Intermediate Accounting 16th edition Kieso Solutions Manual

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CHAPTER 2

Conceptual Framework for Financial Reporting

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Concepts for Analysis
1. Conceptual framework–general.	1		1, 2	1, 2
2. Objective of financial reporting.	2, 7		1, 2	3
3. Qualitative characteristics of accounting.	3, 4, 5, 6, 8	1, 2, 3, 4, 5	2, 3, 4	4, 9
4. Elements of financial statements.	9, 10, 11	9, 7	5	
5. Basic assumptions.	12, 13, 14, 25	8, 9	6, 7, 9	
6. Basic principles:				
a. Measurement.	15, 16, 17, 18	10, 11, 12	6, 7	
b. Revenue recognition.	19, 20, 21, 22, 23	10	7	5
c. Expense recognition.	24	10, 11, 12	6, 7, 9, 10	6, 7, 8, 10
d. Full disclosure.	25, 26, 27	10, 11, 12	6, 7, 8	10
7. Cost constraint.	28, 29		3, 7	11

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ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives		Questions	Brief Exercises	Exercises	Concepts for Analysis
1.	Describe the usefulness of a conceptual framework.	1		1, 2	CA2-1 CA2-2
2.	Understand the objective of financial reporting.	2, 7		1, 2	CA2-3
3.	Identify the qualitative characteristics of accounting information.	3, 4, 5, 6, 8	1, 2, 3, 4, 5	2, 3, 4	CA2-4, CA2-9
4.	Define the basic elements of financial statements.	9, 10, 11	6, 7	5	
5.	Describe the basic assumptions of accounting.	12, 13, 14, 25	8, 9	6, 7	
6.	Explain the application of the basic principles of accounting.	15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27	10, 11, 12	6, 7, 8, 9, 10	CA2-5, CA2-6, CA2-7, CA2-8, CA2-10, CA2-11
7.	Describe the impact that the cost constraint has on reporting accounting information.	28, 29		3, 7	CA2-11

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E2-1	Usefulness, objective of financial reporting.	Simple	15–20
E2-2	Usefulness, objective of financial reporting, qualitative characteristics.	Simple	15–20
E2-3	Qualitative characteristics.	Moderate	20–30
E2-4	Qualitative characteristics.	Simple	15–20
E2-5	Elements of financial statements.	Simple	15–20
E2-6	Assumptions, principles, and constraint.	Simple	15–20
E2-7	Assumptions, principles, and constraint.	Moderate	20–25
E2-8	Full disclosure principle.	Complex	20–25
E2-9	Accounting principles and assumptions–comprehensive.	Moderate	20–25
E2-10	Accounting principles–comprehensive.	Moderate	20–25
CA2-1	Conceptual framework–general.	Simple	20–25
CA2-2	Conceptual framework–general.	Simple	25–35
CA2-3	Objective of financial reporting.	Moderate	25–35
CA2-4	Qualitative characteristics.	Moderate	30–35
CA2-5	Revenue recognition principle.	Complex	25–30
CA2-6	Expense recognition principle.	Complex	20–25
CA2-7	Expense recognition principle.	Moderate	20–25
CA2-8	Expense recognition principle.	Moderate	20–30
CA2-9	Qualitative characteristics.	Moderate	20–30
CA2-10	Expense recognition principle.	Moderate	20–25
CA2-11	Cost Constraint.	Moderate	30–35

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ANSWERS TO QUESTIONS

1. A conceptual framework is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements. A conceptual framework is necessary in financial accounting for the following reasons:
(1) It enables the FASB to issue more useful and consistent standards in the future.
(2) New issues will be more quickly solvable by reference to an existing framework of basic theory.
(3) It increases financial statement users' understanding of and confidence in financial reporting.
(4) It enhances comparability among companies' financial statements.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

2. The basic objective 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.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

3. "Qualitative characteristics of accounting information" are those characteristics which contribute to the quality or value of the information. The overriding qualitative characteristic of accounting information is usefulness for decision-making.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

4. Relevance and faithful representation are the two primary qualities of useful accounting information. For information to be relevant, it should be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations. Faithful representation of a measure rests on whether the numbers and descriptions match what really existed or happened.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

5. The concept of materiality refers to the relative significance of an amount, activity, or item to informative disclosure, proper presentation of financial position, and the results of operations. Materiality has qualitative and quantitative aspects; both the nature of the item and its relative size enter into its evaluation.

An accounting misstatement is said to be material if knowledge of the misstatement will affect the decisions of the average informed reader of the financial statements. Financial statements are misleading if they omit a material fact or include so many immaterial matters as to be confusing. In the examination, the auditor concentrates efforts in proportion to degrees of materiality and relative risk and disregards immaterial items.

The relevant criteria for assessing materiality will depend upon the circumstances and the nature of the item and will vary greatly among companies. For example, an error in current assets or current liabilities will be more important for a company with a flow of funds problem than for one with adequate working capital.

The effect upon net income (or earnings per share) is the most commonly used measure of materiality. This reflects the prime importance attached to net income by investors and other users of the statements. The effects upon assets and equities are also important as are misstatements of individual accounts and subtotals included in the financial statements. The FASB is proposing a definition of materiality in the Conceptual Framework, which will be aligned with that in the securities laws and which can used in disclosure decisions.

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There are no rigid standards or guidelines for assessing materiality. The lower bound of materiality has been variously estimated at 5% of net income, but the determination will vary based upon the individual case and might not fall within these limits. Certain items, such as a questionable loan to a company officer, may be considered material even when minor amounts are involved. In contrast a large misclassification among expense accounts may not be deemed material if there is no misstatement of net income.

LO: 3, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

7. In providing information to users of financial statements, the Board relies on general-purpose financial statements. The intent of such statements is to provide the most useful information possible at minimal cost to various user groups. Underlying these objectives is the notion 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 in the preparation of financial statements a level of reasonable competence can be assumed; this has an impact on the way and the extent to which information is reported.

LO: 2, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: AICPA FC: Reporting, AICPA PC: Communication

8. Comparability facilitates comparisons between information about two different enterprises at a particular point in time. Consistency, a type of comparability, facilitates comparisons between information about the same enterprise at two different points in time.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

9. At present, the accounting literature contains many terms that have peculiar and specific meanings. Some of these terms have been in use for a long period of time, and their meanings have changed over time. Since the elements of financial statements are the building blocks with which the statements are constructed, it is necessary to develop a basic definitional framework for them.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

10. Distributions to owners differ from expenses and losses in that they represent transfers to owners, and they do not arise from activities intended to produce income. Expenses differ from losses in that they arise from the entity's ongoing major or central operations. Losses arise from peripheral or incidental transactions.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

11. Investments by owners differ from revenues and gains in that they represent transfers by owners to the entity, and they do not arise from activities intended to produce income. Revenues differ from gains in that they arise from the entity's ongoing major or central operations. Gains arise from peripheral or incidental transactions.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

12. The four basic assumptions that underlie the financial accounting structure are:
(1) An economic entity assumption.
(2) A going concern assumption.
(3) A monetary unit assumption.
(4) A periodicity assumption.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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13. (a) In accounting it is generally agreed that any measures of the success of an enterprise for periods less than its total life are at best provisional in nature and subject to correction. Measurement of progress and status for arbitrary time periods is a practical necessity to serve those who must make decisions. It is not the result of postulating specific time periods as measurable segments of total life.

(b) The practice of periodic measurement has led to many of the most difficult accounting problems such as inventory pricing, depreciation of long-term assets, and the necessity for revenue recognition tests. The accrual system calls for associating related revenues and expenses. This becomes very difficult for an arbitrary time period with incomplete transactions in process at both the beginning and the end of the period. A number of accounting practices such as adjusting entries or the reporting of corrections of prior periods result directly from efforts to make each period's calculations as accurate as possible and yet recognizing that they are only provisional in nature.

LO: 5, Bloom: C, Difficulty: Simple, Time: 5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

14. The monetary unit assumption assumes that the unit of measure (the dollar) remains reasonably stable so that dollars of different years can be added without any adjustment. When the value of the dollar fluctuates greatly over time, the monetary unit assumption loses its validity.

The FASB in **Concept No. 5** indicated that it expects the dollar unadjusted for inflation or deflation to be used to measure items recognized in financial statements. Only if circumstances change dramatically will the Board consider a more stable measurement unit.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

15. Some of the arguments which might be used are outlined below:

(1) Cost is definite and verifiable; other values would have to be determined somewhat arbitrarily and there would be considerable disagreement as to the amounts to be used.
(2) Amounts determined by other bases would have to be revised frequently.
(3) Comparison with other companies is aided if cost is employed.
(4) The costs of obtaining replacement values could outweigh the benefits derived.

LO: 6, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

16. **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.

LO: 6, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: AICPA PC: None

17. The fair value option gives 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.) The Board believes that fair value measurement for financial instruments provides more relevant and understandable information than historical cost. It considers fair value to be more relevant 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, investments, and debt securities.

LO: 6, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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18. The fair value hierarchy provides insight into the priority of valuation techniques that are used to determine fair value. The fair value hierarchy is divided into three broad levels.

Fair Value Hierarchy

Level 1:	Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.	**Least Subjective**
Level 2:	Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable data.	
Level 3:	Unobservable inputs (for example, a company's own data or assumptions).	**Most Subjective**

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

LO: 6, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

19. The revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. In the case of services, revenue is recognized when the services are performed. In the case of selling a product, the performance obligation is met when the product is delivered. Companies follow a five-step process to analyze revenue arrangements to determine when revenue should be recognized: (1) Identify the contract(s) with the customer; (2) Identify the separate performance obligations in the contract; (3) Determine the transaction price; (4) Allocate the transaction price to separate performance obligations; and (5) Recognize revenue when each performance obligation is satisfied.

LO: 6, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

20. A performance obligation is a promise to deliver a product or provide a service to a customer. The revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. In the case of services, revenue is recognized when the services are performed. In the case of selling a product, the performance obligation is met when the product is delivered.

LO: 6, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

21. The five steps in the revenue recognition process are:

Step 1 **Identify the contract(s) with the customer.** A contract is an agreement between two parties that creates enforceable rights or obligations.

Step 2 **Identify the separate performance obligations in the contract.** A performance obligation is either a promise to provide a service or deliver a product, or both.

Step 3. **Determine the transaction price.** Transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service.

Step 4. **Allocate the transaction price to separate performance obligations.** This is usually done by estimating the value of consideration attributable to each product or service.

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Step 5. Recognize revenue when each performance obligation is satisfied. This occurs when the service is provided or the product is delivered.

Note that many revenue transactions pose few problems because the transaction is initiated and completed at the same time.

LO: 6, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

22. Revenues are recognized when a performance obligation is satisfied–in the case of services, revenue is recognized when the services are performed Therefore, revenue for Selane Eatery should be recognized at the time the luncheon is served.

LO: 6, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

23. The president means that the difference between the fair value and the book value, should be recorded in the books as a 'gain'. This item should not be entered in the accounts, however, because no performance obligation related to this machine has been created or satisfied, GAAP will allow the company to record a gain once the machine is sold and delivered to a buyer.

LO: 6, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

24. The cause and effect relationship can seldom be conclusively demonstrated, but many costs appear to be related to particular revenues and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and cost of products sold or services provided.

Systematic and rational allocation means that in the absence of a direct means of associating cause and effect, and where the asset provides benefits for several periods, its cost should be allocated to the periods in a systematic and rational manner. Examples of expenses that are recognized in a systematic and rational manner are depreciation of plant assets, amortization of intangible assets, and allocation of rent and insurance.

Some costs are immediately expensed because the costs have no discernible future benefits or the allocation among several accounting periods is not considered to serve any useful purpose. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts.

LO: 6, Bloom: AN, Difficulty: Simple, Time: 5-7, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

25. The four characteristics are:
(1) Definitions—The item meets the definition of an element of financial statements.
(2) Measurability—It has a relevant attribute measurable with sufficient reliability.
(3) Relevance—The information is capable of making a difference in user decisions.
(4) Reliability—The information is representationally faithful, verifiable, and neutral.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

26. (a) To be recognized in the main body of financial statements, an item must meet the definition of an element. In addition the item must have been measured, recorded in the books, and passed through the double-entry system of accounting.
(b) Information provided in the notes to the financial statements amplifies or explains the items presented in the main body of the statements and is essential to an understanding of the performance and position of the enterprise. Information in the notes does not have to be quantifiable, nor does it need to qualify as an element.
(c) Supplementary information includes information that presents a different perspective from that adopted in the financial statements. It also includes management's explanation of the financial information and a discussion of the significance of that information.

LO: 6, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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27. The general guide followed with regard to the full disclosure principle is to disclose in the financial statements any facts of sufficient importance to influence the judgment of an informed reader. The fact that the amount of outstanding common stock doubled in January of the subsequent reporting period probably should be disclosed because such a situation is of importance to present stockholders. Even though the event occurred after December 31, 2017, it should be disclosed on the balance sheet as of December 31, 2017, in order to make adequate disclosure. (The major point that should be emphasized throughout the entire discussion on full disclosure is that there is normally no "black" or "white" but varying shades of grey and it takes experience and good judgment to arrive at an appropriate answer).

LO: 6, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

28. Accounting information is subject to the cost constraint. Information is not worth providing unless the benefits exceed the costs of preparing it.

LO: 6, 7, Bloom: K, Difficulty: Simple, Time: 3-5, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

29. The costs of providing accounting information include 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. Occasionally new accounting standards require presentation of information that is not readily assembled by the accounting systems of most companies. A determination should be made as to whether the incremental or additional costs of providing the proposed information exceed the incremental benefits to be obtained. This determination requires careful judgment since the benefits of the proposed information may not be readily apparent.

LO: 7, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

30. In general, conservatism should not be the basis for determining the accounting for transactions, because it is in conflict with the conceptual framework quality of neutrality.

(a) Acceptable if reasonably accurate estimation is possible. To the extent that warranty costs can be estimated accurately, they should be recorded when an obligation exists, usually in the period of the sale.

(b) Not acceptable. Most accounts are collectible or the company will be out of business very soon. Hence sales can be recorded when made. Also, other companies record sales when made rather than when collected, so if accounts for Landowska Co. are to be compared with other companies, they must be kept on a comparable basis. However, estimates for uncollectible accounts should be recorded if there is a reasonably accurate basis for estimating bad debts.

(c) Not acceptable. A provision for the possible loss can be made through an appropriation of retained earnings but until judgment has been rendered on the suit or it is otherwise settled, entry of the loss usually represents anticipation. Recording it earlier is probably an unwise legal strategy as well. For the loss to be recognized at this point, the loss would have to be probable and reasonably estimable. (See FASB ASC 450-10-05 for additional discussion if desired.) Note disclosure is required if the loss is not recorded; however, conservatism is not part of the conceptual framework.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

(a) 5. Comparability
(b) 8. Timeliness
(c) 3. Predictive value
(d) 1. Relevance
(e) 7. Neutrality

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 2-2

(a) 5. Faithful representation
(b) 8. Confirmatory value
(c) 3. Free from error
(d) 2. Completeness
(e) 4. Understandability

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, None, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 2-3

(a) If the company changed its method for inventory valuation, the consistency, and therefore the comparability, of the financial statements have been affected by a change in the method of applying the accounting principles employed. The change would require comment in the auditor's report in an explanatory paragraph.

(b) If the company disposed of one of its two subsidiaries that had been included in its consolidated statements for prior years, no comment as to consistency needs to be made in the CPA's audit report. The comparability of the financial statements has been affected by a business transaction, but there has been no change in any accounting principle employed or in the method of its application. (The transaction would probably require informative disclosure in the financial statements).

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BRIEF EXERCISE 2-3 (continued)

(c) If the company reduced the estimated remaining useful life of plant property because of obsolescence, the comparability of the financial statements has been affected. The change is not a matter of consistency; it is a change in accounting estimate required by altered conditions and involves no change in accounting principles employed or in their method of application. The change would probably be disclosed by a note in the financial statements. If commented upon in the CPA's report, it would be as a matter of disclosure rather than consistency.

LO: 3, Bloom: AN, Moderate, Time: 10-15, None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 2-4

(a) Verifiability
(b) Comparability
(c) Comparability (consistency)
(d) Timeliness

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-7, None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 2-5

Companies and their auditors for the most part have adopted the general rule of thumb that anything under 5% of net income is considered not material. Recently, the SEC has indicated that it is okay to use this percentage for the initial assessment of materiality, but other factors must be considered. For example, companies can no longer fail to record items in order to meet consensus analyst's 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, both quantitative and qualitative factors must be considered in determining when an item is material.

(a) Because the change was used to create a positive trend in earnings, the change is considered material.

(b) Each item must be considered separately and not netted. Therefore each transaction is considered material.

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BRIEF EXERCISE 2-5 (continued)

(c) In general, companies that follow an "expense all capital items below a certain amount" policy are not in violation of the materiality concept. Because the same practice has been followed from year to year, Damon's actions are acceptable.

LO: 3, Bloom: K, Moderate, Time: 10-15, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 2-6

(a) Equity
(b) Revenues
(c) Equity
(d) Assets
(e) Expenses
(f) Losses
(g) Liabilities
(h) Distributions to owners
(i) Gains
(j) Investments by owners

LO: 4, Bloom: K, Difficulty: Simple, Time: 7-10, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 2-7

(a) Should be debited to the Land account, as it is a cost incurred in acquiring land.

(b) As an asset, preferably to a Land Improvements account. The driveway will last for many years, and therefore it should be capitalized and depreciated.

(c) Probably an asset, as it will last for a number of years and therefore will contribute to operations of those years.

(d) If the fiscal year ends December 31, this will all be an expense of the current year that can be charged to an expense account. If statements are to be prepared on some date before December 31, part of this cost would be expense and part asset. Depending upon the circumstances, the original entry as well as the adjusting entry for statement purposes should take the statement date into account.

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BRIEF EXERCISE 2-7 (continued)

(e) Should be debited to the Building account, as it is a part of the cost of that plant asset which will contribute to operations for many years.

(f) As an expense, as the service has already been received; the contribution to operations occurred in this period.

LO: 4, Bloom: AN, Difficulty: Simple, Time: 10-15, Analytic, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 2-8

(a) Periodicity
(b) Monetary unit
(c) Going concern
(d) Economic entity

LO: 5, Bloom: K, Moderate, Time: 5-10, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

BRIEF EXERCISE 2-9

(a) Net realizable value.

(b) Would not be disclosed. Liabilities would be disclosed in the order to be paid.

(c) Would not be disclosed. Depreciation would be inappropriate if the going concern assumption no longer applies.

(d) Net realizable value.

(e) Net realizable value (i.e., redeemable value).

LO: 5, Bloom: K, Moderate, Time: 10-15, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 2-10

(a) Revenue recognition
(b) Expense recognition
(c) Full disclosure
(d) Measurement (historical cost)

LO: 6, Bloom: K, Moderate, 10-15, AACSB: Communication, AICPA BB: None, AICPA FC: AICPA FC: Measurement, Reporting, AICPA PC: None

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BRIEF EXERCISE 2-11

Investment 1—Level 3
Investment 2—Level 1
Investment 3—Level 2

LO: 6, Bloom: AN, Moderate, 5-10, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 2-12

(a) Full disclosure
(b) Expense recognition
(c) Historical cost

LO: 5, 6, Bloom: C, Moderate, Time: 5-10, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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SOLUTIONS TO EXERCISES

EXERCISE 2-1 (15–20 minutes)

(a) True.
(b) False – General-purpose financial reports help 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 in financial reports.
(c) False – Standard-setting that is based on personal conceptual frameworks will lead to different conclusions about identical or similar issues. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones.
(d) False – Information that is decision-useful to capital providers may also be useful to users of financial reporting who are not capital providers.
(e) False – An implicit assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information contained in the financial statements.
(f) True.

LO: 1, 2, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 2-2 (15–20 minutes)

(a) False – The fundamental qualitative characteristics that make accounting information useful are relevance and faithful representation.
(b) False – Relevant information must also be material.
(c) False – Information that is relevant is characterized as having predictive or confirmatory value.
(d) False – Comparability also refers to comparisons of a firm over time (consistency).
(e) False – Enhancing characteristics relate to both relevance and faithful representation.
(f) True.

LO: 1, 2, 3, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

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EXERCISE 2-3 (20–30 minutes)

(a) Confirmatory Value.
(b) Cost.
(c) Neutrality.
(d) Comparability (Consistency.)
(e) Neutrality.
(f) Relevance and Faithful representation.
(g) Timeliness.
(h) Relevance.
(i) Comparability.
(j) Verifiability.

LO: 3, 7, Bloom: C, Moderate, Time: 25-30, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

EXERCISE 2-4 (15–20 minutes)

(a) Comparability.
(b) Confirmatory Value.
(c) Comparability (Consistency.)
(d) Neutrality.
(e) Verifiability.
(f) Relevance.
(g) Comparability, Verifiability, Timeliness, and Understandability.
(h) Materiality.
(i) Faithful representation.
(j) Relevance and Faithful representation.
(k) Timeliness

LO: 3, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None Bloom:

EXERCISE 2-5 (15–20 minutes)

(a) Gains, losses.
(b) Liabilities.
(c) Investments by owners, comprehensive income. (also possible would be revenues and gains).
(d) Distributions to owners. (Note to instructor: net effect is to reduce equity and assets).
(e) Comprehensive income (also possible would be revenues and gains).
(f) Assets.
(g) Comprehensive income.
(h) Revenues, expenses.
(i) Equity.
(j) Revenues.
(k) Distributions to owners.
(l) Comprehensive income.

LO: 4, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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EXERCISE 2-6 (15–20 minutes)

(a) 7. Expense recognition principle.
(b) 5. Measurement (historical cost principle.)
(c) 8. Full disclosure principle.
(d) 2. Going concern assumption.
(e) 1. Economic entity assumption.
(f) 4. Periodicity assumption.
(g) 3. Monetary unit assumption.

LO: 5, 6, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 2-7 (20–25 minutes)

(a) Measurement (historical cost) principle.
(b) Full disclosure principle.
(c) Expense recognition principle.
(d) Measurement (fair value) principle.
(e) Economic entity assumption.
(f) Full disclosure principle.
(g) Revenue recognition principle.
(h) Full disclosure principle.
(i) Expense recognition and revenue recognition principles.
(j) Economic entity assumption.
(k) Periodicity assumption.
(l) Measurement (fair value) principle.
(m) Measurement (historical cost) principle.
(n) Expense recognition principle.

LO: 5, 6, Bloom: C, Moderate, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 2-8 (20–25 minutes)

(a) It is well established in accounting that revenues, expenses, and cost of goods sold must be disclosed in an income statement. It might be noted to students that such was not always the case. At one time, only net income was reported but over time we have evolved to the present reporting format.

(b) The proper accounting for this situation is to report the equipment as an asset and the notes payable as a liability on the balance sheet. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off liabilities.

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EXERCISE 2-8 (Continued)

(c) According to GAAP, the basis upon which inventory amounts are stated (lower of cost or market) and the method used in determining cost (LIFO, FIFO, average cost, etc.) should also be reported. The disclosure requirement related to the method used in determining cost should be emphasized, indicating that where possible alternatives exist in financial reporting, disclosure in some format is required.

(d) Consistency requires that disclosure of changes in accounting principles be made in the financial statements. To do otherwise would result in financial statements that are misleading. Financial statements are more useful if they can be compared with similar reports for prior years.

LO: 6, Bloom: C, Complex, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 2-9

(a) This entry violates the economic entity assumption. This assumption in accounting indicates that economic activity can be identified with a particular unit of accountability. In this situation, the company erred by charging this cost to the wrong economic entity.

(b) The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time in attempting to establish a sales value for a given item without selling it. It should further be noted that the revenue recognition principle provides the answer to when revenue should be recognized. Revenue should be recognized when a performance obligation is satisfied. In this case, the obligation is not satisfied until goods are delivered to a customer.

(c) The expense recognition principle indicates that expenses should be allocated to the appropriate periods involved. In this case, there appears to be a high uncertainty that the company will have to pay. FASB concepts Statement No. 5 requires that a loss should be accrued only (1) when it is probable that the company would lose the suit and (2) the amount of the loss can be reasonably estimated. (Note to instructor: The student will probably be unfamiliar with FASB Statement No. 5. The purpose of this question is to develop some decision framework when the probability of a future event must be assumed.)

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EXERCISE 2-9 (Continued)

(d) At the present time, accountants do not recognize price-level adjustments in the accounts. Hence, it is misleading to deviate from the measurement principle (historical cost) principle because conjecture or opinion can take place. It should also be noted that 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 market value, but are depreciated on the basis of systematic charges of expired costs against revenues. (Note to instructor: It might be called to the students' attention that the FASB does encourage supplemental disclosure of price-level information.)

(e) Most accounting methods are based on the assumption that the business enterprise will have a long life. Acceptance of this assumption provides credibility to the measurement principle (historical cost) principle, which would be of limited usefulness if liquidation were assumed. Only if we assume some permanence to the enterprise is the use of depreciation and amortization policies justifiable and appropriate. Therefore, it is incorrect to assume liquidation as Gonzales, Inc. has done in this situation. It should be noted that only where liquidation appears imminent is the going concern assumption inapplicable.

(f) The answer to this situation is the same as (b).

LO: 6, Bloom: AN, Moderate, Time: 20-25, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 2-10 (20–25 minutes)

(a) Depreciation is an allocation of cost, not an attempt to value assets. As a consequence, even if the value of the building is increasing, costs related to this building should be matched with revenues on the income statement, not as a charge against retained earnings.

(b) A gain should not be recognized until the inventory is sold. Accountants follow the measurement principle (historical cost) approach and write-ups of assets are not permitted. It should also be noted that the revenue recognition principle states that revenue should not be recognized until a performance obligation is satisfied. In this case, when the goods are delivered to the customer.

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EXERCISE 2-10 (Continued)

(c) Assets should be recorded at the fair value of what is given up or the fair market value of what is received, whichever is more clearly evident. It should be emphasized that it is not a violation of the measurement principle (historical cost) principle to use the fair value of the stock. Recording the asset at the par value of the stock has no conceptual validity. Par value is merely an arbitrary amount usually set at the date of incorporation.

(d) The gain should be recognized when the equipment is delivered to the customer. Deferral of the gain should not be permitted, because the company has satisfied the performance obligation.

(e) It appears from the information that the sale should be recorded in 2018 instead of 2017. Revenue should be recognized when a performance obligation is met. In this case, the performance obligation is met when the order is delivered to the buyer. Accounts receivable and Sales revenue should be recorded in 2018. It should be noted that if the company is employing a perpetual inventory system in dollars and quantities, a debit to Cost of Goods Sold and a credit to Inventory is also necessary in 2018.

LO: 6, Bloom: AN, Moderate, Time: 20-25, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 2-1 (Time 20–25 minutes)
Purpose—to provide the student with the opportunity to comment on the purpose of the conceptual framework. In addition, a discussion of the Concepts Statements issued by the FASB is required.

CA 2-2 (Time 25–35 minutes)
Purpose—to provide the student with the opportunity to identify and discuss the benefits of the conceptual framework. In addition, the most important quality of information must be discussed, as well as other key characteristics of accounting information.

CA 2-3 (Time 25–35 minutes)
Purpose—to provide the student with some familiarity with the **Conceptual Framework**. The student is asked to indicate the broad objective of accounting, and to discuss how this statement might help to establish accounting standards.

CA 2-4 (Time 30–35 minutes)
Purpose—to provide the student with some familiarity with the **Conceptual Framework**. The student is asked to describe various characteristics of useful accounting information and to identify possible trade-offs among these characteristics.

CA 2-5 (Time 25–30 minutes)
Purpose—to provide the student with the opportunity to indicate and discuss different points at which revenues can be recognized. The student is asked to discuss the "crucial event" that triggers revenue recognition.

CA 2-6 (Time 20–25 minutes)
Purpose—to provide the student with an opportunity to assess different points to report costs as expenses. Direct cause and effect, indirect cause and effect, and rational and systematic approaches are developed.

CA 2-7 (Time 20–25 minutes)
Purpose—to provide the student with familiarity with the expense recognition principle in accounting. Specific items are then presented to indicate how these items might be reported using the expense recognition principle.

CA 2-8 (Time 20–30 minutes)
Purpose—to provide the student with a realistic case involving association of costs with revenues. The advantages of expensing costs as incurred versus spreading costs are examined. Specific guidance is asked on how allocation over time should be reported.

CA 2-9 (Time 20–30 minutes)
Purpose—to provide the student with the opportunity to discuss the relevance and faithful representation of financial statement information. The student must write a letter on this matter so the case does provide a good writing exercise for the students.

CA 2-10 (Time 20–25 minutes)
Purpose—to provide the student with the opportunity to discuss the ethical issues related to expense recognition.

CA 2-11 (Time 30–35 minutes)
Purpose—to provide the student with the opportunity to discuss the cost constraint.

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SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 2-1

(a) A conceptual framework is a coherent system of concepts that flow from an objective. Some compare it to a constitution. Its objective is to provide a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.

A conceptual framework is necessary so that standard setting is useful, i.e., standard setting should build on and relate to an established body of concepts and objectives. A well-developed conceptual framework should enable the FASB to issue more useful and consistent standards in the future.

Specific benefits that may arise are:
(1) A coherent set of standards and rules should result.
(2) New and emerging practical problems should be more quickly soluble by reference to an existing framework.
(3) It should increase financial statement users' understanding of and confidence in financial reporting.
(4) It should enhance comparability among companies' financial statements.
(5) It should provide guidance on identifying the boundaries of judgment in preparing financial statements.
(6) It should provide guidance to the body responsible for establishing accounting standards.

(b) The FASB has issued eight Statements of Financial Accounting Concepts (SFAC) that relate to business enterprises. Their titles and brief description of the focus of each Statement are as follows:
(1) **SFAC No. 1,** "Objectives of Financial Reporting by Business Enterprises," presents the goals and purposes of accounting.
(2) **SFAC No. 2,** "Qualitative Characteristics of Accounting Information," examines the characteristics that make accounting information useful.
(3) **SFAC No. 3,** "Elements of Financial Statements of Business Enterprises," provides definitions of the broad classifications of items in financial statements.
(4) **SFAC No. 5,** "Recognition and Measurement in Financial Statements," 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,** "Elements of Financial Statements of Business Enterprises," 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.*

LO: 1, Bloom: K, Difficulty: Simple, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

CA 2-2

(a) FASB's Conceptual Framework should provide benefits to the accounting community such as:
(1) guiding the FASB in establishing more useful and consistent pronouncements.
(2) helping the profession to solve new and emerging practical problems.
(3) increasing users' understanding of and confidence in financial reporting.

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CA 2-2 (Continued)

(b) The most important quality for accounting information is usefulness for decision-making. Relevance and faithful representation are the primary qualities leading to this decision usefulness. Usefulness is the most important quality because, without usefulness, there would be no benefits from information to set against its costs.

(c) There are a number of key characteristics or qualities that make accounting information desirable**.** The importance of three of these characteristics or qualities is discussed below.
   (1) Understandability—information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it, or who misuse it.
   (2) Relevance—the accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations (including materiality).
   (3) Faithful representation—the faithful representation of a measure rests on whether the numbers and descriptions matched what really existed or happened, including completeness, neutrality, and free from error.

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

LO: 1, Bloom: K, Difficulty: Simple, Time: 25-35, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 2-3

(a) The basic objective 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.

(b) The purpose of this statement is to set forth fundamentals on which financial accounting and reporting standards may be based. Without some basic set of objectives that everyone can agree on inconsistent standards will be developed. For example, some believe that accountability should be the primary objective of financial reporting. Others argue that prediction of future cash flows is more important. It follows that individuals who believe that accountability is the primary objective may arrive at different financial reporting standards than others who argue for prediction of cash flow. Only by establishing some consistent starting point can accounting ever achieve some underlying consistency in establishing accounting principles.

It should be emphasized to the students that the Board itself is likely to be the major user and thus the most direct beneficiary of the guidance provided by this pronouncement. However, knowledge of the objectives and concepts the Board uses should enable all who are affected by or interested in financial accounting standards to better understand the content and limitations of information provided by financial accounting and reporting, thereby furthering their ability to use that information effectively and enhancing confidence in financial accounting and reporting. That knowledge, if used with care, may also provide guidance in resolving new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.

LO: 2, Bloom: C, Difficulty: Simple, Time: 25-35, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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CA 2-4

(a) (1) Relevance is one of the two primary decision-specific characteristics of useful accounting information. Relevant information is capable of making a difference in a decision. Relevant information helps users to make predictions about the outcomes of past, present, and future events, or to confirm or correct prior expectations. ***Only material information is considered to be relevant and therefore must be disclosed. If information would not make a difference to a decision-maker, then it need not be disclosed***. Information must also be timely in order to be considered relevant.

(2) Faithful representation is one of the two primary decision-specific characteristics of useful accounting information. ***Faithful representation means that numbers and descriptions match what really existed or happened. Reliable***. Representational faithfulness is correspondence or agreement between accounting information and the economic phenomena it is intended to represent stemming from completeness, neutrality, and free from error.

(3) Understandability is a user-specific characteristic of information. Information is understandable when it permits reasonably informed users to perceive its significance. Understandability is a link between users, who vary widely in their capacity to comprehend or utilize the information, and the decision-specific qualities of information.

(4) Comparability means that information about enterprises has been prepared and presented in a similar manner. Comparability enhances comparisons between information about two different enterprises at a particular point in time.

(5) Consistency means that unchanging policies and procedures have been used by an enterprise from one period to another. Consistency enhances comparisons between information about the same enterprise at two different points in time.

(b) (**Note to instructor:** There are a multitude of answers possible here. The suggestions below are intended to serve as examples).

(1) Forecasts of future operating results and projections of future cash flows may be highly relevant to some decision makers. However, they would not be as free from error as historical cost information about past transactions.

(2) Proposed new accounting methods may be more relevant to many decision makers than existing methods. However, if adopted, they would impair consistency and make trend comparisons of an enterprise's results over time difficult or impossible.

(3) There presently exists much diversity among acceptable accounting methods and procedures. In order to facilitate comparability between enterprises, the use of only one accepted accounting method for a particular type of transaction could be required. However, consistency would be impaired for those firms changing to the new required methods.

(4) Occasionally, relevant information is exceedingly complex. Judgment is required in determining the optimum trade-off between relevance and understandability. Information about the impact of general and specific price changes may be highly relevant but not understandable by all users.

(c) Although trade-offs result in the sacrifice of some desirable quality of information, the overall result should be information that is more useful for decision-making.

