Financial Accounting Theory and Analysis Text and Cases 13th edition Schroeder Solutions Manual

SKU: 9781119577775-SOLUTIONS

Accounting Theory and Analysis

13th Edition

FASB ASC Tutorial and Solutions Manual

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Using the Codification to Solve the FASB ASC Cases

Prior to attempting to use the codification website to solve the FASB ASC cases, it is recommended that you read "Test Driving the Codification," by Carolyn Ford and C. William Thomas, *Journal of Accountancy*, December, 2008. Available at http://www.journalofaccountancy.com/Issues/2008/Dec/TestDrivingtheCodification.htm and review the tutorials on the codification website.

Overview of the Codification

The Financial Accounting Standards Board codification (FASB ASC) is organized into general topics listed on the left-hand side of the home page (General Principles, Presentation, etc.). Clicking on any of the general topics will bring up what the FASB terms a "landing page." Each landing page contains a list of sub topics for that link. For example, clicking on the general topic Assets brings up list of seven sub topics (Cash and Cash Equivalents, Receivables, etc.). Notice that each of the subtopics is identified by a three-digit number. This allows for access via the go to function that we will discuss later.

Clicking on any of the subtopics brings up a second link to what are termed sections and contain the content specific area of the FASB ASC. All Subtopics have a set of standard Sections unless there is nothing to include in a particular standard section, in which case that standard Section is left out of the Subtopic and therefore the FASB ASC. There are sixteen standard Sections for each Subtopic. Sections are indicated by a two-digit number between 00 and 99. Some of the most frequently used sections are: 25 Recognition, 30 Initial Measurement 35 Subsequent Measurement, 50 Disclosure and Implementation Guidance and Instructions.

Each Section has Paragraph numbers that start over at the beginning of each Section. Each Paragraph, therefore, has a two-part number. The first number is the Section number, and the second part is the Paragraph number within that Section. The Paragraphs are where "substantive content" of the FASB ASC is found. The rest of the levels only exist to organize the information in the Paragraphs and help navigate to the information contained in them. In order to view the specific content areas, it is necessary to click on the JOIN ALL SECTIONS tab found on each section page. For example, assume we are interested in the authoritative literature on accounting for sales of products when a right to return exists. First, click on the topic Revenue at the left-hand side of the home page, then on the landing page Revenue Recognition. Next, click on the products subsection. Finally click the JOIN ALL SECTIONS tab and all of the paragraph content will appear. Page down through the material and you will find that Paragraph 25-1 contains the authoritative guidance for accounting for sales of products with a right to return.

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The home page also gives other options for navigating the FASB ASC. Two of these are the SEARCH function and the GO TO option. We have found that using these functions is an easy way to start navigating the FASB ASC. To use the search method of navigating the FASB ASC, first, type the general topic in the search box at the top right of the FASB ASC home page. This will give you some references to specific FASB ASC sections where the topic is discussed.

Choose the section that seems most appropriate and type the reference number in the GO TO box at the top left-hand side of the FASB ASC homepage. Once you are redirected to the desired section, click combine sections and all of the information on the topic will be displayed. You can then browse through the material to find the appropriate subsection that addresses the case issue. Let's use this option to find the authoritative literature on accounting for sales of products with a right to return Type "right to return," in the search box at the top right of the FASB ASC web page. You will get references to the place where this issue is discussed. Seven possibilities appear, but in reviewing we see that the criteria are contained in 605-15-25-1. Type this number in the box next to the GO TO link at the top left-hand side of the FASB ASC homepage. This will redirect you to the content specific paragraph that discusses accounting for sales of products where a right of return exists. (Note: in some searches you may be redirected to the section outline. If so, click the JOIN ALL SECTIONS tab and all of the paragraph content will appear.

If the issue involves accessing a previous specific pronouncement, it is also possible to access the topic through the cross reference function. On the home page, select Cross Reference. This feature allows you to access the relevant FASB ASC section by citing the original source. To use this feature, first access the drop down menu under Standard Type. (Standard Type refers to the authoritative body that originally issued the pronouncement. For example, the Financial Accounting Standards Boards uses the acronym FAS. A discussion of the acronyms for the various standard types is contained through a link in the directions). Next, use the drop down menu under standard number and choose the appropriate number. Then click GENERATE REPORT. When the results appear, click on the first paragraph number at the far right side. Next, click on the 3-digit topic at the top under Table of Contents. When the results appear, click and expand and all of the subtopics will appear. Choose the subtopic you wish to view and then combine sections and the relevant authoritative literature will be displayed.

