearly there is a relationship between compliance and fair financial reporting, these are separate concepts, and various criteria, such as materiality, may be defined differently for the various audit reports. Often the auditor performs separate tests to meet many of these separate objectives. For example, if a compliance criteria is the use of prevailing wage rates as specified by the Department of Labor (e.g., Davis-Bacon Act) when expending federal funds for payroll, that is a different objective from the financial statement objective verifying that the wages paid were complete, accurate, and properly recorded in the correct period. The multiplicity of Standards and agency regulations applicable to government entities greatly increases the education and expertise demands on today's CPAs who perform these services.

As an example of the specificity of compliance requirements, the 14 controls identified by the Single Audit Act that require auditor assessment and testing are listed next.

1. Allowed activities
2. Allowable costs
3. Cash management
4. Davis-Bacon Act
5. Eligibility
6. Equipment and real property management
7. Matching or required level of effort of the grantee (where required by the terms of the grant)
8. Period expended
9. Procurement
10. Program income
11. Real property acquisition
12. Reporting
13. Subrecipient monitoring (when relevant)
14. Special tests and provisions

Under some circumstances the attestation (AT series), and not the auditing, standards might be applicable to engagements that are undertaken to examine certain compliance issues such as reporting on the effectiveness of internal controls. This might occur more often when management is required to assert, with auditor review, to certain aspects of regulatory compliance required by regulations that do not relate specifically to the financial statements of the entity as a whole.

Generally, a compliance audit expands the reporting requirements to include the grantor or the report user. Issues of significant deficiencies in internal control, fraud, or abuse might not be reported publicly as a result of the financial statement audit reporting requirements, but they may generate required communications with users or grantors in a compliance audit. Specific reporting requirements might be created for compliance audits. For example, an actual (not extrapolated from a sample) error of $10,000 or more in compliance triggers a finding that needs to be reported in the Schedule of Findings and Questioned Costs. However, the extrapolated amount of a finding might give rise to a contingency of significance for financial audit purposes.

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Special audit and disclosure requirements were set up in 2009 for American Recovery Act funds. Because of the sheer size and potential sensitivity of these funds, a public Web site has been set up to disclose and report on the quarterly expenditures and results. All American Recovery Act awards are designated by OMB as "high inherent risk," triggering higher levels of auditor testing than otherwise (see *www.recovery.gov*).

(c) OPERATIONAL AUDITS. The watchdog function of the GAO is evident in the performance of various program effectiveness (performance) audits. These reports have uncovered significant instances of waste and inefficiency in government. Issuing nearly 1.000 reports annually on various programs and on issues raised by the Congress for investigation, the agency has a multitude of specialists from various fields to assist in the evaluation of program performance, which often goes well beyond the analysis of financial data. For example, the analysis may be as diverse as looking at an advanced weapons system to reported fraud in a food stamp program.

The reports issued are often termed "blue books" based on the color of the covers used over the years. The GAO prides itself in verifying and reviewing all the numerical and information presented as factual contained in these reports so that Congress and the public can place reliance on what is reported therein.

Generally all of the GAO reports are available at the GAO Web site unless they might compromise national security interests.

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1.13 ROLE OF INTERNATIONAL FINANCIAL ACCOUNTING AND AUDITING INSTITUTIONS

The increasing globalization of commerce is contributing to the trends in accounting and auditing to converge Standards. It is hard to ignore the obvious desire to converge and conform accounting and auditing Standards across borders. Whether this will result in better practice in all countries or just some countries is a subject of continuing debate.

1.14 INTERNATIONAL ACCOUNTING STANDARDS BOARD

The IASB promulgates the current international accounting standards. The current hierarchy of IASB literature is:

- International Financial Reporting Standards (IASs issued by IASB)
- International Accounting Standards (issued by the predecessor International Accounting Standards Committee)
- Interpretations from the International Financial Reporting Interpretations Committee (IFRIC) or the Standing Interpretations Committee (SIC)

The IASC issued 40 ISAs prior to the formation of the IASB in 2001. Many of these ISAs have been replaced or modified by subsequent International Financial Reporting Standards (IFRSs). Relatively few Interpretations have been issued to date, in keeping with the desire to establish principles-based Standards in lieu of detailed rules. Nevertheless, some issues can develop quickly and the flexibility of the international interpretive bodies to address these issues serves a similar role as the EITF in the United States.

Still relevant in IASB standard setting is the *Framework for the Preparation of Financial Statements,* a document developed by the predecessor IASC. Like the Conceptual Framework in the United States, the IASC Framework document is not authoritative but guides the application of accounting thought to assist in solving existing and emerging issues in a consistent manner (see *www.iasplus.com/standard/framewk.htm*). The FASB and IASB seek to produce a joint Framework going forward.

