

CHAPTER 1

QUESTIONS

1. The users of accounting information can be divided into two groups: internal users, who make decisions directly affecting the internal operations of an enterprise, and external users, who use the information to make decisions concerning their relationships with the enterprise. Members of the latter group include creditors, investors, government, and the general public. Both types of users benefit by receiving information needed to make economic decisions. Generally, accounting information is used to help make decisions that affect the allocation of scarce resources, including labor, materials, and capital.
2. Because almost all resources used in the world are limited in quantity, these resources must be allocated to specific activities. Accounting information can be used to determine the profitability of activities relative to the using up of resources. By structuring the accounting information in different ways, measurements can be reported that will suggest alternative ways to allocate the resources to better meet the goals and objectives of both society as a whole and specific economic units in particular.
3. Accounting information is of most value in making decisions that will affect the future. There are many examples of how accounting information can be used to assist in this process. Three examples follow:
 - (a) Creditors must evaluate a company's ability to repay money borrowed in the present at specific dates in the future. Past accounting information can be used to forecast whether the future cash flows will be sufficient to meet the repayment schedule.
 - (b) Investors enter into investment arrangements that are expected to produce revenue streams that will meet their needs. Projections of expected cash flows of a company can indicate the likelihood of a company's paying future dividends equal to those needs.
 - (c) Management must use planning to realize the goals and objectives of the company. A key ingredient in any planning process is a budget that projects the inflows and outflows of resources over future time periods. The base for this information is past accounting information that establishes patterns and trends most likely to continue into the future.
4. Management accounting is concerned with the information required by management as a basis for making short- and long-term operating decisions. Financial accounting is concerned with information reported to external users, primarily investors, and creditors. While some of the information required by these different users could be the same, internal accounting reports generally contain more detail than external reports. The added detail assists management in making specific decisions. The accounting system is generally designed to meet the needs of both groups, although accounting personnel may specialize in one or the other areas.
5. The general-purpose financial statements are made up of the following five items:
 - Balance sheet
 - Income statement
 - Statement of cash flows
 - Explanatory notes to the financial statements
 - Auditor's opinion
6. An accountant is generally considered to be the person responsible for recording, summarizing, reporting, and analyzing quantitative financial information. Thus, the accountant is thought of as the preparer of financial statements. The independent auditor examines the financial statements prepared by the accountant and expresses an expert opinion as to the fairness of the statements and their adherence to generally accepted accounting principles. Thus, the auditor adds credibility to the financial statements prepared by the accountant. An auditor must have both good accounting skills and expertise in evidence gathering and evaluation. Considered broadly, the word *accountant* covers all specialties with a background in the discipline of accounting, including auditors, tax specialists, and consultants.

7. Independent audits are necessary to add credibility to the financial statements prepared by management. A significant portion of the productive activity in the United States is conducted by corporations. Corporate owners (stockholders), particularly those in large publicly held corporations, are often investors who are not involved in enterprise operations. Management assumes responsibility for operations and has control over the information reported to stockholders and other external users. It is the auditor's responsibility to review management's reports and to decide independently whether the reports indeed represent the actual conditions existing in the enterprise.
8. Accounting grew very rapidly as a result of the Industrial Revolution. Many diverse accounting methods were developed by companies, some of them much more conservative than others. This made comparisons among statements very difficult. In the 1920s, financial statements often reported very inflated values. The dubious reporting practices and overly enthusiastic investors combined to drive up stock prices to unrealistically high levels. Ultimately, the stock market collapsed and the Great Depression ensued. To avoid a repeat of such an economic disaster, Congress in 1934 created the Securities and Exchange Commission (SEC) to govern financial reporting of publicly held companies. The accounting profession also became involved and, under the AICPA, appointed committees to establish standards that could be used by a wide variety of companies. This led to the establishment of the Accounting Principles Board and later the Financial Accounting Standards Board (FASB).
9. The FASB is a private-sector body with five full-time members who are drawn from a variety of backgrounds—professional accounting, business, and academia. Members are appointed for five-year terms. The FASB has its own research staff and a 2009 operating budget of \$29 million. Most of the FASB's funding comes from fees levied on public companies under the Sarbanes-Oxley Act. The Financial Accounting Foundation (FAF) serves somewhat as a board of directors for the FASB and for its sister organization, the Government Accounting Standards Board (GASB).
10. The FASB Accounting Standards Codification is the official source of accounting standards; the Codification is GAAP in the United States. The FASB follows a definite standard-setting process with provision for input from the various interested parties before final pronouncements are issued. These standards cover accounting methods and disclosure requirements.
FASB Statements of Financial Accounting Concepts are guidelines for future standard setting. They comprise the Conceptual Framework Project. They do not carry the same weight as the Codification and are not considered part of GAAP. However, Concepts Statements often provide the basis for the more specific standards that are issued.
11. The FASB has adopted an open decision-making process that invites and expects input from all interested groups. The use of task forces, open hearings, Exposure Drafts, and open meetings of the Board provide an opportunity for all groups to be heard before the Board comes to a decision. Although this standard-setting process creates lengthy delays, it does result in increased general acceptance by all groups of the final published accounting standard. This process has been characterized as a political consensus approach as opposed to a judicial edict-setting approach.
12. (a) The Emerging Issues Task Force (EITF) was formed by the FASB to assist it in identifying issues that were either too specialized or too small to be addressed by the entire FASB. By stressing a consensus approach, the EITF has been able to establish guidelines to govern practice until the FASB can address various areas. Consensus opinions of the EITF are considered to be GAAP.
(b) The EITF process is not as elaborate as is the FASB process. In addition, the EITF addresses smaller issues than does the FASB. The goal of the EITF is to reach consensus on narrow issues. As a result, decisions issued by the EITF tend to be rendered faster and with less conflict.
13. Although the SEC has the legislative power to establish accounting standards, it has traditionally used this power sparingly. SEC

members and the chief accountant have used their power primarily to encourage the FASB to take various actions. Because they have the authority to usurp the Board's decisions, their opinions cannot be ignored by the Board. The SEC generally supports the positions taken by the FASB.

