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CASES IN FINANCIAL ACCOUNTING

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PREFACE

The case method is a teaching method that has been in existence for some time. It differs from traditional teaching methods in that it does not involve the memorization of facts and an instructor lecturing the students on his thoughts. The emphasis is on the development of thinking, problem solving skills, and technical knowledge through discussion. The lecture method has learning through listening with an emphasis on the acquisition of facts as its primary goal. In contrast, the case method has learning through discussion with an emphasis on thinking as its primary goal.

To some extent the degree of success in reaching the primary goal of the case method is dependent on the availability of a collection of cases which pertains to a variety of issues with varying degrees of difficulty and requiring different levels of student expertise and involvement. This book attempts to satisfy those needs by providing over 238 cases with a variety of formats, solution approaches, and degrees of difficulty. The topics covered include almost all those covered in an Intermediate Accounting textbook and additional topics which might only be studied in advanced accounting courses.

We have attempted to develop a set of cases which will permit different pedagogical approaches to be used. The book may be used alone in the classroom or as a supplement to a more conventional accounting text. Sufficient cases are available in this textbook on which an entire course could be developed; for example as the text for an advanced theory course in financial reporting. It might also be used in connection with outside readings to study many topical and sometimes controversial issues in accounting and financial reporting. The solutions manual presents recommended readings for each chapter which might be used in this respect.

Some instructors might wish to use the text as a supplement and assign only a limited number of cases for classroom discussion in Intermediate Accounting. Others might wish to expand the intermediate accounting sequence as some schools have done (such as three semesters) and integrate the case method into this expanded time allotment.

The cases are aimed at students who have some exposure to basic accounting concepts and methods. However, because of the variation of degrees of difficulty involved in the cases the students might be at the intermediate or advanced level. Master's students and business executives would also find ample materials appropriate at their levels.

The cases themselves are of many different types. Some of the cases are similar to AICPA or CMA type questions. They are relatively short and require a solution that can be considered right or wrong. Others are technically oriented. The issue to be resolved is fairly obvious, the facts are given relative to the issue, some numerical calculations may be required, basic judgments might be made about the relative importance of various considerations, and a technical accounting solution is reached.

Other cases are more of the armchair variety that are not subject to precise definition or a single solution. One armchair approach might require the identification of a particular accounting issue and the evaluation of potential alternative treatments of the issue. Another approach may be to assess the economic implications of the accounting treatment and to speculate as to the motivations of the preparers of the financial statements. The students could also be placed in the role of a decision maker and asked to respond. Although the majority of the armchair cases are conceptual in nature, a number may also require computations and journal entries.

Another type of case may require the consideration and discussion of accounting theory. An excerpt from a speech, editorial comment, magazine article, or other published source may serve as the focus of an accounting theory controversy. Varying degrees of research are required to prepare these solutions.

Finally, certain cases attempt to bring the study of accounting and the real world together. The materials explore and analyse the application of financial accounting in the context of actual annual reports.

The student's role in this course can be easily stated: preparation and participation. It is important that students realize that the case method may require new methods of preparation relative to previous lecture oriented courses and that the first attempts at case solutions may lead to frustration. Students may want closure. They want the "right" answer. They may think that, as in other accounting courses, there are sets of rules or methods of solution that if memorized and followed, will lead to the correct answers. This is not usually the situation with case analysis. There may be no single correct solution, but a variety of solutions. Actual real world situations as depicted in the cases may involve exceptions, little well-defined guidance, and uncertainties.

A generalized procedure is offered as a model to aid the student in approaching most cases. First, scan the case to obtain a fast, accurate overview of the primary issues or problems involved, the type of information provided, type of information required, and whether or not quantitative analysis will be necessary.

Second, the student should read the case carefully. Underline key facts and write notes in the margin.

The next step required may be an examination of the underlined material and margin notes to identify the problems faced by the manager or accountant and if not stated in the case instructions, state the problem as succinctly as possible. By writing down the problems the student may better clarify the issues in their minds.

Fourth, the student should think about the information required for the analysis and solutions. There may be a need to examine accounting textbooks, professional pronouncements, or other literature to search for solutions. This research and investigation process is a valuable bonus of the case method.

The next step is the accumulation of the required information from both within the case, and, if necessary from outside sources and to outline a solution.

Sixth, since communication is important in practice, the student should prepare a case write-up--whether or not it is to be turned in. The write-up should answer the questions logically and if necessary build an argument from an introduction at the beginning to the conclusions and recommendations at the end.

Finally the student should participate in class discussion. The student should be willing both to express and support his or her work and to listen to and objectively analyze the work of others. The key is to relax, learn, and help others learn through your participation.

