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# The Environment and Conceptual Framework of Financial Reporting

## WHAT is the conceptual framework of financial reporting?

It's the process that a private and independent standard-setter—the Financial Accounting Standards Board (FASB)—uses to develop a set of generally accepted reporting standards. At the heart of this framework is the objective of financial reporting.



Source: Adapted from Financial Accounting Foundation.

## WHY is there a need for this conceptual framework?

It's because financial statement users—such as investors and creditors—rely on high-quality information to make better resource allocation decisions. Ultimately, as shown in the graphic, high-quality financial reporting results in increased investor confidence, which supports efficient capital markets.

For example, investors must be able to evaluate and compare financial reports across different industries and companies to determine where they will invest their capital. One recent study found that when accounting comparability is high, investors value \$1 of higher-reported EPS at \$6.76. In contrast, when accounting comparability is low, \$1 of higher-reported EPS is valued at just \$4.04.<sup>1</sup> That's quite a difference!

## HOW are accounting standards established?

The FASB, with oversight by the Securities and Exchange Commission (SEC), develops accounting standards. In setting standards, the FASB is guided by the conceptual framework. The FASB follows a due process so that all stakeholders (investors, auditors, and companies) have an opportunity to provide input, thereby resulting in standards that are generally accepted.

<sup>1</sup>Ahmet Kurt, "The Importance of Accounting Comparability," *CFO.com* (July 6, 2020).

# Chapter Roadmap

LEARNING OBJECTIVES	TOPICS	REVIEW AND PRACTICE
<p><b>LO 1.1</b> Describe the financial reporting environment, major standard-setting bodies, and the meaning of generally accepted accounting principles (GAAP).</p>	<p><b>1.1 Financial Reporting Environment</b></p> <ul style="list-style-type: none"> <li>• Importance of accounting and decision-usefulness</li> <li>• Need to develop standards</li> <li>• SEC</li> <li>• FASB</li> <li>• Other organizations involved</li> <li>• FASB Codification</li> </ul>	<p><b>Put It into Practice LO 1.1</b> Discuss Financial Reporting and Organizations</p>
<p><b>LO 1.2</b> Describe the components and usefulness of the conceptual framework.</p>	<p><b>1.2 Conceptual Framework</b></p> <ul style="list-style-type: none"> <li>• Chapter 1 - The Objective</li> <li>• Chapter 2 - The Reporting Entity</li> <li>• Chapter 3 - Qualitative Characteristics</li> <li>• Chapter 4 - Elements</li> <li>• Chapter 5 - Recognition and Derecognition</li> <li>• Chapter 6 - Measurement</li> <li>• Chapter 7 - Presentation</li> <li>• Chapter 8 - Notes</li> </ul>	<p><b>Put It into Practice LO 1.2</b> Apply Qualitative Characteristics</p>
<p><b>LO 1.3</b> Discuss the basic operational concepts of GAAP.</p>	<p><b>1.3 Operational Concepts</b></p> <ul style="list-style-type: none"> <li>• Assumptions</li> <li>• Principles</li> <li>• Summary</li> </ul>	<p><b>Put It into Practice LO 1.3</b> Identify Assumptions and Principles</p>
<p><b>LO 1.4</b> Identify the major challenges in the financial reporting environment.</p>	<p><b>1.4 Major Challenges in Financial Reporting</b></p> <ul style="list-style-type: none"> <li>• GAAP in a Political environment</li> <li>• Expectations gap</li> <li>• Financial reporting issues</li> <li>• Ethical issues</li> </ul>	

Go to the **Review and Practice** section at the end of the chapter for a targeted summary review. Multiple-choice questions with annotated solutions, as well as additional exercises and practice problems with solutions, are also available online.

# 1.1 Financial Reporting Environment

## LEARNING OBJECTIVE 1

Describe the financial reporting environment, major standard-setting bodies, and the meaning of generally accepted accounting principles (GAAP).

Understanding and trusting data are critical for decision-making purposes. In other words, is the information relevant and reliable, or is it confusing and unhelpful? If the former, we have a sound basis for good decision making. If the latter, the saying “garbage in [bad information] leads to garbage out [bad decision making]” is descriptive.

Accountants face many of the same issues but in a different setting. They also recognize that the information they develop and report must be relevant and reliable. However, that task is often not easy. For example, consider some of the following issues accountants faced during the Covid-19 pandemic.

- **J.C. Penney:** This company filed for bankruptcy in May 2020 after years of struggling with declining sales and the inability to adapt to the changing retail landscape, leading to store closures and ultimately bankruptcy.
- **Hertz:** This company filed for bankruptcy in May 2020. With travel restrictions and a significant drop in tourism and business travel, Hertz faced an unprecedented decline in revenue.
- **Brooks Brothers:** Known for its classic American style, Brooks Brothers filed for bankruptcy in July 2020. The pandemic’s impact on retail, especially formalwear, was a significant factor in its downfall.
- **GNC:** The health and nutrition retailer filed for bankruptcy in June 2020. The company had already been struggling with competition from online retailers and the shift in consumer preferences, which were further impacted by the pandemic.
- **Cirque du Soleil:** The famed entertainment company filed for bankruptcy protection in June 2020. With live performances and large gatherings halted, Cirque du Soleil’s revenue stream dried up, leading to massive layoffs and financial distress.
- **J.Crew:** The preppy clothing retailer was one of the first to file for bankruptcy in May 2020. J.Crew had been grappling with debt issues, a changing retail environment, and was deemed a “non-essential business,” causing government agencies to temporarily close the retailer.
- **Golds Gym:** Covid-19 spurred immediate action to permanently close about 30 company-owned gyms. It also continued to freeze its membership dues until local gyms could reopen again.

In that time of uncertainty, companies were asked to provide as much information as possible about how the coronavirus was affecting their operations and outlook. Therefore, while it is important that the information presented be relevant and reliable, we must also recognize that some degree of uncertainty will exist.

## Importance of Accounting and Decision-Usefulness

When making resource allocation or investing decisions under uncertainty, accounting becomes even more important. We know that resources are limited. As a result, businesses of all types try to conserve resources and ensure that they are used efficiently. In fact, efficient

use of resources often determines whether a business survives. This fact places a substantial burden on the accounting profession to provide useful information for decision-making, often referred to as **decision-usefulness**. Let's next look at three different user groups to see how accounting information helps them make good decisions.

## Owner/Manager

Chances are that many of you will be involved with a small business as an owner, employee, creditor, advisor, or auditor. Data from the **Small Business Administration** indicate that there are 33.2 million small businesses in the United States, with 61.7 million employees. In fact, small businesses (defined as less than 500 employees) account for 99.9% of all businesses in the United States.

To understand the importance of accounting in this type of setting, we examine a small business called Silva Restaurant. Basic questions that Silva needs to answer are:

- How successful was Silva in generating revenues and controlling expenses during the year? An **income statement** answers this question.
- How much compensation was distributed to the owners of Silva during the year and has the equity of the owners increased or decreased during the year? A **statement of owners' (stockholders') equity** answers this question.
- What does Silva own (its assets) and what does it owe (liabilities)? A **balance sheet** answers this question.
- Where did Silva obtain its cash during the year and how was that cash used? A **statement of cash flows** answers this question.

In other words, Silva's **financial statements** (income statement, statement of owners' (stockholders') equity, balance sheet, and statement of cash flows) are the principal means that a company like Silva uses to assess its financial performance.

## Creditors

We now assume that Silva needs additional cash and wishes to borrow \$250,000 from Morgan Bank. For Morgan to approve this loan, it needs to determine whether Silva will be able to pay back the \$250,000 plus the interest on that amount. Silva's financial statements will be important in determining the answer. In most cases, the financial statements will be the starting point because:

- Morgan has to predict what will happen to Silva in the future since Morgan will be receiving interest and principal payments in that time period.
- Morgan must assess the amount, timing, and uncertainty of Silva's future cash flows.

This information can be derived from the income statement and the statement of cash flows.

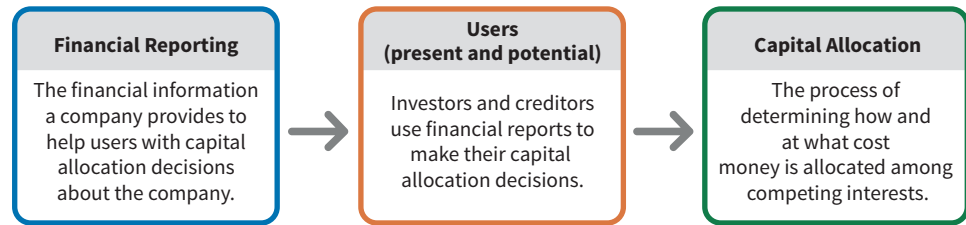
## Stockholders

Most large companies in the United States are corporations. The primary means of funding for these companies is the sale of common stock to investors. Having access to relevant and reliable **financial reporting** helps investors to:

- Assess the amounts, timing, and uncertainty of future cash inflows from dividends, interest, and proceeds from the sale or maturity of investments.
- Compare the income and assets of different companies such as **Nike**, **Microsoft**, and **Berkshire Hathaway**.

When users can assess the relative return and risks associated with investment opportunities, they channel resources more effectively. **Illustration 1.1** shows how this process of capital allocation works.

**ILLUSTRATION 1.1** Capital Allocation Process



An effective process of capital allocation is critical to a healthy economy. It promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the securities markets.

## Need to Develop Standards

### Underlying Concepts

Preparing financial statements according to accepted accounting standards contributes to the comparability of accounting information.

To enhance the decision-usefulness of accounting information, the accounting profession has developed a set of standards that are generally accepted and universally practiced. In the absence of financial statements prepared under these standards, readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. It would then be almost impossible to prepare statements that could be compared (see **Underlying Concepts**).

For example, as a prospective stockholder, you may want to evaluate how efficiently **Nike** uses its assets to generate sales relative to **Under Armour**. You may wonder how quickly **Restoration Hardware** turns over its high-end home furnishings inventory relative to **Williams-Sonoma**. These comparisons would not mean much without the common set of standards and procedures called **generally accepted accounting principles (GAAP)**. The term "generally accepted" can mean one of two things.

- A principle of reporting in a given area that was established by an authoritative accounting rule-making body.
- A given practice that has been accepted as appropriate because of its universal application over time.

Although there will always be debates regarding proposed and existing accounting standards, members of the financial community recognize GAAP as the standards that over time have proven to be most useful. You should recognize that the standard-setting process has worked well in the United States. As a former Secretary of the Treasury indicated, the single most important innovation shaping the capital markets was the idea of generally accepted accounting principles.

Two organizations are primarily responsible for the development of GAAP in the United States:

1. Securities and Exchange Commission (SEC).
2. Financial Accounting Standards Board (FASB).

## Securities and Exchange Commission (SEC)

External financial reporting and auditing developed in tandem with the growth of the industrial economy and its capital markets. However, when the stock market crashed in 1929 and the nation's economy plunged into the Great Depression, there were calls for increased government regulation of business, especially financial institutions and the stock market.

As a result of these events, the federal government established the **Securities and Exchange Commission (SEC)**, a federal agency, to help develop and standardize financial information presented to stockholders. Specifically, the SEC:

- Administers the Securities Exchange Act of 1934 and several other acts.
- Requires most companies that issue securities to the public or are listed on a stock exchange to file audited financial statements with the SEC.
- Has broad powers to prescribe, in whatever detail it desires, the accounting practices and standards to be employed by companies that fall within its jurisdiction.

The SEC currently exercises oversight over 12,000 companies that are listed on the major exchanges (e.g., the New York Stock Exchange and the Nasdaq).

## Accounting Matters

## Global Markets

The SEC's Office of International Affairs is closely focused on cross-border investing, working with a global network of securities regulators all over the world. The International Organization

of Securities Commissions (IOSCO), established in 1987, consists of more than 100 securities regulatory agencies or securities exchanges from all over the world.

## Public/Private Partnership

At the time the SEC was created, no group—public or private—issued accounting standards. The SEC encouraged the creation of a private standard-setting body because it believed that the private sector had the appropriate resources and talent to achieve this daunting task. Presently, accounting standards are developed in the private sector by the Financial Accounting Standards Board (FASB).

The SEC has affirmed its support for the FASB by indicating that financial statements conforming to standards set by the FASB are presumed to have substantial authoritative support. In short, the **SEC requires registrants to adhere to GAAP as developed by the FASB**. In its reports to Congress, the SEC indicated that “it continues to believe that the initiative for establishing and improving accounting standards should remain in the private sector, subject to Commission oversight.”

## SEC Oversight

The SEC's partnership with the private sector works well. The SEC acts with remarkable restraint in the area of developing accounting standards. Generally, **the SEC relies on the FASB to develop accounting standards**.

The SEC's involvement in the development of accounting standards varies. For example, the SEC may:

- Reject a standard proposed by the private sector.
- Prod the private sector into taking quicker action on certain reporting problems, such as the reporting of derivative instruments or the reporting of environmental, social, and governance issues.
- Communicate problems to the FASB, respond to FASB exposure drafts, and provide the FASB with counsel and advice upon request.

The SEC's mandate is to establish accounting principles, which it has delegated to the private sector (the FASB). Therefore, the private sector must listen carefully to the views of the SEC. In some sense, the FASB and others, such as companies and auditors in the private sector, are both the formulators and the implementors of the standards.<sup>2</sup>

<sup>2</sup>One writer described the relationship of the FASB and SEC and the development of financial reporting standards using the analogy of a pearl. The pearl (a financial reporting standard) “is formed by the reaction of certain oysters (FASB) to an irritant (the SEC)—usually a grain of sand—that becomes embedded inside the shell. The oyster coats this grain with layers of nacre, and ultimately a pearl is formed. The pearl is a joint result of the irritant (SEC) and oyster (FASB); without both, it cannot be created.” John C. Burton, “Government Regulation of Accounting and Information,” *Journal of Accountancy* (June 1982).

However, when the private sector fails to address accounting problems as quickly as the SEC would like, the partnership between the SEC and the private sector can be strained. This occurred in the deliberations on the accounting for business combinations and intangible assets. Other examples include concerns over the accounting for off-balance-sheet special-purpose entities. Examples include the failure of **Enron** and the subprime crises that led to the failure of **IndyMac Bank**.

## Enforcement

As we indicated earlier, companies listed on a stock exchange must submit their financial statements to the SEC. If the SEC believes that an accounting or disclosure irregularity exists regarding the form or content of the financial statements, it sends a deficiency letter to the company. If the company does not resolve the issue, the SEC may issue a “stop order,” which prevents the registrant from issuing or trading securities on the exchanges.

The Department of Justice may also file criminal charges for violations of certain laws. The SEC process, private sector initiatives, and civil and criminal litigation help to ensure the integrity of financial reporting for public companies.

### Accounting Matters

Consider companies like **Trek Bicycle**, **SC Johnson**, or **Publix Super Markets**, none of which are publicly traded on a stock exchange. Are these companies required to report their financial statements in accordance with GAAP? Most likely, yes! Even though these private companies are not accountable to the SEC, most private companies are accountable to their owners and creditors.

### Private Company Perspectives

For a company like Trek, it is highly likely that the company borrows money from a bank to help fund its operations, investments, expansions, and so on. As its creditor, the bank will require Trek to provide audited financial statements in accordance with GAAP at least annually. So, while the SEC maintains the integrity of financial reporting for public companies, that does not mean that private companies are off the hook.

## Financial Accounting Standards Board (FASB)

The major standard-setting organization in the private sector is the **Financial Accounting Standards Board (FASB)**. The mission of the FASB is as follows.

To establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information.

The FASB operates with oversight from the **Financial Accounting Foundation (FAF)**. In addition to the research and support of its own staff, the FASB relies on the expertise of various task force groups formed for various projects and on the **Financial Accounting Standards Advisory Council (FASAC)**. The FASAC consults with the FASB on major policy and technical issues and also helps select task force members. **Illustration 1.2** shows the current organizational structure for the development of financial reporting standards.<sup>3</sup>

**ILLUSTRATION 1.2**  
Organizational Structure for  
Setting Accounting Standards



<sup>3</sup>Other advisory groups, such as the Investors Advisory Committee (IAC), the Not-for-Profit Advisor Committee (NAC), and the Private Company Council (PCC), share their views and experience with the FASB on matters related to projects on the Board’s agenda, from the perspective of various constituencies and/or in areas of specific expertise.

