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2 Conceptual Framework for Financial Reporting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the usefulness of a conceptual framework.
2. Understand the objective of financial reporting.
3. Identify the qualitative characteristics of accounting information.
4. Define the basic elements of financial statements.
5. Describe the basic assumptions of accounting.
6. Explain the application of the basic principles of accounting.
7. Describe the impact that the cost constraint has on reporting accounting information.

WHAT IS IT?

Everyone agrees that accounting needs a framework—a conceptual framework, so to speak—that will help guide the development of standards. To understand the importance of developing this framework, let's see how you would respond in the following two situations.

Situation 1: "Taking a Long Shot … "

To supplement donations collected from its general community solicitation, Tri-Cities United Charities holds an annual lottery sweepstakes. In this year's sweepstakes, United Charities is offering a grand prize of $1,000,000 to a single winning ticket holder. A total of 10,000 tickets have been printed, and United Charities plans to sell all the tickets at a price of $150 each.

Since its inception, the sweepstakes has attracted area-wide interest, and United Charities has always been able to meet its sales target. However, in the unlikely event that it might fail to sell a sufficient number of tickets to cover the grand prize, United Charities has reserved the right to cancel the sweepstakes and to refund the price of the tickets to holders.

In recent years, a fairly active secondary market for tickets has developed. This year, buying–selling prices have varied between $75 and $95 before stabilizing at about $90.

When the tickets first went on sale this year, multimillionaire Phil N. Tropic, well-known in Tri-Cities civic circles as a generous but sometimes eccentric donor, bought one of the tickets from United Charities, paying $150 cash.

How would you answer the following questions?

1. Should Phil N. Tropic recognize his lottery ticket as an asset in his financial statements?
2. Assuming that Phil N. Tropic recognizes the lottery ticket as an asset, at what amount should it be reported? Some possible answers are $150, $100, and $90.

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Situation 2: The $20 Million Question

The Hard Rock Mining Company has just completed the first year of operations at its new strip mine, the Lonesome Doe. Hard Rock spent $10 million for the land and $20 million in preparing the site for mining operations. The Mine is expected to operate for 20 years. Hard Rock is subject to environmental statutes requiring it to restore the Lonesome Doe Mine site on completion of mining operations.

Based on its experience and industry data, as well as current technology, Hard Rock forecasts that restoration will cost about $10 million when it is undertaken. Of those costs, about $4 million is for restoring the topsoil that was removed in preparing the site for mining operations (prior to opening the mine). The rest is directly proportional to the depth of the mine, which in turn is directly proportional to the amount of ore extracted.

How would you answer the following questions?

1. Should Hard Rock recognize a liability for site restoration in conjunction with the opening of the Lonesome Doe Mine? If so, what is the amount of that liability?
2. After Hard Rock has operated the Lonesome Doe Mine for 5 years, new technology is introduced that reduces Hard Rock's estimated future restoration costs to $7 million, $3 million of which relates to restoring the topsoil. How should Hard Rock account for this change in its estimated future liability?

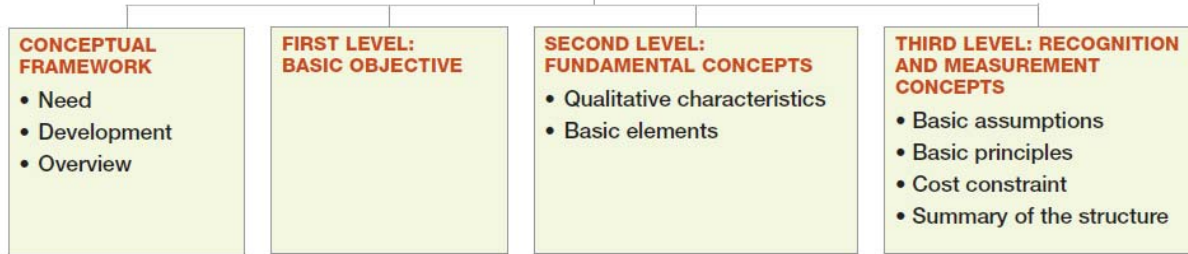
The answer to the questions on the two situations depends on how assets and liabilities are defined and how they should be valued. Hopefully, this chapter will provide you with a framework to resolve questions like these.

Source: Adapted from Todd Johnson and Kim Petrone, *The FASB Cases on Recognition and Measurement*, Second Edition (New York: John Wiley and Sons, Inc., 1996).

PREVIEW OF CHAPTER 2 As our opening story indicates, users of financial statements can face difficult questions about the recognition and measurement of financial items. To help develop the type of financial information that can be used to answer these questions, financial accounting and reporting relies on a conceptual framework. In this chapter, we discuss the conceptual framework as follows.

This chapter also includes numerous conceptual and international discussions that are integral to the topics presented here.

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING



REVIEW AND PRACTICE

Go to the REVIEW AND PRACTICE section at the end of the chapter for a targeted summary review and practice problem with solution. Multiple-choice questions with annotated solutions as well as additional exercises and practice problem with solutions are also available online.

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CONCEPTUAL FRAMEWORK

LEARNING OBJECTIVE 1

Describe the usefulness of a conceptual framework.

A **conceptual framework** establishes the concepts that underlie financial reporting. A conceptual framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on (1) identifying the boundaries of financial reporting; (2) selecting the transactions, other events, and circumstances to be represented; (3) how they should be recognized and measured; and (4) how they should be summarized and reported.[1]

Need for a Conceptual Framework

Why do we need a conceptual framework? First, to be useful, rule-making should build on and relate to an established body of concepts. A soundly developed conceptual framework thus enables the FASB to issue **more useful and consistent pronouncements over time; a coherent set of standards should result**. Indeed, without the guidance provided by a soundly developed framework, standard-setting ends up being based on individual concepts developed by each member of the standard-setting body. The following observation by a former standard-setter highlights the problem.

> "As our professional careers unfold, each of us develops a technical conceptual framework. Some individual frameworks are sharply defined and firmly held; others are vague and weakly held; still others are vague and firmly held .... At one time or another, most of us have felt the discomfort of listening to somebody buttress a preconceived conclusion by building a convoluted chain of shaky reasoning. Indeed, perhaps on occasion we have voiced such thinking ourselves .... My experience ... taught me many lessons. A major one was that most of us have a natural tendency and an incredible talent for processing new facts in such a way that our prior conclusions remain intact.[2]

In other words, standard-setting that is based on personal conceptual frameworks will lead to different conclusions about identical or similar issues than it did previously. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones. Furthermore, the framework should increase financial statement users' understanding of and confidence in financial reporting. It should enhance comparability among companies' financial statements.

Second, as a result of a soundly developed conceptual framework, the profession should be able to more quickly solve new and emerging **practical problems by referring to an existing framework of basic theory**. For example, **Sunshine Mining** sold two issues of bonds. It can redeem them either with $1,000 in cash or

with 50 ounces of silver, whichever is worth more at maturity. Both bond issues have a stated interest rate of 8.5 percent. At what amounts should Sunshine or the buyers of the bonds record them? What is the amount of the premium or discount on the bonds? And how should Sunshine amortize this amount, if the bond redemption payments are to be made in silver (the future value of which is unknown at the date of issuance)? Consider that Sunshine cannot know, at the date of issuance, the value of future silver bond redemption payments.

INTERNATIONAL PERSPECTIVE

The IASB has also issued a conceptual framework. Although the FASB and the IASB have worked together to converge elements of their conceptual frameworks (related to objectives and qualitative characteristics issued in 2010), the IASB has recently proposed additional changes to its own framework. This may result in differences with the FASB conceptual framework.

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It is difficult, if not impossible, for the FASB to prescribe the proper accounting treatment quickly for situations like this or like those represented in our opening story. Practicing accountants, however, must resolve such problems on a daily basis. How? Through good judgment and with the help of a universally accepted conceptual framework, practitioners can quickly focus on an acceptable treatment.

WHAT DO THE NUMBERS MEAN?

WHAT'S YOUR PRINCIPLE?

The need for a conceptual framework is highlighted by accounting scandals such as those at **Enron** and **Lehman Brothers**. To restore public confidence in the financial reporting process, many have argued that regulators should move toward principles-based rules. They believe that companies exploited the detailed provisions in rules-based pronouncements to manage accounting reports, rather than report the economic substance of transactions. For example, many of the off-balance-sheet arrangements of Enron avoided transparent reporting by barely achieving 3 percent outside equity ownership, a requirement in an obscure accounting rule interpretation. Enron's financial engineers were able to structure transactions to achieve a desired accounting treatment, even if that accounting treatment did not reflect the transaction's true nature. Under principles-based rules, hopefully top management's financial reporting focus will shift from demonstrating compliance with rules to demonstrating that a company has attained the objective of financial reporting.

Development of a Conceptual Framework

Over the years, numerous organizations developed and published their own conceptual frameworks, but no single framework was universally accepted and relied on in practice. In 1976, the FASB began to develop a conceptual framework that would be a basis for setting accounting rules and for resolving financial reporting controversies. The FASB has since issued seven Statements of Financial Accounting Concepts that relate to financial reporting for business enterprises:[3]

1. ***SFAC No. 1***, "Objectives of Financial Reporting by Business Enterprises," presents the goals and purposes of accounting (superseded by *SFAC No. 8*, Chapter 1).
2. ***SFAC No. 2***, "Qualitative Characteristics of Accounting Information," examines the characteristics that make accounting information useful (superseded by *SFAC No. 8*, Chapter 3).
3. ***SFAC No. 3***, "Elements of Financial Statements of Business Enterprises," provides definitions of items in financial statements, such as assets, liabilities, revenues, and expenses (superseded by *SFAC No. 6*).

4. ***SFAC No. 5***, "Recognition and Measurement in Financial Statements of Business Enterprises," sets forth fundamental recognition and measurement criteria and guidance on what information should be formally incorporated into financial statements and when.
5. ***SFAC No. 6***, "Elements of Financial Statements," replaces *SFAC No. 3* and expands its scope to include not-for-profit organizations.
6. ***SFAC No. 7***, "Using Cash Flow Information and Present Value in Accounting Measurements," provides a framework for using expected future cash flows and present values as a basis for measurement.
7. ***SFAC No. 8***, Chapter 1, "The Objective of General Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information," replaces *SFAC No. 1* and *No. 2.*

INTERNATIONAL PERSPECTIVE

SFAC No. 8 is the product of a joint conceptual framework project of the FASB and IASB.

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Overview of the Conceptual Framework

Illustration 2-1 provides an overview of the FASB's conceptual framework.[4]

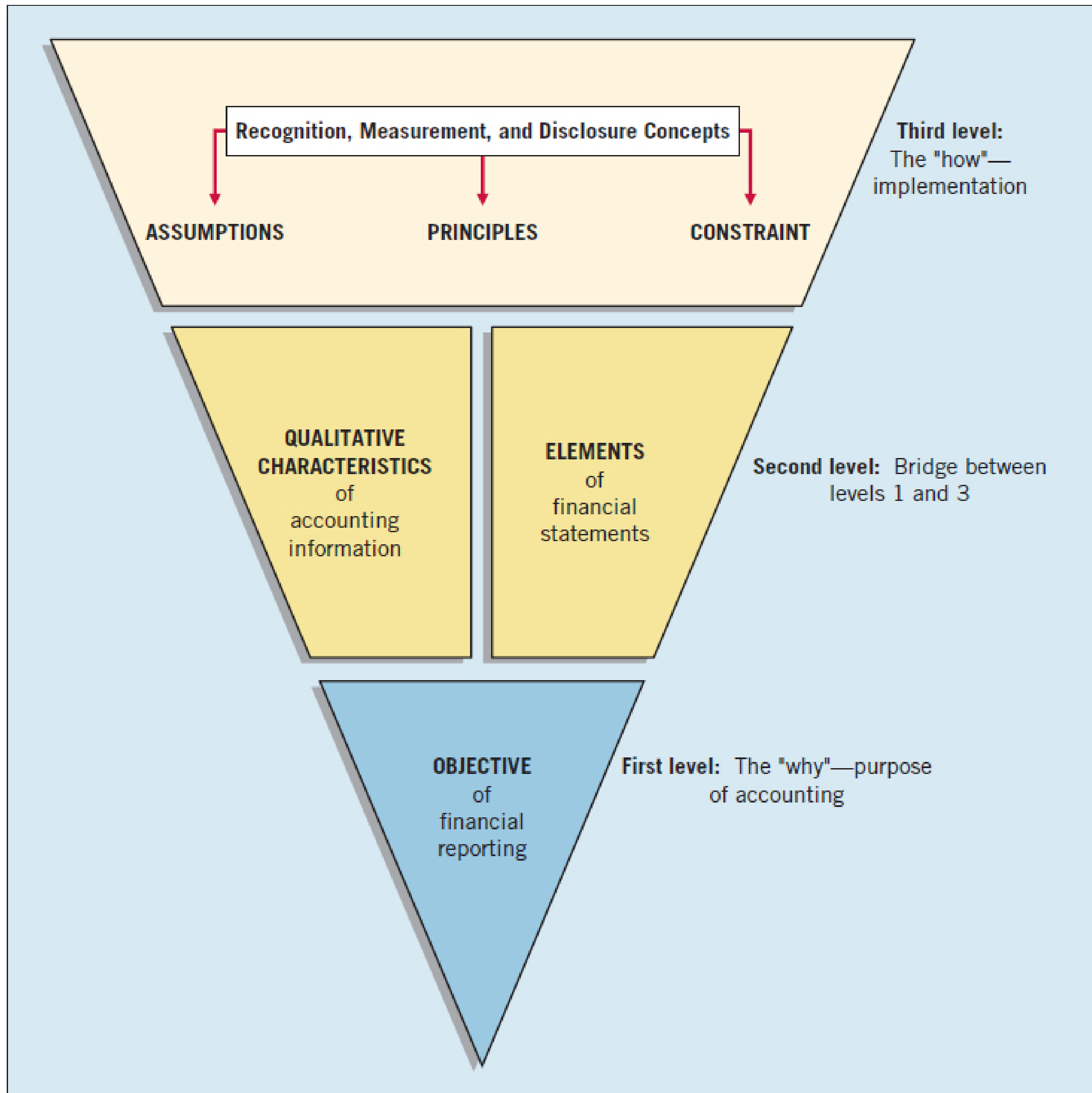

ILLUSTRATION 2-1
Framework for Financial Reporting

The first level identifies the **objective of financial reporting**—that is, the purpose of financial reporting. The second level provides the **qualitative characteristics** that make accounting information useful and the **elements of**

financial statements (assets, liabilities, and so on). The third level identifies the **recognition, measurement, and disclosure concepts** used in establishing and applying accounting standards and the specific concepts to implement the objective. These concepts include assumptions, principles, and a cost constraint that describe the present reporting environment. We examine these three levels of the conceptual framework next.

FIRST LEVEL: BASIC OBJECTIVE

LEARNING OBJECTIVE 2

Understand the objective of financial reporting.

The **objective of financial reporting** is the foundation of the conceptual framework. Other aspects of the framework—qualitative characteristics, elements of financial statements, recognition, measurement, and disclosure—flow logically from the objective.

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Those aspects of the framework help to ensure that financial reporting achieves its objective.

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity**. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit. To make effective decisions, these parties need information to help them assess a company's prospects for future net cash flows, which will support payments and/or provide a return to existing and potential investors, lenders, and other creditors. Information that is decision-useful to capital providers may also be useful to other users of financial reporting, who are not capital providers.[5]

As indicated in Chapter 1, to provide information to decision-makers, companies prepare general-purpose financial statements. **General-purpose financial reporting** helps users who lack the ability to demand all the financial information they need from an entity and therefore must rely, at least partly, on the information provided in financial reports. However, an implicit assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information contained in financial statements. This point is important. It means that financial statement preparers assume a level of competence on the part of users. This assumption impacts the way and the extent to which companies report information.

SECOND LEVEL: FUNDAMENTAL CONCEPTS

LEARNING OBJECTIVE 3

Identify the qualitative characteristics of accounting information.

The objective (first level) focuses on the purpose of financial reporting. Later, we will discuss the ways in which this purpose is implemented (third level). What, then, is the purpose of the second level? The second level provides conceptual building blocks that explain the qualitative characteristics of accounting information and define the elements of financial statements.[6] That is, the second level forms a bridge between the **why** of accounting (the objective) and the **how** of accounting (recognition, measurement, and financial statement presentation).

