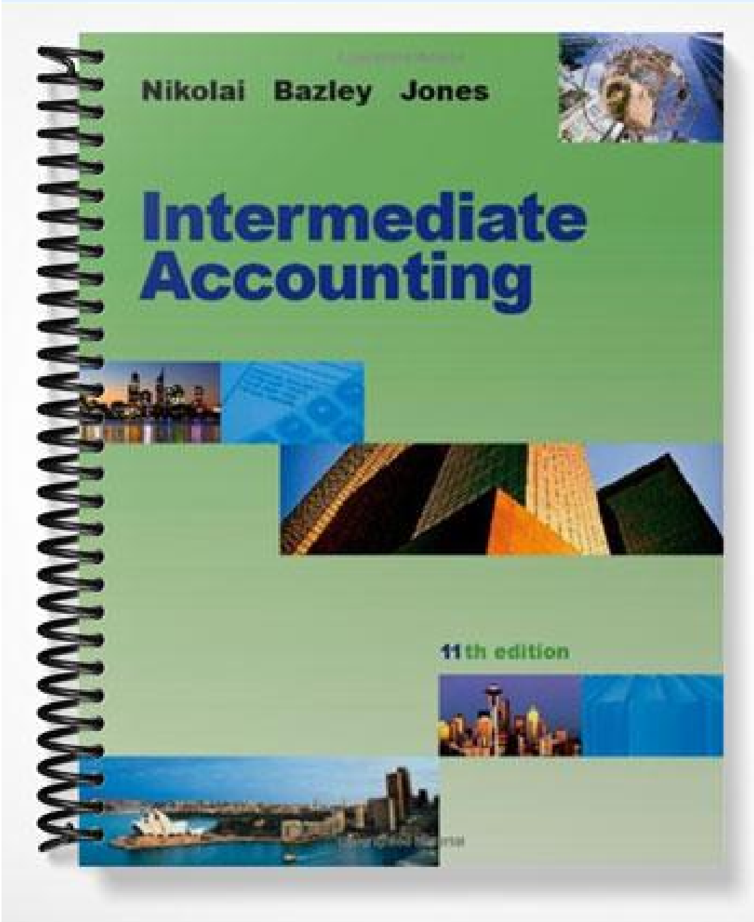
SOLUTIONS MANUAL



CHAPTER 2

FINANCIAL REPORTING: ITS CONCEPTUAL FRAMEWORK

CONTENT ANALYSIS OF CASES

Number	Content	Time Range (minutes)
C2-1	Qualitative Characteristics. Matching of definitions to the qualities of useful accounting information.	10-20
C2-2	Accounting Assumptions and Principles. Matching of a list of descriptive statements with a list of assumptions and principles.	5-15
C2-3	Objectives of Financial Reporting. Discuss general through specific objectives.	15-30
C2-4	Qualitative Characteristics. Identify and discuss qualities of useful accounting information.	20-40
C2-5	(AICPA adapted). Cost and Expense Recognition. Rationale for expense recognition at time of sale, in an accounting period, or due to systematic and rational allocation.	15-30
C2-6	(CMA adapted). Characteristics of Useful Information. Define relevance and reliability (and their ingredients), as well as comparability, consistency, and materiality.	20-30
C2-7	(CMA adapted). Objectives, Users, and Stewardship. Discuss the primary objectives of financial reporting, the sophistication level of users, and the stewardship responsibilities of management.	20-30
C2-8	Segment Reporting. Discuss what types of useful information for investment decision making is provided by a company's disclosures of the revenues, operating profits, and assets of its lines of business.	10-15
C2-9	Relevance Versus Reliability. Define relevance and reliability, and ingredients of each. Discuss which is most important.	10-15
C2-10	(AICPA adapted). Inconsistent Statements about GAAP. Evaluate and discuss two statements containing fallacies, half-truths, circular reasoning, errors, and inconsistencies.	15-30
C2-11	(AICPA adapted). Accounting Entity. Define and discuss an accounting entity; give illustrations.	15-30

Number	Content	Time Range (minutes)
C2-12	(AICPA adapted). Timing of Revenue Recognition. Discuss why point-of-sale recognition is usual. Discuss merits of alternative revenue recognition bases.	20-40
C2-13	(AICPA adapted). Accruals and Deferrals. Discuss accrual accounting, including accruals and deferrals. Contrast with cash accounting.	10-15
C2-14	Revenue Recognition. Describe when revenue should be recognized in four cases, and indicate what method should be used.	15-20
C2-15	Violation of Assumptions and Conventions. For seven situations, identify what accounting assumption or convention each procedure or practice violates. Indicate what should be done to rectify each violation.	15-25
C2-16	(CMA adapted). Conceptual Framework. Describe and discuss benefits of FASB conceptual framework and qualities of useful accounting information.	20-30
C2-17	(Appendix). FASB and IASB Joint Conceptual Framework. Define the objective of financial reporting. Discuss the qualitative characteristics (and constraints) of useful information.	15-20
C2-18	Ethics and Income Reporting. Discuss the financial reporting and ethical issues regarding revenue and expense recognition based on cash receipts and payments.	10-15

ANSWERS TO QUESTIONS

Q2-1 The "conceptual framework" of the FASB is a theoretical foundation of interrelated objectives and concepts that provides a logical structure and direction to financial accounting and reporting. The titles of the "Statements of Concepts" issued by the FASB are: Statement No. 1 "Objectives of Financial Reporting by Business Enterprises," Statement No. 2 "Qualitative Characteristics of Accounting Information," Statement No. 3 "Elements of Financial Statements of Business Enterprises," (replaced by Statement No. 6 "Elements of Financial Statements"), Statement No. 4 "Objectives of Financial Reporting by Nonbusiness Organizations," Statement No. 5 "Recognition and Measurement in Financial Statements of Business Enterprises," and Statement No. 7 "Using Cash Flow Information and Present Value in Accounting Measurements."