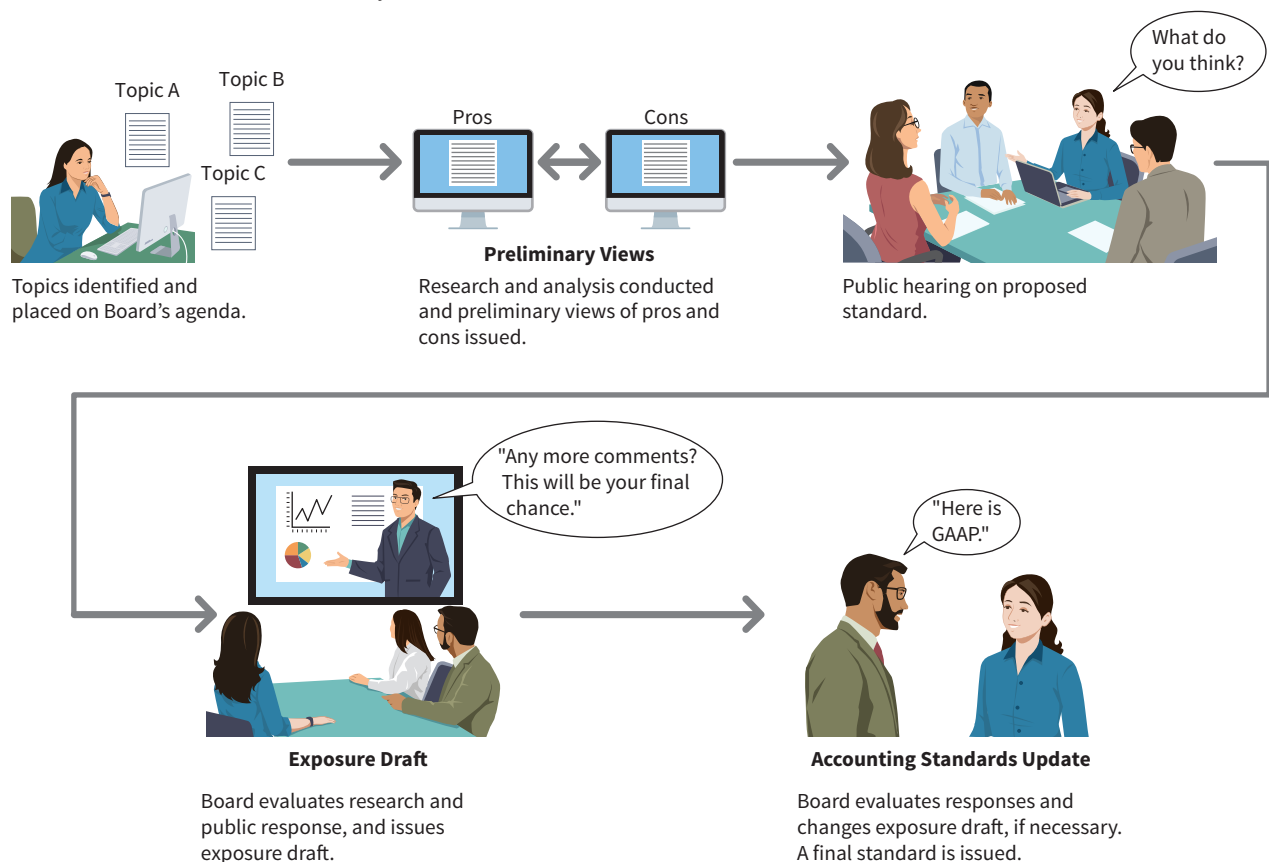
## Due Process

In establishing financial accounting standards, the FASB relies on two basic premises. The FASB should:

1. Be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession.
2. Operate in full view of the public through a **due process** system that gives interested persons ample opportunity to make their views known.

To ensure the achievement of these goals, the FASB follows specific steps to develop a typical FASB pronouncement, as **Illustration 1.3** shows.

**ILLUSTRATION 1.3** The Due Process System of the FASB



The passage of new FASB guidance in the form of an Accounting Standards Update requires the support of four of the seven Board members. FASB pronouncements are considered GAAP and are thereby binding in practice.

## Types of Pronouncements

The FASB issues two major types of pronouncements:

1. Accounting Standards Updates (often referred to as **financial accounting standards**).
2. Financial Accounting Concepts.

**Accounting Standards Updates** The FASB issues accounting pronouncements through **Accounting Standards Updates** (Updates). These Updates amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other

than standards issued by the SEC (we discuss the Codification in more detail later in the chapter). Each Update consists of the following

- An explanation of how the Codification has been amended.
- Information to help the reader understand the changes.
- A date for when the changes will be effective.

Common forms of amendments are accounting standards issued that address a broad area of accounting practice (such as accounting for leases) or interpretations that modify or extend existing standards.

**Financial Accounting Concepts** To provide a framework for the development of financial accounting standards, the FASB has issued a series of **Statements of Financial Accounting Concepts (SFAC)** as part of its conceptual framework project. (The SFAC can be accessed at the FASB website.)

The series sets forth fundamental objectives and concepts that the Board uses in developing standards of financial accounting and reporting. The Board has developed a cohesive set of interrelated concepts—a conceptual framework—that will serve as tools for solving existing and emerging problems in a consistent manner. Unlike an **Accounting Standards Update**, a **Statement of Financial Accounting Concepts does not establish GAAP**. Concepts statements, however, pass through the same due process system (preliminary views, public hearing, exposure draft, etc.) as do standards updates. (We discuss the conceptual framework in more detail later in the chapter.)

## Other Organizations Involved

Two other organizations have also had a major role in standard-setting. The first is the **American Institute of Certified Public Accountants (AICPA)**, which is the national organization of practicing certified public accountants (CPAs). In the early years of standard-setting, the SEC urged the AICPA to develop accounting standards through various committees. Over time, however, due to the voluntary nature of these committees, it was recognized that broader representation coupled with a full-time, well-paid organization like the FASB was needed. As a result, the AICPA no longer has formal involvement in the accounting standard-setting process.

The other organization is the **International Accounting Standards Board (IASB)**, which sets the **International Financial Reporting Standards (IFRS)** used in over 140 countries. Everyone seems to agree that the FASB and the IASB need to work together toward the goal of high-quality global accounting standards, which would result in comparability over time. They have, for example, worked together in developing similar standards for leasing and revenue recognition (see **Global View**).

### Global View

Although global convergence for standard-setting appears unlikely at the present time, we provide a discussion of the similarities and differences between IFRS and GAAP at the end of the chapter in the *IFRS Insights* section.

## FASB Codification

Historically, the documents that comprised GAAP varied in format, completeness, and structure. In some cases, these documents were inconsistent and difficult to interpret. As a result, financial statement preparers sometimes were not sure whether they had the right GAAP. Determining what was authoritative and what was not became difficult.

In response to these concerns, the FASB developed the **Financial Accounting Standards Board Accounting Standards Codification** (or more simply, “the Codification”). The FASB’s goals in developing the Codification are to:

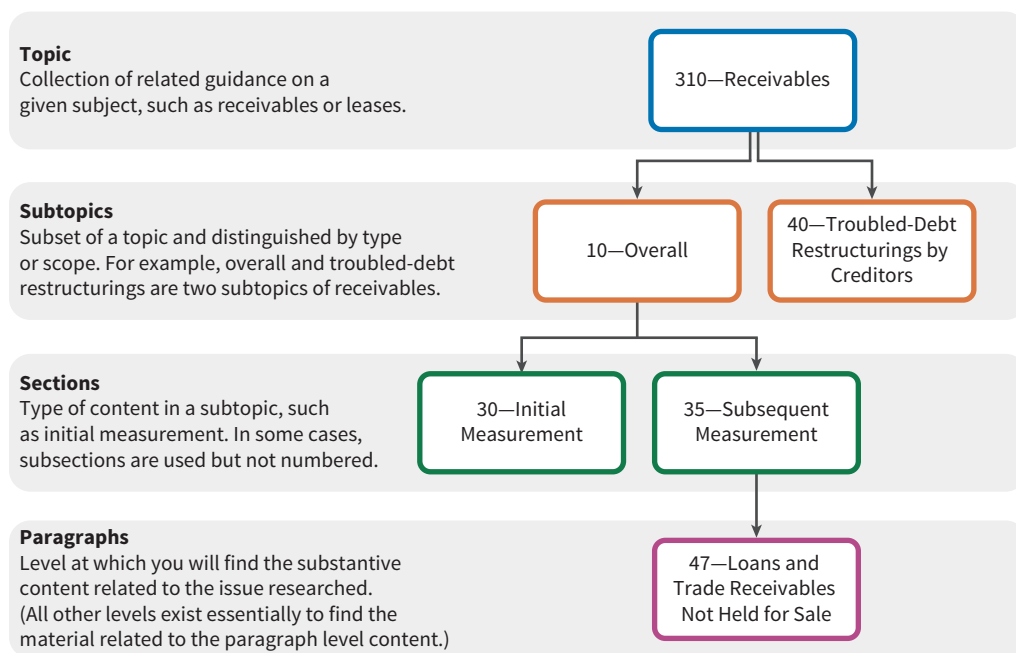
- Provide, in one place, all the authoritative literature related to a particular topic.
- Simplify user access to all authoritative U.S. GAAP.

- Establish the way GAAP is documented, presented, and updated.
- Eliminate nonessential information such as redundant document summaries and historical content.

In short, the Codification integrates and synthesizes existing GAAP; it does not create new GAAP. It creates a single level of GAAP, which is considered authoritative. All other accounting literature is considered non-authoritative.

The Codification can be accessed at [asc.fasb.org](http://asc.fasb.org), and it provides a topically organized structure, subdivided into topic, subtopics, sections, and paragraphs, using a numerical index system. For purposes of referencing authoritative GAAP material in this text, we will use the Codification framework. For example, to determine GAAP for accounting for loans and trade receivables not held for sale subsequent to initial measurement, here is how the Codification framework is cited (see also [Illustration 1.4](#)).

<b>Topic</b>	Go to FASB ASC 310 to access the Receivables topic.
<b>Subtopics</b>	Go to FASB ASC 310-10 to access the Overall subtopic of Topic 310.
<b>Sections</b>	Go to FASB ASC 310-10-35 to access the Subsequent Measurement section of Subtopic 310-10.
<b>Paragraph</b>	Go to FASB ASC 310-10-35-47 to access the Loans and Trade Receivables not Held for Sale paragraph of Section 310-10-35.



**ILLUSTRATION 1.4** FASB Codification Framework

What happens if the Codification does not cover a certain type of transaction or event? In that case, other accounting literature should be considered, such as FASB Concept Statements, IFRS, and other professional literature. This will happen only rarely.<sup>4</sup>

<sup>4</sup>To increase the usefulness of the Codification for public companies, relevant authoritative content issued by the SEC is included in the Codification. In the case of SEC content, an “S” precedes the section number.

For individuals (like you) attempting to learn GAAP, the Codification will be invaluable. It streamlines and simplifies how to determine what GAAP is, which will lead to better financial accounting and reporting. We provide references to the Codification throughout this text, using a numbering system. For example, a bracket with a number, such as [1], indicates that the citation to the FASB Codification can be found in the **FASB Codification References** section near the end of the chapter.

## Accounting Matters

## Is There a Rule for That?

It is, in fact, rare that the Codification does not cover a certain type of transaction. However, that was the exact scenario the financial reporting community found themselves in during 2020 (surprised?) with loans provided by the **Small Business Administration** as part of the Paycheck Protection Program (PPP). To support businesses during the global pandemic brought on by Covid-19, the U.S. government issued potentially forgivable loans to eligible companies. While the nature of these loans varies, the

substance in many cases indicated that the loan was actually a government grant.

As it turns out, GAAP does not have specific guidance on accounting for government grants made to business entities (outside grants made in the form of a tax credit). This required the reporting community to look elsewhere for guidance, leading some companies to follow International Accounting Standard (IAS) 20, *Accounting for Government Grants and Disclosure of Government Assistance*.

## Put It into Practice LO 1.1

### Discuss Financial Reporting and Organizations



**FACTS** The first part of this chapter discusses general concepts related to financial reporting and various organizations involved in the standard-setting process. Here are some terms used in the first part of the chapter.

- a. Financial Accounting Standards Board
- b. American Institute of Certified Public Accountants
- c. Generally accepted accounting principles
- d. Securities and Exchange Commission
- e. International Accounting Standards Board
- f. Public/private partnership
- g. Codification
- h. Statements of Financial Accounting Concepts

### INSTRUCTIONS

Describe the significance of each of the items as it relates to financial reporting.

### SOLUTION

- a. Financial Accounting Standards Board: the U.S. organization established to improve standards of financial reporting for the guidance and education of the public, which includes issuers, auditors, and users of the financial statements.
- b. American Institute of Certified Public Accountants: the national professional organization of practicing certified public accountants.
- c. Generally accepted accounting principles: GAAP is the common set of standards and protocols either established by an authoritative accounting rule-making body or accepted as appropriate because of its universal application in practice.
- d. Securities and Exchange Commission: the SEC is a federal agency that administers the Securities Act of 1934 and other acts. Most companies that issue securities to the public or are listed on the stock exchanges are required to file audited GAAP financial statements with the SEC.
- e. International Accounting Standards Board: the IASB is the international organization established to improve standards of financial reporting for the guidance and education of the public, which includes issuers, auditors, and users of the financial statements. Their statements apply to most countries outside the United States.
- f. Public/private partnership: reflects the SEC's support for the FASB by indicating that financial statements conforming to standards by the FASB are presumed to have authoritative support.
- g. Codification: provides in one place all the authoritative accounting literature related to a topic.
- h. Statements of Financial Accounting Concepts: the series that sets forth fundamental objectives and concepts that the FASB uses in developing standards of financial accounting and reporting.

# 1.2 Conceptual Framework

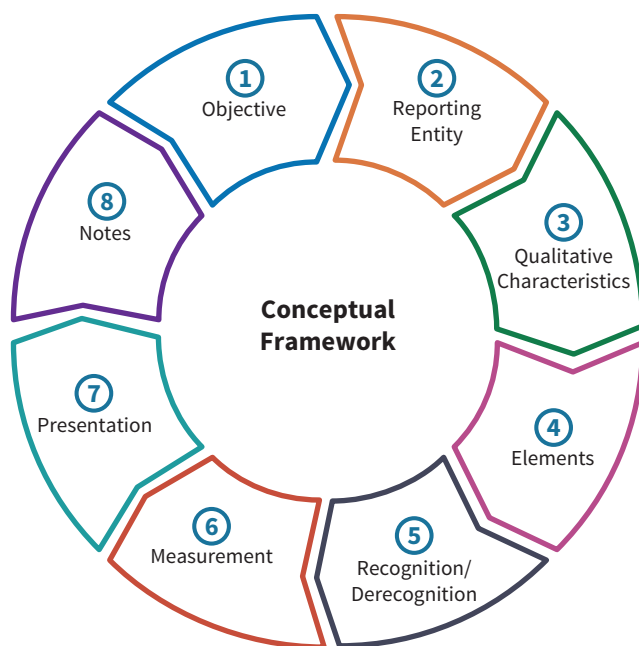
## LEARNING OBJECTIVE 2

Describe the components and usefulness of the conceptual framework.

As noted earlier, a **conceptual framework** establishes the concepts that underlie financial reporting. A conceptual framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on:

1. Identifying the boundaries of financial reporting.
2. Selecting the transactions, other events, and circumstances to be represented.
3. Determining how transactions and events should be recognized and measured.
4. Determining how transactions and events should be summarized and reported.

The framework is not authoritative. It does not define standards for any particular measurement or issue, and nothing in the framework overrides any specific FASB pronouncement that is included in the Codification. **Illustration 1.5** shows the eight chapters of the framework that we will discuss in this section.



**ILLUSTRATION 1.5** Eight chapters of the conceptual framework

## Chapter 1 - The Objective

The **objective of general purpose financial reporting** serves as the foundation of the conceptual framework. What is the objective, or purpose, of financial reporting? It is to provide financial information about the reporting entity that is **useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.**<sup>5</sup>

<sup>5</sup>"The Objective of General Purpose Financial Reporting," *Statement of Financial Accounting Concepts No. 8, Chapter 1* (Norwalk, Conn.: FASB, December 2021).

Think about the types of decisions that investors and lenders are making about companies.

- Investors decide whether to buy, sell, or hold stock in a company.
- Lenders decide whether to lend money to a company, at what interest rate, and for how long.

To make effective decisions, these groups need information to help them assess a company's future net cash flows which will support loan payments and/or provide a return to investors.

To provide information to decision-makers, companies prepare general-purpose financial reports. **General-purpose financial reporting** includes a company's full set of financial statements and the related notes and supplementary information. This reporting helps users who lack the ability to demand all the financial information they need from a company and therefore must rely, at least partly, on the information provided in financial reports. However, it's important to note that users need reasonable knowledge of business and financial accounting matters to understand the information contained in financial reporting.

## Accounting Matters

## What's Your Principle?

There has been no shortage of accounting scandals to highlight the need for a strong conceptual framework, including some of the more notable failures such as **Enron** and **Lehman Brothers**. In both cases, the companies were able to remove, or keep debt off, their balance sheets by carefully structuring transactions to achieve a desired accounting treatment, even if that accounting treatment did not reflect the transactions' true nature.

To restore public confidence in the financial reporting process, many have argued that standard setters should move toward

principles-based rules. They believe that companies exploited the detailed provisions in rules-based pronouncements to manage accounting reports, rather than report the economic substance of transactions. Under principles-based rules, hopefully top management's financial reporting focus will shift from demonstrating compliance with rules to demonstrating that a company has achieved the objective of financial reporting.

## Chapter 2 - The Reporting Entity

The **reporting entity** concept refers to companies that prepare general purpose financial reports.<sup>6</sup> Companies like **Nvidia**, **Microsoft**, and **Intel** are **reporting entities** because they prepare general purpose financial reports for use by investors, regulators, and lenders. You should recognize that any type of entity might be considered a reporting entity. However, for purposes of the conceptual framework, the reporting entity refers to entities that prepare general purpose financial reports. Later in this chapter we discuss the economic entity assumption which is broader in coverage.

