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	6, 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, 30		3, 7	11

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

	Learning Objectives	Questions	Brief Exercises	Exercises	Concepts for Analysis
1.	Describe the usefulness of a conceptual framework and the objective of financial reporting.	1, 2, 7		1, 2	CA2.1 CA2.2, CA2.3
2.	Identify the qualitative characteristics of accounting information and the basic elements of financial statements.	3, 4, 5, 6, 8, 9, 10, 11	1, 2, 3, 4, 5, 6, 7	2, 3, 4, 5	CA2.4, CA2.9
3.	Review the basic assumptions of accounting.	12, 13, 14, 25	8, 9	6, 7	
4.	Explain the application of the basic principles of accounting.	15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30	10, 11, 12	3, 6, 7, 8, 9, 10	CA2.5, CA2.6, CA2.7, CA2.8, CA2.10, 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

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 primary 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: 1, 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: 2, 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: 2, 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 could 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 defines materiality to be consistent with the legal concept of materiality, as established in the securities laws. Specifically, information is material "if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information."

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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: 2, 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: 2, 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 a user needs a 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 for the user can be assumed; this has an impact on the way and the extent to which information is reported.

LO: 1, 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: 2, 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 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: 2, 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: 2, 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: 2, 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) The economic entity assumption.
(2) The going concern assumption.
(3) The monetary unit assumption.
(4) The periodicity assumption.

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

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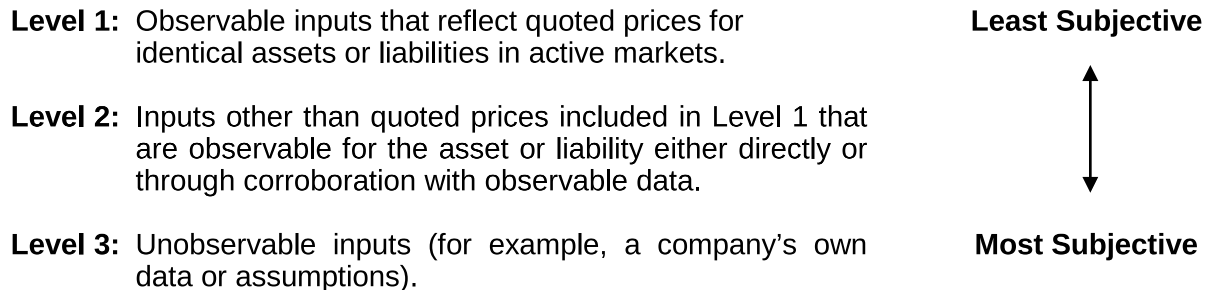
18. The fair value hierarchy provides insight into the priority of valuation techniques that are used to determine fair value. The fair value hierarchy is divided into three broad levels.

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, such as 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: 4, 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: 4, 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: 4, 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.** The 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.

Questions Chapter 2 (Continued)

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: 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: 4, 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: 4, 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: 4, Bloom: AN, Difficulty: Simple, Time: 5-7, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

25. The four characteristics that an item must have before it can be recognized in the financial statements 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: 4, 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: 4, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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, 2020 (referred to as a subsequent event), it should be disclosed on the balance sheet as of December 31, 2020, 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: 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: 47, 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: 4, 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.

LO: 2, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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: 2, 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: 2, 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).

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 might be disclosed by a note in the financial statements if the effect was material. If commented upon in the audit report, it would be as a matter of disclosure rather than consistency.

LO: 2, 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: 2, 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.

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: 2, 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: 2, 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 financial statement date into account.**

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: 2, 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: 3, 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: 3, 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: 4, Bloom: K, Moderate, 10-15, AACSB: Communication, AICPA BB: None, AICPA FC: AICPA FC: Measurement, Reporting, AICPA PC: None

BRIEF EXERCISE 2.11

Investment (1)—Level 3
Investment (2)—Level 1
Investment (3)—Level 2

LO: 4, 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: 3, 4, Bloom: C, Moderate, Time: 5-10, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

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 all users need reasonable knowledge of business and financial accounting matters to understand the information contained in the financial statements.
(f) True.

LO: 1 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 – Verifiability is an enhancing characteristic which relates to both relevance and faithful representation.
(f) True.

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

EXERCISE 2.3 (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: 2, 4, 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: 2, 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: 2, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: None

EXERCISE 2.6 (15–20 minutes)

(a) 7. Expense recognition principle.
(b) 5. Measurement principle (historical cost.)
(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: 3, 4, 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 principle (historical cost.)
(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 principle, Expense recognition principle.
(m) Measurement principle (historical cost.)
(n) Expense recognition principle.

