

Part Three

Managing Financial Reporting

Diversity in Accounting Principles: A Problem,
a Strategic Imperative, or a Strategic Opportunity?

Circuit City Stores, Inc. (A)

First National Bank Corporation (A)

Roosevelt Financial Group, Inc.

Harnischfeger Corporation

Diversity in Accounting Principles: A Problem, a Strategic Imperative, or a Strategic Opportunity?

In our study of accounting decision making, we have been reading and discussing situations in which managers have had choices about the way in which they would report on the results of operations and financial condition of their organizations. We have shown that managers must choose between using LIFO or FIFO in measuring and reporting on inventories, or between straight-line depreciation or accelerated depreciation in reporting on plant, property, and equipment. For almost every classification of assets, liabilities, shareholders' equity, and revenue and expenses, alternative conventions, practices, and principles, exist from which managers and their accountants can choose. With such an array of methods and practices available, what is the meaning of "generally accepted accounting principles?"

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

In general, when managers prepare reports for use by outsiders such as lenders, investors, regulatory authorities, or other interested groups, they must choose among accounting conventions, practices, and principles, which become bases for making the measurements necessary to prepare financial reports. Once a choice is made, the concept of consistency demands that similar conventions and practices be used in subsequent periods unless there is a reason that an alternative method would be preferred. We have seen how auditors refer to the use of "generally accepted" accounting principles in expressing their opinion on many financial statements prepared for the use of outsiders.

The use of the word "principles" is perhaps unfortunate, for it connotes something more basic than, in fact, most accounting principles are. Accounting principles are not fundamental truths or even necessarily rules of conduct. They are methods used in observing, measuring, and reporting, which are widely used or which have substantial, authoritative support. A generally accepted accounting principle is created whenever a method, practice, concept or convention is widely used by those who prepare reports, or whenever an official pronouncement is made by a group such as the Financial Accounting Standards Board in the United States, the International Accounting Standards Committee, by a change to a Company's Act, or by a regulator with authority to influence reporting and securities trading.

The fact that wide use leads to general acceptance in accounting principles makes it critical to understand the accounting process and the way in which it operates. In preparing and distributing their reports, managers and their accountants participate in the development of accounting principles. Through the criteria its managers adopt in deciding which measurements should be made and reported, an organization supports and advances the development of principles that may be used even more widely in the future.

The idea of a set of generally accepted accounting principles is very important historically. When there were fewer constraints on the accounting practices that could be employed by managers in preparing reports, unscrupulous entrepreneurs often took advantage of investors, creditors, and other interested groups by rendering misleading reports about income and financial position. In an effort to avert such practices, professional accountants, regulators, independent authorities, and government agencies in most countries have sought to limit the kinds of practices that fall within the guidelines that generally accepted accounting principles provide.

Nevertheless, there is no definitive list of practices and principles that are "generally accepted." It is much easier to find lists or regulations of methods or practices that are not generally accepted. This means that in spite of all the efforts to reduce diversity in reporting practices, great diversity still remains, and anyone who seeks to use financial reports has to pay close attention to the methods used by the managers and accountants who prepared them.

Unfortunately, diversity in accounting principles presents an important problem to anyone who wants to compare the economic performance or financial position of an organization at two points in time, or with that of another organization, or to some normative standard or model. To merely look at the numbers that are reported without considering the methods that lie behind them creates the risk of faulty conclusions or errors in judgment. The next section demonstrates why this is so.

DIVERSITY IN ACCOUNTING PRINCIPLES

The diversity in accounting principles is so great that it would be impossible to summarize in brief form all of the concepts, methods, and procedures that are at the present time acceptable in accounting practice. It is important at least to realize how many diverse practices are acceptable and the way in which the possibilities are multiplied if combinations of different principles and practices relating to assets, liabilities, shareholders' equity, revenues and expenses are considered. Exhibit 1 lists some selected examples of diverse generally accepted accounting principles for presentation of financial information about important classifications.

It would be helpful if there were some normative standard against which diverse practices and their effect on financial reports might be compared. If there were a normative standard, then accounting principles producing reports that were closest to the normative standard would be preferred. By estimating the difference between a report in hand and one based on the normative standard, a financial report reader could make a judgment about the quality of information available in the financial report. In the absence of a standard, each person who seeks to use accounting information needs to create his or her own reference point. This is harder to do than it appears at first glance. Consider the simple example that follows.

How Is Diversity a Problem?