For example, to answer case 9-3, choose FAS from the drop down Standard Type menu. Then choose 143 from the standard number drop down menu**. (Please note**

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that the standard number for asset retirement obligations was misidentified in the case. It should be 143 not 144). Click on GENERATE REPORT and when the results appear, click on 05-4 on the first line under paragraph number. When the results appear, click 410 Asset Retirement and Environmental Obligations. When the results appear, the most appropriate section seems to be 20 Asset Retirement Obligations. Select it and then click the JOIN ALL SECTIONS tab and all of the paragraph content will appear.

Finding original source material still contained in the Codification

Several of the FASB ASC cases ask for EITF pronouncements related to a particular topic. In order to find original source material from the EITF or any other authoritative body use the following steps:

1. Find the relevant topic in the FASB ASC
2. Click expand for the relevant subtopic
3. Click the JOIN ALL SECTIONS tab
4. From the **menu** ***f* Page/Print functions** **select Printer-friendly with sources**
5. Page through the material to find content originally sourced from the EITF

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CHAPTER 1

Case l-1

a. The FASB had three primary goals in developing the Codification:
   1. Simplify user access by codifying all authoritative US GAAP in one spot.
   2. Ensure that the codified content accurately represented authoritative US GAAP as of July1, 2009.
   3. Create a codification research system that is up to date for the released results of standard-setting activity.

b. The Codification is expected to improve accounting practice by:
   1. Reducing the amount of time and effort required to solve an accounting research issue
   2. Mitigating the risk of noncompliance through improved usability of the literature
   3. Provide accurate information with real-time updates as Accounting Standards Updates are released
   4. Assisting the FASB with the research and convergence efforts.

c. The FASB ASC is composed of the following literature issued by various standard setters:
   1. Financial Accounting Standards Board (FASB)
      a. Statements (FAS)
      b. Interpretations (FIN)
      c. Technical Bulletins (FTB)
      d. Staff Positions (FSP)
      e. Staff Implementation Guides (Q&A)
      f. Statement No. 138 Examples.
   2. Emerging Issues Task Force (EITF)
      a. Abstracts
      b. Topic D.
   3. Derivative Implementation Group (DIG) Issues
   4. Accounting Principles Board (APB) Opinions
   5. Accounting Research Bulletins (ARB)
   6. Accounting Interpretations (AIN)
   7. American Institute of Certified Public Accountants (AICPA)
      a. Statements of Position (SOP)
      b. Audit and Accounting Guides (AAG)—only incremental accounting guidance

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c. Practice Bulletins (PB), including the Notices to Practitioners elevated to Practice Bulletin status by Practice Bulletin 1
d. Technical Inquiry Service (TIS)—only for Software Revenue Recognition

Additionally, in an effort to increase the utility of the FASB ASC for public companies, relevant portions of authoritative content issued by the SEC and selected SEC staff interpretations and administrative guidance have been included for reference in the Codification, such as:

1. Regulation S-X (SX)
2. Financial Reporting Releases (FRR)/Accounting Series Releases (ASR)
3. Interpretive Releases (IR)
4. SEC Staff guidance in:
   a. Staff Accounting Bulletins (SAB)
   b. EITF Topic D and SEC Staff Observer comments

d. The FASB ASC contains all current authoritative accounting literature. However, if the guidance for a particular transaction or event is not specified within it, the first source to consider is accounting principles for similar transactions or events within a source of authoritative GAAP. If no similar transactions are discovered, nonauthoritative guidance from other sources may be considered. Accounting and financial reporting practices not included in the Codification are nonauthoritative. Sources of nonauthoritative accounting guidance and literature include, for example, the following:

1. Practices that are widely recognized and prevalent either generally or in the industry
2. FASB Concepts Statements
3. American Institute of Certified Public Accountants (AICPA) Issues Papers
4. International Financial Reporting Standards of the International Accounting Standards Board Pronouncements of professional associations or regulatory agencies
5. Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
6. Accounting textbooks, handbooks, and articles

Case 1-2

a. Inclusion or omission of information that materially affects net income harms particular stakeholders. Accountants must recognize that their decision to implement (or delay) reporting requirements will have immediate consequences for some stakeholders.

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b. Yes. Because the FASB standard results in a fairer presentation, it should be implemented as soon as possible--regardless of its impact on net income.

c. The accountant's responsibility is to provide financial statements that present fairly the financial condition of the company. By advocating early implementation, Hoger fulfills this task.

d. Potential lenders and investors, who read the financial statement and rely on its fair representation of the financial condition of the company, have the most to gain by early implementation. A stockholder who is considering the sale of stock may be harmed by early implementation that lowers net income (and may lower the value of the stock).

