# CHAPTER 2

**Case 2-1**

a. The FASB's conceptual framework study should provide benefits to the accounting community such as:

1. Guiding the FASB in establishing accounting standards on a consistent basis.

2. Determining bounds for judgment in preparing financial statements by prescribing the nature, functions, and limits of financial accounting and reporting.

3. Increasing users understanding of and confidence in financial reporting.

b. The two fundamental qualities that make accounting information useful for decision making are *relevance* and *faithful representation*.

Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value and confirmatory value and is material. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity’s financial report. Consequently, the FASB was not able to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

 Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena but also must faithfully represent the phenomena that it purports to represent. A perfectly faithful representation has three characteristics: *completeness, neutrality,* and *free from error*. Although perfection is difficult or even impossible to achieve, the objective is to maximize those qualities to the extent possible.

 A complete depiction should include all information necessary for a user to understand the phenomenon being depicted. For some items, a complete depiction also might entail explanations of significant facts about the quality and nature of the items, factors, and circumstances that might affect their quality and nature and the process used to determine the numerical depiction. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users’ decisions. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. Information that is free from error will result in a more faithful representation of financial results.

 *Comparability, verifiability, timeliness,* and *understandability* are the qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

 Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities also can be verified.

 Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information can continue to be timely long after the end of a reporting period because, for example, some users might need to identify and assess trends. Understandabilityinvolves classifying, characterizing, and presenting information clearly and concisely.

**Case 2-2.**

1. i. The Conceptual Framework Project is an attempt by the FASB to develop concepts useful in guiding the board in establishing standards and in providing a frame of reference for resolving accounting issues. Over the years this project first attempted to develop principles or broad qualitative standards to permit the making of systematic rational choices among alternative methods of financial reporting. Subsequently the project focused on how well these overall objectives could be achieved. The FASB has stated that it intends the Conceptual Framework Project to be viewed not as a package of solutions to problems but rather as a common basis for identifying and discussing issues, for asking relevant questions, and for suggesting avenues for research. The Conceptual Framework Project has resulted in the issuance of eight statements of Financial Accounting Concepts that impact upon financial accounting: No.1-Objectives of Financial Reporting by Business Enterprises (superseded); No.2-Qualitative Characteristics of Accounting Information (Superseded); No.3-Elements of Financial Statements of Business Enterprises (Superseded); No.5-Recognition and Measurement in Financial Statements of Business Enterprises; No.6-Elements of Financial Statements;” No. 7-“Using Cash Flow Information and Present Value in Accounting Measurements” and No. 8 “Conceptual Framework for Financial Reporting (Chapters 1 & 3).

ii. The FASB has been criticized for failing to provide timely guidance on emerging implementation and practice problems. During 1984 the FASB attempted to respond to this criticism by (1) establishing a task force to assist in identifying issues and problems that might require action, the Emerging Issues Task Force, and (2) expanding the scope of the FASB Technical Bulletins in an effort to offer quicker guidance on a wider variety of issues.

Emerging issues arise because of new types of transactions, variations in accounting for existing types of transactions, new types of securities, and new products and services. They frequently involve the company's desire to achieve "off balance sheet" financing or "off income statement" accounting.

The Emerging Issues Task Force was formed to assist the FASB in issuing timely guidance on these emerging issues. That is, the task force's responsibility is to identify emerging issues as they develop, investigate and review them, and finally to advise the board whether the issue merits its attention.

The members of the task force all occupy positions that make them aware of emerging issues. The current members include the directors of accounting and auditing from 11 public accounting firms (including all of the "Big Four"), two representatives from the Financial Executives Institute, one from the National Association of Accountants and the Business Roundtable, and the FASB's Director of Research who serves as Chairman.

 b. The Financial Accounting Standards Board, the Securities and Exchange Commission, and the American Institute of Certified Public Accountants have been criticized for imposing too many accounting standards on the business community. The Standards overload problem has been particularly burdensome on small businesses that do not have the necessary economic resources to research and apply all of the pronouncements issued by these sources. Those who contend that there is a standards overload problem base their arguments on two allegations.

1. Not all GAAP requirements arc relevant to small business financial reporting needs.

2. Even when they are relevant, they frequently violate the pervasive cost benefit constraint.

Critics of the standard-setting process for small business also assert that GAAP were developed primary to serve the needs of the securities market. Many small businesses do not raise capital in these markets therefore, it is contended that GAAP were not developed with small business needs in mind.

Some of the consequences of the standards overload problem to small business are as follows.

1. If a small business omits a GAAP requirement from audited financial statements, a qualified or adverse opinion may be rendered.

 2. The cost of complying with GAAP requirements may cause a small business to forgo the development of other, more relevant information.

3. Small CPA firms that audit smaller companies must keep up to date on all of the same requirements as large international firms, but cannot afford the specialists that are available on a centralized basis in the large firms.

 Many accountants have argued for differential disclosure standards as a solution to the standards overload problem. That is, standards might be divided into two groups. One group would apply to business regardless of size. The second group would be applied selectively only to large businesses, small businesses, or particular industries. For example, the disclosure of significant accounting policies would pertain to all businesses, whereas a differential disclosure such as earnings per share would be applicable only to large businesses.

**Case 2-3**

a. Quantitative data are helpful in making rational economic decisions. Stated differently, quantitative data aid the decision maker in making choices among alternatives, so that the actions are correctly related to consequences.

* 1. i. ASOBAT defined accounting as “the process of identifying, measuring, and communicating economic information to permit informed judgments and decision by users of the information.” Both this definition and Sprouse and Moonitz believe that communicating information is helpful for users to make rational decisions and informed judgments.
1. Similarly, *SFAC No. 8* states that accounting information should be useful for investment decision-making. The user should be able to use accounting information to make decisions about investing in a company.