LO: 3, 4, 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.

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: 4, 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 degree of uncertainty about whether the company will have to pay. GAAP 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 the guidance (FASB ASC 450; formerly *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) 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) **The answer to this situation is the same as (b).**

LO: 4, 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) **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, that would be when the goods are delivered to the customer.**

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) 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 2021 instead of 2020. 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 2021. 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 2021.

LO: 4, 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.

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 a brief description of the focus of seven of these Statements are as follows:
(1) **SFAC No. 1,** "Objectives of Financial Reporting by Business Enterprises," presents the goals and purposes of accounting (superseded by **SFAC No. 8,** Chapter 1.)
(2) **SFAC No. 2,** "Qualitative Characteristics of Accounting Information," examines the characteristics that make accounting information useful (**SFAC No. 8,** Chapter 3.)
(3) **SFAC No. 3,** "Elements of Financial Statements of Business Enterprises," provides definitions of items in financial statements such as assets, liabilities, revenues, and expenses.
(4) **SFAC No. 5,** "Recognition and Measurement in Financial Statements of Business Enterprises," sets forth fundamental recognition and measurement criteria and guidance on what information should be formally incorporated into financial statements and when.
(5) **SFAC No. 6,** "Elements of Financial Statements," replaces **SFAC No. 3,** "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," Chapter 3, "Qualitative Characteristics of Useful Financial Information," replaces *SFAC No. 1* and *No. 2,* and Chapter 8: *Notes to Financial Statements.*

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) 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.

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CA 2.2 (Continued)

(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 most important quality for accounting information is its 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 useful for decision-making**.** 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 the 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 the 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: Simple, Time: 25-35, AACSB: Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

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 the information is not likely to make a difference to a decision-maker, then it need not be disclosed***. Information must also be timely in order to be 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:** Many answers are 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: 2, 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 the products are 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 customer 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: 4, 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 accompany 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 the 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, recorded as 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: 4, 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, or 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 a 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: 4, 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.

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

CA 2.9

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

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: 4, 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: 4, Bloom: AP, Moderate, Time: 30-35, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

FINANCIAL REPORTING PROBLEM

From Note 1 – Summary of Significant Accounting Policies:

(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.

Note: P&G has not adopted the recent standard on Revenue (ASC 606).

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) **P&G will adopt the new revenue recognition standard on July 1, 2018 and the new lease standard on July 1, 2019.**

(d) **Policy: Advertising costs are charged to expense as incurred.**

Accounting principle: Expense recognition principle.

Financial statement reporting: Advertising expenses are reported as part of Selling, General, and Administrative Expense in the Income Statement.

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LO: 4, Bloom: AN, Moderate, Time: 30-35, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, Research, AICPA PC: Communication

COMPARATIVE ANALYSIS CASE

(a) ***Coca-Cola***

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.

Operating Segments - Segment Products and Services (Note 19)

1) **The business of our Company is nonalcoholic beverages. Our geographic operating segments (Europe, Middle East, and Africa; 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. Our Bottling Investments operating segment is composed of our Company-owned or consolidated bottling operations, with the exception of those that are classified as discontinued operations, regardless of the geographic location of the bottler. Our Bottling Investments operating segment also includes 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, finished product operations produce higher net revenues but lower gross profit margins compared to concentrate 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), which includes our branded food and snack businesses in the United States and Canada;
2) Quaker Foods North America (QFNA), which includes our cereal, rice, pasta and other branded food businesses in the United States and Canada;
3) North America Beverages (NAB), which includes our beverage businesses in the United States and Canada;
4) Latin America, which includes all of our beverage, food and snack businesses in Latin America;
5) Europe Sub-Saharan Africa (ESSA), which includes all of our beverage, food and snack businesses in Europe and Sub-Saharan Africa; and
6) Asia, Middle East and North Africa (AMENA), which includes all of our beverage, food and snack businesses in Asia, Middle East and North Africa.

COMPARATIVE ANALYSIS CASE (Continued)

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

Coca-Cola: Net operating revenues for 2017 were $35,410 million, comprised primarily of beverage sales.

Pepsi: Net revenue for 2017 was $63,525 million, of which soft drinks are estimated at $20,936 million (North America Beverages) and snack food and limited sales of beverages in other divisions

Coca-Cola has the dominant position for beverage sales.

(c) Inventories, cost allocation method, the effect on comparability. As indicated, the companies use essentially the same inventory valuation method. Therefore, comparability is not affected.

Coca-Cola

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 net realizable value. We determine cost on the basis of the average cost or first-in, first-out methods.

