After reading this chapter, you will be able to:

1. Explain the FASB conceptual framework.
2. Understand the objective of financial reporting.
3. Identify the capital providers of a company.
4. Explain the decision-usefulness of financial reporting.
5. List the specific information that a company should provide in its financial reports.
6. Discuss the types of useful information for investment and lending decision making.
7. Explain the qualitative characteristics of useful financial information.
8. Understand the accounting assumptions and principles that influence GAAP.
9. Define the elements of financial statements.
If It’s Broken … Fix It!

U.S. GAAP is widely considered the most complete and well-developed set of accounting standards in the world. However, U.S. accounting standards recently have come under increasing criticism as being too rules-based. U.S. accounting standards are viewed as having become too long and complex, containing too many percentage tests (bright lines), and allowing numerous exceptions to the principles underlying the standards. Together, the rules-based nature of the standards is seen to have fostered a “check-the-box mentality” that allowed financial “engineers” to comply with the letter of the standards while not always showing the underlying reality of the transactions. In its review of U.S. accounting standards, the Securities and Exchange Commission (SEC) noted that the lease accounting rules are made up of approximately 16 FASB Statements and Interpretations, 9 Technical Bulletins, and more than 30 EITF Abstracts. Also, there are more than 800 pages of accounting guidance relating to derivatives. One prominent controller described recently issued accounting guidance as a mistake that was so complicated that organizations are uncertain if they can even follow the rules. What is the solution?

The SEC has recommended that future accounting standards should not follow a rules-based, nor principles-only approach, but should be “objectives-oriented.” This principles-based standard setting approach should be built on an improved and consistently applied conceptual framework. This approach should clearly state the accounting objective of the standard, provide sufficient detail and structure so that the standard can be applied consistently, minimize exceptions to the standard, and avoid the use of bright-line tests. The development of objectives-oriented standards should result in more informative financial statements by improving the relevance and faithful representation of the information provided.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have recently developed a common Conceptual Framework that will help standard setters achieve this goal.
Chapter 2 • Financial Reporting: Its Conceptual Framework

As we saw in Chapter 1, accounting standards were developed in the United States by the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB) before the inception of the Financial Accounting Standards Board (FASB). The CAP and the APB were not able to develop a broad, normative conceptual framework of accounting theory. The APB did issue APB Statement No. 4, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises.” However, this document described current practice instead of what should be appropriate accounting. Although the CAP and APB considered some accounting concepts in setting of accounting standards, generally this was limited to the concepts related to the particular accounting issue at hand. This led, at times, to accounting principles that were inconsistently applied from one issue to another. These inconsistencies led to political pressure on the FASB to develop a general set of concepts and principles to guide its standard setting. In this chapter, we discuss the conceptual framework of accounting theory. The topics in this chapter include:

• the objective of financial reporting
• the types of useful financial information
• the qualitative characteristics of useful financial information
• accounting assumptions and principles

We also include a brief review of generally accepted accounting principles and financial statements.

DEVELOPMENT OF THE FASB CONCEPTUAL FRAMEWORK

The FASB has been given two charges. First, it is to develop a conceptual framework of accounting theory. Second, it is to establish standards (generally accepted accounting principles) for financial accounting practice. The intent is to develop a theoretical foundation of interrelated objectives and concepts that leads to the establishment of consistent financial accounting and reporting standards. In other words, the conceptual framework should provide a logical structure and direction to financial accounting and reporting. This conceptual framework is expected to:

1. guide the FASB in establishing accounting standards
2. provide a frame of reference for resolving accounting questions in situations where a standard does not exist
3. determine the bounds for judgment in the preparation of financial statements
4. increase users’ understanding of and confidence in financial reporting
5. enhance comparability

The FASB expects that the conceptual framework will encourage companies to provide financial (and related) information that is useful in efficiently allocating scarce economic resources in capital and other markets.1

Exhibit 2-1 shows the relationship among the objectives, concepts, and standards, their purposes, and the documents issued by the FASB. The outputs of the conceptual framework are Statements of Financial Accounting Concepts; to date, eight have been issued. The outputs of the standard-setting process are included in the FASB Accounting Standards Codification discussed in Chapter 1. The standards contained in the Codification identify the preferable accounting practice from the various alternatives that arise in response to the changing, dynamic business environment. As much as possible, the FASB considers its conceptual framework in establishing these standards.

Because of the large task, the FASB divided its conceptual framework activities into several projects. Exhibit 2-2 shows these projects. The first project dealt with identifying

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the objectives of financial reporting. This project resulted in FASB Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises." This document established the focus of the remaining projects, which are divided into two groups (accounting and reporting). The Qualitative Characteristics Project linked

EXHIBIT 2-2 Conceptual Framework Projects for Financial Accounting and Reporting

- Objectives Project
  - Accounting Projects
  - Reporting Projects
  - Qualitative Characteristics Project

- Elements
- Recognition
- Measurement
- Financial Statements and Financial Reporting
- Income
- Cash Flow and Liquidity

Adapted from Figure 1 in "The Conceptual Framework Project," Financial Accounting Standards Board (Stamford, Conn., 1980).
together the accounting and reporting projects, as shown by the dashed lines in Exhibit 2-2. It also resulted in FASB Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information."

The accounting projects define the accounting elements (e.g., assets, liabilities, revenues, expenses) and identify which elements should be reported, when they should be reported (recognized), and how they should be measured. The reporting projects deal with how the elements of financial reports are "displayed." Important issues include general questions such as what information should be provided, who should be required to provide the information, and where the information should be presented. Also included are more specific questions about income and its components, as well as cash flow and its components.

The FASB has issued several Statements of Concepts that deal with one or more of these accounting and reporting projects. FASB Statement of Financial Accounting Concepts No. 3 was issued; however, this Statement of Concepts was replaced by FASB Statement of Financial Accounting Concepts No. 6 dealing with the elements of financial statements. FASB Statement of Financial Accounting Concepts No. 5 focused on the recognition and measurement in financial statements of business enterprises.2 FASB Statement of Financial Accounting Concepts No. 7 dealt with using cash flow information and present value in accounting measurements. An Exposure Draft, FASB Proposed Statement of Financial Accounting Concepts addressing the reporting of income, cash flows, and financial position of business enterprises, was issued regarding the reporting projects. In addition, several working documents dealing with both accounting and reporting issues were published that may eventually lead to the issuance of other statements of financial accounting concepts. We discuss the Statements of Concepts dealing with the elements, recognition and measurement, and reporting of income and cash flows in Chapters 4 and 5.

FASB Statements of Concepts Nos. 1 and 2 were issued more than 25 years ago. More recently, as we discussed in Chapter 1, the FASB and IASB have been working on a joint project to develop a common Conceptual Framework for Financial Reporting. As one FASB member states, "There are areas [in the FASB conceptual framework] that have become out-of-date given the complex . . . nature of financial reporting. That's why it's important to develop an updated framework that will serve as a better, more effective guide for us in developing improved and simplified standards for our constituents."3

The goal of the FASB and IASB is to develop a joint conceptual framework that is both complete and internally consistent. However, they concluded that a comprehensive reconsideration of all the concepts underlying financial reporting would not be an efficient use of their time. They decided to split this project into eight phases: (1) objective and qualitative characteristics, (2) elements and recognition, (3) measurement, (4) reporting entity, (5) presentation and disclosure, (6) framework for a GAAP hierarchy, (7) applicability to the not-for-profit sector, and (8) remaining issues. Each of the phases is expected to involve planning, research, and initial deliberations (currently, only phases two through four are active). Then, an initial document for each phase will be issued for input from external constituents, after which the Boards will redeliberate before issuing a final document. To date, the Boards have met separately and jointly numerous times to address the conceptual issues related to these phases. It is likely to take several years for all the phases of this project to be concluded. In the meantime, the FASB conceptual framework will be a "hybrid" containing aspects of both the existing and the joint conceptual framework.

The Boards have completed the first phase dealing with the objective of financial reporting and the qualitative characteristics of useful financial reporting information. This phase culminated in FASB Statement of Financial Accounting Concepts No. 8, "Conceptual Framework for Financial Reporting: Chapter 1: The Objective of General Purpose Financial Reporting, and Chapter 3: Qualitative Characteristics of Useful Financial Information," which we discuss in this chapter and which replaces FASB Statements of Concepts Nos. 1 and 2.

2. FASB Statement of Financial Accounting Concepts No. 4, titled "Objectives of Financial Reporting by Nonbusiness Organizations," has also been issued but is not discussed in this book.
OBJECTIVE OF FINANCIAL REPORTING

In *FASB Statement of Concepts No. 8*, the FASB states that:

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. These decisions involve buying, selling, or holding equity or debt instruments and providing or settling loans and other forms of credit.\(^4\)

This objective relates to *financial reporting*, which includes but is not limited to the company’s financial statements. The intent is to assist in the efficient allocation of resources in capital markets, so as to help in the efficient functioning of economies. Financial reporting is *general purpose* because it is intended to satisfy the needs of a wide variety of external users. These external users do not have the authority to prescribe all the financial information they need from a company and therefore must rely, at least in part, on the information provided in the company’s financial reports.\(^5\)

**Capital Providers**

Capital providers are those who have a claim to the company’s resources, and therefore have the most critical and immediate need for general-purpose financial information about the economic resources of the company. Capital providers include equity investors, lenders, and other creditors, who have common information needs. Capital providers are the primary external user group of general-purpose financial information. We show the objective of general-purpose financial reporting and its relationship to capital providers’ common information needs in Exhibit 2-3.

