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
2. Objective of financial reporting.	2, 7	13	1, 2	3
3. Qualitative characteristics of accounting.	3, 4, 5, 6, 8	1, 2, 3, 4, 11, 13	2, 3, 4	4, 8
4. Elements of financial statements.	9, 10, 24	5, 6	5	
5. Basic assumptions.	11, 12, 13	7, 8, 12	6, 7	
6. Basic principles:				
a. Measurement.	14, 15, 16, 17	9, 10, 12	6, 7, 9, 10	5
b. Revenue recognition.	18, 19, 20, 21, 22	9	7, 9, 10	5
c. Expense recognition.	23	9, 12	6, 7, 9, 10	5, 6, 7, 9
d. Full disclosure.	24, 25, 26	9, 12	6, 7, 8, 9, 10	
7. Constraint.	27, 28	12, 13	3, 6, 7	10
8. Comprehensive assignments on assumptions, principles, and constraints.		13	6, 7, 9, 10	

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives		Brief Exercises	Exercises	Concepts for Analysis
1.	Describe the usefulness of a conceptual framework and explain the objective of financial reporting.	13	1, 2	1, 2,3
2.	Identify the qualitative characteristics of accounting information and the basic elements of financial statements	1, 2, 3, 4, 5, 6,11, 13	2, 3, 4, 5	8, 4
3.	Review the basic assumptions of accounting.	7, 8, 12	6, 7	
4.	Explain the application of the basic principles of accounting.	9, 10, 11, 12, 13	3, 6, 7, 8, 9, 10	5, 6, 7, 9, 10

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E2.1	Usefulness, objective of financial reporting.	Moderate	10–15
E2.2	Usefulness, objective of financial reporting, qualitative characteristics.	Moderate	10–15
E2.3	Qualitative characteristics.	Moderate	15–20
E2.4	Qualitative characteristics.	Simple	15–20
E2.5	Elements of financial statements.	Simple	10–15
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.	Complex	20–25
CA2.7	Expense recognition principle.	Moderate	20–30
CA2.8	Qualitative characteristics.	Moderate	20–30
CA2.9	Expense recognition principle.	Moderate	20–25
CA2.10	Cost-constraint.	Moderate	30–35

ANSWERS TO QUESTIONS

1. A conceptual framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on (1) identifying the boundaries of financial reporting, (2) selecting the transactions, other events, and circumstances to be represented, (3) how they should be recognized and measured, and (4) how they should be summarized and reported. A conceptual framework is necessary in financial accounting for the following reasons:
(1) It will enable the IASB 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 will increase financial statement users' understanding of and confidence in financial reporting.
(4) It will enhance comparability among companies' financial statements.

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

2. The primary objective of financial reporting is as follows:
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity.** Information that is decision useful to capital providers may also be useful to other users of financial reporting who are not capital providers.

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

3. The IASB identified the qualitative characteristics of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes. They involve determining which alternative provides the most useful information for decision-making purposes (decision-usefulness). The fundamental qualitative characteristics are relevance and faithful representation.

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

4. Relevance and faithful representation are the two fundamental qualities that make accounting information useful for decision-making. To be **relevant,** accounting information must be capable of making a difference in a decision. Information with no bearing on a decision is irrelevant. Financial information is capable of making a difference when it has predictive value, confirmatory value, or both. **Faithful representation** means that the item is representative of the real-world phenomenon that it purports to represent. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. In other words, faithful representation means that the numbers and descriptions match what really existed or happened. To be a faithful representation, information must be complete, neutral, and free of material error.

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

5. Materiality refers to the relative significance of an amount, activity, or item to informative disclosure and a 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.

Materiality is a company-specific aspect of relevance. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information. An individual company determines whether information is material because both the nature and/or magnitude of the item(s) to which the information relates must be considered in the context of an individual company's financial report. Information is immaterial, and therefore irrelevant, if it would have no impact on a decision-maker. In short, it must make a difference or a company need not disclose it. Assessing materiality is one of the more challenging aspects of accounting because it requires evaluating both the relative size and importance of an item. However, it is difficult to provide firm guidelines in judging when a given item is or is not material. Materiality varies both with relative amount and with relative importance.