Assume that two identical companies start business at the same time, and that the events and transactions in which they engage during the first year of their operations are identical. If managers of each company choose alternative accounting principles in preparing their reports, those reports may be quite different, even after only one year. Exhibit 2 shows the statement of financial position for each of the two companies to be the same when they begin operations. Exhibit 3 shows the events and transactions that affect both companies identically. Exhibit 4 shows the accounting methods used by the managers of each company in reporting those identical events and transactions. Exhibit 5 shows the statements of income and financial position that each company will prepare at the end of one year of operations. And finally, Exhibit 6 shows how the income of the two identical companies might be reconciled.

While this example is quite simple and is obviously hypothetical, differences like these arise in actual financial reporting. Anyone who attempts to compare financial statements from two or more entities is faced with the task of identifying the accounting methods used. Then, the impact that particular methods might have had on the reports must be estimated before any comparison of the two organizations can be made. Even when examining the financial statements of a single company through time, attention must be given to possible changes in accounting principles and the impact these

changes may have had before information contained in the financial reports can be used for many purposes.

DIVERSITY: STRATEGIC IMPERATIVE VS. STRATEGIC OPPORTUNITY?

Financial reports are a showcase through which managers can fulfill their obligations to provide information to shareholders and other interested parties. The fact that periodic financial reporting is required shows how important the economic community and society think reporting by managers is in facilitating the free flow of capital and preventing one group from taking advantage of another because of the information available to it. It is difficult to imagine how a modern free-enterprise economy could function without a financial reporting system that is somewhat effective.

The role that financial reporting plays in a modern economy requires that managers should be trying to report about the operations and financial condition of their organizations as accurately and informatively as possible. Those who fear that managers might withhold information to use it to their own advantage would argue that some minimum set of disclosure and reporting requirements is necessary to get managers to report effectively. Whichever points of view you have about the environment in which financial reporting occurs, you must consider what managers should do if they discover that the accounting methods and principles that they are using and reporting are not the right ones, and that a change is needed.

Why might managers or an organization be using accounting methods and principles that are incorrect or ineffective? There are at least three obvious reasons. First, it may be that the initial choice of an accounting method or principle was a poor one. Since many initial choices of accounting principles or methods are made when a firm is small or when a problem is first encountered, the implications of those choices may not be obvious. As the organization grows and develops, or as its activities stabilize, it may become obvious that the method or principle initially chosen does not provide as much or as good information as an alternative might.

A second reason why managers or an organization may need to change accounting methods or principles may be because conditions have changed. The environment in which the organization is operating, or the relationships with various suppliers, investors, or financing sources, or a change in the product mix or strategy of the firm all may dictate that an alternative method or principle would be more informative than one previously employed.

A third reason why change may be necessary may be due to the actions of management itself. In developing new strategies, in taking the organization in new directions, and in adopting new tactics to deal with the action of competitors, managers may want to signal that the old accounting methods supported

the old strategy, but new accounting principles and methods are needed given the chosen change in strategic direction.

Regardless of which of these three reasons creates a need for change in the accounting method or principles used in reporting, management may view the need for change as imperative. It is simply impossible to report effectively using the old method when it is obvious that a new method or principle would be more appropriate or effective.

Despite the demands for consistency that are created by the accountant's concept of consistency, an accounting change is permitted and even encouraged when it can be demonstrated that another method or principle would be preferable. In other case studies, we have seen that auditors must note a change in accounting method, but they do not need to deny an unqualified auditor's opinion simply because managers have changed accounting methods or principles. In fact, in many circumstances, the auditors append to their notice of change some phrase like "with which we concur" to signal that they are in agreement with and support the change that management has made in preparing its reports.

Unfortunately, the strategic imperative also creates the opportunity to use changes as a strategic opportunity. Selecting new accounting methods means that managers can present things differently. The results of operations or financial position can be presented in a light different than they would have been presented had the old methods or principles been retained. Because modern organizations and economic activities are so complex, what may to some managers be a strategic imperative to report things as clearly as possible may open the door to strategic opportunities to other managers who are less scrupulous or who desire to present things in a light particularly advantageous to themselves or their organization.

Diversity in accounting principles is unlikely to be eliminated by policy, law, or practice. Diversity exists because the arena in which financial communication, accounting measurement, and financial reporting takes place is a complex one. Those who use financial reports prepared in an atmosphere where accounting diversity is the norm must examine the accounting principles and methods used, consider what alternatives might have been available, and then decide how to use the information in reports. Those who prepare financial reports and are responsible for them must consider how to balance the strategic imperative to report as accurately and honestly as possible with the strategic opportunity to present information in such a way that some who see and use the information might be misled into drawing erroneous conclusions and taking undesirable actions.