## Chapter 3 - Qualitative Characteristics

Consider these questions:

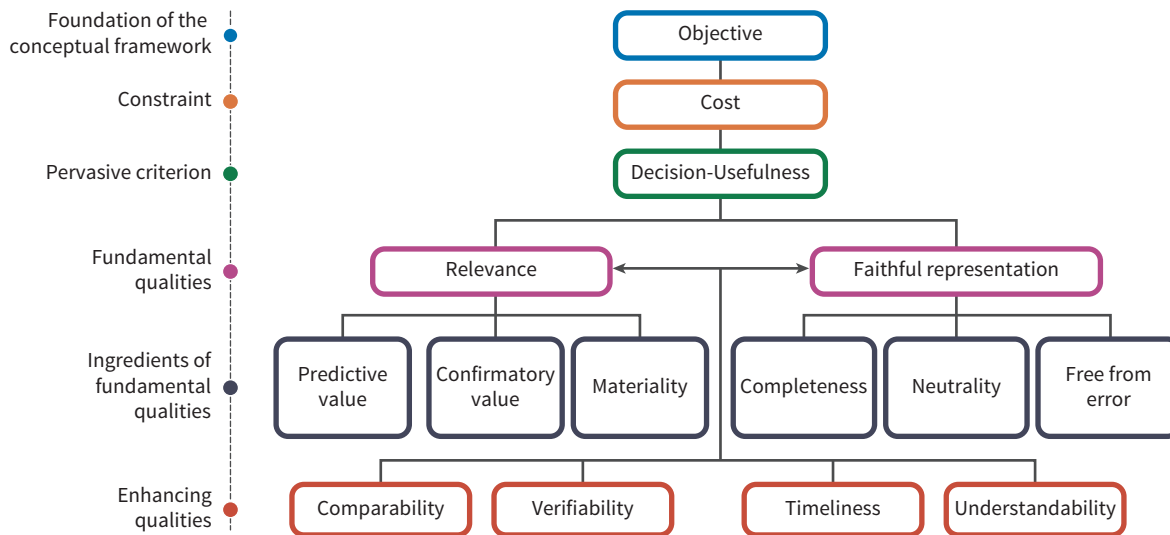
- Should companies like **Walt Disney** or **Kellogg's** provide information in their financial statements on how much it costs them to acquire their assets (historical cost basis) or how much the assets are currently worth (fair value basis)?
- Should **PepsiCo** combine and show as one company the seven main segments of its business, or should it report PepsiCo Beverages North America; Frito-Lay North America; Quaker Foods North America; Latin America; Europe; Africa, Middle East, South Asia; and Asia Pacific, Australia/New Zealand, China as seven separate segments?

<sup>6</sup>"The Reporting Entity," *Statement of Financial Accounting Concepts No. 8, Chapter 2* (Norwalk, Conn.: FASB, June 2023).

How does a company choose an acceptable accounting method, the amount and types of information to disclose, and the format in which to present it? The answer: By determining **which alternative provides the most useful information for decision-making purposes (referred to as decision-usefulness)**. The FASB identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for meeting the objective of financial reporting.<sup>7</sup> In addition, the FASB identified a cost constraint as part of the conceptual framework.

As **Illustration 1.6** shows, the characteristics may be viewed as a hierarchy.

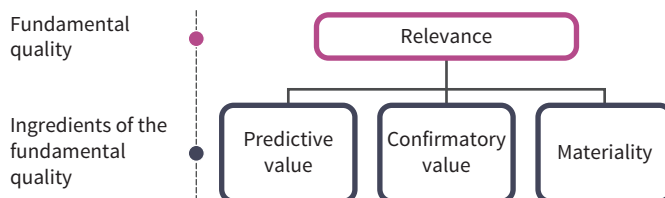
**ILLUSTRATION 1.6** Hierarchy of Accounting Qualities



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

## Fundamental Quality—Relevance

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



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

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

<sup>7</sup>“Qualitative Characteristics of Useful Financial Information,” *Statement of Financial Accounting Concepts No. 8, Chapter 3* (Norwalk, Conn.: FASB, August 2018).

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

**Materiality** **Materiality** is a company-specific aspect of relevance. Information is material if it is probable that the judgment of a reasonable person relying upon the financial information would have been changed or influenced by the inclusion or correction of the information.<sup>8</sup> An individual company determines whether information is material because both the nature and/or magnitude of the item(s) to which the information relates must be considered in the context of an individual company's financial report. Information is *immaterial*, and therefore irrelevant, if it would have no impact on a decision-maker. In short, **it must make a difference** or a company need not report it.

Assessing materiality is one of the more challenging aspects of accounting because it requires evaluating both the **relative size and importance** of an item. For example, let's consider the two sets of numbers in **Illustration 1.7**, which indicate relative size.

**ILLUSTRATION 1.7**  
Materiality Comparison

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

During the period in question, the revenues and expenses, and therefore the incomes from operations of Company A and Company B, are proportional. This means that for both companies, income from operations is 10% of sales.

Each reported an unusual gain, but these amounts have different effects for each company.

- For Company A, the gain is only 2% of the operating income ( $\$20,000 \div \$1,000,000$ ); if included in operating income, it would not seriously distort the income figure.
- For Company B, a gain of \$5,000 amounts to 50% of its income from operations; obviously, the inclusion of such an item in operating income would affect the amount of that income materially.

Thus, we see the importance of the **relative size** of an item in determining its materiality.

Companies and their auditors generally adopt the rule of thumb that anything under 5% of net income is considered immaterial. This may be acceptable for an initial assessment of materiality, but other qualitative factors should also be considered. For example, the relative size of an item might be small, but what if that item:

- Converts a loss to a profit, or vice versa.
- Increases management compensation.
- Hides an illegal transaction, like a bribe.
- Preserves a positive earnings trend.

Ultimately, materiality judgments should be made in the context of the nature and the amount of an item. **Companies must consider both quantitative and qualitative factors in determining whether an item is material.**

<sup>8</sup>“Qualitative Characteristics of Useful Financial Information,” *Statements of Financial Accounting Concepts* No. 8, Chapter 3 (Norwalk, Conn.: FASB, August 2018), para. QC11.

## Accounting Matters

## Living in a Material World

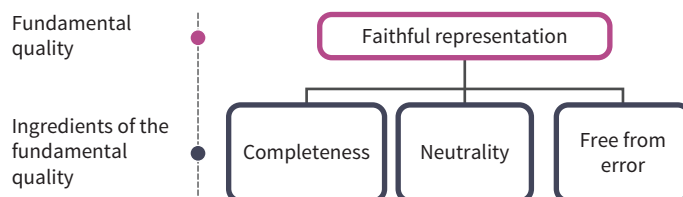
The word “material” can be found 114 times in **Starbucks**’ recent annual report and 88 times in **Apple**’s. This is not unique to these companies but rather shows the impact that materiality has in the financial reporting process. When discussing the judgments and estimates involved in financial reporting, management concedes that actual results could differ **materially** from the estimates. Apple indicated that the adoption of the new revenue recognition

standard did not have a **material** impact on previously reported amounts. Starbucks adopted new guidance on accounting for hedging relationships and indicated that the adoption of the new guidance did not have a **material** impact on its consolidated financial statements. Materiality is indeed a key ingredient of relevant financial information and one that preparers and auditors alike spend a significant amount of time evaluating.

**Source:** Apple, Inc. and Starbucks Corporation 10-K annual reports.

## Fundamental Quality—Faithful Representation

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



**Faithful representation** means that the numbers and descriptions match what really existed or happened. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. For example, if **Microsoft**’s income statement reports sales of \$295,618 million when sales were \$245,122 million, then the statement fails to faithfully represent the proper sales amount. To be a faithful representation, information must be complete, neutral, and free of material error.

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

**Neutrality** **Neutrality** means that a company cannot select information to favor one set of interested parties over another. Unbiased information must be the overriding consideration. For example, in the notes to financial statements, tobacco companies such as **R.J. Reynolds** should not suppress information about the numerous lawsuits that have been filed because of tobacco-related health concerns—even though such disclosure is damaging to the company.<sup>9</sup>

<sup>9</sup>Sometimes, in practice, it has been acceptable to invoke prudence or conservatism as a justification for an accounting treatment under conditions of uncertainty. **Prudence** or **conservatism** means when in doubt, choose the solution that will be least likely to overstate assets or income and/or understate liabilities or expenses. The conceptual framework indicates that prudence or conservatism generally is in conflict with the quality of neutrality. This is because being prudent or conservative likely leads to a bias in the reported financial position and financial performance. In fact, introducing biased understatement of assets (or overstatement of liabilities) in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent. This is inconsistent with neutrality, which encompasses freedom from bias. Accordingly, the conceptual framework does not include prudence or conservatism as desirable qualities of financial reporting information. See “Qualitative Characteristics of Useful Financial Information,” *Statement of Financial Accounting Concepts No. 8, Chapter 3* (Norwalk, Conn.: FASB, August 2018), paras. BC3.27–BC3.29.

**Free from Error** An information item that is **free from error** will be a more accurate (faithful) representation of a financial item. For example, if **JPMorgan Chase** misstates its loan losses, its financial statements are misleading and not a faithful representation of its financial results. However, faithful representation does not imply total freedom from error or total exactness. Think of the many estimates in the financial statements that incorporate the use of management judgment. For example, management must estimate the amount of uncollectible accounts to determine bad debt expense. Also, the determination of depreciation expense requires estimation of the useful lives of plant and equipment, as well as the salvage values of the assets.

## Accounting Matters

## What's in It for Me?

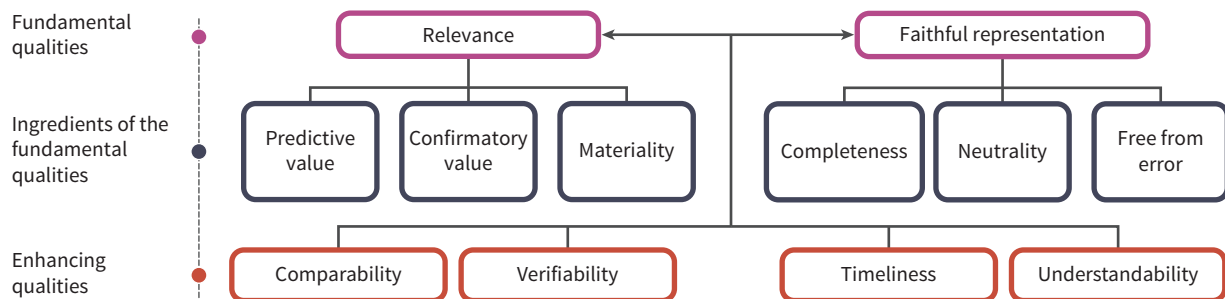
Neutrality in rule-making has always been a difficult concept to achieve. Some argue that the FASB should not issue pronouncements that cause undesirable economic effects on an industry or company. For example, at one time banks and credit unions actively lobbied against the recent standard on loan losses because they argued the rules would put them in an unfavorable light, thereby reducing their ability to make loans. We are glad the FASB stayed with its plan to issue these rules. Accounting rules (and the standard-setting process) must be

free from bias, or we will no longer have credible financial statements. Without credible financial statements, individuals will no longer use this information.

An analogy demonstrates the point: Many individuals bet on boxing matches because such contests are assumed not to be fixed. But nobody bets on wrestling matches. Why? Because the public assumes that wrestling matches are rigged. If financial information is biased (rigged), the public will lose confidence and no longer use it.

## Enhancing Qualities

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



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

Another type of comparability, **consistency**, is present when a company applies the same accounting method to similar events, from period to period. Through such application, the company shows consistent use of accounting standards. The idea of consistency does not mean, however, that companies cannot switch from one accounting method to another.<sup>10</sup> If a company changes methods, it must:

<sup>10</sup>Surveys indicate that users highly value consistency. They note that a change tends to destroy the comparability of data before and after the change. Some companies assist users to understand the pre-and post-change data. Generally, however, users say they lose the ability to analyze over time. GAAP guidelines (discussed in Chapter 21) on accounting changes are designed to improve the comparability of the data before and after an accounting change.

- Demonstrate that the newly adopted method is preferable to the old.
- Disclose in a note to the financial statements the nature and effect of the accounting change, as well as the justification for it, in the period in which it made the change.

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

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

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

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

For example, assume that **Meta** (previously **Facebook**) issues a three-month report that shows interim earnings have declined significantly. This interim report provides relevant and faithfully represented information for decision-making purposes. Some users, upon reading the report, decide to sell their shares. Other users, however, do not understand the report's content and significance. They are surprised when Meta declares a smaller year-end dividend and the share price declines. Although Meta presented highly relevant information that was a faithful representation, it was useless to those who did not understand it.

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

## Chapter 4 - Elements

An important aspect of developing any theoretical structure is the body of basic **elements** or definitions to be included in it. Accounting uses many terms with distinctive and specific meanings. These terms constitute the language of business or the jargon of accounting. For example, one such term is **asset**. Is it merely something we own? Or is an asset something we have the right to use, as in the case of leased equipment? Or is it anything of value used by a company to generate revenues—in which case, should we also consider the managers of a company as an asset? The 10 elements identified by the FASB are as follows.<sup>12</sup>

<sup>11</sup>“Qualitative Characteristics of Useful Financial Information,” *Statement of Financial Accounting Concepts No. 8, Chapter 3* (Norwalk, Conn.: FASB, August 2018), paras. QC30–QC32.

<sup>12</sup>“Elements of Financial Statements,” *Statement of Financial Accounting Concepts No. 8, Chapter 4* (Norwalk, Conn.: FASB, December 2021).

## Elements of Financial Statements

**Assets.** Present rights of an entity to economic benefits.

**Liabilities.** Present obligations of an entity to transfer economic benefits.

**Equity or Net Assets.** The residual interest in the assets of an entity that remains after deducting its liabilities.

**Investments by owners.** Increases in equity of an entity resulting from transfers to the entity from other entities of something valuable to obtain or increase ownership interests (or equity) in the entity.

**Distributions to owners.** Decreases in equity of an entity resulting from transferring assets, rendering services, or incurring liabilities by the entity to owners.

**Comprehensive income.** The change in equity 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.

**Revenues.** Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.

**Expenses.** Outflows or other using up of assets of an entity or incurrences of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.

**Gains.** Increases in equity (net assets) from transactions and other events and circumstances affecting an entity except those that result from revenues or investments by owners.

**Losses.** Decreases in equity (net assets) from transactions and other events and circumstances affecting an entity except those that result from expenses or distribution to owners.

The FASB classifies the elements into two distinct groups.

1. The first group of three elements—assets, liabilities, and equity or net assets—describes amounts of resources and claims to resources at a **moment in time**.
2. The other seven elements describe transactions, events, and circumstances that affect a company during a **period of time**.

The first group, affected by elements of the second group, provides at any time the cumulative result of all changes. This interaction is referred to as “articulation.” That is, key figures in one financial statement correspond to balances in another. We will explain and examine each of these elements in more detail in later chapters.

## Chapter 5 - Recognition and Derecognition

This chapter of the conceptual framework sets forth criteria to guide when an item should be incorporated into, **recognition**, or removed from, **derecognition**, the financial statements. For an item to be recognized, it must

1. Meet the definition of an element,
2. Have a relevant measurement, and
3. Meet the requirement of faithful representation.

When **Walmart** sells goods in one of its stores, it recognizes revenue. If customers sue Walmart for price-fixing and it is unlikely the suit will prevail, Walmart does not recognize an expense. Why recognition in one situation but not the other? In the Walmart sale, the three criteria are met, and revenue is recognized. In the Walmart lawsuit, the expense is not recognized because no liability exists, there is no measurable amount, and there is no faithful representation since the outcome of the lawsuit is not known.

An item is derecognized when it no longer meets any one of the criteria for recognition.<sup>13</sup>

<sup>13</sup>“Recognition and Derecognition,” *Statement of Financial Accounting Concepts No. 8, Chapter 5* (Norwalk, Conn.: FASB, August 2023).

## Chapter 6 – Measurement

**Measurement** is the process of determining relevant numerical depictions of items recognized in the financial statements.<sup>14</sup> The measurement concept identifies two key issues related to the reporting of financial information in general purpose financial reporting. They are:

1. Asset amounts should not be reported at more than what is recoverable, by disposition or use. For example, **Boeing** had to write-down its assets by \$3.5 billion to reflect the financial impact of having to ground some of its planes for a considerable period due to fatal airplane crashes.
2. Reported amounts of liabilities should not be less than what is settleable, by transfer or satisfaction, over an expected benefit or obligation period. For example, the SEC stated that **General Electric** understated its insurance liabilities by several billion dollars.

In short, assets should not be overstated, and liabilities should not be understated.