One should consider the importance of the relative size of an item in determining its materiality. It is generally not feasible to specify uniform quantitative thresholds at which an item becomes material. Rather, materiality judgments should be made in the context of the nature and the amount of an item. Materiality factors into a great many internal accounting decisions. Only by the exercise of good judgment and professional expertise can reasonable and appropriate answers be found, which is the materiality concept sensibly applied.

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

6. The enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. These characteristics enhance the decision usefulness of financial reporting information that is relevant and faithfully represented. Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. Enhancing qualitative characteristics distinguish more-useful information from less-useful information.

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

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

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

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

8. Information that is measured and reported in a similar manner for different companies is considered comparable. Comparability enables users to identify the real similarities and differences in economic events between companies. Another type of comparability, consistency, is present when a company applies the same accounting treatment to similar events, from period to period. Through such application, the company shows consistent use of accounting standards.

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

9. An important aspect of developing any theoretical structure is the body of basic elements or definitions to be included in it. Accounting uses many terms with distinctive and specific meanings. These terms constitute the language of business or the jargon of accounting. One such term is asset. Is it merely something we own? Or is an asset something we have the right to use, as in the case of leased equipment? Or is it anything of value used by a company to generate revenues—in which case, should we also consider the managers of a company as an asset?

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

10. The IASB classifies the elements into two distinct groups. [5] The first group of three elements—assets, liabilities, and equity—describes amounts of resources and claims to resources at a moment in time. The second group of two elements describes transactions, events, and circumstances that affect a company during a period of time. The first class, affected by elements of the second class, provides at any time the cumulative result of all changes. This interaction is referred to as "articulation." That is, key figures in one financial statement correspond to balances in another.

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

11. The five 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.
(5) Accrual-basis assumption.

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

12. a) Users need to know a company's performance and economic status on a timely basis so that they can evaluate and compare companies, and take appropriate actions. Therefore, companies must report information periodically. The periodicity (or time period) assumption implies that a company can divide its economic activities into artificial time periods. These time periods vary, but the most common are monthly, quarterly, and yearly. The shorter the time period, the more difficult it is to determine the proper net income for the period. A month's results usually prove less reliable than a quarter's results, and a quarter's results are likely to be less reliable than a year's results. Investors desire and demand that a company quickly process and disseminate information. Yet the quicker a company releases the information, the more likely the information will include errors. This phenomenon provides an interesting example of the trade-off between relevance and faithful representation in preparing financial data. The problem of defining the time period becomes more serious as product cycles shorten and products become obsolete more quickly. Many believe that, given technology advances, companies need to provide more online, real-time financial information to ensure the availability of relevant information.

b) Companies prepare financial statements using the accrual basis of accounting. Accrual-basis accounting means that transactions that change a company's financial statements are recorded in the periods in which the events occur. For example, using the accrual basis means that companies recognize revenues when it satisfies a performance obligation (the revenue recognition principle). This is in contrast to recognition based on receipt of cash. Likewise, under the accrual basis, companies recognize expenses when incurred (the expense recognition principle) rather than when paid. 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 in making economic decisions.

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

13. The monetary unit assumption assumes that the unit of measure remains reasonably stable so that Euros, Yen, or dollars of different years can be added without any adjustment. When the value of the currency fluctuates greatly over time, the monetary unit assumption loses its validity.

The IASB indicated that it expects the currency 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: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

14. Some of the arguments which might be used are outlined below:
(1) Cost is definite and reliable; 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 fair values could outweigh the benefits derived.

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

15. **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: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

16. The fair value option gives companies the option to use fair value as the basis for measurement of financial assets and financial liabilities. The Board believes that fair value measurement for financial assets and financial liabilities 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 assets and financial liabilities. As a result companies now have the option to record fair value in their accounts for most financial assets and financial liabilities, including such items as receivables, investments, and debt securities.

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

17. 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 reliable fair value measurement.

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

18. 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: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

19. 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: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

20. 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 ether 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.

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

21. Revenues are recognized when a performance obligation is met. The most common time at which these two conditions are met is when the product or merchandise is delivered or services are rendered to customers. Therefore, revenue for Selane Eatery should be recognized at the time the luncheon is served.

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

22. The president means that the “gain” should be recorded in the books. This item should not be entered in the accounts, however, because a reliable measurement of the revenue is questionable.

