

Introduction to Financial Reporting

Users of financial statements include a company's managers, stockholders, bondholders, security analysts, suppliers, lending institutions, employees, labor unions, regulatory authorities, and the general public. These are internal and external stakeholder groups. They use the financial reports to make decisions. For example, potential investors use the financial reports as an aid in deciding whether to buy the stock. Suppliers use the financial reports to decide whether to sell merchandise to a company on credit. Labor unions use the financial reports to help determine their demands when they negotiate for employees. Management could use the financial reports to determine the company's profitability.

Demand for financial reports exists because users believe that the reports help them in decision

making. In addition to the financial reports, users often consult competing information sources, such as new wage contracts and economy-oriented releases.

This book concentrates on using financial accounting information properly. A basic understanding of generally accepted accounting principles and traditional assumptions of the accounting model are introduced. This aids the user in recognizing the limits of financial reports.

The ideas that underlie financial reports have developed over several hundred years. This development continues today to meet the needs of a changing society. A review of the evolution of generally accepted accounting principles and the traditional assumptions of the accounting model should help the reader understand the financial reports and thus analyze them better.

Development of Generally Accepted Accounting Principles (GAAP) in the United States

Generally accepted accounting principles (GAAP) are accounting principles that have substantial authoritative support: The accountant must be familiar with acceptable reference sources in order to decide whether any particular accounting principle has substantial authoritative support.

The formal process of developing accounting principles that exist today in the United States began with the Securities Acts of 1933 and 1934. Prior to these securities acts, the New York Stock Exchange (NYSE), which was established in 1792, was the primary mechanism for establishing specific requirements for the disclosure of financial information. These requirements could be described as minimal and only applied to corporations whose shares were listed on the NYSE. The prevailing view of management was that financial information was for management's use.

The stock market crash of 1929 provoked widespread concern about external financial disclosure. Some alleged that the stock market crash was substantially influenced by the lack of adequate financial reporting requirements to investors and creditors. The Securities Act of 1933 was designed to protect investors from abuses in financial reporting that developed in the United States. This act was intended to regulate the initial offering and sale of securities in interstate commerce.

In general, the Securities Exchange Act of 1934 was intended to regulate securities trading on the national exchanges, and it was under this authority that the **Securities and Exchange Commission (SEC)** was created. In effect, the SEC has the authority to determine GAAP and to regulate the accounting profession. The SEC has elected to leave much of the determination of GAAP and the regulation of the accounting profession to the private sector. At times, the SEC will issue its own standards.

Currently, the SEC issues Regulation S-X, which describes the primary formal financial disclosure requirements for companies. The SEC also issues Financial Reporting Releases (FRRs) that pertain to financial reporting requirements. Regulation S-X and FRRs are part of GAAP and are used to give the SEC's official position on matters relating to financial statements. The formal process that exists today is a blend of the private and public sectors.

A number of parties in the private sector have played a role in the development of GAAP. The American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB) have had the most influence.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

The **AICPA** is a professional accounting organization whose members are certified public accountants (CPAs). During the 1930s, the AICPA had a special committee working with the New York Stock Exchange on matters of common interest. An outgrowth of this special committee was the establishment in 1939 of two standing committees, the **Committee on Accounting Procedures** and the **Committee on Accounting Terminology**. These committees were active from 1939 to 1959 and issued 51 Accounting Research Bulletins (ARBs). These committees took a problem-by-problem approach, because they tended to review an issue only when there was a problem related to that issue. This method became known as the brushfire approach. They were only partially successful in developing a well-structured body of accounting principles. ARBs are part of GAAP unless they have been superseded.

In 1959, the AICPA replaced the two committees with the **Accounting Principles Board (APB)** and the **Accounting Research Division**. The Accounting Research Division provided research to aid the APB in making decisions regarding accounting principles. Basic postulates would be developed that would aid in the development of accounting principles, and the entire process was intended to be based on research prior to an APB decision. However, the APB and the Accounting Research Division were not successful in formulating broad principles.

The combination of the APB and the Accounting Research Division lasted from 1959 to 1973. During this time, the Accounting Research Division issued 14 Accounting Research Studies. The APB issued 31 Opinions (APBOs) and four Statements (APBSs). The Opinions represented official positions of the Board, whereas the Statements represented the views of the Board but not the official opinions. APBOs are part of GAAP unless they have been superseded.

Various sources, including the public, generated pressure to find another way of developing GAAP. In 1972, a special study group of the AICPA recommended another approach—the establishment of the **Financial Accounting Standards Board (FASB)**. The AICPA adopted these recommendations in 1973.

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

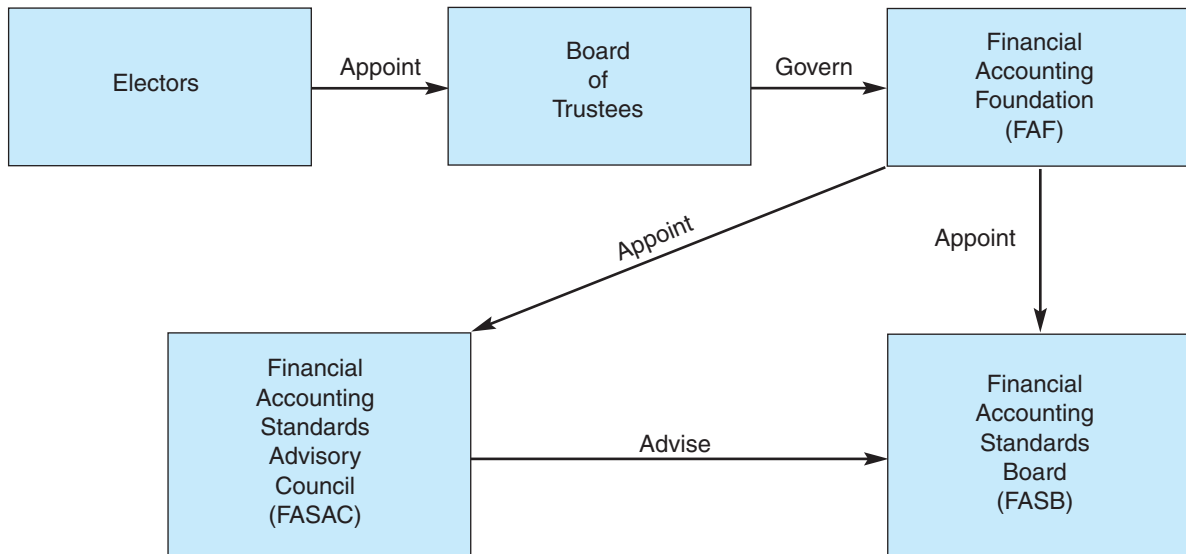
The structure of the FASB is as follows: A panel of electors is selected from nine organizations. They are the AICPA, the Financial Executives Institute, the Institute of Management Accountants, the Financial Analysts Federation, the American Accounting Association, the Security Industry Association, and three not-for-profit organizations. The electors appoint

the board of trustees that governs the **Financial Accounting Foundation (FAF)**. There are 16 trustees.

The FAF appoints the **Financial Accounting Standards Advisory Council (FASAC)** and the FASB.

There are approximately 30 members of the FASAC. This relatively large number is to obtain representation from a wide group of interested parties. The FASAC is responsible for advising the FASB. There are seven members of the FASB. Exhibit 1-1 illustrates the structure of the FASB.

Exhibit 1-1 STRUCTURE OF THE FASB



The FASB issues four types of pronouncements:

1. **Statements of Financial Accounting Standards (SFASs).** These Statements establish GAAP for specific accounting issues. SFASs are part of GAAP unless they have been superseded.
2. **Interpretations.** These pronouncements provide clarifications to previously issued standards, including SFASs, APB Opinions, and Accounting Research Bulletins. The interpretations have the same authority and require the same majority votes for passage as standards (a supermajority of five or more of the seven members). Interpretations are part of GAAP unless they have been superseded.
3. **Technical bulletins.** These bulletins provide timely guidance on financial accounting and reporting problems. They may be used when the effect will not cause a major change in accounting practice for a number of companies and when they do not conflict with any broad fundamental accounting principle. Technical bulletins are part of GAAP unless they have been superseded.
4. **Statements of Financial Accounting Concepts (SFACs).** These Statements provide a theoretical foundation upon which to base GAAP. They are the output of the FASB's Conceptual Framework project, but they are not part of GAAP.

OPERATING PROCEDURE FOR STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS (SFASs)

The process of considering a SFAS begins when the Board elects to add a topic to its technical agenda. The Board receives suggestions and advice on topics from many sources, including the FASAC, the SEC, the AICPA, and industry organizations.

For its technical agenda, the Board considers only “broken” items. In other words, the Board must be convinced that a major issue needs to be addressed in a new area or an old issue needs to be reexamined.

The Board must rely on staff members for the day-to-day work on projects. A project is assigned a staff project manager, and informal discussions frequently take place among Board members, the staff project manager, and staff. In this way, Board members gain an understanding of the accounting issues and the economic relationships that underlie those issues.

On projects with a broad impact, a **Discussion Memorandum (DM)** or an **Invitation to Comment** is issued. A Discussion Memorandum presents all known facts and points of view on a topic. An Invitation to Comment sets forth the Board’s tentative conclusions on some issues related to the topic or represents the views of others.

The Discussion Memorandum or Invitation to Comment is distributed as a basis for public comment. There is usually a 60-day period for written comments, followed by a public hearing. A transcript of the public hearing and the written comments become part of the public record. Then the Board begins deliberations on an **Exposure Draft (ED)** of a proposed Statement of Financial Accounting Standards. When completed, the Exposure Draft is issued for public comment. The Board may call for written comments only, or it may announce another public hearing. After considering the written comments and the public hearing comments, the Board resumes deliberations in one or more public Board meetings. The final Statement must receive affirmative votes from five of the seven members of the Board. The Rules of Procedure require dissenting Board members to set forth their reasons in the Statement. Developing a Statement on a major project generally takes at least two years, sometimes much longer. Some people believe that the time should be shortened to permit faster decision making.

The FASB standard-setting process includes aspects of accounting theory and political aspects. Many organizations, companies, and individuals have input into the process. Some input is directed toward achieving a standard less than desirable in terms of a strict accounting perspective. Often, the end result is a standard that is not the best representation of economic reality.

FASB CONCEPTUAL FRAMEWORK

The Conceptual Framework for Accounting and Reporting was on the agenda of the FASB from its inception in 1973. The Framework is intended to set forth a system of interrelated objectives and underlying concepts that will serve as the basis for evaluating existing standards of financial accounting and reporting.

Under this project, the FASB has established a series of pronouncements, **Statements of Financial Accounting Concepts (SFACs)**, intended to provide the Board with a common foundation and the basic reasons for considering the merits of various alternative accounting principles. SFACs do *not* establish GAAP; rather, the FASB eventually intends to evaluate current principles in terms of the concepts established.

To date, the Framework project has issued seven Concept Statements:

1. *Statement of Financial Accounting Concepts No. 1, “Objectives of Financial Reporting by Business Enterprises.”*
2. *Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information.”*
3. *Statement of Financial Accounting Concepts No. 3, “Elements of Financial Statements of Business Enterprises.”*
4. *Statement of Financial Accounting Concepts No. 4, “Objectives of Financial Reporting by Nonbusiness Organizations.”*
5. *Statement of Financial Accounting Concepts No. 5, “Recognition and Measurement in Financial Statements of Business Enterprises.”*
6. *Statement of Financial Accounting Concepts No. 6, “Elements of Financial Statements” (a replacement of No. 3).*
7. *Statement of Financial Accounting Concepts No. 7, “Using Cash Flow Information and Present Value in Accounting Measurements.”*

Concepts Statement No. 1, issued in 1978, deals with identifying the objectives of financial reporting for business entities and establishes the focus for subsequent concept projects for business entities. Concepts Statement No. 1 pertains to general-purpose external financial reporting and is not restricted to financial statements. The following is a summary of the highlights of Concepts Statement No. 1.¹

1. Financial reporting is intended to provide information useful in making business and economic decisions.
2. The information should be comprehensible to those having a reasonable understanding of business and economic activities. These individuals should be willing to study the information with reasonable diligence.
3. Financial reporting should be helpful to users in assessing the amounts, timing, and uncertainty of future cash flows.
4. The primary focus is information about earnings and its components.
5. Information should be provided about the economic resources of an enterprise and the claims against those resources.

Issued in May 1980, “Qualitative Characteristics of Accounting Information” (SFAC No. 2) examines the characteristics that make accounting information useful for investment, credit, and similar decisions. Those characteristics of information that make it a desirable commodity can be viewed as a hierarchy of qualities, with *understandability* and *usefulness for decision making* of most importance (see Exhibit 1-2).

Relevance and **reliability**, the two primary qualities, make accounting information useful for decision making. To be relevant, the information needs to have *predictive* and feedback value and must be *timely*. To be reliable, the information must be *verifiable*, subject to representational faithfulness, and *neutral*. **Comparability**, which includes consistency, interacts with relevance and reliability to contribute to the usefulness of information.

The hierarchy includes *two constraints*. To be useful and worth providing, the information should have *benefits that exceed its cost*. In addition, all of the qualities of information shown are *subject to a materiality threshold*.

SFAC No. 6, “Elements of Financial Statements,” which replaced SFAC No. 3 in 1985, defines 10 interrelated elements directly related to measuring performance and financial status of an enterprise. The 10 elements are defined as follows:²

1. **Assets.** Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. **Liabilities.** Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
3. **Equity.** Equity is the residual interest in the assets of an entity that remains after deducting its liabilities:

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

4. **Investments by owners.** Investments by owners are increases in equity of a particular business enterprise resulting from transfers to the enterprise from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets, most commonly received as investments by owners, may also include services or satisfaction or conversion of liabilities of the enterprise.
5. **Distribution to owners.** Distribution to owners is a decrease in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.
6. **Comprehensive income.** Comprehensive income is the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

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7. **Revenues.** Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
8. **Expenses.** Expenses are outflows or other consumption or using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
9. **Gains.** Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.
10. **Losses.** Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

“Objectives of Financial Reporting by Nonbusiness Organizations” (SFAC No. 4) was completed in 1980. Organizations that fall within the focus of this statement include churches, foundations, and human-service organizations. Performance indicators for nonbusiness organizations

include formal budgets and donor restrictions. These types of indicators are not ordinarily related to competition in markets.