Q2-2 The most general objective is that financial reporting should provide useful information for present and potential investors, creditors, and other external users in making rational investment, credit, and similar decisions. Investors include both equity security holders (stockholders) and debt security holders (bondholders), while creditors include suppliers, customers and employees with claims, individual lenders, and lending institutions.

Q2-3 The "derived external user objective" is to provide information that is useful to external users in assessing the amounts, timing, and uncertainty of prospective cash receipts. This objective is important because individuals and institutions make cash outflows for investing and lending activities primarily to increase their cash inflows. Financial information is needed to help establish expectations about the timing and amount of prospective cash receipts (e.g., dividends, interest, proceeds from resale or repayment) and assess the risk involved.

Q2-4 The "derived company objective" is to provide information to help investors, creditors, and others in assessing the amounts, timing, and uncertainty of prospective net cash inflows to the related company. Information about (1) a company's economic resources, obligations, and owners' equity; (2) a company's comprehensive income and its components; and (3) a company's cash flows should be reported to satisfy the "derived company objective."

Q2-5 Information about the "economic resources and claims to those resources" of a company is useful to external users for four reasons:

1. To identify the company's financial strengths and weaknesses and to assess its liquidity;
2. To provide a basis to evaluate information about the company's performance during a period;
3. To provide direct indications of the cash flow potentials of some resources and the cash needed to satisfy obligations; and
4. To indicate the potential cash flows that are the joint result of combining various resources in the company's operations.

Information about the "comprehensive income and its components" of a company is useful to external users in:

1. Evaluating management's performance;
2. Estimating the "earning power" or other amounts that are representative of its long-term income producing ability;
3. Predicting future income; and
4. Assessing the risk of investing in or lending to the company.

Information about the cash flows of a company is useful to external users:

1. To help understand its operations;
2. To evaluate its financing and investing activities;
3. To assess its liquidity; and
4. To interpret the comprehensive income information provided.

Q2-6 The terms are defined as follows: (a) return on investment provides a measure of overall company performance, (b) risk is the uncertainty or unpredictability of the future results of a company, (c) financial flexibility is the ability of a company to use its financial resources to adapt to change, (d) liquidity refers to how quickly a company can convert its assets into cash to pay its bills, and (e) operating capability refers to the ability of a company to maintain a given physical level of operations.

Q2-7 Decision usefulness is the overall qualitative characteristic of useful accounting information. The two primary qualities of decision usefulness are relevance and reliability.

Q2-8 Accounting information is relevant if it can make a difference in a decision by helping users predict the outcomes of past, present, and future events or confirm or correct prior expectations. To be relevant, accounting information must be timely and must have either predictive value or feedback value, or both. Predictive value is present when the information helps decision makers forecast the outcome of past or present events more accurately. Feedback value is present when the accounting information enables decision makers to confirm or correct prior expectations. Timeliness is having information available to decision makers before it loses its capacity to influence decisions.

Q2-9 Accounting information is reliable if it is reasonably free from error and bias and faithfully represents what it purports to represent. To be reliable the information must be verifiable, neutral, and possess representational faithfulness. Verifiability is the ability of accountants to agree that the selected method has been used without error or bias. Representational faithfulness is the degree of correspondence between the reported accounting measurements and the economic resources, obligations, and the transactions and events causing changes in these items. Neutrality is present when information is not biased to influence behavior in a particular direction. Neutrality also implies a completeness of information.

Q2-10 The secondary quality of useful accounting information is comparability. Comparability of accounting information enables users to identify and explain similarities and differences between two (or more) sets of economic phenomena. Comparability is enhanced by consistency. Consistency means conformity from period to period with unchanging accounting policies and procedures. Without consistency, it would be difficult to determine whether differences in results were caused by economic differences or simply differences in accounting methods.

Q2-11 Materiality refers to the magnitude of an omission or misstatement of accounting information that makes it likely the judgment of a reasonable person relying on the information would have been influenced by the omission or misstatement. Materiality is closely linked to relevance. Both characteristics are defined in terms of the influences that affect a decision maker. However, relevance deals with the need that the users may have for that information, while materiality occurs because the amount is large enough to make a difference.

Q2-12 The continuity assumption (or going-concern assumption) is the assumption that a company will continue to operate in the near future, unless substantial evidence to the contrary exists. This assumption is important in financial accounting because it is necessary for many of the accounting procedures used by the company. For example, its assets which are depreciated and its method of recording inventory may be affected if the future economic benefits from these items are uncertain.

Q2-13 The period-of-time assumption is the assumption that a company has adopted the year, either calendar or fiscal, as the reporting period. This assumption is important to financial accounting because it is the basis for the adjusting entry process in accounting. If a company's financial statements were not prepared on a yearly (or shorter time) basis, there would be no reason to determine the time frame affected by particular transactions.

Q2-14 Historical cost is the exchange price that is retained in the accounting records as the value of an economic resource. Reliability provides the rationale behind the use of historical cost; it possesses representational faithfulness, neutrality, and verifiability (i.e., source documents are usually available to substantiate the recorded amount).

Q2-15 Recognition is the process of formally recording and reporting an item in the financial statements of a company. Realization is the process of converting noncash resources and rights into cash or rights to cash. Two factors provide guidance for revenue recognition. Revenues should be recognized when: (1) realization has taken place, and (2) the revenues have been earned. Revenues are considered to be earned when a company has substantially completed what it must do to be entitled to the benefits generated by the revenues. Thus, revenue is usually recognized at the point of sale.