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

23. 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: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

24. An item that meets the definition of an element should be recognized if: (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability.

LO: 2,4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

25. (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: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

26. 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 shares doubled in January of the subsequent reporting period probably should be disclosed because such a situation is of importance to present shareholders. Even though the event occurred after December 31, 2019, it should be disclosed on in the notes to the financial statements as of December 31, 2019, 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: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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

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

28. The costs of providing accounting information are paid primarily to highly trained accountants who design and implement information systems, retrieve and analyze large amounts of data, prepare financial statements in accordance with authoritative pronouncements, and audit the information presented. These activities are time-consuming and costly. The benefits of providing accounting information are experienced by society in general, since informed financial decisions help allocate scarce resources to the most effective enterprises. 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: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2.1

(a) Comparability
(b) Timeliness
(c) Predictive value
(d) Relevance
(e) Neutrality

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

BRIEF EXERCISE 2.2

(a) Faithful representation
(b) Confirmatory value
(c) Free from error
(d) Completeness
(e) Understandability

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

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 auditor's 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.)

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 a matter of consistency; it is a change in accounting estimate which leads to a change in accounting principles employed or in their method of application. The change would require comment in the auditor's report in an explanatory paragraph.**

(d) **If the company is using a different inventory valuation method from all other companies in its industry, no comment as to consistency need be made in the CPA's audit report. Consistency refers to a given company following consistent accounting principles from one period to another; it does not mean following the same accounting principles as other companies in the same industry.**

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

BRIEF EXERCISE 2.4

(a) **Verifiability**
(b) **Comparability**
(c) **Consistency**
(d) **Timeliness**

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

BRIEF EXERCISE 2.5

(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.**

BRIEF EXERCISE 2.5 (Continued)

(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.

(e) Should be debited to the Building account; Depreciation Expense during the life of building will include these costs.

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

LO: 2, Bloom: AP, Difficulty: Moderate, Time: 5-7, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

BRIEF EXERCISE 2.6

(a) Equity
(b) Income
(c) Equity
(d) Assets
(e) Expenses
(f) Expenses
(g) Liabilities
(h) Equity
(i) Income
(j) Equity

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

BRIEF EXERCISE 2.7

(a) Fair value, or net realizable value, if the land was sold.

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

(c) Fair value, or selling price less costs to complete.

(d) Fair value (i.e., redeemable value), if the insurance coverage was transferred to another party.

BRIEF EXERCISE 2.7 (Continued)

Note: In each of these cases, historical cost or fair value valuation might be abandoned if it cannot be assumed that the company will not continue on indefinitely.

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

BRIEF EXERCISE 2.8

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

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

BRIEF EXERCISE 2.9

(a) Revenue recognition
(b) Expense recognition
(c) Full disclosure
(d) Historical cost principle

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

BRIEF EXERCISE 2.10

Investment 1—Least verifiable.
Investment 2—Most verifiable.
Investment 3—Intermediate verifiability

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

BRIEF EXERCISE 2.11

(a) Material; although amount is small the change affects the trend.
(b) Material; netting obsures the information on the gain and loss.
(c) Likely not material; the amount of depreciation expense, if capitalized would not have a significant impact on income.

LO: 2,4, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

BRIEF EXERCISE 2.12

(a) Accrual basis (Expense recognition principle)
(b) Full disclosure
(c) Expense recognition principle
(d) Historical cost principle

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

BRIEF EXERCISE 2.13

1. **Costs; costs**
2. **General purpose financial reporting**
3. **Complete**
4. **Understandability**
5. **Comparability**
6. **Confirmatory value**

LO: 1,2,4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

SOLUTIONS TO EXERCISES

EXERCISE 2.1 (10–15 minutes)

(a) True.

(b) False. General purpose financial reporting helps users who lack the ability to demand all the financial information they need from an entity and therefore must rely, at least partly, on the information provided in financial reports. Managers and company insiders generally do not meet these criteria.

(c) False. Accounting standards based on individual conceptual frameworks generally will *not* result in consistent and comparable accounting reports. Rather, standard-setting that is based on personal conceptual frameworks will lead to different conclusions about identical or similar issues than it did previously. As a result, standards will not be consistent with one another and past decisions may not be indicative of future ones.