A basic premise of the case method is that one learns by doing. It follows that the best way to learn about the case method is to use it. It can be a stimulating, rewarding experience for both the student and for the instructor.

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CHAPTER 1

THE ENVIRONMENT OF FINANCIAL ACCOUNTING AND THE DEVELOPMENT OF ACCOUNTING STANDARDS

1-1 Savings and Loan Dilemma

In the early 1980's, hardly a day went by in which the problems of the savings and loan (S&L) industry were not discussed in the financial press. The cause of the S&L's problems was that the rates paid on the monies they borrowed had substantially increased, whereas the return on their assets (mostly long-term fixed rate mortgages) had risen slowly. For example, in the first part of 1981, S&Ls paid 10.31% for their money and received only 9.72% on their mortgages. Such a situation causes two problems financially for the industry namely, capital adequacy and liquidity. Capital adequacy problems arise because if the loan portfolio were written down to its market value, many S&L's net worth would be eliminated. Such a treatment might lead to a total loss of confidence in the industry. Liquidity problems develop because some S&Ls are paying out more than they receive, and therefore may not have enough to pay their bills and to allow depositors to withdraw their monies.

One solution proposed would be to allow the S&Ls to sell mortgage loans at a loss (increase liquidity) but allow them to charge the loss to capital over the life of the loan (maintain capital). The savings and loan industry lobbied hard for such a treatment. The government through the Federal Home Loan Bank Board recommended that such an approach be permitted. Others disagreed. Many accountants argued that the sale of an asset (in this case, mortgage loans) should generate a gain or loss on sale. In addition, it was noted that to defer this loss has the effect of burying this item in the balance sheet such that an investor would not be aware of the transaction. Others argue that a deferred loss account cannot be an asset because no future benefits will be received from it.

You have a Savings and Loan Company as a client who has recently been experiencing a severe liquidity problem. The S&L sold some of its mortgages, but is now concerned with how to account for this transaction. Since this is a relatively new or emerging issue you explain that some research may be necessary to determine a method of accounting for the transaction.

INSTRUCTIONS:

Without addressing the specific financial accounting problem described, what is a general research approach that an accountant might take to investigate emerging issues such as the one described in this case? Include a listing of reference materials that might be helpful in your research.

1-2 "Generally Accepted Accounting Principles"

Following is the report of the independent certified public accountants for Anheuser-Busch Companies, Inc:

To the Shareholders and
Board of Directors of
Anheuser-Busch Companies, Inc.

February 6, 1985

In our opinion, the accompanying Consolidated Balance Sheet and the related Consolidated Statements of Income, Shareholders' Equity and Convertible Redeemable Preferred Stock, and of Changes in Financial Position present fairly the financial position of Anheuser-Busch Companies, Inc. and its subsidiaries at December 31, 1984 and 1983, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1984, in conformity with generally accepted accounting principles consistently applied. Our examinátions of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Price Waterhouse

INSTRUCTIONS:

1. Explain the meaning of the term "accounting principles" as used in the audit report. (Do not discuss the significance of "generally accepted" in this part of the case.)
2. How do you determine whether or not an accounting principle is

generally accepted? Discuss the sources of evidence for determining whether an accounting principle has substantial authoritative support. Do not merely list the titles of publications.
3. Do generally accepted accounting principles allow for diversity in accounting practice? Would you expect diversity of accounting practice to exist in an environment in which the accounting profession continually attempts to improve comparability?

1-3 The Role of the SEC and FASB

A press release announcing the appointment of the trustees of the new Financial Accounting Foundation stated that the Financial Accounting Standards Board (to be appointed by the trustees) "...will become the established authority for setting accounting principles under which corporations report to the shareholders and others" (AICPA news release, July 20, 1972).

INSTRUCTIONS:

1. No mention is made of the SEC in the press release. What role does the SEC play in setting accounting principles?
2. How have accounting principles been set in the past ten years? In your answer identify the body performing this function, the sponsoring organization, and the method by which the body arrives at its decisions.
3. What methods have management and management accountants used to influence the development of accounting principles in the past ten years?

(CMA adapted)

1-4 Economic Consequences

The prospect of revised pension accounting standards continues to cause controversy. The long revision process started formally in the mid-1970's with an FASB research project concerned with employers' accounting for pension plans. The FASB Discussion Memorandum sought to identify all of the issues relevant to pension plan accounting. A significant period of time was allowed for public comment and in November 1982 the FASB published its "Preliminary Views: Employers' Accounting for Pensions and Other Postemployment Benefits."