**Case 2-4**

* 1. In describing continuity, Sprouse and Moonitz stated that in the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.
	2. No. Since a business is presumed to continue indefinitely, the value relevant to a purchaser is fair market value. This value measures the present value of future cash flows to the buyer. It is relevant for the buyer because the buyer presumes that the business will continue and thus will generate those future cash flows.
	3. No. A bankruptcy provides evidence that the business is not expected to remain in operation indefinitely. In this case, the assets that are reported in the company’s balance sheet should be measured at net realizable value.

**Case 2-5**

1. *SFAC No. 6* defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” If your company is using a building to produce automobiles, the probable future economic benefit is the expected inflow of resources from the sales of automobiles. This benefit accrues to the company who may then use them, if it wishes, to make more automobiles. The prior transaction that caused the asset to exist is the acquisition of the building.
2. In this case, the probable future economic benefit is the net realizable value that the company will receive when it sells the building. Again, the acquisition of the building is the result of a prior transaction or event.
3. In this case, the probable future economic benefit is the inflow of resources that will eventually flow into the company when it produces the automobiles. The transaction that caused the asset to exist was the acquisition of the building.

**Case 2-6**

In general, SFAC No. 5 attempts to set forth recognition criteria and guidance on what information should be incorporated into financial statements, and when this information should be reported. According to this Statement, a full set of financial statements for a period shows:

1. Financial position at the end of the period.

2. Earnings for the period.

3. Comprehensive income for the period.

4. Cash flows during the period.

5. Investments by and distributions to owners during the period.

The statement of financial position should provide information about an entity's assets, liabilities, and equity and their relationship to each other at a moment in time. It should also delineate the entity's resource structure major classes and amounts of assets and its financing structure-major classes and amounts of liabilities and equity. The statement of financial position is not intended to show the value of a business, but it should provide information to users wishing to make their own estimates of the enterprise's value.

The pronouncement then indicates that the building blocks to full disclosure are:

1. The scope of recognition and measurement

2. Basic financial statements

3. Areas directly affected by existing FASB standards

4. Financial reporting

5. All information useful for investment, credit, and similar decisions

Earnings is defined a measure of entity performance during a period. It measures the extent to which asset inflows (revenues and gains) exceed asset outflows. The concept of earning provided in SFAC No. 5 is similar to net income for a period in the then current practice. However, it excluded certain adjustments from earlier periods that are now recognized in the current period. It was expected that the concept of earnings would continue to be subject to the process of gradual change that has characterized its development.

In SFAC No. 5, the FASB attempted to broaden the scope of the measurements of the operating results of business enterprises by introducing the definition of comprehensive income as follows:

*Comprehensive income is the change in equity (net assets) of an entity during a period from transactions and events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.*

The relationship between earnings and comprehensive income was illustrated:

|  |  |
| --- | --- |
| Revenues | Earnings |
| Less: Expenses | Plus or minus cumulative accounting adjustments |
| Plus: Gains | Plus or minus other nonowner changes in equity |
| Less: Losses |  |
| = Earnings | = Comprehensive income |

SFAC No. 5 then proceeded to the discussion measurement and recognition. It defined measurement as the process of identifying the proper attribute of an event or transaction and of choosing the proper measurement scale. SFAC No 5 defined recognition as the process of formally recording an item into the financial statements of an entity as an element and indicated that an item and information about it should meet four recognition criteria and be recognized at the time these criteria are met (subject to the cost–benefit and materiality constraints).

1. Definitions. The item meets the definition of an element contained in SFAC No. 6 (Previously SFAC No. 3 at the time SFAC No. 5 was published).

2. Measurability. It has a relevant attribute, measurable with sufficient reliability.

3. Relevance. The information about the item is capable of making a difference in user decisions.

4. Faithful representation. Financial reports represent economic phenomena in words and numbers

**Case 2-7**

1. Employees meet the definition of an asset. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. Employees embody a probable future benefit that will contribute to future net cash flows. They will work so that the company can have revenues. The company will benefit because they control what the employees do on the job. Employment of the employees gave rise to the entity’s right to control the benefit.
2. No. According to *SFAC No. 5*, to report an asset in the balance sheet, it not only must meet the definition of an asset, but it must be capable of being measured.
3. i. The value would be more relevant because it would measure the expected future cash flows that the employees would be expected to generate. It would be less reliable because there is no precise method to measure the value of human capital. It can only be estimated. Therefore, two measurements made by two different measurers are unlikely to be the same.

 ii. Yes. Representational faithfulness means that the items in the balance reflect what they purport to be. If human capital is an asset, then reporting its estimated value would reflect the value of that asset and would as a result provide representational faithfulness.

**Case 2-8**

1. According to *SFAC No. 7* the bonds are distinguished by the uncertainty of their future cash flows. The bonds would sell at the present value of their future cash flows, discounted at the market rate of interest. The company with the better credit rating would yield a lower market rate, assuming that the stated rates for both companies are the same. So, if the stated rates are the same, Company A’s bond might be more valuable it its credit rating were better than Company B’s.
2. If both companies have the same credit rating, then the one reason that Company A’s bond would have a higher market value than would Company B’s bond would be that Company A’s bond has a shorter term than Company B’s bond. If they both have the same term, then Company A’s bond would sell for more than Company B’s bond if Company A were offering a higher stated interest rate.

**FASB ASC**

**FASB ASC 2-1 Use of Present Value**

The information on present value is contained in the FASB ASC at FASB ASC 820-10-55. It can be accessed through the glossary.