While a timetable for adoption of the IASB Standards in the United States was set forth by the SEC in 2008, there is a current reconsideration of that commitment and schedule. Additional insight to the development and contemporary issues regarding IASs is provided in Chapter 3 in this *Handbook* by Tom Jones.

(a) HISTORY OF THE IASB. The IASB began in 1966 with the formation of the AISG. The members of the AISG were representatives of the accounting profession from Canada, the United Kingdom, and the United States. The AISG was formed to perform comparative studies of the major accounting issues among the three originating countries.

In 1973, the AISG formed a committee consisting of representatives from professional accounting organizations from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States. In June 1973, those nine professional organizations founded the IASC. The founding countries constituted the initial board of the IASC.

In 1977, with the formation of the IFAC, the international professional activities of the IASC were organized under IFAC, which later agreed that the IASC would have complete autonomy in setting IASs and in the issuance of discussion documents on international accounting issues.

The work of the IASC was developed and published by its board after due process procedures involving consultation on a worldwide basis. The due process procedures, which involved the issuance of EDs of proposed Standards, provided financial information users, preparers, and auditors with the opportunity to express their views. In setting its technical agenda and in developing IASs, the IASC board consulted with various advisory bodies, including an International Consultative Group, member bodies, and other standard-setting organizations.

In 1997, the IASC board formed the Strategy Working Party (SWP) to consider the structure of the IASC after it completed a "Core Standards" development process.[12] SWP issued its discussion paper, *Shaping IASC for the Future,* enumerating the working party's recommendations on the necessary structural changes to the IASC in meeting its long-term objectives. The SWP's recommendations, although extensive, retained many elements of the existing IASC structure.

In its final report, the SWP noted:

> The comment letters and consultations with interested parties also reflected various views on the attributes that are considered desirable to establish the legitimacy of a standard setting organization. The primary attributes identified were the representativeness of the decision making body, the independence of its members, and technical expertise. As applied to the IASC structure, the legitimacy of IASC's Standards is considered by some to be established through direct participation of key constituents in the decision making process. The other view is that legitimacy is established if the development of Standards is undertaken by an autonomous body of relatively few, full-time and highly skilled experts who are independent of perceived economic incentives which might interfere with their role on the decision making body.[13]

Based on the SWP's final recommendations, the IASC was renamed the IASB and restructured around the basic objectives of the development of a high-quality set of global accounting standards, formation of an independent standard-setting board, and broad geographic representation among its members.

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[12] In 1995, the IASC board entered into an agreement with IOSCO to complete a core set of international accounting Standards by 1999. Upon successful completion of the agreed-on core set of Standards, IOSCO agreed to review them and consider endorsement of IASs for cross-border securities offerings among its member countries. In 1998, IOSCO reviewed those Standards and, in 2000, recommended 30 for cross-border offerings and listings.

[13] Strategic Working Party of the International Accounting Standards Committee, *Recommendations on Shaping the IASC for the Future: A Report of the International Accounting Standards Committee* (London: International Accounting Standards Committee, 1999, p. 6).

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(b) STRUCTURE OF THE INTERNATIONAL ACCOUNTING STANDARDS BOARD. The IASB is the standard-setting body of the larger IASC Foundation (the Foundation). The Foundation's objectives are to:

- Develop a single set of high-quality, understandable, and enforceable global accounting Standards, transparent, and comparable information in financial statements and other financial reporting to enable users to make economic decisions.
- Promote the use and rigorous application of those Standards.
- Consider the special needs of small and medium-size entities and emerging economies.
- Bring about convergence of national and IASs to high-quality solutions.

The operating structure of the Foundation consists of the trustees, the IASB (also called the board), the Standards Advisory Council (SAC), and the IFRIC (IFR Interpretations Committee).

(c) INTERNATIONAL ACCOUNTING STANDARDS BOARD TRUSTEES. The trustees are appointed for a three-year, renewable term. The trustees consist of 22 individuals appointed by the current trustees.

Further, to ensure broad global representation, the convened group must consist of six representatives each appointed from North America, from Europe, and from the Asia/Pacific region. The remaining four representatives can be from any region, so long as overall geographic balance is maintained.

The composition of the trustees should provide a balance of professional backgrounds, including auditors, preparers, users, academics, and other officials serving the public interest. Two trustees normally are senior partners of prominent international accounting firms.