EXHIBIT 1

Selected Examples of Diversity in Generally Accepted Accounting Principles

Cash

1. Include all cash on hand and in banks as one item.
2. Use separate captions for cash on hand, and/or cash in banks, and/or cash in banks that cannot be easily withdrawn, and/or separate currencies.

Receivables

1. Show receivables at gross amount.
2. Show receivables at gross amount less allowances for unearned interest and doubtful accounts.
3. Show receivables classified by type (accounts, notes, etc.), and/or by time, and/or by source (customers, employees, government, etc.).
4. Exclude receivables unless earned and due, as in lease payments receivable.

Marketable securities (temporary investments)

1. Show securities at cost.
2. Show securities at market value when below cost.
3. Show securities at cost plus interest earned but not yet paid.
4. Show securities at approximate market value.

Inventories

1. Show inventories at gross cost and/or by classes (supplies, raw materials, work in process, finished goods ready for sale).
2. Show inventories at cost or market, whichever is lower.
3. Show inventories at market or selling price.
4. Determine "cost" or "price" by assuming average costs or standard costs.
5. Report flow of costs and value of goods remaining by assuming last-in first-out, or first-in first-out, or average costs in and out, or standard costs in and out, etc. (Also see cost of goods sold below.)

Land, plant, and equipment

1. Show land, plant, and equipment at original cost, and/or adjusted original cost, and/or cost or market value, whichever is lower.
2. Show plant and equipment at current value.
3. Show plant and equipment at cost less accumulated depreciation calculated by assuming straight-line allocation of cost to periods, or by an accelerated or decelerated rate of depreciation.
4. Charge all purchases of plant and equipment as expense in period purchased.
5. Show land at original cost less depletion caused by mining, harvesting, or extraction of gases or fluids.

EXHIBIT 1 (continued)**Investments**

1. Show investments in other companies at cost.
2. Show investments in other companies at cost or market value, whichever is lower.
3. Show investments in other companies at cost plus any proportional share of earnings on investment not received.
4. Show investments at market value.

Intangible assets

1. Exclude intangible assets, charging all costs related thereto as expense in the period of expenditure.
2. Show all intangible assets at cost.
3. Show intangible assets at cost but allocate costs over few periods until only a nominal value remains.
4. Show intangible assets at cost but allocate cost to all periods of expected value.
5. Show intangible assets at cost but do not charge costs to periods unless value has clearly fallen.
6. Show intangible assets at estimated value at time of acquisition, adjusted for subsequent charges.

Current liabilities

1. Show liabilities at face amount.
2. Show liabilities at amount at which obligations could be satisfied plus any costs of doing so.

Long-term liabilities

1. Show long-term liabilities at face amount.
2. Show long-term liabilities at face amount adjusted for discounts or premiums given at acceptance and amortized over period of the liability.
3. Show liabilities, including commitments on leases, pensions, and other contractual agreements, at face amount or adjusted for effects of interest.

Owners' equity

1. Show owners' equity as the amount of assets less the amount of liabilities.
2. Show owners' equity classified to show original source.
3. Show owners' equity classified by original source but modified by transactions between the entity and shareholders, and/or extraordinary reclassifications or adjustments.
4. Within owners' equity, segregate earnings retained by implied use of resources earned.

EXHIBIT 1 (continued)

Revenues

1. Recognize revenue in period when products or services are delivered.
2. Recognize revenue in period when product is ready for delivery (as in case of precious gems or metals).
3. Recognize revenue in period when payment is received from customer or client.

Cost of goods sold

1. Recognize expense in the period and at purchase of product delivered.
2. Recognize expense in the period and at purchase cost of some assumed unit of product delivered.
3. Recognize expense in period and at cost of replacement of the product delivered.
(Also see inventories above.)

Expenses

1. Recognize as expenses of the period, all or selected cash payments.
2. Recognize as expenses of the period, all expenditures related to products or services sold in the period. All expenditures are assets or in satisfaction of obligations.
3. Recognize as expenses in the period, all estimated declines in assets value and estimated increases in obligations not related to cost of goods sold.

Net income

1. Show all increases or decreases in net value of owners' equity as net income, regardless of source.
2. Exclude from net income all adjustments relating to prior periods reports, and/or extraordinary events.