Case 1-3

a. CAP. The Committee on Accounting Procedure, CAP, which was in existence from 1939 to 1959, was a natural outgrowth of AICPA (then AIA) committees, which were in existence during the period 1933 to 1938. The committee was formed in direct response to the criticism received by the accounting profession during the financial crisis of 1929 and the years thereafter. The authorization to issue pronouncements on matters of accounting principles and procedures was based on the belief that the AICPA had the responsibility to establish practices that would become generally accepted by the profession and by corporate management.

As a general rule, the CAP directed its attention, almost entirely, to resolving specific accounting problems and topics rather than to the development of generally accepted accounting principles. The committee voted on the acceptance of specific Accounting Research Bulletins published by the committee. A two-thirds majority was required to issue a particular research bulletin. The CAP did not have the authority to require acceptance of the issued bulletins by the general membership of the AICPA, but rather received its authority only upon general acceptance of the pronouncement by the members. That is, the bulletins set forth normative accounting procedures that "should be" followed by the accounting profession but were not "required" to be followed.

It was not until well after the demise of the CAP, in 1964, that the Council of the AICPA adopted recommendations that departures from effective CAP Bulletins should be disclosed in financial statements or in audit reports of members of the AICPA. The demise of the CAP could probably be traced by four distinct factors: (1) the narrow nature of the subjects covered by the bulletins issued by the CAP, (2) the lack of any theoretical groundwork in establishing the procedures presented in the bulletins, (3) the lack of any real authority by the CAP in prescribing adherence the procedures described by the bulletins, and (4) the lack of any formal representation on the CAP of

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interest groups such as corporate managers, governmental agencies, and security analysts.

APB. The objectives of the APB were formulated mainly to correct the deficiencies of the CAP as described above. The APB was thus charged with the responsibility of developing written expression of generally accepted accounting principles through consideration of the research done by other members of the AICPA in preparing Accounting Research Studies. The committee was in turn given substantial authoritative standing in that all opinions of the APB were to constitute substantial authoritative support for generally accepted accounting principles. If an individual member of the AICPA decided that a principle of procedure outside of the official pronouncements of the APB had substantial authoritative support, the member had to disclose the departure from the official APB opinion in the financial statements of the firm in question.

The membership of the committee comprising the APB was also extended to include representation from industry, government, and academe. The opinions were also designed to include minority dissents by members of the board. Exposure drafts of the proposed opinions were readily distributed.

The demise of the APB occurred primarily because the purposes for which it was created were not being accomplished. Broad generally accepted accounting principles were not being developed. The research studies supposedly being undertaken in support of subsequent opinions to be expressed by the APB were often ignored. The committee in essence became a simple extension of the original CAP in that only very specific problem areas were being addressed. Interest groups outside of the accounting profession questioned the appropriateness and desirability of having the AICPA directly responsible for the establishment of GAAP. Politicization of the establishment of GAAP had become a reality because of the far-reaching effects involved in the questions being resolved.

FASB. The formal organization of the FASB represents an attempt to vest the responsibility of establishing GAAP in an organization representing the diverse interest groups affected by the use of GAAP. The FASB is independent of the AICPA. It is independent, in fact, of any private or governmental organization. Individual CPAs, firms of CPAs, accounting educators, and representatives of private industry will now have an opportunity to make known their views to the FASB through their membership on the Board. Independence is facilitated through the funding of the organization and payment of the members of the Board. Full-time members are paid by the organization and the organization itself is funded solely through contributions. Thus, no one interest group has a vested interest in the FASB.

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Conclusion. The evolution of the current FASB certainly does represent "increasing politicization of accounting standard setting." Many of the efforts extended by the AICPA can be directly attributed to the desire to satisfy the interests of many groups within our society. The FASB represents, perhaps, just another step in this evolutionary process.

b. Arguments for politicization of the accounting rule-making process:

1. Accounting depends in large part on public confidence for its success. Consequently, the critical issues are not solely technical, so all those having a bona fide interest in the output of accounting should have some influence on that output.

2. There are numerous conflicts between the various interest groups. In the face of this, compromise is necessary, particularly since the critical issues in accounting are value judgments, not the type which are solvable, as we have traditionally assumed, using deterministic models. Only in this way (reasonable compromise) will the financial community have confidence in the fairness and objectivity of accounting rule making.

3. Over the years, accountants have been unable to establish, on the basis of technical accounting elements, rules, which would bring about the desired uniformity and acceptability. This inability itself indicates rule setting is primarily consensual in nature.