Trustees must meet at least twice each year. They have these responsibilities:

- Handle fundraising activities for the IASB.
- Appoint the members of the IASB, including those with liaison responsibilities with national standard-setting organizations, monitor its effectiveness, and annually review the IASB's strategy.
- Appoint the members of the SAC and the IFRIC.
- Approve the annual budget.
- Promote the IASB and the objective of rigorous application of its Standards.
- Establish and amend the operating procedures for the IASB, the Standard Interpretations Committee, and the Standards Advisory Committee.

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(d) INTERNATIONAL ACCOUNTING STANDARDS BOARD. The trustees' group has broad geographic representation. In contrast, representation on the IASB is based on the individual's technical accounting proficiency and practical experience. The criteria for selection include:

- Demonstrated technical competency and knowledge of financial accounting and reporting
- The ability to analyze accounting issues and to consider the implications of the analysis for the decision process
- Effective oral and written communication skills
- Capability to consider varied viewpoints and impartial and well-reasoned decision making
- Understanding of the global financial, business, and economic environment in which the IASB operates
- Ability to work in a collegial environment
- Integrity, objectivity, and discipline
- Commitment to the Foundation's mission and to serving the public interest

IASB board members are appointed by the trustees. The board consists of 14 members, 12 full time and 2 part time.

The IASB has full responsibility for all technical accounting matters, including the preparation and issuance of the IASs and the associated EDs of financial reporting Standards. Other IASB responsibilities include:

- Publish EDs on all projects and regularly publish draft statements of principles or other discussion documents for public comment on major projects.
- Retain full discretion over the technical agenda of the IASB and over the assignment of technical projects, in organizing the conduct of the technical work, including the outsourcing of technical accounting research or other work to national standard setters or other organizations.
- Establish procedures for reviewing comments received from the IASB constituency on documents issued for public comment.
- Form steering committees or other types of specialist advisory groups to provide advice on major projects.
- Consult the SAC on major projects, agenda decisions, and work priorities.

Each IASB member has one vote on any issue presented for vote by the board. Nine of the 14 members must approve a financial reporting Standard, ED, final Standard, or Interpretation for publication and issuance. Other IASB decisions, including publication of a discussion paper, require a simple majority of the IASB members present at a meeting attended by at least 60 percent of the board.

Except for certain administrative matters, the IASB opens its meeting to the public. When deemed necessary, the IASB may use a public hearing meeting format to discuss specified agenda topics or approve the use of field tests to ensure that proposed accounting approaches are practical and workable.

Except in limited circumstances, IASB EDs of proposed financial reporting Standards, discussion documents, and other similar public documents receive a comment period of 90 days. Under exceptional circumstances, the IASB may issue an ED for 60 days.

(e) STANDARDS ADVISORY COUNCIL. The SAC, which consists of at least 30 members with diverse geographic and professional backgrounds, provides a forum for organizations and individuals with an interest in international financial reporting to participate in the standard-setting process. Members of the SAC are appointed for renewable three-year terms.

As constituted, the SAC's objectives are:

- Advising the IASB on agenda decisions and board priorities
- Informing the IASB of the diverse views of representative organizations and individuals on major standard-setting projects
- Advising the IASB and the trustees on other issues, as requested

In addition, the IASB must consult the SAC in advance of any proposed changes to the IASB constitution.

The SAC meets with the IASB at least three times each year. Meetings between the SAC and the IASB are open to the public.

(f) INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE. The IFRIC consists of 12 members appointed by the trustees. The director of technical activities, a staff position, or other senior member of the IASB Staff is the chair of the IFRIC and a nonvoting member. In addition, the trustees may appoint representatives of regulatory organizations to observe the meetings of the IFRIC. Although not granted voting status, the regulatory observers are permitted to speak at the meetings. Currently, representatives from the International Organizations of Securities Commissions (IOSCO) and the European Commission are observers of IFRIC meetings.

Members of the IFRIC include accountants in public practice and industry and financial statement users.

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In the absence of specific authoritative guidance, the IFRIC reviews emerging accounting issues that might be subject to divergent or unacceptable accounting treatment, with the goal of reaching consensus on the appropriate accounting approach. The framework of the IASB and existing IFRSs guide IFRIC interpretations. As constituted, the IFRIC's responsibilities include:

- Interpreting the application of IFRSs and providing timely guidance on financial reporting issues not specifically addressed in existing international accounting guidance
- Working with national standard-setting organizations to bring about convergence of national accounting standards and IFRSs to high-quality solutions
- Publishing draft interpretations for public comment and, when developing a final Interpretation, considering comments received and issuing a final Interpretation within a reasonable time period

Before issuance, IFRIC's drafts and final Interpretations must be approved by the IASB.

