

Two Open-Ended, Experiential Learning Cases In Accounting


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ABSTRACT

The rapidly changing environment in international business provides an excellent opportunity for instructors to design timely, adaptable, experiential learning, and open-ended cases. This paper presents and discusses how to prepare and use two such cases in the areas of bank accounting and international accounting. The cases can be offered and re-offered until the subjects are no longer relevant or interesting. The structured spreadsheets are easily adapted to other topics for other times and other classes, not just accounting classes. These two cases have been used in online courses as well as traditional courses.

Keywords: fair value measurement, bank accounting, IFRS, cultural drivers of IFRS and US GAAP differences, accounting cases

INTRODUCTION

 Open-ended, experiential learning cases are defined here as cases that do not have specific answers but hone critical thinking skills because they require students to solve problems that are not like other problems they have encountered. There are no answers, just analysis. This paper presents two open-ended, experiential learning cases, both of which have been tested in the classroom and online.

Unlike many published cases with teaching notes that soon become available on the web, students will not be able to get the solutions to these cases because, as the saying goes, “the answers change each semester.” Specifically the cases presented in this paper are open-ended, broad in scope, well thought out and require students to collect, summarize, and analyze their own data. Furthermore, the data is current.

For the instructor’s benefit, the cases are easy and quick to generate and adapt to other classes. A pre-tested, structured response spreadsheet is provided for each case so students can understand the assignments clearly.

SUMMARY OF THE CASES

Case 1, “Theoretical and Cultural Factors Explaining Differences Between IFRS and U.S. GAAP” focuses on the differences between International Accounting Standards (IFRS) and U.S. Accounting Standards (U.S. GAAP), how financial ratios would change if the U.S. adopted IFRS, and the cultural drivers underlying the differences. Case 2, “Fair Value Measurements and Disclosures,” focuses on fair value measurements at U.S. banks and how recent Financial Accounting Standards Board (FASB) Staff Positions (FSPs) have affected bank financial statements during and after the international financial crisis.

Case 1: International Accounting Differences Case: Theoretical and cultural factors explaining differences between IFRS and U.S. GAAP

Students select 10 non-trivial differences between IFRS and U.S. GAAP methods of recognition and measurement and the effect of those differences on relevant financial ratios. Students cite the source of the U.S. GAAP standards from the Accounting Standards Codification and the comparable IFRS standard from The

European Journal, which is an online resource and contains the International Financial Reporting Standards. Then students identify the traditional accounting theories that support the different methods or practices and relate those theories to the current joint IFRS and U.S. GAAP Conceptual Framework project. In addition, students identify the U.S. cultural characteristics that determine the selection of one theory or practice over another. Finally, students predict which method will be adopted, if either, given the current progress of the joint Conceptual Framework project.

Before writing Case 1, students should read:

1. Statement of Financial Accounting Concepts No. 2, “The Qualitative Characteristics of Accounting Information,” (FASB, 1980);
2. “The Evolution of the Conceptual Framework for Business Enterprises in the United States,” (Zeff, 1999);
3. Exposure Draft, “Conceptual Framework For Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information (FASB, 2008).

Ten non-trivial differences are difficult to identify for some groups of students, so for undergraduate classes, the instructor may assign fewer. Some students, depending on their experience with IFRS and U.S. GAAP, use summaries of the differences that are published by the big four accounting firms in pocketbook form and also available on the web. (See Exhibit 1 for a completed excel spreadsheet.)

After Case 1 has been collected and graded, students are asked to present their differences, financial ratio implications, and cultural drivers in class. This is the most exciting part of the case for the instructor and the most rewarding part of the case experience for the students: their work is done and now they get to hear what their peers wrote. Also, at this stage of the case, students soon become aware that some of the differences they chose are “perceived” rather than real and that, more importantly, they were unable to identify cultural drivers for these differences. In some cases, these differences exist only because the FASB and IASB have been focusing on converging more substantive issues and standards-setting is a time-consuming process.

Some students were unable to identify cultural drivers even for non-trivial differences. This is especially typical in accounting programs where students focus on debits and credits and “following the rules,” versus analyzing transactions and representing those transactions faithfully. For example, students may say that the U.S. lease standard has “bright lines” while the IFRS standard is based on substance over form, so the cultural driver is that U.S. GAAP users prefer rules-based accounting while IFRS is principles-based. Albeit that is true, the underlying cultural driver is that U.S. companies engage in off-the-balance-sheet financing using the bright lines in the rules-based U.S. standard to circumvent capitalizing leases. This is what many public companies want—to get debt off the balance sheet.