Issued in 1984, “Recognition and Measurement in Financial Statements of Business Enterprises” (SFAC No. 5) indicates that an item, to be recognized, should meet four criteria, subject to the cost-benefit constraint and materiality threshold:³

1. **Definition.** The item fits one of the definitions of the elements.
2. **Measurability.** The item has a relevant attribute measurable with sufficient reliability.
3. **Relevance.** The information related to the item is relevant.
4. **Reliability.** The information related to the item is reliable.

This concept statement identifies *five* different *measurement attributes* currently used in practice and recommends the composition of a full set of financial statements for a period.

The following are five different measurement attributes currently used in practice:⁴

1. Historical cost (historical proceeds)
2. Current cost
3. Current market value
4. Net realizable (settlement) value
5. Present (or discounted) value of future cash flows

This concept statement probably accomplished little, relating to measurement attributes, because a firm, consistent position on recognition and measurement could not be agreed upon. It states: “Rather than attempt to select a single attribute and force changes in practice so that all classes of assets and liabilities use that attribute, this concept statement suggests that use of different attributes will continue.”⁵

SFAC No. 5 recommended that a full set of financial statements for a period should show the following:⁶

1. Financial position at the end of the period
2. Earnings (net income)
3. Comprehensive income (total nonowner change in equity)
4. Cash flows during the period
5. Investments by and distributions to owners during the period

At the time of issuance of SFAC No. 5, financial position at the end of the period and earnings (net income) were financial statements being presented. Comprehensive income, cash flows during the period, and investments by and distributions to owners during the period are financial statements (disclosures) that have been subsequently developed. All of these financial statements (disclosures) will be extensively covered in this book.

SFAC No. 7, issued in February 2000, provides general principles for using present values for accounting measurements. It describes techniques for estimating cash flows and interest rates and applying present value in measuring liabilities.

The FASB Conceptual Framework for Accounting and Reporting project represents the most extensive effort undertaken to provide a conceptual framework for financial accounting. Potentially, the project can have a significant influence on financial accounting.

Additional Input—American Institute of Certified Public Accountants (AICPA)

As indicated earlier, the AICPA played the primary role in the private sector in establishing GAAP prior to 1973. However, the AICPA continues to play a part, primarily through its Accounting Standards Division. The Accounting Standards Executive Committee (AcSEC) serves as the official voice of the AICPA in matters relating to financial accounting and reporting standards.

The Accounting Standards Division published numerous documents considered as sources of GAAP. These include Industry Audit Guides, Industry Accounting Guides, and Statements of Position (SOPs).

Industry Audit Guides and Industry Accounting Guides are designed to assist auditors in examining and reporting on financial statements of companies in specialized industries, such as insurance. SOPs were issued to influence the development of accounting standards. Some SOPs were revisions or clarifications to recommendations on accounting standards contained in Industry Audit Guides and Industry Accounting Guides.

Industry Audit Guides, Industry Accounting Guides, and SOPs were considered a lower level of authority than FASB Statements of Financial Accounting Standards, FASB Interpretations, APB Opinions, and Accounting Research Bulletins. However, since the Industry Audit Guides, Industry Accounting Guides, and SOPs deal with material not covered in the primary sources, they, in effect, became the guide to standards for the areas they cover. They are part of GAAP unless they have been superseded.

Emerging Issues Task Force (EITF)

The FASB established the Emerging Issues Task Force (EITF) in July 1984 to help identify emerging issues affecting reporting and problems in implementing authoritative pronouncements. The Task Force has 15 members—senior technical partners of major national CPA firms and representatives of major associations of preparers of financial statements. The FASB's Director of Research and Technical Activities serves as Task Force chairperson. The SEC's Chief Accountant and the chairperson of the AICPA's Accounting Standards Executive Committee participate in Task Force meetings as observers.

The SEC's Chief Accountant has stated that any accounting that conflicts with the position of a consensus of the Task Force would be challenged. Agreement of the Task Force is recognized as a consensus if no more than two members disagree with a position.

Task Force meetings are held about once every six weeks. Issues come to the Task Force from a variety of sources, including the EITF members, the SEC, and other federal agencies. The FASB also brings issues to the EITF in response to issues submitted by auditors and preparers of financial statements.

The EITF statements have become a very important source of GAAP. The Task Force has the capability to review a number of issues within a relatively short period of time, in contrast to the lengthy deliberations that go into an SFAS.

EITF statements are considered to be less authoritative than the sources previously discussed in this chapter. However, since the EITF addresses issues not covered by the other sources, its statements become important guidelines to standards for the areas they cover.

A New Reality

In November 2001, Enron, one of the largest companies in the United States, recognized in a federal filing that it had overstated earnings by nearly \$600 million since 1997. Within a month, Enron declared bankruptcy. The Enron bankruptcy probably received more publicity than any prior bankruptcy in U.S. history. This was influenced by the size of Enron, the role of the auditors, the financial loss of investors, and the losses sustained by Enron employees. Many Enron employees lost their jobs and their pensions. There were approximately two dozen guilty pleas or convictions in the Enron case including Ken Lay, former Enron chairman. Ken Lay died before he was sentenced; therefore, Judge Sim Lake erased his convictions.

In June 2002, WorldCom announced that it had inflated profits by \$3.8 billion over the previous five quarters. This represented the largest financial fraud in corporate history. Soon after the WorldCom fraud announcement, WorldCom declared bankruptcy. (In November 2002, a special bankruptcy court examiner indicated that the restatement would likely exceed \$7.2 billion.) On July 13, 2005, Bernard J. Ebbers, founder and former chief executive of WorldCom, was sentenced to 25 years in prison for orchestrating the biggest corporate accounting fraud in U.S. history.

The WorldCom fraud compelled Congress and President George W. Bush to take action. Congress acted swiftly, with the support of President Bush, to pass legislation now known as the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act has many provisions. While it is not practical to review the Act in detail, it is clear that it has far-reaching consequences for financial reporting and the CPA profession. Because of the importance of the Sarbanes-Oxley Act to financial reporting, some additional comments are in order.

Sarbanes-Oxley Section 404 requires companies to document adequate internal controls and procedures for financial reporting. They must be able to assess the effectiveness of the internal controls and financial reporting.

Companies have found it difficult to comply with Section 404 for many reasons. Internal auditing departments have been reduced or eliminated at many companies. Some companies do not have the personnel to confront complex accounting issues. This lack of adequate competent personnel to confront complex accounting issues in itself represents an internal control weakness.

Sarbanes-Oxley makes it an administrative responsibility to have adequate internal controls and procedures in place. Management must acknowledge their responsibility and assert the effectiveness of internal controls and procedures in writing.

The SEC requires companies to file an annual report on their internal control systems. The report should contain the following:⁷

1. A statement of management's responsibilities for establishing and maintaining an adequate system.
2. Identification of the framework used to evaluate the internal controls.
3. A statement as to whether or not the internal control system is effective as of year-end.
4. The disclosure of any material weaknesses in the system.
5. A statement that the company's auditors have issued an audit report on management's assessment.

The financial statements auditor must report on management's assertion as to the effectiveness of the internal controls and procedures as of the company's year-end. Sarbanes-Oxley has changed the relationship between the company and the external auditor. Prior to Sarbanes-Oxley, some companies relied on the external auditor to determine the accounting for complex accounting issues. This was a form of conflict of interest, as the auditor surrendered independence in assessing the company's controls, procedures, and reporting.

Not only have some companies found that they did not have adequately trained personnel to confront complex accounting issues, but external auditors have also been pressed to provide trained accounting personnel. This has led some auditing firms to reduce the number and type of companies that they will audit.

The spring of 2005 represented the first reporting season under Sarbanes-Oxley. Hundreds of companies acknowledged that they had "material weaknesses" in their controls and processes. In some cases, this led to financial statements being restated.

Implementing Sarbanes-Oxley has resulted in several benefits. Companies have improved their internal controls, procedures, and financial reporting. Many companies have also improved their fraud prevention. Systems put in place to review budgets will enable companies to be more proactive in preventing potential problems. Users of financial statements benefit from an improved financial product that they review and analyze to make investment decisions.

Unfortunately, implementing Sarbanes-Oxley has been quite costly. Some firms question the cost/benefit of compliance with Sarbanes-Oxley. In time, we will know how much of the cost was represented by start-up cost and how much was annual recurring costs. The substantial cost of implementing Sarbanes-Oxley will likely result in future changes to this law.

Publicly held companies are required to report under Sarbanes-Oxley, whereas private companies are not. Many state-level legislators have proposed extending certain provisions of Sarbanes-Oxley to private companies. Such proposals are controversial because of the cost. Some private companies support these proposals.

Most of the publicity relating to Sarbanes-Oxley has been related to Section 404, but the Act includes many other sections. This book will revisit Sarbanes-Oxley when covering other areas, such as ethics, in Chapter 2.

Sarbanes-Oxley created a five-person oversight board, the Public Company Accounting Oversight Board (PCAOB). The PCAOB consists of five members appointed by the SEC. Two must be CPAs, but the others cannot be CPAs.

Among the many responsibilities of the PCAOB is to adopt auditing standards. This will materially decrease or eliminate the role of the AICPA in setting auditing standards.

The PCAOB sets an annual accounting support fee for the standard-setting body (FASB). The PCAOB also establishes an annual accounting support fee for the PCAOB. These fees are assessed against each issuer.

The chief executive officer (CEO), and the chief financial officer (CFO), of each issuer must prepare a statement to accompany the audit report to certify disclosures fairly present, in all material respects, the operations and financial condition of the issuer.

In addition to appointing the five members of the PCAOB, the SEC is responsible for the oversight and enforcement authority over the Board. In effect, the PCAOB is an arm of the SEC.

As described in this chapter, the setting of accounting standards has been divided among the SEC, FASB, EITF, and AcSEC. By law, the setting of accounting standards is the responsibility of the SEC. The SEC elected to have most of the accounting standards developed in the private sector with the oversight of the SEC. This substantially meant that the SEC allowed the FASB to determine accounting standards. The FASB allowed some of the standards to be determined by the EITF, and the AcSEC of the AICPA.

The FASB has announced that it was streamlining the accounting rule-making process by taking back powers it had vested to AcSEC (an arm of the AICPA). The AcSEC will be allowed to continue with industry-specific accounting and audit guides (A&A guides). The AICPA is to stop issuing general-purpose accounting Statements of Position (SOPs).

The FASB also streamlined the accounting rule-making process by taking back powers it had vested to EITF (an arm of the FASB). Two FASB members will be involved in the agenda-setting process of the EITF. Statements of the EITF will go to the FASB before release.

FASB Accounting Standards Codification™ (Codification)

As indicated in this chapter, there have been many sources of authoritative U.S. GAAP. This has resulted in thousands of pages addressing U.S. GAAP and some confusion as to the level of authoritative GAAP.

To provide a single source of authoritative U.S. GAAP, the FASB commenced a project to provide a Codification of U.S. GAAP. The result will be one source and one level of authoritative GAAP. The Codification does not change GAAP.

This project reached a verification stage in late 2007. During a one-year verification period the Codification is available to solicit feedback and confirm that the Codification is accurate. The Codification will likely become the single authoritative source of U.S. GAAP in 2009.

The Codification reorganizes the accounting pronouncements into approximately 90 accounting topics. A separate section of the Codification will include SEC guidance. The SEC guidance will use the same 90 accounting topics. The Codification addresses U.S. GAAP for nongovernmental entities.

Traditional Assumptions of the Accounting Model

The FASB's Conceptual Framework was influenced by several underlying assumptions. Some of these assumptions were addressed in the Conceptual Framework, and others are implicit in the Framework. These assumptions, along with the Conceptual Framework, are considered when a GAAP is established. Accountants, when confronted with a situation lacking an explicit standard, should resolve the situation by considering the Conceptual Framework and the traditional assumptions of the accounting model.

In all cases, the reports are to be a "fair representation." Even when there is an explicit GAAP, following the GAAP is not appropriate unless the end result is a "fair representation." Following GAAP is not an appropriate legal defense unless the statements represent a "fair representation."

BUSINESS ENTITY

The concept of separate **entity** means that the business or entity for which the financial statements are prepared is separate and distinct from the owners of the entity. In other words, the entity is viewed as an economic unit that stands on its own.

For example, an individual may own a grocery store, a farm, and numerous personal assets. To determine the economic success of the grocery store, we would view it separately from the other resources owned by the individual. The grocery store would be treated as a separate entity.

A corporation such as Ford Motor Company has many owners (stockholders). The entity concept enables us to account for the Ford Motor Company entity separately from the transactions of the owners of Ford Motor Company.

GOING CONCERN OR CONTINUITY

The **going-concern assumption**, that the entity in question will remain in business for an indefinite period of time, provides perspective on the future of the entity. The going-concern assumption deliberately disregards the possibility that the entity will go bankrupt or be liquidated. If a particular entity is in fact threatened with bankruptcy or liquidation, then the going-concern assumption should be dropped. In such a case, the reader of the financial statements is interested in the liquidation values, not the values that can be used when making the assumption that the business will continue indefinitely. If the going-concern assumption has not been used for a particular set of financial statements, because of the threat of liquidation or bankruptcy, the financial statements must clearly disclose that the statements were prepared with the view that the entity will be liquidated or that it is a failing concern. In this case, conventional financial report analysis would not apply.

Many of our present financial statement figures would be misleading if it were not for the going-concern assumption. For instance, under the going-concern assumption, the value of prepaid insurance is computed by spreading the cost of the insurance over the period of the policy. If the entity were liquidated, then only the cancellation value of the policy would be meaningful. Inventories are basically carried at their accumulated cost. If the entity were liquidated, then the amount realized from the sale of the inventory, in a manner other than through the usual channels, usually would be substantially less than the cost. Therefore, to carry the inventory at cost would fail to recognize the loss that is represented by the difference between the liquidation value and the cost.

The going-concern assumption also influences liabilities. If the entity were liquidating, some liabilities would have to be stated at amounts in excess of those stated on the conventional statement. Also, the amounts provided for warranties and guarantees would not be realistic if the entity were liquidating.

