

ACCOUNTING and AUDITING RESEARCH: A Practical Guide

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SOUTH-WESTERN

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PREFACE

A concern exists among educators and practitioners alike as to the ability of accountants to effectively research practical accounting and auditing issues. It is apparent that with the increasing complexity of the accounting and auditing environment and the continuously changing professional standards, the practitioner should be able to resolve complex accounting or auditing questions on a timely basis. Therefore, this text features a practical methodology for conducting efficient and effective accounting and auditing research.

In a sense, this text is a do-it-yourself, understand-it-yourself manual which serves as a primer on methodology to assist the practitioner in conducting accounting and auditing research. The text is a practical manual which guides the reader, step by step, through the research process. Every attempt is made to communicate with clarity to the reader a basic framework which should assist in the research process of defining the accounting or auditing issue, conducting the research, documenting and evaluating the research findings, and drawing conclusions.

The text is structured to first present an overview of the research process in the accounting and auditing environment followed by applications of the methodology to specific case illustrations. Chapter 1 presents an introduction to accounting and auditing research. Chapters 2 and 3 focus on an overview of the environment of accounting and auditing research with an emphasis on the standard-setting process. The meaning of the term "generally accepted accounting principles" is discussed as well as the role that professional judgment plays in the

research process. Chapter 4 begins a detailed analysis of the research process with Chapters 5 and 6 presenting a discussion of the many sources of authoritative literature and various access techniques to the professional literature. Chapter 7 concludes with a refinement of the research process. This text will familiarize the reader with the many available research tools with special emphasis on the use of the American Institute of Certified Public Accountants' *Index to Accounting and Auditing Technical Pronouncements* and *Professional Standards* series as well as the Financial Accounting Standards Board's *Accounting Standards* series. Moreover, the text provides a number of cases which should give the reader practical experience in utilizing these research tools.

At the collegiate level, this text should serve well as a supplement to intermediate and advanced accounting and auditing classes. The text will provide the student with the "what," "why," and "how" of conducting practical accounting and auditing research. Also presented in the text are comprehensive listings of sources of authoritative and semiauthoritative support to aid in researching complex accounting and auditing problems. Utilized by the practitioner, this text will serve as a reference in providing a framework for resolving the day-to-day accounting or auditing issues confronted. The text could be used in staff training courses as an aid in teaching practical accounting or auditing research.

We greatly appreciate the permission from the AICPA to include liberal quotations from official pronouncements and page illustrations of various publications. Also appreciated are the reviews and suggestions offered by David Simmons, Touche Ross & Co., Detroit, and James Aitken, formerly with Ernst & Whinney, Lansing. However, all limitations of the text are the sole responsibility of the authors.

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Chapter 1

INTRODUCTION TO ACCOUNTING AND AUDITING RESEARCH

Hardly a day goes by in which the professional accountant, whether in public accounting, industry, or government, does not become involved in the investigation and analysis of an accounting or auditing issue. The issue or problem must be clearly defined, facts gathered, authoritative literature reviewed, alternatives evaluated, and conclusions drawn. In conducting this research process, the researcher must answer three basic questions:

1. Does authoritative literature exist as to the issue under review?
2. If authoritative literature does exist, how does the researcher develop a conclusion in an efficient and effective way?
3. If authoritative literature does not exist, what approach does the researcher follow in arriving at a conclusion?

The purpose of this text is to provide the understanding and the research skills needed to answer these questions. The “what,” “why,” and “how” of practical accounting and auditing research are discussed with emphasis on the following topics: What are generally accepted accounting principles and generally accepted auditing standards? What constitutes substantial authoritative support? What are the available sources of current accounting and auditing literature? A practical research approach is presented, along with discussions of various research tools. This research approach is demonstrated through the use of a number of practice problems presented as case studies.

Nature of Accounting and Auditing Research

This text focuses on accounting and auditing research within the practicing segment of the accounting profession in contrast to theoretical research often conducted by academicians. Today’s practitioner must be able to properly conduct research in a systematic fashion to arrive at appropriate and timely conclusions regarding the issues at hand. Efficient and effective accounting or auditing research is often necessary in order to determine the proper recording, classification, and disclosure of economic events; to determine compliance with authoritative accounting or auditing pronouncements; or to determine the preferability of alternative accounting procedures.