Qualitative Characteristics of Accounting Information

Should companies like **Walt Disney** or **Kellogg's** provide information in their financial statements on how much it costs them to acquire their assets (historical cost

basis) or how much the assets are currently worth (fair value basis)? Should **PepsiCo** combine and show as one company the four main segments of its business, or should it report PepsiCo Beverages, Frito Lay, Quaker Foods, and PepsiCo International as four separate segments?

How does a company choose an acceptable accounting method, the amount and types of information to disclose, and the format in which to present it? The answer: By determining **which alternative provides the most useful information for decision-making purposes (decision-usefulness)**. The FASB identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes. In addition, the FASB identified a cost constraint as part of the conceptual framework (discussed later

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in the chapter). As Illustration 2-2 shows, the characteristics may be viewed as a hierarchy.

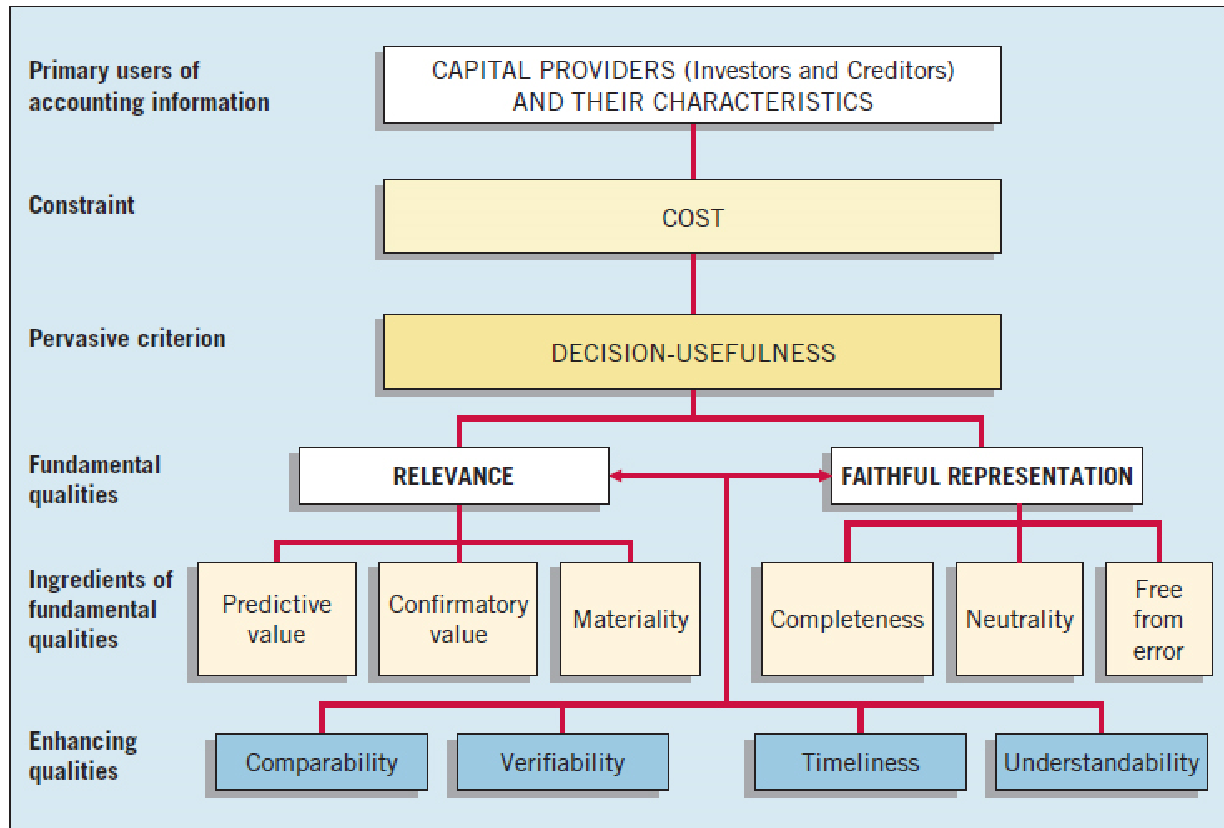
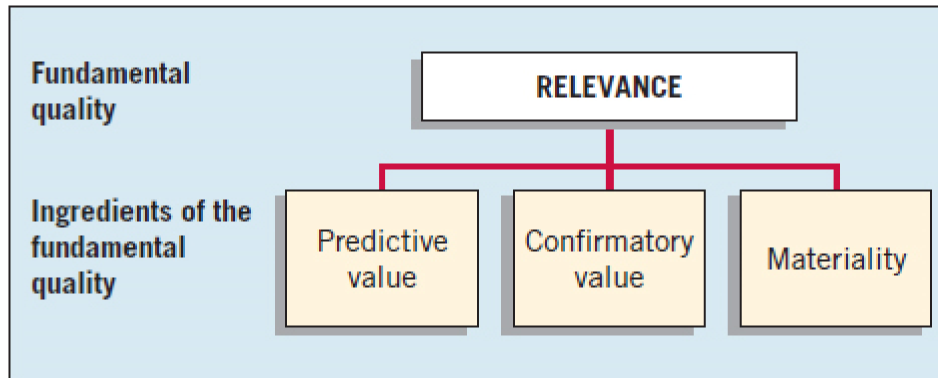


ILLUSTRATION 2-2
Hierarchy of Accounting Qualities

As indicated by Illustration 2-2, qualitative characteristics are either fundamental or enhancing, depending on how they affect the decision-usefulness of information. Regardless of classification, each qualitative characteristic contributes to the decision-usefulness of financial reporting information. However, providing useful financial information is limited by a constraint on financial reporting—cost should not exceed the benefits of a reporting practice.

Fundamental Quality—Relevance

Relevance is one of the two fundamental qualities that make accounting information useful for decision-making. Relevance and related ingredients of this fundamental quality are shown below.



To have **relevance**, accounting information must be capable of making a difference in a decision. Information with no bearing on a decision is irrelevant. Financial information is capable of making a difference when it has predictive value, confirmatory value, or both.

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Financial information has **predictive value** if it has value as an input to predictive processes used by investors to form their own expectations about the future. For example, if potential investors are interested in purchasing common shares in **UPS (United Parcel Service)**, they may analyze its current resources and claims to those resources, its dividend payments, and its past income performance to predict the amount, timing, and uncertainty of UPS's future cash flows.

Relevant information also helps users confirm or correct prior expectations; it has **confirmatory value**. For example, when UPS issues its year-end financial statements, it confirms or changes past (or present) expectations based on previous evaluations. It follows that predictive value and confirmatory value are interrelated. For example, information about the current level and structure of UPS's assets and liabilities helps users predict its ability to take advantage of opportunities and to react to adverse situations. The same information helps to confirm or correct users' past predictions about that ability.

Materiality is a company-specific aspect of relevance. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information. An individual company determines whether information is material because both the nature and/or magnitude of the item(s) to which the information relates must be considered in the context of an individual company's financial report. Information is *immaterial,* and therefore irrelevant, if it would have no impact on a decision-maker. In short, **it must make a difference** or a company need not report it.

Assessing materiality is one of the more challenging aspects of accounting because it requires evaluating both the **relative size and importance** of an item. However, it is difficult to provide firm guidelines in judging when a given item is or is not material. Materiality varies both with relative amount and with relative importance. For example, the two sets of numbers in Illustration 2-3 indicate relative size.

ILLUSTRATION 2-3
Materiality Comparison

	Company A	Company B
Sales	$10,000,000	$100,000
Costs and expenses	9,000,000	90,000
Income from operations	$ 1,000,000	$ 10,000
Unusual gain	$ 20,000	$ 5,000

During the period in question, the revenues and expenses, and therefore the net incomes of Company A and Company B, are proportional. Each reported an unusual gain. In looking at the abbreviated income figures for Company A, it appears insignificant whether the amount of the unusual gain is set out separately or merged

with the regular operating income. The gain is only 2 percent of the operating income. If merged, it would not seriously distort the income figure. Company B has had an unusual gain of only $5,000. However, it is relatively much more significant than the larger gain realized by Company A. For Company B, an item of $5,000 amounts to 50 percent of its income from operations. Obviously, the inclusion of such an item in operating income would affect the amount of that income materially. Thus, we see the importance of the **relative size** of an item in determining its materiality.

Companies and their auditors generally adopt the rule of thumb that anything under 5 percent of net income is considered immaterial. However, much can depend on specific rules. For example, one market regulator indicates that a company may use this percentage for an initial assessment of materiality, but it must also consider other factors. For example, companies can no longer fail to record items in order to meet consensus analysts' earnings numbers, preserve a positive earnings trend, convert a loss to a profit or vice versa, increase management compensation, or hide an illegal transaction like a bribe. In other words, **companies must consider both quantitative and qualitative factors in determining whether an item is material**.

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Thus, it is generally not feasible to specify uniform quantitative thresholds at which an item becomes material. Rather, materiality judgments should be made in the context of the nature and the amount of an item. Materiality factors into a great many internal accounting decisions, too. Examples of such judgments that companies must make include the amount of classification required in a subsidiary expense ledger, the degree of accuracy required in allocating expenses among the departments of a company, and the extent to which adjustments should be made for accrued and deferred items. Only by **the exercise of good judgment and professional expertise** can reasonable and appropriate answers be found with respect to materiality issues.[7]

WHAT DO THE NUMBERS MEAN?

LIVING IN A MATERIAL WORLD

The first line of defense for many companies caught "cooking the books" had been to argue that a questionable accounting item is immaterial. That defense did not work so well in the wake of accounting meltdowns at **Enron** and **Global Crossing** and the tougher rules on materiality issued by the SEC (*SAB 99*).

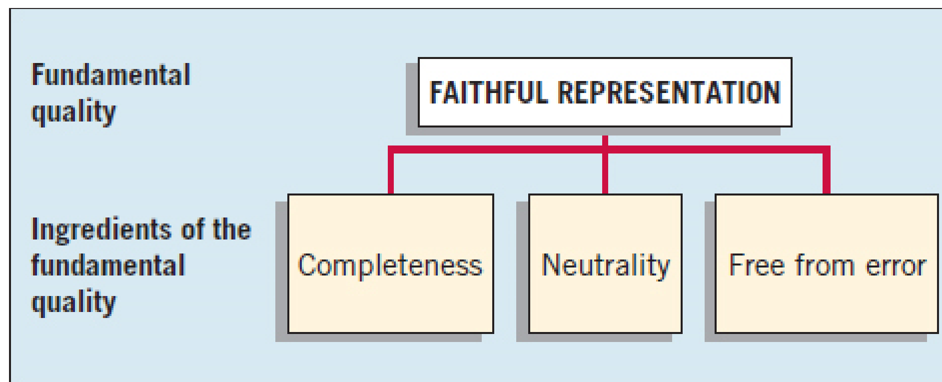
For example, the SEC alleged in a case against **Sunbeam** that the company's many immaterial adjustments added up to a material misstatement that misled investors about the company's financial position. The SEC has called for a number of companies, such as **Jack in the Box**, **McDonald's**, and **AIG**, to restate prior financial statements for the effects of incorrect accounting. In some cases, the restatements did not meet traditional materiality thresholds. Don Nicholaisen, then SEC chief accountant, observed that whether the amount is material or not, some transactions appear to be "flat out intended to mislead investors." In essence he is saying that even small accounting errors for a transaction can represent important information to the users of financial statements.

Responding to new concerns about materiality, blue-chip companies such as **IBM** and **General Electric** are providing expanded disclosures of transactions that used to fall below the materiality radar. As a result, some good may yet come from these accounting failures.

Sources: Adapted from K. Brown and J. Weil, "A Lot More Information Is 'Material' After Enron," *Wall Street Journal Online* (February 22, 2002); S. D. Jones and R. Gibson, "Restaurants Serve Up Restatements," *Wall Street Journal* (January 26, 2005), p. C3; and R. McTauge, "Nicholaisen Says Restatement Needed When Deal Lacks Business Purpose," *Securities Regulation & Law Reporter* (May 9, 2005).

Fundamental Quality—Faithful Representation

Faithful representation is the second fundamental quality that makes accounting information useful for decision-making. Faithful representation and related ingredients of this fundamental quality are shown below.



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Faithful representation means that the numbers and descriptions match what really existed or happened. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. For example, if **General Motors**' income statement reports sales of $180,300 million when it had sales of $155,399 million, then the statement fails to faithfully represent the proper sales amount. To be a faithful representation, information must be complete, neutral, and free of material error.

Completeness. **Completeness** means that all the information that is necessary for faithful representation is provided. An omission can cause information to be false or misleading and thus not be helpful to the users of financial reports. For example, when **Citigroup** fails to provide information needed to assess the value of its subprime loan receivables (toxic assets), the information is not complete and therefore not a faithful representation of their values.

Neutrality. **Neutrality** means that a company cannot select information to favor one set of interested parties over another. Unbiased information must be the overriding consideration. For example, in the notes to financial statements, tobacco companies such as **R.J. Reynolds** should not suppress information about the numerous lawsuits that have been filed because of tobacco-related health concerns—even though such disclosure is damaging to the company.

Neutrality in rule-making has come under increasing attack. Some argue that the FASB should not issue pronouncements that cause undesirable economic effects on an industry or company. We disagree. Accounting rules (and the standard-setting process) must be free from bias, or we will no longer have credible financial statements. Without credible financial statements, individuals will no longer use this information. An analogy demonstrates the point: Many individuals bet on boxing matches because such contests are assumed not to be fixed. But nobody bets on wrestling matches. Why? Because the public assumes that wrestling matches are rigged. If financial information is biased (rigged), the public will lose confidence and no longer use it. [8]

Free from Error. An information item that is **free from error** will be a more accurate (faithful) representation of a financial item. For example, if **JPMorgan Chase** misstates its loan losses, its financial statements are misleading and not a faithful representation of its financial results. However, faithful representation does not imply total freedom from error. This is because most financial reporting measures involve estimates of various types that incorporate management's judgment. For example, management must estimate the amount of uncollectible accounts to determine bad debt expense. And determination of depreciation expense requires estimation of useful lives of plant and equipment, as well as the salvage value of the assets.

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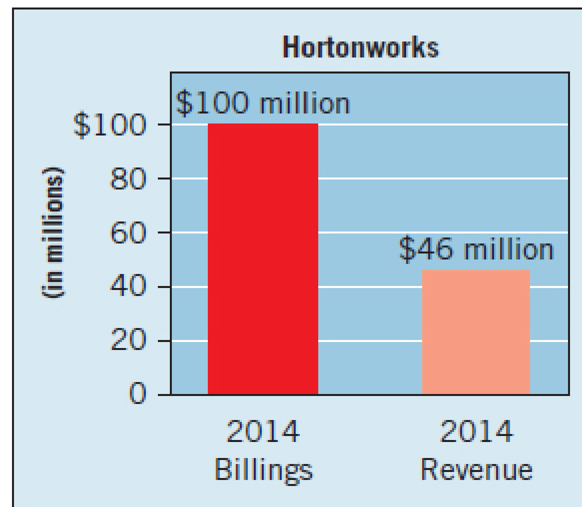
WHAT DO THE NUMBERS MEAN?

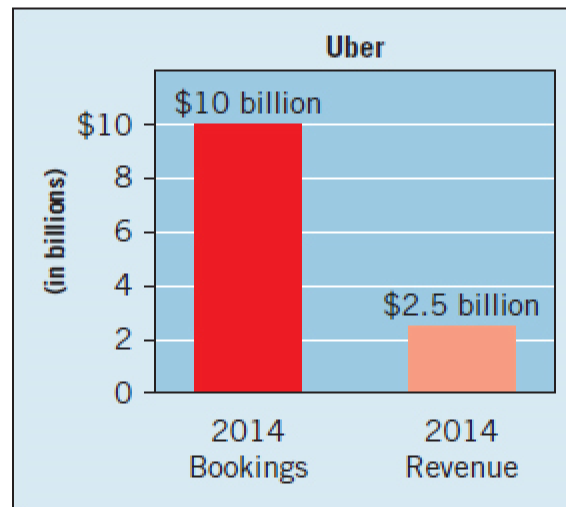
SHOW ME THE EARNINGS!