Q2-16 Accrual accounting is the process of relating the financial effects of transactions, events, and circumstances having cash consequences to the period in which they occur instead of when the cash receipt or payment occurs. This process is related to the matching principle, which 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.

Q2-17 The three principles for matching expenses against revenues are:

1. Associating cause and effect;
2. Systematic and rational allocation; and
3. Immediate recognition.

Q2-18 Conservatism states that when alternative accounting valuations are equally possible, the accountant should select the alternative which is least likely to overstate the company’s assets and income in the current period. Conservatism, however, can conflict with neutrality. Conservative financial statements may be unfair to present stockholders and biased in favor of future stockholders because the net valuation of the company may not fully include future expectations. The result may be a relatively lower current market price of the company's common stock.

Q2-19 A balance sheet (or statement of financial position) is a financial statement that shows the financial position of a company on a particular date (usually the end of the accounting period). There are three elements of a balance sheet: (a) assets, (b) liabilities, and (c) equity.

Q2-20 An income statement is a financial statement that shows 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). There are four elements of an income statement: (a) revenues, (b) expenses, (c) gains, and (d) losses.

Q2-21 A statement of cash flows is a financial statement that shows 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: (a) operating cash flows, (b) investing cash flows, and (c) financing cash flows.

Q2-22 A statement of changes in equity shows the changes in a company's equity for a period of time (generally one year or one-quarter). There are two elements of a statement of changes in equity: (a) investments by owners, and (b) distributions to owners.

Q2-23 The IASB Framework states that the objective of financial statements is to provide information about the financial position, performance, and changes in financial position of a company that is useful to a wide range of users in making economic decisions. The Framework has two underlying assumptions; that a company is a going concern and uses accrual accounting. It identifies four qualitative characteristics of financial statements–understandability, relevance (including materiality), reliability (including faithful presentation, substance over form, neutrality, prudence, and completeness), and comparability. Three constraints on relevant and reliable information are identified; they include timeliness, balance between benefit and cost, and balance between the qualitative characteristics. The Framework calls for financial statements that present a true and fair view of the company and a fair presentation of the company's activities.

Q2-24 The eight phases of the joint FASB and IASB conceptual framework project include: (1) objectives and qualitative characteristics, (2) elements and recognition, (3) measurement, (4) reporting entity, (5) presentation and disclosure, (6) framework for GAAP hierarchy, (7) applicability to not-for-profit sector, and (8) remaining issues.

Q2-25 The two fundamental qualitative characteristics of useful information identified in the tentative joint conceptual framework of the FASB and IASB are relevance and faithful representation.

ANSWERS TO MULTIPLE CHOICE

1. a	3. b	5. a	7. a	9. d
2. a	4. b	6. b	8. c	10. d

ANSWERS TO CASES

C2-1

H	1.	B	4.	E	7.	L	10.
G	2.	I	5.	J	8.	K	11.
C	3.	D	6.	A	9.	F	12.

C2-2

A	1.	E	3.	B	5.	D	7.
G	2.	C	4.	F	6.	H	8.

C2-3

The most general objective of financial reporting states that financial reporting should provide useful information for present and potential investors, creditors, and other users in making their investment, credit, and similar decisions. These external users are expected to have a reasonable understanding of business and economic activities and be willing to study the information carefully.

The second objective is the "derived external user objective." It states that financial reporting should provide information that is useful to external users in assessing the amounts, timing, and uncertainty of prospective cash receipts. This objective is important because to be successful, an investor or creditor must receive not only a return of investment, but also a return on investment in proportion to the risk involved. Financial information is needed to help establish expectations about the prospective cash receipts.

The third objective is the "derived company objective." It states that financial reporting should provide information to help external users in assessing the amounts, timing, and uncertainty of prospective net cash inflows to the related company. Companies, like external users, invest cash in noncash resources to earn more cash and receive a return on their investment in addition to a return of their investment. The company's ability to generate net cash inflows affects both its ability to pay dividends and interest and the market prices of its securities, which, in turn, impact on investors' and creditors' cash flows.

The next three, more specific, objectives indicate the types of information about a company that should be provided in financial reports. The first is to provide information about a company's economic resources, obligations, and owners' equity. This information is useful to external users for four reasons: (a) to identify the company's financial strengths and weaknesses and to assess its liquidity, (b) to provide a basis to evaluate information about the company's performance during a period, (c) to provide direct indications of the cash flow potentials of some resources and the cash needed to satisfy obligations, and (d) to indicate the potential cash flows that are the joint result of combining various resources in the company's operations.

The second specific objective of financial reporting is to provide information about a company's financial performance during a specified period. The primary focus here is information concerning a company's comprehensive income and its components. This information about a company is useful to external users in (a) evaluating management's performance, (b) estimating the "earning power" or other amounts that are representative of its long-term earning ability, (c) predicting future income, and (d) assessing the risk of investing in or lending to the company.

Although comprehensive income is the primary focus, the third specific objective of financial reporting is to provide information about a company's cash flows. External users use cash (or cash and cash equivalents) flow information about a company (a) to help understand its operations, (b) to evaluate its financing and investing activities, (c) to assess its liquidity, and (d) to interpret the comprehensive income information provided.

Other issues (objectives) of financial reporting are to provide information about how the management of a company has discharged its stewardship responsibility for the company's resources and to provide for full disclosure to help external users understand the information presented to them.

C2-4

There are several qualitative characteristics or "ingredients" that accounting information should possess in order to be most useful. The following characteristics should be considered when choosing one of several accounting alternatives: (a) understandability, (b) decision usefulness, (c) relevance, (d) reliability, (e) comparability, and (f) consistency.

Understandability serves as a "link" between the decision makers and the accounting information. Understandability means the quality of information that enables users to perceive its significance. Accounting information should be comprehensible to users who have a reasonable knowledge of business and economic activities and who are willing to study the information carefully.

