Objectives

After careful study of this chapter, you will be able to:

1. Explain the FASB conceptual framework.
2. Understand the relationship among the objectives of financial reporting.
3. Identify the general objective of financial reporting.
4. Describe the three specific objectives of financial reporting.
5. Discuss the types of useful information for investment and credit decision making.
6. Explain the qualities of useful accounting information.
7. Understand the accounting assumptions and principles that influence GAAP.
8. Define the elements of financial statements.
Synopsis

FASB Conceptual Framework

1. The FASB has been charged with developing a conceptual framework of accounting theory and with establishing standards for financial accounting practice.

2. The FASB divided the conceptual framework activities into several projects. The first two projects (objectives of financial reporting and qualitative characteristics of accounting information) comprise the first two Statements of Financial Accounting Concepts and are discussed in this chapter.

Objectives of Financial Reporting

3. FASB Statement of Financial Accounting Concepts No. 1 deals with the objectives of financial reporting. These objectives relate to the general-purpose financial reporting of companies. That is, they are to meet the needs of a variety of external, rather than internal, users.

4. Three broad objectives of financial reporting are identified in FASB Statement of Financial Accounting Concepts No. 1:

   (a) The general objective is to provide information that is useful to present and potential investors, creditors, and other external users for decision making. Users are expected to have a reasonable understanding of business and economic activities.

   (b) On a more specific level, the derived external user objective is to provide information useful in assessing the amounts, timing, and uncertainty of prospective cash flows to be received by external users.

   (c) The derived company objective is to provide information useful in assessing the amounts, timing, and uncertainty of prospective net cash inflows of the company.

5. Additionally, three specific objectives are identified in FASB Statement of Financial Accounting Concepts No. 1:

   (a) To provide information about a company's economic resources and the claims to those resources, that is, its economic resources, obligations, and owners' equity.

   (b) To provide information about a company's comprehensive income and its components.

   (c) To provide information about a company's cash flows.

6. According to Statement No. 1, information about comprehensive income and its components is the primary focus of financial reporting about a company's performance during a period. Comprehensive income should be measured with accrual accounting. That is, the financial effects of transactions, events, and circumstances having cash consequences should be reported in the period when they occur rather than when cash is received or paid.

7. Management is responsible for the custody and use of company resources. Financial reporting should provide information about that stewardship responsibility.

8. Financial reporting should be based on full disclosure. That is, reports should include management explanations and interpretations of benefit to external users as well as quantitative information.
Types of Useful Information

9. The FASB has identified five types of information related to the financial reporting objective to help external users assess the amounts, timing, and uncertainty of the future net cash inflows of the company. They are:

(a) **Return on investment** - Investors expect a return on the capital they invest. Before a company can provide a return on capital, the company must achieve a return of its capital. That is, the company's capital must be maintained or recovered.

(b) **Risk** - The uncertainty or unpredictability of a company's future results is known as risk. In general, the greater the risk of an investment, the higher the rate of return expected by investors and the higher the interest charged by the creditors.

(c) **Financial flexibility** - The ability of a company to respond to unexpected needs and opportunities by changing the amounts and timing of cash flows is referred to as financial flexibility.

(d) **Liquidity** - This relates to how quickly assets can be converted into cash, or liabilities can be paid.

(e) **Operating capability** - A company's ability to maintain a given physical level of operations is called its operating capability.

Qualitative Characteristics of Useful Accounting Information

10. FASB Statement of Financial Accounting Concepts No. 2 specifies qualitative characteristics of accounting information, or “ingredients” that accounting information should possess in order to be useful. The FASB hierarchy of qualitative characteristics is adapted in Exhibit 2-5 in the text.

11. The hierarchy shows two **constraints** to accounting information:

(a) **Cost-benefit** - the benefit of information must be greater than its cost.

(b) **Materiality** - the dollar amounts involved must be large enough to make a difference to decision makers. Because no quantitative guidelines were set by the FASB, materiality must be determined by judgment.

12. **Understandability** is a link between decision makers and the accounting information. Information should be understandable to broad classes of reasonably knowledgeable and diligent users.

13. **Decision usefulness** is the overall quality that accounting information must possess. The two primary qualities making accounting information useful are **relevance** and **reliability**.