Examples of issues frequently encountered by the practitioner include such questions as: What are the accounting or auditing implications of a new transaction? Is the accounting treatment of the transaction in agreement with generally accepted accounting principles? What are the financial statement disclosure requirements? What is the auditor’s association and responsibility when confronted with supplemental information presented in annual reports but not as part of the basic financial statements?

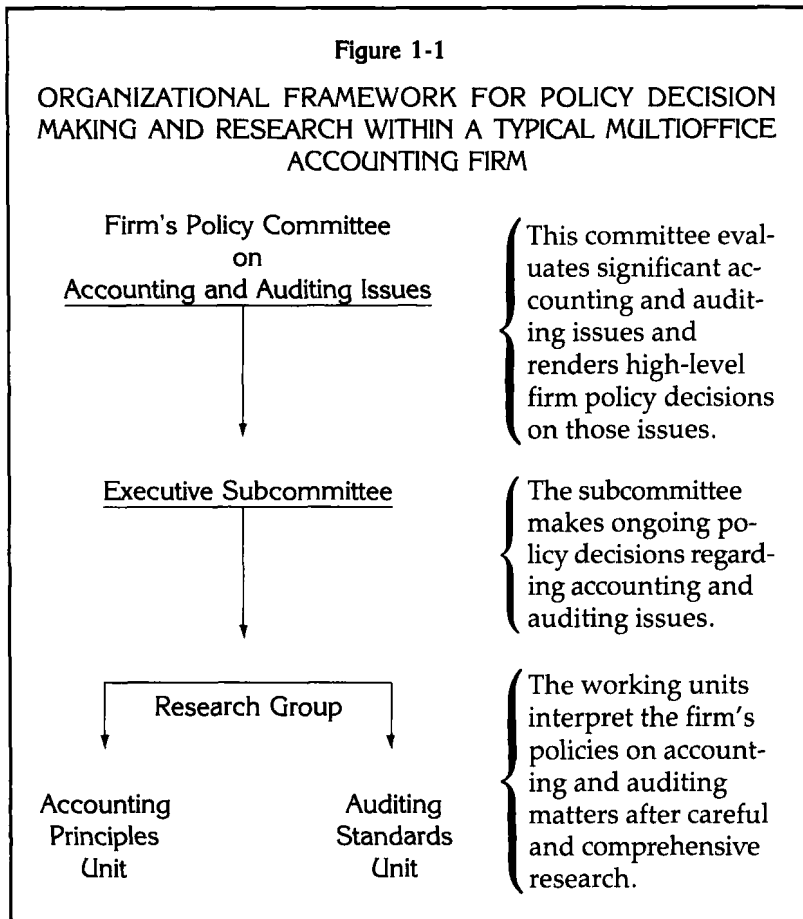
Finding answers to these often-complex questions is becoming more difficult and time-consuming as the financial accounting and reporting requirements and the auditing standards increase in number and complexity. The research process is often further complicated when the accountant or auditor is researching a practical issue for which no authoritative literature exists, or the authoritative literature does not directly address the question.

Role of Research in the Public Accounting Firm

Although research is often conducted by accountants in industry or government, accounting and auditing research is particularly important in the public accounting firm. Due to the number and diversity of clients

served, public accounting firms are constantly engaged in conducting research on a wide range of accounting and auditing issues.

Many of the larger multioffice firms maintain their own research departments. A typical organizational structure for policy decision making and research on accounting and auditing matters within a firm is depicted in Figure 1-1.



The responsibilities of a firm-wide accounting and auditing policy decision function include: maintaining a high level of professional competence in accounting and auditing matters; developing and rendering high-level policies and procedures on accounting and auditing issues for the firm; disseminating the firm's policies and procedures to appropriate personnel within the firm on a timely basis; and supervising the quality control of the firm's practice. Research plays an important role in the decision-making process.