**FASB ASC 2-2 Conceptual Framework**

Search conceptual framework

Found under 605 Revenue Recognition
     10 Overall
     S99 SEC Materials

**FASB ASC 2-3 Decision-Maker Concept**

Search decision maker

10 hits

**FASB ASC 2-4 Understandability Concept**

Search understandability

Found under 715 c[ompensation—Retirement Benefits > 10 Overall > 10 Objectives](http://asc.fasb.org/section%26trid%3D2235023%26exactQuery%3Dunderstandability%20)

**FASB ASC 2-5 Relevance Concept**

Search relevance – 15 hits

**FASB ASC 2-6 Recognition and Measurement Guidance**

Search recognition and measurement-over 70 hits

**FASB ASC 2-7**

Reporting Comprehensive Income is contained in sections FASB ASC 220-10. It is found by searching comprehensive income.

**Currently Viewing:**

**220 Comprehensive Income**

**10 Overall**

**45 Other Presentation Matters**

**General**

**> Reporting Comprehensive Income**

**FASB ASC 2-8 Using Present Value**

Search present value-over 100 hits

**Room for Debate**

**Debate 2-1 A Question of Materiality**

Team 1: Arguments for capitalization of boxes.

1. Objectives of financial reporting

Decision usefulness requires that companies report the status of enterprise resources. The boxes provide future service potential. As such, they meet the definition of an asset found in SFAC No. 6. Hence, they are a resource that should be reported.

2. Definition of assets

SFAC No. 6 defines assets as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

The boxes are assets. They will provide future economic benefits for a particular entity (Roper Co). The company will use them for at least 10 years. They result from past transaction - a purchase.

3. Qualitative Characteristics

Relevance

Capitalization is relevant because it provides information about outcomes of past transactions or events. The user is informed that the boxes are assets. They were purchased by the company, and the company intends to use them over an extended period of time. Hence their cost is not a current period expense.

Faithfull Representation

Capitalization provides reliability. Because the boxes will be used over an extended period of time, they meet the definition of an asset found in SFAC No. 6. Hence, capitalization presents the economic facts and provides information that is representationally faithful. If they are assets, they should be reported as such, rather than expensed, a representation that would not report them as they purport to be. Also, capitalization of the cost would be neutral because it would provide an unbiased representation of the economic substance of the purchase transaction.

Team 2 Arguments against the capitalization of the boxes.

1. Materiality

Materiality was defined in SFAC No 2 as the threshold for recognition. When the dollar amount is small, the particular accounting treatment will not affect the decisions of an informed user. In this case, the cost of boxes is clearly immaterial, implying that they need not be capitalized as assets.

2. Cost Constraint

The benefits derived from capitalization should exceed the cost of capitalization. Since the cost of the boxes is not material, capitalization would not provide sufficient benefit, in terms of decision usefulness, to warrant this accounting treatment. Capitalization would require depreciation over the useful life of the boxes. This would require adjusting entries for a ten-year period. The amount of depreciation reported each period would be trivial and would have essentially no effect on earnings. Hence, the cost of the bookkeeping effort would be greater than the benefits, if any, derived.

3. Objectives of financial reporting

The primary objective of financial reporting is decision usefulness. Accounting information should provide information that is useful to investors, creditors and other users in making decisions regarding investing, lending, etc. This implies that accounting information is relevant to the decision-maker. Even though the boxes will last 10 years, the cost is immaterial and hence irrelevant.

4. Qualitative Characteristics of accounting information Relevance

As stated above, relevance means that the information provided will make a difference in the decisions of investors, creditors and other users. The expenditure is immaterial and as such, the accounting treatment is irrelevant, and capitalization is irrelevant.

**Debate 2-2 The Need for A Universally Accepted Theory of Accounting**

Team 1:

A universally accepted theory of accounting is needed for the development of internally consistent accounting principles. Accounting practices have developed in response to changing economic conditions and, in some cases, in response to what are perceived as crises. For example, SFAS No. 114, was prompted to inconsistent practices of reporting impaired loans, and SFAS No. 94 was prompted by off-balance sheet recognition of lease liabilities. This piece-meal, reactionary approach to accounting has resulted in standards that are not only internally inconsistent, but are also inconsistent with international standards.

A theory of accounting would provide a common basis for identifying and discussing issues. This is the goal of the FASB’s conceptual framework project. Such a theory could be used to help narrow the number of accounting choices currently available to management, thereby reducing management’s ability to manipulate financial statements to suit their personal, or company goals. As such, it could help guide the development of neutral standards, which aids in the allocation of scarce resources and the efficient functioning of capital markets

In addition to helping reduce managerial bias in reporting results of operations and financial position, a universally accepted theory of accounting could serve to reduce personal biases in the standard setting process itself. Reliance on such a theory could result in the development of those standards that are consistent with the theory itself.

A universal theory of accounting would be consistent with the concepts-based approach to accounting standards described by the American Accounting Association. A universally accepted accounting theory could provide a basis for standard setting that would satisfy the following.

1. Economic substance, not the form, of a given transaction should guide its financial reporting.
2. The mapping between economic substance of a transaction and its financial statement representation could be supported by a common theoretical basis, thereby providing understandability and a common basis of comparison across companies and over time.

Team 2:

To date, no standard setting body has developed a universally accepted theory of accounting. An argument against a universal theory of accounting can be based on the complexity of the phenomena that financial statements purport to represent. According to *SATTA*, while there has been general agreement that the purpose of financial accounting is to provide economic data about accounting entities, divergent theories have emerged because of the way different theorists specified users of accounting data and the environment. For example, *users* might be defined either as the owners of the accounting entity or more broadly to include creditors, employees, regulatory agencies, and the general public. Similarly, the environment might be specified as a single source of information or as one of several sources of financial information.

*SATTA* discussed why none of the approaches to theory had gained general acceptance, *SATTA* raised six issues.

1. *The problem with relating theory to practice*. The real world is much more complex than the world specified in most accounting theories. For example, most theory descriptions begin with unrealistic assumptions such as holding several variables constant.

2. *Allocation problem*. Allocation is an arbitrary process. For example, the definition of depreciation as a *rational* and *systematic* method of allocation has led to a variety of interpretations of these terms.