Some young technology companies, in an effort to attract investors who will help them strike it rich, are using unconventional financial terms in their financial reports. As an example, instead of revenue, these privately held companies use terms such as "bookings," annual recurring revenues, or other numbers that often exceed actual revenue.

Hortonworks Inc. (a software company) is a classic illustration. It forecast in March 2014 that it would have a strong $100 million in billings by year-end. It turns out the company was not talking about revenues but rather a non-GAAP number that it uses to gauge future business. This number looked a lot smaller after Hortonworks went public and reported financial results-just $46 million in revenues, as shown in the following chart.



Another example is **Uber Technologies** (the sometimes controversial ride service). Uber recently noted that it is on target to reach $10 billion in bookings for 2015. Uber defines bookings as total fares paid by customers. But Uber keeps little of the money from these bookings. As shown in the chart below, Uber gets only 25 cents on each $1 of bookings.

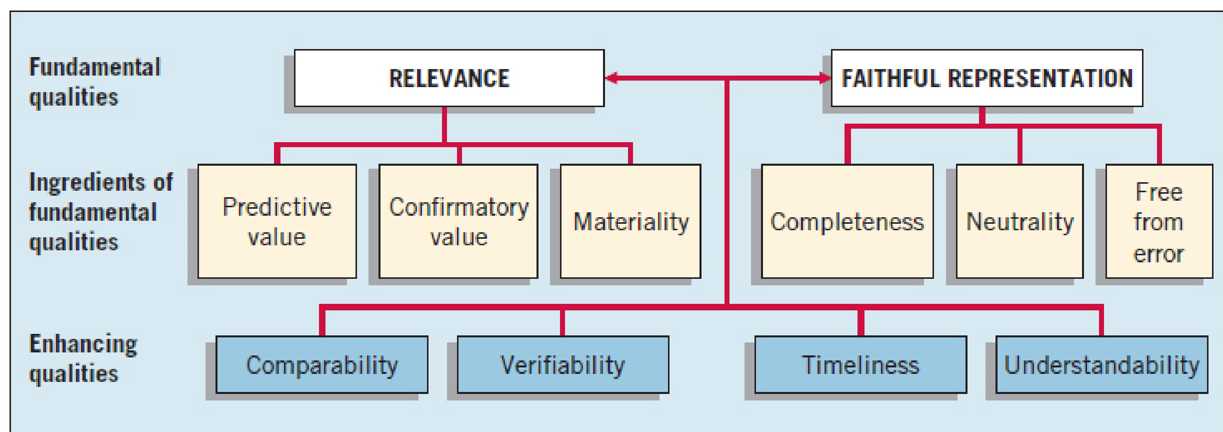


If Uber was a public company, it would report the 25 cents as revenues, not the one dollar. The lesson for investors: Keep an eye on reliable financial measures of performance and be sure to count expenses and net income according to GAAP. Using gross measures such as billings, recurring revenues, or some nonfinancial and non-GAAP measures to determine success may be hazardous to your financial health.

Source: Telis Demos, Shira Ovide, and Susan Pulliam, "Tech Startups Play Numbers Game," *Wall Street Journal* (June 10, 2015), pp. A1 and A12.

Enhancing Qualities

Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. These characteristics distinguish more-useful information from less-useful information. Enhancing characteristics, shown below, are comparability, verifiability, timeliness, and understandability.



Comparability. Information that is measured and reported in a similar manner for different companies is considered comparable. **Comparability** enables users to

identify the real similarities and differences in economic events between companies.
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example, historically the accounting for pensions in Japan differed from that in the United States. In Japan, companies generally recorded little or no charge to income for these costs. U.S. companies recorded pension cost as incurred. As a result, it is difficult to compare and evaluate the financial results of **Toyota** or **Honda** to **General Motors** or **Ford**. Investors can only make valid evaluations if comparable information is available.

Another type of comparability, **consistency**, is present when a company applies the same accounting treatment to similar events, from period to period. Through such application, the company shows consistent use of accounting standards. The idea of consistency does not mean, however, that companies cannot switch from one accounting method to another. A company can change methods, but it must first demonstrate that the newly adopted method is preferable to the old. If approved, the company must then disclose the nature and effect of the accounting change, as well as the justification for it, in the financial statements for the period in which it made the change.[9] When a change in accounting principles occurs, the auditor generally refers to it in an explanatory paragraph of the audit report. This paragraph identifies the nature of the change and refers the reader to the note in the financial statements that discusses the change in detail.[10]

Verifiability. **Verifiability** occurs when independent measurers, using the same methods, obtain similar results. Verifiability occurs in the following situations.

1. Two independent auditors count **PepsiCo**'s inventory and arrive at the same physical quantity amount for inventory. Verification of an amount for an asset therefore can occur by simply counting the inventory (referred to as *direct verification*).
2. Two independent auditors compute PepsiCo's inventory value at the end of the year using the FIFO method of inventory valuation. Verification may occur by checking the inputs (quantity and costs) and recalculating the outputs (ending inventory value) using the same accounting convention or methodology (referred to as *indirect verification*).

Timeliness. **Timeliness** means having information available to decision-makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions. A lack of timeliness, on the other hand, can rob information of its usefulness. For example, if **Dell** waited to report its interim results until nine months after the period, the information would be much less useful for decision-making purposes.

Understandability. Decision-makers vary widely in the types of decisions they make, how they make decisions, the information they already possess or can obtain from other sources, and their ability to process the information. For information to be useful, there must be a connection (linkage) between these users and the decisions they make. This link, **understandability**, is the quality of information that lets reasonably informed users see its significance. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely.

For example, assume that **Google** issues a three-months' report that shows interim earnings have declined significantly. This interim report provides relevant and

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faithfully represented information for decision-making purposes. Some users, upon reading the report, decide to sell their shares. Other users, however, do not understand the report's content and significance. They are surprised when Google declares a smaller year-end dividend and the share price declines. Thus, although Google presented highly relevant information that was a faithful representation, it was useless to those who did not understand it.

Thus, users of financial reports are assumed to have a reasonable knowledge of business and economic activities. In making decisions, users also should review and analyze the information with reasonable diligence. Information that is relevant and faithfully represented should not be excluded from financial reports solely because it is too complex or difficult for some users to understand without assistance.[11]

Basic Elements

LEARNING OBJECTIVE 4

Define the basic elements of financial statements.

An important aspect of developing any theoretical structure is the body of **basic elements** or definitions to be included in it. Accounting uses many terms with distinctive and specific meanings. These terms constitute the language of business or the jargon of accounting.

One such term is **asset**. Is it merely something we own? Or is an asset something we have the right to use, as in the case of leased equipment? Or is it anything of value used by a company to generate revenues—in which case, should we also consider the managers of a company as an asset?

As this example and the lottery ticket example in the opening story illustrate, it therefore seems necessary to develop basic definitions for the elements of financial statements. *SFAC No. 6* defines the 10 interrelated elements that most directly relate to measuring the performance and financial status of a business enterprise. We list them below and on the next page for review and information purposes; you need not memorize these definitions at this point. We will explain and examine each of these elements in more detail in subsequent chapters.

The FASB classifies the elements into two distinct groups. The first group of three elements—assets, liabilities, and equity—describes amounts of resources and claims to resources at a **moment in time**. The other seven elements describe transactions, events, and circumstances that affect a company during a **period of time**. The first class, affected by elements of the second class, provides at any time the cumulative result of all changes. This interaction is referred to as "articulation." That is, key figures in one financial statement correspond to balances in another.

ELEMENTS OF FINANCIAL STATEMENTS

ASSETS. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

LIABILITIES. 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.

EQUITY. Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

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INVESTMENTS BY OWNERS. Increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

DISTRIBUTIONS TO OWNERS. Decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.

COMPREHENSIVE INCOME. Change in equity (net assets) of an entity 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.

REVENUES. Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.

EXPENSES. Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.

GAINS. 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.

LOSSES. 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.[12]

THIRD LEVEL: RECOGNITION AND MEASUREMENT CONCEPTS

LEARNING OBJECTIVE 5

Describe the basic assumptions of accounting.

The third level of the framework consists of concepts that implement the basic objective of level one. These concepts explain how companies should recognize, measure, and report financial elements and events. The FASB sets forth most of these in its *Statement of Financial Accounting Concepts No. 5,* "Recognition and Measurement in Financial Statements of Business Enterprises." According to *SFAC No. 5,* to be recognized, an item (event or transaction) must meet the definition of an "element of financial statements" as defined in *SFAC No. 6* and must be measurable. Most aspects of current practice follow these recognition and measurement concepts.

The accounting profession continues to use the concepts in *SFAC No. 5* as operational guidelines. Here, we identify the concepts as basic assumptions, principles, and a cost constraint. Not everyone uses this classification system, so focus your attention more on **understanding the concepts** than on how we classify and organize them.

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These concepts serve as guidelines in responding to controversial financial reporting issues.

Basic Assumptions

Four basic **assumptions** underlie the financial accounting structure: (1) **economic entity**, (2) **going concern**, (3) **monetary unit**, and (4) **periodicity**. We'll look at each in turn.

INTERNATIONAL PERSPECTIVE

One phase of the conceptual framework convergence project addresses the reporting entity.

Economic Entity Assumption

The **economic entity assumption** **means that economic activity can be identified with a particular unit of accountability**. In other words, a company keeps its activity separate and distinct from its owners and any other business unit.[13] At the most basic level, the economic entity assumption dictates that **Panera Bread Company** record the company's financial activities separate from those of its owners and managers. Equally important, financial statement users need to be able to distinguish the activities and elements of different companies, such as **General Motors**, **Ford**, and **Chrysler**. If users could not distinguish the activities of different companies, how would they know which company financially outperformed the other?

The entity concept does not apply solely to the segregation of activities among competing companies, such as **Home Depot** and **Lowe's**. An individual, department, division, or an entire industry could be considered a separate entity if we choose to define it in this manner. Thus, **the entity concept does not necessarily refer to a legal entity**. A parent and its subsidiaries are separate **legal** entities, but merging their activities for accounting and reporting purposes does not violate the **economic entity** assumption.[14]

WHAT DO THE NUMBERS MEAN?

WHOSE COMPANY IS IT?

The importance of the entity assumption is illustrated by scandals involving **W. R. Grace** and **Adelphia**. In both cases, senior company employees entered into transactions that blurred the line between the employee's financial interests and those of the company. At Adelphia, among many other self-dealings, the company guaranteed over $2 billion of loans to the founding family. W. R. Grace used company funds to pay for an apartment and chef for the company chairman. As a result of these transactions, these insiders benefitted at the expense of shareholders. Additionally, the financial statements failed to disclose the transactions. Such disclosure would have allowed shareholders to sort out the impact of the employee transactions on company results.

Going Concern Assumption

Most accounting methods rely on the **going concern assumption—that the company will have a long life**. Despite numerous business failures, most companies have a fairly high continuance rate. As a rule, we expect companies to last long enough to fulfill their objectives and commitments.

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This assumption has significant implications. The historical cost principle would be of limited usefulness if we assume eventual liquidation. Under a liquidation approach, for example, a company would better state asset values at net realizable value (sales price less costs of disposal) than at acquisition cost. **Depreciation and amortization policies are justifiable and appropriate only if we assume some permanence to the company.** If a company adopts the liquidation approach, the current/noncurrent classification of assets and liabilities loses much of its significance. Labeling anything a fixed or long-term asset would be difficult to justify. Indeed, listing liabilities on the basis of priority in liquidation would be more reasonable.

The going concern assumption applies in most business situations. **Only where liquidation appears imminent is the assumption inapplicable.** In these cases, a total revaluation of assets and liabilities can provide information that closely approximates the company's net realizable value. You will learn more about accounting problems related to a company in liquidation in advanced accounting courses.[15]

Monetary Unit Assumption

The **monetary unit assumption** means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. That is, the monetary unit is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. **The monetary unit is relevant, simple, universally available, understandable, and useful.** Application of this assumption depends on the even more basic assumption that quantitative data are useful in communicating economic information and in making rational economic decisions.

In the United States, accounting ignores price-level changes (inflation and deflation) and assumes that the unit of measure—the dollar—remains reasonably stable. We therefore use the monetary unit assumption to justify adding 1990 dollars to 2017 dollars without any adjustment. The FASB in *SFAC No. 5* indicated that it expects the dollar, unadjusted for inflation or deflation, to continue to be used to measure items recognized in financial statements. Only if circumstances change dramatically (such as if the United States experiences high inflation similar to that in some South American countries) will the FASB again consider "inflation accounting."

INTERNATIONAL PERSPECTIVE

Due to their experiences with persistent inflation, several South American countries produce "constant-currency" financial reports. Typically, companies in these countries use a general price-level index to adjust for the effects of inflation.

Periodicity Assumption

To measure the results of a company's activity accurately, we would need to wait until it liquidates. Decision-makers, however, cannot wait that long for such information. Users need to know a company's performance and economic status on a timely basis so that they can evaluate and compare firms, and take appropriate actions. Therefore, companies must report information periodically.

The **periodicity** (or **time period**) **assumption** implies that a company can divide its economic activities into artificial time periods. These time periods vary, but the most common are monthly, quarterly, and yearly.

See the FASB Codification References (page 73).

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The shorter the time period, the more difficult it is to determine the proper net income for the period. A month's results usually prove less verifiable than a quarter's results, and a quarter's results are likely to be less verifiable than a year's results. Investors desire and demand that a company quickly process and disseminate information. Yet the quicker a company releases the information, the more likely the information will include errors. **This phenomenon provides an interesting example of the trade-off between timeliness and accuracy (free from error) in preparing financial data.**

The problem of defining the time period becomes more serious as product cycles shorten and products become obsolete more quickly. Many believe that, given technology advances, companies need to provide more online, real-time financial information to ensure the availability of relevant information.

Basic Principles of Accounting

LEARNING OBJECTIVE 6

Explain the application of the basic principles of accounting.

We generally use four basic **principles of accounting** to record and report transactions: (1) measurement, (2) revenue recognition, (3) expense recognition, and (4) full disclosure. We look at each in turn.

Measurement Principle

We presently have a "mixed-attribute" system that permits the use of various measurement bases. The most commonly used measurements are based on historical cost and fair value. Here, we discuss each.

Historical Cost. GAAP requires that companies account for and report many assets and liabilities on the basis of acquisition price. This is often referred to as the **historical cost principle**. Historical cost has an important advantage over other valuations: **It is generally thought to be verifiable.**

To illustrate this advantage, consider the problems if companies select current selling price instead. Companies might have difficulty establishing a value for unsold items. Every member of the accounting department might value the assets differently. Further, how often would it be necessary to establish sales value? All companies close their accounts at least annually. But some compute their net income every month. Those companies would have to place a sales value on every asset each time they wished to determine income. Critics raise similar objections against current cost (replacement cost, present value of future cash flows) and any other basis of valuation **except historical cost**.

What about liabilities? Do companies account for them on a cost basis? Yes, they do. Companies issue liabilities, such as bonds, notes, and accounts payable, in

exchange for assets (or services), for an agreed-upon price. **This price, established by the exchange transaction, is the "cost" of the liability.** A company uses this amount to record the liability in the accounts and report it in financial statements. Thus, many users prefer historical cost because it provides them with a **verifiable benchmark** for measuring historical trends.

Fair Value. **Fair value** is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value is therefore a market-based measure. [3] Recently, GAAP has increasingly called for use of fair value measurements in the financial statements. This is often referred to as the **fair value principle**. Fair value information may be more useful than historical cost for certain types of assets and liabilities and in certain industries. For example, companies report many financial instruments, including derivatives, at fair value. Certain industries, such as brokerage houses and mutual funds, prepare their basic financial statements on a fair value basis.

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At initial acquisition, historical cost equals fair value. In subsequent periods, as market and economic conditions change, historical cost and fair value often diverge. Thus, fair value measures or estimates often provide more relevant information about the expected future cash flows related to the asset or liability. For example, when long-lived assets decline in value, a fair value measure determines any impairment loss. In this situation, the FASB believes that fair value information is more relevant to users than historical cost. Fair value measurement, it is argued, provides better insight into the value of a company's assets and liabilities (its financial position) and a better basis for assessing future cash flow prospects.

