

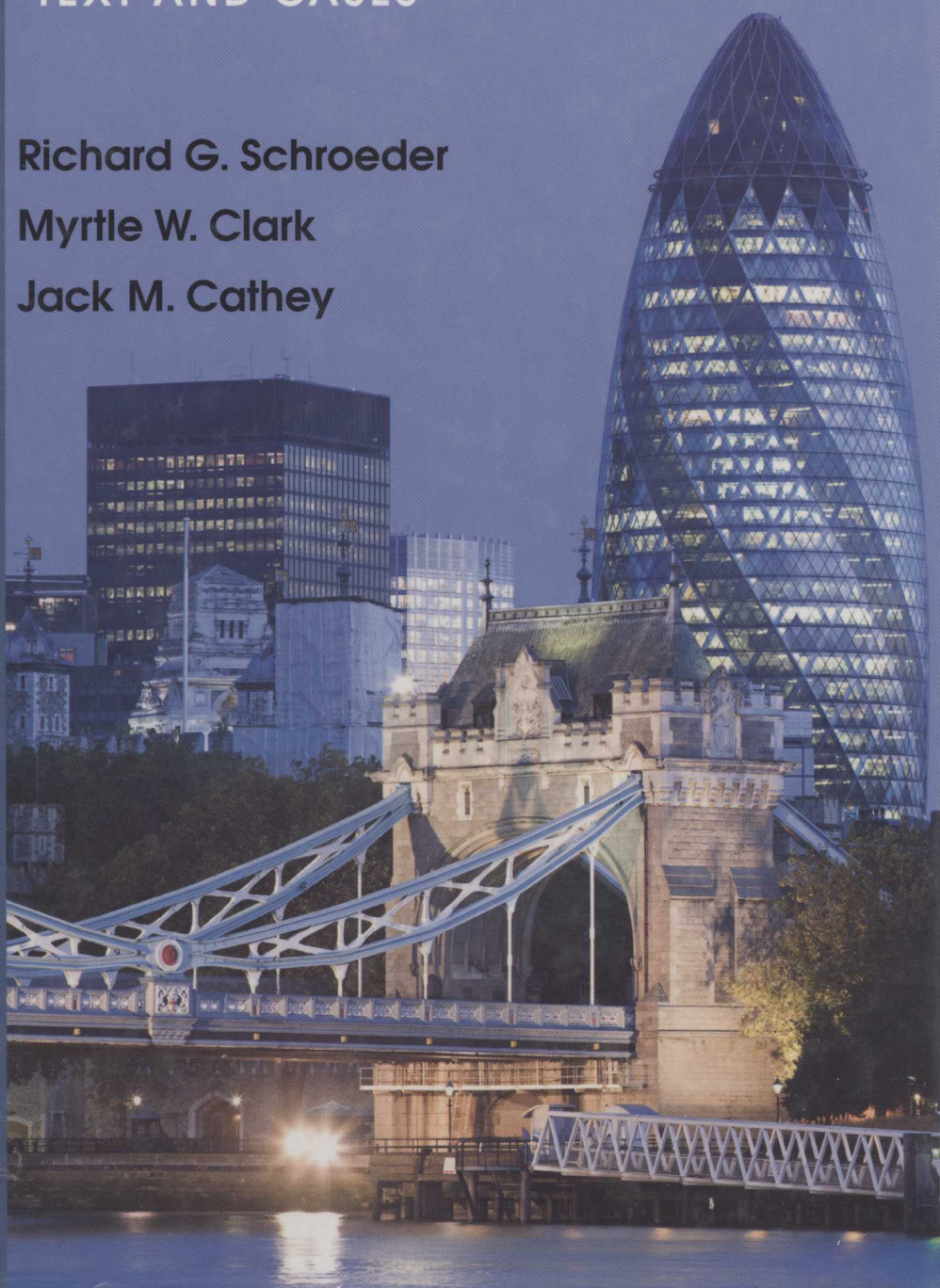
10TH
EDITION

FINANCIAL ACCOUNTING THEORY AND ANALYSIS: TEXT AND CASES

Richard G. Schroeder

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Preface

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

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

- Expanded use of the Web by including cases and updates on the textbook companion site at <http://www.wiley.com/college/schroeder>.
- Added a tutorial on the FASB ASC in the solutions manual.
- Added a test bank to the solutions manual containing over 250 multiple choice and over 200 essay questions.
- Updated the disclosure examples throughout the chapters and updated the financial analysis sections of each chapter using Hershey and Tootsie Roll as the example companies.
- Added 5–10 FASB ASC cases in each chapter.
- Added new “Room for Debate” cases in several chapters.
- Updated the discussion of the sources of GAAP to incorporate the FASB ASC in Chapter 1.
- Added a discussion of the FASB's Accounting Standards Codification in Chapter 1.
- Updated the discussion of the FASB-IASB “Norwich Agreement” and their joint conceptual framework and financial statement presentation projects in Chapter 2.
- Updated the discussion of the IASB-FASB “Roadmap to Convergence” project that is attempting to arrive at a common set of high-quality global accounting standards and the removal of the need for the reconciliation

requirement for non-U.S. companies that use IFRSs and are registered in the United States in Chapter 3.