14. The American Institute of Certified Public Accountants (AICPA) is the professional organization of practicing certified public accountants in the United States. The AICPA has several important responsibilities, including certification and continuing education for CPAs, quality control, standard setting, and administration of the Uniform CPA Examination. The American Accounting Association (AAA) is primarily an organization for accounting professors. The AAA sponsors national and regional meetings where accounting professors discuss technical research and share innovative teaching techniques and materials.
 15. In most areas, financial accounting and tax accounting are closely related. However, the two systems were designed with different purposes in mind—the financial accounting system is intended to provide information useful for decision making, whereas the tax system is designed to produce government revenue fairly and efficiently.
 16. The environment within which business and accounting function is very complex. Several groups are directly affected by accounting standards, and they usually view the standards from different perspectives. Management would like to show the financial condition of the business enterprise in the most favorable light. Management's optimism about what the future might bring often leads to a biased view concerning the statements. Users want information that fully discloses the actual performance and financial condition of a company. They want early warning signals of any potential financial difficulty. Auditors have the responsibility to review company financial statements and the underlying books and records with the objective of issuing an opinion concerning the fairness of the presentation. They desire information in the statements to be objective and reliable. These different points of view can lead to protracted arguments as to the "proper" treatment of a specific financial event.
- Another feature of our complex business environment is that it is constantly changing. The phenomena of increased international activity, government spending, shifting industrial bases, new financial instruments, and technological breakthroughs all have an impact on accounting information. Questions concerning recognizing, measuring, and reporting these factors continually lead to new standards and policies to govern the changes.
17. In the United States, the authoritative source for accounting standards is the FASB ASC. Nonauthoritative sources for accounting guidance include widely recognized industry practices, the standards of the IASB, FASB Concepts statements, and even accounting textbooks.
 18. As companies around the world compete for investors' money, investors are requiring information that is comparable across investment alternatives. For example, a Japanese investor can invest in a Japanese company, a German company, or a U.S. company. To make the best investment decision, financial information must be comparable. Thus, investors and creditors are demanding that similar accounting methods be used around the world so that investment options can be compared.
 19. The International Accounting Standards Board (IASB) was formed in 1973 to develop worldwide accounting standards in an attempt to harmonize conflicting national standards. The IASB now has a formal working relationship with the national accounting standard setters from a number of countries, including the FASB in the United States. For non-U.S. companies that have listed their shares on U.S. stock exchanges, the SEC accepts financial statements prepared using IASB standards.
 20. A conceptual framework of accounting is important for, at least, the following reasons:
 - (a) It defines the basic objectives, key terms, and fundamental concepts of accounting and thereby establishes the boundaries for accounting.
 - (b) It helps the FASB and other standard-setting bodies issue more consistent and comparable standards.
 - (c) It provides a description of current practice and a frame of reference for

resolving new issues not covered by existing GAAP.

- (d) It provides a basis for choosing among alternative reporting practices the method that best represents the economic reality of the situation. Therefore, the framework assists in making the judgments required of accountants and others associated with financial reporting.
21. The major objectives of financial reporting as specified by the FASB include the following:
- (a) "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions."¹
 - (b) ". . . financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise."²
 - (c) Financial reporting should provide information that identifies entity resources and the creditors' and owners' claims against those resources. Financial reports should also disclose significant changes in resources and claims against resources arising from transactions, events, and circumstances.
 - (d) Financial reporting should provide "information about an enterprise's performance provided by measures of earnings and its components."³
 - (e) "Financial reporting should provide information about how an enterprise obtains and spends cash . . . and about other factors that may affect an enterprise's liquidity or solvency."⁴
 - (f) Financial reporting should provide information that allows managers and directors to make decisions that are in the best interest of the owners.
 - (g) Financial reporting should provide information that allows the owners to as-

sess how well management has discharged its stewardship responsibility.

22. The understandability of information depends on both user characteristics and the inherent characteristics of the information itself. Consequently, understandability can be evaluated only in the context of a specific class of decision makers. Financial reporting is assumed to be directed toward a fairly sophisticated user, one who has a reasonable understanding of business and who is willing to study the information presented with reasonable diligence.

23. It is difficult to measure the cost effectiveness of accounting information because the costs and especially the benefits are not always evident or easily measured.

This problem is complicated by the fact that in many cases the party incurring the cost of producing information is not the party intended to benefit from that information. This makes it very difficult to evaluate the cost-benefit relationship of accounting information.

24. *Relevance* refers to the ability of information to make a difference in a decision. The key ingredients of relevance include the feedback or predictive value of the information and its timeliness. Information is relevant if it provides feedback on past actions that helps confirm or correct earlier expectations. The information can then be used to help predict future outcomes. For information to be relevant, it must also be timely or it is of no value in decision making.

Reliability refers to the confidence users can place in the information given. The key ingredients of reliable information are verifiability, neutrality, and representational faithfulness. For information to be reliable, it must be reasonably free from error or bias and provide a faithful representation of the economic circumstances or events that it purports to represent.