Recently, the Board has taken the additional step of giving companies the option to use fair value (referred to as the **fair value option**) as the basis for measurement of financial assets and financial liabilities. [4] The Board considers fair value more relevant than historical cost because it reflects the current cash equivalent value of financial instruments. As a result, companies now have the option to record fair value in their accounts for most financial instruments, including such items as receivables and debt securities.

Use of fair value in financial reporting is increasing. However, measurement based on fair value introduces increased subjectivity into accounting reports when fair value information is not readily available. To increase consistency and comparability in fair value measures, the FASB established a fair value hierarchy that provides insight into the priority of valuation techniques to use to determine fair value. As shown in Illustration 2-4, the fair value hierarchy is divided into three broad levels.

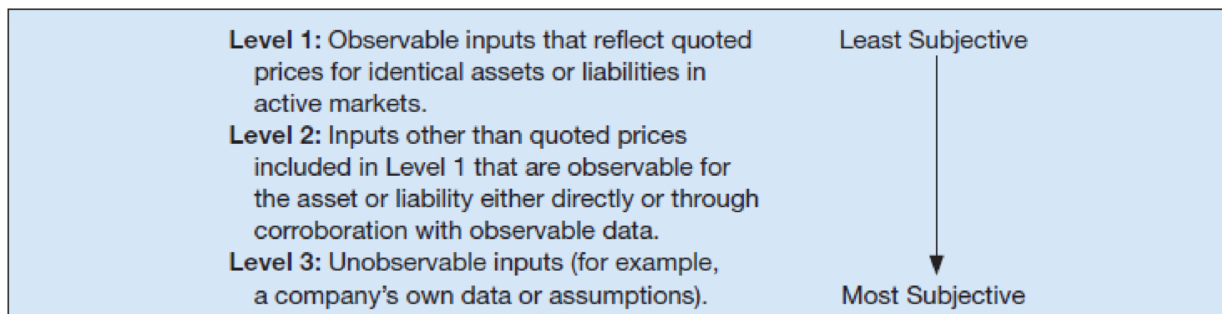

ILLUSTRATION 2-4
Fair Value Hierarchy

As Illustration 2-4 indicates, Level 1 is the least subjective because it is based on quoted prices, like a closing stock price in the *Wall Street Journal*. Level 2 is more subjective and would rely on evaluating similar assets or liabilities in active markets. At the most subjective level, Level 3, much judgment is needed, based on the best information available, to arrive at a relevant and representationally faithful fair value measurement.[16]

It is easy to arrive at fair values when markets are liquid with many traders, but fair value answers are not readily available in other situations. For example, how do

you value the mortgage assets of a subprime lender such as **New Century** given that the market for these securities has essentially disappeared? A great deal of expertise and

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sound judgment will be needed to arrive at appropriate answers. GAAP also provides guidance on estimating fair values when market-related data is not available. In general, these valuation issues relate to Level 3 fair value measurements. These measurements may be developed using expected cash flow and present value techniques, as described in *Statement of Financial Accounting Concepts No. 7*, "Using Cash Flow Information and Present Value in Accounting," discussed in Chapter 6.

As indicated above, we presently have a "mixed-attribute" system that permits the use of historical cost and fair value. Although the historical cost principle continues to be an important basis for valuation, recording and reporting of fair value information is increasing. The recent measurement and disclosure guidance should increase consistency and comparability when fair value measurements are used in the financial statements and related notes.

Revenue Recognition Principle

When a company agrees to perform a service or sell a product to a customer, it has a **performance obligation**. When the company satisfies this performance obligation, it recognizes revenue. The **revenue recognition principle** therefore requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. To illustrate, assume that **Klinke Cleaners** cleans clothing on June 30 but customers do not claim and pay for their clothes until the first week of July. Klinke should record revenue in June when it performed the service (satisfied the performance obligation) rather than in July when it received the cash. At June 30, Klinke would report a receivable on its balance sheet and revenue in its income statement for the service performed.

To illustrate the revenue recognition principle in more detail, assume that **Boeing Corporation** signs a contract to sell airplanes to **Delta Air Lines** for $100 million. To determine when to recognize revenue, Boeing uses the five steps shown in Illustration 2-5.

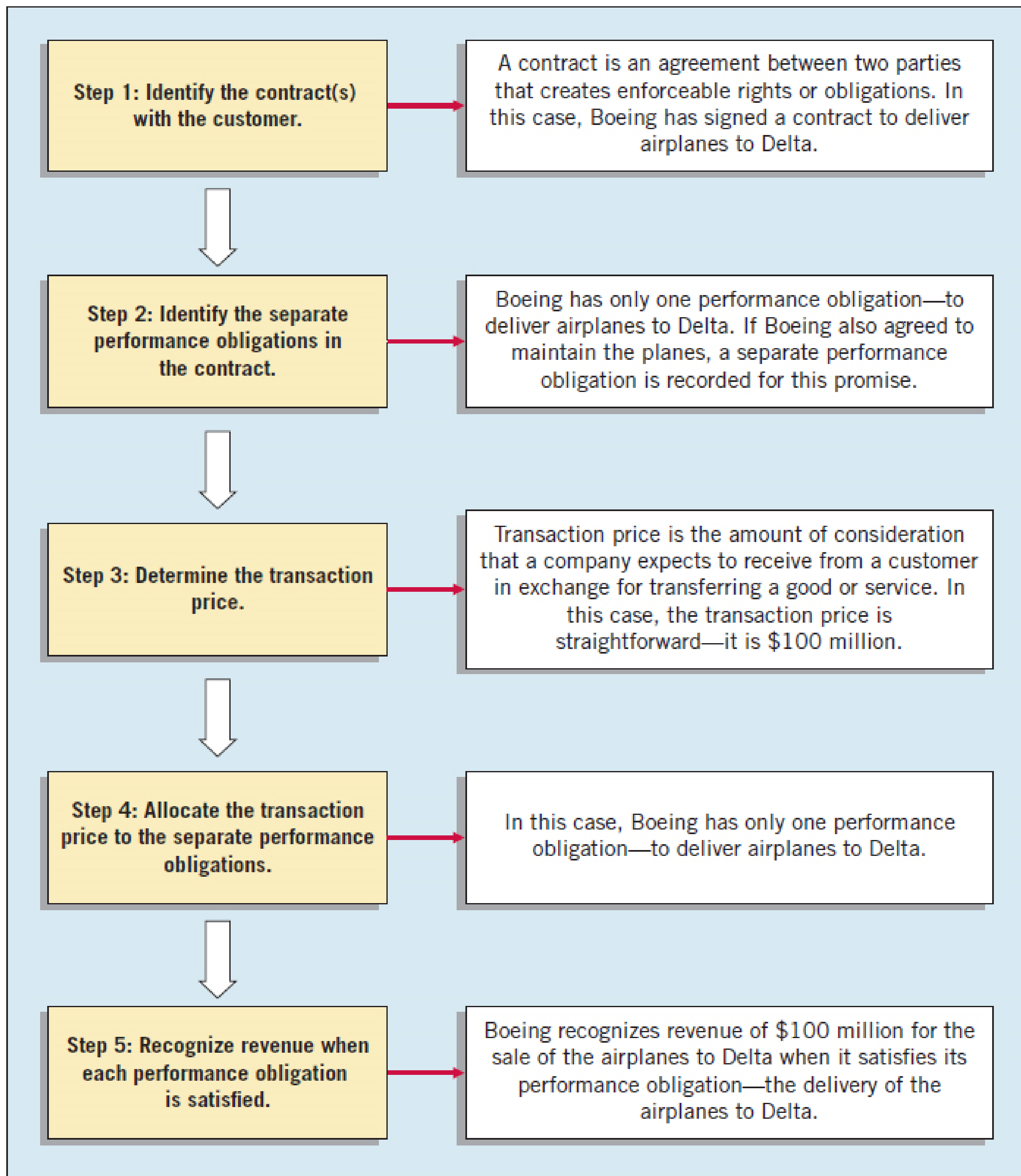

ILLUSTRATION 2-5
The Five Steps of Revenue Recognition

Many revenue transactions pose few problems because the transaction is initiated and completed at the same time. However, when to recognize revenue in other situations is often more difficult, as when a performance obligation is satisfied over time. This is common in service arrangements or in the case of long-term construction contracts. Chapter 18 discusses revenue recognition issues in more detail.[17]

Expense Recognition Principle

As indicated in the discussion of financial statement elements, expenses are defined as outflows or other "using up" of assets or incurring of liabilities (or a combination of both) during a period as a result of delivering or producing goods and/or performing services. It follows then that recognition of expenses is related to net changes in assets and earning revenues. In practice, the approach for recognizing expenses is, "Let the expense follow the revenues." This approach is the **expense recognition principle**.

To illustrate, companies recognize expenses not when they pay wages or make a product, but when the work (service) or the product actually contributes to revenue. Thus, companies tie expense recognition to revenue recognition. That is, by matching **efforts (expenses) with accomplishment (revenues), the expense recognition principle is implemented** in accordance with the definition of expense (outflows or other using up of assets or incurring of liabilities).[18]

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Some costs, however, are difficult to associate with revenue. As a result, some other approach must be developed. Often, companies use a "rational and systematic" allocation policy that will approximate the expense recognition principle. This type of expense recognition involves assumptions about the benefits that a company receives as well as the cost associated with those benefits. For example, a company like **Intel** or **Motorola** allocates the cost of a long-lived asset over all of the accounting periods during which it uses the asset because the asset contributes to the generation of revenue throughout its useful life.

Companies charge some costs to the current period as expenses (or losses) simply because they cannot determine a connection with revenue. Examples of these types of costs are officers' salaries and other administrative expenses.

Costs are generally classified into two groups: **product costs** and **period costs**. **Product costs**, such as material, labor, and overhead, attach to the product. Companies carry these costs into future periods if they recognize the revenue from the product in subsequent periods. **Period costs**, such as officers' salaries and other administrative expenses, attach to the period. Companies charge off such costs in the immediate period even though benefits associated with these costs may occur in the future. Why?

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Because companies cannot determine a direct relationship between period costs and revenue.

Illustration 2-6 summarizes these expense recognition procedures.

Type of Cost	Relationship	Recognition
Product costs: • Material • Labor • Overhead	Direct relationship between cost and revenue.	Recognize in period of revenue (matching).
Period costs: • Salaries • Administrative costs	No direct relationship between cost and revenue.	Expense as incurred.

ILLUSTRATION 2-6
Expense Recognition

Full Disclosure Principle

In deciding what information to report, companies follow the general practice of providing information that is of sufficient importance to influence the judgment and decisions of an informed user. Often referred to as the **full disclosure principle**, it recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive for (1) sufficient detail to disclose matters that **make a difference** to users, yet (2) sufficient condensation to make the **information understandable**, keeping in mind costs of preparing and using it.

Disclosure is not a substitute for proper accounting. As a former chief accountant of the SEC noted, "Good disclosure does not cure bad accounting any more than an adjective or adverb can be used without, or in place of, a noun or verb." Thus, for example, cash-basis accounting for cost of goods sold is misleading even if a company discloses accrual-basis amounts in the notes to the financial statements.

Users find information about financial position, income, cash flows, and investments in one of three places: (1) within the main body of financial statements, (2) in the notes to those statements, or (3) as supplementary information.

As discussed in Chapter 1, the **financial statements** are the balance sheet, income statement, statement of cash flows, and statement of stockholders' equity. They are a structured means of communicating financial information. To be recognized in the main body of financial statements, **an item should meet the definition of a basic element, be measurable with sufficient certainty, and be relevant and reliable.**[19]

The **notes to financial statements** generally amplify or explain the items presented in the main body of the statements. If the main body of the financial statements gives an incomplete picture of the performance and position of the company, the notes should provide the additional information needed. Information in

the notes does not have to be quantifiable, nor does it need to qualify as an element. Notes can be partially or totally narrative. Examples of notes include descriptions of the accounting policies and methods used in measuring the elements reported in the statements, explanations of uncertainties and contingencies, and statistics and details too voluminous for inclusion in the statements. The notes can be essential to understanding the company's performance and position.

Supplementary information may include details or amounts that present a different perspective from that adopted in the financial statements. It may be quantifiable information that is high in relevance but low in faithful representation. For example, oil and gas companies typically provide information on proven reserves as well as the related discounted cash flows.

Supplementary information may also include management's explanation of the financial information and its discussion of the significance of that information. For example, many business combinations have produced financing arrangements that demand new accounting and reporting practices and principles. In each of these

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situations, the same problem must be faced: making sure the company presents enough information to ensure that the **reasonably prudent investor** will not be misled.

We discuss the content, arrangement, and display of financial statements, along with other facets of full disclosure, in Chapters 4, 5, and 24.[20]

Cost Constraint

LEARNING OBJECTIVE 7

Describe the impact that the cost constraint has on reporting accounting information.

In providing information with the qualitative characteristics that make it useful, companies must consider an overriding factor that limits (constrains) the reporting. This is referred to as the **cost constraint** (the **cost-benefit relationship**). That is, companies must weigh the costs of providing the information against the benefits that can be derived from using it. Rule-making bodies and governmental agencies use cost-benefit analysis before making final their informational requirements. In order to justify requiring a particular measurement or disclosure, the benefits perceived to be derived from it must exceed the costs perceived to be associated with it.

A corporate executive made the following remark to the FASB about a proposed rule: “In all my years in the financial arena, I have never seen such an absolutely ridiculous proposal .... To dignify these ‘actuarial’ estimates by recording them as assets and liabilities would be virtually unthinkable except for the fact that the FASB has done equally stupid things in the past .... For God’s sake, use common sense just this once.”[21] Although extreme, this remark indicates the frustration expressed by members of the business community about rule-making and whether the benefits of a given pronouncement exceed the costs.

The difficulty in cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable. The costs are of several kinds: costs of collecting and processing, of disseminating, of auditing, of potential litigation, of disclosure to competitors, and of analysis and interpretation. Benefits to preparers may include greater management control and access to capital at a lower cost. Users may receive better information for allocation of resources, tax assessment, and rate regulation. As noted earlier, benefits are generally more difficult to quantify than are costs.

The implementation of the provisions of the Sarbanes-Oxley Act illustrates the challenges in assessing costs and benefits of standards. One study estimated the increased costs of complying with the new internal-control standards related to the financial reporting process to be an average of $7.8 million per company. However, the study concluded that “quantifying the benefits of improved more reliable financial reporting is not fully possible.” More recent data on compliance indicate that after more than a decade of experience with Sarbanes-Oxley, 61 percent of companies spend

less than $500,000 annually on compliance, and 28 percent spend more than $1,000,000. And that most companies continue to experience year-over-year increases in external auditing fees associated with internal control work.[22]

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Despite the difficulty in assessing the costs and benefits of its rules, the FASB attempts to determine that each proposed pronouncement will fill a significant need and that the costs imposed to meet the rule are justified in relation to overall benefits of the resulting information. In addition, the Board seeks input on costs and benefits as part of its due process.[23]

Summary of the Structure

Illustration 2-7 presents the conceptual framework discussed in this chapter. It is similar to Illustration 2-1 except that it provides additional information for each level. We cannot overemphasize the usefulness of this conceptual framework in helping to understand many of the problem areas that we examine in later chapters.

YOU WILL WANT TO READ THE IFRS INSIGHTS ON PAGES 74–77

For discussion of how IFRS relates to the conceptual framework.

Recognition, Measurement, and Disclosure Concepts

ASSUMPTIONS
1. Economic entity
2. Going concern
3. Monetary unit
4. Periodicity

PRINCIPLES
1. Measurement
2. Revenue recognition
3. Expense recognition
4. Full disclosure

CONSTRAINT
1. Cost

Third level: The "how"—implementation

QUALITATIVE CHARACTERISTICS
1. Fundamental qualities
A. Relevance
(1) Predictive value
(2) Confirmatory value
(3) Materiality
B. Faithful representation
(1) Completeness
(2) Neutrality
(3) Free from error
2. Enhancing qualities
(1) Comparability
(2) Verifiability
(3) Timeliness
(4) Understandability

ELEMENTS
1. Assets
2. Liabilities
3. Equity
4. Investment by owners
5. Distribution to owners
6. Comprehensive income
7. Revenues
8. Expenses
9. Gains
10. Losses

Second level: Bridge between levels 1 and 3

OBJECTIVE
Provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in their capacity as capital providers.