The IFRIC meets as often as necessary, currently about every two months. Each IFRIC member has one vote and is expected to represent his or her own independent views rather than the views of any firm, organization, or other constituency with which the member may be associated. Although an IFRIC member may send an alternate, as approved by the IFRIC chair, such alternates may speak at meetings but are not granted voting privileges.

Except for meetings during which certain administrative matters are discussed, the IFRIC's meetings are open to the public.

(g) INTERNATIONAL FINANCIAL REPORTING STANDARDS. IFRSs are international authoritative guidance on how particular economic events and transactions should be reported in a company's financial statements and reports.

IFRSs are established within the context of the IASC conceptual accounting framework that was approved in 1989. The framework assists the IASB in the development of future Standards; in its periodic review of existing Standards; and in promoting the convergence of regulations, accounting Standards, and procedures relating to the presentation of financial statements. However, the framework is not an authoritative IAS and does not define Standards for any particular measurement or disclosure issue. The framework addresses general-purpose financial statements that a company prepares and presents to meet the common information needs of a wide range of financial information users. It:

- Defines the objectives of financial statements and underlying assumptions
- Identifies the qualitative characteristics of financial statements
- Defines the basic elements of financial statements and the concepts for recognition and measurement of the financial statement elements
- Defines the concepts of capital and capital maintenance

At present, the IASB has no authority to require or enforce compliance with IFRSs. However, for cross-border securities issuances, many countries allow foreign companies to apply IFRSs when those companies prepare financial reports for issuance to the public. Such countries may require certain reconciliations or additional footnote explanations of differences between reported information and local accounting and financial reporting Standards. To identify the changing status of IFRSs in specific countries, consult *www.IASB.org*.

The IOSCO reviewed 30 ISAs for consideration for cross-border reporting by its member countries. Based on that review and subject to the appropriate reconciliation, disclosures, and interpretations, in May 2000, the President's Committee of IOSCO recommended that IOSCO members permit multinational issuers to use the 30 approved Standards to prepare their financial reporting information for cross-border offerings and listings. Further, as of January 1, 2005, the European Union (EU) requires all publicly listed companies to prepare their financial statements in conformity with IFRSs.

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(i) Procedures for the Development of International Financial Reporting Standards. Potential IASB financial accounting and reporting topics may be suggested to the IASB by its board members, members of the SAC, national accounting standard-setting organizations, regulatory organizations, the IASB Staff, and other interested individuals and IASB constituents. Once an item is added to its technical agenda, the IASB is given responsibility for determining the scope of that project. Development of an IFRS may involve these steps:

- Establishment of an advisory committee to consult with the IASB on issues involved in the project
- Preparation and issuance of a discussion document to obtain comments on the topic and proposed guidance from interested parties
- Preparation and issuance of an ED for public comment, after deliberation and consideration of the public comments received
- Issuance of a final IFRS, after deliberation and consideration of public comments received on the ED

A current list of outstanding IFRSs can be found at the official Web site, *www.ifrs.org*.

(ii) Acceptance of IFRS for SEC Purposes by Foreign Private Issuers. In March 2008, the SEC indicated that it would accept financial statements prepared in accordance with IFRS for purposes of the filing requirements by foreign private issuers without reconciliation to U.S.GAAP (SEC Release 33–8879). Prior to this change, Regulation S-X and Form 20-F required reconciliation to U.S. GAAP to be acceptable for filing purposes

1.15 INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

IOSCO was created in 1983. Its members represent national securities regulators and representatives from national securities exchanges that have responsibility for securities regulation and the administration of securities laws. IOSCO's objectives (*www.iosco.org*) are to:

- to cooperate in developing, implementing and promoting adherence to internationally recognized and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks;
- to enhance investor protection and promote investor confidence in the integrity of securities markets, through strengthened information exchange and cooperation in enforcement against misconduct and in supervision of markets and market intermediaries; and
- to exchange information at both global and regional levels on their respective experiences in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation.

IOSCO has three membership categories: ordinary (115), associate (11), and affiliate (67) members. Its activities to promote convergence began in 1989, when it released a report stating that cross-border offerings would be facilitated by the development of a global set of accounting standards. At that time, IOSCO decided to focus its activities on the efforts of the IASC (now the IASB).

In 1998, IOSCO adopted a comprehensive set of Objectives and Principles of Securities Regulation (IOSCO Principles), targeted as a benchmark for securities markets.

Today IOSCO is comprised of and regulates over 100 jurisdictions and its membership represents more than 95% of the world's securities markets.