14. Accounting information that can make a difference to decision makers is relevant. Relevance is closely linked to materiality: If an amount is large enough to affect the judgment of a reasonable person, that amount is material. To be relevant, information must have (a) **predictive value**, and/or (b) **feedback value**. In addition, relevant information must be **timely**.

15. Reliable information is also important for decision usefulness. To be reliable information must (a) be **verifiable**; (b) have **representational faithfulness** (when there is a relationship between the reported accounting measurements or descriptions and the economic resources, obligations, and transactions and events causing changes in these items.); and (c) be **neutral**.
16. **Comparability** is a secondary characteristic of accounting information. Information is more useful if it can be compared with similar information from other companies (intercompany comparison) and with similar information from the same company over time (intracompany comparison). Comparability is closely linked to **consistency**, the use of unchanged accounting policies and procedures from period to period.

**Accounting Assumptions and Principles**

17. The **entity** assumption distinguishes each business organization from its owners. For accounting purposes, the organization's financial records and reports are kept separate from those of the owners.

18. Following the **continuity** (or **going-concern**) assumption, it is assumed that the company will continue to operate in the near future, unless substantial evidence to the contrary exists. This assumption underlies many accounting procedures. If, however, the company appears to be verging on bankruptcy, reports should be prepared on a liquidation basis.

19. The **period-of-time** assumption enables a company to report the results of its activities after short time periods (primarily one year), rather than at the end of the company's existence.

20. An economic activity or resource is initially measured by the exchange price (historical cost) of a transaction. Because the initial exchange price is reliable, verifiable, representationally faithful, and neutral, historical cost is usually retained as the value of an item until the item is removed from the accounting records.

21. Under the **monetary unit** assumption accountants have traditionally treated the dollar, or other currency, as a stable unit of measure.

22. **Realization** is the process of converting non-cash resources or rights into cash or rights to cash. **Recognition** is the process of formally recording and reporting an item in the financial statements.

23. Occasionally, companies recognize revenue before or after the point of sale to more accurately reflect the nature of their operations. In these cases revenue is not recognized at the same time it is realized.

   (a) Revenue may be recognized during production under the **percentage-of-completion** method for certain long-term construction contracts and the **proportional performance** method for certain long-term service contracts.

   (b) When a fixed selling price exists and there is no limit to the amount that can be sold, revenue may be recognized at the end of production. This method might be used for certain valuable minerals or for farm products sold on the futures market.

   (c) When collectibility is highly uncertain, recognition may be postponed using either the **installment method** or the **cost-recovery method**. Under the installment method, a portion of each receipt is recognized as revenue. Under the cost-recovery method, no revenue is recognized until the cost of the product has been recovered.

24. The **matching** principle states that expenses involved in obtaining a period's revenues should be related to (matched against) the revenues recognized during the period.
25. The convention of conservatism states that when alternative accounting valuations are equally possible, a company should select the alternative that is least likely to overstate assets and income in the current period.

**GAAP and Financial Statements**

26. In the Conceptual Framework, the FASB identified four financial statements: the balance sheet, income statement, statement of cash flows, and statement of changes in equity. The elements of each statement are the broad classes of items comprising it. In practice, most companies prepare three primary financial statements—the balance sheet, income statement, and statement of cash flows—and present a schedule of changes in equity either as a separate statement or in a note to the financial statements.

27. The balance sheet (statement of financial position) summarizes the financial position of a company on a particular date. The three elements of the balance sheet are (a) assets, or economic resources; (b) liabilities, or economic obligations; and (c) equity, the owners' residual interest in a company's assets, after obligations have been deducted.

28. The income statement summarizes the results of a company's operations for a period of time. The four elements of an income statement are (a) revenues, increases in assets and/or decreases in liabilities due to the company's ongoing primary operations; (b) expenses, decreases in assets and/or increases in liabilities due to the company's ongoing primary operations; (c) gains, increases in the equity of the company not related to its primary operations or to investments by owners; (d) losses, decreases in the equity of the company not related to its primary operations or to distributions to owners.