First level: The "why"—purpose of accounting

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

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WHAT DO THE NUMBERS MEAN?

DON'T COUNT THESE PLEASE

Beyond touting nonfinancial measures to investors (see the "What Do the Numbers Mean?" box on page 46), many companies increasingly promote the performance of their companies through the reporting of various "pro forma" earnings measures. Pro forma measures are standard measures (such as earnings) that companies adjust, usually for unusual or non-recurring items. Such adjustments make the numbers more comparable to numbers reported in periods without these unusual or non-recurring items.

However, rather than increasing comparability, it appears that some companies use pro forma reporting to accentuate the positive in their results. Examples include **Yahoo!** and **Cisco**, which define pro forma income after adding back payroll tax expense. **Level 8 Systems** transformed an operating loss into a pro forma profit by adding back expenses for depreciation and amortization of intangible assets.

And taking a more macro look, the following table shows the difference between pro forma (non-GAAP) and GAAP earnings per share for the three main Standard & Poor's stock indexes for a recent year.

Index	Non-GAAP Earnings	GAAP Earnings	% Variance (GAAP less Non-GAAP)
S&P 400	$54.53	$45.68	−19.4%
S&P 500	96.82	86.51	−11.9
S&P 600	21.62	16.33	−32.4

What this table shows is that the S&P 600 is especially biased with a variance of 32.4% (non-GAAP higher than GAAP). Lynn Turner, former chief accountant at the SEC, calls such earnings measures EBS—"Everything but Bad Stuff." To provide investors a more complete picture of company profitability, not the story preferred by management, the SEC issued Regulation G (REG G). For example, REG G (and related item 10E) requires companies to reconcile non-GAAP financial measures to GAAP, thereby giving investors a roadmap to analyze the adjustments that companies make to their GAAP numbers to arrive at pro forma results.

Sources: Adapted from Gretchen Morgenson, "How Did They Value Stocks? Count the Absurd Ways," *The New York Times* (March 18, 2001), section 3, p. 1; Regulation G, "*Conditions for Use of Non-GAAP Financial Measures*," *Release No. 33-8176* (March 28, 2003, updated January, 2010); and J. Adamo, "Even GAAP Is Better Than These Adjustments," *Barron's* (November 4, 2013).

REVIEW AND PRACTICE

KEY TERMS REVIEW

assumption, *50*

comparability, *46*

completeness, *45*

conceptual framework, *38*

confirmatory value, *43*

conservatism, *45(n)*

consistency, *47*

cost constraint (cost-benefit relationship), *57*

economic entity assumption, *50*

elements, basic, *48*

expense recognition principle, *54*

fair value, *52*

fair value option, *53*

fair value principle, *52*

faithful representation, *45*

financial statements, *56*

free from error, *45*

full disclosure principle, *56*

general-purpose financial reporting, *41*

going concern assumption, *50*

historical cost principle, *52*

matching principle, *54(n)*

materiality, *43*

monetary unit assumption, *51*

neutrality, *45*

notes to financial statements, *56*

objective of financial reporting, *40*

period costs, *55*

periodicity (time period) assumption, *51*

predictive value, *43*
principles of accounting, *52*
product costs, *55*
prudence, *45(n)*
qualitative characteristics, *41*
relevance, *42*
revenue recognition principle, *54*
supplementary information, *56*
timeliness, *47*
understandability, *47*
verifiability, *47*

LEARNING OBJECTIVES REVIEW

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1. **Describe the usefulness of a conceptual framework.** The accounting profession needs a conceptual framework to (1) build on and relate to an established body of concepts and objectives, (2) provide a framework for solving new and emerging practical problems, (3) increase financial statement users' understanding of and confidence in financial reporting, and (4) enhance comparability among companies' financial statements.

   The FASB issued seven Statements of Financial Accounting Concepts that relate to financial reporting for business enterprises. These concept statements provide the basis for the conceptual framework. They include objectives, qualitative characteristics, and elements. In addition, measurement and recognition concepts are developed.

2.

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Understand the objective of financial reporting. The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors** in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit. Information that is decision-useful to capital providers may also be helpful to other users of financial reporting who are not capital providers.

3. **Identify the qualitative characteristics of accounting information.** The overriding criterion by which accounting choices can be judged is decision-usefulness—that is, providing information that is most useful for decision-making. Relevance and faithful representation are the two fundamental qualities that make information decision-useful. Relevant information makes a difference in a decision by having predictive or confirmatory value and is material. Faithful representation is characterized by completeness, neutrality, and being free from error. Enhancing qualities of useful information are (1) comparability, (2) verifiability, (3) timeliness, and (4) understandability.

4. **Define the basic elements of financial statements.** The basic elements of financial statements are (1) assets, (2) liabilities, (3) equity, (4) investments by owners, (5) distributions to owners, (6) comprehensive income, (7) revenues, (8) expenses, (9) gains, and (10) losses. We define these 10 elements on page 48.

5. **Describe the basic assumptions of accounting.** Four basic assumptions underlying financial accounting are as follows. (1) *Economic entity:* The activity of a company can be kept separate and distinct from its owners and any other business unit. (2) *Going concern:* The company will have a long life. (3) *Monetary unit:* Money is the common denominator by which economic activity is conducted, and the monetary unit provides an appropriate basis for measurement and analysis. (4) *Periodicity:* The economic activities of a company can be divided into artificial time periods.

6. **Explain the application of the basic principles of accounting.** (1) *Measurement principle:* GAAP permits the use of historical cost, fair value, and other valuation bases. Although the historical cost principle (measurement based on acquisition price) continues to be an important basis for valuation, recording and reporting of fair value information is increasing. (2) *Revenue recognition principle:* A company recognizes revenue when it satisfies a performance obligation. (3) *Expense recognition principle:* As a general rule, companies recognize expenses when the service or the product actually makes its contribution to revenue (commonly referred to as *matching*). (4) *Full disclosure principle:*

Companies generally provide information that is of sufficient importance to influence the judgment and decisions of an informed user.

7. **Describe the impact that the cost constraint has on reporting accounting information.** The cost of providing the information must be weighed against the benefits that can be derived from using the information.

ENHANCED REVIEW AND PRACTICE

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PRACTICE PROBLEM

Jeremy Meadow Corporation has hired you to review its accounting records prior to the closing of the revenue and expense accounts as of December 31, the end of the current fiscal year. The following information comes to your attention.

1. During the current year, Jeremy Meadow Corporation changed its policy in regard to expensing purchases of small tools. In the past, it had expensed these purchases because they amounted to less than 2% of net income. Now, the president has decided that the company should follow a policy of capitalization and subsequent depreciation. It is expected that purchases of small tools will not fluctuate greatly from year to year.
2. The company constructed a warehouse at a cost of $1,000,000. It had been depreciating the asset on a straight-line basis over 10 years. In the current year, the controller doubled depreciation expense because the replacement cost of the warehouse had increased significantly.
3. When the balance sheet was prepared, the preparer omitted detailed information as to the amount of cash on deposit in each of several banks. Only the total amount of cash under a caption “Cash in banks” was presented.
4.

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On July 15 of the current year, Jeremy Meadow Corporation purchased an undeveloped tract of land at a cost of $320,000. The company spent $80,000 in subdividing the land and getting it ready for sale. An appraisal of the property at the end of the year indicated that the land was now worth $500,000. Although none of the lots were sold, the company recognized revenue of $180,000, less related expenses of $80,000, for a net income on the project of $100,000.

5. For a number of years, the company used the FIFO method for inventory valuation purposes. During the current year, the president noted that all the other companies in the industry had switched to the LIFO method. The company decided not to switch to LIFO because net income would decrease $830,000.

Instructions

State whether or not you agree with the decisions made by Jeremy Meadow Corporation. Support your answers with reference, whenever possible, to the generally accepted principles, assumptions, and cost constraint applicable in the circumstances.

SOLUTION

1. From the facts, it is difficult to determine whether to agree or disagree. Consistency, of course, is violated in this situation although its violation may not be material. Furthermore, the change of accounting policies regarding the treatment of small tools cannot be judged good or bad but would depend on the circumstances. In this case, it seems that the result will be approximately the same whether the corporation capitalizes and expenses, or simply expenses each period, since the purchases are fairly uniform. Perhaps from a cost standpoint (expediency), it might be best to continue the present policy rather than become involved in detailed depreciation schedules, assuming that purchases remain fairly uniform. On the other hand, the president may believe there is a significant unrecorded asset that should be shown on the balance sheet. If such is the case, capitalization and subsequent depreciation would be more appropriate.

2. Disagree. At the present time, accountants do not recognize price level or current value adjustments in the accounts. Hence, it is misleading to deviate from the historical cost principle because conjecture or opinion can take place. Also, depreciation is not so much a matter of valuation as it is a means of cost allocation. Assets are not depreciated on the basis of a decline in their fair value. Rather, they are depreciated on the basis of a systematic charge of expired cost against revenues.

3. Agree. The full disclosure principle recognizes that reasonable condensation and summarization of the details of a corporation's operations and financial position are essential to readability and comprehension. Thus, in determining what is full disclosure, the accountant must decide whether omission will mislead readers of the financial statements. Generally, companies present only the total amount of cash on a balance sheet unless some special circumstance is involved (such as a possible restriction on the use of the cash). In most cases, however, the company's presentation would be considered appropriate and in accordance with the full disclosure principle.
4. Disagree. The historical cost principle indicates that companies account for assets and liabilities on the basis of cost. If sales value were selected, for example, it would be extremely difficult to establish an appraisal value for the given item without selling it. Note, too, that the revenue recognition principle provides guidance on when revenue should be recognized. Revenue should be recognized when the performance obligation is satisfied. In this case, the revenue was not recognized because the critical event, "sale of the land with transfer to the buyer," had not occurred.
5. From the facts, it is difficult to determine whether to agree or disagree with the president. The president's approach is not a violation of any principle. Consistency requires that accounting entities give accountable events the same accounting treatment from period to period for a given business enterprise. It says nothing concerning consistency of accounting principles among business enterprises. From a comparability viewpoint, it might be useful to report the information on a LIFO basis. But, as indicated above, there is no requirement to do so.

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QUESTIONS

1. What is a conceptual framework? Why is a conceptual framework necessary in financial accounting?
2. What is the primary objective of financial reporting?
3.

What is meant by the term “qualitative characteristics of accounting information”?

4. Briefly describe the two fundamental qualities of useful accounting information.

5.

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How is materiality (or immateriality) related to the proper presentation of financial statements? What factors and measures should be considered in assessing the materiality of a misstatement in the presentation of a financial statement?

6. What are the enhancing qualities of the qualitative characteristics? What is the role of enhancing qualities in the conceptual framework?

7. According to the FASB conceptual framework, the objective of financial reporting for business enterprises is based on the needs of the users of financial statements. Explain the level of sophistication that the Board assumes about the users of financial statements.

8. What is the distinction between comparability and consistency?

9. Why is it necessary to develop a definitional framework for the basic elements of accounting?

10. Expenses, losses, and distributions to owners are all decreases in net assets. What are the distinctions among them?

11. Revenues, gains, and investments by owners are all increases in net assets. What are the distinctions among them?

12. What are the four basic assumptions that underlie the financial accounting structure?

13. The life of a business is divided into specific time periods, usually a year, to measure results of operations for each such time period and to portray financial conditions at the end of each period.

(a) This practice is based on the accounting assumption that the life of the business consists of a series of time periods and that it is possible to measure accurately the results of operations for each period. Comment on the validity and necessity of this assumption.

(b) What has been the effect of this practice on accounting? What is its relation to the accrual system? What influence has it had on accounting entries and methodology?

14. What is the basic accounting problem created by the monetary unit assumption when there is significant inflation? What appears to be the FASB position on a stable monetary unit?

15. The chairman of the board of directors of the company for which you are chief accountant has told you that he has little use for accounting figures based on historical cost. He believes that replacement values are of far more significance to the board of directors than “out-of-date costs.” Present some arguments to convince him that accounting data should still be based on historical cost.

16. What is the definition of fair value?

17. What is the fair value option? Explain how use of the fair value option reflects application of the fair value principle.

18. Briefly describe the fair value hierarchy.

19. Explain the revenue recognition principle.

20. What is a performance obligation, and how is it used to determine when revenue should be recognized?

21. What are the five steps used to determine the proper time to recognize revenue?

22. Selane Eatery operates a catering service specializing in business luncheons for large corporations. Selane requires customers to place their orders 2 weeks in advance of the scheduled events. Selane bills its customers on the tenth day of the month following the date of service and requires that payment be made within 30 days of the billing date. Conceptually, when should Selane recognize revenue related to its catering service?

23. Mogilny Company paid $135,000 for a machine. The Accumulated Depreciation—Equipment account has a balance of $46,500 at the present time. The company could sell the machine today for $150,000. The company president believes that the company has a "right to this gain." What does the president mean by this statement? Do you agree?

24. Three expense recognition methods (associating cause and effect, systematic and rational allocation, and immediate recognition) were discussed in the text under the expense recognition principle. Indicate the basic nature of each of these expense recognition methods and give two examples of each.

25. *Statement of Financial Accounting Concepts No. 5* identifies four characteristics that an item must have before it is recognized in the financial statements. What are these four characteristics?

26. Briefly describe the types of information concerning financial position, income, and cash flows that might be provided (a) within the main body of the financial statements, (b) in the notes to the financial statements, or (c) as supplementary information.

27. In January 2018, Janeway Inc. doubled the amount of its outstanding stock by selling on the market an additional 10,000 shares to finance an expansion of the business. You propose that this information be shown by a footnote on the balance sheet as of December 31, 2017. The president objects, claiming that this sale took place after December 31, 2017, and therefore should not be shown. Explain your position.

28. Describe the major constraint inherent in the presentation of accounting information.

29. What are some of the costs of providing accounting information? What are some of the benefits of accounting information? Describe the cost-benefit factors that should be considered when new accounting standards are being proposed.

30. The treasurer of Landowska Co. has heard that conservatism is a doctrine that is followed in accounting and, therefore, proposes that several policies be followed that are conservative in nature. State your opinion with respect to each of the policies listed.

(a) The company gives a 2-year warranty to its customers on all products sold. The estimated warranty costs

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incurred from this year's sales should be entered as an expense this year instead of an expense in the period in the future when the warranty is made good.

(b) When sales are made on account, there is always uncertainty about whether the accounts are collectible. Therefore, the treasurer recommends recording the sale when the cash is received from the customers.

(c) A personal liability lawsuit is pending against the company. The treasurer believes there is an even chance that the company will lose the suit and have to pay damages of $200,000 to $300,000. The treasurer recommends that a loss be recorded and a liability created in the amount of $300,000.

BRIEF EXERCISES

BE2-1 **(LO3)** Match the qualitative characteristics below with the following statements.

1. Relevance
2. Faithful representation
3. Predictive value
4. Confirmatory value
5. Comparability
6. Completeness
7. Neutrality
8. Timeliness

(a) Quality of information that permits users to identify similarities in and differences between two sets of economic phenomena.

(b) Having information available to users before it loses its capacity to influence decisions.

(c) Information about an economic phenomenon that has value as an input to the processes used by capital providers to form their own expectations about the future.

(d) Information that is capable of making a difference in the decisions of users in their capacity as capital providers.

(e) Absence of bias intended to attain a predetermined result or to induce a particular behavior.

BE2-2 **(LO3)** Match the qualitative characteristics below with the following statements.

1. Timeliness

2. Completeness
3. Free from error
4. Understandability
5. Faithful representation
6. Relevance
7. Neutrality
8. Confirmatory value

(a) Quality of information that assures users that information represents the economic phenomena that it purports to represent.

(b) Information about an economic phenomenon that corrects past or present expectations based on previous evaluations.

(c) The extent to which information is accurate in representing the economic substance of a transaction.

(d) Includes all the information that is necessary for a faithful representation of the economic phenomena that it purports to represent.

(e) Quality of information that allows users to comprehend its meaning.

BE2-3 **(LO3)** Discuss whether the changes described in each of the cases below require recognition in the CPA's audit report as to consistency. (Assume that the amounts are material.)

(a) The company changed its inventory method to FIFO from weighted-average, which had been used in prior years.