(d) False. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. However, that information may also be useful to other 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 financial statements. This point is important. It means that financial statement preparers assume a level of competence on the part of users. This assumption impacts the way and the extent to which companies report information.

(f) True.

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

EXERCISE 2.2 (10–15 minutes)

(a) False. The fundamental qualitative characteristics that make accounting information useful are relevance and faithful representation.

(b) True. (Materiality is also a consideration).

(c) False. The Framework does not include prudence or conservatism as desirable qualities of financial reporting information. The framework indicates that prudence or conservatism generally is in conflict with the quality of neutrality. This is because by being prudent or conservative likely leads to a bias in the reported financial position and financial performance. In fact, introducing biased understatement of assets (or overstatement of liabilities) in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent. This is inconsistent with neutrality, which encompasses freedom from bias.

(d) False. To be a faithful representation, information must be complete, neutral, and free of material error.

(e) False. While comparability does pertain to the reporting of information in a similar manner for different companies, it also refers to the consistency of information, which is present when a company applies the same accounting treatment to similar events, from period to period. Through such application the company shows consistent use of accounting standards and this permits valid comparisons from one period to the next.

(f) False. Verifiability is an enhancing characteristic for both relevance and faithful representation. Verifiability occurs when independent measurers, using the same methods, obtain similar results.

(g) True.

LO: 1,2, Bloom: C, Difficulty: Moderate, Time: 10-15, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

EXERCISE 2.3 (15–20 minutes)

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

LO: 2,4, Bloom: K, Difficulty: Moderate, Time: 15-20, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

EXERCISE 2.4 (15–20 minutes)

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

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

EXERCISE 2.5 (10–15 minutes)

(a) Liabilities.
(b) Equity.
(c) Equity.
(d) Income.
(e) Assets.
(f) Income.
(g) Equity.
(h) Income.
(i) Equity.

LO: 2, Bloom: K, Difficulty: Simple, Time: 10-15, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

EXERCISE 2.6 (15–20 minutes)

(a) 8. Expense recognition principle.
(b) 6. Historical cost principle.
(c) 9. Full disclosure principle.
(d) 2. Going concern assumption.
(e) 10. Revenue recognition principle.
(f) 1. Economic entity assumption.
(g) 4. Periodicity assumption.
(h) 7. Fair value principle.
(I) 3. Monetary unit assumption.

LO: 3,4, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

EXERCISE 2.7 (20–25 minutes)

(a) Historical cost principle.
(b) Accrual-basis assumption.
(c) Full disclosure principle.
(d) Expense recognition principle.
(e) Fair value principle.
(f) Economic entity assumption.
(g) Full disclosure principle.
(h) Revenue recognition principle.
(i) Full disclosure principle.
(j) Revenue and expense recognition principles.
(k) Economic entity assumption.
(l) Periodicity assumption.
(m) Expense recognition principle.
(n) Cost constraint.
(o) Historical cost principle.
(p) Accrual-basis assumption.
(q) Expense recognition principle.

LO: 3,4, Bloom: K, Difficulty: Moderate, Time: 20-25, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

EXERCISE 2.8

(a) It is well established in accounting that revenues, cost of goods sold and expenses 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 statement of financial position. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off liabilities, or when a government grant is involved.

EXERCISE 2.8 (Continued)

(c) **The basis upon which inventory amounts are stated (net realizable value) and the method used in determining cost (Weighted Average, FIFO, 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) **Comparability 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: 4, Bloom: C, Difficulty: Complex, Time: 20-25, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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 the performance obligation has been satisfied (goods have been delivered.)**

(c) **The company should not record this loss. 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. IAS 37 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 this standard. The purpose of this question is to develop some decision framework when the probability of a future event must be assumed.)**

EXERCISE 2.9 (Continued)

(d) At the present time, accountants generally do not recognize price-level adjustments in the accounts. Hence, it is misleading to deviate from the 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 value, but are depreciated on the basis of systematic charges of expired costs against revenues.

(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 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, SpA. has done in this situation. It should be noted that only where liquidation appears imminent is the going concern assumption inapplicable.

(f) The historical cost principle indicates that assets and liabilities are recorded at cost. If we were to select current value, for example, we would have an extremely difficult time in attempting to establish a current value for a given item without selling it. It should further be noted that the revenue recognition principle provides the answer to when revenues or gains should be recognized. Revenue or gains should not be recognized as a result of purchasing equipment, but when a performance obligation is satisfied."