Decision usefulness is the overall qualitative characteristic to be used in judging the quality of accounting information. Usefulness depends on the decision to be made, the way in which the decision is made, the information already available, and the decision maker's ability to process the information. To evaluate decision usefulness, however, this overall quality can be separated into the primary qualities of relevance and reliability. If either of these is completely missing, the information will not be useful.

Accounting information is relevant if it can make a difference in a decision by helping users predict the outcomes of past, present, and future events or confirm or correct prior expectations. To be relevant, accounting information must be timely and must possess either predictive value or feedback value, or both. Timeliness refers to having information available to decision makers before it loses its capacity to influence decisions. If information is not available when needed, it lacks relevance and is of little or no use. Predictive value refers to accounting information that helps decision makers forecast the outcome of past or present events more accurately. Feedback value is present in accounting information that enables decision makers to confirm or correct prior expectations. Often, information has both predictive value and feedback value because knowledge about the previous actions of a company will generally improve the decision makers' abilities to predict the results of similar future actions.

Accounting information is reliable if it is reasonably free from error and bias and faithfully represents what it purports to represent. Information is reliable when it has representational faithfulness and is verifiable and neutral. Representational faithfulness is the degree of correspondence between the reported accounting measurements or descriptions and the economic resources and obligations and the transactions and events causing changes in these items. Having a high degree of representational faithfulness is useful in reducing measurement bias. Verifiability is the ability of measurers to agree that the selected method has been used without error or bias. Verification is useful in reducing measurer bias. Neutrality results when accounting information is not biased to attain a predetermined result or to influence behavior in a particular direction. Neutrality implies a completeness of information.

Comparability and consistency are secondary qualities, interacting with both relevance and reliability to contribute to information usefulness. Comparability is an interactive quality of the relationship between two or more items of information. Comparability of accounting information enables users to identify and explain similarities and differences between two (or more) sets of economic facts. Consistency means conformity from period to period, with unchanging accounting policies and procedures. Consistency helps enhance comparability across periods. Without consistency, it would be difficult to determine whether differences in results were caused by economic differences or simply

C2-4 (continued)

differences in accounting methods. However, some sacrifice in consistency must be made at certain times in order to improve the usefulness of accounting information. These characteristics, however, are bound by two constraints. One constraint is that to justify providing the information, the benefits must be greater than the costs of the information. The second constraint is materiality; the dollar amount of the information must be large enough to make a difference in decision making.

C2-5 (AICPA adapted solution)

Note to Instructor: Parts of this case may be slightly advanced for students at this point but are included to stimulate discussion.

1. Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. This presumed direct association has been identified both as "associating cause and effect" and as the "matching concept."
Direct cause-and-effect relationships can seldom be conclusively demonstrated, but many costs appear to be related to particular revenue, and recognizing them as expenses accompanies recognition of the revenue. Generally, the matching concept requires that the revenue recognized and the expenses incurred to produce the revenue be given concurrent periodic recognition in the accounting records. Only if effort is properly related to accomplishment will the results, called income, have useful significance concerning the efficient utilization of business resources. Thus, applying the matching principle is a recognition of the cause-and-effect relationship that exists between expense and revenue.

   Examples of expenses that are usually recognized by associating cause and effect are sales commissions, freight-out on merchandise sold, and cost of goods sold or services provided.

2. Some costs are assigned as expenses to the current accounting period because (a) their incurrence during the period provides no discernible future benefits; (b) they are measures of assets recorded in previous periods from which no future benefits are expected or can be discerned; (c) they must be incurred each accounting year, and no build-up of expected future benefits occurs; (d) by their nature they relate to current revenues even though they cannot be directly associated with any specific revenues; (e) the amount of cost to be deferred can be measured only in an arbitrary manner or great uncertainty exists regarding the realization of future benefits, or both; (f) uncertainty exists regarding whether allocating them to current and future periods will serve any useful purpose. Thus, many costs are called "period costs" and are treated as expenses in the period incurred because they have neither a direct relationship to revenue earned nor can their occurrence be directly shown to give rise to an asset. The application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or accrued for payment. Examples of costs treated as period expenses would include officers' salaries, advertising, research and development, and auditors' fees.

3. In the absence of a direct basis for associating asset cost with revenue, and if the asset provides benefits for two or more accounting periods, its cost should be allocated to these periods (as an expense) in a systematic and rational manner. Thus, when it is impractical, or impossible, to find a close cause-and-effect relationship between revenue and cost, this relationship is often assumed to exist. Therefore, the asset cost is allocated to the accounting periods by some method. The allocation method used should appear reasonable to an unbiased observer and should be followed consistently from period to period. Examples of systematic and rational allocation of asset cost would include

C2-5 (continued)
3. (continued)

depreciation of fixed assets, amortization of certain intangibles, and allocation of rent and insurance.

C2-6 (CMA adapted)

1. a. Relevance means relating to the matter at hand. Therefore, relevant accounting information has the capacity to:

   - make a difference in a decision.
   - be timely for decision making (timeliness)
   - help users to form predictions about the outcomes of future events (predictive value).
   - confirm or correct prior expectations (feedback value).

   b. Predictive value is that quality of information that improves the decision-maker's ability to determine expected outcomes. Feedback value is that quality of information that assists the decision-maker to confirm or change previously determined expected outcomes. The predictive and feedback qualities are interactive in that knowledge of actual results (feedback) generally improves the results of similar future actions (predictive). Timeliness is that quality of information that makes it available to the user before it loses its capacity to influence the decision. Timeliness may be a trade-off with a degree of precision; however, lack of timeliness can reduce relevance.