¹ *Statement of Financial Accounting Concepts No. 1*, "Objectives of Financial Reporting by Business Enterprises" (Stamford: Financial Accounting Standards Board, November 1978), par. 34.

² *SFAC No. 1*, par. 37.

³ *SFAC No. 1*, par. 43.

⁴ *SFAC No. 1*, par. 49.

25. Reliability does not necessarily imply complete accuracy. Accounting information is often based on judgmental approximations and estimates. For example, depreciation expense is based on approximations of asset life and salvage value as well as an assumption concerning the most desirable depreciation method to be used. Consequently, information relating to depreciation expense may not be totally accurate, but it should be reliable.
26. *Comparability* deals with the ability to relate information to a benchmark or standard. The benchmark can be in the form of another firm's financial data or financial data of the same firm but for some other time period. Comparability requires that like transactions be accounted for uniformly among companies and applied consistently over time. However, different circumstances may require different accounting treatment. The existence of these differences precludes absolute uniformity. Thus, disclosure of accounting methods is required to assist users in evaluating comparability.
27. Consistency in the application of accounting procedures is of value because it is a means of ensuring integrity in financial reporting as well as a means of identifying and evaluating the changes and trends within an enterprise. Without consistency, it is difficult to compare a firm's current performance with past performance.
28. Currently, there is no single numerical materiality standard in accounting. However, the following statement provides a guideline as to what constitutes materiality:
- "The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."⁵
29. *Conservatism* is summarized as follows: When in doubt, recognize all losses but don't recognize any gains. An example of a conservative accounting rule is the valuation of inventory at lower of cost or market.
30. An item must meet the following fundamental criteria to qualify for recognition:
- (a) It must meet the *definition* of an element (specified in *Concepts Statement No. 6*).
 - (b) It must be reliably *measurable* in monetary terms.
31. Five different measurement attributes and their definitions follow:
- (a) *Historical cost* is the cash equivalent price exchanged for goods or services at the date of acquisition.
 - (b) *Current replacement cost* is the cash equivalent price that would be exchanged currently to purchase or replace equivalent goods or services.
 - (c) *Fair value* is the cash equivalent price that could be obtained by selling an asset in an orderly transaction.
 - (d) *Net realizable value* is the amount of cash expected to be received from the conversion of assets in the normal course of business.
 - (e) *Present (or discounted) value* is the amount of net future cash inflows or outflows discounted to their present value at appropriate rate of interest.
32. Five traditional assumptions influence the conceptual framework by helping to establish GAAP. In total, they help determine what will be accounted for and in what manner. They include the following:
- (a) A business enterprise is viewed as a specific *economic entity* separate and distinct from its owners.
 - (b) The entity is viewed as a *going concern*.
 - (c) The transactions of an entity are assumed to be *arm's-length transactions* and therefore provide objective data.
 - (d) Transactions are assumed to be measured in *stable monetary units*.
 - (e) The life of a business entity is divided into specific *accounting periods*.

⁵ *Statement of Financial Accounting Concepts No. 2*, "Qualitative Characteristics of Accounting Information" (Stamford, CT: Financial Accounting Standards Board, May 1980), par. 132.

33. Individuals who start their careers in public accounting and become CPAs often leave public accounting after a few years and join the in-house accounting staff of a business. Typically, the company they join is one of the clients they audited or consulted for as a public accountant.
34. Credit analysts in large banks are required to have a strong working knowledge of accounting. Also, financial analysts working for investment bankers and brokerage firms need to be familiar with the issues covered in intermediate accounting.

EXERCISES

- 1–1.
1. False. Comprehensive income relates only to non-owner changes in equity.
 2. True.
 3. False. The tendency to recognize unfavorable events early is an example of conservatism.
 4. False. The conceptual framework focuses on the needs of external users of financial information, primarily investors and creditors.
 5. False. Concepts Statements are not considered authoritative pronouncements in the sense of establishing, superseding, or amending present GAAP.
 6. True.
 7. False. Recognition involves boiling down all the estimates and judgments into one number and using that one number to make a journal entry. Disclosure skips the journal entry and relies on a financial statement note to convey the information to users.
 8. False. Changing business conditions and activities might warrant a change in accounting method to make financial statements more useful and informative.
- 1–2.
- | | |
|------------|-------|
| 1. h, j | 6. h |
| 2. e, k, n | 7. c |
| 3. b | 8. i |
| 4. a | 9. d |
| 5. l | 10. n |
- 1–3.
1. *General objective of providing useful information for decision makers.* The statements should include information that is of value to present and potential investors and creditors, as well as other external decision makers. In addition, the information disclosed should be sophisticated enough that those with a reasonable understanding can study and understand the information. The most important aspect of this objective for financial reporting is to provide information that investors and creditors need to make economic decisions.
 2. *Objective of providing information for assessing prospective cash flows.* Because investors and creditors are interested primarily in future cash flows, the financial disclosures should provide them with information that will help them assess the future cash flows. The information should provide some clues as to amounts, timing, and risk of future cash flows.
 3. *Objective relating to providing information about the enterprise's economic resources.* The financial statements of a company should provide information about the financial strengths and weaknesses and the liquidity and solvency of the firm.
 4. *Objective of providing information about the enterprise's performance and earnings.* The company should provide information about its earnings. This should include a disclosure of the components of earnings.

1–3. (Concluded)

5. **Objective of assessing future cash flows.** In addition to reporting earnings, the enterprise should provide information about the cash flows for the period. This information should include sources and uses of cash. Sources and uses of cash should include information about the operating, investing, and financing activities of the company.