## Chapter 7 – Presentation

The presentation concept describes the information needed for general purpose financial reporting. To understand what is presented, examine the financial statements of **Coca-Cola** in Appendix C. What you will find is the full set of financial statements of Coca-Cola, which presents the elements of financial statements and the recognition and measurement related to those elements. As a result, the **presentation** concept relates to the display of line items, totals, and subtotals on the financial statements. The displays involve the presentation of numbers and words involving the elements of the financial statements.<sup>15</sup>

## Chapter 8 – Notes

**Notes to financial statements** generally amplify or explain the items presented in the main body of the statements. If the main body of the financial statements gives an incomplete picture of the performance and position of the company, the notes should provide the additional information needed.<sup>16</sup> The Coca-Cola financial statements provide most of the information for decision making purposes, however, certain financial information is better provided in the notes to the financial statements. For example, Coca-Cola's notes to the financial statement provides additional explanation on items such as the nature of its debt, its acquisitions and investitures, and the nature of its intangible assets.

**FACTS** A local broker has called you with a tip about an investment in bonds of a company that she feels is about to take off. The company, AROD, sells sports memorabilia online. The bonds being issued by AROD mature in 15 years and promise a 10% yield. You tell the broker that before investing in this hot commodity, you would like to see AROD's financial statements.

The broker sends you the statements, which are from last year and unaudited. AROD's owner, Roderick Andrews, prepared the statements. You review the statements, and they are quite impressive. AROD reported a profit of \$3,500,000 and showed a low debt-equity ratio. The statement provides no comparative amounts for prior years, and there are no note disclosures provided about AROD's accounting methods related to inventory, depreciation, liabilities, and so on.

**Put It into Practice LO 1.2**  
Apply Qualitative Characteristics



<sup>14</sup>“Measurement,” *Statement of Financial Accounting Concepts No. 8, Chapter 6* (Norwalk, Conn.: FASB, July 2024).

<sup>15</sup>“Presentation,” *Statement of Financial Accounting Concepts No. 8, Chapter 7* (Norwalk, Conn.: FASB, December 2021).

<sup>16</sup>“Notes to Financial Statements,” *Statement of Financial Accounting Concepts No. 8, Chapter 8* (Norwalk, Conn.: FASB, December 2021).

**INSTRUCTIONS**

With a focus on relevance and faithful representation, determine if this would be a wise investment decision based on the financial statements provided by the broker.

**SOLUTION**

The AROD statements are neither relevant nor a faithful representation.

- With respect to **relevance**, this information must be **timely**. Because AROD's financial statements are a year old, they have lost their ability to influence an investor's decision; a lot could have changed in that one year. Another element of relevance is **predictive value**. AROD's accounting information is not relevant because it provides no reference to other years' profitability. Because developing trends are not reported, the information cannot help an investor predict future profitability. Closely related to predictive value is **feedback value**. These financial statements do not provide feedback on any strategies that the company may have used to increase profits.
- With respect to **faithful representation**, information must be **verifiable** by several independent parties. Because no independent auditor has verified these amounts, there is no way of knowing whether they are represented faithfully. For instance, an investor might like to believe that AROD earned \$3,500,000 and that it had a very favorable debt-equity ratio. However, unaudited financial statements do not give reasonable assurance about these claims. The fact that the company owner himself prepared these statements indicates a lack of **neutrality**. Because the company owner is not a disinterested third party, an investor cannot be sure that the owner did not prepare the financial statements to portray the business in the most favorable light.

## 1.3 Operational Concepts

### LEARNING OBJECTIVE 3

Discuss the basic operational concepts of GAAP

As we have mentioned, the conceptual framework is not authoritative, but many concepts of the framework have become operational in practice and incorporated as part of GAAP. The following assumptions and principles help to explain how companies should recognize, measure, and report financial elements and events. In addition, you should also recognize the concept of a **cost constraint**, which we discuss later in the chapter. These concepts serve as guidelines in responding to controversial accounting issues.

### Assumptions

We generally rely on four assumptions in accounting: (1) economic entity, (2) going concern, (3) monetary unit, and (4) periodicity.

#### Economic Entity Assumption

The **economic entity assumption** means that economic activity can be identified with a **particular unit of accountability**. In other words, a company keeps its activity separate and distinct from its owners and any other business unit. Consider these examples:

- The economic entity assumption dictates that **Panera Bread Company** records the company's financial activities separately from those of its owners and managers.
- Financial statement users need to be able to distinguish the activities and elements of different companies, such as **General Motors, Ford, and Fiat Chrysler**.

If users could not distinguish the activities of different companies, how would they know which company financially outperformed the other?

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

**You should recognize that the economic entity assumption and the reporting entity concept identified in the conceptual framework are very similar. The main difference is that the reporting entity concept is limited to general purpose financial reporting whereas the economic entity assumption is broader in scope.**

## Going Concern Assumption

Most accounting methods rely on the **going concern assumption**—that the company will have a long life. This means for accounting purposes, we assume that a company will continue operating as normal, and we follow normal GAAP procedures. The going concern assumption has three significant implications:

1. The historical cost principle is of limited usefulness if we assume eventual liquidation. Under a liquidation approach, a company like **Peleton Interactive** would better state assets at net realizable value (sales price less costs of disposal).
2. Depreciation and amortization approaches for Peleton would not be needed given a liquidation approach.
3. Current and noncurrent classification of assets and liabilities for Peleton would lose their significance and would be difficult to justify. Also, reporting liabilities based on priority in liquidation would be more reasonable.

Most companies have a high continuance rate and fulfill their objectives and commitments. Recently, however, companies (both large and small) have had to declare bankruptcy due to the Covid-19 pandemic. In these cases, when it is known that a company is going out of business or liquidating, we apply a different type of accounting method, called **liquidation accounting**. Because we do not cover liquidation accounting in this text, we will assume companies will remain a going concern in our examples.<sup>17</sup>

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<sup>17</sup>In response to the minimal guidance addressing the going concern assumption, including when it is appropriate to apply or how to apply the liquidation basis of accounting, the FASB has issued two accounting standards. The first, ("Presentation of Financial Statements—Going Concern: Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern") [1] requires additional disclosure when substantial doubt about a company's ability to continue as a going concern occurs. (See the FASB Codification References near the end of the chapter.) The second standard ("Presentation of Financial Statements—The Liquidation Basis of Accounting") [2] requires that companies use the liquidation basis of accounting when liquidation is imminent (when either a plan for liquidation has been approved or a plan for liquidation is being imposed by other forces, such as involuntary bankruptcy). If liquidation accounting is used, financial statements should reflect relevant information about a company's resources and obligations in liquidation by measuring and presenting assets and liabilities at the amount of cash or other consideration that the company expects to collect or pay in liquidation, along with additional disclosures about the plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of liquidation.

## Monetary Unit Assumption

The **monetary unit assumption** means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. That is, the monetary unit is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. **The monetary unit is relevant, simple, universally available, understandable, and useful.**

In the United States, accounting ignores price-level changes (inflation and deflation) and assumes that the unit of measure—the dollar—remains reasonably stable. We therefore use the monetary unit assumption to justify adding 1995 dollars to 2025 dollars without any adjustment. The FASB indicated that it expects the dollar, unadjusted for inflation or deflation, to continue to be used to measure items recognized in financial statements.

## Periodicity Assumption

Users need to know a company's performance and economic status on a timely basis so that they can evaluate and compare firms, and take appropriate actions. Therefore, companies must report information periodically. The **periodicity (or time period) assumption** implies that a company can divide its economic activities into artificial time periods. These time periods vary, but the most common are monthly, quarterly, and yearly.

The shorter the time period, the more difficult it is to determine the proper net income for the period. A month's results usually prove less verifiable than a quarter's results, and a quarter's results are likely to be less verifiable than a year's results. Investors desire and demand that a company quickly process and disseminate information. Yet the quicker a company releases the information, the more likely the information will include errors (see **Underlying Concepts**).

### Underlying Concepts

This phenomenon provides an interesting example of the trade-off between timeliness and accuracy (free from error) in preparing financial data.

## Principles

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

### Measurement Principle

We presently have a “mixed-attribute” system that permits the use of various measurement bases. The most commonly used measurements are based on historical cost and fair value.

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

Suppose a company buys a piece of land in the year 2013 paying \$100,000 cash.

- The transaction is **verifiable** because there are documents, such as a title deed, confirming the purchase and the payment.
- The land would be recorded in the company's accounting records at the historical cost of \$100,000.
- Now fast forward to the year 2028—is the land still worth \$100,000?

Most likely, the land has increased in value. That raises two important questions:

1. Should the company adjust the recorded amount for the land to its current sales value?
2. If so, how would the company determine the current sales value of the land?

One way to determine current sales value is to have the land appraised, but this is merely an estimate of the land's value and is subjective. The only way to truly know the value of the land is to sell it. You can see that if companies were required to adjust assets to current sales value, it could lead to highly subjective valuations that would have low verifiability. Plus, it would be a burden for companies to go through this process every time they want to prepare financial statements.

What about liabilities? Do companies account for them on a cost basis? Yes, they do. Companies issue liabilities, such as bonds, notes, and accounts payable, in exchange for assets (or services), for an agreed-upon price. **This price, established by the exchange transaction, is the “cost” of the liability.** A company uses this amount to record the liability and report it in financial statements. Thus, many users prefer historical cost because it provides them with a **verifiable benchmark** for measuring historical trends.

**Fair Value** **Fair value** is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Fair value is therefore a market-based measure and commonly referred to as the **fair value principle**. [3]

Fair value information may be more useful than historical cost for certain types of assets and liabilities and in certain industries. Therefore, GAAP does allow the use of fair value in certain situations.

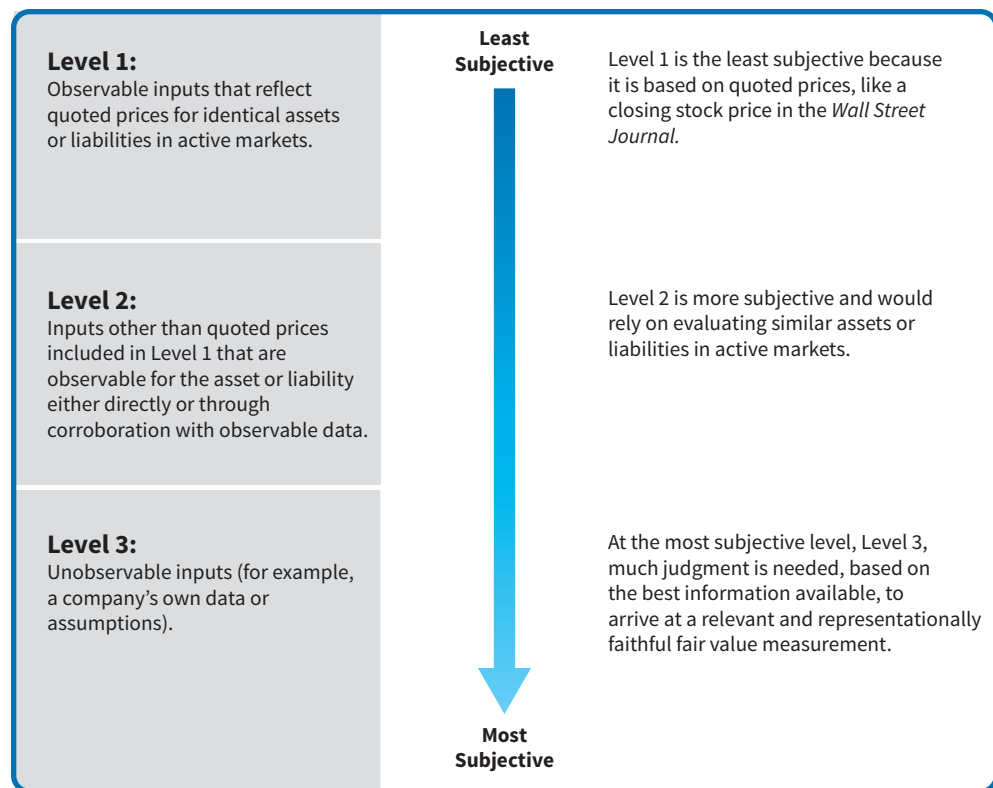
- If long-lived assets such as buildings or equipment decline in value, a fair value measure determines any impairment loss.
- If inventories decline in value, a fair value measure is used to determine the amount of the loss.
- If equity investments and certain types of debt investments either increase or decrease in value, a fair value measure is used to determine the gain or loss.
- If a company chooses, it can use a fair value option to measure its financial assets and financial liabilities, including items such as receivables and debt securities.

In these situations, fair value measurements are considered more relevant than historical cost. And, it is argued that fair value measurement provides better insight into the value of a company's assets and liabilities (its financial position), and a better basis for assessing future cash flow prospects. As you progress through this text, you will learn more about these situations in which fair value is used instead of historical cost.

At initial acquisition, historical cost equals fair value. In subsequent periods, as market and economic conditions change, historical cost and fair value often diverge. Measurement based on fair value introduces subjectivity into accounting reports when fair value information is not readily available. To increase consistency and comparability in fair value measures, a fair value hierarchy is used to determine fair value. As shown in **Illustration 1.8**, the fair value hierarchy is divided into three levels.<sup>18</sup>

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<sup>18</sup>For major groups of assets and liabilities, companies must disclose (1) the fair value measurement and (2) the fair value hierarchy level of the measurements as a whole, classified by Level 1, 2, or 3. Given the judgment involved, it follows that the more a company depends on Level 3 to determine fair values, the more information about the valuation process the company will need to disclose. Thus, additional disclosures are required for Level 3 measurements; we discuss these disclosures in more detail in subsequent chapters.

**ILLUSTRATION 1.8** Fair Value Hierarchy

It is easy to arrive at fair values when markets are liquid with many traders, but fair value answers are not readily available in other situations. For example, **Walt Disney** purchased **21<sup>st</sup> Century Fox** for \$71.3 billion (that is, the mouse swallowed part of the fox).

- In this business combination, Walt Disney must allocate its purchase price to the fair value of the assets and liabilities acquired. For example, the plant and equipment of 21<sup>st</sup> Century Fox would be recorded on Disney's books based on selling price, if selling prices are available.
- Otherwise, where a limited market exists, such as the acquisition of a network of cell towers, an income approach using a present value of future cash flows approach might be used.
- Another possibility would be to use the cost to replace these cell towers (a replacement cost approach).

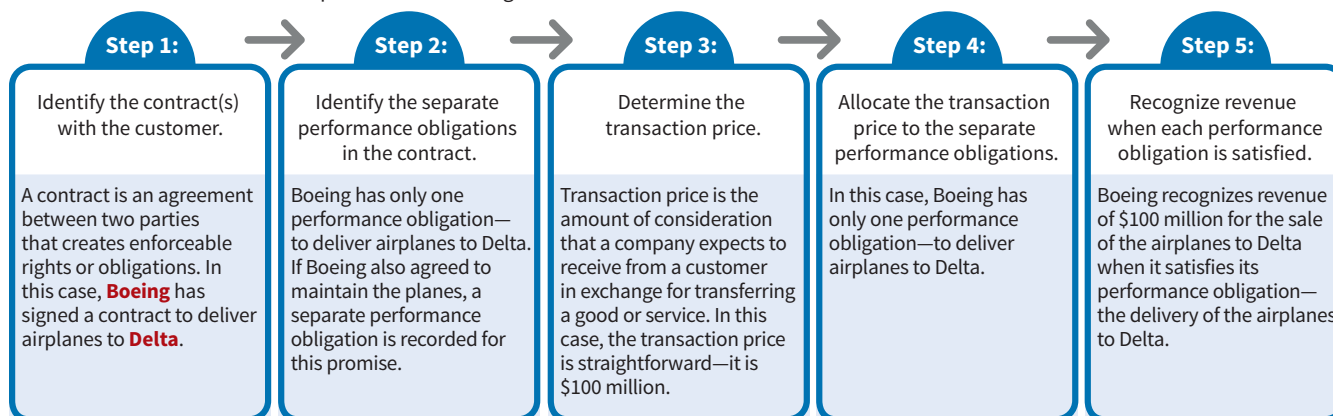
In summary, we presently have a “mixed-attribute” system that permits the use of historical cost and fair value. Although the historical cost principle continues to be an important basis for valuation, recording and reporting of fair value is increasing.

## Revenue Recognition Principle

For an item to be recognized in the financial statements, it must meet the definition of an element, be measurable with sufficient certainty, and be faithfully represented. Two key recognition concepts are the revenue recognition principle and the expense recognition principle. When a company agrees to perform a service or sell a product to a customer, it has a **performance obligation**. The **revenue recognition principle** requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.<sup>[4]</sup>

For example, assume that **Klinke Cleaners** cleans clothing on June 30, but customers do not claim and pay for their clothes until the first week of July. Klinke should record revenue in June when it performed the service (satisfied the performance obligation) rather than in July when it received the cash. At June 30, Klinke would report a receivable on its balance sheet and revenue in its income statement for the service performed.

To illustrate the revenue recognition principle in more detail, assume that **Boeing Corporation** signs a contract to sell airplanes to **Delta Air Lines** for \$100 million. To determine when to recognize revenue, Boeing uses the five steps shown in **Illustration 1.9**.