2. a. Reliability is the quality of accounting information that assures that it is reasonably free from error and bias and faithfully represents what it purports to represent. Reliability is the quality that gives users confidence that they can depend on the information provided in financial statements because the level of accuracy is higher.

   b. Verifiability is that quality of information that assures that accounting information would be substantially duplicated by independent measurers using the same measurement methods. Verifiability implies a consensus among accountants on the measurement of an economic event and the way it is reported. Neutrality is the absence of bias in reported information with no intention to attain a predetermined result or to induce a particular mode of behavior. Accounting information should be arrived at by choosing the proper accounting alternatives without regard for the outcome. Representational faithfulness is that quality of information that indicates an agreement between an economic event and its measure or description.

3. a. Comparability is that quality of accounting information that enables users to identify similarities in and differences between two sets of economic phenomena. Comparability allows users to relate accounting information over time and among similar companies.

   b. Consistency is the application of accounting standards from period to period in the same manner. Through the consistent application of accounting standards, comparability of accounting information is enhanced.

C2-6 (continued)
3. (continued)

c. Materiality in the context of accounting information means being of substance or significance. Materiality judgments are situation specific; however, the essence of the materiality concept is stated in FASB Concepts Statement No. 2 as follows, "The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."

C2-7 (CMA adapted)

1. The primary objectives of financial reporting are to provide information that is useful:

- to present and potential investors, creditors, and other users of financial statements in making rational investment and credit decisions.
- in assessing future cash flows related to the company's operations and its ability to meet financial obligations and pay dividends.
- in assessing the economic resources of the company and claims against these resources.

2. Although the level of sophistication related to business and financial accounting matters varies both within and between user groups, users are expected to possess a reasonable understanding of business and economic activities and are expected to be willing to study the information with reasonable diligence. Financial information is intended to be a useful tool to those who are able and willing to use it.

3. One of the results of the corporate form of organization has been the tendency to separate ownership from management. Thus, the stewardship function has been added to the management responsibilities of recording and reporting financial information. The stewardship responsibilities of management include the following:

- Periodic accountability to the owners not only for the custody and safekeeping of the company's resources but also for their efficient and profitable use.
- Accountability to prospective investors and to the general public when the company's securities are offered to the public.

C2-8

By requiring a company that is organized in different operating segments to disclose the revenues, profits, and assets of each major operating segment, several types of useful information for investment decision making are provided. First, information about risk is provided because the revenues and profits of each operating segment can be compared over time to assess the uncertainty or unpredictability about the future operating results of the segment. Second, information about return on investment is provided because the profits of each operating segment can be compared with the assets invested to achieve the profits. Third, information about operating capability is provided because the revenues of each operating segment can be compared to its assets to assess the company's ability to maintain a given physical level of operations in the operating segment.

C2-9

Accounting information is relevant if it can make a difference in a decision by helping users predict the outcomes of past, present, and future events or confirm or correct prior expectations. To be relevant, accounting information must be timely and must possess either predictive value or feedback value, or both. Timeliness refers to having information available to decision makers before it loses its capacity to influence decisions. If information is not available when needed, it lacks relevance and is of little or no use. Predictive value refers to accounting information that helps decision makers to more accurately forecast the outcome of past or present events. Feedback value is present in accounting information that enables decision makers to confirm or correct prior expectations.

Accounting information is reliable if it is reasonably free from error and bias and faithfully represents what it purports to represent. Information is reliable when it has representational faithfulness and is verifiable and neutral. Representational faithfulness is the degree of correspondence between the reported accounting measurements or descriptions and the economic resources and obligations and the transactions and events causing changes in these items. Having a high degree of representational faithfulness is useful in reducing measurement bias. Verifiability is the ability of measurers to agree that the selected method has been used without error or bias. Verification is useful in reducing measurer bias. Neutrality results when there is an absence of bias intended to attain a predetermined result or to influence behavior in a particular direction. Neutrality implies a completeness of information.

The FASB's conceptual framework was not designed to assign priorities among the qualitative characteristics in all circumstances. To be useful, accounting information must have both the qualitative characteristics of relevance and reliability to a minimum degree. If importance is to be assigned, relevance would be the most important characteristic because of their order of occurrence. The information gathered is first narrowed down to include only that information which is pertinent (relevant) to the decision at hand. Then, all relevant accounting information is examined for its reliability.

C2-10 (AICPA adapted solution)

STATEMENT 1

1. Erroneous conclusion: That the primary accounting function is to provide financial information to management.

2. Accounting is a service activity that provides quantitative financial information for making economic decisions. One area of accounting, called managerial accounting, is concerned primarily with providing quantitative information to management. Another area, often called financial accounting, is concerned primarily with providing to external users a continual financial history of economic resources and obligations of an individual company and of the economic activities that change those resources and obligations. This information is intended to aid the decision making of external users.

   Auditing or the attest function, often considered to be a part of accounting, is concerned primarily with providing an opinion by an independent expert that a communication of economic data by one party to another is fairly presented.

C2-10 (continued)

STATEMENT 2

1. Fallacy: That financial statements prepared with due regard for the conservatism convention can be free from bias with respect to continuing, prospective, and retiring stockholders.

   Half-truth: That financial statements can be free from bias, even if the conservatism convention is not applied, except possibly with respect to the outlook of the processor or preparer of the data.

2. The conventional definition of conservatism, "to anticipate all possible losses but no possible gains," tends to result in the reported income and net assets of a company being less than they otherwise might be (for example, using the lower of cost or market approach for inventories, or recognizing revenue on a completed contract basis where the percentage of completion method would be more appropriate). Thus, to the extent (a) that reported income is reduced thereby and (b) that reported income affects the price of a share of the stock of a company, the market price per share will be less, and the retiring stockholders may be encouraged to (1) sell rather than hold their shares and (2) sell at a price that is less than would otherwise be the case.