LO: 4, Bloom: C, Difficulty: Moderate, Time: 20-25, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

EXERCISE 2.10

(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 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 the performance obligation has been satisfied.

EXERCISE 2.10 (Continued)

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

(d) The gain should be recognized at the point of sale. Deferral of the gain should not be permitted. Revenue should be recognized when the performance obligation has been satisfied (when the equipment is delivered to the customer).

(e) It appears from the information that the sale should be recorded in 2019 instead of 2018. Regardless of whether the terms are f.o.b. shipping point or f.o.b. destination, the point is that the inventory was sold in 2019. 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 2019.

LO: 4, Bloom: AP, Difficulty: Moderate, Time: 20-25, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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.

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 objective of financial reporting. The student is asked to indicate the 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 qualitative characteristics. 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 20–30 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 2.8 (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 2.9 (Time 20–25 minutes)
Purpose—to provide the student with the opportunity to discuss the ethical issues related to expense recognition.

CA 2.10 (Time 30–35 minutes)
Purpose—to provide the student with the opportunity to discuss the cost constraint.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 2.1

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

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 IASB to issue more useful and consistent standards in the future.

(b) 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 solved 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 help determine the bounds for judgment in preparing financial statements.
(6) It should provide guidance to the body responsible for establishing accounting standards.

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

CA 2.2

(a) The Conceptual Framework should provide benefits to the accounting community such as:
(1) A coherent set of standards and rules should result.
(2) New and emerging practical problems should be more quickly solved 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 help determine the bounds for judgment in preparing financial statements.
(6) It should provide guidance to the body responsible for establishing accounting standards.

(b) The Conceptual Framework identifies the most important quality for accounting information as usefulness for decision making. Relevance and faithful representation are the fundamental 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) The qualitative characteristics can be distinguished as fundamental or enhancing characteristics, depending on how they affect the usefulness of information. Each quality is described briefly below.

Fundamental Qualities

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

Faithful Representation For accounting information to be useful, it must be a faithful representation of the real-world phenomenon that it purports to represent. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. To be a faithful representation, information must be complete, neutral, and free of material error.

CA 2.2 (Continued)

Enhancing Qualities

Comparability. Information that is measured and reported in a similar manner for different companies is considered comparable. Comparability enables users to identify the real similarities and differences in economic events between companies. Another type of comparability, consistency, is present when a company applies the same accounting treatment to similar events, from period to period, the company shows consistent use of accounting standards.

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

Timeliness. Timeliness means having information available to decision makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its usefulness.

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

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

CA 2.3

(a) The objective of general purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity.** Information that is decision useful to capital providers may also be useful to other users of financial reporting who are not capital providers. However, an implicit assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information contained in financial statements. This point is important. It means that financial statement preparers assume a level of competence on the part of users. This assumption impacts the way and the extent to which companies report information.

(b) The purpose of the Conceptual Framework is to set forth fundamentals on which financial accounting and reporting standards may be based. Without an objective that everyone can agree to, 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: 1, Bloom: C, Difficulty: Moderate, Time: 25-35, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 2.4

(a) (1) **Relevance** is one of the two fundamental 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.

(2) **Faithful representation** is one of the two fundamental decision-specific characteristics of useful accounting information. Faithfully represented information can be depended upon to represent the conditions and events that it is intended to represent. Faithful representation stems from completeness, neutrality, and lack of error.

(3) **Understandability** is an enhancing 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 companies has been prepared and presented in a similar manner. Comparability enhances comparisons between information about two different companies at a particular point in time. Consistency is present when a Company applies the same accounting to similar events over time.

(5) **Neutrality** means that a company cannot select information to favor one set of parties over another. Reporting unbiased information must be the overriding consideration. If financial reporting is biased, financial reports will lose their credibility.

(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 representationally faithful 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 a company'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 companies, 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: 2, Bloom: C, Difficulty: Moderate, Time: 30-35, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 2.5

(a) The "crucial event" in determining when revenue is recognized is when a performance obligation is satisfied. In the case of subscriptions, the performance obligation is met when the magazines are delivered (including ads contained therein). The new director suggests that this principle does not apply in the magazine business and that revenue from subscription sales and advertising should be recognized in the accounts when the difficult task of selling is accomplished and not when the magazines are published and delivered to fill the subscriptions or to carry the advertising.