**Equity Investors**

Equity investors include holders of equity securities, holders of partnership interests, and other equity interests. These equity investors generally invest economic resources (usually cash) in order to receive a return on, as well as a return of, the cash they invested. In other words, they expect to receive more cash than they provided, in the form of distributions (e.g., dividends) as well as in increases in the prices of the shares they own (or other ownership interests). Therefore, equity investors are directly interested in the amount, timing, and uncertainty of a company’s future cash flows, as well as how the perception of the company’s ability to generate these cash flows affects the market price of their equity interests. They are also interested in how well the company’s management has discharged its stewardship responsibilities to safely, efficiently, and profitably use the economic resources entrusted to them.

**Lenders**

Lenders, including financial institutions and purchasers of traded debt securities (e.g., bonds), provide financial capital to a company by lending it economic resources (usually cash). Lenders generally expect to receive a return on their lending in the form of interest and repayments of borrowings (and increases in the prices of the debt securities they own). Therefore, lenders are also interested in the amount, timing, and uncertainty of a company’s future cash flows, as well as how the perception of the company’s ability to generate these cash flows affects the market price of their debt securities. They are also interested in how well the company’s management has discharged its stewardship responsibilities.

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\(^5\) The discussion in this section primarily is a summary of that presented in *FASB Statement of Financial Accounting Concepts No. 8*, *ibid.*, par. OB3–OB21.
Other Creditors

Other groups provide resources to a company as a result of their relationship with it, even though the relationship is not that of a capital provider. For example, employees provide human capital in exchange for a salary or other compensation, suppliers may extend credit for the sale of inventory and equipment to the company, and customers may prepay for goods or services to be provided by the company in the future. These groups may make decisions relating to providing “capital” to the company, and therefore would also be considered capital providers.

Decision-Usefulness of Financial Reporting in Assessing Cash Flow Prospects

A company’s capital providers are directly interested in the amount, timing, and uncertainty of their cash flows from dividends and interest, as well as from the sale, redemption, or maturity of securities or loans. The likelihood of these cash flows depends on the company’s present cash resources and its ability to generate enough cash to satisfy its operating needs (e.g., pay its employees and suppliers), to meet its obligations when due, and to reinvest in its operations. Furthermore, the judgments of capital markets participants...
about the company’s ability to generate net cash inflows affects the values of capital providers’ equity or debt securities, and the cash flows related to sales of these securities. Therefore, for capital providers to assess their likely cash flows, financial reporting must provide financial information useful in assessing the company’s prospective net cash flows, as we show in Exhibit 2-3.

Decision-Usefulness of Financial Reporting in Assessing Stewardship
A company’s management is responsible to the company’s capital providers for safely, efficiently, and profitably using its economic resources. Management is responsible for protecting the company’s economic resources from unfavorable effects of economic factors (e.g., price changes, technological changes). Management is also responsible for ensuring that the company complies with applicable laws and regulations, as well as contractual provisions. Management’s performance in discharging its stewardship responsibilities is important to equity investors in their decisions regarding, for example, whether to replace or reappoint company officers, how to compensate them, and how to vote on shareholders’ proposals about company policies and other matters. Because management’s performance in regard to its stewardship responsibilities usually affects the company’s ability to generate net cash flows, information about the discharge of these responsibilities is important to current and potential capital providers.

Information about a Company’s Economic Resources and Claims to These Resources
A company’s financial reports should provide information about its economic resources (its assets) and the claims to these resources (its liabilities and equity). These financial reports can provide capital providers with information useful in identifying the company’s financial strengths and weaknesses, and in assessing its liquidity (how quickly it can convert its assets into cash to pay its bills) and solvency (its ability to pay its debts over the long term). This information indicates the cash flow potentials of some assets and the cash needed to satisfy most claims of lenders and other creditors. For instance, accounts receivable are direct sources of future cash inflows, while accounts payable are direct causes of future cash outflows. However, many cash flows generated by a company’s operations are the result of combining various assets to produce, provide, and market goods or services to customers. Capital providers need to know the nature and quantity of these resources available for use in the company’s operations. Information about the company’s financial structure (i.e., its financial position) also helps users evaluate the company’s need for additional borrowing and how successful it is likely to be in obtaining this borrowing. This information is also helpful in predicting the distribution of the future cash flows to capital providers. External users may also use information in the company’s financial reports to evaluate the effectiveness of its management in discharging its stewardship responsibilities.

Information about the Changes in a Company’s Economic Resources and Claims to These Resources
A company’s financial reports should also provide information about the effects of transactions, other events, and circumstances that change the company’s economic resources and claims to these resources. This information helps capital providers assess the amount, timing, and uncertainty of the company’s future cash flows. It also helps users assess the effectiveness with which management has discharged its stewardship responsibilities. This information includes both quantitative measures and other information about changes in the company’s economic resources and claims that are (1) a result of the company’s financial performance and (2) not a result of the company’s financial performance.

Changes in a Company’s Resources and Claims Resulting from Financial Performance
A company’s financial reports provide information about the return that the company has earned on its economic resources (its “financial performance”). In the long run, a company
must provide a positive return on its economic resources to be able to generate net cash inflows, and thus provide a return to its capital providers. Both the variability of the return and the components of the return are important in evaluating the uncertainty of future cash flows. Capital providers usually find information about a company's past financial performance useful in predicting the future returns on its economic resources, as well as evaluating how well management has discharged its stewardship responsibility. Information about financial performance reflected by both accrual accounting and cash flow accounting is useful to capital providers.

**Accrual Accounting** Under accrual accounting, the financial effects of a company's transactions, other events, and circumstances having cash consequences are related to the period in which they occur instead of to when the cash receipts or payments take place. The buying, producing, selling, and other operations of a company, as well as changes in fair value, often do not occur in the same period as the related cash receipts and cash payments. Financial reports prepared under accrual accounting generally provide better information for assessing past financial performance and future prospects than simply information about cash receipts and payments. Without accrual accounting, information about important economic resources, claims to these resources, and the related changes would be excluded from the company's financial statements. This information is useful in assessing the company's past and future ability to generate net cash inflows through its operations, rather than by obtaining additional capital from capital providers. It is also useful for evaluating how changes in market prices or interest rates have affected the company's economic resources and claims to these resources, thereby affecting the company's ability to generate future net cash inflows.

The FASB and IASB noted that the net change during a period in a company's economic resources and the claims to these resources (other than those resulting from transactions with owners as owners) may be referred to by a variety of terms, such as comprehensive income, net income, or profit or loss. The Boards concluded that none of these terms communicates the critical idea that changes in a company's economic resources and claims to these resources must be recognized and measured according to applicable GAAP, and then separated into those related to claims by owners and claims by other parties. Because the terms *comprehensive income* and *net income* (measured under accrual accounting) are important measures of a company's performance under current U.S. GAAP, we will continue to use these terms throughout this book where appropriate.

**Cash Flow Accounting** Information about a company's cash flows during a period also helps capital providers assess its ability to generate future net cash inflows. Information about how a company obtains and spends cash, including information about its borrowing and repayment of borrowing, cash dividends, or other distributions to equity owners may affect the company's liquidity or solvency. Capital providers use information about a company's cash flows to understand its business model and operations, evaluate its investing and financing activities, assess its liquidity and solvency, or interpret other information about its financial performance. Thus, a company should provide cash flow accounting information in addition to accrual accounting information in its financial reports.

**Changes in a Company's Resources and Claims Not Resulting from Financial Performance** A company's financial reports should also provide information about changes in its economic resources and claims to these resources that do not result from its financial performance. For instance, a company should report on any transactions between it and its owners. This information helps capital providers distinguish between changes that result from the company's financial performance and those that do not. With this information, capital providers can evaluate to what extent the total change in a company's resources

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6. *FASB Statement of Concepts No. 1* originally used the term "earnings" instead of "comprehensive income." This latter term was substituted in *FASB Statement of Concepts No. 5* because comprehensive income includes more components. We discuss this issue more fully in Chapter 4.
Types of Useful Information

Management’s Explanations
A company’s financial reports should also include management’s explanations and other information needed to help capital providers understand the information presented. Management’s explanations enhance the ability of capital providers to assess the company’s past performance and to form expectations about its future performance. Management knows more about the company than external users and can often provide useful information by explaining particular transactions, other events, and circumstances that have affected or may affect the company. In addition, a company’s financial reports frequently include information that is based on management’s estimates and judgments. Capital providers can better evaluate the company’s financial information when management provides explanations of underlying assumptions or methods used, as well as disclosures of significant uncertainties about major assumptions or estimates.

Limitations of General-Purpose Financial Reporting
A company’s financial reports are only one source of information needed by capital providers. External users of financial reports must also consider information from other sources such as general economic conditions, political events and political climate, and industry and company outlooks. In addition, external users must understand that a company’s financial reporting information is based on estimates and judgments of the effects of certain transactions and events on the company, rather than exact depictions. In other words, capital providers must be aware of the characteristics and limitations of the information about a company provided in its financial reports.

Types of Useful Information
The objective of financial reporting is to provide information that is useful to capital providers in investment and lending decision making. On a more specific level, a company’s financial reports should provide information to help external users assess the amounts, timing, and uncertainty about its future net cash inflows. The FASB has identified five types of information as being useful in meeting these needs. Exhibit 2-4 shows

Interrelationship of Financial Reports, Useful Information, and Decision Making

- Financial Reports
  - Communication Documents
    - Types of Useful Information
      - Return on Investment
      - Risk
      - Financial Flexibility
      - Liquidity
      - Operating Capability
    - External Decision Making
      - Buy
      - Hold
      - Sell
      - Extend Credit
      - Continue Credit
      - Deny Credit
the interrelationship of this useful information with financial reports and external decision making.

**Return on Investment**

Return on investment provides a measure of overall company performance. Shareholders (stockholders) invest capital for a share of the equity (stockholders’ equity) of a company. These capital providers are concerned with a return on capital. Before a company can provide a return on capital, its capital must be maintained or recovered (i.e., first there must be a return of capital to the company). Once a company’s capital is maintained, the return on capital (i.e., comprehensive income) may be distributed to investors or may be retained by the company for reinvestment.