The Policy Committee and Executive Subcommittee, as shown in Figure 1-1, generally consist of highly competent audit partners with years of practical experience. The Policy Committee's primary function is to evaluate significant accounting and auditing issues and establish firm-wide policies on these issues. The Executive Subcommittee handles the daily ongoing policy decisions (lower-level decisions) for the firm as a whole. The responsibility of the accounting and auditing research units is to interpret firm policies in the context of specific client situations. Frequently, technical accounting and auditing issues that arise during the course of a client engagement can be resolved through research conducted by personnel assigned to the engagement. When a matter cannot be satisfactorily resolved at the local-office level, assistance is requested from the firm's research units. These units conduct careful and comprehensive research in arriving at the firm's response to technical inquiries.

Practical accounting and auditing research is not confined to the public accounting firm. Every practitioner should possess the ability to conduct efficient research and develop logical and well-supported conclusions on a timely basis. The research process is the same regardless of whether the researcher is engaged in public accounting, management accounting, internal auditing, or governmental accounting or auditing.

What Is Research?

The term "research" has frequently been misunderstood by those unfamiliar with the research process, which is often perceived as a mechanical process conducted in a mystical environment by a strange individual. The approach is anything but mystical or mechanistic. The process of conducting any type of research, including practical accounting and auditing research, is simply a systematic investigation of an issue or problem.

Research in general can be classified into two primary categories: (1) pure research and (2) applied research. *Pure research*, often labeled *basic research*, involves the investigation of questions that appear interesting to the researcher, generally an academician, but may have little or no practical application at the present time. For example, a researcher may be interested in the impact of inflation on earnings per share figures and security prices.¹ Such research has little present practical application and can be referred to as *empirical research*, i.e., research based upon experiment or observation. However, pure or basic research should not be discounted as worthless. Such research adds to

¹William A. Hillison, "Empirical Investigation of General Purchasing Power Adjustments on Earnings per Share and the Movement of Security Prices," *Journal of Accounting Research* (Spring, 1979), pp. 60-73.

the body of knowledge in a particular field and may ultimately contribute directly or indirectly to practical problem solutions. Empirical research studies, for example, are frequently reviewed and evaluated by standard-setting bodies in drafting authoritative accounting and auditing pronouncements.

Applied research, which is the focus of this text, involves the investigation of an issue of immediate practical importance. For example, assume that a public accounting firm has been asked to evaluate a client's proposed new accounting treatment for self-insurance. The client expects an answer within two days as to the acceptability of the new method and the impact it would have on the financial statements. In such a case, a member of the accounting firm's professional staff would investigate authoritative literature as to the acceptability of the method or develop a logical theoretical justification for or against the new method if no authoritative literature exists on the topic.

The applied research in the preceding example can be subcategorized as *a priori* (before the fact) research. In other words, the research is conducted before the client actually enters into a transaction. On the other hand, a client may request advice relating to a transaction that has already been executed. Research relating to a completed transaction or other past event is referred to as *a posteriori* (after the fact) research. There are frequently advantages to conducting *a priori* as opposed to *a posteriori* research. For example, if research reveals that a proposed transaction will have an unfavorable impact on financial statements, the transaction can be abandoned or possibly restructured to avoid undesirable consequences. These options are not available, however, once a transaction is completed.

There is a need to conduct both pure and applied research. If either type of research is conducted properly, the methodology is the same, only the environment differs. Both types of research require sound research design to effectively and efficiently resolve the issue under investigation.

Overview of the Research Process

The research process in general is often defined as the *scientific method of inquiry*, a systematic study of a particular field of knowledge in order to discover scientific facts or principles. The basic purpose of research, therefore, is to obtain knowledge or information that specifically pertains to some issue or problem. An operational definition of research encompasses the following elements:²

²David J. Luck, Hugh C. Wales, and Donald A. Taylor, *Marketing Research* (Englewood Cliffs: Prentice-Hall, Inc., 1961), p. 5.

1. There must be an orderly investigation and analysis of a clearly defined issue or problem.
2. An appropriate scientific approach must be used.
3. Adequate and representative evidence must be gathered and documented.
4. Logical reasoning must be employed in drawing conclusions.
5. The researcher must be able to support the validity or reasonableness of the conclusions.