29. The statement of cash flows summarizes a company's cash inflows and outflows for a period of time, and reconciles the company's beginning and ending cash balances as reported on the balance sheets. The three elements of the statement of cash flows are (a) operating cash flows, cash inflows and outflows from acquiring, selling, and delivering goods, and providing services; (b) investing cash flows, cash inflows and outflows from acquiring and selling investments, property, plant, and equipment, and intangibles, as well as from making and collecting on loans; and (c) financing cash flows, cash inflows and outflows from investments by and distributions to owners, as well as receipts from and distributions to creditors.

30. The statement of changes in equity (for a corporation generally called the statement of changes in stockholders' equity) summarizes the changes in a company's equity for a period of time and reconciles the equity items a company reports on its beginning and ending balance sheets. Two key elements of the statement of changes in equity are (a) investments by owners and (b) distributions to owners.

**IASB Framework**

31. The IASB Framework states that the objective of financial statements is to present information that is useful in making economic decisions. The Framework has two assumptions: that a company is a going concern, and that it uses accrual accounting. The Framework identifies four qualitative characteristics of financial statements: understandability, relevance, reliability, and comparability. It identifies three constraints: timeliness, balance between benefit and cost, and balance between the qualitative characteristics.

32. The IASB Framework identifies the elements (e.g., assets, income) of the financial statements, and also discusses conceptual issues related to recognition and measurement of these elements. The Framework is designed to help the IASB develop international accounting standards.
True-False Questions

Determine whether each of the following statements is true or false.

1. Liquidity is the ability of a company to respond to events by changing the amounts and timing of future cash flows.  
   **Answer: False**
   Liquidity is the ability of a company to convert its assets to cash in order to pay bills.

2. Verifiability is useful in reducing measurer bias.  
   **Answer: True**
   Verification is useful in reducing measurer bias. By using the same method to repeat measurements, both intentional and unintentional errors are reduced.

3. The entity assumption calls for separation of owners from the company for accounting purposes.  
   **Answer: True**
   The entity assumption specifically calls for separation of owners from the company for accounting purposes.

4. Accountants tailor financial statements to meet the specific information needs of individual users.  
   **Answer: False**
   To meet the needs of external users, financial statements should apply consistent principles to all companies and not tailored to one specific company.

5. According to FASB Statement of Financial Accounting Concepts No. 1, the primary focus of financial reporting is on presentation of a company's resources and obligations at a point in time.  
   **Answer: False**
   While this is one of the three specific objectives of financial reporting identified by FASB, it is not the primary focus.

6. Using accrual accounting, the financial effects of transactions, events, and circumstances having cash consequences are reported in the period when they occur.  
   **Answer: True**
   This is the definition of accrual accounting.

7. In FASB Statement of Financial Accounting Concepts No. 2, the FASB set the threshold for materiality at 8% of income.  
   **Answer: False**
   The FASB did not set overall quantitative guidelines for materiality because they felt it required judgment and that no general statement could be set that took into account all the elements of sound human judgment.

8. Timeliness, predictive value, and feedback value are components of the qualitative characteristic of reliability.  
   **Answer: False**
   These are the three qualitative components of relevance.

9. In its hierarchy of qualitative characteristics of accounting information, the FASB ranks "reliability" as the most important characteristic.  
   **Answer: False**
   Decision usefulness is the overall qualitative characteristic to be used in judging the quality of accounting information. Relevance and reliability are the two equal primary qualities of decision usefulness.
10. The historical cost principle is supported on the grounds of reliability and verifiability.  
Answer: True  
Historical cost is used because it is reliable, with source documents available to confirm the recorded amount.

11. According to the monetary unit assumption, the dollar (or other currency) is considered a stable unit of measure.  
Answer: True  
While the FASB encourages the use of supplemental disclosures to discuss the impact of changing price levels on financial statements, it still considers the dollar to be a stable unit of measurement.

12. Under the matching principle, liabilities involved in obtaining a period's assets are related to those assets.  
Answer: False  
Matching is one of the principles on which the accrual accounting system is built. These expenses are related to or “matched with” revenue in the period in which they help to generate the revenue.

13. In general, the greater the risk of an investment, the lower the rate of return expected by investors.  
Answer: False  
In order to accept a riskier investment, investors require a higher rate of return on their investments.

14. To be recognized, an item must meet the definition of an element, be measurable, be relevant and be reliable.  
Answer: True  
Recognition means the process of formally recording and reporting an item in the financial statement of a company. To be recognized, an item must meet the definition of an element, be measurable, be relevant and be reliable.