The going-concern assumption also influences the classification of assets and liabilities. Without the going-concern assumption, all assets and liabilities would be current, with the expectation that the assets would be liquidated and the liabilities paid in the near future.

The audit opinion for a particular firm may indicate that the auditors have reservations as to the going-concern status of the firm. This puts the reader on guard that the statements are misleading if the firm does not continue as a going concern. For example, the annual report of Trump Hotels & Casino Resorts, Inc. indicated a concern over the company's ability to continue as a going concern.

The Trump Hotels & Casino Resorts, Inc. annual report included these comments in Note 1 and the auditor's report.

Trump Hotels & Casino Resorts, Inc.
Notes to Consolidated Financial Statements (in Part)
December 31, 2004

Accounting Impact of Chapter 11 Filing (Part of Note 1)

The accompanying consolidated financial statements have been prepared in accordance with AICPA Statement of Position No. (SOP) 90-7, "Financial Reporting by Entities in Reorganization under the Bankruptcy Code" ("SOP 90-7") and on a going concern basis,

which contemplates continuity of operations, realization of assets and liquidation of liabilities in the ordinary course of business. The ability of the Company, both during and after the chapter 11 cases, to continue as a going concern is dependent upon, among other things, (i) the ability of the Company to successfully achieve required cost savings to complete its restructuring; (ii) the ability of the Company to maintain adequate cash on hand; (iii) the ability of the Company to generate cash from operations; (iv) the ability of the Company to confirm a plan of reorganization under the Bankruptcy Code and obtain emergency financing; (v) the ability of the Company to maintain its customer base; and (vi) the Company's ability to achieve profitability. There can be no assurance that the Company will be able to successfully achieve these objectives in order to continue as a going concern. The accompanying consolidated financial statements do not include any adjustments that might result should the Company be unable to continue as a going concern.

Report of Independent Registered Public Accounting Firm (in Part)
Board of Directors
Trump Hotels & Casino Resorts, Inc.

We have audited the accompanying consolidated balance sheets of Trump Hotels & Casino Resorts, Inc. as of December 31, 2003 and 2004, and the related consolidated statements of operations, stockholders' equity/deficit, and cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedules as listed in the index at item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As more fully described in Note 1, the Company has experienced increased competition, incurred significant recurring losses from operations, has an accumulated deficit and has filed a voluntary petition seeking to reorganize under chapter 11 of the federal bankruptcy laws. Such circumstances raise substantial doubt about its ability to continue as a going concern. Although the Company is currently operating as a debtor-in-possession under the jurisdiction of the Bankruptcy Court, the continuation of the business as a going concern is contingent upon, among other things: (1) the ability of the Company to maintain compliance with all terms of its current debt structure; (2) the ability of the Company to generate cash from operations and to maintain adequate cash on hand; (3) the resolution of the uncertainty as to the amount of claims that will be allowed; (4) the ability of the Company to confirm a plan of reorganization under the Bankruptcy Code and obtain the required debt and equity financing to emerge from bankruptcy protection; and (5) the Company's ability to achieve profitability. Management's plans in regard to these matters are also described in Note 1. The accompanying consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Ernst & Young, LLP
Philadelphia, Pennsylvania
March 30, 2005

TIME PERIOD

The only accurate way to account for the success or failure of an entity is to accumulate all transactions from the opening of business until the business eventually liquidates. Many years ago, this time period for reporting was acceptable, because it would be feasible to account for and divide up what remained at the completion of the venture. Today, the typical business has a relatively long duration, so it is not feasible to wait until the business liquidates before accounting for its success or failure.

This presents a problem: Accounting for the success or failure of the business in midstream involves inaccuracies. Many transactions and commitments are incomplete at any particular time between the opening and the closing of business. An attempt is made to eliminate the

inaccuracies when statements are prepared for a period of time short of an entity's life span, but the inaccuracies cannot be eliminated completely. For example, the entity typically carries accounts receivable at the amount expected to be collected. Only when the receivables are collected can the entity account for them accurately. Until receivables are collected, there exists the possibility that collection cannot be made. The entity will have outstanding obligations at any time, and these obligations cannot be accurately accounted for until they are met. An example would be a warranty on products sold. An entity may also have a considerable investment in the production of inventories. Usually, until the inventory is sold in the normal course of business, the entity cannot accurately account for the investment in inventory.

With the time period assumption, we accept some inaccuracies of accounting for the entity short of its complete life span. We assume that the entity can be accounted for with reasonable accuracy for a particular period of time. In other words, the decision is made to accept some inaccuracy, because of incomplete information about the future, in exchange for more timely reporting.

Some businesses select an accounting period, known as a **natural business year**, that ends when operations are at a low ebb in order to facilitate a better measurement of income and financial position. In many instances, the natural business year of a company ends on December 31. Other businesses use the **calendar year** and thus end the accounting period on December 31. Thus, for many companies that use December 31, we cannot tell if December 31 was selected because it represents a natural business year or if it was selected to represent a calendar year. Some select a 12-month accounting period, known as a **fiscal year**, which closes at the end of a month other than December. The accounting period may be shorter than a year, such as a month. The shorter the period of time, the more inaccuracies we typically expect in the reporting.

At times, this text will refer to *Accounting Trends & Techniques*. This is a book compiled annually by the American Institute of Certified Public Accountants, Inc. *Accounting Trends & Techniques* is "a compilation of data obtained by a survey of 600 annual reports to stockholders undertaken for the purpose of analyzing the accounting information disclosed in such reports. The annual reports surveyed were those of selected industrial, merchandising, technology, and service companies for fiscal periods ending between February 25, 2005, and February 3, 2006."⁸

Exhibit 1-3 summarizes month of fiscal year-end from a financial statement compilation in *Accounting Trends & Techniques*. In Exhibit 1-3 for 2005, 171 survey companies were on a 52- to 53-week fiscal year.⁹ Jack in the Box Inc. was one of those companies. Jack in the Box disclosed in its notes to consolidated financial statements: "Our fiscal year is 52 or 53 weeks ending the Sunday closest to September 30. Fiscal years 2005 and 2003 includes 52 weeks, and fiscal year 2004 includes 53 weeks."¹⁰

Text not available due to copyright restrictions

MONETARY UNIT

Accountants need some standard of measure to bring financial transactions together in a meaningful way. Without some standard of measure, accountants would be forced to report in such terms as 5 cars, 1 factory, and 100 acres. This type of reporting would not be very meaningful.

There are a number of standards of measure, such as a yard, a gallon, and money. Of the possible standards of measure, accountants have concluded that money is the best for the purpose of measuring financial transactions.

Different countries call their monetary units by different names. For example, Japan uses the **yen**. Different countries also attach different values to their money—1 dollar is not equal to 1 yen. Thus, financial transactions may be measured in terms of money in each country, but the statements from various countries cannot be compared directly or added together until they are converted to a common monetary unit, such as the U.S. dollar.

In various countries, the stability of the monetary unit has been a problem. The loss in value of money is called **inflation**. In some countries, inflation has been more than 300% per year. In countries where inflation has been significant, financial statements are adjusted by an inflation factor that restores the significance of money as a measuring unit. However, a completely acceptable restoration of money as a measuring unit cannot be made in such cases because of the problems involved in determining an accurate index. To indicate one such problem, consider the price of a car in 1997 and in 2007. The price of the car in 2007 would be higher, but the explanation would not be simply that the general price level has increased. Part of the reason for the price increase would be that the type and quality of the equipment have changed between 1997 and 2007. Thus, an index that relates the 2007 price to the 1997 price is a mixture of inflation, technological advancement, and quality changes.

The rate of inflation in the United States prior to the 1970s was relatively low. Therefore, it was thought that an adjustment of money as a measuring unit was not appropriate, because the added expense and inaccuracies of adjusting for inflation were greater than the benefits. During the 1970s, however, the United States experienced double-digit inflation. This made it increasingly desirable to implement some formal recognition of inflation.

In September 1979, the FASB issued *Statement of Financial Accounting Standards No. 33*, “Financial Reporting and Changing Prices,” which required that certain large, publicly held companies disclose certain supplementary information concerning the impact of changing prices in their annual reports for fiscal years ending on or after December 25, 1979. This disclosure later became optional in 1986. Currently, no U.S. company provides this supplementary information.

HISTORICAL COST

SFAC No. 5 identified five different measurement attributes currently used in practice: historical cost, current cost, current market value, net realizable value, and present value. Often, historical cost is used in practice because it is objective and determinable. A deviation from historical cost is accepted when it becomes apparent that the historical cost cannot be recovered. This deviation is justified by the conservatism concept. A deviation from historical cost is also found in practice where specific standards call for another measurement attribute such as current market value, net realizable value, or present value.

CONSERVATISM

The accountant is often faced with a choice of different measurements of a situation, with each measurement having reasonable support. According to the concept of **conservatism**, the accountant must select the measurement with the least favorable effect on net income and financial position in the current period.

To apply the concept of conservatism to any given situation, there must be alternative measurements, each of which must have reasonable support. The accountant cannot use the conservatism concept to justify arbitrarily low figures. For example, writing inventory down

to an arbitrarily low figure in order to recognize any possible loss from selling the inventory constitutes inaccurate accounting and cannot be justified under the concept of conservatism. An acceptable use of conservatism would be to value inventory at the lower of historical cost or market value.

The conservatism concept is used in many other situations, such as writing down or writing off obsolete inventory prior to sale, recognizing a loss on a long-term construction contract when it can be reasonably anticipated, and taking a conservative approach in determining the application of overhead to inventory. Conservatism requires that the estimate of warranty expense reflects the least favorable effect on net income and the financial position of the current period.

REALIZATION

Accountants face a problem of when to recognize revenue. All parts of an entity contribute to revenue, including the janitor, the receiving department, and the production employees. The problem becomes how to determine objectively the contribution of each of the segments toward revenue. Since this is not practical, accountants must determine *when* it is practical to recognize revenue.

In practice, revenue recognition has been the subject of much debate. This has resulted in fairly wide interpretations. The issue of revenue recognition has represented the basis of many SEC enforcement actions. In general, the point of recognition of revenue should be the point in time when revenue can be reasonably and objectively determined. It is essential that there be some uniformity regarding when revenue is recognized, so as to make financial statements meaningful and comparable.

Point of Sale

Revenue is usually recognized at the point of sale. At this time, the earning process is virtually complete, and the exchange value can be determined.

There are times when the use of the point-of-sale approach does not give a fair result. An example would be the sale of land on credit to a buyer who does not have a reasonable ability to pay. If revenue were recognized at the point of sale, there would be a reasonable chance that sales had been overstated because of the material risk of default. There are many other acceptable methods of recognizing revenue that should be considered, such as the following:

1. End of production
2. Receipt of cash
3. During production
4. Cost recovery

End of Production

The recognition of revenue at the completion of the production process is acceptable when the price of the item is known and there is a ready market. The mining of gold or silver is an example, and the harvesting of some farm products would also fit these criteria. If corn is harvested in the fall and held over the winter in order to obtain a higher price in the spring, the realization of revenue from the growing of corn should be recognized in the fall, at the point of harvest. The gain or loss from the holding of the corn represents a separate consideration from the growing of the corn.

Receipt of Cash

The receipt of cash is another basis for revenue recognition. This method should be used when collection is not capable of reasonable estimation at the time of sale. The land sales business, where the purchaser makes only a nominal down payment, is one type of business where the collection of the full amount is especially doubtful. Experience has shown that many purchasers default on the contract.

During Production

Some long-term construction projects recognize revenue as the construction progresses. This exception tends to give a fairer picture of the results for a given period of time. For example, in the building of a utility plant, which may take several years, recognizing revenue as work progresses gives a fairer picture of the results than does having the entire revenue recognized in the period when the plant is completed.

Cost Recovery

The cost recovery approach is acceptable for highly speculative transactions. For example, an entity may invest in a venture search for gold, the outcome of which is completely unpredictable. In this case, the first revenue can be handled as a return of the investment. If more is received than has been invested, the excess would be considered revenue.

In addition to the methods of recognizing revenue described in this chapter, there are many other methods that are usually industry-specific. Being aware of the method(s) used by a specific firm can be important to your understanding of the financial reports.

MATCHING

The revenue realization concept involves when to recognize revenue. Accountants need a related concept that addresses when to recognize the costs associated with the recognized revenue: the **matching concept**. The basic intent is to determine the revenue first and then match the appropriate costs against this revenue.

Some costs, such as the cost of inventory, can be easily matched with revenue. When we sell the inventory and recognize the revenue, the cost of the inventory can be matched against the revenue. Other costs have no direct connection with revenue, so some systematic policy must be adopted in order to allocate these costs reasonably against revenues. Examples are research and development costs and public relations costs. Both research and development costs and public relations costs are charged off in the period incurred. This is inconsistent with the matching concept because the cost would benefit beyond the current period, but it is in accordance with the concept of conservatism.

CONSISTENCY

The **consistency concept** requires the entity to give the same treatment to comparable transactions from period to period. This adds to the usefulness of the reports, since the reports from one period are comparable to the reports from another period. It also facilitates the detection of trends.

Many accounting methods could be used for any single item, such as inventory. If inventory were determined in one period on one basis and in the next period on a different basis, the resulting inventory and profits would not be comparable from period to period.

Entities sometimes need to change particular accounting methods in order to adapt to changing environments. If the entity can justify the use of an alternative accounting method, the change can be made. The entity must be ready to defend the change—a responsibility that should not be taken lightly in view of the liability for misleading financial statements. Sometimes the change will be based on a new accounting pronouncement. When an entity makes a change in accounting methods, the justification for the change must be disclosed, along with an explanation of the effect on the statements.

FULL DISCLOSURE

The accounting reports must disclose all facts that may influence the judgment of an informed reader. If the entity uses an accounting method that represents a departure from the official position of the FASB, disclosure of the departure must be made, along with the justification for it.

Several methods of disclosure exist, such as parenthetical explanations, supporting schedules, cross-references, and notes. Often, the additional disclosures must be made by a note in

order to explain the situation properly. For example, details of a pension plan, long-term leases, and provisions of a bond issue are often disclosed in notes.

The financial statements are expected to summarize significant financial information. If all the financial information is presented in detail, it could be misleading. Excessive disclosure could violate the concept of **full disclosure**. Therefore, a reasonable summarization of financial information is required.

