# CHAPTER 2

**Case 2-1**

a. The FASB's conceptual framework study should provide benefits to the accounting community such as:

1. Guiding the FASB in establishing accounting standards on a consistent basis.

2. Determining bounds for judgment in preparing financial statements by prescribing the nature, functions, and limits of financial accounting and reporting.

3. Increasing users understanding of and confidence in financial reporting.

b. The two fundamental qualities that make accounting information useful for decision making are *relevance* and *faithful representation*.

Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value and confirmatory value and is material. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity’s financial report. Consequently, the FASB was not able to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena but also must faithfully represent the phenomena that it purports to represent. A perfectly faithful representation has three characteristics: *completeness, neutrality,* and *free from error*. Although perfection is difficult or even impossible to achieve, the objective is to maximize those qualities to the extent possible.

A complete depiction should include all information necessary for a user to understand the phenomenon being depicted. For some items, a complete depiction also might entail explanations of significant facts about the quality and nature of the items, factors, and circumstances that might affect their quality and nature and the process used to determine the numerical depiction. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users’ decisions. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. Information that is free from error will result in a more faithful representation of financial results.

*Comparability, verifiability, timeliness,* and *understandability* are the qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities also can be verified.

Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information can continue to be timely long after the end of a reporting period because, for example, some users might need to identify and assess trends. Understandabilityinvolves classifying, characterizing, and presenting information clearly and concisely.

**Case 2-2.**

1. i. The Conceptual Framework Project is an attempt by the FASB to develop concepts useful in guiding the board in establishing standards and in providing a frame of reference for resolving accounting issues. Over the years this project first attempted to develop principles or broad qualitative standards to permit the making of systematic rational choices among alternative methods of financial reporting. Subsequently the project focused on how well these overall objectives could be achieved. The FASB has stated that it intends the Conceptual Framework Project to be viewed not as a package of solutions to problems but rather as a common basis for identifying and discussing issues, for asking relevant questions, and for suggesting avenues for research. The Conceptual Framework Project has resulted in the issuance of eight statements of Financial Accounting Concepts that impact upon financial accounting: No.1-Objectives of Financial Reporting by Business Enterprises (superseded); No.2-Qualitative Characteristics of Accounting Information (Superseded); No.3-Elements of Financial Statements of Business Enterprises (Superseded); No.5-Recognition and Measurement in Financial Statements of Business Enterprises; No.6-Elements of Financial Statements;” No. 7-“Using Cash Flow Information and Present Value in Accounting Measurements” and No. 8 “Conceptual Framework for Financial Reporting (Chapters 1 & 3).

ii. The FASB has been criticized for failing to provide timely guidance on emerging implementation and practice problems. During 1984 the FASB attempted to respond to this criticism by (1) establishing a task force to assist in identifying issues and problems that might require action, the Emerging Issues Task Force, and (2) expanding the scope of the FASB Technical Bulletins in an effort to offer quicker guidance on a wider variety of issues.

Emerging issues arise because of new types of transactions, variations in accounting for existing types of transactions, new types of securities, and new products and services. They frequently involve the company's desire to achieve "off balance sheet" financing or "off income statement" accounting.

The Emerging Issues Task Force was formed to assist the FASB in issuing timely guidance on these emerging issues. That is, the task force's responsibility is to identify emerging issues as they develop, investigate and review them, and finally to advise the board whether the issue merits its attention.

The members of the task force all occupy positions that make them aware of emerging issues. The current members include the directors of accounting and auditing from 11 public accounting firms (including all of the "Big Four"), two representatives from the Financial Executives Institute, one from the National Association of Accountants and the Business Roundtable, and the FASB's Director of Research who serves as Chairman.

b. The Financial Accounting Standards Board, the Securities and Exchange Commission, and the American Institute of Certified Public Accountants have been criticized for imposing too many accounting standards on the business community. The Standards overload problem has been particularly burdensome on small businesses that do not have the necessary economic resources to research and apply all of the pronouncements issued by these sources. Those who contend that there is a standards overload problem base their arguments on two allegations.

1. Not all GAAP requirements arc relevant to small business financial reporting needs.

2. Even when they are relevant, they frequently violate the pervasive cost benefit constraint.

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

Some of the consequences of the standards overload problem to small business are as follows.