- Updated the discussion of the impact of international versus U.S. GAAP accounting standards in Chapter 3 to incorporate SEC's decision to partially eliminate the Form 20-F reconciliation requirement for foreign companies.
- Added a discussion of the IFRS on the use of GAAP for small and medium-sized entities in Chapter 3.
- Added a discussion of the FASB-IASB discussion paper on revenue recognition in Chapter 5.
- Updated the discussion of the proposed new format for the statement of comprehensive income in Chapter 6.
- Added a discussion FASB-IASB financial statement presentation project in Chapter 6.
- Added a summary of FSP FAS 157-4 to the discussion of fair value measurements in Chapter 7.
- Added a discussion of the proposed format of the statement of financial position in Chapter 7.
- Added a discussion of the proposed format of the statement of cash flows in Chapter 7.
- Added a discussion of the reissued IAS No. 39, "Financial Instruments: Recognition and Measurement," in Chapter 10.
- Added a discussion of IFRS No. 7, "Financial Instruments: Disclosures," in Chapter 10.
- Added a discussion of IASB's exposure draft on income taxes in Chapter 12.
- Added a discussion of the FASB-IASB joint project on accounting for leases in Chapter 13.
- Added a discussion of the proposed amendment to *IAS No. 19*, "Retirement Benefit Costs" in Chapter 14.
- Added a discussion of the "acquisitions method" in Chapter 16.
- Added a discussion of accounting for "noncontrolling interests" in Chapter 16.
- Added a discussion of the revised *IFRS No 3*, "Business Combinations," in Chapter 16.
- Added a discussion of *IFRS No 8*, "Operating Segments," in Chapter 16.
- Added a discussion of the SEC's interpretive guidelines regarding the disclosure of items in the MD&A section of the 10-K report in Chapter 17.
- Added a discussion of the "Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States" in Chapter 17.

The publication of this text would not be possible without the assistance of many individuals. We are extremely indebted to our colleagues; Gurav Kumar, Benjamin, and Stephen Zeff whose comments and criticisms

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We extend our thanks to the editorial staff at John Wiley & Sons, including Michael McDonald, Acquisitions Editor, Brian Kamins, Project Editor, and Jacqueline Kepping, Editorial Assistant. Our thanks also goes to the production staff on the book, Elaine Chew, Assistant Production Editor of John Wiley & Sons, as well as our copyeditor, Chris Thillen.

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CHAPTER 1

The Development of Accounting Theory

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

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

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

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

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

The development of a general theory of accounting is important because of the role accounting plays in our economic society. We live in a capitalistic society,

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

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

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

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

The Early History of Accounting

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

According to Hain, “The Zenon papyri give evidence of a surprisingly elaborate accounting system which had been used in Greece since the fifth century B.C. and which, in the wake of Greek trade or conquest, gradually spread throughout the Eastern Mediterranean and Middle East.”³ Zenon’s accounting system contained provisions for responsibility accounting, a written record of all transactions, a personal account for wages paid to employees, inventory records, and a record of asset acquisitions and disposals. In addition, there is evidence that all the accounts were audited.⁴

2. See, for example, Robert Sterling, “On Theory Structure and Verification,” *The Accounting Review* (July 1970), 444–57.

3. H. P. Hain, “Accounting Control in the Zenon Papyri,” *The Accounting Review* (October 1966), 699.

4. *Ibid.*, 700–701.

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

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

Statements of profit and loss and statements of balances emerged in about 1600.⁵ Initially, the primary motive for separate financial statements was to obtain information regarding capital. Consequently, balance sheet data were stressed and refined in various ways, while expense and income data were viewed as incidental.⁶

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

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

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

In the later part of the nineteenth century, the industrial revolution arrived in the United States, bringing the need for more formal accounting procedures and standards. Railroads became a major economic influence. These companies created the need for supporting industries, which in turn led to increases in the

5. A. C. Littleton, *Accounting Evolution to 1900* (New York: AICPA, 1933).

6. John L. Carey, *The Rise of the Accounting Profession* (New York: AICPA, 1969), 5.

market for corporate securities and an increased need for trained accountants as the separation of the management and ownership functions became more distinct.