LO: 3, Bloom: C, Moderate, Time: 30-35, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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CA 2-5

(a) Recognition when cash is received is not appropriate, unless the magazines are delivered to the customer at the same time. That is, the revenue recognition principle indicates that companies recognize revenue when each performance obligation is satisfied. This occurs when tthe product is delivered – in this case, the magazines.

(b) Recognition when the magazines are published each month in not appropriate. That is, the revenue recognition principle indicates that companies recognize revenue when each performance obligation is satisfied. This occurs when the product is delivered – publication of the magazines is a necessary step in the process, but until the magazines are delivered the performance obligation has not been satisfied.

(c) Recognition over time, as the magazines are delivered to customers, is appropriate. That is, the revenue recognition principle indicates that companies recognize revenue when each performance obligation is satisfied. This occurs when the product is delivered, which is the case when the magazines are delivered to customers each month. When the customers pays for the annual subscription, the company has a performance obligation (a liability – Unearned Revenue) that is satisfied over time as magazines are published and delivered to customers.

(**Note to instructor:** CA 2-5 might also be assigned in conjunction with Chapter 18.)

LO: 6, Bloom: AP, Complex, Time: 25-30, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 2-6

(a) Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. This presumed direct association has been identified both as “associating cause and effect” and as “matching (expense recognition principle).”

Direct cause-and-effect relationships can seldom be conclusively demonstrated, but many costs appear to be related to particular revenue, and recognizing them as expenses accompanies recognition of the revenue. Generally, the expense recognition principle requires that the revenue recognized and the expenses incurred to produce the revenue be given concurrent period recognition in the accounting records. Only if effort is properly related to accomplishment will the results, called earnings, have useful significance concerning the efficient utilization of business resources. Thus, applying the expense recognition principle is recognition of the cause-and-effect relationship that exists between expense and revenue.

Examples of expenses that are usually recognized by associating cause and effect are sales commissions, freight-out on merchandise sold, and cost of goods sold or services provided.

(b) Some costs are assigned as expenses to the current accounting period because
(1) their incurrence during the period provides no discernible future benefits;
(2) they are measures of assets recorded in previous periods from which no future benefits are expected or can be discerned;
(3) they must be incurred each accounting year, and no build-up of expected future benefits occurs;
(4) by their nature they relate to current revenues even though they cannot be directly associated with any specific revenues;
(5) the amount of cost to be deferred can be measured only in an arbitrary manner or great uncertainty exists regarding the realization of future benefits, or both;
(6) and uncertainty exists regarding whether allocating them to current and future periods will serve any useful purpose.

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CA 2-6 (Continued)

Thus, many costs are called "period costs" and are treated as expenses in the period incurred because they have neither a direct relationship with revenue earned nor can their occurrence be directly shown to give rise to an asset. The application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or accrued for payment. Examples of costs treated as period expenses would include officers' salaries, advertising, research and development, and auditors' fees.

(c) A cost should be capitalized, that is, treated as a measure of an asset when it is expected that the asset will produce benefits in future periods. The important concept here is that the incurrence of the cost has resulted in the acquisition of an asset, a future service potential. If a cost is incurred that resulted in the acquisition of an asset from which benefits are not expected beyond the current period, the cost may be expensed as a measure of the service potential that expired in producing the current period's revenues. Not only should the incurrence of the cost result in the acquisition of an asset from which future benefits are expected, but also the cost should be measurable with a reasonable degree of objectivity, and there should be reasonable grounds for associating it with the asset acquired. Examples of costs that should be treated as measures of assets are the costs of merchandise on hand at the end of an accounting period, costs of insurance coverage relating to future periods, and the cost of self-constructed plant or equipment.

(d) In the absence of a direct basis for associating asset cost with revenue and if the asset provides benefits for two or more accounting periods, its cost should be allocated to these periods (as an expense) in a systematic and rational manner. Thus, when it is impractical, or impossible, to find a close cause-and-effect relationship between revenue and cost, this relationship is often assumed to exist. Therefore, the asset cost is allocated to the accounting periods by some method. The allocation method used should appear reasonable to an unbiased observer and should be followed consistently from period to period. Examples of systematic and rational allocation of asset cost would include depreciation of fixed assets, amortization of intangibles, and allocation of rent and insurance.

(e) A cost should be treated as a loss when no revenue results. The matching of losses to specific revenue should not be attempted because, by definition, they are expired service potentials not related to revenue produced. That is, losses result from events that are not anticipated as necessary in the process of producing revenue.

LO: 6, Bloom: AN, Complex, Time: 20-25, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 2-7

(a) Costs should be recognized as expiring in a given period if they are not chargeable to a prior period and are not applicable to future periods. Recognition in the current period is required when any of the following conditions or criteria are present:
   (1) A direct association of charges with revenue of the period, such as goods shipped to customers.
   (2) An indirect association with the revenue of the period, such as fire insurance or rent.
   (3) A period charge where no association with revenue in the future can be made so the expense is charged this period, such as officers' salaries.
   (4) A measurable expiration of asset costs during the period, even though not associated with the production of revenue for the current period, such as a fire or casualty loss.

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CA 2-7 (Continued)

(b) (1) Although it is generally agreed that inventory costs should include all costs attributable to placing the goods in a salable state, receiving and handling costs are often treated as cost expirations in the period incurred because they are irregular or are not in uniform proportion to sales.

The portion of the receiving and handling costs attributable to the unsold goods processed during the period should be inventoried. These costs might be more readily apportioned if they are assigned by some device such as an applied rate. Abnormally high receiving and handling costs should be charged off as a period cost.

(2) Cash discounts on purchases are treated as "other revenues" in some financial statements in violation of the revenue and expense recognition principles. Revenue is not recognized when goods are purchased or cash disbursed. Furthermore, inventories valued at gross invoice price are recorded at an amount greater than their cash outlay resulting in misstatement of inventory cost in the current period and inventory cost expirations in future periods.

Close adherence to the expense recognition principle (or matching) requires that cash discounts be recorded as a reduction of the cost of purchases and that inventories be priced at net invoice prices. Where inventories are priced at gross invoice prices for expediency, however, there is a slight distortion of the financial statements if the beginning and ending inventories vary little in amount.

LO: 6, Bloom: AP, Moderate, Time: 20-25, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 2-8

(a) The preferable treatment of the costs of the sample display houses is expensing them over more than one period. These sample display houses are assets because they represent rights to future service potentials or economic benefits.

(1) The alternative of expensing the costs of sample display houses in the period in which the expenditure is made is based primarily upon the expense recognition principle. These costs are of a promotional nature. Promotional costs often are considered expenses of the period in which the expenditures occur due to the uncertainty in determining the time periods benefited (do they meet the definition of an asset?). It is likely that no decision is made concerning the life of a sample display house at the time it is erected. Past experience may provide some guidance in determining the probable life. A decision to tear down or alter a house probably is made when sales begin to lag or when a new model with greater potential becomes available.

There is uncertainty not only as to the life of a sample display house but also as to whether a sample display house will be torn down or altered. If it is altered rather than torn down, a portion of the cost of the original house may be attributable to the new model.

(2) According to the expense recognition principle, the costs of service potentials should be amortized as the benefits are received. Thus, costs of the sample display houses should be matched with the revenue from the sale of the houses which is receivable over a period of more than one year. As the sample houses are left on display for three to seven years, Daniel Barenboim apparently expects to benefit from the displays for at least that length of time.

(b) There is uncertainty regarding the number of homes of a particular model which will be sold as a result of the display sample. The success of this amortization method is dependent upon accurate estimates of the number and selling price of shell houses to be sold. The estimate of the number of units of a particular model which will be sold as a result of a display model should include not only units sold while the model is on display but also units sold after the display house is torn down or altered.

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CA 2-8 (Continued)

(1) Cost amortization solely on the basis of time may be preferable when the life of the models can be estimated with a great deal more accuracy than can the number of units which will be sold. If unit sales and selling prices are uniform over the life of the sample, a satisfactory matching of costs and revenues may be achieved if the straight-line amortization procedure is used.

(2) If all of the shell houses are to be sold at the same price, it may be appropriate to allocate the costs of the display houses on the basis of the number of shell houses sold. This allocation would be similar to the units-of-production method of depreciation and would result in a good matching of costs with revenues. On the other hand, if the shell houses are to be sold at different prices, it may be preferable to allocate costs on the basis of the revenue contribution of the shell houses sold.

LO: 6, Bloom: AP, Moderate, Time: 20-30, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 2-9

Date

Dear Uncle Carlos,

I received the information on Neville Corp. and appreciate your interest in sharing this venture with me. However, I think that basing an investment decision on these financial statements would be unwise because they are neither relevant nor representationally faithful.

One of the most important characteristics of accounting information is that it is relevant, i.e., it will make a difference in my decision. To be relevant, this information must be timely. Because Neville's financial statements are a year old, they have lost their ability to influence my decision: a lot could have changed in that one year.

Another element of relevance is predictive value. Once again, Neville's accounting information proves irrelevant. Shown without reference to other years' profitability, it cannot help me predict future profitability because I cannot see any trends developing. Closely related to predictive value is confirmatory value. These financial statements do not provide feedback on any strategies which the company may have used to increase profits.

These financial statements are also not representationally faithful. In order to be representationally faithful, their assertions must be verifiable by several independent parties. Because no independent auditor has verified these amounts, there is no way of knowing whether or not they are represented faithfully. For instance, I would like to believe that this company earned $2,424,240, and that it had a very favorable debt-to-equity ratio. However, unaudited financial statements do not give me any reasonable assurance about these claims.

Finally, the fact that Mrs. Neville herself prepared these statements indicates a lack of neutrality. Because she is not a disinterested third party, I cannot be sure that she did not prepare the financial statements in favor of her husband's business.

I do appreciate the trouble you went through to get me this information. Under the circumstances, however, I do not wish to invest in the Neville bonds and would caution you against doing so. Before you make a decision in this matter, please call me.

Sincerely,

Your Nephew/Niece

LO: 3, Bloom: c, Moderate, Time: 20-30, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

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CA 2-10

(a) The stakeholders are investors, creditors, etc.; i.e., users of financial statements, current and future.

(b) Honesty and integrity of financial reporting, job protection, profit.

(c) Applying the expense recognition principle and recording expense during the plant's life, or not applying it. That is, record the mothball costs in the future.

(d) The major question may be whether or not the expense of mothballing can be estimated properly so that the integrity of financial reporting is maintained. Applying the expense recognition principle will result in lower profits and possibly higher rates for consumers. Could this cost anyone his or her job? Will investors and creditors have more useful information? On the other hand, failure to apply the expense recognition principle means higher profits, lower rates, and greater potential job security.

(e) Students' recommendations will vary.

Note: Other stakeholders possibly affected are present and future consumers of electric power. Delay in allocating the expense will benefit today's consumers of electric power at the expense of future consumers.

LO: 6, Bloom: E V, Moderate, Time: 20-25, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

CA 2-11

1. Information about competitors might be useful for benchmarking the company's results but if management does not have expertise in providing the information, it could be highly subjective. In addition, it is likely very costly for management to gather sufficiently verifiable information of this nature.

2. While users of financial statements might benefit from receiving internal information, such as company plans and budgets, competitors might also be able to use this information to gain a competitive advantage relative to the disclosing company.

3. In order to produce forecasted financial statements, management would have to make numerous assumptions and estimates, which would be costly in terms of time and data collection. Because of the subjectivity involved, the forecasted statements would not be faithful representations, thereby detracting from any potential benefits. In addition, while management's forecasts of future profitability or balance sheet amounts could be of benefit, companies could be subject to shareholder lawsuits, if the amounts in the forecasted statements are not realized.

4. It would be excessively costly for companies to gather and report information that is not used in managing the business.

5. Flexible reporting allows companies to "fine-tune" their financial reporting to meet the information needs of its varied users. In this way, they can avoid the cost of providing information that is not demanded by its users.

6. Similar to number 3, concerning forecasted financial statements, if managers report forward-looking information, the company could be exposed to liability if investors unduly rely on the information in making investment decisions. Thus, if companies get protection from unwarranted lawsuits (called a safe harbor), then they might be willing to provide potentially beneficial forward-looking information.

LO: 7, Bloom: AP, Moderate, Time: 30-35, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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FINANCIAL REPORTING PROBLEM

From note 1:

(a) Sales are recognized when revenue is realized or realizable and has been earned. Revenue transactions represent sales of inventory. The revenue recorded is presented net of sales and other taxes we collect on behalf of governmental authorities. The revenue includes shipping and handling costs, which generally are included in the list price to the customer. Our policy is to recognize revenue when title to the product, ownership and risk of loss transfer to the customer, which can be on the date of shipment or the date of receipt by the customer. A provision for payment discounts and product return allowances is recorded as a reduction of sales in the same period the revenue is recognized.

Trade promotions, consisting primarily of customer pricing allowances, merchandising funds and consumer coupons, are offered through various programs to customers and consumers. Sales are recorded net of trade promotion spending, which is recognized as incurred, generally at the time of the sale. Most of these arrangements have terms of approximately one year. Accruals for expected payouts under these programs are included as accrued marketing and promotion in the Accrued and other liabilities line item in the Consolidated Balance Sheets.

(b) Historical Cost

Buildings, Machinery and equipment.

Fair Value (Notes)

Investments (U.S. government securities, corporate bond securities, other investments), derivatives (relating to foreign currency hedges, other foreign currency instruments, interest rates, net investment hedges)

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(c) Principles prepared on a consistent basis

New Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." This guidance outlines a single, comprehensive model for accounting for revenue from contracts with customers. We will adopt the standard on July 1, 2017. We are evaluating the impact, if any, that the standard will have on our financial statements. No other new accounting pronouncement issued or effective during the fiscal year had or is expected to have a material impact on the Consolidated Financial Statements.

(d) Accounting Policy Related to Advertising

Selling, general and administrative expense (SG&A)

Advertising costs, charged to expense as incurred, include worldwide television, print, radio, internet and in-store advertising expenses and were $9.2 billion in 2014, $9.6 billion in 2013 and $9.2 billion in 2012. Non-advertising related components of the Company's total marketing spending include costs associated with consumer promotions, product sampling and sales aids, which are included in SG&A, as well as coupons and customer trade funds, which are recorded as reductions to net sales.

LO: 6, Bloom: AN, Moderate, Time: 30-35, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, Research, AICPA PC: Communication

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COMPARATIVE ANALYSIS CASE

(a) ***Coke***

Primary Lines of Business

Description of Business (Note 1)

The Coca-Cola Company is the world's largest beverage company. We own or license and market more than 500 nonalcoholic beverage brands, primarily sparkling beverages but also a variety of still beverages such as waters, enhanced waters, juices and juice drinks, ready-to-drink teas and coffees, and energy and sports drinks. We own and market four of the world's top five nonalcoholic sparkling beverage brands: Coca-Cola, Diet Coke, Fanta and Sprite. Finished beverage products bearing our trademarks, sold in the United States since 1886, are now sold in more than 200 countries.

Segment Products and Services (Note 19)

The business of our Company is nonalcoholic beverages. With the exception of North America, our geographic operating segments (Eurasia and Africa; Europe; Latin America; North America; and Asia Pacific) derive a majority of their revenues from the manufacture and sale of beverage concentrates and syrups and, in some cases, the sale of finished beverages. The North America operating segment derives the majority of its revenues from the sale of finished beverages. Our Bottling Investments operating segment is composed of our Company-owned or consolidated bolttling operations outside of North America, regardless of the geographic location of the bottler, and equity income from the majority of our equity method investments. Company-owned or consolidated bottling operations derive the majority of their revenues from the sale of finished beverages. Generally, bottling and finished product operations produce higher net revenues but lower gross profit margins compared to concentrate and syrup operations.

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PepsiCo

Our Divisions (Note 1)

Through our operations, authorized bottlers, contract manufacturers and other third parties, we make, market, sell and distribute a wide variety of convenient and enjoyable foods and beverages, serving customers and consumers in more than 200 countries and territories with our largest operations in North America, Russia, Mexico, the United Kingdom and Brazil.

Our Operations (Item1, Business)

We are organized into six reportable segments (also referred to as divisions), as follows:

1) **Frito-Lay North America (FLNA);**
2) **Quaker Foods North America (QFNA);**
3) **Latin America Foods (LAF), which includes all of our food and snack businesses in Latin America;**
4) **PepsiCo Americas Beverages (PAB), which includes all of our North American and Latin American beverage businesses;**
5) **PepsiCo Europe (Europe), which includes all beverage, food and snack businesses in Europe and South Africa; and**
6) **PepsiCo Asia, Middle East and Africa (AMEA), which includes all beverage, food and snack businesses in AMEA, excluding South Africa.**

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COMPARATIVE ANALYSIS CASE (Continued)

(b) Dominant Position - Beverage Sales: Coke or Pepsi

Coca-Cola: Net operating revenues for 2014 were $45,998 million, comprised primarily of beverage sales.
Pepsi: Net revenue for 2014 was $66,683 million, of which soft drinks are estimated at $21,154 million (PepsiCo Americas Beverages) and food and food and beverage sales of $13,290 million for Europe and $6,727 million for AMEA.
Coca-Cola has the dominant position for beverage sales.

(c) Inventories, cost allocation method, effect on comparability

<u>Coke</u>

Inventories consist primarily of raw materials and packaging (which includes ingredients and supplies) and finished goods (which include concentrates and syrups in our concentrate operations and finished beverages in our finished product operations). Inventories are valued at the lower of cost or market. We determine cost on the basis of the average cost or first-in, first-out methods. Refer to Note 4.

<u>Pepsi</u>

Inventory

***Inventories* - Note 14. Inventories are valued at the lower of cost or market. Cost is determined using the average, first-in, first-out (FIFO) or last-in, first-out (LIFO) methods. Approximately 3% of the inventory cost in both 2014 and 2013 were computed using the LFIO method. The differences between LIFO and FIFO methods of valuing these inventories were not material.**

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(d) Change in accounting policy (2014)

Coke

Recently Issued Accounting Guidance

In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-08 Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. Under ASU 2014-08, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results. Additionally, ASU 2014-08 requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income and expenses of discontinued operations. ASU 2014-08 is effective for fiscal and interim periods beginning on or after December 15, 2014. The impact on our consolidated financial statements will depend on the facts and circumstances of any specific future transactions.

Pepsi

Recent Accounting Pronouncements (one example)

In June 2014, the Financial Accounting Standards Board (FASB) issued accounting guidance for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. The guidance requires that a performance target that could be achieved after the requisite service period is treated as a performance condition that affects the vesting of the award rather than factored into the grant date fair value. The guidance is effective as of the beginning of our 2016 fiscal year and can be applied prospectively to all share-based payments granted or modified on or after the effective date with early adoption permissible. This guidance is not expected to have any impact on our financial statements.

LO: 4, 5, 6, Bloom: AN, Moderate, Time: 30-35, AACSB: Analytic, Global, Communication, AICPA BB: Global, AICPA FC: Measurement, Reporting, Research, AICPA PC: Communication

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FINANCIAL STATEMENT ANALYSIS CASE—WAL-MART

(a) (1) In the year of the change, Wal-Mart will reverse the revenue recognized in prior periods for layaway sales that are not complete. This will reduce income in the year of the change.

(2) In subsequent years, after the adjustment in the year of the change, as long as Wal-Mart continues to make layaway sales at the same levels, income levels should return to prior levels (except for growth). That is, the accounting change only changes the timing of the recognition, not the overall amount recognized.

(b) By recognizing the revenue before delivery, Wal-Mart was recognizing revenue before the earnings process was complete. In addition, if customers did not pay the remaining balance owed, the realizability criterion is not met either. While Wal-Mart likely could estimate expected deliveries and payments, it is not apparent that this was done.

(c) Even if all retailers used the same policy, it still might be difficult to compare the results for layaway transactions. For example what if retailers have different policies as to how much customers have to put down in order for the retailer to set aside the merchandise. Note that the higher (lower) the amount put down, the more (less) likely the customer will complete the transaction. The concern under the prior rules is that retailers might give very generous layaway terms in order to accelerate revenue recognition. Investors would be in for a surprise if customers do not complete the transactions and the revenue recorded earlier must be reversed, thereby lowering reported income.

Note to instructor: The requirements for this case relate to Walmart accounting policies for revenue recognition prior to implementation of the new revenue standard. The new standard and its provisions are addressed in more detail in Chapter 18.

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ACCOUNTING, ANALYSIS, AND PRINCIPLES

Accounting

Caddie Shack Driving Range
Statement of Financial Position
May 31, 2017

Assets		*Liabilities*	
Cash	$15,100	Advertising payable	$ 150
Building	6,000	Utilities payable	100
Equipment	800		
		Owners' Equity	
		Owners' capital	21,650
Total Assets	$21,900	*Total Liabilities & Equity*	$21,900

Accrual income = $4,700 – $1,000 – $750 – $400 – $100 = $2,450
Owners' capital balance = $20,000 + $2,450 – $800 = $21,650

Murray might conclude that his business earned a profit of $1,650 because that is his earned capital at the end of the month. The conclusion that his business lost $4,900 might come from the change in the business's cash balance, which started at $20,000 and ended the month at $15,100.

Analysis

The income measure of $2,450 is most relevant for assessing the future profitability and hence the payoffs to the owners. For example, charging the cost of the building and equipment to expense in the first month of operations understates income in the first month. These costs should be allocated to future periods of benefit through depreciation expense. Similarly, although not paid, the utilities were used to generate revenues so they should be recognized when incurred, not when paid.

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Principles

GAAP income is the accrual income computed above as $2,450. The key concept illustrated in the difference between the loss of $4,900 and profit of $1,650 is the *expense recognition principle*, which calls for recognition of expenses when incurred, not when paid. Excluding the cash withdrawal from the measurement of income (the difference between income measures in parts c and d) is an application of the definition of basic elements. Cash withdrawals are distributions to owners, not an element of income (expenses or losses).

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CODIFICATION EXERCISES

CE2-1

(a) The master glossary provides three definitions of fair value that are found in GAAP:

Fair Value—The amount at which an asset (or liability) could be bought (or incurred) or settled in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Fair Value—The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if there is an active market for the investment. If there is no active market for the investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows, discounted at a rate commensurate with the risk involved, may be used to estimate fair value. The fair value of an investment shall be reported net of the brokerage commissions and other costs normally incurred in a sale.

Fair Value is 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.

(b) Revenue—Revenue earned by an entity from its direct distribution, exploitation, or licensing of a film, before deduction for any of the entity's direct costs of distribution. For markets and territories in which an entity's fully or jointly-owned films are distributed by third parties, revenue is the net amounts payable to the entity by third party distributors. Revenue is reduced by appropriate allowances, estimated returns, price concessions, or similar adjustments, as applicable.

The glossary references a revenue definition for the SEC: (Revenue (SEC))—See paragraph 942-235-S599-1, Regulation S-X Rule 9-05(c)(2), for the definition of revenue for purposes of Regulation S-X Rule 9-05.

This definition relates to segment reporting requirements for public companies.

(c) Comprehensive Income is defined as the change in equity (net assets) of a business 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.

LO: 4, 6, Bloom: Bloom: K, Difficulty: Simple, Time: 10-15, AACSB: Communication, Technology, AICPA BB: Technology, AICPA FC: Research, Technology, AICPA PC: Communication

CE2-2

The FASB Codification's organization is closely aligned with the elements of financial statements, as articulated in the Conceptual Framework. This is apparent in the layout of the "Browse" section, which has primary links for Assets, Liabilities, Equity, Revenues, and Expenses.

LO: 4, Bloom: K, Difficulty: Simple, Time: 5, AACSB: Communication, Technology, AICPA BB: Technology, AICPA FC: Research, Technology, AICPA PC: Communication

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CODIFICATION RESEARCH CASE

<u>Search Strings</u>: concept statement, "materiality", "articulation"

(a) According to Concepts Statement 2 (CON 2): Qualitative Characteristics of Accounting Information, "Glossary":

"Materiality is defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

(b) CON 2, Appendix C—See Table 1—refers to several SEC cases which apply materiality. Students might also research SEC literature (e.g. Staff Accounting Bulletin No. 99), although SEC literature is not in the FARS database.

SFAC No. 2, 128. provides the following examples of screens that might be used to determine materiality:

" a. An accounting change in circumstances that puts an enterprise in danger of being in breach of covenant regarding its financial condition may justify a lower materiality threshold than if its position were stronger.
b. A failure to disclose separately a nonrecurrent item of revenue may be material at a lower threshold than would otherwise be the case if the revenue turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend.
c. A misclassification of assets that would not be material in amount if it affected two categories of plant or equipment might be material if it changed the classification between a noncurrent and a current asset category.
d. Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events."

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However, according to CON 2, Pars. 129, 131 the FASB notes that more than magnitude must be considered in evaluating materiality:

Almost always, the relative rather than the absolute size of a judgment item determines whether it should be considered material in a given situation. Losses from bad debts or pilferage that could be shrugged off as routine by a large business may threaten the continued existence of a small one. An error in inventory valuation may be material in a small enterprise for which it cut earnings in half but immaterial in an enterprise for which it might make a barely perceptible ripple in the earnings. Some of the empirical investigations referred to in Appendix C throw light on the considerations that enter into materiality judgments.

SFAC No. 2, Par. 131. Some hold the view that the Board should promulgate a set of quantitative materiality guides or criteria covering a wide variety of situations that preparers could look to for authoritative support. That appears to be a minority view, however, on the basis of representations made to the Board in response to the Discussion Memorandum, Criteria for Determining Materiality. The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.

(c) SFAC No. 3, Par. 15. The two classes of elements are related in such a way that (a) assets, liabilities, and equity are changed by elements of the other class and at any time are their cumulative result and (b) an increase (decrease) in an asset cannot occur without a corresponding decrease (increase) in another asset or a corresponding increase (decrease) in a liability or equity. Those relationships are sometimes collectively referred to as "articulation." They result in financial statements that are fundamentally interrelated so that statements that show elements of the second class depend on statements that show elements of the first class and vice versa.

LO: 5, 6, Bloom: C, Moderate, Time: 25-30, AACSB: Global, Communication, AICPA BB: Global, AICPA FC: Measurement, Reporting, Research, AICPA PC: Communication

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IFRS CONCEPTS AND APPLICATION

IFRS2-1

The IASB framework makes two assumptions. One assumption is that financial statements are prepared on an accrual basis; the other is that the reporting entity is a going concern. The FASB discuss accrual accounting extensively but does not identify it as an assumption. The going concern concept is only briefly discussed. The going concern concept will undoubtedly be debated as to its place in the conceptual framework.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

IFRS2-2

While there is some agreement that the role of financial reporting is to assist users in decision-making, the IASB framework has had more of a focus on the objective of providing information on management's performance—often referred to as stewardship. It is likely that there will be much debate regarding the role of stewardship in the conceptual framework.

LO: 8, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

IFRS2-3

The FASB differentiates gains and losses from revenue and expenses where gains and losses are incidental transactions of the entity. Further, the FASB includes changes in equity as elements: investment by owners, distributions to owners, and comprehensive income.

LO: 8, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

IFRS2-4

As indicated, the measurement project relates to both initial measurement and subsequent measurement. Thus, the continuing controversy related to historical cost and fair value accounting suggests that this issue will be controversial. The reporting entity project that addresses which entities should be included in consolidated statements and how to implement such consolidations will be a difficult project. Other difficult issues relate to the trade off between highly relevant information that is difficult to verify? Or how do we define control when we are developing a definition of an asset? Or is a liability the future sacrifice itself or the obligation to make the sacrifice?

LO: 8, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Diversity, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

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IFRS2-5

The IASB and FASB frameworks are strikingly similar. This is not surprising, given that the IASB framework was adopted after the FASB developed its framework (the IASB framework was approved in April 1989). In addition, the IASC, the predecessor to the IASB, was formed to facilitate harmonization of accounting standards across countries. This objective could be aided by adopting a similar conceptual framework.

Specific similarities include that both frameworks adopt similar definitions for assets and liabilities and define equity as the residual of assets minus liabilities.

Some differences with regard to the elements are that the IASB defines just five elements without specific definitions for Investments by and Distributions to Owners or Comprehensive Income. There is also no distinction in the IASB framework between gains and revenues and losses and expenses.

Note to Instructors—These differences may be resolved as the FASB and IASB work on their performance reporting projects.

LO: 4, 8, Bloom: C, Difficulty: Simple, Time: 5-10, AACSB: Diversity I, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

IFRS2-6

Search Strings: "materiality", "completeness"

(a) According to the Framework (para. 30): Information is defined to be material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

(b) (1) According to the Framework, (para. 29–30):

29 The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.

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30 Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

(2) With respect to Completeness (para. 30):

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

This statement indicates that excluding immaterial items will not affect the completeness of the financial statements.

(c) According to the Framework (para. 22):

Accrual basis

In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

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IFRS2-7

Marks and Spencer plc

(a) Revenue Recognition

Revenue
Revenue comprises sales of goods to customers outside the Group less an appropriate deduction for actual and expected returns, discounts and loyalty scheme vouchers, and is stated net of value added tax and other sales taxes. Revenue is recognized when goods are delivered and the significant risks and rewards of ownership have been transferred to the buyer.

(b) Historical Cost

1) **Property, plant, and equipment - The Group's policy is to state property, plant and equipment at cost less accumulated depreciation and any recognized impairment loss. Property is not revalued for accounting purposes.**

2) **Intangible Assets-(B. Brands) Acquired brand values are held on the statement of financial position initially at cost. Defined life intangibles are amortized on a straight-line basis over their estimated useful lives. Indefinite life intangibles are tested for impairment at least annually. Any impairment in value is recognized immediately in the income statement.**

Fair Value
Trade receivables, trade payables, investments and other financial assets, bank loans, overdrafts, and loan notes

A. Goodwill
Goodwill arising on consolidation represents the excess of the consideration transferred and the amount of any non-controlling interest in the acquiree over the fair value of the identifiable assets and liabilities (including intangible assets) of the acquired entity at the date of the acquisition. Goodwill is recognized as an asset and assessed for impairment at least annually. Any impairment is recognized immediately in the income statement.

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IFRS2-7 (Continued)

(c) New Accounting Policies (Note 1)

The following IFRS, IFRS IC interpretations and amendments are effective for the first time in this financial year:

IFRS 10 'Consolidated Financial Statements',

IFRS 11 'Joint arrangements' and

IFRS 12 'Disclosure of Interests in Other Entities' and the amendments to IAS 27 (2011) 'Separate Financial Statements' and IAS 28 (2011) 'Investments in Associates and Joint Ventures'.

These have not had a material impact on the Group.

(d) Accounting policy related to refunds and loyalty schemes

E. Refunds and loyalty scheme accruals

Accruals for sales returns and loyalty scheme redemptions are estimated on the basis of historical returns and redemptions and these are recorded so as to allocate them to the same period as the original revenue is recorded. These accruals are reviewed regularly and updated to reflect management's latest best estimates, however, actual returns and redemptions could vary from these estimates.

M & S includes this note to comply with the full disclosure principle.