1. If a small business omits a GAAP requirement from audited financial statements, a qualified or adverse opinion may be rendered.

2. The cost of complying with GAAP requirements may cause a small business to forgo the development of other, more relevant information.

3. Small CPA firms that audit smaller companies must keep up to date on all of the same requirements as large international firms, but cannot afford the specialists that are available on a centralized basis in the large firms.

Many accountants have argued for differential disclosure standards as a solution to the standards overload problem. That is, standards might be divided into two groups. One group would apply to business regardless of size. The second group would be applied selectively only to large businesses, small businesses, or particular industries. For example, the disclosure of significant accounting policies would pertain to all businesses, whereas a differential disclosure such as earnings per share would be applicable only to large businesses.

**Case 2-3**

a. Quantitative data are helpful in making rational economic decisions. Stated differently, quantitative data aid the decision maker in making choices among alternatives, so that the actions are correctly related to consequences.

* 1. i. ASOBAT defined accounting as “the process of identifying, measuring, and communicating economic information to permit informed judgments and decision by users of the information.” Both this definition and Sprouse and Moonitz believe that communicating information is helpful for users to make rational decisions and informed judgments.

1. Similarly, *SFAC No. 8* states that accounting information should be useful for investment decision-making. The user should be able to use accounting information to make decisions about investing in a company.

**Case 2-4**

* 1. In describing continuity, Sprouse and Moonitz stated that in the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.
  2. No. Since a business is presumed to continue indefinitely, the value relevant to a purchaser is fair market value. This value measures the present value of future cash flows to the buyer. It is relevant for the buyer because the buyer presumes that the business will continue and thus will generate those future cash flows.
  3. No. A bankruptcy provides evidence that the business is not expected to remain in operation indefinitely. In this case, the assets that are reported in the company’s balance sheet should be measured at net realizable value.

**Case 2-5**

1. *SFAC No. 6* defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” If your company is using a building to produce automobiles, the probable future economic benefit is the expected inflow of resources from the sales of automobiles. This benefit accrues to the company who may then use them, if it wishes, to make more automobiles. The prior transaction that caused the asset to exist is the acquisition of the building.
2. In this case, the probable future economic benefit is the net realizable value that the company will receive when it sells the building. Again, the acquisition of the building is the result of a prior transaction or event.
3. In this case, the probable future economic benefit is the inflow of resources that will eventually flow into the company when it produces the automobiles. The transaction that caused the asset to exist was the acquisition of the building.

**Case 2-6**

In general, SFAC No. 5 attempts to set forth recognition criteria and guidance on what information should be incorporated into financial statements, and when this information should be reported. According to this Statement, a full set of financial statements for a period shows:

1. Financial position at the end of the period.

2. Earnings for the period.

3. Comprehensive income for the period.

4. Cash flows during the period.

5. Investments by and distributions to owners during the period.

The statement of financial position should provide information about an entity's assets, liabilities, and equity and their relationship to each other at a moment in time. It should also delineate the entity's resource structure major classes and amounts of assets and its financing structure-major classes and amounts of liabilities and equity. The statement of financial position is not intended to show the value of a business, but it should provide information to users wishing to make their own estimates of the enterprise's value.

The pronouncement then indicates that the building blocks to full disclosure are:

1. The scope of recognition and measurement

2. Basic financial statements

3. Areas directly affected by existing FASB standards

4. Financial reporting

5. All information useful for investment, credit, and similar decisions

Earnings is defined a measure of entity performance during a period. It measures the extent to which asset inflows (revenues and gains) exceed asset outflows. The concept of earning provided in SFAC No. 5 is similar to net income for a period in the then current practice. However, it excluded certain adjustments from earlier periods that are now recognized in the current period. It was expected that the concept of earnings would continue to be subject to the process of gradual change that has characterized its development.