In 2003, the organization endorsed a comprehensive methodology (IOSCO Principles Assessment Methodology) to provide a way to objectively assess the effective implementation of the IOSCO Principles in the jurisdictions of its members and the development of practical action plans to correct identified deficiencies.

In 2005, IOSCO agreed the IOSCO multilateral Memorandum of Understanding as a benchmark for international cooperation among securities regulators, "facilitating cross-border

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cooperation, reducing global systemic risk, protecting investors and ensuring fair and efficient securities markets."

In its report on the IASB core Standards, IOSCO discusses the supplemental treatments that IOSCO members may want to consider when deciding on the implementation. IOSCO is also working with the IAASB to develop a similar work plan to consider recommending IAS to its members for cross-border auditing and assurance engagements.

Since its inception, the U.S. SEC has had considerable influence on the leadership and direction of IOSCO. The decline of the relative dominance of the United States in worldwide securities trading has weakened U.S. influence on this international body.

1.16 EUROPEAN UNION

In 1957, the Treaty of Rome created the EC (European Community). In 1967, three existing communities—the European Economic Community, the European Coal and Steel Community, and the European Atomic Energy Community—were merged. In 1993, the European Community became the EU (European Union). Currently, a single Commission, a Council of Ministers (the Council), and a European Parliament exercise the powers and responsibilities incorporated in the separate treaties comprising the EU.

The Council represents the governments of its member states and is the EU's decision-making body. It deliberates proposals developed by the representatives in the Commission. A qualified majority vote by Council is generally required for approval of all proposals. Council votes are weighted based on the population of the individual member countries.

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(a) COUNCIL DIRECTIVES. EU Directives are one approach used to harmonize company law throughout member states. Directives are developed through a complex and lengthy process, including ratification by its member states. Once Directives are ratified, each member state adopts and implements it, although national authorities are given some latitude on matters of implementation.

Directives address all aspects of company law, including accounting and auditing. Of the relevant company Directives that have been issued, two have significantly influenced European efforts to converge accounting and financial reporting: the Fourth and Seventh Directives, which are discussed next. The Eighth Directive addresses the qualification of accounting professionals authorized to conduct statutory audits.

The Fourth Directive, issued in 1978, is applicable to public and private companies with the exception of banks and insurance companies. According to this Directive, in preparing financial reports, companies must provide a "true and fair" view of their assets, liabilities, financial position, and results of operations. The guidance of the Fourth Directive includes:

- The format for a company's balance sheet and profit and loss statement
- The minimum footnote disclosure requirements and the contents of the annual report
- A section addressing the valuation rules and concepts considered in preparing financial statements and reported information

The Seventh Directive, issued in 1983, applies to groups of companies that include at least one public or private limited liability company. The Directive requires member states to mandate, under certain specified criteria, consolidation accounting between parent companies and their controlled subsidiaries.

(b) EUROPEAN UNION—RECENT DEVELOPMENTS. The EU has stressed support of convergence of accounting and financial reporting standards around those issued by the IASC (now IASB). For example:

- In 1999, the EC issued its action plan to improve the Single Market for Financial Services over a five-year period. In that action plan, the Commission noted that the IASC Standards represent the benchmark for companies that intend to participate in cross-border securities transactions.

- In 2000, the EC issued a report, *EU Financial Reporting Strategy: The Way Forward,* which contains its recommendations on an approach to European convergence. In that report, the EC recommends making it mandatory for all EU-listed companies to prepare consolidated financial statements in accordance with IASs. Further, the report proposed amending existing Directives and developing an IAS endorsement mechanism with the goal of achieving European application of IASs by January 1, 2005. In June 2002, the EC adopted a regulation requiring listed companies to prepare consolidated financial reports in accordance with IAS (now IFRSs).
- The EU, through its various committees on accounting issues, has been a vocal supporter and sometimes critic of IASB proposals. For example, in 2004, the EU objected to certain provisions of the revised IAS on accounting and reporting for derivative transactions. Rather than reject the revised Standard in total, the EU accepted a modified version of the final Standard, IAS No. 39, *Financial Instruments: Recognition and Measurement,* and requested that the IASB reconsider certain provisions. In response, the IASB reconsidered those provisions and issued amendments. In 2005, the EU accepted the amended Standard for use by listed companies in EU member states. It is clear that the EU intends to continue to be an active participant in IASB activities.
- In 2005, the EU approved amendments to the Eighth Directive. Consistent with some of the provisions of the Sarbanes-Oxley Act in the United States, the amendments establish public oversight of the auditing profession and increase audit committee oversight over the acceptance and conduct of the corporate audit. In addition, similar to the acceptance of IFRSs issued by the IASB, the amendments make the application of IAASB auditing Standards mandatory for all statutory audits.