15. To be neutral, accounting information must be timely and must be prepared by an independent accountant.  
Answer: False  
Timeliness is a characteristic of relevance while neutrality is a characteristic of reliability.

16. The IASB Framework discusses conceptual issues related to the recognition and measurement of the elements of the financial statements.  
Answer: True  
The IASB Framework is similar to the FASB Conceptual Framework in that it helps to establish conceptual issues related to financial reporting.

17. The elements of the statement of cash flows are operating cash flows, investing cash flows, and marketing cash flows.  
Answer: False  
The elements of the statement of cash flows are operating cash flows, investing cash flows, and financing cash flows. Marketing cash flows is not an element of the statement of cash flows.
18. Following the qualitative characteristics of verifiability and objectivity, companies present only quantitative information in their financial reports.

**Answer: False**

While quantitative information is important, nonquantitative information is equally important. The AICPA's Special Committee on Financial Reporting prepared a comprehensive model of business reporting. This model was designed to help focus attention on a broader, integrated range of financial information to help users of financial information.
Multiple Choice Questions

Select the one best answer for each of the following questions.

1. **General** objectives of financial reporting identified in FASB Statement of Financial Accounting Concepts No. 1 do not include:
   (a) providing information tailored to the unique needs of identified user groups.
   (b) providing information useful to external users for decision making.
   (c) providing information useful in assessing the amounts, timing, and uncertainty of cash flows to be received by external users.
   (d) providing information useful in assessing the amounts, timing, and uncertainty of prospective net cash inflows of the company.

   **Answer:** (a) providing information tailored to the unique needs of identified user groups
   Answer (a) is not a general objective of financial accounting because the objectives relate to a variety of external users as opposed to identified user groups.
   Answers (b), (c), and (d) are the general objectives of financial reporting.

2. **Specific** objectives identified in FASB Statement of Financial Accounting Concepts No. 1 do not include providing information about a company's:
   (a) comprehensive income and its components.
   (b) economic resources and the claims to those resources.
   (c) compliance with regulatory requirements.
   (d) cash flows.

   **Answer:** (c) compliance with regulatory requirements
   While information regarding a company's compliance with regulatory requirements is important, it is not a specific objective of financial reporting.
   Answers (b), (c), and (d) are the specific objectives of financial reporting.

3. According to FASB Statement of Financial Accounting Concepts No. 1, the primary focus of financial reporting about a company's financial performance is information regarding:
   (a) resources and obligations.
   (b) comprehensive income and its components.
   (c) management's stewardship of resources.
   (d) cash flows, liquidity, and financial flexibility.

   **Answer:** (b) comprehensive income and its components
   The primary focus of financial reporting about a company's performance is information concerning the company's comprehensive income and its components, therefore answer (b) is correct.
   While answers (a), (c), and (d) are the specific objectives of financial reporting, they are not the primary focus of financial reporting.
4. In the hierarchy of qualitative characteristics of accounting information, components of relevance do not include:
(a) predictive value.
(b) timeliness.
(c) feedback value.
(d) verifiability.

**Answer:** (d) verifiability

Answer (d), verifiability, is a qualitative characteristic of reliability not relevance. Answers (a), (b), and (c) are all qualitative characteristics of relevance.

5. Materiality is determined:
(a) by judgment.
(b) as a proportion of net income.
(c) using quantitative guidelines issued by the FASB.
(d) all of the above.

**Answer:** (a) by judgment

The FASB did not set overall quantitative guidelines for materiality in the Statements of Concepts. It felt that materiality involves judgment, and that no general standards could be set that took into account all the elements of sound human judgment, therefore, answer (a) is correct.

Some companies will use a threshold of a percentage of net income to determine materiality. However, the use of just percentages does not consider the qualitative factors of the information, therefore answer (b) is correct. FASB specifically refused to set quantitative guidelines regarding materiality, therefore answer (c) is incorrect.

6. Realization is the:
(a) matching of expenses incurred in earning revenues of the period to those revenues.
(b) recording of revenues in the accounting records.
(c) process of earning revenue as economic utility is added to goods produced.
(d) conversion of noncash resources or rights into cash or rights to cash.