- 1–4.
- | | |
|---------------|-------------|
| 1. b, i, j | 6. k |
| 2. i, b | 7. i, b |
| 3. k | 8. c |
| 4. a, d, g, l | 9. a, d, f |
| 5. h | 10. g, i, l |

- 1–5.
1. **Relevance vs. Reliability.** The fair value of the building may provide more relevant information to decision makers, but fair value estimates are not as reliable as historical cost information.
 2. **Comparability vs. Consistency.** A change to the prevalent method used in the industry would allow JCB's financial statements to be more easily compared with competitors; however, it would reduce the ability to analyze JCB's previous financial statements because the inventory method would not be consistently applied over time.
 3. **Timeliness vs. Verifiability.** Because the bank has asked that Hobson Inc. provide financial statements as quickly as possible after year-end, the qualitative characteristic of timeliness dictates that financial information be collected and summarized as quickly as possible. However, because some suppliers are slow in submitting invoices, estimating liabilities will make the financial statements less verifiable.
 4. **Neutrality vs. Relevance.** The officers of Starship Inc. believe that disclosing the potential liability will unnecessarily bias the financial statements in a negative fashion. On the other hand, the auditors believe that given the potential liability associated with the malfunctions, external users would find knowledge of this risk very relevant.

- 1–6.
1. Comprehensive income
 2. Owners' equity
 3. Liabilities
 4. Revenues
 5. Gains
 6. Investments by owners
 7. Losses
 8. Distributions to owners
 9. Expenses
 10. Assets

- 1-7.
1. ***Arm's-length transactions.*** By selling inventory to the parent company at a price other than the market price, the transaction between the parent and its subsidiary violated the arm's-length assumption.
 2. ***Economic entity.*** The assets of owners of a company are not to be included when disclosing the assets of the company itself.
 3. ***Going concern.*** An assumption made when preparing financial statements is that the company will continue into the foreseeable future. In this example, the continued existence of the savings and loan is in doubt.
 4. ***Accounting period.*** To enhance comparability and consistency as well as to provide periodic financial statement information, the economic life of a company is partitioned into specific accounting periods. By producing financial statements at two-year intervals, instead of annually, this assumption is violated.
 5. ***Stable monetary unit.*** Financial statements assume that the value of the dollar remains the same over time. That is, a dollar can buy just as much today as it can in one year. This assumption ignores the effects of inflation. It is, however, consistent with the historical cost measurement attribute.
- 1-8.
- When a company cannot justify applying the going concern assumption, different measurement attributes may be required. The identified situations would most likely require the use of the following attributes:
1. Plant and equipment would be valued on a liquidation basis. Thus, an exit market value under distressed conditions would be the proper valuation.
 2. The discounted value of expected future principal and interest payments would be the proper valuation for these bonds.
 3. Accounts receivable should be valued at their net realizable value, regardless of the going concern assumption. A company in financial difficulty may have to sell its receivables to a third party rather than wait for the orderly collection process to occur. The expected sales price would be the proper valuation.
 4. Inventory should be valued at expected liquidation value under forced sale. LIFO inventory values are lower than current market prices in a normal inflationary market. The revaluation of inventory in this case may result in an increase in inventory values rather than a decrease. Although such an increase would normally not be recorded before a sale validated the market value, the increase could be recorded earlier if evidence of a higher market value was strong.
 5. Investments in other companies would be valued at fair value if fair value can be determined.

1–9. The answers to the sample CPA Exam questions are as follows:

- 1. The correct answer is c. Comprehensive income includes all changes to equity except those resulting from investments by owners or distributions to owners, including dividends to stockholders. A loss on discontinued operations is included in both net income and comprehensive income. Unrealized loss from foreign currency translation and unrealized losses on investments in noncurrent marketable equity securities are both reported as adjustments to stockholders' equity, but they are also part of comprehensive income.**
- 2. The correct answer is d. One of the objectives of financial reporting identified by *SFAC No. 1* is to provide information that is useful to users in their decision making. Response A is incorrect because GAAP is derived from the objectives. Response B is incorrect because financial statements report on the business entity, not the management. Management's stewardship may only be indirectly inferred from the financial statements. Response C is incorrect because conservatism is not explicitly included in the conceptual framework.**
- 3. The correct answer is c. Statements of Financial Accounting Concepts (SFACs) establish a conceptual framework for accounting, which includes the objectives and concepts used in developing standards of financial accounting and reporting. Generally accepted accounting principles (GAAP) are based upon the conceptual framework and must be followed in order for financial statements to be presented fairly in accordance with GAAP. When two or more principles apply to a given situation, the hierarchy of GAAP sources provides guidance as to which principle or principles should be given priority.**
- 4. The correct answer is b. Neutrality, along with representational faithfulness and verifiability, are the ingredients of reliability, one of the primary qualitative characteristics. The other primary qualitative characteristic is relevance, which includes timeliness, feedback value, and predictive value.**
- 5. The correct answer is b. Realization occurs when noncash resources and rights are converted into money or claims to money. This would be the case when equipment is sold for a note receivable. Assigning of costs is a form of allocation. Realization occurs at the time that sales of merchandise are made in exchange for accounts receivable, not when the receivables are collected.**

CASES

Discussion Case 1–10

Even a basic understanding of accounting provides a foundation for analyzing some of the information and relationships in the basic financial statements. Following are some examples of information you would expect to find that would be pertinent to an investment decision.