4. The public accounting profession, through bodies such as the Accounting Principles Board, made rules which business enterprises and individuals "had" to follow. For many years, these businesses and individuals had little say as to what the rules would be, in spite of the fact that their economic well-being was influenced to a substantial degree by those rules. It is only natural that they would try to influence or control the factors that determine their economic well-being.

c. Arguments against the politicization of the accounting rule-making process:

1. Many accountants feel that accounting is primarily technical in nature. Consequently, they feel that substantive, basic research by objective, independent and fair-minded researchers ultimately will result in the best solutions to critical issues, such as the concepts of income and capital, even if it is accepted that there isn't necessarily a single "right" solution.

2. Even if it is accepted that there are no "absolute truths" as far as critical issues are concerned, many feel that professional accountants, taking into account the

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diverse interests of the various groups using accounting information, are in the best position, because of their independence, education, training, and objectivity, to decide what generally accepted accounting principles ought to be.

3. The complex situations that arise in the business world require that trained accountants develop the appropriate accounting principles.

4. The use of consensus to develop accounting principles would decrease the professional status of the accountant.

5 This approach would lead to "lobbying" by various parties to influence the establishment of accounting principles.

Case 1-4

a. The term "accounting principles" in the auditor's report includes not only accounting principles but also\practices and the methods of applying them. Although the term quite naturally emphasizes the primary or fundamental character of some principles, it includes general rules adopted or professed as guides to action in practice. The term does not however, mean rules from which there can be no deviation. In some cases, the question is which of several partially relevant principles has determining applicability. Neither is the term "accounting principles" necessarily synonymous with accounting theory. Accounting theory is the broad area of inquiry devoted to the definition of objectives to be served by accounting, the development and elaboration of relevant concepts, the promotion of consistency through logic, the elimination of faulty reasoning, and the evaluation of accounting practice.

b. Generally accepted accounting principles are those principles (whether or not they have only limited usage) that have substantial authoritative support. Whether a given principle has authoritative support is a question of fact and a matter of judgment. Since September 15, 2009 the primary source of GAAP has been the FASB's accounting standards codification. However, if the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources (FASB ASC 105-10-5-2). The CPA is responsible for collecting the available evidence of authoritative support and judging whether it is sufficient to bring the practice within bounds of generally accepted accounting principle.

c. The auditor's report states that a company's financial statements present "fairly," in all material respects, its financial position, based on his or her judgment as to whether the accounting principles selected and applied have general acceptance and that the accounting principles selected are appropriate given the circumstances. This statement

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is necessary because there are many areas where companies make choices among and between accounting principles (Depreciation method, inventory cost flow assumptions, etc.). Therefore, it is expected that financial reports are prepared in a manner that reflects the underlying economic events and activities of the reporting entity. This expectation was stressed in *SAS No. 90* which stated, "In each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles applied in its financial reporting. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. "As a consequence, the choices of accounting principles made by one company are often different than those made by another company.

Case 1-5

A factor that influenced the development of accounting during the 19th century was the evolution of joint ventures into business corporations in England. The fact that many individuals, external to the business, needed information about the corporation's activities created the necessity for periodic reports. Additionally, the emerging existence of corporations created the need to distinguish between capital and income.

The statutory establishment of corporations in England in 1845 stimulated the development of accounting standards, and laws were subsequently passed that were designed to safeguard shareholders against improper actions by corporate officers. Dividends were required to be paid from profits, and accounts were required to be kept and audited by persons other than the directors. However, initially anyone could claim to be an accountant, as there were no organized professions or standards of qualifications.

The industrial revolution and the succession of Companies Acts in England also served to increase the need for professional standards and accountants. In the later part of the 19th century, the industrial revolution arrived in the United States, and with it came the need for more formal accounting procedures and standards. This period was also characterized by widespread speculation in the securities markets, watered stocks, and large monopolies that controlled segments of the United States economy.

In the 19th century the progressive movement was established in the United States, and in 1898 the Industrial Commission was formed to investigate and report on questions relating to immigration, labor, agriculture, manufacturing, and business. Although no accountants were either on the Commission or used by the Commission, a preliminary report issued in 1900 suggested that an independent public accounting profession should be established in order to curtail observed corporate abuses.

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

The major concern of accounting during the early 1900s was the development of a theory that could cope with corporate abuses that were occurring at that time, and capital maintenance emerged as a concept. This concept evolved from maintaining invested capital intact, to the maintenance of the physical productive capacity of the firm, to the maintenance of real capital. In essence this last view of capital maintenance was an extension of the economic concept of income (see Chapter 3) that there could be no increase in wealth unless the stockholder or the firm were better off at the end of the period than at the beginning.

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

The 1904 International Congress of Accountants marked the initial development of the organized accounting profession in the United States, although there had been earlier attempts to organize and several states had state societies. At this meeting, the American Association of Public Accountants was formed as the professional organization of accountants in the United States. In 1916, after a decade of bitter interfactional disputes, this group was reorganized into the American Institute of Accountants (AIA).