Because of the complexity of many businesses and the increased expectations of the public, full disclosure has become one of the most difficult concepts for the accountant to apply. Lawsuits frequently charge accountants with failure to make proper disclosure. Since disclosure is often a judgment decision, it is not surprising that others (especially those who have suffered losses) would disagree with the adequacy of the disclosure.

MATERIALITY

The accountant must consider many concepts and principles when determining how to handle a particular item. The proper use of the various concepts and principles may be costly and time-consuming. The **materiality concept** involves the relative size and importance of an item to a firm. A material item to one entity may not be material to another. For example, an item that costs \$100 might be expensed by General Motors, but the same item might be carried as an asset by a small entity.

It is essential that material items be properly handled on the financial statements. Immaterial items are not subject to the concepts and principles that bind the accountant. They may be handled in the most economical and expedient manner possible. However, the accountant faces a judgment situation when determining materiality. It is better to err in favor of an item being material than the other way around.

A basic question when determining whether an item is material is: “Would this item influence an informed reader of the financial statements?” In answering this question, the accountant should consider the statements as a whole.

The Sarbanes-Oxley Act has materiality implications. “The Sarbanes-Oxley Act of 2002 has put demands on management to detect and prevent material control weaknesses in a timely manner. To help management fulfill this responsibility, CPAs are creating monthly key control processes to assess and report on risk. When management finds a key control that does not meet the required minimum quality standard, it must classify the result as a key control exception.”¹¹

INDUSTRY PRACTICES

Some **industry practices** lead to accounting reports that do not conform to the general theory that underlies accounting. Some of these practices are the result of government regulation. For example, some differences can be found in highly regulated industries, such as insurance, railroad, and utilities.

In the utility industry, an allowance for funds used during the construction period of a new plant is treated as part of the cost of the plant. The offsetting amount is reflected as other income. This amount is based on the utility’s hypothetical cost of funds, including funds from debt and stock. This type of accounting is found only in the utility industry.

In some industries, it is very difficult to determine the cost of the inventory. Examples include the meat-packing industry, the flower industry, and farming. In these areas, it may be necessary to determine the inventory value by working backward from the anticipated selling price and subtracting the estimated cost to complete and dispose of the inventory. The inventory would thus be valued at a net realizable value, which would depart from the cost concept and the usual interpretation of the revenue realization concept. If inventory is valued at net realizable value, then the profit has already been recognized and is part of the inventory amount.

The accounting profession is making an effort to reduce or eliminate specific industry practices. However, industry practices that depart from typical accounting procedures will probably never be eliminated completely. Some industries have legitimate peculiarities that call for accounting procedures other than the customary ones.

TRANSACTION APPROACH

The accountant records only events that affect the financial position of the entity and, at the same time, can be reasonably determined in monetary terms. For example, if the entity purchases merchandise on account (on credit), the financial position of the entity changes. This change can be determined in monetary terms as the inventory asset is obtained and the liability, accounts payable, is incurred.

Many important events that influence the prospects for the entity are not recorded and, therefore, are not reflected in the financial statements because they fall outside the **transaction approach**. The death of a top executive could have a material influence on future prospects, especially for a small company. One of the company's major suppliers could go bankrupt at a time when the entity does not have an alternative source. The entity may have experienced a long strike by its employees or have a history of labor problems. A major competitor may go out of business. All these events may be significant to the entity. They are not recorded because they are not transactions. When projecting the future prospects of an entity, it is necessary to go beyond current financial reports.

Some of the items not recorded will be disclosed. This is done under the full disclosure assumption.

CASH BASIS

The **cash basis** recognizes revenue when cash is received and recognizes expenses when cash is paid. The cash basis usually does *not* provide reasonable information about the earning capability of the entity in the short run. Therefore, the cash basis is usually *not* acceptable.

ACCRUAL BASIS

The **accrual basis** of accounting recognizes revenue when realized (realization concept) and expenses when incurred (matching concept). If the difference between the accrual basis and the cash basis is not material, the entity may use the cash basis as an alternative to the accrual basis for income determination. Usually, the difference between the accrual basis and the cash basis is material.

A modified cash basis is sometimes used by professional practices and service organizations. The modified cash basis adjusts for such items as buildings and equipment.

The accrual basis requires numerous adjustments at the end of the accounting period. For example, if insurance has been paid for in advance, the accountant must determine the amounts that belong in prepaid insurance and insurance expense. If employees have not been paid all of their wages, the unpaid wages must be determined and recorded as an expense and as a liability. If revenue has been collected in advance, such as rent received in advance, this revenue relates to future periods and must, therefore, be deferred to those periods. At the end of the accounting period, the unearned rent would be considered a liability.

The use of the accrual basis complicates the accounting process, but the end result is more representative of an entity's financial condition than the cash basis. Without the accrual basis, accountants would not usually be able to make the time period assumption—that the entity can be accounted for with reasonable accuracy for a particular period of time.

The following illustration indicates why the accrual basis is generally regarded as a better measure of a firm's performance than the cash basis.

Assumptions:

1. Sold merchandise (inventory) for \$25,000 on credit this year. The merchandise cost \$12,500 when purchased in the prior year.
2. Purchased merchandise this year in the amount of \$30,000 on credit.
3. Paid suppliers of merchandise \$18,000 this year.
4. Collected \$15,000 from sales.

Accrual Basis		Cash Basis	
Sales	\$ 25,000	Receipts	\$ 15,000
Cost of sales (expenses)	(12,500)	Expenditures	(18,000)
Income	<u>\$ 12,500</u>	Loss	<u>\$ (3,000)</u>

The accrual basis indicates a profitable business, whereas the cash basis indicates a loss. The cash basis does not reasonably indicate when the revenue was earned or when to recognize the cost that relates to the earned revenue. The cash basis does indicate when the receipts and payments (disbursements) occurred. The points in time when cash is received and paid do not usually constitute a good gauge of profitability. However, knowing the points in time is important; the flow of cash will be presented in a separate financial statement (statement of cash flows).

In practice, the accrual basis is modified. Immaterial items are frequently handled on a cash basis, and some specific standards have allowed the cash basis.

Using the Internet

The **Internet** is a global collection of computer networks linked together and available for your use. Information passes easily among these networks because all connected networks use a common communication protocol. The Internet includes local, regional, national, and international backbone networks.

There are many reasons for using the Internet. Some of these reasons include (1) retrieving information, (2) finding information, (3) sending and receiving electronic mail, (4) conducting research, and (5) accessing information databases.

COMPANIES' INTERNET WEB SITES

The majority of publicly held companies in the United States have established a Web site on the Internet. The contents of these Web sites vary. A few companies only provide advertisements and product information. In these cases, a phone number may be given to order more information. Other companies provide limited financial information, such as total revenues, net income, and earnings per share. These companies may also provide advertisements and a phone number for more information. Many companies provide comprehensive financial information and possibly advertisements. The comprehensive financial information may include the annual report and quarterly reports. It may also include the current stock price and the history of the stock price.

HELPFUL WEB SITES

A number of Web sites can be very useful when performing analysis. Many of these Web sites have highlighted text or graphics that can be clicked to go to another related site. Several excellent Web sites follow:

1. **SEC Edgar Database:** <http://www.sec.gov>. The Securities and Exchange Commission provides a Web site that includes its Edgar Database. This site allows users to download publicly available electronic filings submitted to the SEC from 1994 to the present. By citing the company name, you can select from a menu of recent filings. This will include the 10-K report and the 10-Q.
2. **Rutgers Accounting Web (RAW):** <http://accounting.rutgers.edu>. This site provides links to many other accounting sites. RAW provides rapid access to many accounting sites without separately targeting each site. These include Edgar, the International Accounting Network, and many other accounting resources. Accounting organizations include the American Accounting Association, American Institute of Certified Public Accountants, and Institute of Management Accountants.
3. **Report Gallery:** <http://www.reportgallery.com>. This site lists Web sites and annual reports of publicly traded companies.
4. **Financial Accounting Standards Board (FASB):** <http://www.fasb.org>. Many useful items can be found here including publications, technical projects, and international activities.

5. **U.S. General Services Administration:** <http://www.info.gov>. This site serves as an entry point to find state, federal, and foreign government information.
6. **U.S. Government Accountability Office (GAO):** <http://www.gao.gov/>. This is an independent, nonpartisan agency that works for Congress. The GAO issues more than 1,000 reports each year.
7. **Virtual Finance Library:** <http://fisher.osu.edu/fin/overview.htm>. Contains substantial financial information.

8. Financial Markets/Stock Exchanges

- a. **American Stock Exchange:** <http://www.amex.com>
- b. **Chicago Mercantile Exchange:** <http://www.cme.com>
- c. **NASDAQ Stock Market:** <http://www.nasdaq.com>
- d. **New York Stock Exchange:** <http://www.nyse.com>
- e. **Chicago Board of Trade:** <http://www.cbot.com>

The contents of the financial markets/stock exchange sites vary and are expanding.

9. Newspapers

- a. **The Wall Street Journal:** <http://www.wsj.com> (subscription-only site)
- b. **The New York Times:** <http://www.nytimes.com>
- c. **Financial Times:** <http://news.ft.com>
- d. **Investor's Business Daily:** <http://www.investors.com>

These sites contain substantial financial information including information on the economy, specific companies, and industries.

10. **American Institute of Certified Public Accountants (AICPA):** <http://www.aicpa.org>. The AICPA is the national organization for U.S. certified public accountants. This site contains substantial information relating to the accounting profession.
11. **International Accounting Standards Board (IASB):** <http://www.iasb.org>. The IASB sets global financial accounting and reporting standards. This site helps accountants keep abreast of financial accounting and reporting standards worldwide.
12. **Public Company Accounting Oversight Board (PCAOB):** <http://www.pcaobus.org>. The PCAOB is the private-sector corporation created by the Sarbanes-Oxley Act of 2002. This board is responsible for overseeing the audits of public companies and has broad authority over public accounting firms and auditors. Its actions are subject to the approval of the Securities and Exchange Commission.
13. **Global Accounting Digital Archive Network (GADAN):** <http://raw.rutgers.edu/digitalibrary>. Combines sources of available digital information and archives related to accounting in various parts of the world.

14. Financial Portals

- a. **The Street.com:** <http://www.thestreet.com>
- b. **Smart Money's Map of the Market:** <http://www.smartmoney.com>
- c. **Yahoo! Finance:** <http://finance.yahoo.com>
- d. **Morningstar.com:** <http://www.morningstar.com>
- e. **MSN Money:** <http://moneycentral.msn.com>
- f. **MarketWatch.com:** <http://www.marketwatch.com>
- g. **Reuters:** <http://www.investor.reuters.com>
- h. **Briefing.com:** <http://www.briefing.com>
- i. **Zacks Investment Research:** <http://www.zacks.com>
- j. **BigCharts:** <http://www.bigcharts.com>
- k. **Dow Jones Indexes:** <http://www.djindexes.com>
- l. **Russell Investments:** <http://www.russell.com>
- m. **Standard & Poor's:** <http://www.standardandpoors.com>
- n. **Wilshire Associates:** <http://www.wilshire.com>
- o. **Bloomberg.com:** <http://www.bloomberg.com>

These financial portals provide information on stock quotes, individual companies, industries, and much more.

Summary

This chapter has reviewed the development of U.S. generally accepted accounting principles and the traditional assumptions of the accounting model. You need a broad understanding of GAAP and the traditional assumptions to reasonably understand financial reports. The financial reports can be no better than the accounting principles and the assumptions of the accounting model that are the basis for preparation.

This chapter also introduced helpful Web sites that can be very useful when performing analysis.



to the net

1. Go to the FASB Web site: <http://www.fasb.org>.
 - a. Click on "Facts about FASB." Be prepared to discuss The Mission of the Financial Accounting Standards Board.
 - b. Click on "FASAC." Read "An Overview." Be prepared to discuss.
2. Go to the SEC Web site: <http://www.sec.gov>. Under "Filings & Forms (EDGAR)," click on "Search for Company Filings." Click on "Companies & Other Filers." Enter the name of a company of your choice. Use this site to obtain the address of the company. Click on any form listed. The telephone number of the company can be found toward the top of the form. Contact the company, requesting a copy of its annual report, 10-K, and proxy.
3. Go to the International Accounting Standards Board (IASB) Web site: <http://www.iasb.org>.
 - a. Click on "About Us." Be prepared to discuss the structure of the International Accounting Standards Board.
 - b. Click on "About Us." Be prepared to discuss the history of the International Accounting Standards Board.
4. Go to the Public Company Accounting Oversight Board (PCAOB) Web site: <http://www.pcaobus.org>.
 - a. What is the mission of the Public Company Accounting Oversight Board?
 - b. Click on "Rules." Comment on the PCAOB's rule-making process.
5. Go to the American Institute of Certified Public Accountants (AICPA) Web site: <http://www.aicpa.org>.
 - a. Click on "About the AICPA." Click on "AICPA Mission." Be prepared to discuss the mission of the AICPA.
 - b. Click on "About the AICPA." Click on "Understanding the Organization." Click on "History." Be prepared to discuss the history of the AICPA.
6. Go to the Yahoo! Finance Web site: <http://finance.yahoo.com>.
 - a. Enter the name of a company in the "Get Quotes" box. Click on "Get Quotes." Comment on what you found.
 - b. Click on "Finance Search." Search—"Yahoo! Finance" for—type in "Airbus"—click on "Search." Comment on what you found.

Questions

- Q 1-1. Discuss the role of each of the following in the formulation of accounting principles:
- a. American Institute of Certified Public Accountants
 - b. Financial Accounting Standards Board
 - c. Securities and Exchange Commission
- Q 1-2. How does the concept of consistency aid in the analysis of financial statements? What type of accounting disclosure is required if this concept is not applied?
- Q 1-3. The president of your firm, Lesky and Lesky, has little background in accounting. Today, he walked into your office and said, "A year ago we bought a piece of land for \$100,000. This year, inflation has driven prices up by

6%, and an appraiser just told us we could easily resell the land for \$115,000. Yet our balance sheet still shows it at \$100,000. It should be valued at \$115,000. That's what it's worth. Or, at a minimum, at \$106,000." Respond to this statement with specific reference to accounting principles applicable in this situation.