3. *The difficulty with normative standards.* Normative standards are desired states; however, different users of accounting information have different desired states. As a result, no set of standards can satisfy all users.

4. *The difficulties in interpreting security price behavior research*. Market studies (such as the efficient market studies discussed in Chapter 4) attempt to determine how users employ accounting numbers. These studies have attempted to control for all variables except the one of interest, but there have been disagreements over whether their research designs have actually accomplished this goal.

5. *The problem cost-benefit considerations accounting theories*. A basic assumption of accounting is that the benefits derived from adopting a particular accounting alternative exceed its costs. However, most existing theories do no indicate how to measure benefits and costs.

6. *Limitations of data expansion*. At the time *SATTA* was published, a view was emerging that more information is preferable than less. Subsequent research has indicated that users have a limited ability to process accounting information. (The issue of information processing is discussed in Chapter 4.)

The FASB’s conceptual framework project (CPF) cannot be viewed as a universally accepted theory of accounting, nor does the FASB purport that it is. The FASB intends the CFP to be viewed not as a package of solutions to problems but rather as a common basis for identifying and discussing issues. For example, *SFAC No. 8* can be described as the goal to guide practice. It does not even directly affect practice. Rather, the *SFAC*s affect practice only by means of their influence on the development of new accounting standards.

So, rather than a universally accepted theory of accounting, we have settled for the CFP, which does not provide all the answers, but has been relied upon to aid the standard-setting process. And, it has provided a basis to narrow alternatives and to eliminate those that are inconsistent with it. It also is used to guide the development of neutral standards, which aids in the allocation of scarce resources and the efficient function of capital markets

In other words, we can operate with concept-based accounting standards by relying upon the CFP rather than a universally accepted theory of accounting. The CFP has been criticized and will evolve to address criticism from the SEC that the objectives of the standards that are derived from it need to be more clearly defined, implementation guidance needs to be improved, scope exceptions need to be reduced and the asset-liability approach to standard setting should be retained

**WWW**

**Case 2-9**

1. An example of the way Veblen influenced Scott is contained in Lawrence and Stewart:

“Veblen believed men acquired habits of thought unconsciously and the thoughts men get are shaped by their daily activities. Any change in daily activities, such as that occasioned by the Industrial Revolution, would be expected to lead to a major shift in previous habits of thought. Scott saw the scientific method as the new habit of thought coming to dominance.”

1. Scott’s hierarchy of postulates and principles were:

*Orientation Postulate*. Accounting is based on a broad consideration of the current social, political, and economic environment.

*The Pervasive Principle of Justice*. The second level in Scott’s conceptual framework was justice, which was seen as developing accounting rules that offer equitable treatment to all users of financial statements.

*The Principles of Truth and Fairness*. Scott’s third level contained the principles of truth and fairness. Truth was seen as an accurate portrayal of the information presented. Fairness was viewed as containing the attributes of objectivity, freedom from bias, and impartiality.

*The Principles of Adaptability and Consistency*. The fourth level of the hierarchy contained two subordinate principles, adaptability and consistency. Adaptability was viewed as necessary because society and economic conditions change; consequently, accounting must also change. However, Scott indicated a need to balance adaptability with consistency by stating that accounting rules should not be changed to serve the temporary purposes of management.

**Case 2-10**

a. The project

1. Focused on changes in the environment since the original frameworks were issued, as well as omissions in the original frameworks, in order to efficiently and effectively improve, complete, and converge the existing frameworks.

2. Gave priority to addressing and deliberating those issues within each phase that were likely to yield benefits to the Boards in the short term—that is, cross‐cutting issues that affect a number of their projects for new or revised standards. Consequently, work on several phases of the project was to be conducted simultaneously, and the Boards expected to benefit from work being conducted on other projects.

3. Initially considered concepts applicable to private‐sector business entities. Later, the Boards were to jointly consider the applicability of those concepts to private‐sector not‐for‐profit organizations.

1. The eight phases of the CFP, are:

A. Objectives and qualitative characteristics

B. Definitions of elements, recognition, and derecognition

C. Measurement

D. Reporting entity concept

E. Boundaries of financial reporting, and presentation and disclosure

F. Purpose and status of the framework

G. Application of the framework to not‐for‐profit entities

**Case 2-11**

**Qualitative Characteristics**

The qualitative characteristics are described in Chapter 3 of SFAC *No. 8* and distinguish between better (more useful) information and inferior (less useful) information. These qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision usefulness of information. The two fundamental qualities that make accounting information useful for decision making are *relevance* and *faithful representation.*

**Case 2-12**

The answer to this case requires a visit to the FASB’s home page at the time it is assigned.

**Case 2-13**

The answer to this case requires a visit to the FASB’s home page at the time it is assigned.

**Case 2-14**

The answer to this case requires a visit to the FASB’s home page at the time it is assigned.

**Case 2-15**

During the early 2000s, the FASB noted that concerns were being expressed about the quality and transparency of accounting information. One of the main concerns was the increasing complexity of FASB standards. The Board concluded that much of the detail and complexity associated with accounting standards was the result of rule-driven implementation guidance, which allows “accounting engineering” to get around the rules thereby allowing companies to circumvent the intent and spirit of the standards.

Additionally, the FASB noted that its Conceptual Framework has not provided all of the necessary tools for resolving accounting problems. This deficiency was attributed to the fact the certain aspects of the Conceptual Framework are internally inconsistent and incomplete. As a result, the Board is considering the need to develop an overall reporting framework similar to *International Accounting Standard No. 1*. Such a framework would provide guidance on issues such as materiality assessments, going concern assessments, professional judgment, consistency and comparability. It would also allow few, if any, exceptions and fewer implementation guidelines.