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CHAPTER 1

Financial Accounting and Accounting Standards

ASSIGNMENT CLASSIFICATION TABLE (By Topic)

Topics		Questions	Cases
1.	Subject matter of accounting.	1	4
2.	Environment of accounting.	2, 3, 21	6, 7
3.	Role of principles, objectives, standards, and accounting theory.	4, 5, 6, 7	1, 2, 3, 5
4.	Historical development of GAAP.	8, 9, 10, 11	8
5.	Authoritative pronouncements and rule-making bodies.	12, 13, 14, 15, 16, 17, 18, 19, 20	3, 9, 11, 12, 14
6.	Role of pressure groups.	21, 22, 23, 24, 25, 26	10, 16, 17
7.	Ethical issues.	28	13, 15

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ASSIGNMENT CLASSIFICATION TABLE (By Learning Objective)

Learning Objectives	Questions	Cases
1. Understand the financial reporting environment.	1, 2, 3, 4, 5, 6, 7	CA1-2, CA1-3, CA1-4, CA1-5, CA1-6, CA1-7, CA1-9
2. Identify the major policy-setting bodies and their role in the standard-setting process.	8, 9, 10, 11, 13, 14, 15, 16, 18, 19	CA1-1, CA1-2, CA1-3, CA1-7, CA1-8, CA1-9, CA1-10, CA1-11, CA1-12, CA1-14
3. Explain the meaning of generally accepted accounting principles (GAAP) and the role of the codification for GAAP.	12, 14, 18, 19, 20, 21	CA1-2, CA1-3, CA1-7, CA1-8, CA1-12
4. Describe major challenges in the financial reporting environment.	16, 17, 21, 22, 23, 24, 25, 26, 27, 28	CA1-6, CA1-10, CA1-11, CA1-13, CA1-15, CA1-16, CA1-17

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
CA1-1	FASB and standard-setting.	Simple	15–20
CA1-2	GAAP and standard-setting.	Simple	15–20
CA1-3	Financial reporting and accounting standards.	Simple	15–20
CA1-4	Financial accounting.	Simple	15–20
CA1-5	Objective of financial reporting.	Moderate	20–25
CA1-6	Accounting numbers and the environment.	Simple	10–15
CA1-7	Need for GAAP.	Simple	15–20
CA1-8	AICPA's role in rule-making.	Simple	20–25
CA1-9	FASB role in rule-making.	Simple	20–25
CA1-10	Politicization of GAAP.	Complex	30–40
CA1-11	Models for setting GAAP.	Simple	15–20
CA1-12	GAAP terminology.	Moderate	30–40
CA1-13	Rule-making Issues.	Complex	20–25
CA1-14	Securities and Exchange Commission.	Moderate	30–40
CA1-15	Financial reporting pressures.	Moderate	25–35
CA1-16	Economic consequences.	Moderate	25–35
CA1-17	GAAP and economic consequences.	Moderate	25–35

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ANSWERS TO QUESTIONS

1. Financial accounting measures, classifies, and summarizes in report form those activities and that information which relate to the enterprise as a whole for use by parties both internal and external to a business enterprise. Managerial accounting also measures, classifies, and summarizes in report form enterprise activities, but the communication is for the use of internal, managerial parties, and relates more to subsystems of the entity. Managerial accounting is management decision oriented and directed more toward product line, division, and profit center reporting.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

2. Financial statements generally refer to the four basic financial statements: balance sheet, income statement, statement of cash flows, and statement of changes in owners' or stockholders' equity. Financial reporting is a broader concept; it includes the basic financial statements and any other means of communicating financial and economic data to interested external parties. Examples of financial reporting other than financial statements are annual reports, prospectuses, reports filed with the government, news releases, management forecasts or plans, and descriptions of an enterprise's social or environmental impact.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

3. If a company's financial performance is measured accurately, fairly, and on a timely basis, the right managers and companies are able to attract investment capital. To provide unreliable and irrelevant information leads to poor capital allocation which adversely affects the securities market.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

4. 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 decisions about providing resources to the entity through equity investments and loans or other forms of credit. Information that is decision-useful to capital providers (investors) may also be useful to other users of financial reporting who are not investors.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC:: None

5. Investors are interested in financial reporting because it provides information that is useful for making decisions (referred to as the decision-usefulness approach). When making these decisions, investors are interested in assessing the company's (1) ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. In order for investors to make these assessments, the economic resources of an enterprise, the claims to those resources, and the changes in them must be understood.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

6. A common set of standards applied by all businesses and entities provides financial statements which are reasonably comparable. Without a common set of standards, each enterprise could, and would, develop its own theory structure and set of practices, resulting in noncomparability among enterprises.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

7. General-purpose financial statements are not likely to satisfy the specific needs of all interested parties. Since the needs of interested parties such as creditors, managers, owners, governmental agencies, and financial analysts vary considerably, it is unlikely that one set of financial statements is equally appropriate for these varied uses.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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8. The SEC has the power to prescribe, in whatever detail it desires, the accounting practices and principles to be employed by the companies that fall within its jurisdiction. Because the SEC receives audited financial statements from nearly all companies that issue securities to the public or are listed on the stock exchanges, it is greatly interested in the content, accuracy, and credibility of the statements. For many years the SEC relied on the AICPA to regulate the profession and develop and enforce accounting principles. Lately, the SEC has assumed a more active role in the development of accounting standards, especially in the area of disclosure requirements. In December 1973, in ASR No. 150, the SEC said the FASB's statements would be presumed to carry substantial authoritative support and anything contrary to them to lack such support. It thereby supports the development of accounting principles in the private sector.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

9. The Committee on Accounting Procedure was a special committee of the American Institute of CPAs that, between the years of 1939 and 1959, issued 51 **Accounting Research Bulletins** dealing with a wide variety of timely accounting problems. These bulletins provided solutions to immediate problems and narrowed the range of alternative practices. But, the Committee's problem-by-problem approach failed to provide a well-defined and well-structured body of accounting theory that was so badly needed. The Committee on Accounting Procedure was replaced in 1959 by the Accounting Principles Board.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

10. The creation of the Accounting Principles Board was intended to advance the written expression of accounting principles, to determine appropriate practices, and to narrow the differences and inconsistencies in practice. To achieve its basic objectives, its mission was to develop an overall conceptual framework to assist in the resolution of problems as they became evident and to do substantive research on individual issues before pronouncements were issued.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

11. **Accounting Research Bulletins** were pronouncements on accounting practice issued by the Committee on Accounting Procedure between 1939 and 1959; since 1964 they have been recognized as accepted accounting practice unless superseded in part or in whole by an opinion of the APB or an FASB standard. **APB Opinions** were issued by the Accounting Principles Board during the years 1959 through 1973 and, unless superseded by FASB Statements, are recognized as accepted practice and constitute the requirements to be followed by all business enterprises. **Accounting Standards Updates** are pronouncements of the Financial Accounting Standards Board that are incorporated into the FASB codification and therefore represent the accounting profession's authoritative pronouncements on financial accounting and reporting practices.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

12. The explanation should note that generally accepted accounting principles or standards have "substantial authoritative support." They consist of accounting practices, procedures, theories, concepts, and methods which are recognized by a large majority of practicing accountants as well as other members of the business and financial community. Bulletins issued by the Committee on Accounting Procedure, opinions rendered by the Accounting Principles Board, and statements issued by the Financial Accounting Standards Board constitute "substantial authoritative support."

LO: 3, Bloom: K, Difficulty: Simple, 5-10, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

13. It was believed that FASB Pronouncements would carry greater weight than APB Opinions because of significant differences between the FASB and the APB, namely: (1) the FASB has a smaller membership, (2) full-time compensated members; (3) the FASB has greater autonomy, (4) increased independence; (5) the FASB has broader representation than the APB.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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14. The technical staff of the FASB conducts research on an identified accounting topic and prepares a "preliminary views" that is released by the Board for public reaction. The Board analyzes and evaluates the public response to the preliminary views, deliberates on the issues, and issues an "exposure draft" for public comment. The preliminary views merely present all facts and alternatives related to a specific topic or problem, whereas the exposure draft is a tentative "statement." After studying the public's reaction to the exposure draft, the Board may reevaluate its position, revise the draft, and vote on the issuance of a final statement.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

15. Statements of financial accounting **standards** contained in Accounting Standards updates constitute generally accepted accounting principles and dictate acceptable financial accounting and reporting practices as promulgated by the FASB. The first standards statement was issued by the FASB in 1973.

Statements of financial accounting **concepts** do not establish generally accepted accounting principles. Rather, the concepts statements set forth fundamental objectives and concepts that the FASB intends to use as a basis for developing future standards. The concepts serve as guidelines in solving existing and emerging accounting problems in a consistent, sound manner. Both the standards statements and the concepts statements may develop through the same process from discussion memorandum, to exposure draft, to a final approved statement.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

16. Rule 203 of the Code of Professional Conduct prohibits a member of the AICPA from expressing an opinion that financial statements conform with GAAP if those statements contain a material departure from an accounting principle promulgated by the FASB, or its predecessors, the APB and the CAP, unless the member can demonstrate that because of unusual circumstances the financial statements would otherwise have been misleading. Failure to follow Rule 203 can lead to a loss of a CPA's license to practice. This rule is extremely important because it requires auditors to follow FASB standards.

LO: 2, 4, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

17. The chairman of the FASB was indicating that too much attention is put on the bottom line and not enough on the development of quality products. Managers should be less concerned with short-term results and be more concerned with the long-term results. In addition, short-term tax benefits often lead to long-term problems.

The second part of his comment relates to accountants being overly concerned with following a set of rules, so that if litigation ensues, they will be able to argue that they followed the rules exactly. The problem with this approach is that accountants want more and more rules with less reliance on professional judgment. Less professional judgment leads to inappropriate use of accounting procedures in difficult situations.

In the accountants' defense, recent legal decisions have imposed vast new liability on accountants. The concept of accountant's liability that has emerged in these cases is broad and expansive; the number of classes of people to whom the accountant is held responsible are almost limitless.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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18. The Emerging Issues Task Force often arrives at consensus conclusions on certain financial reporting issues. These consensus conclusions are then looked upon as GAAP by practitioners because the SEC has indicated that it will view consensus solutions as preferred accounting and will require persuasive justification for departing from them. Thus, at least for public companies which are subject to SEC oversight, consensus solutions developed by the Emerging Issues Task Force are followed unless subsequently overturned by the FASB. It should be noted that the FASB took greater direct ownership of GAAP established by the EITF by requiring that consensus positions be ratified by the FASB.

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

19. The Financial Accounting Standards Board Accounting Standards Codification (Codification) is a compilation of all GAAP in one place. Its purpose is to integrate and synthesize existing GAAP and not to create new GAAP. It creates one level of GAAP which is considered authoritative. The FASB Codification Research Systems (CRS) is an-on-line real time data base which provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure which is subdivided into topic, subtopics, sections, and paragraphs.

LO: 3, Bloom: K, Difficulty: Moderate, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

20. Hopefully, the codification will help users to better understand what GAAP is. If this occurs, companies will be more likely to comply with GAAP and the time to research accounting issues will be substantially reduced. In addition, through the electronic web-based format, GAAP can be easily updated which will help users stay current.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

21. The sources of pressure are innumerable, but the most intense and continuous pressure to change or influence accounting principles or standards come from individual companies, industry associations, governmental agencies, practicing accountants, academicians, professional accounting organizations, and public opinion.

LO: 3, Bloom: K, Difficulty: Simple, 5-10, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

22. Economic consequences means the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact. In other words, accounting information impacts various users in many different ways which leads to wealth transfers among these various groups.

If politics plays an important role in the development of accounting rules, the rules will be subject to manipulation for the purpose of furthering whatever policy prevails at the moment. No matter how well intentioned the rule maker may be, if information is designed to indicate that investing in a particular enterprise involves less risk than it actually does, or is designed to encourage investment in a particular segment of the economy, financial reporting will suffer an irreplaceable loss of credibility.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

23. No one particular proposal is expected in answer to this question. The students' proposals, however, should be defensible relative to the following criteria:
(1) The method must be efficient, responsive, and expeditious.
(2) The method must be free of bias and be above or insulated from pressure groups.
(3) The method must command widespread support if it does not have legislative authority.
(4) The method must produce sound yet practical accounting principles or standards.
The students' proposals might take the form of alterations of the existing methodology, an accounting court (as proposed by Leonard Spacek), or governmental device.

LO: 4, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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24. Concern exists about fraudulent financial reporting because it can undermine the entire financial reporting process. Failure to provide information to users that is accurate can lead to inappropriate allocations of resources in our economy. In addition, failure to detect massive fraud can lead to additional governmental oversight of the accounting profession.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

25. The expectations gap is the difference between what people think accountants should be doing and what accountants think they can do. It is a difficult gap to close. The accounting profession recognizes it must play an important role in narrowing this gap. To meet the needs of society, the profession is continuing its efforts in developing accounting standards, such as numerous pronouncements issued by the FASB, to serve as guidelines for recording and processing business transactions in the changing economic environment.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

26. The following are some of the key provisions of the Sarbanes-Oxley Act:

- Establishes an oversight board for accounting practices. The Public Company Accounting Oversight Board (PCAOB) has oversight and enforcement authority and establishes auditing, quality control, and independence standards and rules.
- Implements stronger independence rules for auditors. Audit partners, for example, are required to rotate every five years and auditors are prohibited from offering certain types of consulting services to corporate clients.
- Requires CEOs and CFOs to personally certify that financial statements and disclosures are accurate and complete and requires CEOs and CFOs to forfeit bonuses and profits when there is an accounting restatement.
- Requires audit committees to be comprised of independent members and members with financial expertise.
- Requires codes of ethics for senior financial officers.

In addition, Section 404 of the Sarbanes-Oxley Act requires public companies to attest to the effectiveness of their internal controls over financial reporting.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

27. Some major challenges facing the accounting profession relate to the following items:

Nonfinancial measurement—how to report significant key performance measurements such as customer satisfaction indexes, backlog information and reject rates on goods purchased.
Forward-looking information—how to report more future oriented information.
Soft assets—how to report on intangible assets, such as market know-how, market dominance, and well-trained employees.
Timeliness—how to report more real-time information.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

28. Accountants must perceive the moral dimensions of some situations because GAAP does not define or cover all specific features that are to be reported in financial statements. In these instances accountants must choose among alternatives. These accounting choices influence whether particular stakeholders may be harmed or benefited. Moral decision-making involves awareness of potential harm or benefit and taking responsibility for the choices.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Ethics, Communication, AICPA BB: Professional Demeanor, AICPA FC: Reporting, AICPA PC: Communication

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TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 1-1 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to answer questions about FASB and standard setting.

CA 1-2 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to answer questions about GAAP and standard setting.

CA 1-3 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to answer questions about financial reporting and accounting standards topics.

CA 1-4 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to distinguish between financial accounting and managerial accounting, identify major financial statements, and differentiate financial statements and financial reporting.

CA 1-5 (Time 20–25 minutes)
Purpose—to provide the student with an opportunity to explain the basic objective of financial reporting.

CA 1-6 (Time 10–15 minutes)
Purpose—to provide the student with an opportunity to describe how reported accounting numbers might affect an individual's perceptions and actions.

CA 1-7 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to evaluate the viewpoint of removing mandatory accounting rules and allowing each company to voluntarily disclose the information it desired.

CA 1-8 (Time 20–25 minutes)
Purpose—to provide the student with an opportunity to explain the evolution of accounting rule-making organizations and the role of the AICPA in the rule making environment.

CA 1-9 (Time 20–25 minutes)
Purpose—to provide the student with an opportunity to identify the sponsoring organization of the FASB, the method by which the FASB arrives at a decision, and the types and the purposes of documents issued by the FASB.

CA 1-10 (Time 30–40 minutes)
Purpose—to provide the student with an opportunity to focus on the types of organizations involved in the rule making process, what impact accounting has on the environment, and the environment's influence on accounting.

CA 1-11 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to focus on what type of rule-making environment exists in the United States. In addition, this CA explores why user groups are interested in the nature of GAAP and why some groups wish to issue their own rules.

CA 1-12 (Time 30–40 minutes)
Purpose—to provide the student with an opportunity to identify and define acronyms appearing in the first chapter. Some are self-evident, others are not so.

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Time and Purpose of Concepts for Analysis (Continued)

CA 1-13 (Time 20–25 minutes)
Purpose—to provide the student with an opportunity to consider the ethical dimensions of implementation of a new accounting pronouncement.

CA 1-14 (Time 30–40 minutes)
Purpose—to provide the student with an assignment that explores the role and function of the Securities and Exchange Commission.

CA 1-15 (Time 25–35 minutes)
Purpose—to provide the student with a writing assignment concerning the ethical issues related to meeting earnings targets.

CA 1-16 (Time 25–35 minutes)
Purpose—to provide the student with the opportunity to discuss the role of Congress in accounting rule-making.

CA 1-17 (Time 25–35 minutes)
Purpose—to provide the student with an opportunity to comment on a letter sent by business executives to the FASB and Congress on the accounting for derivatives.

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SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 1-1

1. True
2. False. Any company claiming compliance with GAAP must comply with all standards and interpretations, including disclosure requirements.
3. True
4. False. In establishing financial accounting standards, the FASB relies on two basic premises: (1) the FASB should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (2) it should operate in full view of the public through a "due process" system that gives interested people ample opportunities to make their view known.

LO: 2, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: AICPA BB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

CA 1-2

1. False. In addition to providing decision-useful information about future cash flows, management also is accountable to investors for the custody and safekeeping of the company's economic resources and for their efficient and profitable use; however, this is not considered an objective.
2. False. The objective of 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 in their capacity as capital providers.
3. False. The FASB follows the same due process procedures for interpretations and standards.
4. True

LO: 1, 2, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: AICPA BB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

CA 1-3

1. (d)
2. (d)
3. (d)
4. (a)
5. (a)
6. (b)
7. (d)
8. (b)

LO: 1, 2, 3, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: AICPA BB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: None

CA 1-4

(a) Financial accounting is the process that culminates in the preparation of financial reports relative to the enterprise as a whole for use by parties both internal and external to the enterprise. In contrast, managerial accounting is the process of identification, measurement, accumulation, analysis, preparation, interpretation, and communication of financial information used by the management to plan, evaluate, and control within an organization and to assure appropriate use of, and accountability for, its resources.

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CA 1-4 (Continued)

(b) The financial statements most frequently provided are the balance sheet, the income statement, the statement of cash flows, and the statement of changes in owners' or stockholders' equity.

(c) Financial statements are the principal means through which financial information is communicated to those outside an enterprise. As indicated in (b), there are four major financial statements. However, some financial information is better provided, or can be provided only, by means of financial reporting other than formal financial statements. Financial reporting (other than financial statements and related notes) may take various forms. Examples include the company president's letter or supplementary schedules in the corporate annual reports, prospectuses, reports filed with government agencies, news releases, management's forecasts, and descriptions of an enterprise's social or environmental impact.

LO: 1, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-5

(a) In accordance with **Statement of Financial Accounting Concepts No. 1,** "Objectives of Financial Reporting by Business Enterprises," the objectives of financial reporting are to provide information to investors, creditors, and others

1. that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
2. to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.
3. about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

(b) **Statement of Financial Accounting Concepts No. 1** established standards to meet the information needs of large groups of external users such as investors, creditors, and their representatives. Although the level of sophistication related to business and financial accounting matters varies both within and between these user groups, users are expected to possess a reasonable understanding of accounting concepts, financial statements, and business and economic activities and are expected to be willing to study and interpret the information with reasonable diligence.

LO: 1, Bloom: K, Difficulty: Moderate, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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CA 1-6

Accounting numbers affect investing decisions. Investors, for example, use the financial statements of different companies to enhance their understanding of each company's financial strength and operating results. Because these statements follow generally accepted accounting principles, investors can make meaningful comparisons of different financial statements to assist their investment decisions.

Accounting numbers also influence creditors' decisions. A commercial bank usually looks into a company's financial statements and past credit history before deciding whether to grant a loan and in what amount. The financial statements provide a fair picture of the company's financial strength (for example, short-term liquidity and long-term solvency) and operating performance for the current period and over a period of time. The information is essential for the bank to ensure that the loan is safe and sound.

LO: 1, 4, Bloom: C, Difficulty: Simple, Time: 10-15, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-7

It is not appropriate to abandon mandatory accounting rules and allow each company to voluntarily disclose the type of information it considers important. Without a coherent body of accounting theory and standards, each accountant or enterprise would have to develop its own theory structure and set of practices, and readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

In addition, voluntary disclosure may not be an efficient way of disseminating information. A company is likely to disclose less information if it has the discretion to do so. Thus, the company can reduce its cost of assembling and disseminating information. However, an investor wishing additional information has to pay to receive additional information desired. Different investors may be interested in different types of information. Since the company may not be equipped to provide the requested information, it would have to spend additional resources to fulfill such needs; or the company may refuse to furnish such information if it's too costly to do so. As a result, investors may not get the desired information or they may have to pay a significant amount of money for it. Furthermore, redundancy in gathering and distributing information occurs when different investors ask for the same information at different points in time. To the society as a whole, this would not be an efficient way of utilizing resources.

LO: 1, 2, 3, Bloom: AN, Difficulty: Simple, Time: 15-20, AACSB: Reflective Thinking, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-8

(a) One of the committees that the AICPA established prior to the establishment of the FASB was the Committee on Accounting Procedures (CAP). The CAP, during its existence from 1939 to 1959, issued 51 Accounting Research Bulletins (ARB). In 1959, the AICPA created the Accounting Principles Board (APB) to replace the CAP. Before being replaced by the FASB, the APB released 31 official pronouncements, called APB Opinions.

(b) Although the ARBs issued by the CAP helped to narrow the range of alternative practices to some extent, the CAP's problem-by-problem approach failed to provide the well-defined, structured body of accounting principles that was both needed and desired. As a result, the CAP was replaced by the APB.

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CA 1-8 (Continued)

The APB had more authority and responsibility than did the CAP. Unfortunately, the APB was beleaguered throughout its 14-year existence. It came under fire early, charged with lack of productivity and failing to act promptly to correct alleged accounting abuses. The APB also met a lot of industry and CPA firm opposition and occasional governmental interference when tackling numerous thorny accounting issues. In fear of governmental rule making, the accounting profession investigated the ineffectiveness of the APB and replaced it with the FASB.

Learning from prior experiences, the FASB has several significant differences from the APB. The FASB has: (1) smaller membership, (2) full-time, compensated membership, (3) greater autonomy, (4) increased independence, and (5) broader representation. In addition, the FASB has its own research staff and relies on the expertise of various task force groups formed for various projects. These features form the bases for the expectations of success and support from the public. In addition, the due process taken by the FASB in establishing financial accounting standards gives interested persons ample opportunity to make their views known. Thus, the FASB is responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession.

(c) The AICPA has supplemented the FASB's efforts in the present standard-setting environment. The issue papers, which are prepared by the Financial Reporting Executive Committee (FinREC) formally the Accounting Standards Executive Committee (AcSEC), identify current financial reporting problems for specific industries and present alternative treatments of the issue. These papers provide the FASB with an early warning device to insure timely issuance of FASB standards. In situations where the FASB avoids the subject of an issue paper, FinREC may issue a Statement of Position to provide guidance for the reporting issue. FinREC also issues Practice Bulletins which indicate how the AICPA believes a given transaction should be reported.

Recently, the role of the AICPA in standard-setting has diminished. The FASB and the AICPA agreed, that after a transition period, the AICPA and FinREC no longer issues authoritative accounting guidance for public companies.

LO: 2, Bloom: K, Difficulty: Simple, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-9

(a) The Financial Accounting Foundation (FAF) is the sponsoring organization of the FASB. The FAF selects the members of the FASB and its Advisory Council, funds their activities, and generally oversees the FASB's activities.

The FASB follows a due process in establishing a typical FASB Statement of Financial Accounting Standards. The following steps are usually taken: (1) A topic or project is identified and placed on the Board's agenda. (2) A task force of experts from various sectors is assembled to define problems, issues, and alternatives related to the topic. (3) Research and analysis are conducted by the FASB technical staff. (4) A preliminary views document is drafted and released. (5) A public hearing is often held, usually 60 days after the release of the preliminary views. (6) The Board analyzes and evaluates the public response. (7) The Board deliberates on the issues and prepares an exposure draft for release. (8) After a 30-day (minimum) exposure period for public comment, the Board evaluates all of the responses received. (9) A committee studies the exposure draft in relation to the public responses, reevaluates its position, and revises the draft if necessary. (10) The full Board gives the revised draft final consideration and votes on issuance of a Standards Statement. The passage of a new accounting standard in the form of an FASB Statement requires the support of five of the seven Board members, before it is incorporated in the codification.

(b) The FASB issues two major types of pronouncements: Accounting Standards Updates (ASUs) and Concepts Statements. ASUs issued by the FASB are considered GAAP.

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CA 1-9 (Continued)

ASU's may be comprised of major standards projects, EITF consensus, or interpretations. Regardless of nature, if approved by the FASB in a ASU, then the guidance is considered GAAP.

The Statements of Financial Accounting Concepts (SFAC) help the FASB to avoid the "problem-by-problem approach." These statements set forth fundamental objectives and concepts that the Board will use in developing future standards of financial accounting and reporting. They are intended to form a cohesive set of interrelated concepts, a body of theory or a conceptual framework, that will serve as tools for solving existing and emerging problems in a consistent, sound manner.

In addition, the FASB's Emerging Issues Task Force (EITF) issues statements to provide guidance on how to account for new and unusual financial transactions that have the potential for creating diversity in reporting practices. The EITF identifies controversial accounting problems as they arise and determines whether they can be quickly resolved or whether the FASB should become involved in solving them. In essence, it becomes a "problem filter" for the FASB. Thus, it is hoped that the FASB will be able to work on more pervasive long-term problems, while the EITF deals with short-term emerging issues.

LO: 2, Bloom: K, Difficulty: Simple, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-10

(a) **CAP.** The Committee on Accounting Procedure, CAP, which was in existence from 1939 to 1959, was a natural outgrowth of AICPA committees which were in existence during the period 1933 to 1938. The committee was formed in direct response to the criticism received by the accounting profession during the financial crisis of 1929 and the years thereafter. The authorization to issue pronouncements on matters of accounting principles and procedures was based on the belief that the AICPA had the responsibility to establish practices that would become generally accepted by the profession and by corporate management.

As a general rule, the CAP directed its attention, almost entirely, to resolving specific accounting problems and topics rather than to the development of generally accepted accounting principles. The committee voted on the acceptance of specific Accounting Research Bulletins published by the committee. A two-thirds majority was required to issue a particular research bulletin. The CAP did not have the authority to require acceptance of the issued bulletins by the general membership of the AICPA, but rather received its authority only upon general acceptance of the pronouncement by the members. That is, the bulletins set forth normative accounting procedures that "should be" followed by the accounting profession, but were not "required" to be followed.

It was not until well after the demise of the CAP, in 1964, that the Council of the AICPA adopted recommendations that departures from effective CAP Bulletins should be disclosed in financial statements or in audit reports of members of the AICPA. The demise of the CAP could probably be traced to four distinct factors: (1) the narrow nature of the subjects covered by the bulletins issued by the CAP, (2) the lack of any theoretical groundwork in establishing the procedures presented in the bulletins, (3) the lack of any real authority by the CAP in prescribing adherence to the procedures described by the bulletins, and (4) the lack of any formal representation on the CAP of interest groups such as corporate managers, governmental agencies, and security analysts.

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APB. The objectives of the APB were formulated mainly to correct the deficiencies of the CAP as described above. The APB was thus charged with the responsibility of developing written expression of generally accepted accounting principles through consideration of the research done by other members of the AICPA in preparing Accounting Research Studies. The committee was in turn given substantial authoritative standing in that all opinions of the APB were to constitute substantial authoritative support for generally accepted accounting principles. If an individual member of the AICPA decided that a principle or procedure outside of the official pronouncements of the APB had substantial authoritative support, the member had to disclose the departure from the official APB opinion in the financial statements of the firm in question.

The membership of the committee comprising the APB was also extended to include representation from industry, government, and academe. The opinions were also designed to include minority dissents by members of the board. Exposure drafts of the proposed opinions were readily distributed.

The demise of the APB occurred primarily because the purposes for which it was created were not being accomplished. Broad generally accepted accounting principles were not being developed. The research studies supposedly being undertaken in support of subsequent opinions to be expressed by the APB were often ignored. The committee in essence became a simple extension of the original CAP in that only very specific problem areas were being addressed. Interest groups outside of the accounting profession questioned the appropriateness and desirability of having the AICPA directly responsible for the establishment of GAAP. Politicization of the establishment of GAAP had become a reality because of the far-reaching effects involved in the questions being resolved.

FASB. The formal organization of the FASB represents an attempt to vest the responsibility of establishing GAAP in an organization representing the diverse interest groups affected by the use of GAAP. The FASB is independent of the AICPA. It is independent, in fact, of any private or governmental organization. Individual CPAs, firms of CPAs, accounting educators, and representatives of private industry will now have an opportunity to make known their views to the FASB through their membership on the Board. Independence is facilitated through the funding of the organization and payment of the members of the Board. Full-time members are paid by the organization and the organization itself is funded solely through contributions. Thus, no one interest group has a vested interest in the FASB.

Conclusion. The evolution of the current FASB certainly does represent “increasing politicization of accounting standards setting.” Many of the efforts extended by the AICPA can be directly attributed to the desire to satisfy the interests of many groups within our society. The FASB represents, perhaps, just another step in this evolutionary process.

(b) Arguments for politicalization of the accounting rule-making process:

1. Accounting depends in large part on public confidence for its success. Consequently, the critical issues are not solely technical, so all those having a bona fide interest in the output of accounting should have some influence on that output.
2. There are numerous conflicts between the various interest groups. In the face of this, compromise is necessary, particularly since the critical issues in accounting are value judgments, not the type which are solvable, as we have traditionally assumed, using deterministic models. Only in this way (reasonable compromise) will the financial community have confidence in the fairness and objectivity of accounting rule-making.
3. Over the years, accountants have been unable to establish, on the basis of technical accounting elements, rules which would bring about the desired uniformity and acceptability. This inability itself indicates rule-setting is primarily consensual in nature.

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CA 1-10 (Continued)

4. The public accounting profession, through bodies such as the Accounting Principles Board, made rules which business enterprises and individuals "had" to follow. For many years, these businesses and individuals had little say as to what the rules would be, in spite of the fact that their economic well-being was influenced to a substantial degree by those rules. It is only natural that they would try to influence or control the factors that determine their economic well-being.

(c) Arguments against the politicalization of the accounting rule-making process:
1. Many accountants feel that accounting is primarily technical in nature. Consequently, they feel that substantive, basic research by objective, independent and fair-minded researchers ultimately will result in the best solutions to critical issues, such as the concepts of income and capital, even if it is accepted that there isn't necessarily a single "right" solution.
2. Even if it is accepted that there are no "absolute truths" as far as critical issues are concerned, many feel that professional accountants, taking into account the diverse interests of the various groups using accounting information, are in the best position, because of their independence, education, training, and objectivity, to decide what generally accepted accounting principles ought to be.
3. The complex situations that arise in the business world require that trained accountants develop the appropriate accounting principles.
4. The use of consensus to develop accounting principles would decrease the professional status of the accountant.
5. This approach would lead to "lobbying" by various parties to influence the establishment of accounting principles.

LO: 4, Bloom: E, Difficulty: Complex, Time: 30-40, AACSB: Analytic, Communication, Ethics, AICPA BB: Professional Demeanor, AICPA FC: Reporting, AICPA PC: Communication

CA 1-11

(a) The public/private mixed approach appears to be the way rules are established in the United States. In many respects, the FASB is a quasi-governmental agency in that its pronouncements are required to be followed because the SEC has provided support for this approach. The SEC has the ultimate power to establish GAAP but has chosen to permit the private sector to develop these rules. By accepting the standards established by the FASB as authoritative, it has granted much power to the FASB. (It might be useful to inform the students that not all countries follow this model. For example, the purely political approach is used in France and West Germany. The private, professional approach is employed in Australia, Canada, and the United Kingdom).

(b) Publicly reported accounting numbers influence the distribution of scarce resources. Resources are channeled where needed at returns commensurate with perceived risk. Thus, reported accounting numbers have economic effects in that resources are transferred among entities and individuals as a consequence of these numbers. It is not surprising then that individuals affected by these numbers will be extremely interested in any proposed changes in the financial reporting environment.

(c) The Accounting Standards Executive Committee (AcSEC of the AICPA), among other groups, has presented a potential challenge to the exclusive right of the FASB to establish accounting principles. Also, Congress has been attempting to legislate certain accounting practices, particularly to help struggling industries.

Some possible reasons why other groups might wish to establish GAAP are:
1. As indicated in the previous answer, these rules have economic effects and therefore certain groups would prefer to make their own rules to ensure that they receive just treatment.
2. Some believe the FASB does not act quickly to resolve accounting matters, either because it is not that interested in the subject area or because it lacks the resources to do so.

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CA 1-11 (Continued)

3. Some argue that the FASB does not have the competence to legislate GAAP in certain areas. For example, many have argued that the FASB should not legislate GAAP for not-for-profit enterprises because the problems are unique and not well known by the FASB.

LO: 2, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-12

(a) **AICPA.** American Institute of Certified Public Accountants. The national organization of practicing certified public accountants.

(b) **CAP.** Committee on Accounting Procedure. A committee of practicing CPAs which issued 51 Accounting Research Bulletins between 1939 and 1959 and is a predecessor of the FASB.

(c) **EITF.** Emerging Issues Task Force. Provides implementation guidance to reduce diversity in practice in a timely basis. To become GAAP, EITF consensues must be approved by the FASB.

(d) **APB.** Accounting Principles Board. A committee of public accountants, industry accountants and academicians which issued 31 Opinions between 1959 and 1973. The APB replaced the CAP and was itself replaced by the FASB. Its opinions, unless superseded, remain a primary source of GAAP.

(e) **FAF.** Financial Accounting Foundation. An organization whose purpose is to select members of the FASB and its Advisory Councils, fund their activities, and exercise general oversight.

(f) **FASAC.** Financial Accounting Standards Advisory Council. An organization whose purpose is to consult with the FASB on issues, project priorities, and select task forces.

(g) **GAAP.** Generally accepted accounting principles. A common set of standards, principles, and procedures which have substantial authoritative support and have been accepted as appropriate because of universal application.

(h) **CPA.** Certified public accountant. An accountant who has fulfilled certain education and experience requirements and passed a rigorous examination. Most CPAs offer auditing, tax, and management consulting services to the general public.

(i) **FASB.** Financial Accounting Standards Board. The primary body which currently establishes and improves financial accounting and reporting standards for the guidance of issuers, auditors, users, and others.

(j) **SEC.** Securities and Exchange Commission. An independent regulatory agency of the United States government which administers the Securities Acts of 1933 and 1934 and other acts.

(k) **IASB.** International Accounting Standards Board. An international group, formed in 1973, that is actively developing and issuing accounting standards that will have international appeal and hopefully support.

LO: 3, Bloom: K, Difficulty: Moderate, Time: 30-40, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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CA 1-13

(a) Inclusion or omission of information that materially affects net income harms particular stakeholders. Accountants must recognize that their decision to implement (or delay) reporting requirements will have immediate consequences for some stakeholders.

(b) Yes. Because the FASB rule results in a fairer representation, it should be implemented as soon as possible—regardless of its impact on net income. SEC Staff Bulletin No. 74 (December 30, 1987) requires a statement as to what the expected impact of the standard will be.

(c) The accountant's responsibility is to provide financial statements that present fairly the financial condition of the company. By advocating early implementation, Weller fulfills this task.

(d) Potential lenders and investors, who read the financial statements and rely on their fair representation of the financial condition of the company, have the most to gain by early implementation. A stockholder who is considering the sale of stock may be harmed by early implementation that lowers net income (and may lower the value of the stock).

LO: 3, Bloom: K, Difficulty: Complex, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-14

(a) The Securities and Exchange Commission (SEC) is an independent federal agency that receives its authority from federal legislation enacted by Congress. The Securities and Exchange Act of 1934 created the SEC.

(b) As a result of the Securities and Exchange Act of 1934, the SEC has legal authority relative to accounting practices. The U.S. Congress has given the SEC broad regulatory power to control accounting principles and procedures in order to fulfill its goal of full and fair disclosure.

(c) There is no direct relationship as the SEC was created by Congress and the Financial Accounting Standards Board (FASB) was created by the private sector. However, the SEC historically has followed a policy of relying on the private sector to establish financial accounting and reporting standards known as generally accepted accounting principles (GAAP). The SEC does not necessarily agree with all of the pronouncements of the FASB. In cases of unresolved differences, the SEC rules take precedence over FASB rules for companies within SEC jurisdiction.

LO: 2, Bloom: K, Difficulty: Moderate, Time: 30-40, AACSB: Communication, AICPA BB: AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-15

(a) The ethical issue in this case relates to making questionable entries to meet expected earnings forecasts. As indicated in this chapter, businesses' concentration on "maximizing the bottom line," "facing the challenges of competition," and "stressing short-term results" places accountants in an environment of conflict and pressure.

(b) Given that Normand has pleaded guilty, he certainly acted improperly. Doing the right thing, making the right decision, is not always easy. Right is not always obvious, and the pressures to "bend the rules," "to play the game," "to just ignore it" can be considerable.

(c) No doubt, Normand was in a difficult position. He was concerned that if he failed to go along, it would affect his job performance negatively or that he might be terminated. These job pressures, time pressures, peer pressures often lead individuals astray. Can it happen to you? One individual noted that at a seminar on ethics sponsored by the CMA Society of Southern California, attendees were asked if they had ever been pressured to make questionable entries. This individual noted that to the best of his recollection, everybody raised a hand, and more than one had eventually chosen to resign.

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CA 1-15 (Continued)

(d) Major stakeholders were: (1) Troy Normand, (2) present and potential stockholders and creditors of WorldCom, (3) employees, and (4) family. Recognize that WorldCom is the largest bankruptcy in United States history, so many individuals are affected.