CA 2.5 (Continued)

The director's view that there is a single crucial event in the process of earning revenue in the magazine business is questionable even though the amount of revenue is determinable when the subscription is sold. Although the firm cannot prosper without good advertising contracts and while advertising rates depend substantially on magazine sales, it also is true that readers will not renew their subscriptions unless the content of the magazine pleases them. Unless subscriptions are obtained at prices that provide for the recovery in the first subscription period of all costs of selling and filling those subscriptions, the editorial and publishing activities are as crucial as the sale in the earning of the revenue. Even if the subscription rate does provide for the recovery of all associated costs within the first period, however, the editorial and publishing activities still would be important since the firm has an obligation (in the amount of the present value of the costs expected to be incurred in connection with the editorial and publication activities) to produce and deliver the magazine. Not until this obligation is fulfilled should the revenue associated with it be recognized in the accounts since the revenue is the result of delivering on a promise (selling and filling subscriptions) and not just the first one. The director's view also presumes that the cost of publishing the magazines can be computed accurately at or close to the time of the subscription sale despite uncertainty about possible changes in the prices of the factors of production and variations in efficiency. Hence, only a portion–not most–of the revenue should be recognized in the accounts at the time the subscription is sold.

(b) Recognizing in the accounts all the revenue in equal portions with the publication of the magazine every month is subject to some of the same criticism from the standpoint of theory as the suggestion that all or most of the revenue be recognized in the accounts at the time the subscription is sold. Although the journalistic efforts of the magazine are important in the process of earning revenue, the firm could not prosper without magazine sales and the advertising that results from paid circulation. Hence, some revenue could be recognized in the accounts at the time of the subscription sale (i.e., when cash is received) to the extent that part of the performance obligation to the subscriber and advertisers has been met. That is, the ads are in the public domain.

This approach requires the magazine to allocate the proportion of the revenue related to advertising from that related to subscriptions. For this reason, and because the task of estimating the amount of revenue associated with the subscription sale often has been considered subjective, recognizing revenue in the accounts with the monthly publication of the magazine has received support even though it does not meet the tests of revenue recognition as well as the next alternative.

(c) Recognizing in the accounts a portion of the revenue at the time a cash subscription is obtained and a portion each time an issue is published meets the tests of revenue recognition better than the other two alternatives. A portion of the net income is recognized in the accounts at the time of each major or crucial event – that is, when a performance obligation has been met. Each crucial event is clearly discernible and is a time of interaction between the publisher and subscriber. A legal sale is transacted before any revenue is recognized in the accounts. Prior to the time the revenue is recognized in the accounts, it already has been received in distributable form. Finally, the total revenue is measurable with more than the usual certainty, and the revenue attributable to each crucial event is determinable using reasonable (although sometimes conceptually unsatisfactory) assumptions about the relationship between revenue and costs when the costs are indirect.

(**Note to instructor:** CA 2.5 might also be assigned in conjunction with Chapter 18.)

LO: 4, Bloom: C, Difficulty: Complex, Time: 25-30, AACSB: None, AICPA BB: None, AICPA FC: 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 as the expense recognition principle, or in this case as "associating cause and effect" ("matching concept.")

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 periodic 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 a 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 their incurrence during the period provides no discernible future benefits and uncertainty exists regarding whether allocating them to current and future periods will serve any useful purpose. 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.

CA 2.6 (Continued)

(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.

There is no simple way of identifying a loss because ascertaining whether a cost should be a loss is often a matter of judgment. The accounting distinction between an asset, expense, loss, and prior period adjustment is not clear-cut. For example, an expense is usually voluntary, planned, and expected as necessary in the generation of revenue. But a loss is a measure of the service potential expired that is considered abnormal, unnecessary, unanticipated, and possibly nonrecurring and is usually not taken into direct consideration in planning the size of the revenue stream.

LO: 4, Bloom: AP, Difficulty: Complex, Time: 20-25, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 2.7

(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. 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.