- Q 1-4. Identify the accounting principle(s) applicable to each of the following situations:
- Tim Roberts owns a bar and a rental apartment and operates a consulting service. He has separate financial statements for each.
 - An advance collection for magazine subscriptions is reported as a liability titled Unearned Subscriptions.
 - Purchases for office or store equipment for less than \$25 are entered in Miscellaneous Expense.
 - A company uses the lower of cost or market for valuation of its inventory.
 - Partially completed television sets are carried at the sum of the cost incurred to date.
 - Land purchased 15 years ago for \$40,500 is now worth \$346,000. It is still carried on the books at \$40,500.
 - Zero Corporation is being sued for \$1,000,000 for breach of contract. Its lawyers believe that the damages will be minimal. Zero reports the possible loss in a note.
- Q 1-5. A corporation like General Motors has many owners (stockholders). Which concept enables the accountant to account for transactions of General Motors, separate and distinct from the personal transactions of the owners of General Motors?
- Q 1-6. Zebra Company has incurred substantial financial losses in recent years. Because of its financial condition, the ability of the company to keep operating is in question. Management prepares a set of financial statements that conform to generally accepted accounting principles. Comment on the use of GAAP under these conditions.
- Q 1-7. Because of assumptions and estimates that go into the preparation of financial statements, the statements are inaccurate and are, therefore, not a very meaningful tool to determine the profits or losses of an entity or the financial position of an entity. Comment.
- Q 1-8. The only accurate way to account for the success or failure of an entity is to accumulate all transactions from the opening of business until the business eventually liquidates. Comment on whether this is true. Discuss the necessity of having completely accurate statements.
- Q 1-9. Describe the following terms, which indicate the period of time included in the financial statements:
- Natural business year
 - Calendar year
 - Fiscal year
- Q 1-10. Which standard of measure is the best for measuring financial transactions?
- Q 1-11. Countries have had problems with the stability of their money. Briefly describe the problem caused for financial statements when money does not hold a stable value.
- Q 1-12. In some countries where inflation has been material, an effort has been made to retain the significance of money as a measuring unit by adjusting the financial statements by an inflation factor. Can an accurate adjustment for inflation be made to the statements? Can a reasonable adjustment to the statements be made? Discuss.
- Q 1-13. An arbitrary write-off of inventory can be justified under the conservatism concept. Is this statement true or false? Discuss.
- Q 1-14. Inventory that has a market value below the historical cost should be written down in order to recognize a loss. Comment.
- Q 1-15. There are other acceptable methods of recognizing revenue when the point of sale is not acceptable. List and discuss the other methods reviewed in this chapter, and indicate when they can be used.
- Q 1-16. The matching concept involves the determination of when to recognize the costs associated with the revenue that is being recognized. For some costs, such as administrative costs, the matching concept is difficult to apply. Comment on when it is difficult to apply the matching concept. What do accountants often do under these circumstances?

- Q 1-17. The consistency concept requires the entity to give the same treatment to comparable transactions from period to period. Under what circumstances can an entity change its accounting methods, provided it makes full disclosure?
- Q 1-18. Discuss why the concept of full disclosure is difficult to apply.
- Q 1-19. No estimates or subjectivity is allowed in the preparation of financial statements. Discuss.
- Q 1-20. It is proper to handle immaterial items in the most economical, expedient manner possible. In other words, generally accepted accounting principles do not apply. Comment, including a concept that justifies your answer.
- Q 1-21. The same generally accepted accounting principles apply to all companies. Comment.
- Q 1-22. Many important events that influence the prospect for the entity are not recorded in the financial records. Comment and give an example.
- Q 1-23. Some industry practices lead to accounting reports that do not conform to the general theory that underlies accounting. Comment.
- Q 1-24. An entity may choose between the use of the accrual basis of accounting and the cash basis. Comment.
- Q 1-25. Generally accepted accounting principles have substantial authoritative support. Indicate the problem with determining substantial authoritative support.
- Q 1-26. Would an accountant record the personal assets and liabilities of the owners in the accounts of the business? Explain.
- Q 1-27. At which point is revenue from sales on account (credit sales) commonly recognized?
- Q 1-28. Elliott Company constructed a building at a cost of \$50,000. A local contractor had submitted a bid to construct it for \$60,000.
- At what amount should the building be recorded?
 - Should revenue be recorded for the savings between the cost of \$50,000 and the bid of \$60,000?
- Q 1-29. Dexter Company charges to expense all equipment that costs \$25 or less. What concept supports this policy?
- Q 1-30. Which U.S. government body has the legal power to determine generally accepted accounting principles?
- Q 1-31. What is the basic problem with the monetary assumption when there has been significant inflation?
- Q 1-32. Explain the matching principle. How is the matching principle related to the realization concept?
- Q 1-33. Briefly explain the term generally accepted accounting principles.
- Q 1-34. Briefly describe the operating procedure for Statements of Financial Accounting Standards.
- Q 1-35. What is the FASB Conceptual Framework for Accounting and Reporting intended to provide?
- Q 1-36. Briefly describe the following:
- Committee on Accounting Procedures
 - Committee on Accounting Terminology
 - Accounting Principles Board
 - Financial Accounting Standards Board
- Q 1-37. The objectives of general-purpose external financial reporting are primarily to serve the needs of management. Comment.
- Q 1-38. Financial accounting is designed to measure directly the value of a business enterprise. Comment.

- Q 1-39. According to SFAC No. 2, relevance and reliability are the two primary qualities that make accounting information useful for decision making. Comment on what is meant by relevance and reliability.
- Q 1-40. SFAC No. 5 indicates that, to be recognized, an item should meet four criteria, subject to the cost-benefit constraint and materiality threshold. List these criteria.
- Q 1-41. There are five different measurement attributes currently used in practice. List these measurement attributes.
- Q 1-42. Briefly explain the difference between an accrual basis income statement and a cash basis income statement.
- Q 1-43. The cash basis does not reasonably indicate when the revenue was earned and when the cost should be recognized. Comment.
- Q 1-44. It is not important to know when cash is received and when payment is made. Comment.
- Q 1-45. Comment on what Section 404 of the Sarbanes-Oxley Act requires of companies.
- Q 1-46. Under the Sarbanes-Oxley Act, what must the financial statement auditor do in relation to the company's internal control?
- Q 1-47. Comment on perceived benefits from Section 404 of the Sarbanes-Oxley Act.
- Q 1-48. Comment on the responsibility of private companies under the Sarbanes-Oxley Act.
- Q 1-49. If its accounting period ends December 31, would a company be using a natural business year or a fiscal year?
- Q 1-50. Describe the book *Accounting Trends & Techniques*.
- Q 1-51. Comment on the materiality implications of the Sarbanes-Oxley Act.
- Q 1-52. Briefly describe the Public Company Accounting Oversight Board (PCAOB).
- Q 1-53. Why did the FASB commence the Accounting Standards Codification™ project?

Problems

- P 1-1. FASB Statement of Concepts No. 2 indicates several qualitative characteristics of useful accounting information. Following is a list of some of these qualities, as well as a list of statements and phrases describing the qualities.
- | | |
|---|-------------------------------|
| a. Benefits > costs | f. Verifiability, neutrality, |
| b. Decision usefulness | representational faithfulness |
| c. Relevance | g. Comparability |
| d. Reliability | h. Materiality |
| e. Predictive value, feedback value, timeliness | i. Relevance, reliability |
- _____ 1. Without usefulness, there would be no benefits from information to set against its cost.
- _____ 2. Pervasive constraint imposed upon financial accounting information.
- _____ 3. Constraint that guides the threshold for recognition.
- _____ 4. A quality requiring that the information be timely and that it also have predictive value, or feedback value, or both.
- _____ 5. A quality requiring that the information have representational faithfulness and that it be verifiable and neutral.
- _____ 6. These are the two primary qualities that make accounting information useful for decision making.
- _____ 7. These are the ingredients needed to ensure that the information is relevant.
- _____ 8. These are the ingredients needed to ensure that the information is reliable.
- _____ 9. Includes consistency and interacts with relevance and reliability to contribute to the usefulness of information.

Required

Place the appropriate letter identifying each quality on the line in front of the statement or phrase describing the quality.

P 1-2.

Certain underlying considerations have had an important impact on the development of generally accepted accounting principles. Following is a list of these underlying considerations, as well as a list of statements describing them.

- | | |
|--------------------------------|-----------------------|
| a. Going concern or continuity | i. Industry practices |
| b. Monetary unit | j. Verifiability |
| c. Conservatism | k. Consistency |
| d. Matching | l. Realization |
| e. Full disclosure | m. Historical cost |
| f. Materiality | n. Time period |
| g. Transaction approach | o. Business entity |
| h. Accrual basis | |

- _____ 1. The business for which the financial statements are prepared is separate and distinct from the owners.
- _____ 2. The assumption is made that the entity will remain in business for an indefinite period of time.
- _____ 3. Accountants need some standard of measure to bring financial transactions together in a meaningful way.
- _____ 4. Revenue should be recognized when the earning process is virtually complete and the exchange value can be objectively determined.
- _____ 5. This concept deals with when to recognize the costs that are associated with the recognized revenue.
- _____ 6. Accounting reports must disclose all facts that may influence the judgment of an informed reader.
- _____ 7. This concept involves the relative size and importance of an item to a firm.
- _____ 8. The accountant is required to adhere as closely as possible to verifiable data.
- _____ 9. Some companies use accounting reports that do not conform to the general theory that underlies accounting.
- _____ 10. The accountant records only events that affect the financial position of the entity and, at the same time, can be reasonably determined in monetary terms.
- _____ 11. Revenue must be recognized when it is realized (realization concept), and expenses are recognized when incurred (matching concept).
- _____ 12. The entity must give the same treatment to comparable transactions from period to period.
- _____ 13. The measurement with the least favorable effect on net income and financial position in the current period must be selected.
- _____ 14. Of the various values that could be used, this value has been selected because it is objective and determinable.
- _____ 15. With this assumption, inaccuracies of accounting for the entity short of its complete life span are accepted.

Required

Place the appropriate letter identifying each quality on the line in front of the statement describing the quality.

P 1-3.

Required

Answer the following multiple-choice questions:

- a. Which of the following is a characteristic of information provided by external financial reports?
1. The information is exact and not subject to change.
 2. The information is frequently the result of reasonable estimates.
 3. The information pertains to the economy as a whole.
 4. The information is provided at the least possible cost.
 5. None of the above.
- b. Which of the following is *not* an objective of financial reporting?
1. Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
 2. Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans.

3. Financial reporting should provide information about the economic resources of an enterprise, the claims against those resources, and the effects of transactions, events, and circumstances that change the resources and claims against those resources.
 4. Financial accounting is designed to measure directly the value of a business enterprise.
 5. None of the above.
- c. According to FASB Statement of Concepts No. 2, which of the following is an ingredient of the quality of relevance?
1. Verifiability
 2. Representational faithfulness
 3. Neutrality
 4. Timeliness
 5. None of the above
- d. The primary current source of generally accepted accounting principles for nongovernment operations is the
1. New York Stock Exchange
 2. Financial Accounting Standards Board
 3. Securities and Exchange Commission
 4. American Institute of Certified Public Accountants
 5. None of the above
- e. What is the underlying concept that supports the immediate recognition of a loss?
1. Matching
 2. Consistency
 3. Judgment
 4. Conservatism
 5. Going concern
- f. Which statement is *not* true?
1. The Securities and Exchange Commission is a source of some generally accepted accounting principles.
 2. The American Institute of Certified Public Accountants is a source of some generally accepted accounting principles.
 3. The Internal Revenue Service is a source of some generally accepted accounting principles.
 4. The Financial Accounting Standards Board is a source of some generally accepted accounting principles.
 5. Numbers 1, 2, and 4 are sources of generally accepted accounting principles.
- g. Which pronouncements are *not* issued by the Financial Accounting Standards Board?
1. Statements of Financial Accounting Standards
 2. Statements of Financial Accounting Concepts
 3. Technical bulletins
 4. Interpretations
 5. Opinions

P 1-4.

Required

Answer the following multiple-choice questions:

- a. Which of the following does the Financial Accounting Standards Board *not* issue?
1. Statements of Position (SOPs)
 2. Statements of Financial Accounting Standards (SFASs)
 3. Interpretations
 4. Technical bulletins
 5. Statements of Financial Accounting Concepts (SFACs)
- b. According to SFAC No. 6, assets can be defined by which of the following?
1. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
 2. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
 3. Residual interest on the assets of an entity that remains after deducting its liabilities.

4. Increases in equity of a particular business enterprise resulting from transfers to the enterprise from other entities of something of value to obtain or increase ownership interests (or equity) in it.
 5. Decrease in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise.
- c. According to SFAC No. 6, expenses can be defined by which of the following?
1. Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
 2. Outflows or other consumption or using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
 3. Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from revenues or investments.
 4. Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from expenses or distributions to owners.
 5. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
- d. SFAC No. 5 indicates that an item, to be recognized, should meet four criteria, subject to the cost-benefit constraint and the materiality threshold. Which of the following is *not* one of the four criteria?
1. The item fits one of the definitions of the elements.
 2. The item has a relevant attribute measurable with sufficient reliability.
 3. The information related to the item is relevant.
 4. The information related to the item is reliable.
 5. The item has comparability, including consistency.
- e. SFAC No. 5 identifies five different measurement attributes currently used in practice. Which of the following is *not* one of the measurement attributes currently used in practice?
1. Historical cost
 2. Future cost
 3. Current market value
 4. Net realizable value
 5. Present, or discounted, value of future cash flows
- f. Which of the following indicates how revenue is usually recognized?
1. Point of sale
 2. End of production
 3. Receipt of cash
 4. During production
 5. Cost recovery
- g. *Statement of Financial Accounting Concepts No. 1*, "Objectives of Financial Reporting by Business Enterprises," includes all of the following objectives, except one. Which objective does it *not* include?
1. Financial accounting is designed to measure directly the value of a business enterprise.
 2. Investors, creditors, and others may use reported earnings and information about the elements of financial statements in various ways to assess the prospects for cash flows.
 3. The primary focus of financial reporting is information about earnings and its components.
 4. Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
 5. The objectives are those of general-purpose external financial reporting by business enterprises.