LO: 4, Bloom: AN, Difficulty: Moderate, Time: 25-30, AACSB:Ethics, Analytic, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 1-16

(a) Considering the economic consequences of GAAP, it is not surprising that special interest groups become vocal and critical (some supporting, some opposing) when rules are being formulated. The FASB's derivative accounting pronouncement is no exception. Many from the banking industry, for example, criticized the rule as too complex and leading to unnecessary earnings volatility. They also indicated that the proposal may discourage prudent risk management activities and in some cases could present misleading financial information.

As a result, Congress is often approached to put pressure on the FASB to change its rulings. In the stock option controversy, industry was quite effective in going to Congress to force the FASB to change its conclusions. In the derivative controversy, Rep. Richard Baker introduced a bill which would force the SEC to formally approve each standard issued by the FASB. Not only would this process delay adoption, but could lead to additional politicalization of the rule-making process. Dingell commented that Congress should stay out of the rule-making process and defended the FASB's approach to establishing GAAP.

(b) Attempting to set GAAP by a political process will probably lead to the following consequences:
(a) Too many alternatives.
(b) Lack of clarity that will lead to inconsistent application.
(c) Lack of disclosure that reduces transparency.
(d) Not comprehensive in scope.

Without an independent process, GAAP will be based on political compromise. A classic illustration is what happened in the savings and loan industry. Applying generally accepted accounting principles to the S&L industry would have forced regulators to restrict activities of many S&Ls. Unfortunately, accounting principles were overridden by regulatory rules and the resulting lack of transparency masked the problems. William Siedman, former FDIC Chairman noted later that it was "the worst mistake in the history of government."

Another indication of the problem of government intervention is shown in the accounting standards used by some countries around the world. Completeness and transparency of information needed by investors and creditors is not available in order to meet or achieve other objectives.

LO: 4, Bloom: C, Difficulty: Moderate, Time: 25-30, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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CA 1-17

(a) The "due process" system involves the following:
1. Identifying topics and placing them on the Board's agenda.
2. Research and analysis is conducted and preliminary views of pros and cons issued.
3. A public hearing is often held.
4. Board evaluates research and public responses and issues exposure draft.
5. Board evaluates responses and changes exposure draft, if necessary. Final statement is then issued.

(b) Economic consequences mean the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact.

(c) Economic consequences indicated in the letter are: (1) concerns related to the potential impact on the capital markets, (2) the weakening of companies' ability to manage risk, and (3) the adverse control implications of implementing costly and complex new rules imposed at the same time as other major initiatives, including the Year 2000 issues and a single European currency.

(d) The principal point of this letter is to delay the finalization of the derivatives standard. As indicated in the letter, the authors of this letter urge the FASB to expose its new proposal for public comment, following the established due process procedures that are essential to acceptance of its standards and providing sufficient time for affected parties to understand and assess the new approach. (Authors note: The FASB indicated in a follow-up letter that all due process procedures had been followed and all affected parties had more than ample time to comment. In addition, the FASB issued a follow-up standard, which delayed the effective date of the standard, in part to give companies more time to develop the information systems needed for implementation of the standard).

(e) The reason why the letter was sent to Congress was to put additional pressure on the FASB to delay or drop the issuance of a rule on derivatives. Unfortunately, in too many cases, when the business community does not like the answer proposed by the FASB, it resorts to lobbying members of Congress. The lobbying efforts usually involve developing some type of legislation that will negate the rule. In some cases, efforts involve challenging the FASB's authority to develop rules in certain areas with additional Congressional oversight.

LO: 4, Bloom: E, Difficulty: Moderate, Time: 25-30, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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FINANCIAL REPORTING PROBLEM

(a) The key organizations involved in rule making in the U.S. are the AICPA, FASB, and SEC. See also (c).

(b) Different authoritative literature pertaining to methods recording accounting transactions exists today. Some authoritative literature has received more support from the profession than other literature. The literature that has substantial authoritative support is the one most supported by the profession and should be followed when recording accounting transactions. These standards and procedures are called generally accepted accounting principles (GAAP).

With implementation of the Codification, what qualifies as authoritative is any literature contained in the Codification. The Codification changes the way GAAP is documented, presented, and updated. It creates one level of GAAP which is considered authoritative. All other accounting literature is considered non-authoritative.

What happens if the Codification does not cover a certain type of transaction or event? In this case, other accounting literature should be considered which includes FASB Concepts Statements, international financial reporting standards and other professional literature.

(c) Rule-making in the U.S. has evolved through the work of the following organizations:

1. **American Institute of Certified Public Accountants (AICPA)—it is the national professional organization of practicing Certified Public Accountants (CPAs). Outgrowths of the AICPA have been the Committee on Accounting Procedure (CAP) which issued Accounting Research Bulletins and the Accounting Principles Board (APB) whose major purposes were to advance written expression of accounting principles, determine appropriate practices, and narrow the areas of difference and inconsistency in practice.**
2. **Financial Accounting Standards Board (FASB)—the mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of the financial information.**

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3. **Securities and Exchange Commission (SEC)—the SEC is an independent regulatory agency of the United States government which administers the Securities Act of 1933, the Securities Exchange Act of 1934, and several other acts. The SEC has broad power to prescribe the accounting practices and standards to be employed by companies that fall within its jurisdiction.**

(d) The SEC and the AICPA have been the authority for compliance with GAAP. The SEC has indicated that financial statements conforming to standards set by the FASB will be presumed to have authoritative support. The AICPA, in Rule 203 of the Code of Professional Ethics, requires that members prepare financial statements in accordance with GAAP. Failure to follow Rule 203 can lead to the loss of a CPA's license to practice.

LO: 2, 3, Bloom: K, Difficulty: Simple, Time: 20-25, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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SOLUTIONS TO CODIFICATION EXERCISES

CE1-1

The information at this link describes the elements offered in The FASB Accounting Standards Codification. As indicated, the website offers several resources to enhance your working knowledge of the Codification and the Codification Research System. This page includes links to help pages which describe specific functions and features of the Codification. Links to frequently asked questions, the FASB Learning Guide, and the Notice to Constituents are also available on this page.

Help pages

FAQ

Learning Guide

About the Codification—Notice of Constituents

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-10, AACSB: Communication, Technology, AICPA BB: Technology, AICPA FC: Research, Reporting, Technology, AICPA PC: Communication

CE1-2

The following information is provided at the Providing Feedback link:

The Codification includes a feature which can be used to submit content-related feedback or general, system-related comments. The feedback system is not designed for comments on proposed Accounting Standards Updates.

Content-related feedback

As a registered user of the FASB Accounting Standards Codification Research System website, you are able and are encouraged to provide feedback, at the paragraph level, to the FASB about any content-related matters. For specific information about the Codification and the feedback process, please read the Notice to Constituents.

To provide content-related feedback:

Click the Submit feedback button beneath the paragraph for which you want to provide feedback. Enter or copy/paste your comments in the text box. Note that formatting (lists, bold, etc.) is not retained and there is a 4,000 character limit on feedback submissions.

Click SUBMIT. Your comments are sent to the FASB and reviewed by FASB staff. You can also submit multiple comments for any given paragraph, if, for example, you determine that more information would be useful to the FASB staff.

General feedback

Click here to provide general feedback on the Codification in general, the Codification Research System website, and other system-related items that are not content specific.

LO: 3, Bloom: K, Difficulty: Simple, Time: 10-15, AACSB: Communication, Technology, AICPA BB: Technology, AICPA FC: Research, Reporting, Technology, AICPA PC: Communication

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CE1-3

The “What’s New” page provides links to Codification content that has been recently issued. During the verification phase, updates may result from either the issuance of Codification update instructions that accompany new Standards or from changes to the Codification due to incorporation of constituent feedback.

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-10, AACSB: Communication, Technology, AICPA BB: Technology, AICPA FC: Research, Reporting, Technology, AICPA PC: Communication

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RESEARCH CASE

(a) CON 1, Par. 32. The objectives begin with a broad focus on information that is useful in investment and credit decisions; then narrow that focus to investors' and creditors' primary interest in the prospects of receiving cash from their investments in or loans to business enterprises and the relation of those prospects to the enterprise's prospects; and finally focus on information about an enterprise's economic resources, the claims to those resources, and changes in them, including measures of the enterprise's performance, that is useful in assessing the enterprise's cash flow prospects.

(b) CON 1, Par. 7. Financial reporting includes not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system—that is, information about an enterprise's resources, obligations, earnings, etc. Management may communicate information to those outside an enterprise by means of financial reporting other than formal financial statements either because the information is required to be disclosed by authoritative pronouncement, regulatory rule, or custom or because management considers it useful to those outside the enterprise and discloses it voluntarily. Information communicated by means of financial reporting other than financial statements may take various forms and relate to various matters. Corporate annual reports, prospectuses, and annual reports filed with the Securities and Exchange Commission are common examples of reports that include financial statements, other financial information, and nonfinancial information. News releases, management's forecasts or other descriptions of its plans or expectations, and descriptions of an enterprise's social or environmental impact are examples of reports giving financial information other than financial statements or giving only nonfinancial information.

(c) CON 1, Par, 24 and 25: 24. Many people base economic decisions on their relationships to and knowledge about business enterprises and thus are potentially interested in the information provided by financial reporting. Among the potential users are owners, lenders, suppliers, potential investors and creditors, employees, management, directors, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities,

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legislators, financial press and reporting agencies, labor unions, trade associations, business researchers, teachers and students, and the public. Members and potential members of some groups—such as owners, creditors, and employees—have or contemplate having direct economic interests in particular business enterprises. Managers and directors, who are charged with managing the enterprise in the interest of owners (paragraph 12), also have a direct interest. Members of other groups—such as financial analysts and advisors, regulatory authorities, and labor unions—have derived or indirect interests because they advise or represent those who have or contemplate having direct interests.

Potential users of financial information most directly concerned with a particular business enterprise are generally interested in its ability to generate favorable cash flows because their decisions relate to amounts, timing, and uncertainties of expected cash flows. To investors, lenders, suppliers, and employees, a business enterprise is a source of cash in the form of dividends or interest and perhaps appreciated market prices, repayment of borrowing, payment for goods or services, or salaries or wages. They invest cash, goods, or services in an enterprise and expect to obtain sufficient cash in return to make the investment worthwhile. They are directly concerned with the ability of the enterprise to generate favorable cash flows and may also be concerned with how the market's perception of that ability affects the relative prices of its securities. To customers, a business enterprise is a source of goods or services, but only by obtaining sufficient cash to pay for the resources it uses and to meet its other obligations can the enterprise provide those goods or services. To managers, the cash flows of a business enterprise are a significant part of their management responsibilities, including their accountability to directors and owners. Many, if not most, of their decisions have cash flow consequences for the enterprise. Thus, investors, creditors, employees, customers, and managers significantly share a common interest in an enterprise's ability to generate favorable cash flows. Other potential users of financial information share the same interest, derived from investors, creditors, employees, customers, or managers whom they advise or represent or derived from an interest in how those groups (and especially stockholders) are faring.

LO: 1, Bloom: AN, Difficulty: Simple, Time: 25-30, AACSB: Analytic, Communication, AICPA BB: Technology, AICPA FC: Research, Reporting, Technology, AICPA PC: Communication

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IFRS CONCEPTS AND APPLICATION

IFRS 1-1

The two organizations involved in international standard-setting are IOSCO (International Organization of Securities Commissions) and the IASB (International Accounting Standards Board.) The IOSCO does not set accounting standards, but ensures that the global markets can operate in an efficient and effective manner. Conversely, the IASB's mission is to develop a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS 1-2

The standards issued by these organizations are sometimes principles-based, rules-based, tax-oriented, or business-based. In other words, they often differ in concept and objective.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS 1-3

A single set of high quality accounting standards ensures adequate comparability. Investors are able to make better investment decisions if they receive financial information from a U.S. company that is comparable to an international competitor.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS 1-4

The international standards must be of high quality and sufficiently comprehensive. To achieve this goal, the IASB and the FASB have set up an extensive work plan to achieve the objective of developing one set of world-class international standards. This work plan actually started in 2002, when an agreement was forged between the two Boards, where each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting (referred to as the Norwalk Agreement).

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IFRS 1-4 (Continued)

At that meeting, the FASB and the IASB pledged to use their best efforts to (1) make their existing financial reporting standards fully compatible as soon as is practicable, and (2) coordinate their future work programs to ensure that once achieved, compatibility is maintained. This document was reinforced in 2006 when the parties issued a memorandum of understanding (MOU) which highlighted three principles:

- **Convergence of accounting standards can best be achieved through the development of high-quality common standards over time.**
- **Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead, a new common standard should be developed that improves the financial information reported to investors.**
- **Serving the needs of investors means that the Boards should seek convergence by replacing standards in need of improvement with jointly developed new standards.**

Subsequently, in 2009 the Boards agreed on a process to complete a number of major projects by 2011, including monthly joint meetings. As part of achieving this goal, it is critical that the process by which the standards are established be independent. And, it is necessary that the standards are maintained, and emerging accounting issues are dealt with efficiently.

The SEC directed its staff to develop and execute a plan ("Work Plan") to enhance both the understanding of the SEC's purpose and public transparency in this area. The SEC Work Plan addresses such areas as independence of standard-setting, investor understanding of IFRS, and auditor readiness. Based on the staff report issued in 2012, it does not appear that the SEC is ready to adopt IFRS any time soon. However, the SEC has encouraged the FASB and IASB to continue their convergence efforts.

LO: 5, Bloom: K, Difficulty: Simple, 20-25, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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IFRS 1-5

(a) The International Accounting Standards Board is an independent, privately funded accounting standards setter based in London, UK. The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the Board cooperates with national accounting standards setters to achieve convergence in accounting standards around the world.

(b) In summary, the following groups might gain most from convergence of financial reporting:

- **Investors, investment analysts and stockbrokers: to facilitate international comparisons for investment decisions.**
- **Credit grantors: for similar reasons to bullet point above.**
- **Multinational companies: as preparers, investors, appraisers of products or staff, and as movers of staff around the globe; also, as raisers of finance on international markets (this also applies to some companies that are not multinationals).**
- **Governments: as tax collectors and hosts of multinationals; also interested are securities markets regulators and governmental and nongovernmental rule makers.**

(c) The fundamental argument against convergence is that, to the extent that international differences in accounting practices result from underlying economic, legal, social, and other environmental factors, harmonization may not be justified. Different accounting has grown up to serve the different needs of different users; this might suggest that the existing accounting practice is "correct" for a given nation and should not be changed merely to simplify the work of multinational companies or auditors. There does seem to be strength in this point particularly for smaller companies with no significant multinational activities or connections. To foist upon a small private family company in Luxembourg lavish disclosure requirements and the need to report a "true and fair" view may be an expensive and unnecessary piece of convergence.

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IFRS1-5 (Continued)

The most obvious obstacle to harmonization is the sheer size and deep rootedness of the differences in accounting. These differences have grown up over the previous century because of differences in users, legal systems, and so on. Thus, the differences are structural rather than cosmetic, and require revolutionary action to remove them.

LO: 5, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS 1-6

(a) "IFRS Framework OB2 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential 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."

(b) IFRS financial reports include note disclosures which will contain additional information relevant to the needs of users about items in the financial statements. In addition to these note disclosures IFRS Framework OB6 indicates: "However, general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks. Explanations with this additional pertinent information are often found in the Management Discussion and Analysis included in the annual report but not as part of audited financial statements and therefore not subject to accounting standards.

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IFRS1-6 (Continued)

(c) As indicated in the introduction to the IFRS framework, financial statements prepared to meet the objective of financial reporting meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information. In addition, financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management. Although management is also a user of financial information as discussed in OB9 of the IFRS Framework, they are able to access the information internally rather than through general purpose financial statements.

LO: 5, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS1-7

(a) Operating retail stores (clothing, home, and food).

(b) Operations are primarily in the UK, China, Czech Republic, Greece, Hungary, India, Indonesia, Jersey, Kuwait, Latvia, Lithuania, Malaysia, Malta, Oman, Philippines, Poland, Qatar, Republic of Ireland, Romania, Russia, Saudi Arabia, Serbia, Singapore, Slovakia, Slovenia, South Korea, Spain, Switzerland, Taiwan, Thailand, Turkey, UAE, and Ukraine.

(c) Waterside House, 35 North Wharf Road, London W2 1NW.

(d) Pound.

LO: 5, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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CHAPTER 1

Financial Accounting and Accounting Standards

ASSIGNMENT CLASSIFICATION TABLE

Topics		Questions	Cases
1.	Subject matter of accounting.	1, 2	4
2.	Environment of accounting.	3, 29	6, 7
3.	Role of principles, objectives, standards, and accounting theory.	4, 5, 6, 7	1, 2, 3, 5
4.	Historical development of GAAP.	8, 9, 10, 11	8, 9
5.	Authoritative pronouncements and rule-making bodies.	12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 24	3, 9, 11, 12, 13, 14, 16, 17
6.	Role of pressure groups.	22, 23, 26, 27, 28	10, 15, 16, 17
7.	Ethical issues.	25, 27, 29	15

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
CA1-1	FASB and standard-setting.	Simple	15–20
CA1-2	GAAP and standard-setting.	Simple	15–20
CA1-3	Financial reporting and accounting standards.	Simple	15–20
CA1-4	Financial accounting.	Simple	15–20
CA1-5	Objective of financial reporting.	Moderate	20–25
CA1-6	Accounting numbers and the environment.	Simple	10–15
CA1-7	Need for GAAP.	Simple	15–20
CA1-8	AICPA's role in rule-making.	Simple	20–25
CA1-9	FASB role in rule-making.	Simple	20–25
CA1-10	Politicalization of GAAP.	Complex	30–40
CA1-11	Models for setting GAAP.	Simple	15–20
CA1-12	GAAP terminology.	Moderate	30–40
CA1-13	Rule-making Issues.	Complex	20–25
CA1-14	Securities and Exchange Commission.	Moderate	30–40
CA1-15	Financial reporting pressures.	Moderate	25–35
CA1-16	Economic consequences.	Moderate	25–35
CA1-17	GAAP and economic consequences.	Moderate	25–35

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LEARNING OBJECTIVES

1. Understand the financial reporting environment.
2. Identify the major policy-setting bodies and their role in the standard-setting process.
3. Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.
4. Describe major challenges in the financial reporting environment.

*5. Compare the procedures related to financial accounting and accounting standards under GAAP and IFRS.

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CHAPTER REVIEW

1. Chapter 1 describes the environment that has influenced both the development and use of the financial accounting process. The chapter traces the development of financial accounting standards, focusing on the groups that have had or currently have the responsibility for developing such standards. Certain groups other than those with direct responsibility for developing financial accounting standards have significantly influenced the standard-setting process. These various pressure groups are also discussed.

Nature of Financial Accounting

2. (L.O. 1) The essential characteristics of accounting are (1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties. **Financial accounting** is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties.

3. **Financial statements** are the principal means through which a company communicates its financial information to those outside it. The financial statements most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners' or stockholders' equity. Other means of financial reporting include the president's letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management forecasts, and social or environmental impact statements.

Accounting and Capital Allocation

4. Accounting is important for markets, free enterprise, and competition because it assists in providing information that leads to capital allocation. The better the information, the more effective the process of capital allocation and then the healthier the economy.

Objective of Financial Reporting

5. 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 decisions about providing resources to the company. **General-purpose financial statements** provide financial reporting information to a wide variety of users.

6. The objective of financial reporting identifies investors and creditors as the primary users for general-purpose financial statements. As part of the objective of general-purpose financial reporting, an **entity perspective** is adopted. Companies are viewed as separate and distinct from their owners. When making decisions, investors are interested in assessing (1) the company's ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments.

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7. The accounting profession has developed a common set of standards and procedures known as **generally accepted accounting principles (GAAP).** These principles serve as a general guide to the accounting practitioner in accumulating and reporting the financial information of a business enterprise.

Securities and Exchange Commission (SEC)

8. (L.O. 2) After the stock market crash in 1929 and the Great Depression, there were calls for increased government regulation and supervision—especially of financial institutions and the stock market. As a result, the federal government established the Securities and Exchange Commission (**SEC**) to help develop and standardize financial information presented to stockholders. The SEC is a federal agency and administers the Securities Exchange Act of 1934 and several other acts. Most companies that issue securities to the public or are listed on a stock exchange are required to file audited financial statements with the SEC. In addition, the SEC has broad powers to prescribe the accounting practices and standards to be employed by companies that fall within its jurisdiction.

9. At the time the SEC was created, it encouraged the creation of a private standards-setting body. As a result, accounting standards have generally been developed in the private sector either through the American Institute of Certified Public Accountants (**AICPA**) or the Financial Accounting Standards Board (**FASB**). The SEC has affirmed its support for the FASB by indicating that financial statements conforming to standards set by the FASB will be presumed to have substantial authoritative support.

10. Over its history, the SEC's involvement in the development of accounting standards has varied. In some cases, the private sector has attempted to establish a standard, but the SEC has refused to accept it. In other cases, the SEC has prodded the private sector into taking quicker action on setting standards.

11. If the SEC believes that an accounting or disclosure irregularity exists regarding a company's financial statements, the SEC sends a deficiency letter to the company. If the company's response to the deficiency letter proves unsatisfactory, the SEC has the power to issue a "stop order," which prevents the registrant from issuing securities or trading securities on the exchanges. Criminal charges may also be brought by the Department of Justice.

The AICPA and Development of Accounting Principles

12. The first group appointed by the AICPA to address the issue of uniformity in accounting practice was the **Committee on Accounting Procedure (CAP).** This group served the accounting profession from 1939 to 1959. During that period, it issued 51 **Accounting Research Bulletins (ARBs)** that narrowed the wide range of alternative accounting practices then in existence.

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13. In 1959, the AICPA created the **Accounting Principles Board (APB).** The major purposes of this group were (a) to advance the written expression of accounting principles, (b) to determine appropriate practices, and (c) to narrow the areas of difference and inconsistency in practice. The APB was designated as the AICPA's sole authority for public pronouncements on accounting principles. Its pronouncements, known as **APB Opinions,** were intended to be based mainly on research studies and be supported by reason and analysis.

Transition to FASB

14. The APB operated in a somewhat hostile environment for 13 years. Early in its existence it was criticized for lack of productivity and failing to act promptly, then it was criticized for overreacting to certain issues. A committee, known as the **Study Group on Establishment of Accounting Principles (Wheat Committee),** was set up to study the APB and recommend changes in its structure and operation. The result of the Study Group's findings was the demise of the APB and the creation of the Financial Accounting Standards Board (FASB).

The FASB

15. The FASB represents the current rule-making body within the accounting profession. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information. The FASB differs from the predecessor APB in the following ways:

    a. Smaller membership (7 versus 18 on the APB).

    b. Full-time remunerated membership (APB members were unpaid and part-time).

    c. Greater autonomy (APB was a senior committee of the AICPA).

    d. Increased independence (FASB members must sever all ties with firms, companies, or institutions).

    e. Broader representation (it is not necessary to be a CPA to be a member of the FASB).

    Two basic premises of the FASB are that in establishing financial accounting standards: (a) it should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (b) it should operate in full view of the public through a "due process" system that gives interested persons ample opportunity to make their views known.

Due Process

16. The FASB issues two major types of pronouncements:

    a. **Accounting Standards Updates.** The Updates amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC. Each Update explains how the Codification has been amended and also includes information to help the reader understand the

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changes and when those changes will be effective. They are considered GAAP and must be followed in practice.

b. **Financial Accounting Concepts**. The SFACs represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework that will serve as tools for solving existing and emerging problems in a consistent manner. Unlike FASB statements, the Concept Statements do not establish GAAP.

17. In 1984, the FASB created the **Emerging Issues Task Force (EITF).** The purpose of the Task Force is to reach a consensus on how to account for new and unusual financial transactions that have the potential for creating differing financial reporting practices. The EITF can deal with short-term accounting issues by reaching a consensus and thus avoiding the need for deliberation by the FASB and the issuance of an FASB Statement.

GAAP

18. (L.O. 3) Generally accepted accounting principles (GAAP) are those principles that have **substantial authoritative support.** Accounting principles that have substantial authoritative support are those found in FASB Statements, Interpretations, and Staff Positions; APB Opinions; and Accounting Research Bulletins (ARBs). If an accounting transaction is not covered in any of these documents, the accountant may look to other authoritative accounting literature for guidance.

19. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("**the Codification**") to provide in one place all the authoritative literature related to a particular topic. The Codification changes the way GAAP is documented, presented, and updated. The Financial Accounting Standards Board Codification Research System (CRS) is an online real-time database that provides easy access to the Codification.

Impact of User Groups

20. (L.O. 4) Although accounting standards are developed by using careful logic and empirical findings, a certain amount of pressure and influence is brought to bear by groups interested in or affected by accounting standards. The FASB does not exist in a vacuum, and politics and special-interest pressures remain a part of the standard-setting process.

21. Along with establishing the PCAOB, the **Sarbanes-Oxley Act** implements stronger independence rules for auditors, requires CEOs and CFOs to personally certify that financial statements and disclosures are accurate and complete, requires audit committees to be comprised of independent members, and requires a code of ethics for senior financial officers. In addition, the Sarbanes-Oxley Act requires public companies to attest to the effectiveness of their internal controls over financial reporting.

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Financial Reporting Chalenges

23. Some of the challenges facing financial reporting in the future include:

    a. **Nonfinancial measurements,** which include customer satisfaction indexes, backlog information, and reject rates on goods purchased.

    b. **Forward-looking information.**

    c. **Soft assets,** include such intangibles as market dominance, expertise in supply chain management, and brand image.

    d. **Timeliness,** including real-time financial statement information.

    e. **Understandability,** including concerns about the complexity and lack of understandability of financial reports raised by investors and market regulators.

24. Most countries have recognized the need for more global standards. The **International Accounting Standards Board (IASB)** and U.S. rule-making bodies are working together to reconcile U.S. GAAP with the IASB International Financial Reporting Standards (IFRS). The FASB and the IASB agreed to make their existing financial reporting standards fully compatible as soon as practicable, and coordinate their future work programs to ensure that once achieved, compatibility is maintained.

25. In accounting, ethical dilemmas are encountered frequently. The whole process of ethical sensitivity and selection among alternatives can be complicated by pressures that may take the form of time pressures, job pressures, client pressures, personal pressures, and peer pressures. Throughout the textbook, ethical considerations are presented to sensitize you to the type of situations you may encounter in your profession.

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LECTURE OUTLINE

The material in this chapter usually can be covered in one class session. The issues in this chapter can be addressed by organizing a lecture around the following.

A. (L.O. 1) Major financial statements and financial reporting.

1. **Identification, measurement,** and **communication** of financial information (discuss differences between financial statements and financial reporting).

   a. Financial statements:

      (1) Income statement.

      (2) Balance sheet.

      (3) Statement of cash flows.

      (4) Statement of owners' or stockholders' equity.

   b. Other financial reporting means:

      (1) President's letter or supplementary schedules in the annual report.

      (2) Prospectuses.

      (3) Reports filed with the SEC and other government agencies.

      (4) News releases and management forecasts.

      (5) Social or environmental impact statements.

2. About **economic entities.**

3. To **interested parties** (including stockholders, creditors, government agencies, management, employees, consumers, labor unions, etc.).

B. **Accounting and capital allocations.**

1. A world of scarce resources. Accounting helps to identify efficient and inefficient users of resources.

2. Capital allocation. Accounting assists in the effective capital allocation process by providing financial reports to interested users.

3. Changing user needs. Accounting will continue to be faced with challenges to providing information needed for an efficient capital allocation process.

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C. Objective of financial reporting.

1. 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.

   a. General-purpose financial statements.

   b. Equity investors and creditors.

   c. Entity perspective.

   d. Decision-usefulness.

D. Need for accounting standards.

1. To meet the various needs of users, companies prepare a single set of general-purpose financial statements.

2. Users expect financial statements to present fairly, clearly, and completely the company's financial operations.

3. The accounting profession has developed a set of standards and procedures called **generally accepted accounting principles (GAAP)**.

E. (L.O. 2) Parties involved in standard-setting.

1. Standard setting in the public sector:

   a. The role of the SEC, reasons for its establishment, SEC jurisdiction.

   b. Delegation of SEC's authority to the private sector (AICPA and FASB).

2. Standard setting in the private sector.

   a. History of private-sector standard setting:

      (1) Committee on Accounting Procedure (CAP).

         a. This group served the accounting profession from 1939 to 1959. During that period, it issued 51 **Accounting Research Bulletins (ARBs)** that narrowed the wide range of alternative accounting practices then in existence.

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(2) Accounting Principles Board (APB).

a. The major purposes of this group were (a) to advance the written expression of accounting principles, (b) to determine appropriate practices, and (c) to narrow the areas of difference and inconsistency in practice. Its pronouncements, known as **APB Opinions,** were intended to be based mainly on research studies and be supported by reason and analysis.

(3) Financial Accounting Standards Board (FASB).

a. Reasons for establishment of the FASB.

b. Composition, membership, and voting rules of the FASB.

c. Organization and funding of the FASB.

b. Description of the FASB's "due process" system in setting standards.

c. Two major types of pronouncements issued by FASB:

(1) **Accounting Standards Updates** amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC.

(2) **Financial Accounting Concepts** represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework.

d. **Emerging Issues Task Force** were created by FASB for the purpose of reaching a consensus on how to account for new and unusual financial transactions that have a potential for creating differing financial reporting practices.

3. The SEC continues to play an active role in influencing standards, e.g., accounting for business combinations and intangible assets; and concerns about the accounting for off-balance sheet items raised by the failure of Enron.

F. (L.O. 3) Meaning of GAAP.

1. Generally accepted accounting principles (GAAP) have substantive authoritative support.

2. The AICPA's Code of Professional Conduct requires that members prepare financial statements in accordance with GAAP.

3. GAAP includes:

a. FASB Standards and Interpretations, APB Opinions, AICPA Accounting Research Bulletins. (Most authoritative.)

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b. AICPA Industry Audit and Accounting Guides, AICPA Statements of Position, FASB Technical Bulletins.

c. FASB Emerging Issues Task Force, AICPA AcSEC Practice Bulletins, widely recognized/prevalent industry practices.

(1) The AICPA no longer issues authoritative accounting guidance for public companies.

d. AICPA Accounting Interpretations, FASB Implementation Guides (Q and A)

4. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("the Codification").

a. The Codification changes the way GAAP is documented, presented and updated.

b. Explains what GAAP is and eliminates nonessential information.

G. (L.O. 4) Major challenges in the financial reporting environment.

1. **Politicization** and the impact of various user groups on the development of GAAP

2. The **expectations gap.**

a. What people think accountants should do vs. what accountants think they can do.

b. Sarbanes-Oxley Act and the Public Company Accounting Oversight Board.

3. Financial reports fail to report:

a. Nonfinancial measurements. Financial reports failed to provide some key performance measures widely used by management.

b. Forward-looking information. Financial reports failed to provide forward-looking information needed by present and potential investors and creditors

c. Soft assets. Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information about a company's soft assets (intangibles).

d. Timeliness. Generally only historical information is provided with little to no real-time financial statement information available.

e. Understandability. Financial reports are often complex and hard to understand.

f. International accounting standards.

1) Companies outside the U.S. often prepare financial statements using standards different from GAAP.

2) There is a growing demand for one set of high-quality international standards.

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3) There are two sets of acceptable rules for international use—GAAP and International Financial Reporting Standards issued by the International Accounting Standards Board (IASB).

4) The FASB and the IASB have agreed to use their best efforts to:

a) Make their existing financial reporting standards fully compatible as soon as practicable, and

b) Coordinate their future work programs to ensure that once achieved, compatibility is maintained.

H. Ethics and financial accounting.

1. In accounting, companies frequently encounter ethical dilemmas. Some of these dilemmas are easy to resolve but many are not, requiring difficult choices among allowable alternatives.

2. Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives.

3. Decisions are sometimes difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines in making ethical judgments.

*I. (L.O. 5) **IFRS Insights.**

1. Most agree that there is a need for one set of international accounting standards. Here is why:

a. ***Multinational corporations.*** Today's companies view the entire world as their market. For example, Coca-Cola, Intel, and McDonald's generate more than 50 percent of their sales outside the United States, and many foreign companies, such as Toyota, Nestlé, and Sony, find their largest market to be the United States.

b. ***Mergers and acquisitions.*** The mergers between Fiat/Chrysler and Vodafone/Mannesmann suggest that we will see even more such business combinations in the future.

c. ***Information technology.*** As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.

d. ***Financial markets.*** Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

2. Relevant Facts

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a. International standards are referred to as *International Financial Reporting Standards (IFRS),* developed by the International Accounting Standards Board (IASB). As a result of recent events in the global capital markets, many are examining which accounting and financial disclosure rules should be followed.

b. U.S. standards, referred to as generally accepted accounting principles (GAAP), are developed by the Financial Accounting Standards Board (FASB). The fact that there are differences between what is in this textbook (which is based on U.S. standards) and IFRS should not be surprising because the FASB and IASB have responded to different user needs. It appears that the United States and the international standard-setting environment are primarily driven by meeting the needs of investors and creditors.

c. The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation as it will generate higher costs.

d. A number of ethics violations have occurred.

e. IFRS tends to be simpler in its accounting and disclosure requirements; some people say more "principles-based." GAAP is more detailed; some people say more "rules-based." This difference in approach has resulted in a debate about the merits of "principles-based" versus "rules-based" standards.

3. International Standards-Setting Organizations.

   a. **International Organization of Securities Commissions** (IOSCO) is dedicated to ensuring that the global markets can operate in an efficient and effective basis.

   b. **International Accounting Standards Boards** issues International Financial Reporting Standards (IFRS) which are used on most foreign exchanges.

   c. Three types of pronouncements.

      (1) International Financial Reporting Standards.

      (2) Framework for financial reporting. This Framework sets forth fundamental objectives and concepts that the Board uses in developing future standards of financial reporting.

      (3) International financial reporting interpretations. These interpretations cover (1) newly identified financial reporting issues not specifically dealt with in IFRS, and (2) issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop, in the absence of authoritative guidance.

4. International Accounting Convergence.

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a. The FASB and the IASB have been working diligently to (1) make their existing financial reporting standards fully compatible as soon as is practicable, and (2) coordinate their future work programs to ensure that once achieved, compatibility is maintained.