The alternative of expensing the costs of sample display houses in the period in which the expenditure is made is based primarily upon the uncertainty of measurement. 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. 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.

(b) 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.

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.

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.

LO: 4, Bloom: AP, Difficulty: Moderate, Time: 20-30, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 2.8

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 a faithful representation.

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 have predictive value, confirmatory value, or both. Being timely is also important. 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.

As indicated, one element of relevance is predictive value. 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 also are not faithfully presented. In order to be so, 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

LO: 2, Bloom: AP, Difficulty: Moderate, Time: 20-30, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 2.9

(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 matching 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: 4, Bloom: AP, Difficulty: Moderate, Time: 20-25, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

CA 2.10

1. Information about competitors might be useful for benchmarking the company's results but if management does have expertise in providing the information, it could lack reliability. In addition, it is likely very costly for management to gather sufficiently reliable 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 lack reliability, thereby detracting from any potential benefits. In addition, while management's forecasts of future profitability or statement of financial position 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: 4, Bloom: AP, Difficulty: Moderate, Time: 30-35, AACSB: None, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

FINANCIAL REPORTING PROBLEM

(a) **According to Note 1—Accounting Policies, "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 to our franchise partners or customers and the significant risks and rewards of ownership have been transferred to the buyer."**

(b) **Most of the information presented in M&S's financial statements is reported on an historical cost basis. Examples are: Property, Plant, and Equipment, Intangible Assets, Investment Properties, and Inventories (subject to net realizable value). Regarding the use of fair value, some investments and other financial assets are reported at fair value. In addition, the fair value of the company's financial instruments and the market value of pension assets are disclosed.**

(c) **Examination of the auditor's report. Also, M&S discusses a number of new accounting pronouncements issued or effective during the fiscal year (e.g., IFRS 7, IFRIC 11, IFRIC 14). M&S indicates that they have had or are expected to have a material impact on the financial statements.**

(d) **According to the discussion of "Critical accounting estimates and judgements":**
<u>Refunds, gift cards and loyalty scheme accruals</u>

Accruals for sales returns, deferred income in relation to loyalty scheme redemption and gift card and credit voucher redemptions are estimated on the basis of historical returns and redemptions. These are recorded so as to allocate them to the same period as that in which the original revenue is recorded. These balances are reviewed regularly and updated to reflect management's latest best estimates. However, actual returns and redemptions could vary from these estimates.

Companies include an expanded discussion of items like refunds and loyalty schemes because the preparation of financial statements requires estimates and assumptions. However, actual results may differ from these estimates and these estimates and assumptions have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities.

COMPARATIVE ANALYSIS CASE

(a) Both companies use the Euro as their currency. Since both companies use the same currency, comparability is enhanced.

(b) adidas reports segments by regional markets, including Western Europe, North America, Greater China, Russia/CIS, Latin America, Japan, Middle East, South Korea, Southeast Asia/Pacific, as well as other centrally managed businesses (TaylorMade-adidas Golf, Reebok-CCM Hockey, Runtastic). Puma reports segments for Accessories, Apparel, Footwear.

(c) Both companies value inventory at lower of cost or net realizable value, using the average cost method. Therefore, comparability is enhanced.

(d) adidas reported the following with respect to new accounting standards:

The following new standards and interpretations and amendments to existing standards and interpretations are applicable for the first time for financial years beginning on January 1, 2015:

/ IAS 19 Amendment – Defined Benefit Plans: Employee Contributions (EU effective date: July 1, 2014): This amendment had no material impact on the Group's financial statements.

/ Improvements to IFRSs (2010-2012) (EU effective date: July 1, 2014): These improvements required additional disclosures in the Group's financial statements.

/ Improvements to IFRSs (2011-2013) (EU effective date: July 1, 2014): These improvements had no material impact on the Group's financial statements.

FINANCIAL STATEMENT ANALYSIS CASE—NOKIA

(a) The IASB's framework indicates that revenue is to be recognized when it is probable that future economic benefits will flow to the entity and reliable measurement of the amount of revenue is possible. Based on these fundamental concepts of revenue recognition, criteria are then established for various kinds of revenue transactions through the development of related IFRS.

1. For revenue related to sales, Nokia indicates that the criteria are met when it is probable that economic benefits associated with the transaction will flow to the Group and the costs incurred or to be incurred in respect of the transaction can be measured reliably and when the significant risks and rewards of ownership have transferred to the buyer. Thus, it would appear that sales of products are recognized at point of sale.