In SFAC No. 5, the FASB attempted to broaden the scope of the measurements of the operating results of business enterprises by introducing the definition of comprehensive income as follows:

*Comprehensive income is the change in equity (net assets) of an entity during a period from transactions and events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.*

The relationship between earnings and comprehensive income was illustrated:

|  |  |
| --- | --- |
| Revenues | Earnings |
| Less: Expenses | Plus or minus cumulative accounting adjustments |
| Plus: Gains | Plus or minus other nonowner changes in equity |
| Less: Losses |  |
| = Earnings | = Comprehensive income |

SFAC No. 5 then proceeded to the discussion measurement and recognition. It defined measurement as the process of identifying the proper attribute of an event or transaction and of choosing the proper measurement scale. SFAC No 5 defined recognition as the process of formally recording an item into the financial statements of an entity as an element and indicated that an item and information about it should meet four recognition criteria and be recognized at the time these criteria are met (subject to the cost–benefit and materiality constraints).

1. Definitions. The item meets the definition of an element contained in SFAC No. 6 (Previously SFAC No. 3 at the time SFAC No. 5 was published).

2. Measurability. It has a relevant attribute, measurable with sufficient reliability.

3. Relevance. The information about the item is capable of making a difference in user decisions.

4. Faithful representation. Financial reports represent economic phenomena in words and numbers

**Case 2-7**

1. Employees meet the definition of an asset. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. Employees embody a probable future benefit that will contribute to future net cash flows. They will work so that the company can have revenues. The company will benefit because they control what the employees do on the job. Employment of the employees gave rise to the entity’s right to control the benefit.
2. No. According to *SFAC No. 5*, to report an asset in the balance sheet, it not only must meet the definition of an asset, but it must be capable of being measured.
3. i. The value would be more relevant because it would measure the expected future cash flows that the employees would be expected to generate. It would be less reliable because there is no precise method to measure the value of human capital. It can only be estimated. Therefore, two measurements made by two different measurers are unlikely to be the same.

ii. Yes. Representational faithfulness means that the items in the balance reflect what they purport to be. If human capital is an asset, then reporting its estimated value would reflect the value of that asset and would as a result provide representational faithfulness.

**Case 2-8**

1. According to *SFAC No. 7* the bonds are distinguished by the uncertainty of their future cash flows. The bonds would sell at the present value of their future cash flows, discounted at the market rate of interest. The company with the better credit rating would yield a lower market rate, assuming that the stated rates for both companies are the same. So, if the stated rates are the same, Company A’s bond might be more valuable it its credit rating were better than Company B’s.
2. If both companies have the same credit rating, then the one reason that Company A’s bond would have a higher market value than would Company B’s bond would be that Company A’s bond has a shorter term than Company B’s bond. If they both have the same term, then Company A’s bond would sell for more than Company B’s bond if Company A were offering a higher stated interest rate.

**FASB ASC**

**FASB ASC 2-1 Use of Present Value**

The information on present value is contained in the FASB ASC at FASB ASC 820-10-55. It can be accessed through the glossary.

**FASB ASC 2-2 Conceptual Framework**

Search conceptual framework

Found under 605 Revenue Recognition  
     10 Overall  
     S99 SEC Materials

**FASB ASC 2-3 Decision-Maker Concept**

Search decision maker

10 hits

**FASB ASC 2-4 Understandability Concept**

Search understandability

Found under 715 c[ompensation—Retirement Benefits > 10 Overall > 10 Objectives](http://asc.fasb.org/section&trid=2235023&exactQuery=understandability%20)

**FASB ASC 2-5 Relevance Concept**

Search relevance – 15 hits

**FASB ASC 2-6 Recognition and Measurement Guidance**

Search recognition and measurement-over 70 hits

**FASB ASC 2-7**

Reporting Comprehensive Income is contained in sections FASB ASC 220-10. It is found by searching comprehensive income.

**Currently Viewing:**

**220 Comprehensive Income**

**10 Overall**

**45 Other Presentation Matters**

**General**

**> Reporting Comprehensive Income**

**FASB ASC 2-8 Using Present Value**

Search present value-over 100 hits

**Room for Debate**

**Debate 2-1 A Question of Materiality**

Team 1: Arguments for capitalization of boxes.

1. Objectives of financial reporting

Decision usefulness requires that companies report the status of enterprise resources. The boxes provide future service potential. As such, they meet the definition of an asset found in SFAC No. 6. Hence, they are a resource that should be reported.

2. Definition of assets

SFAC No. 6 defines assets as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

The boxes are assets. They will provide future economic benefits for a particular entity (Roper Co). The company will use them for at least 10 years. They result from past transaction - a purchase.