**ILLUSTRATION 1.9** The Five Steps of Revenue Recognition

Many revenue transactions pose few problems because the transaction is initiated and completed at the same time. However, identifying when to recognize revenue in other situations is often more difficult, such as when a performance obligation is satisfied over time or multiple performance obligations are involved. We will revisit the five steps of revenue recognition in more detail in Chapters 3, 6, 7, 12, and 17.

### Expense Recognition Principle

Expenses are outflows or other “using up” of assets or incurring of liabilities during a period as a result of delivering or producing goods and/or performing services. It follows then that recognition of expenses is related to net changes in assets and earning revenues. In practice, the approach for recognizing expenses is, “Let the expense follow the revenues.” This approach is the **expense recognition principle**.

- Companies recognize expenses not when they pay wages or make a product, but when the work (service) or the product actually contributes to revenue. Thus, companies tie expense recognition to revenue recognition.
- By matching **effort (expenses) with accomplishment (revenues)**, the **expense recognition principle is implemented** in accordance with the definition of an expense.<sup>19</sup>

Some costs, however, are difficult to associate with revenue. As a result, some other approach must be developed. Often, companies use a **rational and systematic allocation policy** that will approximate the expense recognition principle. This type of expense recognition involves assumptions about the benefits that a company receives as well as the cost associated with those benefits.

For example, **Southwest Airlines** allocates the cost of an airplane over all of the accounting periods during which it uses the airplane because the asset contributes to the generation of revenue throughout its useful life. Companies also charge some costs to the current period as expenses simply because they cannot determine a connection with revenue. Examples of these types of costs are officers’ salaries and other administrative expenses.

For a manufacturer like **New Balance** or **Intel**, costs are generally classified into two groups for expense recognition purposes: **product costs** and **period costs**.

- **Product costs**, such as material, labor, and overhead, attach to the product. Companies carry these costs into future periods if they recognize the revenue from the product in subsequent periods.
- **Period costs**, such as officers’ salaries and other administrative expenses, are attached to the period. Companies expense such costs in the immediate period even though benefits associated with these costs may occur in the future. Why? Because companies cannot determine a direct relationship between period costs and revenue.

**Illustration 1.10** summarizes these expense recognition procedures.

<sup>19</sup>This approach is commonly referred to as the matching principle. However, there is much debate about the conceptual validity of the matching principle. A major concern is that matching permits companies to defer certain costs and treat them as assets on the balance sheet. In fact, these costs may not have future benefits. If abused, this principle permits the balance sheet to become a “dumping ground” for unmatched costs.

**ILLUSTRATION 1.10** Expense Recognition

Type of Cost	Relationship	Recognition
<b>Product costs:</b>		
<ul style="list-style-type: none"> <li>• Material</li> <li>• Labor</li> <li>• Overhead</li> </ul>	Direct relationship between cost and revenue.	Recognize in period of revenue.
<b>Period costs:</b>		
<ul style="list-style-type: none"> <li>• Salaries</li> <li>• Administrative costs</li> </ul>	No direct relationship between cost and revenue.	Expense as incurred.

## Full Disclosure Principle

Consider the following questions:

- Should a company have to disclose the environmental impact of its operations such as reporting the amount of carbon emissions it produces?
- Should a company be required to provide information related to its cyber security vulnerability?
- Should a company be required to disclose its level of political spending?
- Should a company be required to disclose its level of diversity in its board of directors?

Answers to questions like these are difficult as they do not directly affect a specific asset, liability, revenue, or expense. However, non-disclosure may have a significant effect on the financial reports from a longer-term point of view.

In deciding what information to report, companies follow the general practice of providing information that is of sufficient importance to influence the judgment and decisions of an informed user. The **full disclosure principle** recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive to balance two objectives:

1. Sufficient details to disclose matters that make a difference to users.
2. Sufficient condensation to make the information understandable, keeping in mind the costs of preparing and using it.

Disclosure is not a substitute for proper accounting. As a former chief accountant of the SEC noted, “Good disclosure does not cure bad accounting any more than an adjective or adverb can be used without, or in place of, a noun or verb.”

Users find information about financial position, income, cash flows, and investments in one of three places:

1. Within the main body of financial statements.
2. In the notes to those statements.
3. As supplementary information.

**Financial Statements** The financial statements are the balance sheet, income statement, statement of cash flows, and statement of stockholders’ equity. They are a structured means of communicating financial information. To be recognized in the main body of financial statements, **an item should meet the definition of an element, be measurable with sufficient certainty, and be faithfully represented.**

**Notes to the Financial Statements** Notes generally amplify or explain the items presented in the main body of the statements. Information in the notes does not have to be quantifiable, nor does it need to qualify as an element. Notes can be partially or totally narrative.

Examples of notes include descriptions of the accounting policies and methods used in measuring the elements reported in the statements, explanations of uncertainties and contingencies, and statistics and details too voluminous for inclusion in the statements. The notes are essential to understanding the company's performance and position.

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

Supplementary information may also include management's explanation of the financial information and its discussion of the significance of that information. For example, many business combinations have produced financing arrangements that demand new accounting and reporting practices and principles. In each of these situations, the same problem must be faced—making sure the company presents enough information to ensure that the **reasonably prudent investor** will not be misled.

## Cost Constraint

In providing information that is decision-useful, companies must weigh the costs of providing the information against the benefits that can be derived from using it. This is referred to as the **cost constraint**, or the **cost-benefit relationship**. Rule-making bodies use cost-benefit analysis before making final their informational requirements. To justify requiring a particular measurement or disclosure, the benefits perceived to be derived from it must exceed the costs perceived to be associated with it.

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

The difficulty in cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable. There are several types of costs associated with providing information:

- Collecting, processing, and disseminating information.
- Auditing information.
- Potential litigation caused by disclosure.
- Disclosure to competitors.
- Analyzing and interpreting information.

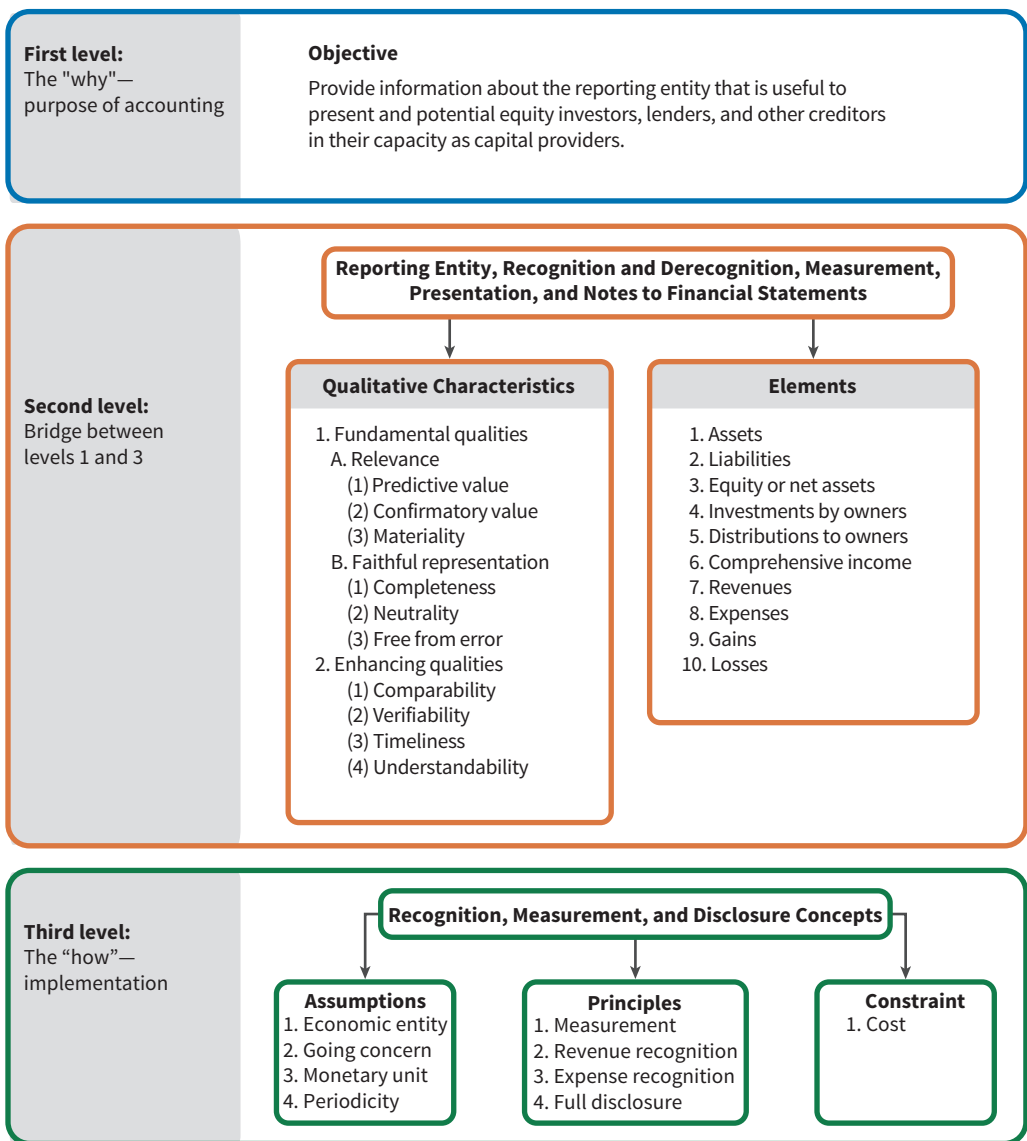
However, benefits to preparers of the information may include greater management control and access to capital at a lower cost. Users may receive better information for allocation of resources and tax assessment. Benefits are generally more difficult to quantify than are costs.

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

## Summary

**Illustration 1.11** presents the conceptual framework discussed in this chapter. It is similar to Illustration 1.5, except that it provides additional information for each level. We cannot over-emphasize the usefulness of this conceptual framework in helping to understand many of the problem areas that we examine in later chapters.

**ILLUSTRATION 1.11**  
Conceptual Framework for  
Financial Reporting



**Put It into Practice LO 1.3**  
Identify Assumptions and Principles



**FACTS** Here are assumptions and principles that are operational concepts used in the application of GAAP.

- a. Economic entity assumption
- b. Going concern assumption
- c. Monetary unit assumption
- d. Periodicity assumption
- e. Historical cost principle
- f. Revenue recognition principle
- g. Expense recognition principle
- h. Full disclosure principle

**INSTRUCTIONS**

Match each item above with the description below.

1. The belief that the company will continue for the foreseeable future.
2. The reporting of all information that would make a difference to financial statement users.
3. The practice of preparing financial statements at regular intervals.
4. The belief that items should be reported on the balance sheet at the price that was paid to acquire the item.
5. Tracing accounting events to companies.
6. Reporting only those things that can be measured in dollars.
7. Recognize wages when the work contributes to revenue.
8. Recognize sale of goods when performance obligation is satisfied.

**SOLUTION**

1. **b.** Going concern assumption
2. **h.** Full disclosure principle
3. **d.** Periodicity assumption
4. **e.** Historical cost principle
5. **a.** Economic entity assumption
6. **c.** Monetary unit assumption
7. **g.** Expense recognition principle
8. **f.** Revenue recognition principle

# 1.4 Major Challenges in Financial Reporting

## LEARNING OBJECTIVE 4

Identify the major challenges in the financial reporting environment.

Since the implementation of GAAP may affect many interests, much discussion occurs about who should develop GAAP and to whom it should apply. We discuss some of the major issues below.

### GAAP in a Political Environment

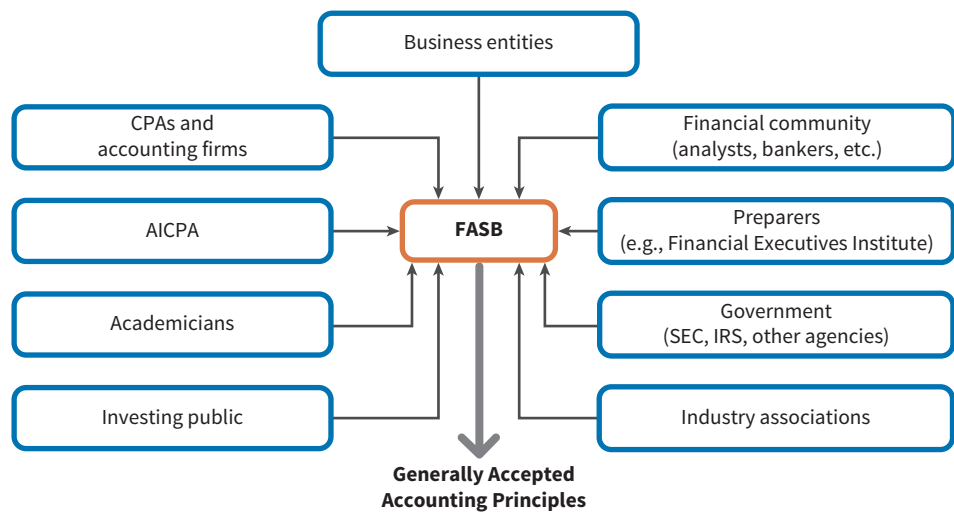
User groups are possibly the most powerful force influencing the development of GAAP. User groups consist of those most interested in or affected by accounting rules. Like lobbyists in our state and national capitals, user groups play a significant role. **GAAP is as much a product of political action as it is of careful logic or empirical findings.**

- User groups may want particular economic events accounted for or reported in a particular way, and they know that the most effective way to influence GAAP is to participate in the formulation of these rules or try to influence the formulator of them.

- These user groups often target the FASB, to pressure it to influence changes in the existing rules and the development of new ones.

**Illustration 1.12** shows the various user groups that apply pressure.

**ILLUSTRATION 1.12** User Groups that Influence the Formulation of Accounting Standards



Should there be politics in establishing GAAP for financial accounting and reporting? Why not? We have politics at home; at school; at the fraternity, sorority, and dormitory; at the office; and at church, temple, and mosque. Politics is everywhere. GAAP is part of the real world, and it cannot escape politics and political pressures.<sup>20</sup>

That is not to say that politics in establishing GAAP is a negative force. Considering the **economic consequences**<sup>21</sup> of many accounting rules, special interest groups should vocalize their reactions to proposed rules. What the Board should *not* do is issue pronouncements that are primarily politically motivated. While paying attention to its constituencies, the Board should base GAAP on sound research and a conceptual framework that has its foundation in economic reality.

## Expectations Gap

The **Sarbanes-Oxley Act** was passed in response to a string of accounting scandals at companies like **Enron**, **Cendant**, **Sunbeam**, **Rite-Aid**, **Xerox**, and **WorldCom**. This law increased the resources for the SEC to combat fraud and curb poor reporting practices.<sup>22</sup> In addition, the Sarbanes-Oxley Act introduced sweeping changes to the institutional structure of the accounting profession. The following are some of the key provisions of the legislation.

- Establishes an oversight board, the **Public Company Accounting Oversight Board (PCAOB)**, for accounting practices. The PCAOB has oversight and enforcement authority and establishes auditing, quality control, and independence standards and rules.
- Requires CEOs and CFOs to personally certify that financial statements and disclosures are accurate and complete, and requires CEOs and CFOs to forfeit bonuses and profits when there is an accounting restatement.

<sup>20</sup>FASB board members acknowledged that they undertook many of the Board's projects, such as "Accounting for Contingencies," "Accounting for Pensions," "Statement of Cash Flows," and "Recognition and Measurement of Financial Assets and Liabilities," due to political pressure.

<sup>21</sup>**Economic consequences** means the impact of accounting reports on the wealth positions of issuers and users of financial information, and the decision-making behavior resulting from that impact. The resulting behavior of these individuals and groups could have detrimental financial effects on the providers of the financial information. See Stephen A. Zeff, "The Rise of 'Economic Consequences,'" *Journal of Accountancy* (December 1978), pp. 56–63. We extend appreciation to Professor Zeff for his insights on this chapter.

<sup>22</sup>*Sarbanes-Oxley Act of 2002*, H. R. Rep. No. 107-610 (2002).

- Requires audit committees to be comprised of independent members and members with financial expertise and requires codes of ethics for senior financial officers.
- Requires large public companies to document and evaluate the effectiveness of their internal controls over financial reporting.

Are these changes enough to address deficiencies in financial reporting? The **expectations gap**, which is what the public thinks accountants **should** do versus what accountants think they **can** do, is difficult to close. Although the profession can argue rightfully that accounting cannot be responsible for every financial catastrophe, it must continue to strive to meet the needs of society. However, efforts to meet these needs will become more costly to society. The development of a highly transparent, clear, and reliable system will require considerable resources.

## Financial Reporting Issues

While our reporting model has worked well in capturing and organizing financial information in a useful and reliable fashion, much still needs to be done, as shown in **Illustration 1.13**.