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CHAPTER 2

Conceptual Framework for Financial Reporting

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Concepts for Analysis
1. Conceptual framework–general.	1, 7			1, 2
2. Objectives of financial reporting.	2, 7		1, 2	3
3. Qualitative characteristics of accounting.	3, 4, 5, 6, 8	1, 2, 3, 4	2, 3, 4	4, 9
4. Elements of financial statements.	9, 10, 11, 30	6, 12	5	
5. Basic assumptions.	12, 13, 14	5, 7, 10	6, 7	
6. Basic principles:				
a. Measurement.	15, 16, 17, 18	8, 9	6, 7	5
b. Revenue recognition.	19, 20, 21, 22, 23, 30	8	7	5
c. Expense recognition.	24, 30	8	6, 7	6, 7, 8, 10
d. Full disclosure.	25, 26, 27	8	6, 7, 8	11
7. Accounting principles–comprehensive.			9, 10	
8. Constraints.	28, 29, 30	10	3, 6, 7	11
9. Assumptions, principles, and constraints.		11	6, 7	

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ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises
1. Describe the usefulness of a conceptual framework.		1, 2
2. Understand the objective of financial reporting.		1, 2
3. Identify the qualitative characteristics of accounting information.	1, 2, 3, 4, 5	2, 3, 4
4. Define the basic elements of financial statements.	6, 12	5
5. Describe the basic assumptions of accounting.	7, 10	6, 7
6. Explain the application of the basic principles of accounting.	8, 9, 11	6, 7, 8, 9, 10
7. Describe the impact that the cost constraint has on reporting accounting information.	11	3, 6, 7
*8. Compare the conceptual frameworks underlying GAAP and IFRS.		

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E2-1	Usefulness, objectives of financial reporting.	Simple	15–20
E2-2	Usefulness, objectives of financial reporting, qualitative characteristics.	Simple	15–20
E2-3	Qualitative characteristics.	Moderate	25–30
E2-4	Qualitative characteristics.	Simple	15–20
E2-5	Elements of financial statements.	Simple	15–20
E2-6	Assumptions, principles, and constraint.	Simple	15–20
E2-7	Assumptions, principles, and constraint.	Moderate	20–25
E2-8	Full disclosure principle.	Complex	20–25
E2-9	Accounting principles–comprehensive.	Moderate	20–25
E2-10	Accounting principles–comprehensive.	Moderate	20–25
CA2-1	Conceptual framework–general.	Simple	20–25
CA2-2	Conceptual framework–general.	Simple	25–35
CA2-3	Objective of financial reporting.	Moderate	25–35
CA2-4	Qualitative characteristics.	Moderate	30–35
CA2-5	Revenue recognition principle.	Complex	25–30
CA2-6	Expense recognition principle.	Moderate	30–35
CA2-7	Expense recognition principle.	Complex	20–25
CA2-8	Expense recognition principle.	Moderate	20–25
CA2-9	Qualitative characteristics.	Moderate	20–30
CA2-10	Expense recognition principle.	Moderate	20–25
CA2-11	Cost constraint.	Moderate	30–35

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LEARNING OBJECTIVES

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.

*8. Compare the conceptual frameworks underlying GAAP and IFRS.

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CHAPTER REVIEW

1. Chapter 2 outlines the development of a conceptual framework for financial reporting. The conceptual framework is composed of a basic objective, fundamental concepts, and recognition, measurement, and disclosure concepts. Each of these topics is discussed in Chapter 2 and should enhance your understanding of the topics covered in intermediate accounting.

Conceptual Framework

2. (L.O. 1) A **conceptual framework** in accounting is important because rule-making should be built on and relate to an established body of concepts. The benefits of a soundly developed conceptual framework are as follows: (a) it should be easier to issue a coherent set of standards and rules; and (b) practical problems should be more quickly solved.

3. The FASB's conceptual framework is developed in a series of concept statements (collectively the Conceptual Framework). The conceptual framework has the following 3 levels:

   a. First level: The objective of financial reporting, the "why" or purpose of accounting.

   b. Second level: The qualitative characteristics and the elements of financial statements, which form a bridge between the 1st and 3rd levels.

   c. Third level: Recognition, measurement, and disclosure concepts, the "how" or implementation.

First Level: Basic Objective

4. (L.O. 2) The basic objective of financial reporting is the foundation of the conceptual framework and requires that general-purpose financial reporting provide 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. In order to understand general-purpose financial reporting, users need reasonable knowledge of business and financial matters.

Second Level: Fundamental Concepts

5. (L.O. 3) Companies must decide what type of information to disclose and how to disclose it. These choices are determined by which method or alternative provides the most decision-useful information. The qualitative characteristics of accounting information distinguish better and more useful information from inferior and less useful information.

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Fundamental Qualities

6. The fundamental qualities of accounting information are:

   a. **Relevance** – information that is capable of making a difference in a decision. Comprised of

      1. **Predictive value** means that the information can help users form expectations about the future.
      2. **Confirmatory value** means that the information validates or refutes expectations based on previous evaluations.
      3. **Materiality** means that information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

   b. **Faithful representation** – numbers and descriptions match what really happened or existed. Comprised of

      1. **Completeness** means that all necessary information is provided.
      2. **Neutrality** means that the information is unbiased.
      3. **Free from error** means that the information is accurate.

Enhancing Qualities

7. Enhancing qualities complement the fundamental qualities and include:

   a. **Comparability** means that companies record and report information in a similar manner. **Consistency** is another type of comparability and means the company uses the same accounting methods from period to period.

   b. **Verifiability** means that independent people using the same methods arrive at similar conclusions.

   c. **Timeliness** means that information is available before it loses its relevance.

   d. **Understandability** means that reasonably informed users should be able to comprehend the information that is clearly classified and presented.

Basic Elements

8. (L.O. 4) An important aspect of developing an accounting theoretical structure is the body of basic elements or definitions. Ten basic elements that are most directly related to measuring the performance and financial status of a business enterprise are formally defined in *SFAC No. 6*. These elements, as defined below, are further discussed and interpreted throughout the text.

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

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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.

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 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.

Basic Assumptions

9. (L.O. 5) In the practice of financial accounting, certain basic assumptions are important to an understanding of the manner in which data are presented. The following four basic assumptions underlie the financial accounting structure:

Economic Entity Assumption. Economic activity can be identified with a particular unit of accountability in a manner that assumes the company is separate and distinct from its owners or other business units.

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Going Concern Assumption. In the absence of contrary information, a company is assumed to have a long life. The current relevance of the historical cost principle is dependent on the going-concern assumption.

Monetary Unit Assumption. Money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. The monetary unit is assumed to remain relatively stable over the years in terms of purchasing power. In essence, this assumption disregards any inflation or deflation in the economy in which the company operates.

Periodicity Assumption. The economic activities of a company can be divided into artificial time periods for the purpose of providing the company's periodic reports.

Basic Principles

10. (L.O. 6) Certain **basic principles** are followed by accountants in recording and reporting the transactions of a business entity. These principles relate to how assets, liabilities, revenues, and expenses are to be **identified, measured,** and **reported.**

Measurement Principle. A 'mixed-attribute' system permits the use of various measurement bases.

Historical Cost Principle. Acquisition cost is considered a reliable basis upon which to account for assets and liabilities of a company. Historical cost has an advantage over other valuations, as it is thought to be verifiable.

Fair Value Principle. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in on orderly transaction between market participants at the measurement date. Recently, GAAP has increasingly called for the use of fair value measurements in the financial statements.

Revenue Recognition Principle. Revenue is recognized at the time in which the performance obligation is satisfied.

Expense Recognition Principle (matching principle). Recognition of expenses is related to net changes in assets and earning revenues. The expense recognition principle is implemented in accordance with the definition of expense by matching efforts (expenses) with accomplishment (revenues).

Product costs, such as material, labor, and overhead, attach to the product, and are recognized in the same period the products are sold.

Period costs, such as officers' salaries and other administrative expenses, attach to the period, and are recognized in the period incurred.

Full Disclosure Principle. In the preparation of financial statements, the accountant should include sufficient information to influence the judgment and decision of an informed user. A series of judgmental tradeoffs must occur.

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Cost Constraint

11. (L.O. 7) Although accounting theory is based upon certain assumptions and the application of basic principles, there are some exceptions to these assumptions. One exception is often called a constraint, and sometimes justifies departures from basic accounting theory.

    Cost Constraint. The cost constraint (or cost-benefit relationship) relates to the notion that the benefits to be derived from providing certain accounting information should exceed the costs of providing that information. The difficulty in cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable.

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LECTURE OUTLINE

The material in this chapter can usually be covered in two class sessions. The first class session can be used for lecture and discussion of the concepts presented in the chapter. The second class session can be used to develop the students' understanding of these concepts by applying them to specific accounting situations. Students frequently believe that they understand the concepts, but have difficulty correctly identifying improper accounting procedures in practical situations. Apparently, students are not alone in this difficulty.

A. (L.O. 1) Need for a Conceptual Framework.

1. Build on and relate to an established body of concepts.
2. Issue more useful and consistent pronouncements over time.
3. Increase financial statement users' understanding of and confidence in financial reporting.
4. Enhance comparability among companies' financial statements.
5. Provide a framework for solving new and emerging practical problems.

B. Development of a Conceptual Framework.

C. (L.O. 2) First Level: Basic Objective. (Also discussed in Chapter 1).

1. Information that is **useful** to present and potential equity **investors, lenders** and other **creditors** in making decisions in their capacity as capital providers.
2. Information helpful to capital providers may also be helpful to other users who are not capital providers.

D. (L.O. 3) Second Level: Fundamental Concepts.

1. Qualitative characteristics. The overriding criterion for evaluating accounting information is that it must be **useful for decision making.** To be useful, it must be **understandable.**
   a. Fundamental qualities of useful accounting information.
      (1) **Relevance.** Accounting information is relevant if it is capable of making a difference in a decision. Relevant information has
         (a) Predictive value.
         (b) Confirmatory value.
         (c) Materiality.

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(2) **Faithful Representation.** For accounting information to be useful, the numbers and descriptions contained in the financial statements must faithfully represent what really existed or happened. To be a faithful representation, information must be

(a) Complete.

(b) Neutral.

(c) Free of error.

b. Enhancing qualities of useful information.

(1) **Comparability.** Information that is measured and reported in a similar manner for different companies is considered comparable. **Consistency** exists when a company applies the same accounting treatment to similar events, period to period.

(2) **Verifiability.** When independent measurers, using the same methods, obtain similar results.

(3) **Timeliness.** Having information available to decision-makers before it loses its capacity to influence decisions.

(4) **Understandability.** When information lets reasonably informed users see the connection between their decisions and the information contained in the financial statements.

2. (L.O. 4) Elements. (See text page 55 for definitions.) Items a-c are elements at a moment in time. Items d-j are elements during a period of time.

a. Assets.

b. Liabilities.

c. Equity.

d. Investments by owners.

e. Distributions to owners.

f. Comprehensive income.

g. Revenues.

h. Expenses.

i. Gains.

j. Losses.

E. (L.O. 5) Third Level: Recognition, Measurement, and Disclosures Concepts.

1. Assumptions.

a. **Economic entity assumption**. Economic activity can be identified with a particular unit of accountability.

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b. **Going concern assumption**. Companies will have a long enough life to justify depreciation and amortization.

c. **Monetary unit assumption**. The monetary unit (i.e., the dollar) is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. A second assumption is that the monetary unit remains reasonably stable.

d. **Periodicity assumption.** Activities of an enterprise can be divided into artificial time periods.

2. (L.O. 6) Basic Principles of Accounting.

a. **Measurement principle**. GAAP permits the use of historical cost and fair value bases.

(1) **Historical cost principle.** Generally thought to be verifiable.

(2) **Fair value principle.** Fair value information may be more useful for certain types of assets and liabilities. The three broad levels of the fair value hierarchy are:

a. **Level 1**. Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.
b. **Level 2**. Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable data.
c. **Level 3**. Unobservable inputs such as discounted expected future net cash flows.

b. **Revenue recognition principle.** Revenue is recognized at the time in which the performance obligation is satisfied.

c. **Expense recognition principle (matching principle).** Efforts (expenses) should be matched with accomplishments (revenues) if feasible.

(1) Practical rules for expense recognition: Analyze costs to determine whether a direct relationship exists with revenue.

(a) When a direct relationship exists, expense costs against revenues in the period when the revenue is recognized.

(b) When a direct relationship exists but is difficult to identify, allocate costs rationally and systematically to an expense in the periods benefited.

(c) When little, if any, direct relationship exists, expense as incurred.

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d. **Full disclosure principle.** Reveals in financial statements any facts of sufficient importance to influence the judgment and decisions of an informed reader. (Develop concept of reasonably prudent investor.) Discuss use of notes and supplementary information in financial reporting.

3. (L.O. 7) **Cost constraint.** The benefit to be derived from having accounting information should exceed the cost of providing it. Frequently it is easier to assess the costs than it is to determine the benefits of providing a particular item of information.

*F. (L.O. 8) **IFRS Insights.**

1. The IASB and FASB are working on a joint project to develop a common conceptual framework. This framework is based on the existing conceptual frameworks underlying GAAP and IFRS. The objective of this joint project is to develop a conceptual framework that leads to standards that are principles-based and internally consistent and that leads to the most useful financial reporting.

2. Relevant Facts.

   a. Similarities.

      (1) In 2010, the IASB and FASB completed the first phase of a jointly created conceptual framework. In this first phase, they agreed on the objective of financial reporting and a common set of desired qualitative characteristics.

      (2) The existing conceptual frameworks underlying GAAP and IFRS are very similar. That is, they are organized in a similar manner (objectives, elements, qualitative characteristics; etc.).

      (3) The converged framework should be a single document, unlike the two conceptual frameworks that presently exist; it is unlikely that the basic structure related to the concepts will change.

      (4) Both the IASB and FASB have similar measurement principles, based on historical cost and fair value.

   b. Differences.

      (1) Although both GAAP and IFRS are increasing the use of fair value to report assets, at this point IFRS has adopted it more broadly.

      (2) GAAP has a concept statement to guide estimation of fair values when market-related data is not available. The IASB is considering a proposal to provide expanded guidance on estimating fair values.

      (3) 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.

      (4) The economic entity assumption is also part of each framework although some cultural differences result in differences in its application.

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Prepared by:
Coby Harmon
University of California, Santa Barbara
Westmont College

WILEY

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PREVIEW OF CHAPTER 2

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

CONCEPTUAL FRAMEWORK
- Need
- Development
- Overview

FIRST LEVEL: BASIC OBJECTIVE

SECOND LEVEL: FUNDAMENTAL CONCEPTS
- Qualitative characteristics
- Basic elements

THIRD LEVEL: RECOGNITION AND MEASUREMENT CONCEPTS
- Basic assumptions
- Basic principles
- Cost constraint
- Summary of the structure

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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.

CONCEPTUAL FRAMEWORK

The Need for a Conceptual Framework

- To develop a coherent set of standards and rules.
- To solve new and emerging practical problems.

LO 1

CONCEPTUAL FRAMEWORK

Question (true or false):

A conceptual framework underlying financial accounting is important because it can lead to consistent standards and it prescribes the nature, function, and limits of financial accounting and financial statements.

True

LO 1

CONCEPTUAL FRAMEWORK

Question (true or false):

A conceptual framework underlying financial accounting is necessary because future accounting practice problems can be solved by reference to the conceptual framework and a formal standard-setting body will not be necessary.

False

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.

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Development of Conceptual Framework

The **FASB** has issued seven **Statements of Financial Accounting Concepts** (SFAC) for business enterprises.

SFAC No.1 - Objectives of Financial Reporting (superseded by SFAC No. 8)

SFAC No.2 - Qualitative Characteristics of Accounting Information. (superseded by SFAC No. 8)

SFAC No.3 - Elements of Financial Statements. (superseded by SFAC No. 6)

SFAC No.5 - Recognition and Measurement in Financial Statements.

SFAC No.6 - Elements of Financial Statements (replaces SFAC No. 3).

SFAC No.7 - Using Cash Flow Information and Present Value in Accounting Measurements.

SFAC No.8 - The Objective of General Purpose Financial Reporting and Qualitative Characteristics of Useful Financial Information (replaces SFAC No. 1 and No. 2)

LO 1

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CONCEPTUAL FRAMEWORK

Overview of the Conceptual Framework

- **First Level** = Basic Objectives
- **Second Level** = Qualitative Characteristics and Elements
- **Third Level** = Recognition, Measurement, and Disclosure Concepts.

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.

LO 1

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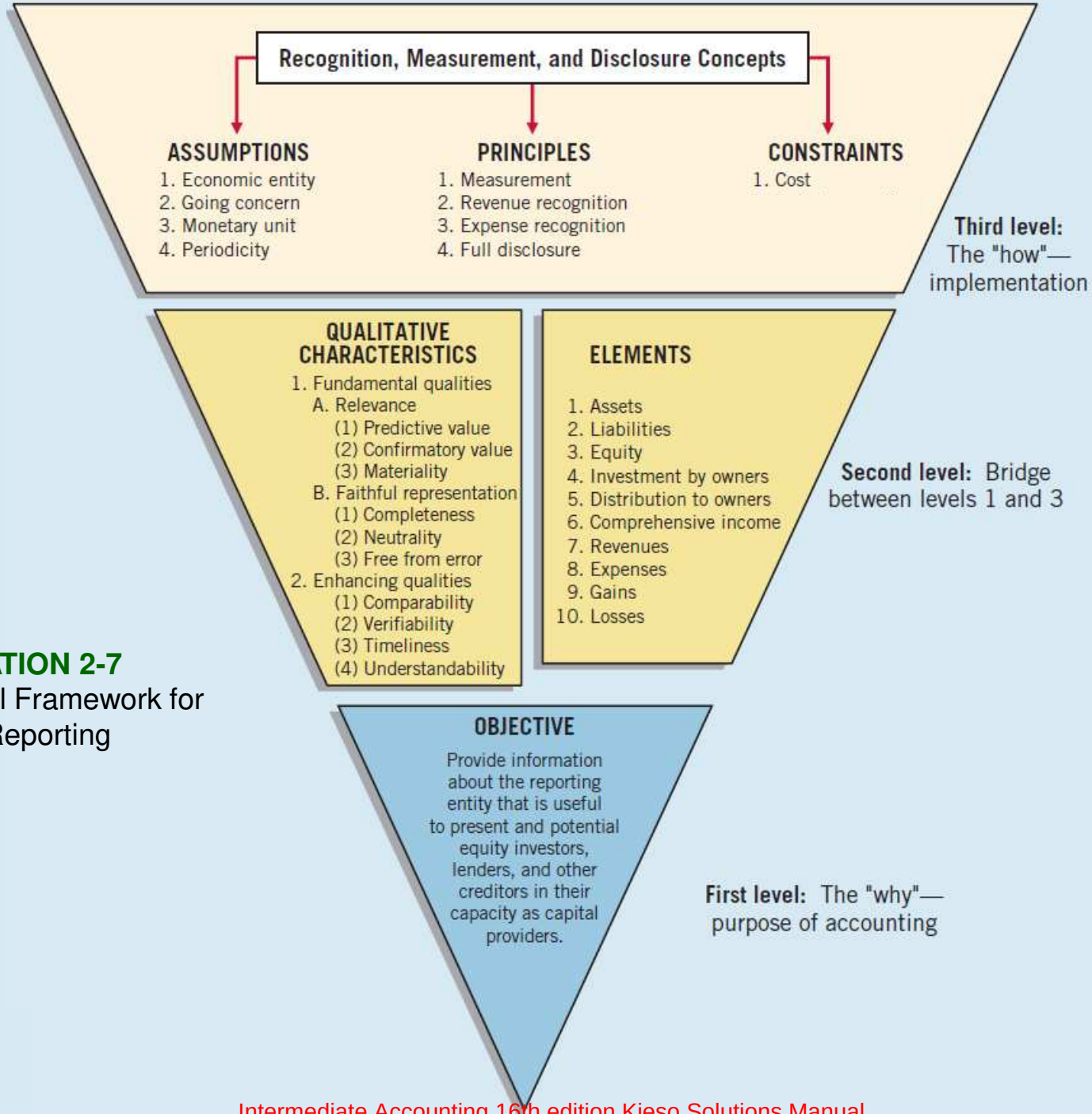
ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting



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LO 1

CONCEPTUAL FRAMEWORK

Question

What are the Statements of Financial Accounting Concepts intended to establish?

a. Generally accepted accounting principles in financial reporting by business enterprises.

b. The meaning of “Present fairly in accordance with generally accepted accounting principles.”

c. The objectives and concepts for use in developing standards of financial accounting and reporting.

d. The hierarchy of sources of generally accepted accounting principles.

LO 1

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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.

FIRST LEVEL: BASIC OBJECTIVES

Objective of financial reporting:

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**.

LO 2

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FIRST Level: Basic Objectives

Question

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on?

a. Generally accepted accounting principles

b. Reporting on management's stewardship.

c. The need for conservatism.

d. The needs of the users of the information.

LO 2

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.

LO 3

SECOND LEVEL: FUNDAMENTAL CONCEPTS

Qualitative Characteristics of Accounting Information

"The **FASB** identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes."

LO 3

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Second Level: Fundamental Concepts

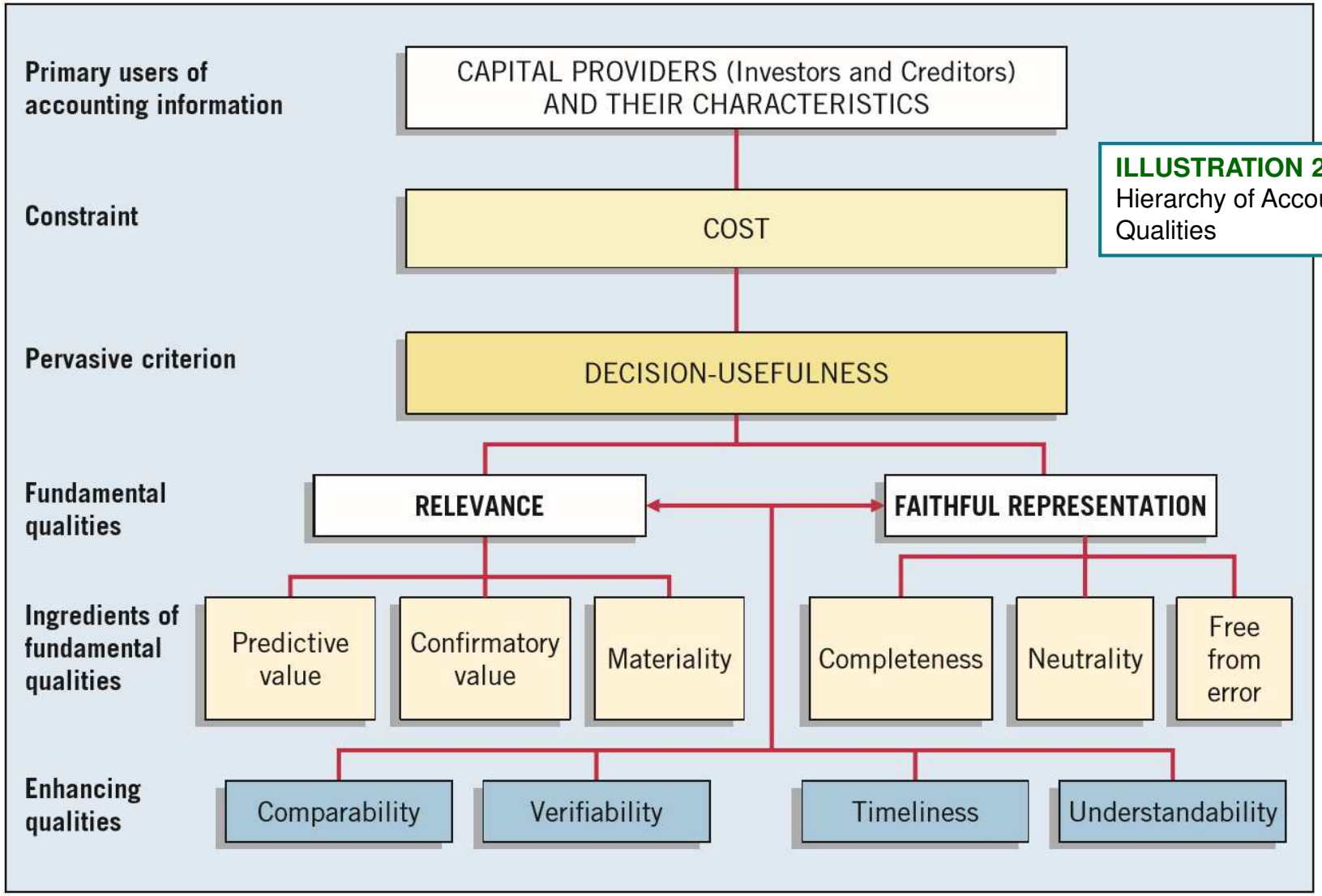

ILLUSTRATION 2-2
Hierarchy of Accounting Qualities

LO 3

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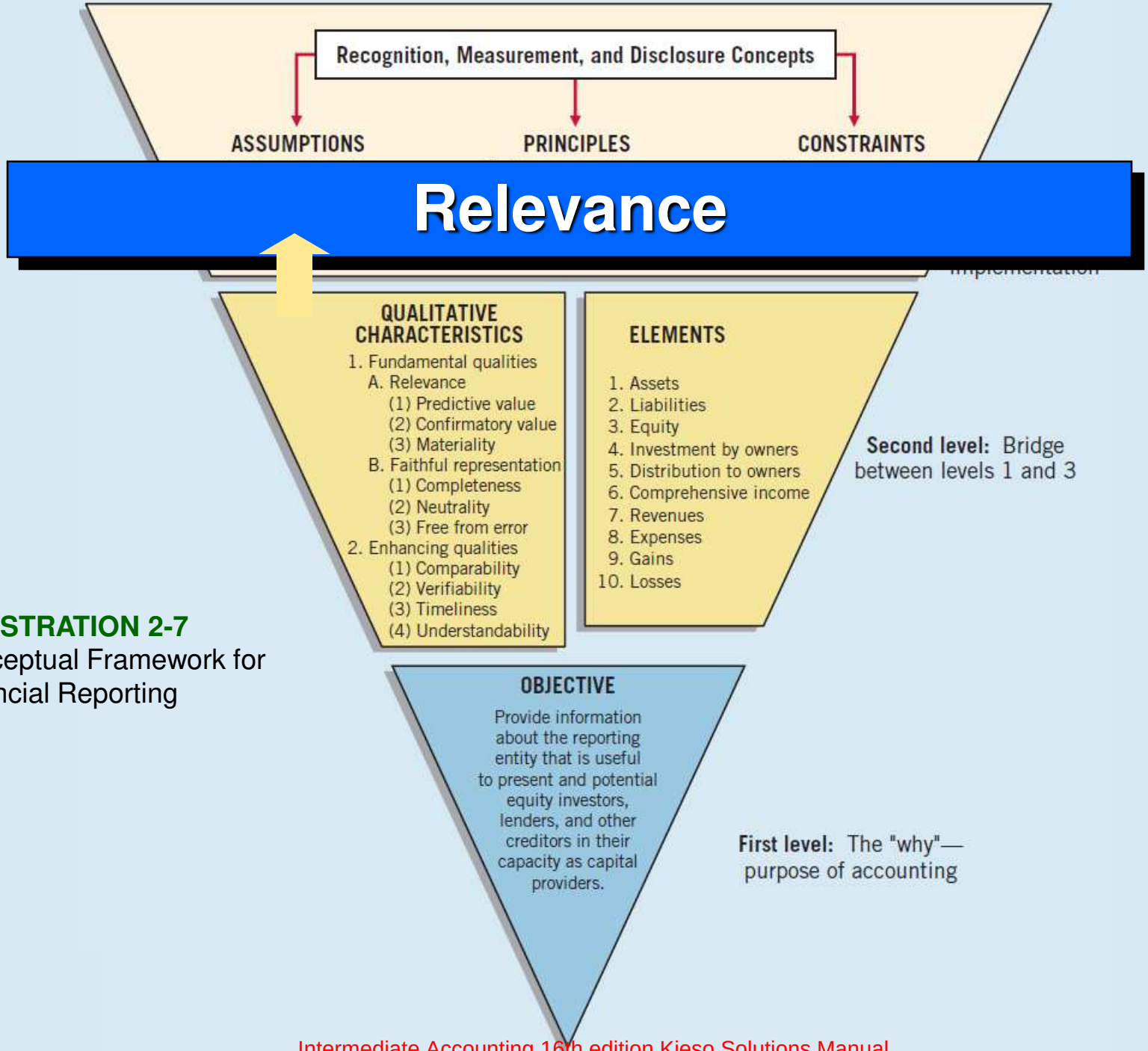

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 3

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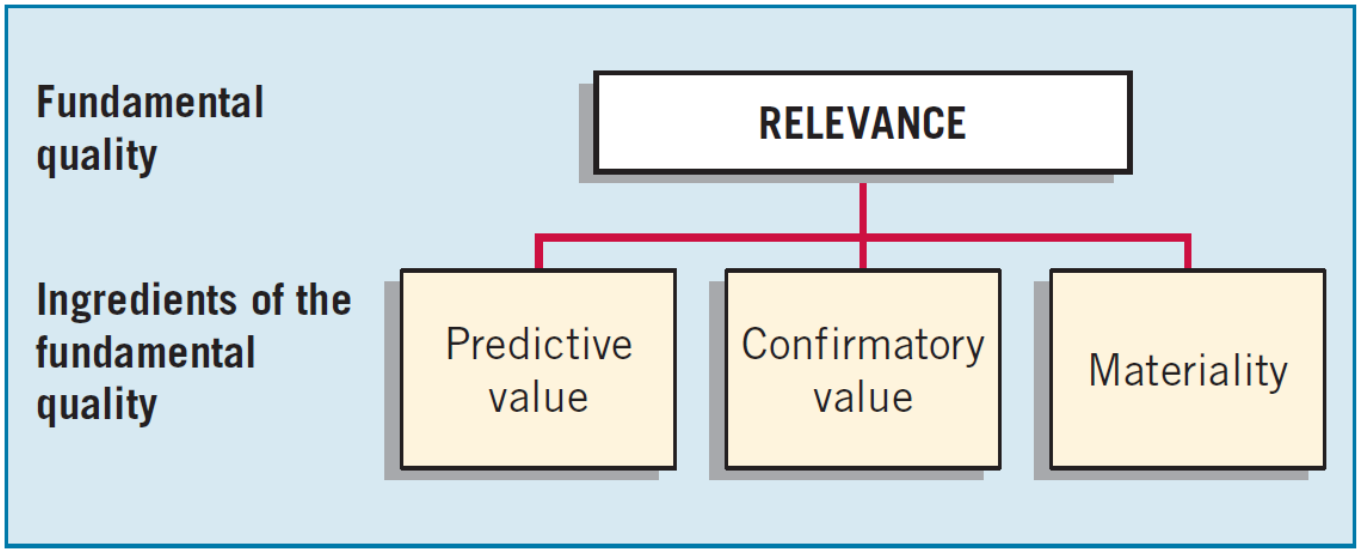
Second Level: Fundamental Concepts

Fundamental Quality—Relevance



To be **relevant**, accounting information must be capable of **making a difference in a decision**.

LO 3

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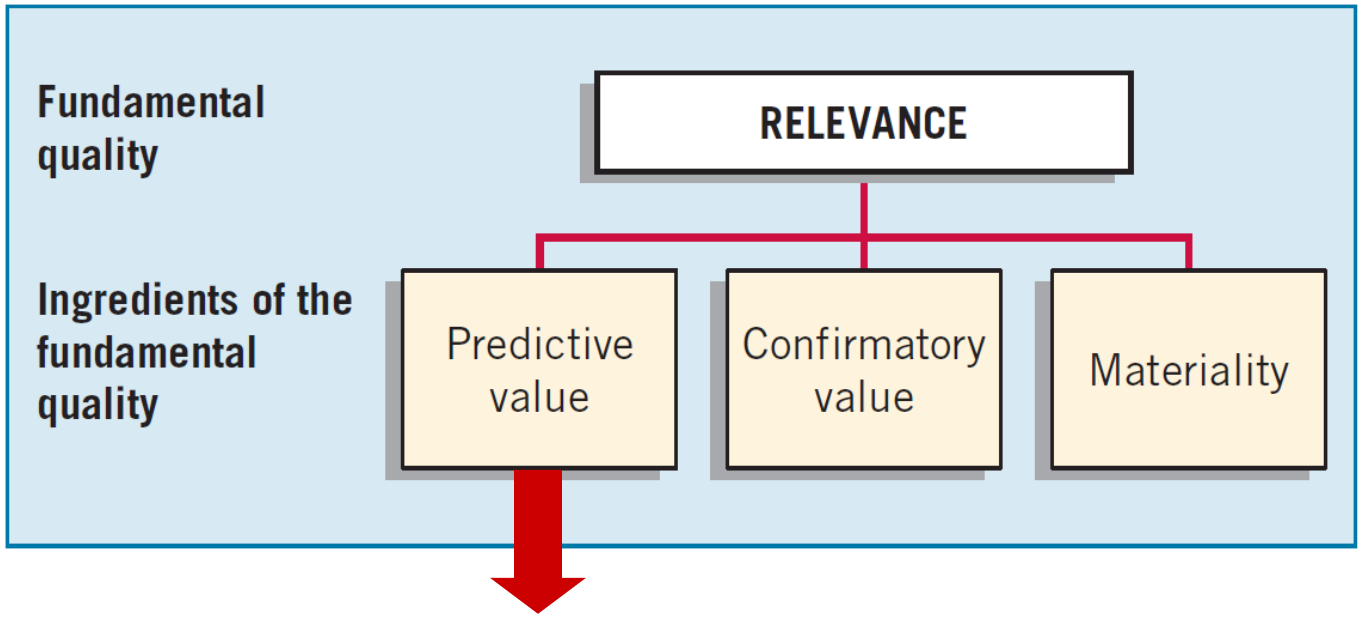
Second Level: Fundamental Concepts

Fundamental Quality—Relevance

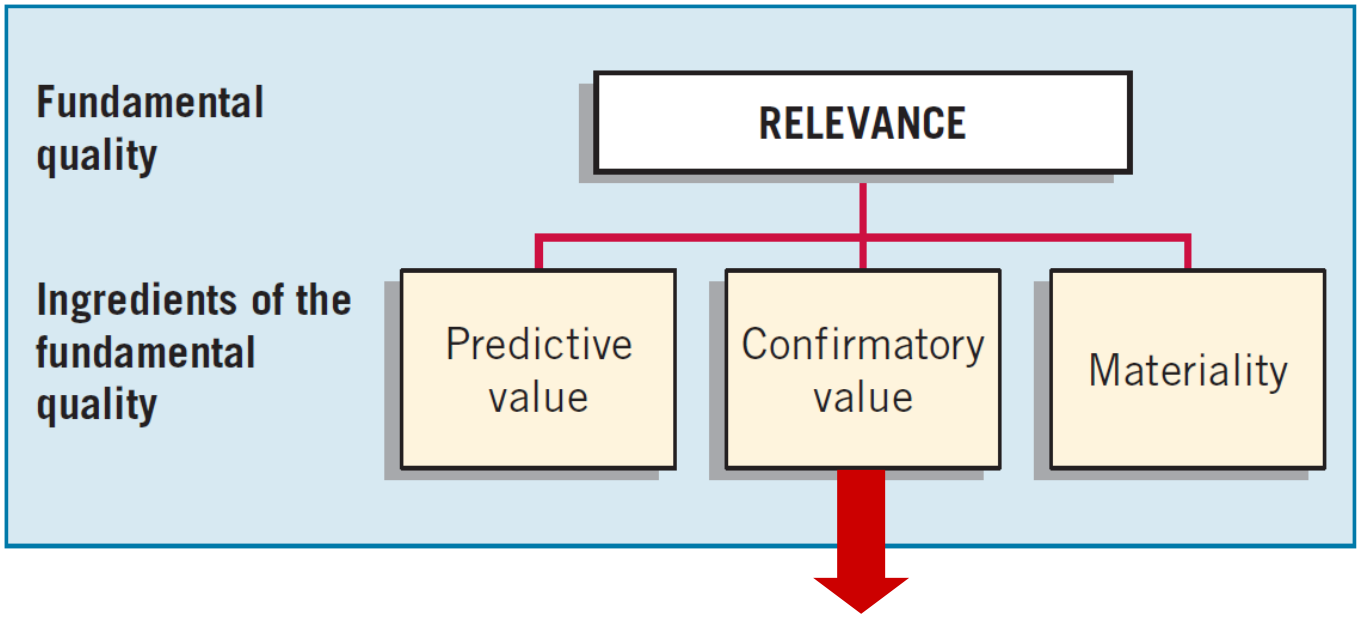


Financial information has **predictive value** if it has value as an input to predictive processes used by investors to form their own expectations about the future.