In summary, students learn to identify remaining convergence issues between U.S. GAAP and IFRS, practice citing accounting standards, review how and what accounts underlie particular ratios, and analyze potential cultural barriers to further convergence.

CONCLUSION

Exhibit 3 contains the average scores of student evaluations of Case 1 and Case 2. In General, students agreed that the cases helped them meet the goals, which differed for each case, according to the questionnaire.

AUTHOR INFORMATION

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REFERENCES

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2. Financial Accounting Standards Board, FASB Staff Position FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," April 9, 2009.
3. Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," May, 1980.
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5. Kamm, J. and J. Fuglister, "SEC Report Prompts FASB to Improve Standards on Fair Value Measurements and Disclosures," *Today's CPA*, May-June, 2010.
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EXHIBIT 1

CASE 1: Differences Between IFRS and U.S. GAAP - Example

| Issue | Inventory Valuation |
|--|---|
| 1. IFRS (cite standard & para.) IAS 2, para. 23-25. | No LIFO |
| 2. US GAAP (cite ASC) ASC 330-10-30-9 | LIFO Allowed |
| 3. Underlying theoretical difference | US-some argue that current cost is matched with current revenues (Income statement focus, which is not consistent with the Conceptual Framework). LIFO is also consistent with conservatism. IFRS-inventory at current cost before estimating lower of cost or NRV. (balance sheet focus) |
| 4. Effect of convergence on US financial statements, ratios, and decisions | This is the biggest objection US companies have to IFRS. Giving up LIFO could increase earnings, but increase taxes and decrease cash flows. (Now may be a good time to adopt IFRS because firms may be going into LIFO layer. Also, if we have to give up LIFO, now may be the optimal time, even though amounts owed may be in the billions. Maybe the Federal Government could forgive the taxes due or phase them in.) The effect of not using LIFO depends on whether the firm is in manufacturing or service, whether it is going into its LIFO layer, and whether prices are rising. If earnings increased, ROE would also increase. |
| 5. Cultural Driver | US-- LIFO is a tax reducing method. U.S. attitude has been to support manufacturing and retail through reducing/deferring taxes. In periods of increasing prices, cash flows are higher. IFRS-- More taxes will be collected without LIFO. Many Code Law countries need the higher tax revenue to support social programs. |

Case 2: Fair Value Measurements and Disclosures

We present Case 2 here because it demonstrates how our case system can be used for complex analyses and also because it is topical and relevant to the current global financial crisis. Before students write Case 2 they should read “SEC Report Prompts FASB to Improve Standards on Fair Value Measurements and Disclosures” (Kamm and Fuglister, 2010). The article is a simple outline of the recent fair value standards that the students are to evaluate in Case 2.

Background to Case 2

Subsequent to the financial crisis of 2008, measurement of financial assets at banks was the topic of many news events, a Congressional Hearing, and an SEC Report from the Office of the Chief Accountant, Division of Corporation Finance of the U.S. Securities and Exchange Commission (U.S. Securities and Exchange Commission, 2008). Many banks complained that they had to write down financial assets too low because:

1. They were required to use quoted market prices for certain trading securities measured at fair value during a period when markets were illiquid and market values were understated and
2. they were required to recognize all impairments, regardless of the cause, on mortgages held for investments directly in earnings.

These two sources of write-downs reduced earnings and legal capital and threatened bank solvency. The result was government bailouts through the Troubled Asset Relief Program (TARP). Another result was that, to somewhat ease and clarify fair value and impairment accounting, the Financial Accounting Standards Board issued two new Staff Positions (FSPs), described in the paragraphs below.

FSP FAS157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability have Significantly Decreased and Identifying Transactions that are Not Orderly,” encourages banks NOT to use readily available quoted market, or level 1, prices when those prices are unreasonable as in the case of illiquid

markets. Banks may use internally generated estimates and models, level 3, to price financial assets, if and when markets are illiquid (ASC 820-10-35-51). Level 3 is the lowest and least verifiable level of estimation because it uses unobservable inputs that reflect assumptions developed by the bank. Level 2 uses inputs from independent market data including active market prices for similar items, or if no similar items exist, pricing models having independent inputs. Case 2 is an analysis of reclassification of banks' financial assets among the three levels.

FSP FAS115-2, "Recognition and Presentation of Other-Than-Temporary Impairments," encourages banks not to recognize impairments due to market-related factors in income, but instead to take them directly to other comprehensive income (an equity account that is not part of legal capital). Only impairments due to credit losses will be recorded in income (ASC 320-10-35-33). This standard results in a cumulative effect increase in retained earnings (and legal capital) and an offsetting decrease in other comprehensive income. Case 2 is an analysis of the cumulative effect adjustment to retained earnings.