To illustrate the difference between rules based and principles based standards, the standard setting process can be viewed as a continuum ranging from highly rigid standardson one end to general definitions of economics-based concepts on the other end. For example, consider accounting for the intangible asset goodwill. An example of the extremely rigid end of the continuum is the previously acceptable practice:

Goodwill is to be amortized over a 40-year life until it is fully amortized.

This requirement leaves no room for judgment or disagreement about the amount of amortization expense to be recognized. Comparability and consistency across firms and through time is virtually assured under such a rule. However, the requirement lacks relevance because it does not reflect the underlying economics of the reporting entity, which differ across firms and through time.

At the opposite end of the continuum is the FASB’s new rule:

Goodwill is not amortized. Any recorded goodwill is to be tested for impairment and if impaired, written down to its current fair value on an annual basis.

This requirement necessitates the application of judgment and expertise by both managers and auditors. The goal is to record the economic deterioration of the asset, goodwill

**Case 2-16**

At a joint meeting in Norwalk, Connecticut, on September 18, 2002, the FASB and the IASB both acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting (the Norwalk Agreement). The two boards pledged to use their best efforts to (1) make their existing financial reporting standards fully compatible as soon as is practicable and (2) coordinate their future work programs to ensure that once it is achieved, compatibility is maintained. The international convergence project has three major aspects: (1) the Financial Statement Presentation Project, (2) the Conceptual Framework Project, and (3) the Standards Update Project.

**Case 2-17**

 a. FASB’s Conceptual Framework should provide benefits to the accounting community such as:

1. Guiding the FASB in establishing accounting standards on a consistent basis.

2. Determining bounds for judgment in preparing financial statements by prescribing the nature, functions and limits of financial accounting and reporting.

3. Increasing users’ understanding of and confidence in financial reporting.

1. The most important quality for accounting information as usefulness for decision making. Relevance and faithful representation are the primary qualities leading to this decision usefulness. Usefulness is the most important quality because, without usefulness, there would be no benefits from information to set against its costs.
2. There are several key characteristics or qualities that make accounting information desirable. The importance of three of these characteristics or qualities is discussed below.

**Understandability**—information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it, or who misuse it.

**Relevance**—the accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations (including is material).

**Faithful representation—**the faithful representation of a measure rests on whether the numbers and descriptions matched what really existed or happened, including completeness, neutrality, and free from error.

(Note to instructor: Other qualities might be discussed by the student, such as enhancing qualities. All these qualities are defined in the textbook).

## Financial Analysis Case

The solutions to the financial analysis depend upon the company and year selected.

# CHAPTER 3

**Case 3-1**

The greatest advantage attributed by advocates of the harmonization of accounting standards is that international financial information would be comparable. Consequently, the concerns about the reliability of foreign financial statements would be alleviated; and the free flow of international investments would be enhanced. Harmonization is also seen as resulting in improved risk analysis which would result in the lowering of interest rates.

Another advantage is that the time and money now spent to consolidate divergent financial information would be saved. Presently, many adjustments, often arbitrary and sometimes base on faulty assumptions are needed.

A third advantage would be the tendency for accounting standards to be raised to the highest level to be consistent with local economic, legal and social conditions. This is seen as overcoming the presently deficient accounting information presently supplied by developing economies.

Critics of harmonization hold that it is neither practical nor perhaps even valuable. They point to the spotty record of domestic standard setters in the United States where they are well-funded and widely supported. They also argue that a well-developed global capital market already exists and has evolved without uniform accounting standards; consequently, there is no compelling need to harmonize standards. Other critics indicate that widespread cultural differences, especially language, make harmonization an almost impossible goal. Finally, some individuals feel that the issue of legal enforcement of standards may be an insurmountable problem

**Case 3-2**

1. A company may take different approaches in preparing financial statements for users in foreign companies. These are as follows:

1. Send the same set of financial statements to all users (domestic or foreign). This is, in essence, a do-nothing approach, and puts the entire burden of understanding the financial reports on the user. On the other hand, if a company raises very little capital outside its home country, the added expense of taking another approach may not be worthwhile. Also, some companies using foreign investment may sell directly to sophisticated users who are able to use the unadjusted financial statements such as pension funds.

1. Translate the financial statements sent to foreign users into the language of the foreign nation's users. This is termed convenience translation and is a relatively inexpensive method of accommodation of foreign users. The user is saved the inconvenience of dealing with a foreign language, but still must understand another country's accounting practices and monetary unit. This is a low-cost alternative to the do-nothing approach.

 3. Translate the financial statements sent to foreign users into the foreign nation's language and currency. This is termed preparing convenience statements. Although this process makes the statements easy for foreign users to read, it may mislead them into believing that the statements were prepared using the foreign country's accounting principles.

 4. Prepare two sets of financial statements, one using the home country language, currency and accounting principles, the second using the language, currency and accounting principles of the foreign country’s users. This is a large step in the direction of accommodating foreign users and should only be considered when the perceived benefits exceed the costs.

 5. Prepare one set of financial statements based on worldwide accepted accounting principles. This is a utopian approach. At the present time there are no worldwide accepted accounting standards. This approach can only be taken if international accounting standards are harmonized.

1. No correct answer. Asks for an opinion.

**Case 3-3**

a. The IASB was formed to develop worldwide accounting standards. In 2001 it was replaced by the International Accounting Standards Board. Its purpose was to develop worldwide accounting standards.

b. The IASC attempts to achieve its objectives through the formulation and publication of accounting standards to be observed in the presentation of financial statements. The IASC also attempts to use its membership in achieving its objectives. It attempts to promote the worldwide acceptance and observance of the accounting standards that it publishes. The members of the IASC agree to support the standards and to use their best endeavors to ensure that published financial statements comply with the standards, to ensure that auditors enforce the standards, and to persuade governments, stock exchanges and other bodies to support the standards. However, the IASC has no enforcement authority and must rely on the "best endeavors" of its members.