With this general understanding of the research process, practical accounting and auditing research may be defined as follows:

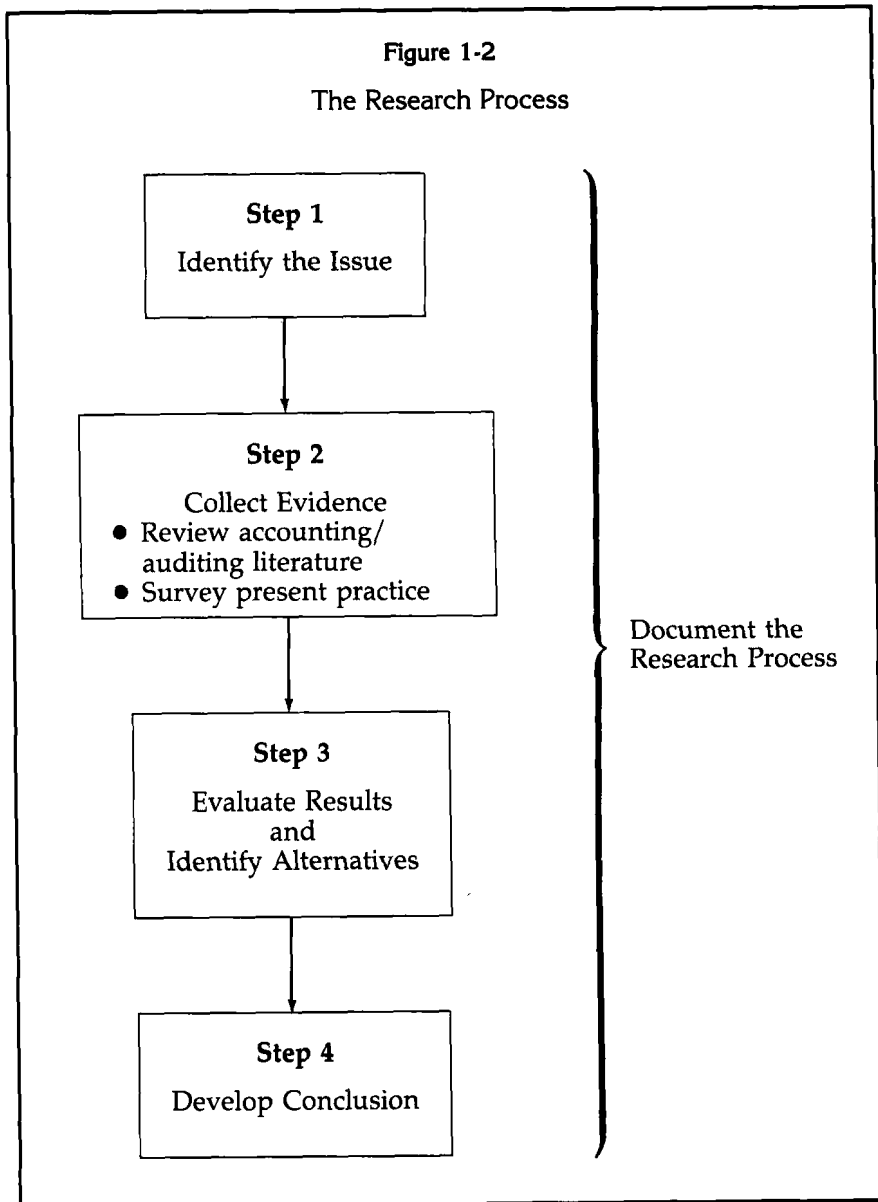
Accounting or auditing research — A systematic and logical approach to obtaining and documenting evidence underlying a conclusion relating to an accounting or auditing issue or problem currently confronting the accountant or auditor.

The basic steps in the research process are illustrated in Figure 1-2 and discussed in the following sections. As indicated in the illustration, each step of the research process should be carefully documented.

Identify the Issue. In many cases, the basic issue has already been identified before the research process begins, e.g., when a client requests advice as to the proper handling of a specific transaction. However, further identification of the exact issue is often required. This process of refining the issue at hand is referred to as *problem distillation*, whereby a general issue is restated in sufficiently specific terms. If the statement of the issue is too broad or general, the researcher is apt to waste valuable time consulting sources which are not relevant to the specific issue.