LO 3

Second Level: Fundamental Concepts

Fundamental Quality—Relevance

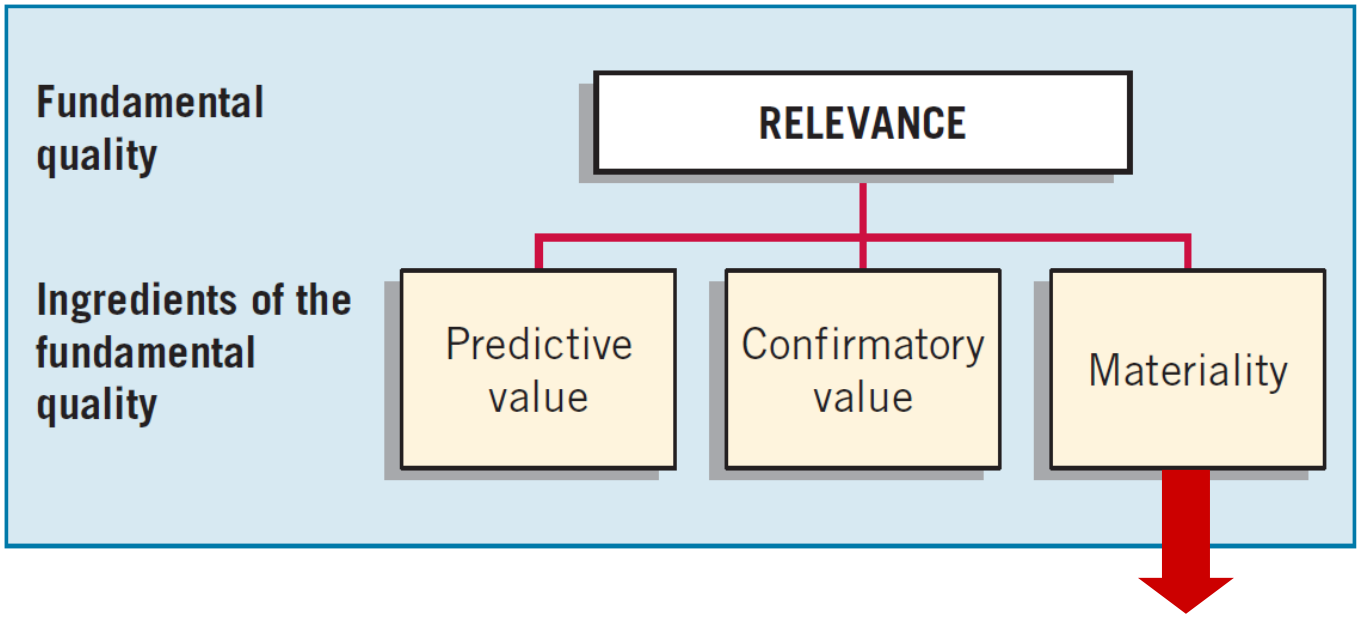


Relevant information also helps users **confirm** or correct prior expectations.

LO 3

Second Level: Fundamental Concepts

Fundamental Quality—Relevance



Information is **material** if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

LO 3

WHAT DO THE NUMBERS MEAN? LIVING IN A MATERIAL WORLD

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.

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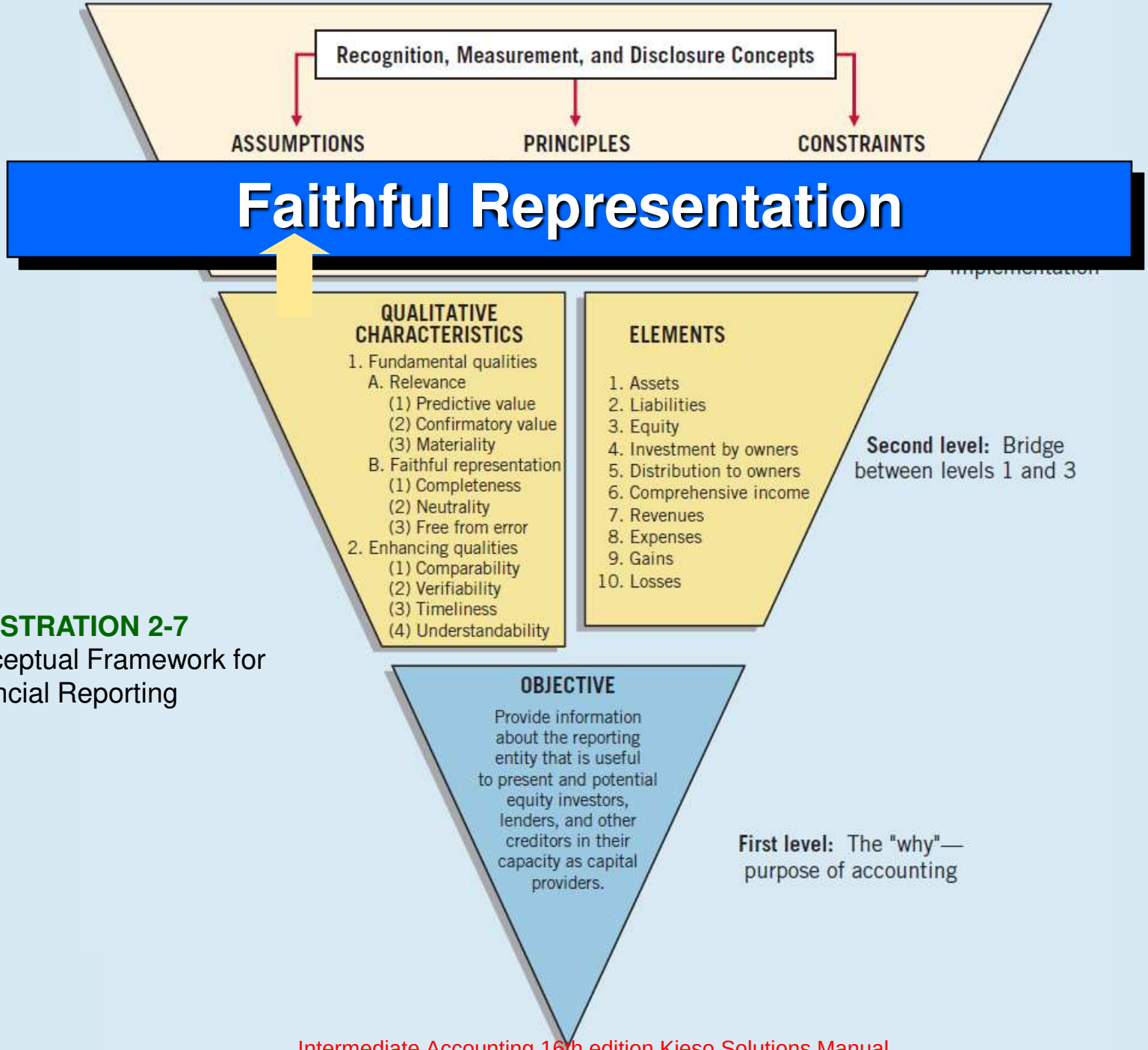

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 3

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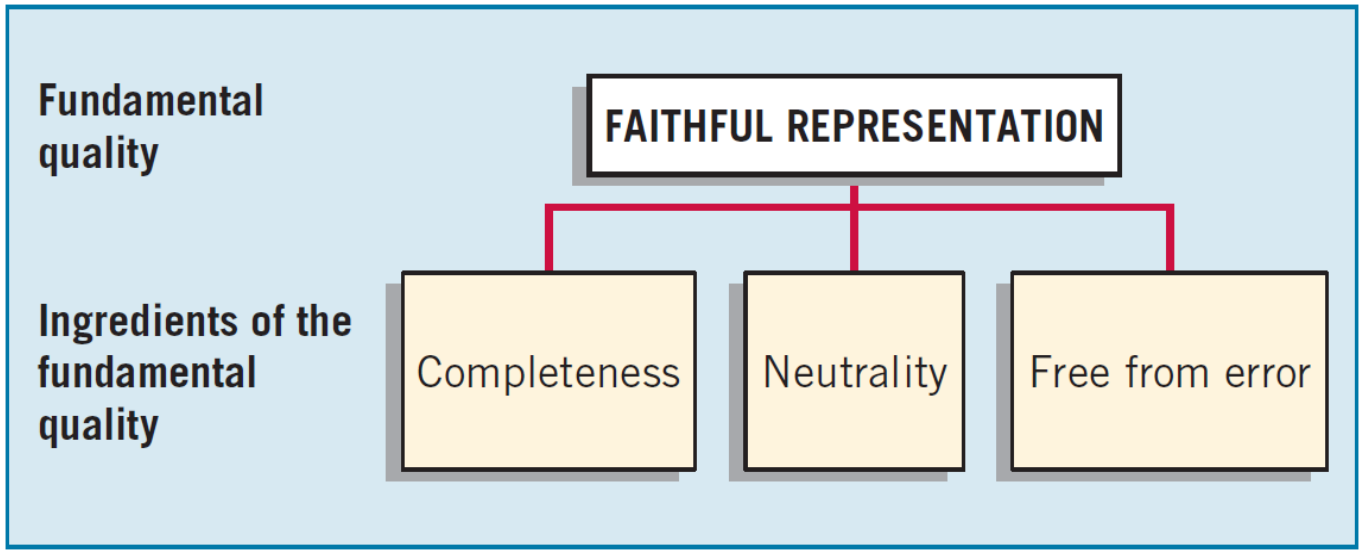
Second Level: Fundamental Concepts

Fundamental Quality—Faithful Representation

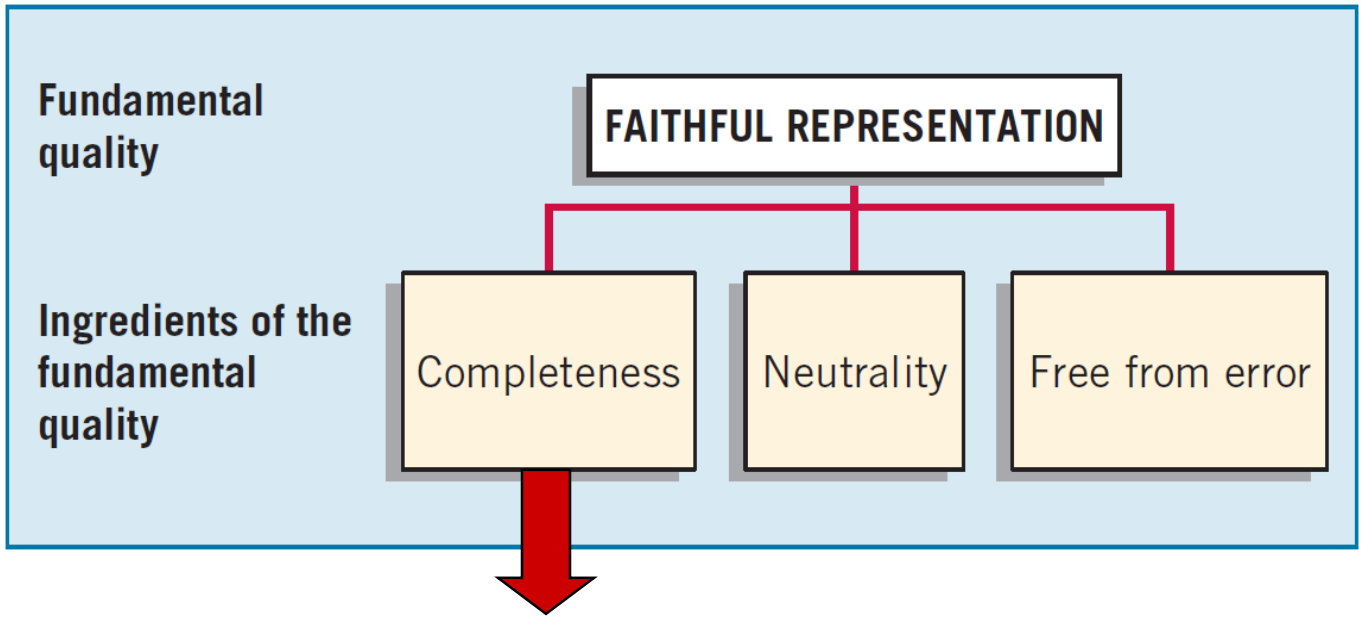


Faithful representation means that the numbers and descriptions match what really existed or happened.

LO 3

Second Level: Fundamental Concepts

Fundamental Quality—Faithful Representation

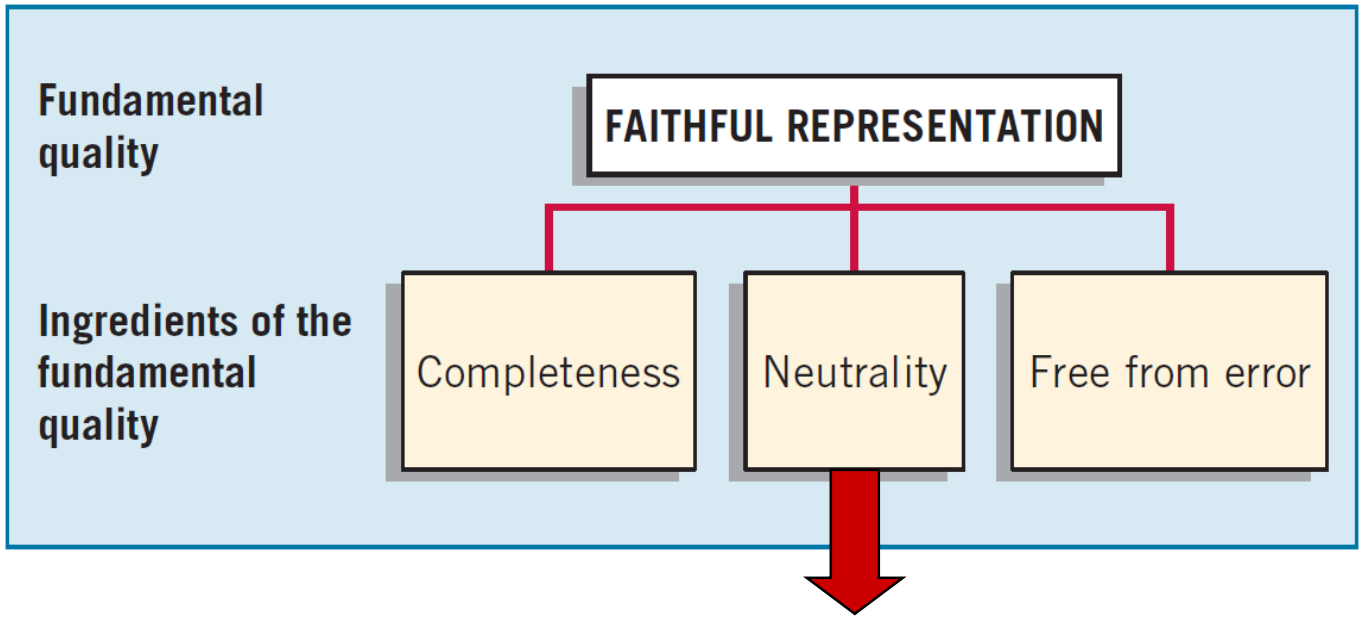


Completeness means that all the information that is necessary for faithful representation is provided.

LO 3

Second Level: Fundamental Concepts

Fundamental Quality—Faithful Representation



Neutrality means that a company cannot select information to favor one set of interested parties over another.

LO 3

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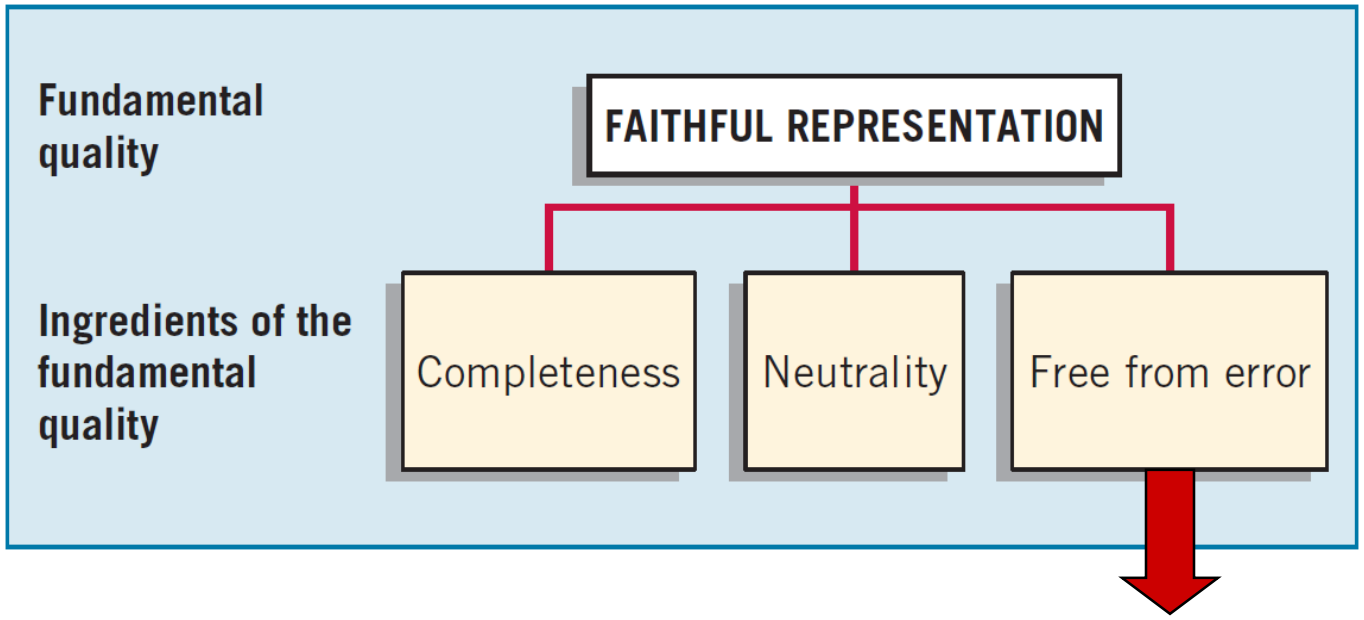
Second Level: Fundamental Concepts

Fundamental Quality—Faithful Representation

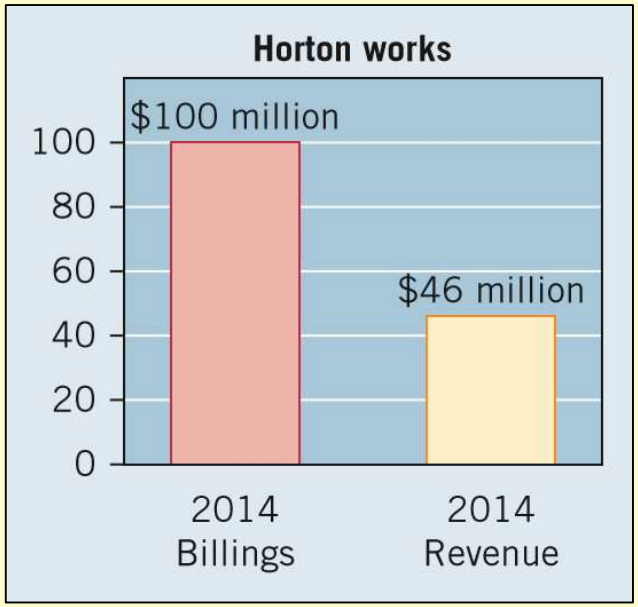


An information item that is **free from error** will be a more accurate (faithful) representation of a financial item.

LO 3

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 billing 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 chart.



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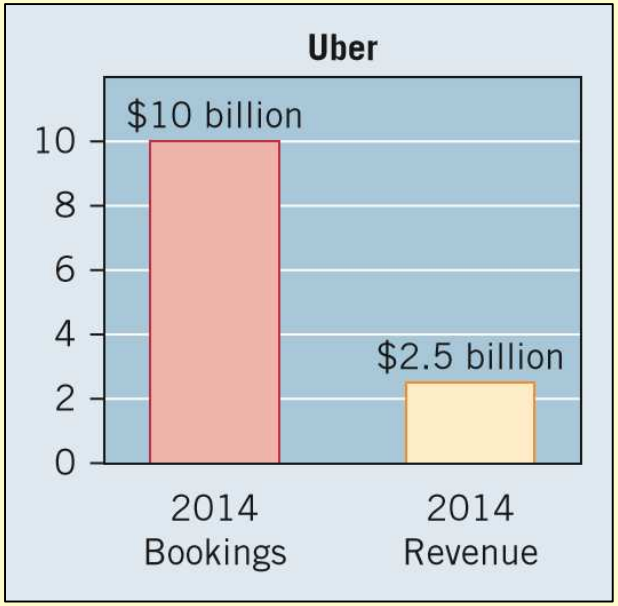
WHAT DO THE NUMBERS MEAN? SHOW ME THE EARNINGS!

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.

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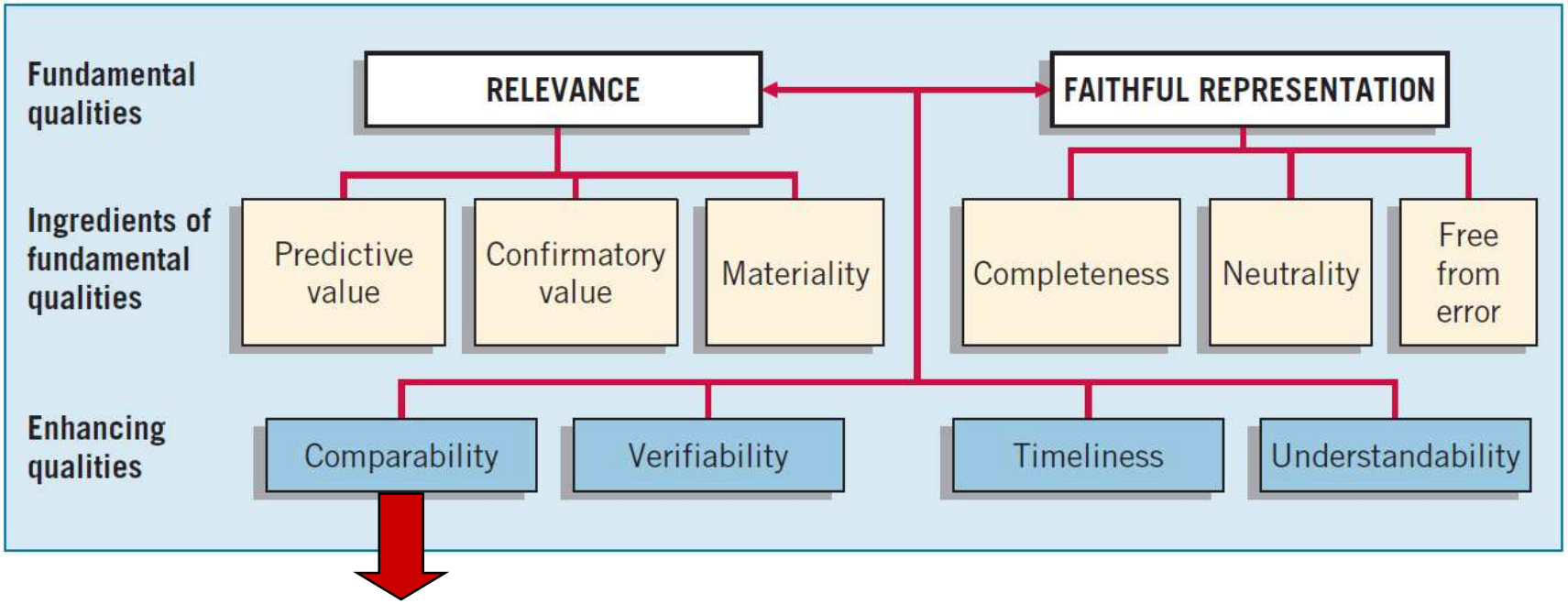
Second Level: Fundamental Concepts

Enhancing Qualities



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

LO 3

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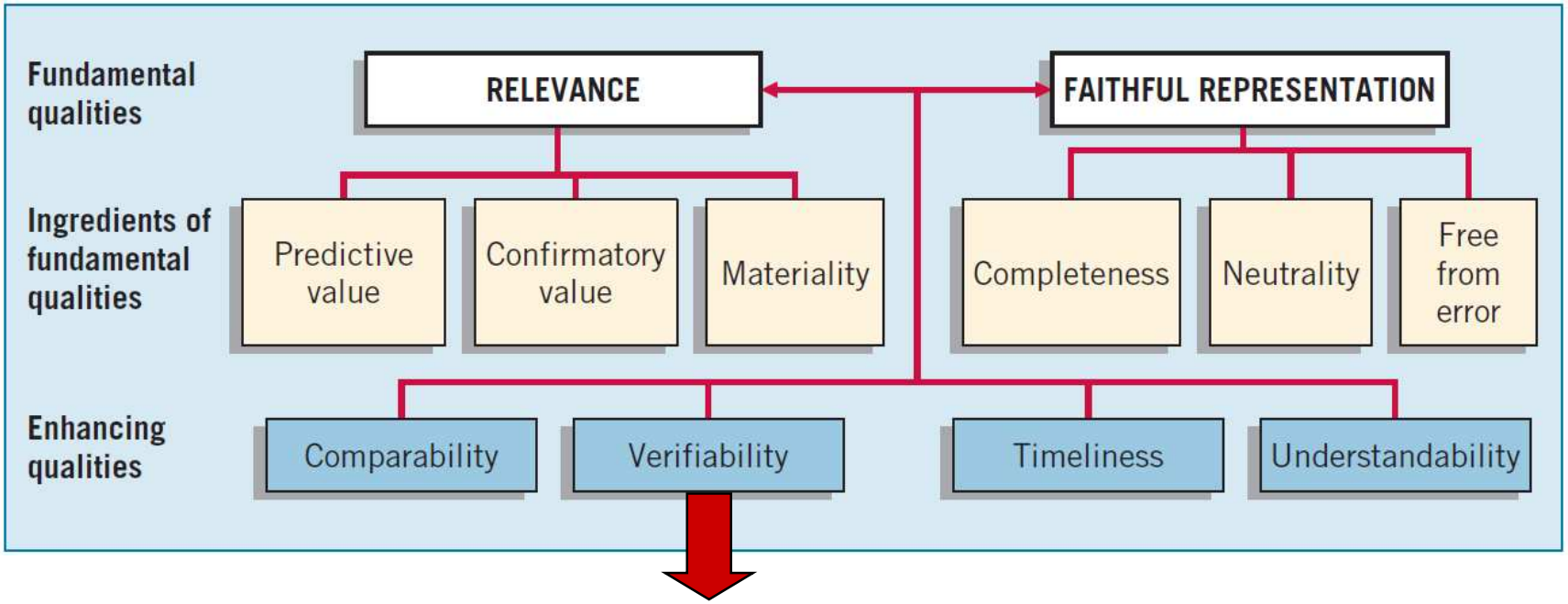
Second Level: Fundamental Concepts

Enhancing Qualities



Verifiability occurs when independent measurers, using the same methods, obtain similar results.

LO 3

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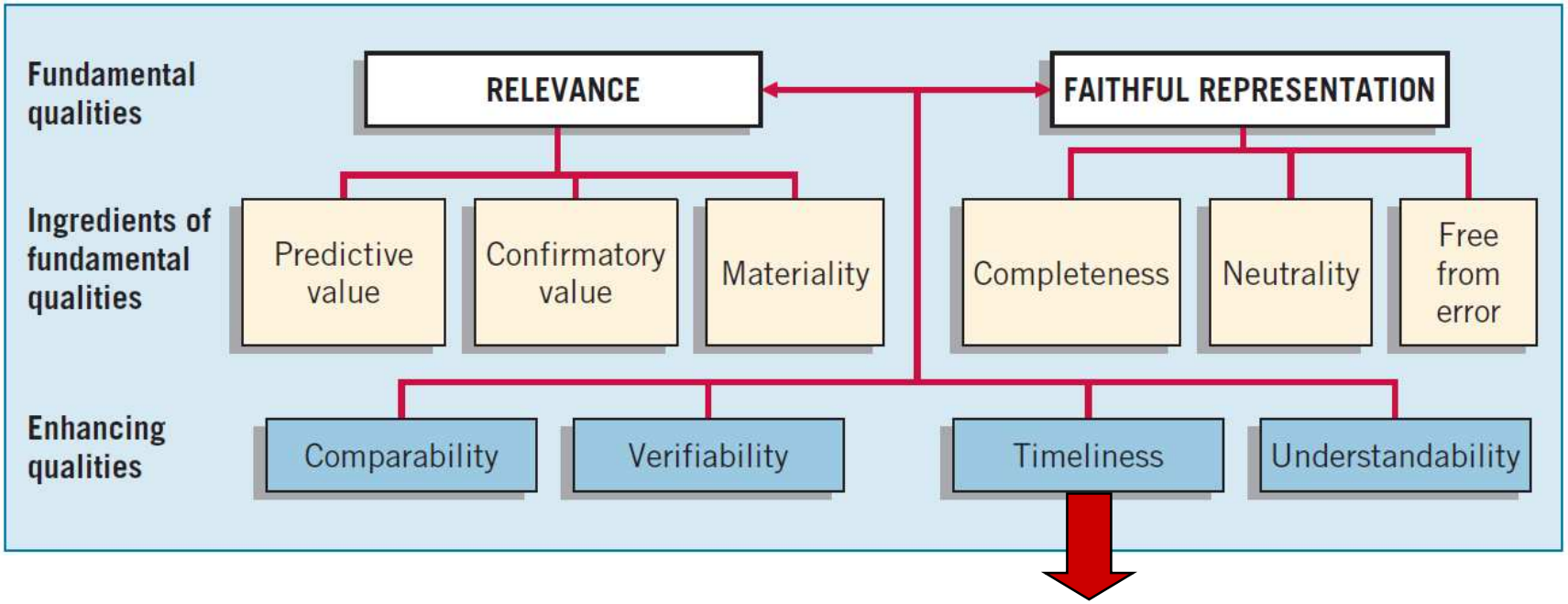
Second Level: Fundamental Concepts

Enhancing Qualities



Timeliness means having information available to decision-makers before it loses its capacity to influence decisions.

LO 3

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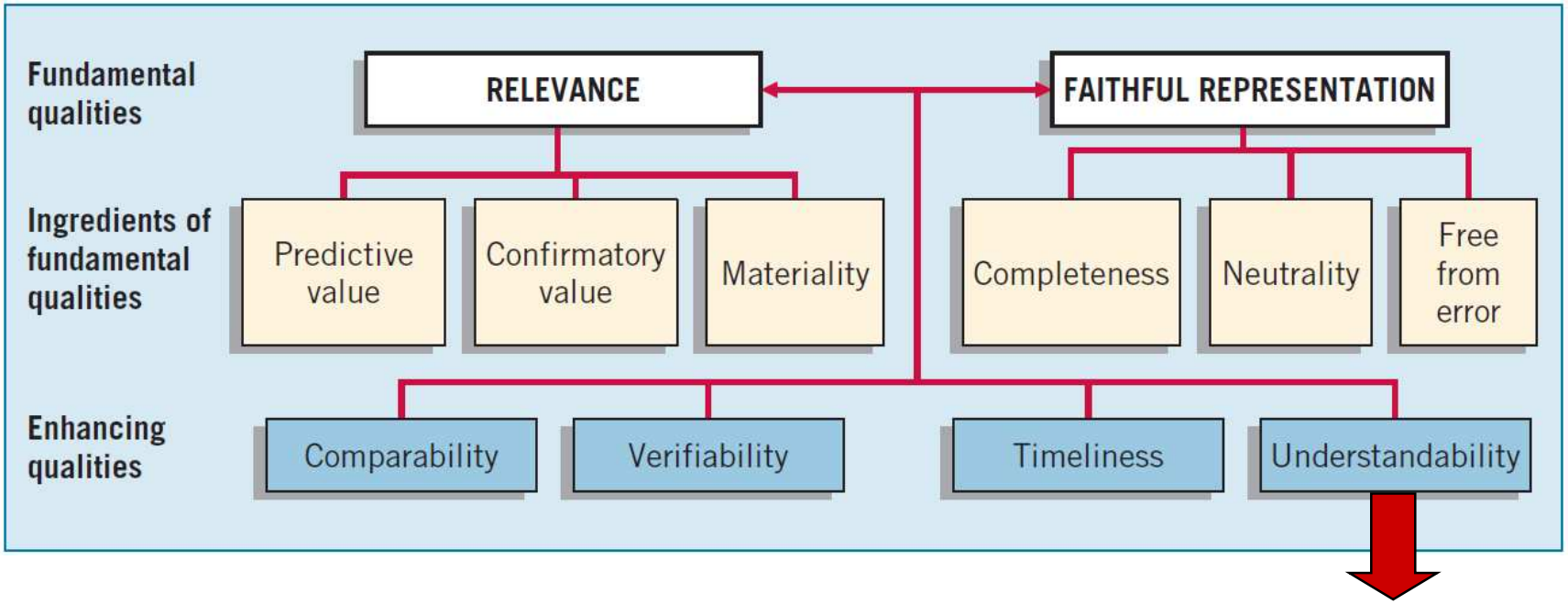
Second Level: Fundamental Concepts

Enhancing Qualities



Understandability is the quality of information that lets reasonably informed users see its significance.