**Answer:** (d) conversion of noncash resources or rights into cash or rights to cash

Realization is defined as the process of converting noncash resources and rights into cash or rights to cash, therefore answer (d) is correct.

The matching of expenses incurred in earning revenues of the period to those revenues is the matching principle; therefore, answer (a) is incorrect. The recording of revenues in the accounting records is a portion of the recognition process; therefore, answer (b) is incorrect. Answer (c) is the definition of the earning process.

7. The principles of matching expenses against revenues do not include:
(a) arbitrary assignment.
(b) systematic and rational allocation.
(c) association of cause and effect.
(d) immediate recognition.

**Answer:** (a) arbitrary assignment

In accrual accounting, the recording of expenses is far from arbitrary; therefore, choice (c) is the correct answer. Answers (b), (c), and (d) are the three principles on which the matching principle is based.
8. Which of the following statements about the income statement is correct?
(a) The income statement covers a specific point in time.
(b) The elements of the income statement include income from operations and distributions to owners.
(c) The income statement summarizes the results of a company's operations for a period.
(d) All of the above.

**Answer:** (c) The income statement summarizes the results of a company's operations for a period.

The purpose of the income statement is to summarize a company's results during an accounting period; therefore, answer (c) is correct.

Answer (a) is incorrect because an income statement covers a period of time, not a specific point in time. Answer (b) is incorrect because distributions to owners, called dividends, are reported on the statement of cash flows.

9. The use of the same accounting principle from period to period, such as always using the straight-line method of depreciation, is preferable because of:
(a) materiality.
(b) verifiability.
(c) neutrality.
(d) consistency.

**Answer:** (d) consistency

Consistency means conformity from period to period, with accounting policies and procedures remaining unchanged. Consistency helps enhance comparability across periods.

Answer (a) is incorrect because materiality refers to the magnitude of an omission or misstatement of accounting information that makes it likely the judgment of a reasonable person relying on the information would have been influenced by the omission or misstatement. It has nothing to do with the use of the same accounting method over various periods of time. Answers (b) and (c) are both components of the qualitative characteristic of reliability.

10. A company chooses to charge to expense the entire cost of a stapler that was purchased for $25 instead of allocating the cost over the ten-year useful life of the stapler. The reason for their action can be explained by which of the following?
(a) consistency
(b) matching
(c) historical cost
(d) materiality

**Answer:** (d) materiality

Choosing to expense the entire cost of $25 as opposed to allocating the cost over the expected ten-year life of the stapler would not affect the judgment of a reasonable person because the cost is insignificant or immaterial, therefore materiality is the correct answer.

Answer (a) is incorrect because consistency refers to the use of the same accounting principles from period to period. Answer (b) is incorrect because a stickler for the matching principle would match the expense of the stapler over its entire useful life. The historical cost principle is not at use in this example because the entire cost of the stapler is expensed in the first year.
11. According to FASB Statement of Financial Accounting Concepts No. 2, the timeliness is a component of:

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<th>Reliability</th>
<th>Relevance</th>
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<td>(a) Yes</td>
<td>Yes</td>
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<td>(b) Yes</td>
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<td>(c) No</td>
<td>Yes</td>
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<td>(d) No</td>
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**Answer:** (c) Reliability - No; Relevance - Yes

The components of reliability are representational faithfulness, verifiability, and neutrality. The components of relevance are feedback value, predictive value, and timeliness. Answers (a), (b), and (d) are not correct because timeliness is a component of relevance and not reliability.

12. When alternative accounting valuations are equally possible, the accountant should select the one that is least likely to overstate the company's assets and income in the current period. This action is based on:

(a) the entity assumption.
(b) materiality.
(c) relevance.
(d) the conservatism principle.

**Answer:** (d) the conservatism principle

The conservatism principle requires that when faced with a choice in choosing accounting methods, the one least likely to overstate assets and income is chosen.

Answer (a) is incorrect because the entity assumption deals with the separation of financial records of the owners and the company. Materiality deals with the magnitude of omissions and misstatements; therefore, answer (b) is incorrect. Answer (c), relevance, is a qualitative characteristic of accounting information and is incorrect.

13. A company would report its financial statements on a liquidation basis if there was doubt about their future in accordance with which principle?