2. Revenue from contracts is recognized on the percentage of completion basis, when the outcome of the contract can be estimated reliably. Under this approach Nokia must reassess over the life of the contract whether it is probable that future economic benefits will flow to the entity and reliable measurement of the amount of revenue is possible.

Note to instructor: Nokia has not yet adopted the new revenue standard (IFRS 15), in which revenue is recognized when a performance obligation is satisfied.

(b) A number of estimates are required in applying these revenue recognition policies. For example, sales may materially change if management's assessment of such criteria was determined to be inaccurate. Specifically, Nokia makes price protection adjustments based on estimates of future price reductions and certain agreed customer inventories at the date of the price adjustment. Possible changes in these estimates could result in revisions to the sales in future periods. In this case, the revenue amounts will not be faithful representations and they will lack predictive value (not relevant).

With respect to revenue from contracts, recognized revenues and profits are subject to revisions during the project in the event that the assumptions regarding the overall project outcome are revised. Current sales and profit estimates for projects may materially change due to the early stage of a long-term project, new technology, changes in the project scope, changes in costs, changes in timing, changes in customers' plans, realization of penalties, and other corresponding factors. Again, the revenue amounts will not be faithful representations and they will lack predictive value (not relevant).

(c) Even if all phone-makers use the same policy, it still might be difficult to compare their revenue numbers. As indicated in (b), management makes a number of judgments and estimates in determining whether the criteria have been met. For example, if one company's management is more optimistic in estimating the costs to complete a contract, it will recognize more revenue from a contract and it will recognize the revenue earlier. This will result in revenue numbers that are not comparable to another company with a similar contract but whose management used less optimistic estimates.

ACCOUNTING, ANALYSIS AND PRINCIPLES

ACCOUNTING

CADDIE SHACK DRIVING RANGE
Statement of Financial Position
May 31, 2019

Assets		**Owners' equity**	
Building	$ 6,000	Contributed capital	$20,000
Equipment	800	Retained earnings	1,650
Cash	15,100		
Total assets	$21,900	**Liabilities**	
		Advertising payable	150
		Utilities payable	100
		Total liabilities & equity	$21,900

Accrual income = $4,700 – $1,000 – $750 – $400 – $100 = $2,450
Retained Earnings balance = $0 + $2,450 – $800 = $1,650

Murray's might conclude that his business earned a profit of $2,450 because that is his accrual income for 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.

PRINCIPLES

IFRS 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 $2,450 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 is an application of the definition of basic elements. Cash withdrawals are distributions to owners, not an element of income (expenses or losses).

RESEARCH CASH

<u>Search Strings</u>: “materiality”, “completeness”

(a) According to the Conceptual Framework (chapter 3, par. QC11): 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) According to the Conceptual Framework, (chapter 3, paras. QC12–QC13):

To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete*, *neutral* and *free from error*. Of course, perfection is seldom, if ever, achievable. The Board’s objective is to maximize those qualities to the extent possible.

A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description, of what the numerical depiction represents (for example, original cost, adjusted cost or fair value). For some items, a complete depiction may also entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.

(c) According to the Conceptual Framework (chapter 1, par. OB17):

Financial performance reflected by accrual accounting

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

GAAP CONCEPTS and APPLICATION

2.1. Both the IASB and FASB have similar measurement principles, based on historical cost and fair value. The boards issued converged fair value standards in 2011. However, U.S. 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.")

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

2.2. The IASB framework identifies 5 elements: ASSETS, LIABILITIES, EQUITY, INCOME, and EXPENSES. The U.S. GAAP framework has the following additional elements – which expand on equity-related items.

INVESTMENTS BY OWNERS.

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

DISTRIBUTIONS TO OWNERS.

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

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.

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.

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.

Source: "Elements of Financial Statements," *Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, December 1985), pp. ix and x.

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

2.3. The IASB and the FASB face a difficult task in attempting to update, modify, and complete a conceptual framework. There are many challenging issues to overcome. 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? We are optimistic that the revised conceptual framework will be a significant improvement over its predecessors and will lead to standards that will help financial statement users to make better decisions.

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