   Freedom from bias is often advanced as a desirable standard or ideal for accounting information; this probably is unattainable with respect to general-purpose financial statements because of the conflicting interests among the many users of the statements (for example, management versus owners or owners versus employees and creditors).

   It often appears that many accountants relate the freedom-from-bias concept to the attitude of the accountant or auditor and the closely related concept of independence. But the freedom-from-bias concept is concerned primarily with the ability of the measurement method to portray accurately the activity being measured. Thus, the accountant may be completely independent in attitude, yet, by the choice of measurement methods, may introduce bias into the accounting information.

C2-11 (AICPA adapted solution)

1. a. The conventional or traditional approach has been to define the accounting entity in terms of a specific company or enterprise unit that is separate and apart from the owner or owners and from other companies having separate legal and accounting frames of reference. For example, partnerships and sole proprietorships are accounted for separately from the owners, although such a distinction might not exist legally. Thus, it is recognized that the transactions of the entity should be accounted for and reported upon separately from those of the owners.

   An extension of this approach is to define the accounting entity in terms of an economic unit that controls resources, makes and carries out commitments, and conducts economic activity. In the broadest sense, an accounting entity could embrace any object, event, or attribute of an object or event for which there is an input-output relationship. Such an accounting entity may be an individual, a profit-seeking or not-for-profit company, or any subdivision or attribute thereof for which a system of accounts is maintained. Thus, this approach is oriented toward the unit for which financial reports are prepared.

C2-11 (continued)
1. a. (continued)

An alternative approach is to define the accounting entity in terms of an area of economic interest to a particular individual, group, or institution. The boundaries of such an economic entity would be identified by determining (1) the interested individual, group, or institution, and (2) the nature of that individual's, group's, or institution's interest. Thus, this approach is oriented to the users of financial reports.

b. The accounting-entity concept defines the area of interest and thus narrows the range and establishes the boundaries of the possible objects, activities, or attributes of objects or activities that may be selected for inclusion in accounting records and reports. Further, postulates as to the nature of the entity also may aid in determining (1) what information to include in reports of the entity and (2) how best to present information of the entity so that relevant features are disclosed and irrelevant features do not cloud the presentation.

The applicability of all the other generally accepted concepts (or principles or postulates) of accounting (such as continuity, money measurement, and time periods) depends upon the established boundaries and nature of the accounting entity. The other accounting concepts lack significance without reference to an entity. The entity must be defined before the balance of the accounting model can be applied and the accounting can begin. Thus, the accounting-entity concept is so fundamental that it pervades all of accounting.

2. a. Yes, units created by or under law would include corporations, partnerships, and, occasionally, sole proprietorships. Thus, legal units probably are the most common types of accounting entities.

b. Yes, a product line operating segment of a company, such as a division, department, profit center, branch, or cost center, could be an accounting entity. The stimuli for financial reporting by operating segments include investors, the SEC, financial executives, and the accounting profession.

c. Yes, most large corporations issue consolidated financial reports for two or more legal entities that constitute a controlled economic entity. Accounting for investments in subsidiary companies by the equity method also is an example of an accounting unit that extends beyond the legal entity. The financial reports for a company that includes two or more product-line operating segments would also be a form of a consolidated report that most commonly would be considered to be the report of a single legal entity.

d. Yes, although the accounting entity often is defined in terms of a company that is separate and distinct from other activities of the owner or owners, it is also possible for an accounting entity to embrace all of the activities of an owner or a group of owners. Examples include financial statements for an individual (personal financial statements) and the financial report of a person's estate.

e. Yes, the accounting entity could embrace an industry. Examples include financial data compiled for an industry by a trade association (industry averages) or by the federal government. Probably the best examples of an industry being the accounting entity are in the accounting systems prescribed by the Federal Power Commission and the Federal Communications Commission, which define the original cost of an asset in terms of the cost to the person first devoting it to public service.

C2-11 (continued)
2. (continued)

f. Yes, the accounting-entity concept can embrace the economy of the United States. An example is the national income accounts compiled by the U.S. Department of Commerce. Another area where the entity concept is applicable is in the yet-to-be-developed area of socioeconomic accounting.

C2-12 (AICPA adapted solution)

Note to Instructor: Parts of this case may be slightly advanced for students at this point but are included to stimulate discussion.

1. The point of sale is the most widely used basis for the timing of revenue recognition because, in most cases, it provides the degree of verifiable evidence accountants consider necessary for reliable measurement of periodic business income. In other words, sales transactions with outsiders represent the point in the revenue-generating process at which most of the uncertainty about the final outcome of business activity has been alleviated.

   It is also at the point of sale in most cases that substantially all of the costs of generating revenues are known, and they can at this point be matched with the revenues generated to produce a reliable statement of a company's effort and accomplishment for the period. Any attempt to measure business income prior to the point of sale would, in the vast majority of cases, introduce considerably more subjectivity into financial reporting than most accountants are willing to accept.

2. a. Although it is recognized that revenue is earned throughout the entire production process, generally it is not feasible to measure revenue on the basis of operating activity because of the absence of suitable criteria for consistently and objectively arriving at a periodic determination of the amount of revenue to take up. Also, in most situations the sale represents the most important single step in the earning process. Prior to the sale, the amount of revenue anticipated from the processes of production is merely prospective revenue; its realization remains to be validated by actual sales. The accumulation of costs during production does not alone generate revenue; rather, revenues are earned by the entire process, including making sales.