(b) The company disposed of one of the two subsidiaries that had been included in its consolidated statements for prior years.

(c) The estimated remaining useful life of plant property was reduced because of obsolescence.

BE2-4 **(LO3)** Identify which qualitative characteristic of accounting information is best described in each item below. (Do not use relevance and faithful representation.)

The annual reports of **Best Buy Co.** are audited by certified public accountants.

(a) **Black & Decker** and **Cannondale Corporation** both use the FIFO cost flow assumption.

(b)

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Starbucks Corporation has used straight-line depreciation since it began operations.

(c) **Motorola** issues its quarterly reports immediately after each quarter ends.

BE2-5 **(LO3)** Presented below are three different transactions related to materiality. Explain whether you would classify these transactions as material.

(a) Blair Co. has reported a positive trend in earnings over the last 3 years. In the current year, it reduces its bad debt allowance to ensure another positive earnings year. The impact of this adjustment is equal to 3% of net income.

(b) Hindi Co. has an unusual gain of $3.1 million on the sale of plant assets and a $3.3 million loss on the sale of investments. It decides to net the gain and loss because the net effect is considered immaterial. Hindi Co.'s income for the current year was $10 million.

(c) Damon Co. expenses all capital equipment under $25,000 on the basis that it is immaterial. The company has followed this practice for a number of years.

BE2-6 **(LO4)** For each item below, indicate to which category of elements of financial statements it belongs.

(a) Retained earnings

(b) Sales

(c) Additional paid-in capital

(d) Inventory

(e) Depreciation

(f) Loss on sale of equipment

(g) Interest payable

(h) Dividends

(i) Gain on sale of investment

(j) Issuance of common stock

BE2-7 **(LO4)** Explain how you would decide whether to record each of the following expenditures as an asset or an expense. Assume all items are material.

(a) Legal fees paid in connection with the purchase of land are $1,500.

(b) Eduardo, Inc. paves the driveway leading to the office building at a cost of $21,000.

(c) A meat market purchases a meat-grinding machine at a cost of $3,500.

(d) On June 30, Monroe and Meno, medical doctors, pay 6 months' office rent to cover the month of July and the next 5 months.

(e) Smith's Hardware Company pays $9,000 in wages to laborers for construction on a building to be used in the business.

(f) Alvarez's Florists pays wages of $2,100 for the month to an employee who serves as driver of their delivery truck.

BE2-8 **(LO5)** Identify which basic assumption of accounting is best described in each item below.

(a) The economic activities of **FedEx Corporation** are divided into 12-month periods for the purpose of issuing annual reports.

(b) **Solectron Corporation, Inc.** does not adjust amounts in its financial statements for the effects of inflation.

(c) **Walgreen Co.** reports current and noncurrent classifications in its balance sheet.

(d) The economic activities of **General Electric** and its subsidiaries are merged for accounting and reporting purposes.

BE2-9 **(LO5)** If the going concern assumption is not made in accounting, discuss the differences in the amounts shown in the financial statements for the following items.

(a) Land.

(b) Unamortized bond premium.

(c) Depreciation expense on equipment

(d) Inventory.

(e) Prepaid insurance.

BE2-10 **(LO6)** Identify which basic principle of accounting is best described in each item below.

(a) **Norfolk Southern Corporation** reports revenue in its income statement when the performance obligation is satisfied instead of when the cash is collected.

(b) **Yahoo!** recognizes depreciation expense for a machine over the 2-year period during which that machine helps the company earn revenue.

(c) **Oracle Corporation** reports information about pending lawsuits in the notes to its financial statements.

(d) **Gap, Inc.** reports land on its balance sheet at the amount paid to acquire it, even though the estimated fair value is greater.

BE2-11 **(LO6)** Vande Velde Company made three investments during 2017. (1) It purchased 1,000 shares of Sastre Company, a start-up company. Vande Velde made the investment based on valuation estimates from an internally developed model. (2) It

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purchased 2,000 shares of **GE** stock, which trades on the NYSE. (3) It invested $10,000 in local development authority bonds. Although these bonds do not trade on an active market, their value closely tracks movements in U.S. Treasury bonds. Where will Vande Velde report these investments in the fair value hierarchy?

BE2-12 **(LO6)** What accounting assumption, principle, or constraint would **Target Corporation** use in each of the situations below?

- **(a)** Target was involved in litigation over the last year. This litigation is disclosed in the financial statements.
- **(b)** Target allocates the cost of its depreciable assets over the life it expects to receive revenue from these assets.
- **(c)** Target records the purchase of a new **Dell** PC at its cash equivalent price.

EXERCISES

E2-1 **(LO1,2)** **(Usefulness, Objective of Financial Reporting)** Indicate whether the following statements about the conceptual framework are true or false. If false, provide a brief explanation supporting your position.

- **(a)** Accounting rule-making that relies on a body of concepts will result in useful and consistent pronouncements.
- **(b)** General-purpose financial reports are most useful to company insiders in making strategic business decisions.
- **(c)** Accounting standards based on individual conceptual frameworks generally will result in consistent and comparable accounting reports.
- **(d)** Capital providers are the only users who benefit from general-purpose financial reporting.
- **(e)** Accounting reports should be developed so that users without knowledge of economics and business can become informed about the financial results of a company.
- **(f)** The objective of financial reporting is the foundation from which the other aspects of the framework logically result.

E2-2 **(LO1,2,3)** **(Usefulness, Objective of Financial Reporting, Qualitative Characteristics)** Indicate whether the following statements about the conceptual framework are true or false. If false, provide a brief explanation supporting your position.

- **(a)** The fundamental qualitative characteristics that make accounting information useful are relevance and verifiability.
- **(b)** Relevant information only has predictive value, confirmatory value, or both.

(c) Information that is a faithful representation is characterized as having predictive or confirmatory value.

(d) Comparability pertains only to the reporting of information in a similar manner for different companies.

(e) Verifiability is solely an enhancing characteristic for faithful representation.

(f) In preparing financial reports, it is assumed that users of the reports have reasonable knowledge of business and economic activities.

E2-3 (LO3,7) GROUPWORK (Qualitative Characteristics) *SFAC No. 8* identifies the qualitative characteristics that make accounting information useful. Presented below are a number of questions related to these qualitative characteristics and underlying constraint.

(a) What is the quality of information that enables users to confirm or correct prior expectations?

(b) Identify the pervasive constraint developed in the conceptual framework.

(c) The chairman of the SEC at one time noted, "If it becomes accepted or expected that accounting principles are determined or modified in order to secure purposes other than economic measurement, we assume a grave risk that confidence in the credibility of our financial information system will be undermined." Which qualitative characteristic of accounting information should ensure that such a situation will not occur? (Do not use faithful representation.)

(d) Muruyama Corp. switches from FIFO to average-cost to FIFO over a 2-year period. Which qualitative characteristic of accounting information is not followed?

(e) Assume that the profession permits the savings and loan industry to defer losses on investments it sells because immediate recognition of the loss may have adverse economic consequences on the industry. Which qualitative characteristic of accounting information is not followed? (Do not use relevance or faithful representation.)

(f) What are the two fundamental qualities that make accounting information useful for decision-making?

(g) Watteau Inc. does not issue its first-quarter report until after the second quarter's results are reported. Which qualitative characteristic of accounting is not followed? (Do not use relevance.)

(h)

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Predictive value is an ingredient of which of the two fundamental qualities that make accounting information useful for decision-making purposes?

(i) Duggan, Inc. is the only company in its industry to depreciate its plant assets on a straight-line basis. Which qualitative characteristic of accounting information may not be followed?

(j) Roddick Company has attempted to determine the replacement cost of its inventory. Three different appraisers arrive at substantially different amounts for this value. The president, nevertheless, decides to report the middle value for external reporting purposes. Which qualitative characteristic of information is lacking in these data? (Do not use relevance or faithful representation.)

E2-4 **(LO3)** **(Qualitative Characteristics)** The qualitative characteristics that make accounting information useful for decision-making purposes are as follows.

Relevance	Neutrality	Verifiability
Faithful representation	Completeness	Understandability
Predictive value	Timeliness	Comparability
Confirmatory value	Materiality	Free from error

Instructions

Identify the appropriate qualitative characteristic(s) to be used given the information provided below.

(a) Qualitative characteristic being employed when companies in the same industry are using the same accounting principles.

(b) Quality of information that confirms users' earlier expectations.

(c) Imperative for providing comparisons of a company from period to period.

(d) Ignores the economic consequences of a standard or rule.

(e) Requires a high degree of consensus among individuals on a given measurement.

(f) Predictive value is an ingredient of this fundamental quality of information.

(g) Four qualitative characteristics that are related to both relevance and faithful representation.

(h) An item is not recorded because its effect on income would not change a decision.

(i)

Neutrality is an ingredient of this fundamental quality of accounting information.

(j) Two fundamental qualities that make accounting information useful for decision-making purposes.

(k) Issuance of interim reports is an example of what enhancing quality of relevance?

E2-5 **(LO4)** **(Elements of Financial Statements)** Ten interrelated elements that are most directly related to measuring the performance and financial status of an enterprise are provided below.

Assets	Distributions to owners	Expenses
Liabilities	Comprehensive income	Gains
Equity	Revenues	Losses
Investments by owners		

Instructions

Identify the element or elements associated with the 12 items below.

(a) Arises from peripheral or incidental transactions.

(b) Obligation to transfer resources arising from a past transaction.

(c) Increases ownership interest.

(d) Declares and pays cash dividends to owners.

(e) Increases in net assets in a period from nonowner sources.

(f) Items characterized by service potential or future economic benefit.

(g) Equals increase in assets less liabilities during the year, after adding distributions to owners and subtracting investments by owners.

(h) Arises from income statement activities that constitute the entity's ongoing major or central operations.

(i) Residual interest in the assets of the enterprise after deducting its liabilities.

(j) Increases assets during a period through sale of product.

(k) Decreases assets during the period by purchasing the company's own stock.

(l) Includes all changes in equity during the period, except those resulting from investments by owners and distributions to owners.

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E2-6 (LO5,6) (Assumptions, Principles, and Constraint) Presented below are the assumptions, principles, and constraint used in this chapter.

1. Economic entity assumption
2. Going concern assumption
3. Monetary unit assumption
4. Periodicity assumption
5. Measurement principle (historical cost)
6. Measurement principle (fair value)
7. Expense recognition principle
8. Full disclosure principle
9. Cost constraint
10. Revenue recognition principle

Instructions

Identify by number the accounting assumption, principle, or constraint that describes each situation below. Do not use a number more than once.

(a) Allocates expenses to revenues in the proper period.

(b) Indicates that fair value changes subsequent to purchase are not recorded in the accounts. (Do not use revenue recognition principle.)

(c) Ensures that all relevant financial information is reported.

(d) Rationale why plant assets are not reported at liquidation value. (Do not use historical cost principle.)

(e) Indicates that personal and business record keeping should be separately maintained.

(f) Separates financial information into time periods for reporting purposes.

(g) Assumes that the dollar is the “measuring stick” used to report on financial performance.

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E2-7 (LO5,6) (Assumptions, Principles, and Constraint) Presented below are a number of operational guidelines and practices that have developed over time.

Instructions

Select the assumption, principle, or constraint that most appropriately justifies these procedures and practices. (Do not use qualitative characteristics.)

(a) Fair value changes are not recognized in the accounting records.

(b) Financial information is presented so that investors will not be misled.

(c) Intangible assets are amortized over periods benefited.

(d) Agricultural companies use fair value for purposes of valuing crops.

(e) Each enterprise is kept as a unit distinct from its owner or owners.

(f) All significant post-balance-sheet events are disclosed.

(g) Revenue is recorded when the product is delivered.

(h) All important aspects of bond indentures are presented in financial statements.

(i) Rationale for accrual accounting.

(j) The use of consolidated statements is justified.

(k) Reporting must be done at defined time intervals.

(l) An allowance for doubtful accounts is established.

(m) Goodwill is recorded only at time of purchase.

(n) A company charges its sales commission costs to expense.

E2-8 (LO6) (Full Disclosure Principle) Presented below are a number of facts related to Weller, Inc. Assume that no mention of these facts was made in the financial statements and the related notes.

Instructions

Assume that you are the auditor of Weller, Inc. and that you have been asked to explain the appropriate accounting and related disclosure necessary for each of these items.

(a) The company decided that, for the sake of conciseness, only net income should be reported on the income statement. Details as to revenues, cost of goods sold, and expenses were omitted.

(b) Equipment purchases of $170,000 were partly financed during the year through the issuance of a $110,000 notes payable. The company offset the equipment against the notes payable and reported plant assets at $60,000.

(c)

Weller has reported its ending inventory at $2,100,000 in the financial statements. No other information related to inventories is presented in the financial statements and related notes.

(d) The company changed its method of valuing inventories from weighted-average to FIFO. No mention of this change was made in the financial statements.

E2-9 (LO6) GROUPWORK (Accounting Principles and Assumptions—Comprehensive) Presented below are a number of business transactions that occurred during the current year for Gonzales, Inc.

Instructions

In each of the situations, discuss the appropriateness of the journal entries in terms of generally accepted accounting principles.

(a) The president of Gonzales, Inc. used his expense account to purchase a new Suburban solely for personal use. The following journal entry was made.

Miscellaneous Expense	29,000	
Cash		29,000

(b) Merchandise inventory that cost $620,000 is reported on the balance sheet at $690,000, the expected selling price less estimated selling costs. The following entry was made to record this increase in value.

Inventory	70,000	
Sales Revenue		70,000

(c) The company is being sued for $500,000 by a customer who claims damages for personal injury apparently caused by a defective product. Company attorneys feel extremely confident that the company will have no liability for damages resulting from the situation. Nevertheless, the company decides to make the following entry.

Loss from Lawsuit	500,000	
Liability for Lawsuit		500,000

(d) Because the general level of prices increased during the current year, Gonzales, Inc. determined that there was a $16,000 understatement of depreciation expense on its equipment and decided to record it in its accounts. The following entry was made.

Depreciation Expense	16,000	
Accumulated Depreciation—Equipment		16,000

(e) Gonzales, Inc. has been concerned about whether intangible assets could generate cash in case of liquidation. As a consequence, goodwill arising from a purchase transaction during the current year and recorded at $800,000 was written off as follows.

Retained Earnings	800,000	
Goodwill		800,000

(f) Because of a "fire sale," equipment obviously worth $200,000 was acquired at a cost of $155,000. The following entry was made.

Equipment	200,000	
Cash		155,000
Sales Revenue		45,000

E2-10 (LO6) GROUPWORK (Accounting Principles—Comprehensive) Presented below is information related to Cramer, Inc.

Instructions

Comment on the appropriateness of the accounting procedures followed by Cramer, Inc.

(a) Depreciation expense on the building for the year was $60,000. Because the building was increasing in value during the year, the controller decided to charge the depreciation expense to retained earnings instead of to net income. The following entry is recorded.

Retained Earnings	60,000	
Accumulated Depreciation—Buildings		60,000

(b) Materials were purchased on January 1, 2017, for $120,000 and this amount was entered in the Materials account. On December 31, 2017, the materials would have cost $141,000, so the following entry is made.

Inventory	21,000	
Gain on Inventories		21,000

(c) During the year, the company purchased equipment through the issuance of common stock. The stock had a par value of $135,000 and a fair value of $450,000. The fair value of the equipment was not easily determinable. The company recorded this transaction as follows.

Equipment	135,000	
Common Stock		135,000

(d) During the year, the company sold certain equipment for $285,000, recognizing a gain of $69,000. Because the controller believed that new equipment would be needed in the near future, she decided to defer the gain and amortize it over the life of any new equipment purchased.

(e)

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An order for $61,500 has been received from a customer for products on hand. This order was shipped on January 9, 2018. The company made the following entry in 2017.

Accounts Receivable	61,500	
Sales Revenue		61,500

CONCEPTS FOR ANALYSIS

CA2-1 (Conceptual Framework—General) Wayne Cooper has some questions regarding the theoretical framework in which GAAP is set. He knows that the FASB and other predecessor organizations have attempted to develop a conceptual framework for accounting theory formulation. Yet, Wayne's supervisors have indicated that these theoretical frameworks have little value in the practical sense (i.e., in the real world). Wayne did notice that accounting rules seem to be established after the fact rather than before. He thought this indicated a lack of theory structure but never really questioned the process at school because he was too busy doing the homework.