Factors to consider in the identification and statement of the issue include the exact source of the issue, justification for the issue, and a determination of the scope of the issue. To successfully design and execute an investigation, the issue must be clearly stated.

Collect Evidence. Once the issue is adequately defined, the researcher is ready to proceed with step two of the research process, the collection of evidence. The research begins with the development of a plan that carefully presents the procedures to follow in collecting evidence. The actual collection of evidence will usually encompass a detailed review of relevant authoritative accounting or auditing literature and a survey of present practice. A number of research tools that will aid in the collection of evidence are available and are discussed in detail in Chapters 4 through 6. In cases where authoritative literature does not exist on a specific issue, the accountant or auditor needs to develop a theoretical resolution of the issue based upon a logical analysis of the factors involved.



Evaluate Results and Identify Alternatives. Once a thorough investigation and collection of evidence has been completed, the next step is to evaluate the results and identify alternatives to arrive at one or more tentative conclusions to the issue at hand. Each alternative should be fully supported by authoritative literature or a theoretical justification with complete and concise documentation.

Further analysis and research may be needed as to the appropriateness of the various alternatives identified. This reevaluation may require further discussions with the client or consultations with colleagues. In discussing an issue with a client, the researcher should be cognizant of the fact that management may not be objective in evaluating alternatives. For example, the issue may involve the acceptability of an accounting method that is currently being used by the client. In such cases, the research is directed toward the support or rejection of an alternative already decided on by management. The possibility of bias should cause the researcher to retain a degree of skepticism in discussions with the client regarding a conclusion.

Develop Conclusion. After a detailed analysis of the alternatives, the researcher develops a conclusion. The final conclusion selected from the alternatives identified should be thoroughly documented and well supported by the evidence gathered. The conclusion is then presented to the client as a proposed solution to the issue.

A serious weakness in any part of the research process threatens the worth of the entire research effort. Therefore, each segment of the process should be addressed with equal seriousness as to its impact on the entire research project.

Summary

The importance of research in the work of a practicing accountant or auditor should now be apparent. Few practitioners ever experience a workweek which does not include the investigation and analysis of an accounting or auditing issue. Thus, every practicing accountant or auditor should possess the ability to conduct practical research in a systematic way. The goal of this text is to aid the practitioner in developing a basic framework to assist in the research process.

The emphasis of the following chapters is on applied or practical research that deals with solutions to immediate practical issues rather than pure or basic research that has little or no present day application. Chapters 2 and 3 provide an overview of the environment of accounting and auditing research, with an emphasis on the standard-setting process. Chapter 4 expands upon the four research steps discussed in this chapter and applies the steps to an illustrative problem. Chapter 5 presents a discussion of the sources of authoritative literature as well as

an explanation of access techniques to the professional literature. Chapter 6 discusses other available research tools that may aid in the efficient and effective conduct of practical research. Chapter 7 concludes with a refinement of the research process by presenting specific annotated steps and formatting procedures for conducting and documenting the research process via a comprehensive problem.

DISCUSSION QUESTIONS

1. Why is accounting or auditing research necessary?
2. What is the objective of accounting or auditing research?
3. Describe the role of research within the public accounting firm.
4. Differentiate between pure and applied research.
5. Distinguish between *a priori* and *a posteriori* research.
6. Explain the four steps involved in the accounting or auditing research process.
7. Discuss how research can support or refute a biased alternative.
8. Explain what is meant by problem distillation and its importance in the research process.

Chapter 2

THE ENVIRONMENT OF ACCOUNTING RESEARCH

In researching an accounting issue, the practitioner must be cognizant of the professional and business environment. The practitioner does not operate in a stagnant environment, but one that is very dynamic. New professional standards are constantly being issued, and existing standards are being updated or completely deleted. The following list includes major environmental factors that influence the development of accounting standards:

1. Requirements of governmental and other regulatory bodies.
2. Influence of various tax laws on the financial reporting process.
3. Practices or problems of certain specialized industries, such as the motion picture and oil and gas industries.
4. Inconsistencies in practice.
5. Disagreement among accountants, business executives, and others as to the objectives of financial statements.
6. Various professional organizations.