**Risk**

Risk is the uncertainty or unpredictability of the future results of a company. The greater the range within which a company’s future results are likely to fall, the greater the risk of an investment in or extension of credit to the company. Risk is caused by numerous factors including, for example, high rates of technological change, uncertainty about demand, exposure to the effects of price changes, and political changes in the United States and other countries. In general, the greater the risk of an investment in a particular company, the higher the rate of return expected by investors (or the higher the rate of interest charged by lenders).

**Financial Flexibility**

Financial flexibility is the ability of a company to use its financial resources to adapt to change. Financial flexibility is important because it enables a company to respond to unexpected needs and opportunities. Financial flexibility comes from a company’s ability to:

- adapt operations to increase net operating cash inflows
- raise new capital through, for instance, the sale of debt or stock securities at short notice
- obtain cash by selling assets without disrupting ongoing operations

Financial flexibility affects risk as well as cash flows. It reduces the risk of failure in the event of a shortage in net cash flows from operations.

**Liquidity**

Liquidity refers to how quickly a company can convert its assets into cash to pay its bills. Liquidity reflects an asset’s “nearness to cash.” For operating assets, liquidity relates to the timing of cash flows in the normal course of business. For nonoperating assets, liquidity refers to marketability. The liquidity of a company is an indication of its ability to meet its obligations when they come due. Liquidity is positively related to financial flexibility but negatively related to both risk and return on investment. A more liquid company is likely to have a superior ability to adapt to unexpected needs and opportunities, as well as a lower risk of failure. On the other hand, liquid assets often offer lower rates of return than nonliquid assets.

**Operating Capability**

Operating capability refers to the ability of a company to maintain a given physical level of operations. This level of operations may be indicated by (1) the quantity of goods or services (e.g., inventory) of a specified quality produced in a given period or (2) the
physical capacity of the fixed assets (e.g., property, plant, and equipment). Information about operating capability is helpful in understanding a company’s past performance and in predicting future changes in its volume of activities. Operating capability may be affected by changes in methods of operations, changes in product lines, and the timing of the replacement of the service potential used up in operations.  

**Quick Check 2-1**

- The FASB conceptual framework is intended to provide a theoretical underpinning that helps the FASB establish consistent financial accounting and reporting standards.

- The FASB and IASB are working on a joint project consisting of eight phases to develop a common conceptual framework.

- The objective of financial reporting is to provide financial information about a company that is useful to capital providers (equity investors and lenders) in making decisions about providing resources to the company.

- Financial reporting should provide financial information that is useful to capital providers in predicting the amounts, timing, and uncertainty of their future cash flows.

- Financial reporting should provide financial information that is useful to capital providers in predicting the amounts, timing, and uncertainty of a company’s future net cash flows, as well as management’s stewardship of the company’s economic resources.

- A company’s financial reports should provide:
  - financial information about the company’s economic resources (and claims to them),
  - financial information about the changes in the company’s economic resources (and claims to them), and
  - explanations by management of the information in the financial reports.

- Information relating to a company’s return on investment, risk, financial flexibility, liquidity, and operating capability is considered to be useful in predicting the amounts, timing, and uncertainty of the company’s future net cash flows.

**Qualitative Characteristics of Useful Financial Information**

In the previous sections we discussed the types of information that are helpful in investment and lending decisions. But what are the characteristics of useful information? The purpose of FASB Statement of Financial Accounting Concepts No. 8 is to specify the qualitative characteristics or “ingredients” that financial information should have to be most useful. These characteristics should be considered when choosing among accounting alternatives, because these qualities distinguish more useful from less useful information.

Each accounting alternative, however, may possess more of one quality and less of another. Although there is much agreement about the qualitative characteristics that “good” accounting information should possess, no “equation” can determine which information has the “best” combination of qualitative characteristics for decision-making purposes. Furthermore, the FASB and IASB strive to meet the needs of all users through

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8. The discussion in this section primarily is a summary of that presented in FASB Statement of Financial Accounting Concepts No. 8, op. cit, par. QC1–QC39.
Explain the qualitative characteristics of useful financial information.

Framework of Qualitative Characteristics

Economic phenomena are economic resources and claims to these resources, as well as the transactions, other events, and circumstances that change them. Financial reporting information depicts these economic phenomena in words and numbers in financial reports. To be useful in the decisions of capital providers, this information must possess certain qualitative characteristics (or “ingredients”). Exhibit 2-5 shows a “framework” of the qualitative characteristics of useful financial reporting information. This section presents an overview of the framework, after which we define and discuss the components in detail. The framework consists of two levels: fundamental qualitative characteristics and enhancing qualitative characteristics. The framework is bounded by one constraint: the cost constraint.

Fundamental Qualitative Characteristics

Fundamental qualitative characteristics are characteristics that financial reporting information must possess to be useful. There are two fundamental qualitative characteristics: relevance and faithful representation. Each fundamental qualitative characteristic also has several components.

Relevance

Financial information is relevant when it can make a difference in the decisions made by external users in their capacity as capital providers. Whether information about an economic phenomenon can make a difference is not dependent on whether the information

EXHIBIT 2-5 Framework of Qualitative Characteristics

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<thead>
<tr>
<th>Constraint</th>
<th>Cost</th>
<th>Components</th>
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<tr>
<td>Fundamental Qualitative Characteristics</td>
<td></td>
<td>Relevance</td>
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<td></td>
<td></td>
<td>Faithful Representation</td>
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<td></td>
<td></td>
<td>Comparability (including Consistency)</td>
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<td>Understandability</td>
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<td>Enhancing Qualitative Characteristics</td>
<td></td>
<td>Cost</td>
</tr>
</tbody>
</table>

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has actually made a difference or will make a difference in the future. What is critical is that the information can make a difference, even if a user chooses not to take advantage of it. To be relevant, financial information should have predictive value, confirmatory value, or both. In addition, materiality is an entity-specific aspect of relevance.

**Predictive Value**
Financial information has **predictive value** when it can help capital providers in their predictive processes to form their expectations about the future. The information itself does not have to be predictable to have predictive value. For example, the future amounts of straight-line depreciation are predictable, but may not be useful in predicting a company's future cash flows. In addition, financial information about an economic phenomenon does not have to be in the form of a forecast; it only needs to be useful in a predictive process.

**Confirmatory Value**
Financial information has **confirmatory value** if it confirms or changes capital providers' previous expectations. Information that confirms previous expectations increases the likelihood that future outcomes or results will be as previously expected. On the other hand, information that changes previous expectations will also change the perceived probabilities of future outcomes or results. Confirmatory value is sometimes referred to as **feedback value**.

Financial information that has predictive value usually also has confirmatory value. That is, these values are interrelated. For example, information about a company's economic resources helps capital providers predict the company's ability to take advantage of market opportunities. This information also helps to confirm capital providers' predictions about this ability. Another example is a company's interim income statement, which provides feedback about its income to date and can be used to predict its annual income.

**Materiality**
Materiality is an entity-specific aspect of relevance. **Materiality** refers to the nature or magnitude of an omission or misstatement of financial information which could influence the decisions that external users make in the context of an individual company's financial report. In other words, if the dollar amount of an omission or misstatement of financial information would be large enough to influence the judgment of a decision maker, then the information is material. Immaterial information does not affect a user's decision and is, therefore, not relevant.

Because materiality depends on the entity-specific circumstances under which an item is being judged as to its omission or misstatement, it is not possible to specify a uniform quantitative threshold at which a particular type of information becomes material. However, the following factors are usually considered when evaluating whether an item is material:

- The **nature** of the item (i.e., items considered too small to be significant when they result from routine transactions might be material if they arose from abnormal circumstances)
- The **relative size** rather than the absolute size of an item (i.e., a $10,000 error in inventory of a large company may be insignificant while a similar $10,000 error by a small company may be material)

In regard to the relative size of an omission or misstatement, some companies establish an initial percentage threshold; for instance, 5% of net income for the income statement and 5% of total assets for the balance sheet. Thus, if the omission or misstatement of an amount is less than 5% of net income, it is not considered material for the income statement. External users feel that some companies are using a percentage threshold as an "absolute" cutoff without considering the qualitative factors of the information, such
as the surrounding circumstances or the “total mix” of information. In response, the SEC and the AICPA have provided guidance in assessing the materiality of an omission or misstated item for a company. These include, for instance, whether the omission or misstatement:

- Has an effect on trends (particularly trends in profitability)
- Masks a change in earnings (and earnings per share)
- Is currently immaterial but may have a material impact in future periods because of a cumulative effect
- Changes a loss into net income (or vice versa)
- Misrepresents the company’s compliance with loan agreements
- Relates to a segment of the company that is of particular importance to the company’s long-run profitability
- Has the effect of increasing management’s compensation

Thus, companies may use a quantitative threshold as an initial step in assessing materiality, but need to consider qualitative factors in making the final judgment on the materiality of an item.

**Faithful Representation**

Faithful representation means that the financial information about an economic phenomenon accurately depicts the economic substance of the underlying transaction, other event, or circumstance. In other words, the financial information should represent the substance of the underlying economic phenomenon rather than merely representing its legal form. Some accountants refer to faithful representation as reliability, although these terms do not have quite the same meaning. Social scientists also refer to this concept as “validity.” Faithful representation occurs when the depiction of an economic phenomenon is complete, neutral, and free from material error.

**Completeness**

Financial information is complete when it includes all the information that is necessary for the faithful representation of the economic phenomenon that is being reported, including any descriptions and explanations. An omission can cause information to be false or misleading and, therefore, not useful to the users of financial reports.