**Case 3-4**

a. The IASB has noted that its standards may be used

 1. As national requirements

 2. As the basis for some or all national requirements

 3. As an international benchmark for countries that develop their own requirements

 4. By regulatory authorities for domestic and foreign companies

 5. By companies themselves

b. The IASB has no enforcement authority and must rely on the best endeavors of its members

c. The globalization of business and finance has led more than 12,000 companies in approximately 166 jurisdictions to adopt IFRS.

**Case 3-5**

* 1. In 1989, the IASC issued its initial conceptual framework titled “Framework for the Preparation and Presentation of Financial Statements.” In 2010, the IASB and FASB issued a joint revision to their conceptual frameworks titled by the IASB *The Conceptual Framework for Financial Reporting*. However, changed pri­or­i­ties and the slow progress of the project led to it being abandoned in 2010 after only Phase A of the joint project had been finalized and in­tro­duced into the existing IASB and FASB frameworks as Chapters 1 and 3 in 2010. Subsequently, in 2011 the IASB implemented an agenda consultation initiative (Discussed earlier). Many of the par­tic­i­pants in this initiative suggested re­ac­ti­vating the conceptual framework project due to the large number of conceptual issues associated with many of its current projects. As a result, the IASB added the conceptual framework project back to its agenda in 2012, as an IASB-only project. This project is no longer aimed at a sub­stan­tial revision of the framework but rather is focused on those topics that are not yet covered. The current project focuses on the following five topics:

• Reporting entity

• Presentation (including OCI)

• Disclosure

• Elements

• Measurement

A Dis­cus­sion Paper covering all aspects of the project was published in 2013, followed by two Exposure Drafts one covering the Conceptual Framework itself, and one covering ref­er­ences to the Conceptual Framework in other IASB pro­nounce­ments. The IASB’s goal ass to make significant improvements to the *Conceptual Framework* as soon as possible.

* 1. A revised Conceptual Framework (CF) was issued in 2018. It contains an introduction and eight chapters as follows:

Chapter 1 - The objective of general-purpose financial reporting.

Chapter 2 - Qualitative characteristics of useful financial information.

Chapter 3 - Financial Statements and the reporting entity.

Chapter 4 - The elements of financial statements.

Chapter 5 - Recognition and Derecognition.

Chapter 6 - Measurement.

Chapter 7 - Presentation and disclosure.

Chapter 8 - Concepts of capital and capital maintenance.

**Case 3-6**

a. The IASC’s revised Framework for the Preparation of Financial Statements describes qualitative characteristics as the attributes that make the information provided in financial statements useful. The following four principal qualitative characteristics were defined.

* Comparability - Information about a reporting entity is more useful if it can be compared with a similar in-formation about other entities and with similar information about the same entity for another period or an-other date.
* Verifiability - Verifiability helps to assure users that information represents faithfully the economic phenomena it purports to represent.
* Timeliness - Information is available to decision-makers in time to be capable of influencing their decisions.
* Understandability - Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information with diligence.

b. The qualitative characteristics identified by the FASB Conceptual Framework in SFAC No. 8 were described as a hierarchy of accounting qualities. As such they were more specific than those identified by the IASC.

**Case 3-7**

a. SFAC 8 defines comparability as the qualitative characteristic that enables users to identify and understand similarities in, and differences among items. Making comparisons is normally a quantitative assessment of those characteristics. Such comparisons are valid only if the measurements used reliably represent the characteristic that is being compared. Moreover, comparability cannot be achieved without consistency of inputs and classification.

 Comparability can refer to comparisons across time or between or among business entities. The usefulness of accounting information of an enterprise is greatly enhanced when it can be compared to similar information of another enterprise or to similar information of the same enterprise for some other reporting period. The purpose of making such comparisons is to detect and explain similarities or differences.

 The financial statements of a U.S. company’s operating in a foreign country, which allowed fixed assets to be valued on balance sheets at current value, would not be comparable to the financial statement of companies in those countries. Comparability implies that measurements of two companies being compared to each other be made in the same way. It would be difficult to directly compare the fixed assets of a company that measures the assets at historical cost with one that measures fixed assets at current value.

1. The user should be able to rely upon accounting information. Accounting information is reliable when users can depend on it to represent the economic conditions and circumstances it purports to represent. Reliability implies that the accounting information is representationally faithful, verifiable, and neutral.

 According to SFAC No. 8, faithful representation is correspondence or agreement between a measure or description and the phenomenon it purports to represent. Accounting phenomena to be represented and reported are economic resources and obligations and the transactions and events that change those economic resources and obligations.

 Verifiability means that several measurers are likely to obtain the same measure. This quality contributes to the usefulness of accounting information because verification should provide a significant degree of assurance that accounting measures represent what they purport to represent. It is successful in minimizing measurer bias, but not necessarily measurement bias. As a result, verifiability does not guarantee that amounts reported are in fact representationally faithful because verification cannot guarantee the appropriateness of the accounting method selected. It can only guarantee consensus among different measurers.

 Neutrality means that in either formulating or implementing accounting standards, the primary concern should be the relevance and reliability of the information being provided, not the effect that the accounting standards will have on a particular interested party. That is, accounting information should be free from bias toward a predetermined result. Neutrality implies that accounting information reports economic activity and financial position as faithfully as possible without attempting to influence behavior in some particular direction. Accounting information that is not neutral loses credibility.

 Amounts reported for property plant and equipment would be more reliable. Current cost requires estimates and some educated guesswork, particularly with regard to fixed assets which do not have a ready resale market. Historical cost-based amounts rely on historical transactions which provide objective balance sheet measures. Although some discrepancies may still occur between different measurers due to estimating useful life or salvage value, and even different accounting approaches to cost allocation, the historical cost-based amounts have greater reliability because they are verifiable and objectively determined.

c. Relevant accounting information is capable of making a difference in a decision by facilitating user predictions about outcomes of past, present, and future events or by confirming or correcting expectations. Hence, relevant information has predictive and feedback value. Moreover, to be relevant to the decision at hand, the information must be timely. It must be provided when it is needed. Thus, timeliness is an ancillary aspect of relevance because information needs to be available to the decision-maker before it loses its capacity to influence decisions.