Learning Objectives

Case 2 has two learning objectives. First, students are asked to collect data from five FDIC insured banks. The data is only available in the notes to the financial statements, not in the financial statements themselves. Specifically, the notes say when they adopted the FSPs and the effect of FSP FAS115-2 on retained earnings. The notes do not indicate the effect of FSP 157-4 because that was a prospective treatment. But students should be able to infer the effect by looking at the changes in the financial assets across the three levels, before and after adoption of the standards and by analyzing the note disclosure about changes in level 3 assets in particular.

Thus, students will acquire some experience with searching, understanding and appreciating notes to the financial statements for their disclosure and their disclosure limitations. Students will use the data they collected to analyze how and if banks reclassified financial assets to and from levels in the fair value hierarchy when they adopted the new FSPs. Also, students will determine if banks that adopted the FSPs early were larger and had more significant financial statement effects, reflected by cumulative effect adjustments to retained earnings, than banks that adopted at the effective or required date. (Firms could early adopt for the quarter ended March 31, 2009. Required adoption was the quarter ended June 30, 2009.)

In this case, students will become well versed in Topics ASC 820 and ASC 320. After the cases have been collected one student presents descriptive statistics comparing early and late adopters with regard to reclassifications across the fair value hierarchy and the cumulative adjustment to retained earnings. The most exciting portion of this case is, as in Case 1, the day for class presentation. As each student summarizes his/her banks' financial accounting reactions to the new standards, the class sees a pattern of differences between early/late adopters and also, as an unexpected bonus observation, differences between big investment banks and smaller community banks.(See Exhibit 2 for a completed spreadsheet.)

In summary, Case 2 on "Fair Value Measurements and Disclosures" requires students to select their sample, find the quarterly reports, and analyze information in the financial statements and notes. In general, we have found that students have not experienced this kind of familiarity with financial statements and footnotes before. The main benefit, however, is that students began to analyze the financial crisis and the role that banks played in it. In a few cases students claimed to find evidence that big banks were "gaming the system" and this was long before recent news events reported that they may very well have been doing just that. This type of statement reflects that students became involved and interested in the role that banks played in the international financial crisis.

EXHIBIT 2

CASE 2: Completed Spreadsheet - National Penn Bank

| | \$ | Ratio % | Notes |
|---|--------------------|---------|---|
| Adoption Date | | | Quarter 1, 3-31-2009 |
| Was the effect stated as being Significant or Not Significant | | | Adoption was not material to the consolidated financial statements 10Q pg 14 |
| Total Assets (T.A.) | \$9,633,042,000.00 | | 1st Quarter Balance Sheet |
| Total Assets (T.A.) PRE-Adoption quarter | \$9,403,431,000.00 | | 2nd Quarter Balance Sheet |
| Change in T.A. | \$ 229,611,000.00 | 2.44% | |
| Cum. Effect Adjustment to opening Retained Earnings to reclassify the concredit portion of previously recognized OTTI in adoption quarter | \$19,100,000.00 | 0.20% | The credit-related OTTI recognized during the first quarter 2009 was \$7.8 million and was solely related to held to maturity securities newly deemed other than temporarily impaired with a book value of \$29.8 million. Noncredit-related OTTI on these securities, which are not expected to be sold, was \$18.8 million and was recognized in OCI during the first quarter 2009. In addition, \$19.1 million was reclassified from retained earnings to OCI for the noncredit-related portion of OTTI losses previously recognized in prior quarters. 10Q pg 9 |
| Sum and Percentage of T.A. that were Held to Maturity (HTM) loans, adoption quarter | \$6,560,618,000.00 | 68.11% | 1st Qtr Balance Sheet |
| Sum and Percentage of T.A. that were Held to Maturity (HTM) loans, PRE - adoption quarter | \$6,554,353,000.00 | 69.70% | 2nd Qtr Balance Sheet |
| Sum and Percentage of T.A. measured at Fair Value, at the adoption quarter | \$1,718,941,000.00 | 17.84% | recurring + nonrecurring, pg. 19 |
| Sum and Percentage of T.A. measured at Fair Value, PRE adoption quarter | \$1,655,407,000.00 | 17.60% | |
| Amount and Percentage Level 1 FV Assets, adoption quarter | \$ 23,045,000.00 | 1.34% | 1st Qtr 10Q pg 18-19 |
| Amount and Percentage Level 1 FV Assets, PRE-adoption quarter | \$31,002,000.00 | 1.87% | 1st Qtr 10Q pg 18-19 |
| Percentage Change from PRE Adoption Quarter to Adoption Quarter Level 1 | | -25.67% | |
| Amount and Percentage Level 2 FV Assets, adoption quarter | \$1,565,466,000.00 | 91.07% | 1st Qtr 10Q pg 18-19 |
| Amount and Percentage Level 2 FV Assets, PRE-adoption quarter | \$1,523,195,000.00 | 92.01% | 1st Qtr 10Q pg 18-19 |
| Percentage Change from PRE Adoption Quarter to Adoption Quarter Level 2 | | 2.78% | |