1. *Balance Sheet.* The asset section will reveal the mix of current and noncurrent assets. The percentage of total assets invested in plant and equipment will indicate the capital intensiveness of the company. The percentage of plant and equipment cost that has been depreciated will give some information as to the age of the assets. The mix of the current assets will indicate information as to the liquidity of the company. If the statements contain several years' data, trends can be observed.

The liability and owners' equity sections will indicate how the assets have been financed. If a high proportion of debt exists, added risk is present if economic conditions soften. The nature of long-term debt and its terms will indicate how restricted the company might be for future expansion. The amount of retained earnings relative to total owners' equity will disclose how much of the financing has been with internal funds.

Various ratios might be used to evaluate liquidity, solvency, stability, and turnover efficiency. How extensively you can use these ratios depends on the extent of your knowledge.

Examination of the balance sheet gives a reader a snapshot of a company at a given point in time. With the accompanying notes, it can provide a good overview of a company's financial position.

2. *Income Statement.* The bottom line, net income, will disclose the profitability of a company. If there are unusual items that might not recur, these should be listed separately on the statement. An earnings-per-share figure will indicate the profitability per share of stock. The detailed list of expenses can give some indication of the nature of expenses for that company. Usually, several years of data are included in the annual report. This will permit a reader to see the trend of profitability over time.

The use of income statement figures in combination with balance sheet amounts can produce ratios that will highlight relationships, such as percentage return on investment and return on owners' equity.

3. *Statement of Cash Flows.* This statement will disclose what financing has been done during the current period. It describes the major cash flows, including acquisition of new plant assets, new and retired loans, sale of additional equity securities, cash flow from operations, and so on. This statement, combined with information from management as to future plans, can be used by a reader to assess the risks the company might have during a future period.

Financial statements provide much raw data for decisions such as the investment decision. There are dangers, however, in relying solely on this historical information. The varying accounting principles used by companies can distort statement results and make comparisons among companies difficult. Acquisition and disposition of subsidiaries may make statements noncomparable from one period to the next. There is no guarantee that past relationships will continue in the future. Even with these limitations, the financial statements are still a useful tool in many decisions, including investment decisions. (*Warning:* Don't interpret this discussion as a suggestion that financial statements can be used to pick winning stocks in the stock market. The stock markets in the United States react very rapidly to new information, so it is unlikely that one can make abnormally high returns through analyzing financial statements that have been publicly available for many months. On the other hand, for small companies, especially those that are not publicly traded, the financial statements are often the only reliable source of financial information. With those companies, careful financial statement analysis can help determine whether an investment is a good one.)

Discussion Case 1–11

The key to the difference in the information required is in the types of decisions these two groups of users are making. In the external user case, the decisions involve questions such as these: Should we buy the stock? Should we lend the money? Should we extend the loan for another six months? Should we sell the stock? The external users do not have direct access to the records of a company. They must rely primarily on the information that is made available to them by accountants and auditors.

The internal users have a multitude of management decisions to make that require accounting information. Decisions include adding or deleting product lines, selling divisions, pricing goods, paying bonuses, expanding plants, and preparing budgets. The information needed by internal users is usually more detailed than that provided to external users. For example, information about subunits is usually needed to better manage the company. Many companies use a profit center concept that requires measuring the income for each smaller area of the company.

Discussion Case 1–12

An auditor cannot serve as a guarantor against losses by external users. The auditor's role is to express an opinion as to whether the financial statements present fairly the financial condition of a company as of a given time and the results of operation for a period of time. Subsequent business failure does not mean that there was an audit failure. Users of financial statements, however, often expect the audit opinion to mean more than what the auditor is stating. This case illustrates clearly how the difference in expectations of users and auditors can lead to lawsuits and congressional investigations. Some of the conditions that led to the bankruptcy could have existed at the time the financial statements were issued. If inventory and accounts receivable were overstated based on the evidence obtainable on February 22, 2013, there could be a case against the auditors for issuing an audit report that did not inform external users of the overstatements. However, the worsening economic conditions could have triggered the reduction in sales and the loss of the large account receivable. Because the recession seems to have occurred subsequent to the statement date, it could have been the primary cause of the business failure.

Class discussion could explore more fully how the expectation gap can be narrowed and how the accounting profession can take action that will make financial reporting more useful to external decision makers.

Discussion Case 1–13

1. Possible improvements from eliminating FASB lobbying:
 - a. The FASB would have more latitude to derive standards from underlying fundamental concepts without being constrained by economic interests of the affected parties.
 - b. The FASB could move more quickly to implement theoretically correct solutions to reporting problems.
 - c. The FASB could more easily tailor standards to be useful to the broad spectrum of users. Few users have sufficient incentive to expend resources to lobby about any particular standard, but users do have a general interest in more useful financial statements.
2. Possible harmful effects from eliminating FASB lobbying:
 - a. Derivation of standards in an abstract setting sometimes results in overlooking critical practical concerns. Lobbying parties currently bring these concerns to the FASB's attention if they are viewed as being material.
 - b. The FASB and its staff are not the sole repository of accounting expertise in the country. There is a vast body of knowledge in the accounting community that would not be fully utilized if the FASB discouraged comment.
 - c. Imposition by the FASB of accounting standards that are widely viewed as being inappropriate could lead to a breakdown in the essential voluntary support for generally accepted accounting principles.

Discussion Case 1–14

The issue of the economic consequences of accounting standards is extremely important to an understanding of the difficulty facing the FASB in setting standards. There are many sides to this issue, and this case provides an early opportunity for students to see how challenging accounting can be.