   Thus, as a general rule the sale cannot be regarded as being an unduly conservative basis for the timing of revenue recognition. Except in unusual circumstances, revenue recognition prior to sale would be anticipatory in nature and unverifiable in amount.

   b. To criticize the sale basis as not being sufficiently conservative because accounts receivable do not represent disposable funds, it is necessary to assume that the collection of receivables is the decisive step in the earning process and that periodic revenue measurements, and therefore net income, should depend on the amount of cash generated during the period. This assumption disregards the fact that the sale usually represents the decisive factor in the earning process and substitutes for it the administrative function of managing and collecting receivables. In other words, the investment of funds in receivables should be regarded as a policy designed to increase total revenues, properly recognized at the point of sale; and the cost of managing receivables (such as bad debts and collection costs) should be matched with the sales in the proper period.

C2-12 (continued)
2. b. (continued)

The fact that some revenue adjustments (for example, sales returns) and some expenses (for example, bad debts and collection costs) may occur in a period subsequent to the sales does not detract from the overall usefulness of the sales basis for the timing of revenue recognition. Both can be estimated with sufficient accuracy so as not to detract from the reliability of reported net income.

Thus, in the vast majority of cases for which the sales basis is used, estimating errors, though unavoidable, will be too immaterial in amount to warrant deferring revenue recognition to a later time.

3. a. During production: This basis of recognizing revenue is frequently used by companies whose major source of revenue is long-term construction projects. For these companies, the point of sale is far less significant to the earning process than is production activity because the sale is assured under the contract, except, of course, where performance is not substantially in accordance with the contract terms.

To defer revenue recognition until the completion of long-term construction projects could impair significantly the usefulness of the intervening annual financial statements because the volume of completed contracts during a period is likely to bear no relationship to production volume. During each year that a project is in process a portion of the contract price is therefore appropriately recognized as that year's revenue. The amount of the contract price to be recognized should be proportionate to the year's production progress on the project.

It should be noted that the use of the production basis in lieu of the sales basis for the timing of revenue recognition is justifiable only when total profit or loss on the contracts can be estimated with reasonable accuracy and its ultimate realization is reasonably assured.

b. When cash is received: The most common application of this timing of revenue recognition is in connection with installment sales contracts. Its use is justified on the grounds that, due to the length of the collection period, increased risks of default, and higher collection costs, there is too much uncertainty to warrant the recognition of revenue until cash is actually received.

The mere fact that sales are made on an installment contract basis does not justify using the cash receipts basis of revenue recognition. The justification for this departure from the sales basis depends essentially upon an absence of a reasonably objective basis for estimating the amount of collection costs and bad debts that will be incurred in later periods. If these expenses can be estimated with reasonable accuracy, the sales basis should be used.

C2-13 (AICPA adapted solution)

1. Accrual accounting recognizes and reports the effects of transactions and other events on the assets and liabilities of a company in the time periods to which they relate rather than only when cash is received or paid. Accrual accounting attempts to match revenues and the expenses associated with those revenues in order to determine net income for an accounting period. Revenues are recognized and recorded when earned. Expenses are recognized and recorded as follows:

    - Associating Cause and Effect. Some expenses are recognized and recorded on a presumed direct association with specific revenue.

    - Systematic and Rational Allocation. In the absence of a direct association with specific revenue, some expenses are recognized and recorded by attempting to allocate expenses in a systematic and rational manner among the periods in which benefits are provided.

    - Immediate Recognition. Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits, or (3) allocating costs either on the basis of association with revenues or among several accounting periods is considered to serve no useful purpose.

    An accrual represents a transaction that affects the determination of income for the period but has not yet been reflected in the cash accounts of that period. Accrued revenue is revenue earned but not yet collected in cash. An example of accrued revenue is accrued interest revenue earned on bonds from the last interest payment date to the end of the accounting period. An accrued expenses is an expense incurred but not yet paid in cash. An example of an accrued expense is salaries incurred for the last week of the accounting period that are not payable until the subsequent accounting period.

    A deferral represents a transaction that has been reflected in the cash accounts of the period but has not yet affected the determination of income for that period. Deferred (prepaid) revenue is revenue collected or collectible in cash but not yet earned. An example of deferred (prepaid) revenue is rent collected in advance by a lessor in the last month of the accounting period, which represents the rent for the first month of the subsequent accounting period. A deferred (prepaid) expense is an expense paid or payable in cash but not yet incurred. An example of a deferred (prepaid) expense is an insurance premium paid in advance in the current accounting period, which represents insurance coverage for the subsequent accounting period.

2. In cash accounting, the effects of transactions and other events on the assets and liabilities of a company are recognized and reported only when cash is received or paid; while in accrual accounting, these effects are recognized and reported in the time periods to which they relate. Because cash accounting does not attempt to match revenues and the expenses associated with those revenues, cash accounting is not in conformity with generally accepted accounting principles.

C2-14

Note to Instructor: These answers are based on what students would be expected to understand from the discussion of the revenue recognition methods presented in the chapter. If desired, more comprehensive class discussion may be directed at matching expenses against these revenues.

A. Company A should recognize revenue under the percentage of completion method during production based upon the percentage of the highway completed each period. This approach is reasonable because realization takes place based upon the degree completed, and at that point a percentage of the revenue has been earned.

B. Company B should recognize revenue at the time of sale because realization has occurred and revenue has been earned because the earning process is substantially complete.

C. Company C should recognize revenue periodically under the proportional performance method based on the services completed to date. Although realization occurred at the time the contracts were signed, revenue was not yet earned because the earning process had not been completed.

D. Company D should recognize revenue periodically under the installment method or cost recovery method until the roads and clubhouse are completed. This is because realization is uncertain up to this point and the revenue has not been earned because the earning process has not been substantially completed.

C2-15

A. Violation of the matching principle; cost of goods sold should be matched against the revenues when the goods are sold, not purchased.