EXHIBIT 2 (Continued)

CASE 2: Completed Spreadsheet - National Penn Bank

| | | | |
|---|-------------------|--------|--|
| Amount and Percentage Level 3 FV Assets, adoption quarter | \$ 130,430,000.00 | 7.59% | 1st Qtr 10Q pg 18-19 |
| Amount and Percentage Level 3 FV Assets, PRE-adoption quarter | \$ 101,210,000.00 | 6.11% | 1st Qtr 10Q pg 18-19 |
| Percentage Change from PRE Adoption Quarter to Adoption Quarter Level 3 | | 28.87% | |
| Sum and % of Level 1 reclassified to level 2, adoption quarter | n/a | | |
| Sum and % of Level 1 reclassified to level 3, adoption quarter | n/a | | |
| Sum and % of Level 2 reclassified to level 3 during adoption quarter. | n/a | | |
| Redeemable Preferred as a % of Equity, 12-31-08 | \$ 144,076,000.00 | 12.21% | Total Equity - 1,179,995,000 1st Qtr 10Q |
| Redeemable Preferred as a % of equity, 6-30-09. | \$ 144,517,000.00 | 11.88% | Total Equity - 1,216,623,000 2ndt Qtr 10Q |
| Non-redeemable Preferred as a % of Equity, 12-31-08 | n/a | | |
| Price per share at the end of the pre-adoption quarter | \$ 14.51 | | http://www.google.com/finance?q=NASDAQ:NPBC |
| Price per share at the end of the adoption quarter | \$ 8.30 | | http://www.google.com/finance?q=NASDAQ:NPBC |
| Earnings per share at the end of the pre-adoption quarter | \$ 0.42 | | 2008 10k pg 86 |
| Earnings per share at the end of the adoption quarter | \$ 0.33 | | 10Q pg 13 |
| Book value per share at the end of the pre-adoption quarter | \$ 12.33 | | (1179995000-144076000)/83983442 |
| Book value per share at the end of the adoption quarter | \$ 12.29 | | (1176102000-144297000)/83983442 - |
| Adopted 107 Early or Late | | | Adopted in 1st Quarter - pg.19 |
| Tarp | \$ 150,000,000.00 | 1.60% | National Penn received \$ 150,000,000 from TARP: http://philadelphia.bizjournals.com/philadelphia/stories/2008/11/24/daily27.html |

EXHIBIT 3

QUESTIONNAIRE: Two Open-ended Cases in Accounting Policy, ACT 639 - Spring, 2010

Rank from 1 to 7, with 1 being “I **disagree** most strongly,” and 7 being “I **agree** most strongly” the following statements. For example:

1. -- most strongly disagree
2. -- strongly disagree
3. -- somewhat disagree
4. -- no opinion
5. --agree
6. --strongly agree
7. --most strongly agree

Questions about Case 1: Differences between US GAAP and IFRS

1. Case 1 helped me understand why the US is having some difficulty converging to IFRS. 5.25
2. Case 1 helped me focus on US GAAP and learning how to use the Accounting Standards Codification (ASC). 5.63
3. Case 1 was a challenge, especially identifying the cultural drivers that underlie differences between US GAAP and IFRS. 5.13
4. I learned a significant amount of relevant material that is consistent with the current U.S. GAAP IFRS Convergence project . 5.44
5. Case 1 is consistent with and complements other assignments in the class. 5.75

Questions about Case 2: Fair Value Measurements and Disclosures

1. Case 2 helped me understand how important it is to learn how to read, write and interpret notes to financial statements of banks. 5.75
2. Case 2 helped me focus on recent US GAAP FSPs on fair value accounting and how they affected the financial statements of banks. 5.31
3. Case 2 was a challenge. 5.44
4. I learned a significant amount of relevant material that was consistent with the current financial crisis environment from Case 2. 5.44
5. Case 2 is consistent with and complements other assignments in the class. 5.19