The EU's recent activities make it clear that, subject to its review and evaluation of IFRSs, its objective is promote convergence of accounting Standards with the guidance of the IASB.

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1.17 INTERNATIONAL AUDITING—INTERNATIONAL FEDERATION OF ACCOUNTANTS

IFAC is a nongovernmental global professional organization of national accounting groups that represent accountants employed in public practice, business and industry, the public sector, and education that interact regularly with the accounting profession. IFAC was established in 1977 as a result of the growth in international trade and multinational business enterprises coupled with a significant increase in investors' attraction to investments outside of their national borders and the associated increase in cross-border capital flows.

IFAC's stated mission is

> to strengthen the worldwide accountancy profession and [to] contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues,

where applicable. IFAC accomplishes its mission through its communications with national professional accounting organizations that are its official members and through its interactions with the many other professional organizations that rely on or have an interest in the activities of the international accounting profession.

In 2001, IFAC issued a paper, *Enhancing Financial Reporting and Auditing,* containing initiatives proposed to strengthen IFAC and improve the global professional accounting self-regulatory structure. The main elements of the initiatives include:

- Strengthening the processes and broadening the membership of the IAASB (formerly the International Auditing Practices Committee)

- Establishing a self-regulatory regime for firms performing transnational audits, comprising the Forum of Firms and its executive arm, the Transnational Audit Committee (an IFAC standing committee)
- Establishing a global Public Oversight Board
- Introducing a program for monitoring the compliance by IFAC member bodies with IFAC Standards and other pronouncements

IFAC's current structure reflects implementation of many of the recommendations proposed in the paper.

(a) MEMBERSHIP. Membership in IFAC is open to accountancy organizations recognized by law or general consensus within their countries as substantial national organizations of good standing within the accounting profession. In 2011, IFAC has 164 member organizations in 125 countries representing more than 2.5 million accountants.

Members of IFAC are expected to:

- Make to fulfill IFAC's mission and objectives.
- Provide financial support of IFAC.
- Demonstrate compliance with the obligations set out in the Statements of Membership Obligations (SMOs), which are issued or revised periodically. (SMOs are issued by the IFAC board and provide clear benchmarks to current member organizations to assist them in meeting their membership requirements.)

(b) GOVERNANCE OF THE INTERNATIONAL FEDERATION OF ACCOUNTANTS. IFAC is governed by an organization consisting of IFAC Council, the board, and standing technical committees. See Section (c)(ii) for more information on these standing committees.

(c) COUNCIL. The Council consists of one representative from each member body of IFAC. The Council meets one time each year and is responsible for deciding constitutional questions and electing the IFAC board. Council members retain one vote on any issue addressed to the Council during its meeting. Other Council responsibilities include:

- Appointing a nominating committee
- Electing board members, based on the recommendations of the nominating committee
- Electing from its members, based on the recommendations of the nominating committee, the deputy president, who replaces the president for a term of two years
- Monitoring the progress and achievement of IFAC
- Admitting and expelling members, as appropriate
- Determining the basis for financial contributions from members
- Determining IFAC's strategic initiatives, budgetary priorities, and other major policy matters

(i) International Federation of Accountants Board. The Council, based on the recommendations of the nominating committee, elects the board, which is comprised of the president and 21 individuals from 18 countries. These members are elected for up to three-year terms and are responsible for setting policy and overseeing IFAC operations, implementing programs, and the work of IFAC boards and committees. The board has broad regional representation as no more than two members may be from any single country.[14] The board is elected for up to three-year terms and meets three times each year.

[14] Except that the country of the president may have an additional representative on the board. See Part 5 of the IFAC Constitution dated November 2004.

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(ii) Standing Committees. The standing committees work toward achieving the broad objectives of IFAC by issuing guidance that member organizations are committed to implement in their own countries. The standing committees include:

- *Transnational Auditors Committee (TAC).* TAC is the executive committee of the Forum of Firms. Membership in the Forum of Firms is open to all accounting firms that perform or wish to perform audits of transnational audits. Member firms are expected to conform to certain quality control standards and are subject to an evolving global peer review process to assess the firm's compliance with the quality control standards. TAC is responsible for coordinating the global peer review process and supervising the development of additional guidance regarding transnational audit work.
- *Compliance Advisory Panel.* The CAP oversees the implementation and operation of the IFAC compliance program. The CAP also makes recommendations to the IFAC board about the membership application process, including recommending new applicants for membership.
- *IAASB International Auditing and Assurance Standards Board.* This board works to improve the uniformity of auditing practices and related services by issuing pronouncements on a variety of audit and assurance functions and by promoting global acceptance of their Standards.
- *Ethics Committee.* The Ethics Committee consults and advises the board on all aspects of ethical issues, develops appropriate guidance on these issues for the board's ultimate approval, and promotes an understanding of ethical issues among its member bodies. In addition, the Ethics Committee continually monitors and stimulates debate on a wide range of ethical issues to ensure that its guidance is responsive to the expectations of its constituency.
- *International Public Sector Accounting Standards Board.* This board issues accounting and auditing pronouncements and conducts educational and research programs aimed at improving the financial management and accountability of national governments, regional and local governments, related governmental agencies, and the constituencies they serve.
- *Education Committee.* This committee develops standards and guidelines, conducts research, and facilitates the exchange of information to ensure that accountants are adequately trained. An important Education Committee focus is assisting developing nations in the advancement of accounting education.
- *Professional Accountants in Business Committee (PAIB).* PAIB publishes guidance, sponsors research programs, and facilitates the international exchange of ideas to develop and support financial and management accounting professionals. The Financial and Management Accounting Committee also works to increase public awareness, understanding, and demand for the services of these professionals worldwide.
- *Nominating Committee.* This committee makes recommendations regarding the composition of IFAC boards, committees, and task forces.

Occasionally, IFAC's Council appoints small working groups, ad hoc committees, or special task forces to address significant issues that warrant focused attention.

(d) INTERNATIONAL STANDARDS ON AUDITING. The IAASB issues ISAs and guidance on the application of the ISAs. The IAASB consists of 18 members. The chair is a full-time position; the remaining 17 members are volunteer, part-time positions. Members are appointed by the IFAC board based on recommendations from the IFAC Nominating Committee. The IAASB has broad geographical representation.

The IAASB meets about four times each year. Meetings, which are open to the public, are held in New York and several locations around the world. Information about meeting locations, the agenda, and minutes are available on the IFAC Web site (*www.ifac.org*).

In developing its auditing and assurance guidance, the IAASB establishes subcommittees to prepare and present draft auditing Standards and Statements. Subcommittees are composed of IAASB committee members, technical auditors from member organizations, and International Federation of

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Accountants (IFAC) Staff. The IAASB deliberates on draft Standards and Statements at its regular meetings. After extensive discussion and debate, the subcommittee prepares an ED of a Statement or Standard for public issuance. Comments received on the ED are summarized and discussed at subsequent subcommittee meetings, and a revised document is prepared for discussion at an IAASB meeting. The IAASB deliberates on the revised draft and associated public comments and makes recommendations to the subcommittee, which are used to prepare a final document.

Each IAASB member has one vote on any document received. A final Standard requires approval of at least 75 percent of attending members.

The IAASB issues three types of formal guidance:

1. *ISAs,* which are applied in the audit of financial statements and adapted to the audit of other information and related services.
2. *International Standards on Assurance Engagements (ISAEs),* which are applied to assurance engagements performed by professional accountants in public practice when such engagements are not covered by an ISA or an International Auditing Practices Statement.
3. *International Auditing Practices Statements (IAPSs),* which provide practical assistance to auditors in implementing ISAs and promoting good practice. IAPSs do not have the authority of ISAs.

Neither ISAs nor ISAEs override local or national auditing or assurance services regulations, respectively.

The IAASB also issues various Discussion Papers with the intention of promoting discussion or debate on auditing and assurance issues affecting the accounting profession, presenting findings, or describing situations of interest relating to auditing and assurance issues. A Discussion Paper does not carry the authority of either an ISA or an IAPS.

Recently the format of the ISAs has been modified to facilitate incorporation of auditing requirements into local country law, as required in some international locations. The length of some auditing Standards would have made it awkward to bring the existing Standards into the law, so in practice only the requirements section of the ISA is brought into the country law. A major difference in the reformatted ("clarified") Standards is that the requirements of the Standard are set apart from the explanatory and other contextual material in it. Requirements are always expressed by the phrase "the auditor shall."[15] The format followed in the ISAs is the current direction taken in the clarified U.S. Standards. In addition, the reconciliation at the end of the U.S. reformatted Standards identifies any differences between U.S. and IAASB Standards.

ISAs now follow the format: Introduction, Objective, Definitions, Requirements, and Application and Other Explanatory Material. As of 2011, the final set of clarified Standards consists of 36 remaining ISAs and one International Standard on Quality Control (ISQC 1), including 16 Standards that contain new and revised requirements.