The American Association of the University Instructors in Accounting was also formed in 1916. Initially this group focused on matters of curriculum development, and it was not until much later that it attempted to become involved in the development of accounting theory.

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

Critics of accounting theory during the 1920s suggested that accountants abdicated the stewardship role, placed too much emphasis on the needs of management, and permitted too much flexibility in financial reporting. During this time financial statements were viewed as

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the representations of management, and accountants did not have the ability to require businesses to use accounting principles they did not wish to employ.

Case 1-6

a. Historically, accounting has been considered a highly trustworthy profession. Public accounting firms trained new accountants in the audit function with oversight from senior partners who believed that their firm's integrity rode on every engagement. That is, new auditors were assigned client responsibility after minimal formal audit training. Most of the training of new accountants took place on-site, and the effectiveness of the new auditor depended on the effectiveness of the instructor.

CPA firms have always called their customers "clients" and have worked hard to cultivate them. Partners routinely entertained clients at sporting events, country clubs, and restaurants, and many CPA firm employees later moved on to work in their clients' firms. Any conflicts in these relationships were, at least partially, offset by the CPA firm's commitment to professional ethics.

These relationships changed as information technology advisory services grew in the late 1970s and early '80s. Also in the mid-1980s, the AICPA lifted its ban on advertising. As a result, revenue generation became more critical to partners' compensation. Thereafter, the profit structure of CPA firms changed dramatically and in 1999, revenues for management consulting accounted for more than 50 percent of the then Big Five's revenue.

As a result, the audit function evolved into a loss leader that public accounting firms offered in conjunction with vastly more lucrative consulting engagements. But as pubic accounting firms competed more aggressively on price for audit engagements, they were forced by cost considerations to reduce the number of procedures performed for each client engagement. This resulted in increased test of controls and statistical models, and fewer of the basic, time-consuming tests of transactions that increase the likelihood of detecting fraud. In addition, junior auditors were frequently assigned the crucial oversight roles usually filled by senior partners, who were otherwise engaged in marketing activities to prospective clients. This reduced the effectiveness of the instructor–new accountant training process.

b.
1. Arthur Andersen, formerly one the Big Five audit firms, has gone out of business.
2. In July 2002, President George W. Bush signed into law the Sarbanes-Oxley Bill, which imposes a number of corporate governance rules on publicly traded companies
3. Establishment of PCAOB.

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Case 1-7

a. The structure of the FASB is as follows. A board of trustees nominated by organizations whose members have special knowledge and interest in financial reporting is selected. The organizations originally chosen to select the trustees were the American Accounting Association; the AICPA; the Financial Executives Institute; the National Association of Accountants (The NAA's name was later changed to Institute of Management Accountants in 1991) and the Financial Analysts Federation. In 1997 the Board of Trustees added four members from public interest organizations. The board that governs the FASB is the Financial Accounting Foundation (FAF). The FAF appoints the Financial Accounting Standards Advisory Council (FASAC), which advises the FASB on major policy issues, the selection of task forces, and the agenda of topics. The number of members on the FASAC varies from year to year. The bylaws call for at least twenty members to be appointed. However, the actual number of members has grown to about thirty in recent years to obtain representation from a wider group of interested parties.

The FAF appoints the Financial Accounting Standards Advisory Council, which advises the FASB on major policy issues, the selection of task forces, and the agenda of topics. The FAF is also responsible for appointing the seven members of the FASB and raising the funds to operate the FASB. The FAF currently collects in excess of $23 million a year to support the activities of the FASB.

b. The members of the Financial Accounting Foundation are come from various accounting, business, financial and government organizations and entities that have been invited to nominate FAF Trustees; however, the final authority for all appointments rests solely with the discretion of the Board of Trustees

FASB ASC 1-1 Variable Interest Entities (VIEs)

Special purpose entities are accounted for by using the requirements for variable interest entities (VIEs). The information for this question is found by searching the topic "variable interest entities."

1. The definition of variable interest entities is contained in FASB ASC 810-10- 25-20
2. The guidance of the consolidation of VIEs is contained in 810-10-05-8 to 13.

