5. The Development of GAAP

Generally accepted accounting principles, or GAAP, encompass the rules, practices, and procedures that define the proper execution of accounting. It is important to note that this definition is quite broad, taking in more than just the specific rules issued by standard setters. It encompasses the long-standing methodologies and assumptions that have become engrained within the profession through years of thought and development. Collectively, GAAP form the foundation of accounting by providing comprehensive guidance and a framework for addressing most accounting issues.

5.1 The Audit Function

To provide a measure of integrity, financial reports of public companies are required to be audited by independent CPAs. Auditors will spend considerable time in evaluating the systems and data that lead to the reported financial statements. At the end of the day, however, the auditor will usually only issue an opinion letter on the fairness of the reports. This letter is rather brief and to the point and includes a paragraph similar to the following:

> In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

Note that the auditor is expressing an opinion about the conformity of the financial statements with generally accepted accounting principles. Thus, conformity with GAAP is the key to obtaining the desired audit opinion. Being alert to the detection of potential fraud is important, but it is not the primary mission of a financial statement audit. If you are quite astute, you will also note the reference to U.S. GAAP. This chapter will conclude with a discussion of global accounting issues.

5.2 The Development of GAAP

In one sense, GAAP traces its roots to the renaissance era when creative mathematicians conceived the double-entry system and the related self-balancing statements of account. However, modern efforts to bring structure and conformity are most clearly understood by considering a time line of events that were catalysts for institutionalization of GAAP development.

5.3 The 1929 Stock Crash and Great Depression

A dark moment in economic history was the collapse of the stock markets in 1929, and the ensuing shock waves that brought about business failures, unemployment, bankruptcies, and a prolonged period of economic difficulty. What you may not know is that it was preceded by several years of grand economic expansion. The introduction of assembly lines, electricity, phones, automation and other innovations created enhanced productivity and wealth. These opportunities for profit attracted large amounts of investment capital in pursuit of the hottest new concept. And, the stock markets reflected this excitement by climbing upward in what seemed to be an unstoppable phoenix. Toward the end of the expansion streak, the burgeoning supply of capital in pursuit of business opportunities surpassed the legitimate opportunities for its effective deployment, and businesses began to struggle to make the profits expected by investors. As you might suspect, some business began to stretch the limits of fair accounting in an effort to keep up a good front. Finally, though, economic truth prevailed, and investors were quickly unnerved. Capital took flight, and it was a long time before investors were willing to tread back into the capital markets.

5.4 The Securities and Exchange Commission

Prior to the mid-1930's, security markets were without significant regulation, and GAAP was not promulgated by any single authoritative body. In a depression-era effort to restore credibility to the capital markets, the U.S. Congress created the Securities and Exchange Commission (SEC). The SEC was charged with the administration of laws that regulate the reporting practices of companies whose stock is publicly traded. Today, U.S. public companies must register and report to the SEC on a continuing basis. Although the SEC has a heavy hammer it can bring to bear on the setting of accounting rules (e.g., the SEC issues occasional Staff Accounting Bulletins (SABs) that define certain accounting rules), it has instead elected to operate under a tradition of cooperation and largely defers to the private sector FASB for most accounting rules.

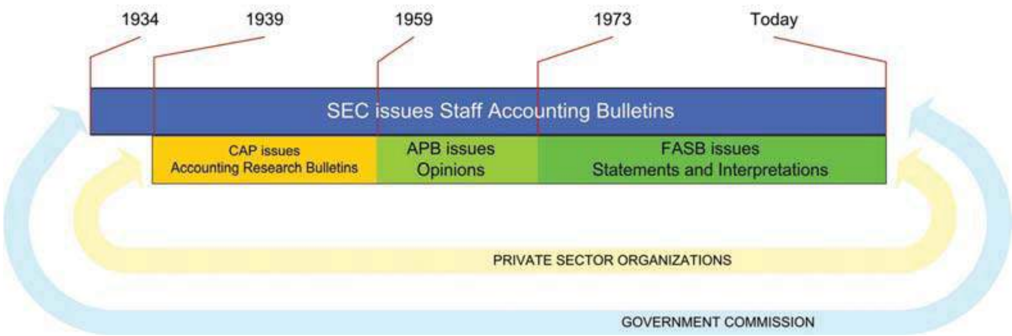
The SEC's deferral to the FASB may strike you as odd. Seemingly, a natural tendency of government regulation is toward expansion and dominance. However, most public policy makers have a keen sense that accounting is about fair presentation of economic activity and are remiss to allow government/political processes to gain a foothold on shaping GAAP. For example, it is easy to conceive that a political process could result in a rule that depreciation need not be recorded for companies having manufacturing plants in _________ (fill in the blank with your favorite locale); such companies would have an increase in accounting "profit" no matter how efficient or inefficient they were as producers. On a grand scale, this sort of political rule-making could distort the ability of investors to correctly allocate capital.

