Prior to these standards, most OPEB benefits were accounted for on a cash basis, allowing companies to expense these benefits as they were paid to employees. These new standards created economic consequences, whereby firms moved to reduce their postretirement benefits. For example, as reported in The Wall Street Journal (November 4, 1992), McDonnell Douglas Corp. cut benefits to retired employees upon realizing that it faced a $1.2-billion charge against earnings from SFAS 106.

Required:

a. What is the after-tax impact on a firm's cash flows following adoption of current value accounting for OPEBs, assuming benefits are not cut?

b. Why would some firms move to reduce retiree benefits following adoption of current value accounting for OPEBs?

c. Give an argument for how a firm's share price might rise following the reporting of a major charge from adopting current value accounting for OPEBs.
The text states that matching of costs and revenues is a major challenge in historical cost accounting. A related challenge is revenue recognition, that is, when to recognize revenue as realized, or earned. Most firms recognize revenue as earned at the point of sale. More generally, according to IAS 18, revenue from sale of goods should be recognized when the significant risks and rewards of ownership are transferred to the buyer, the seller loses effective control of the goods, and the amount of consideration to be received can be reliably measured. For services and long-term contracts, revenue should be recognized on a percentage of completion basis.

It is often not clear just when these general criteria are met. For example, revenue recognition at point of sale may be a reasonable tradeoff between relevance and reliability in most cases. However, relevance is increased (and reliability decreased) if revenue is recognized earlier than point of sale.

Furthermore, revenue recognition policy may be used by firms to impress investors. For example, firms with no earnings history (e.g., startup firms) and firms that are incurring significant losses or declines in earnings have an incentive to record revenue as early as possible, so as to improve the appearance of their financial statements.

Consider the case of Lucent Technologies Inc. In December 2000, Lucent restated its revenue for its fiscal year ended September 30, 2000, reducing the amounts originally reported as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vendor financing</td>
<td>$199</td>
</tr>
<tr>
<td>Partial shipments</td>
<td>28</td>
</tr>
<tr>
<td>Distribution partners</td>
<td>452</td>
</tr>
<tr>
<td>Total</td>
<td>$679</td>
</tr>
</tbody>
</table>

The vendor financing component of the restatement represents previously unrecorded credits granted by Lucent to customers, to help them finance purchases of Lucent products. That is, the customer sales were originally recorded gross, rather than net, of the credits. The distribution partners' component represents product shipped to firms with which Lucent did not deal at arm's length, but which was not resold by these firms at year-end. These firms included certain distributors in which Lucent had an ownership interest. The practice of overshipping to distributors is called "stuffing the channels."

In its 2000 annual report, Lucent reported net income of $1,219 million, compared to $4,789 million for 1999 and $1,065 million for 1998.

On May 17, 2004, the SEC announced charges against Lucent and several of its officers for overstating revenues by $1,148 million in 2000 in order to meet sales targets. The company's share price fell by 5.5% on that day. Tactics used, the SEC claimed, included the granting of improper credits to customers to encourage them to buy company products and invoicing sales to customers that were subject to renegotiation in subsequent periods.

Subsequently, Lucent paid a fine of $25 million for "lack of cooperation." In addition, the company and some of the executives charged, settled the allegations by paying penalties, without admitting or denying guilt.

Required

a. What is the most relevant point of revenue recognition? The most reliable? Explain. In your answer, consider manufacturing firms, oil and gas exploration firms, retail firms, and firms with long-term contracts.

b. Do you feel that Lucent's original recognition of the above components as revenue was consistent with the general revenue recognition criteria given above? Explain why or why not. In your answer, consider the tradeoff between relevance and reliability.

c. What additional revenue recognition questions arise when the vendor has an ownership interest in the customer?
Under IAS 39 and SFAS 115, most loan assets held by banks are held in the loans and receivables or held-to-maturity categories, where they are valued at amortized cost. Of course, if the fair value of a loan should fall below this amount, the impaired loans standards require a writedown. Following the 2000 economic downturn, investors watched loan writedowns with particular care. Major writedowns will likely result in a decline in the bank’s share price, as investors interpret the writedown as a sign of loan quality problems to come. For example, in Canada, The Globe and Mail, March 7, 2001, reported “Scotiabank profit overshadowed by impaired loans.” The bank reported a substantial increase in first quarter, 2001, net income. However, it also reported a 44% increase in impaired loans. The share price on the Toronto Stock Exchange fell by $3.46, closing at $42.44.