P 1-5. The following data relate to Jones Company for the year ended December 31, 2007:

Sales on credit	\$80,000
Cost of inventory sold on credit	65,000
Collections from customers	60,000
Purchase of inventory on credit	50,000
Payment for purchases	55,000
Cash collections for common stock	30,000
Dividends paid	10,000
Payment to salesclerk	10,000

- Required
- Determine income on an accrual basis.
 - Determine income on a cash basis.

P 1-6. Matching Acronyms

- Required
- Listed below are phrases with the appropriate acronym. Match the letter that goes with each definition.
- Generally accepted accounting principles (GAAP)
 - Securities and Exchange Commission (SEC)
 - Financial Reporting Releases (FRRs)
 - American Institute of Certified Public Accountants (AICPA)
 - Certified public accountants (CPAs)
 - Accounting Principles Board (APB)
 - Accounting Principles Board Opinions (APBOs)
 - Accounting Principles Board Statements (APBSs)
 - Financial Accounting Standards Board (FASB)
 - Financial Accounting Foundation (FAF)
 - Financial Accounting Standards Advisory Council (FASAC)
 - Statements of Financial Standards (SFASs)
 - Statements of Financial Accounting Concepts (SFACs)
 - Discussion Memorandum (DM)
 - Exposure Draft (ED)
 - Accounting Standards Executive Committee (AcSEC)
 - Statements of Position (SOP)
 - Emerging Issues Task Force (EITF)
 - The Public Company Accounting Oversight Board (PCAOB)
- Accounting principles that have substantial authoritative support.
 - A task force of representatives from the accounting profession created by the FASB to deal with emerging issues of financial reporting.
 - A proposed Statement of Financial Accounting Standards.
 - Issued by the Accounting Standards Division of the AICPA to influence the development of accounting standards.
 - Created by the Securities Exchange Act of 1934.
 - A professional accounting organization whose members are certified public accountants.
 - Issued official opinions on accounting standards between 1959–1973.
 - Represent views of the Accounting Principles Board but not the official opinions.
 - This board issues four types of pronouncements: (1) Statements of Financial Accounting Standards, (2) Interpretations, (3) Technical bulletins, and (4) Statements of Financial Accounting Concepts.
 - Governs the Financial Accounting Standards Board.
 - These statements are issued by the Financial Accounting Standards Board and establish GAAP for specific accounting issues.
 - These statements are issued by the Financial Accounting Standards Board and provide a theoretical foundation upon which to base GAAP. They are not part of GAAP.
 - Serves as the official voice of the AICPA in matters relating to financial accounting and reporting standards.
 - Presents all known facts and points of view on a topic. Issued by the FASB.
 - Responsible for advising the FASB.
 - Represented official positions of the APB.
 - An accountant who has received a certificate stating that he/she has met the requirements of state law.
 - Issued by the SEC and give the SEC's official position on matters relating to financial statements.
 - Adopts auditing standards.

Case

1-1

STANDARDS OVERLOAD?*

Even though accounting records go back hundreds of years, there was little effort to develop accounting standards until the 1900s. The first major effort to develop accounting standards in the United States came in 1939 when the American Institute of Certified Public Accountants formed the Committee on Accounting Procedures.

As the number of standards increased, an issue called “standards overload” emerged. Essentially, the charge of “standards overload” is that there are too many accounting standards and that the standards are too complicated. Many individuals charging that standards overload is a problem maintain that more professional judgment should be allowed in financial accounting. Some individuals take a position that selected standards should not apply to nonpublic companies. Others take a position that “little” companies should be exempt from selected standards. There has been some selective exclusion from standards in the past. Examples of selective exclusion are the following:

1. *Statement of Financial Accounting Standards No. 21*, “Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises.”
“Although the presentation of earnings per share and segment information is not required in the financial statements of nonpublic enterprises, any such information that is presented in the financial statements of nonpublic enterprises shall be consistent with the requirements of APB Opinion No. 15 and FASB Statement No. 14.”
2. *Statement of Financial Accounting Standards No. 33*, “Financial Reporting and Changing Prices.”
This statement required supplemental reporting on the effects of price changes. Only large public companies were required to present this information on a supplementary basis.

Required

- a. Financial statements should aid the user of the statements in making decisions. In your opinion, would the user of the statements be aided if there were a distinction between financial reporting standards for public vs. nonpublic companies? Between little and big companies?
- b. In your opinion, would CPAs favor a distinction between financial reporting standards for public vs. nonpublic companies? Discuss.
- c. In your opinion, would small business owner-managers favor a distinction between financial reporting standards for small and large companies? Discuss.
- d. In your opinion, would CPAs in a small CPA firm view standards overload as a bigger problem than CPAs in a large CPA firm? Discuss.
- e. Comment on standards overload, considering *Statement of Financial Accounting Concepts No. 1*, “Objectives of Financial Reporting by Business Enterprises.” Particularly consider the following objective:
Financial reporting should provide information useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those having a reasonable understanding of business and economic activities and willing to study the information with reasonable diligence.

*The standards referenced in this case should not be considered current standards. The financial reporting issues referenced in this case are discussed in later chapters, using current requirements.

Case

1-2

STANDARD SETTING: “A POLITICAL ASPECT”

This case consists of a letter from Dennis R. Beresford, chairperson of the Financial Accounting Standards Board, to Senator Joseph I. Lieberman. The specific issue was proposed legislation relating to the accounting for employee stock options.

Permission to reprint the following letter was obtained from the Financial Accounting Standards Board.

(continued)

August 3, 1993

Senator Joseph I. Lieberman
United States Senate
Hart Senate Office Building
Room 316
Washington, DC 20510

Dear Senator Lieberman:

Members of the Financial Accounting Standards Board (the FASB or the Board) and its staff routinely consult with members of Congress, their staffs, and other government officials on matters involving financial accounting. For example, FASB members and staff met with Senator Levin both before and after the introduction of his proposed legislation, Senate Bill 259, which also addresses accounting for employee stock options.

The attachment to this letter discusses the accounting issues (we have not addressed the tax issues) raised in your proposed legislation, Senate Bill 1175, and issues raised in remarks introduced in the *Congressional Record*. My comments in this letter address an issue that is more important than any particular legislation or any particular accounting issue: why we have a defined process for setting financial reporting standards and why it is harmful to the public interest to distort accounting reports in an attempt to attain other worthwhile goals.

Financial Reporting

Markets are enormously efficient information processors—when they have the information and that information faithfully portrays economic events. Financial statements are one of the basic tools for communicating that information. The U.S. capital market system is well-developed and efficient because of users' confidence that the financial information they receive is reliable. Common accounting standards for the preparation of financial reports contribute to their credibility. The mission of the FASB, an organization designed to be independent of all other business and professional organizations, is to establish and improve financial accounting and reporting standards in the United States.

Investors, creditors, regulators, and other users of financial reports make business and economic decisions based on information in financial statements. Credibility is critical whether the user is an individual contemplating a stock investment, a bank making lending decisions, or a regulatory agency reviewing solvency. Users count on financial reports that are evenhanded, neutral, and unbiased.

An efficiently functioning economy requires credible financial information as a basis for decisions about allocation of resources. If financial statements are to be useful, they must report economic activity without coloring the message to influence behavior in a particular direction. They must not intentionally favor one party over another. Financial statements must provide a neutral scorecard of the effects of transactions.

Economic Consequences of Accounting Standards

The Board often hears that we should take a broader view, that we must consider the economic consequences of a new accounting standard. The FASB should not act, critics maintain, if a new accounting standard would have undesirable economic consequences. We have been told that the effects of accounting standards could cause lasting damage to American companies and their employees. Some have suggested, for example, that recording the liability for retiree health care or the costs for stock-based compensation will place U.S. companies at a competitive disadvantage. These critics suggest that because of accounting standards, companies may reduce benefits or move operations overseas to areas where workers do not demand the same benefits. These assertions are usually combined with statements about desirable goals, like providing retiree health care or creating employee incentives.

(continued)

There is a common element in those assertions. The goals are desirable, but the means require that the Board abandon neutrality and establish reporting standards that conceal the financial impact of certain transactions from those who use financial statements. Costs of transactions exist whether or not the FASB mandates their recognition in financial statements. For example, not requiring the recognition of the cost of stock options or ignoring the liabilities for retiree health benefits does not alter the economics of the transactions. It only withholds information from investors, creditors, policy makers, and others who need to make informed decisions and, eventually, impairs the credibility of financial reports.

One need only look to the collapse of the thrift industry to demonstrate the consequences of abandoning neutrality. During the 1970s and 1980s, regulatory accounting principles (RAP) were altered to obscure problems in troubled institutions. Preserving the industry was considered a "greater good." Many observers believe that the effect was to delay action and hide the true dimensions of the problem. The public interest is best served by neutral accounting standards that inform policy rather than promote it. Stated simply, truth in accounting is always good policy.

Neutrality does not mean that accounting should not influence human behavior. We expect that changes in financial reporting will have economic consequences, just as economic consequences are inherent in existing financial reporting practices. Changes in behavior naturally flow from more complete and representationally faithful financial statements. The fundamental question, however, is whether those who measure and report on economic events should somehow screen the information before reporting it to achieve some objective. In FASB Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information" (paragraph 102), the Board observed:

Indeed, most people are repelled by the notion that some "big brother," whether government or private, would tamper with scales or speedometers surreptitiously to induce people to lose weight or obey speed limits or would slant the scoring of athletic events or examinations to enhance or decrease someone's chances of winning or graduating. There is no more reason to abandon neutrality in accounting measurement.

The Board continues to hold that view. The Board does not set out to achieve particular economic results through accounting pronouncements. We could not if we tried. Beyond that, it is seldom clear which result we should seek because our constituents often have opposing viewpoints. Governments, and the policy goals they adopt, frequently change.

Standard Setting in the Private Sector

While the SEC and congressional committees maintain active oversight of the FASB to ensure that the public interest is served, throughout its history the SEC has relied on the Board and its predecessors in the private sector to establish and improve financial accounting and reporting standards. In fulfilling the Board's mission of improving financial reporting, accounting standards are established through a system of due process and open deliberation. On all of our major projects, this involves open Board meetings, proposals published for comment, "field testing" of proposals, public hearings, and redeliberation of the issues in light of comments.

Our due process has allowed us to deal with complex and highly controversial accounting issues, ranging from pensions and retiree health care to abandonment of nuclear power plants. This open, orderly process for standard setting precludes placing any particular special interest above the interests of the many who rely on financial information. The Board believes that the public interest is best served by developing neutral accounting standards that result in accounting for similar transactions similarly and different transactions differently. The resulting financial statements provide as complete and faithful a picture of an entity as possible.

Corporations, accounting firms, users of financial statements, and most other interested parties have long supported the process of establishing accounting standards in the private

(continued)

Case

1-2

STANDARD SETTING: "A POLITICAL ASPECT" (Continued)

sector without intervention by Congress or other branches of government. Despite numerous individual issues on which the FASB and many of its constituents have disagreed, that support has continued. The resulting system of accounting standards and financial reporting, while not perfect, is the best in the world.

Conclusion

We understand that there are a number of people who believe that their particular short-term interests are more important than an effectively functioning financial reporting system. We sincerely hope, however, that you and others in the Congress will review the reasons that have led generations of lawmakers and regulators to conclude that neutral financial reporting is critical to the functioning of our economic system and that the best way to achieve that end is to allow the existing private sector process to proceed. We respectfully submit that the public interest will be best served by that course. As former SEC Chairman Richard Breeden said in testimony to the Senate Banking Committee in 1990:

The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose.

The attachment to this letter discusses your proposed legislation. It also describes some aspects of our project on stock compensation and the steps in our due process procedures that remain before the project will be completed. In your remarks in the Congressional Record, you said that you will address future issues, including an examination of the current treatment of employee stock options, over the next weeks and months. We would be pleased to meet with you or your staff to discuss these topics and the details of our project. I will phone your appointments person in the next two weeks to see if it is convenient for you to meet with me.

Sincerely,

Dennis R. Beresford

Dennis R. Beresford

Enclosure

cc: The Honorable Connie Mack
The Honorable Dianne Feinstein
The Honorable Barbara Boxer
The Honorable Carl S. Levin
The Honorable Christopher J. Dodd
The Honorable Arthur J. Levitt

- Required**
- “Financial statements must provide a neutral scorecard of the effects of transactions.” Comment.
 - “Costs of transactions exist whether or not the FASB mandates their recognition in financial statements.” Comment.
 - In the United States, standard setting is in the private sector. Comment.
 - Few, if any, accounting standards are without some economic impact. Comment.

Case

1-3

STANDARD SETTING: "BY THE WAY OF THE UNITED STATES CONGRESS"

In the summer of 1993, the Senate and the House introduced identical bills to amend the Internal Revenue Code of 1986. Section 4 of these bills addressed stock option compensation and financial reporting.

(continued)

Case

STANDARD SETTING: "BY THE WAY OF THE UNITED STATES CONGRESS" (Continued)

1-3

SEC. 4 Stock Option Compensation.

Section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) is amended by adding at the end the following new subsection:

“(h) STOCK OPTION COMPENSATION—The Commission shall not require or permit an issuer to recognize any expense or other charge in financial statements furnished to its security holders resulting from, or attributable to, either the grant, vesting, or exercise of any option or other right to acquire any equity security of such issuer (even if the right to exercise such option or right is subject to any conditions, contingencies or other criteria including, without limitation, the continued performance of services, achievement of performance objectives, or the occurrence of any event) which is granted to its directors, officers, employees, or other persons in connection with the performance of services, where the exercise price of such option or right is not less than the fair market value of the underlying security at the time such option or right is granted.”

- Required**
- a. The United States Congress is well qualified to debate and set generally accepted accounting principles. Comment.
 - b. Speculate on why these bills were directed to amend the Securities Exchange Act of 1934.

Case

FLYING HIGH*

1-4

Note 1

Summary of Significant Accounting Policies (in Part)

Contract accounting—Contract accounting is used for development and production activities predominately by the Aircraft and Weapons Systems (A&WS), Network Systems, Support Systems, and Launch and Orbital Systems (L&OS) segments within Integrated Defense Systems (IDS). These activities include the following products and systems: military aircraft, helicopters, missiles, space systems, missile defense systems, satellites, rocket engines, and information and battle management systems. The majority of business conducted in these segments is performed under contracts with the U.S. Government and foreign governments that extend over a number of years. Contract accounting involves a judgmental process of estimating the total sales and costs for each contract, which results in the development of estimated cost of sales percentages. For each sale contract, the amount reported as cost of sales is determined by applying the estimated cost of sales percentage to the amount of revenue recognized.