1.18 SUMMARY AND COMMENTARY

This chapter has shown how financial accounting is important to society because of its contribution to the economy by helping the capital markets operate more effectively. Because of the importance of this social goal, and because history has shown that abusive accounting tends to occur as preparers attempt to gain unfair advantages, financial accounting is significantly regulated

[15] To date, the U.S. clarified Standards continue to use the terms *must* and *should* to denote requirements. Internationally, one country protested the use of the term *must* in International Standards because when it was translated into its native language, the term was one used to describe the type of commands that are directed at young children. *Shall* was a more acceptable term. This is another example of how cultural and language differences can introduce complexities when writing technical accounting and auditing pronouncements.

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by governmental agencies, by private standard-setting bodies that are endorsed and supported by governmental agencies, and by professional organizations. This regulation deals with reporting standards, competency standards, and ethical standards.

The regulation of accounting involves politics because of the conflicting interests among financial statement preparers, auditors, users, and regulators. The tension among these interests helps bring about change and improvement, but only at the risk of not fully serving the public interest. The current structure has evolved with what appears to be the central goal of protecting the public, but that mission will be attained only through careful vigilance and oversight.

While the trend toward globalization is unmistakable, the surrender of local decision making regarding accounting and auditing regulation is a step that many developed countries continue to approach with caution. The international bodies have been patient in permitting nonconforming countries to make contributions to the standard-setting process. However, the longer-range intent of these bodies is unmistakable: Adopt the international Standards you are helping to create or face declining influence or expulsion from the international process. This has been made clear by the IASB and IAASB.[16]

While not contributing to the harmony and good relations among members that mutual committee service engenders, drawing such lines in the sand does force decisions about where you are going. To date, many accounting and auditing bodies have had the opportunity to observe existing practices and policies developed in the more mature markets countries and have compared and contrasted the approaches and results obtained. With such existing models to consider, simplification and harmonization may have been enhanced. Some questions need to be addressed on the front end, since reparations may be difficult on the back end once the decision is made. These include:

- Will this process work the same way when topics are being debated that might be first experienced or recognized in only one or two of the participating countries?
- Will intimidation of countries to commit and join the process help or hurt the implementation process for international accounting and auditing Standards?
- Will the combined body be respectful of the fact that the issue may have originated in one environment or the other and may reflect issues likely to impact only a few environments? Comments and writings have criticized U.S. Standards for being detail oriented. Will ideology and nationalist issues be an impediment to addressing issues on a timely basis?
- Do detailed Standards grow out of a desire to issue detailed Standards, or do they grow from more complex and detailed issues that are recognized in practice and where harmonization on principles alone is unlikely? If the latter is the case, we may wind up in the same place in the long run anyway. If principles are cross-industry, why did the IASC develop an ISA on the agricultural industry?
- What role will the FASB and the ASB serve once their standard-setting roles have been assimilated into the international bodies? Will a void develop between the practicing profession and the standard-setting process?
- What past or existing international body will serve as a role model for how the international standards process will create greater harmony and commerce? The effectiveness of the United Nations in meeting its lofty goals is not a great endorsement for the likely effectiveness of international bodies.
- How will the SEC exercise its congressional mandate to oversee the profession in the United States in the context of the international standard-setting process?
- How will the PCAOB participate in the new standard-setting process, or will continue to "do its own thing" as it relates to setting U.S. public company audits?

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[16] M. Lamoreaux, "New IASB Leader Embraces Challenges: An Interview with Chairman Hans Hoogervorst," *Journal of Accountancy* (September 2011); and A. Hickley and N. York, "IFRS Tiff Heats Up as US Banks Weigh In," *Global Financial Strategy News,* August 11, 2011, at *www.gfsnews.com*.

- Will the environment in which auditors operate (e.g., regulatory, professional, and economic) be conducive to their making tough judgments on principles-based issues? There is considerable evidence that the SEC has been a major resolution resource for issues that U.S. auditors and clients disagree on. Will the dynamics change when the system changes, and how?

Only time will tell.

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1.20 SELECTED WEB SITES

American Institute of Certified Public Accountants: *www.aicpa.org*
Federal Accounting Standards Advisory Board: *www.fasab.gov*
Financial Accounting Standards Board: *www.fasb.org/home*
Government Accountability Office: *www.gao.gov*
International Federation of Accountants / International Auditing and Attest Standards Board: *http://ifac.org*
International Financial Reporting Standards/International Accounting Standards Board: *www.ifrs.org/Home.htm*
International Organizations of Securities Commissions: *www.iosco.org*

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