Challenge	Issue to Be Addressed
<b>Nonfinancial measurements</b>	Financial reports fail to provide some key performance measures widely used by management, such as customer satisfaction indexes, backlog information, reject rates on goods purchased, as well as the results of companies' sustainability efforts.
<b>Forward-looking information</b>	Financial reports fail to provide forward-looking information needed by present and potential investors and creditors. One individual noted that financial statements in 2024 should have started with the phrase, "Once upon a time," to signify their use of historical cost and accumulation of past events.
<b>Soft assets</b>	Financial reports are focused on hard assets (inventory, plant assets) but fail to provide much information about a company's soft assets (intangibles). The best assets are often intangible. Consider <b>Microsoft's</b> know-how and market dominance, <b>Walmart's</b> expertise in supply chain management, and <b>Procter &amp; Gamble's</b> brand image.
<b>Timeliness</b>	Companies only prepare financial statements quarterly and provide audited financials annually. Little to no real-time financial statement information is available.
<b>Understandability</b>	Investors and market regulators are raising concerns about the complexity and lack of understandability of financial reports.
<b>Changing landscape</b>	Issues such as environmental, social, and governance reporting, cybersecurity, and the impact of artificial intelligence models on the reporting function need to be considered.

**ILLUSTRATION 1.13** Financial Reporting Challenges

We believe each of these challenges must be met for the accounting profession to provide the type of information needed for an efficient capital allocation process. We are confident that changes will occur, based on these positive signs.

- **Companies are voluntarily disclosing information deemed relevant to investors.** Often, such information is nonfinancial. For example, banking companies now disclose data on loan growth, credit quality, fee income, operating efficiency, capital management,

and management strategy. Increasingly, companies are preparing reports on their sustainability efforts by reporting such information as water use and conservation, carbon impacts, and labor practices. In some cases, “integrated reports” are provided, which incorporate sustainability reports into the traditional annual report, leading some to call for standards for sustainability reporting.

- **The FASB is now working on projects that address disclosure effectiveness, a reporting framework for non-public companies, and a simplification initiative.** The projects could go a long way toward addressing the complexity and understandability of the information in financial statements, allowing for more-effective, less-complex, and flexible reporting to meet the needs of investors.
- Most companies publish their annual reports in several formats on the Internet. The most innovative companies offer sections of their annual reports in a format that the user can readily manipulate, such as in an electronic spreadsheet format. Companies also format their financial reports using eXtensible Business Reporting Language (XBRL), which permits quicker and lower-cost access to their financial information.

Changes in these directions will enhance the relevance of financial reporting and provide useful information to financial statement readers.

## Analytics in Action: Big Data for Big Decisions

Accounting software systems collect vast amounts of data about a company’s economic events as well as its suppliers and customers. With financial information delivered in a fully digital format, decision-makers are taking advantage of this wealth of information (big data) by using data analytics.

- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.

*An end-of-chapter Analytics in Action Activities section, which includes Excel-based problems with data sets, is available for most chapters in this text.*

- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies.

Data analytics often employs software and statistics to make inferences and make more informed business decisions.

## Ethical Issues

Robert Sack, a noted commentator on the subject of accounting ethics, observed, “Based on my experience, new graduates tend to be idealistic . . . thank goodness for that! Still, it is very dangerous to think that your armor is all in place and say to yourself, ‘I would have never given in to that.’ The pressures don’t explode on us; they build, and we often don’t recognize them until they have us.”

These observations are particularly appropriate for anyone entering the business world. In accounting, as in other areas of business, we frequently encounter ethical dilemmas. Some of these dilemmas are simple and easy to resolve. However, many are not, requiring difficult choices among allowable alternatives. Consider these examples:

- Companies that concentrate on “maximizing the bottom line,” “facing the challenges of competition,” and “stressing short-term results” place accountants in an environment of conflict and pressure.
- Basic questions such as, “Is this way of communicating financial information good or bad?” “Is it right or wrong?” and “What should I do in this circumstance?” cannot always be answered by simply adhering to GAAP or following the rules of the profession.
- Technical competence is not enough when encountering ethical decisions.

Doing the right thing is not always easy or obvious. The pressures “to bend the rules,” “to play the game,” or “to just ignore it” can be considerable. For example, “Will my decision affect my job performance negatively?” “Will my superiors be upset?” and “Will my colleagues be unhappy with me?” are often questions businesspeople face in making tough ethical decisions. The decision is more difficult because there is no comprehensive ethical system to provide guidelines.

Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives. *Throughout this text, we present ethical considerations to help sensitize you to the type of situations you may encounter in the performance of your professional responsibility.* As Warren Buffet noted: “A word of caution as you go through life—It takes 20 years to build a reputation and five minutes to lose it. If you think about that, you will do things differently.”

## Review and Practice

### Key Terms Review

Accounting Standards Updates 1-7	Financial Accounting Standards Board (FASB) 1-6	periodicity (time period) assumption 1-20
American Institute of Certified Public Accountants (AICPA) 1-8	Financial Accounting Standards Board Accounting Standards Codification 1-8	predictive value 1-13
comparability 1-15	free from error 1-15	presentation 1-19
completeness 1-14	full disclosure principle 1-24	product costs 1-23
conceptual framework 1-11	generally accepted accounting principles (GAAP) 1-4	Public Company Accounting Oversight Board (PCAOB) 1-29
confirmatory value 1-13	general-purpose financial reporting 1-12	qualitative characteristics 1-12
consistency 1-16	going concern assumption 1-19	recognition 1-18
cost constraint (cost-benefit relationship) 1-25	historical cost principle 1-20	relevance 1-13
decision-usefulness 1-3	International Accounting Standards Board (IASB) 1-8	reporting entity 1-12
derecognition 1-18	International Financial Reporting Standards (IFRS) 1-8	revenue recognition principle 1-22
due process 1-7	materiality 1-13	Sarbanes-Oxley Act 1-28
economic entity assumption 1-19	measurement 1-19	Securities and Exchange Commission (SEC) 1-5
elements 1-17	monetary unit assumption 1-20	Statements of Financial Accounting Concepts (SFAC) 1-8
expectations gap 1-29	neutrality 1-14	supplementary information 1-25
expense recognition principle 1-23	notes to financial statements 1-24	timeliness 1-16
fair value 1-21	objective of general purpose financial reporting 1-11	understandability 1-16
fair value principle 1-21	performance obligation 1-22	verifiability 1-16
faithful representation 1-14	period costs 1-23	
Financial Accounting Foundation (FAF) 1-6		
financial accounting standards 1-7		
Financial Accounting Standards Advisory Council (FASAC) 1-6		

### Learning Objectives Review

- 1 Describe the financial reporting environment, major standard-setting bodies, and the meaning of generally accepted accounting principles (GAAP).

The **objective of general-purpose financial reporting** is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in decisions about providing resources to the entity through equity investments and loans or other forms of credit. Information that

is decision-useful to investors may also be helpful to other users of financial reporting who are not investors.

To achieve this objective, the accounting profession has attempted to **develop a set of standards that is generally accepted** and universally practiced. Without this set of standards, each company would have to develop its own standards. Readers of financial statements would have to familiarize themselves with every company’s peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

The **Securities and Exchange Commission (SEC)** is a federal agency that has the broad powers to prescribe, in whatever detail it desires, the accounting standards to be employed by companies that fall within its jurisdiction. The **Financial Accounting Standards Board (FASB)** establishes and improves standards of financial accounting and reporting for the guidance and education of the public. **Generally accepted accounting principles (GAAP)** are those principles that have substantial authoritative support. All authoritative accounting documents are classified in one source referred to as the Codification. The purpose of the Codification is to simplify user access to all authoritative GAAP. The Codification is the means by which GAAP is documented, presented, and updated.

## 2 Describe the components and usefulness of the conceptual framework.

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

The conceptual framework is divided into eight chapters. (1) Objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. (2) The **reporting entity** refers to companies that prepare general purpose financial reports, which include the full set of financial statements and related notes and supplementary information. (3) Qualitative characteristics of useful information include relevance and faithful representation. Relevant information has predictive or confirmatory value and is material. Faithfully represented information is complete, neutral, and free from error. Enhancing qualities of useful information are comparability, verifiability, timeliness, and understandability. (4) Elements of financial statements are assets, liabilities, equity (net assets), investments by owners, distributions to owners, comprehensive income, revenues, expenses, gains, and losses. (5) Recognition and derecognition criteria guide when an item should be incorporated into and removed from the financial statements. (6) Measurement is the process of determining relevant numerical depictions of items recognized in the financial statements. (7) Presentation refers to display of line items, totals, and subtotals on the financial statements. (8) Notes to financial statements supplement or further explain the information on the face of financial statements.

## 3 Discuss the basic operational concepts of GAAP.

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

The principles underlying accounting are as follows. (1) **Measurement principle:** GAAP permits the use of historical cost, fair value, and other valuation bases. Although the historical cost principle (measurement based on acquisition price) continues to be an important basis for valuation, recording and reporting of fair value information is increasing. (2) **Revenue recognition principle:** A company recognizes revenue when it satisfies a performance obligation. (3) **Expense recognition principle:** As a general rule, companies recognize expenses when the service or the product actually makes its contribution to revenue. (4) **Full disclosure principle:** Companies generally provide information that is of sufficient importance to influence the judgment and decisions of an informed user. (5) **Cost constraint:** The cost of providing the information must be weighed against the benefits that can be derived from using the information.

## 4 Identify the major challenges in the financial reporting environment.

One major challenge is that user groups may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. They especially target the FASB to influence changes in existing GAAP and in the development of new rules. A second challenge is that financial reports fail to provide (1) some key performance measures widely used by management, (2) forward-looking information needed by investors and creditors, (3) sufficient information on a company's soft assets (intangibles), (4) real-time financial information, and (5) easy-to-comprehend information. Finally, financial accountants are called on for moral discernment and ethical decision-making. Decisions are sometimes difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines for making ethical judgments.

## Questions

- How does accounting help the capital allocation process?
- Briefly explain the meaning of decision-usefulness in the context of financial reporting.
- Of what value is a common set of standards in financial accounting and reporting?
- In what way is the Securities and Exchange Commission concerned about and supportive of accounting principles and standards?
- If you had to explain or define "generally accepted accounting principles or standards," what essential characteristics would you include in your explanation?
- What are the primary advantages of having a Codification of generally accepted accounting principles?
- What is a conceptual framework? Why is a conceptual framework necessary in financial accounting?
- What is the primary objective of financial reporting?

9. What is meant by the term “qualitative characteristics of accounting information”?
10. Briefly describe the two fundamental qualities of useful accounting information.
11. How is materiality (or immateriality) related to the proper presentation of financial statements? What factors and measures should be considered in assessing the materiality of a misstatement in the presentation of a financial statement?
12. What are the enhancing qualities of the qualitative characteristics? What is the role of enhancing qualities in the conceptual framework?
13. According to the FASB conceptual framework, the objective of financial reporting for business enterprises is based on the needs of the users of financial statements. Explain the level of sophistication that the Board assumes about the users of financial statements.
14. What is the distinction between comparability and consistency?
15. Why is it necessary to develop a definitional framework for the elements of accounting?
16. Expenses, losses, and distributions to owners are all decreases in net assets. What are the distinctions among them?
17. Revenues, gains, and investments by owners are all increases in net assets. What are the distinctions among them?
18. What is meant by recognition and derecognition?
19. Explain the presentation concept.
20. What are the four basic operational concepts of GAAP?
21. The life of a business is divided into specific time periods, usually a year, to measure the results of operations for each such time period and to portray financial conditions at the end of each period.
  - a. This practice is based on the accounting assumption that the life of the business consists of a series of time periods and that it is possible to measure accurately the results of operations for each period. Comment on the validity and necessity of this assumption.
  - b. What has been the effect of this practice on accounting? What is its relation to the accrual system? What influence has it had on accounting entries and methodology?
22. What is the basic accounting problem created by the monetary unit assumption when there is significant inflation? What appears to be the FASB position on a stable monetary unit?
23. What is the definition of fair value?
24. Briefly describe the fair value hierarchy.
25. Explain the revenue recognition principle.
26. What is a performance obligation, and how is it used to determine when revenue should be recognized?
27. What are the five steps used to determine the proper time to recognize revenue?
28. Selane Eatery operates a catering service specializing in business luncheons for large corporations. Selane requires customers to place their orders 2 weeks in advance of the scheduled events. Selane bills its customers on the tenth day of the month following the date of service and requires that payment be made within 30 days of the billing date. Conceptually, when should Selane recognize revenue related to its catering service?
29. Three expense recognition methods (associating cause and effect, systematic and rational allocation, and immediate recognition) were discussed in the text under the expense recognition principle. Indicate the basic nature of each of these expense recognition methods and give two examples of each.
30. Briefly describe the types of information concerning financial position, income, and cash flows that might be provided (a) within the main body of the financial statements, (b) in the notes to the financial statements, or (c) as supplementary information.
31. In January 2029, Janeway Inc. doubled the amount of its outstanding stock by selling on the market an additional 10,000 shares to finance an expansion of the business. You propose that this information be shown by a footnote on the balance sheet as of December 31, 2028. The president objects, claiming that this sale took place after December 31, 2028, and therefore should not be shown. Explain your position.
32. Describe the major constraint inherent in the presentation of accounting information.
33. What are some of the costs of providing accounting information? What are some of the benefits of accounting information? Describe the cost-benefit factors that should be considered when new accounting standards are being proposed.
34. What are the sources of pressure that change and influence the development of GAAP?
35. Some individuals have indicated that the FASB must be cognizant of the economic consequences of its pronouncements. What is meant by “economic consequences”? What dangers exist if politics play too much of a role in the development of GAAP?
36. One writer recently noted that 99.4% of all companies prepare statements that are in accordance with GAAP. Why then is there such concern about fraudulent financial reporting?
37. What is the “expectations gap”? What is the profession doing to try to close this gap?
38. What are some of the major challenges facing the accounting profession?
39. How are financial accountants challenged in their work to make ethical decisions? Is technical mastery of GAAP not sufficient for the practice of financial accounting?

## Brief Exercises

**BE1.1 (LO 1)** Presented below are four statements, which you are to identify as true or false. If false, explain why the statement is false.

1. GAAP is the term used to indicate the whole body of FASB authoritative literature.
2. Any company claiming compliance with GAAP must comply with most standards and interpretations but does not have to follow the disclosure requirements.
3. The primary governmental body that has influence over the FASB is the SEC.
4. The FASB has a government mandate and therefore does not have to follow due process in issuing a standard.

**BE1.2 (LO 1)** Wayne Rogers, an administrator at a major university, recently said, “I’ve got some CDs in my IRA, which I set up to beat the IRS.” As elsewhere, in the world of accounting and finance, it often helps to be fluent in abbreviations and acronyms. Presented below is a list of common accounting acronyms. Identify the term for which each acronym stands, and provide a brief definition of each term.

- |           |          |
|-----------|----------|
| a. AICPA. | e. CPA.  |
| b. FAF.   | f. FASB. |
| c. FASAC. | g. SEC.  |
| d. GAAP.  | h. IASB. |

**BE1.3 (LO 2)** Match the qualitative characteristics below with the following statements.

- |                             |                   |
|-----------------------------|-------------------|
| 1. Relevance.               | 5. Comparability. |
| 2. Faithful representation. | 6. Completeness   |
| 3. Predictive value.        | 7. Neutrality.    |
| 4. Confirmatory value.      | 8. Timeliness.    |
- Quality of information that permits users to identify similarities in and differences between two sets of economic phenomena.
  - Having information available to users before it loses its capacity to influence decisions.
  - Information about an economic phenomenon that has value as an input to the processes used by capital providers to form their own expectations about the future.
  - Information that is capable of making a difference in the decisions of users in their capacity as capital providers.
  - Absence of bias intended to attain a predetermined result or to induce a particular behavior.

**BE1.4 (LO 2)** Match the qualitative characteristics below with the following statements.

- |                       |                             |
|-----------------------|-----------------------------|
| 1. Timeliness.        | 5. Faithful representation. |
| 2. Completeness.      | 6. Relevance.               |
| 3. Free from error.   | 7. Neutrality.              |
| 4. Understandability. | 8. Confirmatory value.      |
- Quality of information that assures users that information represents the economic phenomena that it purports to represent.
  - Information about an economic phenomenon that corrects past or present expectations based on previous evaluations.
  - The extent to which information is accurate in representing the economic substance of a transaction.
  - Includes all the information that is necessary for a faithful representation of the economic phenomena that it purports to represent.
  - Quality of information that allows users to comprehend its meaning.

**BE1.5 (LO 2)** Identify which qualitative characteristic of accounting information is best described in each item below. (Do not use relevance and faithful representation.)

- The annual reports of **Best Buy Co.** are audited by certified public accountants.
- Black & Decker** and **Cannondale Corporation** both use the FIFO cost flow assumption.
- Starbucks Corporation** has used straight-line depreciation since it began operations.
- Motorola** issues its quarterly reports immediately after each quarter ends.

**BE1.6 (LO 2)** Presented below are three different transactions related to materiality. Explain whether you would classify these transactions as material.

- Blair Co. has reported a positive trend in earnings over the last 3 years. In the current year, it reduces its bad debt allowance to ensure another positive earnings year. The impact of this adjustment is equal to 3% of net income.
- Hindi Co. has an unusual gain of \$3.1 million on the sale of plant assets and a \$3.3 million loss on the sale of investments. It decides to net the gain and loss because the net effect is considered immaterial. Hindi Co.’s income for the current year was \$10 million.
- Damon Co. expenses all capital equipment under \$2,500 on the basis that it is immaterial. The company has followed this practice for a number of years.