FASB ASC 1-2 Status of ARBs

First search the glossary for the three terms

Revenue recognition topic 605

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Treasury stock topic 505-30

Comparative financial statements topic 205

Then

Search ARB 43 in cross reference
Look for topic 605 (revenue) in the results

Treasury Stock

Search ARB 43 in cross reference
Look for topic 505- 30 (treasury stock) in the results

Comparative Financial Statements

Search ARB 43 in cross reference
Look for topic 205 (comparative financial statements) in the results

205-10-45 Use print function printer friendly with sources

FASB ASC 1-3 Accounting for the Investment Tax Credit

Search investment tax credit

Found at

740-10-25- 45 7 46

740-10-47-27 & 28

FASB ASC 1-4 SEC Comments

1. Search revenue recognition

   Found under customer payment and incentives 605-50-S99-1

   Comments Made by SEC Observer at Emerging Issues Task Force (EITF) Meetings

2. Search debt with conversions and other options

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Found under 470-20 -S99

Comments Made by SEC Observer at Emerging Issues Task Force (EITF) Meetings

3. Search software cost of sales and services

Found under 985-705-S99

Comments Made by SEC Observer at Emerging Issues Task Force (EITF) Meetings

FASB ASC 1-5 GAAP Guidelines

Search "generally accepted accounting principles."

Found under 105-10

Room for Debate

Debate 1-1 Which Body Should Set Accounting Standards in the United States?

This question has no one correct answer. It is meant to get students talking about something that they probably haven't thought about before.

Students in favor of the SEC being the rule making body could argue that the FASB has failed to ensure that financial statements fairly present the results of operations. They could then cite the recent scandals. They could argue that the SEC has the power to regulate and they don't see why the profession should then need to be self-regulated. They could also argue that under the FASB there is too much flexibility and too much reliance on managerial intent, thereby allowing management to manage earnings and otherwise manipulate its financial statements. Moreover, lack of exercise of government direct oversight could result in diminishing the effectiveness of accountants to audit due to a potential erosion of independence. They could point to Sarbanes-Oxley.

Students in favor of the FASB making the rules could argue against big government. They could point out that government sets accounting standards in countries that are not capitalistic. The result in those countries is a cookie cutter approach to financial statements and lack of flexibility that leaves no room for professional judgment. Whereas, the standards provided by the FASB are aimed to provide financial statements that fairly present financial statements, taking into consideration the circumstances in which a company operates. They could also argue

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that accountants, not government officials, best understand their role and how best to measure and report financial information.

Debate 1-2 Should the scope of accounting standards be narrowed further?

Team 1.

This question should prompt the student to investigate how management might benefit from alternative accounting choices. They can go to the web and find out that accounting choices provide managerial incentives that are either income increasing or income decreasing. They may also find instances that management can choose methods of presenting financial information that make the company appear less risky.

Income-increasing choices afford management the ability to paint a better picture of company performance. Management may be inclined to select income increasing policies because

- They believe the stock market will react favorably and their own personal wealth and position in the firm may be more secure.
- Their bonus may be tied to the bottom line.
- The company may appear better able to pay suppliers and thus may be in a better position to negotiate favorable terms with suppliers
- The company may appear better able to repay debt and thus look good to a lender.
- Students can cite real-world examples, e.g., World Com capitalized expenses

Income-decreasing choices may be selected by companies that

- Are highly regulated, such as utility companies. Poor performance can support the notion that the company deserves a rate increase
- If a company is having a bad year, it may choose to load up the income statement with expenses and losses so that it will appear better off in future years.
- Have labor unions hope to fare better in negotiations for labor contracts

Companies have used off-balance sheet financing to improve the perception of a company's riskiness. Enron is a prime example. Enron used special purpose entities to hide debt from investors.

The student can also argue that accounting choice can be used to provide more relevant financial statements. For example, SFAS 115 provides choices that are intended to result in financials that better disclose the results of management investment choices.

Team 2.

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All of the above can be used as arguments against the proliferation of accounting choices. Narrowing accounting choices has been a goal of accounting professionals for many years. For example, one of the objectives of the APB was to narrow areas of difference in GAAP.

Critics maintain that management is allowed too much leeway in the selection of the accounting procedures used in corporate financial reports. These criticisms revolve around two issues (1) Executive compensation is frequently tied to reported earnings, so management is inclined to adopt accounting principles that increase current revenues and decrease current expenses and (2) the value of a firm in the marketplace is determined by its stock price. This value is highly influenced by financial analysts' quarterly earnings estimates. Managers are fearful that failing to meet these earnings estimates will trigger a sell-off of the company's stock and a resultant decline in the market value of the firm.
The large number of accounting frauds that were evident during recent years provide examples of the ways that management has manipulated financial statement in order to fool the public. Many of these cases might not have occurred if management were not afforded the discretion to choose accounting procedures and practices. In short, accounting choice can result in earnings management, fraudulent financial reporting, a lack of financial statement transparency, financial statements that are not reliable, and financial statements that are biased.