Substantial criticism was directed at the FASB. A primary concern was the recognition of previously unrecorded pension liabilities. Opponents of the Preliminary Views fear severe economic consequences. For example, debt to equity ratios may deteriorate to the extent that companies may be in violation of existing debt covenants. This could cause massive loan defaults--and even bankrupcy. The higher debt to equity ratios may make it more difficult to raise capital and would surely raise the firm's interest expense. Besides, said many opponents, these liabilities do not represent legal liabilities and will never have to be paid. Employers might become reluctant to improve pension plan benefits. This could have severe economic (and social) consequences for future retired workers and even for the social security system.

Proponents of the liability recognition cite a consistent line of reasoning flowing from the conceptual framework and pension theory as a basis for the recognition of the pension liability. After all, neutrality in accounting is an important criterion for the establishment of accounting principles and information that is not neutral loses credibility. Slanting accounting information to favor one group or another is not consistent with the accountant's responsibility to "fairly present" the financial statements.

The criticisms continue: "The proposals do not portray economic reality," "the proposals will have severe economic consequences on capital markets, firms, and plan participants." "The FASB's problem is that it uses accounting theory to explain the world solely in terms of faith and reason and without direct observation of the economic consequences."

INSTRUCTIONS:

1. What is meant by the term "economic consequences" in regards to financial reporting standards? Present your discussion without specific reference to the pension accounting issue.
2. What role should economic consequences play in the development of financial reporting standards?
3. What has been the response of the FASB to the important issue of economic consequences?

1-5 Accounting Standard Setting

Mark Hauser, a new staff accountant, is confused in his first few months on the job because of the complexities involving accounting standard setting. Specifically, he is confused by the number of bodies issuing financial reporting standards of one kind or another and the level of authoritative support that can be attached to these reporting standards. Mark decides that he must review the environment in which accounting standards are set, if he is to increase his understanding of the accounting profession.

Mark recalls that during his accounting education there was a chapter or two in his accounting textbook regarding the environment of financial accounting and the development of accounting standards. However, he remembers that little emphasis was placed on these chapters by his instructor.

INSTRUCTIONS:

1. Help Mark (and yourself) by identifying key organizations involved in accounting standard setting.
2. In what ways is accounting involved in the environment as Mark refers to it? That is, what environmental factors influence accounting and how does accounting influence its environment?
3. Mark asks for guidance regarding authoritative support. Please assist him by defining, explaining, and noting the diversity of GAAP.
4. Give Mark a historical overview as regards to how standard setting has evolved so he will not feel as if he is the first one to be confused.
5. What authority for compliance with GAAP has existed throughout the period of standard setting?

1-6 Models for Setting Accounting Standards

Presented below are three models for setting accounting standards:

1. The purely political approach, where national legislative action decrees accounting standards.
2. The private, professional approach, where financial accounting standards are set and enforced by private professional actions only.
3. The public/private mixed approach, where standards are basically set by private sector bodies that behave as though they were public agencies and whose standards to a great extent are enforced through governmental agencies.

INSTRUCTIONS:

1. Which of these three models best describes standard setting in the United States? Comment on your answer.
2. Why do companies, financial analysts, labor unions, industry trade associations, and others take such an active interest in standard setting?

3. Cite an example of a group other than the FASB that attempts to establish accounting standards. Speculate as to why another group might wish to set its own standards.

1-7 The Role of Research

Recently, much attention has been directed toward the role of research in the accounting standard setting process. Alvin Jennings in a speech that led to formation of the Accounting Principles Board said, "Development of accounting principles should be regarded as in the nature of pure research." An examination of a number of journal articles indicates that there is disagreement with his position.

For example one writer noted, "Although the techniques of accounting research excel in systematic analysis of explicit information, accounting rulemakers must go beyond knowledge obtained from research and consider also knowledge largely intuitive, and of a high logical order amenable to systematic analysis. If the FASB should want no more than a recommendation as regards which course to follow, it would look to the wrong place if it looked to research. It would be better to consult a man of wide experience and demonstrated understanding, and to rely on his intuition."

Another writer notes that the choice among financial reporting alternatives is a political process. He states that "there is a misconception that the critical issues of accounting inquiry are essentially technical when they are actually political." Another author suggests that we have various possibilities available to use to attack the problem from a political angle. One approach is the confrontation mode in which the profession decides to take a firm stand on a given issue regardless of the consequences. A second approach is referred to as the incremental approach, in which the profession attempts to slowly change the financial reporting environment. Finally, there is simple abdication, where the FASB simply permits the public sector to legislate accounting standards.

INSTRUCTIONS:

1. What do you believe to be the roles of research and intuition in the accounting standard setting process? Are the roles complementary or opposing?
2. What do you believe to be the roles of research and politics in the accounting standard setting process? Are the roles complementary or opposing?
3. What type of approach confrontation, incrementation or abdication do you believe the accounting profession presently pursues? What approach do you believe the profession should follow?