Some of the points that can be included in discussing this case are as follows:

- a. Many accounting issues other than the accounting for postretirement health care benefits have attracted attention beyond the financial accounting community. They include valuation of investments by banks and other institutions, accounting for income taxes, accounting for foreign currency translation, accounting for inflation, accounting for research and development costs, and accounting for stock options given to employees as compensation. For each of these issues, strong lobbies from various businesses, government, and union groups have argued for a particular accounting treatment that would benefit their interests.
- b. Accounting principles and practices are very pervasive and influence the entire business and financial communities of not only the United States but also the world. The International Accounting Standards Board (IASB) has been established in an attempt to bring some harmony across national boundaries. Frequently, business leaders argue that accounting standards should be used as a tool to increase a country's international competitiveness. It is probably not possible for accountants in today's world to ignore the ramifications of their actions, even if it were desirable to do so. The accounting profession has become quite political in its impact and, as such, must consider many variables before making decisions.
- c. Although societal goals and considerations obviously should not be ignored in establishing accounting principles, there is much controversy concerning how and to what extent accounting principles should be affected by the potential impact on society. For now, the FASB must perform a careful balancing act, striving for conceptual purity but mindful of the potential economic consequences of accounting standards.

Discussion Case 1–15

This case is designed to provide students with the opportunity of considering how different economic and social conditions can affect the establishment of accounting standards. It also provides a setting for exploring the need for accountants in the United States to consider international factors.

Tom may never leave the United States, but he will still probably be directly affected by international accounting issues. For example, if the company Tom works for sells goods to firms in other countries, the creditworthiness of those companies will need to be assessed. This will require that the financial condition of those customers be evaluated. Unless one knows the rules with which financial condition is measured, it will be difficult to properly assess a customer's creditworthiness.

More than ever before, the FASB, the IASB, and other accounting bodies are now working closely together to develop accounting standards. If Tom wants to know what U.S. GAAP will look like in the future, he should keep an eye on how GAAP is developing in other countries as accounting standards around the world are converging.

One can ignore the developments in accounting that are occurring around the world. However, the person who does is at a disadvantage as the global economy develops and national boundaries disappear.

Discussion Case 1–16

This case can be used as a basis for class discussion concerning education in the accounting profession. At the time this edition is being written, more than 90% of the states require 150 college credit hours before a person may sit for the CPA examination. The arguments in favor of more education stress the increased complexities of the business world, expanding technology, and the need for accountants to be grounded in technical skills. They should also be broad based in their ability to communicate effectively, appreciate humanities and the fine arts, and be able to adapt quickly to change. All of this, the proponents argue, requires more education.

Discussion Case 1–16 (Concluded)

There are opposing voices. They include 4-year colleges, small practitioners who fear the added education will cause an increased demand for higher wages, and some CPAs in larger firms who are concerned that the supply of quality entrants to the profession will be dangerously low. One group of opponents has argued that students will select other majors if the movement to an advanced degree becomes mandatory. This case gives students an opportunity to express their views about how this issue affected their decision and to consider why education is so important to a profession.

Discussion Case 1–17

The difference between the objectives of tax regulations and accounting standards in the United States has a long history. For many years, income as measured by these two bodies was similar. However, as the role of raising revenues through income taxes has become more pervasive, politicians and economists have made alterations to the tax regulations that vary markedly from accounting standards. Users and preparers have come to accept these differences, and although the increasing magnitude of these differences has created considerable difficulty in deciding how deferred income taxes should be computed and reported, it is doubtful that there will be any serious attempt to bring the standards arising from these two sources into harmony with each other.

If one set of standards were feasible, it would be easier for preparers and auditors of financial statements. Two separate sets of records dealing with some assets and liabilities are required when the rules are different. Because income taxes paid are viewed as expenses by companies, the accounting standard-setting bodies through the years have required deferred tax accounting for temporary differences arising from these rule differences. Perhaps no topic has created more confusion and difficulty for the FASB than deferred taxes. The major disadvantage to a single set of standards would be the need for compromise between two conflicting sets of objectives. The result could be a tax law that really is not fair to taxpayers and a set of financial statements that is not relevant to users' needs. No group would be satisfied with the results.

Discussion Case 1–18

This case emphasizes the strengths and limitations associated with accrual and cash measures of a firm's performance. The following issues can be addressed in discussing the case:

- a. While an investor's major objective could be to assess future cash flows, past cash flow is not necessarily the best measure for doing this. Because management could be able to manipulate the payment or receipt of cash over the short term, cash-basis information could provide information that is not representationally faithful. As an example, suppose management is considering postponing the recording of an expense until payment is made in the next fiscal year. Using accrual accounting, the expense would be recorded when it is incurred (i.e., this year). However, a cash-basis earnings measure would recognize the expense in the year of payment (i.e., next year). Measuring a firm's performance using cash flows would allow management the opportunity to manipulate the measure of the company's performance.
- b. Accrual-based earnings figures reflected in the income statement measure revenues when they are earned and expenses when they are incurred. The receipt or payment of cash has no impact on revenue and expense recognition and, as a result, is not reflected on the income statement. While this alleviates the opportunity for income manipulation, it also negates the provision of information regarding a firm's sources and uses of cash. Many firms, particularly high-growth firms, disclose positive net income while they experience cash shortages. Firms invest in inventory, expand production facilities, or grant liberal credit terms that tie up cash. This information is not reflected in an accrual-basis earnings statement. Only cash flow information can provide investors and creditors an indication of a firm's sources and uses of cash.

Discussion Case 1–18 (Concluded)

- c. A combination of both accrual-basis information and cash flow information provides investors and creditors the information they need to make decisions for allocating their resources. Accrual-basis information indicates how a firm generates revenues and incurs expenses while cash flow information indicates where a firm's cash is coming from and where it is going.