**Neutrality**

Financial information is neutral when it is not biased to attain a predetermined result or to influence behavior in a particular direction. Neutrality does not mean that financial information has no purpose or does not influence behavior. Financial information is intended to be useful in decision making, thereby influencing the decision makers’ behavior, but not in a predetermined direction. Sometimes, in conjunction with neutrality, you will hear that financial information needs to be transparent. Transparent financial information is clear and not distorted, which allows external users to clearly see the information they need to make decisions.

**Free from Error**

Financial information is free from error when it is presented as accurately as possible, reflecting the best available inputs. Freedom from error, however, does not imply that

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financial reports must be 100 percent accurate. Many financial reporting measures involve estimates that are based on management’s judgments. Each estimate must reflect the best available information, with some minimum level of accuracy. In addition, sometimes it may be necessary to explicitly disclose the degree of uncertainty in the reported financial information.

**Application of the Fundamental Qualitative Characteristics**

Relevance is concerned with identifying which economic phenomena should be depicted in financial reports to provide decision-useful information to capital providers. Relevance relates to the economic phenomena, not to their predictions, and therefore is considered before the other qualitative characteristics. Once financial information is determined to be relevant, then faithful representation is applied to determine whether a depiction of the economic phenomena in words and numbers accurately reflects the economic substance, as we show in Exhibit 2-5. As fundamental qualitative characteristics, both relevance and faithful representation are necessary if financial information is to be useful. Neither a faithful representation of irrelevant economic phenomena nor unfaithful representation of relevant economic phenomenon results in information that is useful to decision makers.

**Enhancing Qualitative Characteristics**

Enhancing qualitative characteristics distinguish between more useful financial information and less useful financial information. Enhancing qualitative characteristics increase the decision-usefulness of financial information to capital providers and other users, and complement the fundamental qualitative characteristics. As we show in the lower portion of Exhibit 2-5, there are four enhancing qualitative characteristics: comparability (including consistency), verifiability, timeliness, and understandability.

**Comparability (including Consistency)**

Financial information is comparable when it enables external users to identify similarities and differences between two sets of economic phenomena. Decision making involves choosing between alternatives. Thus, financial information about a company is more useful if it can be validly compared with similar information about the company from some other time period or with similar information about other companies. Comparability is not a quality of an individual item of information, but rather between two (or more) items of information. Comparability also includes consistency. Consistency means that the same accounting policies and procedures are used, either from period to period within the company or in a single period across companies. Consistency helps to achieve the goal of comparability. Without consistency, it would be difficult for a user to determine whether differences in results were caused by economic differences or simply by differences in accounting methods. While different accounting methods are often allowed by GAAP, permitting alternative accounting methods for the same economic phenomenon reduces comparability.

**Verifiability**

Financial information is verifiable when different knowledgeable and independent measurers would reach a consensus that the economic phenomenon is faithfully represented. Verifiable information can be used with confidence. To be verifiable, financial information does not have to be a single amount. A range of possible amounts and the related probabilities can also be verified. Verification can be either direct or indirect. Under direct verification, an amount itself is verified (e.g., counting inventory). Under indirect verification, an amount is verified by checking the inputs and recomputing the outputs using
the same accounting method (e.g., applying the first-in, first-out inventory method). Sometimes the term objective is used as a synonym for verifiable.

Verification is a primary concern of auditing. The Certified Public Accountant (CPA) is an independent professional who reviews (audits) the published financial statements of a company. The performance of this duty is termed the attest function. It involves a review of a company’s internal control over its financial reporting and the sampling of the company’s transactions during a reporting period to provide assurance that the recording and reporting of its financial information can be duplicated substantially by an independent measurer. As a result, the CPA issues an auditor’s report. We discuss audit reports in Chapters 4 and 6.

**Timeliness**

Financial information is timely when it is available to decision makers before it loses its ability to influence decisions. Timeliness alone cannot make information useful, but a lack of timeliness reduces its potential usefulness. Timeliness does not imply that financial information is only useful in the current accounting period. Some information may continue to be timely because some users may consider it when assessing trends in various items in a company’s financial reports. As an example of timeliness, the SEC requires that each large company under its jurisdiction file a Form 10-K annual report within 60 days of its fiscal year-end and a Form 10-Q quarterly report within 40 days of the end of each quarter.

**Understandability**

Financial information is understandable when external users are able to comprehend its meaning. Financial information is more understandable when it is classified, characterized, and presented clearly and concisely. External users are assumed to have a reasonable knowledge of business and economic activities, and are able to read a financial report. They are also expected to carefully review and analyze the information contained in the financial report. However, some financial information may be particularly complex. In this case, external users may seek the aid of an advisor to evaluate the information. Financial information should not be excluded from financial reports solely because it may be too complex for some users to understand without assistance from an advisor.

**Application of the Enhancing Qualitative Characteristics**

Enhancing qualitative characteristics improve the usefulness of financial information. They should be maximized to the extent possible to increase the relevance and faithful representation of financial information. However, the enhancing qualitative characteristics either individually or in combination with each other cannot make irrelevant or unfaithfully represented information useful for decision making. The application of the enhancing qualitative characteristics does not follow a prescribed order, like the fundamental qualitative characteristics. Sometimes, one or more of the enhancing qualitative characteristics may be sacrificed to varying degrees to maximize another qualitative characteristic. For example, comparability may be temporarily sacrificed to include relevant information based on the use of a new accounting method in a company’s financial report.

**Constraints to the Framework**

To identify what financial information should be disclosed in financial reports, the qualitative characteristics are bounded by a single pervasive constraint—the cost constraint.
Cost Constraint

Financial information is a commodity. Financial reporting of this information imposes costs. Unless the benefit expected from a commodity exceeds its costs, the commodity will not be sought after. This benefit-greater-than-cost relationship is a limitation of providing useful financial information, and is called the cost constraint. The determination of whether the benefits of providing (and receiving) financial information justify the related costs is usually more of a qualitative assessment than a quantitative one.

The benefits of financial information are that the information helps capital providers make better decisions, which in turn results in the more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. In addition, individual companies may reap the benefits of financial reporting information through improved access to capital markets, favorable effects on public relations, lower costs of capital, and improved management decisions (i.e., internal decision making).

The costs to a company of providing financial information include the costs of collecting and processing the information, the costs of verifying it, and the costs of disseminating the information. Users also incur the costs of analysis and interpretation of the financial information. Thus, standard-setting regulatory bodies (and companies) must weigh the costs of providing financial information against the benefits of the information. In so doing, they must also consider the costs of not providing decision-useful information. If this information is not provided in financial reports, external users must obtain, or attempt to estimate, needed information using incomplete data in financial reports or data available elsewhere.

Quick Check 2-2

- For financial information to be useful for decision making, it must possess both fundamental qualitative characteristics and enhancing qualitative characteristics.

- The fundamental qualitative characteristics of useful financial information are relevance and faithful representation.
  - Relevant financial information can make a difference in the decision making of capital providers; it has predictive value and confirmatory value. Materiality is also an entity-specific aspect of relevance.
  - Faithfully represented financial information accurately depicts the economic substance of the related transaction, other event, or circumstance; the information must be complete, neutral, and free from error.

- The enhancing qualitative characteristics of useful financial information are comparability (including consistency), verifiability, timeliness, and understandability.
  - Comparable financial information means that external users can identify similarities and differences between two sets of economic phenomena. (Consistency means that the same accounting policies and procedures are used.)
  - Verifiable financial information means that different knowledgeable and independent measurers would reach a consensus about the information.
  - Timely financial information means that it is available to decision makers before it loses its ability to influence decisions.
  - Understandable financial information means that external users are able to comprehend its meaning.

- The cost constraint—the benefits of disclosing the information must be greater than the related costs—helps to identify what financial information should be disclosed in financial reports.
**ACCOUNTING ASSUMPTIONS AND PRINCIPLES**

Certain accounting assumptions and principles have had an important impact on the development of GAAP. Exhibit 2-6 is useful in understanding the relationship among the objectives, types of useful information, qualitative characteristics, accounting assumptions and principles, generally accepted accounting principles, financial reports, and elements of financial statements. We discuss the accounting assumptions and principles listed in Exhibit 2-6 in this section. We will discuss others later in the book as they apply to specific accounting standards.

### EXHIBIT 2-6  Framework of Financial Reporting Theory and Practice

<table>
<thead>
<tr>
<th>Framework</th>
<th>Content</th>
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| **Objective and Decision-Usefulness Information** | 1. Objective: Provide information about a company useful to capital providers in making decisions about the efficient allocation of their resources.  
2. Provide information to assess amounts, timing, and uncertainty of capital providers’ prospective cash flows.  
3. Provide information about a company to assess amounts, timing, and uncertainty of the company’s prospective net cash flows.  
4. Provide information about management’s stewardship of a company’s economic resources.  
5. Provide information about a company’s economic resources (and claims to these resources), changes in its economic resources (and claims to them), and explanations of information in its financial reports. |
| **Types of Useful Information** | 1. Return on investment.  
2. Risk.  
3. Financial flexibility.  
4. Liquidity.  
5. Operating capability. |
| **Qualitative Characteristics of Useful Financial Information** | 1. Fundamental qualitative characteristics: relevance (predictive value, confirmatory value, materiality) and faithful representation (completeness, neutrality, free from error).  
2. Enhancing qualitative characteristics: comparability (including consistency), verifiability, timeliness, understandability.  
3. Cost constraint. |
| **Accounting Assumptions and Principles** | 1. Entity (assumption).  
2. Continuity (going concern) (assumption).  
3. Period of time (assumption).  
4. Monetary unit (assumption).  
5. Historical cost (principle).  
6. Recognition (principle).  
7. Matching and accrual (principles).  
| **Generally Accepted Accounting Principles** | 1. Guidelines, procedures, and practices that a company is required to use to record and report its accounting information in audited financial statements.  
2. The **FASB Accounting Standards Codification** is the only source of authoritative U.S. GAAP for companies (except for publicly traded companies that file with the SEC). |
2. Income statement.  
5. Notes to financial statements.  
6. Supplementary and other information. |
| **Elements of Financial Statements** | 1. Assets, liabilities, and equity.  
2. Revenues, expenses, gains, and losses.  
3. Operating, investing, and financing cash flows.  
4. Investments by and distributions to owners. |
Entity (Assumption)
Most of the economic activity in the United States can be directly or indirectly attributed to business enterprises, termed economic entities. These entities vary in size from small, one-owner companies such as hair salons or restaurants, to partnerships such as law or accounting firms, and to large multinational corporations such as Wal-Mart. Financial accounting is concerned with the economic activity of each of these entities, regardless of its size, and involves recording and reporting its transactions and events. A transaction involves the transfer of something of value between the entity and another party. In certain instances the financial records of related but separate legal entities may be consolidated (combined) to report more realistically the resources, obligations, and operating results of the overall economic entity.