Sales related to contracts with fixed prices are recognized as deliveries are made, except for certain fixed-price contracts that require substantial performance over an extended period before deliveries begin, for which sales are recorded based on the attainment of performance milestones. Sales related to contracts in which we are reimbursed for costs incurred plus an agreed upon profit are recorded as costs are incurred. The majority of these contracts are with the U.S. Government. The Federal Acquisition regulations provide guidance on the types of cost that will be reimbursed in establishing contract price. Contracts may contain provisions to earn incentive and award fees if targets are achieved. Incentive and award fees that can be reasonably estimated are recorded over the performance period of the contract. Incentive and award fees that cannot be reasonably estimated are recorded when awarded.

*“The Boeing Company, together with its subsidiaries . . . is one of the world’s major aerospace firms.”
10-K

(continued)

Case

FLYING HIGH (Continued)

1-4

Program accounting—We use program accounting to account for sales and cost of sales related to all our commercial airplane programs by the Commercial Airplanes segment. Program accounting is a method of accounting applicable to products manufactured for delivery under production-type contracts where profitability is realized over multiple contracts and years. Under program accounting, inventoriable production costs, program tooling costs and warranty costs are accumulated and charged as cost of sales by program instead of by individual units or contracts. A program consists of the estimated number of units (accounting quantity) of a product to be produced in a continuing, long-term production effort for delivery under existing and anticipated contracts. To establish the relationship of sales to cost of sales, program accounting requires estimates of (a) the number of units to be produced and sold in a program, (b) the period over which the units can reasonably be expected to be produced, and (c) the units' expected sales prices, production costs, program tooling, and warranty costs for the total program.

We recognize sales for commercial airplane deliveries as each unit is completed and accepted by the customer. Sales recognized represent the price negotiated with the customer, adjusted by an escalation formula. The amount reported as cost of sales is determined by applying the estimated cost of sales percentage for the total remaining program to the amount of sales recognized for airplanes delivered and accepted by the customer.

Service revenue—Service revenue is recognized when the service is performed. This method is predominately used by our Support Systems, L&OS and Commercial Airplanes segments. Service activities include the following: Delta launches, ongoing maintenance of International Space Station, Space Shuttle and explosive detection systems, support agreements associated with military aircraft and helicopter contracts and technical and flight operation services for commercial aircraft. BCC lease and financing revenue is also included in "Service revenue" on the Consolidated Statements of Operations. See the "Lease and financing arrangements" section below for a discussion of BCC's revenue recognition policies.

Notes receivable—At commencement of a note receivable issued for the purchase of aircraft or equipment, we record the note and any unamortized discounts. Interest income and amortization of any discounts are recorded ratably over the related term of the note.

Requireda. **Contract Accounting (in Part)**

"Contracts may contain provisions to earn incentive and award fees if targets are achieved. Incentive and award fees that can be reasonably estimated are recorded over the performance period of the contract. Incentive and award fees that cannot be reasonably estimated are recorded when awarded."

Comment on the difficulty in determining which incentive and award fees can be reasonably estimated.

b. **Program Accounting (in Part)**

"We recognize sales for commercial airplane deliveries as each unit is completed and accepted by the customer. Sales recognized represent the price negotiated with the customer, adjusted by an escalation formula."

Comment on the difficulty in determining the sales amount.

"The amount reported as cost of sales is determined by applying the estimated cost of sales percentage for the total remaining program to the amount of sales recognized for airplanes delivered and accepted by the customer."

Does it appear more difficult to determine the sales or cost of sales? Comment.

c. **Service Revenue (in Part)**

"Service revenue is recognized when the service is performed."

Is it difficult to determine service revenue? Comment.

d. **Notes Receivable**

"At commencement of a note receivable issued for the purchase of aircraft or equipment, we record the note and any unamortized discounts. Interest income and amortization of any discounts are recorded ratably over the related term of the note."

Is it difficult to determine revenue from notes receivable? Comment.

Case

HAWAII CENTERED

1-5

Alexander & Baldwin, Inc.*

Notes to Consolidated Financial Statements (in Part)

1. Summary of Significant Accounting Policies (in Part)

Real Estate Sales Revenue Recognition: Sales are recorded when the risks and benefits of ownership have passed to the buyers (generally on closing dates), adequate down payments have been received, and collection of remaining balances is reasonably assured.

Real Estate Leasing Revenue Recognition: Rental revenue is recognized on a straight-line basis over the terms of the related leases, including periods for which no rent is due (typically referred to as “rent holidays”). Differences between revenue recognized and amounts due under respective lease agreements are recorded as increases or decreases, as applicable, to deferred rent receivable. Also included in rental revenue are certain tenant reimbursements and percentage rents determined in accordance with the terms of the leases. Income arising from tenant rents that are contingent upon the sales of the tenant exceeding a defined threshold are recognized in accordance with Staff Accounting Bulletin 101, which states that this income is to be recognized only after the contingency has been removed (i.e., sales thresholds have been achieved).

Sugar and Coffee Revenue Recognition: Revenue from bulk raw sugar sales is recorded when delivered to the cooperative of Hawaiian producers, based on the estimated net return to producers in accordance with contractual agreements. Revenue from coffee is recorded when the title to the product and risk of loss passes to third parties (generally this occurs when the product is shipped or delivered to customers) and when collection is reasonably assured.

- Required**
- a. Real Estate Sales Revenue Recognition—Conservative? Reasonable?
 - b. Real Estate Leasing Revenue Recognition—Why is income arising from tenant rents that are contingent upon the sales of the tenant exceeding a defined threshold handled differently than the “normal” real estate leasing?
 - c. Sugar and Coffee Revenue Recognition
 1. Bulk raw sugar sales (why recorded based on the estimated net return to producers)?
 2. Revenue from coffee (revenue recognition reasonable)?

*“Alexander & Baldwin, Inc. (‘A&B’) is a diversified corporation with most of its operations centered in Hawaii. It was founded in 1870 and incorporated in 1900. Ocean transportation operations, related shoreside operations in Hawaii, and intermodal, truck brokerage and logistics services are conducted by a wholly-owned subsidiary, Matson Navigation Company, Inc. (‘Matson’) and two Matson subsidiaries. Property development and food products operations are conducted by A&B and certain other subsidiaries of A&B.” 10-K

Case

GOING CONCERN?

1-6

TRM Corporation

Annual report to the United States Securities and Exchange Commission
For the fiscal year ended December 31, 2006

Part I (in Part)

ITEM 1. BUSINESS (in Part)

General

Where you can find more information. We file annual, quarterly and other reports, proxy statements and other information with the Securities and Exchange Commission (“SEC”). We also make available free of charge through our website at www.trm.com, our annual report on Form 10-K, quarterly

(continued)

Case

1-6

GOING CONCERN? (Continued)

reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after they are filed electronically with the SEC.

Overview. We are an owner and operator of off-premises networks of automated teller machines, or ATMs. We expanded into the ATM business in 1999, leveraging the experience and infrastructure we had established in developing our photocopier operations, which began in 1981. During 2006 we operated ATM networks in the United States, United Kingdom, Canada and Germany, and operated photocopier networks in the United States, United Kingdom and Canada. From 2001 to 2005, we expanded our ATM operations through both internal growth and through acquisitions including, in November 2004, the acquisition of a network of over 15,000 ATMs from eFunds Corporation. However, as a result of financial difficulties that we encountered beginning in 2005, in 2006 we determined to sell assets in order to reduce debt and to focus our business on our U.S. ATM operations. As a result, we sold our United Kingdom photocopy business in June 2006, our United Kingdom, Canadian and German ATM businesses in January 2007, and our United States photocopy business in January 2007. Currently, we operate ATMs in the United States and photocopiers in Canada. During 2006 our United States ATM networks had an average of 12,378 transacting ATMs and our Canadian photocopier network had an average of 2,751 photocopiers.

We locate our ATMs and photocopiers in high traffic retail environments through national merchants such as The Pantry, Cumberland Farms, and Wal-Mart, and through regional and locally-owned supermarkets, convenience and other stores. In addition to providing our merchant customers with supplemental revenues from shared transaction fees, we believe that the presence of ATMs and photocopiers in a merchant's store helps to promote higher foot traffic, increased impulse purchases and longer shopping times since they often make the retail site a destination for cash and photocopies. We attempt to maximize the usefulness of our ATMs to our customers by participating in as many electronic funds transfer networks, or EFTNs, as practical, including NYCE, Visa, Mastercard, Cirrus, Plus, American Express, Discover/Novus, and STAR.

Net sales from our ATM operations accounted for 93% of our net sales from continuing operations in both 2005 and 2006.

Net sales from our photocopier operations accounted for 7% of our net sales from continuing operations in both 2005 and 2006.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENT DATA (in Part)

Report of Independent Registered Public Accounting Firm (in Part)

To the Board of Directors and Shareholders of TRM Corporation:

We have completed integrated audits of TRM Corporation's 2006 and 2005 consolidated financial statements and of its internal control over financial reporting as of December 31, 2006 and an audit of its 2004 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based upon our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the index appearing under item 15(a)(1) present fairly, in all material respects, the financial position of TRM Corporation and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the evidence supporting the amounts and disclosures in the financial statements assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

(continued)

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company incurred a net loss for 2006 resulting in its inability to meet certain financial covenants of its financing agreement with GSO Origination Funding Partners LP and other lenders, and based on its projections the Company does not expect to meet the required financial covenants during 2007, which may render the debt callable by the lenders and trigger the cross-default provisions in TRM Funding Trust's Loan and Servicing Agreement. This raises substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Notes to Consolidated Financial Statements (in Part)

1. Description of Business and Summary of Significant Accounting Policies (in Part)

Description of Business and Basis of Presentation

TRM Corporation ("we" or "TRM") delivers convenience services to consumers in retail environments. We currently deliver self-service cash delivery and account balance inquiry through ATM machines and photocopy services.

As of December 2006 we offered our services in retail locations in the United States, the United Kingdom, Germany and Canada. We provide the equipment, maintenance, supplies and point of sale materials required for each of our installations, while the retailer oversees the daily operation of the equipment, provides the necessary floor space and shares in the revenue generated by our offerings.

In June 2006 we sold our United Kingdom photocopy business. In January 2007 we sold our ATM businesses in the United Kingdom, Germany and Canada and our United States photocopy business. The results of the businesses we have sold are reflected as discontinued operations in our consolidated statement of operations. Our remaining businesses operate ATMs in the United States and photocopiers in Canada. During 2006 our United States ATM networks had an average of 12,378 transacting ATMs and our Canadian photocopy network had an average of 2,751 photocopiers.

During the fourth quarter of 2004, we decided to discontinue efforts in the software development segment of our business. In December 2004, the last employee of this segment was terminated and we negotiated the termination of its office lease and accrued a related termination payment. Therefore, results of the software development segment have been reflected as discontinued operations in 2004.

We incurred a net loss of \$120.1 million in the year ended December 31, 2006. As a result of our financial performance for the three months ended September 20, 2006, we failed to meet certain financial covenants of our financing agreements with GSO Origination Funding Partners LP and other lenders. On November 20, 2006, we entered into amendments that restructured our loans and waived the failure to meet the loan covenants. Under the restructured loan agreements principal payments of \$69.9 million were due in the first quarter of 2007. During January 2007 we sold our Canadian, United Kingdom and German ATM businesses and our United States photocopy business and used \$98.5 million from the proceeds of those sales to make principal and interest payments under these loans, leaving a remaining balance of principal plus accrued interest of \$2.0 million. We are uncertain whether our remaining operations can generate sufficient cash to comply with the covenants of our restructured loan agreements and to pay our obligations on an ongoing basis. Because there are cross-default provisions in TRM Inventory Funding Trust's Loan and Servicing Agreement, if we fail to comply with the covenants of our restructured loan agreements and are declared to be in default by GSO Origination Funding Partners LP and other lenders, we may be declared in default of the provisions of the Loan and Servicing Agreement as well, and the lender may be able to demand payment. These factors, among others, may indicate that we may be unable to continue as a going concern for a reasonable period of time. Our financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that may be necessary should we be unable to continue as a going concern. Our continuation as a going concern is contingent upon our ability to generate sufficient cash to pay our obligations on an ongoing basis.

In connection with the sales of our ATM businesses in the United Kingdom, Germany and Canada, and our photocopy business in the United States in January 2007, we have made various representations and warranties and/or provided indemnities including those relating to taxation matters. Further, the sales prices may be subject to adjustment based on working capital

(continued)

Case

GOING CONCERN? (Continued)

1-6

amounts, the value of accounts receivable as of the closing of the sale or other factors which have not yet been agreed upon. The purchasers may make claims against us relating to the representations or warranties or provisions for adjustment of the sales prices, and those claims could be substantial. Because we used substantially all of the net proceeds from the business sales to reduce our debt, we might not have sufficient cash to pay such claims without additional financing.

In November 2006 we announced the implementation of a corporate restructuring plan involving an initial reduction of then-existing controllable selling, general and administrative expenses of approximately 15%. Subsequent to that announcement, we have sold operations that accounted for approximately 58% of our net sales in 2006. In connection with our restructuring plan and the sales of a substantial part of our operations, we have reduced our number of employees from 364 as of December 31, 2006 to 91 as of March 31, 2007, and we anticipate additional staff reductions during the second quarter of 2007.

We expect to be able to refinance the outstanding balances under our financing agreement and have begun initial efforts to do so. However, we can provide no assurance that we will be able to do so. If we are unable to refinance our debt or to get our lenders to agree to any further forbearance from calling our loans, we might be forced to seek protection of the courts through reorganization, bankruptcy or insolvency proceedings.

- Required**
- What is the going-concern assumption?
 - Has TRM Corporation prepared financial statements using the going-concern assumption? Comment.
 - What is the significance of the disclosure that this company may not be able to continue as a going concern?