Wayne feels that some of his anxiety about accounting theory and accounting semantics could be alleviated by identifying the basic concepts and definitions accepted by the profession and considering them in light of his current work. By doing this, he hopes to develop an appropriate connection between theory and practice.

Instructions

(a) Help Wayne recognize the purpose of and benefit of a conceptual framework.

(b) Identify any Statements of Financial Accounting Concepts issued by the FASB that may be helpful to Wayne in developing his theoretical background.

CA2-2 WRITING (Conceptual Framework—General) The Financial Accounting Standards Board (FASB) has developed a conceptual framework for financial accounting and reporting. The FASB has issued eight Statements of Financial Accounting Concepts. These statements are intended to set forth the objective and fundamentals that will be the basis for developing financial accounting and reporting standards. The objective identifies the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties.

The purpose of the statement on qualitative characteristics is to examine the characteristics that make accounting information useful. These characteristics or

qualities of information are the ingredients that make information useful and the qualities to be sought when accounting choices are made.

Instructions

(a) Identify and discuss the benefits that can be expected to be derived from the FASB's conceptual framework.

(b) What is the most important quality for accounting information as identified in the conceptual framework? Explain why it is the most important.

(c) *Statement of Financial Accounting Concepts No. 8* describes a number of key characteristics or qualities for accounting information. Briefly discuss the importance of any three of these qualities for financial reporting purposes.

(CMA adapted)

CA2-3 (Objective of Financial Reporting) Homer Winslow and Jane Alexander are discussing various aspects of the FASB's concepts statement on the objective of financial reporting. Homer indicates that this pronouncement provides little, if any, guidance to the practicing professional in resolving accounting controversies. He believes that the statement provides such broad guidelines that it would be impossible to apply the objective to present-day reporting problems. Jane concedes this point but indicates that the objective is still needed to provide a starting point for the FASB in helping to improve financial reporting.

Instructions

(a) Indicate the basic objective established in the conceptual framework.

(b) What do you think is the meaning of Jane's statement that the FASB needs a starting point to resolve accounting controversies?

CA2-4 GROUPWORK (Qualitative Characteristics) Accounting information provides useful information about business transactions and events. Those who provide and use financial reports must often select and evaluate accounting alternatives. The FASB statement on qualitative characteristics of accounting information examines the characteristics of accounting information that make it useful for decision-making. It also points out that various limitations inherent in the measurement and reporting process may necessitate trade-offs or sacrifices among the characteristics of useful information.

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Instructions

(a) Describe briefly the following characteristics of useful accounting information.

- **(1)** Relevance.
- **(2)** Faithful representation.
- **(3)** Understandability.
- **(4)** Comparability.
- **(5)** Consistency.

(b) For each of the following pairs of information characteristics, give an example of a situation in which one of the characteristics may be sacrificed in return for a gain in the other.

- **(1)** Relevance and faithful representation.
- **(2)** Relevance and consistency.
- **(3)** Comparability and consistency.
- **(4)** Relevance and understandability.

(c) What criterion should be used to evaluate trade-offs between information characteristics?

CA2-5 (Revenue Recognition Principle) After the presentation of your report on the examination of the financial statements to the board of directors of Piper Publishing Company, one of the new directors expresses surprise that the income statement assumes that an equal proportion of the revenue is recognized with the publication of every issue of the company's magazine. She feels that the "crucial event" in the process of earning revenue in the magazine business is the cash sale of the subscription. She says that she does not understand why most of the revenue cannot be "recognized" in the period of the cash sale.

Instructions

Discuss the propriety of timing the recognition of revenue in Piper Publishing Company's accounts with:

- **(a)** The cash sale of the magazine subscription.
- **(b)** The publication of the magazine every month.
- **(c)** Over time, as the magazines are published and delivered to customers.

CA2-6 (Expense Recognition Principle) An accountant must be familiar with the concepts involved in determining earnings of a business entity. The amount of earnings reported for a business entity is dependent on the proper recognition, in general, of revenues and expenses for a given time period. In some situations, costs are

recognized as expenses at the time of product sale. In other situations, guidelines have been developed for recognizing costs as expenses or losses by other criteria.

Instructions

(a) Explain the rationale for recognizing costs as expenses at the time of product sale.

(b) What is the rationale underlying the appropriateness of treating costs as expenses of a period instead of assigning the costs to an asset? Explain.

(c) In what general circumstances would it be appropriate to treat a cost as an asset instead of as an expense? Explain.

(d) Some expenses are assigned to specific accounting periods on the basis of systematic and rational allocation of asset cost. Explain the underlying rationale for recognizing expenses on the basis of systematic and rational allocation of asset cost.

(e) Identify the conditions under which it would be appropriate to treat a cost as a loss.

(AICPA adapted)

CA2-7 (Expense Recognition Principle) Accountants try to prepare income statements that are as accurate as possible. A basic requirement in preparing accurate income statements is to record costs and revenues properly. Proper recognition of costs and revenues requires that costs resulting from typical business operations be recognized in the period in which they expired.

Instructions

(a) List three criteria that can be used to determine whether such costs should appear as charges in the income statement for the current period.

(b) As generally presented in financial statements, the following items or procedures have been criticized as improperly recognizing costs. Briefly discuss each item from the viewpoint of matching costs with revenues and suggest corrective or alternative means of presenting the financial information.

- **(1)** Receiving and handling costs.
- **(2)** Cash discounts on purchases.

CA2-8 (Expense Recognition Principle) Daniel Barenboim sells and erects shell houses, that is, frame structures that are completely finished on the outside but are unfinished on the inside except for flooring, partition studding, and ceiling joists. Shell houses are sold chiefly to customers who are handy with tools and who have time to do the interior wiring, plumbing, wall completion and finishing, and other work necessary to make the shell houses livable dwellings.

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Barenboim buys shell houses from a manufacturer in unassembled packages consisting of all lumber, roofing, doors, windows, and similar materials necessary to complete a shell house. Upon commencing operations in a new area, Barenboim buys or leases land as a site for its local warehouse, field office, and display houses. Sample display houses are erected at a total cost of $30,000 to $44,000 including the cost of the unassembled packages. The chief element of cost of the display houses is the unassembled packages, inasmuch as erection is a short, low-cost operation. Old sample models are torn down or altered into new models every 3 to 7 years. Sample display houses have little salvage value because dismantling and moving costs amount to nearly as much as the cost of an unassembled package.

Instructions

(a) A choice must be made between (1) expensing the costs of sample display houses in the periods in which the expenditure is made and (2) spreading the costs over more than one period. Discuss the advantages of each method.

(b) Would it be preferable to amortize the cost of display houses on the basis of (1) the passage of time or (2) the number of shell houses sold? Explain.

(AICPA adapted)

CA2-9 WRITING (Qualitative Characteristics) Recently, your uncle, Carlos Beltran, who knows that you always have your eye out for a profitable investment, has discussed the possibility of your purchasing some corporate bonds. He suggests that you may wish to get in on the "ground floor" of this deal. The bonds being issued by Neville Corp. are 10-year debentures which promise a 40% rate of return. Neville manufactures novelty/party items.

You have told Uncle Carlos that, unless you can take a look at Neville's financial statements, you would not feel comfortable about such an investment. Believing that this is the chance of a lifetime, Uncle Carlos has procured a copy of Neville's most recent, unaudited financial statements which are a year old. These statements were prepared by Mrs. Andy Neville. You peruse these statements, and they are quite impressive. The balance sheet showed a debt-to-equity ratio of 0.10 and, for the year shown, the company reported net income of $2,424,240.

The financial statements are not shown in comparison with amounts from other years. In addition, no significant note disclosures about inventory valuation, depreciation methods, loan agreements, etc. are available.

Instructions

Write a letter to Uncle Carlos explaining why it would be unwise to base an investment decision on the financial statements that he has provided to you. Be sure to explain why these financial statements are neither relevant nor representationally faithful.

CA2-10 ETHICS (Expense Recognition Principle) Anderson Nuclear Power Plant will be "mothballed" at the end of its useful life (approximately 20 years) at great expense. The expense recognition principle requires that expenses be recognized as

assets are used up or liabilities are incurred. Accountants Ana Alicia and Ed Bradley argue whether it is better to allocate the expense of mothballing over the next 20 years or ignore it until mothballing occurs.

Instructions

Answer the following questions.

- **(a)** What stakeholders should be considered?
- **(b)** What ethical issue, if any, underlies the dispute?
- **(c)** What alternatives should be considered?
- **(d)** Assess the consequences of the alternatives.
- **(e)** What decision would you recommend?

CA2-11 (Cost Constraint) The AICPA Special Committee on Financial Reporting proposed the following constraints related to financial reporting.

1. Business reporting should exclude information outside of management's expertise or for which management is not the best source, such as information about competitors.
2. Management should not be required to report information that would significantly harm the company's competitive position.
3. Management should not be required to provide forecasted financial statements. Rather, management should provide information that helps users forecast for themselves the company's financial future.
4. Other than for financial statements, management need report only the information it knows. That is, management should be under no obligation to gather information it does not have, or does not need, to manage the business.
5. Companies should present certain elements of business reporting only if users and management agree they should be reported—a concept of flexible reporting.
6. Companies should not have to report forward-looking information unless there are effective deterrents to unwarranted litigation that discourages companies from doing so.

Instructions

For each item, briefly discuss how the proposed constraint addresses concerns about the costs and benefits of financial reporting.

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USING YOUR JUDGMENT

Financial Reporting Problem

The Procter & Gamble Company (P&G)

The financial statements of **P&G** are presented in Appendix B. The company's complete annual report, including the notes to the financial statements, is available online.

Instructions

Refer to P&G's financial statements and the accompanying notes to answer the following questions.

(a) Using the notes to the consolidated financial statements, determine P&G's revenue recognition policies. Discuss the impact of trade promotions on P&G's financial statements.

(b) Give two examples of where historical cost information is reported in P&G's financial statements and related notes. Give two examples of the use of fair value information reported in either the financial statements or related notes.

(c) How can we determine that the accounting principles used by P&G are prepared on a basis consistent with those of last year?

(d) What is P&G's accounting policy related to advertising? What accounting principle does P&G follow regarding accounting for advertising? Where are advertising expenses reported in the financial statements?

Comparative Analysis Case

The Coca-Cola Company and PepsiCo, Inc.

The financial statements of **Coca-Cola** and **PepsiCo** are presented in Appendices C and D, respectively. The companies' complete annual reports, including the notes to the financial statements, are available online.

Instructions

Use the companies' financial information to answer the following questions.

(a) What are the primary lines of business of these two companies as shown in their notes to the financial statements?

(b) Which company has the dominant position in beverage sales?

(c) How are inventories for these two companies valued? What cost allocation method is used to report inventory? How does their accounting for inventories affect comparability between the two companies?

(d) What accounting policy changes do the companies discuss?

Financial Statement Analysis Case

Wal-Mart Stores, Inc.

Wal-Mart Stores, Inc. provided the following disclosure in a recent annual report.

> ***New accounting pronouncement (partial)*** ... the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101—"Revenue Recognition in Financial Statements" (*SAB 101*). This SAB deals with various revenue recognition issues, several of which are common within the retail industry. As a result of the issuance of this SAB ... the Company is currently evaluating the effects of the SAB on its method of recognizing revenues related to layaway sales and will make any accounting method changes necessary during the first quarter of [next year].

In response to *SAB 101*, Wal-Mart changed its revenue recognition policy for layaway transactions, in which Wal-Mart sets aside merchandise for customers who make partial payment. Before the change, Wal-Mart recognized all revenue on the sale at the time of the layaway. After the change, Wal-Mart does not recognize revenue until customers satisfy all payment obligations and take possession of the merchandise.

Instructions

(a) Discuss the expected effect on income (1) in the year that Wal-Mart makes the changes in its revenue recognition policy, and (2) in the years following the change.

(b) Evaluate the extent to which Wal-Mart's previous revenue policy was consistent with the revenue recognition principle.

(c) If all retailers had used a revenue recognition policy similar to Wal-Mart's before the change, are there any concerns with respect to the qualitative characteristic of comparability? Explain.

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Accounting, Analysis, and Principles

William Murray achieved one of his life-long dreams by opening his own business, The Caddie Shack Driving Range, on May 1, 2017. He invested $20,000 of his own savings in the business. He paid $6,000 cash to have a small building constructed to house the operations and spent $800 on golf clubs, golf balls, and yardage signs. Murray leased 4 acres of land at a cost of $1,000 per month. (He paid the first month's rent in cash.) During the first month, advertising costs totaled $750, of which $150 was unpaid at the end of the month. Murray paid his three nephews $400 for retrieving golf balls. He deposited in the company's bank account all revenues from customers ($4,700). On May 15, Murray withdrew $800 in cash for personal use. On May 31, the company received a utility bill for $100 but did not immediately pay it. On May 31, the balance in the company bank account was $15,100.

Murray is feeling pretty good about results for the first month, but his estimate of profitability ranges from a loss of $4,900 to a profit of $1,650.

Accounting

Prepare a balance sheet at May 31, 2017. Murray appropriately records any depreciation expense on a quarterly basis. How could Murray have determined that the business operated at a profit of $1,650? How could Murray conclude that the business operated at a loss of $4,900?

Analysis

Assume Murray has asked you to become a partner in his business. Under the partnership agreement, after paying him $10,000, you would share equally in all future profits. Which of the two income measures above would be more useful in deciding whether to become a partner? Explain.

Principles

What is income according to GAAP? What concepts do the differences in the three income measures for The Caddie Shack Driving Range illustrate?

BRIDGE TO THE PROFESSION

FASB Codification References

[1] FASB ASC 205–40. [Predecessor literature: None.]

[2] FASB ASC 205. [Predecessor literature: None.]

[3] FASB ASC 820-10. [Predecessor literature: "Fair Value Measurement," *Statement of Financial Accounting Standards No. 157* (Norwalk, Conn.: FASB, September 2006).]

[4] FASB ASC 825-10-25. [Predecessor literature: "The Fair Value Option for Financial Assets and Liabilities," *Statement of Financial Accounting Standards No. 159* (Norwalk, Conn.: FASB, 2007).]

[5] FASB ASC 718-10. [Predecessor literature: "Share-Based Payment," *Financial Accounting Standards No. 123(R)* (Norwalk, Conn.: FASB, 2004).]

Codification Exercises

If your school has a subscription to the FASB Codification, go to *http://aaahq.org/ascLogin.cfm* to log in and prepare responses to the following. Provide Codification references for your responses.

CE2-1 Access the glossary ("Master Glossary") at the FASB Codification website to answer the following.

(a) What is the definition of fair value?

(b) What is the definition of revenue?

(c) What is the definition of comprehensive income?

CE2-2 Briefly describe how the organization of the FASB Codification corresponds to the elements of financial statements.

Codification Research Case

Your aunt recently received the annual report for a company in which she has invested. The report notes that the statements have been prepared in accordance with "generally accepted accounting principles." She has also heard that certain terms have special meanings in accounting relative to everyday use. She would like you to explain the meaning of terms she has come across related to accounting.

Instructions

Go to *http://www.fasb.org* and access the FASB Concepts Statements and respond to the following items. (Provide paragraph citations.) When you have accessed the documents, you can use the search tool in your Internet browser.

(a) How is "materiality" defined in the conceptual framework?

(b)

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The concepts statements provide several examples in which specific quantitative materiality guidelines are provided to firms. Identity at least two of these examples. Do you think the materiality guidelines should be quantified? Why or why not?

(c) The concepts statements discuss the concept of “articulation” between financial statement elements. Briefly summarize the meaning of this term and how it relates to an entity’s financial statements.

ADDITIONAL PROFESSIONAL RESOURCES

Go to **WileyPLUS** for other career-readiness resources, such as career coaching, internship opportunities, and CPAexcel prep.

IFRS Insights

LEARNING OBJECTIVE 8

Compare the conceptual frameworks underlying GAAP and IFRS.

In 2004, the IASB and FASB started a joint comprehensive project on the conceptual framework. In 2010, the two Boards issued a converged concepts statement which covered the objective of financial reporting and a common set of desired qualitative characteristics of useful information. After this phase of the conceptual framework project was completed, the IASB decided to addresses the remaining phases of the project as an IASB-only comprehensive project.