 The student could argue for either approach as being relevant.

 Current cost would be relevant in evaluating a company from a physical capital maintenance perspective. It would provide a measure of what it would cost to replace the physical capacity of existing assets. Alternatively, the student could argue that historical information is more objective and reliable and provides information consistent with the stewardship function of accounting and the financial capital maintenance concept of income.

**Case 3-8**

1. Under IFRS No. 1, entities must explain how the transition to IASB standards affects their reported financial position, financial performance, and cash flows. IFRS No. 1 requires an entity to comply with each IFRS that has become effective at the reporting date of its first financial statements issued under IASB standards. The following principles apply:

1. Recognize all assets and liabilities whose recognition is required under existing IFRSs.

2. Do not recognize items as assets or liabilities when existing IFRSs do not allow such recognition.

3. Reclassify assets, liabilities, and equity as necessary to comply with existing IFRSs.

4. Apply existing IFRSs in measuring all recognized assets and liabilities.

b. The amendments to *IAS No. 1* contained in the 2014 Disclosure Initiative encourage companies to apply professional judgment in determining what information to disclose and how to structure it in their financial statements. The key provisions of the amendments include:

1. Materiality — Clarifies that entities should not obscure information by aggregating or providing immaterial information and that materiality considerations apply to all parts of the financial statements, even when a standard requires a specific disclosure.
2. Statement of financial position and statement of profit or loss and other comprehensive income — Explains that the list of line items to be presented in these statements can be disaggregated and aggregated as relevant and that an entity’s share of other comprehensive income of equity-accounted associates and joint ventures should be presented in the aggregate as a single line item according to whether the share will subsequently be reclassified as profit or loss.
3. Notes — Add examples of possible ways to arrange the notes to clarify that entities should consider understandability and comparability when determining the order of the notes and to demonstrate that the notes need not be presented in the order listed in paragraph 114 of *IAS No. 1*. The IASB also removed guidance and examples related to the identification of significant accounting policies that were perceived as potentially unhelpful.

**Case 3-9**

a. Since General Motors and Ford use LIFO, inventory in their balance sheets will reflect old costs. These costs will not represent recent costs and could be many years old. As a result, it could be argued that these balance sheet figures in no way purport to reflect the status of these resources at the balance sheet date and hence are useless for investor decision-making. On the other hand, Honda and Daimler-Benz use FIFO. Their inventory balances would reflect recent purchase prices which would more closely reflect the current value of the inventory at the balance sheet date. Although these values would be based on cost, they would be closer to replacement cost than what would be reported under LIFO and hence more relevant to decisions regarding the financial status of the enterprise.

b. If two estimates of an amount that is to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate. As a result, accountants tend to recognize losses more often than gains.

 Under the assumption that price rise rather than fall, General Motors, Chrysler, and Ford provide more conservative accounting information as it relates to inventory. Each of these companies uses LIFO. LIFO matches recent, higher costs with revenues, resulting in lower reported profits and lower asset values that Honda and Daimler-Benz. However, in recent years this conclusion is tempered by the incidence of relatively low inflation.

**FASB ASC 3-1 IASB and GAAP**

Search “Generally accepted accounting standards”

105-10-05 Indicates that IASB standards are not presently considered GAAP

**FASB ASC 3-2 FASB ASC 3-2 Share-Based Payments**

Information on stock compensation is contained in FASB ASC 718-10-S99. It is accessed through the share-based payment topic

**Room for Debate**

**Debate 3-1 Principles of Consolidation**

Team 1

According to the conceptual framework, financial statements should be relevant, reliable, comparable, and understandable. Investors should be able to understand the financial information of companies that operate in foreign countries. They should be able to compare the financial results across international boundaries. If companies throughout the world prepare financial statements using the same, or at least similar accounting principles and practices, comparability will be among companies would be greatly enhanced. Moreover, the investor would better understand financial results if companies use similar, and internally consistent accounting approaches.

Both US GAAP and the IASB define assets as having probable future benefit and as resources that are controlled by the entity. Even though we don’t agree that the assets of one entity should be reported by another entity if we cannot control through our voting rights, consolidation of those assets of controlled entity would provide comparability internationally. Improved decision making would occur because it would no longer be necessary to interpret foreign financial statements and because comparability would be improved.

Also, if the US were to increase harmonization of their accounting standards with the IASB, due to its status as a world leader, economically and otherwise, it would aid in the IASB’s efforts to promote worldwide acceptance and observance of international accounting standards. The result would be an enhanced general acceptability of international accounting standards. If general acceptance and use of international accounting standards is increased in other countries, the result would be not only enhanced comparability, but increased transparency of financial reporting worldwide. Moreover, the increase transparency would provide more relevant information for user decision making. Reliability would also be enhanced because more preparers would conform to accounting practices, based on acceptable, unbiased measurement methods.

Team 2

We do not believe that harmonization of accounting standards should be the paramount consideration when setting accounting standards. Accounting standards should be based on the U.S. conceptual framework. According to the conceptual framework, financial statements should be understandable, reliable, relevant, and as a result, aid investors to make better decisions. If an international accounting standard does not meet those criteria, it should not be adopted by the US. In other words, harmonization should not be our primary goal, providing relevant, transparent financial statements should be.

We do not believe that a company should report assets that it does not control by exercise of voting rights. An investee company is a separate legal entity. Even though its decision making may be influenced by a large minority stockholder, that stockholder can be over-ruled by the majority. If so, the stockholder does not, in fact, maintain control over the assets of the investee company and those assets do not meet the definition of providing future benefit to the minority investor because their use may not benefit the minority investor. If so, those assets not only will not meet the conceptual framework’s definition of an asset, consolidating those assets on the parent company balance sheet would result in reporting items that are not representationally faithful. Thus, the resulting consolidated balance sheet could not be viewed as containing items, all of which are relevant to users.