Initially anyone could claim to be an accountant, for there were no organized professions or standards of qualifications, and accountants were trained through an apprenticeship system. Later, private commercial colleges began to emerge as the training grounds for accountants. These institutions emphasized the quality of value, but discussions of the nature of value in accounting education did not surface until much later. At the end of the nineteenth century, widespread speculation in the securities markets, watered stocks, and large monopolies that controlled segments of the U.S. economy resulted in the establishment of the progressive movement. In 1898 the Industrial Commission was formed to investigate questions relating to immigration, labor, agriculture, manufacturing, and business. Although no accountants were either on the commission or used by the commission, a preliminary report issued in 1900 suggested that an independent public accounting profession should be established to curtail observed corporate abuses.

Although most accountants did not necessarily subscribe to the desirability of the progressive reforms, the progressive movement conferred specific social obligations on accountants.⁷ As a result, accountants generally came to accept three general levels of progressiveness: (1) a fundamental faith in democracy, a concern for morality and justice, and a broad acceptance of the efficiency of education as a major tool in social amelioration; (2) an increased awareness of the social obligation of all segments of society and introduction of the idea of the public accountability of business and political leaders; and (3) an acceptance of pragmatism as the most relevant operative philosophy of the day.⁸

The major concern of accounting during the early 1900s was the development of a theory that could cope with corporate abuses that were occurring at that time, and capital maintenance emerged as a concept. This concept evolved from maintaining invested capital intact to maintaining the physical productive capacity of the firm to maintaining real capital. In essence, this last view of capital maintenance was an extension of the economic concept of income (see Chapter 5) that there could be no increase in wealth unless the stockholder or the firm were better off at the end of the period than at the beginning.

During the period 1900–1915, the concept of income determination was not well developed. There was, however, a debate over which financial statement should be viewed as more important, the balance sheet or the income statement. Implicit in this debate was the view that either the balance sheet or the income statement must be considered fundamental and the other as residual and that relevant value could not be disclosed in both statements.

The 1904 International Congress of Accountants marked the initial development of the organized accounting profession in the United States, although there had been earlier attempts to organize and several states had state societies. At this meeting, the American Association of Public Accountants was formed as

7. Gary John Previts and Barbara Dubis Merino, *A History of Accounting in America* (New York: Ronald Press, 1979), 136.

8. Richard Hofstadter, *Social Darwinism in American Thought* (Philadelphia: University of Pennsylvania Press, 1944).

the professional organization of accountants in the United States. In 1916, after a decade of bitter inter-factional disputes, this group was reorganized into the American Institute of Accountants (AIA).

In the early 1900s, many universities began offering accounting courses. At this time no standard accounting curriculum existed.⁹ In an attempt to alleviate this problem, in 1916 the American Association of the University Instructors in Accounting (AAUIA) was also formed. Since curriculum development was the major focus at this time, it was not until much later that the AAUIA attempted to become involved in the development of accounting theory.

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

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

Accounting in the United States since 1930

One of the first attempts to improve accounting began shortly after the inception of the Great Depression with a series of meetings between representatives of the New York Stock Exchange (NYSE) and the American Institute of Accountants. The purpose of these meetings was to discuss problems pertaining to the interests of investors, the NYSE, and accountants in the preparation of external financial statements.

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

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

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

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

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

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

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

Committee on Accounting Procedure

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

The CAP was relatively inactive during its first two years but became more active in response to the SEC's release of ASR No. 4 and voiced concerns that the SEC would become more active if the committee did not respond more quickly. One of the first responses was to expand CAP membership from seven to twenty-one members.

A major concern arose over the use of the historical cost model of accounting. The then-accepted definition of assets as unamortized cost was seen by some critics as allowing management too much flexibility in deciding when to charge costs to expense. This practice was seen as allowing earnings management (see Chapter 5) to occur.

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

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

Accounting Principles Board

By 1959 the methods of formulating accounting principles were being questioned as not arising from research or based on theory. The CAP was also criticized for acting in a piecemeal fashion and issuing standards that, in many cases, were inconsistent. Additionally, all of its members were part-time and as a result their independence was questioned. Finally, the fact that all of the CAP members were required to be AICPA members prevented many financial executives, investors, and academics from serving on the committee. As a result, accountants and financial statement users were calling for wider representation in the development of accounting principles. The AICPA responded to the alleged shortcomings of the CAP by forming the Accounting Principles Board (APB). The objectives of this body were to advance the written expression of generally accepted accounting principles (GAAP), to narrow areas of difference in appropriate practice, and to in the method of establishing accounting principles was quickly squelched when the first APB chairman, Weldon Powell, voiced his belief that accounting research was more applied and pure and that the usefulness of the end product was a major concern.

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

This controversy was over the proper method to use in accounting for the investment tax credit. In the early 1960s the country was suffering from the effects