5.5 The FASB and its Predecessors

You already know that the Financial Accounting Standards Board (FASB) is the primary accounting rule-making body in the United States. The FASB has seven voting members, each bringing vast knowledge and experience to the rule-making process. These are well compensated individuals who are supported by a large research and administrative staff. FASB members must sever outside employment to maintain their independence. They are put in place by a foundation governed by a group of trustees, and their funding is from the foundation and other fees. Hopefully, these controls are sufficient to allow each Board member the autonomy necessary to act with the public interest at heart.

The FASB issues a variety of rules. Foremost among these are the Statements of Financial Accounting Standards (SFAS) and FASB Interpretations (FIN). But, there are also numerous other guiding documents that emanate from the FASB. Spend some time on the FASB web site to develop a full appreciation of the breadth and scope of the FASB's activities.

The FASB has been the primary accounting rule maker since the early 1970's. Prior to its creation, rules were set by the Accounting Principles Board (APB). The APB was created in 1959 by the American Institute of Certified Public Accounts (AICPA). The AICPA is a large association of professional accountants who are seeking to advance the practice of accounting. The APB issued its own authoritative pronouncements (called APB Opinions), some of which are still effective today. Before 1959, the duty of standard development fell on the shoulders of an AICPA committee known as the Committee on Accounting Procedure (CAP). CAP's rules were articulated in Accounting Research Bulletins (ARBs), and some of those are still effective today! CAP's origin can be traced to the late 1930's, in proximity to the timing of the creation of the SEC. Perhaps the following chart will put this discussion in historical context:



5.6 A More Recent Crisis of Reporting Confidence

A dark moment in economic history was the collapse of the stock markets in 1929, and the ensuing shock waves that brought about business failures, unemployment, bankruptcies, and a prolonged period of economic difficulty. What you may not know is that it was preceded by several years of grand economic expansion. The introduction of assembly lines, electricity, phones, automation inexpensive high speed computers, low cost global communication, the internet, highly efficient robotic manufacturing, and other innovations created enhanced productivity and wealth. These opportunities for profit attracted large amounts of investment capital in pursuit of the hottest new concept. And, the stock markets reflected this excitement by climbing upward in what seemed to be an unstoppable phoenix. Toward the end of the expansion streak, the burgeoning supply of capital in pursuit of business opportunities surpassed the legitimate opportunities for its effective deployment, and businesses began to struggle to make the profits expected by investors. As you might suspect, some business began to stretch the limits of fair accounting in an effort to keep up a good front. Finally, though, economic truth prevailed, and investors were quickly unnerved. Capital took flight, and it was a long time before investors were willing to tread back into the capital markets. Sound familiar?

What happened this time? For one thing, some businesses engineered complex financial transactions in a way that seemingly satisfied detailed accounting rules but did not really report economic reality (illegitimate swaps, special purpose entities, off-balance sheet financing, etc.). In addition, some auditors became fixated on systems evaluations while failing to perform sufficient detailed transaction analysis. Perhaps others auditors were simply swayed to ignore problems because of the generous fees they were generating for their services. The U.S. Congress again responded, and created the Sarbanes-Oxley Act of 2002 (SOX).

5.7 Sarbanes-Oxley

This extensive piece of legislation sought to cure a number of ills. It imposed stringent financial statement certification requirements by corporate officers, raised the fiduciary duty of corporate boards, imposed systematic ethics awareness, and placed a much greater burden on auditors to be more thorough. In addition, Section 404 of the Act requires public companies to implement a robust system of internal control; an independent auditor must issue a separate report on the effectiveness of this control system.

The Act also created a new regulatory body -- the Public Company Accounting Oversight Board (PCAOB). The PCAOB is a private-sector, non-profit corporation, charged with overseeing the auditors of public companies. Its mission is to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. You should carefully note that SOX mostly addresses issues about corporate reporting integrity (auditing, certifications, ethics, etc.); very little change was made in the structure by which GAAP is developed. One reason is that the most recent crisis in confidence had more to do with deficits in human behavior patterns than it did with inadequacies in GAAP.