3. Qualitative Characteristics

Relevance

Capitalization is relevant because it provides information about outcomes of past transactions or events. The user is informed that the boxes are assets. They were purchased by the company, and the company intends to use them over an extended period of time. Hence their cost is not a current period expense.

Faithfull Representation

Capitalization provides reliability. Because the boxes will be used over an extended period of time, they meet the definition of an asset found in SFAC No. 6. Hence, capitalization presents the economic facts and provides information that is representationally faithful. If they are assets, they should be reported as such, rather than expensed, a representation that would not report them as they purport to be. Also, capitalization of the cost would be neutral because it would provide an unbiased representation of the economic substance of the purchase transaction.

Team 2 Arguments against the capitalization of the boxes.

1. Materiality

Materiality was defined in SFAC No 2 as the threshold for recognition. When the dollar amount is small, the particular accounting treatment will not affect the decisions of an informed user. In this case, the cost of boxes is clearly immaterial, implying that they need not be capitalized as assets.

2. Cost Constraint

The benefits derived from capitalization should exceed the cost of capitalization. Since the cost of the boxes is not material, capitalization would not provide sufficient benefit, in terms of decision usefulness, to warrant this accounting treatment. Capitalization would require depreciation over the useful life of the boxes. This would require adjusting entries for a ten-year period. The amount of depreciation reported each period would be trivial and would have essentially no effect on earnings. Hence, the cost of the bookkeeping effort would be greater than the benefits, if any, derived.

3. Objectives of financial reporting

The primary objective of financial reporting is decision usefulness. Accounting information should provide information that is useful to investors, creditors and other users in making decisions regarding investing, lending, etc. This implies that accounting information is relevant to the decision-maker. Even though the boxes will last 10 years, the cost is immaterial and hence irrelevant.

4. Qualitative Characteristics of accounting information Relevance

As stated above, relevance means that the information provided will make a difference in the decisions of investors, creditors and other users. The expenditure is immaterial and as such, the accounting treatment is irrelevant, and capitalization is irrelevant.

**Debate 2-2 The Need for A Universally Accepted Theory of Accounting**

Team 1:

A universally accepted theory of accounting is needed for the development of internally consistent accounting principles. Accounting practices have developed in response to changing economic conditions and, in some cases, in response to what are perceived as crises. For example, SFAS No. 114, was prompted to inconsistent practices of reporting impaired loans, and SFAS No. 94 was prompted by off-balance sheet recognition of lease liabilities. This piece-meal, reactionary approach to accounting has resulted in standards that are not only internally inconsistent, but are also inconsistent with international standards.

A theory of accounting would provide a common basis for identifying and discussing issues. This is the goal of the FASB’s conceptual framework project. Such a theory could be used to help narrow the number of accounting choices currently available to management, thereby reducing management’s ability to manipulate financial statements to suit their personal, or company goals. As such, it could help guide the development of neutral standards, which aids in the allocation of scarce resources and the efficient functioning of capital markets

In addition to helping reduce managerial bias in reporting results of operations and financial position, a universally accepted theory of accounting could serve to reduce personal biases in the standard setting process itself. Reliance on such a theory could result in the development of those standards that are consistent with the theory itself.

A universal theory of accounting would be consistent with the concepts-based approach to accounting standards described by the American Accounting Association. A universally accepted accounting theory could provide a basis for standard setting that would satisfy the following.

1. Economic substance, not the form, of a given transaction should guide its financial reporting.
2. The mapping between economic substance of a transaction and its financial statement representation could be supported by a common theoretical basis, thereby providing understandability and a common basis of comparison across companies and over time.

Team 2:

To date, no standard setting body has developed a universally accepted theory of accounting. An argument against a universal theory of accounting can be based on the complexity of the phenomena that financial statements purport to represent. According to *SATTA*, while there has been general agreement that the purpose of financial accounting is to provide economic data about accounting entities, divergent theories have emerged because of the way different theorists specified users of accounting data and the environment. For example, *users* might be defined either as the owners of the accounting entity or more broadly to include creditors, employees, regulatory agencies, and the general public. Similarly, the environment might be specified as a single source of information or as one of several sources of financial information.

*SATTA* discussed why none of the approaches to theory had gained general acceptance, *SATTA* raised six issues.