Case

ECONOMICS AND ACCOUNTING: THE UNCONGENIAL TWINS*

1-7

“Economics and accountancy are two disciplines which draw their raw material from much the same mines. From these raw materials, however, they seem to fashion remarkably different products. They both study the operations of firms; they both are concerned with such concepts as income, expenditure, profits, capital, value, and prices. In spite of an apparently common subject-matter, however, they often seem to inhabit totally different worlds, between which there is remarkably little communication.”

“It is not surprising that the economist regards much accounting procedure as in the nature of ritual. To call these procedures ritualistic is in no way to deny or decry their validity. Ritual is always the proper response when a man has to give an answer to a question, the answer to which he cannot really know. Ritual under these circumstances has two functions. It is comforting (and in the face of the great uncertainties of the future, comfort is not to be despised), and it is also an answer sufficient for action. It is the sufficient answer rather than the right answer which the accountant really seeks. Under these circumstances, however, it is important that we should know what the accountant’s answer means, which means that we should know what procedure he has employed. The wise businessman will not believe his accountant although he takes what his accountant tells him as important evidence. The quality of that evidence, however, depends in considerable degree on the simplicity of the procedures and the awareness which we have of them. What the accountant tells us may not be true, but, if we know what he has done, we have a fair idea of what it means. For this reason, I am somewhat suspicious of many current efforts to reform accounting in the direction of making it more ‘accurate’.”

“If accounts are bound to be untruths anyhow, as I have argued, there is much to be said for the simple untruth as against a complicated untruth, for if the untruth is simple, it seems to me that we have a fair chance of knowing what kind of an untruth it is. A known untruth

*Source: Quotes from the article “Economics and Accounting: The Uncongenial Twins,” in *Accounting Theory*, edited by W. T. Baxter and Sidney Davidson (Homewood, IL., R. D. Irwin, 1962), pp. 44–55.

(continued)

Case

ECONOMICS AND ACCOUNTING: THE UNCONGENIAL TWINS (Continued)

1-7

is much better than a lie, and provided that the accounting rituals are well known and understood, accounting may be untrue but it is not lies; it does not deceive because we know that it does not tell the truth, and we are able to make our own adjustment in each individual case, using the results of the accountant as evidence rather than as definitive information.”

Required

- a. Assume that accounting procedures are in the form of ritual. Does this imply that the accountant’s product does not serve a useful function? Discuss.
- b. Does it appear that Kenneth Boulding would support complicated procedures and a complicated end product for the accountant? Discuss.
- c. Accounting reports must be accurate in order to serve a useful function. Discuss.

Text not available due to copyright restrictions

Case

OVERSIGHT

1-9

Selected sections of the Sarbanes-Oxley Act follow:

Public Law 107-204—July 30, 2002

Section 1. Short title. This Act may be cited as the “Sarbanes-Oxley Act of 2002”

TITLE I—Public Company Accounting Oversight Board

Sec.101. Establishment; Administrative Provisions

- (a) Establishment of Board—There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.
- (b) Duties of the Board—The Board shall, subject to action by the Commission under section 107, and once a determination is made by the Commission under subsection (d) of this section—
 - (1) register public accounting firms that prepare audit reports for issuers, in accordance with section 102;
 - (2) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, in accordance with section 103;

(continued)

- (3) conduct inspections of registered public accounting firms, in accordance with section 104 and the rules of the Board;
- (4) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms, in accordance with section 105;
- (5) perform such other duties or functions as the Board (or the Commission, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof, or otherwise to carry out this Act, in order to protect investors, or to further the public interest;
- (6) enforce compliance with this Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof; and
- (7) set the budget and manage the operations of the Board and the staff of the Board.

Sec.102. Registration with the Board

- (a) **Mandatory Registration**—Beginning 180 days after the date of the determination of the Commission under section 101(d), it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer.

Sec.103. Auditing, Quality Control, and Independence Standards and Rules

- (a) **Auditing, quality control, and ethics standards**
 - (1) **In General**—The Board shall, by rule, establish, including, to the extent it determines appropriate, through adoption of standards proposed by 1 or more professional groups of accountants designated pursuant to paragraph (3)(A) or advisory groups convened pursuant to paragraph (4), and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.

Sec.104. Inspections of Registered Public Accounting Firms

- (a) **In General**—The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

Sec.105. Investigations and Disciplinary Proceedings

- (a) **In General**—The Board shall establish, by rule, subject to the requirements of this section, fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.
 - (3) **Noncooperation with Investigations**
 - (A) **In General**—If a registered public accounting firm or any associated person thereof refuses to testify, produce documents, or otherwise cooperate with the Board in connection with an investigation under this section, the Board may—
 - (i) suspend or bar such person from being associated with a registered public accounting firm, or require the registered public accounting firm to end such association;
 - (ii) suspend or revoke the registration of the public accounting firm; and
 - (iii) invoke such other lesser sanctions as the Board considers appropriate, and as specified by rule of the Board.

(continued)

Sec. 106. Foreign Public Accounting Firms

(a) Applicability to Certain Foreign Firms

- (1) In General—Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act and the rules of the Board and the Commission issued under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States or any State, except that registration pursuant to section 102 shall not by itself provide a basis for subjecting such a foreign public accounting firm to the jurisdiction of the Federal or State courts, other than with respect to controversies between such firms and the Board.

Sec. 107. Commission Oversight of the Board

- (a) General Oversight Responsibility—The Commission shall have oversight and enforcement authority over the Board, as provided in this Act.

Sec. 108. Accounting Standards

- (a) Amendment to Securities Act of 1933—Section 19 of the Securities Act of 1933 (15 U.S.C. 77s) is amended

(b) Recognition of Accounting Standards

- (1) In General—In carrying out its authority under subsection (a) and under section 13(b) of the Securities Exchange Act of 1934, the Commission may recognize, as “generally accepted” for purposes of the securities laws, any accounting principles established by a standard setting body—

(A) that—

- (i) is organized as a private entity;
- (ii) has, for administrative and operational purposes, a board of trustees (or equivalent body) serving in the public interest, the majority of whom are not, concurrent with their service on such board, and have not been during the 2-year period preceding such service, associated persons of any registered public accounting firm;
- (iii) is funded as provided in section 109 of the Sarbanes-Oxley Act of 2002;
- (iv) has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; and
- (v) considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors; and

- (B) that the Commission determines has the capacity to assist the Commission in fulfilling the requirements of subsection (a) and section 13(b) of the Securities Exchange Act of 1934, because, at a minimum, the standard setting body is capable of improving the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws.

Sec. 109. Funding

- (a) In General—The Board, and the standard setting body designated pursuant to section 19(b) of the Securities Act of 1933, as amended by section 108, shall be funded as provided in this section.

(d) Annual Accounting Support Fee for the Board

- (1) Establishment of Fee—The Board shall establish, with the approval of the Commission, a reasonable annual accounting support fee (or a formula for the computation thereof), as may be necessary or appropriate to establish and maintain the Board. Such fee may also cover costs incurred in the Board’s first fiscal year (which may be a short fiscal year), or may be levied separately with respect to such short fiscal year.

(continued)

- (2) Assessments—The rules of the Board under paragraph (1) shall provide for the equitable allocation, assessment, and collection by the Board (or an agent appointed by the Board) of the fee established under paragraph (1), among issuers, in accordance with subsection (g), allowing for differentiation among classes of issuers, as appropriate.
- (e) Annual Accounting Support Fee for Standard Setting Body—The annual accounting support fee for the standard setting body referred to in subsection (a)—
 - (1) shall be allocated in accordance with subsection (g), and assessed and collected against each issuer, on behalf of the standard setting body, by 1 or more appropriate designated collection agents, as may be necessary or appropriate to pay for the budget and provide for the expenses of that standard setting body, and to provide for an independent, stable source of funding for such body, subject to review by the Commission; and
 - (2) may differentiate among different classes of issuers.

TITLE II—Auditor Independence

Sec. 201. Services Outside the Scope of Practice of Auditors

- (a) Prohibited Activities—Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1) is amended by adding at the end the following:
- (g) Prohibited Activities—Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the “Board”), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including—
 - (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
 - (2) financial information systems design and implementation;
 - (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
 - (4) actuarial services;
 - (5) internal audit outsourcing services;
 - (6) management functions or human resources;
 - (7) broker or dealer, investment adviser, or investment banking services;
 - (8) legal services and expert services unrelated to the audit; and
 - (9) any other service that the Board determines, by regulation, is impermissible.
- (h) Preapproval Required for Non-Audit Services—A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).

TITLE IV—Enhanced Financial Disclosures

Sec. 404. Management Assessment of Internal Controls

- (a) RULES REQUIRED—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78m or 78o(d)] to contain an internal control report, which shall—
 - (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(continued)

Case

OVERSIGHT (Continued)

1-9

(b) INTERNAL CONTROL EVALUATION AND REPORTING—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Required

- a. The Sarbanes-Oxley Act refers to “the Commission” in several sections. To what Commission is the Sarbanes-Oxley Act referring?
- b. Describe the responsibility of the Commission in relation to the “Board.”
- c. Describe the Board.
- d. Describe the duties of the Board.
- e. Who must register with the Board?
- f. Describe the Board’s responsibility as to the inspection of those registered with the Board.
- g. Describe the responsibilities of the Board in relation to auditing standards.
- h. Contrast the applicability of the Sarbanes-Oxley Act to domestic public accounting firms versus foreign public accounting firms.
- i. Describe the recognition of accounting standards by the Commission as provided.
- j. Comment on the funding for the:
 1. Board.
 2. Financial Accounting Standards Board.
- k. Describe prohibited activities of the independent auditor. Can the independent auditor perform tax services for an audit client?
 1. Describe management’s responsibility in relation to internal controls.
- m. Speculate on why Title IV, Section 404, “Management Assessment of Internal Controls,” has received substantial criticism.

Case

REGULATION OF SMALLER PUBLIC COMPANIES

1-10

The U.S. Securities and Exchange Commission (SEC) chartered the Advisory Committee on Smaller Public Companies on March 23, 2005. The charter provided an objective of assessing the regulatory system for smaller companies under the securities laws of the United States, and makes recommendations for changes.

The SEC Advisory Committee gave its final recommendations to the SEC in April 2006. These recommendations included several primary recommendations including: establish a scaled or proportional securities regulation for smaller public companies based on a stratification of smaller public companies into two groups; micro cap companies and small cap companies.*

The report indicates that a scales or proportional securities regulation for smaller public companies assures the full benefits and protection of federal securities regulation for investors in large companies that make up 94% of the total public U.S. equity capital markets. . . .[†]

The committee acknowledges the relative risk to investors and the capital markets as it’s currently used by professional investors when using proportional securities regulations.

Required

It is perceived that the risk is greater when investing in smaller public companies with proportional securities regulations than in larger companies. Speculate on why the committee considers this risk worth taking.

*Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (April 23, 2006), p. 4.

[†]Ibid., p. 16.

Web
Case**Thomson One** *Business School Edition*

Please complete the Web case that covers material discussed in this chapter at academic.cengage.com/accounting/Gibson. You'll be using Thomson One Business School Edition, a powerful tool, that combines a full range of fundamental financial information, earnings estimates, market data, and source documents for 500 publicly traded companies.

Endnotes

1. *Statement of Financial Accounting Concepts No. 1*, "Objectives of Financial Reporting by Business Enterprises" (Stamford, Conn.: Financial Accounting Standards Board, 1978).
2. *Statement of Financial Accounting Concepts No. 6*, "Elements of Financial Statements" (Stamford, Conn.: Financial Accounting Standards Board, 1985).
3. *Statement of Financial Accounting Concepts No. 5*, "Recognition and Measurement in Financial Statements of Business Enterprises" (Stamford, Conn.: Financial Accounting Standards Board, 1984), par. 63.
4. *Statement of Financial Accounting Concepts No. 5*, par. 67.
5. *Statement of Financial Accounting Concepts No. 5*, par. 70.
6. *Statement of Financial Accounting Concepts No. 5*, par. 13.
7. Release No. 33-8238, February 24, 2004, Securities and Exchange Commission, Final Rule: "Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," <http://www.sec.gov>.
8. *Accounting Trends & Techniques* (New York: American Institute of Certified Public Accountants, Inc., 2006), preface.
9. *Ibid.*, p. 39.
10. *Ibid.*, p. 40.
11. James Brady Vorhies, "The New Importance of Materiality," *Journal of Accounting* (May 2005), pp. 53–59.

Introduction to Financial Statements and Other Financial Reporting Topics

This chapter introduces financial statements. Subsequent chapters present a detailed review of the principal financial statements. Chapter 3 covers the balance sheet, Chapter 4 covers the income statement, and Chapter 10 covers the statement of cash flows.

This chapter also reviews the forms of business entities and the sequence of accounting procedures (called the accounting cycle). Other financial reporting topics included in this chap-

ter that contribute to the understanding of financial reporting are: Treadway Commission, auditor's opinion, auditor's report on the firm's internal controls, Report of Management on Internal Control over Financial Reporting, management's responsibility for financial statements, the SEC's integrated disclosure system, proxy, the summary annual report, the efficient market hypothesis, ethics, harmonization of international accounting standards, consolidated statements, and accounting for business combinations.

Forms of Business Entities

A business entity may be a **sole proprietorship**, a partnership, or a corporation. A sole proprietorship, a business owned by one person, is not a legal entity separate from its owner, but the accountant treats the business as a separate accounting entity. The profit or loss of the proprietorship goes on the income tax return of the owner. The owner is responsible for the debts of the sole proprietorship.

In the United States, a sole proprietorship may qualify to be treated as a limited liability company (LLC). As an LLC, the owner may limit the liability of the sole proprietor, but may increase the tax exposure of the proprietorship.

A **partnership** is a business owned by two or more individuals. Each owner, called a partner, is personally responsible for the debts of the partnership. The accountant treats the partners and the business as separate accounting entities. The profit or loss of the partnership goes on the individual income tax return of the partners. Like a proprietorship, a partnership may qualify to be treated as an LLC. As an LLC, the owners may limit the liability of the partners, but may increase the tax exposure of the partnership.

In the United States, a business **corporation** is a legal entity incorporated in a particular state. Ownership is evidenced by shares of stock. A corporation is considered to be separate and distinct from the stockholders. The stockholders risk only their investment; they are not responsible for the debts of the corporation.