Because the entity assumption distinguishes each organization from its owners, each separate entity prepares its own financial records and reports. The personal transactions of the owners are kept separate from those of the business enterprise. Throughout this book, we refer to a business enterprise as a company (and when the discussion applies to a type of company, we use the specific type of entity, e.g., corporation).

Continuity (Assumption)
The continuity assumption is also known as the going-concern assumption. This assumption is that the company will continue to operate in the near future, unless substantial evidence to the contrary exists. Obviously, not all companies are successful, and failures do occur. However, the continuity assumption is valid in most cases and is necessary for many of the accounting procedures used. For example, if a company is not regarded as a going concern, the company should not depreciate its fixed assets over their expected useful lives, nor should the company record its inventory at its cost, because the receipt of future economic benefits from these items is uncertain.

The continuity assumption does not imply permanence. It simply indicates that the company will operate long enough to carry out its existing commitments. 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.

Period of Time (Assumption)
The profit or loss earned by a company cannot be determined accurately until it stops operating. At that time, the total lifetime profit or loss may be determined by comparing the cash on hand after liquidating the business (plus any cash payments to the owners during the period of operations) with the amount invested by the owners during the company’s lifetime. Obviously, financial statement users need more current information to evaluate a company’s profitability. Companies primarily use a year as the reporting period. In accordance with the period-of-time assumption, a company prepares financial statements at the end of each year and includes them in its annual report. Furthermore, the annual reporting period (called the accounting period or fiscal year) is used for reports issued to government regulators such as the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC).

The period-of-time assumption is the basis for the adjusting entry process in accounting. If companies did not prepare financial statements on a yearly (or shorter time) basis, there would be no reason to determine the time frame affected by particular transactions. Historically, most companies adopted the calendar year as the accounting period. However, many companies now choose a fiscal year that more closely approximates their annual business cycle. (The yearly period from lowest sales through highest sales and back to lowest sales is known as a business cycle.) For example, consider Exhibit 2-7, which shows the annual sales pattern for Company G. Notice that peak sales occur each year in January, while the lowest sales volume occurs in June. A company that sells ski equipment
might have such a sales pattern. If Company G were to report on a calendar-year basis, its financial reports would be prepared at about the time of peak yearly sales (i.e., the midpoint of the business cycle). Alternatively, a fiscal year that ended on June 30 would include a single complete annual business cycle. Many large retail chains have a fiscal year-end that follows the peak Christmas selling season. For example, Wal-Mart’s year-end is January 31, which is after most of the returns and allowances related to those sales have occurred. Fiscal-year reports that include an annual business cycle contain information that is more easily comparable to past and future periods because annual sales patterns are not broken by the reporting period.

In addition to annual reports, publicly traded companies issue financial statements for interim (quarterly) periods. These interim periods are integral parts of the annual period, and interim reports disclose summary information to furnish capital providers with more timely information.

**Monetary Unit (Assumption)**

Since the time when gold and other precious metals were accepted in exchange for goods and services, there has been a unit of exchange. This unit of exchange is different for almost every nation. Accountants generally have adopted the national currency of the reporting company as the unit of measure in preparing financial statements.

In using the dollar or any other currency as the unit of measure, accountants traditionally have assumed that it is a stable measuring unit. Prior to the FASB, accounting policy-making bodies had felt that fluctuations in the value of the dollar were not a serious enough problem to affect the comparability of accounting information. Therefore, any adjustment in the monetary unit assumption was not needed.

In today’s world, the assumption that the dollar or any other national currency is a stable measure over time is not necessarily valid. Consider the building you are now in. If you were to measure its width in feet and inches today, next year, and five years from now, an accurate physical measurement would yield the same results each time. In contrast, consider the monetary value of the same building. Real estate prices have changed (increased or decreased) during the past several years and undoubtedly will continue to vary, resulting in changing monetary measures of value even though the physical capacity remains the same.

There are two primary reasons for changes in reported values over time:

1. The real value of the item in question may change in relation to the real value of all other goods and services in the economy.
2. The purchasing power of the measuring unit (in this case the dollar) may change.

Currently, the dollar is considered to be a stable monetary unit for preparing a company’s financial reports. As we mentioned earlier, however, to enhance comparability the FASB
encourages companies to make supplemental disclosures relating to the impacts of changing prices.

**Historical Cost (Principle)**

The economic activities and resources of a company initially are measured using the exchange price at the time each transaction occurs. For many economic resources, usually the company retains the exchange price (the *historical cost*) in its accounting records as the value of the resource until the company consumes or sells it and removes it from the records. That is, a company usually delays recording gains and losses resulting from value changes of assets (or liabilities) until another exchange occurs. The reason for using historical cost (as opposed to other valuation methods such as current market value or appraisal value) is that source documents usually are available to confirm (verify) the recorded amount. Also, historical cost information provides evidence that an independent buyer and seller were in agreement on the value of an exchanged good or service at the time of the transaction and thus has the quality of faithful representation.

One of the most frequently heard criticisms of historical cost comes from those who prefer alternative valuation methods that they believe would report information more relevant for user decisions. Accountants understand that historical cost information may not always be the most relevant information. In certain cases, accounting standards require the use of valuation methods other than historical cost to report the fair value of selected items in a company’s financial statements. These methods are required when they provide more relevant information than historical cost and faithfully represent the substance of the underlying transaction or event. However, it is sometimes felt that the measurement problems inherent in alternative valuation methods are greater than those of historical cost. If the alternative valuation method results in an unfaithful representation of the underlying transaction or event, a valuation method (such as historical cost) that provides less relevant information but results in a more faithful representation may be used.

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**Ethical Dilemma**

You have been hired as an accounting consultant to review the financial reporting policies of Parker Company as it enters merger negotiations with an interested buyer. Of particular interest is the way in which Parker Company accounts for its property, plant, and equipment. As rumors of possible mergers began several years ago, the company’s management periodically began using independent valuation experts to determine fair market values for the company’s net assets. As a result of these analyses, management was able to determine that its long-term productive assets had book values that were significantly less than their market values. Citing the increased verifiability provided by the valuation experts, management decided to write the company’s assets up to market value to provide investors and creditors with the most relevant information possible and to be consistent with the FASB’s increasing use of fair value measurements. Do you agree with this decision?

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Recognition (Principle)

Recognition means the process of formally recording and reporting an item in the financial statements of a company. A recognized item is shown in both words and numbers, with the amount included in the financial statement totals. The FASB has identified four fundamental recognition criteria. To be recognized, an item must:

- meet the definition of an element
- be measurable
- be relevant
- be representationally faithful

In regard to revenues, two other factors provide guidance for revenue recognition. Revenues should be recognized when (1) realization has taken place, and (2) they have been earned. These factors provide acceptable assurance of the existence and amounts of revenues.

A company usually recognizes revenue at the time of sale because this is when realization occurs and its earning process is substantially complete. Realization means the process of converting noncash resources and rights into cash or rights to cash; that is, when the company receives cash or obtains a receivable. Actually, revenue is earned by a company throughout the earning process as it adds economic utility to goods. This earning process includes acquisition, production and/or distribution, sales, and the collection and payment of cash. A company could recognize revenue at one or more points in this process. In this regard, the FASB suggests that revenues are considered to be earned when a company has substantially completed what it must do to be entitled to the benefits (i.e., assets) generated by the revenues. Usually, this is the point of sale.11

Occasionally, a company may advance (accrue) or delay (defer) the recognition of revenue in the earning process to increase the relevance of its income statement. Thus, a company may not recognize (record) revenue at the same time as realization. A company might recognize revenue (1) during production, (2) at the end of production, or (3) after the sale. In the case of certain long-term construction contracts extending over more than one accounting period, a company usually recognizes revenue during production to better depict economic reality by the use of the percentage-of-completion method. Similarly, revenue usually is recognized for certain long-term service contracts by use of the proportional performance method. These methods allocate the revenues of each contract to each period, based on an estimate of the percentage completed during the period. We discuss these revenue recognition methods in Chapters 5 and 18.

A company might recognize revenue at the completion of production if there is a fixed selling price and there is no limit on the amount that it can sell. This situation might be the case for certain valuable minerals or farm products sold on the futures market. Finally, revenue may be recognized after the sale if the ultimate collectibility of the revenue is highly uncertain. This situation might arise, for instance, in the case of real estate land sales where a very small down payment is required and the payment terms extend over many years. In situations of high uncertainty about collections, a company uses either the installment or the cost-recovery method to recognize revenue. 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.

Matching and Accrual Accounting (Principles)

Earlier, accrual accounting was defined as the process of relating the financial effects of transactions, other events, and circumstances having cash consequences to the period in which they occur instead of to when the cash receipt or payment occurs. The matching principle is linked closely to accrual accounting and to revenue recognition. The matching principle states that to determine the income of a company for an accounting period, the company computes the total expenses involved in obtaining the revenues of the

period and relates these total expenses to (matches them against) the total revenues recorded in the period. Thus, some expenses are advanced (accrued) or delayed (deferred) in a manner similar to revenues. The intent is to match the sacrifices against the benefits (i.e., the efforts against the accomplishments) in the appropriate accounting period.