PepsiCo

Inventory

***Inventories* – Note 2 and Note 13. Inventories are valued at the lower of cost or net realizable value. Cost is determined using the average, first-in, first-out (FIFO) or last-in, first-out (LIFO) methods. Approximately 5% of the inventory cost in both 2017 and 2016 were computed using the LIFO method. The differences between LIFO and FIFO methods of valuing these inventories were not material.**

(d) Change in accounting policy

<u>Coke</u>

Recently Issued Accounting Guidance for Revenue

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers, which will replace most existing revenue recognition guidance in U.S. GAAP and is intended to improve and converge with international standards the financial reporting requirements for revenue from contracts with customers. The core principle of ASU 2014-09 is that an entity should recognize revenue for the transfer of goods or services equal to the amount that it expects to be entitled to receive for those goods or services. ASU 2014-09 also requires additional disclosures about the nature, timing, and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments. ASU 2014-09 allows for adoption either on a full retrospective basis to each prior reporting period presented or on a modified retrospective basis with the cumulative effect of initially applying the new guidance recognized at the date of initial application, which will be effective for the Company beginning January 1, 2018.

The Company will adopt ASU 2014-09 and its amendments on a modified retrospective basis. We have closely assessed the new guidance, including the interpretations by the FASB Transition Resource Group for Revenue Recognition, throughout 2017. We have concluded that ASU 2014-09's broad definition of variable consideration will require the Company to estimate and record certain variable payments resulting from collaborative funding arrangements, rebates, and other pricing allowances earlier than it currently does. While we do not expect this change to have a material impact on our net operating revenues on an annual basis, as revenue recognized from the sale of concentrate and finished goods occurs at a point in time when goods are transferred to the customer and the transfer of control is determined, we do expect that it will have an impact on our revenue in interim periods. The cumulative-effect adjustment upon adoption of the new revenue recognition standard as of January 1, 2018, is comprised primarily of the Company's estimated variable consideration and is expected to decrease the opening balance of retained earnings by less than $350 million, net of tax.

COMPARATIVE ANALYSIS CASE (Continued)

As a result of electing certain of the practical expedients available under the ASU, the Company expects there will be some reclassifications to or from net operating revenues, cost of goods sold, and selling, general and administrative expenses, primarily related to the classification of shipping and handling costs.

Additionally, the provisions of the new guidance provided clarification relating to the classification of certain costs incurred relating to revenue arrangements with customers. As a result, we will be classifying certain amounts in cost of goods sold or selling, general and administrative expenses that were previously classified as reductions in net operating revenues. The Company also evaluated the principal versus agent considerations as it relates to certain of its arrangements with third-party manufacturers and co-packers. We concluded that certain costs from these arrangements will be reflected in net operating revenues rather than in cost of goods sold. These changes will have no impact on the Company's consolidated operating income.

The Company has also identified and implemented changes to our accounting policies and practices, business processes, systems and controls, as well as designed and implemented specific controls over our evaluation of the impact of the new guidance on the Company, including the cumulative effect calculation, disclosure requirements and the collection of relevant data into the reporting process. While we are substantially complete with the process of quantifying the impacts that will result from applying the new guidance, our assessment will be finalized during the first quarter of 2018.

Pepsi

Recent Accounting Pronouncements (one example)

In 2014, the FASB issued guidance on revenue recognition, with final amendments issued in 2016. The guidance provides for a five-step model to determine the revenue recognized for the transfer of goods

or services to customers that reflects the expected entitled consideration in exchange for those goods or services.

It also provides clarification for principal versus agent considerations and identifying performance obligations. In addition, the FASB introduced practical expedients related to disclosures of remaining performance obligations, as well as other amendments related to guidance on collectibility, non-cash consideration and the presentation of sales and other similar taxes. Financial statement disclosures required under the guidance will enable users to understand the nature, amount, timing, judgments and uncertainty of revenue and cash flows relating to customer contracts. The two permitted transition methods under the guidance are the full retrospective approach or a cumulative effect adjustment to the opening retained earnings in the year of adoption (cumulative effect approach). We will adopt the guidance using the cumulative effect approach when it becomes effective in the first quarter of 2018.