LO 3

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Basic Elements

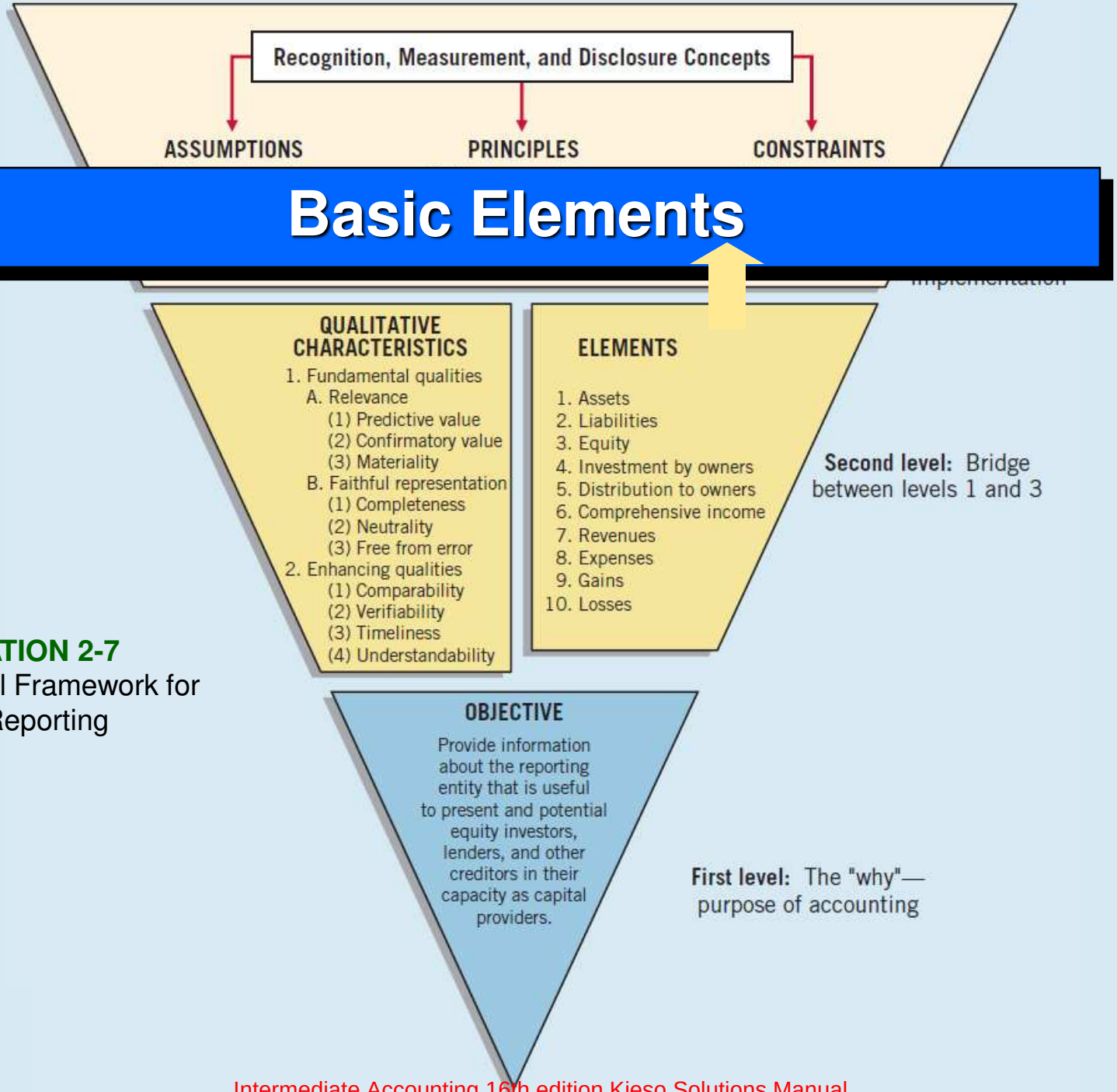

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 3

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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.

Second Level: Basic Elements

Concepts Statement No. 6 defines ten interrelated elements that relate to measuring the performance and financial status of a business enterprise.

"Moment in Time"

- Assets
- Liabilities
- Equity

"Period of Time"

- Investment by owners
- Distribution to owners
- Comprehensive income
- Revenue
- Expenses
- Gains
- Losses

Second Level: Basic Elements

Question

According to the FASB conceptual framework, an entity's revenue may result from

a. A decrease in an asset from primary operations.

b. An increase in an asset from incidental transactions.

c. An increase in a liability from incidental transactions.

d. A decrease in a liability from primary operations.

LO 4

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.

LO 5

Third Level: Recognition and Measurement

The FASB sets forth most of these concepts in its **Statement of Financial Accounting Concepts No. 5**, "Recognition and Measurement in Financial Statements of Business Enterprises."

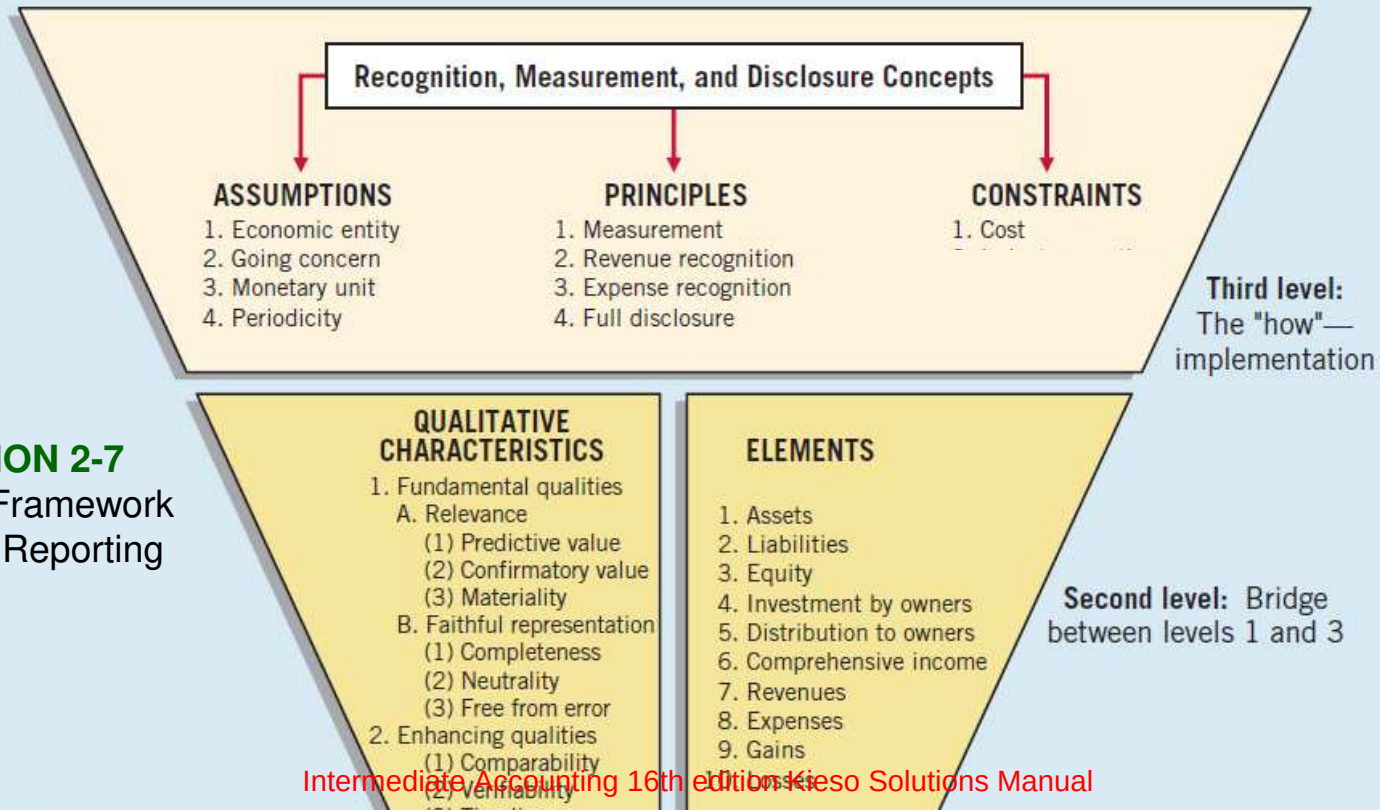

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 5

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Third Level: Basic Assumptions

Economic Entity – company keeps its activity separate from its owners and other businesses.

Going Concern - company to last long enough to fulfill objectives and commitments.

Monetary Unit - money is the common denominator.

Periodicity - company can divide its economic activities into time periods.

Third Level: Basic Assumptions

Illustration: Identify which basic assumption of accounting is best described in each item below.

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

Periodicity

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

Monetary Unit

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

Going Concern

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

Economic Entity

WHAT DO THE NUMBERS MEAN?

WHOSE COMPANY IS IT?

The importance of the entity assumption is illustrated by scandals involving **W. R. Grace** and, more recently, **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.

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.

LO 6

Third Level: Basic Principles

Measurement Principle – The most commonly used measurements are based on **historical cost** and **fair value**.

Issues:

- **Historical cost** provides a reliable benchmark for measuring historical trends.
- **Fair value** information may be more useful.
- Recently the FASB has taken the step of giving companies the option to use fair value as the basis for measurement of financial assets and financial liabilities.
- Reporting of fair value information is increasing.

Third Level: Basic Principles

Revenue Recognition - requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

Expense Recognition - "Let the expense follow the revenues."

ILLUSTRATION 2-6
Expense Recognition

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.

Third Level: Basic Principles

Illustration: Assume the **Boeing Corporation** signs a contract to sell airplanes to **Delta Air Lines** for $100 million. To determine when to **recognize revenue**, use the five steps for revenue recognition shown at right.

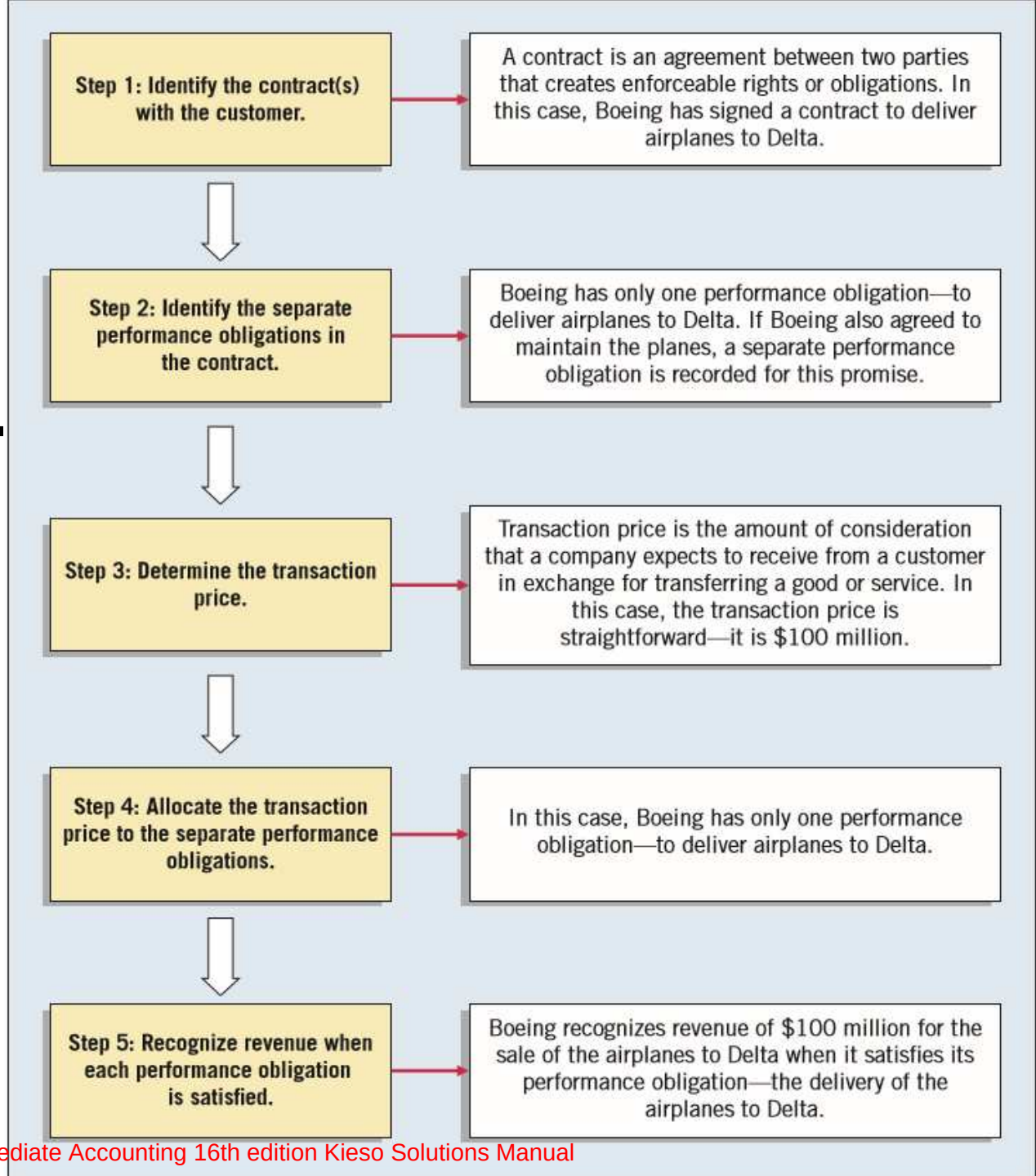

ILLUSTRATION 2-5

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Third Level: Basic Principles

Full Disclosure – providing information that is of sufficient importance to influence the judgment and decisions of an informed user.

Provided through:

- Financial Statements
- Notes to the Financial Statements
- Supplementary information

LO 6

Third Level: Basic Principles

Illustration: Identify which basic principle of accounting is best described in each item below.

(a) KC Corporation reports revenue in its income statement when it is earned instead of when the cash is collected.

Revenue Recognition

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

Expense Recognition

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

Full Disclosure

(d) Eastman Kodak Company reports land on its balance sheet at the amount paid to acquire it, even though the estimated fair market value is greater.

Measurement

WHAT DO THE NUMBERS MEAN? DON'T COUNT THESE PLEASE

Beyond touting nonfinancial measures to investors, 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 recent year.

continued

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WHAT DO THE NUMBERS MEAN? DON'T COUNT THESE PLEASE

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).

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.**

Third Level: Constraints

Cost Constraint – cost of providing information must be weighed against the benefits that can be derived from using it.

Illustration: The following two situations represent applications of the cost constraint.

(a) Rafael Corporation discloses fair value information on its loans because it already gathers this information internally.

(b) Willis Company does not disclose any information in the notes to the financial statements unless the value of the information to users exceeds the expense of gathering it.

Summary of the Structure

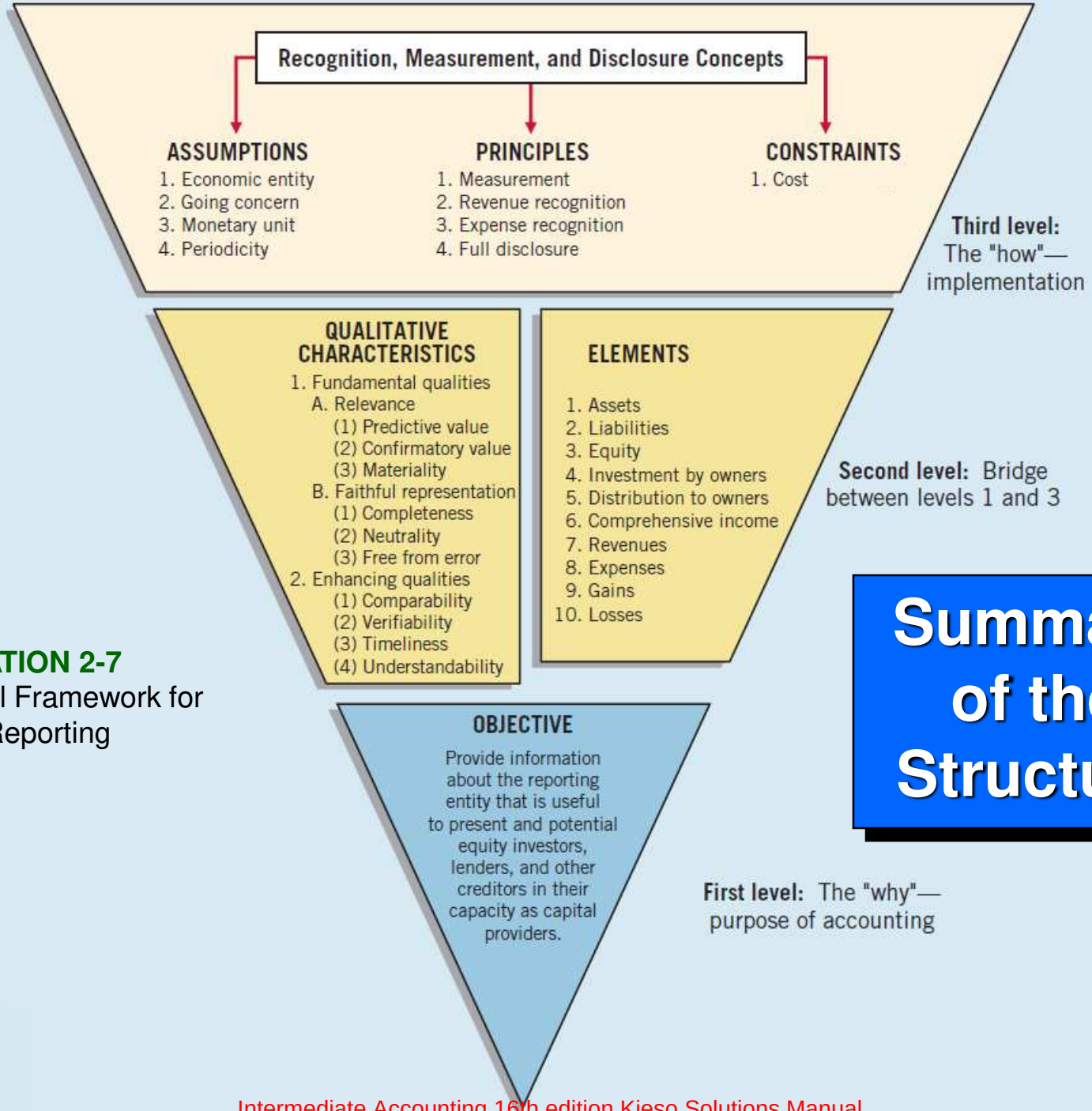

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 7

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RELEVANT FACTS

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.

LO 8 Compare the conceptual frameworks underlying GAAP and IFRS.

RELEVANT FACTS

Similarities

- 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.

RELEVANT FACTS

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.

RELEVANT FACTS

Differences

- 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.

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.

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.

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.

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 QUESTION

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

LO 8

IFRS SELF-TEST QUESTION

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 working on a joint conceptual framework project.

d. Under IFRS, there are the same number of financial statement elements as in GAAP.

IFRS SELF-TEST QUESTION

The issues that the FASB and IASB must address in developing a common 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 be used?

c. Should the common framework lead to standards that are principles-based or rules-based?

d. Should the role of financial reporting focus on internal decision-making as well as providing information to assist users in decision-making?

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INTERMEDIATE ACCOUNTING | 16E

Prepared by:
Coby Harmon
University of California, Santa Barbara
Westmont College

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PREVIEW OF CHAPTER 1

FINANCIAL ACCOUNTING AND ACCOUNTING STANDARDS

FINANCIAL REPORTING ENVIRONMENT

- Accounting and capital allocation
- Objective of financial reporting
- Need to develop standards

PARTIES INVOLVED IN STANDARD-SETTING

- Securities and Exchange Commission
- American Institute of CPAs
- Financial Accounting Standards Board

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

- FASB Codification

MAJOR CHALLENGES IN FINANCIAL REPORTING

- Political environment
- Expectations gap
- Financial reporting issues
- International accounting standards
- Ethics

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1 Financial Accounting and Accounting Standards

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. **Understand the financial reporting environment.**
2. Identify the major policy-setting bodies and their role in the standard-setting process.
3. Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.
4. Describe major challenges in the financial reporting environment.

FINANCIAL REPORTING ENVIRONMENT

Essential characteristics of accounting are:

(1) the **identification**, **measurement**, and **communication** of financial information about

(2) economic entities to

(3) interested parties.

LO 1

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FINANCIAL REPORTING ENVIRONMENT

Economic Entity

Financial Information

Accounting?

Identifies

and

Measures

and

Communicates

Financial Statements

Balance Sheet

Income Statement

Statement of Cash Flows

Statement of Owners' or Stockholders' Equity

Note Disclosures

GAAP

Additional Information

President's letter

Prospectuses

Reports filed with governmental agencies

News releases

Forecasts

Environmental impact statements

Etc.

LO 1

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FINANCIAL REPORTING ENVIRONMENT

Question

What is the purpose of information presented in notes to the financial statements?

a. To provide disclosure required by generally accepted accounting principles.

b. To correct improper presentation in the financial statements.

c. To provide recognition of amounts not included in the totals of the financial statements.

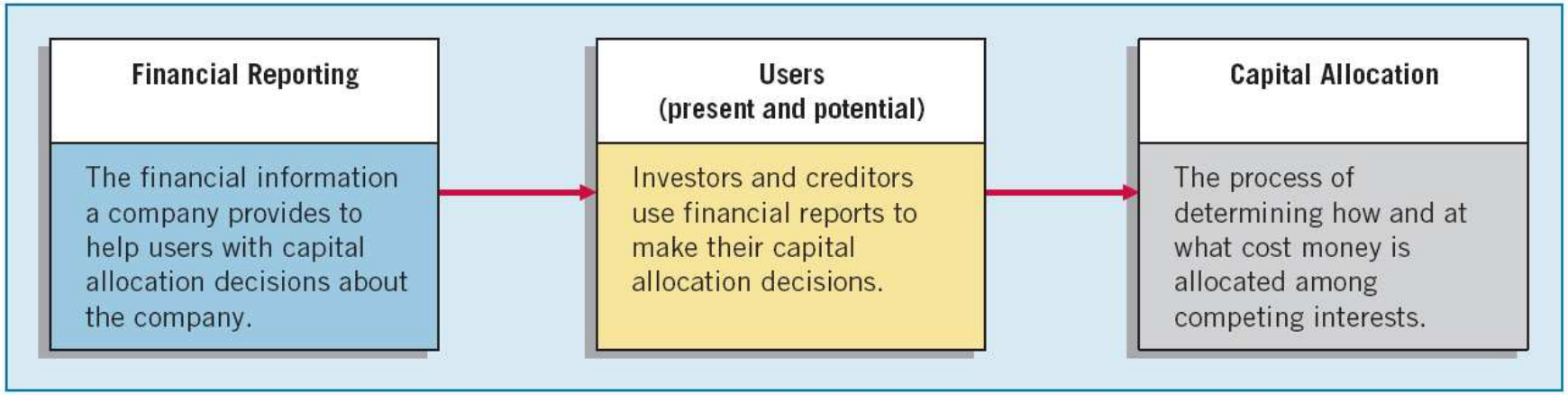
d. To present management's responses to auditor comments.

FINANCIAL REPORTING ENVIRONMENT

Accounting and Capital Allocation

Resources are **limited**. Efficient use of resources often determines whether a business thrives.

ILLUSTRATION 1-1
Capital Allocation Process



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Accounting and Capital Allocation

Question

An effective process of capital allocation is critical to a healthy economy, which

a. promotes productivity.

b. encourages innovation.

c. provides an efficient and liquid market for buying and selling securities.

d. All of the above.

LO 1

WHAT DO THE NUMBERS MEAN? IT'S THE ACCOUNTING

"It's the accounting." That's what many investors seem to be saying these days. Even the slightest hint of any accounting irregularity at a company leads to a subsequent pounding of the company's stock price. For example, the Wall Street Journal has run the following headlines related to accounting and its effects on the economy:

- Stocks take a beating as accounting woes spread beyond **Enron**.
- Quarterly reports from **IBM** and **Goldman Sachs** sent stocks tumbling.
- **VeriFone** finds accounting issues; stock price cut in half.
- **Bank of America** admits hiding debt.
- **Facebook**, **Zynga**, **Groupon**: IPO drops due to accounting, not valuation.

It now has become clear that investors must trust the accounting numbers, or they will abandon the market and put their resources elsewhere. With investor uncertainty, the cost of capital increases for companies who need additional resources. In short, relevant and reliable financial information is necessary for markets to be efficient.

FINANCIAL REPORTING ENVIRONMENT

Objectives of Financial Reporting

Provide financial information about the reporting entity that is **useful** to

- present and potential equity investors,
- lenders, and
- other creditors

in making decisions in their capacity as capital providers.

LO 1

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Objective of Financial Accounting

General-Purpose Financial Statements

- Provide financial reporting information to a wide variety of users.
- Provide the most useful information possible at the least cost.

Equity Investors and Creditors

- Investors are the primary user group.

UNDERLYING CONCEPTS

While the objective of financial reporting is focused on investors and creditors, financial statements may still meet the needs of others.

LO 1

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Objective of Financial Accounting

Entity Perspective

- Companies viewed as separate and distinct from their owners.

Decision-Usefulness

Investors are interested in assessing the company's

1. ability to generate net cash inflows and
2. management's ability to protect and enhance the capital providers' investments.

WHAT DO THE NUMBERS MEAN? DON'T FORGET STEWARDSHIP

In addition to providing decision-useful information about future cash flows, management also is accountable to investors for the custody and safekeeping of the company's economic resources and for their efficient and profitable use. For example, the management of **The Hershey Company** has the responsibility for protecting its economic resources from unfavorable effects of economic factors, such as price changes, and technological and social changes. Because Hershey's performance in discharging its responsibilities (referred to as its **stewardship** responsibilities) usually affects its ability to generate net cash inflows, financial reporting may also provide decision-useful information to assess management performance in this role.

Source: 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), paras. OB4–OB10.

The Need To Develop Standards

Various users need financial information

Financial Statements

- Balance Sheet
- Income Statement
- Statement of Stockholders' Equity
- Statement of Cash Flows
- Note Disclosure

The accounting profession has attempted to develop a set of standards that are generally accepted and universally practiced.

Generally Accepted Accounting Principles (GAAP)

LO 1

1 Financial Accounting and Accounting Standards

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1 Understand the financial reporting environment.

2 **Identify the major policy-setting bodies and their role in the standard-setting process.**

3 Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.

4 Describe major challenges in the financial reporting environment.

PARTIES INVOLVED IN STANDARD SETTING

Three organizations:

- Securities and Exchange Commission (SEC).
- American Institute of Certified Public Accountants (AICPA).
- Financial Accounting Standards Board (FASB).

LO 2

Parties Involved In Standard Setting

Securities and Exchange Commission (SEC)

- Established by federal government.
- Accounting and reporting for public companies.

Securities Act of 1933	Securities Act of 1934

http://www.sec.gov/

- Encouraged private standard-setting body.
- SEC requires public companies to adhere to GAAP.
- SEC Oversight.
- Enforcement Authority.

Parties Involved In Standard Setting

American Institute of CPAs (AICPA)

- National professional organization
- Established the following:

http://www.aicpa.org/

Committee on Accounting Procedures	Accounting Principles Board
• 1939 to 1959 • Issued 51 Accounting Research Bulletins (ARBs) • Problem-by-problem approach failed	• 1959 to 1973 • Issued 31 Accounting Principle Board Opinions (APBOs) • Wheat Committee recommendations adopted in 1973

Parties Involved In Standard Setting

Financial Accounting Standards Board (FASB)

Wheat Committee's recommendations resulted in creation of FASB.

Financial Accounting Foundation

- Selects members of the FASB.
- Funds their activities.
- Exercises general oversight.

Financial Accounting Standards Board

- Mission to establish and improve standards of financial accounting and reporting.

Financial Accounting Standards Advisory Council

- Consult on major policy issues.

LO 2

Financial Accounting Standards Board

Missions is to establish and improve standards of financial accounting and reporting. Differences between FASB and APB include:

- Smaller Membership.
- Full-time, Remunerated Membership.
- Greater Autonomy.
- Increased Independence.
- Broader Representation.

http://www.fasb.org/

Financial Accounting Standards Board

Question

The first step taken in the establishment of a typical FASB statement is

a. The board conducts research and analysis and a discussion memorandum is issued.

b. A public hearing on the proposed standard is held.

c. The board evaluates the research and public response and issues an exposure draft.

d. Topics are identified and placed on the board's agenda.

LO 2

Financial Accounting Standards Board

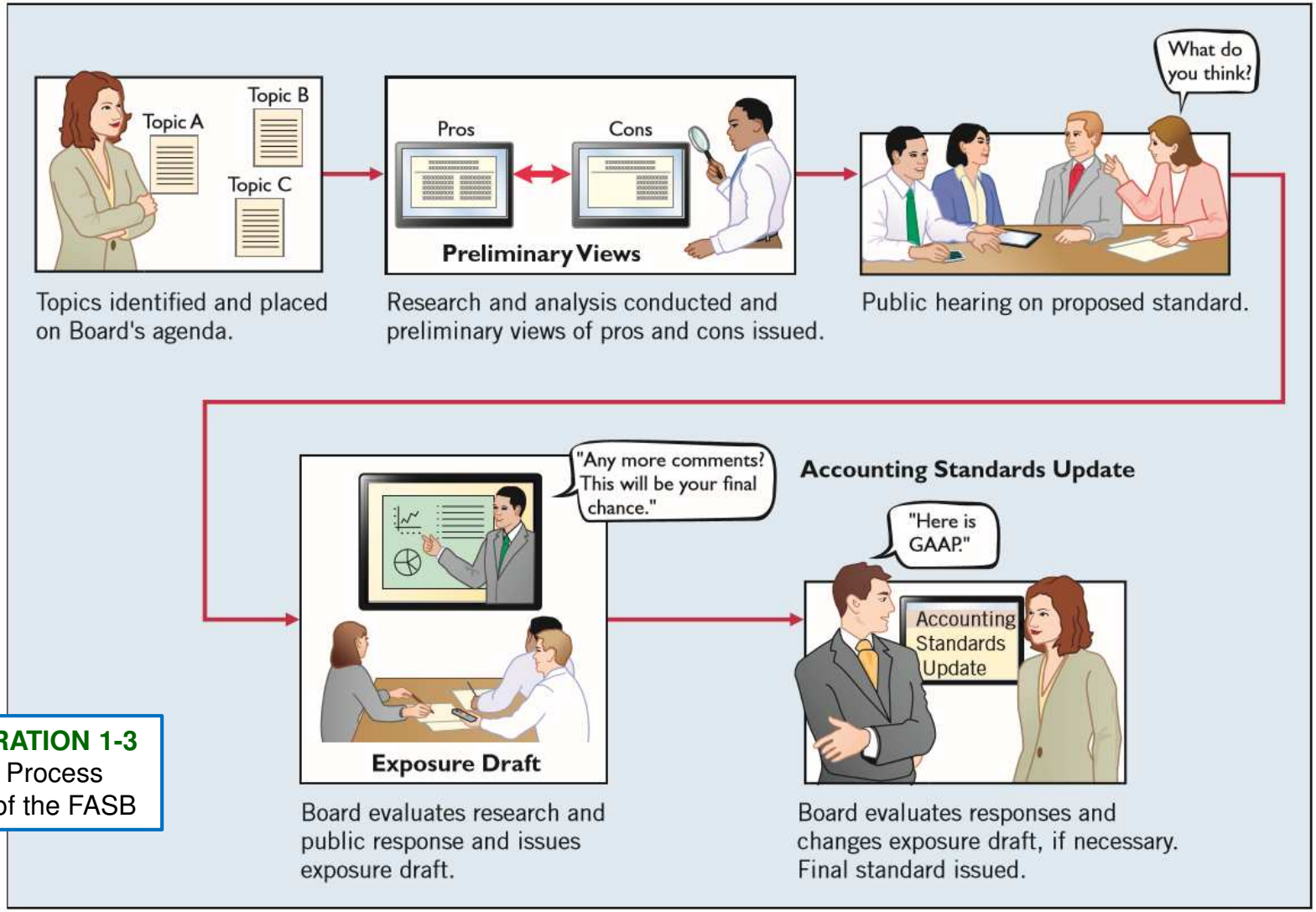
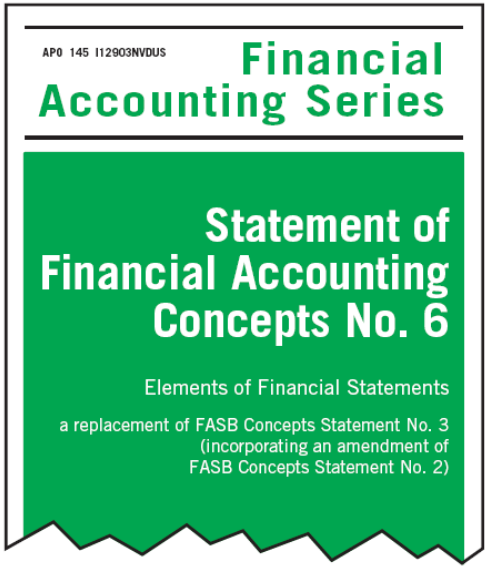


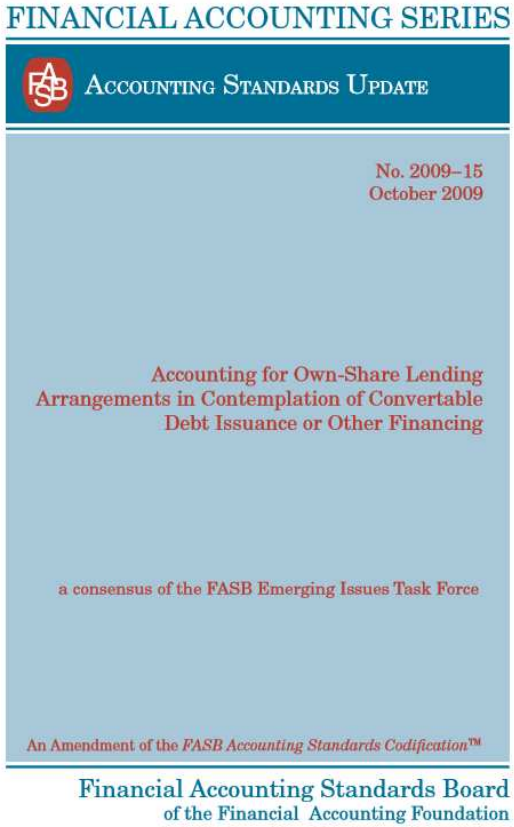
ILLUSTRATION 1-3
The Due Process System of the FASB

Financial Accounting Standards Board

Types of Pronouncements

- Accounting Standards Updates. →
- Financial Accounting Concepts.