A company recognizes and matches expenses against revenues on the basis of three principles:

- association of cause and effect
- systematic and rational allocation
- immediate recognition

Expenses recorded as a result of associating cause and effect include sales commissions and the product costs included in cost of goods sold. Expenses recorded on the basis of systematic and rational allocation include depreciation of property and equipment and amortization of intangibles. Immediate recognition is appropriate for period costs—those expenses related to a period of time, such as administrative salaries.\(^\text{12}\)

Some smaller companies do not use accrual accounting and matching. Instead they use cash basis accounting for simplicity. In cash basis accounting, a company computes its income for an accounting period by subtracting the cash payments from the cash receipts from operations. While this method may be convenient to use, it can lead to incorrect evaluations of a company's operating results. This may happen because the receipt and payment of cash may occur much earlier or later than the sale of goods or the providing of services to customers (benefits) and the related costs (sacrifices). Because cash basis accounting does not attempt to match expenses against revenues, it is not a generally accepted accounting principle.

**Conservatism (Principle)**

The principle of conservatism states that 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. Over the years, conservatism gained prominence because of the optimism of management and the tendency, during the first three decades of the twentieth century, to overstate assets and net income on financial statements. Recently, conservatism has been criticized for being "anticonservative" in the years following the conservative act. That is, a deliberate understatement of an asset with a corresponding loss and understatement of income in one year will result in an overstatement of income in a later year when the asset is sold because of the greater difference between the selling price and lower recorded value of the asset. Furthermore, conservatism can conflict with components of fundamental qualitative characteristics such as neutrality. For instance, conservative financial statements may be unfair to present stockholders and biased in favor of future stockholders because the net valuation of the company does not include some future expectations. This factor may result in a relatively lower current market price of the company's common stock. These criticisms notwithstanding, conservatism has played an important role in the establishment of certain generally accepted accounting principles.

Over time, the principle of conservatism has become more synonymous with prudence. That is, conservatism should be a prudent reaction to uncertainty. However, the FASB and the IASB have chosen not to include conservatism (prudence) in their joint conceptual framework. Instead, the Boards have suggested that when faced with uncertainty, companies should search for additional information to reduce this uncertainty, disclose a range of possible estimates to reflect that uncertainty, and/or select the midpoint of a range of estimates if a specific number is required.\(^\text{13}\) While the Boards do not view conservatism as a desirable quality of financial information, it is still expected to play a major role in practice.

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GAAP AND FINANCIAL STATEMENTS

As we noted in Chapter 1, generally accepted accounting principles (GAAP) are the guidelines, procedures, and practices that a company is required to use in recording and reporting its accounting information in its audited financial statements. In its conceptual framework, the FASB has identified various sources from which investors, lenders, and other users might obtain information useful in decision making. Exhibit 2-8 shows this model of financial reporting. We discuss components of this model in Chapters 4, 5, and 23.

EXHIBIT 2-8 Sources of Information Used in External Decision Making

Conceptually, the FASB identified the four specific financial statements listed in Exhibit 2-8. In practice, companies prepare at least three major financial statements: (1) the balance sheet (statement of financial position), (2) the income statement, and (3) the statement of cash flows. Many companies also prepare a statement of changes in equity as a major financial statement (or in a note to the financial statements).14 In this section, we discuss briefly these financial statements and the elements of the financial statements. The elements of each financial statement are the broad classes of items comprising it. In other words, they are the “building blocks” with which each financial statement is prepared.15 We discuss the financial statements and their elements in more depth in later chapters.

14. Each company also must report its comprehensive income and may choose to do so on its income statement, a statement of comprehensive income, or on its statement of changes in stockholders’ equity. We will discuss these alternatives in Chapter 5.

Balance Sheet
A balance sheet (or statement of financial position) is a financial statement that summarizes the financial position of a company on a particular date (usually the end of the accounting period). The financial position of a company includes its economic resources, economic obligations, and equity, and their relationships to each other. There are three elements of a balance sheet:

1. **Assets:** Assets are the probable future economic benefits obtained and controlled by a company as a result of past transactions or events.
2. **Liabilities:** Liabilities are the probable future sacrifices of economic benefits arising from present obligations of a company to transfer assets or provide services in the future as a result of past transactions or events.
3. **Equity:** Equity is the owners’ residual interest in the assets of a company that remains after deducting its liabilities.

In other words, the assets of a company are its economic resources, and the liabilities are its economic obligations. The equity of a corporation is referred to as stockholders’ equity because the owners are the stockholders.

Income Statement
An income statement is a financial statement that summarizes the results of a company’s operations (i.e., net income) for a period of time (generally a one-year or one-quarter accounting period). A company’s operations (sometimes called the earning process) include its purchasing, producing, selling, delivering, servicing, and administrating activities. There are four elements of an income statement:

1. **Revenues:** Revenues are inflows of assets of a company or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that are the company’s ongoing major or central operations. Revenues increase the equity of a company.
2. **Expenses:** Expenses are outflows of assets of a company or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that are the company’s ongoing major or central operations. Expenses decrease the equity of a company.
3. **Gains:** Gains are increases in the equity of a company from peripheral or incidental transactions, and from all other events and circumstances during a period, except those that result from revenues or investments by owners.
4. **Losses:** Losses are decreases in the equity of a company from peripheral or incidental transactions, and from all other events and circumstances during a period, except those that result from expenses or distributions to owners.

Revenues may be thought of as measures of the accomplishments of a company during its accounting period, while expenses are measures of the efforts to achieve the revenues. Gains are similar to revenues and losses are similar to expenses, except that revenues and expenses relate to a company’s primary operations, while gains and losses relate to its secondary activities.

Statement of Cash Flows
A statement of cash flows is a financial statement that summarizes the cash inflows and outflows of a company for a period of time (generally one year or one quarter). There are three elements of a statement of cash flows:
1. **Operating Cash Flows:** Operating cash flows are the inflows and outflows of cash from acquiring, selling, and delivering goods for sale, as well as providing services.

2. **Investing Cash Flows:** Investing cash flows are the inflows and outflows of cash from acquiring and selling investments, property, plant, and equipment, and intangibles, as well as from lending money and collecting on loans.

3. **Financing Cash Flows:** Financing cash flows are the inflows and outflows of cash from obtaining resources from owners and paying them dividends, as well as obtaining and repaying resources from creditors on long-term credit.

In addition to these three elements, the statement of cash flows reconciles the amount of cash a company reports on its balance sheets at the beginning and end of the accounting period.

**Statement of Changes in Equity**

A **statement of changes in equity** summarizes the changes in a company’s equity for a period of time (generally one year or one quarter). For a corporation, the statement is called the statement of changes in stockholders’ equity. There are two elements in a statement of changes in equity:

1. **Investments by Owners:** Investments by owners are increases in the equity of a company resulting from transfers of something valuable (usually cash) to the company in order to obtain or increase ownership interests.

2. **Distributions to Owners:** Distributions to owners are decreases in the equity of a company caused by transferring assets, rendering services, or incurring liabilities.

In addition to these elements, the statement of changes in equity also reconciles the amounts of the equity items a company reports on its beginning and ending balance sheets for such items as net income and other comprehensive income.

**Models of Business Reporting**

The AICPA Special Committee on Financial Reporting issued a report that addressed concerns about the relevance and usefulness of reporting by companies. In this report, the committee developed a comprehensive model of **business reporting**—the information that a company provides to help users with capital allocation decisions about the company. The model was designed to help focus attention on a broader, integrated range of information than that addressed in the FASB’s conceptual framework. The goal was to provide the foundation for future improvement in business reporting. The model includes 10 items within five categories of information. These categories are designed to fit the decision processes of external users to make projections, value companies, or assess the likelihood of loan repayments. The framework of the model is as follows:

1. **Financial and nonfinancial data** including (a) financial statements and related disclosures and (b) high-level operating data and performance measurements that a company’s management uses to manage the business.

2. **Management’s analysis of the financial and nonfinancial data**, including (a) reasons for changes in the financial, operating, and performance-related data and (b) the identity and past effect of key trends.

3. **Forward-looking information**, including (a) the assessment of opportunities and risks, including those resulting from key trends, (b) management’s plans, including critical success factors, and (c) a comparison of actual business performance to previously disclosed opportunities, risk, and management’s plans.
4. Information about management and shareholders, including (a) directors, management, compensation, and major shareholders and (b) transactions and relationships among related parties.

5. Background about the company, including (a) broad objectives and strategies, (b) scope and description of the company's business and properties, and (c) the impact of industry structure on the company.

The model is responsive to users' needs, but includes practical constraints to balance the costs and benefits of reporting. Since the AICPA committee is not a standard-setting body, the model is a recommendation to standard setters who have an interest in improving the cost-effective quality of business reporting. We discuss components of this model in Chapters 4, 5, and 6.

The Comprehensive Business Reporting Model Subcommittee of the CFA Institute for Financial Market Integrity also has issued a report that includes a very different comprehensive business reporting model for investors. In this model, the Subcommittee does not develop its own conceptual framework. Instead, it offers additional guiding concepts to help improve financial reporting. Two key weaknesses in the current financial reporting model that the Subcommittee observes are as follows:

1. Current financial statements and related disclosures are not presented in a structure that is useful to investors.

2. Current financial statements and related disclosures do not present sufficient information to enable investors to make effective decisions.