We are utilizing a comprehensive approach to assess the impact of the guidance on our contract portfolio by reviewing our current accounting policies and practices to identify potential differences that would result from applying the new requirements to our revenue contracts, including evaluation of our performance obligations, principal versus agent considerations and variable consideration. We are substantially complete with our contract and business process reviews and implemented changes to our controls to support recognition and disclosures under the new guidance. As a result of implementing certain changes to our accounting policies upon adoption, we plan to record an adjustment to opening retained earnings to reflect marketplace spending that our customers and independent bottlers expect to be entitled to in line with revenue recognition; exclude all sales, use, value-added and certain excise taxes assessed by governmental authorities on revenue-producing transactions from net revenue and cost of sales; and to record shipping and handling activities that are performed after a customer obtains control of the product as a fulfillment cost. Based on the foregoing, we currently do not expect this guidance to have a material impact on our financial statements or disclosures.

LO: 2, 5, 6, Bloom: AN, Moderate, Time: 30-35, AACSB: Analytic, Global, Communication, AICPA BB: Global, AICPA FC: Measurement, Reporting, Research, AICPA PC: Communication

FINANCIAL STATEMENT ANALYSIS CASE—WAL-MART

Note to instructor: The requirements for this case relate to Wal-Mart 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.

(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.

LO: 4, Bloom: AN, Moderate, Time: 15-20, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

ACCOUNTING, ANALYSIS, AND PRINCIPLES

Accounting

Caddie Shack Driving Range
Statement of Financial Position
May 31, 2020

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 ($21,650* - $20,000) because of the difference between his ending Owner's Capital and beginning Owner's Capital. The conclusion that his business lost $4,900 ($20,000* - $15,100***) 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 payouts 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.**

ACCOUNTING, ANALYSIS, AND PRINCIPLES (Continued)

Principles

GAAP income is the accrual income computed above as $2,450 (excluding depreciation expense.) 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).

LO: 2, 3, 4, Bloom: AN, Moderate, Time: 20-25, AACSB: Analytic, Communication, AICPA BB: None, AICPA FC: Measurement, Reporting, AICPA PC: Communication

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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 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: 2, 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: 2, Bloom: K, Difficulty: Simple, Time: 5, AACSB: Communication, Technology, AICPA BB: Technology, AICPA FC: Research, Technology, AICPA PC: Communication

CODIFICATION RESEARCH CASE

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

(a) According to Concepts Statement 8 (CON 8, Chapter 3): 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 could have been changed or influenced by the omission or misstatement.”

(b) CON 8 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.

CON 8, Chapter 3. 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 a 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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CODIFICATION RESEARCH CASE (Continued)

However, the FASB notes that more than magnitude must be considered in evaluating materiality:

The relative rather than the absolute size of a judgment item almost always 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.

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. 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. 6, Paras. 20-21. 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: 3, 4, Bloom: C, Moderate, Time: 25-30, AACSB: Global, Communication, AICPA BB: Global, AICPA FC: Measurement, Reporting, Research, AICPA PC: Communication

IFRS CONCEPTS AND APPLICATION

IFRS2.1

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. Both Boards have the same objective, and that is to develop a conceptual framework consisting of standards that are principles-based and internally consistent, thereby leading to the most useful financial reporting. Hopefully, the two Boards will eventually agree on the key components of a common 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

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

IFRS2.3

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

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IFRS2.4

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: 2, 5, Bloom: C, Difficulty: Simple, Time: 5-10, AACSB: Diversity l, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

IFRS2.5

Search Strings: "materiality", "completeness"

(a) According to the Framework (QC 11): 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.

IFRS2.5 (Continued)

(b) According to the Framework (OB 17): 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.

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

IFRS2.6

Marks and Spencer plc (per Note 1 – Accounting Policies)

(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 to our franchise partners or the customer and the significant risks and rewards of ownership have been transferred to the buyer. (Note 1)

IFRS2.6 (Continued)

(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 amortised on a straight-line basis over their estimated useful lives. Indefinite life intangibles are tested for impairment at least annually or as triggering events occur. Any impairment in value is recognised within in the income statement.**

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

New Accounting Standards Adopted by the Group

There have been no significant changes to accounting under IFRS which have affected the Group's results for the current financial year. The only changes to the IFRS, IFRS IC interpretations and amendments that are effective for the first time in this financial year, and are applicable for the Group, are the Annual Improvements to IFRSs 2012-2014 cycle. These have not had a material impact on the Group.

IFRS2.7 (Continued)

(c) Revenue Recognition

Accruals for the sales returns, deferred income in relation to loyalty scheme redemptions and gift card and credit voucher redemptions are estimated on the basis of historical returns and redemptions. These are recorded so as to be allocated against revenue in 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 those estimates.

LO: 5, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Diversity, Communication, Technology, AICPA BB: Global, Technology, AICPA FC: Measurement, Reporting, Technology, AICPA PC: Communication

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