B. Violation of the historical cost principle; the historical cost (exchange price) should be retained in the accounting records until the economic resources have been consumed, sold, or liquidated.

C. Violation of period-of-time assumption; the financial statements should be prepared at least once a year.

D. Violation of the realization principle; revenue should not be recognized until realization has taken place and the earning process is substantially complete (i.e., the revenue has been earned).

E. Violation of the stable monetary unit assumption; the financial statements should not be adjusted for the effects of inflation.

F. Violation of entity assumption; Thomas should maintain separate records of his personal and business transactions and prepare his company's financial statements based only on the business transactions.

G. Violation of continuity assumption (and historical cost principle); the economic resources should be reported on an historical cost basis.

C2-16 (CMA adapted)

1. The FASB's conceptual framework study should provide benefits to the accounting community such as

   - guiding the FASB in establishing accounting standards on a consistent basis.

   - determining bounds for judgement in preparing financial statements by prescribing the nature, functions, and limits of financial accounting and reporting.

   - increasing users' understanding of and confidence in financial reporting.

2. Statement of Financial Accounting Standards No. 2 identifies the most important quality for accounting information as usefulness for decision-making. Relevance and reliability are the primary qualities leading to this decision usefulness. Usefulness is the most important quality because, without usefulness, there would be no benefits from information to set against its costs.

3. A number of key characteristics of qualities that make accounting information desirable are described in the Statement of Financial Accounting Concepts No. 2. The importance of three of these characteristics or qualities are discussed below.

   - Understandability -- information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it or who misuse it.

   - Relevance -- the accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations.

   - Reliability -- the reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user, which comes through verification, that it has representational quality.

C2-17

The objective of general purpose external financial reporting is to provide financial information about a company (including the entities under its control) that is useful to external users in making decisions in their capacity as capital providers. The primary user group includes the company's present and potential equity investors, lenders, and other creditors (capital providers).

Relevance and faithful representation are the fundamental qualitative characteristics that must be present for financial reporting information to be useful. Relevant information must be capable of making a difference in the decisions made by external users in their capacity as capital providers. To be relevant, information must have predictive value, confirmatory value, or both. Predictive value relates to the ability of the information to help external users (capital providers) evaluate the potential effects of past, present, or future events on future cash flows. Confirmatory value relates to the ability of the information to confirm or correct external users' previous evaluations.

C2-17 (continued)

Faithful representation of economic phenomena occurs when the related information is complete, neutral, and free from material error. Completeness means including all information necessary for faithful representation in financial reporting. Neutral means that there is an absence of bias to attain a predetermined result or induce a particular behavior. Free from material error means that the information (including estimates) presented is as accurate as possible, reflecting the best available inputs.

Comparability, verifiability, timeliness, and understandability are the “enhancing” characteristics that distinguish more useful information from less useful information, and increase the decision usefulness of information. Comparability (including consistency) is the quality of accounting information that enables external users to identify similarities and differences between two sets of economic facts. Consistency means using the same accounting policies and procedures from period to period, or in a single period across companies. Verifiability implies that different knowledgeable and independent measurers would reach a consensus that either the information presented is free from material error or bias, or an appropriate recognition or measurement method has been applied without material error or bias. Timeliness means that information is made available to decision makers before it loses its ability to influence decisions. Understandability means that external users who are reasonably knowledgeable about business and financial accounting can comprehend the meaning of the financial information presented.

These qualities are subject to two constraints: (1) materiality and (2) benefits that justify the costs. Information is material when its omission or misstatement could influence the resource allocation that a decision maker would make based on the company’s financial information. The benefits that justify the costs constraint means that the benefits of better investment, credit, and similar resource allocation decisions are greater than the direct costs (the costs of collecting, processing, verifying, and disseminating) and indirect costs (the costs to external users of analysis and interpretation) of the information.

C2-18

Note to Instructor: This case does not have a definitive answer. From a financial reporting perspective, GAAP is identified and summarized. From an ethical perspective, various issues are raised for discussion purposes.

From a financial reporting perspective, Watson Company is not following GAAP because it recognizes revenues as cash is collected and expenses as cash is paid. This is called cash-basis accounting. Under GAAP, revenues are recognized when realization has taken place (cash or receivables are obtained) and they have been earned. The expenses involved in obtaining the revenues are matched against the revenues recorded during the period. This is called accrual accounting, which is the process of relating the financial effects of transaction, events, and circumstances that have cash consequences to the period in which they occur rather than when the cash receipt or payment occurs. Use of accrual accounting provides relevant and reliable information about a company's return on investment, risk, financial flexibility, liquidity, and operating capability that helps users in making rational investment and credit decisions.

C2-18 (continued)

From an ethical perspective, the issue is whether cash basis accounting responds to the rights of, and is fair to, all the stakeholders. In this situation, the primary stakeholders are the stockholders, creditors, and Chris. It can be argued that cash basis accounting does not provide relevant information that has predictive value (for forecasting purposes) and feedback value (for evaluating prior expectations). While Chris claims the information under cash basis accounting is reliable and conservative, it may not portray a valid description of the company's income-earning activities and may not be neutral. Even though use of cash basis accounting may be "easy" for Chris, it may not be fair for Watson Company to use this method because stockholders and creditors need accrual-basis accounting information for their decision making. Accrual-based accounting makes information comparable across companies. On the other hand, since Watson Company's stock is not publicly traded, there is no requirement that it follow GAAP. Because the company is small and has few stockholders, cash-basis accounting may be acceptable if the stockholders have sufficient access to the company's operating information for their investment decision making. Furthermore, if the creditors are short-term and the amounts owed are small, cash basis accounting may provide them with enough information to assess the liquidity of the company in regard to paying its short-term debts.