1. *The problem with relating theory to practice*. The real world is much more complex than the world specified in most accounting theories. For example, most theory descriptions begin with unrealistic assumptions such as holding several variables constant.

2. *Allocation problem*. Allocation is an arbitrary process. For example, the definition of depreciation as a *rational* and *systematic* method of allocation has led to a variety of interpretations of these terms.

3. *The difficulty with normative standards.* Normative standards are desired states; however, different users of accounting information have different desired states. As a result, no set of standards can satisfy all users.

4. *The difficulties in interpreting security price behavior research*. Market studies (such as the efficient market studies discussed in Chapter 4) attempt to determine how users employ accounting numbers. These studies have attempted to control for all variables except the one of interest, but there have been disagreements over whether their research designs have actually accomplished this goal.

5. *The problem cost-benefit considerations accounting theories*. A basic assumption of accounting is that the benefits derived from adopting a particular accounting alternative exceed its costs. However, most existing theories do no indicate how to measure benefits and costs.

6. *Limitations of data expansion*. At the time *SATTA* was published, a view was emerging that more information is preferable than less. Subsequent research has indicated that users have a limited ability to process accounting information. (The issue of information processing is discussed in Chapter 4.)

The FASB’s conceptual framework project (CPF) cannot be viewed as a universally accepted theory of accounting, nor does the FASB purport that it is. The FASB intends the CFP to be viewed not as a package of solutions to problems but rather as a common basis for identifying and discussing issues. For example, *SFAC No. 8* can be described as the goal to guide practice. It does not even directly affect practice. Rather, the *SFAC*s affect practice only by means of their influence on the development of new accounting standards.

So, rather than a universally accepted theory of accounting, we have settled for the CFP, which does not provide all the answers, but has been relied upon to aid the standard-setting process. And, it has provided a basis to narrow alternatives and to eliminate those that are inconsistent with it. It also is used to guide the development of neutral standards, which aids in the allocation of scarce resources and the efficient function of capital markets

In other words, we can operate with concept-based accounting standards by relying upon the CFP rather than a universally accepted theory of accounting. The CFP has been criticized and will evolve to address criticism from the SEC that the objectives of the standards that are derived from it need to be more clearly defined, implementation guidance needs to be improved, scope exceptions need to be reduced and the asset-liability approach to standard setting should be retained

**WWW**

**Case 2-9**

1. An example of the way Veblen influenced Scott is contained in Lawrence and Stewart:

“Veblen believed men acquired habits of thought unconsciously and the thoughts men get are shaped by their daily activities. Any change in daily activities, such as that occasioned by the Industrial Revolution, would be expected to lead to a major shift in previous habits of thought. Scott saw the scientific method as the new habit of thought coming to dominance.”

1. Scott’s hierarchy of postulates and principles were:

*Orientation Postulate*. Accounting is based on a broad consideration of the current social, political, and economic environment.

*The Pervasive Principle of Justice*. The second level in Scott’s conceptual framework was justice, which was seen as developing accounting rules that offer equitable treatment to all users of financial statements.

*The Principles of Truth and Fairness*. Scott’s third level contained the principles of truth and fairness. Truth was seen as an accurate portrayal of the information presented. Fairness was viewed as containing the attributes of objectivity, freedom from bias, and impartiality.

*The Principles of Adaptability and Consistency*. The fourth level of the hierarchy contained two subordinate principles, adaptability and consistency. Adaptability was viewed as necessary because society and economic conditions change; consequently, accounting must also change. However, Scott indicated a need to balance adaptability with consistency by stating that accounting rules should not be changed to serve the temporary purposes of management.

**Case 2-10**

a. The project

1. Focused on changes in the environment since the original frameworks were issued, as well as omissions in the original frameworks, in order to efficiently and effectively improve, complete, and converge the existing frameworks.

2. Gave priority to addressing and deliberating those issues within each phase that were likely to yield benefits to the Boards in the short term—that is, cross‐cutting issues that affect a number of their projects for new or revised standards. Consequently, work on several phases of the project was to be conducted simultaneously, and the Boards expected to benefit from work being conducted on other projects.

3. Initially considered concepts applicable to private‐sector business entities. Later, the Boards were to jointly consider the applicability of those concepts to private‐sector not‐for‐profit organizations.