(a) materiality
(b) continuity
(c) historical cost
(d) conservatism

**Answer:** (b) continuity

Under the continuity principle, it is assumed that a company will continue to operate in the near future, unless substantial evidence to the contrary exists. If a company appears to be going bankrupt, it must discard the continuity assumption. The company then reports its financial statements on a liquidation basis, with all assets and liabilities valued at the amounts estimated to be collected or paid when they are sold or liquidated.

Materiality deals with the magnitude of omissions and misstatements; therefore, answer (a) is incorrect. Liquidation does not represent historical cost; therefore, answer (c) is incorrect. The conservatism principle requires that when faced with a choice in choosing accounting methods the one least likely to overstate assets and income is chosen. While this might appear to merit the use of the conservatism principle, the situation described is better aligned with the continuity principle.
Matching

1. Below is a list of accounting assumptions and conventions. Following the list is a series of descriptive phrases. Match each assumption and convention with its descriptive phrase by placing the appropriate letter in the space provided.

   a. entity assumption          f. prudence
   b. continuity assumption      g. matching principle
   c. period-of-time assumption   h. historical cost
   d. conservatism convention    i. realization
   e. monetary unit assumption   j. recognition

   _____ 1. Measures an economic activity or resource by the initial exchange price.
   _____ 2. The basis for adjusting entries.
   _____ 3. Relates expenses to revenues using association of cause and effect, systematic and rational allocation, and immediate recognition.
   _____ 4. Selects the accounting alternative least likely to overstate assets and income.
   _____ 5. Should not be followed if the company appears to be verging on bankruptcy.
   _____ 6. Traditional use of the dollar as a stable measuring unit.
   _____ 7. Treats a company's resources, transactions, records, and reports as separate from those of its owners under this assumption.
   _____ 8. Occasionally occurs before or after the point of sale to more accurately reflect a company's operations.
   _____ 9. Conversion of noncash resources or rights into cash or rights to cash.
   _____ 10. Favored by the FASB for those reporting about business risks and uncertainties.
2. Below is a list of phrases related to the recognition of revenue. Following the list is a series of descriptions. Match each description with the appropriate phrase or phrases to indicate the timing of revenue recognition.

   a. point of sale  
   b. percentage-of-completion method  
   c. installment method  
   d. cost-recovery method  
   e. proportional performance  
   f. completion of production

   ___  1. McKie Construction is building an office complex for the Granite Insurance Company over a four-year period.

   ___  2. Silver Company mines a mineral in great demand. The price of the mineral is supported under international agreements.

   ___  3. The Nordic Store sells kitchen appliances for cash and on credit.

   ___  4. Sunshine Resorts signed a long-term contract to sell a large condominium development to Starshine Company. Soon afterward, Starshine fell behind in its payments to Sunshine. Ultimate collectability is uncertain.

   ___  5. Drewton Software is working under a multi-year contract to develop custom software system for Clazy Corp.
Below is a list of the qualitative characteristics identified in FASB Statement of Financial Accounting Concepts No. 2. Following the list is a series of descriptive phrases. Match each characteristic with the appropriate phrase.

a. decision usefulness  
g. understandability  
b. relevance  
h. neutrality  
c. reliability  
i. verifiability  
d. predictive value  
j. representational faithfulness  
e. feedback value  
k. comparability  
f. timeliness  
l. consistency

1. Enables users to confirm or correct prior expectations.
2. Reasonable freedom from error and bias, and reports what it is intended to show.
3. The quality of being needed by users.
4. Closely linked to consistency.
5. Completeness and freedom from intentional bias.
6. Capable of duplication using the same method.
7. The use of unchanged accounting policies and procedures from period to period.
8. The overall quality that accounting information must possess.
9. Helpfulness in correctly forecasting the outcome of events.
10. Promptness allowing usefulness to decision makers.
11. Correspondence to the economic reality it represents.
12. Defined for users who are reasonably knowledgeable and willing to study the information with reasonable diligence.

**Answers to Matching**

1. 1. h 6. e  2. 1. b 3. 1. e 7. l  2. c  7. a  2. f  2. c  8. a  
   3. g  8. j  3. a  3. b  9. d  
   4. d  9. i  4. c or d  4. k  10. f  
   5. b  10. f  5. e  5. h  11. j  
   6. i  12. g