The Subcommittee argues that investors must make many routine changes to the current financial statements in order to generate the information they need to analyze and value securities. Furthermore, investors must resort to estimates and best guesses to arrive at the information they need for financial decision making. Therefore, companies’ financial statements and related disclosures need to be changed so that they present more complete information in the correct form. Furthermore, the associated disclosures must provide enough information so that investors can understand how the numbers reported in the financial statements were generated, including full descriptions of any estimation models and assumptions that were used to generate the numbers. The disclosures also must explain the risk exposures and possible future occurrences that may affect investors’ wealth. The Subcommittee goes on to develop a business reporting model including revised financial statements based on fair value. Although these recommendations are not GAAP, we briefly discuss the related conceptual issues for assets, liabilities, and income in Chapters 4 and 5.

Quick Check 2-3

- Four basic assumptions underlie GAAP. These are:
  - The entity assumption, which relates economic activities to a particular economic entity;
  - The continuity (going concern) assumption, which states that with no evidence to the contrary, a company will continue to operate in the near future;
  - The period of time assumption, which allows the life of a company to be divided into artificial time periods and serves as the basis for the adjusting entry process; and
  - The monetary unit assumption, which requires financial statement elements to be expressed in terms of the dollar.

(Continued)


Four broad principles have greatly influenced the development of GAAP. These are:

- The historical cost principle, which provides representationally faithful, although not always the most relevant, information by measuring economic activities at their historical exchange price;
- The recognition principle, which determines when an item is to be reported in the financial statements (revenue recognition usually occurs when revenue is realized and the earnings process is complete);
- The matching principle, which applies accrual accounting by stating that expenses should be recognized in the same period as the related revenues; and
- The conservatism principle, which states that when given alternative accounting valuations, the accountant should select the one that is least likely to overstate current period assets and income.

The FASB identified four basic financial statements (the balance sheet, the income statement, the statement of cash flows, and the statement of changes in stockholders’ equity) as sources of useful information.

Summary

At the beginning of the chapter, we identified several objectives you would accomplish after reading the chapter. The objectives are listed below, each followed by a brief summary of the key points in the chapter discussion.

1. Explain the FASB conceptual framework. The FASB conceptual framework is a theoretical foundation of interrelated objectives and concepts that leads to the establishment of consistent financial accounting and reporting standards. It provides a logical structure and direction to financial accounting and reporting.

2. Understand the objective of financial reporting. The objective of financial reporting is to provide financial information about a company that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company.

3. Identify the capital providers of a company. The capital providers of a company include equity investors, lenders, and other creditors.

4. Explain the decision-usefulness of financial reporting. Financial reporting information must be useful to capital providers in assessing the amounts, timing, and uncertainty about prospective cash flows to them from a company. Therefore, financial reporting must provide financial information to its capital providers useful in assessing the company’s prospective net cash flows. In addition, the company’s financial reporting must provide useful information about its management’s stewardship.

5. List the specific information that a company should provide in its financial reports. In its financial reports, a company should provide information about its economic resources (and claims to these resources). The company should also provide information about the changes in its economic resources (and claims to these resources) resulting from financial performance (under accrual accounting and cash flow accounting), as well as not from financial performance. Its financial reports should also include management’s explanations of the information.

6. Discuss the types of useful information for investment and lending decision making. For investment and lending decision making, a company’s financial reports should provide useful information about its return on investment, risk, financial flexibility, liquidity, and operating capability.

7. Explain the qualitative characteristics of useful financial information. The fundamental qualitative characteristics are relevance and faithful representation. The components of relevance are predictive value, confirmatory value, and materiality. The components of faithful representation are completeness, neutrality, and freedom from error. The enhancing qualitative characteristics are comparability (including consistency), verifiability, timeliness, and understandability.

8. Understand the accounting assumptions and principles that influence GAAP. Certain assumptions and principles play an important role in the development of GAAP. These include the entity, continuity (going-concern), accounting period, historical cost, monetary unit, recognition and realization, accrual accounting and matching, and conservatism (prudence) assumptions and principles.

9. Define the elements of financial statements. The elements of each financial statement are the broad classes of items comprising it. For a balance sheet, the elements are assets, liabilities, and equity. For an income statement, they are revenues, expenses, gains, and losses. For a statement of cash flows, they are operating, investing, and financing cash flows. For a statement of changes in equity, they are investments by and distributions to owners.
Q2-1 What is the "conceptual framework" of the FASB? What are the titles of the Statements of Concepts issued by the FASB?

Q2-2 What is the objective of general-purpose financial reporting?

Q2-3 What are "capital providers"? Name the two primary capital providers.

Q2-4 How must financial reporting information be useful?

Q2-5 What specific information should a company provide in its financial reports?

Q2-6 Define (a) return on investment, (b) risk, (c) financial flexibility, (d) liquidity, and (e) operating capability.

Q2-7 What are "economic phenomena" and how does financial reporting information depict them?

Q2-8 What are fundamental qualitative characteristics? List them (and their components).

Q2-9 How are the fundamental qualitative characteristics applied with respect to economic phenomena?

Q2-10 When is financial information relevant? Identify and define the three components of relevance.

Q2-11 What is faithful representation? Identify and define the three components of faithful representation.

Q2-12 What are enhancing qualitative characteristics? List them.

Q2-13 When is financial information verifiable? How does verification relate to the attest function of auditing?

Q2-14 List and explain the constraint to the framework of qualitative characteristics of useful financial information.

Q2-15 What is the continuity assumption and why is it important in financial accounting?

Q2-16 What is the period-of-time assumption and why is it important in financial accounting?

Q2-17 Discuss the relationship between historical cost and verifiability.

Q2-18 What is recognition? What is realization? What two factors provide guidance for revenue recognition? Why is revenue usually recognized at the time of sale?

Q2-19 What is accrual accounting and how does it relate to the matching principle?

Q2-20 List the three principles for matching expenses against revenues.

Q2-21 What is conservatism and how might it conflict with neutrality?

Q2-22 Define a balance sheet and list its three elements.

Q2-23 Define an income statement and list its four elements.

Q2-24 Define a statement of cash flows and list its three elements.

Q2-25 Define a statement of changes in equity and list its two elements.

Multiple Choice (AICPA Adapted)

Select the best answer for each of the following.

M2-1 Accruing net losses on noncancelable purchase commitments for inventory is an example of
a. Conservatism
b. Realization
c. Consistency
d. Materiality

M2-2 The information provided by financial reporting pertains to
a. Individual companies, rather than to industries or the economy as a whole or to members of society as consumers.

M2-3 According to Statement of Financial Accounting Concepts No. 8, an interim earnings report is expected to have which of the following?

b. Individual companies and industries, rather than to the economy as a whole or to members of society as consumers.

c. Individual companies and the economy as a whole, rather than to industries or to members of society as consumers.

d. Individual companies, industries, and the economy as a whole, rather than to members of society as consumers.
Predictive value  Confirmatory value
a. No No
b. Yes Yes
c. Yes No
d. No Yes

M2-4 A patent, purchased in 2007 and being amortized over a 10-year life, was determined to be worthless in 2010. The write-off of the asset in 2010 is an example of which of the following principles?

a. Associating cause and effect
b. Immediate recognition
c. Systematic and rational allocation
d. Objectivity

M2-5 An accrued expense is an expense

a. Incurred but not paid
b. Incurred and paid
c. Paid but not incurred
d. Not reasonably estimable

M2-6 Which of the following accounting concepts states that an accounting transaction should be supported by sufficient evidence to allow two or more qualified individuals to arrive at essentially similar measures and conclusions?

a. Matching
d. Stable monetary unit
b. Verifiability
c. Periodicity

M2-7 Which of the following is considered a constraint of providing financial information by Statement of Financial Accounting Concepts No. 8?

a. Cost less than benefits
d. Timeliness
b. Conservatism
c. Going concern
d. Verifiability

M2-8 The valuation of a promise to receive cash in the future at present value on the financial statements of a company is valid because of the accounting concept of

a. Entity
d. Neutrality
b. Materiality
c. Going concern

c. Timeliness

d. Verifiability

M2-9 Under Statement of Financial Accounting Concepts No. 8, which of the following relates to relevance?

a. Timeliness
d. Consistency
b. Neutrality
c. Predictive value

M2-10 Under Statement of Financial Accounting Concepts No. 6, which of the following, in the most precise sense, means the process of converting noncash resources and rights into cash or claims to cash?

a. Allocation
d. Realization
b. Recordation
c. Recognition

c. Materiality

d. Stable monetary unit

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**C2-1 Qualitative Characteristics**

FASB Statement of Concepts No. 8 identified several qualitative characteristics and their components, as well as constraints of useful financial information. The following is a list of these terms, as well as a list of statements describing the terms.

A. Comparability  H. Verifiability
B. Understandability  I. Neutrality
C. Relevance  J. Faithful representation
D. Free from error  K. Consistency
E. Predictive value  L. Materiality
F. Confirmatory value  G. Timeliness

1. Ability of measurers to form a consensus that the selected accounting method has been used without error or bias.
2. Making information available to decision makers before it loses its capacity to influence decisions.
3. Capacity to make a difference in a decision.
4. External users are able to comprehend its meaning.
5. Absence of bias intended to influence behavior in a particular direction.
6. Information presented as accurately as possible.
7. Helps decision makers forecast correctly.
8. Financial information represents the substance of the economic phenomenon rather than merely representing its legal form.

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**C2-2 Accounting Assumptions and Principles**

Certain accounting assumptions and principles have had an important impact on the development of generally accepted accounting principles. The following is a list of these assumptions and principles as well as a list of statements describing certain accounting practices.

A. Entity  E. Monetary unit
B. Continuity  F. Realization
C. Period of time  G. Matching
D. Historical cost  H. Conservatism

1. The business, rather than its owners, is the reporting unit.
C2-2 Accounting Assumptions and Principles

Required
Select the accounting assumption or principle that justifies each accounting practice and place the appropriate letter on the line preceding the statement.