Discussion Case 1–19

This case is designed to emphasize the definitional aspect of the conceptual framework. The following definitions could be applied to software development costs:

- a. *Expenses*—outflows of assets or incurrences of liabilities during a period from the development of computer software, which is the ongoing and central operation at Conserv.
- b. *Assets*—probable future economic benefits that will be obtained as a result of software development costs incurred in the past.

If the development costs are considered expenses, Conserv should write them off as soon as they are incurred. As expenses, these costs will have no future benefit or value. Reporting these costs as assets on the balance sheet would overstate earnings and could mislead investors.

If the development costs are considered assets, Conserv should capitalize them as assets and amortize the costs over a period of time commensurate with their expected future benefit. If the costs did in fact have future benefit, classifying them as expenses would understate earnings and could also mislead investors.

Although not required in answering the questions in this case, the FASB standards for accounting for software development costs might be discussed with students. *Statement No. 86*, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed" (August 1985), requires companies to capitalize a certain portion of development costs. Costs to establish technological feasibility for a product are charged to expense as research and development when incurred. This includes all costs up to the completion of a detailed program design or, in its absence, the completion of a working model.

Thereafter, all software production costs should be capitalized and reported at the lower of unamortized cost or net realizable value. The amortization of capitalized costs is based on current and future product revenues. An annual minimum charge equal to straight-line amortization over the product's estimated remaining useful life is required.

Discussion Case 1–20

This case discusses the advantages and disadvantages of various measurement attributes in valuing a specific financial statement item—bonds payable. Each measurement attribute can be discussed individually, or the attributes can be compared.

Historical Selling Price. While historical cost is often used to value financial statement items, in the case of bonds, historical cost does not reflect the amount to be paid in the future to retire the bonds. Historical cost certainly is reliable information, but more relevant information for investors and creditors is the amount of cash to be sacrificed in the future to retire the bonds.

Discounted Present Value. This measurement attribute recognizes the time value of money. Present value measures reflect the amount of cash to be sacrificed in the future and recognize that the value of that future outlay of cash is not equivalent to an outlay of cash made today. Discounted present value is the measurement attribute most consistent with the definition of a liability. For bonds payable, the *market value* is presumed to be equal to the discounted present value.

Maturity Value. Maturity value is the amount of money to be paid in the future when the bonds mature. This attribute recognizes the probable sacrifice of cash relating to the face amount of the bonds. It does not, however, incorporate the value of the interest payments to be made associated with the bond.

While each of these measurement attributes can have desirable characteristics, discounted present value is the attribute most consistent with the definition of a liability provided in the conceptual framework.

Discussion Case 1–21

Students will probably view this proposal as a naive approach to a very complex problem. The proposal by Leonard Spacek of Arthur Andersen, however, was not a frivolous one. In concept, the proposal recognizes that the ideal objective of financial reporting is to be fair to all readers. The conceptual framework used other terms to capture the essence of this idea (e.g., neutrality and freedom from bias). The identification of one overriding concept does simplify the establishment of a conceptual framework. If an accounting treatment is fair, it is automatically relevant and reliable for decision makers.

The problem with the concept, however, is that fairness, like beauty, is in the eye of the beholder. What is fair in one person's mind might not be fair to another. Managers of business have their own biases and needs to fulfill. As a group, they desire stability in their employment position and want to appear as being successful in their endeavors. To the extent that they can influence financial reporting principles, they have motivation to prepare financial statements that will meet these needs. To ask managers to consider the needs and interests of investors, creditors, labor, and the government equal to their own is probably not reasonable. The FASB decided that the only way fairness can be applied is to identify other concepts and principles that are more objective and easier to evaluate. Society asks auditors to review the statements prepared in accordance with these accepted principles and determine whether management has been reasonable in its determinations.

Discussion Case 1–22

1. This case provides for a discussion of the advantages and disadvantages of large professional CPA firms. The following comments are not intended to be all-inclusive, but they could be made by students in discussing this issue.

Dangers of concentration of power:

- a. The needs of smaller private entities serviced by regional and local CPAs will not be adequately considered if large firms dominate the profession. This has been a problem in the past. However, the establishment of the private companies section of the AICPA seems to be a positive step in overcoming this danger.
- b. Large firms that consider themselves to have monopoly power will become inefficient in performing their services, especially audits. They will be less willing to suggest improvements in reporting and disclosure techniques that might add to their costs of operation. Because there are several large firms, however, there has been and continues to be a considerable amount of competition in the profession.
- c. Large firms will tend to lose their independence because of the long-standing relationship they tend to have with their clients. Even changing from one large firm to another may not produce different results because of the close-knit fraternity that exists among partners of these firms.

Advantages of concentration of power:

- a. Most fields of business and finance are controlled by large international entities with operations in many locations. Their activities are often varied and touch on many different segments of business. Only similarly large international CPA firms have the resources and expertise to service these large clients.
- b. If a smaller firm were to service a large client, the fees for the services rendered to the client would amount to a significant percentage of the firm's revenue. This would limit the degree of perceived and perhaps real independence when conflicts arise between the CPA's position and that of management in the client firm. The potential loss of the client over a matter of principle is less threatening to the larger firms.
- c. The needs of large business entities are frequently highly technical and varied. Large CPA firms have continuing professional education programs in process and are organized so that members of the firm can specialize in particular industries or in particular phases of accounting. This means that in some cases the services rendered by the larger firm are likely to be of higher quality than those offered by smaller and more generally trained CPAs.