1. The eight phases of the CFP, are:

A. Objectives and qualitative characteristics

B. Definitions of elements, recognition, and derecognition

C. Measurement

D. Reporting entity concept

E. Boundaries of financial reporting, and presentation and disclosure

F. Purpose and status of the framework

G. Application of the framework to not‐for‐profit entities

**Case 2-11**

**Qualitative Characteristics**

The qualitative characteristics are described in Chapter 3 of SFAC *No. 8* and distinguish between better (more useful) information and inferior (less useful) information. These qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision usefulness of information. The two fundamental qualities that make accounting information useful for decision making are *relevance* and *faithful representation.*

**Case 2-12**

The answer to this case requires a visit to the FASB’s home page at the time it is assigned.

**Case 2-13**

The answer to this case requires a visit to the FASB’s home page at the time it is assigned.

**Case 2-14**

The answer to this case requires a visit to the FASB’s home page at the time it is assigned.

**Case 2-15**

During the early 2000s, the FASB noted that concerns were being expressed about the quality and transparency of accounting information. One of the main concerns was the increasing complexity of FASB standards. The Board concluded that much of the detail and complexity associated with accounting standards was the result of rule-driven implementation guidance, which allows “accounting engineering” to get around the rules thereby allowing companies to circumvent the intent and spirit of the standards.

Additionally, the FASB noted that its Conceptual Framework has not provided all of the necessary tools for resolving accounting problems. This deficiency was attributed to the fact the certain aspects of the Conceptual Framework are internally inconsistent and incomplete. As a result, the Board is considering the need to develop an overall reporting framework similar to *International Accounting Standard No. 1*. Such a framework would provide guidance on issues such as materiality assessments, going concern assessments, professional judgment, consistency and comparability. It would also allow few, if any, exceptions and fewer implementation guidelines.

To illustrate the difference between rules based and principles based standards, the standard setting process can be viewed as a continuum ranging from highly rigid standardson one end to general definitions of economics-based concepts on the other end. For example, consider accounting for the intangible asset goodwill. An example of the extremely rigid end of the continuum is the previously acceptable practice:

Goodwill is to be amortized over a 40-year life until it is fully amortized.

This requirement leaves no room for judgment or disagreement about the amount of amortization expense to be recognized. Comparability and consistency across firms and through time is virtually assured under such a rule. However, the requirement lacks relevance because it does not reflect the underlying economics of the reporting entity, which differ across firms and through time.

At the opposite end of the continuum is the FASB’s new rule:

Goodwill is not amortized. Any recorded goodwill is to be tested for impairment and if impaired, written down to its current fair value on an annual basis.

This requirement necessitates the application of judgment and expertise by both managers and auditors. The goal is to record the economic deterioration of the asset, goodwill

**Case 2-16**

At a joint meeting in Norwalk, Connecticut, on September 18, 2002, the FASB and the IASB both acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting (the Norwalk Agreement). The two boards pledged to use their best efforts to (1) make their existing financial reporting standards fully compatible as soon as is practicable and (2) coordinate their future work programs to ensure that once it is achieved, compatibility is maintained. The international convergence project has three major aspects: (1) the Financial Statement Presentation Project, (2) the Conceptual Framework Project, and (3) the Standards Update Project.

**Case 2-17**

a. FASB’s Conceptual Framework should provide benefits to the accounting community such as:

1. Guiding the FASB in establishing accounting standards on a consistent basis.

2. Determining bounds for judgment in preparing financial statements by prescribing the nature, functions and limits of financial accounting and reporting.

3. Increasing users’ understanding of and confidence in financial reporting.

1. The most important quality for accounting information as usefulness for decision making. Relevance and faithful representation are the primary qualities leading to this decision usefulness. Usefulness is the most important quality because, without usefulness, there would be no benefits from information to set against its costs.
2. There are several key characteristics or qualities that make accounting information desirable. The importance of three of these characteristics or qualities is discussed below.

**Understandability**—information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it, or who misuse it.

**Relevance**—the accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations (including is material).

**Faithful representation—**the faithful representation of a measure rests on whether the numbers and descriptions matched what really existed or happened, including completeness, neutrality, and free from error.

(Note to instructor: Other qualities might be discussed by the student, such as enhancing qualities. All these qualities are defined in the textbook).

## Financial Analysis Case

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