2. Depreciation costs are expensed in the periods of use rather than at the time the asset is acquired.
3. Accounting measurements are reported in dollars.
4. The year is the normal reporting unit.
5. In the absence of evidence to the contrary, the company will operate long enough to carry out its existing commitments.
6. Revenue is usually recognized at the time of sale.
7. Exchange price is retained in the accounting records.
8. An accounting alternative is selected that is least likely to overstate assets and income.

Required
Select the accounting assumption or principle that justifies each accounting practice and place the appropriate letter on the line preceding the statement.

C2-3 Objective of Financial Reporting and Decision-Usefulness

The FASB has defined the objective of financial reporting, identified the types of capital providers, and clarified what “decision-useful” financial reporting cash flow information is needed by these capital providers.

Required
Prepare a written report that defines the objective of financial reporting, discusses the primary capital providers, and explains what general financial reporting cash flow information is decision-useful to these capital providers.

C2-4 Financial Reporting Information

In Statement of Financial Accounting Concepts No. 8, the FASB specified the financial information that a company should report in regard to its economic resources and claims to these resources, as well as the changes in these items.

Required
Prepare a written report that identifies and discusses the financial information that a company should include in its financial reports.

C2-5 Joint Conceptual Framework

The FASB and IASB are working on developing a common Conceptual Framework for Financial Reporting. To date, they have agreed on an objective of financial reporting. They have also identified two fundamental qualitative characteristics and four enhancing qualitative characteristics of decision-useful financial reporting information, as well as a constraint to these qualities.

Required
Define the objective of general purpose external financial reporting. Then discuss each of the fundamental and enhancing qualitative characteristics of decision-useful financial reporting information. Finish by discussing the constraint to these qualities.

C2-6 Qualities of Useful Financial Information

A friend of yours, who is not an accounting major, is concerned about the “usefulness” of financial information. The friend states: “I have watched you prepare many financial statements in completing your homework assignments. But how do you determine whether the information in these financial statements is useful? What are the characteristics or qualities of useful financial information?” And, are there any constraints to providing financial information?

Required
Prepare a written response for your friend that defines economic phenomena, identifies and explains the qualitative characteristics of useful financial information, and discusses the constraints to providing financial information.

C2-7 Cost and Expense Recognition

AICPA Adapted An accountant must be familiar with the concepts involved in determining earnings of a company. The amount of earnings reported for a company is dependent on the proper recognition, in general, of revenue and expense 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.

Required
1. Explain the rationale for recognizing costs as expenses at the time of product sale.
2. What is the rationale underlying the appropriateness of treating costs as expenses of a period instead of assigning the costs to an asset? Explain.
3. 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 this basis.

C2-8 Characteristics of Useful Information

CMA Adapted The qualitative characteristics of useful financial information were identified in the FASB’s Statement of Financial Accounting Concepts No. 8. These characteristics distinguish better information (more useful) from inferior information (less useful).

Required
1. For the fundamental quality relevance,
a. define relevance
b. explain the meaning and importance of each of the three components of relevance
2. For the fundamental quality faithful representation,
a. define faithful representation
b. explain the meaning and importance of each of the three components of faithful representation
3. Explain the concepts ofa. comparabilityb. consistency
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C2-9 Objective, Users, and Stewardship
CMA Adapted The owners of CSC Inc., a privately held company, are considering a public offering of the company’s common stock as a means of acquiring additional funds. Prior to making a decision about a public offering, the owners had a lengthy conversation with John Duncan, CSC’s chief financial officer. Duncan informed the owners of the reporting requirements of the Securities and Exchange Commission, including the necessity for audited financial statements. At the request of the owners, Duncan also discussed the objective of general-purpose financial reporting, the sophistication of users of financial information, and the stewardship responsibilities of management, all of which are addressed in Statement of Financial Accounting Concepts No. 8.

Required
1. Identify the objective of general-purpose financial reporting.
2. Describe the level of sophistication that can be expected of the users of financial information.
3. Explain the stewardship responsibilities of management.

C2-10 Segment Reporting
The FASB requires that a company organized in different “operating segments” disclose the revenues, profits, and assets of each of its major operating segments.

Required
Prepare a short memo that briefly explains what types of useful information for investment decision making is provided by requiring these disclosures.

C2-11 Relevance versus Faithful Representation
You are listening to two accounting majors, both of whom are in an auditing class. They are debating the merits of having relevant information versus information that is a faithful representation of the underlying transaction or event. One student states: “In my decision making, I would always want the most relevant information, even if it is not the most faithful representation of the transaction.” The other student replies: “Nonsense! If the information does not faithfully represent what happened, then of what use is it?”

Required
Based on your knowledge of the conceptual framework discussed in this chapter, define and explain the qualitative characteristics of relevance and faithful representation (and their components). Which do you think is more important?

C2-12 Inconsistent Statements on Accounting Principles
AICPA Adapted The following two statements have been taken directly or with some modification from the accounting literature. Each of them is either taken out of context, involves circular reasoning, and/or contains one or more fallacies, half-truths, erroneous comments, conclusions, or inconsistencies (internally or with generally accepted principles or practices).

Statement 1 Accounting is a service activity. Its function is to provide quantitative financial information that is intended to be useful in making economic decisions about and for economic entities. Thus the accounting function might be viewed primarily as being a tool or device for providing quantitative financial information to management to facilitate decision making.

Statement 2 Financial statements that were developed in accordance with generally accepted accounting principles, which apply the conservatism convention, can be free from bias (or can give a presentation that is fair with respect to continuing and prospective stockholders as well as to retiring stockholders).

Required
1. List the fallacies, half-truths, circular reasoning, erroneous comments or conclusions, and/or inconsistencies.
2. Explain by what authority and/or on what basis each item listed in (1) can be considered to be fallacious, circular, inconsistent, a half-truth, or an erroneous comment or conclusion. If the statement or a portion of it is merely out of context, indicate the context(s) in which the statement would be correct.

C2-13 Accounting Entity
AICPA Adapted The accounting entity assumption often is considered to be the most fundamental of accounting concepts, one that pervades all of accounting.

Required
1. a. What is an accounting entity? Explain.
b. Explain why the accounting entity assumption is so fundamental that it pervades all of accounting.
2. For each of the following indicate whether the accounting concept of entity is applicable; discuss and give illustrations.
   a. A unit created by or under law
   b. The product-line operating segment of an enterprise
   c. A combination of legal units and/or product-line operating segments
   d. All of the activities of an owner or a group of owners
   e. An industry
   f. The economy of the United States
C2-14 Timing of Revenue Recognition

Required
1. Why is the point of sale usually used as the basis for the timing of revenue recognition?
2. Disregarding the special circumstances when bases other than the point of sale are used, discuss the merits of each of the following objections to the sales basis of revenue recognition:
   a. It is too conservative because revenue is earned throughout the entire process of production.
   b. It is not conservative enough because accounts receivable do not represent disposable funds; sales returns and allowances may be made; and collection and bad debt expenses may be incurred in a later period.
3. Revenue may also be recognized (a) during production and (b) when cash is received. For each of these two bases of timing revenue recognition, give an example of the circumstances in which it is properly used and discuss the accounting merits of its use in lieu of the sales basis.

C2-15 Accruals and Deferrals

Required
1. How does accrual accounting affect the determination of income? Include in your discussion what constitutes an accrual and a deferral, and give appropriate examples of each.

C2-16 Revenue Recognition

The following are brief descriptions of several companies in different lines of business.

A. Company A is a construction company. It has recently signed a contract to build a highway over a three-year period. A down payment was collected; the remaining collections will occur periodically over the construction period based upon the degree of completion.
B. Company B is a retailer. It makes sales on a daily basis for cash and on credit cards.
C. Company C is a health spa. It has recently signed contracts with numerous individuals to use its facilities over a two-year period. The contract price was collected in advance.
D. Company D is a land development company. It has recently begun developing a "retirement community" and has sold lots to senior citizens. The sales contract requires a small down payment and periodic payments until completion of the roads and a clubhouse, after which the remainder of the purchase price is due. Prior to this point, a purchaser may cancel the contract and receive a refund of all payments.

Required
Describe when revenue should be recognized by each company. If revenue should not be recognized at the time of sale, indicate what method should be used to recognize the revenue. Justify your decision.

C2-17 Violations of Assumptions and Principles

The following are accounting procedures and practices used by several companies.

A. As soon as it purchases inventory, Sokolich Company records the purchase price as cost of goods sold to simplify its accounting procedures.
B. At the end of each year, Sloan Company records and reports its economic resources based on appraisal values.
C. Ebert Company prepares financial statements only every two years to reduce its costs of preparing the statements.
D. Guthrie Company sells on credit and records revenue at that time, even though it knows that collection is highly uncertain and very significant efforts have to be made to collect the accounts.
E. Because of inflation, Cross Company adjusts its financial statements each year to show the current purchasing power for all items.
F. David Thomas combines his personal transactions and business transactions when he prepares his company’s financial statements so that he can tell how well he is doing on an “overall” basis.
G. At the end of each year, Vann Company reports its economic resources on a liquidation basis even though it is likely to operate in the future.

Required
Identify what accounting assumption or principle each procedure or practice violates, and indicate what should be done to rectify the violation.

C2-18 Ethics and Income Reporting

You have been hired as an “accounting consultant” by Watson Company to evaluate its financial reporting policies. Watson is a small corporation with a few stockholders owning stock that is not publicly traded. In a discussion with you, Chris Watson, the company president, says “For the Watson Company’s annual income statement, it is our policy to always record and report revenues when we collect the cash and to record and report expenses when we pay the cash. I like this approach, and I think our stockholders and creditors do, too. This policy results in income that is verifiable and conservative, which is the way accounting should be. Besides, it is easy to keep track of our income. All I need are the receipts and payments recorded in the company’s checkbook.”

Required
From financial reporting and ethical perspectives, how would you reply to Chris?