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Case 1-8

a. The ultimate authority to issue accounting pronouncements rests with the Securities and Exchange Commission (SEC) which was created by the Securities Act of 1933 and the Securities Exchange Act of 1934, The SEC was created to administer various securities acts. Under powers provided by Congress, the SEC was given the authority to prescribe accounting principles and reporting practices. Nevertheless, because the SEC has generally acted as an overseer and allowed the private sector to develop accounting principles, and this authority has seldom been used. However, the SEC has exerted pressure on the accounting profession and has been especially interested in narrowing areas of difference in accounting practice.

In 1936 the AICPA's Committee on Accounting Procedure (CAP) was formed. This committee had the authority to issue pronouncements on matters of accounting practice and procedure in order to establish generally accepted practices. The works of the CAP were originally published in the form of *Accounting Research Bulletins* (*ARB*s); however, these pronouncements did not dictate mandatory practice and received authority only from their general acceptance. The *ARB*s were consolidated in 1953 into *Accounting Terminology Bulletin No. 1*, "Review and Resume," and

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ARB No. 43. *ARB*s *No. 44* through *No. 51* were published from 1953 until 1959. The recommendations of these bulletins that have not been superseded are contained in the FASB Accounting Standards Codification (FASB ASC; discussed below) and referenced throughout this text where the specific topics covered by the *ARBs* are discussed.

By 1959 the methods of formulating accounting principles were being questioned as not arising from research or based on theory. The AICPA responded to the alleged shortcomings of the CAP by forming the Accounting Principles Board (APB). The objectives of this body were to advance the written expression of generally accepted accounting principles (GAAP), to narrow areas of difference in appropriate practice, to narrow areas of difference in appropriate practice and to discuss unsettled controversial issues. The pronouncements of this body were termed "APB Opinions."

In 1974 the APB was replaced with the Financial Accounting Standards Board. The pronouncements of this organization were originally terms Statements of Financial Accounting Standards. Subsequently, after the publication of the Accounting Standards Codification, they have been termed Accounting Standards Updates.

b. This term, initially proposed by Carman Blough, the first chief accountant of the SEC, is meant to mean authority of 'substantial weight' or importance, and not necessarily a majority view. Thus there might be three authoritative positions all of which are appropriate at a point in time before some standard is established. The majority may have gone in one direction, but the minority who were also considered 'authoritative' and could be used.

c. The SEC and the AICPA have been the sources of authority for compliance with accounting standards. The SEC has indicated that financial statements conforming to standards set by the FASB will be presumed to have authoritative support. The AICPA, in Rule 203 of the Code of Professional Ethics, requires that members prepare financial statements in accordance with GAAP. Failure to follow Rule 203 can lead to the loss of a CPA's license to practice.

Case 1-9

a. This controversy was over the proper method to use in accounting for the investment tax credit. In the early 1960s the country was suffering from the effects of a recession. After President John F. Kennedy took office, his advisors suggested an innovative fiscal economic policy that involved a direct income tax credit (as opposed to a tax deduction) based on a percentage of the cost of a qualified investment. Congress passed legislation creating the investment tax credit in 1961. The APB was then faced with deciding how companies should record and report the effects of the investment tax credit. It considered two alternative approaches:

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1. The *flow-through* method, which treated the tax credit as a decrease in income tax expense in the year it occurred.
2. The *deferred* method, which treated the tax credit as a reduction in the cost of the asset and therefore was reflected over the life of the asset through reduced depreciation charges.

The APB decided that the tax credit should be accounted for by the deferred method and issued *APB Opinion No. 2*. This pronouncement stated that the tax reduction amounted to a cost reduction, the effects of which should be amortized over the useful life of the asset acquired. The reaction to this decision was quite negative on several fronts. Members of the Kennedy administration considered the flow-through method more consistent with the goals of the legislation, and three of the then–Big Eight accounting firms advised their clients not to follow the recommendations of *APB Opinion No. 2*. In 1963, the SEC issued *Accounting Series Release No. 96*, allowing firms to use either the flow-through or deferred method in their SEC filings.

The fact that the SEC had the authority to issue accounting pronouncements, and the lack of general acceptance of *APB Opinion No. 2*, resulted in the APB's partially retreating from its previous position. Though reaffirming the previous decision as being the proper and most appropriate treatment, *APB Opinion No. 4* approved the use of either of the two methods.

b. The lack of support for some of the APB's pronouncements and concern over the formulation and acceptance of U. S. GAAP caused the Council of the AICPA to adopt Rule 203 of the Code of Professional Ethics. This rule requires departures from accounting principles published in APB Opinions or Accounting Research Bulletins (or subsequently FASB Statements and now the FASB ASC) to be disclosed in footnotes to financial statements or in independent auditors' reports when the effects of such departures are material. This action has had the effect of requiring companies and public accountants who deviate from authoritative pronouncements to justify such departures.