Discussion Case 1–22 (Concluded)

- d. The concentration of power in larger firms permits these firms to devote more time to developing auditing techniques and researching of accounting problems than is true for smaller firms. Most of the large firms have departments within their own national offices that are devoted full-time to research and writing.
2. Skepticism about auditor independence increased as large accounting firms did more consulting. Users of financial statements are unlikely to place as much confidence in an accounting firm's audit opinion when another segment of that same accounting firm does millions of dollars of consulting work for the audit client. As a result of recent accounting scandals, Congress passed the Sarbanes-Oxley Act, which does not allow audit firms to do consulting work for companies for whom they perform the audit.

Case 1–23

1. Net income for Disney in 2009 was \$3,307 million, compared to net income of \$4,427 million in 2008 and \$4,687 million in 2007. As will be discussed in Chapter 4, net income is sometimes not the best number to look at to get an idea of a company's economic performance for the year. For example, in 2009 Disney reported the impact of restructuring and impairment charges, which reduced pre-tax income for the year by \$492 million. For comparison purposes, this charge might be excluded when comparing performance across time. However, even after eliminating this one-time charge, it is clear that the recession year of 2009 was not a great one for Disney.
2. Users always want more detail in financial statements. The level of detail reported by Disney is probably not enough to satisfy our curiosity. More information on selected balance sheet items is given in the notes to the financial statements. See Note 14 for a host of detail about individual items reported in the balance sheet.
3. Disney's 2009 net cash from operations was \$5,064 million, more than enough to pay for the \$2,270 million (\$1,753 + \$517) invested in parks, resorts, and other property and in the acquisition of other businesses.
4. Four of the notes with a lot of new information are as follows:
 - Note 1, giving details of Disney's different business segments
 - Note 4, discussing the company's acquisitions
 - Note 7, outlining Disney's continuing tempestuous relationship with EuroDisney as well as some data about Hong Kong Disneyland
 - Note 17, providing a description of Disney's derivative instruments
5. Disney's auditor is PricewaterhouseCoopers LLP, and the 2009 audit opinion was unqualified.

Case 1–24

1. The \$26.0 billion in future minimum payments expected to be received by McDonald's in connection with its agreements with franchisees certainly represents a future economic benefit. The rights to receive the payments are guaranteed to McDonald's by contract, so it seems safe to say that they are controlled by McDonald's. The big question is whether the payments are the result of a past transaction or event. Some might argue that the signing of the franchise contracts is a past event. However, the payments come about because of *future* sales and *future* occupancy by franchisees. So, the \$26.0 billion is not recognized as an asset. If it were recognized, the appropriate amount would be the discounted present value of the future payments.
2. This accounting treatment illustrates that conservatism still lies behind many accounting rules. If the \$26.0 billion in cash flows were payments to be *made* by McDonald's, they might be recognized as a liability. This is the treatment afforded some long-term leases. This topic is covered in Chapter 15.

Case 1–25

This writing assignment focuses on a continuing relevant issue. It is related to a case competition that was held nationally by Beta Alpha Psi, the national accounting fraternity. The case can give students an opportunity to see that there are pros and cons to the advisability of a governmental oversight role. As indicated in this chapter, the SEC's role has varied over time, depending on the mood of Congress and of the SEC officials in power at the time. Students might include the following points:

Arguments supporting governmental oversight:

1. Accounting firms are profit-making entities. Although they service many clients and are considered to be representing the interests of varied users of external financial reports, they often can become too inward-directed in their approach. Time pressures may preclude them from monitoring the quality of the service they are rendering. It is noteworthy that the present heavy emphasis upon peer review and quality control among CPA firms of all sizes occurred in the late 1970s and 1980s in response to the increased pressure from Congress and the SEC.
2. The primary benefit of the audit function is its addition to the credibility of management's financial statements. If the oversight function of a government agency is viewed by the public as increasing the credibility of the auditor's report, the benefit of the function to society will be increased.

Arguments against governmental oversight:

1. Government agencies have a history of expanding their authority beyond that which was originally intended. By granting an oversight power, the danger exists that authority for establishing principles of accounting and standards of auditing would move from the private to the public sector. Increased bureaucratic operations could then lead to inefficiencies and to a reduction in the credibility of the accounting profession.
2. Employees of government agencies are subject to influence from special interest groups. The existence of fraud and mismanagement in the government sector is well recognized. The oversight function may give the appearance of improvement in the quality of accounting service when the actual situation may not justify this conclusion.

Case 1–26

The easy answer is that accountants should ignore the impact of accounting choices on income and just focus on the most conceptually correct accounting treatment. This answer ignores the fact that the accounting standards themselves provide for allowable alternatives in many areas. For example, a company can use LIFO or FIFO, accelerated or straight-line depreciation, and can choose the interest rate in computing pension expense.

Since GAAP allows for a range of numbers for reported income, why shouldn't the accountant try to help his or her company by reporting the highest possible income? One reason is that this approach can lead to inconsistency in the application of accounting standards and judgments—pressure to use income-increasing accounting would be greatest in years when a firm's economic performance is the worst.

Just as the FASB must practice a balancing act in setting accounting standards, an accountant must practice a balancing act in applying them. The hard-line accountant who will never budge on any accounting assumption, no matter what the consequences to the company, is ignoring the important role that judgment plays in accounting. On the other hand, the accountant who will report any number management requests is both unreliable and dishonest.

For tax accountants, the question is not as difficult. The objective of a good tax accountant is to minimize the client's tax bill within the constraints of the law.