LO 2

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1 Financial Accounting and Accounting Standards

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Understand the financial reporting environment.
2. Identify the major policy-setting bodies and their role in the standard-setting process.
3. **Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.**
4. Describe major challenges in the financial reporting environment.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Principles that have **substantial authoritative support**.

Major sources of GAAP:

- FASB Standards, Interpretations, and Staff Positions.
- APB Opinions.
- AICPA Accounting Research Bulletins.

WHAT DO THE NUMBERS MEAN? YOU HAVE TO STEP BACK

Should the accounting profession have principles-based standards or rules-based standards? Critics of the profession today say that over the past three decades, standard-setters have moved away from broad accounting principles aimed at ensuring that companies' financial statements are fairly presented. Instead, these critics say, standard-setters have moved toward drafting voluminous rules that, if technically followed in "check-box" fashion, may shield auditors and companies from legal liability. That has resulted in companies creating complex capital structures that comply with GAAP but hide billions of dollars of debt and other obligations. To add fuel to the fi re, the chief accountant of the enforcement division of the SEC noted, "One can violate SEC laws and still comply with GAAP."

In short, what he is saying is that it is not enough just to check the boxes. This point was reinforced by the chief accountant of the SEC, who remarked that judgments should result in "accounting that refl ects the substance of the transaction, as well as being in accordance with the literature." That is, you have to exercise judgment in applying GAAP to achieve high-quality reporting.

Sources: Adapted from S. Liesman, "SEC Accounting Cop's Warning: Playing by the Rules May Not Head Off Fraud Issues," Wall Street Journal (February 12, 2002), p. C7.

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Generally Accepted Accounting Principles

FASB Codification

- Goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic.
- Creates one level of GAAP, which is considered authoritative.
- All other accounting literature is considered non-authoritative.

FASB has developed the **Financial Accounting Standards Board Codification Research System (CRS)**. The FASB's primary goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic.

Generally Accepted Accounting Principles

Topic
Provides a collection of related guidance on a given subject, such as receivables or leases.

Subtopics
Subset of a topic and distinguished by type or scope. For example, overall and troubled-debt restructurings are two subtopics of receivables.

Sections
Indicate the type of content in a subtopic, such as initial measurement. In some cases, subsections are used but not numbered.

Paragraphs
This level is where you will find the substantive content related to the issue researched. (All other levels exist essentially to find the material related to the paragraph level content.)

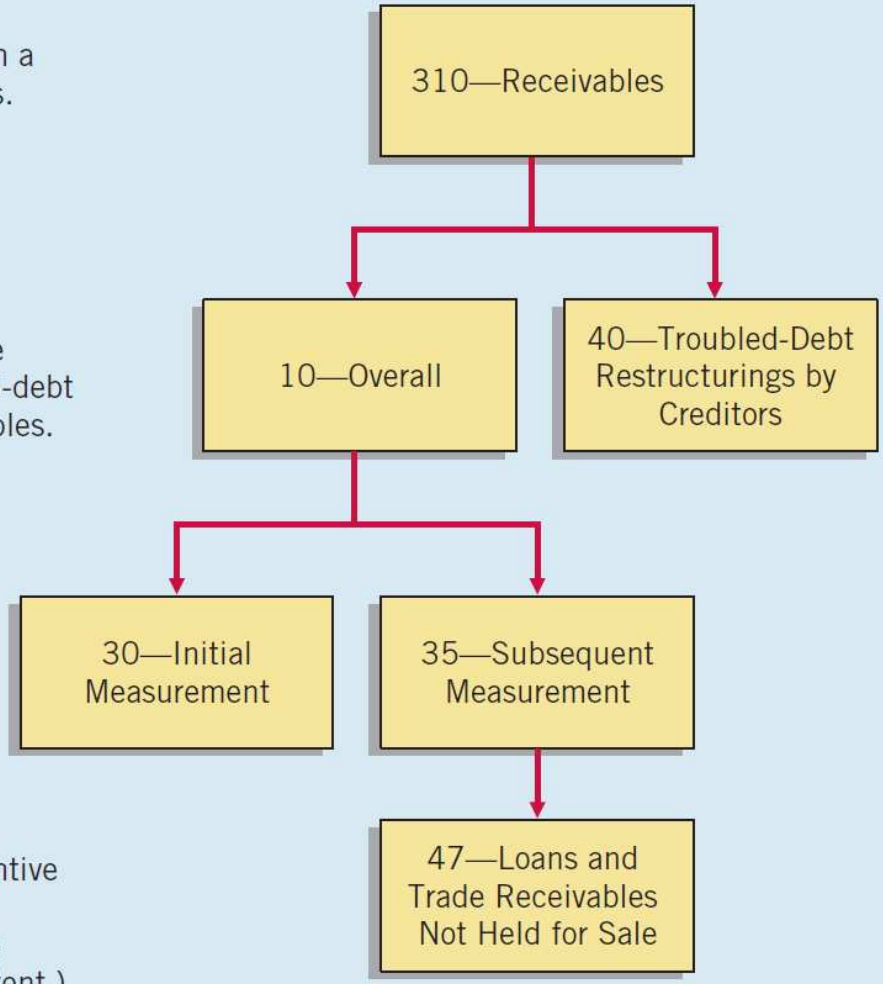

ILLUSTRATION 1-4
FASB Codification Framework

LO 3

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1 Financial Accounting and Accounting Standards

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Understand the financial reporting environment.
2. Identify the major policy-setting bodies and their role in the standard-setting process.
3. Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.
4. **Describe major challenges in the financial reporting environment.**

MAJOR CHALLENGES IN FINANCIAL REPORTING

GAAP in a Political Environment

GAAP is as much a product of political action as it is of careful logic or empirical findings.

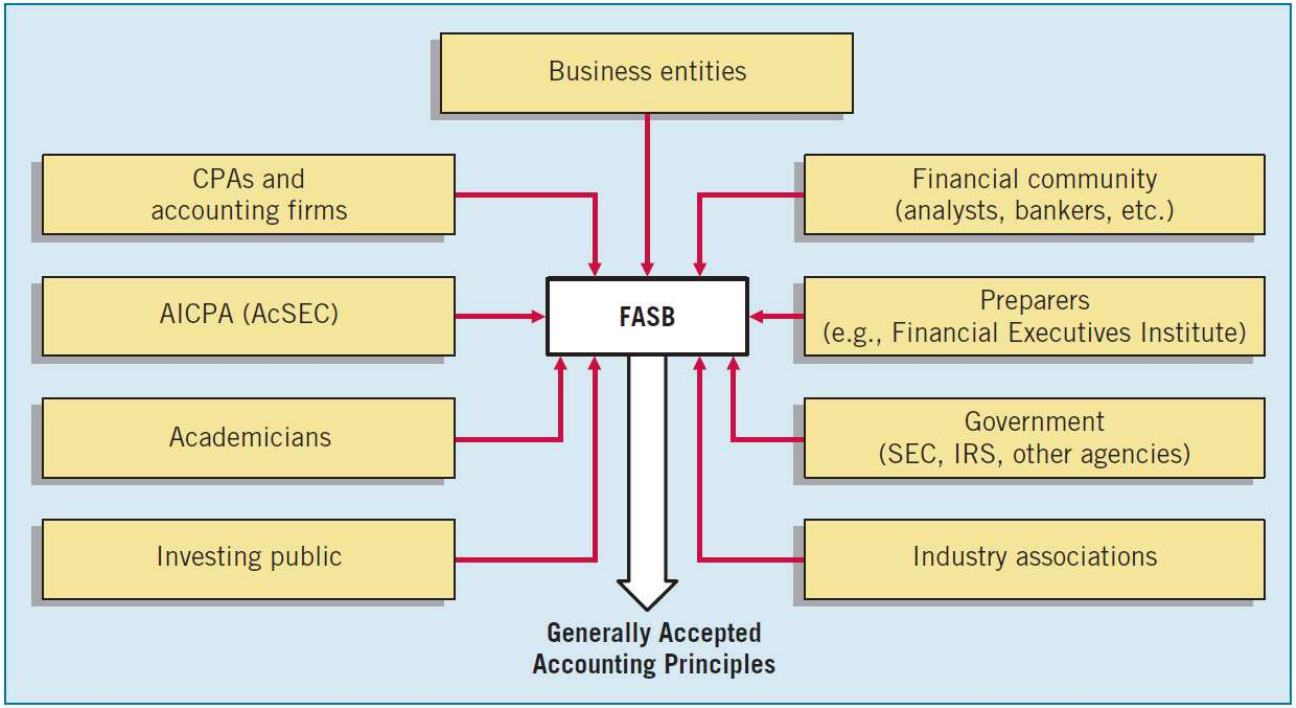

ILLUSTRATION 1-5
User Groups that Influence the Formulation of Accounting Standards

LO 4

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EVOLVING ISSUES

FAIR VALUE, FAIR CONSEQUENCES

No recent accounting issue better illustrates the economic consequences of accounting than the current debate over the use of fair value accounting for financial assets. Both the FASB and the International Accounting Standards Board (IASB) have standards requiring the use of fair value accounting for financial assets, such as investments and other financial instruments. Fair value provides the most relevant and reliable information for investors about these assets and liabilities. However, in the wake of the recent credit crisis, some countries, their central banks, and bank regulators want to suspend fair value accounting, based on concerns that use of fair value accounting, which calls for recording significant losses on poorly performing loans and investments, could scare investors and depositors and lead to a "run on the bank." For example, in 2009, Congress ordered the FASB to change its accounting rules so as to reduce the losses banks reported, as the values of their securities had crumbled. These changes were generally supported by banks. But these changes produced a strong reaction from some investors, with one investor group complaining that the changes would "effectively gut the transparent application of fair value measurement." The group also says suspending fair value accounting would delay the recovery of the banking system. Such political pressure on accounting standard-setters is not confined to the United States. For example, French President Nicolas Sarkozy urged his European Union counterparts to

continued ***LO 4***

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back changes to accounting rules and give banks and insurers some breathing space amid the market turmoil. And more recently, international finance ministers are urging the FASB and IASB to accelerate their work on accounting standards, including the fair value guidance for financial instruments. Most recently, IASB chair Hans Hoogervorst indicated that work remains to be done in the fair value debate and that "the dichotomy between historical cost and fair value is not as stark as one would expect." Mr. Hoogervorst noted that while historical cost is to some extent based on fair value, it needs a degree of current measurement to maintain its relevance. It is not free from subjective updating requirements, and it is not necessarily stable. Moreover, historical cost is also vulnerable to abuse. In sum, all the vulnerabilities that are often attributed to fair value accounting can be equally pertinent to historical cost. It is unclear whether these political pressures will have an effect on fair value accounting, but there is no question that the issue has stirred signifi cant worldwide political debate. In short, the numbers have consequences.

Sources: Adapted from Ben Hall and Nikki Tait, "Sarkozy Seeks EU Accounting Change," The Financial Times Limited (September 30, 2008); Floyd Norris, "Banks Are Set to Receive More Leeway on Asset Values," The New York Times (March 31, 2009); E. Orenstein, "G20 Finance Ministers Urge FASB, IASB Converge Key Standards by Mid-2013 at the Latest," FEI Financial Reporting Blog (April 2012); and Speech at the Paris IFRS Conference, http://www.ifrs.org/Alerts/ Conference/Documents/2015/Hans-Hoogervorst-speech-ParisJune-2015.pdf (June 2015).

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Major Challenges In Financial Reporting

Expectation GAAP

What the public thinks accountants should do vs. what accountants think they can do.

- Difficult to close in light of accounting scandals.
- Sarbanes-Oxley Act.
- Public Company Accounting Oversight Board (PCAOB).

LO 4

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Major Challenges In Financial Reporting

Financial Reporting Challenges

- Nonfinancial measurements.
- Forward-looking information.
- Soft assets.
- Timeliness.
- Understandability.

LO 4

Major Challenges In Financial Reporting

International Accounting Standards

Two sets of standards accepted for international use:

- U.S. GAAP, issued by the FASB.
- International Financial Reporting Standards (IFRS), issued by the IASB.

INTERNATIONAL PERSPECTIVE

The adoption of IFRS by U.S. companies would make it easier to compare U.S. and foreign companies, as well as for U.S. companies to raise capital in foreign markets.

LO 4

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WHAT DO THE NUMBERS MEAN? CAN YOU DO THAT?

One of the more difficult issues related to convergence and international accounting standards is that countries have different cultures and customs. For example, the former chair of the IASB explained it this way regarding Europe:

> "In the U.K. everything is permitted unless it is prohibited. In Germany, it is the other way around; everything is prohibited unless it is permitted. In the Netherlands, everything is prohibited even if it is permitted. And in France, everything is permitted even if it is prohibited. Add in countries like Japan, the United States and China, it becomes very difficult to meet the needs of each of these countries."

With this diversity of thinking around the world, it understandable why accounting convergence has been so elusive.

Source: Sir D. Tweedie, "Remarks at the Robert P. Maxon Lectureship," George Washington University (April 7, 2010).

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Major Challenges In Financial Reporting

Ethics in the Environment of Financial Accounting

In accounting, we frequently encounter ethical dilemmas.

- GAAP does not always provide an answer.
- Doing the right thing is not always easy or obvious.

LO 4

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RELEVANT FACTS

Similarities

- Generally accepted accounting principles (GAAP) for U.S. companies are developed by the Financial Accounting Standards Board (FASB). The FASB is a private organization. The Securities and Exchange Commission (SEC) exercises oversight over the actions of the FASB. The IASB is also a private organization. Oversight over the actions of the IASB is regulated by IOSCO.
- Both the IASB and the FASB have essentially the same governance structure, that is, a Foundation that provides oversight, a Board, an Advisory Council, and an Interpretations Committee. In addition, a general body that involves the public interest is part of the governance structure.
- The FASB relies on the SEC for regulation and enforcement of its standards. The IASB relies primarily on IOSCO for regulation and enforcement of its standards.

LO 5 Compare the procedures related to financial accounting and accounting standards under GAAP and IFRS.

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RELEVANT FACTS

Similarities

- Both the IASB and the FASB are working together to find common grounds for convergence. A good example is the recent issuance of a new standard on revenue recognition that both organizations support. Also, the Boards are working together on other substantial projects, such as the accounting for leases.

Differences

- GAAP is more detailed or rules-based. IFRS tends to simpler and more flexible in its accounting and disclosure requirements. The difference in approach has resulted in a debate about the merits of principles-based versus rules-based standards.

RELEVANT FACTS

Differences

- Differences between GAAP and IFRS should not be surprising because standard-setters have developed standards in response to different user needs. In some countries, the primary users of financial statements are private investors. In others, the primary users are tax authorities or central government planners. In the United States, investors and creditors have driven accounting-standard formulation.

IFRS Insights

ABOUT THE NUMBERS

World markets are becoming increasingly intertwined. International consumers drive Japanese cars, wear Italian shoes and Scottish woolens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, watch U.S. movies, and use Arabian oil. The tremendous variety and volume of both exported and imported goods indicates the extensive involvement in international trade—for many companies, the world is their market. To provide some indication of the extent of globalization of economic activity, Illustration IFRS1-1 provides a listing of the top 20 global companies in terms of sales.

ILLUSTRATION IFRS 1-1
Global Companies

Rank	Company	Country	Revenues ($ millions)	Rank	Company	Country	Revenues ($ millions)
1	**Wal-Mart Stores**	U.S.	476,294	11	**Total**	France	227,882
2	**Royal Dutch Shell**	Netherlands	459,599	12	**Chevron**	U.S.	220,356
3	**Sinopec Group**	China	457,201	13	**Samsung Electronics**	South Korea	208,938
4	**China National Petroleum**	China	432,007	14	**Berkshire Hathaway**	U.S.	182,150
5	**ExxonMobil**	U.S.	407,666	15	**Apple**	U.S.	170,910
6	**BP**	U.K.	396,217	16	**AXA**	France	165,893
7	**State Grid**	China	333,386	17	**Gazprom**	Russia	165,016
8	**Volkswagen**	Germany	261,539	18	**E.ON**	Germany	162,560
9	**Toyota Motor**	Japan	256,454	19	**Phillips 66**	U.S.	161,175
10	**Glencore International**	Switzerland	232,694	20	**Daimler**	Germany	156,628

International Standard-Setting Organizations:

International Accounting Standards Board (IASB)

- Issues **International Financial Reporting Standards (IFRS)**.
- Standards used on most foreign exchanges.
- Standards used by foreign companies listing on U.S. securities exchanges.
- IFRS used in over 115 countries.

International Organization of Securities Commissions (IOSCO)

- Does not set accounting standards.
- Dedicated to ensuring that global markets can operate in an efficient and effective basis.

http://www.iosco.org/

IFRS SELF-TEST QUESTIONS

The major key players on the international side are the:

a. IASB and FASB.

b. SEC and FASB.

c. IOSCO and the SEC.

d. IASB and IOSCO.

International Accounting Standards Board (IASB)

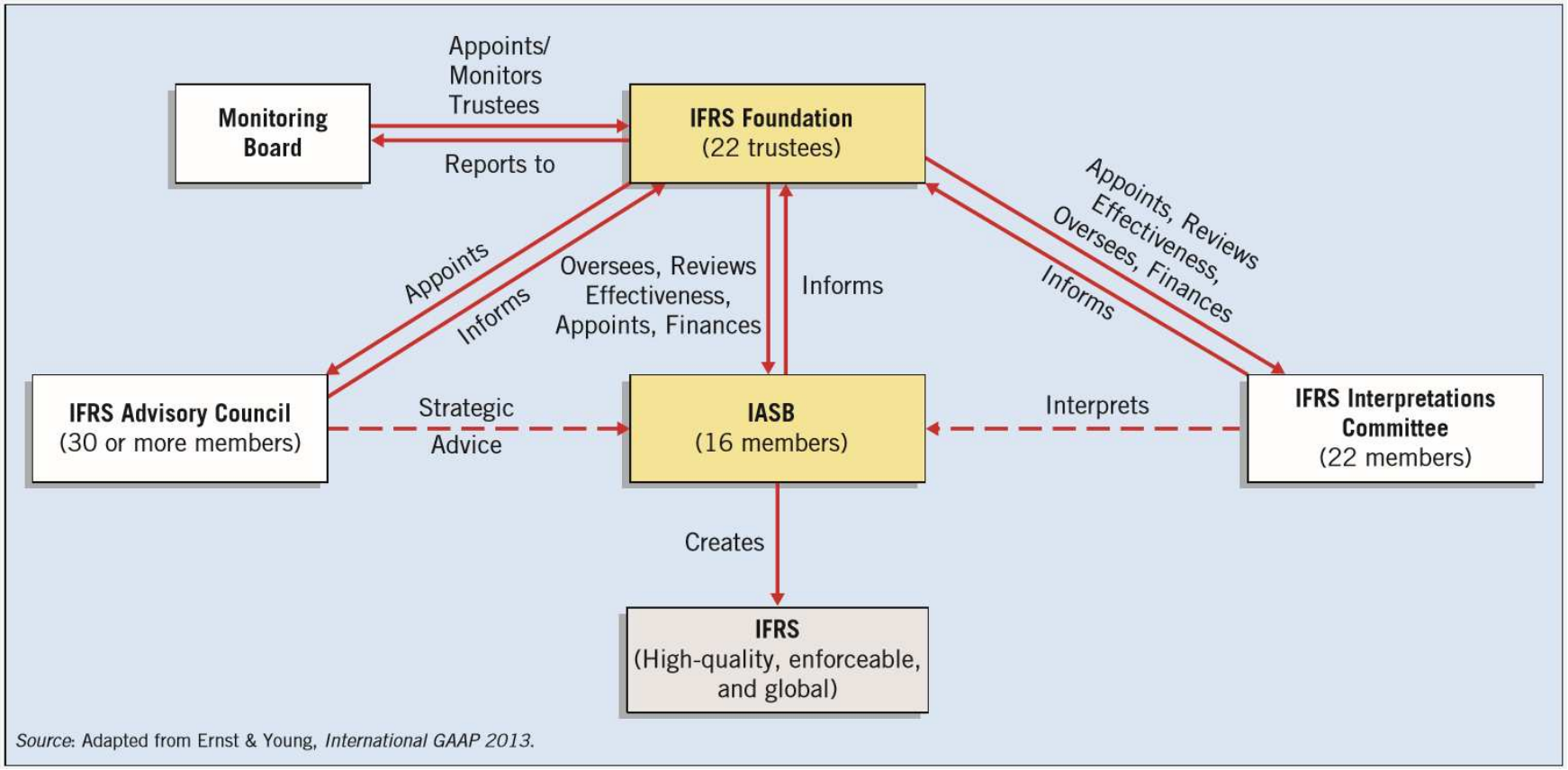
Composed of four organizations—

- International Accounting Standards Committee Foundation (IASCF).
- International Accounting Standards Board (IASB).
- Standards Advisory Council.
- International Financial Reporting Interpretations Committee (IFRIC).

International Accounting Standards Board®

http://www.iasb.org

IFRS Insights

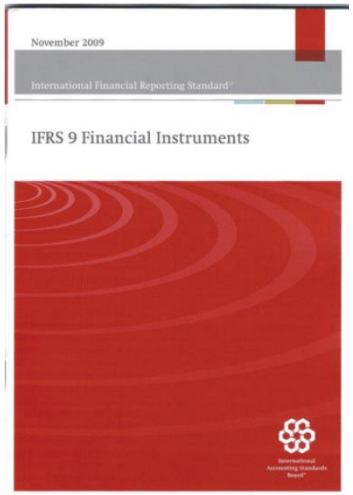


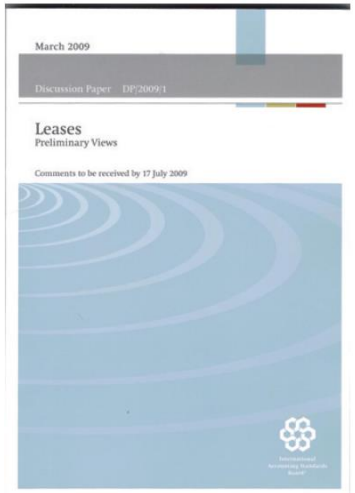
Source: Adapted from Ernst & Young, *International GAAP 2013*.

ILLUSTRATION IFRS 1-2
International Standard-Setting Structure

Types of Pronouncements

- International Financial Reporting Standards.
- Framework For Financial Reporting.
- International Financial Reporting Interpretations.





Hierarchy of IFRS

Companies first look to:

1. International Financial Reporting Standards;
2. International Accounting Standards; and
3. Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

IFRS SELF-TEST QUESTIONS

IFRS is comprised of:

a. International Financial Reporting Standards and FASB financial reporting standards.

b. International Financial Reporting Standards, International Accounting Standards, and international accounting interpretations.

c. International Accounting Standards and international accounting interpretations.

d. FASB financial reporting standards and International Accounting Standards.

International Accounting Convergence

The SEC appears committed to move to IFRS, assuming that certain conditions are met.

The FASB and the IASB have been working diligently to (1) make their existing financial reporting standards fully compatible as soon as is practicable, and (2) coordinate their future work programs to ensure that once achieved, compatibility is maintained.

IFRS SELF-TEST QUESTIONS

Which of the following statements is true?

a. The IASB has the same number of members as the FASB.

b. The IASB structure has both advisory and interpretation functions, but no trustees.

c. The IASB has been in existence longer than the FASB.

d. The IASB structure is quite similar to the FASB's, except the IASB has a larger number of board members.

ON THE HORIZON

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported. In fact, beginning in 2010, the IASB (and the FASB on its joint projects with the IASB) started its policy of phasing in adoption of new major standards over several years. The major reason for this policy is to provide companies time to translate and implement international standards into practice. Much has happened in a very short period of time in the international accounting environment. While adoption of IFRS in the United States is an unlikely avenue to achieve a single set of high-quality accounting standards, there continues to be strong support for the Boards to continue their work to narrow the differences between GAAP and IFRS.

IFRS SELF-TEST QUESTIONS

IFRS stands for:

a. International Federation of Reporting Services.

b. Independent Financial Reporting Standards.

c. International Financial Reporting Standards.

d. Integrated Financial Reporting Services.

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E3-5 (LO 3) Adjusting Entries

The ledger of Duggan Rental Agency on March 31 of the current year includes the following selected accounts before adjusting entries have been prepared.

	Debit	Credit
Prepaid Insurance	$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		$ 8,400
Notes Payable		20,000
Unearned Rent Revenue		9,300
Rent Revenue		60,000
Interest Expense	-	
Salaries and Wages Expense	14,000	

An analysis of the accounts shows the following.

1. The equipment depreciates $250 per month.
2. One-third of the unearned rent was recognized as revenue during the quarter.
3. Interest of $500 is accrued on the notes payable.
4. Supplies on hand total $850.
5. Insurance expires at the rate of $300 per month.

Instructions

Prepare the adjusting entries at March 31, assuming that adjusting entries are made quarterly. Additional accounts are Depreciation Expense, Insurance Expense, Interest Payable, and Supplies Expense. (Omit explanations.)

		Debit	Credit
1			
2			
3			
4			

5			

Solution: E3-5 (LO 3) Adjusting Entries

The ledger of Duggan Rental Agency on March 31 of the current year includes the following selected accounts before adjusting entries have been prepared.

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5. Insurance expires at the rate of $300 per month.

Instructions

Prepare the adjusting entries at March 31, assuming that adjusting entries are made quarterly. Additional accounts are Depreciation Expense, Insurance Expense, Interest Payable, and Supplies Expense. (Omit explanations.)

		Debit	Credit
1	Depreciation Expense	750	
	Accumulated Depreciation - Equipment		750
2	Unearned Rent Revenue	3,100	
	Rent Revenue		3,100
3	Interest Expense	500	
	Interest Payable		500
4	Supplies Expense	1,950	
	Supplies		1,950
5	Insurance Expense	900	
	Prepaid Insurance		900

E3-8 (LO3) Adjusting Entries

Andy Roddick is the new owner of Ace Computer Services. At the end of August 2017, his first month of ownership, Roddick is trying to prepare monthly financial statements. Below is some information related to unrecorded expenses that the business incurred during August.

1. At August 31, Roddick owed his employees $1,900 in wages that will be paid on September 1.
2. At the end of the month, he had not yet received the month's utility bill. Based on past experience, he estimated the bill would be approximately $600.
3. On August 1, Roddick borrowed $30,000 from a local bank on a 15-year mortgage. The annual interest rate is 8%.
4. A telephone bill in the amount of $117 covering August charges is unpaid at August 31.

Instructions

Prepare the adjusting journal entries as of August 31, 2017, suggested by the information above.

		Debit	Credit
1			
2			
3			
4			

Solution: E3-8 (LO3) Adjusting Entries

Andy Roddick is the new owner of Ace Computer Services. At the end of August 2017, his first month of ownership, Roddick is trying to prepare monthly financial statements. Below is some information related to unrecorded expenses that the business incurred during August.

1. At August 31, Roddick owed his employees $1,900 in wages that will be paid on September 1.
2. At the end of the month, he had not yet received the month's utility bill. Based on past experience, he estimated the bill would be approximately $600.
3. On August 1, Roddick borrowed $30,000 from a local bank on a 15-year mortgage. The annual interest rate is 8%.
4. A telephone bill in the amount of $117 covering August charges is unpaid at August 31.

Instructions

Prepare the adjusting journal entries as of August 31, 2017, suggested by the information above.

		Debit	Credit
1	Salaries and Wages Expense	1,900	
	Salaries and Wages Payable		1,900
2	Utilities Expenses	600	
	Accounts Payable		600
3	Interest Expense	200	
	Interest Payable		200
4	Telephone and Internet Expense	117	
	Accounts Payable		117

P3-2 (LO 3.4) Adjusting Entries and Financial Statements

Mason Advertising was founded in January 2013. Presented below are adjusted and unadjusted trial balances as of December 31, 2017.

MASON ADVERTISING
Trial Balance
December 31, 2017

	Unadjusted		Adjusted	
	DR	CR	DR	CR
Cash	$ 11,000		$ 11,000	
Accounts Receivable	20,000		23,500	
Supplies	8,400		3,000	
Prepaid Insurance	3,350		2,500	
Equipment	60,000		60,000	
Accumulated Depreciation—Equipment		$ 28,000		$ 33,000
Accounts Payable		5,000		5,000
Interest Payable		-		150
Notes Payable		5,000		5,000
Unearned Service Revenue		7,000		5,600
Salaries and Wages Payable		-		1,300
Common Stock		10,000		10,000
Retained Earnings		3,500		3,500
Service Revenue		58,600		63,500
Salaries and Wages Expense	10,000		11,300	
Insurance Expense			850	
Interest Expense	350		500	
Depreciation Expense			5,000	
Supplies Expense			5,400	
Rent Expense	4,000		4,000	
	$117,100	$ 117,100	$ 127,050	$ 127,050

Instructions

(a) Journalize the annual adjusting entries that were made. (Omit explanations.)

Dec		Debit	Credit
31			
31			

31			
31			
31			
31			
31			

(b) Prepare an income statement and a statement of retained earnings for the year ending December 31, 2017, and an unclassified balance sheet at December 31.

Mason Advertising
Income Statement
For the Year Ended December 31, 2017

Revenues

Expenses

Mason Advertising
Statement of Retained Earnings
For the Year Ended December 31, 2017

Mason Advertising
Balance Sheet
December 31, 2017

Assets

Liabilities and Stockholders' Equity

(c) Answer the following questions.

(1) If the note has been outstanding 3 months, what is the annual interest rate on that note?

(2) If the company paid $12,500 in salaries and wages in 2017, what was the balance in Salaries and Wages Payable on December 31, 2016?

Solution: P3-2 (LO 3.4) Adjusting Entries and Financial Statements

Mason Advertising was founded in January 2013. Presented below are adjusted and unadjusted trial balances as of December 31, 2017.

MASON ADVERTISING
Trial Balance
December 31, 2017

	Unadjusted		Adjusted	
	DR	CR	DR	CR
Cash	$ 11,000		$ 11,000	
Accounts Receivable	20,000		23,500	
Supplies	8,400		3,000	
Prepaid Insurance	3,350		2,500	
Equipment	60,000		60,000	
Accumulated Depreciation—Equipment		$ 28,000		$ 33,000
Accounts Payable		5,000		5,000
Interest Payable		-		150
Notes Payable		5,000		5,000
Unearned Service Revenue		7,000		5,600
Salaries and Wages Payable		-		1,300
Common Stock		10,000		10,000
Retained Earnings		3,500		3,500
Service Revenue		58,600		63,500
Salaries and Wages Expense	10,000		11,300	
Insurance Expense			850	
Interest Expense	350		500	
Depreciation Expense			5,000	
Supplies Expense			5,400	
Rent Expense	4,000		4,000	
	$ 117,100	$ 117,100	$ 127,050	$ 127,050

Instructions

(a) Journalize the annual adjusting entries that were made. (Omit explanations.)

Dec		Debit	Credit
31	Accounts Receivable	3,500	
	Service Revenue		3,500
31	Unearned Service Revenue	1,400	
	Service Revenue		1,400

31	Supplies Expense	5,400	
	Supplies		5,400
31	Depreciation Expense	5,000	
	Accumulated Depreciation - Equipment		5,000
31	Interest Expense	150	
	Interest Payable		150
31	Insurance Expense	850	
	Prepaid Expense		850
31	Salaries and Wages Expense	1,300	
	Salaries and Wages Payable		1,300

(b) Prepare an income statement and a statement of retained earnings for the year ending December 31, 2017, and an unclassified balance sheet at December 31.

Mason Advertising
Income Statement
For the Year Ended December 31, 2017

Revenues		
Service revenue		$ 63,500
Expenses		
Salaries and wages expense	$ 11,300	
Supplies expense	5,400	
Depreciation expense	5,000	
Rent expense	4,000	
Insurance expense	850	
Interest expense	500	
Total expenses		27,050
Net income		$ 36,450

Mason Advertising
Statement of Retained Earnings
For the Year Ended December 31, 2017

Retained earnings, January 1	$ 3,500
Add: Net income	36,450
Retained earnings, December 31	$ 39,950

Mason Advertising Balance Sheet December 31, 2017		
Assets		
Cash		$ 11,000
Accounts receivable		23,500
Supplies		3,000
Prepaid insurance		2,500
Equipment	$ 60,000	
Less: Accumulated depreciation—equipment	33,000	27,000
Total assets		$ 67,000

Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	5,000	
Unearned service revenue	5,600	
Salaries and wages payable	1,300	
Interest payable	150	
Total liabilities		$ 17,050
Stockholders' equity		
Common stock	10,000	
Retained earnings	39,950	49,950
Total liabilities and stockholders' equity		$ 67,000

(c) Answer the following questions.

(1) If the note has been outstanding 3 months, what is the annual interest rate on that note?

Interest is $50 per month or 1% of the note payable.
1% X 12 = 12% per year

(2) If the company paid $12,500 in salaries and wages in 2017, what was the balance in Salaries and Wages Payable on December 31, 2016?

Salaries and wages expense	$ 11,300
Less Salaries and wages payable, 12/31/17	1,300
	$ 10,000
Less total payments	12,500
Salaries and wages payable, 12/31/16	$ 2,500