EXHIBIT 2**Statements of Financial Position, January 1, 1992**

	Company A	Company B
Assets		
Cash	\$ 500	\$ 500
Marketable securities	1,000	1,000
Inventories (100 units @ \$10)	1,000	1,000
Building and equipment (estimated life 10 years)	\$2,000	\$2,000
Less: Accumulated depreciation	<u>—</u>	<u>—</u>
	2,000	2,000
Total assets	<u>\$4,500</u>	<u>\$4,500</u>
Equities		
Accounts payable	\$ 200	\$ 200
Bank loans	1,000	1,000
Total liabilities	\$1,200	\$1,200
Owners' equity:		
Common Stock	3,300	3,300
Total equities	<u>\$4,500</u>	<u>\$4,500</u>

EXHIBIT 3**Events and Transactions of Companies A and B^a For the Year 1992**

Sales of merchandise (200 units @ \$40 each)	\$8,000
Purchase of inventory on account (a 3% discount is available if paid within 10 days):	
March 31 50 units @ \$10	500
June 30 50 units @ \$12	600
September 30 50 units @ \$15	750
December 31 50 units @ \$20	1,000
 Paid accounts payable:	
April 30	500
July 31	600
October 31	750
 Paid salaries	\$2,500
 Increased bank loan	\$2,000
 Purchased new equipment (estimated life, 4 years)	\$2,000
 Paid for research on new product not yet introduced	\$ 500
 Value of marketable securities, December 31, 1992	\$ 950

^a Assumed to be identical for each company

EXHIBIT 4**Accounting Methods Used In Preparing Financial Reports By Companies A and B**

Item	Company A	Company B
Cash	Report face amount on hand and in bank.	Report face amount on hand and in bank.
Marketable securities	Report at cost unless market is "materially" lower and sale contemplated.	Report at lower of market cost or market.
Inventory	Report at cost, assuming first-in, first-out.	Report at cost, assuming last-in, first-out.
Buildings and equipment	Report at cost less accumulated straight-line depreciation.	Report at cost less accumulated depreciation accelerated at two times straight-line rate.
Intangible assets	Hold as asset at cost until related revenues are realized.	Charge against revenues when cash expended.
Accounts payable	Report at amount due less discounts available.	Report at face amount.
Bank loan	Report at amount due.	Report at amount due.
Owners' equity	Assets - Liabilities	Assets - Liabilities

EXHIBIT 5
Financial Reports of Companies A and B

Statement of Income For the Year

1992	Company A	Company B
Sales revenues	\$8,000	\$8,000
Less cost of goods sold:		
Beginning inventory	\$1,000	\$1,000
Add: purchases	<u>2,850</u>	<u>2,850</u>
Available	\$3,850	\$3,850
Ending inventory	<u>1,750</u>	<u>1,000</u>
	<u>2,100</u>	<u>2,850</u>
Gross margin	\$5,900	\$5,150
Less expenses:		
Salaries	\$2,500	\$2,500
Depreciation	700	1,400
Research on new product	<u>—</u>	<u>500</u>
	<u>3,200</u>	<u>4,400</u>
Operating income:	\$2,700	\$ 750
Add: Discount available	30	—
Less: Loss on securities held	<u>—</u>	<u>50</u>
Net Income	<u>\$2,730</u>	<u>\$ 700</u>

Statements of Financial Position,
 December 31, 1992

	Company A	Company B
Assets		
Cash	\$ 3,650	\$3,650
Marketable securities	1,000	950
Inventories	1,750	1,000
Building and equipment:		
Cost	\$4,000	\$4,000
Accumulated depreciation	<u>700</u>	<u>1,400</u>
	<u>3,300</u>	<u>2,600</u>
Research on new product	<u>500</u>	<u>—</u>
Total assets	<u>\$10,200</u>	<u>\$8,200</u>
Equities		
Accounts payable	\$ 1,170	\$1,200
Bank loans	<u>3,000</u>	<u>3,000</u>
Total liabilities	\$ 4,170	\$4,200
Owners' equity:		
Common stock	3,300	3,300
Retained earnings	<u>2,730</u>	<u>700</u>
	<u>6,030</u>	<u>4,000</u>
Total equities	<u>\$10,200</u>	<u>\$8,200</u>

EXHIBIT 5 (continued)