**WWW**

**Case 3-10**

1. The SEC’s rationale for this decision was to foster the adoption of a set of globally accepted accounting standards.
2. An American Accounting Association committee concluded that eliminating the reconciliation requirement was premature. The committee noted that the decision to eliminate the 20-F reconciliation requirement for a subset of foreign-private issuers must be based on at least one of the following premises:
3. U.S. GAAP and IFRS are, at a minimum, informationally equivalent sets of accounting principles, or
4. Investors can reconstruct consistent and comparable U.S.-GAAP-based summary accounting measures from IFRS financial statements.

The committee noted the following points in support of its conclusion:

1. Material reconciling items exist between U.S. GAAP and IFRS and the reconciliation currently reflects information that participants in U.S. stock markets appear to impound into stock prices.
2. In international contexts, U.S. GAAP and IAS/IFRS appear to possess information attributes of high-quality accounting standards \_e.g., value relevance or mitigation of information asymmetry; however, U.S. GAAP appears to be preferred by U.S. investors.
3. Cross-country institutional differences will likely result in differences in the implementation of any single set of standards. Thus, IFRS may be a high-quality set of reporting standards pre-implementation but the resulting, published financial statement information could be of low quality, given inconsistent cross-border implementation practices.
4. Legal and institutional obstacles inhibit private litigation against foreign firms in the United States, and the SEC rarely undertakes enforcement actions against cross-listed firms. In the absence of a reliable enforcement mechanism, even high-quality accounting standards can yield low-quality financial reporting.
5. Differential implementation of standards across countries and differential enforcement efforts directed toward domestic and cross-listed firms creates differences in financial reporting even with converged standards. Whether the required reconciliation mitigates differences in implementation or improves compliance is an open issue; however, the SEC should understand the role of the reconciliation in mitigating differences in implementation and compliance before it is eliminated.
6. Despite the cost associated with preparing the reconciliation and satisfying the other listing requirements, evidence suggests that non-U.S. firms garner financial benefits from listing on U.S. exchanges and that the net benefits of a U.S. listing have not been eroded in recent years.
7. Harmonization of accounting standards could be beneficial to U.S. investors if it yields greater comparability and if IFRS provides information U.S. investors prefer for their investment decisions. Harmonization appears to be occurring via the joint standard-setting activities of the FASB and the IASB; thus, special, statutory intervention by the SEC appears to be unnecessary.

**Case 3-11**

Some of the factors that influence the development of a country’s accounting practices are:

* + 1. **Level of Education** - There tends to be a direct correlation between the level of education obtained by a country’s citizens and the development of the financial accounting reporting practices in that country.
		2. **Political System**- The type of political system (socialist, democratic, totalitarian, etc.) can influence the development of accounting standards and procedures.
		3. **Legal System -** The extent to which a country’s laws determine accounting practice influences the strengths of that country’s accounting profession.
		4. **Economic Development -** The level of a country’s economic development influences both the development and application of its financial reporting practices

**Case 3-12**

The IASB trustees’ duties include the following:

1. Appointing the members of the Board, including those who will serve in liaison capacities with national standard setters, and establishing their contracts of service and performance criteria

2. Appointing the members of the Standing Interpretations Committee and the Standards Advisory Council

3. Reviewing annually the strategy of the IASB and its effectiveness

4. Approving annually the budget of the IASB and determining the basis for funding

5. Reviewing broad strategic issues affecting accounting standards, promoting IASB and its work, and promoting the objective of rigorous application of IASs, provided that the trustees shall be excluded from involvement in technical matters relating to accounting standards

6. Establishing and amending operating procedures for the Board, the Standing Interpretations Committee, and the Standards Advisory Council (SAC)

7. Approving amendments to this constitution after following a due process, including consultation with the SAC and publication of an exposure draft for public comment.

**Case 3-13**

a. The objectives of the IFRS Foundation are:

1. To develop, in the public interest, a single set of high-quality, understandable, enforceable, and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high-quality, transparent, and comparable information in financial statements and other financial reporting to help investors, other participants in the world’s capital markets, and other users of financial information make economic decisions.

2. To promote the use and rigorous application of those standards.

3. In fulfilling the objectives associated with the first two objectives, to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings.

4. To promote and facilitate adoption of IFRSs, being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

b. Some other issues addressed in the IASB constitution are:

1. How the organization is governed
2. The duties of the trustees, and their selection process
3. The responsibilities of the Monitoring Board
4. The composition, qualifications, and duties of the IASB
5. The composition, qualifications, and duties of the IFRS Interpretations Committee
6. The composition, qualifications and duties of the IFRS Advisory Council

**Case 3-14**

The ASAF was established to:

* Support the IFRS Foundation in its objectives, and contribute towards the development, in the public interest, of a single set of high quality understandable, enforceable and globally accepted financial reporting standards to serve investors and other market participants in making informed resource allocations and other economic decisions;
* Formalize and streamline the IASB’s collective engagement with the global community of national standard-setters and regional bodies in its standard setting process to ensure that a broad range of national and regional input on major technical issues related to the IASB’s standard setting activities are discussed and considered; and
* Facilitate effective technical discussions on standard-setting issues, primarily on the IASB’s work plan, but which may include other issues that have major implications for the IASB’s work, in sufficient depth, with representatives at a high level of professional capability and with a good knowledge of their jurisdictions/regions

**Case 3-15**

The structure of the IASB is as follows:



**Case 3-16**

The solution for this case requires a review of the IASC’s webpage at the time it is assigned.

***Financial Analysis Case***

The answer to this case depends on the company selected.