RELEVANT FACTS

Following are the key similarities and differences between GAAP and IFRS related to the conceptual framework.

Similarities

- In 2010, the IASB and FASB agreed on the objective of financial reporting and a common set of desired qualitative characteristics. These were presented in the Chapter 2 discussion. Note that prior to this agreement, the IASB conceptual framework gave more emphasis to the objective of providing information on management's performance (stewardship).
- The existing conceptual frameworks underlying GAAP and IFRS are very similar. That is, they are organized in a similar manner (objective, elements, qualitative characteristics, etc.). There is no real need to change many aspects of the existing frameworks other than to converge different ways of discussing essentially the same concepts.
- Both the IASB and FASB have similar measurement principles, based on historical cost and fair value. In 2011, the Boards issued a converged standard fair value measurement so that the definition of fair value, measurement techniques, and disclosures are the same between GAAP and IFRS when fair value is used in financial statements.

Differences

- Although both GAAP and IFRS are increasing the use of fair value to report assets, at this point IFRS has adopted it more broadly. As examples, under IFRS, companies can apply fair value to property, plant, and equipment; natural resources; and in some cases, intangible assets.
- GAAP has a concept statement to guide estimation of fair values when market-related data is not available (*Statement of Financial Accounting Concepts No. 7*, "Using Cash Flow Information and Present Value in Accounting"). The IASB has not issued a similar concept statement; it has issued a fair value standard *(IFRS 13)* that is converged with GAAP.
- The monetary unit assumption is part of each framework. However, the unit of measure will vary depending on the currency used in the country in which the company is incorporated (e.g., Chinese yuan, Japanese yen, and British pound). IFRS makes an explicit assumption that financial statements are prepared on an accrual basis.
- The economic entity assumption is also part of each framework, although some cultural differences result in differences in its application. For example, in Japan many companies have formed alliances that are so strong that they act similar to related corporate divisions although they are not actually part of the same company.

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As indicated earlier, the IASB is developing a new conceptual framework. In these proposed conceptual framework amendments, the IASB has introduced two new qualitative characteristics: prudence and substance over form. Also, as noted in the next section, the IASB is making modifications to other parts of its conceptual framework by revising the definitions of a number of the basic elements. The IASB is also introducing updated chapters on such items as measurement, classification of income and expense, derecognition of assets and liabilities, and the reporting entity.

ABOUT THE NUMBERS

Financial Statement Elements

While the conceptual framework that underlies IFRS is very similar to that used to develop GAAP, the elements identified and their definitions under IFRS are different. The IASB elements and their definitions are as follows.

Assets. A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Liabilities. A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities may be legally enforceable via a contract or law, but need not be, i.e., they can arise due to normal business practice or customs.

Equity. A residual interest in the assets of the entity after deducting all its liabilities.

Income. Increases in economic benefits that result in increases in equity (other than those related to contributions from shareholders). Income includes both revenues (resulting from ordinary activities) and gains.

Expenses. Decreases in economic benefits that result in decreases in equity (other than those related to distributions to shareholders). Expenses includes losses that are not the result of ordinary activities.

In its new conceptual framework project, it is likely that the IASB will change some definitions. For example, the IASB has proposed the following definition of as asset: "An asset is a present economic resource controlled by the entity as a result of a past event." Thus, "expected flow of economic benefits" in the current definition is not present in the proposed definition.

Conceptual Framework Work Plan

Moving ahead in its stand-alone conceptual framework project, the IASB has decided that:

1. The conceptual framework project should focus on elements of financial statements, reporting entity, presentation, and disclosure.

2. The aim should be to work toward a single discussion paper covering all of the identified areas, rather than separate discussion papers for each area.

ON THE HORIZON

The IASB and the FASB face a difficult task in attempting to update, modify, and complete a converged conceptual framework. There are many difficult issues. For example: How do we trade off characteristics such as highly relevant information that is difficult to verify? How do we define control when we are developing a definition of an asset? Is a liability the future sacrifice itself or the obligation to make the sacrifice? Should a single measurement method, such as historical cost or fair value, be used, or does it depend on whether it is an asset or liability that is being measured?

IFRS SELF-TEST QUESTIONS

---

1. Which of the following statements about the IASB and FASB conceptual frameworks is **not** correct?

   (a) The IASB conceptual framework does not identify the element *comprehensive income*.

   (b) The existing IASB and FASB conceptual frameworks are organized in similar ways.

   (c) The FASB and IASB agree that the objective of financial reporting is to provide useful information to investors and creditors.

   (d)

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IFRS does not allow use of fair value as a measurement basis.

2. Which of the following statements is **false**?
   - **(a)** The monetary unit assumption is used under IFRS.
   - **(b)** Under IFRS, companies may use fair value for property, plant, and equipment.
   - **(c)** The FASB and IASB are no longer working on a joint conceptual framework project.
   - **(d)** Under IFRS, there are the same number of financial statement elements as in GAAP.
3. Companies that use IFRS:
   - **(a)** must report all their assets on the statement of financial position (balance sheet) at fair value.
   - **(b)** may report property, plant, and equipment and natural resources at fair value.
   - **(c)** may refer to a concept statement on estimating fair values when market data are not available.
   - **(d)** may only use historical cost as the measurement basis in financial reporting.
4. The issues that the FASB and IASB must address in developing a conceptual framework include all of the following **except**:
   - **(a)** should the characteristic of relevance be traded-off in favor of information that is verifiable?
   - **(b)** should a single measurement method such as historical cost be used?
   - **(c)** what are the key elements of asset and liability definitions?
   - **(d)** should the role of financial reporting focus on internal decision-making as well as providing information to assist users in decision-making?
5. With respect to the IASB conceptual framework project:
   - **(a)** work is being conducted to produce separate discussion papers.
   - **(b)** work is being conducted with the FASB.
   - **(c)** work is being conducted to result in a discussion paper covering all the identified areas.
   - **(d)** the framework will not address elements of financial statements.

IFRS CONCEPTS AND APPLICATION

IFRS2-1 What two assumptions are central to the IASB conceptual framework?

IFRS2-2 Do the IASB and FASB conceptual frameworks differ in terms of the role of financial reporting? Explain.

IFRS2-3 What are some of the differences in elements in the IASB and FASB conceptual frameworks?

IFRS2-4 What are some of the challenges to the IASB in developing a conceptual framework?

Financial Reporting Case

IFRS2-5 As discussed in Chapter 1, the **International Accounting Standards Board (IASB)** develops accounting standards for many international companies. The IASB also has developed a conceptual framework to help guide the setting of accounting standards. While the FASB and IASB have issued converged concepts statements on the objective and qualitative characteristics, other parts of their frameworks differ.

Instructions

Briefly discuss the similarities and differences between the FASB and IASB conceptual frameworks as related to elements and their definitions.

Professional Research

IFRS2-6 Your aunt recently received the annual report for a company in which she has invested. The report notes that the statements have been prepared in accordance with IFRS. She has also heard that certain terms have special meanings in accounting relative to everyday use. She would like you to explain the meaning of terms she has come across related to accounting.

Instructions

Access the IASB conceptual framework at the IASB website (*http://eifrs.iasb.org/*). (Click on the IFRS tab and then register for free eIFRS access if necessary.) When you have accessed the documents, you can use the search tool in your Internet browser to prepare responses to the following items. (Provide paragraph citations.)

(a) How is “materiality” defined in the framework?

(b) Briefly discuss how materiality relates to (1) the relevance of financial information, and (2) completeness.

(c) Your aunt observes that under IFRS, the financial statements are prepared on the accrual basis. According to the framework, what does “accrual basis” mean?

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International Financial Reporting Problem

Marks and Spencer plc (M&S)

IFRS2-7 The financial statements of **M&S** are presented in Appendix E. The company's complete annual report, including the notes to the financial statements, is available online.

Instructions

Refer to M&S's financial statements and the accompanying notes to answer the following questions.

(a) Using the notes to the consolidated financial statements, determine M&S's revenue recognition policies.

(b) Give two examples of where historical cost information is reported in M&S's financial statements and related notes. Give two examples of the use of fair value information reported in either the financial statements or related notes. What new accounting policies are discussed?

(c) How can we determine that the accounting principles used by M&S are prepared on a basis consistent with those of last year?

(d) What is M&S's accounting policy related to refunds and loyalty schemes? Why does M&S include the accounting for refunds and loyalty schemes in its critical accounting estimates and judgments?

ANSWERS TO IFRS SELF-TEST QUESTIONS

1. d **2.** d **3.** b **4.** d **5.** c

[1]"Chapter 1, The Objective of General Purpose Financial Reporting" and "Chapter 3, Qualitative Characteristics of Useful Financial Information," *Statement of Financial Accounting Concepts No. 8* (Norwalk, Conn.: FASB, September 2010). Recall from our discussion in Chapter 1 that while the conceptual framework and any changes to it pass through the same due process (discussion paper, public hearing, exposure draft, etc.) as do the other FASB pronouncements, the framework is not authoritative. That is, the framework does not define standards for any particular measurement or disclosure issue, and nothing in the framework overrides any specific FASB pronouncement that is included in the Codification.

[2]C. Horngren, "Uses and Limitations of a Conceptual Framework," *Journal of Accountancy* (April 1981), p. 90.

[3]The FASB also issued a Statement of Financial Accounting Concepts that relates to nonbusiness organizations: "Objectives of Financial Reporting by Nonbusiness Organizations," *Statement of Financial Accounting Concepts No. 4* (December 1980).

[4]Adapted from William C. Norby, *The Financial Analysts Journal* (March—April 1982), p. 22.

[5]"Chapter 1, The Objective of General Purpose Financial Reporting," *Statement of Financial Accounting Concepts No. 8* (Norwalk, Conn.: FASB, September 2010), par. OB2.

[6]"Chapter 3, Qualitative Characteristics of Useful Financial Information," *Statement of Financial Accounting Concepts No. 8* (Norwalk, Conn.: FASB, September 2010).

[7]The FASB has proposed an amendment to the conceptual framework that would modify the definition of materiality to be consistent with the legal concept of materiality (as established in the securities laws). Specifically, information is material "if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information." The FASB notes that it cannot advise or specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation. Thus, to avoid creating uncertainty or confusion, the Board makes it clear that the conceptual framework does not define materiality but instead relies on the U.S. Supreme Court's definition in the context of the antifraud provisions of the U.S. securities laws. See Proposed Concepts Statement, *Conceptual Framework for Financial Reporting Chapter 3: Qualitative Characteristics of Useful Financial Information* (September 24, 2015).

[8]Sometimes, in practice, it has been acceptable to invoke prudence or conservatism as a justification for an accounting treatment under conditions of uncertainty. Prudence or conservatism means when in doubt, choose the solution that will be least likely to overstate assets or income and/or understate liabilities or expenses. The conceptual framework indicates that prudence or conservatism generally is in conflict with the quality of neutrality. This is because being prudent or conservative likely leads to a bias in the reported financial position and financial performance. In fact, introducing biased understatement of assets (or overstatement of liabilities) in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent. This is inconsistent with neutrality, which encompasses freedom from bias. Accordingly, the conceptual framework does not include prudence or conservatism as desirable qualities of financial reporting information. See "Chapter 3, Qualitative Characteristics of Useful Financial Information," *Statement of Financial Accounting Concepts No. 8* (Norwalk, Conn.: FASB, September 2010), paras. BC3.27–BC3.29.

[9]Surveys indicate that users highly value consistency. They note that a change tends to destroy the comparability of data before and after the change. Some companies assist users to understand the pre- and post-change data. Generally, however, users say they lose the ability to analyze over time. GAAP guidelines (discussed in Chapter 22) on accounting changes are designed to improve the comparability of the data before and after an accounting change.

[10]These provisions are specified in “Reports on Audited Financial Statements,” *Statement on Auditing Standards No. 58* (New York: AICPA, April 1988), par. 34.

[11]“Chapter 3, Qualitative Characteristics of Useful Financial Information,” *Statement of Financial Accounting Concepts No. 8* (Norwalk, Conn.: FASB, September 2010), paras. QC30–QC31.

[12]“Elements of Financial Statements,” *Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, December 1985), pp. ix and x.

[13]The FASB has proposed to link the definition of an entity to its financial reporting objective. That is, a reporting entity is described as a circumscribed area of business activity of interest to present and potential equity investors, lenders, and other capital providers. See IASB/FASB, “The Reporting Entity,” *Exposure Draft ED/2010/2: Conceptual Framework for Financial Reporting* (March 2010).

[14]The concept of the entity is changing. For example, defining the “outer edges” of companies is now harder. Public companies often consist of multiple public subsidiaries, each with joint ventures, licensing arrangements, and other affiliations. Increasingly, companies form and dissolve joint ventures or customer-supplier relationships in a matter of months or weeks. These “virtual companies” raise accounting issues about how to account for the entity. As discussed in footnote 13, the FASB (and IASB) is addressing these issues in the entity phase of its conceptual framework project.

[15]In response to the minimal guidance addressing the going concern assumption, including when it is appropriate to apply or how to apply the liquidation basis of accounting, the FASB has issued two accounting standards. The first, (“Presentation of Financial Statements—Going Concern: Disclosure of Uncertainties about an Entity’s Abillity to Continue as a Going Concern”) **[1]** requires additional disclosure when substantial doubt about a company’s ability to continue as a going concern occurs. The second standard (“Presentation of Financial Statements—The Liquidation Basis of Accounting”) **[2]** requires that companies use the liquidation basis of accounting when liquidation is imminent (when either a plan for liquidation has been approved or a plan for liquidation is being imposed by other forces, such as involuntary bankruptcy). If liquidation accounting is used, financial statements should reflect relevant information about a company’s resources and obligations in liquidation by measuring and presenting assets and liabilities at the amount of cash or other consideration that the company expects to collect or pay in liquidation, along with additional disclosures about the plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of liquidation.

[16]For major groups of assets and liabilities, companies must disclose (1) the fair value measurement and (2) the fair value hierarchy level of the measurements as a whole, classified by Level 1, 2, or 3. Given the judgment involved, it follows that the more a company depends on Level 3 to determine fair values, the more information about the valuation process the company will need to disclose. Thus, additional disclosures are required for Level 3 measurements; we discuss these disclosures in more detail in subsequent chapters.

The FASB has also issued additional guidance related to issues surrounding the use of fair value in financial statements (Accounting Standards Update 2011–04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS)*. A major benefit of the guidance is to provide a better definitional structure of what is meant by fair value and an improved understanding of how fair value should be measured.

[17]The framework illustrated here is based on the recent new standard [ASU No. 2014–09, "Revenue from Contracts with Customers" (Topic 606)]. The new guidance establishes the principles to report useful information to users of financial statements about the nature, timing, and uncertainty of revenue from contracts with customers.

[18]This approach is commonly referred to as the **matching principle**. However, there is much debate about the conceptual validity of the matching principle. A major concern is that matching permits companies to defer certain costs and treat them as assets on the balance sheet. In fact, these costs may not have future benefits. If abused, this principle permits the balance sheet to become a "dumping ground" for unmatched costs.

[19]*SFAC No. 5*, par. 63.

[20]The FASB has recently issued an exposure draft, *Conceptual Framework for Financial Reporting: Chapter 8: Notes to Financial Statements*. If approved, this new Concepts statement will help the Board to identify relevant information and establish limits on information that should be included in the notes to the financial statements. A related proposed Accounting Standards Update (ASU) [*Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material* (September 24, 2015)] is intended to promote the appropriate use of discretion by companies when deciding which disclosures should be considered material in their particular circumstances.

[21]"Decision-Usefulness: The Overriding Objective," *FASB Viewpoints* (October 19, 1983), p. 4.

[22]Charles Rivers and Associates, "Sarbanes-Oxley Section 404: Costs and Remediation of Deficiencies," letter from Deloitte and Touche, Ernst and Young, KPMG, and Pricewaterhouse-Coopers to the SEC (April 11, 2005); and Protiviti, SOX Compliance—Changes Abound Amid Drive for Stability and Long-Term Value (2015), *http://www.protiviti.com/soxsurvey*.

[23]For example, as part of its project on "Share-Based Payment" **[5]**, the Board conducted a field study and surveyed commercial software providers to collect information on the costs of measuring the fair values of share-based compensation arrangements.