Case 1-10

Originally, the FASB issued two types of pronouncements, Statements of Financial Accounting Standards (SFASs) and Interpretations. Subsequently, the FASB established two new series of releases: Statements of Financial Accounting Concepts (SFACs) and Technical Bulletins.

The SFASs constitute the FASBs conceptual Framework (discussed in Chapter 2). SFASs convey required accounting methods and procedures for specific accounting issues and officially created U. S. GAAP.

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Interpretations were modifications or extensions of issues pronouncements.

SFACs constitute the FASBs conceptual framework (discussed in Chapter 2 and are intended to establish the objectives and concepts that the FASB will use in developing standards of financial accounting and reporting. To date, the FASB has issued eight SFACs, which are discussed in depth in Chapters 2, 6, 7, 14 and 17. SFACs differ from SFASs in that they do not establish U. S. GAAP. Similarly, they are not intended to invoke Rule 203 of the Rules of Conduct of the Code of Professional Ethics. It is anticipated that the major beneficiary of these SFACs will be the FASB itself. However, knowledge of the objectives and concepts the Board uses should enable users of financial statements to better understand the content and limitations of financial accounting information.

Technical Bulletins were strictly interpretive in nature and did not establish new standards or amend existing standards. They were intended to provide guidance on financial accounting and reporting problems on a timely basis.

Case 1-11

a. The FASB had three primary goals in developing the codification:
   1. Simplify user access by codifying all authoritative U.S. U. S. GAAPs in one spot.
   2. Ensure that the codified content accurately represented authoritative U.S. U. S. GAAPs as of July 1, 2009.
   3. Create a codification research system that is up to date for the released results of standard-setting activity.

b. The FASB ASC was expected to impact accounting practice by:
   1. Reduce the amount of time and effort required to solve an accounting research issue
   2. Mitigate the risk of noncompliance through improved usability of the literature
   3. Provide accurate information with real-time updates as Accounting Standards Updates are released
   4. Assist the FASB with the research and convergence efforts

c. The FASB no longer issues Statements of Financial Accounting Standards. Changes to authoritative U.S. GAAP, the FASB ASC, are publicized through an Accounting Standards Update (ASU). Each ASU
   1. Summarizes the key provisions of the project that led to the ASU
   2. Details the specific amendments to the FASB Codification
   3. Explains the basis for the Board's decisions

Case 1-12

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Those who contend that there is a standards overload problem base their arguments on two allegations: Not all U. S. GAAP requirements are relevant to small business financial reporting needs, and even when U. S. GAAP requirements are relevant, they often violate the pervasive cost–-benefit constraint.

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

The standards overload problem has several consequences for small business:

1. If a small business omits a U. S. GAAP requirement from audited financial statements, a qualified or adverse opinion may be rendered.
2. The cost of complying with U. S. GAAP requirements can 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 the same requirements as large international firms, but they cannot afford the specialists who 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 businesses regardless of size. The second group would apply 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 apply only to large businesses.

The FASB and various other organizations have studied but have not reached a consensus. A special committee of the AICPA favored differential reporting standards. The FASB had historically taken the position that financial statement users might be confused when two different methods are used to describe or disclose the same economic event, but in 2009 the International Accounting Standards Board (IASB) issued a pronouncement that omits or simplifies the applicability of its standards and disclosure requirements for small and medium-sized companies (see Chapter 3). The attempt to harmonize U.S. and international U. S. GAAP can result in the adoption of a similar FASB standard; however, bankers (a major source of capital for small businesses) and financial analysts have fairly consistently criticized differential reporting requirements as a solution to the standards overload problem.

Case 1-13

a. The term economic consequences refers to the impact of accounting reports on various segments of our economic society. This concept holds that the accounting practices a company adopts affect its security price and value. Consequently, the choice of

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accounting methods influences decision making rather than just reflecting the results of these decisions.

b. One example of the economic consequences of an accounting standard was the release of the FASB's pronouncement on other postretirement benefits (OPRBs), FASB Statement No. 106, "Other Post Retirement Benefits". The accounting guidelines for OPRBs required companies to change from a pay-as-you-go basis to an accrual basis for health care and other benefits that companies provide to retirees and their dependents. The accrual basis requires companies to measure the obligation to provide future services and accrue these costs during the years employees provide service. This change in accounting caused a large increase in recorded expenses for many companies. Consequently, a number of companies simply ceased providing such benefits to their employees, at a large social cost. There are many more examples.

Case 1-14

The answer to this case requires a visit to the Microsoft Corporation's homepage at the time it is assigned.

Financial Analysis Case

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

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