Statement of Cash Flows For the Year 1992	Company A	Company B
Cash from Operations:		
Net income	\$ 2,730	\$ 700
Add: Depreciation	700	1,400
Decrease in marketable securities	-	50
Increase in inventories	(750)	-
Increase in Accounts Payable	970	1,000
Total cash from operations	<u>\$ 3,650</u>	<u>\$ 3,150</u>
Cash from Inventories:		
Purchase of new equipment	(\$2,000)	(\$ 2,000)
Research on new product	(500)	-
Total cash from Inventory	<u>(\$2,500)</u>	<u>(\$ 2,000)</u>
Cash from financing:		
New bank loan	<u>\$ 2,000</u>	<u>\$ 2,000</u>
Total changes in cash	\$ 3,150	\$ 3,150
Cash, January 1, 1992	500	500
Cash, December 31, 1992	<u>\$ 3,650</u>	<u>\$ 3,650</u>

EXHIBIT 6**Reconciliation of Income for Companies A and B**

Company B income	\$ 700
Add \$50 because Company A does not reduce value of marketable securities to market value of \$950	50
Add \$750 because Company A uses FIFO instead of LIFO for inventory values and determining cost of goods sold	750
Add \$700 because Company A uses straight-line depreciation instead of an accelerated method	700
Add \$500 because Company A retains research costs as an asset	500
Add \$30 because Company A reduced liabilities to discounted amount	<u>30</u>
Company A income	<u>\$2,730</u>

Circuit City Stores, Inc. (A)

Michael Chalifoux, the senior vice president and chief financial officer of Circuit City Stores, a discount specialty retailer, was disturbed about a problem that had been brewing for some time. The issue involved Circuit City's accounting practices, specifically regarding the recognition of revenue from the sale of extended warranty and product maintenance contracts.

Chalifoux had just learned that the Financial Accounting Standards Board (FASB) had released a proposed FASB technical bulletin that would require Circuit City Stores to change its accounting for extended warranty and product maintenance contracts. The proposed accounting change would delay full recognition of revenue and income until the warranty period had expired. As a result, reported income would be lower than if Circuit City's present accounting policies were continued.

Circuit City believed that revenue from sales of extended warranty contracts most closely matched costs under the Partial Revenue Recognition method. The FASB was proposing that the Deferral of Revenue Method was more appropriate, whereas Circuit City argued that this would result in a mismatch of revenues and expenses.

Background

Circuit City Stores was one of the first consumer-electronics and major-appliance retailers to adopt the concept of low pricing, selection, and service. By 1990 the company operated 149 retail outlets, 125 of which were designated

Susan S. Harmeling prepared this case under the supervision of Professor William J. Bruns, Jr.

Copyright © 1990 by the President and Fellows of Harvard College. Harvard Business School case 191-086.

Circuit City superstores. These 32,000-square-foot stores were designed to display a broad product selection from 2,800 brand-name items sold by Circuit City. In a typical superstore, customers could choose from almost 150 color televisions, more than 50 video cassette recorders, 30 camcorders, 30 compact disc players, 45 refrigerators, and 25 washer-and-dryer pairs. In addition, the selections could include car stereos, microwaves, cellular phones, telephones, telephone answering machines, and facsimile machines. Large in-store warehouses provided instant product availability, and mechanized distribution centers allowed overnight inventory replenishment. Complete delivery, installation, and service were offered for almost every item sold.

Circuit City had experienced rapid growth in sales and profitability. Net revenues had increased from \$705 million in 1986 to \$2.1 billion in 1990. During the same period, net earnings had increased from \$22 million to \$78 million. Financial statements included in the 1990 Annual Report of Circuit City Stores are shown in **Exhibit 1**.

Circuit City Stores and other discount retailers like it made substantial profit margins on extended warranty contracts. An example of a typical transaction would be the following scenario. A retailer would sell a stereo system with a cost of \$900 for \$1,000. At the same time, the retailer offered the customer the option to purchase a two-year service contract for \$100. Under the terms of the service contract, the retailer would clean and inspect the stereo every six months and would cover the cost of parts and labor should it need repair. Future costs to perform under the contract were estimated at \$20. The retailer generally sold service contracts only to customers who also purchased a stereo from that retailer. The transaction could be summarized as follows:

	Stereo	Contract	Total
Revenue	\$1,000	\$100	\$1,100
Cost	<u>900</u>	<u>20</u>	<u>920</u>
Profit	100	80	180

The joint sale of equipment and service contracts was part of Circuit City's corporate strategy. By successfully selling extended warranty and service contracts to a substantial portion of equipment customers, Circuit City could price its merchandise more competitively and draw customers to its stores through advertising. Circuit City had had much experience with the combined sale of equipment and extended warranty contracts. They looked on the combined sale as one transaction because they could predict with great certainty the percentage of customers, between 40% and 70% depending on the product, who would purchase both the item for sale and the warranty contract.