Accounting essay example

[Business](), [Company]()

Question 3

FASB creates rules for reporting the accounting standards for private and public sector companies. SEC, on the other hand, creates rules to protect the interests of investors, facilitate capital formation and maintain efficient market. Let’s say both the companies do not exist. In such scenario, some of the companies may try to report their earnings in a way to show more profit than actually is. Even it will be difficult for investors to compare two companies by merely looking at their financial statements as each company may use their own financial and accounting standards and variations. Without accounting standards and investment rules in place, companies will have no incentive to report losses. Reporting of losses means stagnation of stock price growth and less chances of getting future funding. It is important that some kind of rule exists. It may seem that the free market forces will ensure to have companies reporting reliable information but that probably is not true. The corporate ethics of each company differs from one another. Different companies will follow different methods of publishing reliable information in different formats. Market forces may create an environment of reliable information, but then also companies will try not to follow it because that will get them more rewards that the competitors. Regulatory bodies like FASB and SEC are thus required.

Question 4

There is no difference between two companies if we compare their income statements. The income statement will show the same revenue and expenses. However, the balance sheet of two companies will look different.

The company selling products evenly through the quarter has higher cash and lower accounts receivable than the other company. The following accounting ratios can be used to distinguish the two companies:

- Accounts Receivable to Turnover ratio (Sales/ Accounts Receivable) . The company with even sales will have higher number than the other company.
- Cash Ratio (Cash+ short term investment / Current Liabilities) --- The company with even sales will have higher number.
- Days Receivable (Accounts Receivable/ Sales per day) -- The company with more quarter end sales will have higher number.

Question 5. a

Taken the management report to be true, it seems that as per the current standards the company was only allowed to depreciate a machine within 10 years whereas due to proper preventive maintenance the company can use the machine for at least 20 years. In such cases, the management will depreciate the asset in 20 years. This means less depreciation cost per year and more income. This kind of truthful accounting practice will provide a picture closer to the truth to the investors than a regulated accounting practice, which, in this case, provides a pessimistic picture about the earnings of the company.

In most of the cases, companies try to decrease the allowance for uncollectible accounts because then the bad debt expense is less in the income statement while the profit is more. This way an overstated profit is presented to the investors (Lehman Brothers is a great example). By reporting truthfully, the management will publish the real picture of the company accounts to the investors.

Some of the companies recognize revenue at the point of delivery. This accelerates the revenue recognition. Accounts receivable, if gone too high, is a problem for the company. In practice, the management should report revenue when cash is received. Cash revenue can be recognized with some certainty than revenue at the point of delivery.

If a company wants to understate its profit to avoid the tax burden then it wants to capitalize costs. Software R&D cost is one that can be capitalized over several years, but sometimes companies want to capitalize all R&D cost in the current year to reduce the net income and avoid tax. According to SFAS NO. 86, the cost incurred in software development needs to be capitalized.

Question 5. b

Third party validation of the accounting process will certainly make it costly for the dishonest managers to make the same changes. For an honest manager, it will not take an extra effort to get the accounting process verified by an independent auditor. However, a dishonest manager needs to put in extra effort and cost to get the same thing verified by an independent auditor. They need to spend extra bucks to bend the rules and bribe the auditors.

Works Cited

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