Faced with reactions such as these, banks may wish to disguise the extent of major loan writedowns. An article in The Economist, March 22, 2001, “Shell game,” describes how some U.S. banks have responded to similar situations.

The trick, according to The Economist, is to transfer problem loans to the available-for-sale category. Under SFAS 115, available-for-sale securities are valued at their fair value. Thus, the transferred loans must be written down. However, the writedown will be buried in larger totals and the market would not know how much of the total adjustment to fair value belongs to the loans transferred. Furthermore, unrealized gains and losses from fair valuation of available-for-sale securities are included in other comprehensive income under SFAS 115, so that writedowns do not affect net income. Another consequence is that the book value of held-to-maturity loans on the balance sheet is reduced, so that any existing loan loss allowance will appear more adequate.

Whether banks actually sell the transferred problem loans is an open question. The Economist points out that the dollar amount of secondary trading has risen dramatically in recent years. However, the length of time that banks can hold loans in the available-for-sale category without selling them is a “grey area.” Presumably, the banks’ auditors will be aware of these practices and will take steps to discourage them. However, The Economist quotes an official of the Office of the Comptroller of the Currency (a U.S. banking regulator) as saying auditors “too often side with their clients” in “grey areas.”

Required:

a. What is the likely effect on banks’ share prices and on the operation of capital markets of the above practice? Explain.

b. Why do IAS 39 and SFAS 115 allow loans and receivables and held-to-maturity loans to be valued at cost, or amortized cost, instead of at fair value like held for trading and available-for-sale securities? To what extent would amending these standards to require fair value accounting for all financial instruments be feasible? Explain.

c. If you were the auditor of a bank engaging in the above practice, would you qualify your audit report if the bank refused your request to stop? Discuss why or why not. In your answer, consider both principles of ethical behavior and your own reputation and economic well-being.
6. IAS 39, *Financial Instruments: Recognition and Measurement*, requires companies using IASB standards to fair-value many financial instruments including derivatives, effective January 1, 2005. This standard moved the accounting for financial instruments into substantial agreement with SFAS 115 and 133 and similar standards in Canada. It is an example of the ongoing movement towards international harmonization of accounting standards.

However, IAS 39 met substantial opposition from the European Union (EU), which has required its members to adopt IASB standards effective in 2005. The opposition arose from concerns of European banks and insurance companies, who claimed that fair-value accounting would introduce volatility into their financial statements. As a result, the EU carved out the fair value option and hedging provisions of IAS 39.

Required

a. Why would banks and insurance companies be concerned about financial statement volatility introduced by IAS 39? Consider both the balance sheet and income statement in your answer.

b. As international harmonization of accounting standards progresses, there will be increasing pressure on the SEC to accept either FASB or IASB standards for firms under its jurisdiction. What would the costs and benefits to firms and investors be if the SEC was to accept either FASB or IASB standards? In your answer, consider the possibility of a “race to the bottom.”

c. How will the EU carve-outs of IAS 39 affect the likelihood that the SEC will accept either FASB or IASB standards?

7. In a June 2007 article in *The New York Times*, Floyd Norris discusses recent moves by the SEC to speed up its proposed halting of reconciliation to U.S. GAAP by foreign companies whose shares are traded in the United States and whose financial statements are prepared according to IASB accounting standards. Mr. Norris indicates that the SEC will propose halting reconciliation beginning with 2008 financial statements. At the same time, the SEC may allow U.S. companies to prepare financial statements in accordance with IASB GAAP. If so, companies would be able to choose between two sets of GAAP, resulting in a degree of competition between IASB and FASB standard-setting bodies.

Mr. Norris mentions the possibility of a “race to the bottom,” also raised by Dye and Sunder (2001) outlined in Section 13.6.5. However, he raises an alternate possibility, of a “race to the top.”

Note: In 2007, the SEC did decide to halt reconciliation.

Required

a. What is meant by “a race to the top” in this context?

b. Assuming that standard-setting bodies wish to maximize the number of firms using their standards, why might a race to the top, rather than a race to the bottom, result?

c. Assuming the SEC does drop its reconciliation requirement, what difficulties are created for investors who wish to use financial statements for investment decisions?