**BE1.7 (LO 2)** For each item below, indicate to which category of elements of financial statements it belongs.

- |                                |                                |
|--------------------------------|--------------------------------|
| a. Retained earnings.          | f. Loss on sale of equipment.  |
| b. Sales revenue.              | g. Interest payable.           |
| c. Additional paid-in capital. | h. Dividends.                  |
| d. Inventory.                  | i. Gain on sale of investment. |
| e. Depreciation.               | j. Issuance of common stock.   |

**BE1.8 (LO 2)** Indicate the accounting for each of the following expenditures as an asset or an expense. Justify your choices. Assume all items are material.

- Legal fees paid in connection with the purchase of land are \$1,500.
- Eduardo, Inc. paves the driveway leading to the office building at a cost of \$21,000.
- A meat market purchases a meat-grinding machine at a cost of \$3,500.
- On June 30, Monroe and Meno, medical doctors, pay 6 months' office rent to cover the month of July and the next 5 months.
- Smith's Hardware Company pays \$9,000 in wages to laborers for construction on a building to be used in the business.
- Alvarez's Florists pays wages of \$2,100 for the month to an employee who serves as the driver of their delivery truck.

**BE1.9 (LO 3)** Identify which basic assumption of accounting is best described in each item below.

- The economic activities of **FedEx Corporation** are divided into 12-month periods for the purpose of issuing annual reports.
- Solectron Corporation**, Inc. does not adjust amounts in its financial statements for the effects of inflation.
- Walgreen Co.** reports current and noncurrent classifications in its balance sheet.
- The economic activities of **General Electric** and its subsidiaries are merged for accounting and reporting purposes.

**BE1.10 (LO 3)** If the going concern assumption is not made in accounting, discuss the differences in the amounts shown in the financial statements for the following items.

- Land.
- Depreciation expense on equipment.
- Inventory.
- Prepaid insurance.

**BE1.11 (LO 3)** Identify which basic principle of accounting is best described in each item below.

- Norfolk Southern Corporation** reports revenue in its income statement when the performance obligation is satisfied instead of when the cash is collected.
- Yahoo!** recognizes depreciation expense for a machine over the 2-year period during which that machine helps the company earn revenue.
- Oracle Corporation** reports information about pending lawsuits in the notes to its financial statements.
- Gap, Inc.** reports land on its balance sheet at the amount paid to acquire it, even though the estimated fair value is greater.

**BE1.12 (LO 3)** Vande Velde Company made three investments during 2028. (1) It purchased 1,000 shares of Sastre Company, a start-up company. Vande Velde made the investment based on valuation estimates from an internally developed model. (2) It purchased 2,000 shares of **GE** stock, which trades on the NYSE. (3) It invested \$10,000 in local development authority bonds. Although these bonds do not trade on an active market, their value closely tracks movements in U.S. Treasury bonds. Where will Vande Velde report these investments in the fair value hierarchy?

**BE1.13 (LO 3)** What accounting assumption, principle, or constraint would **Target Corporation** use in each of the situations below?

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

## Exercises

**E1.1 (LO 1) Writing (Need for GAAP)** Some argue that having various organizations establish accounting principles is wasteful and inefficient. Rather than mandating accounting rules, each company could voluntarily disclose the type of information it considered important. In addition, if an investor wants additional information, the investor could contact the company and pay to receive the additional information desired.

### Instructions

Comment on the appropriateness of this viewpoint.

**E1.2 (LO 1, 4) (Financial Reporting and Accounting Standards)** Answer the following multiple-choice questions.

1. GAAP stands for:
  - a. governmental auditing and accounting practices.
  - b. generally accepted attest principles.
  - c. government audit and attest policies.
  - d. generally accepted accounting principles.
2. Accounting standard-setters use the following process in establishing accounting standards:
  - a. Research, exposure draft, discussion paper, standard.
  - b. Discussion paper, research, exposure draft, standard.
  - c. Research, preliminary views, discussion paper, standard.
  - d. Research, discussion paper, exposure draft, standard.
3. GAAP is comprised of:
  - a. FASB standards, interpretations, and concepts statements.
  - b. FASB financial standards.
  - c. FASB standards, interpretations, EITF consensuses, and accounting rules issued by FASB predecessor organizations.
  - d. any accounting guidance included in the FASB Codification.
4. The authoritative status of the conceptual framework is as follows.
  - a. It is used when there is no standard or interpretation related to the reporting issues under consideration.
  - b. It is not as authoritative as a standard but takes precedence over any interpretation related to the reporting issue.
  - c. It takes precedence over all other authoritative literature.
  - d. It has no authoritative status.
5. The objective of financial reporting places the most emphasis on:
  - a. reporting to capital providers.
  - b. reporting on stewardship.
  - c. providing specific guidance related to specific needs.
  - d. providing information to individuals who are experts in the field.
6. General-purpose financial reports are prepared primarily for:
  - a. internal users.
  - b. external users.
  - c. auditors.
  - d. government regulators.
7. Economic consequences of accounting standard-setting means:
  - a. standard-setters must give first priority to ensuring that companies do not suffer any adverse effect as a result of a new standard.
  - b. standard-setters must ensure that no new costs are incurred when a new standard is issued.

- c. the objective of financial reporting should be politically motivated to ensure acceptance by the general public.
  - d. accounting standards can have detrimental impacts on the wealth levels of the providers of financial information.
8. The expectations gap is:
- a. what financial information management provides and what users want.
  - b. what the public thinks accountants should do and what accountants think they can do.
  - c. what the governmental agencies want from standard-setting and what the standard-setters provide.
  - d. what the users of financial statements want from the government and what is provided.

**E1.3 (LO 2) (Usefulness, Objective of Financial Reporting)** Indicate whether the following statements about the conceptual framework are true or false. If false, provide a brief explanation supporting your position.

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

**E1.4 (LO 2) (Usefulness, Objective of Financial Reporting, Qualitative Characteristics)** Indicate whether the following statements about the conceptual framework are true or false. If false, provide a brief explanation supporting your position.

- a. The fundamental qualitative characteristics that make accounting information useful are relevance and verifiability.
- b. Relevant information only has predictive value, confirmatory value, or both.
- c. Information that is a faithful representation is characterized as having predictive or confirmatory value.
- d. Comparability pertains only to the reporting of information in a similar manner for different companies.
- e. Verifiability is solely an enhancing characteristic for faithful representation.
- f. In preparing financial reports, it is assumed that users of the reports have reasonable knowledge of business and economic activities.

**E1.5 (LO 2) Groupwork (Qualitative Characteristics)** SFAC No. 8, Chapter 3, identifies the qualitative characteristics that make accounting information useful. Presented below are a number of questions related to these qualitative characteristics and underlying constraint.

- a. What is the quality of information that enables users to confirm or correct prior expectations?
- b. Identify the pervasive constraint developed in the conceptual framework.
- c. The chairman of the SEC at one time noted, "If it becomes accepted or expected that accounting principles are determined or modified in order to secure purposes other than economic measurement, we assume a grave risk that confidence in the credibility of our financial information system will be undermined." Which qualitative characteristic of accounting information should ensure that such a situation will not occur? (Do not use faithful representation.)
- d. Muruyama Corp. switches from FIFO to average-cost to FIFO over a 2-year period. Which qualitative characteristic of accounting information is not followed?
- e. Assume that the profession permits the savings and loan industry to defer losses on investments it sells because immediate recognition of the loss may have adverse economic consequences on the industry. Which qualitative characteristic of accounting information is not followed? (Do not use relevance or faithful representation.)
- f. What are the two fundamental qualities that make accounting information useful for decision-making?

- g. Watteau Inc. does not issue its first-quarter report until after the second quarter's results are reported. Which qualitative characteristic of accounting is not followed? (Do not use relevance.)
- h. Predictive value is an ingredient of which of the two fundamental qualities that make accounting information useful for decision-making purposes?
- i. Duggan, Inc. is the only company in its industry to depreciate its plant assets on a straight-line basis. Which qualitative characteristic of accounting information may not be followed?
- j. Roddick Company has attempted to determine the replacement cost of its inventory. Three different appraisers arrive at substantially different amounts for this value. The president, nevertheless, decides to report the middle value for external reporting purposes. Which qualitative characteristic of information is lacking in these data? (Do not use relevance or faithful representation.)

**E1.6 (LO 2) (Qualitative Characteristics)** The qualitative characteristics that make accounting information useful for decision-making purposes are as follows.

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

### Instructions

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

- a. The qualitative characteristic being employed when companies in the same industry are using the same accounting principles.
- b. Quality of information that confirms users' earlier expectations.
- c. Imperative for providing comparisons of a company from period to period.
- d. Ignores the economic consequences of a standard or rule.
- e. Requires a high degree of consensus among individuals on a given measurement.
- f. Predictive value is an ingredient of this fundamental quality of information.
- g. Four qualitative characteristics that are related to both relevance and faithful representation.
- h. An item is not recorded because its effect on income would not change a decision.
- i. Neutrality is an ingredient of this fundamental quality of accounting information.
- j. Two fundamental qualities that make accounting information useful for decision-making purposes.
- k. Issuance of interim reports is an example of what enhancing quality of relevance?

**E1.7 (LO 2) (Elements of Financial Statements)** Ten interrelated elements that are most directly related to measuring the performance and financial status of an enterprise are provided below.

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

### Instructions

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

- a. Decreases in equity except those that result from expenses or distributions to owners.
- b. Obligation to transfer economic benefits.
- c. Increases ownership interest.
- d. Declares and pays cash dividends to owners.
- e. Increases in net assets in a period from nonowner sources.
- f. Items characterized by service potential or future economic benefit.
- g. Equals increase in assets less liabilities during the year, after adding distributions to owners and subtracting investments by owners.
- h. Arises from income statement activities that constitute the entity's ongoing major or central operations.
- i. Residual interest in the assets of the enterprise after deducting its liabilities.

- j. Increases assets during a period through the sale of product.
- k. Includes all changes in equity during the period, except those resulting from investments by owners and distributions to owners.

**E1.8 (LO 3) (Assumptions, Principles, and Constraint)** Presented below are the assumptions, principles, and constraint used in this chapter.

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

### Instructions

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

- a. Allocates expenses to revenues in the proper period.
- b. Indicates that fair value changes subsequent to purchase are not recorded in the accounts. (Do not use revenue recognition principle.)
- c. Ensures that all relevant financial information is reported.
- d. Rationale why plant assets are not reported at liquidation value. (Do not use historical cost principle.)
- e. Indicates that personal and business record keeping should be separately maintained.
- f. Separates financial information into time periods for reporting purposes.
- g. Assumes that the dollar is the “measuring stick” used to report on financial performance.

**E1.9 (LO 3) (Assumptions, Principles, and Constraint)** Presented below are a number of operational guidelines and practices that have developed over time.

### Instructions

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

- a. Fair value changes are not recognized in the accounting records.
- b. Financial information is presented so that investors will not be misled.
- c. Intangible assets are amortized over periods benefited.
- d. Agricultural companies use fair value for purposes of valuing crops.
- e. Each company is kept as a unit distinct from its owner or owners.
- f. All significant post-balance-sheet events are disclosed.
- g. Revenue is recorded when the product is delivered.
- h. All important aspects of bond indentures are presented in financial statements.
- i. Rationale for accrual accounting.
- j. The use of consolidated statements is justified.
- k. Reporting must be done at defined time intervals.
- l. An allowance for doubtful accounts is established.
- m. Goodwill is recorded only at the time of purchase.
- n. A company charges its sales commission costs to expense.

**E1.10 (LO 3) (Full Disclosure Principle)** Presented below are a number of facts related to Weller, Inc. Assume that no mention of these facts was made in the financial statements and the related notes.

**Instructions**

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

- The company decided that, for the sake of conciseness, only net income should be reported on the income statement. Details as to revenues, cost of goods sold, and expenses were omitted.
- Equipment purchases of \$170,000 were partly financed during the year through the issuance of a \$110,000 note payable. The company offset the equipment against the note payable and reported plant assets at \$60,000.
- Weller has reported its ending inventory at \$2,100,000 in the financial statements. No other information related to inventories is presented in the financial statements and related notes.
- The company changed its method of valuing inventories from weighted-average to FIFO. No mention of this change was made in the financial statements.

**E1.11 (LO 3) Groupwork (Accounting Principles and Assumptions—Comprehensive)** Presented below are a number of business transactions that occurred during the current year for Gonzales, Inc.

**Instructions**

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

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

Miscellaneous Expense	63,000	
Cash		63,000

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

Inventory	70,000	
Sales Revenue		70,000

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

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

- Because of a “fire sale,” equipment obviously worth \$200,000 was acquired at a cost of \$155,000. The following entry was made.

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

**E1.12 (LO 3) Groupwork (Accounting Principles—Comprehensive)** Presented below is information related to Cramer, Inc.

**Instructions**

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

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

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

- Materials were purchased on January 1, 2028, for \$120,000 and this amount was entered in the Materials account. On December 31, 2028, the materials would have cost \$141,000, so the following entry is made.

Inventory	21,000	
Gain on Inventories		21,000

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

Equipment	135,000	
Common Stock		135,000

- d. During the year, the company sold certain equipment for \$285,000, recognizing a gain of \$69,000. Because the controller believed that new equipment would be needed in the near future, she decided to defer the gain and amortize it over the life of any new equipment purchased.
- e. An order for \$61,500 has been received from a customer for products on hand. This order was shipped on January 9, 2029. The company made the following entry in 2028.

Accounts Receivable	61,500	
Sales Revenue		61,500

## Using Your Judgment

### Financial Reporting Problem: The Procter and Gamble Company (P&G)

**UYJ1.1** The financial statements of **P&G** are presented in Appendix B. The company's complete annual report, including the notes to the financial statements, is available online.

#### Instructions

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

- Using the notes to the consolidated financial statements, determine P&G's revenue recognition policies. Discuss the impact of trade promotions on P&G's financial statements.
- Give two examples of where historical cost information is reported in P&G's financial statements and related notes. Give two examples of the use of fair value information reported in either the financial statements or related notes.
- What is P&G's accounting policy related to advertising? What accounting principle does P&G follow regarding accounting for advertising? Where are advertising expenses reported in the financial statements?

### Comparative Analysis Case: The Coca-Cola Company and PepsiCo, Inc.

**UYJ1.2** The financial statements of **Coca-Cola** and **PepsiCo** are presented in Appendices C and D, respectively. The companies' complete annual reports, including the notes to the financial statements, are available online.

#### Instructions

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

- What are the primary lines of business of these two companies as shown in their notes to the financial statements?
- Which company has the dominant position in beverage sales?
- How are inventories for these two companies valued? What cost allocation method is used to report inventory? How does their accounting for inventories affect comparability between the two companies?

## Accounting, Analysis, and Principles

**UYJ1.3** William Murray achieved one of his lifelong dreams by opening his own business, The Caddie Shack Driving Range, on May 1, 2028. He invested \$20,000 of his own savings in the business. He paid \$6,000 cash to have a small building constructed to house the operations and spent \$800 on golf clubs, golf balls, and yardage signs. Murray leased 4 acres of land at a cost of \$1,000 per month. (He paid the first month's rent in cash.) During the first month, advertising costs totaled \$750, of which \$150 was unpaid at the end of the month. Murray paid his three nephews \$400 for retrieving golf balls. He deposited in the company's bank account all revenues from customers (\$4,700). On May 15, Murray withdrew \$800

in cash for personal use. On May 31, the company received a utility bill for \$100 but did not immediately pay it. On May 31, the balance in the company bank account was \$15,100.

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

### Accounting

Prepare a balance sheet at May 31, 2028. Murray appropriately records any depreciation expense on a quarterly basis. How could Murray have determined that the business operated at a profit of \$1,650? How could Murray conclude that the business operated at a loss of \$4,900?

### Analysis

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

### Principles

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

## Developing Your Professional Skills

### Critical-Thinking Cases

**CT1.1 (LO 1) (Securities and Exchange Commission)** The U.S. Securities and Exchange Commission (SEC) was created in 1934 and consists of five commissioners and a large professional staff. The SEC professional staff is organized into five divisions and several principal offices. The primary objective of the SEC is to support fair securities markets. The SEC also strives to foster enlightened stockholder participation in corporate decisions of publicly traded companies. The SEC has a significant presence in financial markets, the development of accounting practices, and corporation-shareholder relations, and has the power to exert influence on entities whose actions lie within the scope of its authority.

#### Instructions

- Explain from where the Securities and Exchange Commission receives its authority.
- Describe the official role of the Securities and Exchange Commission in the development of financial accounting theory and practices.
- Discuss the interrelationship between the Securities and Exchange Commission and the Financial Accounting Standards Board with respect to the development and establishment of financial accounting theory and practices.

(CMA adapted)

**CT1.2 (LO 2) (Conceptual Framework—General)** Wayne Cooper has some questions regarding the theoretical framework in which GAAP is set. He knows that the FASB and other predecessor organizations have attempted to develop a conceptual framework for accounting theory formulation. Yet, Wayne's supervisors have indicated that these theoretical frameworks have little value in the practical sense (i.e., in the real world). Wayne did notice that accounting rules seem to be established after the fact rather than before. He thought this indicated a lack of theory structure but never really questioned the process at school because he was too busy doing the homework.

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

#### Instructions

- Help Wayne recognize the purpose and benefit of a conceptual framework.
- Identify any *Statements of Financial Accounting Concepts* issued by the FASB that may be helpful to Wayne in developing his theoretical background.

**CT1.3 (LO 2, 4) Writing (Conceptual Framework—General)** The Financial Accounting Standards Board (FASB) has developed a conceptual framework for financial accounting and reporting. The FASB has issued *Statement of Financial Accounting Concepts No. 8* that has eight chapters. These statements are intended to set forth the objective and fundamentals that will be the basis for developing financial accounting and reporting standards. The objective identifies the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties.

The purpose of Chapter 3 on qualitative characteristics is to examine the characteristics that make accounting information useful. These characteristics or qualities of information are the ingredients that make information useful and the qualities to be sought when accounting choices are made.

### Instructions

- Identify and discuss the benefits that can be expected to be derived from the FASB's conceptual framework.
- What is the most important quality of accounting information as identified in the conceptual framework? Explain why it is the most important.
- Chapter 3 of *Statement of Financial Accounting Concepts No. 8* describes a number of key characteristics or qualities for accounting information. Briefly discuss the importance of any three of these qualities for financial reporting purposes.

(CMA adapted)

**CT1.4 (LO 2) (Objective of Financial Reporting)** Homer Winslow and Jane Alexander are discussing various aspects of the FASB's concepts statement on the objective of financial reporting. Homer indicates that this pronouncement provides little, if any, guidance to the practicing professional in resolving accounting controversies. He believes that the statement provides such broad guidelines that it would be impossible to apply the objective to present-day reporting problems. Jane concedes this point but indicates that the objective is still needed to provide a starting point for the FASB in helping to improve financial reporting.

### Instructions

- Indicate the objective established in the conceptual framework.
- What do you think is the meaning of Jane's statement that the FASB needs a starting point to resolve accounting controversies?

**CT1.5 (LO 2) (Qualitative Characteristics)** Accounting information provides useful information about business transactions and events. Those who provide and use financial reports must often select and evaluate accounting alternatives. The FASB statement on qualitative characteristics of accounting information examines the characteristics of accounting information that make it useful for decision-making. It also points out that various limitations inherent in the measurement and reporting process may necessitate trade-offs or sacrifices among the characteristics of useful information.

### Instructions

- Describe briefly the following characteristics of useful accounting information.
  - Relevance.
  - Faithful representation.
  - Understandability.
  - Comparability.
  - Consistency.
- For each of the following pairs of information characteristics, give an example of a situation in which one of the characteristics may be sacrificed in return for a gain in the other.
  - Relevance and faithful representation.
  - Relevance and consistency.
  - Comparability and consistency.
  - Relevance and understandability.
- What criterion should be used to evaluate trade-offs between information characteristics?

**CT1.6 (LO 3) (Revenue Recognition Principle)** After the presentation of your report on the examination of the financial statements to the board of directors of Piper Publishing Company, one of the new directors expresses surprise that the income statement assumes that an equal proportion of the revenue is recognized with the publication of every issue of the company's magazine. She feels that the "crucial event" in the process of earning revenue in the magazine business is the cash sale of the subscription. She says that she does not understand why most of the revenue cannot be "recognized" in the period of the cash sale.

### Instructions

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

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

**CT1.7 (LO 3) (Expense Recognition Principle)** An accountant must be familiar with the concepts involved in determining the earnings of a business entity. The amount of earnings reported for a business entity is dependent on the proper recognition, in general, of revenues and expenses for a given time period. In some situations, costs are recognized as expenses at the time of product sale. In other situations, guidelines have been developed for recognizing costs as expenses or losses by other criteria.

### Instructions

- a. Explain the rationale for recognizing costs as expenses at the time of product sale.
- b. What is the rationale underlying the appropriateness of treating costs as expenses of a period instead of assigning the costs to an asset? Explain.
- c. In what general circumstances would it be appropriate to treat a cost as an asset instead of as an expense? Explain.
- d. Some expenses are assigned to specific accounting periods on the basis of systematic and rational allocation of asset cost. Explain the underlying rationale for recognizing expenses on the basis of systematic and rational allocation of asset cost.
- e. Identify the conditions under which it would be appropriate to treat a cost as a loss.

(AICPA adapted)

**CT1.8 (LO 3) (Expense Recognition Principle)** Accountants try to prepare income statements that are as accurate as possible. A basic requirement in preparing accurate income statements is to record costs and revenues properly. Proper recognition of costs and revenues requires that costs resulting from typical business operations be recognized in the period in which they expired.

### Instructions

- a. List three criteria that can be used to determine whether such costs should appear as charges in the income statement for the current period.
- b. As generally presented in financial statements, the following items or procedures have been criticized as improperly recognizing costs. Briefly discuss each item from the viewpoint of matching costs with revenues and suggest corrective or alternative means of presenting the financial information.
  1. Receiving and handling costs.
  2. Cash discounts on purchases.

**CT1.9 (LO 3) (Expense Recognition Principle)** Daniel Barenboim sells and erects shell houses, that is, frame structures that are completely finished on the outside but are unfinished on the inside except for flooring, partition studding, and ceiling joists. Shell houses are sold chiefly to customers who are handy with tools and who have time to do the interior wiring, plumbing, wall completion and finishing, and other work necessary to make the shell houses livable dwellings.

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

**Instructions**

- a. A choice must be made between (1) expensing the costs of sample display houses in the periods in which the expenditure is made and (2) spreading the costs over more than one period. Discuss the advantages of each method.
- b. Would it be preferable to amortize the cost of display houses on the basis of (1) the passage of time or (2) the number of shell houses sold? Explain.

(AICPA adapted)

**CT1.10 (LO 2) Writing (Qualitative Characteristics)** Recently, your uncle, Carlos Beltran, who knows that you always have your eye out for a profitable investment, has discussed the possibility of your purchasing some corporate bonds. He suggests that you may wish to get in on the “ground floor” of this deal. The bonds being issued by Neville Corp. are 10-year debentures which promise a 40% rate of return. Neville manufactures novelty/party items.

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

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

**Instructions**

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

**CT1.11 (LO 3, 4) Ethics (Expense Recognition Principle)** Anderson Nuclear Power Plant will be “retired” at the end of its useful life (approximately 20 years) at great expense. The expense recognition principle requires that expenses be recognized as assets are used up or liabilities are incurred. Accountants Ana Alicia and Ed Bradley argue whether it is better to allocate the expense of mothballing over the next 20 years or ignore it until mothballing occurs.

**Instructions**

Answer the following questions.

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

**CT1.12 (LO 3) (Cost Constraint)** The AICPA Special Committee on Financial Reporting proposed the following constraints related to financial reporting.

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

**Instructions**

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

**CT1.13 (LO 4) Ethics (Rule-Making Issues)** When the FASB issues new pronouncements, the implementation date is usually 12 months from the date of issuance, with early implementation encouraged. Karen Weller, the controller, discusses with her financial vice president the need for early implementation of a rule that would result in a fairer presentation of the company's financial condition and earnings. When the financial vice president determines that early implementation of the rule will adversely affect the reported net income for the year, he discourages Weller from implementing the rule until it is required.

**Instructions**

Answer the following questions.

- What, if any, is the ethical issue involved in this case?
- Is the financial vice president acting improperly or immorally?
- What does Weller have to gain by advocacy of early implementation?
- Which stakeholders might be affected by the decision against early implementation?

(CMA adapted)

**CT1.14 (LO 4) (Models for Setting GAAP)** Presented below are three models for setting GAAP.

- The purely political approach, where national legislative action decrees GAAP.
- The private, professional approach, where GAAP is set and enforced by private professional actions only.
- The public/private mixed approach, where GAAP is basically set by private-sector bodies that behave as though they were public agencies and whose standards to a great extent are enforced through governmental agencies.

**Instructions**

- Which of these three models best describes standard-setting in the United States? Provide justification for your answer.
- Why do companies, financial analysts, labor unions, industry trade associations, and others take such an active interest in standard-setting?
- Cite an example of a group other than the FASB that attempts to establish accounting standards. Speculate as to why another group might wish to set its own standards.

**CT1.15 (LO 4) (Economic Consequences)** Presented below are comments made in the financial press.

**Instructions**

Prepare responses to the requirements in each item.

- Rep. John Dingell, at one time the ranking Democrat on the House Commerce Committee, threw his support behind the FASB's controversial derivatives accounting standard and encouraged the FASB to adopt the rule promptly. Indicate why a member of Congress might feel obligated to comment on this proposed FASB standard.
- In a strongly worded letter to Senator Lauch Faircloth (R-NC) and House Banking Committee Chairman Jim Leach (R-IA), the American Institute of Certified Public Accountants (AICPA) cautioned against government intervention in the accounting standard-setting process, warning that it had the potential of jeopardizing U.S. capital markets. Explain how government intervention could possibly affect capital markets adversely.

**CT1.16 (LO 4) Groupwork (GAAP and Economic Consequences)** The following letter was sent to the SEC and the FASB by leaders of the business community.

Dear Sirs:

The FASB has been struggling with accounting for derivatives and hedging for many years. The FASB has now developed, over the last few weeks, a new approach that it proposes to adopt as a final standard. We understand that the Board intends to adopt this new approach as a final standard without exposing it for public comment and debate, despite the evident complexity of the new approach, the speed with which it has been developed, and the significant changes to the exposure draft since it was released more than one year ago. Instead, the Board plans to allow only a brief review by selected parties, limited to issues of operationality and clarity, and would exclude questions as to the merits of the proposed approach.

As the FASB itself has said throughout this process, its mission does not permit it to consider matters that go beyond accounting and reporting considerations. Accordingly, the FASB may not have adequately considered the wide range of concerns that have been expressed about the derivatives and hedging proposal, including concerns related to the potential impact on the capital markets, the weakening of companies' ability to manage risk, and the adverse control implications of implementing costly and complex new rules imposed at the same time as other major initiatives, including the Year 2000 issues and a single European currency. We believe that these crucial issues must be considered, if not by the FASB, then by the Securities and Exchange Commission, other regulatory agencies, or Congress.

We believe it is essential that the FASB solicit all comments in order to identify and address all material issues that may exist before issuing a final standard. We understand the desire to bring this process to a prompt conclusion, but the underlying issues are so important to this nation's businesses, the customers they serve, and the economy as a whole that expediency cannot be the dominant consideration. As a result, we urge the FASB to expose its new proposal for public comment, following the established due process procedures that are essential to acceptance of its standards, and providing sufficient time for affected parties to understand and assess the new approach.

We also urge the SEC to study the comments received in order to assess the impact that these proposed rules may have on the capital markets, on companies' risk management practices, and on management and financial controls. These vital public policy matters deserve consideration as part of the Commission's oversight responsibilities.

We believe that these steps are essential if the FASB is to produce the best possible accounting standard while minimizing adverse economic effects and maintaining the competitiveness of U.S. businesses in the international marketplace.

Very truly yours,

(This letter was signed by the chairs of 22 of the largest U.S. companies.)

### Instructions

Answer the following questions.

- a. Explain the "due process" procedures followed by the FASB in developing a financial reporting standard.
- b. What is meant by the term "economic consequences" in accounting standard-setting?
- c. What economic consequences arguments are used in this letter?
- d. What do you believe is the main point of the letter?
- e. Why do you believe a copy of this letter was sent by the business community to influential members of the U.S. Congress?

### FASB Codification

#### References

[1] FASB ASC 205-40.

[2] FASB ASC 205.

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

[4] FASB ASC 606.

### Codification Exercises

If your school has a subscription to the FASB Codification, log in and prepare responses to the following. Provide Codification references for your responses.

**CE1.1** Describe the main elements of the link labeled "Help, FAQ, Learning Guide, and About the Codification."

**CE1.2** Describe the procedures for providing feedback.

**CE1.3** Briefly describe the purpose and content of the "What's New" link.

**CE1.4** Access the glossary ("Master Glossary") at the FASB Codification website to answer the following.

- a. What is the definition of fair value?
- b. What is the definition of revenue?
- c. What is the definition of comprehensive income?

**CE1.5** Briefly describe how the organization of the FASB Codification corresponds to the elements of financial statements.

### Codification Research Case

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

#### Instructions

Go to the FASB website and access the FASB Concepts Statements and respond to the following items. (Provide paragraph citations.) When you have accessed the documents, you can use the search tool in your Internet browser.

- a. How is “materiality” defined in the conceptual framework?
- b. The concepts statements provide several examples in which specific quantitative materiality guidelines are provided to firms. Identify at least two of these examples. Do you think the materiality guidelines should be quantified? Why or why not?
- c. The concepts statements discuss the concept of “articulation” between financial statement elements. Briefly summarize the meaning of this term and how it relates to an entity’s financial statements.

## IFRS Insights

### LEARNING OBJECTIVE 5

Compare GAAP and IFRS and their standard-setting process.

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

- **Multinational corporations.** Today’s companies view the entire world as their market. For example, **Coca-Cola**, **Intel**, and **McDonald’s** generate more than 50 percent of their sales outside the United States, and many foreign companies, such as **Toyota**, **Nestlé**, and **Sony**, find their largest market to be the United States.
- **Mergers and acquisitions.** The mergers between **Fiat/Chrysler** and **Vodafone/Mannesmann** suggest that we will see even more such business combinations in the future.
- **Information technology.** As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.
- **Financial markets.** Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

Following are the key similarities and differences between GAAP (the standards issued by the Financial Accounting Standards Board) and IFRS related to the financial reporting environment.

#### Similarities

- Generally accepted accounting principles (GAAP) for U.S. companies are developed by the Financial Accounting Standards Board (FASB). The FASB is a private organization. The Securities and Exchange Commission (SEC) exercises oversight over the actions of the FASB. The IASB is also a private organization. Oversight over the actions of the IASB is regulated by IOSCO.
- Both the IASB and the FASB have essentially the same governance structure, that is, a Foundation that provides oversight, a Board, an Advisory Council, and an Interpretations Committee. In addition, a general body that involves the public interest is part of the governance structure.
- Both the IASB and the FASB are working together to find common grounds for convergence. A good example is the issuance of a standard on revenue recognition that both organizations support.
- Both the IASB and the FASB have completed their conceptual framework. The concepts are consistent between the two frameworks. For example, the objective of financial reporting and the qualitative characteristics are the same between the two frameworks.

- Both frameworks have similar measurement principles, based on historical cost and fair value concepts. The mixed model (historical cost and fair value) is essentially the same in the two frameworks. In 2011, the Boards issued a converged standard on fair value measurement so that the definition of fair value, measurement techniques, and disclosures are the same between GAAP and IFRS when fair value is used in financial statements.

## Differences

- GAAP is more detailed or rules-based. IFRS tends to be simpler and more flexible in its accounting and disclosure requirements. The difference in approach has resulted in a debate about the merits of principles-based versus rules-based standards.
- Differences between GAAP and IFRS should not be surprising because standard-setters have developed standards in response to different user needs. In some countries, the primary users of financial statements are private investors. In others, the primary users are tax authorities or central government planners. In the United States, investors and creditors have driven accounting-standard formulation.
- The IASB gives more emphasis to stewardship in its conceptual framework. The framework indicates that users need information about the resources of the entity not only to assess an entity's prospects for future cash inflows but also to determine how effectively and efficiently management has discharged their responsibilities to use the entity's existing resources (i.e., stewardship). In other words, the IASB conceptual framework explicitly discusses the need to provide information related to stewardship of an entity's resources as well as the need for information to help users understand the prospects for future net cash inflows to the entity.
- The concept of prudence is introduced to support the principle of neutrality in relation to the purpose of faithful representation. Prudence is defined as the exercise of caution when making judgments under conditions of uncertainty. As an example, prudence means that revenues are not overstated, and expenses are not understated.
- The IASB also clarified two other concepts—measurement uncertainty and substance over form. The framework indicates that measurement uncertainty does not prevent information from being useful. However, in some cases, the most relevant information may have such a high degree of uncertainty that the most useful information is that which is slightly less relevant but is subject to lower measurement uncertainty.
- Although both GAAP and IFRS are increasing the use of fair value to report assets, at this point IFRS has adopted it more broadly. For example, under IFRS, companies can apply fair value to property, plant, and equipment; natural resources; and, in some cases, intangible assets.
- The monetary unit assumption is part of each framework. However, the unit of measure will vary depending on the currency used in the country in which the company is incorporated (e.g., Chinese yuan, Japanese yen, and British pound). IFRS makes an explicit assumption that financial statements are prepared on an accrual basis.
- The economic entity assumption is also part of each framework although some cultural differences result in differences in its application. For example, in Japan many companies have formed alliances that are so strong that they act similarly to related corporate divisions although they are not actually part of the same company. IFRS defines a reporting entity as one that is required to (or chooses to) prepare financial statements. A reporting entity does not need to be a legal entity; it could be a portion of an entity or a combination of entities. GAAP uses a different definition (more aligned with legal entities).

### Additional IFRS Resources

Additional IFRS discussion with assessment is available online at Wiley Course Resources. For those who want even more IFRS coverage, *Intermediate Accounting, IFRS Fourth Edition* exists as another resource.